CHAPTER 5

CRISIS OF CONFIDENCE

The Global Critique

NO ONE still quite knows how it happened. In retrospect it seems to have been inevitable, and yet what unfolded on the night of November 9, 1989, was also accidental. What is known is that the border guards along the East German side of the Berlin Wall became wholly confused on that evening. The members of the Central Committee of East Germany's Communist Party were locked in an endless meeting, arguing and maneuvering for power among themselves. And Günter Schabowski, the head of the Communist Party of Berlin, was just about to go on television for a live press conference when party secretary Egon Krenz handed him the draft of a new regulation from the Interior Ministry.

"This could be a hit," Krenz told him.

And indeed it would be. The draft described proposed new bureaucratic procedures for obtaining visas in order to visit the West. It was not central to what Schabowski was talking about in his rambling press conference; he was distracted and was not clear about what he had read, and even less clear as to how he would express it. In any event it was only a draft. Yet in reply to an Italian journalist, he seemed to say that East Germans could go to the West with no restrictions—and at once. Egon Krenz was later to describe those words as "a small mistake"—an understatement, to say the least.

It was now just about seven o'clock in the evening, and much of East Germany was watching the press conference. In response to Schabowski's words, thousands and then tens of thousands and then hundreds of thousands of East Germans headed toward the Wall to test the new policy, whatever it was. Whole families joined the march, many of them in their pajamas. For three hours the throng swelled in front of the Wall, refusing to move and chanting, "Open the gate! Open the gate!" In all the years of communist oppression, the guards had received endlessly detailed instructions about what to do in case people tried to breach the Wall. But now the unthinkable had happened; they had no instructions for this eventuality. There were no directives about how to react in this situation, and so the guards were paralyzed. Were they to shoot, or were they to open the gates? In their confusion, they did the latter. Hundreds of thousands of East Berliners surged through, to be met on the other side by huge crowds of waiting West Berliners, who engulfed them with hugs and doused them with champagne and beer.

It was unbelievable; what West German chancellor Helmut Kohl had only the year before said would not happen in his lifetime had just occurred. The Berlin Wall, for all practical purposes, had fallen. Together, East Berliners and West Berliners danced and sang the night through. Now they were all Berliners. The next day, at an emergency meeting of East Germany's Communist Party, one speaker glumly summed up the new reality: "The party is basically kaput." Soon enough, East Germany was swept away by history. As for the Wall itself, it was demolished, and chunks of it would be sold off as souvenirs of a bygone era. The cold war was over. It had ended with neither a bang nor a whimper but with a party.

The Wall had symbolized the division between East and West, between communism and capitalism. Its fall was a great symbol, too, of the end of the confrontation and the passage into a new era. What also disappeared was an intellectual wall, opening up the frontiers of ideas and knowledge and transforming what had been two different worlds, each with billions of people, into a common landscape—and a common market. As communism was the most extreme form of state economic control, its demise signaled an enormous shift—from state control to market consensus. The apparent success, and thus the prestige, of the communist economic model had been one of the most important drivers of government control. Now, certainly, the failure of Marxism and the communist system constituted one of the most important forces shaping this new era.

It was an era in which conceptual shifts would culminate in a sharp revision in thinking and policy about the organization of economies around the world. Within regions and countries there were many variations. But taken as a whole, this change represented a process through which the issues of national sovereignty were resolved, the residue of classic colonialism and imperialism were relegated to the past, and economics won precedence over politics. Moreover, a common stock of ideas and perspectives would provide the pivot, the hinge, on which the relationship between government and marketplace would swing. And how did it begin? With disillusionment about the mixed economies of the industrial world.[1]

Crisis of Confidence

Experience is a teacher, and what experience taught in the 1970s and into the 1980s was an increasing skepticism about the capabilities of what had become the traditional mixed economy. For some, it would result in an outright rejection of government's abilities. For others, there was unease and the growing sentiment that the economic structures of the postwar era no longer fulfilled the aims their founders had intended. In either case, the change of heart happened over time as, in one form or another, the confidence generated by the thirty glorious years began to dissipate. It was less a revelation than a process of learning about the limits of government's ability to run a modern economy.

For three decades the consensus held that achieving economic growth and improvements in the standard of life and human welfare required some form of central management. The extent of coordination was considered so great that only the state could provide it. This consensus rested upon trust. In order for it to work, the public and business enterprises would have to believe that political leadership—tested and recalibrated by elections, to be sure—could gather the knowledge required to look into the highly uncertain future and apply economic tools to improve a country's prospects and make that future more secure. The governments of the mixed economy did so by using some combination of five sets of tools—regulation, planning, state ownership, industrial policy, and Keynesian fiscal management. These tools could be augmented by a sixth—monetary policy. The actual mix varied considerably among countries, depending upon their traditions and history.

The basic rationale for government's role was the economists' concept of "market failure." Some desired outcomes required a degree of coordination that individual competitors in the marketplace could not muster. As a result of this failure, government would step in and provide that coordination. Time horizons and returns were often important concerns. Business alone could not provide investment; it either would take too long to come to fruition or would generate benefits that went to society at large, rather than the individual firm that had made the investment. Infrastructure was an example of something that took too long to develop, as were expenditures on basic research and development—a case in which the benefits might be quite diffused and thus not capturable by the firm that spent the money.

There was another sense to market failure as well—a failure of acumen, of knowledge. "Government knowledge"—what the government knew and was considered responsible for knowing—was different from "business knowledge." The former was cultivated in different academies—in schools of law and policy, not business, and certainly not in the "trades." It was thought that the more an economic activity aimed toward the future and affected the broad population, the less sufficient was simple business knowledge to see it through. The instruments of intervention became the tools with which to apply government knowledge. Resources were directed and allocated by the state, by political and bureaucratic decision making, rather than by the elemental forces of supply and demand—forces shaped by the knowledge of those in the marketplace. Valéry Giscard d'Estaing, the former French president, was a star pupil at the École Nationale d'Administration, France's great repository of government knowledge, in the early 1950s. Looking back on his education, he recalled that he was taught about indicative planning and price controls, "but there was no reference, no discussion whatsoever of the market or about the market."

At first, government's assumption of the risks of economic activity seemed logical—and safe. No one could forget the 1930s. Thus government became a sort of national insurance company, guaranteeing growth while protecting the public from the risks of the market. Like vast insurers, governments collected premiums to pay for their outlays via direct and indirect taxes of all sorts. Unlike insurers, they also had at their disposal the prerogative of public authorities—deficit spending, on which they increasingly drew. But as government's role as insurer became entrenched, so too did the expectations of consumers, workers, and businesses. Once established, an interventionist government could only grow larger, not shrink. The expectation that government could and would guarantee growth and expanding benefits became part of the political culture.

Yet who could deny the success of the experiment? From the end of the Second World War until the oil crises of the 1970s, the industrial world enjoyed three decades of prosperity and rising incomes that sparked aspirations and dreams. It was an extraordinary achievement. The children of wartime and postwar rationing became the adolescents of economic recovery and growth and then the parents of the consumer society. Housing improved enormously. Families bought their first and then their second car; they acquired appliances and televisions. They shopped in supermarkets and department stores, they went on vacations and traveled to foreign countries, and they purchased products that had been turned into brand names and status symbols by advertising. And, most of all, they had jobs. Social critics bemoaned consumerism and materialism; they identified the gulf between "private affluence" and "public squalor." But the fundamental fact was that a quality of life had emerged that could not have been dreamed of at the end of World War II. It is no wonder that throughout the noncommunist, industrialized world, voters gave politicians the go-ahead to use that standard set of tools to guarantee a steadily growing economy—and, hence, full employment. In so doing, they deferred to government's superior knowledge of the national economic interest.

The warning flag was inflation. Throughout the 1960s, inflationary tendencies crept upward in the mixed economies, but never to the point of causing serious alarm. However, by the early 1970s, inflationary pressures were becoming more pronounced and visible. The tools governments had used to muddle through—to sustain consumer demand, to match inflation with wage increases—were now inadequate. Keynesian demand management assumed that low unemployment and a low, managed rate of inflation was a sustainable combination. That proved wrong.

The lesson took time to learn, for it challenged all that had been accepted as the received wisdom. The shortage of political will to tackle the problem head-on only gave conditions time to get worse. Inflation was becoming entrenched in many ways: by the growth of government deficits, by the expansion of the welfare state, by the barriers to competition, by the rigidities of the labor market, by the "social charges" added to the labor bill, and by the nature of the bargaining between labor and management over wages and the way they would be passed through the system. A good part of the inflation was a cost of the protection provided by the insurance state against uncertainties, volatilities, and competition. The adoption of wage and price controls became testament to the prevalence of the inflationary dynamics. But controls were no more than a stopgap. They could hold inflation at bay ever so briefly but could not disable its causes.

