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Saving Capitalism from the Capitalists:

Unleashing the power of financial markets to create wealth and spread opportunity

Introduction

Capitalism, or more precisely, the free market system, is the most effective way to organize production and distribution that human beings have found. While free markets, particularly free financial markets, fatten peoples' wallets, they have made surprisingly little inroads into their hearts and minds. Financial markets are among the most highly criticized and least understood parts of the capitalist system. The behavior of those involved in recent scandals like the collapse of Enron only solidifies the public conviction that these markets are simply tools for the rich to get richer at the expense of the general public. Yet, as we argue, healthy and competitive financial markets are an extraordinarily effective tool in spreading opportunity and fighting poverty. Because of their role in financing new ideas, financial markets keep alive the process of "creative destruction" – whereby old ideas and organizations are constantly challenged and replaced by new, better, ones. Without vibrant, innovative financial markets, economies would invariably ossify and decline.

In the United States, constant financial innovation creates devices to channel risk capital to people with daring ideas. While commonplace here, such financing vehicles are still treated as radical, even in developed countries like Germany. And the situation in third-world countries borders on the hopeless: People find it difficult to get access to even

a few dollars of financing, which would give them the freedom to earn an independent, fulfilling, living. If financial markets bring prosperity, why are they so underdeveloped around the world and why were they repressed, until recently, even in the United States?

Throughout its history, the free market system has been held back, not so much by its own economic deficiencies as Marxists would have it, but because of its reliance on political goodwill for its infrastructure. The threat primarily comes from two groups of opponents. The first are incumbents, those who already have an established position in the marketplace and would prefer to see it remain exclusive. The identity of the most dangerous incumbents depends on the country and the time period, but the part has been played at various times by the landed aristocracy, the owners and managers of large corporations, their financiers, and organized labor.

The second group of opponents, the distressed, tends to surface in times of economic downturn. Those who have lost out in the process of "creative destruction" unleashed by markets – unemployed workers, penniless investors, and bankrupt firms -- see no legitimacy in a system where they have been proven losers. They want relief, and since the markets offer them none, they will try the route of politics.

The unlikely alliance of the incumbent industrialist – the capitalist in the title -- and the distressed unemployed worker is especially powerful amidst the debris of corporate bankruptcies and layoffs. In an economic downturn, the capitalist is more likely to focus on costs of the competition emanating from free markets than on the opportunities they create. And the unemployed worker will find many others in a similar condition and with similar anxieties to his, which will make it easy for them to organize

together. Using the cover and the political organization provided by the distressed, the capitalist captures the political agenda.

For at such times it requires an extremely courageous (or foolhardy) politician to extol the virtues of free markets. Instead of viewing destruction as the inevitable counterpart of creation, it is far easier for the politician to give in to the capitalist, who ostensibly champions the distressed by demanding that competition be shackled and markets suppressed. Under the guise of making improvements to markets so as to prevent future downturns, political intervention at such times is aimed at impeding their working. The capitalist can turn against the most effective organ of capitalism, and the public, whose future is directly harmed by these actions, stands by the sideline, seldom protesting, often uncomprehending, and occasionally applauding.

This book starts with the reminder that much of the prosperity, innovation, and increased opportunity we have experienced in recent decades should be attributed to the reemergence of free markets, especially free financial markets. We then move on to our central thesis: Because free markets depend on political goodwill for their existence and because they have powerful political enemies among the establishment, their continued survival cannot be taken for granted, even in developed countries. Based on our reading of the reasons for the fall and rise of markets in recent history, we propose policies that can help make free markets more viable politically.

After the longest peacetime economic expansion in recent history, an expansion that has seen the implosion of socialist economies, it may seem overly alarmist to worry about the future of free markets. Perhaps! But success tends to breed complacency. Recent corporate scandals, the booms and busts engendered by financial markets, and

economic hardship, have led to growing distrust of markets. Other worrying signs abound, ranging from the virulent anti-immigration rhetoric of the extreme right to the anti-globalization protests of the rejuvenated left. And imminent demographic and technological change will create new tensions. It is important to understand that the ascendancy of free markets is not necessarily the culmination of an inevitable process of economic development, the end of economic history so to speak, but may well be an interlude, as it has been in the past. For free markets to become politically more viable, we have to repeat to ourselves and to others, often and loudly, why they are so beneficial. We have to recognize and address their deficiencies. And we have to act to shore up their defenses. This book is a contribution towards these goals.

We will start the book by explaining why competitive free markets are so useful. Perhaps the least understood of markets, the most unfairly criticized, and the one most critical to making a country competitive, is the financial market. It is also the market that is most sensitive to political winds. Many of the most important changes in our economic environment in the last three decades are due to changes in the financial market. For all these reasons, and because it is a fitting representative of its genus, we will pay particular attention to the financial market.

