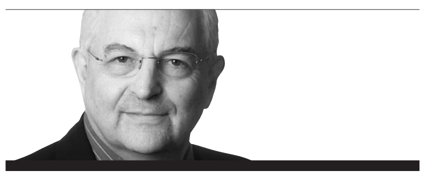
Cutting back financial capitalism is America's big test



Martin Wolf

Is the US Russia? The question seems provocative, if not outrageous. Yet the person asking it is Simon Johnson, former chief economist at the International Monetary Fund and a professor at the Sloan School of Management at the Massachusetts Institute of Technology. In an article in the May issue of the *Atlantic Monthly*, Prof Johnson compares the hold of the "financial oligarchy" over US policy with that of business elites in emerging countries. Do such comparisons make sense? The answer is Yes, but only up to a point.

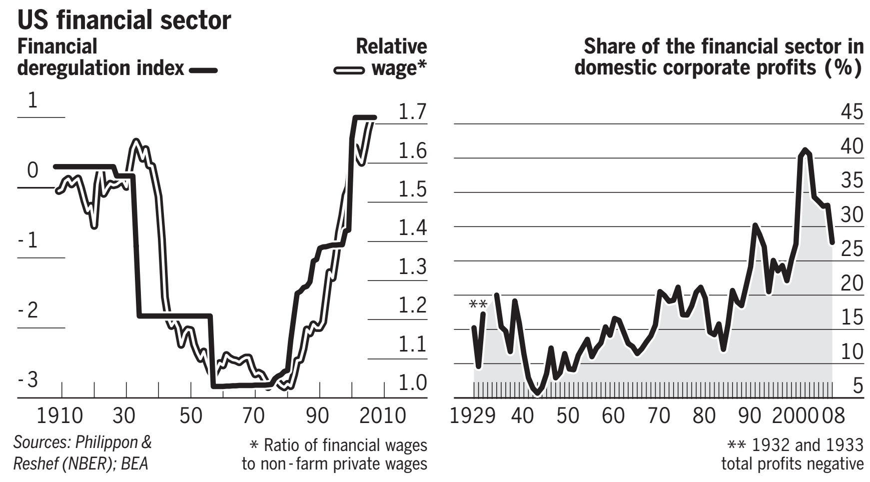
"In its depth and suddenness," argues Prof Johnson, "the US economic and financial crisis is shockingly reminiscent of moments we have recently seen in emerging markets." The similarity is evident: large inflows of foreign capital; torrid credit growth; excessive leverage; bubbles in asset prices, particularly property; and, finally, asset-price collapses and financial catastrophe.

"But," adds Prof Johnson, "there's a deeper and more disturbing similarity: elite business interests – financiers, in the case of the US – played a central role in creating the crisis, making ever-larger gambles, with the implicit backing of the government, until the inevitable collapse." Moreover, "the great wealth that the financial sector created and concentrated gave bankers enormous political weight."

Now, argues Prof Johnson, the weight of the financial sector is preventing resolution of the crisis. Banks "do not want to recognise the full extent of their losses, because that would likely expose them as insolvent . . . This behaviour is corrosive: unhealthy banks either do not lend (hoarding money to shore up reserves) or they make desperate gambles on high-risk loans and investments that could pay off big, but probably won't pay off at all. In either case, the economy suffers further, and, as it does, bank assets themselves continue to deteriorate – creating a highly destructive cycle."

Does such an analysis make sense? This is a question I thought about during my recent three-month stay in New York and visits to Washington, DC, now capital of global finance. They are why Prof Johnson's analysis is so important.

Unquestionably, we have witnessed a massive rise in the significance of the financial sector. In 2002, the sector generated an astonishing 41 per cent of US domestic corporate profits (see chart). In 2008, US private indebtedness reached 295 per cent of gross domestic product, a record, up from 112 per cent in 1976, while financial sector debt reached 121 per cent of GDP in 2008. Average pay in the sector rose from close to the average for all industries between 1948 and 1982 to 181 per cent of it in 2007.



Sources: Philippon & Reshef (NBER); BEA

* Ratio of financial wages to non-farm private wages

** 1932 and 1933 total profits negative

In recent research, Thomas Philippon of New York University's Stern School of Business and Ariell Reshef of the University of Virginia conclude that the financial sector was a high-skill, high-wage industry between 1909 and 1933. It then went into relative decline until 1980, whereupon it again started to be a high-skill, high-wage sector.* They conclude that the prime cause was deregulation, which "unleashes creativity and innovation and increases demand for skilled workers".