When the oil crisis of 1973–74 hit, the mixed economy was already straining. What made the dramatic rise in the price of oil truly a "shock" was the extent to which it upset the familiar patterns of costs in the economy. In the slump that followed the oil crisis, inflation and unemployment began to rise together in a deadly and unprecedented spiral. The phenomenon was christened stagflation. And between 1974 and 1980 governments of the left and the right alike learned that attempts to buy one's way out of the crisis by means of deficit spending would be futile and counterproductive. Keynesianism lost its cachet. The economic growth of the preceding decades, formerly much taken for granted, was now sorely missed.

Poor economic performance and the muddling and confusions of government policy engendered a loss of confidence in existing arrangements. Government knowledge was less powerful; governments, less all-knowing. By the end of the troubled 1970s, a new realization had gained ground: More than daily management, it was the entire structure of the economy that had reached its limits. It was imperative to rethink government's role in the marketplace. For the pioneers—the economists, politicians, and technocrats who shepherded the early programs of government withdrawal from the economy in various countries—the task was nothing short of revolutionary. For the first time in decades, governments would seek to reverse direction—to shed assets and to confront at least the idea of giving up some control. The dissatisfactions with the mixed economy were already evident in the industrial world by the end of the 1970s, and they would shortly make their impact felt at the ballot box. In the meantime, while the industrial world was reassessing its arrangements, the developing world was about to encounter its own transforming crisis.

The Debt Crisis and the Lost Decade

Jesús Silva Herzog carried a proud name in Mexican history. In 1937, his father had drawn up the historic bill of complaint against the foreign oil companies that provided the rationale for Mexico to nationalize the oil industry—one of the most important events in modern Mexican history. He himself had followed the path of the new technocrats, in his case getting a graduate degree in economics from Yale. He became his country's minister of finance in April 1982, just as Mexico seemed poised to rise to a new rank in the world. Large new petroleum discoveries were turning the country into a major oil exporter, and the present and projected surge in earnings meant the country would be able to spend liberally on new public investments. President José López Portillo demanded a global leadership role for Mexico. In so doing, he struck a magisterial pose: The economy should not "eat more than it could digest," he declared.

But then, in the summer of 1982, Silva Herzog discovered that it was all a house of cards. Mexico had been on a borrowing spree that nobody would or could stop—certainly not President López Portillo, who had surrounded himself with courtiers and sycophants in order to be told what a wonderful president he was. Some months earlier, a group of officials had screwed up their courage and actually warned the president that trouble was coming. He had rewarded them for their troubles by firing them. But now the truth was clear, at least to Silva Herzog. On August 12, 1982, he concluded that Mexico could not pay the interest on its international debt. The game was just about over. Mexico was about to go bankrupt.

"It was horrible," said Silva Herzog. "We had just committed terrible mistakes on the basis of oil. But there had been this great mood of victory in Mexico. We had been in the largest boom in Mexican history. And for the first time in our history, in those years 1978 through 1982, we were being courted by the most important people in the world. We thought we were rich. We had oil."

Silva Herzog hastened to Washington, where, after very tough negotiations with the U.S. Treasury and the Federal Reserve Board, he worked out the first steps in an emergency rescue package. The American officials had no trouble recognizing the extreme danger. It was not just Mexico, or even the whole of Latin America, that was at risk. So heavy had been the lending to the developing world that most of America's major banks, and indeed the entire global banking system, were in grave peril of collapse.

A few weeks later, at the behest of American authorities, Silva Herzog flew to New York City to meet with the heads of the several hundred U.S. banks that had lent to Mexico in order to tell them how much trouble they were really in. He was accompanied by another senior official, Ángel Gurría. Silva Herzog laid out the bleak picture and described the rescue plans thus far. The banks would have to cooperate by agreeing to allow Mexico to postpone its repayments. The president of the New York Federal Reserve Bank called the postponement a "standstill." American officials did not want to use the word *default,* for fear that it would immediately induce a panic. No one could doubt the gravity of the situation. And this was not just a Mexican problem. They all knew their exposure, and now they clearly understood the interconnections—everyone was standing at the precipice together. It was not a cheerful meeting. So stunned were the assembled bankers that they could hardly muster any questions. Searching for something comforting to say, Jesús Silva Herzog finally told the bankers that over the long term they need not worry about their Mexican debt. After all, he added, pointing to his colleague Ángel Gurría and himself, both Jesús and Ángel would be looking out for them. The reassurance was meager, but it would have to do. The great debt crisis of the 1980s had begun.

Just as stagflation and rigidity had toppled the consensus within the industrial world in the 1970s, so the protracted debt crisis in the 1980s undermined both the confidence placed in the expanding state in the developing world and the adherence to third worldism. The borrowing that began with high ambition and great assurance ended in what has been described as "the most widespread debt problem in history." It had been generated with remarkable rapidity in the second half of the 1970s. In those years, the world's money centers were flush with deposits from the oil producers' windfall. Bankers rapidly recycled these newly dubbed "petrodollars" in the form of loans—many of them to developing countries, both to governments and to government-owned companies. Some worried about the ability of these government and state companies to handle the consequent debt service, but the concern was brushed aside. In fact, with the 1920s and 1930s very much in mind, there was great fear that failure to recycle those funds could trigger a world depression.

At the same time, in the spirit of the day, it seemed to both lenders and borrowers that this was money being loaned to the future. After all, were not global power and influence shifting from developed to developing countries? Wasn't the South redressing the balance against the North, expiating the sins of colonialism and imperialism? Add to it all one other factor: Because of the downturn in the industrial countries, business in the home markets of the banks was poor. Real estate in the United States had just gone bust. Intensified competition among banks led to ever sweeter and more enticing terms for would-be borrowers. In fact, the in thing was to lend to third world countries, and no one wanted to be at the bottom of the league tables. "To a Third World president or finance minister," Federal Reserve chairman Paul Volcker observed afterward, "international banking in the 1970s" was "like receiving a credit card in the mail—with three or four more zeros on the size of the credit line."

In ways that were not very well recognized or accounted for as it was happening, developing-country borrowing exploded. Overall, between 1972 and 1981, the external debts of developing countries increased sixfold, reaching

$500 billion by 1981. The infusion of money stimulated, at least for a few years, higher economic growth. By the beginning of the 1980s, the nine largest U.S. banks had committed the equivalent of 250 percent of their capital to loans to developing countries. Those who questioned the rapid buildup of debt were dismissed as grumpy old men. After all, insisted the head of America's largest bank, governments could not go bankrupt.

Right at the top of the borrowing league was Mexico, boosted by its oil boom. By the early 1980s, it owed over $80 billion. Banks fell all over themselves to lend to Mexico. Amidst the feverish lending, one Mexican official was even pronounced, with great admiration, "borrower of the year." After August 1982, however, that was a title no one would want.

How did the borrowing turn into the debt crisis? In retrospect, the formula for bankruptcy was very simple: growing debt, rising interest rates, and falling revenues. The rapid buildup of debt reached its peak at a bad time—just at the moment when, owing to the recession in industrial countries, demand was weakening for the primary products that made up the livelihood of most developing countries. That meant lower prices for their goods, and thus lower income. At the same time, the high interest rates of the early 1980s, aimed at counteracting the inflation in the industrial countries, raised the cost of developing countries' floating debt, increasing the repayment burden. Yes, the borrowed money went into investment, which should have been generating more income. Unfortunately, it also went into things that did not generate much of a return—expensive imports, extravagance, inflation, waste, corruption, and numbered bank accounts. As a result, there was a lot less to show for all the loans in terms of productive assets than might have been anticipated.

During the 1920s, when there was some discussion about debt relief for Germany, President Calvin Coolidge said, "They hired the money, didn't they?" That mistake was not going to be made again. This time around, vast efforts would be expended to help "solve" the debt crisis through rescheduling and repackaging the debt, write-downs and forgiveness, and conversion of existing debt into new kinds of bonds or equity. The alternative was protracted economic misery, with highly uncertain but potentially very serious political consequences. Thus the rest of the 1980s was spent on the cleanup. For parts of the developing world, the 1980s became known as the "lost decade"—a period of either very modest or negative economic growth and, when taking population into account, sharply declining per capita real income. Banks, meanwhile, wrote down their loans, greatly weakening their own balance sheets. All this was the price of ambition and hubris—and imprudence.

The lasting impact of the debt crisis was to fall on the frontier between government and market in the developing world. As part of the rescue packages, the International Monetary Fund became partner to the debt-ridden governments, a sort of international bankruptcy receiver. Imposing tough conditions in its workout deals, the IMF pushed countries to get their fiscal houses in order. That meant removing trade protections that drained resources, devaluing currencies to realistic exchange rates, and restraining wage increases. And, crucially, it meant reducing deficits and fiscal drain. Governments would have to cut spending, stop subsidizing loss-making enterprises, and sell or transfer state-owned assets to the private sector. To help finance this transition and oversee its implementation, the World Bank devised "structural adjustment loans," which it disbursed only when recipients met certain policy conditions. Austerity replaced profligacy.

