Capitalism:
A Very Short Introduction
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Chapter 1
What is capitalism?

Merchant capitalism

In April 1601 the English East India Company sent its first expedition to the East Indies. After some eighteen months its four ships, *Ascension, Dragon, Hector,* and *Susan,* had returned from Sumatra and Java with a cargo mainly of pepper. The success of this venture led to a second expedition by the same ships, which left London in March 1604. On the return journey *Hector* and *Susan* set off first, but *Susan* was lost at sea and *Hector* was rescued by *Ascension* and *Dragon*, which found her drifting off South Africa with most of her crew dead. *Ascension, Dragon,* and *Hector* made it back to England in May 1606 with a cargo of pepper, cloves, and nutmegs. The shareholders in these two voyages made a profit of 95 per cent on their investment.

Despite the similar success of the third expedition in 1607, the fourth one in 1608, consisting of the ships *Ascension* and *Union,* was a complete disaster. The *Ascension* reached the west coast of India but was there wrecked by its 'proud and headstrong master', who drove his ship aground after ignoring local warnings about shoaling waters. The *Union* called in at a Madagascan port, where the crew was ambushed and the captain killed, but nonetheless the ship made it to Sumatra and loaded a cargo. On her way back, the *Union* was wrecked off the coast of Brittany. The investors in this expedition lost all their capital.

Capitalism is essentially the investment of money in the expectation of making a profit, and huge profits could be made at some considerable risk by long-distance trading ventures of this kind. Profit was quite simply the result of scarcity and distance. It was made from the huge difference between the price paid for, say, pepper in the Spice Islands and the price it fetched in Europe, a difference that dwarfed the costs of the venture. What mattered was whether the cargo made it back to Europe, though market conditions were also very important, for the sudden return of a large fleet could depress prices. Markets could also become saturated if the high profitability of the trade led too many to enter it. A glut of pepper eventually forced the East India Company to diversify into other spices and other products, such as indigo.

A large amount of capital was needed for this trade. An *East Indiaman*, as the ships engaged in this trade were called, had to be built, fitted out, armed with cannon against Dutch and Portuguese rivals, and repaired, if and when it returned. The Company's shipyards at Blackwall and Deptford, which were major employers of local labour, required financing. Capital was also needed to stock outgoing vessels with bullion and goods to pay for the spices, with munitions, and with food and drink for the large crews they carried. On the Company's third expedition, *Dragon* had a crew of 150, *Hector* 100, and *Consent* 30—in all 280 mouths to feed, at least initially. One reason for the large crews was to make sure there were enough sailors to get the ships back after the hazards of the expedition had taken their toll.

The East India Company's capital was obtained largely but not entirely from the rich London merchants who controlled and administered it. Aristocrats and their hangers-on were another source, and one welcomed by the Company because of their

influence at Court. The Company's privileges depended on royal favour. Foreign money was also involved, mainly from Dutch merchants excluded by the rival Dutch East Indies Company. They were also a useful source of intelligence about that company's activities.

The first twelve voyages were each financed separately, with capital committed to one voyage only and the profits of the voyage distributed among its shareholders, according to traditional merchant practices. This was, however, a risky way of financing long-distance trade, for it exposed capital to a long period of uncertainty in far-away and unknown places. Risk could be spread by sending out several ships on each expedition, so that not all the eggs were in one basket, but whole expeditions could, nonetheless, be lost, as in 1608. The company shifted to a method of finance that spread risks over a number of voyages and then became a fully fledged joint-stock company, with, after 1657, continuous investment unrelated to specific voyages. In 1688 trading in its stocks began on the London Stock Exchange.

Risk was also reduced through monopolistic practices. Like its counterparts abroad, the English East India Company was closely intertwined with the state, which granted it a monopoly for the import of oriental goods and gave it the right to export bullion to pay for them. In exchange the state, always short of money, gained revenue from customs duties on the large and valuable imports made by the company. There was certainly competition but it was international competition, in the Indies between the English, the Dutch, and the Portuguese, and as far as possible eliminated within each country. Outsiders were always trying to break into the trade, and one of the key privileges bestowed on the East India Company by the state was the right to take action against 'interlopers'.

