The inequalities that could not happen: what the Cold War did to economics

Erik S. Reinert [Tallinn University of Technology & Centre for the Study of Sciences and the Humanities, University of Bergen][1]

This chapter attempts to flag the profound changes that underwent *economic practice* and *economic theory* during the Cold War – from 1947 to 1991 – as being at the roots of the present Inequality Crisis. Two aspects are raised. As regards the worsening inequality *between* nations it is argued that a key distinction between economic activities – at the core of the 1947 Marshall Plan – was increasingly marginalized as the tools of neo-classical economics carried the profession towards higher levels of abstraction.

As regards the worsening inequality *within* nations it is argued that a) the system of wage-setting changed from a virtual ratchet wheel effect, making wages practically irreversible without a devaluation, to a system of "internal devaluations" (whether or not recognized by that name) and b) the distinction between *financial capital* and *production capital* – which had been there since the Bible and the Quran via Medieval church fathers and persisted in Continental European economics from Marx to Schumpeter – gradually disappeared, leading to the present financialization of economic life.

During the Cold War we find that a very successful *economic practice* – starting with the 1947 Marshall Plan – dominated *economic policy* up until and including the theoretical foundation for the Maastricht Treaty and the European Single Market: Paulo Cecchini's 1988 book *The European Challenge 1992. The Benefits of a Single Market.*[2]

This period from the 1947 Marshall Plan to the Cecchini report 41 years later represents an important continuity. The insights from the Marshall Plan about the importance of manufacturing industry were built into the original foundations of the European Union, and – in that same spirit – Cecchini argued in 1988 that almost all of the benefits from the Single Market would be the result of the *increasing returns to scale* mostly found in the manufacturing sector. However, the practice of the European Union after Maastricht slowly changed to represent almost the opposite of Cecchini's vision.

Simultaneously – but completely separately from what happened in *economic policy* – at the start of the Cold War Paul Samuelson brought David Ricardo's trade theory into the core of economics with two articles in *The Economic Journal* in 1948 and 1949.[3] This theory – as did Ricardo's trade theory from 1817 – left out the contrast between manufacturing (increasing

---

[1] This approach in this chapter grew out of a project with colleagues at the University of Bergen on the problems of responsible quantification and modelling. I co-authored the following publications on this issue: Saltelli, Andrea, et al., "The technique is never neutral. How methodological choices condition the generation of narratives for sustainability", *Environmental Science & Policy*, Vol. 106, 87-98, April 2020, and Saltelli, Andrea, et al. "Five ways to ensure that models serve society: a manifesto", *Nature*, June 25, 2020.

[2] Aldershot, Wildwood House, 1988.

[3] Samuelson, Paul A. "International Trade and the Equalisation of Factor Prices", *Economic Journal*, June 1948, Vol 58., pp. 163-184, and "International Factor-Price Equalisation once again", *Economic Journal,* June 1949, Vol. 59, pp. 181-197.

returns and imperfect competition) on the one hand, and agriculture and other resource-based industries (diminishing returns and generally perfect competition) on the other.[4] As did David Ricardo's 1817 version, this theory defended what was in effect the essence of colonialism: manufacturing *does not* matter, i.e. the opposite of the Marshall Plan.

We can trace the 1947 ideas of the Marshall Plan paradigm in EU policy all through the 1980s, including the gradual integration of Spain while saving its manufacturing industry. But after the 1991-92 Maastricht meetings virtually all traces of George Marshall's and Paulo Cecchini's ideas are gone.[5] Economics became a profession which to a large extent came to profess that "free markets" automatically would create a world of economic harmony, a type of theory that Lionel Robbins had called a *Harmonielehre*.

In 1997 the Ricardo/Samuelson theorem saw its final ideological victory when WTO Director-General, Renato Ruggiero, declared that we should unleash "*the borderless economy's potential to equalize relations among countries and regions*".[6] This illusion – that trade under all circumstances would tend to even out economic differences among nations – is the main mechanism that since then has created an increasing inequality crisis between nations.

At the same time – as mentioned above – the qualitative separation between *financial capital* and *production capital* came to an end, best illustrated by contrasting the policies of the Federal Reserve under Marriner Eccles (1934-1948) and the European Central Bank under Mario Draghi (2011-2019). While Eccles – in a Keynesian fashion – created purchasing power, Draghi spread Bernanke's "helicopter money" with a perfect aim at financial capital, creating asset price inflation, artificially bloated stock prices, and an income distribution rapidly skewing in favor of the 99 %.[7]

For those of us who remember it – as does this author living in a NATO member country bordering the Soviet Union – the Cold War represented a constant threat. However, the theoretical foundations that came to front the theories behind the cold war ideological extremes were exceedingly abstract and too simplistic to be practical guides to human societies. The defense of the "market economy" was essentially built on tautologies where the conclusions to a large extent were built into the assumptions: it is not surprising that a system where all inputs are assumed to be qualitatively identical – as in Ricardo's trade theory – leads to harmonious outcomes. "Equality in, equality out." But, for political reasons these theories were highly in demand. We in the West really wanted to believe in the superiority of

[4] However, in the 10th edition of his famous textbook *Economics* (New York, McGraw-Hill, 1976) Paul Samuelson – with some qualifications – confirms the validity of the infant industry/infant economy argument for protectionism (pp. 701-703). However, his discussion is not tied to the critical increasing/diminishing returns argument lastly proved in the United States by Frank Graham's 1923 article "Some Aspects of Protection Further Considered", *Quarterly Journal of Economics* 37: 199-227.

[5] I analyze this problem in an EU publication: Reinert, Erik, "European Integration, Innovations and Uneven Economic Growth: Challenges and Problems of EU 2005", in Compañó, R, C. Pascu, A. Bianchi, J-C. Burgelman, S. Barrios, M. Ulbrich, I. Maghiros (eds.), *The Future of the Information Society in Europe: Contributions to the debate*, Seville, Spain, European Commission, JRC, Institute for Prospective Technological Studies (IPTS), 2006, pp. 124-152. Also published in The Other Canon Foundation and Tallinn University of Technology Working Papers in Technology Governance and Economic Dynamics, No 5, 2006.
http://technologygovernance.eu/eng/the_core_faculty/working_papers/

[6] Ruggiero, Renato, Speech in Berlin October 23, 1997 (italics mine).

[7] This is discussed in detail in Reinert, Erik "Financial Crises and Countermovements. Comparing the times and attitudes of Marriner Eccles (1930s) and Mario Draghi (2010s)", in Dimitri Papadimitriou (ed.), *Contributions of Economic Theory, Policy, Development and Finance. Essays in Honor of Jan A. Kregel*, London, Routledge, 2014, pp. 319-344.

our system, regardless of the fanciful assumptions that accompanied the proofs of this superiority. And the economics profession delivered.[8]

The implicit conclusion when the Cold War was over in 1989 appears to have been that because communism had proven to be wrong, neoliberalism – the other political extreme – could be assumed to be perfect. The policies emanating from this belief – sometimes referred to as *triumphalism* – have since the times of Thatcher and Reagan been an important source of economic inequality. Since markets were assumed to be perfect, it became too easy to blame the poor – peoples or nations – for their poverty.

What was forgotten with the neoliberalist triumphalism after the Cold War, however, was the one important thing communism and capitalism had in common. How and why this happened – why David Ricardo's 1817 theory suddenly during the Cold War reached a level of popularity never before thought possible – is explained in the next section of this paper.

Figure 1 The one thing Capitalism and Communism had in common but neoliberalism forgot. The cult of manufacturing industry was a key common element between communism and capitalism during the Cold War, and the core element of the Marshall Plan. Here represented with the theorist behind this strategy, German economist Friedrich List (1789-1846) (in stamps by capitalist West Germany to the left and communist East Germany to the right). List's work entered the communist sphere through his Russian translator, Sergei Witte (1849-1915), Minister of Finance under the two last tsars.