We start with two examples, the first from a country where financial markets do not exist, and the second from a country where they are vibrant. All too often, finance is criticized as merely a tool of the rich. Yet, as our first example suggests, the poor may be totally incapacitated when they do not have access to finance. For the poor to have better access, financial markets have to develop and become more competitive. And when they

do so, as our second example suggests, all that holds back the individual is their talent and their capacity to dream.

The Stool Maker of Jobra Village.

There is, perhaps, no greater authority on how to make credit available to the poor than Muhammad Yunus, the founder of the Grameen Bank. In his autobiography, Yunus described how he came to understand the importance of finance when he was a professor of Economics in a Bangladesh university. Appalled by the consequences of a recent famine on the poor, he wandered out of the sheltered walls of the university to the neighboring village, Jobra, to find out how the poor made a living. He started up a conversation with a young mother, Sufiya Begum, who was making bamboo stools[i].

He learnt that Sufiya Begum needed twenty-two cents to buy the raw material for the stools. Because she did not have any money, she borrowed it from middlemen, and was forced to sell the stools back to them as repayment for the loan. That left her with a profit of only two cents. Yunus was appalled[ii]:

`I watched as she set to work again, her small brown hands plaiting the strands of bamboo as they had every day for months and years on end…How would her children break the cycle of poverty she had started? How could they go to school when the income Sufiya earned was barely enough to feed her, let alone shelter her family and clothe them properly?'

Because Sufiya did not have twenty-two cents, she was forced into the clutches of the middlemen. The middlemen made her accept a measly pittance of two cents for a hard day's labor. Finance would liberate her from the middlemen and enable her to sell directly to customers. But the middlemen would not let her have finance for then they would lose their hold over her. For want of twenty-two cents, Sufiya Begum's labor was captive.

The paucity of finance, which is all too often the normal state of affairs in much of the world is rendered even more stark when one contrasts it with the alternative: The extraordinary impact of the financial revolution in some parts of the world. To see this, we move to California for our second example.

The Search Fund

Kevin Taweel, who was about to graduate from Stanford Business School, was not excited by the idea of going to work for a large, traditional corporation. His goal was to start running his own business.

Job offers were plentiful, but no one gave him the opportunity to be his own boss. After all, who would trust someone with such little experience to run their firm? The choice was clear. If he wanted to run a company, he had to buy one. But how? Not only did he not have the money, he did not even have enough to pay for his expenses while he searched for an attractive target.

Kevin's situation is common. For millions around the world, the lack of resources to fund their ideas is the main roadblock to riches. All too often, you have to have money to make money. But Kevin overcame this barrier by making use of a little-known financing device called a Search Fund. Little over two years after leaving Stanford, he was running his own firm.

A Search Fund is a pool of money to finance a search for companies that might be willing to be bought out.[iii] Typically, a recent graduate from a business or law school, with no money of his own, puts the fund together. The fund pays for the expenses of the search, and some living expenses for the principal (the searching graduate). After identifying an appropriate target, the principal has to negotiate the purchase as well as

arrange financing. In return for their initial investment in the pool, investors in the search fund get the right to invest in the acquisition at favorable terms. Once the target is acquired, the principal runs the firm for a few years, and eventually sells it, pays off investors, and hopefully, keeps a sizeable fortune for himself.

In December 1993, Kevin raised $250,000 to fund his search. The search was more difficult than expected and Kevin asked a fellow graduate, Jim Ellis, to join him. A year and a half later, however, they identified a suitable target: Road Rescue, an emergency road services company. The owner asked for $8.5 million to sell out, a sum that Kevin and Jim were able to raise from banks and individual investors (most of them the original investors in the search fund). In fact, the prospects they offered the individual investors were so attractive, they were able to raise the money they sought in just 24 hours!

Under Kevin and Jim's management, Road Rescue grew at an extremely rapid pace, both through internal expansion and through acquisitions. While sales in 1995 were only $6 million, in 2001 they reached $200 million. The company delivered a fantastic return to investors: Shares bought by investors at $3 in 1995 were bought back by the company at the end of 1999 for $115.

Not all search funds have such a happy ending. Some principals run out of money before they find an attractive target. Others do succeed in finding a target, but are not as successful in running it. On average, however, search funds are very profitable, yielding an average 36 percent annual return to investors, and much more to the principals.[iv]

But more remarkable than their average return is the concept behind Search Funds. What is being financed in a Search Fund is not a hard asset that offers good

collateral to the financiers. It is not even a solid business proposition. What is being financed is a search for a business proposition – in effect a search for an idea. The Search Fund hints at a world that did not exist in the past, a world where a person's ability to create wealth and attain economic freedom is determined by the quality of her ideas rather than the size of her bank balance.