The debt crisis was the great turning point for the developing world. Far-reaching lessons were drawn from the entire drama. Countries had gotten into these severe straits owing in part to bloated government sectors and inefficient state-owned companies. Nations could not expect the international capital markets to finance a huge, undisciplined government sector. And it was the very expansion of government, justified by the ideas of the times, that had led these nations down the road to what in reality was bankruptcy. Both economic arrangements and the guiding ideas derived from development economics would have to be changed, for they could no longer deliver the economic growth they had promised. Ideas that had been beyond the pale and politically impossible only a few years earlier now moved to the fore, and doors opened to new people who would apply those ideas. Fiscal reality simply would not allow otherwise.[2]

The National Champions

When Franco Bernabè, the somewhat scholarly chief executive of the Italian oil company ENI, came to the United States in 1995, he told a group in Houston, "We have to privatize." Then he added simply, "There is no choice."

What a long arc it had been. ENI, Italy's largest company, would never have come into existence after World War II had it not been state owned. Without state funding and the élan and mission of the national champion, it would never have been able to elbow itself successfully into prominence and technical excellence and grow to become one of the world's ten largest oil companies. Yet what made sense in the 1940s and 1950s no longer held true by the 1990s. Of that Franco Bernabè was sure.

Bernabè's conviction arose from experience—bitter struggles within ENI and the Italian political arena, in which he often found himself on the defensive. Every day, it seemed, he learned and relearned the same lesson—that there was a huge gap between the ideal of the state company and the reality of its predicament. The son of a railway worker and trained as an economist, Bernabè had already played a role in the restructuring of Italy's largest private company, Fiat, by the time he joined ENI in 1983. He had no idea of how bad the conditions inside ENI were. The company was losing money. It was also under constant pressure from Italy's political parties, which regarded it both as a source of funds and as a prize in terms of patronage. The company was not able to function as a coherent business.

From the outset, Bernabè tried to free the company from political influence. But when he began to work on the reorganization of the loss-making chemical business, he found himself subjected to a vicious assault from ministries, parliamentary commissions, ministers, and party officials. That was the turning point for him. "From then on," he said, "I felt a violent hatred for political interference, and I began to think of a way of liberating ENI from the public sector." He quietly started to sketch out a concept for privatization. But then politicians and people in the company who wanted things to stay just the same got wind of his efforts. They unleashed a new war against him; they wanted his head. He was saved in part by the "Clean Hands" investigation into Italy's pervasive corruption that led to the jailing of numerous government officials and businessmen. Among those thrown into prison were twenty senior managers from ENI, including the company's chairman, who committed suicide while in jail. The Clean Hands campaign created a vacuum within ENI. Appointed managing director and CEO in 1992, Bernabè quickly realized that time was running out for the loss-making company. That year, it nearly failed to meet its payroll. Bernabè now set about ferociously restructuring the company, selling off unproductive assets, changing the management, and focusing the company not on meeting the interests of politicians but on creating value for shareholders—although at that time the only shareholder was the state. He also initiated a plan for a privatization. Late in 1995, several months after his visit to the United States, ENI shares were offered, for the first time, on the Milan, New York, and London exchanges.

ENI had been one of the most famous state-owned companies in the world. Although it was uniquely shaped by Italy's political culture, its travails and transformation nevertheless demonstrated in a particularly dramatic form how the position of such enterprises had changed. State companies had come into existence to meet worthy and important ambitions—to secure national objectives, to assert sovereignty and escape foreign domination, to fuel economic growth, to constrain private monopoly, and to ensure that the nation's resources served the interests of the people. They were also to marshal investment and promote technical development. But the difficulties for state companies had already begun to emerge in the 1970s, and indeed, one of the great losers from the crisis of the 1970s was confidence in state-owned companies. The shine of their hallmarks—their corporate cultures, their modes of operation, their pride and sense of mission, their ability to attract skills and mobilize technology—now faded. Coordination had turned into unwieldy control; allocation had turned into distortion; government taxes and revenues had turned into subsidies and obstacles to growth. Political intervention was a chronic ailment. They suffered from inflexibility and inefficiency; they were forced to misallocate resources; and they became an increasing drain on nations' finances. Public enterprises now came to be seen as big contributors to the overall economic crises that nations faced.

The inflexibility of state-owned companies was reflected in the difficulties they faced in innovating. Some were protected from having to innovate because they enjoyed monopolies over domestic markets or exclusive rights to the use of certain basic resources. They did not have to respond to signals from consumers; and entrenched interests within their corporate structures impeded new technologies. In many countries, to be sure, large private companies also fell prey to the failure to keep up with economic and technological change, but competitive economics left them no choice. Many were forced into painful restructurings. State-owned companies, on the other hand, were usually sheltered for all too long. Of course, there were many exceptions. From Norway and France to Latin America and Southeast Asia, one could point to companies that were technological leaders. Yet no less telling was the deplorable condition of public services, equipment, and infrastructure in so many countries. In Argentina, for example, it took over two thousand dollars to get a phone line put in—and several years of waiting. The inflexibility was also obvious in terms of employment. Powerful public-sector unions held an iron grip over labor practices. In many cases, overstaffing and featherbedding were endemic.

Missing were the forces that could have most potently driven the public enterprises to become more efficient, to innovate, to control their investments and expenditures better—competition and the discipline of the capital markets. Whether national champions or outright monopolies, in practice state-owned companies became massive, hierarchical establishments, with a particular culture that seemed endemic to public-enterprise management the world over. Many firms ended up self-regulating: They did what they wanted to do, and some came to resemble "a state within a state." They took pride in their productive, expansionary accomplishments, in the inherent worth of their output, and in their contribution to a nation's development. But their critics said they were also closed off to the rest of the country. They could not control their budgets. And they were not responsive to their customers. Their investment decisions were subject to interference, political criteria, and endless second-guessing rather than to economic realities and opportunities. That would prove to be one of the greatest downsides of the efficient functioning of the state-owned company.

What also became clear was that state ownership creates permanent confusion for enterprises when it comes to their basic purpose. This is what Vijay Kelkar, a distinguished Indian economist and civil servant, observed while serving on the boards of state-owned companies in the 1980s. The experience led him to question one of the fundamental premises of India's development strategy—the ability of governments to run business enterprises. "When the 'people of India' are the shareholders," he said, "it creates multiple and conflicting objectives for the management, which cannot be resolved in any effective way. That makes the companies slow and inefficient and difficult to run. The interests of shareholders and management need to be aligned, and the only objective way to measure performance is through profitability."

There was another consequence of state ownership—what economists euphemistically called "directly unproductive practices"—otherwise known as corruption. The "state within a state" drew in resources—loans, equity, revenues—and attracted fortune seekers. The machinery for nepotism and patronage was in place. Because state companies or governments decided who would get what rights or opportunities under the umbrella of monopoly, those who made such decisions were provided with opportunities for personal enrichment. At times of prosperity, public opinion might be content to accept that kickbacks, contract padding, politically motivated investments, and payoffs to political parties were facts of life. But as growth slowed or transparency increased, the advantages of favored groups became more objectionable and blatant, and were renamed corruption.

The most formidable challenge to state-owned companies was to be found in their bottom line. Although many companies were intended to be self-sustaining, the shelter provided by government ownership gave them greater latitude to spend than what a private firm would have enjoyed. Their spending often exceeded their revenues and they ran ever-larger losses. There was often no discipline. This was the number-one problem. It was inescapable—in developing and developed countries alike. And yet national champions could hardly be shut down. They were frequently not allowed to raise their prices, even if the current prices did not come close to covering costs, for governments feared the inflationary effect—and, no less, angry demonstrations in the streets.

With international lending abruptly foreclosed, the companies could no longer borrow. And so there was only one place left to go for the money—the public coffers. Together, inexorably, companies' losses mounted and government deficits skyrocketed. The financial position of the state itself was now imperiled. Governments acted because they had no choice. They had hit a brick wall. Traditional state-owned companies seemed to have achieved their historic role. But now, they had to be dramatically restructured and reformed, reattuned to the market and financial discipline—in short, "commercialized." Or, more radically, they should cease to exist as state-owned companies and be privatized. Competition and the specter of bankruptcy would work better than monopoly and government funding. The government would relinquish its position on the commanding heights to the capital markets. It would not simply abandon its stake; it would sell the holdings, potentially making a lot of money in the process.

That is what happened with ENI. By late 1997, the Italian government had made $17.6 billion on the sale of its shares in the company; and ENI in turn had generated an annual profit that reached $3 billion in 1996. For Franco Bernabè, the chief architect, the company's transformation arose in part from the need to escape from the struggles and demands of an entangling, corrupt political system. But it was also driven by larger forces. "State companies are finished," he said. "They are basically archaic in a world that has lost many borders and that is becoming global. In fact, state companies are inward-looking and defensive; private companies are outward-looking. In a state-owned company, you are a state official, not an entrepreneur. You're not accountable. Nation-states do not have the tools for competing in a global economy.