1. Paul Samuelson and the Cold War rebirth of David Ricardo (1817)

In complete contradiction to the ruling *practice* of the Marshall Plan at the time, Paul Samuelson started building what was to become Cold War economic *theory* with two articles in *The Economic Journal* in 1948 and 1949. Communism advanced under the utopian slogan "from each according to his ability, to each according to his needs". With his renewed interpretation of David Ricardo, Paul Samuelson produced a counter-utopia: under the standard assumptions of neo-classical economics free trade would produce a tendency towards factor-price equalization: the prices of labor and capital would tend to equalize across the planet. This became the *noble lie* of the neo-classical economics and of neoliberalism as the West faced the evils of communism.

Today's economists would naturally tend to believe that Cold War Economics – the theories that stood victorious after the 1989 Fall of the Berlin Wall – is part of a tradition that has ruled

[8] I have previously written about this methodological problem in "Full Circle: Economics from Scholasticism through Innovation and back into Mathematical Scholasticism". Reflections around a 1769 price essay: "Why is it that Economics so Far has Gained so Few Advantages from Physics and Mathematics?" in *Journal of Economic Studies,* Vol. 27, No. 4/5, 2000, pp. 364-376.

in economic science since David Ricardo's 1817 book. However, recent n-gram technology has made it possible to illustrate how David Ricardo and his theory of "comparative advantage" were virtually neglected until the Cold War.

The n-grams below show how Cold War economics brought David Ricardo out of the shadows. Compared to other English economists and economic philosophers – father and son James and John Stuart Mill – David Ricardo had indeed been much less important during the first 100 years after his 1817 theory.

Figure 2 The frequency of "David Ricardo" (in English) during the first 100 years after the 1817 publication of his main work, Principles of Economics, compared to that of two other, then much more famous, English economists.

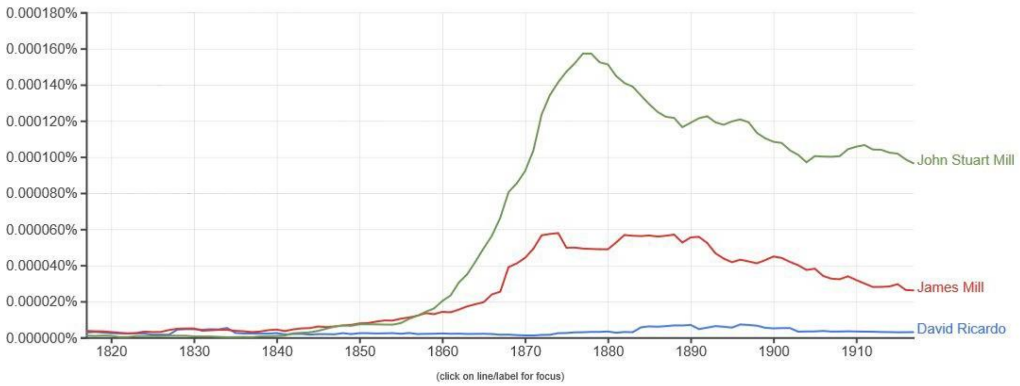
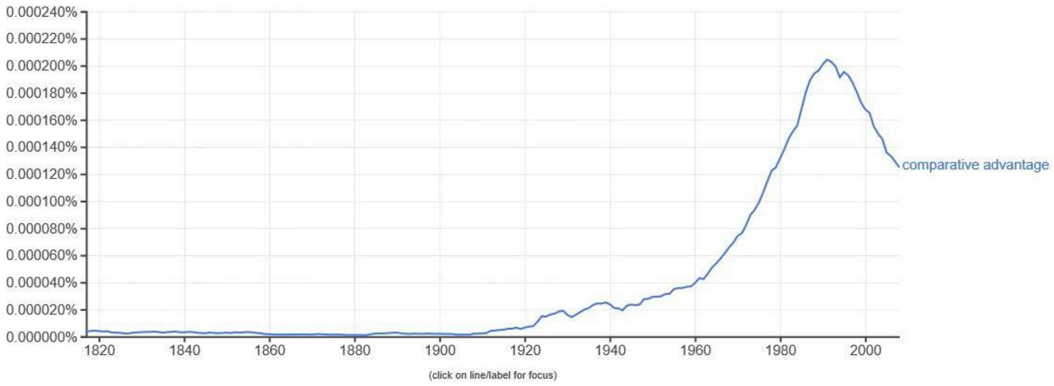


Figure 3 Frequency of the term "comparative advantage" (in English) from 1817 until today. As is clearly shown the term was very little used for the first 100 years of existence, but the use of the term started with the birth of the planned economy and exploded with the start of the Cold War in the late 1940s.



On the theoretical level, the Cold War (1947-1989) was fought between two *cosmo*political theories. Neither in neo-classical/neo-liberal theory nor in communism was the nation state a unit of analysis. In both *theories* the nation-state was not seen as having a place. Neo-classical economics is built on methodological individualism – the state assumed away – and also in Marxism the state was supposed to wither away as obsolete after a brief "dictatorship of the proletariat". In practice, of course, it was not the state but the rights of individuals that withered away under communism.

An important goal of science must be objectivity. Friedrich Nietzsche described objectivity as attempting to gain as many perspectives as possible on a matter:

> "There is only a perspective 'seeing', only a perspective 'knowing'; and the more affects we allow to speak about one thing, the more eyes, different eyes, we can use to observe one thing, the more complete will our 'concept' of this thing, our 'objectivity', be."[9]

In this way – by seeing the world from as many angles as possible – one can potentially understand the interplay between economic contexts and economic policies: how formulas for economic development will vary in different contexts. A condition for scientific objectivity, then, is the ability to observe diversity.

With Cold War neo-classical economics, however, came a theory a) void of context, and b) with only one angle from which to see international trade. With the politics of neoliberalism arriving with Thatcher and Reagan came two myths – not only of creating free trade as the historical normality, as did Samuelson – but as part and parcel of the same problem came the myth of *laissez-faire*. All seriously studying the subject have come up with the same conclusion as an American business historian did: "King Laissez Faire was not only dead; the hallowed report of his reign had all been a mistake".[10]

As economics Nobel Laureate James Buchanan wrote: "Any generalized prediction in social science implies at its basis a theoretical model that embodies elements of *an equality assumption*. If individuals differ, one from the other, in all attributes, social science becomes impossible."[11] Faced with this trade-off between "science" and "diversity", neo-classical economics chose a supposedly "scientific" path, by in effect making all human beings (perfect information) and all economic activities (perfect competition) qualitatively alike. The basic metaphor of economics became equilibrium, taken from the physics profession of the 1880s.

A great intellectual mystery of the 20th century is how, on the one hand, standardized mass production and the concomitant growing importance of increasing returns to scale under imperfect competition came to dominate economic life in the rich industrialized countries. On the other hand, sometime in the 1930s increasing returns to scale – the very basis for standardized mass production – was thrown out of economic theory because it was not compatible with equilibrium.[12] The logical thing had been to throw out equilibrium because it was not compatible with the most prevalent of all economic "laws" at the time, increasing returns.

Some philosophers came to see diversity as a goal in itself. Johann Gottlob Fichte (1762-1814) was one of them. When most Germans felt that the subdivision of Germany into a large

[9] Nietzsche, Friedrich, *Genealogy of Morals, third Essay*, New York, Oxford University Press, 1999 [1887].
[10] Lively, Robert, "The American System: A Review Article", in Business History Review, Volume 29, Issue 1, March 1955, pp 81-96.
[11] Buchanan, James, *What Should Economists Do?,* Indianapolis, Liberty Press, 1979, p. 231. Italics added.
[12] For a discussion see Reinert, Erik, *How Rich Countries Got Rich... and Why Poor Countries Stay Poor,* London, Constable, 2007. New edition, New York, publicaffairs, 2019.

number of small states – after the 1648 Peace of Westphalia there had been about 400 of them – Fichte argued that the diversity of the many states was an advantage.

