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Economic Theory and Reality

Spontaneous Chaos – Economics in a Time of Wolves

by **Erik S. Reinert**

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I

The ongoing world financial crisis has caused numerous reactions both amongst the academic economists, as well as amongst those more practically oriented. Economists from different schools and of different orientations are trying to uncover the reasons that have brought it about, and to suggest appropriate measures so that future crises of large proportions can be prevented or at least weakened. Some analysts are also using the contemporary financial crisis as a good reason for a much deeper and far-reaching questioning of the very foundations of economic science (precisely, questioning the dominant economic paradigm). First of all, the question arises, what is happening to economic science if it is not able to recognize an economic crisis before it "steps on it"? How is it possible that the economic science was caught off guard yet again? Besides, what is the implication for the status of economics as a science if it is not able to successfully deal with real economic problems? This is the critical approach of the Norwegian economist Erik S. Reinert in his interesting book *Spontaneous Chaos – economics in a time of wolves*.

Erik Reinert studied economics in Switzerland, and then in the United States, first at Harvard, and then at Cornell, where he obtained his doctorate in 1980. The title of his doctoral dissertation was *International Trade and the Economic Mechanisms of Underdevelopment*. Reinert was searching for the answer to the question why the economic growth so unevenly distributed. International trade and its influence on the economic growth and development are topics that directly or indirectly appear in most of his studies, including the book that is the topic of this review.

Reinert is a visiting professor at several universities in different countries. He is the founder of the organization *The Other Canon*, which he has established as an alternative to traditional economic theory (the theory he has in mind is neoclassical economics). The *Other Canon* supports an economics based on empirical inquiry into economic history, and not on sophisticated mathematical models which rest on the idea of equilibrium. The *Other Canon* is also a way of thinking, but one in which the knowledge of relevant facts is the most important. In his texts and lectures, Reinert has stood against the orthodoxy both on the left and on the right. Besides his academic work, he has shown himself to be a successful businessman and a consultant, which has contributed to his work always as it always has a pulse of real economic life.

Erik Reinert has published numerous texts on economic theory and economic history, development economics, as well as on the history of science (he especially deals with technology and innovation). His most famous book is *How Rich Nations Got Rich and Why Poor Countries Stay Poor*, published in English in 2007, and by now translated to numerous languages. (The translation of the Norwegian version from 2004 to Serbian was published in 2006).[1] This book was on the *Financial Times* bestseller list and it has brought Reinert the prestigious Myrdal Prize for the best book in the field of evolutionary political economy in 2008.

The book that is the topic of this review has been published in Norwegian in 2009 and in the rest of the text, I will focus on the key thesis that Reinert supports in it.

II

The book *Spontaneous Chaos* is comprised of texts that were written for various occasions and on different economic topics. Parts of the book have been published in Norwegian daily and weekly newspapers, which have made them free of excess technical jargon and accessible for a wider readership. The author himself states that the book is not meant to be strictly academic, but rather an attempt to make analytical insights, gathered over the course of several decades of theoretical and practical work available to the wider public. Even though the texts were written for various reasons, the basic idea that binds them is easily recognizable.

”A Time of Wolves“ is the term that Erik Reinert uses to mark the period from the fall of the Berlin Wall to the outbreak of the world financial crisis in 2008. That was the time, according to Reinert's opinion, when theories of spontaneous order and the economic and social consequences that it brings about were undoubtedly dominant. He staunchly defends the thesis – based on historical experience – that an unregulated market can create spontaneous order, but also spontaneous chaos. Reinert directly associates the key ongoing problems of the world economy with the economic science. That is, he considers these problems to be a direct consequence of an unreasonable insistence on the application of ”questionable economic theories“. Therefore, the first step in the process of healing should be to free ourselves from unsustainable theories.

