A VULNERABLE MIRACLE

To fully appreciate what we’ve lost, we need to begin with a deeper understanding of the egalitarian capitalism that the West once had—and how it eroded. The system created at the end of World War II was, of course, incomplete. Women were not equal citizens, nor were blacks. Much of the West still had colonies. But compared to any version of capitalism before or since, the three decades after World War II were remarkable.

The postwar system squared a circle. It achieved the improbable feat of combining dynamic capitalism with near-full employment, increasing income equality based on rising wages, and expanding social benefits. Such a convergence was unprecedented in the history of capitalism. Core elements of the system were the tight regulation of private finance, the offsetting empowerment of organized labor, and the activist role of government. The reign of finance in the 1920s had proved both deflationary and destabilizing—promoting speculation during booms and austerity during busts, and creating protracted unemployment. Joblessness, in turn, fed fascism and pan-European war. This was the fate the postwar architects were determined to avoid.

The new conception of the economy rested not just on drastic shifts in policy and new theoretical insights, but on altered power dynamics that made the policies possible. Yet the success of the postwar system was also the result of some happy accidents.

An anomaly of the postwar era was the temporary hegemony of the United States—in three respects. First, the US temporarily enjoyed towering economic supremacy, enough to be the flywheel of the sys-
tem. America provided the capital, the currency, and the mass market for other nations’ exports. This could not continue forever.

Second, because of the common threat of the Cold War, the US was prepared to use its power magnanimously in western Europe. In drastic contrast to the period after World War I, most Americans were now internationalists, thanks to Hitler and then Stalin—even most of the once-isolationist right. Public capital—the Marshall Plan—was central and reliable, in contrast to the volatile and speculative private-capital flows after World War I. For a time, the postwar brand of internationalism contained rather than liberated private capital.

Third, the US had a rare, effective left-wing government after twelve years of the Roosevelt administration. So, Washington became a partner of western Europe’s managed capitalism rather than an obstacle. All of these elements would weaken and then reverse over time. America did remain internationalist and the leader of the Western alliance, but economically, the internationalism increasingly took the form of promoting the global laissez-faire that had been emphatically rejected in the reconstruction of the 1940s.

On the European side of the bargain, a generation of farsighted postwar leaders whose nations were recent enemies shared a common vision. They concluded from the ruinous events of the previous decade that fascism grew in the soil of human misery; that laissez-faire capitalism generated depression; that Europe must never again suffer a civil war; and that to fuse these several goals, Europe needed to move in the direction of both a managed form of capitalism and a federation. Thus was born an egalitarian system, unique in the history of international commerce. The roots of these events began more than a decade earlier in the United States, under Roosevelt’s New Deal.

In the late 1940s, after a few years of uncertainty about postwar geopolitical alignments and confusion about economic goals and means, just about everything seemed to come round right. The United States, once isolationist, exercised unprecedented peacetime leadership. The Soviet Union was contained. Europe was soon on the road to reconstruction, embracing a new democratic Germany. The founders of the postwar order evidently found a recipe that combined growth with equity, showing the world that democratic capitalism was far superior to totalitarian communism. The postwar mixed economy enjoyed broad popular support. What could possibly go wrong?
In the final third of the twentieth century, the economy went wrong first, beginning in the 1970s—sacrificing both growth and equity, and then becoming mired in austerity. That story is told in succeeding chapters.

The global security order, which appeared so solid after the collapse of communism in 1989, faced new unsettling threats from terrorists early in the twenty-first century. Citizens rebelled against both economic and political insecurity, putting parliamentary democracy itself at risk.

This chapter begins an inquest. The basic finding: the postwar bargain was built more on a convergence of circumstances than on durable, permanent changes. The bargain proved surprisingly fragile, once capitalists regained their normal, temporarily suppressed powers in a still-capitalist economy. This shift occurred both in national politics and in the new globalization.

Yet, other roads were possible. As a matter of economics, the inflationary turmoil of the 1970s did not have to destroy the postwar social compact. Alternative, superior policies were available that might have continued the containment of finance and the commitment to empowered labor and full employment. However, the accident of inflation combined with rising unemployment gave an opening to the corporate and ideological right wing to pursue deflationary and deregulatory policies that fed on themselves and intensified the power shift, undermining the democratic and egalitarian nation-state.

THE RADICALISM OF ROOSEVELT

Literally thousands of books have been written on Franklin Roosevelt. My purpose here is not to repeat well-worked material, but to succinctly remind us how both the New Deal and then Roosevelt’s structuring of the wartime economy contoured the postwar social settlement. The historian Jefferson Cowie has termed the New Deal “the great exception.” However, it was not only the New Deal that was exceptional, but the entire era from 1933 to the mid-1970s, in Europe and America.

The crash of 1929 discredited laissez-faire ideology and the Republican Party, yet it was far from a foregone conclusion that Roosevelt
would use the economic crisis to offer such a radical program. Some historians have argued that because the Great Depression had been deepening for three full years by the time of FDR’s election in November 1932, his radicalism was almost inevitable. But a different president might well have been far less transformative. Roosevelt was famously a class traitor, comfortable enough in his own patrician skin to call out other patricians as economic royalists.