The European Union has forced a one-size-fits-all policy on its member states, while at the same time locking many of them into the straightjacket of a common currency. “Fichte sought to establish that there were no inherent limits on the extent to which a world of multiple states would come to approximate his humanitarian ideal, despite remaining a world of states”.[13] With an asymmetrical economic integration tearing the union apart, Fichte’s is a perspective which is probably worth re-considering in Europe, and also at the global level.

2. The 1848 moment and the balance of countervailing powers

1848 produced both Marx and Engels’ *Communist Manifesto* and English liberalist John Stuart Mill’s *Principles of Political Economy*. The same year also gave us an early work in the tradition of the German Historical School, Bruno Hildebrand’s *Economics of the Present and the Future* (*Die National-Oekonomie der Gegenwart und Zukunft*). Bruno Hildebrand (1812-1878) was an early representative of the German historical school of economics. All three books gave support to strategies of industrialization. As opposed to David Ricardo, the great liberalist Mill was a strong supporter of “infant industry protection” for countries that were not yet industrialized, and Hildebrand strongly criticized the theories of Ricardo. One of his criticisms was that Ricardo’s theories were *cosmopolitical,* they did not consider the fact that different nations might be facing very different contexts. At the time it was obvious that just as medicines prescribed for a person should be tailored to the condition of the patient, economic policies should be tailored to the context of a nation. In this period in the United States, *snake oil* was the name given to fake cure-all medicines. The same criticism could be made against Ricardian theory at the time, as well as against today’s neoliberalist theories.

We shall come back to this problem when we discuss the issue of the *level of abstraction* in economic theory, and the possible rent-seeking that may occur if this abstraction is too high. Manchester Liberalism – the 18th century version of today’s neo-liberalism – was not really a brainchild of David Ricardo (1772-1823), but rather of Richard Cobden (1804-1865). An n-gram comparing the two authors shows Cobden passing Ricardo in mentions already in the early 1840s, and by the 1880s Cobden has about six times as many mentions as Ricardo. It is only 100 years later – in the late 1940s – that Ricardo again passes the number of mentions that Cobden has.

The hatred towards the state that we later saw during the Cold War was already there in Manchester Liberalism. John Bright (1811-1889) – Richard Cobden’s partner in the free trade movement – was convinced that “Most of our evils arise from legislative interference”.[14] Here we find ourselves at the start of the school also represented by Ronald Reagan, when he pronounced in 1986 that “The nine most terrifying words in the English language are: I'm from the government and I'm here to help.” In times of the Corona virus these statements come across as particularly misplaced.

The Manchester School contrast sharply with what was to be become, in Bright’s lifetime, a very different approach in Germany. In 1872 German economists, among them Hildebrand,

[13] Isaac Nakhimovsky in the introduction to Fichte, *Addresses to the German Nation*, Indianapolis, IN, Hackett Publishing, 2013. p. xvi.
[14] C. A. Vince, *John Bright,* [1898] Kessinger Publishing, 2005, p. 35.

founded the *Verein für Socialpolitik*. This association, with their annual meetings, would bring forth the theories and practical policies for what became the European Welfare State. By 1932, when the *Verein* ceased functioning, 188 volumes of proceedings – organized according to annual themes – had been published.

The reason for organizing the *Verein für Socialpolitik* was a much discussed problem which at the time was called *Die Soziale Frage* (*The Social Question*). This was an *inequality crisis* similar to our own. In the first founding meeting of the Verein, in the Fall of 1872, Gustav Schmoller (1838-1917) expressed the worries of the time in the following way:

> We believe the healthiest and most normal society can be expressed by a ladder containing rungs between different existences, depicting easy access from one step to another. Today's society threatens more and more to look like a ladder which grows fast at the top and at the bottom, but where the middle steps increasingly fall out, and where there is solid hold only at the very top and at the very bottom" (Verein für Socialpolitik 1873:5).

Over the next 60 years the *Verein* was to build the institutional design of generalized European welfare, and the prescription was copied in many other countries. The starting point in the *Verein's* discussions was practical problems at hand, and whether the private sector or the public sector would be the best agent to solve a specific problem was part of a pragmatic discussion. In the United Kingdom the 1942 Beveridge Report played a similar role of creating a holistic view of the social agenda.

Today both Schmoller's ladder metaphor and William Beveridge's "five giants" – want, squalor, ignorance, disease and idleness – ring a bell of recognition, more than ever since World War II. New is particularly that the United States – for so long the land of opportunity – seems to suffer from the same European-type problems from which the country had seemed free except during the 1930s.

The two cosmopolitical ideologies that came to fight the Cold War – communism and neoliberalism – were already taking shape during the latter part of the 19th century. However, English economic theory at the time – represented by Cambridge economists Alfred Marshall, John Neville Keynes (John Maynard Keynes' father) and Herbert Somerton Foxwell[15] – were far more experienced-based and pragmatic than English theories had with David Ricardo. y. They were all free from what Schumpeter called "the Ricardian vice", building extremely abstract theories and drawing policy applications from these, leaving out key complexities of real life. These English economists were closer to the German tradition.[16] The Ricardian vice was, however, to come back with a vengeance during the Cold War. As we shall see later, in section 4, with it came what I have dubbed the "Krugmanian vice": having models that better describe how the real world works, but refusing to recommend them in practical policies.

Gustav Schmoller – already mentioned above as the founder of the *Verein für Sozialpolitik* – clearly saw that both political extremes were unfit for practical purposes. In his 1897 inaugural

[15] Herbert Foxwell, in his 110 page introduction to a book by Anton Menger, delivered the fiercest attack ever on the economics of David Ricardo. Foxwell, Herbert S., "Introduction" to Anton Menger, *The Right to the Whole Produce of Labour,* London: Macmillan, 1899.
[16] Unfortunately neo-classical economics came to be more based on Alfred Marshall's appendices in his 1890 *Principles of Economics* than on his texts in the same book and elsewhere, i.e. the necessary qualifications for these abstractions in the appendices were left out.

speech as *Rektor* of the University of Berlin, Schmoller expressed the hope that the world had seen the end of the two ideological extremes, Manchester Liberalism (today's neoliberalism) and communism. His characterization of both these ideologies was harsh:

> "…the naïve optimism of "laissez-faire" and the childish and frivolous appeal to revolution, the naïve hope that the tyranny of the proletariat would lead to world happiness, increasingly showed their real nature, they were *twins of an ahistorical rationalism"*[17] (Schmoller 1897, my translation, italics added).

In practice, the ideological extremes of "the irrational twins" opened up for a wide spectrum of possible economic policies. In Western Europe Germany's *soziale Marktwirtschaft* (social market economy)[18] and Sweden's *Middle Way*[19] were successful models navigating the broad spectrum of opportunities between the "irrational twins".

The 20th century Swedish model of capitalism expresses John Kenneth Galbraith's balance of countervailing powers in successful capitalism: big business, big government, and big labor.[20] Swedish economists Gunnar Myrdal (1898-1987) – who had produced a theory where vicious and virtuous circles were dominating forces – and pragmatic economist Johan Åkerman (1896-1992) also provided the theoretical background for the Swedish model. That country's industrial policy after WW II is didactically interesting because for a very long period it was dominated by just three individuals, industrialist Marcus Wallenberg (1899-1982), also the main shareholder of Stockholms Enskilda Bank, Schumpeterian economist Erik Dahmén (1916-2005) who worked for the bank for several decades, and Labour Party politician Gunnar Sträng (1906-1992). Sträng held ministerial posts in the Swedish government from 1947 to 1976, the last 21 years as Minister of Finance.

