

Weekly Perspectives

Website: www.lomam.com

Email: info@lomam.com

iraj.pouyandeh@lom.com



A Weekly View of Global Economies

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SG Warburg, the merchant bank, decades before it was absorbed by UBS, was noted for its innovations. It is said that one of the principals used to interview potential candidates for vacant positions by asking them questions about history and politics, rather than anything about finance. This may appear to be somewhat strange behaviour for the head of a profitable company. But it is not really unusual when we recall that the firm had experienced radical upheaval and was forced to relocate from Germany to Britain after the Nazis came to power. And, being outside the Old Boys' network in the City, they were much more prone to innovate.

Evidently they thought that "soft" subjects like history and politics weren't irrelevant and provided useful knowledge about the real world. However, keeping a balanced view, we should also add that, a "hard" subject like maths is obviously enormously useful too. A difficulty often faced by a quant (common parlance for an investment professional with a quantitative bent) is that he has to deal with people who lack such skills but are very keen to denigrate mathematical models even though their understanding of such constructs is very modest. Fools can be ignored but when the fool has a supervisory role, it can be a delicate problem.

George Soros, another accomplished investment wizard, also appears to have an appreciation of the "soft" subjects. He has a sense of the fragility of social arrangements and the possibility of breakdown. There are many areas of the world where people have experienced political revolutions, runaway inflation and property crashes. These things haven't happened in Western developed countries for many decades but they have been common elsewhere.

Economists restrict themselves mainly to questions about market efficiency, often ignoring underlying political, social, legal and cultural forms and structures. But, markets will not function in an efficient manner unless there is an adequate infrastructure in place. A test case, in recent times, is that of Russia after the collapse of the Soviet Union. It was a laboratory experiment in introducing capitalism and democracy without much regard to the institutional base that makes them work properly. The results are well known: an economy in disarray, mafia capitalism and a breakdown of law and order.

In contrast, the Chinese communist party did not relax its powerful grip, even as it introduced economic liberalisation on a gradual basis. They ignored all advice about the necessity of opening up the political process, and they were prepared to use force and risk international opprobrium, as the Tien An Men incident demonstrated, when troops violently repressed demonstrators who were calling for more democracy. But it was a pragmatic and ultimately successful approach. As Teng Hsiao-ping famously commented "It doesn't matter if a cat is black or white as long as it can catch mice".

Europe had first-mover advantage, so the stage of primitive capital accumulation was extended over a long period, accompanied by the gradual democratisation of the political process. For countries like China and Russia, which came late to the race, this stage had to be compressed into a short time interval. The central authority imposed social regimentation and extracted forced saving from society, via central planning, to build up the capital base. But after the capital infrastructure has been built, central planning becomes redundant and is a barrier to further economic development. It is essential to switch to market forms to avoid the enormous inefficiencies of a planned economy in the misallocation of resources. Consumers' vote in the marketplace begins to count, but they don't necessarily get the right to vote at the ballot box.

India followed a somewhat different path historically. The economy was not centrally planned but had a good deal of regulation and central direction, as well as being highly protected by tariff barriers. And, of course, India is a prime example of democracy among developing countries. It is well recorded that the country's growth rate got a significant boost after the government started to liberalise the economy.

It is not clear that liberty is universally valued at all times, and in all places. There is a sketch in Luis Bunuel's satirical film "The Phantom of Liberty" in which Spanish prisoners facing a French firing squad, during the Napoleonic period, shout "Long live chains". According to Bunuel, this is not far-fetched. Spaniards preferred their oppressive monarchy to the idea of liberty represented by the French Revolution. One can certainly think of modern parallels. But the rejection of liberty may be a passing phase due to specific factors, in a particular context. There is no reason to think that it is permanent.

Authoritarian regimes tend to be more fragile than democratic ones. In democracies, there is always room for letting off some steam if the pressure builds up. Authoritarian systems have few in-built mechanisms for doing this. So when the ideology wilts, along with the economy, the people in power have to rely on greater coercion to run the system and this exacerbates the situation. The case of North Korea comes to mind.

The overall evidence does not support the view that there is a close correlation between political liberty and economic development. But there are some principles that stand out as being particularly important. One is the protection of property rights and the other is the freedom from arbitrary acts by authorities in power. However, it could be argued that democracies have a better record in upholding these rights than authoritarian regimes.

The success of capitalism in Europe was in no small part due to the establishment of these principles. Merchants were protected from the arbitrary expropriation of their property by the monarch, for whatever purpose he deemed necessary. This allowed the burgers to plan effectively and gave them an incentive to accumulate capital. Their counterparts in the Islamic world, and elsewhere, never got these rights and were always at the mercy of the ruler's whim.

As a modern example, Putin's Russia is moving towards a more authoritarian and centralised mode of government. But does this mean that economic development is compromised? Not necessarily; to the extent that property rights are protected, there is a more stable form of government, and they refrain from arbitrary acts of expropriation. Certainly, the move to crush Khodorkovsky and other non-compliant oligarchs broke the rules. But, a charitable view is that this is an attempt to establish a stable central authority that will allow greater efficiency in government. If this interpretation is correct, it should boost economic development in Russia and attract foreign investors in the long run.

Iraj Pouyandeh
Strategist / Senior Portfolio Manager

Prior to joining LOM Asset Management, Iraj Pouyandeh worked for Sun Life Financial in Toronto, advising on the global economic and financial outlook and strategy for the company.

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27 Reid Street
Hamilton, HM 11
Bermuda
441-295-6999

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