History is a blend of deep structural forces and contingent events that can be lucky or unlucky. To imagine that something like the New Deal was inevitable, one need only consider what might have occurred if Giuseppe Zangara, the assassin who fired five bullets at FDR while the president-elect was giving a speech in February 1933 in Miami, and who killed the mayor of Chicago instead, had hit his intended target. Rep. John Nance ("Cactus Jack") Garner, the vice-president-elect, a mediocrity from Texas added for ticket-balancing purposes, was no FDR.

The deeper radicalism of the New Deal was less in FDR’s program of public investment and social insurance—strategies used by conservatives such as Otto von Bismarck as well as liberals—than in the collective empowerment of organized labor and the drastic regulation of private capital. Roosevelt, after dithering, also decided to delink the domestic economy from the international constraints of the gold standard, the better to pursue recovery at home—a radical decision early in his presidency that prefigured the design for the postwar system and contained private finance in yet another respect.

It is close to an iron law of American politics that the party of a new president loses seats in that president’s first midterm election. In FDR’s first midterm, however, the Democrats—uniquely in modern political history—picked up seats. The gains in 1934, subsequently reinforced by Roosevelt’s own landslide reelection in 1936, made possible the so-called Second New Deal, which went even further than the first. FDR was emphatically on the side of the people, and the people reciprocated.

The empowering of organized labor came in several stages. In 1932, unionized workers were just 7 percent of the American labor force (about the same as their share of private-sector unionism today). Most of them were in relatively conservative craft unions that were closer to guilds. Except in New York and a few other cities that had
left-wing unions in the needle trades, the labor movement was weak and not much of a progressive force. That would change drastically. Even before Roosevelt’s inauguration, the majority-Democratic Congress elected in 1930 enacted the 1932 Norris-LaGuardia Act (sponsored by two progressive Republicans) barring courts from issuing injunctions in nonviolent labor disputes, effectively overturning earlier Supreme Court decisions holding that unions were “conspiracies in restraint of trade” that violated antitrust laws. Norris-LaGuardia also prohibited employers from requiring workers to be non-union as a condition of employment (“yellow-dog contracts”).

The right to unionize was explicitly recognized in the 1933 National Industrial Recovery Act, Roosevelt’s flawed attempt at corporatist industry codes, which was soon declared unconstitutional by the Supreme Court. Collective bargaining was explicitly legalized in the Wagner Act of 1935, which for the first time put government on the side of trade unionism. The word “collective” is key and worth a moment’s reflection. So much of American liberalism, before and since, has been about individual rights. For a brief moment in the 1930s, however, American progressivism was about collective empowerment and class advancement—the stuff of mass movements. The Wagner Act also created a jurisprudence to make sure that the right to unionize would be enforced.

Radical unionism, meanwhile, was advancing on the ground. In another fortuitous coincidence, the stage of industrialization prevalent in the 1930s utilized immense factories. With a shift in worker consciousness and a friendly national government, these giant plants could be organized—and they were. The Committee for Industrial Organization, created in 1935 to organize the semiskilled assembly workers previously disdained by the American Federation of Labor (AFL), soon became the Congress of Industrial Organizations (CIO). The militants in these unions were a broad spectrum of the left—communists, socialists, left-wing Democrats. Organizing tactics such as sit-down strikes that occupied auto factories sometimes broke the law. But in contrast to the era of mass union busting in the late nineteenth century, labor after 1933 had a rare alliance with the state that, though far from consistent, allowed these tactics to succeed more often than they failed.

In 1937, Roosevelt followed bad fiscal advice and cut spending to
narrow the budget deficit as recommended by orthodox economists who considered the Great Depression all but over. Deep recession ensued, raising unemployment rates, and the 1938 midterm election was a rout for the Democrats. The so-called Roosevelt Recession weakened the nascent labor movement, as hundreds of thousands of newly unionized workers were laid off in steel, automobile, rubber, and electrical manufacturing. Organizing efforts stalled as industrial giants such as the Ford Motor Company and Bethlehem Steel successfully resisted unionism, despite the guarantees of the Wagner Act.

But then, fortuitously, came the war. World War II strengthened worker bargaining power and reinforced labor’s role as institutional social partner. In 1941, Roosevelt named Sidney Hillman, head of the Amalgamated Clothing Workers of America, a senior CIO leader and a longtime FDR confidante, as codirector of the Office of Production Management, an early wartime planning agency later replaced by the War Production Board. To get labor fully behind the war mobilization and reduce strike activity, which had burgeoned as the economy recovered in the defense buildup of 1940 and 1941, Roosevelt created a National Mediation Board, and then a War Labor Board, with a formal tripartite structure of business, government, and labor. All of this helped elevate the labor movement to the role of a full social partner.

**THE GOOD WAR, FULL EMPLOYMENT, AND LABOR POWER**

In 1942, the Roosevelt administration guaranteed union recognition in war production. In exchange for a no-strike pledge by labor, all defense contractors had to accept unions as collective-bargaining agents if a majority of workers signed up. Senior corporate executives were prosecuted for violating this strong enforcement of the Wagner Act and barred from receiving military contracts; and during the war, virtually every corporation of any size had defense contracts. In 1944, Sewell Avery, head of Montgomery Ward, defied Roosevelt’s request to settle a strike with his 7,000 union workers. Many trade unionists still have on their walls an iconic photo of Avery being arrested in his Chicago office and carried out by National Guardsmen. The war even
gave unions a foothold in the South, because of its defense contracts. The closed shop, later to be outlawed by the 1947 Taft-Hartley Act, allowed unions to insist that only union members be considered for jobs in factories with union contracts.