Industrialist Wallenberg and his economic advisor Dahmén[21] - who had been working on "development blocks"[22] – had lunch in the bank every Wednesday. Wallenberg and Sträng were also in close contact, seemingly also unofficially, to discuss economic policy. The result is what economists of the French regulation School refer to as "the Fordist wage regime".[23] The fruits of innovations and productivity growth were divided between capital and labor: roughly would 4 per cent productivity increase give 4 per cent wage increase. Theever-increasing real wages made labor increasingly more expensive in relationship to capital while increasing demand was assured. This provided a very strong incentive for industrial mechanization, and in inflationary periods – like in the 1970s – there is no doubt that the combination of ever-increasing wages, sometimes combined with negative cost of capital for the industrialists, helped mechanization. Wages developed in the industrial export sector,

---

17 Schmoller, Gustav*, Wechselnde Theorien und feststehende Wahrheiten im Gebiete der Staats- und Socialwissenschaften und die heutige deutsche Volkswirthschaftslehre: Rede bei Antritt des Rectorats gehalten in der Aula der Königlichen Friedrich-Wilhelms-Universität am 15. October 1897,* Berlin, W. Büxenstein, 1897.
Italics added.
18 Economist Alfred Müller-Armack used the term in a 1947 book, also defining it as a Third Way, but it became popular later.
19 Childs, Marquis William, *Sweden; the middle way,* New Haven, Yale University Press, 1936.
20 John Kenneth Galbraith, *The New Industrial State,* Boston, Houghton Mifflin, 1967.
21 This story was told by Erik Dahmén at the 1991 Schumpeter conference in Stockholm.
22 Similar to what François Perroux called "growth poles" and what Michael Porter later came to call "clusters".
23 Boyer, Robert, "Development and *régulation* theory", in Reinert, Erik, Jayati Ghosh and Rainer Kattel, *Handbook of Alternative Theories of Economic Development,* Cheltenham, Edward Elgar, 2016, pp. 352-385.

then spread to the whole economy, also e.g. to barbers – who had small possibilities for productivity improvement – and to the public sector as well.

Strangely enough this wage policy resulted in high real growth also in Italy, although here the union-driven wage policy appeared to be irresponsible.[24] During the 1970s and 1980s, I ran a small industrial company in Northern Italy. With a certain unwillingness I have come to think that the communist threat – in spite of what it did to economic theory – actually served the purpose of increasing the capital-labor ratio in industry and services and thus creating labor-saving innovations, not only in manufacturing but also exemplified by containers and self-service supermarkets. History would prove David Ricardo wrong when he assumed that the natural wage level would be subsistence![25]

In the US the existence of free land at the Western frontier had kept wages up,[26] and later in the 19th century, the "muckraking" started by American journalists and the theories of Thorstein Veblen kept any attempt of creating feudal-like traditions and institutions – such as in the Europe the immigrants had left – at bay. In Europe, however, wages historically had lagged. But with industrialization came political pressures from the left that lifted wages.

Sometimes these came at the cost of inflation, but they always tended to increase the relative price of labor compared to the cost of capital. Wages came to be locked as in a *ratchet wheel*, movements upwards were possible, movements backwards were not.

The adjustment to the ratchet wheel system came in the form of devaluations: countries with "irresponsible" wage policies were forced to devalue. These devaluations made the wage level responsible again, and they would also automatically devalue the national debt (which tended to be in the national currency). In my view this combination of wage pressures combined with devaluations must be seen as a key mechanism producing the golden years of Western capitalism. In Europe neoliberalism carried with it the end of these mechanisms: first of all with "austerity" came the idea of "internal devaluation" (whether or not called by that name): where nominal wages were often cut, and secondly the Euro made the after all well-functioning adjustment mechanism of devaluations come to an end. While "old-fashioned" devaluations devalued capital and wages alike, internal devaluations directly reduce wages as a percentage of GDP, thus benefitting the capital sector at the cost of labor.

With the exchange rate flexibility gone for the Euro countries, the only mechanism to adjust economic mismatches between countries ended up being moving people: Greeks and Italians had to migrate, creating political tensions in the European Union between the "responsible North" and the "irresponsible South". Few, if anyone, now care to look into the political background for this "irresponsibility": Both in Italy and in Greece the inflation-creating mechanisms were at the time – probably correctly – seen as the only political option in order to save democracy from communist parties with a very strong popular support.

---

[24] The details are explained in my chapter "Financial Crises and Countermovements. Comparing the times and attitudes of Marriner Eccles (1930s) and Mario Draghi (2010s)", cited above.

[25] When David Ricardo, in the third edition of his Principles (1821), added a new chapter "On Machinery", he assumed that the sole effect of machinery would be to bring down prices. In Reinert (1994) I have discussed the different ways that technological change may spread in the economy, this mechanism – which I call the "classical" mechanism – being one ("Catching-up from way behind - A Third World perspective on First World history" in Fagerberg, Jan, Bart Verspagen and Nick von Tunzelmann (eds.) *The Dynamics of Technology, Trade, and Growth,* Aldershot, Edward Elgar, 1994, pp. 168-197.

[26] Sombart, Werner, *Why is there no socialism in the United States?,* White Plains, NY, M.E.Sharpe, [1905] 1976.

3. The simple dichotomy that separates rich from poor countries

In 1613 Italian economist Antonio Serra produced a theory presenting two dichotomies, between the *real economy* and the *financial economy*, and between activities subject to *diminishing returns* to scale – where one factor of production is limited by an act of nature (agriculture, mining, and fisheries) – and *increasing returns* to scale, where there are no limits to how costs can fall as the volume of production increases. The dichotomy between *the real economy* and *money by itself (mammon)* had been there since biblical times, but the distinction between increasing and diminishing returns is new with Antonio Serra.[27]

This is the first theoretical observation as to why – as former World Bank Chief Economist Justin Yifu Lin put it very succinctly – "Except for a few oil-exporting countries, no countries have ever gotten rich without industrialization first".[28]

In my view, the mechanism suggested by Serra is still the main reason for the income gap between rich and poor countries. In 19th century English economics one side of the argument was strongly present: the dismal science created by Reverend Malthus in 1798 was based on diminishing returns, and fifty years later John Stuart Mill was acutely aware of its consequences. Four decades later than Mill, Alfred Marshall, the founder of neo-classical economics – came up with a plan that would have pleased classical development economists:

> "One simple plan would be the levying of a tax by the community on their own incomes, or on the production of those goods which obey the Law of Diminishing Returns, and devoting the tax to a bounty on the production of those goods with regard to which the Law of Increasing Returns acts sharply."[29]

Here Marshall describes what all presently wealthy countries have done, mostly through the protection of increasing returns activities through tariffs, ever since England in the 1400s started to tax the export of raw wool, while at the same time subsidizing the local production of woollen cloth. Although the tools differed, this was the essence of import-substitution industrialization that took some non-Western countries out of economic colonialism. It was also the core of the Marshall Plan, a plan which in its essence addressed the intimate relationship between *economic structure*, *possible population density*, and GDP per capita.

In early 1947, worries grew in Washington that an impoverished Germany – where manufacturing industry had been forbidden in the allied zones under the Morgenthau Plan – would fall an easy prey to the Soviet Union.[30] US President Truman therefore sent former president Herbert Hoover on a fact-finding mission to Germany. One powerful sentence in Hoover's report of March 18 zeroed in on the basic problem:

---

[27] See Serra, Antonio, *A* Short Treatise *on the Wealth and Poverty of Nations [1613*], edited and with a foreword by Sophus A. Reinert, London, Anthem, 2011 & Patalano, Rosario and Sophus A Reinert (eds), *Antonio Serra and the Economics of Good Government,* Basingstoke, Palgrave Macmillan, 2016.
[28] Lin, Justin Yifu, *New Structural Economics: A Framework for Rethinking Development and Policy*, Washington DC, World Bank Publications, 2012, p. 350.
[29] Marshall, Alfred, *Principles of Economics*, London, Macmillan, 1890, p. 452.
[30] I have described the mechanisms behind this in Reinert, Erik, "Increasing Poverty in a Globalised World: Marshall Plans and Morgenthau Plans as Mechanisms of Polarisation of World Incomes" in Chang, Ha-Joon (ed.), *Rethinking Economic Development*, London, Anthem, 2003, pp. 453-478.