Reinert writes about the Ricardian and Krugmanian vices (he wrote about them for the first time in the book *How Rich Nations Got Rich and Why Poor Countries Stay Poor*). The Ricardian vice consists out of constructing economic models based on the assumptions that are unrealistic (Reinert would say made up), while the Krugmanian vice consists out of having models that are undoubtedly more relevant than Ricardo's theory, but not applying them in the economic analysis and not basing economic policy on them. In this book Reinert repeats a point that he makes often as well, namely that developed countries are recommending undeveloped countries pol-

[1] **Erik S. Reinert**. 2006. *Globalna ekonomija – kako su bogati postali bogatiji i zašto siromašniji postaju siromašniji*. Beograd: Čigoja.

icies that are opposite to what they themselves have used both in recent and far past. After climbing to the top, they try to "kick the ladder".

A special target of his attack is the theory of international trade, and in that context Ricardo's theory of comparative advantage and Samuelson's thesis about factor price equalization (that international exchange will equalize factor prices). Reinert draws our attention to the fact that Ricardo's theory of international trade was not warmly received outside of England. It was especially unpopular in Germany, Japan and the United States. As an illustration of this attitude, Reinert reminds us that Thomas Jefferson was against publishing Ricardo's *Principles of Political Economy* in the United States.

III

What, according to Reinert's opinion, leads to financial crises? Under normal circumstances, the financial economy supports the real economy. Problems arise when the financial sphere gets decoupled from the real, and when it grows into something that is very hard to control and begins to deform economic processes as a whole. Reinert also thinks that Ricardo failed to establish money as a separate category, so he has left economic science unprepared for situations in which the financial economy begins to get out of control. He also contends that the German economic tradition has produced very good (useful) analyses of money and financial markets, but that this tradition has disappeared after the Second World War.

Reinert points to three key mechanisms that have caused the money (financial) sphere to "tear away" from the real sphere (he first presented them in a text published in 1998). The first mechanism is the interest paid on interest, which Reinert calls the "Hammurabi effect". After a while, this effect by itself (interest on interest) leads to an exponential growth of the financial sphere. The second effect is the Perez effect (named after the Venezuelan economist Carlota Perez), and it focuses on the possibility that innovations in real economy can create large bubbles in the financial economy. Financial bubbles are often caused by new financial instruments, as is shown by the economic history. This has been the case in the latest crisis as well.

Finally, the third effect is the Minsky effect which points to economic problems that arise from the sphere of financial markets. Hyman Minsky (an American economist whose ideas have been pushed aside, but who has been "rediscovered" due to the latest crisis) argued that too much deregulation of financial markets leads to financial crises. A deregulated banking sector encourages competition among banks for market shares. After a while, the battle for the market share increases the risk and banks change their behavior strategy and begin to withdraw assets so as to increase liquidity. This increases the risk in the economy as a whole and a downward spiral begins to take shape. On the other hand, clients also begin to withdraw money from banks, which further destabilizes the financial system. At one point, the financial bubble bursts and the crisis becomes a fact. Reinert argues that one of the more important points of Minsky's analysis is his insistence on the fact that the ruling economy theory prevents us from seeing when a system crisis is about to strike.

All in all, Reinert defends the thesis that financial crises are associated with a wrong balance between the financial and the real economy. The point is in the misbalance between these two economic sectors. A misbalance so large that – this was Reinert's prediction before the contemporary financial crisis struck – after the financial bubble bursts, it will have far-reaching negative consequences for the real economy. Financial crises are system crises and they can be prevented only on that level. What is a possible (effective) solution? It is necessary, according to Reinert, to bring the financial sector once under control again and subordinate it to the needs of the real economy.

IV

In one of his articles, Reinert has presented the argument that economics has made a full circle from scholasticism to new scholasticism. More precisely, he considers that after the scholastic period, a serious advance in economics has been made, but that over time economics has reverted to new scholasticism. Therefore, Reinert suggests that we should return to the "old economists" whose analyses and insights he considers crucial for understanding real economic phenomena and processes. Who does Reinert see as the representatives of "old economics" used to offer relevant theoretical insights? Those are thinkers which have been pushed aside by the dominant academic economic paradigm. More precisely, Reinert reminds us of the ideas of economists who had a different vision of how the economy works, and who had a different interpretation of the factors of economic growth and development than the dominant economic paradigm.