The combination of a war-driven full-employment economy plus the government guarantee of organizing rights massively increased union membership, especially in the new unions affiliated with the CIO. The United Auto Workers’ membership rose from 165,000 in 1939 to over a million by 1944. The United Steelworkers’ membership nearly tripled, from 225,000 in 1939 to 708,000 in 1944. Organized electrical, rubber, and packinghouse workers achieved similar gains.

Yet the war’s official recognition of unions was double-edged. With war profiteering by corporations, and the cost of living often outstripping wages until price controls became fully effective in 1942, the union rank and file chafed under the no-strike pledge and the efforts of union officials to enforce it. There was also great tension between the membership and leadership as leaders loyal to FDR sought to carry out his efforts to hold down overtime pay.

On balance, the formal labor partnership gave labor an institutional role but sapped labor militancy as a social movement. When labor was again under siege in the late twentieth century, that militancy would not be there to draw on. Historian Nelson Lichtenstein, in his authoritative history of labor during World War II, writes, “The home-front pressures for social order and political orthodoxy during World War II did much to weaken the independence and shop-floor power that the industrial union movement had won in the 1930s.” True enough, but this was still a rare moment when organized labor enjoyed substantial institutional power in the American system, while the power of private capital was contained.

The brief twelve-year period between 1935, when a Democratic Congress passed the Wagner Act, and 1947, when a Republican Congress crippled its key provisions via the Taft-Hartley Act, was literally the only time in American history when the immense power of government helped build and solidify a labor movement. That movement, in turn, provided a powerful constituency for progressive government. Taft-Hartley removed some of labor’s strongest weapons, by barring the closed shop, prohibiting sympathy strikes and boycotts, and allowing states to destroy union shops by passing so-called
right-to-work laws. Taft-Hartley also weakened union control over pensions. The Act, which Truman—no radical—termed the “Slave Labor Act,” began the slow erosion of institutional labor power.

But at the apex of labor influence, unions represented about one-third of American workers, and their influence extended to other employers, many of whom matched union wages and benefits as union-avoidance medicine. Unionists also provided the foot soldiers of the New Deal electoral machine. When Harry Truman surprised nearly everyone by his come-from-behind win in 1948, his alliance with labor was key.

The practical experience of labor solidarity offset the social conservatism of much of the working class. The labor movement gives working people a political understanding of class. To this day, union members and their families vote far more progressively than do people with identical demographic and occupational characteristics who are not in unions. But there are far fewer unionists today, and they have fewer legal protections in the face of a business counterattack that began in 1947 with Taft-Hartley and only intensified over time.

The war did extend the New Deal system for several more years in other respects. The New Deal had used public capital on a number of fronts. Public power efforts, from TVA to the great western dams to local rural electrification co-ops promoted by the New Deal, demonstrated that public power was often more efficient than private power. These projects also provided what Roosevelt liked to call “benchmark competition” to restrain price gouging by private competitors. All of these broadly beneficial measures, not incidentally, increased the credibility and prestige of the state over the market.

The Reconstruction Finance Corporation provided $50 billion—an immense sum in the 1930s—in public funds to recapitalize industry at a time when the stock market was still traumatized and bank lending was unreliable. With RFC financing came public-interest quid pro quos. RFC representatives sat on corporate boards. They demanded arrangements that limited the pay and perks of senior executives.

The war was an accidental full-employment program, which disproved the claims of many economists who argued in the late 1930s that capitalism had settled into a stage of technological unemployment where there were just not enough human jobs to go around. The quick return to full employment vindicated Keynes’s argument that in the
aftermath of a depression—when trauma to the banking system coupled with a shortfall in consumer demand can lock the economy into a subpar equilibrium far below its productive potential—only public outlay and public investment can get the economy back on track.

The war gave the Roosevelt administration not just the massive jolt of demand that had eluded even FDR’s several public works programs, but also greater control of capital and public planning and investment. An elaborate war-planning bureaucracy directed the operation and gained unprecedented powers over the private sector in requisitioning materials and orchestrating the conversion of peacetime production to military uses.

As the US mobilized for war, government provision of capital became far larger and more explicit. The RFC moved into war finance. Its subsidiary, the Defense Plan Corporation, spent $9.2 billion to capitalize some 2,300 war production factories in forty-six states. During World War I, by contrast, the government spent only $600 million on industrial plants for defense production, 90 percent of which were financed privately. In the first six months of 1942, the government entered about $100 billion of war production orders, more than the entire GDP of 1939. Most of the RFC-financed plants were leased to industry for a dollar a year, and then privatized after the war—a stunning government gift to private commerce.

