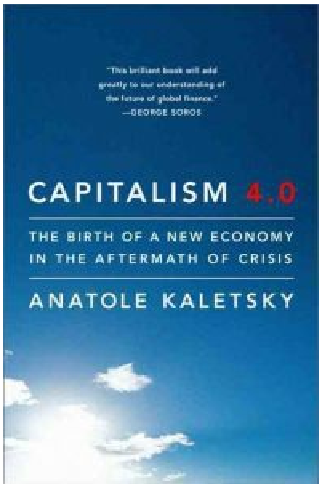

Book Capitalism 4.0

The Birth of a New Economy in the Aftermath of Crisis

Anatole Kaletsky
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Recommendation

Capitalism is dead; long live capitalism. That's the central tenet of veteran business journalist Anatole Kaletsky's instructive, perceptive tome. Global capitalism has served humanity pretty well over the centuries, and it has survived by changing with the times. The aftermath of the 2008 financial crisis and the near collapse of the world's financial system demand a major revamp of free market thinking. The new version, which Kaletsky posits as the fourth in capitalism's history, will take its lessons from the past and adapt them to harness market forces in the 21st century. *BooksInShort* recommends his thorough recap of what's happened and his vision of what probably will happen – including economic recovery – to all those looking for a cogent handle on the economic future.

Take-Aways

- Global capitalism is a fluid, adaptable system that best serves the world's economies.
- To respond to the 2008 crisis, capitalism needs to assume a new face: "Capitalism 4.0."
- Three distinct phases mark capitalism's 200-year history:
- Laissez-faire "Capitalism 1.0" began in the mercantilist 18th century.
- Government intervention during the Great Depression started "Capitalism 2.0."
- High inflation and the "Thatcher-Reagan revolution" led to "Capitalism 3.0," which collapsed with the Lehman Brothers bankruptcy in 2008.
- In 1989, cyclical trends meshed with historic, groundbreaking events to foreshadow the economic problems of 2008.
- Belief in free markets' power to self-correct led George W. Bush's administration to make strategic errors that nearly destroyed the world's financial system.
- Capitalism 4.0 will emerge as a melding of market economics with a judicious dose of government involvement.
- Capitalism's next iteration will call for adapting to changing environments and issues, and mixing the public and private sectors in working partnerships.

Summary

Inflection Point

The 2008 financial crisis didn't destroy capitalism, as many predicted. But it did destroy an economic way of thinking that had reigned for 30 years: the blind adherence to the theories of free, rational and self-regulating markets. The traumas following Lehman Brothers' bankruptcy on September 15, 2008, earth-shattering as they were, built the foundations for a new capitalist structure. The commercial system that economists broadly defined as capitalism has endured for more than two centuries, but it has changed over time, fluidly adapting to political, economic, and social needs and events. In those 200 years, capitalism passed through three major iterations. The woes of 2008 were the catalyst for the latest version, "Capitalism 4.0." This new variation renounces the belief that markets are always right and embraces the concept that government has an important role in economic life. The 2008 crisis demonstrated that political policy and economics must work together to ensure capitalism's survival and the growth of the world's economy. Capitalism 4.0 posits that the world is too complex and the future is too uncertain to leave matters up to abstract mathematical models and unyielding theories. Instead, in the coming years, "global capitalism will be replaced by nothing other than global capitalism."

"The Arrow and the Ring"

History may record 2010 as the beginning of the 21st century, just as the upheaval of World War I marked the actual start of the 20th and Napoléon Bonaparte's defeat at Waterloo in 1815 demarcated the 19th. Capitalism is a modern concept, but its roots derive from humanity's primordial aspirations to achieve, expand and conquer. Capitalism changes at major "inflection points," reinventing itself in relation to the "arrow of technological progress," which shoots the system forward through repeating circular boom-and-bust cycles. The historical "Ages of Capitalism" are:

"Capitalism 1.0" (1776-1932)

Existing notions of "the main organizing principles of economic life" coalesced in 1776 with the publication of Adam Smith's *The Wealth of Nations*. Smith's "invisible hand" theory explained the compelling efficiency of a market economy and predated by only months America's Declaration of Independence, a document that created "the first self-consciously capitalistic nation." By the time of the Battle of Waterloo in 1815, "imperialist capitalism" had spread to Europe and its colonies. Capitalism 1.0's steering principle was laissez-faire, the conviction that government should stay out of business and let free trade and free markets guide economic progress. Governments did intrude by setting protectionist trade policies and tariffs, but economists saw such incursions as temporary obstacles on the path to liberalized commerce. Marxism – capitalism's opponent and polar opposite – agreed that government should have no hand in controlling finance or creating jobs. Mercantilism boomed in the latter 1800s, but income inequities and injustices led to violent protests by anarchists and socialists after World War I. Increasing democratic sentiment, fed by voting rights and the rise of labor unions, signaled the beginning of the end of this era.

