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THE COMMANDING HEIGHTS

THE BATTLE BETWEEN GOVERNMENT AND THE MARKETPLACE THAT IS REMAKING THE MODERN WORLD

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PULITZER PRIZE–WINNING AUTHOR OF *THE PRIZE*

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THE COMMANDING HEIGHTS

The Battle Between Government and the Marketplace That Is Remaking the Modern World

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To Angela, Alexander, and Rebecca Yergin
and
To Augusta, Louis, Katrina, and Henry Stanislaw

ABOUT THE AUTHORS

A writer of international renown, **Daniel Yergin** is the author of *The Prize: The Epic Quest for Oil, Money, and Power,* the global best-seller and winner of the Pulitzer Prize and the Eccles Prize that was made into an eight-part PBS/BBC series. He is also the author of *Shattered Peace,* the classic account of the Cold War, and coauthor of the best-seller *Energy Future* and *Russia 2010 and What It Means for the World.* Yergin is chairman of Cambridge Energy Research Associates, a leading analytic firm in the energy industries, and vice-chairman of Global Decisions Group, which provides economic and risk analysis on major global markets. He is a Fellow of the Center for Business and Government at Harvard's Kennedy School. He received a B.A. from Yale University and a Ph.D. from Cambridge University, where he was a Marshall Scholar.

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"A fascinating tale . . . In every way, the book is very well done . . . nicely paced and often witty. . . . There is no triumphalism: the authors are keen on markets, but aware of their drawbacks, and give them their proper attention. . . .[A] better guide to the future of capitalism."

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"Their book reads like a juicy nonfiction soap opera, tracing the paths of more than 30 characters as they redefine the econo-political landscape of the last half-century."

—David R. Henderson, *Fortune*

"A lively and authoritative treatment of the re-emergence of the market as not just a way in the world but as a respectable idea . . . and ideal."

—Martin Peretz, *TheStreet.com*

"Yergin and Stanislaw are . . . skilled in turning dense evidence into an entertaining and persuasive read. Free of economic jargon, the book is packed instead with anecdotal glimpses of the personalities and events of the era."

—Martin Vander Weyer, *The Sunday Telegraph*

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—Robe *ional Economy*

"A grand tale, and [the authors] relate i . ambition. . . . *The Commanding Heights* brims with personality and incident."

—Gary Rosen, *Commentary*

"Excellent . . . *The Commanding Heights* provides a sweeping vision . . . a great read and highly recommended."

—Claire Liuksila, *Finance and Development*

"Yergin and Stanislaw have magnificently charted the economic history of the past fifty years and noted the parallel developments of technology and the growth of free markets. Yet something suggests that the cycle is not over yet."

—Chris Cragg, *Financial Times Energy*

"Mr. Yergin and Mr. Stanislaw tell this story well, drawing on their own lengthy interviews with many of the key figures in this transformation."

—Benjamin M. Friedman, *The New York Review of Books*

"Extraordinarily accessible but deep-reaching, this book is a tour-de-force."

—Michael Pakenham, *The Sun* (Baltimore)

"The crowning achievement of *The Commanding Heights* is that it illuminates today's profound changes through the great sweep of history."

—Valéry Giscard d'Estaing, former President of France

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—Lawrence Summers

"The Commanding Heights captures the modern world's most crucial changes in a dramatic and vivid way. This book will be invaluable for readers in every part of the world."

—Yegor Gaidar, former Deputy Prime Minister and Minister of Finance, Russia

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—Gary Becker, winner of the Nobel Prize for Economics, 1992

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—John Browne, Chief Executive, BP (British Petroleum)

"A stunning and eminently readable account of how the market has captured the commanding heights of economic thinking. Transforming economic analysis into a compelling narrative, the authors give us a comprehensive picture of an unfolding and dramatic story. It is as engrossing as it is instructive."

—George P. Schultz, former U.S. Secretary of State and
former U.S. Secretary of the Treasury

CONTENTS

AT THE FRONTIER

Introduction

BOOKS BEGIN in unexpected places. This book began in part on a summer's day on the outskirts of Moscow. The Izmailovo outdoor market sprawls over acres on the southwest edge of the city, almost at the very end of the subway line. Its transformation—from a park for exhibiting painting and crafts into a vast bazaar—was one of the earliest and most visible signs of communism's collapse and the transition to an economy that was no longer state controlled but responded to the demands of the marketplace.