The Search Fund reflects a revolutionary improvement in the ability of a broad sector of people to obtain access to finance. This has had profound implications for their lives, often in ways they are oblivious of. For example, throughout much of history, labor was plentiful, while only a privileged few had access to capital. As a result, employees were weak relative to capital – in the prototypical large corporation of yesteryear, the owners of capital (the shareholders) or their nominees (top management) made decisions, while those lower in the hierarchy had no alternative but to obey. With the widespread availability of capital from developed financial markets, the human being has gained in strength in many industries relative to the owners of capital. Increasingly, the term "capitalism" as a description of free market enterprise is becoming an anachronism in many industries.

While this may seem hard to believe in the midst of a recession, the average educated worker or manager in developed countries does indeed have far more choice than before. Phenomena ranging from worker empowerment to the flattening of corporate hierarchies, from the growth of employee ownership to the break-up of large firms, are all, in some significant measure, consequences of the development of financial markets.

The Puzzle

There are many obvious differences between Kevin or Jim and Sufiya Begum. A Stanford M.B.A., whether in his Hickey Freeman suit or in Birkenstock sandals, is indeed far removed from a barefoot villager in Bangladesh with callused hands and nails black with grime. But there are important similarities: Both have valuable skills that only need to be supplemented with resources. As a multiple of the value of the income each one expects to generate, the amount of financing they seek is not very different. Neither has hard assets or prior wealth to offer as collateral. Yet Kevin and Jim obtained the funding they needed, while Sufiya Begum continued to be trapped in poverty.

Why could Sufiya Begum not get twenty-two cents at a reasonable interest rate while Kevin and Jim could raise hundreds of thousands of dollars easily in setting up their Search Fund? Why are financial markets developed in some countries only and not in others? Will even the countries where they are developed continue to enjoy the fruits of finance or is the surge in financial markets that we have experienced in the last two decades a temporary lull in millennia of financial oppression?

The "Conventional" Answer.

The Search Fund works because it gives the searching MBA the right incentives. For this, it relies on a variety of *institutions*. The rights of the principal and those of the investors are clearly demarcated by contract not just when the fund is set up but going forward. The legal system works so contracts can be enforced at low cost. Secure in their shares, the parties do not have incentives to deceive or manipulate each other. An effective accounting and disclosure system, and a reliable system of public record-keeping contributes to mutual trust. This also helps make everyone's stakes liquid. The principal knows that he is not locked in to the firm for life, but can make improvements

to the target firm and then exit by selling his stake in a liquid stock market. Since the market will capitalize the entire future stream of profits, the principal will get a tremendous compensation for his effort in locating under-performing firms. Thus the best talent is attracted to this business, further improving the level of trust…

The main reason why Sufiya Begum cannot get finance at a reasonable rate is that countries like Bangladesh are deficient in institutions: Ownership rights are neither well-demarcated nor well enforced, there are no agencies collecting, storing, and disseminating information on the credit worthiness of potential borrowers, there is little competition between moneylenders, the laws governing credit are outdated, contracts are not enforced because the judiciary is, all too often, either asleep or corrupt…

To remedy the deficiency in Bangladesh, however, one has to go beyond the conventional answer, "Fix the institutions!" One has to understand first why the necessary institutions do not exist. Perhaps the existing institutions cannot be changed because they run too deep in a country's history or a people's psyche. If this were the case, countries like Bangladesh would be condemned to remain underdeveloped for many years to come. Fortunately, as we will argue in this book, the historic evidence does not suggest that the legacy of history necessarily dooms a people. Thanks to human ingenuity, whenever allowed to do so people create substitute institutions if the existing ones cannot be fixed cheaply. In doing so, they demonstrate that institutional change is possible no matter how damned a country is by its history.

Perhaps poor countries lack the necessary endowments such as trained manpower, wealth, and sophisticated technologies to create new institutions. The difficulty with this explanation is that the logic is somewhat circular – countries are poor because they do not

have institutions and they do not have institutions because they are poor. This sheds little light on how some countries managed to break out of this vicious cycle. It does not explain why some countries that are rich – in 1790, the richest country in the world on a per capita basis was Haiti – never develop the necessary institutions and fall behind.[v] And it does not explain why countries do not develop the specific institutions that facilitate access to finance, even though they have other basic market institutions. Ten years ago, something like the Search Fund would have been virtually impossible to contemplate in France or Germany. These countries did not lack the capacity to create the institutions necessary for a vibrant, competitive financial sector – their laws are detailed and well enforced, their people are no less educated than Americans, their industries no less reliant on high technology… We have to seek elsewhere to explain why the institutions necessary for competitive financial markets in particular, and markets in general, are so underdeveloped or non-existent in many countries.

The Politics of Markets.

Our explanation is simple. Small, informal markets are no doubt possible without much institutional infrastructure. But the large arm's length markets required in a modern capitalist economy need a substantial amount of infrastructure to support them. These market institutions are underdeveloped when the powerful see them as undermining their power. The economically powerful are concerned about the institutions underpinning free markets because they treat people equally, making power redundant. The markets themselves add insult to injury. They are a source of competition, forcing the powerful to prove their competence again and again. Since a person may be powerful because of his

past accomplishments or inheritance rather than his current abilities, the powerful have a reason to fear markets.