There was widespread concern that as soon as the war ended, with over 12 million GIs being demobilized, the economy would sink back into depression. In 1944, Senators Robert Wagner of New York (sponsor of the 1935 Wagner Act) and James Murray of Montana drafted the Wagner-Murray Full Employment Act, creating a detailed system modeled on wartime planning for keeping the peacetime economy at full employment. The president was to transmit an annual National Production and Employment Budget to Congress. This budget would include estimates of the size of the labor force, total national production needed to provide jobs for the labor force, and the total projected production without special measures by the federal government. But if anticipated production was insufficient, the federal government was to encourage enough additional nonfederal investment to stimulate the creation of private-sector jobs, and if necessary, federal expenditures were to close the remaining gap to ensure full employment.
The bill passed the Senate overwhelmingly but was killed in the more conservative House in late 1945, after the Democrats lost dozens of seats in the 1944 election to a war-weary electorate. The eventual Employment Act of 1946 was substantially weakened into a set of goals rather than a concrete planning document. Indeed, the House bill was known as the Whittington-Taft bill, cosponsored by the same Robert Taft who in 1947 would be the lead author of the antilabor Taft-Hartley Act. Whittington-Taft ended the explicit planning system and was a harbinger of reversals to come.

However, the Cold War soon served as a partial proxy for public investment and planning. Spending on the Cold War played a tacit Keynesian role on both sides of the Atlantic. US defense spending continued at high and relatively stable levels, independent of the ups and downs of the private economy. Investment in military technologies allowed significant government-funded scientific innovation with both military and commercial uses. Even though planning was now ideologically verboten, the Pentagon played a de facto role as a kind of planning ministry for major segments of the industrial economy. Yet because this role was tacit and inconsistent with resurgent free-market ideology, the use of the military as a proxy Keynesian planning state was also vulnerable.

**ROOSEVELT AND RACISM**

Another fault line and source of deferred crisis in the New Deal system was race. Roosevelt was able to expand labor regulation, social insurance, and public investment only by guaranteeing the Dixie members of his coalition that nothing in his program would alter the Southern Jim Crow system of white supremacy. Indeed, some of the New Deal actually extended state-mandated segregation to the North, into neighborhoods that had previously been integrated. When the federal government began building large-scale social housing for the first time under the WPA, Southern congressmen initially demanded that it be for whites only. Harold Ickes, former chairman of the Chicago NAACP and one of the most left-wing of Roosevelt’s senior advisers, was able to broker a compromise under which public housing did get built for blacks, but it was rigidly segregated. Public
works projects were also racially segregated, with the better jobs reserved for whites. Thus did the New Deal reinforce—and in many cases, introduce—not just racial segregation but white supremacy. Even so, FDR won increased black support because at least he was providing some practical help.

Under Southern pressure, new programs such as Social Security and protections for workers under the Wagner Act also preserved and reinforced the Jim Crow system. Occupations such as domestic worker and farm laborer, held predominantly by blacks or Hispanics, were explicitly excluded from Social Security and unemployment insurance, lest African Americans gain increased economic independence or bargaining power. Agriculture was deliberately not covered by the Wagner Act. Some blacks, in more mainstream occupations, did qualify for Social Security. Black workers, in integrated CIO unions or in segregated ones like the Brotherhood of Sleeping Car Porters, did benefit from the Wagner Act, but not enough to alter the racial system. Though Dixiecrats reluctantly went along with Social Security, the companion drive for national health insurance was blocked, partly because Southern leaders feared that it would bring integrated hospitals.

Thus, with minor exceptions, Roosevelt was able to construct an American quasi social democracy only by limiting it to whites; or at most, by providing that any benefits extended to blacks maintain or expand strict segregation. Working-class unity (among whites) was also somewhat easier to maintain because the immigration restrictions enacted by Congress in 1924 drastically reduced the number of foreign-born workers.

The settlement with segregation weakened working-class solidarity in several respects. It meant a narrower class coalition, since a third of the working class was not fully participating, as voters or as beneficiaries. Though cross-race class solidarity had been attempted since the early days of Reconstruction, racism invariably trumped efforts at transracial coalition. As late as the 1890s, there were multiracial governing coalitions in a number of Southern cities, such as Wilmington, North Carolina, where white violence literally destroyed the city government in a coup. Earlier, cross-race coalitions had governed in dozens of Southern cities, from Mobile to Memphis. But these were gradually crushed, as black voting rights were wiped out.
By 1901, the last post-Reconstruction members of both the House and the Senate were gone, and biracial class coalitions were dead.

Martin Luther King appreciated the political consequences. “The Southern aristocracy took the world and gave the poor white man Jim Crow,” King said from the steps of the Alabama capitol following the 1965 march from Selma to Montgomery. “And when his wrinkled stomach cried out for the food that his empty pockets could not provide, he ate Jim Crow, a psychological bird that told him that no matter how bad off he was, at least he was a white man, better than a black man.”

The deferral of racial justice would come back to haunt the Democratic Party class coalition in the 1960s, when the landmark civil rights acts and executive orders finally prohibited discrimination in education, lodging, dining, transportation, voting, housing, and employment, and companion executive orders required employers and unions to take “affirmative action” to overcome current effects of past discrimination. Those reforms drove many white workers into the arms of George Wallace and Richard Nixon in 1968. In subsequent decades, in the absence of robust policies to help the entire working class, the continuing sense of white displacement and grievance prefigured the rise of the Tea Parties and Donald Trump.