Deregulation also generates growth of credit, the raw stuff the financial sector creates and on which it feeds. Transmutation of credit into income is why the profitability of the financial system can be illusory. Equally, the expansion of the financial sector will reverse, at least within the US: credit growth and leverage masked low or even non-existent profitability of much activity, which will disappear, and part of the debt must also be liquidated. The golden age of Wall Street is over: the return of regulation is cause and consequence of this shift.

Yet Prof Johnson makes a stronger point than this. He argues that the refusal of powerful institutions to admit losses – aided and abetted by a government in thrall to the "money-changers" – may make it impossible to escape from the crisis. Moreover, since the US enjoys the privilege of being able to borrow in its own currency it is far easier for it than for mere emerging economies to paper over cracks, turning crisis into long-term economic malaise. So we have witnessed a series of improvisations – or "deals" whose underlying aim is to rescue as much of the financial system as possible in as generous a way as policymakers think they can get away with.

I agree with the critique of the policies adopted so far. In the debate on the Financial Times's economists' forum on Treasury secretary Tim Geithner's "public/private investment partnership", the critics are right: if it works, it is because it is a non-transparent way of transferring taxpayer wealth to banks. But it is unlikely to fill the capital hole that the markets are, at present, ignoring, as Michael Pomerleano argues. Nor am I persuaded that the "stress tests" of bank capital under way will lead to action that fills the capital hole.

Yet do these weaknesses make the US into Russia? No. In many emerging economies corruption is egregious and overt. In the US, influence comes as much from a system of beliefs as from lobbying (although the latter was not absent). What was good for Wall Street was deemed good for the world. The result was a bipartisan programme of ill-designed deregulation for the US and, given its influence, the world.

Moreover, the belief that Wall Street needs to be preserved largely as it is now is mainly a consequence of fear. The view that large and complex financial institutions are too big to fail may be wrong. But it is easy to understand why intelligent policymakers shrink from testing it. At the same time, politicians fear a public backlash against large infusions of public capital. So, like Japan, the US is caught between the elite's fear of bankruptcy and the public's loathing of bail-outs. This is a more complex phenomenon than the "quiet coup" Prof Johnson describes.

Yet decisive restructuring is indeed necessary. This is not because returning the economy to the debt-fuelled growth of recent years is either feasible or desirable. But two things must be achieved: first, the core financial institutions must become credibly solvent; and, second, no profit-seeking private institution can remain too big to fail. That is not capitalism, but socialism. That is one of the points on which the right and the left agree. They are right. Bankruptcy – and so losses for unsecured creditors – must be a part of any durable solution. Without that change, the resolution of this crisis can only be the harbinger of the next.

* *Wages and Human Capital in the US Financial Industry 1909-2006, January 2009, www.nber.org*

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Uncertainty bedevils the best system

Edmund Phelps

In countries operating a largely capitalist system, there does not appear to be a wide understanding among its actors and overseers of either its advantages or its hazards. Ignorance of what it can contribute has in the past led some countries to throw out the system or clip its wings. Ignorance of the hazards has made imprudence in markets and policy neglect all the more likely. Regaining a well-functioning capitalism will require re-education and deep reform.

Capitalism is not the "free market" or laisser faire – a system of zero government "plus the constable". Capitalist systems function less well without state protection of investors, lenders and companies against monopoly, deception and fraud. These systems may lack the requisite political support and cause social stresses without subsidies to stimulate inclusion of the less advantaged in society's formal business economy. Last, a huge social insurance system, with resulting high taxes, low take-home pay and low wealth, may not hurt capitalism.

In essence, capitalist systems are a mechanism by which economies may generate growth in knowledge – with much uncertainty in the process, owing to the incompleteness of knowledge. Growth in knowledge leads to income growth and job satisfaction; uncertainty makes the economy prone to sudden swings – all phenomena noted by Marx in 1848. Understanding was slow to come, though.

Well into the 20th century, scholars viewed economic advances as resulting from commercial innovations enabled by the discoveries of scientists – discoveries that come from outside the economy and out of the blue. Why then did capitalist economies benefit more than others? Joseph Schumpeter's early theory proposed that a capitalist economy is quicker to seize sudden opportunities and thus has higher productivity, thanks to capitalist culture: the zeal of capable entrepreneurs and diligence of expert bankers. But the idea of all-knowing bankers and unerring entrepreneurs is laughable. Scholars now find that most growth in knowledge is not science-driven. Schumpeterian economics – Adam Smith plus sociology – captures very little.