"A state company has to do with war, national interest, and self-defense," Bernabè reflected. "And economies were adapted to war until 1990. They were part of closed and antagonist systems. Access to raw materials was considered key to survival. Privatization, on the other hand, is driven by the absence of war, and by the opening of the international system that makes raw materials, money, and technology available to everyone." He added, "The nation-state with all its paraphernalia, including state companies, is a relatively recent invention. The global economy already existed by the fourteenth and fifteenth century. And it's the global economy in which we have to compete."[3]

Red Star Sinking

Call it a model—or an icon. Or call it a spell that was cast upon the twentieth century. For so much of the century was defined by Marxism and the struggle among those who were mesmerized by it and those who rejected it—and those who, through no choice of their own, were caught up in it. Marxism and communism not only constituted a competitive model to market societies but also shaped the terms of the global debate, weighting it toward a powerful role for the state even within capitalist systems. In the aftermath, in communism's ruins, it is hard to understand the enormous prestige the Soviet system garnered around the world first through industrialization and then through the (apparent) very high growth rates of the 1950s and 1960s. That system seemed to have found the solution to the problem of unemployment; it glorified central planning; and it provided a powerful development model, which affected national strategies around the world.

The appeal of Marxism extended beyond the practical questions of how to organize an economy. It also offered a framework for interpreting the ways of the world, an all-embracing theory of everything, from economics, political organization, and relations among nations, to every sort of "structure," whether of the novel, the family, or the sexes. If one could not make it through the impenetrable pages of *Das Kapital,* there was also the romantic appeal of the "young Marx." In its various forms, Marxism attracted intellectuals, provided an outlet for a sense of injustice and outrage and alienation, and delivered a mechanism for political mobilization and control.

And Marxism seemed able to claim so many successes. Was not East

Germany the world's tenth-largest economy on a per capita basis? Did not China's Cultural Revolution show how a decadent society could be both developed and purified? Did not the victory of North Vietnam over the South demonstrate the authority of Marx and the power of Marxism to transform and modernize a backward peasant culture? Even the critics had to concede that there might be something there, at least so long as the curtains—Iron or Bamboo—were firmly in place, impeding the flow of knowledge.

It took decades for those curtains finally to be drawn back. But when they were, reality turned out to be strikingly different from appearances. As an economic system, communism had failed, and spectacularly so. By the 1980s, the sclerotic Soviet economy found its perfect correlative in a series of sclerotic Soviet leaders—the faltering Leonid Brezhnev; the ailing Yuri Andropov, previously head of the KGB; and the doddering Konstantin Chernenko, onetime border guard and Brezhnev crony. By the time Mikhail Gorbachev came to power in 1985, the economy was in deep crisis. Although still a military superpower, the Soviet Union increasingly looked like an underdeveloped country, and a failing one at that. Even before the Soviet Union fell apart in 1991, it had become apparent that communism and Marxism—with their distinctive central planning and pervasive state ownership—had also run into a wall.

The system had worked no better in Eastern Europe, from which the Soviet Union was disengaging. Meanwhile China, although maintaining a rhetorical and political allegiance to Marxism, was rapidly opening the door to the market system—and, in the process, doubling the size of its economy every seven years. The admonition of party leader Deng Xiaoping to the Chinese people was the very un-Marxist "Go out and enrich yourselves." Deng had actually begun the process of reform in the late 1970s, but the dramatic change was not widely recognized until the mid-1980s. By then, China had already taken the crucial step of separating politics from economics in the country's communist system.

In earlier decades in the West, one could have been a fervent anticommunist, appalled by the gulags and the repression, and yet still be influenced by the fact that the Soviet system appeared to be so successful. By the 1980s, that was no longer possible. The result was a vast discrediting of central planning, state intervention, and state ownership. A famous collection of essays by disillusioned former Communists published in the 1950s was called, appropriately enough, *The God That Failed.* But now it was the economic model that had failed. "Between the fall of the Berlin Wall in 1989 and the collapse of the Soviet Union in 1991," recalled one of the most senior economic officials in India, "I felt as though I were awakening from a thirty-five-year dream. Everything I had believed about economic systems and had tried to implement was wrong." The spell had been broken.[4]

Asian Star Rising

Even as the red star was disappearing, another one was rising, and it accentuated the tilt away from the state-centered economy. It was the "Asian miracle," which began, of course, with Japan. The Japanese, as officials there were fond of repeating, lived in a very small part of a few islands, with hardly any natural resources—in sharp contrast to a resource-rich Soviet Union, which spread across eleven time zones. Yet already by the mid-1980s Japan was becoming recognized as an "economic superpower." It was not alone. Next came the "tigers"—South Korea, Taiwan, Hong Kong, and Singapore. And close behind them came the "new tigers"—Malaysia, Indonesia, Thailand, the Philippines—plus a fifth one, the Guangdong province of China. These became the countries to emulate and from which to learn.

What made Asia a miracle was not just the speed of economic growth. Rather, it was that growth was sustained; that it involved industrial transformation; and, most of all, that ordinary people appeared to share in it, sparking a revolution in lifestyles. But politicians and academics alike hastened to argue that, far from being a miracle, East Asia's success could be explained—and could offer practical lessons for the rest of the world. They set off a vigorous debate over the wellsprings of growth. The arguments came to focus on the role of government intervention—or government restraint. Success was the result of industrial policy, some said—that is, they explained, government had "picked winners" from among domestic companies, nurtured them with subsidies and tariff protection and patronage, and then worked inextricably with these national champions to go out and conquer markets around the world. The results could be measured in growth rates. Others disagreed. They noted that the Asian countries were still much more open to commerce and entrepreneurship than were other parts of the world. Whatever the ambiguities, the Asian nations were, as economist and Nobel Prize winner Gary Becker put it, "by world standards at the time, pretty market-oriented."

The latter view gained ground in the 1990s with the rise of a new formulation that directly challenged the industrial policy thesis. This was the interpretation of the "macro-fundamentalists." The impact of government intervention, they said, was much exaggerated. The decisive factor was that these Asian governments got the economic fundamentals right: low inflation, low government deficits, high savings, education, consistency, institutional and legal frameworks that encouraged enterprise, and—crucially—a willingness to become part of the global system of international trade. In this view, government's direct positive contribution was its promotion of human capital with education and primary health. Picking winners was secondary, and in any event, as an activity it was overrated.

New Zealand: "You've Got No Economy"

These lessons had been underscored in the second half of the 1980s and early 1990s by a radical experiment in a remote part of the Pacific Rim—New Zealand. Clothed for decades in a heavy social-democratic coat, New Zealand was an unlikely but important laboratory for economic liberalization. One of the richest countries at the beginning of the century, New Zealand had developed a classic mixed economy in the postwar years that was intended to fulfill the social-democratic dream of "cradle-to-grave security against economic uncertainty." It was highly regulated and highly protected, with a large state-owned sector and a commitment to generate full employment. Wages were controlled; so were prices. As in many other countries, the two television channels were state owned. But unlike other countries, the state also determined who produced television sets and how much they cost. By the 1980s, it was clear that the entire system was malfunctioning. The economy was not competitive; per capita income was falling relative to other economies. Debt as a share of gross domestic product had zoomed up. Unemployment was high. A foreign-exchange crisis in 1984 left no room for maneuver.

The Labour government that came to power after a snap election immediately began a rapid process of liberalization—"breathtaking," some called it—that threw out most of the policy measures associated with left-of-center governments. Over the next several years, the economy was deregulated and state-owned companies underwent a massive program of privatization. Protection of every kind—whether in terms of trade barriers or the job market—was reduced or eliminated. In a direct repudiation of classic egalitarianism, taxes were slashed from the top bracket down. The results were striking. Inflation and unemployment were reduced; growth resumed; debt as a share of GDP went down; and New Zealand became internationally competitive. "Looking back on it, I don't see how we could have avoided it," one prime minister said several years after the reforms began. "You can't have social justice if you've got no economy." Unlike the Asian tigers, New Zealand did not become a household word in the world of economic policy, but its program of change—initiated by an ostensibly left-of-center government—certainly had an important impact on thinking of decision makers in other parts of the world.

New Zealand's reforms ran in parallel to the Thatcher Revolution in Britain. Both reflected a conjunction of an economic crisis with political leadership willing to go against the grain and apply ideas that up until then had mostly had their impact only in theory. But the fundamental framework of economics through which the world was seen was changing. And here was a classic demonstration of the power of ideas.[5]

Friedrich von Hayek and the "Battle of Ideas"

In retrospect, it was the awarding of the 1974 Nobel Prize in economics that first captured, almost by chance, the great intellectual change. The Swedish academy wanted to honor Gunnar Myrdal, distinguished Keynesian, a father of development economics, and a great figure of Swedish socialism. But the grantors, worried about the appearance of choosing so local a favorite, decided that they ought to balance the ticket with a more conservative figure, and they awarded the prize to Myrdal jointly with Friedrich von Hayek. A good part of the economics profession was scandalized by the choice of Hayek; many economists in the United States, if polled, would have hardly even considered him an economist. He was regarded as right-wing, certainly not mainstream, even something of a crank as well as a fossil from an archaic era. As for Gunnar Myrdal, the lore among other Nobel winners is that he was so irritated that he hardly even spoke to Hayek during the ceremonies.