Markets were manipulated by buying up stocks and holding back sales. In the 17th century Amsterdam merchants were particularly skilled in these practices and busily established monopolies not only in spices but in Swedish copper, whale products, Italian silks, sugar, perfume ingredients, and saltpetre (an ingredient of gunpowder). Large warehouses were crucial to this and Fernand Braudel comments that the warehouses of the Dutch merchants were bigger and more expensive than large ships. They could hold sufficient grain to feed the entire country for 10–12 years. This was not just a matter of holding goods back to force up prices, for large stocks also enabled the Dutch to destroy foreign competitors by suddenly flooding the whole European market with goods.

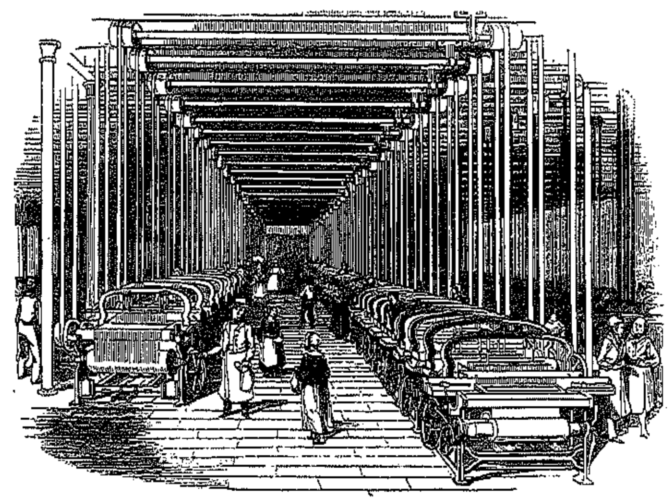
This was certainly capitalism, for long-distance trade required a heavy investment of capital in the expectation of large profits, but a free market capitalism it clearly was not. The secret of making high profits was to secure monopolies by one means or another, exclude competitors, and control markets in every way possible. Since profit was made from trading in scarce products rather than rationalizing production, the impact of merchant capitalism on society was limited. Most of the European population could get on with their daily work without being affected by the activities of these owners of capital.

Capitalist production

In the 1780s two Scots, James M'Connel and John Kennedy, travelled south to become apprentices in the Lancashire cotton industry. After gaining experience and making some money in the manufacture of cotton machinery, they set up their own firm in 1795 with an initial capital of £1,770. They soon made good profits from cotton spinning, achieving a return on capital of over 30 per cent in 1799 and 1800. They accumulated capital rapidly and by 1800 their capital had risen to £22,000, by 1810 to £88,000. By 1820 the company had three mills and had established itself as the leading spinner of fine cotton in Manchester, the global metropolis of cotton spinning.

This soon became a very competitive industry, however, and profits could not be sustained at the high level of the early 1800s. This was, indeed, largely because high profits had resulted in expansion and attracted new entrants. There were already 344 cotton mills by 1819 but by 1839 there were 1,815. Technical advances enabled huge increases in productivity during the 1830s, and competition drove companies to invest heavily in the new machinery. The bigger mills built at this time contained 40,000 spindles, as compared with the 4,500 or so of their predecessors. The costs of this heavy investment in buildings and machinery, together with the downward pressure of increased productive capacity on yarn prices, depressed the industry's profitability to low levels in the 1830s.

Profit depended ultimately on the workers who turned raw cotton into yarn (Figure 1). M'Connel and Kennedy's labour force grew from 312 in 1802 to around 1,500 by the 1830s. Much of this was cheap child labour and at times nearly half those employed were



1. Power looms dominate a 19th-century cotton mill.

under the age of 16. In 1819 there were 100 children under the age of 10, some as young as 7, who worked from 6.00 in the morning until 7.30 at night.

Apart from the occasional heavy cost of new factories and new machinery, wages were the company's main cost. Its annual wage bill was over £35,000 by 1811 and over £48,000 by the mid-1830s. Wage costs were minimized not just by holding wage rates down but also by replacing craft workers with less skilled and cheaper labour, as the invention of automatic machinery made this possible. The cyclical instability of the industry resulted in periodic slumps in demand, which forced employers to reduce wages and hours in order to survive.