The past and future were simultaneously on sale. Oil paintings of snowy villages and religious icons, many of dubious origin, were commingled with South Korean electronics and cheap videocassettes. Stalls competed to sell old dishes and stained uniforms, czarist mementos, and pins decorated with Lenin's face. There were carpets from Central Asia, swords from the Caucasus, and military souvenirs from both czarist and Red armies. And everywhere were the *matrioshki,* wooden dolls within dolls, but of endless variation—not only the traditional peasant women but also a host of other characters, from Soviet leaders and American presidents to the Harlem Globetrotters. The favored mode of payment for all of this was the dollar—the same dollar whose possession only a few years earlier could have resulted in a stiff prison term.

The market drew all sorts of people, including, on this particular day Sir Brian Fall, the then British ambassador. As a career diplomat in the Foreign Office, Fall had dealt with Soviet and Russian affairs for thirty years, going back to the cold war days of George Smiley. In between, he had held a number of other positions, including senior adviser to three foreign secretaries as well as high commissioner to Canada. This day, however, he was at Izmailovo with his wife and daughter not for diplomatic purposes but, like everybody else, to shop. They were looking for a painting of a rural village scene, an evocation of traditional Mother Russia. But Sir Brian, every now and then, still had to stop to remind himself that the dramatic changes in modern Russia were really happening. Every stall at Izmailovo brought one face-to-face with that change.

The market was a metaphor for a society disjointed and confused, but also reenergized, experiencing a transition more wrenching and more rapid than Russians could comprehend, having passed through a revolution they had not anticipated—and were certainly not prepared for.

"How much easier it would have been for the Russians," he said as we wound down one of the aisles, "if the Soviet Union had collapsed in the 1960s or 1970s."

Why?

"Because that was when government intervention loomed large in the West, and national planning and state ownership were the methods of the day. That would have made it much more acceptable for Russia to hold on to its huge state-owned companies and keep pumping money into them, no matter how big the losses. And then the move to a market economy would not have been so severe and traumatic."

His observations brought into sudden and sharp focus how much has changed around the world since the 1970s in thinking about the appropriate relationship between state and marketplace. What was the conventional, indeed the dominating, wisdom of that time is now widely criticized, and in some cases discredited and abandoned. What seemed to be ideas on the fringe, or even beyond the fringe, discussed only around a few seminar tables, have now moved into the center. As a consequence, economies almost everywhere are being reordered, in some cases radically, with immense and far-reaching effects.

All around the globe, socialists are embracing capitalism, governments are selling off companies they had previously nationalized, and countries are seeking to entice back multinational corporations that they had expelled just two decades earlier. Marxism and state control are being jettisoned in favor of entrepreneurship; the number of stock markets is exploding; and mutual fund managers have become celebrities. Today, politicians on the left admit that their governments can no longer afford the expansive welfare state, and American liberals recognize that more government may not hold the solution to every problem. Many people are being forced to reexamine and reassess their root assumptions. These changes are opening up new prospects and new opportunities throughout the world. The shift is also engendering, for many, new anxieties and insecurities. They fear that government will no longer be there to protect them as they become increasingly intertwined in a global economy that seeks to ignore national borders. And they express unease about the price that the market demands of its participants. Shocks and turbulence in international capital markets, such as those that roiled Latin America in 1995 and Asia in 1997, turn that unease into fundamental questions about the danger and even legitimacy of markets.

The global financial crisis that began in Asia in 1997 and spread to the rest of the world in 1998 raised profound new issues about the powerful impact and unanticipated risks arising from integration into the global market. But all these considerations need to be set in context.

Why the Shift?

Why the move to the market? Why, and how, the shift from an era in which the "state"—national governments—sought to seize and exercise control over their economies to an era in which the ideas of competition, openness, privatization, and deregulation have captured world economic thinking? This question, in turn, begets others: Are these changes irreversible? Are they part of a continuing process of development and evolution? What will be the consequences and prospects—political, social, and economic—of this fundamental alteration in the relationship between government and marketplace? These are the basic questions that this book seeks to answer.

