

## Saving Capitalism From Capitalists: A Key Economist Proposes Re- forms

*Review by Zenit*

NEW YORK, NOV. 15, 2003 (Zenit.org).- One of the institutions most criticized for its role in globalization, the International Monetary Fund, looks as if it has taken notice of the protests.

In July, Indian-born Raghuram Rajan was appointed as economic counselor and director of the IMF's research department. Previously, Rajan was a professor of finance at the University of Chicago Graduate School of Business.

Earlier this year Rajan published, with colleague Luigi Zingales, a book entitled "Saving Capitalism From the Capitalists." The book very much favors the free market system but recognizes that the growing protests against some of its failings are well founded.

At an Oct. 24 conference on the legacy of Milton Friedman, Rajan told the Federal Reserve Bank of Dallas that the backlash against the free market caused by the continuing anti-globalization movement has been fortified by a combination of the current economic downturn and recent corporate scandals.

"Many of the people protesting in the streets against globalization are protesting against capitalism, which they accuse of oppressing workers, exploiting the poor, and making only the rich richer," he warned. One of the consequences of a growing opposition to free markets was the recent failure of the Cancun meeting of the World Trade Organization.

In their book, Rajan and Zingales affirmed that the open borders of a globalized world have improved the well-being of many people. Yet, markets also create losers, they added. And "the costs of competition and technological change fall disproportionately on some."

They argue that it is a mistake to ignore the concerns of the losers. But they also contend that it would be wrong to forsake the benefits of the free market by only taking into consideration the costs and not to see the future benefits for many of an open economic system.

The central thesis of the book is that neither the left nor the right has the answer to coping with tensions caused by free markets. The left tends to argue exclusively for greater government intervention, and the right favors free enterprise over what it sees as the inefficiency and corruption of the public sector. Both arguments have elements of truth, state Rajan and Zingales. Yet, "the political

stability of markets cannot rest on one-sided ideological prescriptions," they say. Instead, they favor a "sophisticated system of checks and balances."

### Flaws of the free market

The book focuses primarily on financial markets, a sector long reviled for its alleged immorality. Financiers, they acknowledge, are often held to be leeches or overly powerful, and many works of literature "have financiers occupying a moral space considerably below that of prostitutes."

Some inherent factors in the financial sector make it insecure: uncertainty over how much an investment will return; bad luck; and dishonesty on the part of some. In underdeveloped countries the situation is complicated by a lack of competition, which means there are fewer lenders to choose from, and a lack of property rights that often works against the poor who cannot establish a clear title to their house or land that would in other circumstances serve as collateral for loans.

When structures are underdeveloped, finance tends to benefit the rich, the book observes. The financier will naturally tend to concede loans to people or firms who already have connections and assets, making it difficult for others to get a first step on the ladder of prosperity.

But while preferential treatment to those who already are well off is economically rational, note Rajan and Zingales, it is also something to be concerned about. "As a result, the poor are doubly damned, not only because they lose an option but also because their bargaining power when they work for those who have resources is weakened."

As well, when a few control resources they tend to restrict access to economic information and collude to make profits at the expense of the general economy. In fact, the authors observe, that many of the evils of capitalism -- oppression of workers, cartels, unequal distribution of income -- come about when the financial system is underdeveloped and the wealthy are able to successfully bar entry to newcomers.

### What is to be done?

The 20th century showed that the solution to these defects does not lie in extending government ownership in the economy. "The socialist economy eventually fails to increase the size of the societal pie or even to redistribute the shrunken remains equitably," argue Rajan and Zingales.

A better answer is to disperse economic power. One of the ways to do this is by expanding access to finance. Risk management, stock markets, derivatives and other instruments are all helpful in reducing risks to investors, thus enabling greater financial flows that benefit an econ-

omy. Developed and competitive financial markets also normally oblige companies to divulge more financial information to the public, thus benefiting outsiders who wish to invest.

An important part of improving markets, they continue, lies in ensuring that managers will work to benefit public shareholders, and not loot the companies for their own benefit. For this to happen governments need to ensure there is a comprehensive body of laws, courts need to be fair and efficient and tax enforcement, which requires disclosure of profits, needs to be effective.

The book also defends the importance of permitting corporate takeovers. Some portray takeovers as part of a culture of greed where financiers act as vultures, picking over companies for their assets. Instead of vultures, the authors prefer to think of takeover merchants as having a role "similar to that of undertakers." Weeding out underperformers who are wasting shareholder funds enables a process of elimination that in the end will ensure a more productive economy.

### **Creative destruction**

Enabling takeovers does not mean that Rajan and Zingales are in favor of huge, vertically integrated companies. Instead they point out the advantage of competition and promoting smaller, more flexible enterprises. In a telling example, they explain that in the late 1980s General Motors employed 750,000 workers to make 8 million cars, while Toyota employed only 65,000 to make 4.5 million. Toyota could manage this by relying on independent suppliers.

General Motors had to change its methods, and in 2001 it had only 362,000 employees producing 8.5 million cars.

The upside of this is that the increased pace of technological change, the growth in new firms based on innovation, and the rise in cross-border competition has made the modern economy more dynamic and efficient. The downside is that the concept of a lifetime job is over.

Overall, Rajan and Zingales judge the new entrepreneurial style to be beneficial for workers, as leaner and less hierarchical firms value more highly their human resources. Moreover, skilled workers in the modern economy command better remuneration. A critical observer could add, however, that they pay insufficient attention to the fate of unskilled workers or to the difficulties of employees (especially older ones) who face frequent job changes.

Regarding open financial markets, the book does note some drawbacks. Increased financial volatility leads to more frequent and more disastrous collapses. Free financial markets have the power to do both great good and great evil, they observe. Moreover, developing countries with weak institutions face substantial risks in opening up their economies.

The book finishes with a number of recommendations ranging from keeping economic power from getting overly concentrated and ensuring it is used efficiently, to improving corporate governance. They also recommend assistance for workers who lose their jobs through restructuring and improving education and health care in developing countries.

A large gap still exists between the views expressed in this book and the position of many critics of a globalized economic system. But a positive sign is that the IMF is giving an important role to someone who favors the free market even as he recognizes its limitations.