As industrial capitalism developed, conflict over wages became increasingly organized. The spinners defended themselves against wage reductions through their unions, organizing at first locally but then regionally and nationally. In 1810, 1818, and 1830 there were increasingly organized strikes, but these were defeated by the employers, with the assistance of the state, which arrested strikers and imprisoned union leaders. The employers had created their own associations, so that they could 'black-list' union militants, answer strikes with 'lock-outs', and provide mutual financial support. Vigorous action by the spinners' unions does seem, nonetheless, to have been quite successful, for wages remained stable, in spite of declining profitability and employers' attempts to reduce them.

The exploitation of labour was not just a matter of keeping the wage bill down but also involved the disciplining of the worker. Industrial capitalism required regular and continuous work, if costs were to be minimized. Expensive machinery had to be kept constantly in use. Idleness and drunkenness, even wandering around and conversation, could not be allowed. The cotton mills did indeed have trouble recruiting labour because people simply did not like long, uninterrupted shifts and close supervision.

Employers had to find ways of enforcing a discipline that was quite alien to the first generation of industrial workers. They commonly used the crude and negative sanctions of corporal punishment (for children), fines, or the threat of dismissal, but some developed more sophisticated and moralistic ways of controlling their workers.

Robert Owen introduced 'silent monitors' at his New Lanark mills. Each worker had a piece of wood, with its sides painted black for bad work, blue for indifferent, yellow for good, and white for excellent. The side turned to the front provided a constant reminder, visible to all, of the quality of the previous day's work. Each department had a 'book of character' recording the daily colour for each worker. Discipline was not only a factory matter, for Owen also controlled the community. He sent round street patrols to report drunkenness and fined the drunks next morning. He insisted on cleanliness and established detailed rules for the cleaning of streets and houses. There was even a curfew that required everyone to be indoors after 10.30 p.m. in the winter.

As E. P. Thompson has emphasized, disciplined work was regular, timed work. It meant turning up every day, starting on time, and taking breaks of a specified length at specified times. Employers had a long battle against the well-established tradition of taking off, as additional 'saint's days', 'St Monday', and even 'St Tuesday', to recover from weekend drinking. Time became a battleground, with some unscrupulous employers putting clocks forward in the morning and back at night. There are stories of watches being taken off workers, so that the employer's control of time could not be challenged. Significantly, timepiece ownership spread at the same time as the Industrial Revolution and at the end of the 18th century the government tried to tax the ownership of clocks and watches.

Industrial capitalism not only created work, it also created 'leisure' in the modern sense of the term. This might seem surprising, for the early cotton masters wanted to keep their machinery running as long as possible and forced their employees to work very long hours. However, by requiring continuous work during work hours and ruling out non-work activity, employers had separated out leisure from work. Some did this quite explicitly by creating distinct holiday periods, when factories were shut down, because it was better to do this than have work disrupted by the casual taking of days off. 'Leisure' as a distinct non-work time, whether in the form of the holiday, weekend, or evening, was a result of the disciplined and bounded work time created by capitalist production. Workers then wanted more leisure and leisure time was enlarged by union campaigns, which first started in the cotton industry, and eventually new laws were passed that limited the hours of work and gave workers holiday entitlements.

Leisure was also the creation of capitalism in another sense, through the commercialization of leisure. This no longer meant participation in traditional sports and pastimes. Workers began to pay for leisure activities organized by capitalist enterprises. The new railway companies provided cheap excursion tickets and Lancashire cotton workers could go to Blackpool for the day. In 1841 Thomas Cook organized his first tour, an excursion by rail from Leicester to Loughborough for a temperance meeting. Mass travel to spectator sports, especially football and horse-racing, where people could be charged for entry, was now possible. The importance of this can hardly be exaggerated, for whole new industries were emerging to exploit and develop the leisure market, which was to become a huge source of consumer demand, employment, and profit.

Capitalist production had transformed people's work and leisure lives. The investment of capital in the expectation of profit drove the Industrial Revolution and rapid technical progress increased productivity by leaps and bounds. But machines could not work on their own and it was wage labour that was central to the making of profit. The wage bill was the employer's main cost and

became the focus of the conflict between the owners of capital and, as Karl Marx put it, those who owned only their 'labour power', the capacity to make money through physical work. Workers were concentrated in factories and mills, where they had to work in a continuous and disciplined manner under the supervisor's watchful eye, but also now had an opportunity to organize themselves collectively in unions. Non-work activities were expelled from work time into leisure time and daily life was now sharply divided between work and leisure. Wage labour also meant, however, that workers had money to spend on their leisure life. The commercialization of leisure created new industries that fed back into the expansion of capitalist production.

