

## Chapter 2

# The Post-War Economic Order

*I believe that we should make available to peace-loving peoples the benefits of our store of technical knowledge in order to help them realize their aspirations for a better life.*

Inaugural speech of President Truman, 1949

*Idleness is not the same as Want, but a separate evil, which men do not escape by having an income. They must also have the chance of rendering useful service and feeling that they are doing so. This means that employment is not wanted for the sake of employment, irrespective of what it produces.*

William Henry Beveridge, *Full Employment in a Free Society*

By mid 1943 the tide of war had turned against the Germans. The Russians had started their counterattack and soon were near Kiev in Ukraine. By the fall of that year Mussolini was deposed and American troops landed in Italy. Perhaps a sane person would have surrendered. The Allies now could look forward to the end of the war and the kind of world that would emerge although planning for the post-war economic environment had started as early as 1942 in the United States and England. In both countries the planners—Harry Dexter White in the United States and John Maynard Keynes in England—were at work to come up with arrangements and innovations that would prevent a repeat of the 1930s. Their efforts culminated in the Bretton Woods Conference of 1944, and both can be considered as architects of the post-War international economic order.

No doubt the Great Depression and the War had scarred the world and had changed both the economic landscape and the outlook of nations and governments on world affairs. Post War realities as well as people's expectations demanded new economic arrangements and policies both domestically and in international relations.

Domestically, the time of minimal government and hands off business and the economy was over. Governments were held responsible for the smooth functioning of the economy and the economic well being of their citizens. Furthermore, at the time of war everyone had made sacrifices; the rich did not sacrifice more because they had more. Thus, during peacetime everyone was entitled to share more equally. One group should not monopolize the resources and enjoyment during the peace and ask everyone to sacrifice during war. The welfare state was born.

Internationally the old monetary system had failed and there was no reason to revive it. Yet, the world economic powers did not have the courage to design a completely new system and decided on a more flexible version of the gold standard. But the follies of the beggar-thy-neighbor policies were obvious, and efforts were made to liberalize international trade.

What completed the international scene was the confrontation between the United States and Western Europe—the free world of capitalism and democracy—and the Soviet Union and its satellites representing socialism or, more aptly, state capitalism and dictatorship. The old enemies had been vanquished, but new enemies had emerged.

The United States had emerged as the dominant power, and the old world of European powers had crumbled. Worse, Europe was economically devastated and needed help to get back on its feet. On the other hand, while during the War the Soviet Union had been an ally and Joseph Stalin had been nicknamed “Uncle Joe,” few in positions of power in the West had any illusions about the nature of the Soviet system. A confrontation between the free world and the Soviet Union was expected once the war was over. If anyone had any doubts, Stalin’s behavior after the War disabused them of any hope for a change in the nature of the oppressive regime in the Soviet Union.

The age of colonialism was over and many countries were struggling for independence and would soon achieve it. The confrontation with the Soviet Union could be fought in any region in the world. In particular, the poor countries, some of them newly independent, were susceptible to communist propaganda and agitation. The United States as the leader of the free world felt an obligation to help the poor countries both as a moral obligation and as a strategic instrument in the confrontation of the free world against the Soviet Union.

A new age had started, and both the domestic scene in the United States and the international economic order would undergo drastic change.

## The G.I. Bill

On June 22, 1944 President Roosevelt signed into law the Servicemen’s Readjustment Act of 1944, which became known as the G.I. Bill.<sup>1</sup> It provided, authorized, and funded benefits for returning veterans (specifically those who had served from September 16, 1940 to the end of the War) in four areas: health, education, housing, and employment.

It provided for the health care of veterans and allocated \$500 million for the construction of additional hospitals.

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<sup>1</sup>It was “An Act to provide Federal Government aid for the readjustment in civilian life of returning World War II veterans.” Thus, it is called The Servicemen’s Readjustment Act of 1944. A good read on the subject is *Over Here: How the G.I. Bill Transformed the American Dream* by Edward Humes, 2006.

But perhaps the most important aspect of the bill and the provision for which it is best known was in the area of education. The federal government would pay university tuition, fees, and costs of books of veterans up to \$500 per year and pay for their living expenses of \$50 per month for those without dependents and \$75 for those with dependents.

The Bill also authorized the Administrator of Veterans Affairs to guarantee 50% of loans for the purchase or construction of homes, farms, and businesses up to \$2000. This may seem like a small amount compared with present day housing prices but indeed enabled many veterans to buy homes.<sup>2</sup>

Finally, it provided for job counseling and unemployment benefits for returning veterans.