Of course, the powerful also benefit from some markets. What use is it being the monopoly producer of bananas in a republic if there is no market to sell them in? But when these markets exist, the powerful like to control them as the father of economics, Adam Smith, recognized long ago[vi]:

"To widen the market and to narrow the competition is always the interest of the dealers…The proposal of any new law or regulation of commerce which comes from this order, ought always to be listened to with great precaution, and ought never to be adopted, till after having been long and carefully examined, not only with the most scrupulous, but with the most suspicious attention. It comes from an order of men, whose interest is never exactly the same with that of the public, who generally have an interest to deceive and even oppress the public, and who accordingly have, upon many occasions, both deceived and oppressed it."

Many markets like the financial markets, once allowed to flourish, are intrinsically hard to tame. The middlemen who have Sufiya Begum in their grasp have the power and the local knowledge to get around the otherwise Byzantine system for recovering from defaulting borrowers. Better laws, better demarcation of property, and the creation of public credit rating agencies would create a vibrant competitive financial market, bring in outside lenders, and make these middlemen's skills redundant, thus jeopardizing the fat profits they made. Anticipating this, the middlemen would rather not see the market develop at all. What better way than opposing the creation of the necessary institutions?

It is not just incumbents in poor countries who have to fear the increase in competition as financial markets develop. In the United States, which has a vibrant financial market, fully half the top twenty firms by sales in 1999 were not in the top

twenty in 1985. By contrast, in Germany, where the financial markets till recently were dormant, eighty percent of the firms in the top twenty in 1999 were also in the top twenty in 1985. While other factors are partially responsible for these differences, financial markets do seem to affect corporate mobility even in rich countries, threatening the establishment.[vii]

Our point thus far is a simple one. Those in power – the incumbents – prefer to stay in power. They feel threatened by free markets. Free financial markets are especially problematic because they provide resources to newcomers, who then can make other markets competitive. Hence financial markets are especially worthy of opposition.

For this to be more than a conspiracy theory, it has to be useful in predicting when and where markets will develop. If incumbents have a stranglehold on power, markets will develop either when incumbents benefit directly from them, or when the incumbents have no other choice. There are at least three phases in the historical development of financial markets that can be easily identified. The initial phase when a country obtains more representative government and begins to respect property rights, a second phase when it opens its borders to tame the incumbent groups that would otherwise capture democratic government, and a third reactionary phase, when incumbent groups ride the coattails of the distressed back into power. The phases do not inevitably follow each other, nor do they occur in all countries. But they are general enough to merit greater attention.

The Initial Phase: Respect for Property Rights

For free competitive markets to develop, the first step is that the government has to respect and guarantee the property rights of even the weakest and most defenseless

citizen. The greatest threat, historically, has often been the government itself: Under the guise of protecting citizens from foreign or ideological enemies, governments used their powerful armies or police forces to prey on their own citizens. In some societies, governments changed character quite early on and became representative of the people, policing their interactions with a firm but light hand, and inspiring trust rather than fear. In others, rulers still treat their countries as personal fiefdoms, to be looted as they please. Why were some countries fortunate while others are still damned?

While one-dimensional answers to such questions rarely satisfy, the historical evidence suggests an intriguing pattern: In many of the fortunate countries, the distribution of property, especially land, was typically much more egalitarian. For example, among the countries of the New World, land in Canada and Northern United States was widely distributed, with a sizeable number of "yeoman" farmers managing moderate plots of land. In the countries of the Caribbean and in Latin America, the norm was large estates, often run by owners exploiting slave labor, or reliant on feudal relationships with the docile local population.[viii]

The link between land distribution and responsive government may not be a coincidence. In North America, most farmers were individually too small to create their own police force. It made collective sense to create transparent, representative government where each citizen was treated similarly according to the rule of law. Moreover, because the yeoman farmer in North America owned his land, he had strong incentives to farm it well and to try and improve his production techniques. Over time, he grew to understand his land -- the right crops and the right times to plant and harvest as well as the right scientific techniques to use. Even if ownership was initially distributed

almost by accident as immigrants enclosed their plots and started farming it, over time the yeoman farmer grew to be a productive owner of his land. Even the most rapacious government would think twice about disturbing his ownership. It was far better to tax the farmer steadily than kill the goose, so to speak, by seizing his property.

In short, because property was held widely, the propertied in North America pressed for a government that would be open, fair, and respect the rule of law. The small but prosperous farmers had the collective economic might to press for such a government. And because the farmers were close to their property and managed it well, it made economic sense to respect their property rights. All this created a fertile ground for the emergence of a strong free market economy.

Let us now turn to Southern America. The European colonists set up large plantations and haciendas operated with the help of imported slave labor or docile indigenous populations.[ix] But the estate owners had quite different incentives from the yeomanry in North America. These powerful incumbents had no use for an impartial, representative government. Instead, they had sufficient size to maintain their own police forces, and sufficient money to influence whatever government existed.