Yet the award documented the beginning of a great shift in the intellectual center of gravity of the economics profession toward a restoration of confidence in markets, indeed a renewed belief in the superiority of markets over other ways of organizing economic activity. Within a decade and a half, the shift would be largely complete. And the eventual victory of this viewpoint was really a tale of two cities—Vienna and Chicago.

Friedrich von Hayek was the figure who tied the two together; he also connected the post–World War I Austrian School of economics to the renewed embrace of markets in the 1980s. A product of the Austro-Hungarian Empire and its collapse, Hayek was shaped by the vibrant, vital culture of Vienna both before World War I and, in its more tortured form, after the war. A second cousin to the philosopher Ludwig Wittgenstein, he came from a family of biologists and government officials, and he was headed toward his father's career, botany. But then World War I fundamentally changed his outlook. As a junior officer in the war, he came face-to-face with the complexities and dangers of nationalistic fervor. "I saw, more or less, the great empire collapse over the nationalist problem," he later said. "I served in a battle in which eleven different languages were spoken. It's bound to draw your attention to the problems of political organization." The war also left him with a compulsion to find an answer to "the burning question" of how to build a "juster society."

To that end, returning to Vienna after the war, Hayek earned doctorates in both economics and law. He went to New York City in 1923 and enrolled in the Ph.D. program at New York University. But he ran out of money and returned to Vienna to continue his work in economics. The war drove him, like many of his young contemporaries, toward an idealistic search for renewal, a quest for a better world—which meant socialism. "We felt that the civilization in which we had grown up had collapsed," he later said. "This desire to reconstruct society led many of us to the study of economics. Socialism promised to fulfill our hopes for a more rational, more just world." But then, as he began to study economics, he went through a painful and reluctant reassessment, in which he concluded that his idealistic objectives could be better served through a market economy.

His transformation occurred under the influence of Ludwig von Mises, the most prominent member of the Austrian School of economics. In his book *Socialism,* published in 1922, Mises presented a devastating analysis of the central economic failing of socialism. He called it the economic calculation. The problem was that under central planning, there was no economic calculation—no way to make a rational decision to put this resource here or buy that good there, because there was no price system to weigh the alternatives. Central planners could make technical decisions but not economic ones. Over the rest of the century, that criticism would prove to be extraordinarily prescient. "*Socialism* shocked our generation," Hayek later said. Yet, he added, it profoundly altered the outlook of idealists returning from the war. "I know, for I was one of them. . . . *Socialism* told us that we had been looking for improvement in the wrong direction."

Hayek became Mises' student and then, for several years, his research assistant. Owing to the postwar Austrian inflation, he learned firsthand, in his very first job, what inflation could mean. He began at five hundred kronen a month. Nine months later, his salary had swollen to 1 million kronen a month. In 1931, Hayek was invited to become a professor at the London School of Economics (LSE). The invitation was proffered by William Beveridge (who would author the Beveridge Report a decade later) but was at the specific instance of Lionel Robbins, the outstanding British liberal economist. In his inaugural address at LSE, Hayek declared that it was "almost inevitable" that any "warm-hearted person, as soon as he becomes conscious of the existing misery, should become a socialist." But economic study would bring that person to a more conservative point of view. This would happen to people who "have all possible sympathy with the ethical motives" from which radicalism springs and who "would be only too glad if they could believe that socialism or planning can do what they promise to do."

The London School of Economics had been founded by the Fabian socialists in 1895, and since the 1930s it had had a reputation as a leftist institution, dominated by socialists and devoted to propagating left-wing doctrines both in Britain and to the young people who went to study there from around the world. Yet by the 1930s, LSE's economics department, with Robbins, Hayek, and others, became the redoubt of traditional liberalism, battling to uphold the creed as socialism and Keynesianism became the dominant forces of the time. Hayek was at the forefront, not only the most consistent but indeed the most vocal critic of Keynes' work both before and after *The General Theory.* Keynes' approach, Hayek believed, was based on error; it would not solve the slump but would institutionalize inflation. Indeed, in Hayek's view, *The General Theory* was not a general theory of economics at all but rather a dressed-up specific theory to get around a political impasse in Britain. Keynes was no less slashing in his rejoinders. Hayek, he said, had started in one article "with a mistake" and then proceeded to "bedlam." Another Hayek article, he said, was "the wildest farrago of nonsense." In 1933 Keynes wrote his wife about a visit that Hayek had made to Cambridge. Keynes sat next to him at dinner and then lunched with him the following day. "We get on very well in private life. But what rubbish his theory is."[6]

The Road to Serfdom

As World War II progressed, Hayek became increasingly apprehensive about what he saw as the advance of collectivism, central planning, and what would become Keynesian interventionism. In one of his most famous articles, he argued that the problem of knowledge defeats central control of economies: Those at the center can never have enough information to make their decisions. Much better, he argued, was the price system, which, in "its real function" was "a mechanism for communicating information." For Hayek, it was nothing less than "a marvel." He explained, "The marvel is that in a case like that of a scarcity of one raw material, without an order being issued, without more than perhaps a handful of people knowing the cause, tens of thousands of people whose identity could not be ascertained by months of investigation, are made to use the material or its products more sparingly; that is, they move in the right direction."

At the same time Hayek was preparing a full-scale broadside in a much more popular form—*The Road to Serfdom.* That book, which appeared in 1944, might have become a best-seller in Britain were it not for the extreme paper rationing of the war. Nevertheless, at least one copy found its way into the hands of an Oxford undergraduate, Margaret Roberts, not yet Margaret Thatcher. The University of Chicago Press published it in the United States, and Hayek's arguments went on to have much wider fame when *Reader's Digest* published a condensed version. To some degree, Hayek had to make his arguments in code, for it was not acceptable to criticize the Soviet Union, which at the time was a great ally. Even so, after World War II, the four-power-occupation authorities in Germany banned the book there at the behest of the Soviet Union.

Keynes, who read *The Road to Serfdom* while on his way to the Bretton Woods conference, wrote Hayek, more than oddly, that it was "a grand book." He added that he was in "deeply moved agreement" with the whole of it. He then proceeded to lay out his profound disagreement: "According to my ideas you greatly under-estimate the practicability of the middle course. . . . What we want is not no planning, or even less planning, indeed I should say that we almost certainly want more." He concluded by advising

Hayek to take up "the restoration of right moral thinking." For "if only you could turn your crusade in that direction you would not feel quite so much like Don Quixote."

But after the initial splash of *The Road to Serfdom,* Hayek did rather seem a Don Quixote off on a fanciful campaign. In later years, Hayek would ruefully acknowledge that the book was too "popular" for his own academic good and had discredited him within the economics profession. The breakup of his first marriage occurred shortly after, and he married a woman he had first fallen in love with over twenty years earlier. In 1950, Hayek left LSE for an appointment at the University of Chicago. He was professor of social and moral sciences and a member of the prestigious Committee on Social Thought, where his colleagues included some of America's most stellar intellectuals. He was not part of the economics department and did not have much direct impact on students there. He struck people as very much an old-style Central European gentleman—reserved, rather austere. When a young graduate student (much later a Nobel Prize winner) asked him to read a draft essay on economic analysis and political choice, Hayek politely declined. He did not read handwritten manuscripts, he explained.

It was while at Chicago that Hayek wrote what many consider his outstanding work, *The Constitution of Liberty,* published in 1960. In it, he further developed one of his most important themes: Laissez-faire was not enough. Government did have a clear role: to ensure the development and maintenance of the institutions—the laws and rules—that would ensure a competitive economy. And that, whatever emotion might otherwise say, remained the best mechanism for achieving the ideals that had captured him on the battlefield of World War I. Hayek never quite felt at home in Chicago. He kept a car in Paris, and whenever he could, he returned to the Alps with his new wife. Depression began to unsettle him. After a dozen years at the University of Chicago, he took up an appointment at the University of Freiburg, amid the Ordoliberals.

The Alps had already provided the venue from which Hayek would extend his influence. In 1947, he had taken the lead in convening a meeting of a remarkable group of intellectuals, mainly economists, numbering just thirty-six. It was held at a Swiss spa on Mont Pèlerin, and ever after became known as the Mont Pèlerin Society. The first session was such a success that the group reconvened two years later and thereafter on a regular basis, in different locations, with ever-growing numbers. It provided a framework for like-minded thinkers to dissect socialism and collectivism and to debate and argue philosophy and policies. It also provided liberal (in the European sense) economists with the sense of an international community, with a fervor to develop their ideas, and—especially for those coming from countries where liberal economists were few and far between—the means to overcome their isolation and the comfort of knowing that they were not alone.