Yet, for the time being anyway, the New Deal gave labor an important place at the table (even if organized labor was mostly white), and its power did serve to counterbalance that of industry. Wartime full employment, coupled with the recognition of unions, both dramatically increased worker earnings and equalized the income distribution. Every bit as important for the political economy of the era was the suppression of the power of private capital—a revolution that also proved temporary and reversible.

SUPPRESSING SPECULATIVE FINANCE

The New Deal shackled private finance in a fashion that has not been equaled before or since. The 1933 Glass-Steagall Act removed one entire category of speculation and conflict of interest from the financial system by requiring stock brokerages and investment-banking houses to be divorced from commercial banking.
banks were invited to accept federal deposit insurance (nearly all did) and were subjected to a far more rigorous system of regular examination. The interest rates they could charge borrowers and pay depositors were also tightly regulated, to discourage forms of competition for customers that could damage solvency—reckless behavior that recurred after regulation was weakened in the 1970s and 1980s.

Though it remained privately owned, retail banking was converted into something close to a public utility. Nationwide banking was prohibited, and branch banking limited. What was sacrificed in the arguable efficiency of larger-scale banks was more than offset by the purging of speculation, conflict of interest, and corruption. It was the behemoth banking conglomerates, liberated from the New Deal restraints, that engaged in complex speculation and excess leverage, reaped immense speculative profits, and then crashed the system in 2007–8.

The New Deal also created a national system of housing finance from scratch, and invented the modern, long-term self-amortizing mortgage. FDR's set of policies included a kind of central bank for housing lenders via the Federal Home Loan Bank System, modeled on the Federal Reserve. It added the Federal National Mortgage Association to purchase mortgages from savings banks and savings and loan associations. These were mostly local nonprofits, mutually owned. Government insured the mortgages. The original FNMA, in contrast to its post-1969 namesake, was a public institution. It used direct Treasury borrowing to finance its operations, and there was no complex private securitization of the sort introduced in the 1980s to add layers of opaque risk.

In addition, the New Deal created a Home Owners Loan Corporation, to help struggling homeowners refinance underwater mortgages resulting from collapsing property values in the Depression. At its peak, one mortgage in five was written by the HOLC. Rather than going through private bankers, the HOLC was a true public institution, with tens of thousands of government employees working in direct retail branches.

In this system, nobody got extremely rich, and nobody had any incentive to complicate transactions for the sake of speculative profiteering. Credit evaluation was not delegated to third parties, but was performed directly by loan officers. There were no layers of mid-
dlemen adding costs and complexity. Despite the hard times of the Depression, the system—purged of its speculative elements—worked like a Swiss watch. Mortgage defaults were soon as rare as bank failures. Once the Depression ended, home ownership rates rose dramatically, from less than 40 percent in the 1930s to about 64 percent by the 1960s.

The entire system of underwriting and marketing stocks, meanwhile, was subjected to a rigorous system of regulation and disclosure, via the Securities Act of 1933, the Securities Exchange Act of 1934, and finally the Investment Company Act and the Investment Advisers Act, both of 1940. In this structure, investment banking was simplified and made transparent. The system allowed no complex private securitization of mortgage loans, no leveraged buyouts, no private-equity or hedge fund firms taking advantage of loopholes. FDR wanted to go even further, to prohibit brokerages from both trading for their own accounts and trading for customers, a potential conflict of interest that became increasingly abusive after the 1980s. This reform he did not get from Congress. But the New Deal went far enough to render finance the servant rather than master of the real economy. Despite the slow recovery from the Depression, there were no significant bank failures after 1934.

The political preconditions of the New Deal system of financial regulation began eroding right after Roosevelt’s death and the Republican takeover of Congress in 1946. But the system had a long half-life. Strictly regulated finance underwrote the great postwar economic boom. Even if it deprived financiers of the opportunity to become very rich, the system was salutary for the real economy—in many respects because it constrained private financiers. Not until the economic slowdown of the 1970s, which brought the resurgence of business influence, laissez-faire ideology, and right-wing politicians, did both political parties begin working to dismantle much of New Deal financial regulation—with calamitous results.

It’s worth drawing an important distinction here. In a capitalist economy, enterprises need capital, and the provision of investment capital is the job of well-regulated private-capital markets. All investment is in a sense speculative, since the investor or banker does not know in advance how well the investment will pay off. If the enterprise thrives, so does the investor, and the banker gets repaid. Importantly,
however, investments directly connected to the real economy are less of a gamble. It is possible for a loan officer to assess the business plan and the competence of the entrepreneur, and determine how much of the entrepreneur’s own money is in the deal. The risk to the bank can be roughly calculated and priced accordingly. The additional risk is assumed by the entrepreneur.