With the passage of time, civilization forced the emancipation of slaves, and the docile domestic population became aware of their rights. This changed the economics of producing in large estates for the worse. The only way for these estates to remain profitable was for the owners to ensure the working population had little other economic opportunities – for example, by ensuring that they were starved of education and finance.[x] Far from creating free market institutions, therefore, the powerful incumbents had an incentive to actively suppress them.

Of course, history is too colorful for each country to precisely follow our sketch. But the broad pattern is clear: Countries, or even areas such as Southern Italy or North East India, that were dominated by large feudal estates had a difficult time establishing the rule of law and respect for property.

The stranglehold of the incumbent magnates was not unbreakable. But, typically, dramatic internal political upheaval, or challenge from forces outside a country, was necessary for change to take place. In England, the Tudors destroyed the great lords and the Church in order to shore up their power, and this led to the rise of Parliament and constitutional government. In Brazil, economic reforms followed the revolution in the late nineteenth century. In the countries of Continental Europe, land reform and political reform followed on the seismic waves generated by the French Revolution and the subsequent Napoleonic conquests. Many of these countries joined the ranks of the fortunate. The unfortunate ones, shielded from reforming internal or external disturbances, continued to be slowly strangulated.

The Second Phase: Taming Incumbents in Democracies

The emergence of a constitutionally bound democracy is a big step towards free financial markets because citizens obtain greater assurance that their property will be respected. But it is not sufficient. For even in an industrialized democracy, there are powerful incumbents – established industrial firms and established financiers. They can be opposed to free access to finance simply because they already have enough financing of their own, and the financial markets fund unwanted new competitors.

Incumbents have the power to block the institutions necessary for finance because they are an organized group, focused on their goal, and endowed with plentiful resources.

They have a far greater ability to sway legislators and bureaucrats to their view than the larger mass of unorganized citizens. Consider whom the U.S. Congress first sought to help after the terrible tragedy of September 11th 2001. The terrorist attacks affected the entire tourism industry. But the first legislation was not relief for the hundreds of thousands of taxi drivers or restaurant and hotel workers, but for the airlines that conducted an organized lobbying effort for taxpayer subsidies.

Analogously, if industrial and financial incumbents are opposed to financial development, they have the organization and the political clout to prevent institution building from becoming an important part of a government's agenda. Finance can languish even if the people want it, simply because they do not have the organization to push for it.

To see how political expediency can overcome the public interest, one only has to turn to the rural South in the United States not so long ago.[xi]

For the farmer who needed credit in the rural South in the early years of the 20th century, the alternatives were dismal. Few banks would even consider making agricultural loans, and those who did charged extremely high interest rates. Rural credit was fertile ground for the loan sharks, and year after year, farmers turned over their crops to help pay exorbitant interest charges on loans made to keep their farms operating. Should a crop fail, the chances of a farmer extricating himself and his family from a loan shark's clutches were virtually non-existent.

The root of the problem was that state banking laws in the United States were not designed with the public in mind. Some states did not allow banks to open more than one branch. Many states also debarred out-of-state banks from opening branches. The reason, quite simply, was to ensure that competition between banks was limited so that existing in-state banks could remain profitable. It did not matter that without competition, in-state banks became fat and lazy, and that with limits on branching, banks were too small and

risky and thus may not have wanted to make agricultural loans that would tie them even more closely to the vicissitudes of local weather. The people of the state were served badly. But the in-state banks contributed large sums to political campaigns, and their will prevailed for a long time against the needs of the people. It was only in the 1990s that these archaic banking regulations in the United States were finally repealed.

If the most powerful economic players in a state or a country decide to oppose the creation of free market institutions, then there is only one hope for the emergence of markets. And that is competition from outside. This is because the political restraints imposed on domestic competition and markets tend to make domestic players, no matter how powerful internally, inefficient and uncompetitive relative to outside players who have cut their teeth in a more competitive environment. As a result, if competition seeps through from outside across political borders, domestic incumbents have only two choices: Remove the regulations that stand in the way of free domestic markets or perish. Typically, they make the rational choice.

This is, in fact, what happened with regulations limiting bank branching in the United States. As technology improved the ability of banks to lend and borrow from customers at a distance, competition from out-of-state banks increased, even though they had no in-state branches. Local politicians could not stamp this competition out since they had no jurisdiction over it. Rather than seeing their small, inefficient, local champions being overwhelmed by outsiders, they withdrew the regulations limiting branching. With the exception of a few inefficient banks, studies show everyone benefited. The withdrawal of these regulations typically led to a significant increase in the growth rate of per capita income in the state and a reduction in bank riskiness.[xii]

Similarly, cross-border trade and cross-border capital flows subject incumbents in a country to vigorous competition from outside. Countries are forced to do what is necessary to make their economies competitive, not what is best for their incumbents. Typically, this means strengthening the institutions necessary for domestic markets.