For Hayek, the meetings of the Mont Pèlerin Society were essential bivouacs in the war of ideas. He believed that the struggle would be a long one; liberal thinking would be on the defensive "for the next ten or twenty years, during which the present collectivist trend is bound to continue." In a paper entitled "The Intellectuals and Socialism," which he circulated after the first meeting of the society, he warned the participants that they should prepare for the protracted struggle, though it was one that they could win. "What to the contemporary observer appears as a battle of conflicting interests decided by the votes of the masses," he said, "has usually been decided long before in a battle of ideas confined to narrow circles."[7]

The Chicago School

Among those attending that first Mont Pèlerin meeting was a young economist from the University of Chicago who was making his first trip to Europe—Milton Friedman. Mont Pèlerin certainly helped Friedman become part of an international network—and at the same time contributed to the dissemination of Friedman's increasingly influential work. Indeed, the fundamental shift in the global attitude toward markets might never have happened, at least in the form it did, had it not been for several decades' worth of highly unfashionable academic "scribbling" by Friedman and his colleagues at the University of Chicago. The Chicago School, as it became known, provided a substantial part of the foundation for the intellectual reformulation, both in the United States and around the world.

Like many great university departments in the United States, Chicago's economics faculty came together in the 1930s and 1940s as an amalgam of distinguished American academics, rising young stars, and eminent Europeans, some of them refugees from fascism. It was a diverse group. The leader was Frank Knight, a free-market economist. But there was also Paul Douglas, a firebrand New Deal liberal, who eventually departed for a career in politics and ended up a U.S. senator. Another member was a Polish refugee, Oskar Lange, who, ironically enough, while at Chicago did much to develop a model for market socialism. Lange was expected to become a major figure in the department but instead left Chicago at the end of World War II to join the new Communist-dominated government in Poland and became its ambassador to the new United Nations.

By the end of the 1950s, people were already talking about a distinctive Chicago School, which, in opposition to the new Keynesianism, emphasized laissez-faire—free markets—and argued against government intervention. What made Chicago special? The economics faculty was committed to famously rigorous and well-defined standards of teaching in the Ph.D. program. People flunked. The department focused on workshops, which brought faculty and students together on a regular basis to thrash out and argue over issues. Members of the department cohered around a particular worldview and set of ideas, which they explored and advanced single-mindedly and which was basic to the training of new Ph.D's. George Shultz, later secretary of the Treasury and secretary of state, noticed the difference as soon as he joined the Chicago faculty after fifteen years at MIT. "It was more a university than anywhere else," he said. "People from all over the university interacted together as colleagues."

"Chicago always had a strong tradition of a belief in the power of markets," said Gary Becker, who went to Chicago as a graduate student in 1951 and won the Nobel Prize in 1992. "Chicago's contribution was to show the power of markets and people's choices, not only in public policy but also in economic science. The department also had very strong leadership. There was a lot of self-confidence that we had the right answers and the rest of the profession was wrong. We saw economic analysis as a powerful way to understand behavior, providing a lot of insight not only into the economy itself, but also how society organized. I think that at most places economics was taught as a game; it was not clear that teachers elsewhere thought economics was a powerful tool. Chicago did."

The Chicago economists believed, in practice, in a very small number of theorems about the way decision makers allocated resources and the ways these allocations led to prices. They trusted in markets and the effectiveness of competition. Left to their own devices, markets produced the best outcomes. Prices were the best allocators of resources. Any intervention to change what markets, left alone, would achieve was likely to be counterproductive. For the Chicago economists, the conclusions for government policy were clear: Wherever possible, private activity should take over from public activity. The less government did, the better. Intervention in the money supply distorted the markets; better instead to have a steady, predictable growth in the money supply. This was the very opposite of the Keynesian idea that government could smooth out economic fluctuations. This aspect of the Chicago approach, and its later variants, became known as monetarism.

Through most of the 1950s, the Chicago School remained obscure and unfashionable, at least as far as the public was concerned. It seemed to contradict the conventional wisdom in almost every respect. But by the end of the decade, all that was changing, partly driven by Milton Friedman, who was not only a powerfully capable economist but also charismatic, optimistic, and unfazed, whether by the spotlight or by the enormous amount of criticism that would be heaped upon him.

While in high school Friedman had fallen in love with mathematics, inspired by a teacher who was so passionate about geometry that he concluded the proof of the Pythagorean theorem by quoting John Keats's "Ode on a Grecian Urn"—"Beauty is truth, truth beauty." Attending Rutgers on a state scholarship, Friedman was eager to find a profession in which he could use mathematics, and he aspired to become an insurance actuary. That ambition was terminated when he failed some of his actuarial courses. But by then he was already interested in economics, again inspired by outstanding teachers, including Arthur Burns, who went on to become chairman of the Federal Reserve Board. Economics was an almost-inevitable career choice for Friedman: "I graduated from college in 1932, when the United States was at the bottom of the deepest depression in its history before or since," he later wrote. "Becoming an economist seemed more relevant to the burning issues of the day than becoming an applied mathematician or an actuary." He enrolled as a graduate student in economics at the University of Chicago and did his doctoral work there, interspersed with research at Columbia.

It was upon becoming a professor at Chicago in 1946 that Friedman truly began to go his own way. He emerged from among the Chicago faculty as an iconoclastic and controversial thinker and leader of what was, by the late 1950s, an all-out assault on virtually every aspect of Keynesian economics. He was a formidable debater. Colleagues joked that people preferred to debate him when he wasn't there. As a teacher, he was demanding and relentless. "Everything you could say, he could say better," recalled one student. His students also developed enormous loyalty to him. There was a great sense of camaraderie. They were part of a small band, fighting for the truth.

According to the Chicago approach, intervention almost always did more harm than good. In a famous early article, "Roofs or Ceilings? The Current Housing Problem," Friedman and his coauthor, George Stigler, rigorously demonstrated that however good its intentions, rent control had the perverse effect of reducing available housing by removing the incentives for landlords and builders to bring new housing to the market. Overall, Friedman would argue, taxation and government spending were appropriate only for the most limited set of "public goods," such as national defense. Everything else was best left alone.[8]

The members of the Chicago School rejected the concept of market failure and the tenets of Keynesianism. They were also much more concerned about the extension of government power than about the dangers of monopoly, the latter having been one of the main motivators of regulation in the United States. They regarded the problem of private monopoly as much overstated, partly because of technological change. "Private unregulated monopoly," wrote Friedman, was the lesser of the evils "when compared to government regulation and ownership."

While Friedman attacked the sacred cows of macroeconomics, his colleagues challenged other aspects of the dominant thought. George Stigler conducted a quiet but no less devastating critique of government intervention through regulation. Gary Becker applied economic analysis to an array of social issues, beginning with discrimination. "I believe that people make rational decisions and that they try to look ahead to the consequences of their decisions," explained Becker. "They are affected by incentives. You can take markets, rationality, and incentives and illuminate issues involving race, education, and the family." Becker's most famous work was a pathbreaking analysis of "human capital." Although now more than fashionable as a subject, it was hardly studied at all before Becker took it up. "Human capital," he said, "deals with expenditures on people—for education, training, health—that in a broad sense raise productivity." He agonized, however, about using "Human Capital" as the title. "I was concerned that it would set too many people off. It was unacceptable to many people to link 'human' and 'capital.' Now people are happy to use it." Chicago's 1995 Nobel Prize winner, Robert Lucas, led a new line of research, starting in the 1970s, around the issue of "rational expectations." That work argues that government decisions are not likely to have the anticipated results, owing to the responses of decision makers in the economy. Market knowledge outwits government knowledge.

The Chicago School was derided for being dogmatic, rigid, and reductionist. Friedman was happy to counterattack. He enjoyed the pulpit. He believed his ideas could transform the world—and, arguably, they did. He saw a direct, explicit, and unabashed connection between capitalism and democracy. Free markets produced the best results, and economic freedom rested, in turn, on political liberty. He propounded his ideas not only in a constant flow of journal articles but also in more popular form. His 1962 classic, *Capitalism and Freedom,* was aimed at economists and the general public alike. In 1964, he was economics adviser to the conservative Republican presidential candidate Barry Goldwater. He had become so much a celebrity upon receiving the 1976 Nobel Prize that he found himself, he said, interviewed "on everything from a cure for the common cold to the market value of a letter signed by John F. Kennedy." He conveyed his ideas in a mass-market best-seller, *Free to Choose,* which became a public-television series. In the 1980s, he could recall with some satisfaction that in the 1950s the ideas he and his colleagues were propounding were those of "a small, beleaguered minority regarded as eccentrics by our fellow intellectuals." By the 1980s, those very same ideas were "at least respectable in the intellectual community and very likely almost conventional among the broader public." Still a decade later, in the middle 1990s, MIT economist Paul Krugman would write that Friedman's "long campaign against the ideas of Keynesian economics" had made him into "the world's best-known economist." So much for Keynes.

The Chicago School was hardly alone, and by the early 1980s, "Chicago" itself had become more dispersed. Friedman retired from teaching and, along with others, shifted his base to the Hoover Institution at Stanford, which afforded direct connection to Ronald Reagan and his advisers. But by then it became clear that the Chicago School had carried out a devastatingly successful "neoclassical counterattack" in economics and in its applications. Macroeconomics management did not work, while tinkering with the money supply only increased uncertainty and discouraged investment. And the Chicago School also showed that regulation would inevitably drift away from the ideal of promoting an impersonal public good. Instead, it would be captured by special interests. On top of everything else, government had failed to prove itself as a forecaster. Faith in "big government" fell under the attack.