But there is a whole other category of capital that is purely speculative, and often damaging to the real economy. This kind of financial play invents and uses complex financial instruments, often at several removes from the underlying asset. These instruments are known as derivatives. It’s an insiders’ game, in which financial entrepreneurs can profit whether or not the real economy does, by making bets on bets and ensuring that the house is better informed than the rubes who are gullied into playing. Often the insiders profit by betting against the success of the underlying enterprise—the essence of the subprime scam. This was the kind of speculative game that contributed to the crash of 1929—that was shut down by the New Deal–postwar regulatory system, and then clawed its way back in the 1980s and 1990s to crash the economy again in 2008. These plays operate at so many removes from the real economy that the securities and risks were opaque both to regulators and to customers, and even to the so-called credit-rating agencies, private companies like Moody’s or Standard & Poor’s that blessed such deals with triple-A ratings in exchange for fees.

CONFISCATION OF CAPITAL WITH NEGATIVE INTEREST RATES

In the system that prevailed between the 1930s and the 1970s, finance was suppressed in one other notable respect that has largely escaped general attention. The real interest rate was negative for much of the postwar boom, making the capital costs of the real economy very low. The negative interest rate did impose some costs on the wealth-owning class, contributing to the unprecedented compression of the income structure during this era, but that shift did little economic damage and was a net gain for both the income distribution and the real economy.
In both the United States and Britain, the rate of inflation tended to exceed the interest rate on public debt for three decades after World War II. This meant that the real value of the debt gradually dwindled. If you hold a bond worth $100,000 and the inflation rate is 10 percent, after a year the real value of the bond is now about $90,000 (more or less, depending on the prevailing interest rate and the bond’s maturity). Even if the bond pays 5 percent interest, you are still out something like $5,000 in real money. The flip side of your loss is the government’s gain: the burden of public debt declines over time. For the US and the UK during the postwar period, Harvard economist Carmen Reinhart calculated, “the annual liquidation of debt via negative real interest rates amounted on average from 3 to 4 percent of GDP a year.”

Various public policies can be used to keep real interest rates low or negative, and these policies converged in the postwar era. Government can require its central bank to finance public debt at very low interest rates. This is just what the US government did between 1941 and 1951. And government can also put ceilings on rates paid and charged by banks, as federal policy did from the 1930s until the 1970s, and as state government did via usury laws until the 1980s. (Taken to an extreme, these policies can reduce the supply of capital, but within limits they are salutary for the real economy.) Government can promote high rates of growth, so that the cost of past debt fades relative to GDP. And it can tolerate moderate inflation to reduce the real value of the legacy debt. All of these policies are abhorrent to private financiers but tonic for the rest of the economy. The fact that government could pursue these policies reflects the temporarily suppressed political power of private capital. The fact that the real economy thrived despite the pain to private bondholders defies a lot of standard economic theory and blows away a core premise of supply-side economics.

If private markets had set interest rates on government bonds during the period of very high public debt after World War II, debt-financing costs would have been much higher, reduction of the debt overhang far lower, and the drag on the real economy more substantial. But thanks to the tight regulatory policies, real interest rates were significantly lower from 1945 to 1980 than in the freer capital markets in the period before World War II and after financial liberalization in the 1980s.
The negative real interest rate on government bonds was yet another legacy of the war. When the United States entered World War II in December 1941, the government immediately faced the challenge of how to finance it. Government massively increased direct spending on the military and entered into huge war production contracts. The war ended up costing just under $300 billion—about one-third of total GDP for four years once full mobilization was reached in 1942.

Government financed the war both with surtaxes on the wealthy, at rates as high as 94 percent, and with massive sales of bonds. War bond sales totaled about $167.2 billion. Bonds were purchased as patriotic acts by the general public, and were also bought by banks, pension funds, corporations, and most important, by the Federal Reserve. Usually in wartime, government is dependent on commercial and investment banks to underwrite and sell bonds, and bankers make a lot of money. Interest rates are high because it’s hard to find enough bond buyers. This was the case in World War I. But World War II, as a total mobilization, was different. The Federal Reserve was directed to peg interest rates on government debt at three-eighths of 1 percent on short-term ninety-day debt and 2.5 percent on long-term debt. How did the Fed achieve that goal? It simply bought bonds in large enough quantity to maintain those low rates. Whatever the public did not buy, the Fed did. The policy was formalized in a memorandum between the Treasury and the Fed, pursuant to an order from President Roosevelt. Had private money markets set rates, the costs of the war would have been prohibitive, and economic recovery slower. A total war, of course, is not a model for a normal economy. But the containment of private finance can be constructive in peacetime as well.

The combination of demand stimulated by massive deficit financing, plus pegged interest rates and virtually unlimited bond buying by the Fed, was initially not inflationary for two reasons. The ultra-Keynesian policy promoted rapid growth of the real economy—almost 50 percent over the four war years—and the economy had temporary wage and price controls, as well as rationing. Once price controls took effect in 1942, the inflation rate for the remainder of the war was less than 3 percent per year. In other words, buyers of 2.5 percent war bonds were earning no interest and losing a sliver of principal.
Once the war ended, however, inflation did break out, because of suppressed demand both for products and for wage increases. It was 8.3 percent in 1946, 14.4 percent in 1947, and 7.7 percent in 1948—enough to inflate away a lot of 2.5 percent war debt in those three years alone. Inflation did not settle down to a range of 1–3 percent until after the Korean War. Even though price controls and rationing ended with demobilization and all controls were lifted by 1946 at the insistence of Congress, the Fed-Treasury agreement to peg interest rates on government debt continued until 1951. The policy persisted out of concern that letting private markets dictate rates on the large debt overhang would be a huge burden on government and on taxpayers. Interest rates on corporate bonds tended to be influenced by safer government bonds, and were suppressed as well. With low interest costs, high growth rates, and modest inflation, the debt-to-GDP ratio in the United States fell from 113 percent in 1945 to 51 percent in 1955. For Britain, the ratio dropped from 240 percent to 138 percent during the same period, because of the same dynamics.