In a short, but brilliantly written, chapter, "Necrology department", Reinert presents the key ideas of List, Veblen, Schumpeter, Abramowitz, Nurkse, Galbraith, as well as of the Norwegian economist Torkel Halvorsen Aschehoug. By reminding us of the basic viewpoints of these economists, Reinert wishes to point out that there is a different way of understanding the economy than the one offered by the neoclassical economics. Friedrich List is a thinker whose ideas have been an important precondition for the welfare state (Reinert considers that the idea that the welfare state is exclusively a compromise between liberalism and Marxism is wrong). Two key challengers to the standard economic theory are institutional and evolutionary economics. Reinert argues that Veblen is the founder of both those schools. He also reminds us that Veblen argued that the market system behaves differently when it is dominated by the productive capital, compared to when it is dominated by the financial capital. When the economy is dominated by the financial capital, public capital gets privatized, but no new public wealth gets created. Joseph Schumpeter brought the notion of the entrepreneur into the economic picture, and put him at its very center. Without entrepreneurship and innovativeness, there is no economic dynamics. The entrepreneur breaks the equilibrium through innovations and in doing so he makes the market more dynamic.

The Estonian economist Ragnar Nurkse is significant due to his contributions to development economics. He argued that the vicious circle of underdevelopment must be broken by the industrialization, but that in doing so, one must keep a balanced growth of both the supply and demand. This concept does not accept the idea that poor countries should specialize in delivering raw materials to developed countries. Moses Abramowitz proved in his time that capital and labor account for only about 15% of the economic growth in the United States in the period 1870-1950. The rest is ”residual“. Reinert says that it was exactly Abramowitz’s residual that formed the key point in his own doctoral dissertation. Reinert argued that the residual is unequally distributed between different economic activities, which makes the choice between industries extremely important for economic growth. More precisely, the wealth of a country depends on what it produces. The Norwegian economist Aschehoug (1822–1909) has presented, among other things, the basic elements of the theory that is today associated with Hyman Minsky, and he also stressed the role of the entrepreneur in the economy before Schumpeter. He was amongst those economists who were against the Ricardian economic theory. Galbraith consistently dealt with topics which the dominant economic paradigm simply ignored: economic power and its misuse, poverty and system crises.

Reinert’s key objection is that academic economics has distanced itself from life (from reality) and history, and that it has been reduced to complex models taken from the world of physics which rest on mechanical adjustments and the idea of equilibrium. In short, such a theory is not applicable to the problems of real life, nor does it deal with them at all. As a key step in this direction, Reinert points to Friedman’s book *Essays in Positive Economics*, in which the famous thesis that the realisticness of the assumptions of economic theory is not decisive for its validity. This viewpoint has, according to Reinert’s opinion, ”fenced off“ economics from economic life, and it has begun living on its own. Reinert is explicit: ”We have to get rid of a theory in which prestige is increased proportionately with the level of abstraction, and in its place bring back old economics in which prestige increases proportionately with practical relevance.“ (p. 92).

V

Reinert offers a different understanding of capitalism as a solution to the ongoing global economic challenges, that is, a capitalism which would have a different form than the current one. This form would consist of three key elements: entrepreneurs, a strong state which ensures that the way people earn money is also useful for society, and new knowledge and technology. The author stresses that this view is grounded both on the ideas of the left and the right, but that it also contains elements that are completely alien to both. The idea that the state plays an important role in the economy is retained from the left political orientation (among other things, Reinert speaks of the need to create world Keynesianism, but adds that he does not know how it should look), and placing the entrepreneur and entrepreneurship at the very center of the economy is taken from the right political orientation. An evolutionary understanding of the economy, according to Reinert’s opinion, opposes the left-right division that is traditionally forced on economic policy.