For example, in Japan in the early 1980s, corporate bond markets were tiny. This was because commercial banks controlled the so-called "Bond Committee," an official body to which each firm desiring to issue unsecured bonds (bonds that are not backed by collateral) had to apply. Ostensibly, the reason for this arrangement was to ensure that companies marketed only safe issues to the public. The *real* reason was that banks used the Bond Committee to protect their commercial lending business. Hitachi—then a blue-chip AA-rated firm (AAA being the highest rating)—couldn't obtain permission to issue bonds and thus had to borrow from the banks at high rates.

The growth of the Euromarket (an offshore market in London) and the opening of Japan's borders to capital flows in 1980 finally loosened the banks' longtime stranglehold on companies. Large Japanese firms now bypassed domestic markets to borrow in the Euromarket. There, they faced no collateral requirements, and they could freely issue a wide range of instruments in different maturities and currencies. Whereas Euromarket issues accounted for only 1.7 percent of Japanese corporate financing in the early 1970s, they accounted for 36.2 percent of it by 1984. The Bond Committee was forced to disband—not because the government or the banks saw how inefficient it was, but because cross-border competition dictated it.

More generally, during the twentieth century, periods of high international mobility of goods and capital (1900-1930 and 1990-2000) have paralleled periods of

maximum development of financial markets. More telling, countries that proved most open to international trade during these eras boasted more mature financial markets. As one example, small countries like Hong Kong, Luxembourg and Switzerland have to be open by necessity and, not coincidentally, tend to be important financial centers. Open borders limit the ability of domestic politics to close down competition and retard financial and economic growth. They help save capitalism from the capitalists!

The hope then for countries like Bangladesh is that as they become integrated into the world economy, the archaic institutions that literally and figuratively imprison their people will be forced to change for the better. People will have free access to finance, and with that, a hope of economic freedom.

In sum, our argument thus far is that each stage in a country's development brings its own set of incumbents who have an interest in allowing only those institutions that sustain their power. If economic power in the country is concentrated in the hands of those who do not have economic ability – the feudal lords or the inefficient plantation owners -- pro-market institutions have a chance of emerging only after political change democratizes power. But democratization may not be sufficient. Even in a democracy, incumbents can have their way, relying on the tendency of the general public to be apathetic towards political action. A free press, active political participation, and competitive political parties help mitigate this, but what ultimately keeps a new set of incumbents from capturing a country's economic policies is competitive pressure from outside a country's political borders. This pressure forces domestic politicians to adopt more efficient market friendly policies, if only to help domestic incumbents survive. Competition between political systems gives free markets a chance.

The Third Phase: The Reaction

But if all that stands between the tyranny of incumbents and competitive free markets are open borders, how stable are markets? Is the opening of a country's borders to foreign goods and services not itself a political decision, dependent on the mood of a country's people? If so, do free markets rest on shifting and fragile foundations?

The foundations can shift, but not with every political whim and fancy. A country's borders are porous. When the rest of the world is open, it is difficult for any single country to put up barriers to the flow of goods, capital, and people. There will always be ways through, around, or under the barriers a country puts up. So when the world is open, a country's borders will perforce be open except if it is a police state. Incumbent interests will be subdued. This is perhaps why the Asian Crisis in 1998, which occurred when much of the world was steaming ahead healthily, did not change the stance of most East Asian governments towards open borders.

Matters can change if a number of large countries close their borders. Not only will such actions weaken the champions of openness in each open country, it will also make it easier for a country to control flows across its own borders. So a reversal in globalization can be contagious. Such concerted action is not unthinkable. Not only can a global downturn reverberate in many countries, it also can turn significant vocal segments of the public against competitive markets, and by association, open borders.

To understand why economic downturns spawn opposition to markets, consider the natural consequences of a competitive and transparent market: It creates new risks and destroys traditional sources of insurance. The dark side of risks is invariably

experienced in downturns, and the lack of insurance keenly felt then. No wonder opposition mounts.

Let us explain in more detail. Competition naturally distinguishes the competent from the incompetent, the hard working from lazy, the lucky from the unlucky. It thus adds to the risk that firms and individuals face. It also increases risk by expanding opportunities in good times and reducing them in bad ones thus subjecting people to a roller coaster of a ride. Ultimately, most people are better off, but the ride is not always pleasant, and some do fall off.

Also, when competition is limited, individuals and firms enjoy various forms of implicit insurance. This can dry up as markets develop. An example should make the point clear. When competition between firms for workers is limited, firms know their workers will have little mobility in the future. Knowing their workers will be loyal, firms would rather retrain than fire their workers in times of trouble, providing them some insurance against bad times. By contrast, in a competitive economy, workers have greater mobility in good times. This makes it hard for a firm to justify retraining or holding on to excess employees in bad times because the firm knows fully well that the employees need not be loyal when the economy turns around. Similarly, traditional forms of implicit insurance between firms and lenders, suppliers and customers, citizens and communities, can all become more strained as markets develop and provide participants more choice. Often, explicit forms of insurance do not, or cannot, fully replace traditional sources.