Where the frontier between the state and market is to be drawn has never been a matter that could be settled, once and for all, at some grand peace conference. Instead, it has been the subject, over the course of this century, of massive intellectual and political battles as well as constant skirmishes. In its entirety, the struggle constitutes one of the great defining dramas of the twentieth century. Today the clash is so far-reaching and so encompassing that it is remaking our world—and preparing the canvas for the twenty-first century.

This frontier defines not the boundaries of nations but the division of roles within them. What are the realm and responsibility of the state in the economy, and what kind of protection is the state to afford its citizens? What is the preserve of private decision making, and what are the responsibilities of the individual? This frontier is not neat and well defined. It is constantly shifting and often ambiguous. Yet through most of the century, the state has been ascendant, extending its domain further and further into what had been the territory of the market. Its victories were propelled by revolution and two world wars, by the Great Depression, by the ambitions of politicians and governments. It was also powered by the demands of the public in the industrial democracies for greater security, by the drive for progress and improved living conditions in developing countries—and by the quest for justice and fairness. Behind all this was the conviction that markets went to excesses, that they could readily fail, that there were too many needs and services they could not deliver, that the risks and the human and social costs were too high and the potential for abuse too great. In the aftermath of the traumatic upheavals of the first half of the twentieth century, governments expanded their existing responsibilities and obligations to their populaces and assumed new ones. "Government knowledge"—the collective intelligence of decision makers at the center—was regarded as superior to "market knowledge"—the dispersed intelligence of private decision makers and consumers in the marketplace.

At the extreme, the Soviet Union, the People's Republic of China, and other communist states sought to suppress market intelligence and private property altogether and replace them with central planning and state ownership. Government would be all-knowing. In the many industrial countries of the West and in large parts of the developing world, the model was the "mixed economy," in which governments flexed their knowledge and played a strong dominating role without completely stifling the market mechanism. They would reconstruct, modernize, and propel economic growth; they would deliver equity, opportunity, and a decent way of life. In order to achieve all that, governments in many countries sought to capture and hold the high ground of their economies—the "commanding heights."

The term goes back three quarters of a century. In November 1922, half a decade after leading the Bolsheviks to victory, the already ailing Vladimir Illyich Lenin made his way to the platform of the Fourth Congress of the Communist International in St. Petersburg, then called Petrograd. It was his penultimate public appearance. The year before, amid economic breakdown and out of desperation, Lenin had initiated the New Economic Policy, permitting a resumption of small trade and private agriculture. Now, communist militants were attacking him for compromising with capitalism and selling out the revolution. Responding with his old acerbity and sarcasm, despite his physical enfeeblement, Lenin defended the program. Although the policy allowed markets to function, he declared, the state would control the "commanding heights," the most important elements of the economy. And that, Lenin assured any who doubted him, was what counted. All this was before collectivization, Stalinism, and the total eradication of private markets in the Soviet Union.

The phrase found its way to Britain, via the Fabians and the British Labour Party, in the interwar years; it was then adopted by Jawaharlal Nehru and the Congress Party in India, and spread to many other parts of the world. Whether or not the term was used, the objective was one and the same: to ensure government control of the strategic parts of the national economy, its major enterprises and industries. In the United States, government exerted its control over the commanding heights not through ownership but rather through economic regulation, giving rise to a special American brand of regulatory capitalism.[1]

Overall, the advance of state control seemed to be inexorable. In the immediate post–World War II years, only governments could marshal the resources necessary to rebuild devastated and dislocated nations. The 1960s seemed to prove that they could effectively run, and indeed fine-tune, their economies. By the beginning of the 1970s, the mixed economy was virtually unchallenged and government continued to expand. Even in the United States, the Republican administration of Richard Nixon sought to implement a massive program of detailed wage and price controls.

Yet by the 1990s, it was government that was retreating. Communism had not only failed, it had all but disappeared in what had been the Soviet Union and, at least as an economic system, had been put aside in China. In the West, governments were shedding control and responsibilities. Instead of "market failure," the focus was now on "government failure"—the inherent difficulties that arise when the state becomes too expansive and too ambitious and seeks to be the main player, rather than a referee, in the economy. Paul Volcker, who conquered inflation as chairman of the U.S. Federal Reserve System, explained the reason for the change in simple terms: "Governments had become overweening."