The impetus for the bill may have been the prevention of the sorry experience of World War I veterans (see Chap. 1). It also reflected the changed attitude toward the role of government in a democratic society. Whatever the motive, the G.I. Bill had a great impact on American society. Up to World War II, higher education was generally, although not exclusively, available to upper class youth. The G.I. Bill changed that and opened the door of universities and colleges to sons and daughters of all strata of the society. In this respect it is noteworthy that the Bill did not confine its provisions to men or whites; it was for all veterans including women and blacks. One consequence of the bill was to foster the expansion of universities; another was to open homeownership to many more families.

The importance of the G.I. Bill is that it made a big difference in the lives of several million veterans and transformed American society. But it also showed how the government could improve the lots of many and improve the distribution of resources without imposing undue regulations on the economy or interfering with the working of the free market.

In 1984 the G.I. Bill was updated so that later generations of veterans could receive home loan guarantees and help with their education. The new bill is known as Montgomery G.I. Bill after its sponsor congressman Gillespie Montgomery of Mississippi.

## **The Employment Act of 1946**

The Great Depression was an enormous shock to Americans. Many could not forget it many decades later and their behavior and psyche were affected by it. Immediately after the War, there was fear of the repeat of the Great Depression. The end of the War meant that government expenditures and purchases would be scaled back, while at the same time a large number of veterans would be discharged and return to civilian life. Thus, a huge additional labor supply would coincide with a decline in aggregate demand. The memory of recessions following World War I was still alive.

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<sup>2</sup>Based on data from the US Census Bureau, I estimated the median price of a house in the United States to be about \$2500 in 1940 and \$6250 in 1950.

Some economists, including Alvin Hansen, forwarded the *stagnation theory* based on which, in the long run, a capitalist system would tend toward stagnation. Some also forwarded *underconsumptionist* theories.

Many believed that the experience of the Great Depression should not be repeated. The loss of output and the loss of livelihood and dignity of the unemployed were too much to bear more than once. John Maynard Keynes had shown the way for avoiding another depression. The cause of depression was a lack of effective demand compared to the amount of aggregate supply that would be available with the full employment. The government could and should step in and by managing the aggregate demand prevent wild fluctuations in output and employment.

Proponents of government action used employment data contained in a book by former Vice President Henry Wallace<sup>3</sup> to document the depth of the problem during the Great Depression. Wallace had projected the labor force in the United States from 1900 to 1944. After subtracting the number of frictionally unemployed—that is, those moving between jobs whose unemployment is a condition for the smooth working of the labor market—he arrived at the number of jobs needed for full employment. A comparison of the estimated employment data with the projected number needed for full employment showed that a large number of Americans were unemployed during that period.<sup>4</sup>

That depression had to be avoided and the government had a duty to do so was not in dispute anymore. The question was how and to what extent the government should be involved in the economy. Is each individual entitled to have a job? How would that entitlement be achieved? At one extreme were those who considered

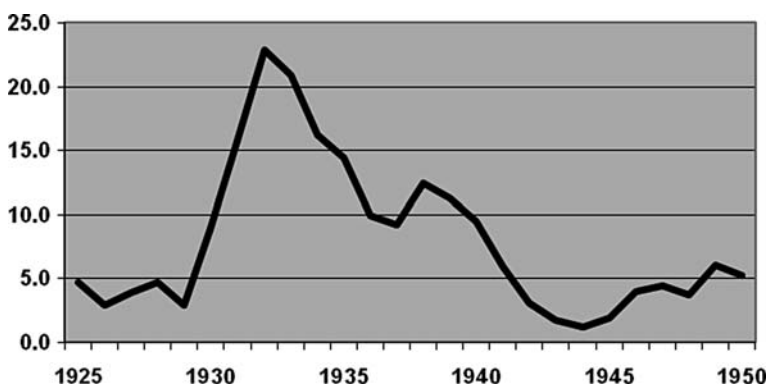


Fig. 2.1 Annual unemployment rate in the United States: 1925–1950

<sup>3</sup>Henry A. Wallace (1888–1965) was the Vice President during FDR's third term (1941–1945). He also served as FDR's Secretary of Agriculture and Secretary of Commerce. In 1948 Wallace ran as the presidential candidate of Progressive Party and lost to President Harry S. Truman.

<sup>4</sup>Henry Wallace, *Sixty Million Jobs* (1945). The general pattern of unemployment in Wallace's data resembles that shown in Fig. 2.1. The last year in Wallace's data was 1944.

employment a basic *right* and those who advocated some kind of planning. At the other were those who thought that government intervention in the economy ran opposite to American values. There had to be a compromise and the result was the Employment Act of 1946.