> "There is the illusion that the New Germany left after the annexations can be reduced to a 'pastoral state' [i.e. a country without industry]. It cannot be done unless we exterminate or move 25,000,000 out of it."[31]

Hoover understood that the population density of a country is determined by its economic structure. Industrialization makes it possible to dramatically increase the population-carrying capacity of a nation. "Exterminate" was a very strong word to use after the horrors of the Second World War, and everyone understood that there was no place where 25 million Germans could be sent. Re-industrialization was the only option.

The lesson from the Marshall Plan is that only extreme danger, in this case a communist takeover of Germany, will convince the West temporarily to give up what has been called "free-trade imperialism". As the memory of the Marshall Plan faded, this wisdom disappeared with the economics of the Cold War, giving birth to the kind of Ricardian/Samuelsonian free trade neo-colonialist ideology that still dominates.

4. Levels of abstraction and assumption-based rent-seeking

In neo-classical economics, rent-seeking – the practice of manipulating public policy as a strategy for increasing profits – is a serious sin. But, if the world actually functions as outlined in the section above, what if national wealth is actually a kind of rent produced by dynamic imperfect competition which is not available in all economic activities? The fact that the most efficient farmers in the world – in the US and EU – normally need heavy subsidies and/or protection is a sign confirming this. Nations engaged in agriculture alone become – in this perspective – the only rent-free societies.

History has abundantly shown that the above statement of Justin Yifu Lin is correct. If neo-classical mainstream economics *pretends* that this distinction between increasing and diminishing returns activities does not exist – if the theory is placed at such a high level of abstraction that there is no room for this distinction – then, I would argue, this high level of abstraction is a tool for massive rent-seeking by the industrialized countries, a type of rent-seeking that is a major source of the present global inequality crisis. In other words, high levels of abstraction are *per se* sources of assumption-based rent-seeking. Assuming away differences increases the level of abstraction of our understanding.

In some sports – like boxing and wrestling – the existence of weight categories opens up for games that are perceived as much fairer than if no categories existed. The outcome of a match between a feather-weight boxer and a heavy-weight one is fairly predictable. So, if we imagine that all weight categories would be eliminated from boxing and wrestling, most sportsmen – those in the lower weight categories – would not be able to participate in their sport any longer. A degree of fairness is provided by establishing different categories. One could say that if boxing eliminated weight categories – if all boxers, regardless of their weight, were seen as being "alike" – this would create a "winner takes it all" for the heaviest of them. The elimination of qualitative differences would be a source of rent-seeking for heavyweight boxers, as it is for heavy-weight industrial nations towards poor countries.

[31] Quoted in Baade, Fritz, "Gruß und Dank an Herbert Hoover", *Weltwirtschaftliches Archiv*, 74(1), 1-6, 1955.

The essence of colonialism was the prohibition of manufacturing activities in these areas. This becomes clear when now long forgotten economic bestsellers are studied.[32] Joshua Gee's 1720 book *The Trade and Navigation of Great Britain Considered* is just one example of this. Gee's book became immensely popular, appearing in at least 20 editions before 1780, in English in London, Glasgow and Dublin, in French translations published in London, Amsterdam and Geneva, and further translations into Dutch, Spanish, and German.[33]

One factor leading both to the geographical spread of Gee's book, and to its later oblivion is probably that Gee not only was very straightforward when he described English interest in protecting their manufacturing industry, he was also unusually honest about the intention of colonialism being the opposite, to hinder manufacturing there:

> "That all Negroes shall be prohibited from weaving or spinning or combing of Wool, or manufacturing hats, …Indeed, if they set up manufactures, and the Government afterwards shall be under a Necessity of stopping their progress, we must not expect that it will be done with the same ease that now it may."

Since the Irish at the time were subject to the same kind of policies, it must have been clear to them that the statement above is not as racist as it appears at first sight. In 1779 John Hely-Hutchinson, then Provost of Trinity College, Dublin, anonymously published *Commercial Restraints of Ireland considered in a series of letters addressed to a Noble Lord*.[34] The English authorities thought Hely-Hutchinson's book protesting against the prohibition to export woolen manufactures from Ireland so insidious that the book became the last book in the United Kingdom to be publicly burned by the hangman.

Many economists have returned to Antonio Serra's and Alfred Marshall's discussion of increasing and diminishing returns. All come to the same conclusion, a conclusion which does not enter into the sphere of economic policy. In a 1981 article, Paul Krugman again – once – raises the issue.[35] He reaches the same conclusion as Antonio Serra and Alfred Marshall, the country producing under increasing returns benefits, noting "that in addition to exporting capital, the industrial region might, in the second stage of growth, begin importing labor" – Krugman specifically mentions that this was noted both by Hobson and Lenin.[36]

The interesting question here is *why* these insights are kept away from the policy level. Above I have referred to this as the "Krugmanian Vice": economic theorists produce many kinds of models, but those models that would favor poor countries are not employed in practical policies. This is not how a scientific community is supposed to work: if this had been seen from another planet – free from political noise – it is as if a political racket sorts out the theories that will be employed by the OECD and the Washington Institutions – inevitably

---

[32] Reinert, Erik S. & Fernanda Reinert, "33 Economic Bestsellers published before 1750", in *The European Journal of the History of Economic Thought*, Vol. 25 (6), 1206−1263, 2018.

[33] Gee, Joshua, *The trade and navigation of Great-Britain considered: shewing that the surest way for a nation to increase in riches, is to prevent the importation of such foreign commodities as may be rais'd at home. That this Kingdom is capable of raising within itself, and its colonies, materials for employing all our poor in those manufactures, which we now import from such of our neighbours who refuse the admission of ours. Some account of the commodities each country we trade with take from us, and what we take from them; with observations on the Balance*. London, Sam. Buckley, 1729.

[34] Dublin, William Hallhead, 1779. For the reproduction of a second edition (Dublin, M. H. Gill & Son, 1882), see http://www.gutenberg.org/files/38841/38841-h/38841-h.htm

[35] "Trade, accumulation, and uneven development", in *Journal of Development Economics* (8), 1981, pp. 149-161.

[36] English economist John Hobson inspired Lenin's theory of imperialism.

those in favor of a Samuelsonian neo-colonialism – and those that will be discarded. Apart from the ideological contributions from a myriad of "think-tanks",[37] I am suggesting this is the outcome of Veblenian "vested interests" coming together, rather than "conspiracies". The result of this, however, is in line with Herbert Hoover's theory above: massive migrations from poor non-industrial countries to North America and Northern Europe. If North Americans and Europeans want to diminish immigration – and let most people live in the country where they were born, which most prefer – they will have to reinvent the logic of Herbert Hoover.[38]

The assumption that "all economic activities are alike" creates a blind eye to the fact that all industrialized countries de-facto collect rents based on this assumption. Allowing models separating increasing returns activities from diminishing returns activities would clearly add an element of fairness to world trade.

Although not expressed in terms of rent-seeking – a recent term – 19th century US economists understood that David Ricardo's trade theory was working against them at the moment, but would be working in their favor if they managed to create the same economic conditions England had.

Joseph Dorfman, the historian of US economic thought, expresses this 19th century position of the United States particularly well, partly using quotes from List and partly using his own words as follows:

> "...free trade is the ideal, and United States will proclaim the true cosmopolitan principles when the time is ripe. This will be when the United States has a hundred million people and the seas are covered with her ships; when American industry attains the greatest perfection, and New York is the greatest commercial emporium and Philadelphia the greatest manufacturing city in the world; and when no earthly power can longer resist the American Stars, then our children's children will proclaim freedom of trade throughout the world, by land and sea."[39]

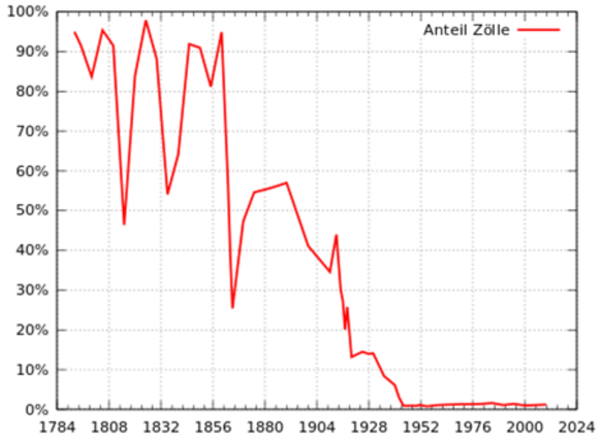
In this prophetic statement, the English strategy for growth was recreated. The United States indeed had the courage to follow the strategy that England had followed, and not the one she preached at the moment. As a result of this, in the end the United States surpassed the old master, England. This required what John Stuart Mill in 1848 would call "infant industry protection", a level of protection that for most of the 19th century would be the main income for the US Federal Government.