The work of Chicago—and, more indirectly, Hayek's contribution—proved crucial to a general shift in the center of gravity of economic thinking and to a reevaluation of the appropriate balance of government and marketplace. Fiscal management was no longer seen as an effective tool; fine-tuning was beyond the knowledge and skill of the tuners. Higher inflation did not assure lower unemployment, but it did mean more uncertainty. Smaller government was better; it was all too easy for big government to crowd out private activity. In contradiction to the received wisdom of Keynesianism, reducing deficits, rather than increasing them, could stimulate economic activity. Keynes, it turned out, was not a man for all seasons.

Professors at Chicago felt for many years that other major universities—such as Harvard, Yale, MIT, and Berkeley—did not take Chicago seriously and would not hire its students. Schools like UCLA and the University of Rochester were much more sympathetic. The University of Virginia became a center for free-market thinking, around the figure of James Buchanan. Buchanan and the "public choice" theory applied economic assumptions of self-interested behavior to the actions of politicians, bureaucrats, and voters. A groundswell of Nobel Prizes, beginning with Hayek and Friedman in the mid-1970s, chronicled Chicago's ascendancy. Altogether, since 1974, eight professors from Chicago and another eleven associated at some time with Chicago have won Nobel Prizes in economics. "The shift toward Chicago was clear to me after 1975," said Gary Becker. "It was a result of what was going on in the economics profession and what was going on in the world. They came together."

As Friedman himself saw it, the acceptance of Chicago's ideas resulted first from the stagflation and economic impasse of the 1970s—and then from the fall of the Berlin Wall. "People are not influential in arguing for different courses in the economy," he said. "The role of people is to keep ideas alive until a crisis occurs. It wasn't my talking that caused people to embrace these ideas, just as the rooster doesn't make the sun rise. Collectivism was an impossible way to run an economy. What has brought about the change is reality, fact—and what Marx called the inevitable forces of history."[9]

Grudging Respect

This intellectual migration wrought three changes: in the economics profession, in the minds of those within it, and in national and international economic policies. All three are clear in the career of Jeffrey Sachs. He was "raised" at Harvard as a Keynesian. And in 1976, as a reward for being selected the best undergraduate in economics, he was invited to lunch at the New York Federal Reserve. "I remember," he recalled, "saying the word *monetarist* and almost spitting it out." From the mid-1980s on, he was at the center of economic reform in Latin America and since then in Eastern Europe, the former Soviet Union, Asia, and Africa. His experience in confronting the results of government control of the commanding heights proved profoundly disillusioning; he lost his confidence in the ability of governments to control their economies in a rational way. "The more that I have sat and discussed the economy with government ministers," he said, "the more I have come to believe in the anonymous, competitive processes of the market. And now I am attacked all over the world as a Friedmanite. Considering where I came from, that's amazing for me."

The shift in thinking converged with the experience and learning of the preceding decades. Confidence in market knowledge rather than government knowledge formed the foundations of the global critique. The new viewpoint was powerfully articulated in the 1991 edition of the World Bank's authoritative annual *World Development Report.* The 1991 report signified a sharp break with the conventional wisdom. Instead of intervening, it said, governments should pursue "market friendly" policies—policies that encouraged the private sector. By inference, the bulk of past policies had been "market unfriendly."

The person in charge of the report was Lawrence Summers, then the World Bank's chief economist and President Clinton's secretary of the treasury. The nephew of two Nobel Prize winners in economics—Paul Samuelson and Kenneth Arrow—and himself educated at MIT and Harvard, Summers won the Clark Medal for the best economist under the age of forty. "In 1955, it was not unreasonable to focus on the Depression and the impact of World War II," he said. "The autarkic countries of Latin America were doing well, and the Soviet Union seemed to be growing at three and a half times the rate of the United States. Today, the Depression and World War II are much smaller parts of historical experience.

"Three things happened to change people's thinking in recent years," he continued. "First, they have seen how badly the public sector can mess things up. With competition, things seem to go better. Innovation happens. The world is more focused on variety than quantity. Secondly, markets are able to do things that people used to think required government coordination. Markets make it possible to rent videos in every town in America, with no public involvement. There is now a skepticism about the view that you have to have the public sector to get things done. And thirdly, a gradual refinement in economic science has led to an upward revision in elasticities, in how systems respond. There is a greater response to tax rates than people used to think. If you interfere with property rights, business responds by going elsewhere. Maybe it is because economies are more global.

"What's the single most important thing to learn from an economics course today?" Summers asked. "What I tried to leave my students with is the view that the invisible hand is more powerful than the hidden hand. Things will happen in well-organized efforts without direction, controls, plans. That's the consensus among economists. That's the Hayek legacy.

"As for Milton Friedman," Summers added, "he was the devil figure in my youth. Only with time have I come to have large amounts of grudging respect. And with time, increasingly ungrudging respect." [10]

The Emergence of Emerging Markets

Tom Hansberger was a man with an obsession. It started when he was serving with the U.S. Air Force in North Africa and Europe in the late 1950s. During a mission to Greece and Turkey, he was particularly struck to discover countries that were modernizing with well-run private companies. And no one in the United States seemed to know anything about those companies. That was the beginning of his obsession with global investing, although it was hardly a term that would have been used at the time. Entering the securities business, Hansberger bounced around from Wall Street to Ohio, and ended up running a trust department for a bank in Tampa, Florida. There, at a local meeting of security analysts, he ran into John Templeton. He had seen an article in *Forbes* that described Templeton as the "wise old owl" of investing, and indeed Templeton, working from a small office in the Bahamas, was already on the way to becoming one of the great legends of the business. Templeton was one of those people with the ability to see things long before others. He was also highly disciplined both in his work and his life, and he remained parsimonious on principle even when he became a billionaire. "For John, every investment had its own personality and life," said Hansberger, "and he never allowed emotion to get mixed up in his decision making. Everything was decided on its own merits."

At the time of their meeting, Templeton, who had put up to 60 percent of the funds he was managing into Japan, was just beginning to expand his global investment portfolio. And that was exactly what most interested Hansberger. In 1979, he went to work as chief executive officer of Templeton Investment, which was still a small firm. And the first thing Hansberger did was get himself a passport. Then he bought an extended airline ticket and took off for several months, visiting companies around the world and looking for local specialists. Over the next decade and a half, Templeton and Hansberger would do as much anybody else in the world to open up stock markets in developing countries to American and European investors. It was not all that easy at first. "We would go and see potential investors and talk about investing internationally, but almost no one thought it necessary to do something overseas," said Hansberger. "They would tell us that they didn't need the currency risk, the economic risk, and certainly not the political risk. Sometimes people would laugh at us. Sometimes they would look at us as though we should be committed."

At this same time, the International Finance Corporation (IFC), a World Bank affiliate that focuses on the private sector, was trying to promote the flow of funds into the stock markets of developing countries. Antoine van Agtmael, a Dutch banker, had worked in Thailand in the late 1970s, when that country's stock market went through the exhilaration of its first great boom and then a massive bust. "That left me with three conclusions," van Agtmael recalled. "There was enormous potential in such countries. There was an enormous need for funds for companies that were being completely overlooked by major investors. And there was enormous risk. That argued to me for diversification, investing in a lot of countries." Van Agtmael joined the IFC, working with a small group that sought to promote that kind of investment. "We were fighting," he said, "against the dominant ethos in the World Bank at that time, which regarded these markets as crazy little casinos and which was much more interested in government intervention."

One day, as part of his crusade, van Agtmael went to New York to talk to a group of investors about his pet idea of a "third world investment fund." After he finished speaking, someone from the audience stood up and said, "I think it is an interesting idea, but you can never sell it. No one wants to put money into the *third world investment fund*. You'd better come up with something better." Van Agtmael realized that the criticism was right, and spent the following weekend anxiously wracking his brain. *Underdeveloped markets* was a complete nonstarter. *Third world* wouldn't do. Nor would the World Bank's favorite, *developing nations*. None of those terms would exactly entice Americans to part with their savings—not at the very moment when the debt crisis was shining a huge spotlight on these countries' economic infirmities. "I knew we needed something positive, uplifting, not negative," van Agtmael said. And by the time he came to work on Monday morning, he had the answer: *emerging markets*. That was the magic nomenclature.

But it was a long road from words to reality. In what proved to be a most inauspicious beginning, the IFC helped get the Mexico Fund launched just as Mexico veered toward bankruptcy. It did better supporting the launch of the Korea Fund. Van Agtmael even wrote a book, *Emerging Securities Markets*. Yet by the middle 1980s there was still not much to show for all the effort. The need, if anything, was even more urgent; the debt crisis and the abrupt cessation of lending accentuated the importance of getting money into the cash-starved growth companies of the third world.