The Greatest Sale

Today, in response to the high costs of control and the disillusionment with its effectiveness, governments are privatizing. It is the greatest sale in the history of the world. Governments are getting out of businesses by disposing of what amounts to trillions of dollars of assets. Everything is going—from steel plants and phone companies and electric utilities to airlines and railroads to hotels, restaurants, and nightclubs. It is happening not only in the former Soviet Union, Eastern Europe, and China but also in Western Europe, Asia, Latin America, and Africa—and in the United States, where federal, state, and city governments are turning many of their traditional activities over to the marketplace. In a parallel process that is more far-reaching and less well understood, they are also overturning the regulatory apparatus that has affected almost every aspect of daily life in America for the last six decades. The objective is to move away from governmental control as a substitute for the market and toward reliance on competition in the marketplace as a more efficient way to protect the public.

This shift does not, by any means, signal the end of government. In many countries, governments continue to spend as large a share of national income each year as the year before. The reason, in the industrial countries, is social spending—transfer payments and entitlements—and almost everywhere, government remains the solution of last resort for a host of societal demands. Yet the scope of government, the range of duties it takes on in the economy, is decidedly receding. The world over, governments have come to plan less, to own less, and to regulate less, allowing instead the frontiers of the market to expand.

The decamping of the state from the commanding heights marks a great divide between the twentieth and twenty-first centuries. It is opening the doors of many formerly closed countries to trade and investment, vastly increasing, in the process, the effective size of the global market. Many new jobs are being created. Still, it is capital and technology that, in this new mobile economy, easily move around the world in search of new opportunities and markets and more favorable business environments. Labor, which does not travel as easily, could be left behind. The result for workers is a double anxiety—about global competition and about the loss of the social safety net.

The word *globalization,* minted not much more than a decade ago, has become the all-too-familiar description for the process of integration and internationalization of economic activities and strategies. Yet the term has already been overtaken by events. A new reality is emerging. This is not a process but a condition—a globality, a world economy in which the traditional and familiar boundaries are being surmounted or made irrelevant. The end of the Soviet Union and communism has redrawn the map of world politics and subdued ideology as a dominating factor in international affairs. The growth of capital markets and the continued lowering of barriers to trade and investment are further tying markets together—and promoting a freer flow of ideas. The advent of emerging markets brings dynamism and opportunity on a massive scale to the international economy. National firms are turning themselves into international operators; and companies, whether long experienced in international business or newcomers, are hastening to generate global strategies. Paralleling and facilitating much of this is a technological revolution of momentous but uncertain consequences. Information technology—through computers—is creating a "woven world" by promoting communication, coordination, integration, and contact at a pace and scale of change that far outrun the ability of any government to manage. The accelerating connections make national borders increasingly porous—and, in terms of some forms of control, increasingly irrelevant.

The Power of Ideas

Underlying all this has been a fundamental shift in ideas. In 1936, in the concluding pages of his famous *General Theory of Employment, Interest and Money,* the eminent British economist John Maynard Keynes wrote that ideas "are more powerful than is commonly understood. Indeed, the world is ruled by little else. Madmen in authority, who hear voices in the air, are distilling their frenzy from some academic scribblers of a few years back. . . . Sooner or later it is ideas, not vested interests, which are dangerous for good or evil."

The dramatic redefinition of state and marketplace over the last two decades demonstrates anew the truth of Keynes' axiom about the overwhelming power of ideas. For concepts and notions that were decidedly outside the mainstream have now moved, with some rapidity, to center stage and are reshaping economies in every corner of the world. Even Keynes himself has been done in by his own dictum. During the bombing of London in World War II, he arranged for a transplanted Austrian economist, Friedrich von Hayek, to be temporarily housed in a college at Cambridge University. It was a generous gesture; after all, Keynes was the leading economist of his time, and Hayek, his rather obscure critic. In the postwar years, Keynes' theories of government management of the economy appeared unassailable. But a half century later, it is Keynes who has been toppled and Hayek, the fierce advocate of free markets, who is preeminent.