In sum, the three-decade postwar period was great for the real economy, while investors in bonds had negative rates of return. Stock prices were also somewhat depressed by the combination of high real interest rates and inflationary expectations.

So, finance was repressed in multiple respects—through the strict limits on what the banking industry was permitted to do, in the debt-financing policy of the government, and in the negative real returns for the rentier class. Those constraints, in turn, limited both the wealth and the political power of financiers. Keynes had famously called for “the euthanasia of the rentier,” meaning that a modern economy relying on public credit and low interest rates could innovate and achieve full employment without being at the mercy of the whims of stockholders, bondholders, and speculators. The postwar suppression of finance partly (and felicitously) carried out Keynes’s wish.

The industrial structure of that era was concentrated, which meant that large companies were able to extract monopoly or oligopoly profits. But because of the institutionalized labor power, these profits were shared with workers. Today’s economy, by contrast, is a blend of some companies with immense market power (Apple, Google, Amazon) and others that are hypercompetitive—some of which cash in big in an initial stock sale. But in neither case are windfalls shared
Can Democracy Survive Global Capitalism?

with ordinary workers, because of the shift in the rules of the game and the distribution of power.

With stock and bond prices depressed, how did industry finance its impressive growth in the postwar era? Partly with public capital via defense contracts, mainly with retained earnings, later with issues of stock. Purely financial returns were low or negative, but corporate profits were solid, thanks to rising consumer demand, corporate concentration, and the low real capital costs. Policy tolerated no financial engineering, no funny-money securities, no leveraged buyouts in which speculators took over corporations with borrowed money collateralized by the target company’s own stock. All that came later. It was a very different way to run an economy.

A JOLLY GOOD FELLOW

While the wartime system of pegged interest rates on government borrowing was an emergency expedient, it also reflected the Roosevelt administration’s own eight-year peacetime experience containing the abuses of the banking industry and FDR’s own mistrust of the power and destructive potential of private finance. The same sensibility pervaded the assumptions of the Bretton Woods system, which proposed an architecture for global finance unlike any the world had ever seen. Yet the actual Bretton Woods system that materialized in the late 1940s only partly realized the goals of its architects, and it eroded over time.

On July 22, 1944, as allied troops were racing across Normandy to liberate Paris, representatives of forty-four nations met at the Mount Washington resort in Bretton Woods, New Hampshire, to plan the postwar monetary and financial structure. The idea was to create a global currency system that would insulate domestic full-employment economies from the deflationary pressures of private finance—a global counterpart to the economic and financial assumptions of the New Deal. The conference took three weeks of exhausting diplomacy. At the closing banquet, the assembled delegates rose and sang “For He’s a Jolly Good Fellow.” The fellow in question was the chairman of the conference, John Maynard Keynes, leader of
the British delegation and intellectual inspiration of the Bretton Woods design.

Keynes’s core insight was that market economies tended to get stuck at levels of output and employment well below their capacity for growth. The international correlate was the tendency of global finance to produce systemic austerity by placing fiscal balance, currency stability, and debt repayment ahead of economic growth. This bias was “pro-cyclical,” producing euphoric booms as finance chased fads, followed by crashes and then recessions or depressions.

Even in the gold-standard era, monetary stability came at the price of regular panics, crashes, and depressions, as economies regularly lost and struggled to regain the confidence of international private creditors. Keynes’s idea was to create an international financial and monetary structure that permitted nations to run high-employment economies at home without being constrained by the pressure of private global finance.

As a young man, Keynes had been the leading critic of the austerity and reparations imposed at the Versailles Peace Conference in 1919, the gathering of the victorious Allied powers to set the terms of the peace. The Treaty of Versailles can be understood as a blunder on several levels. The best-known mistake was the attempt by Britain and France to punish Germany by imagining that a defeated and economically shrunken German economy was capable of paying war reparations far beyond its capacity, and doing nothing to help Germany to recover. But this folly was only one part of the broader deflationary effort by elites to set back the clock and restore the financial assumptions of the nineteenth century. Britain tried to revert to the prewar value of the pound, condemning its citizens to an era of high interest rates and permanent recession for the two decades between the wars. In the interwar period prior to the New Deal, all of the Allied powers supported a laissez-faire global financial system, in which the fates of real economies were tied to the fads and whims of private investors and speculators.

Unlike the period following World War II, the inter-ally loans after 1919 were underwritten mainly by commercial banks. Thus the credit system was also pro-cyclical, exaggerating the ups and downs of business cycles. When times were tough, credit was hard to come
by. When times were booming, credit flowed too freely and created bubbles. The intermittent efforts of governments to contain the damage, with periodic ad hoc conferences to reschedule debt, were futile because they accepted these fundamental premises.