Still, with the debt cleanup continuing, few investors were clambering to put their funds to work in what seemed a very risky proposition. Finally in 1986, the IFC, working with the Capital Group, a money management company, succeeded in persuading a group of major institutional investors to come up with a grand total of $50 million for an emerging-markets fund. It was a cautious experiment. The developing countries were going through the wringer, and the opportunities looked to be very limited. Templeton followed suit with the first public mutual fund for emerging markets. "When we launched our emerging market fund in 1986," said Hansberger, "we raised $80 million. Our biggest worry at the time was that we would not be able to invest it, because there were not enough opportunities." Templeton's emerging-market funds now invest over $10 billion.

With the kick start from the IFC, emerging markets began their dramatic growth in the second half of the 1980s. In 1987, the capitalization of emerging stock markets totaled $332 billion, 5 percent of a world stock capitalization of $7.8 trillion. A decade later, in 1996, the capitalization was $2.2 trillion, 11 percent of a total world capitalization of $20.2 trillion. "I always knew that it had to happen," said Hansberger, "but it's come more quickly than I thought." The real propulsion came from the fall of the Berlin Wall. "Billions of people living in communist and third world nations joined the marketplace. That catalyzed the global investing theme. Before that, it had only been regional." By the early 1990s, developing countries were beginning to compete hard for the investment. What had seemed highly risky only a decade ago has become commonplace. Investment experts advise Americans to put 5 to 10 percent of their total savings into emerging markets. Calpers, the mammoth pension fund of California's state workers, at one point had over $2.5 billion in those markets.

When Templeton was sold to another fund group, Hansberger decided to start over with his own company. But the circumstances were very different from when he had joined up with John Templeton in 1979. "When I started doing international investing," he said, "there were only seven markets outside the United States in which we could invest. Germany and Japan were the emerging markets at the time, although no one called them that. Now, we've invested in forty-seven countries, and we research sixty-two. Altogether there are ninety emerging markets, and the number is continually growing. Technology is helping to speed up the growth. With computers, we can screen twenty thousand companies for investment objectives before lunch. Technology also makes possible the instantaneous transfer of money. You push a button, and in a second you move a billion dollars."

The development of emerging markets was central to economic change around the world. It responded to the specific need in the 1980s to find new sources of money to fuel growth. Governments would not take on new debt, which was not available to them in any event; capital would instead be attracted through local stock markets into private companies in developing countries. In this way, the developing countries could gain access to the savings—as represented in the mutual funds and pension funds—of the industrialized world. And in order to attract capital, countries would have to display stable currencies, encouraging prospects for growth, and a receptive political climate. In practice, of course, the flow of investment also depends on less quantifiable, more psychological factors. The rise of the emerging markets has had far-reaching impact. It has accelerated the shift toward reliance on market knowledge, tied economies together, become a force for change, and created a major counterbalance to traditional government intervention. Across the developing world, government decision makers now have to worry not only about the domestic impact of their decisions but also about the reaction of foreign investors. Officials still can, and often do, intervene as they will; they can impose autarkic policies or put up barriers; they can pursue policies that stimulate inflation or create deficits. But they risk engendering a reaction—a speedy exit from their stock markets—that did not exist before.

Emerging markets deliver a tremendous jolt to the old system. To understand the impact of the new calculus on governments, the Indian economist Vijay Kelkar suggested borrowing from the psychologist Erich Fromm. Explained Kelkar, "Fromm talks about the balance between 'mother love,' which is unconditional, and 'father love,' which is conditional. What we are seeing is the shift from the unconditional love of the treasury, which takes the form of deficits and endless subsidies for loss-making state enterprises, to the conditional father love, which is the discipline imposed by international capital markets. That father love was not there before."

Yet few anticipated how stern that "father love" could be. Certainly, there were those who, remembering the debt crisis, cautioned that investors often miscalculate risk. With large amounts of money traveling among what were still relatively thin markets, highly sensitive to investor psychology and market trends, there was a constant risk of "corrections" in emerging markets.

But no one was prepared for the fury with which the global financial crisis wreaked its way across the world's emerging markets in 1997 and 1998. The high growth rates in Asia had provided the rationale not only for the expansion of stock markets, but also for a rapid buildup of short-term borrowing. The regulatory processes for the financial systems proved wholly inadequate to the flow of funds. It turned out that the national systems did not have the institutional capability—or sufficient levels of knowledge or independence—to cope with the rapid buildup in short-term loans and investments.

The ensuing crisis proved to be a self-fulfilling prophecy. High interest rates, plunging currencies, and devaluations—all these meant that the debt could neither be serviced nor repaid. International investors fled the countries; nationals sought to move their own funds out as well. No one wanted to be the last one out the door. Around the world, emerging-country stock markets tumbled. "Contagion" became the phrase that described the spreading market collapse. It was a condition not of countries but of investors—a massive recalibration of risk perceptions and a resulting flight of capital away from emerging markets. Some called it an out-and-out panic. Liquidity dried up in many countries. Emerging stock markets plunged. The quickly declining arc of their indices captured the abrupt loss of confidence. The funds will not flow again until economic recovery is in sight—and until there is a renewed assurance in the durability and transparency of the markets in those countries. In the future, investors will look not only at growth rates but also at the quality of regulation and political institutions. It all comes down, once again, to confidence.

Financial Integration

The world was already being tied together by continuing increases in cross-border investment by companies and the globalization of their activities. But beginning in the mid-1980s, the development and coalescing of capital markets—financial integration—gave a new meaning to the international economy. The powerful effects of financial integration depended, in turn, upon informational integration. Rapid advances in telecommunications and computing, which linked markets and investors together, provided instant knowledge of performance. As a result, not only national but also global capital markets could vote not every day or every hour but every minute on stock markets—and thus on national economies. A negative vote could mean a very swift outflow of capital.

In ways that could not easily be disentangled, the information and telecommunications revolution was partly responsible for the global critique. State control depends upon a state that is in charge. And one of its most important sources of power is monopoly over information. That was most obvious with the Soviet Union, where oil reserves were a state secret and a factory manager had hardly any opportunity to learn about developments in the rest of the world that might affect his operations unless he took the risk of listening to Radio Liberty or the BBC. In the classic autarkic system, control of information was as important as control over licenses, currency, and investment.

But once information began to flow more freely with improved and less expensive phone service, fax machines, and computerization (and, of course, with increased travel), entire economic systems became more transparent. With the speed and reach of new information technology, governments can no longer keep up. As information flies around the world, people can compare and contrast; they can trade knowledge instantaneously; they can act upon it. Investors can make far more informed decisions no matter where they sit. Access to a Reuters terminal or a Bloomberg machine provides a range and depth of information hardly imaginable ten years ago—and without a moment's delay. Inside countries where the walls had been high, people can now learn about alternatives and choices.

The impact of the information and telecommunications revolution is only beginning to be felt. But it is a very different kind of economy when companies establish virtual headquarters and software designers in Silicon Valley and Bangalore, or oil geologists in Siberia and Houston, or auto designers in Detroit and Cologne, function via computer as one team. The effectiveness of state control and the very borders of the nation-state are being eroded. Nations' economic managers become parochial when the market becomes universal. Thus the notion of government knowledge, as decades of planners and regulators had developed it, has come under siege. Government may not know as much as it thought it knew—and may not be able to act effectively on what it does know. The result is increased limits on governments. Political impulses are now subject to economic imperatives as market systems take control of delivering goods, lowering prices, decreasing inflation, and improving universal living standards. But the intellectual victory of the marketplace has also transferred a new set of duties and responsibilities to the market, leading to new questions about just what and how much the market knows and how effectively it will be used—and how badly awry things could go. For global markets also mean global risks. Just as vastly increased travel means that diseases can be transported more quickly, so financial integration means that contagion can pass rapidly among markets.

That last is a powerful lesson of the global contagion that struck the international economy in the late 1990s. Just as the debt crisis of the 1980s forced new ways of thinking and operating, so will the crisis that struck in 1997 and 1998. The interconnected risk was on a scale that had not been comprehended. The tumult will force a new examination of the role of government in this new world economy. There will be a new critique. What roles are national governments to play in this integrated world economy? What new forms of international cooperation—or even regulation—are required? What are the future responsibilities of international organizations like the International Monetary Fund? What kind of standards, norms, rules, and regulations should be promulgated across borders? What can be done to increase the transparency and fairness of markets—and to ensure that risks are not hidden beneath special interests and crony connections?

All this will add up to a critical reexamination of the new global economy. Yet the result is unlikely to be a wholesale reversion back toward government management of economies. Too much has happened. The connections across borders have become much too deep and entrenched. Indeed, a lasting consequence of the global critique is greater modesty about government knowledge and what government ought to do with the knowledge it does have. For Valéry Giscard d'Estaing, the shift from state control to market control was symbolized by something as simple as bread. As France's junior minister of finance in the late 1960s, he oversaw the implementation of price controls for basic goods. "I had an army of civil servants," he recalled, "whose job was to inspect every bakery in France and make sure the price of a *baguette* followed the guidelines." Thousands of officials fanned out across the cities to bicker and argue with the bakers in every town and village. "This was nonsense," Giscard concluded. "I realized the system could not go on."[11]