Rebuilding the World Economy

Lecture 10

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- World War II halted the growth and integration of the global economy, similar to the disruptions caused by World War I and the Great Depression.
- The war left behind staggering human and economic losses, more than 40 million deaths and widespread destruction in Europe, Asia, and North Africa.
- In Germany, coal production and industrial output fell to half of pre-war levels; the European economy was essentially broken down.
- The Soviet Union suffered a heavy death toll but later emerged as a superpower, promoting centralized planning and communism.
- By the late 1940s, geopolitical tensions between the US and Soviet Union had already escalated, marking the beginning of the Cold War.
- These conditions set the stage for major rebuilding efforts like the Marshall Plan and Truman Doctrine to promote recovery and market-based economies.

The Marshall Plan: Rehabilitating Europe

- After WWII, the United States emerged in a dominant global position— with only 6% of the world's population, it produced over 25% of global output and accounted for more than 65% of world trade.
- This economic strength allowed the U.S. to shape post-war policies, even over the objections of its allies like Great Britain.
- In 1948, the U.S. Congress approved the European Recovery Program, known as the Marshall Plan, to revive the European economy.
- The plan transferred around $13 billion (roughly 2% of recipients' combined GDP) to European countries from 1948 to 1951.
- Contrary to popular belief, the Marshall Plan did not directly rebuild infrastructure or inject massive financial resources.
- Instead, it served as a symbolic and strategic commitment to stabilizing Western Europe and promoting market-based recovery.

What the Marshall Plan Did (I)

1. U.S. officials promoted a vision of recovery through market-based growth and increased exports.
2. European governments were encouraged to adopt market principles as a foundation for postwar welfare policies.
3. Aid was conditional—countries had to implement certain reforms or meet requirements to access funds.
4. France was denied credit access in 1948 until it reduced its budget deficit.
5. The U.S. withheld funds from Britain when social housing expenditures rose too rapidly.
6. These conditions often limited expansions of the welfare state, reflecting American priorities.

What the Marshall Plan Did (II)

7. The Marshall Plan lasted four years and included a wide range of sub-programs.
8. Total aid: $9.1 billion in grants, $1.1 billion in loans, and $1.5 billion in conditional aid.
9. Support included food supplies, raw materials, and capital goods to fuel recovery.
10. Conditional aid aimed to increase intra-European trade and economic cooperation.
11. Programs supported technical training, business management, and productivity improvements.
12. In Italy, U.S. training programs significantly boosted industrial productivity and business revenues.

What the Marshall Plan Did Not Do (I)

1. **Limited Role in Infrastructure Reconstruction**
   - The Marshall Plan did not substantially contribute to the reconstruction of Europe's physical infrastructure.
   - By the time the program commenced in 1948, most essential infrastructure—such as railways and bridges—had already been restored.
   - In fact, by 1947, railway freight volumes in several major continental European countries had already surpassed prewar levels.
2. **Marginal Contribution to Investment**
   - Although frequently credited with stimulating investment, the Plan's actual financial magnitude was limited.
   - Total aid represented approximately 2% of recipient countries' combined GDP, while investment typically accounted for around 20%.
   - Even under the unrealistic assumption that all aid was directed to investment, its share would not exceed 10% of total investment.
   - Empirical estimates indicate that only 35% of the aid was allocated to investment-related activities, implying a contribution of less than 1% of GDP.

What the Marshall Plan Did Not Do (II)

3. **Overstated Role in Alleviating Production Bottlenecks**
   - A prominent narrative emphasizes the Plan's function in addressing shortages of critical inputs, such as coal.
   - However, as DeLong and Eichengreen argue, this interpretation likely overstates its macroeconomic relevance.
   - Even in scenarios where countries lacked foreign exchange reserves, the structural bottlenecks may not have been the binding constraint on growth.
4. **Institutional impact rather than direct economic impact**
   - The primary legacy of the Marshall Plan may lie in its promotion of market-oriented institutions and policy frameworks.
   - It reinforced a commitment to liberal economic principles over centralized planning.
   - While direct economic effects were modest, the Plan contributed to the ideological and institutional foundations of Western Europe's postwar economic resurgence.

The Golden Age: Economic Growth and the Global Economy in Western Europe

- The period from 1950 to 1973 is widely regarded as the "golden age" of economic growth in Western Europe.
- During these years, the region experienced rapid and sustained increases in output, productivity, and living standards.
- Postwar growth rates significantly exceeded those of earlier historical periods, including the first wave of globalization and the interwar years.
- Average annual growth of GDP per capita reached 3.8%, nearly three times higher than the pre-1950 historical average of 1.3%.
- The impact on societal well-being, economic security, and the global economic order was profound and historically unprecedented.
- This exceptional performance marked a unique convergence of reconstruction, institutional reform, technological diffusion, and favorable global conditions.