Now, a quarter century later, Keynes wanted to be certain that this would never happen again. He did not prevail on the details of what became the Bretton Woods system, but he did inspire the basic economic assumptions. The architects of the post–World War II economy rejected both the folly of permanent punishment for Germany and the assumption that laissez-faire needed to be restored. Instead, they combined a program of economic recovery with a global financial system that allowed each nation to pursue a managed form of capitalism domestically.

In Keynes’s design, a new “clearing union” would provide loans to help tide nations over during shortfalls so that private speculation would not generate austerity, while a new global public bank would be a source of investment capital for recovery and development based on solid investments, not faddish bubbles. Exchange rates would be fixed, but periodically adjustable if fundamental misalignments arose. Keynes also proposed a global currency, which he named “ban- cor.” He wanted debtor nations to be able to borrow money in the new currency virtually at will, to prevent temporary national financial crises from aggregating to general austerity. He also wanted to put pressure on creditor nations to expand their economies rather than having a system that achieved balance by causing debtors to contract. Keynes’s proposed mechanism was a provision that fined chronic creditors and allowed other nations to “discriminate” (his word) against the exports of creditor nations. In the context of 1944, the only such creditor nation was the United States.

But in 1944, it was never in the cards for the US to assent to a scheme that allowed discrimination against its exports. Nor were the Americans, who held 80 percent of the world’s reserves and the sole viable currency, going to embrace an untested form of global money beyond American control.

There was to be a third institution, the International Trade Organization, whose job was to reconcile relatively liberal trade with decent labor standards and full employment. To that end, discrimination against imports was expressly permitted when necessary to keep
down domestic joblessness, and in the draft charter the ITO’s members made a commitment to domestic policies to promote high labor standards. When politics in the US moved to the right after Roosevelt’s death in 1945 and Republicans took back Congress in 1946, the ITO went unratified. In its place, a General Agreement on Tariffs and Trade, later expanded into the World Trade Organization, would promote the traditional form of laissez-faire trade.

Here is the key point. While the Bretton Woods meeting did create an International Monetary Fund and a World Bank, the actual postwar system did not carry out Keynes’s explicit design. The system was only incidentally and temporarily Keynesian. It did boost demand, it did constrain finance, and it did create a system of fixed exchange rates, which also proved temporary. But none of these took the forms that Keynes had proposed. All relied on the anomaly of American economic supremacy. Thus, the entire system was weakly anchored—politically, institutionally, and ideologically.

In theory, the IMF was supposed to provide advances that would allow nations to defend currencies against private speculation. In practice, the actual IMF did little of this, and it later became a leading instrument of the very austerity it was intended to contain. Capital controls were maintained for a time, mainly as a by-product of the financial disruptions of the war, and not as a systemic principle. The World Bank provided only a tiny fraction of the reconstruction aid and aggregate demand that was needed. That responsibility would fall mainly to the Marshall Plan. Currency parities were volatile and chaotic through the end of the 1940s. They finally stabilized, more than four years after the Bretton Woods meetings, thanks to the anchor of the dollar and the muscle of the US Treasury, not the interventions of the IMF.

At the Bretton Woods meetings, the rival proposal by Keynes’s American counterpart, Harry Dexter White, prevailed. White, a left-wing New Dealer serving as number two man at the Treasury, shared Keynes’s basic views on money and expansionary fiscal policy. But the White plan provided a much more modest fund and bank. In practice, these entities turned out to be far more limited than even White’s design dictated, and White was bitterly disappointed at the truncated institutions.

Nonetheless, the early postwar system was a vast improvement
over both the rigid gold standard of pre-1914 and the monetary anarchy and deflationary bias of the interwar period. The key features that helped nations pursue recovery programs, free from the deflationary pressure of speculative finance, were capital controls and fixed exchange rates, plus the temporary role of the US as residual market and source of capital. But its success, like so much else about the postwar exception to predatory capitalism, was a happy convergence of accidents. New York bankers had lobbied mightily against the Bretton Woods system, and in favor of free movements of capital. Their political power, however, was temporarily suppressed. When it revived in the 1970s, their influence was a key factor in the shift back to laissez-faire global finance.

The Bretton Woods system survived less than three decades. Its successor system restored the primacy of speculative private finance, and with familiar results.

Some economic historians contend that the imperatives of recovery and rebuilding were the core explanation for the stunning revival of postwar Europe. In his comprehensive study *The European Economy since 1945*, Barry Eichengreen writes, “Initially, Europe could grow rapidly simply by repairing wartime damage, rebuilding its capital stock, and redeploying men drafted into the wartime task of destroying output and productive capacity into the normal peacetime job of rebuilding them.” Eichengreen’s description of the opportunity is accurate. Yet as Eichengreen has recognized in his other work, market systems do not automatically deliver such results. The same imperatives existed after World War I, but the system failed. Nor did the egalitarian path that postwar recovery took happen automatically. It required the convergence described in these pages—one that was both fortuitous and ideological.

As capitalism reverted to its more normal power structure, the splendid anomaly of broadly egalitarian capitalism common to the West was living on borrowed time. An intriguing question is whether events might have played out differently. Was managed capitalism destined to be a historical blip, or might the shift have been more durable, given different patterns of leadership and luck, policy, and power?