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‘Saving Capitalism from the Capitalists’

Abstract: The capitalist economic order, which involves the allocation of resources driven by the profit motive, is the most efficient of economic orders. However, it will not work without advanced finances. Insider corporations have no interest in the creation of a modern and flexible financial system, as that would also provide opportunities for others. Left to its own devices, the market is not efficient enough and needs government regulation. This is not without risk either, as insider corporations often keep governments in their service and suppress the market. Therefore, in order to leverage the advantages of capitalism the right course between the Scylla of weak government regulation and the Charybdis of an underdeveloped market needs to be steered. The Hungarian lesson: we should not take a path which even the USA is forced to abandon.

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We can hardly expect the IMF to appoint an antiglobalist armchair scientist as its chief economist. It is fairly unlikely that a Professor of Finance at the University of Chicago, looked upon as the citadel of free market thinking, would be antiglobalist.

IMF Chief Economist for five years and the only non-American to occupy that position over the past half a century, *Raghuram Rajan* is indeed not an antiglobalist.

Yet, he co-authored a book with *Luigi Zingales* under the odd title *Saving Capitalism from the Capitalists*. Subsequently, Rajan’s own work *Fault Lines* was published in 2010 and went on to win the prestigious Financial Times and Goldman Sachs Business Book of the Year Award. According to the panel, the book deserved the award because it identifies the roots of the 2008 world financial crisis not only in financial and economic terms but also in social terms, and does so in a clear, lucid and convincing style.

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Although they firmly believe that capitalism is the most efficient economic system allowing a reasonable allocation of capital, Rajan and Zingales posit that the market, when left to its own devices, will not perform at its best. The market needs the very visible hand and active participation of government. That said, the form which such active participation takes is crucial. Preferably, it should consist of the government adopting measures to *provide the institutional conditions* for a market economy that actually works well.

The authors place great emphasis on explaining the damage potentially caused by anti-market and antiglobalist action being taken in response to the anomalies undeniably occurring in the world economy.

Namely, an *odd coalition* has formed against the operation of the free market, the essence of capitalism, demanding government intervention to remedy problems. Government protection is not only needed by employees dreading unemployment who are the hardest hit by globalism, but, first and foremost, by the *capi-*

talists themselves, who are, so to speak, already *insiders*. Those who expect the government to protect the position they have achieved against competitors that may emerge internally, or, in particular, externally. For them, the free market and an advanced financial system are not desirable and in fact represent the greatest threat. Namely, in such a system, anyone with a good idea can gain access to funds to implement it, and that is not in the interest of those currently dominating the market. Insiders benefit if the government *fails* to take firm action to create an efficient and flexible system of financial institutions. They already have their established financial channels and sources of funding. They would not want others to tap those resources and move into their markets with more competitive production.

While drawing from a wide range of examples in terms of time and space, the authors build primarily on the specific features of the American market. It is on those grounds that they see great danger in workers' solidarity with employers in demanding bailouts and protective action by the government. For American employees, losing their jobs has more severe consequences than for their peers in Europe. In the USA, the pension system and health insurance are closely linked to corporations. As a result, the bankruptcy of a corporation will not only cause its workers to lose their jobs and wages, but will also result in the most serious problems in terms of livelihood. Those who fail to find employment soon will be left without insurance and vulnerable to adversity. Therefore, when bankruptcy is imminent, workers take the side of employers and seek help from the government. The authors use the illustrative image of insider corporations using their employees as human shields in the fight for subventions and tariffs. Rather strong words, but undoubtedly expressive. On grounds that government needs citizens' votes, capital owners and managers are successful in selling their own profit requirements as public interest to the government.

Rajan and Zingales point out that in a modern society, government must of course enable citizens to provide the conditions for their existence. That, however, does not mean saving corporations at all costs, but creating an appropriate social safety net for individuals. 'Enterprise protection' will result in a hardened structure of products and production, which prevents innovation and limits opportunities for new SMEs.

The free market therefore is in constant danger. Its development is difficult and, even in developed democracies, it is susceptible to the influence of lobbies through the monopolies which they create.

WHOSE INTERESTS ARE SERVED BY AN ADVANCED FINANCIAL SYSTEM?

Sovereigns in the Middle Ages were faced with a continuous shortage of money. Treasuries were constantly depleted by wars and the trappings of power. Subjects could not be scourged to no end as productivity was low, with undeveloped markets and cash flows. Sovereigns, then, used every means available to raise money. When a notorious American robber was asked why he robbed banks, he answered: 'because that's where the money is' (Rajan – Zingales, 2003).