Proximate Causes of Growth (I)

1. **Postwar Rebound and Neoclassical Expectations**
   - According to neoclassical growth theory, economies are expected to rebound rapidly following major negative shocks, such as wars or depressions.
   - The accelerated growth in Western Europe after 1950 is understood, in part, as a result of this convergence dynamic.
2. **High Investment Rates**
   - Countries with lower initial GDP per capita in 1950 experienced faster growth due to higher marginal returns on capital investment.
   - Investment played a central role in physical capital accumulation, a key proximate determinant of output growth.
3. **Low and Stable Inflation**
   - A departure from the high inflation volatility of the interwar years, inflation remained low and predictable—averaging around 3.5% annually.
   - This macroeconomic stability supported long-term investment decisions and reduced uncertainty in labor and capital markets.

Proximate Causes of Growth (II)

4. **Rapid Growth of Exports and Trade Integration**
   - Export growth was exceptionally strong, averaging 13.5% per year between 1950 and 1973, outpacing the post-1973 average of 9.5%.
   - Integration into global markets facilitated specialization based on comparative advantage and increased competitive pressures in domestic markets.
   - Countries with more dynamic export performance generally achieved higher rates of overall economic growth.
5. **Toward Ultimate Causes: Institutions and Social Compacts**
   - Beyond proximate drivers, institutional arrangements—particularly the postwar social compact between labor and capital—underpinned growth sustainability.
   - International frameworks and policy cooperation (e.g., Bretton Woods system) further reinforced domestic reform and macroeconomic coordination.
   - These institutional foundations provided the environment necessary for the effective realization of proximate growth factors.

The Labor-Capital Game: Strategic Choices

1. Postwar economic outcomes in Western Europe can be interpreted using the framework of a strategic game between two players: capital (firm owners) and labor (workers).
2. Each player faces two strategic choices:
   - Capital: either invest heavily in productive assets or withhold investment to prioritize short-term profits.
   - Labor: either restrain wage demands or press for immediate wage increases.
3. The observed result, high investment and wage moderation, suggests the emergence of a cooperative equilibrium.
4. To understand how such an outcome was sustained, it is essential to analyze the payoffs for each player and the institutional arrangements that reinforced mutual cooperation.

Payoffs and Incentives: Why Cooperation Emerged

1. Investment improves productivity and long-termm profitability, benefiting both capital and labor throughhigherr wages and revenues.
2. However, in the absence of trust, capitalists may withhold investment to reap short-term gains, and labor may demand higher immediate wages.
3. Workers' wage restrictions can increase firm savings, which in turn can fund productive investment, creating higher rewards for both parties in the long run.
4. Institutional mechanisms were required to ensure that such cooperative behavior could be credibly maintained over time.

Institutional Mechanism I: Monitoring

1. Monitoring enabled workers to observe managerial behavior and verify that firms upheld their investment commitments.
2. Postwar Europe institutionalized worker participation through structures such as Works Councils and codetermination agreements.
3. In Germany, these allowed labor representatives to participate in firm-level decision-making.
4. Such arrangements increased transparency and trust, reducing the risk of defection, and helping to sustain wage restraint by labor.

Institutional Mechanism II: Bonding

1. Bonding mechanisms created financial and political costs for reneging on agreements.
2. Governments offered targeted incentives such as tax breaks, investment subsidies, and preferential market arrangements to firms maintaining investment.
3. Simultaneously, expansive welfare provisions—including health care, housing, and pensions—reduced pressure on labor to demand immediate wage increases.
4. These arrangements acted as implicit contracts: firms received state support contingent on continued investment, while workers gained economic security.

Institutional Mechanism III: Coordination

1. National-level wage bargaining helped internalize the externalities of decentralized wage-setting, preventing cost-push inflation.
2. Without coordination, sector-specific wage increases (e.g., in coal) could trigger price hikes across industries, undermining macroeconomic stability.
3. Centralized negotiations aligned wage growth with inflation and productivity targets, thus supporting competitiveness and employment.
4. Coordinated bargaining fostered macroeconomic discipline and contributed to the credibility of postwar wage-investment pacts.

Institutional Mechanism IV: International Integration

1. Integration with global markets further reinforced domestic cooperation and growth in productivity.
2. European initiatives such as the European Coal and Steel Community (ECSC, 1951) reduced trade barriers and facilitated access to key inputs.
3. France and Germany mutually benefitted: French firms accessed German coal, while German companies imported French iron ore at lower cost.
4. Thus, international institutions played a critical role in promoting specialization, reducing uncertainty, and embedding national economies in a broader cooperative framework.