Friedrich Hayek offered another view in the 1930s. Any modern economy, capitalist or state-run, is a great soup of private "know-how" dispersed among the specialised participants. No one, he said, not even a state agency, could amass all the knowledge that each participant "on the spot" inevitably acquires. The state would have no idea where to invest. Only capitalism solves this "knowledge problem".

Later, Hayek fleshed out a theory of how capitalism makes "discoveries" on its own. He had no problem with the concept of an innovative idea, for he understood that, even among experts, knowledge is incomplete about most things not yet tried. So he felt free to suppose that, thanks to the specialised insights each acquires, a manager or employee may one day "imagine" (as Hayek's hero, David Hume, would have put it) a commercial departure – one that could not be inferred or envisioned by people outside the individual's line of work. Then he portrays a well-functioning capitalist system as a broad-based, bottom-up organism that gives diverse new ideas opportunities to compete for development and, with luck, adoption in the marketplace. That "discovery procedure" makes it far more innovative than the top-down systems of socialism or corporatism. The latter are too bureaucratic to learn about ideas from below and unlikely to obtain approval from all the social partners of the ideas that do get through.

Well-functioning capitalist economies, with their high propensity to innovate, could arise only when serviceable institutions were in place. The freedoms borne by England's Glorious Revolution of 1688 and the "commercial society" of the Scots were not enough. There had to be financial institutions where there would be disinterested financiers, each trying to make the best investment, and – importantly – a plurality of views among them, so financiers funded a diversity of projects. There also had to be limited liability for companies and a market enabling their takeover. Such institutions had to wait for demand by wide numbers of business people wanting to build a new product or new market or new business model. Rudimentary institutions began to emerge early in the 19th century, from company law and stock exchanges to joint-stock banks and "merchant" banks lending to industry.

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Unprecedented rewards soon followed in Europe and America: new cities rising, unbroken productivity growth, steadily climbing wages and generally high employment. Lifetime prospects improved for all or nearly all participants. Less measurable but ultimately fundamental, growing numbers of people in capitalist economies had engaging careers and were energised by their challenges and explorations. Capitalism was a godsend for them.

From the outset, the biggest downside was that creative ventures caused uncertainty not only for the entrepreneurs themselves but also for everyone else in the global economy. Swings in venture activity created a fluctuating economic environment. Frank Knight, observing US capitalism in his 1921 book, said that a company, in all of its decisions aside from the handful of routine ones, faces what is now called "Knightian uncertainty". In an innovative economy there are not enough precedents to be able to estimate the probability of this or that outcome. John Maynard Keynes in 1936 insisted on the "precariousness" of much of the "knowledge" used to value an investment – thus the "flimsiness" of investors' beliefs. (Yet now he is seen as "Smith plus psychological swings".)

No coherent moral justification was ever suggested for throwing out a system providing invaluable and irreplaceable novelty, problem-solving and exploration, thus personal growth. On the contrary, humanist philosophy has continued since ancient times to hold up such experience as the "good life". Socialists and corporatists never offered an alternative good life. They simply claimed that the system they advocated could out-do capitalism: wider prosperity, or more jobs, or greater job satisfaction. Unfortunately, there is still no wide understanding among the public of the benefits that can fairly be credited to capitalism and why these benefits have costs. This intellectual failure has left capitalism vulnerable to opponents and to ignorance within the system.

Capitalism lost much of its standing in the interwar period, when many countries in western continental Europe shifted to corporatist systems. This was a low point in the public's grasp of political economy. In the end, the promises of greater prosperity and lesser swings could not be delivered. The nations that kept capitalism while making reforms, some good and others maybe not, ultimately performed well again – until now. Those that broke from capitalism were less innovative. After the disturbances of the 1970s, they saw unemployment rise far more than the capitalist nations did. They were worse on economic inclusion too.

Now capitalism is in the midst of its second crisis. An explanation offered is that the bankers, whatever they knew about capitalism, knew that to keep their jobs and their bonuses they would have to borrow more and more to lend more and more, in order to meet profit targets and hold up share prices. The implication was that the crisis flowed from a failure of corporate governance to curb bonuses and of regulation to rein in leveraging of bank capital to levels that made the banks vulnerable to a break in housing prices.