Financial capitalism

On Thursday, 23 February 1995, Nick Leeson, the manager of Baring Securities in Singapore, watched the Nikkei, the Japanese stock market index, drop 330 points. In that one day, Barings lost £143 million through the deals that he had made, though he was the only one who knew what was happening. These losses came on top of the earlier ones of some £470 million that Leeson had kept hidden from his bosses. He knew the game was up and bolted, with his wife, to a hideaway on the north coast of Borneo. Meanwhile Barings' managers, puzzling over the large sums of money that had gone missing in Singapore, tried desperately to find him. By the next morning it was clear that Baring Brothers, the oldest merchant bank in London, had sustained such huge losses that it was effectively bankrupt. Leeson tried to find his way back to England but was arrested in Frankfurt, extradited by Singapore for breaches of its financial regulations, and jailed for six and a half years.

Leeson had been trading in 'derivatives'. These are sophisticated financial instruments that *derive* their value from the value of something else, such as shares, bonds, currencies, or indeed commodities, such as oil or coffee. *Futures,* for example, are contracts to buy shares, bonds, currencies, or commodities at their *current* price at some point in the future. If you think that the price of a share is going to rise, you can buy a three months' future in it. After the three months have expired, you receive shares at the original price and make a profit by selling them at the higher price now prevailing. You can also buy *options,* which do not commit you to the future deal but allow you to decide later whether you want to go ahead or not.

The buying of futures can perform a very important function, since it enables the reduction of uncertainty and therefore risk. If the price of corn is high but the harvest is some way off, a farmer can lock into the existing price by making a deal with a merchant to sell the corn at this price in three months' time. Futures can also, however, be bought for purely speculative reasons to make money out of movements in prices. Financial futures of the kind that Leeson was trading in were more or less informed gambles on future price movements. This was what Susan Strange has called 'casino capitalism'.

Money could also be made from 'arbitrage', which exploits the small price differences that occur for technical reasons between markets. If you are able to spot these differences, calculate rapidly what they are worth, and move large sums of money very quickly, you can make big profits this way. Leeson found that he could exploit small differences, lasting less than a minute, between futures prices on the Osaka and Singapore stock exchanges. Operations of this kind could be carried out with little risk, since an immediate and calculable profit was taken from an existing, if short-lived, price difference.

Why then did things go so wrong for Leeson? He started down a slippery slope when he created a special error account, no. 88888, supposedly to handle innocent dealing and accountancy mistakes.

This was the place where he hid his losses and he also found a way of concealing the accumulated end-of-the-month deficits by getting the Singapore 'back office' to make temporary but illegal transfers of money between various accounts. This and other manipulations bamboozled the auditors, who should have uncovered what was going on.

The existence of 88888 allowed Leeson to gamble with Barings' money. He could build his reputation by taking risks and trading aggressively on the futures markets, since any losses could be hidden. These *could* be covered by later trades and at one time he came close to breaking even, but if he had then closed 88888 down this would have ended the operation that made him the star dealer of Barings. Eventually his losses built up again and accumulated to the point at which they could no longer be concealed just by switching money around.

At this point he plunged into selling options, which, unlike futures, could immediately raise money to cover the monthly shortfalls in 88888. Leeson was gambling heavily on future price movements and the Tokyo stock market went the wrong way. As his losses increased, he raised the stakes by selling more and riskier options, supposedly on behalf of a mythical client called Philippe. When the Nikkei fell after the Kobe earthquake, his losses became so great that he tried single-handedly to force the market up by buying large numbers of futures. The downward pressures were far too strong and the market fell. By now, the losses and liabilities that he had built up were greater than the total capital of Barings.