[37] A recent article by Quinn Slobodian addresses the role of think-tanks in this process https://www.theguardian.com/commentisfree/2019/nov/11/democracy-defenders-economic-freedom-neoliberalis m

[38] See https://oecd-development-matters.org/2018/10/19/africa-time-to-rediscover-the-economics-of-population-density -and-development/

[39] Dorfman, Joseph, *The Economic Mind in the American Civilization*, Vol 2., London, Harrap, 1947, p. 581.

Figure 4 Customs duties as share of the US Federal Budget 1796 to the present.



5. The collapse of the balance of countervailing powers and of the ratchet wheel effect

During the triumphalism following the 1989 fall of the Berlin Wall, and the political reign of the Washington Institutions, these previously mentioned "middle ways" were in practice outlawed. In his review of Thomas Piketty's *Capital in the Twenty-First Century*, James Galbraith – in my view correctly – criticized the author for not seeing the role of minimum wages and labor unions in the rising inequalities within nations.[40]

In this section we shall look at the effect of an economic crisis under two crisis scenarios, the 1930s and the 2000s. If the ratchet wheel mechanism – the irreversibility of wages – were functioning, we would expect an economic crisis to show up as shrinking sales, higher unemployment, and obviously falling profits.

This is the result arrived at by German economist Wilhelm Krelle[41] in the figure below. During the crisis in the 1930s in the United States, Krelle's data shows us that the percentage of GDP going to labor *increased,* meaning that capital income decreased more than labor income during the crisis. This would be the case if – in spite of high unemployment – the workers who kept their jobs tended to keep their wages. With the ratchet wheel of trade unionism intact, profits – rather than wage level – would be the factor suffering first during a recession.

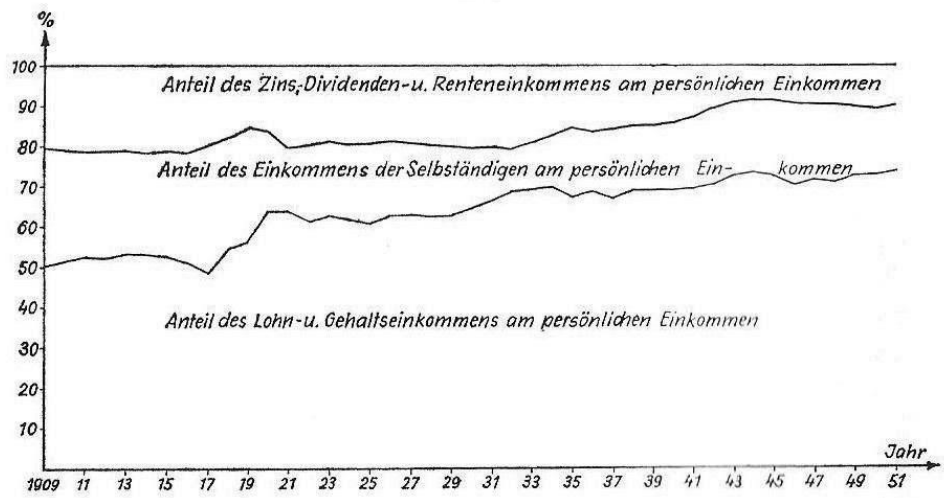
The dramatic losers in the 1930s, however, were the farmers who had no market power or unions to protect them. Comparing the above figure of recent data with the record of the crisis in the 1930s it would seem that the loss of union power has – in later decades – put workers in the same position that farmers used to be in in the 1930s.

[40] Galbraith, James, "*Kapital* for the 21st Century", in *Dissent Magazine*, spring 2014. https://www.dissentmagazine.org/article/kapital-for-the-twenty-first-century
[41] Krelle, Wilhelm, *Verteilungstheorie.* Tübingen, Mohr, 1962.

Figure 5 United States. Percentage of Pre-Tax income by Sector 1909-1951

- Top: share of total US income from interests, dividends, and rents.
- Middle: share of total US income from the self-employed (mostly farmers).
- Bottom: Share of total US income from salaries and wages.

Total 100%. All incomes pre-tax. Social transfers have been added salaries and wages. Profits retained in companies are not included.



Source: Krelle, page 12.

The graph of what happened in the 1930s – which has a certain logic to it – contrasts sharply with what happened during the crisis in the early 2000s. The figure below shows the share of labor in the output of the non-farm business sector in the United States from 1947 to 2016.

The recessions clearly mark the start of sometimes precipitous falls in the share of labor. This appears to show an entirely new ball game, where the ratchet wheel effect appears to be gone.

In the 1930s the ratchet wheel effect was no product of the market, but of political decisions. If we look at Secretary of Labor Robert Reich's failed attempts to raise minimum wages in the 1990s during the Clinton administration, it was clear that the vast majority of US economists at the time wanted "the market" to set wages. Cold War economics had brought back the social Darwinism of the American past[42] and – this time around – in a sense proves that David Ricardo was right when he predicted that the "natural" wage level would be subsistence.

Comparing the philosophy behind the careful and gradual economic integration of Spain, Portugal and Greece into the EU in the 1980s on the one hand, and the 1 May 2004 integration eastwards on the other, we can observe a qualitative quantum leap towards the worse. The 2004 integration destroyed most of what was left of the ratchet wheel effect in the European labor markets.

[42] Hofstadter, Richard, *Social Darwinism in American Thought, 1860–1915*, Philadelphia, University of Pennsylvania Press, 1944.

Figure 6 Labor's share of output in the non-farm business sector, in the first quarter 1947 through third quarter 2016

Note: Shaded areas indicate recessions, as determined by the National Bureau of Economic Research.
Source: U.S. Bureau of Labor Statistics.

These negative consequences of the 2004 enlargement of the European Union were predictable, as my Estonian colleague Rainer Kattel and I argued already from 2004.[43] A free trade shock had, since the fall of the Berlin Wall and the subsequent disintegration of the COMECON trade pact, led to a massive de-industrialization of the former communist countries. On May 1, 2004, these same countries became subject to a new free trade shock with the European Union. In a situation where "losers" in Germany were sweeping the streets of Frankfurt for € 10 an hour while the most successful workers in Estonia were mounting cell phones at € 1 an hour, a minimum sense of economic gravity would predict that this would put enormous pressures on wages in Western Europe.

That English construction workers – and others – lost around 30 per cent of their real wages due to labor migration from the East was one reason for Brexit. In Norway we could observe an interesting case of technological retrogression[44] with the arrival of cheap labor in the construction industry. Building sites with less than 5-6 floors discontinued the use of lifts: it was cheaper to have Polish workers carry the cement up ladders than to install lifts. This migration of Polish workers to the West had curious effects in other Eastern European countries. Asking, on a visit to Western Ukraine, about the situation there, one response was that the only good news was that construction workers in Western Ukraine now got well-paying jobs in Poland. About a year later, on a visit to Moldova, I was told that the good news there was that many Moldovan workers found well-paying jobs in the Ukraine. Here we can observe an interesting version of what Hollis Chenery and the World Bank once promoted as the "trickle-down effect" in development economics. In this case wealth did not trickle down,

[43] Reinert, Erik S. and Rainer Kattel, "The Qualitative Shift in European Integration: Towards Permanent Wage Pressures and a 'Latin-Americanization' of Europe?" *Praxis Working Papers* No. 17, Praxis Foundation, Estonia, 2004. Downloadable at: https://ideas.repec.org/p/pra/mprapa/47909.html & by the same authors "European Eastern Enlargement as Europe's Attempted Economic Suicide." *The Other Canon Foundation and Tallinn University of Technology Working Papers in Technology Governance and Economic Dynamics* No. 14, 2007. http://technologygovernance.eu/eng/the_core_faculty/working_papers/

[44] Endresen, Sylvi, *Technological Retrogression*, London, Anthem, forthcoming 2021.

instead a reduction of real wages in the wealthy countries trickles down – via migration to lift the wages in poor countries in what clearly is not a positive-sum game.