The sponsors of the Employment Act wanted the government to declare that all Americans were “entitled to an opportunity for useful, remunerative, regular, and full-time employment.” It was the duty of the government to provide continuous full employment in the economy and the tool would be government expenditures. Such a goal would have been unrealistic, unattainable and detrimental to the economy. Instead Sect. 2 of the act declared the federal government has the responsibility “to use all practical means . . . to promote maximum employment, production, and purchasing power.”<sup>5</sup>

The President was to transmit an Economic Report to Congress. It was to contain data on the condition of the economy, forecast of future trends, a review of the federal government’s economic program, and a program for carrying out the policy of maximum employment, production, and purchasing power.

Thus, in the post war era the government was to be held responsible for the employment and well being of its people. The era of minimal government, responsible only for internal and external security, had come to an end. This was not confined to America; indeed, the transformation of the role of government in the US was less drastic compared to European nations. The mid 1940s ushered in the welfare state in many European countries (see below).

In 1976 Senator Hubert Humphrey and Representative Augustus Hawkins sponsored a bill to revive the intents of the original Employment Act by recognizing the rights of all Americans to gainful employment. The end result was the Full Employment and Balanced Growth Act of 1978, which again did not recognize such a right.

## The Council of Economic Advisers

Section 4 of the Employment Act of 1946 created the Council of Economic Advisers (CEA) in order to “appraise programs and activities of the Government . . . and to formulate and recommend national economic policy to promote employment, production, and purchasing power under free competitive enterprise.” The Council would be composed of three individuals whose “training, experience, and attainments” made them “exceptionally qualified” for the job.

During the years many luminaries of the economics profession have served on the Council. They include two Nobel laureates (James Tobin and Joseph Stiglitz), three future Chairmen of the Board of Governors of the Federal Reserve (Arthur Burns, Alan Greenspan, and Ben Bernanke), and top economists (including among others Arthur Okun, Martin Feldstein, John Taylor, Alan Blinder, and Gregory Mankiw).

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<sup>5</sup>For a short history of the Employment Act and opposing views see G. J. Santoni (1986).

The CEA is charged with advising the President on economic matters and preparing an *Economic Report of the President*. This annual publication includes an assessment of the economic conditions of the country, economic policies of the government and their intended results, and a compendium of macroeconomic data tables.

As a part of the executive branch, the influence of the CEA and its economists depends on the views and attitudes of the President and their closeness to that of the CEA chairman and its staff. The Administration hasn't always heeded the advice of economists. Faced with policies they could not support, some have decided to keep quiet, some have returned to academia, and some like Martin Feldstein, the CEA chairman under President Reagan, have been outspoken.

It seems that the profile of the CEA rose during the early years of its operation. Its influence peaked in the early 1960s during the administrations of Presidents Kennedy and Johnson. After the 1970s and particularly in the past two decades its influence, with ebbs and flows, has waned. One reason may be the demise of the fixed exchange rates system in 1971 and the current system of flexible rates (see Chap. 6). In a fixed exchange regime monetary policy is ineffective as a counter-cyclical measure and fiscal policy is effective (see Chap. 5). In a system of flexible exchange rates, the situation is reversed and monetary policy is effective in avoiding recessions or at least ameliorating their effects while fiscal policy is less effective. Hence the prominence of monetary policy and the Federal Reserve System as the center of economic policy and the rising profile of the Fed's chairman.

## The Birth of the Welfare State

The New Deal ushered in many elements of the welfare state including the establishment of social security and unemployment insurance. Yet as a comprehensive state policy we may date, with no pretence of being precise, the birth of the modern welfare state<sup>6</sup> as 1942 and the submission of the Beveridge Report<sup>7</sup> in England. It called for a "comprehensive policy of social progress," and "An attack upon Want," "Disease, Ignorance, Squalor, and Idleness." The report called for a revolutionary approach to the problem of social security and a comprehensive program, not a piecemeal approach. Furthermore,

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<sup>6</sup>Here we speak of the modern welfare state. Welfare of citizens has been the concern of governments for many centuries. It is not difficult to find precedence for welfare measures in ancient China or other parts of the world. Here we are talking of a deliberate, comprehensive, and sustained policy of modern governments.

<sup>7</sup>The report is entitled *Social Insurance and Allied Services* and was prepared by a committee under the chairmanship of Sir William H. Beveridge. The members of the committee were drawn from different departments concerned with the well being of citizens including Home Office, Ministry of Labour and National Service, Ministry of Health, and Treasury. The report was submitted to the British Parliament in November 1942.

social security must be achieved by co-operation between the State and the individual. The State should offer security for services and contribution. The State in organizing security should not stifle incentive, opportunity, responsibility; in establishing a national minimum, it should leave room and encouragement for voluntary action by each individual to provide more than that minimum for himself and his family.

All modern governments are welfare states; the difference is the degree with which they interfere in the market to deliver services. Providing education, health care, unemployment compensation, insurance against catastrophic outcome, and taking care of citizens who could not take care of themselves have become normal duties of all governments. There is no reason to believe that one scheme of income distribution is better than the other. Nevertheless, we can argue that at least the starting point of life should be reasonably equal for all members of society regardless of their families' positions.