Sovereigns of the day were keen to target the 'infidels' dealing with money, from whom they 'borrowed', or mostly seized large sums. However, the Christian Europe of that period also saw the emergence of a kind of bank network, which was significant and flourished for nearly a century and a half, created by the Christian Knights Templar. As part of the network, pilgrims and crusaders heading for the Holy Land could borrow from or deposit money with the Templars. Wealth was protect-

ed by the knights' moral superiority and renowned swordsmanship. The Kings of England and France set their eyes on the treasures of the Templars on several occasions (this inspired a number of literary works). Finally, it was *King Philip of France*, by means of a show trial, who destroyed the moral superiority of the Order. He accused its members of all sorts of sacrilege, to which they admitted as a result of torture. Power always seeks to legitimise its actions. Despite the masters of the Order revoking their testimonies, they were burnt at the stake and the Order was dissolved. Its wealth then fell into the hands of the King (as part of damage control, the Pope made efforts to reclaim some of it for other orders). The Christian bank network thus came to an end, and the kings squandered its capital.

Events took a somewhat different course in England. In the Middle Ages, ownership was strongly concentrated. The sees and monasteries of the Church were particularly wealthy, as those admitted had no descendants, and wealth kept accumulating over generations (also in France, the huge differences in wealth and income, including the enormous wealth of the Church, led to the Great French Revolution). In England, *Henry VIII* broke with the Papacy. He seized the wealth of monastic orders but rather than using it directly for his purposes, he distributed it among the smallholders who supported him. Thereby he created the society of the *gentry*, comprised of small and medium landowners, taking a very important step towards laying the foundations of a free market. His move was motivated by the need to counterbalance the power of influential lords — he could not possibly have *everyone* executed... The gentry, however, strived to protect their interests against the more powerful lords, including the King himself. They could only achieve that by joining forces, which led to the evolution of a strong political organisation, the Parliament. For medium landowners, the Parliament became a forum which allowed them to represent and reconcile their interests. It passed acts that served to protect private property. The inviolability of property forms the basis of market economy (incidentally, the secular attacks against the wealth of the Church, as referred to above, also drove the Church to emphasise the origins of property in natural law; secular scholars drew upon Roman law in providing further support for this.)

As long as power robbed subjects, as it were, by means of dispossession or the arbitrary assessment of taxes, it was not possible for a class of entrepreneurs interested in the growth of wealth to emerge either in agriculture or in industry, which was slowly beginning to evolve.

The strengthening of competitive positions requires development, which in turn requires capital acquisition. The development of an adequately working system of financial intermediation is an essential prerequisite for access to capital by small and medium enterprises. In such societies, the middle class, of significant political power, would facilitate the creation of the appropriate institutional system, as it has a vital interest in doing so. This was the case in the United States as well. Farmers, operating small but efficient husbandries, enforced respect for their proprietary rights, statutory provisions to ensure the framework of a constitutional state, and transparent governance. *Democratic capitalism requires a strong class of small and medium owners.* The importance of small and medium property was frequently pointed out later on as well. A number of thinkers in the 1930s and 1940s, especially those committed to democratic society such as *Chesterton* of England (1910) or *Roepke* of Switzerland (1996), argued for the importance of small and medium property. A close friend of Chesterton's, *Hilaire Belloc* said, for example: 'Property is like muck, it is good only if it be spread' (Botos, 1999). Such trends of thought continued into the second half of the

20th century. In the 1970s, *Schumacher's* famous work 'Small Is Beautiful' was also based on an emphasis on distributed property (Schumacher, 1973). Indeed, small enterprises continue to spread even today, which is connected to more rational methods of enterprise management, and the practice of *outsourcing*.

The situation was different in South American economies, where property was concentrated in large estates. Following the emancipation of slaves, owners of large estates had an interest in ensuring that cheap labour was available and that people's opportunities to find employment were limited. This did not benefit the development of a flexible financial system, which would have presented opportunities for other entrepreneurs as well. At the turn of the 19th and 20th centuries, a wave of globalisation was emerging. Building on enormous markets, giant corporations were created despite anti-trust laws. Following World War I, the situation which had evolved in the USA resulted in an overproduction crisis, massive unemployment and asset bubbles, ultimately leading to the outbreak of the Great Depression. In response, the New Deal provided for significant government intervention. However, that would not have been possible if the gold standard were to be maintained. As a result, countries deviated from the gold standard. On the other hand, the gold standard served as a guarantee for international capital flows. The transition to the new system thus imposed limitations on international capital flow, and ultimately international trade fell to a fraction of previous levels.

Reduced competition from foreign markets mostly benefited domestic insider corporations. The measures adopted during the Depression stabilised their position, while also preventing the cleansing mechanism of 'constructive destruction'. In the America of the 1930s, a social safety net to mitigate the volatile effects of crises was barely in existence, and was relatively undeveloped worldwide, thus it appeared easier to mitigate cyclical swings by imposing direct limitations on competition. In the period of reconstruction following WW II, the possibility of such limitations causing problems was not yet foreseen. However, the growth of the world economy gradually slowed. From the 1970s on, the view was increasingly advanced that closed borders were detrimental to the growth of the world economy, and factor movements, in particular the free flow of capital, were gradually liberated. Simultaneously, the development of the financial system also gained momentum, and a great number of financial innovations were introduced.