6. Beggar-thy-neighbor in a novel fashion: imposing overvalued exchange rates as an economic policy

The term beggar-thy-neighbor refers to policies that a country enacts to favor its own economy in ways that, in turn, actually worsen the economic problems of other countries. The impact of such policies may make "a beggar" out of neighboring countries.

One typical example would be devaluations in countries that are not really under heavy pressure in order to increase their "competitiveness". Sweden had several devaluations starting in the late 1970s that would – at least according to neighboring Finland at the time – fit the term beggar-thy-neighbor, particularly because the two countries were competing internationally in many of the same industries, such as paper.

The European Union brought with it a new form of beggar-thy-neighbor policies – which in my definition also fits the term rent-seeking – by creating a system that overvalues the exchange-rates of other countries. The effect is similar to the examples above, with the difference that in this case the strong country – instead of devaluing its own currency – manages to increase the value of other nations' currencies.

We saw the first sign of this during the German reunification, the *Wiedervereinigung*. At the time of the 1990 monetary unification of East and West Germany, the value of the currency of the two countries – both called Mark – had drifted apart. At the time the market exchange rate was as low as 4,3 Ostmark to one Westmark, and the black market rates were much higher in favor of the Westmark. In spite of this many items, such as savings, were converted at the rate of 2 Ostmark to 1 Westmark. This favored the savings of the East Germans. However, running wages were converted at an exchange rate of 1 to 1. This of course gave an initial burst of increased purchasing power in the East, but – in spite of probably being the most high-tech of the Soviet Block – and in spite of some large industrial relocations eastward, the technologically inferior East German industry could not survive the cost shock. In spite of Germany doing all the right things in terms of building infrastructure, production – and with it, people – moved to the West. It might be argued that keeping wages high in East Germany would prevent migration to West Germany. In effect this policy might have slowed migration a bit, but definitely making migration much stronger in the medium term than it would have been using a more realistic exchange rate. The destructive long-term effects of an over-valued currency were soon obvious, but still the same mistake was systematically repeated in the EU.

At the end of section 2 I explained how – as a result of political pressures – countries in Southern Europe had developed high inflation economies. When this kind of inflationary pressures becomes part of the system it is virtually impossible to stop it overnight. Part of this story is also that the Euro originally was intended only for the strong currencies of the European Union, such as the German Mark and the Dutch Guilder. It is said that German chancellor Helmuth Kohl – who was also in power during the *Wiedervereinigung* exchange rate policy with East Germany – when travelling back from a meeting in Maastricht, decided also to do the countries in the poorer periphery in Europa "a favor" by including them in the Euro. As with the East German wages, the initial reaction was positive. The high-inflation countries benefitted short-term from low interest rates, but as the underlying inflationary pressures continued, the countries in what to the European Union later became "the irresponsible South" saw their manufacturing industries losing out due to the wage drift that could not be stopped instantly. The basic mechanism had been the same as the one that came to destroy much of the industry in former East Germany: German rent-seeking improving its own "competitiveness" by creating mechanisms overvaluing the currencies of other nations.

In a second round of events, the Southern EU periphery saw debts, and the costs of servicing those debts, growing fast. This situation recalls a term describing the situation of Germany in the 1920s and 1930s: Greece and Italy are being forced into *Zinsknechtschaft*, or "debt serfdom". Having unlearned Keynes' "paradox of saving", the European Union now forces budget savings in Italy than can only further the shrinking of the economy.[45] The disastrous consequences of the Covid 19 in Italy can be partly explained by the brutal savings forced on Italy under neoliberalism. The governments of Berlusconi and Monti cut the health budgets by 25 Billion Euro between 2010 and 2015, while other governments cut another 15 Billion between 2015 and 2019.[46] The German health budget per capita is now almost the double of that of Italy.

7. Separating the real economy from the financial economy

Journalists coming home from abroad with reports based on their conversations with local taxi drivers is an old joke. A couple of years ago, on a job for the EU research center (JRC) in Seville, I had a very interesting talk on the way from the Seville airport to the hotel. On a very general question from me, the driver – who did not know I was an economist – started to paint a broad picture of what was going on in the Spanish economy: "You see", he said, "The European Central Bank under Mario Draghi is printing a lot of money, and this money is invested in assets like apartments" [he did not use the term "asset-price inflation", but that was really what he referred to]. "This makes it impossible for normal people like myself to afford buying an apartment. In addition to that", he said, "while the rent of an apartment goes up with the price of apartments, real wages for people like myself are shrinking. So we are in a doble squeeze". Austerity for the poor and helicopter money accurately aimed at the rich have been the 21st century approach to solving economic crises.

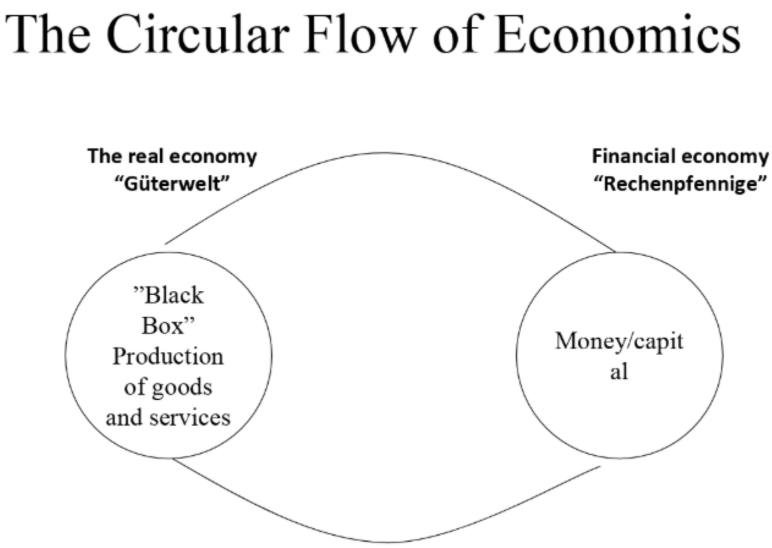
A key element in Western culture has been the prevention of hoarding. In other words, making sure money was circulating, not idle. The biblical term for idle money is *mammon*. We find a clear expression of this principle in the Bible (Mathew 25; 14-30), where servants are given money (*talents*), and, later, the servant who has simply buried the money – instead of putting it in circulation – is severely punished. Below we shall see how 14th century monetary theorist Nicolas Oresme testifies to the importance of keeping money in circulation in order for the real economy – and the very process of life – to keep going. We also find this issue raised by Martin Luther (1483-1546), whose measure of good and bad was "does it serve life?". Luther lived in a time where a lot of money was buried in the ground instead of being in

[45] Kregel, Jan, "Growth and the Single Currency", 2018, pp. 55-73 in the following http://documenti.camera.it/leg18/resoconti/commissioni/stenografici/pdf/14c14/audiz2/audizione/2018/09/25/leg.18.stencomm.data20180925.U1.com14c14.audiz2.audizione.0003.pdf (in English)
[46] See my article https://www.lafionda.org/2020/05/19/litalia-e-il-coronavirus/

circulation.[47] In the US tradition we find this focus on *the process of life* in John Dewey, and in economics with Thorstein Veblen and Clarence Ayres.[48]

Continental European economics has always continued this in a sense Biblical separation of the *financial economy* from the *real economy*. We find this from Marx (in volume 3 of Das Kapital) on the left of the political axis to the conservative Schumpeter on the right. Figure 7 below renders Schumpeter's idea of separating the *money* (Rechenpfennige/accounting units) from what you can buy for money in the *real economy* (Güterwelt, the world of goods and services).