Technology is the starting point that is alien to both the left and the right. The technology, and not capital, is placed at the very center among the driving forces of the economy. Technology and new knowledge are key variables in this context. In this way, Reinert is reviving Schumpeter's thesis from the beginning of the twentieth century that innovations and new knowledge are the key drivers of economic development. He notes that if one looks at the economic movements in the twentieth century, one can see that the enormous economic growth in that century was caused by two factors: technological changes and economies of scale. Seen from a different angle, that means that in modern markets it is important to create a comparative advantage in knowledge.

An abundance of capital does not create the incentives for a timely preparation for a new techno-economic paradigm. Reinert reminds us of Michael Porter's theory that economic stagnation begins when societies are no longer set in motion by the innovation, but by wealth. The author especially notes the fact that changes in technological paradigms change the economy, but that they also change society as a whole. Reinert repeats in several places in the book that society is a system whose structure of institutions, education and way of thinking are shaped around one type of technology. He also argues that innovations are necessary primarily in order to maintain wealth. So, entrepreneurship, new technology and a strong state are key concepts for sustainable economic growth. The economic growth is a synergetic phenomenon.

VI

One special topic that Reinert deals with in this book is overcoming poverty. That is a topic that economics has been facing since the very begining. He argues for a general thesis that it is necessary for undeveloped countries to develop manufacturing industry. All other measures directly or indirectly amount to the same thing – "aid colonialism". Undeveloped countries must make their economies more diversified, and that means that they have to give up their one-sided specialization in agriculture. In order to support this argument, Reinert uses both economic theory and economic history.

To illustrate his point, in several places in the book Reinert points to the views that the Italian economist Antonio Serra presented in 1613. Serra claimed that Venice's wealth was the product of a great division of labor and economies of scale. Reinert also reminds us that John Stuart Mill, in his *Principles of Political Economy*, recommended poor countries to industrialize (J. M. Keynes held a similar opinion). Reinert points to the fact that the industrial sector is important because of its economies of scale. All in all, before engaging in free trade (before they are capable of engaging in free trade), undeveloped countries should have the right to use those economic policies that were used by today's developed countries. In order to help the poor in the right way, it is necessary to create economic growth where they live. From this perspective, Reinert questions some of the existing strategies to help the poor. For example, in this context he points out that microcredits undoubtedly help the poor, but that they by themselves they cannot be the solution to the problem of underdevelopment. It is not microcredits, Reinert notes, which have made Europe rich.

Reinert also points to the current problems within the European Union. The transition strategy has led to a sudden deindustrialization of former socialist countries (which have become new EU members). Their existing economic structure was thoroughly altered. They were then integrated into the EU ”over night“. These countries are, according to Reinert, the Achilles’ heel of Europe in the ongoing financial crisis. The key problem is that these countries have no manufacturing industry, that is, the basic mistake was that they were integrated without preserving their industrial sector. Hence, the short- and long-term consequences of the financial crisis will be far worse for these countries than for countries which have a developed manufacturing industry.

VII

Considering that Erik Reinert consistently insists on the relevance of economics for real economic life, the reader will think differently about everyday economic topics after closing the pages of this stimulating book. Even though the author mainly refers to the Norwegian society and its problems and challenges in this book, it is important to note that the topics that Reinert talks about are very important for Serbia as well, a country which faces the challenge of determining its economic development strategy and questioning its experience of the transition process. Hence, the publishing of this book in the Serbian language will raise the level of the academic and public debate and stimulate it in new directions. In any case, it will enrich it with new topics and shake up some existing stereotypes.

This book is very interesting and provocative, and it both directly and indirectly questions the very foundations of the theories and ideologies that contemporary economies and societies are based on. Besides, the book is replete with interesting details from economic theory, the history of economic ideas and political philosophy, but also with skillfully chosen examples from real economic life. All in all, this book will not leave the reader indifferent. The main tone of the book means that it will face two groups of readers: those who agree with it and those who hold a different opinion. Both will find it useful. For those who agree with it, the book will offer additional support (new arguments), and for those with different opinions, the book will be a great challenge and will stimulate them to react.