Today, judgement on these is rather ambivalent. At the dawn of the new millennium, the authors tend to underline the positive aspects. They point out that innovation creates plenty of opportunities which, undeniably, benefit citizens and serve their interests. They give the extreme example of life insurance securitisation. Suppose an AIDS patient has previously taken out a life insurance policy, but lacks sufficient cash to cover the cost of expensive treatment after contracting the disease. This method can be used by the patient to raise cash. The profit motive definitely plays a role, as the institution undertaking the financial operation will profit from the deal. It will also take a certain degree of risk, because the life prospects of the patient cannot be accurately determined. Consequently, these securities too are sold in 'packages'. That diminishes the moral problem of the investor having to speculate on the death of certain individuals. Morbidly, financial institutions appear to make money on human distress, but a closer look would suggest that the opportunity in fact eases the patient's suffering.

Another, more common example is the privatisation of the French corporation Rhone-Poulenc. French employees had been reluctant

to buy into their own company for fear of fluctuations in share prices and the risk of losing their assets. Bankers Trust offered insurance under which it would top up returns should they fall below 25 percent, in exchange for one-third of investors' earnings on share price gains. Using dynamic hedging, BT traded the liquid corporate securities on the stock exchange, and invested part of the money raised in the guarantee fund. While doing so, it also made a handsome profit of its own. The deal satisfied three needs: the government could privatise the company, investors could expect guaranteed returns, and Bankers Trust made a pretty penny on the deal.

Today, the negative aspects of financial innovation are more prominent (suffice it to consider the highly damaging impact of the above-mentioned 'packaging' on the property market). Thus, it could be argued that a great number of factors need to work perfectly in order for the advanced financial system to produce the benefits that the authors refer to with such conviction. Statutory provisions, the legal practice of enforcing such provisions, the practice of transfer price control by the tax authority, a prohibition on insider trading, and the institution of personal bankruptcy, as well as a number of other factors need to be operated effectively in order for financial markets to function properly. Most importantly, sound moral foundations are needed, which can by no means be guaranteed with all actors. Frankly speaking, one cannot expect either market players, or government bodies, which also tend to align regulations with their own interests, to be driven by public interest in every action they take. A well-functioning market economy benefits all of its players, who will nevertheless try to avoid the burdens of those benefits, such as reporting information or strict compliance with the rules. Therefore, the existence of a financial system to ensure economic freedom can by no means be considered a given. Still, such a system is becoming increasingly important as in today's knowledge-based society, human capital has replaced real capital as the main driver of development. However, the success of human capital and the application of creative energies require the *financing needed to implement good ideas*. In turn, access to financing will be provided only by an advanced, flexible and innovative financial system.

BETWEEN SCYLLA AND CHARYBDIS

In times of crises, which are inherent features of market economy, government regulators tend to overreact and introduce severe restrictions. Such restrictions will be maintained later on when they are not necessarily justified. By doing so, regulators prevent both destructive and healthy competition, to the delight of insider corporations already established in the market. As a result, a flexible and modern system of financial institutions that enables economic freedom will always come at the price of political battles. Such battles are fought not only with insiders, who have no interest in creating opportunities for others, but also with government, which has a tendency to overregulate. On the one hand, because any power will be keen to keep its 'subjects' on a short leash, driving them in a 'stick and carrot' system of subsidies, preferences, penalties and fines.

On the other hand, because power itself is often in the pockets of insiders, irrespective of the efforts that individual countries make in their legal systems with a view to the clarity and transparency of party financing. Accordingly, fighting government overregulation often involves a fight against the interests of insider corporations. An efficient market steers a narrow course between overregulation and chaos ensuing in the absence of rules. When left to its own devices, the market is fragile. It is easy for an economy to develop

that is 'of insiders, by insiders, for insiders'. (Quoted from the authors, the sentence is an unambiguous reference to President Lincoln's Gettysburg Address following the great battle of the American Civil War: 'government of the people, by the people, for the people'). Nevertheless, capital markets accessible by anyone and a modern financial system are, in theory, capable of addressing the severe shortcomings of the traditional order of capitalist economy and society, such as the tyranny of capital over labour, excessive concentration of industry, and lack of opportunity for the poor. True, this belief has been challenged by the corporate crises at the turn of the millennium (Enron case) and the dotcom meltdown. When 'Saving Capitalism from the Capitalists' was written, the emergence of a new crisis was not yet foreseen (it is discussed in detail in 'Fault Lines', 2010), but the concerns were already raised: What could prevent the outbreak of another crisis that may set back market liberalisation by up to half a century? We now know the answer: nothing. There was nothing to prevent the outbreak of a crisis.