Why did Barings allow all this to happen? They were a merchant bank which in 1984 had ventured into stockbroking by creating Baring Securities. This was a successful move and by 1989 dealings in mainly Japanese stocks and shares were accounting for half Barings' profits. Baring Securities then moved into the increasingly fashionable activity of derivatives trading. In 1993

Barings merged its capital with that of Barings Securities and in doing so fatally removed the 'fire-wall' protecting the bank from possible losses by its securities department. This was a particularly dangerous thing to do, since senior Barings managers had a poor grasp of the new game that they had entered, while no proper management structure had been put in place and financial controls were very weak. Fraud was an ever-present danger in this financially very complex world and Barings broke a golden rule by allowing Leeson to be both a trader and the manager of the Singapore 'back office', which checked the trades and balanced the books.

Leeson was apparently a very successful dealer who was making large profits for Barings and they backed him to the hilt. Ironically, when Barings crashed, his bosses had just decided to reward his 1994 activities with a £450,000 bonus. As Leeson's operations drained increasing amounts of money from London and sent Barings hunting for loans around the world to cover them, Leeson's bosses actually thought they were financing profitable deals made by their star trader. It was not only the complexities of the financial markets and the extraordinarily weak financial controls within Barings that enabled Leeson to get away with things for so long, but also the corporate hunger for ever greater profits.

What then is capitalism?

We have examined three very different examples of capitalism. The various business activities involved are about as different as they could be, but all involve the investment of money in order to make a profit, the essential feature of capitalism. It is not the nature of the activity itself that matters but the possibility of making profit out of it. Indeed, it is typical of a capitalist society that virtually all economic activities that go on within it are driven by the opportunity to make profit out of capital invested in them.

Capital is money that is invested in order to earn more money. By extension the term capital is often used to refer to money that is *available* for investment or, indeed, any asset that can be readily turned into money for it. Thus, a person's house is often described as their capital, because they can turn it into capital either by selling it or by borrowing on the strength of it. Many small businesses are indeed set up in this way. It is, however, only possible to turn property into capital if its ownership is clearly established, its value can be measured, its title can be transferred, and a market exists for it. A characteristic feature of the development of capitalist societies is the emergence of institutions that enable the conversion of assets of all kinds into capital. Hernando de Soto has argued persuasively that it is the absence of these institutions, above all functioning systems of property law, that frustrates the emergence of local capitalisms in the Third World. He claims that an enormous amount of value that is locked up in property cannot therefore be realized and put by entrepreneurs to productive use.

Capitalists existed before capitalism proper. Since the earliest times merchants have made money by investing in goods that they sold at a profit. As we saw with the East India Company, a merchant capitalism of this kind could be highly organized and very profitable, but it was an activity that involved only a small part of the economy. Most people's livelihoods did not come from economic activities financed by the investment of capital. In capitalism proper the whole economy becomes dependent on the investment of capital and this occurs when it is not just trade that is financed in this way but production as well.

Capitalist production is based on wage labour. A clear line of division and conflict emerges between the owners of capital, who own what Karl Marx called 'the means of production', and those who sell their labour in exchange for wages. The means of production are the workplace, the machinery, and the raw materials, which in pre-capitalist societies were owned not by the owners of capital but by the craftsmen who made the goods. A wage (or salary) is the price paid by the employer for labour sold by the worker. Just as a capitalist will invest money in any activity that brings a profit, a worker can find employment in any activity that pays a wage.

In a capitalist society, both capital and labour have an abstract and disembedded quality, since both are separated from specific economic activities and are therefore able in principle to move into any activity that suitably rewards them. In real life this mobility is constrained by the existing skills and experience of both the owners of capital and workers, and by the relationships and attachments that they have formed. The potential mobility of capital and labour is, nonetheless, one of the features of capitalist societies that gives them their characteristic dynamism.

Wage labour is both free and unfree. Unlike slaves, who are forced to work by their owners, wage labourers can decide whether they work and for whom. Unlike the serfs in feudal society, who were tied to their lord's land, they can move freely and seek work wherever they choose. These freedoms are, on the other hand, somewhat illusory, since in a capitalist society it is difficult to survive without paid work and little choice of work or employer may be available. Wage labourers are also subject to tight control by the employer and, as we saw in the cotton mills, capitalist production meant a new kind of disciplined and continuous work. Workers had become, as Marx put it, 'wage slaves'.