The Keynesian "new economic ay have dominated the Kennedy and Johnson admin but it is the University of Chicago's free-market sch ly influential in the 1990s.[2]

But if economists and other thinkers have as, it is politicians who implement them; and one of the preeminent lessons of this remarkable shift is the importance of leaders and leadership. Keith Joseph, Britain's self-appointed "minister of thought," and his disciple Margaret Thatcher seemed to be embarking on a quixotic project when they set out to overturn Britain's mixed economy. Not only did they prevail, but they influenced the agenda for a good part of the rest of the world. It was a dedicated revolutionary, Deng Xiaoping, who, while genuflecting to Marx, resolutely forced the world's largest country to disengage from communism and integrate itself into the world economy. And in the United States, the victories of Ronald Reagan forced the Democratic Party to redefine itself.

The vocabulary of this march toward the marketplace requires a word of clarification. For Americans, the global battle between the state and market can be puzzling, for it appears to pit "liberalism" against "liberalism." In the United States, *liberalism* means the embrace of an activist, interventionist government, expanding its involvement and responsibility in the economy. In the rest of the world, *liberalism* means almost exactly the opposite —what an American liberal would, in fact, describe as *conservatism*. This kind of liberalism supports a reduced role for the state, the maximization of individual liberty, economic freedom and reliance on the market, and decentralized decision making. It has its intellectual roots in such thinkers as John Locke, Adam Smith, and John Stuart Mill. It emphasizes the importance of property rights and sees government's role as the facilitation and adjudication of civil society. Thus, in this book, when *liberalism* is discussed outside the United States, whether it is in the former Soviet Union or Latin America or elsewhere, it means less government, not more.*

* How was the meaning of this word altered so dramatically in the United States? During the First World War, some of the leading Progressive writers began to use the word *liberalism* as a substitute for *progressivism,* which had become tarnished by its association with their fallen hero, Theodore Roosevelt, who had run and lost on a Progressive third-party ticket. Traditional liberals were not happy to see their label transformed. In the 1920s, *The New York Times* criticized "the expropriation of the time-honored word 'liberal' " and argued that "the Radical-Red school of thought . . . hand back the world 'liberal' to its original owners." During the early 1930s, Herbert Hoover and Franklin Roosevelt duked it out as to who was the true liberal. Roosevelt won, adopting the term to ward off accusations of being left-wing. He could declare that liberalism was "plain English for a changed concept of the duty and responsibility of government toward economic life." And since the New Deal, liberalism in the United States has been identified with an expansion of government's role in the economy.

Relinking Past and Future

The reassertion of this traditional liberalism represents a rebirth—indeed, a reconnection—for it had its heyday in the late nineteenth century. Indeed, the world at the dawn of the twenty-first century bears resemblance to the late-nineteenth-century world—a world of expanding economic opportunity and ever-diminishing barriers to travel and trade. Then, as now, new technologies helped foster the change. Two innovations in the nineteenth century decisively broke the bounds of the natural rhythms of winds and tides, that had, from the beginning of civilization, defined commerce. In the early part of the nineteenth century, the steam engine made possible rail and ship transportation of people and goods that was safer, faster, and more expedient than any method known at the time. As early as 1819, the American ship *Savannah* crossed the Atlantic using a steam engine to augment its sails. By the middle of the nineteenth century, steam was beginning to supplant wind power altogether. When the first telegraph cable was laid across the floor of the Atlantic in 1865, after three failed attempts, markets were connected. The spread of these technologies powered a dramatic expansion of world trade. Moreover, they provided outlets for private investment capital. European funds were poured into the construction of railroads in North and South America and in Africa and Asia, and into the mines and plantations they connected to the ports. With British money financing so much of America's railway development, the United States became the champion emerging market of the nineteenth century. In the late nineteenth century and early twentieth century, the world economy experienced an era of peace and growth that, in the aftermath of the carnage of World War I, came to be remembered as a golden age.

Critical Tests

What powered the return toward traditional liberalism around the world? The previous embrace of the state as modernizer turned into disillusionment with state ownership and intervention, owing to the unexpectedly heavy costs and consequences. The financial burden had gone beyond the ability of governments to manage: Debts and deficits had grown too big. Inflation had become chronic and embedded. As the perceived gap between intentions and actual performance grew, confidence turned into cynicism. The implosion of the Soviet system—the great lodestar for central planning—discredited statism of all kinds, while the rise of prospering East Asian economies pointed toward a different balance between state and marketplace and underlined the virtues of participation in the global economy.

Will the apparent triumph of the market endure? Or will government's role expand once again? The response will depend, we believe, on how the