The authors correctly predicted that in Eastern European societies abandoning socialism and entering capitalism, including in Hungary, the absence of institutions would present an enormous obstacle. Although it may be possible to formally create market institutions relatively quickly, this is not sufficient. The question is whether the mentality of market operators would change, and in what direction. The authors' concern was not that socialism would be an alternative to capitalism, but that the countries would take the path which they referred to as 'network capitalism'. What they meant was that corporations becoming insiders would seize and have control over power, thereby preventing the evolution of a financial system that is in fact efficient, serves everyone's interests, and provides opportunities for a wide range of actors. If there are no broad masses that have an interest in the creation of such an institutional system and would therefore support market development, transformation cannot be successful.

What can we say? In Hungary, indeed it was not.

The very factors were lacking which the authors put forward as preconditions for the efficient functioning of a modern financial system. These are as follows:

- an efficient but not excessively concentrated ownership structure;
- a flexible workforce capable of adapting;
- a safety net suitable for managing extreme tensions; and
- an openness towards other countries to protect the regulatory apparatus from overregulation.

The structure of production is rather concentrated and so is, consequently, apart from pseudo-self-employment, that of ownership. The workforce is becoming less qualified, and the safety net is cracking. Only the level of openness is high, but that poses a competitiveness problem in a number of areas that for the time being is impossible to overcome.

The authors put forward plenty of good ideas on how to facilitate the functioning of a more efficient financial system. More effective anti-trust laws are needed; but the concern was raised that such increased effectiveness might be directed at forcing out companies that are not loyal to the government. A property tax should replace income taxes to better reward efficiency; an inheritance tax should be introduced to impede the inefficient use of assets by heirs who are not necessarily competent; and corporate governance systems also need improvement. The means of the latter include independent boards and the use of efficient auditors to better protect the interests of small investors, and to make corporate takeovers more flexible.

Such wisdom may indeed be useful for the

American economy itself (in the steel industry, protectionist measures taken at the turn of the millennium envisaged this kind of isolationism, and there is also a strong demand for legislation to give a protectionist response to China's export dumping), and Obama's health insurance reform also points to the extension of the safety net. Yet, Hungary has done and is doing just the opposite of all that. Partly under pressure, and partly for lack of wisdom. It may in fact be in the interests of insiders.

But who indeed are the insiders in Hungary? They are not domestic capitalists, but multinationals who bought markets in this little country and created a relatively well capitalised export sector (everything is relative). Through their advanced financial services, even the parent banks of banks operating in Hungary can serve the financial needs of such multinationals. The Hungarian banking product structure is not particularly sophisticated. A majority of enterprises are struggling for survival, and cannot be said to be looking forward to 'constructive destruction'. No doubt, it is difficult to obtain financing even for the few good ideas around, as it is so expensive. Banks themselves may be considered to be insiders, with no interest at all in the proliferation of cheaper capital market financing. Most market players though are not prepared for that either. It is no wonder that a majority of the bank system has switched to foreign-currency home loans instead of targeting companies. That too turned into a pile of problems in the aftermath of the global financial crisis. The role of government overspending in those events cannot be overlooked. At its root lies a huge government debt, which Hungary is financing using external funds. As a result of all that, the proposals put forward in the book for better education opportunities and to strengthen the social safety net of pensions and healthcare, have little practical bearing. Those are the very sectors from which government bodies are forced to transfer funds due to problems with financing. Today, it would be an achievement if things were not getting worse. On the above grounds, it could be argued that Hungary should not have taken and should not take a path (cuts on education spending, transfer of funds from healthcare) which, according to American authors, even the USA should abandon.

CONCLUSION

Although I agree that an efficient economy needs an efficient financial system, saving capitalism from the capitalists does not appear to be easy. Where money is the only measure of success, and the bank system is one such sector, it is difficult to delimit selfishness that is still socially useful. Countries which have become heavily indebted by financing most of their debt using external funds, will find it difficult to laud openness. The international financial system erected only soft barriers to overspending economies. In that sense, it shares the liability for the difficult situations that have arisen. In an economy intertwined with politics, voters will always elect a government which promises a better future — from public funds. They will never elect a government that insists on the necessity of restrictions right from the start. And if the four-year election cycles are not enough for the necessary changes, there will always be candidates to play this trump card yet again with credulous voters who are facing great difficulty. The foregoing may suggest that, to some extent, I consider the authors of the book idealists. Nevertheless, I cannot help being an idealist myself. I hope that it is possible to find the narrow course between Scylla and Charybdis, the repressed government and the suppressed financial sector. I believe that there is an ideal combination of well regulated government and an innovative financial sector. Credo quia absurdum est.

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