"Capitalism 2.0" (1931-1980)

The 1930s' Great Depression marked a radical change in political and economic thought. John Maynard Keynes' 1936 *General Theory of Employment, Interest and Money* became the touchstone for capitalism's next phase. To survive, capitalism had to redress its egregious inequalities and embody democratic values in the face of Nazism and fascism. Ironically, Nazi Germany resurrected its economy using Keynes' prescriptions (which Britain ignored, to its detriment). Capitalism 2.0's overriding feature was its recognition that unfettered capitalism was inherently harmful, so electing "benign and competent governments" to administer economic development was crucial to eliminating "the inevitable chaos of free markets." Keynesian economics reached its height from 1946 to 1969, "the most successful period of economic management, in terms of living standards, technological progress and financial stability, in the history of the world."

> "Capitalism 4.0 will demand new financial systems that will improve economic stability without sacrificing the main benefits of financial freedom and innovation."

All good things come to an end, and so did Capitalism 2.0. Massive U.S. spending on the Vietnam War and President Lyndon Johnson's Great Society, as well as inflation and terrorism in Europe, added to growing financial pressures. In 1971, the U.S. detached the dollar's value from gold, sundering the global monetary system instituted after WW II. Oil prices soared during the 1973 Arab oil embargo, and the resulting high unemployment and inflation plunged economies into "stagflation" for most of the '70s. Again, capitalism had to reinvent itself to survive.

"Capitalism 3.0" (1979-2008)

The "Thatcher-Reagan political revolution" responded to growing disenchantment with big government, massive spending and intervention in their economic lives. Monetarism, as espoused by Milton Friedman and the University of Chicago economists, provided the economic counterpart to the Thatcher-Reagan revolt, declaring that free markets would always do a better job of maintaining full employment and economic equilibrium than the state. The horrendous inflation of the 1970s was proof, said the monetarists, of government's inability to manage economies, thus spelling the ignominious decline of "Keynesian capitalism." Yet inflation was an indicator of, not the reason for, the Keynesian view's collapse. Inflation escalated in the face of a new cohort of demanding workers – now at a greater remove from the Great Depression's job losses – and of business owners confident in the state's perpetual willingness to print money to accommodate growing wages and full employment. The only way to stop inflation was to let unemployment rise and to remove government from the economy. This "market fundamentalism," the certainty that markets are right and the government is wrong, peaked and ended in 2008 under President George W. Bush and Federal Reserve Chair Alan Greenspan.

The Road to Capitalism 4.0

In 1989, five major transformations acted as the arrows of progress aimed inexorably toward the 2008 crisis:

1. The Berlin Wall came down, and with it, communist ideology fell, too. The impact extended far beyond Eastern Europe and the Soviet Union; countries as disparate as China, India and South Africa realized the failures of their centrally planned economies.
2. Asia – notably China – surged to become integral to the world's economy. The Chinese economic changeover that started in the late '70s began to bear fruit in the late '80s.
3. In 1989, Tim Berners-Lee drafted his proposal for a World Wide Web. The ensuing "technological revolution" cut communication costs to virtually nothing.
4. After the Cold War, governments began to slash defense budgets. Unlike prior generations of prudent savers, people spent their "peace dividend."
5. The "demystification of money," which began in 1971 with a fiat U.S. dollar, was complete by 1989, when Europe first invented the concept of the euro, a currency that would be backed solely by the participating states' economic standing.

> "Black-and-white dividing lines between the responsibilities of government and business will be turned into shades of grey."

These seemingly dissimilar events coalesced into four "megatrends":

2. Globalization grew, boosting trade, manufacturing, productivity and communications.
3. "The Great Moderation" led to 20 years of steadily growing world economies.
4. Economic stability, capitalist propensities and massive Asia-generated savings led bankers to lend more freely to borrowers who no longer feared unemployment and financial breakdown.

> "Recurrent booms and busts have shaken capitalism since its inception."