In short, a competitive market not only creates clearly identified losers, it also deprives them of traditional safety nets. These people become the distressed: The workers whose industries have no future as a result of competition, the investors who lose

their entire life savings, the small business owners and farmers who are overburdened with debt taken to finance investment in rosier times… The distressed, staring at destitution, will have a strong incentive to organize and obtain protection through the political system. If they do manage to organize, though, they will demand far more than subsidies. Indeed, their demands are likely to turn against the economic system that led to their plight, especially because this coincides with the desires of incumbent capitalists. This is not just a theoretical possibility, it has happened before.

The Great Reversal.

The world experienced a period of increasing globalization and a great expansion of markets at least once before. Reflecting on his times, the President of the International Congress of Historical Studies said in 1913.

> "The world is becoming one in an altogether new sense…As the earth has been narrowed through the new forces science has placed at our disposal….the movements of politics, of economics, and of thought, in each of its regions, become more closely interwoven…Whatever happens in any part of the globe has now a significance for every other part. World History is tending to become One History."[xiii]

Markets were indeed vibrant at the time he spoke those words. But soon after, the First World War and the Great Depression created great dislocation and unemployment. These events occurred at a time where the level of formal insurance available to ordinary people ranged from the minimal to the non-existent (only 20 percent of the labor force in Western Europe had some form of pension insurance in 1910, only 22 percent had health insurance, and unemployment insurance was almost unheard of). Workers, many of whom had become political aware in the trenches of World War I, organized to demand for some form of protection against economic adversity. But the reaction really set in during the Great Depression when they were joined in country after country by others who had lost out – farmers, investors, war veterans, the elderly…

Politicians had to respond, but such a large demand for protection could not be satisfied within the tight constraints on government budgets imposed by the Gold Standard. Hence, the world abandoned the straitjacket of the Gold Standard, which at that time was the prime guarantor of free trade and free capital flows. Borders closed.

Governments obtained control over access to financial markets and many countries also nationalized significant portions of their banking systems. With their ability to turn on or turn off finance, governments obtained extraordinary power over private business. In addition, they intervened more directly by nationalizing industrial firms or by setting up government-sponsored cartels. In part, these actions reflected a distrust of the market, in part they reflected the inadequacies of past government policies. Since the government could not set up a reasonable safety net quickly, it tried to directly limit the size of market fluctuations by limiting competition.

With no external competition, and with the government willing to intervene to protect jobs and firms, incumbents had a field day. They used this period when domestic policies were no longer disciplined by international competition, not just to gain temporary advantage, but to mould legislation in their own favor so that their advantage would continue into rosier times when they would not be able to direct the anger of the distressed against markets. The reversal in openness provided the conditions under which markets could be, and indeed were, repressed. And this repression lasted for a long time.

As competition dried up, a few large firms dominated most industries. New entrants did not get a chance. Worse, economies could no longer renew themselves through "creative destruction," whereby old and jaded institutions give way to the young and innovative. While all this may not have mattered in the immediate post World War II

years when the emphasis through much of the world was on reconstruction, eventually the world economy began to slow.

It is only through the progressive opening up of the world economy in the last three decades, driven in no small part by the realization that closed borders produce economic stagnation, that finance, and economies, have become free again.

In sum, history suggests the political consensus in favor of free markets cannot be taken for granted, even in the developed countries of the world. The political battle has to be fought again and again to preserve economic freedom. Sufiya Begum's plight, although extreme, is not that distant from us!

The Dangers of the Anti-Globalization Movement.

Open borders have improved the well being of a broad swathe of people—many of whom are equally oblivious to the role that finance has played in their lives *and* to the risk that closing borders would pose for them personally. Unfortunately, too few people understand this, which is why anti-globalization protests grow unchecked around the world. With a serious economic downturn, open borders will look less and less attractive, even though they are politically most beneficial at such times.

Markets will always create losers if they are to do their job. There is no denying that the costs of competition and technological change fall disproportionately on some. Unfortunately, it is largely their voice, rather than the desires of the silent majority or the interests of future generations, that will influence politicians. The danger, stemming from conservative politics, is to ignore the concerns of the losers or the threat they pose to general prosperity. Liberal politics is equally misguided when it attacks the system that created losers, instead of seeing that it is an inevitable aspect of the market.

Recent developments do not augur well. The increase in militarism across the globe may hopefully be only a minor footnote in history. Regardless of whether it is or not, war fervor tends to increase faith in action by governments, even in the economic arena, while reducing the public's faith in the logic of open markets. An economic downturn with many cheated of prosperity that seemed to be within their grasp, corporate scandals that suggest the unlimited greed of the rich, a chance of a prolonged war, and a backlash against open borders: We have seen such conditions before. Markets did not come out well from the encounter.

