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## Better than the alternatives

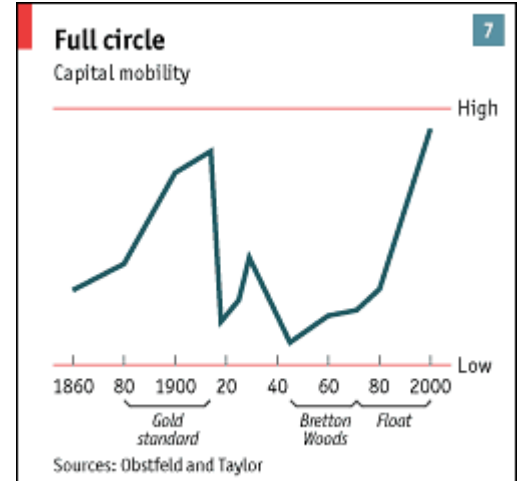
May 16th 2002

From The Economist print edition

### But capitalism needs nurturing, in poor and rich countries alike

JUDGED by international trade and capital flows and by the integration of markets, the world's economies were almost as globalised 100 years ago as they are now. Arguably, it was only during the past decade that globalisation got back to where it was at its previous peak, on the eve of the first world war. As chart 7 shows, between then and the end of the second world war, globalisation—as measured by capital mobility—went into rapid reverse as anti-capitalists took control of many countries, trade barriers went up and capital markets disintegrated. It was only with the demise of the post-war Bretton Woods fixed-exchange-rate system in 1971 that capital mobility started to rebound.

What lessons should be drawn from the move away from unrestrained capitalism during the first half of the past century? That it can happen, for one thing: capitalism can ebb as well as flow. That it has miserable economic consequences, for another, in rich and poor countries alike: the period when it was at its lowest ebb started with the 1929 Wall Street crash and continued through the Great Depression, probably not by coincidence.



World wars are clearly bad for global capital. So, too, are trade barriers, as capital often moves hand-in-hand with trade flows. Moreover, the globalisation of capitalism may already have peaked. Argentina's debt default, coupled with increasing hostility to foreign banks and capital, looks ominous to many observers. In terms of loans extended by foreign creditors, Argentina was by far the biggest emerging market. If it now submerges, what chance for other emerging markets?

Some economists and international investors have taken comfort from the absence of "contagion" from Argentina to other developing countries. This contrasts with 1997-98, when problems in Thailand spread throughout South-East Asia, and Russia's debt default caused knock-on problems first in Latin America and later in the rich world's debt markets. There has not been much of that this time; even Brazil, despite its close economic ties to Argentina, has suffered few ill effects on its domestic economy and has continued to tap the international capital markets.

### Catching something nasty

Some economists are inclined to dismiss the notion of contagion altogether. But if there is such a thing as a financial-crisis virus, it is most likely to be transmitted by big international financial businesses, such as Wall Street firms and hedge funds. In 1998, emerging-market problems spread to rich-country debt markets via their effect on Long-Term Capital Management, a hedge fund that collapsed as a result, and on investment banks that had copied LTCM's investment strategy. International investors last year had much less exposure to Argentina and other emerging countries than in 1998 and, crucially, they were not caught by surprise, as they had been then when Russia defaulted. In financial markets, being able to prepare for bad news usually means it will end up less bad.

The reduced flows of capital from richer to poorer countries are a worrying sign. Some analysts have predicted that emerging markets will disappear as an asset class through lack of interest, although a recent rise in asset

prices in those markets other than Argentina lifted the gloom for a while. In February CalPERS, a huge pension fund for public employees in California, announced it was pulling out of several emerging stockmarkets, starting with Thailand, Indonesia, Malaysia and the Philippines. Other funds may soon follow.

Compared with the previous peak of global capital, the amount of money flowing to poorer countries today is already small. Maurice Obstfeld and Alan Taylor, two economists, point out that less-developed countries' share of total global debt is at an all-time low. In 1900, these countries accounted for 33% of the total; in the 1990s, the figure was down to 11%. In 1913, the countries in the bottom fifth of income per person received around 25% of the world stock of foreign capital, much the same as the countries in the richest fifth. By 1997, the poorest fifth's share was down to under 5%, compared with 36% for the richest fifth. According to Messrs Obstfeld and Taylor, today's capital transactions seem to be "mostly a rich-rich affair, a process of 'diversification finance' rather than 'development finance'...foreign investment in the poorest developing countries lags far behind the levels attained at the start of the last century." Why?

A decade ago, there seemed to be a simple formula for getting capitalism established in a country: bring inflation down, stabilise the exchange rate, create capitalist institutions such as a central bank and a stock exchange, and privatise as fast as possible. Now international investors have realised that sound public finances are also needed, says Richard Sylla, an economist at New York University's Stern School. Argentina was a case in point: its public-sector debt eventually became so large that international investors rightly lost faith in its ability to service it.