Over time the welfare state has had both its defenders and detractors. At times the phrase has been made into a code word for derision against government meddling in the economy. But the rationale for it remains persuasive. A glance at any society shows that there are those who have more than they even can keep account of and those who can hardly make ends meet. If we take some developing nations we even encounter people whose survival is at risk or barely survive with a dollar or two per day. Why is there such dispersion in income and wealth?

One can consider human society engaged in a vast economic game, which has its own rules and regulations. There will always be losers and winners because people are different. Human beings are not born equal; some are stronger, some more intelligent, and some more beautiful. Some work harder and some are lucky. Of course the starting points of players are not equal either. Some are born into rich families and some in dirt-poor environments. In the jargon of economics, the initial endowments are vastly different.

In nature the rule is the survival of the fittest; why shouldn't that apply to human society? Let the market determine the outcome and let us accept it as the best. Indeed, the fundamental theorem of welfare economics shows that once equilibrium is reached under the free market no one can be made better off unless someone else is made worse off (Pareto optimality). In other words, improving on market equilibrium requires interpersonal comparisons and value judgments. And it may be asked that "who are we to make value judgments?"

But there is more than one problem with the above argument. First, the rules of the game are human-made and there could be a different set of rules that would result in a less unequal distribution of income. Why is it that property rights should be enforced by the government? Let the market or the survival-of-the-fittest take care of that. Think of armed shareholders who may pay a visit to a bandit CEO's house who has helped himself to a great reward when the company shares have gone down.

The fact that initial endowments are not equal is also a consequence of human-made rules. Furthermore, Pareto optimality does not depend on initial distribution of wealth. For every distribution of initial wealth there is a different outcome, and every one of them is Pareto optimal. It is not true that there exists a value free initial

distribution of wealth. Acceptance of any initial distribution of wealth or rules of inheritance involves moral and value judgment.

But even if we accept the rules of the game still there are circumstances in which markets fail and the outcome is not optimal. These situations clearly call for intervention. These cases are extensively discussed in microeconomics and public economics and we need not elaborate here. Yet a great contribution of Keynes and Keynesian economics was to show that the free enterprise system might fail in the macro sense. It could fail to bring equilibrium at a level of employment that everyone willing and able to work can find gainful employment at market wages; hence, involuntary unemployment would occur.

The opponents of welfare state point to three problems. Welfare programs create vast bureaucracies, are fraught with waste, corruption, and fraud, interfere with efficient functioning of markets, and create an underclass of loafers who live out of handouts. The challenge of any government or any party advocating welfare for all is to come up with a mechanism to provide services without adverse effects. Thus, the question is not whether we should take care of our fellow citizens, but how.

Figures 2.2 and 2.3 show public and private social expenditures in the United States, Sweden, and the OECD.<sup>8</sup> Social expenditures include pension, unemployment benefits, health, education, and other benefits.

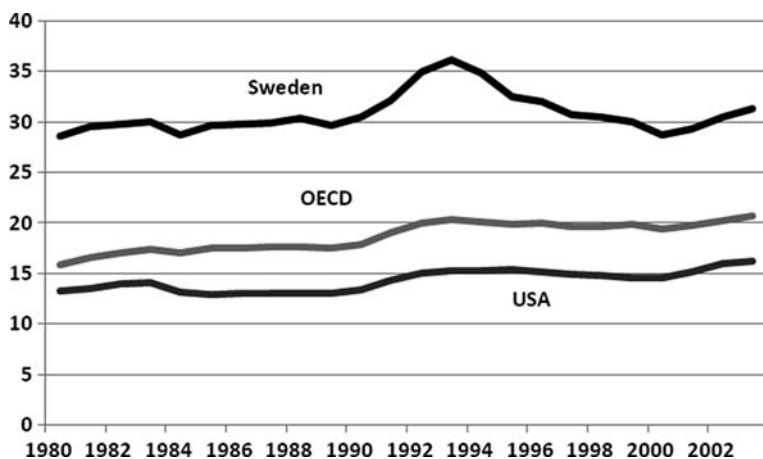


Fig. 2.2 Public social expenditures as a % of the GDP

<sup>8</sup>The Organization for Economic Co-Operation and Development was established in 1961 and presently has 30 members. They include Canada, the United States, Mexico, many European countries, Australia, Japan, and Korea. Member countries are committed to market economy and democracy.