That is not to say that we have learnt nothing from the 1930s. History is not so boring as to repeat itself exactly. Developed countries have built safety nets for their people, though there are holes in even the best of them. But newly developed and developing countries are still reliant on informal safety nets that have frayed long ago under the onslaught of markets. It is not inconceivable that the anti-market movement may gather strength there and then spread to developed countries.

And developed countries have to face new problems. Technological change and the economic growth of countries like India and China are forcing entire industries to shrink and restructure. The aging of populations in developing countries and the consequent need for immigration from developing countries may fuel great political tension in the future, when working immigrants will be asked to pay benefits to the retired old indigenous population. Furthermore, as the retired in the rich West merely own but do not create value, conflicts over property rights can increase.

None of these looming problems are without resolution. But they require policies that are pragmatic rather than ideological, and we will suggest some. Broadly speaking,

borders have to be kept open so that countries can enjoy competitive free markets, and keep the playing field level. But open borders and free markets also have to be made politically palatable. There is little common ground between free markets and incumbents. But more common ground can be found between free markets and the distressed. To prevent politics from working at cross-purposes to the market, those who lose out in competition should be helped, not to continue the lost fight, but to ease their pain, and to prepare them for a better future.

To sum up: Politics—for better or worse—lays the foundations for markets, and thus for prosperity. For creative destruction, sustained by free markets, is the elixir that has let the free enterprise system flourish for so many years. Yet the disruptions that creative destruction spawns sometimes prove too big for a free society to survive without a safety net. Markets need to be preserved against their biggest enemy: Themselves. Markets need a heart for their own good.

[i] *Banker to the Poor: the autobiography of Muhammad Yunus, founder of the Grameen Bank*, Muhammad Yunus, 1998, Aurum Press, London, p46-48
[ii] *Banker to the Poor: the autobiography of Muhammad Yunus, founder of the Grameen Bank*, Muhammad Yunus, 1998, Aurum Press, London, p46-48
[iii] The description of the search fund relies on "Early Career LBOs using the Search Fund Model" HBS case note 9-897-092 by Professor Howard Stevenson. We thank Kevin Taweel and Jim Ellis for consenting to be interviewed for this book.
[iv] Center for Entrepreneurial Studies at Stanford University, *Search Fund Study-2001,* http://www.gsb.stanford/ces/search_funds_study_2001.html.
[v] This is from David Eltis' work, cited by Kenneth Sokoloff , 2000, "Institutions, Factor Endowments, And Paths of Development in the New World", unpublished working paper, UCLA.
[vi] Adam Smith 1776 ed. Edwin Canan 1976. The Wealth of Nations Chicago: University of Chicago Press, Book 1, Chapter XI, p. 278.
[vii] See Kathy He, Randall Morck and Bernard Yeung, "Corporate Stability and Economic Growth"*,* New York University Working Paper.
[viii] See "Factor Endowments, Institutions, and Differential Paths of Growth Among New World Economies: A View from Economic Historians of the United States", Stanley Engerman and Kenneth Sokoloff , NBER Historical Working Paper # 66, 1994.
[ix] See D. Acemoglu, S. Johnson, and J. Robinson 2001, "The Colonial Origins Of Comparative Development: An Empirical Study" *American Economic Review* 91: 1369-1401, on the differences in the nature of European rule based on mortality rates.
[x] For low education, see Kenneth Sokoloff, 2000, "Institutions, Factor Endowments, And Paths of Development in the New World", unpublished working paper, UCLA and Engerman Stanley L. and Kenneth Sokoloff, 2000, "Institutions, Factors Endowment, and Path of Development in the New World", *Journal of Economic Perspective*, 3: 217-232, for poor finance, see Stephen Haber "Financial Markets and Industrial Development: A Comparative Study of Governmental Regulation, Financial Innovation, and Industrial Structure in Brazil and Mexico, 1840-1930", in Stephen Haber ed. *How Latin America Fell Behind*, Stanford University Press, Stanford, 1997.
[xi] From "Rural Credit in North Carolina" by Gabriel Kirkpatrick.
[xii] See R. Kroszner and P.Strahan, 1999, "What drives deregulation? Economics and Politics of the Relaxation of Bank Branching Restrictions", *Quarterly Journal of Economics,* November 1999: 1437-1467 and Jith Jayaratne and Philip Strahan, "Entry Restrictions, Industry Evolution, and Dynamic Efficiency: Evidence from Commercial Banking", *Journal of Law and* Economics, 1998, vol 41, 239-274
[xiii] Address on April 3, 1913 of Mr Bryce, President of the International Congress of Historical Studies, cited in E. Powell 1915, *The Evolution of the Money Market (1385-1915): A Historical and Analytical Study of the Rise and Development of Finance as a Centralized Coordinated Force*, p704.