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Capitalism and its troubles

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The capitalist system has proved surprisingly robust in the face of recent crises, but if it is to keep delivering the goods it needs an overhaul, says Matthew Bishop

CAPITALISM has had a rotten time lately. Not as rotten as in 1917, when those revolutionary shots in St Petersburg launched a form of anti-capitalism that ended (except in Cuba and North Korea) only just over a decade ago. Nor, with luck, as rotten as in 1929, when a stockmarket crash on Wall Street set off the global Great Depression. But rotten, nonetheless. Nobody knows for sure yet, but 2001 might come to be seen as the year when two decades of mostly unbroken progress for capitalism gave way to something more ambiguous and uncertain.



That year was the first in ages, perhaps since the start of America's great equity bull market in 1982, when the world became significantly less wealthy. Total global marketable wealth—that is, all assets traded in the financial markets, such as shares and bonds—fell by 4% last year, according to a study by the Boston Consulting Group. The number of households with at least \$250,000 of marketable wealth dropped from 39m to 37m. Those who believed that in today's economy wealth always increases and the rich keep getting richer have been proved wrong.

The sudden collapse of Enron, a Texan energy-to-finance-to-fraud conglomerate, has shaken faith of another sort: in the integrity of corporate America, and in the Wall Street-centred model of capitalism that has been hawking its wares to investors the world over. The dotcom bubble was one thing; the realisation that apparently profitable companies are not making any money quite another. Much of the appeal of American securities to investors rested on the belief that companies have become much more productive and profitable. After Enron, investors are now questioning the accounts of many American firms, including such admired stalwarts as General Electric and American International Group (AIG), as well as some foreign ones. Given that the American economy has become the engine of the world economy and its companies are being held up as models, this is troubling.

If the doubts about the supposed revolution in productivity and profitability prove justified, the consequences could be dire. Huge amounts of debt have been accumulated by firms and individuals alike, in the belief that the general optimism about corporate America—reflected in continuing high share prices—is justified. Huge amounts of foreign capital have flooded into America for similar reasons, allowing the country to run an enormous current-account deficit and keeping the dollar strong. If these trends were reversed, America's economy could suffer serious damage, and America's model of capitalism might lose much of its appeal to other countries.

In many countries, experience calls that model into question in any case. Argentina's problems have already dealt a serious blow to the idea that the global triumph of capitalism is inevitable.

Even such rich countries as Japan flinch from American efficiencies such as securitising bad debt and getting it off bank balance sheets. To a lesser degree Europe is also a reluctant capitalist. Progress of the model can no longer be taken for granted in large parts of Asia, Latin America and the former Soviet Union, and has never been a serious prospect in much of Africa and the Arab world.



The most awful shock of the past year was the terrorist attack on September 11th. The financial system stood up to it remarkably well. Moreover, both the American economy and, more broadly, the world economy have rebounded much more strongly than anybody dared hope. Yet the attacks proved that even where capitalism is well established, it is increasingly vulnerable to those who hate it. No amount of success in the current war on terrorism will eliminate this hideous new risk, which is impossible to quantify—as the insurance industry is indicating by making cover against it prohibitively expensive.

Assuming terror can be kept away from the developed world, there are two broad schools of thought about the future of capitalism. The bulls argue that the system's performance over the past year, particularly in America, bodes well for the future. Clearly, bursting stockmarket bubbles and scandal-ridden collapses of leading companies are cause for concern. But America has a long record of learning from its excesses to improve the working of its particular brand of capitalism, dating back to the imposition of antitrust controls on the robber barons in the late 1800s and the enhancement of investor protection after the 1929 crash. There is no reason why it should not turn the latest calamities to its advantage too. Senator Jon Corzine, a former boss of Goldman Sachs, puts the case for the optimists: "At the conclusion of any bull market there are always elements of excess that get washed out or cause the system to evolve. But the fact is, we are coming out of the most shallow recession in post-war history, and the outlook is good."

Star performer

The resilience of the financial system has surprised even the regulators responsible for its health on both sides of the Atlantic. As one of them put it, "If you had told me on September 10th that we were going to get the terrorism, Enron and Argentina, I'd have predicted at least one major international financial institution going bust, and serious consequences for the economy." As it is, the only financial firms to go under were on the fringes of the system: some banks in Argentina, and a handful of mostly long-troubled or small insurers.

The bears too have been surprised by the system's resilience, but they still see a large remaining financial bubble which they fear may burst, possibly plunging America and the world into a depression similar to that of the 1930s, or at least of the past decade in Japan. The threat of further terrorism, fighting in the Middle East (with its repercussions for the oil price) and maybe a transatlantic trade war, conjuring up ghastly parallels with the 1930s, have all clouded their

crystal balls further. With Argentina's default, they feel, perhaps globalisation has peaked.

The dotcom bubble has burst, but not the bubble in the broader stockmarket. Pessimists predict economic collapse when it does. As Robert Shiller noted in his best-seller "Irrational Exuberance", it can take a while for bubbles to burst, and longer for their full economic consequences to become clear. The Wall Street crash of 1929 was followed by numerous rallies and dips, and only a couple of years later by the Depression. For now, Alan Greenspan, the chairman of the Federal Reserve (and the man who coined the phrase "irrational exuberance"), continues to blow air into the bubble that his loose monetary policy has created. But he cannot pull off this trick forever. Interest rates can go only so low.

Neither the optimists' nor the pessimists' scenario is inevitable. In America and elsewhere, there are important choices to be made that will influence the outcome. Should there be new rules to curb abuses by investment banks? Can accounting information be made more meaningful? Can the incentives of company bosses be aligned more closely with the interests of shareholders? Can capitalism take root in the developing world? The answer to each of these questions is yes, up to a point, but what needs to be done to achieve that result is not easy.

One big hurdle is that the will to reform may be lacking, especially if the world economy continues to recover. Already, there are signs that Congress is backing away from some of its more radical proposals (several of which will be no loss). As Harvard's Andrei Shleifer and others point out in a recent article, Wall Street's heart may not be in it either: "Compared to the profits directly related to high stock prices, those from unwinding bubbles must be minuscule." Although market forces are likely to solve some of these problems, and are already punishing any firm that might conceivably become the next Enron, they may not be sufficient. Bill Gross of PIMCO, a huge bond fund, is unimpressed by the market's response: "My fear is that this newborn faux hostility in the investment attitudes of lenders and stockholders will go the way of many other short-term jiggles in the inevitable march of capitalistic excess."

Is Mr Gross right? The answer lies in the financial system, which is where this survey begins.