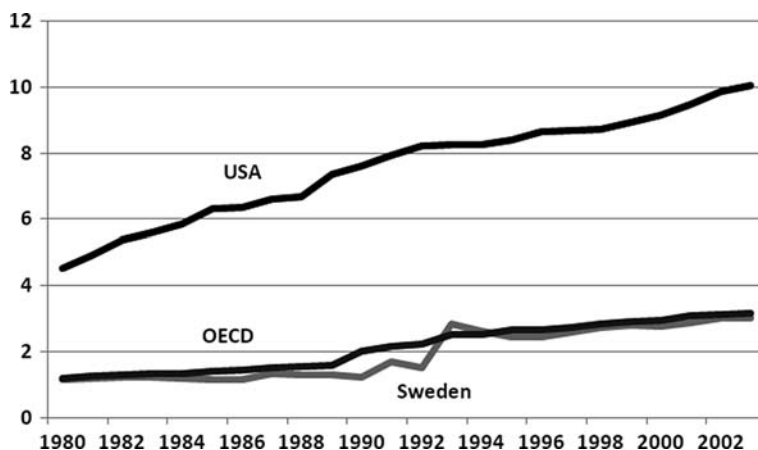


Fig. 2.3 Private social expenditures as a % of the GDP

## The Bretton Woods Agreement

On the international front, the most urgent issue was the restoration of a credible monetary system. Such a system was a prerequisite for the expansion of trade. The restrictive inter-war policies of beggar-thy-neighbor had brought losses to everyone and had to be avoided. It was also hoped that the system would help eliminate exchange controls. In July 1944, representatives of 44 countries gathered in the Mount Washington Hotel in Bretton Woods, New Hampshire, USA to forge the post-war international monetary order and exchange rates regime. The preparatory work had started long ago, and the United Kingdom and the United States had each brought a plan to the meetings.

The British plan, referred to as Keynes Plan after its principal author, called for an international clearing union with an international currency that could be used to settle the accounts between members. Members with surplus in their international balance would commit funds to the union and members with deficit in their international balance would use credit extended to them by the union. Such an overdraft facility would be in an international currency and in the books of the union. Needless to say, the plan favored the United Kingdom and other countries in similar position while putting the burden of footing the bills on the United States.

The American plan, referred to as the White Plan after its principal author Harry Dexter White,<sup>9</sup> called for the establishment of a fund. Members would subscribe

<sup>9</sup>Harry Dexter White (1892–1948) was a Harvard educated economist and a high ranking official in the US Department of Treasury. He was the principal architect of the Bretton Woods Agreement, the IMF, and the World Bank. White has been accused by several sources of being a Soviet spy. He died of a heart attack three days after testifying before the House Committee on Un-American Activities (he had had several heart attacks before that testimony).

gold and currency from which the fund would extend credit to members experiencing temporary deficit. The final Bretton Woods Agreement was principally based on the White Plan.

An international monetary system can be characterized by four main features: an international currency, how exchange rates are determined, a central authority to manage the system and if necessary back the currency, and a mechanism for correcting disequilibrium, i.e., eliminating chronic deficits or surpluses. For example, during the Gold Standard regime, gold was the international currency. By defining the gold content of their currencies each and every country determined its exchange rates with all other currencies. Thus, the ratio of the gold contents of every two currencies was equal to their exchange rate and, as long as the gold contents remained constant, the exchange rates were fixed. During the 19th and early years of 20th centuries Britain played the role of the central authority and through the Bank of England supervised the system. Small deficits and surpluses resulted in changes in the book entries in the Bank of England. The account of deficit countries would be debited and that of the surplus countries credited. Large imbalances would trigger shipments of gold between countries resulting in expansion or contraction of money supply in that country.

The Bretton Woods Agreement chose the gold-backed-dollar as its international currency. The value of the dollar was fixed in terms of gold at \$35 per ounce. Thus, while nominally gold was still the international currency, members had to express the par value of their currency in terms of gold or the dollar. Hence the international monetary system hammered out at the Bretton Woods conference was called the gold exchange standard.

The ratio of par values determined the exchange rates between currencies. For example, if the par value of the Swedish kronor was 5.2 per dollar and that of the Egyptian pound 0.44 per dollar, then the exchange rate between the kronor and the Egyptian pound would be 11.818 kronor per Egyptian pound or 0.085 Egyptian pounds per kronor. Thus, the exchange rates were fixed.

Furthermore, the members had to contain the fluctuations in the rate within 1% of the parity, which meant that in the most extreme case (one country being 1% above and the other 1% below parity) the exchange rates would be 2% above or below the fixed rates. Central banks were obligated to maintain dollar reserves and to maintain parity by intervening in the market, i.e., by buying or selling the dollar at the official rate.

Thus, the dollar became the international currency and the United States the financial center. The coordination mechanism was to work through the IMF (see below).