Nor did Argentina's pegged exchange rate do it any favours as the dollar appreciated and the Brazilian real depreciated. Although the peg to the dollar was strong enough to cause Argentina's economy enormous problems, it fell short of the total dollarisation embraced by some other Latin American countries, such as Ecuador, and could not prevent a devaluation that damaged Argentina's standing with investors at home and abroad. Argentina's large number of foreign-owned banks might have helped to protect its economy from domestic problems, but the government's treatment of these banks after the country's default undermined this potential force for stability. Corruption is also rife in Argentina, and there is concern that rapid privatisation often merely caused valuable state-owned assets to be handed to political insiders and crooks.

Two crucial ingredients in the successful transition to capitalism are political will and political effectiveness. These have often been overlooked, but that is changing, which may help to explain the lack of contagion after Argentina's default. Wall Street firms are waking up to the need to understand political risk. For example, Lehman Brothers has teamed up with Eurasia Group, a political consultancy, to produce political-risk indices for emerging economies. This kind of analysis can produce quite different advice from standard rankings based only on economic criteria. According to Ian Bremmer of Eurasia Group, "Investors are starting to understand that economic reform depends on the politicians promoting it remaining in power." If international private capital (which in most emerging economies is far more important than aid or loans from international financial institutions such as the World Bank) goes to countries that offer a combination of good politics and good economics, it will send a powerful signal.

## Essential ingredients

A society's ability to adopt capitalism also depends heavily on its culture and its legal framework. That is particularly true of market-based capitalism as practised in America, which has increasingly been regarded as the superior model—at least until Enron went bust. Strong investor protection is crucial. So, too, are legal rights to property that treat everybody fairly rather than merely protecting the rich, as Hernando de Soto explained in his book, "The Mystery of Capital: Why Capitalism Triumphs in the West and Fails Everywhere Else"—still the best book on the subject.

According to Ira Millstein, a lawyer at Yale's International Institute for Corporate Governance, market-based capitalism seems much more likely to take root in countries with a legal system based on English common law and with an independent judiciary. It seems to fare less well in countries with legal systems based on European civil law, particularly the French version of it. Common law is more flexible and quicker to adapt to change, provides stronger investor protection and is less likely to sanction heavy-handed state intervention. But it will be difficult for civil-law countries to move in that direction, says Mr Millstein. "You can't just become a common-law system overnight."

America will have a big part to play in establishing capitalism in the developing world. The terrorist attacks of

September 11th appear to have energised the Bush administration to try to spread capitalism as widely as possible. The thinking behind this is that as countries get wealthier, and the wealth is shared by larger numbers of people, they become less likely to provide a breeding ground for terrorism.

One priority will be to lean on the big international financial institutions, notably the IMF and the World Bank, to do a much better job. Over the years these institutions have often handed out poor advice and squandered many billions of dollars on loans that helped governments to postpone necessary economic and political reform. Against that background, the IMF's decision to stop lending Argentina any more money late last year, which made the country's default inevitable, may be seen as progress of a sort. The \$250 billion lent by the IMF during the previous seven years to rescue countries from a variety of crises may have created a moral hazard, convincing borrowers and lenders alike that they would always be bailed out.

The World Bank has achieved little for its \$500 billion of loans during the past half-century, besides saddling very poor countries with huge debts that should now mostly be forgiven. Its own internal review in 2000 found that, of the projects it had sponsored in the poorest countries, barely one in three had achieved acceptable results. It is hard to imagine worse results from America's latest proposal for the World Bank to switch from lending to making grants, subject to performance targets being met.

Establishing a successful capitalist economy in an Arab country would be a particularly precious prize, but so far this has proved elusive. America seems to have settled upon Turkey as the next best thing, encouraging the IMF to treat it much more kindly than it did Argentina. Arabs made wealthy by oil seem to understand enough about capitalism to invest most of their fortunes in America and Europe, but not to allow it to operate at home. Benn Steil, an economist at America's Council on Foreign Relations, points out that the wealth of Osama Bin Laden's family came from the monopoly it was given over much of the construction sector in Saudi Arabia—the “sort of state-fashioned monopoly that dominates the economic landscape across most major sectors throughout the impoverished Arab Middle East”.

## **A better class of capitalism**

Compared with the problems of the developing world, the weaknesses in American capitalism revealed by the Enron debacle or the dotcom bubble may seem minor. But this does not absolve America and other rich countries from putting their own house in order. The financial system has proved surprisingly resilient during the recent shocks, but there is no guarantee that it will remain so in future. The crucial role played by accounting and auditors in a capitalist system needs to be recognised, and legal safeguards put in place to ensure that they play it properly. If this increases the cost of auditing, then it is a price worth paying. Above all, shareholders—particularly big institutional investors—need to accept the responsibilities that come with ownership. If they do not insist on the highest standards of integrity in the running of their companies, no one else will.

Capitalism, like democracy, may not be perfect, but it beats the alternatives. And making it as good as possible will advance the future prosperity of us all.