But why did big shareholders not move to stop over-leveraging before it reached dangerous levels? Why did legislators not demand regulatory intervention? The answer, I believe, is that they had no sense of the existing Knightian uncertainty. So they had no sense of the possibility of a huge break in housing prices and no sense of the fundamental inapplicability of the risk management models used in the banks. "Risk" came to mean volatility over some recent past. The volatility of the price as it vibrates around some path was considered but not the uncertainty of the path itself: the risk that it would shift down. The banks' chief executives, too, had little grasp of uncertainty. Some had the instinct to buy insurance but did not see the uncertainty of the insurer's solvency.

Much is dysfunctional in the US and the UK: a financial sector that turned away from the business sector, then caused its self-destruction, and a business sector beset by short-termism. If we still have our humanist values we will try to restructure these sectors to make capitalism work well again – to guard better against reckless disregard of uncertainty in the financial sector while reviving innovativeness in business. We will not close the door on systems that gave growing numbers rewarding lives.

The writer is director of the Center on Capitalism and Society, Columbia University, and winner of the 2006 Nobel Prize in Economics. To join the debate go to www.ft.com/capitalismblog

History vindicates the science of muddling through

John Kay

When I was a student, Penguin published several collections of classic articles on economics and business. They were an indispensable resource. The first book on business strategy I ever read was the title in that series edited by Dr H. Igor Ansoff. Recently I re-opened it and understood how much changes in the way we think about business strategy – and how much remains the same.

Only one article found there is still widely cited. It was written by the American political scientist Charles Lindblom and published in 1959 under the title *The Science of Muddling Through*. Prof Lindblom contrasted what he called the "root" method of decision-making with the "branch" approach. The root method required comprehensive evaluation of options in the light of defined objectives. The branch method involved building out, step-by-step and by small degrees, from the current situation. Prof Lindblom claimed "the root method is in fact not usable for complex policy questions". The practical man must follow the branch approach – the science of muddling through.

Ansoff included Prof Lindblom's article mainly to poke fun at those who acted on this advice. He told students the article was instructive, since "it describes a widely prevalent state of practice in business and government organisations". We can imagine sniggering MBA students.

They would be chortling when Ansoff turned his attention to France's Saint-Gobain, the glass and materials group. "Saint-Gobain, for all the modernity of its headquarters building, will remain something of an old lady, likely to move only with the slow deliberate steps of great age."

America, and Ansoff, were pointing to the road ahead. Prof Lindblom, he explained, "is wrong when he claims the 'root' method to be impossible". Ansoff's analysis of TRW, the US conglomerate, "shows how one of the world's most dynamic corporations goes about a methodical exploration of wide vistas of opportunities in the process of formulating its corporate strategy". The future held no bounds. Senior management "feels that the corporation hasn't begun to exploit the opportunities . . . they believe that TRW is equipped, for example, to play a three-sided role in technological programmes for the solution to such pressing problems as urban renewal, mass transportation, and pollution".

But Ansoff's highest praise was reserved for Litton Industries, another US conglomerate. Litton – "a proverbial success story by any conceivable yardstick" – was the creation of Tex Thornton, the leader of the "whiz kids". This group of brilliant young men had made an important contribution to US military organisation in the second world war. A letter from Thornton to Henry Ford II led Ford to hire the entire group to help the Ford Motor Company recover from the chaos left by war and its irascible founder. Robert McNamara, the most famous whiz kid, was the company's president before being recruited by John Kennedy as US defence secretary.

Lindblom claimed 'the root method is in fact not usable for complex policy questions'

Ansoff died in 2002. History has not been kind to him, or to the whiz kids. Even as Ansoff was putting together his collection in 1968, the future of Litton Industries was being questioned. Like many acquisitive conglomerates, it experienced a rapid ascent and sharp fall. Its reputation and share price rose steadily before a setback to earnings made its stock less attractive. Acquisitions became impossible. The business gradually unwound. Tex Thornton is today forgotten, McNamara was driven from the defence department by public hostility and his private doubts. He went on to preside over a substantial expansion of lending – much of it never repaid – at the World Bank. Today, he reminisces on his experiences – and the virtues of muddling through.

TRW, like Litton, would be forced to slim operations and ambition and return to its modest roots in automobile parts supply. Saint-Gobain, by contrast, is a successful multinational, with 200,000 employees worldwide. Prof Lindblom, still muddling through at 92, celebrates the 50th anniversary of his article. We should celebrate too – and applaud the relevance of his insight.

John Kay's latest book is The Long and the Short of It

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