## **The International Monetary Fund (IMF)**

The IMF was officially established on December 27, 1945 and began operation on March 1, 1947. The membership was initially open to countries participating in

the Bretton Woods conference.<sup>10</sup> The par value of each nation’s currency would be determined in gold or the US dollar. The par values would determine the exchange rates between currencies. After such determination all trading between member states would be carried out on that basis (except for a prescribed trading margin). The working assets of the fund were contributed by the members. Each country had a quota, part of which was paid in gold and the rest in that country’s currency. The United States had the largest quota and the total working capital of the fund was expected to reach \$8.8 billion.

The members were entitled to borrow from the fund to cover temporary imbalances in their international transactions. But if a fundamental disequilibrium developed, the country, with the agreement of the IMF, could devalue its currency. Such arrangements were meant to avoid any devaluation “war” between countries.

As will be discussed in Chap. 6, in 1971 the United States severed the tie between the dollar and gold and effectively ended the Bretton Woods system. With the collapse of the Bretton Woods system in 1971, the IMF lost its *raison d’être*s and became another useless bureaucracy providing jobs for educated middle class individuals of different countries. Today it continues its existence and is still in search of a mission.

**The Bank for Reconstruction and Development (the World Bank)**

The Bretton Woods Agreement also envisioned the establishment of a bank for Reconstruction and Development. The genesis of the bank was a proposal by Harry Dexter White in 1942. At the beginning the bank was meant as a vehicle for financing the reconstruction of war-ravaged Europe. The idea of development was added later on—particularly at the insistence of developing countries with the acquiescence of White—while Keynes and the British were against it.

Data on World Bank loans (Table 2.1) confirms that in the early years the bank’s loans were extended to Europe and to a lesser extent Latin America, while Africa, Asia, and the Middle East received none. It is after 1950 that the bank paid attention to developing countries.

**Table 2.1** Distribution of world bank lending (%)

Region	1946–49	1950–59	1960–69	1970–79	1980–89	1990–95
Africa	0	15	12	14	15	15
Asia	0	38	40	38	43	37
Europe	81	20	12	12	9	16
Latin America	19	22	28	24	26	25
Middle East/North Africa	0	5	7	11	7	7

Source: *The World Bank, Its First Half Century*, by Kapur et al. (1997).

<sup>10</sup>The Soviet Union was one of the 44 countries participating in the conference, but it decided not to join the fund. Later on, nations other than the original 44 joined the fund.

The bank's capital would be raised from members' subscription. Part of each member's quota was to be paid within a year and the rest as needed. The bank would make loans from its own capital or by borrowing in the international financial markets. In addition the bank could guarantee a loan by a third party to a member country, thus reducing the risk and therefore the cost of the loan.

The World Bank's loans were made for specific projects and would only cover the foreign exchange portion of such projects. Each loan had to be guaranteed by the government of the receiving country. Over the years the bank's objectives have evolved. Nevertheless, in a world with disparity among countries and with problems of poverty, corruption, and AIDS, it has played an important role. Surely, it can play a more significant role in alleviating such problems as AIDS in Africa.

It was unfortunate that in recent years the Bank was embroiled in needless controversy. In 2005, President Bush nominated Paul Wolfowitz, deputy secretary of Defense to be the president of the World Bank. His appointment was controversial, and later he was embroiled in a controversy involving his relationship with a bank senior officer. It was alleged that he had granted her excessive salary raise. Fortunately that undignified episode is over. Wolfowitz resigned in 2007 and was succeeded by Robert Zoellick, who has brought calm and stability to the bank.

## General Agreement on Tariffs and Trade (GATT)

In 1947 a group of countries<sup>11</sup> signed an agreement to promote free trade by cutting tariffs and removing barriers to international trade. The pact which came to be known as the General Agreement on Tariffs and Trade (GATT) went into effect on January 1, 1948. The idea of free trade and its effects on growth and well being of nations have been debated for centuries among economists and politicians. There have been many who have thought that by closing the doors and avoiding imports or by following mercantilist policies a country could gain income and employment for their people. Such policies were tried after World War I in many countries including the United States as embodied in the Smoot-Hawley Act. The upshot was that everyone lost. If everyone follows a beggar-thy-neighbor policy, you end up with a neighborhood populated by beggars. The idea behind the GATT was to avoid the same mistakes.

The echo of the Great Depression and the influence of the Keynesian ideas is quite apparent in the preamble to GATT:

Recognizing that their relations in the field of trade and economic endeavour should be conducted with a view to raising standards of living, *ensuring full employment* and a large and steadily growing volume of real income and *effective demand*, developing the full use of the resources of the world and *expanding the production and exchange of goods*.

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<sup>11</sup>They included Australia, Belgium, Brazil, Burma, Canada, Ceylon, Chile, China, Cuba, Czechoslovakia, France, India, Lebanon, Luxemburg, the Netherlands, New Zealand, Norway, Pakistan, Rhodesia, Syria, South Africa, United Kingdom, and the United States.