These trends, notably free lending, foreshadowed the "ring of repetition," the cyclical boom-bust inherent in economies and all human endeavors. But the Great Moderation's longevity led many observers to ask if these modern transformations and trends meant that fiscal cycles were antiquated and basic fundamentals had changed. A growing sense that economic rules were suspended fed increasing debt, greater financial product innovation, rising property values and growing household wealth. "Ambition" and "greed" replaced "prudence" and "fear." The impetus moving businesses and people forward needs the braking power of boom-and-bust cycles to halt excess risk taking and bring economies back into equilibrium. To change and progress, capitalism depends on those two forces, cycles of growth and decline, the "yin and yang" of economics.

"Market Fundamentalism Self-Destructs"

Despite the buildup of borrowing, outlandish securities and real estate values leading into 2008, one person's decisions turned a relatively serious but controllable crisis into a global would-be death spiral. U.S. Treasury Secretary Henry Paulson and other officials shared a blind faith in the markets' ability to right themselves, and an equally strong conviction that government shouldn't interfere in this natural process. That belief in market fundamentalism led Paulson to seize Fannie Mae and Freddie Mac on September 7, 2008, in order to resolve conservatives' long-simmering animosity toward their "hybrid public-private status." The move led to "shock and awe" among global shareholders, who saw their investments in Fannie and Freddie (some made just months before the seizure) suddenly evaporate. The "rescue" frightened the global investing community, including sovereign wealth funds that had already poured billions into propping up ailing U.S. banks. The move cut off the banks' ability to raise new capital and gave bank stock short sellers the go-ahead to subject shares to arbitrage. Paulson's takeover signaled to the market that a bank could expect to survive only via a government bailout.

> "Nothing about this new version of the capitalist system will be rational or perfectly efficient or eternally balanced. The future will always be unpredictable and ambiguous and inconsistent – just like human life. But this is what Capitalism 4.0 is about."

A week later, Lehman, struggling under speculators' pressures and the loss of potential international white knights, faced insolvency. Paulson, fresh from his Fannie and Freddie "triumph," chose not to support Lehman, forcing it into bankruptcy. The aftereffects were swift: Interbank credit halted, investors sold the market and AIG hit the brink. Despite the Bush administration's refusal to save Lehman, two days later it found $85 billion to rescue AIG. But the onslaught continued; speculators attacked the remaining banks, betting that "the next would fall like a domino." However, exotic mortgages and greedy bankers didn't cause the near death of the U.S. financial system; it was the last gasp of a dying philosophy that believed markets would beat the public sector. World governments quickly approved massive rescue packages for their banks. Chastened, the Bush administration pushed for the $700 billion Troubled Assets Relief Program, a dramatic government economic intervention.

The Economics of Capitalism 4.0

To apply Capitalism 4.0, national economies must accept three major concepts: 1) Market economies are always changing; 2) the public-private relationship must be "symbiotic, not mutually exclusive"; and 3) the actions of people and markets are intrinsically unforeseeable. Already, "Imperfect Knowledge Economics," which eschews rational, efficient market theories to focus mathematically on uncertainty in human behavior, is deriving more real-world conclusions than its more formulaic predecessors. Capitalism 4.0 ushers in "an adaptive mixed economy" – adaptive, in that it flexibly will alter its structures, rules and thinking to respond to changing developments; and mixed, in that it will unite state and private interests to allow free and controlled markets to exist at the same time. That is, government will exercise more control over the financial industry because banking's outcomes are inherently uncertain and require oversight. Similarly, societies cannot make decisions about energy independence and climate change, for example, solely on market terms. Critics of state influence maintain:

- **Government spending burdens future generations** – It does not. If capitalism works as usual, they will have the resources and time to solve debt problems.
- **Stimulus does not create jobs** – It does, given unused capacity and labor.
- **The U.S. will go broke** – It can't; it represents its citizens' combined work and wealth.

> "Four words even more expensive and foolish than 'This time it's different' are 'Everything's always the same'."

Already the economy has bounced out of recession, and the only variables that could stall the recovery are rising interest rates (unlikely while there is an "output gap," that is, a difference between real and potential economic activity), inflation (doubtful in the foreseeable future) and a U.S. dollar freefall (not while it is the world's reserve currency). The future will always remain unknowable, but capitalism, like people, will find a way to adjust to whatever changes unfold.

About the Author

Anatole Kaletsky, a veteran financial journalist, is editor at large for *The Times* (of London) and has written for *The Economist* and the *Financial Times*.