Figure 7 Separating the Real Economy in a Schumpeterian fashion, Güterwelt = the world of goods (and services), Rechenpfennige = accounting units. The EU solution to the financial crisis has been to create more "accounting units", inflating the size of the financial sector, but – through austerity – preventing these newly created accounting units from reaching the real economy in the form of increased demand for goods and services. In this way the financial economy goes from working in symbiosis with the real economy into being a parasite decreasing the size of the real economy.



In good times the financial economy serves as scaffolding for the real economy, as a bridge in time as Keynes put it. If allowed to grow in ways that do not positively impact the real economy – by making money on money without going through production in the real economy – the financial sector will become like a parasite which grows at the expense of the real economy.[49] Since the times of Hammurabi, 1.500 BC, societies which survived have

[47] See Rössner, Philipp Robinson, "Burying Money. The Monetary Origins of Luther's Reformation", *The Other Canon Foundation and Tallinn University of Technology Working Papers in Technology Governance and Economic Dynamics*, No. 54, 2013.

[48] Both of these great pioneers [John Dewey and Thorstein Veblen] recognized this process as (in Veblen's words) "'the life process' of mankind, a process that runs in unbroken continuity through the activities of all societies and has the same meaning for all, so that a good charitable bequest, or a good peace treaty, or a good system of regulation of the flights of airplanes, is good in exactly the same sense that a cave man's striking stone was good: good in the sense of bringing home the bacon" in Ayres, Clemence E, *Toward a reasonable Society. The Values of Industrial Civilization,* Austin, University of Texas Press, 1961, p. 29.

[49] Hudson, Michael, *Killing the Host: How Financial Parasites and Debt Bondage Destroy the Global Economy,* New York, Perseus Books Group, 2015.

managed to cancel unpayable debt.[50] Bankruptcy, like bookkeeping, was a necessary invention in the early centuries of capitalism. At the moment the combination of printing new money, which are assets in the financial sector but liabilities in the real economy,[51] coupled with austerity in the real economy appears to be producing the situation Lenin looked forward to: the last stage of capitalism will be when financial capital takes the reign. Presumably because the real economy will collapse under the weight of debt and underconsumption.

With a single-minded focus on preventing inflation – at all costs – Mario Draghi was elected head of the European Central Bank for an eight-year period, from 2011 to 2019. Interestingly enough, Mario Draghi himself had issued a written warning against monetary power coming into the hands of the wrong people in a process resembling rent-seeking:

> "The currency…is one of those precious institutions which may become malignant if used to the advantage of organized groups".[52]

This is an exact description of what happened to the Euro in the hands of Mario Draghi: the currency is used to the advantage of the financial sector – *of high finance* – in the disfavor of the real economy. German fear of inflation and that country's obvious short-term benefits from the present frozen exchange rates increase the power of the financial sector. What is now taking place is financial hoarding on a large scale, huge amounts of money are essentially out of circulation in the real economy. It is time to go back and read Nicolas Oresme and Martin Luther on the subject of hoarding.

In practice Draghi's Quantitative Easing ends up being the opposite of Keynesianism – creating money instead of creating jobs – and it is surprising that this ideological turnaround has not created more political discussions than it has. To the extent that the problem at hand is one of too low inflation, this could have been solved by increasing wages in a systematic way, e.g. parallelly inside the European Union. This would have been a Keynesian version of Ben Bernanke's "helicopter money" because it would have been distributed widely, and as purchasing power rather than as *mammon.*

Quantitative Easing is part of the new logic of Supply Side economics, and at odds with pre-Cold War understandings of the relationship between capital and production. Supply-side economics brought back what Schumpeter had labelled "the pedestrian view that it is capital per se which propels the capitalist engine".[53] This theory justified tax cuts for the rich – the 1 per cent – as an engine of growth, whereas what actually happened was that the concurrent destruction of demand among the rest (the 99 per cent) killed off investment and led the rich to seek revenue in what was often financial speculation: instead of making money from the production of goods and services, increasingly money was being made in schemes that never left the financial sector.

---

[50] See my article "Mechanisms of Financial Crises in Growth and Collapse: Hammurabi, Schumpeter, Perez, and Minsky", in *Jornal Ekonomi Malaysia*, No. 46 (1) (2012), pp. 85-100, and *The Other Canon Foundation and Tallinn University of Technology Working Papers in Technology Governance and Economic Dynamics*, No 39, 2012.

[51] This is one of the basic principles of double entry bookkeeping, a system which macroeconomists rarely study.

[52] Draghi writes this in reference to economist and first President of Italy, Luigi Einaudi: "La moneta, nella sua visione (i.e. Einaudi's), è una di quelle istituzioni preziose che possono però divenire perniciose se usate a vantaggio di gruppi organizzati", Draghi, Mario 'Prefazione', in Gigliobianco, Alfredo, *Luigi Einaudi: Libertà economica e coesione sociale,* Collana Historica della Banca d'Italia, Bari, Laterza, 2011, p. vii.

[53] Schumpeter, Joseph*, History of Economic Analysis,* New York, Oxford University Press, 1954, p. 468.

The same type of propaganda that during the Reagan years gave us “trickle-down economics”, over the last ten years or so has been re-incarnated in the term “job creator”. Meaning that anyone with funds – be they productively employed or unproductive *mammon* – has come to be seen as a *job creator*.

But, *cui bono?* – who benefits from the present crises? The answers are very clear: The major beneficiary of the crisis is the financial sector, which is growing far too big also according to IMF.[54] When the financial sector is allowed to print money, they in effect print debt. What is on the asset side of the balance sheets of the banks is on the liability side of the balance sheets of the real economy. When bankruptcies – as the one that obviously should have happened in Greece – are no longer permitted, the financial sector becomes a parasite shrinking the size of the real economy: wages and consumption.

In the real economy, the only short-term beneficiary is Germany and to some degree Holland, which get to keep their manufacturing sector. On the other hand, this advantage is shrinking as the purchasing power in the rest of the EU – important customers for Germany and Holland – is shrinking. Henry Ford’s idea that one’s customers should be given more purchasing power is another casualty of Cold War economics. The whole concept of austerity has become a tool for financial hoarding, rather than for creating markets for production capitalists.

Since financial capital was criticized by the wrong people in the 1930s, a deeper discussion of the separation between financial capital and production capital raises some uncomfortable issues. In these times of the Corona virus, perhaps we should have monetary theorist Nicholas Oresme (1320-1382) have the last word as regards the conflict between hoarding and human well-being. His worry is that money – in those days gold and silver – would be withdrawn from circulation:

> “And therefore so much of them ought not to be allowed to be applied to other uses that there should not be enough left for money. It was this consideration that led Theodoric, king of Italy [493-526[55]], to order the gold and silver deposited according to pagan custom in the tombs, to be removed and used for coining for the public profit, saying: *‘It was a crime to leave hidden among the dead and useless, what would keep the living alive’*.”[56]

Author contact: eriksreinert@gmail.com

SUGGESTED CITATION:
Reinert, Erik S. (2020) “The inequalities that could not happen: what the Cold War did to economics.” *real-world economics review*, issue no. 92, 29 June, pp. 186-206, http://www.paecon.net/PAEReview/issue92/Reinert92.pdf

You may post and read comments on this paper at https://rwer.wordpress.com/comments-on-rwer-issue-no-92/

[54] http://www.ft.com/cms/s/0/4b70ee3a-f88c-11e4-8e16-00144feab7de.html
[55] Years added by this author.
[56] Oresme, Nicolas, *De Moneta*, 1356.