Being desirous of contributing to these objectives by entering into reciprocal and mutually advantageous arrangements *directed to the substantial reduction of tariffs and other barriers to trade and to the elimination of discriminatory treatment in international commerce* [emphasis added].

While GATT has been less glamorous and talked about than either the IMF or the World Bank, it has been more enduring and more effective in promoting trade and growth in the world. The original agreement was followed by further talks<sup>12</sup> that resulted in further tariff reductions and the expansion of the agreement into other areas including services and patents.

In 1995 the World Trade Organization (WTO) was born, which currently has 153 members. WTO is the main organization for promoting international trade and resolving trade dispute between member countries.

## The Marshall Plan

World War II was over but Europe was devastated. Factories and roads had been destroyed, international commerce and trade had been disrupted, and industrial production was recovering at a very slow pace. To add to the misery there had been crop failures and bad harvest. There were shortages and hunger everywhere. It was not surprising that Europeans were discouraged, desperate, and angry. Perhaps nothing can illustrate the hopelessness of Europe better than neo-realist films made by the brilliant Italian directors Vittorio de Sica, Roberto Rossellini, and others.

On the horizon loomed the specter of a communist takeover of European countries. Some like Albania, Poland, Czechoslovakia, and others were already written off. But others such as Italy, Greece, France, and Austria were not safe. People in these countries were desperate and easy prey to communist propaganda. Up to the spring of 1947, the United States had provided credit and aid to Europe. Although substantial in sum, these had the nature of relief funds, and credits and loan had strings attached to them. The fact was that Europe needed long term growth and a hope for the future. The United States had the means to rescue Europe, and the Truman administration rose to the challenge.

Secretary of State George Marshall<sup>13</sup> announced the plan for the European recovery in his commencement speech at Harvard University on June 5, 1947. According to Marshall, Europe was in a critical situation because

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<sup>12</sup>Among the more famous ones are the Kennedy round (1962–1967), Tokyo round (1973–1979), Uruguay round (1986–1994), and the Doha round (2001–2008). The Doha round ended in failure. Negotiators from different countries gathered in Geneva Switzerland in July 2008. Despite extended discussion they could not reach an agreement. The sticky point was developing nations' demand to be able to impose temporary tariff barriers to control prices or block a surge in imports. On one side stood the United States and on the other China and India.

<sup>13</sup>General George C. Marshall (1880–1959) as the Chief of Staff of the United States Army (1939–1945) was instrumental in the Allies' victory in World War II. He served as Secretary of State (1947–1949) and Secretary of Defense (1950–1951) during the Truman administration. He was awarded the Nobel Peace Prize in 1953 to honor his "great work for the establishment of peace." During the ceremony in the University of Oslo, communists protested by shouting and throwing leaflets.

Long-standing commercial ties, private institutions, banks, insurance companies and shipping companies disappeared, through loss of capital, absorption through nationalization or by simple destruction. In many countries, confidence in local currency has been severely shaken. The breakdown of the business structure of Europe during the war was complete. . . . Raw materials and fuel are in short supply. Machinery is lacking or worn out. . . . Thus a very serious situation is rapidly developing which bodes no good for the world.

He added:

Europe's requirements for the next three or four years of foreign food and other essential products—principally from America—are so much greater than her present ability to pay that she must have substantial additional help, or face economic, social and political deterioration of a grave character.

The remedy lies in breaking the vicious circle and restoring the confidence of the European people in the economic future of their own countries and of Europe as a whole.

The consequences [of the crisis] to the economy of the United States should be apparent to all. It is logical that the United States should do whatever it is able to do to assist in the return of normal economic health in the world, without which there can be no political stability and no assured peace.

[G]overnments, political parties or groups which seek to perpetuate human misery in order to profit therefrom politically or otherwise will encounter the opposition of the United States.

It would be neither fitting nor efficacious for this Government to undertake to draw up unilaterally a program designed to place Europe on its feet economically. This is the business of the Europeans. The initiative, I think, must come from Europe. The role of this country should consist of friendly aid in the drafting of a European program and of later support of such a program so far as it may be practical for us to do so. The program should be a joint one, agreed to by a number, if not all European nations.

From its inception to 1952 when the Marshall Plan was ended, the United States spent about \$13 billion. Using the GDP deflator as a measure of price change and comparing 2006 to 1950 (the mid year of the Marshall Plan), the amount spent by the US is equivalent to \$92 billion in 2006 prices. Alternatively, \$13 billion was about 4.4% of the United States GDP in 1950. In 2006 4.4% of the US GDP was more than \$580 billion. Thus, the sum was substantial and required a real sacrifice by the US taxpayers.