The importance of wage labour is not only its role in production but also its role in consumption. Wage labourers cannot themselves produce what they need or may wish to consume, they have to buy it, thereby providing the demand that activates a whole range of new capitalist enterprises. This applies not only to their food and clothing and personal possessions but to their leisure activities as well. As we saw earlier, capitalist production rapidly led to the creation of whole new industries based on the

commercialization of leisure. This double role of wage labour, which enabled the dynamic interaction of production and consumption, explains why capitalist production expanded so very rapidly once it had got going.

Markets, like merchants, are nothing new, but they are central to a capitalist society in a quite new and more abstract way. This is because production and consumption are divorced—people do not consume what they produce or produce what they consume—and are linked only through the markets where goods and services are bought and sold. Instead of being a place where you can buy some extra item that you do not produce yourself, markets become the only means by which you can obtain anything. They are no longer located just in market-places but exist wherever buyers and sellers make their exchanges and, nowadays, this commonly means in some electronic space where prices are listed and deals registered. This applies not only to goods and services but also to labour, money, and capital. The wage, that is the price, for labour is established on a labour market, where employers compete for labour and workers compete for jobs. Money itself is bought and sold on currency markets. The ownership of companies is bought and sold in stock exchanges.

As we saw with the cotton mills, markets generate intense competition between capitalist enterprises. They compete in many different ways by, for example, exploiting labour more efficiently or using technical innovation to reduce costs or marketing products more effectively. Competition forces companies into constant change as they seek to beat the competition or at least keep up with it. Some of course fail and go under, throwing their employees out of work. This competitiveness, which contrasts strongly with the monopolistic practices of merchant capitalism, makes capitalist production exceptionally dynamic.

Capitalist enterprises have, nonetheless, found ways of reducing competition. Those with an edge over their rivals may relish the cut and thrust of competition, but this also creates uncertainty, reduces profits, and causes bankruptcies. Companies thus form trade associations to regulate competition. The market can be rigged by agreeing not to engage in price competition or deciding that all will pay the same wage rates. Competition can also be reduced by mergers and take-overs which concentrate production in fewer hands. There is in capitalism always a tension between competition and concentration, which are equally characteristic of it.

Since prices change, any market provides an opportunity to make money through speculation. This occurs when something is bought in the expectation of selling it at a higher price in the future, without increasing its value by processing it in some way. It can occur in relation to almost any commodity. It may be grain, it may be a currency, it may be a derivative, it may be a slave. Speculation of this kind is often regarded as an unproductive and parasitic activity that is wholly separable from the real economy where goods and services are produced. Unproductive it may often be, but it is not just a means of making money through speculation but also a way of avoiding risk. Since the relationship between supply and demand is always changing, markets are unstable. The building up and storage of stocks is a means of insuring against some adverse price movement that could destroy profit and wipe out a business. Trading in futures, of the kind that Leeson speculated in, is another way of reducing uncertainty and originated long ago as a sophisticated way of protecting producers and traders against unpredictable future movements in prices.

The huge growth in the trading of currency during the 1980s and 1990s followed the shift from fixed to floating exchange rates in the 1970s, which created much greater uncertainty about future currency values. One way of reducing this uncertainty was to 'hedge' one's bets by buying currency futures. So, though the vast bulk of trading in currency futures is undoubtedly speculative, the expansion of this market and the financial innovations associated with it were grounded in real economic needs.

The same argument applies to the speculative trading of company shares. The existence of markets for capital is central to capitalism. They are essential to its functioning since they bring together those seeking to finance economic activities and those with money to invest. Since the stock market prices of companies change, as their economic situation and profitability changes, there are inevitably opportunities for speculating on future price movements. Speculation is not something separate from capitalism but an inevitable outgrowth of its essential machinery.

So, the answer to our question is that capitalism involves the investment of money to make more money. While merchants have long done this, it is when production is financed in this way that a transformative capitalism comes into being. Capitalist production depends on the exploitation of wage labour, which also fuels the consumption of the goods and services produced by capitalist enterprises. Production and consumption are linked by the markets that come to mediate all economic activities. Markets enable competition between enterprises but also generate tendencies towards concentration in order to reduce uncertainty. Market fluctuations also provide the basis of a speculative form of capitalism, which may not be productive but is, nonetheless, based on mechanisms that are central to the operation of a capitalist economy.