The effect of the Marshall Plan on the recovery of Europe has been the subject of many inquiries. Some have argued that except for the first two years of the plan, the annual amount of the aid was small compared to the amount of domestic capital formation of the recipient countries. It is also said that European economies had already started on the path to growth when the Marshall Plan went into effect. Finally, some have emphasized the role of economic reforms in Europe, for instance, the German economic and monetary reform of 1948.

There can be no doubt, however, that the Marshall Plan played a crucial role in reviving the economies of Europe. Table 2.2 shows the amount of American aid as a percentage of domestic capital formation in four European countries.

It can be seen that the amount, particularly in the first years, was substantial. The \$13 billion dollars of aid helped to relax the foreign exchange constraint of the recipient countries and “thus solved the catch-22 of having to export in order to pay for imports but being unable to produce for export without first importing materials

**Table 2.2** American aid as a percentage of gross domestic capital formation

	1948	1949	1950	1951
United Kingdom	9	11	10	2
France	14	12	10	7
West Germany	31	22	11	7
Italy*	27	34	10	9

\*As a % of net domestic capital formation.

Source: Lucrezia Reichlin (1995)

and machinery.”<sup>14</sup> It also gave European governments the resources to fund social and welfare programs and at the same time continue with economic liberalization. Further, the aid was both an economic and political boost that brought confidence to Europe and jump-started the growth. Finally, it fostered American style management in Europe. None of these, of course, detracts from the importance of economic reforms of these countries. Indeed, the main lesson of the Marshall Plan for international intervention is that only foreign aid combined with domestic reforms could succeed. There has to be a close partnership between donor and recipient country with the latter having resolved to succeed.

## The Point Four

In his inaugural address of Thursday, January 20, 1949, President Truman outlined four major courses of action for peace and freedom. The first point noted the continued support for the United Nations and related agencies; the second referred to the Marshall Plan for the European recovery and the removal of barriers to world trade; the third point was about the North Atlantic security plan (NATO).

Fourth, we must embark on a bold new program for making the benefits of our scientific advances and industrial progress available for the improvement and growth of underdeveloped areas. More than half the people of the world are living in conditions approaching misery. Their food is inadequate. They are victims of disease. Their economic life is primitive and stagnant. Their poverty is a handicap and a threat both to them and to more prosperous areas. . . . I believe that we should make available to peace-loving peoples the benefits of our store of technical knowledge in order to help them realize their aspirations for a better life. And, in cooperation with other nations, we should foster capital investment in areas needing development.

The idea of the Point Four was that a vast area of the world and a large part of humanity were in the grip of poverty. Whatever the reason, poverty would create a fertile ground for the communists to sow the seeds of discontent, revolution, and takeover by a puppet of the Soviet Union. The United States had the resources and

<sup>14</sup>Barry Eichengreen (2007), p. 65.

technology to help the people of poor nations out of their poverty and thus deprive the Soviet Union of an easy prey.

In October 1950, the United States signed the first Point Four agreement with Iran. Technical assistance was provided in the fields of agriculture, public health, and education. In later years the Point Four program was merged with other international aid programs of the United States.

Many Point Four programs were small and diffused projects which could not compete with spectacular projects (Aswan Dam, for instance) in grabbing headlines. Yet their usefulness could not be denied. Some have wondered why despite American aid to some countries, the population developed a hostile attitude toward the United States and in some countries the communist parties gained ground. Indeed, why did in some countries, leftist revolutions or coup d'états occur? A possible answer to these questions rests on the following observations.

First, anti-Americanism is more a reflection of the insecurity of a nation that needs to find a culprit for its own failings. The alternative to blaming the United States for all ills in the world is to accept responsibility for some of them. Second, the lure of communism has been due to income inequality rather than poverty. The selling point of Marxism and communism is the promise of security and equality for everyone; "from each according to his/her ability, to each according to his/her need." It promises to take the wealth of the wealthy and share its fruits with everyone. Many members of communist parties and definitely most of the party leaders in developing countries have been members of the middle class and, in many cases, upper class. Finally, the spirit of rebellion and revolution is directly correlated with economic well-being. It is hard to find a revolution that occurred during a time of famine or misery. Most revolutions are preceded by a period of economic prosperity.

The discussion above points to one conclusion. There is a connection between economics and politics but the relationship is neither simple nor mechanical. The emphasis should be on incentives, partnership, and respect for the dignity of the aid recipient.

## **The Brave New Post War World**

In many respects the post World War II world was a different world. On the domestic front national governments assumed an increasing role in the economy. This was true in the United States and around the world. Internationally, countries became more intertwined than before. The idea of a free market for exchange rates was set aside in favor of fixed and managed rates. This was not surprising given that the memory of the Great Depression was still fresh. Nevertheless, countries were expected to open their markets to each other, promote trade, and to help each other. The march toward globalization had started and more was to come.





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