State Capitalism Comes of Age (Foreign Affairs magazine)
The End of the Free Market?

By Ian Bremmer

May/June 2009

Across the United States, Europe, and much of the rest of the developed world, the recent wave of state interventionism is meant to lessen the pain of the current global recession and restore ailing economies to health. For the most part, the governments of developed countries do not intend to manage these economies indefinitely. However, an opposing intention lies behind similar interventions in the developing world: there the state's heavy hand in the economy is signaling a strategic rejection of free-market doctrine.

Governments, not private shareholders, already own the world's largest oil companies and control three-quarters of the world's energy reserves. Other companies owned by or aligned with the state enjoy growing market power in major economic sectors in the world's fastest-growing economies. "Sovereign wealth funds," a recently coined term for state-owned investment portfolios, account for one-eighth of global investment, and that figure is rising. These trends are reshaping international politics and the global economy by transferring increasingly large levers of economic power and influence to the central authority of the state. They are fueling the large and complex phenomenon of state capitalism.

Not quite 20 years ago, the situation looked a lot different. After the Soviet Union buckled under the weight of its many internal contradictions, the new Kremlin leadership moved quickly to embrace the Western economic model. The young governments of the former Soviet republics and satellites championed the West's political values and began joining its alliances. Meanwhile, in China, liberal market reforms that had been launched a decade before began to breathe new life into the Chinese Communist Party. Emerging-market powers, such as Brazil, India, Indonesia, South Africa, and Turkey, began deregulating their dormant economies and empowering domestic free enterprise. Across western Europe, waves of privatization washed away state management of many companies and sectors. Trade volumes swelled. The globalization of consumer choice and supply chains, of capital flows and foreign direct investment, of technology and innovation strengthened these trends still further.

But the free-market tide has now receded. In its place has come state capitalism, a system in which the state functions as the leading economic actor and uses markets primarily for political gain. This trend has stoked a new global competition, not between rival political ideologies but between competing economic
models. And with the injection of politics into economic decision-making, an entirely different set of winners and losers is emerging.

If business and politics are closely linked, then domestic instabilities that threaten ruling elites begin to take on greater importance.

During the Cold War, the decisions taken by the managers of the Soviet and Chinese command economies had little impact on Western markets. Today’s emerging markets had yet to emerge. But now, state officials in Abu Dhabi, Ankara, Beijing, Brasília, Mexico City, Moscow, and New Delhi make economic decisions -- about strategic investments, state ownership, regulation -- that resonate across global markets. The challenge posed by this potent brand of state-managed capitalism has been sharpened by the international financial crisis and the global recession. Now, the champions of free trade and open markets have to prove these systems' value to an increasingly skeptical international audience.

This development is not simply a function of the decline in the United States’ power and influence relative to those of emerging states. If the governments of these states had chosen to embrace free-market capitalism, the United States’ declining share in the world market would have been offset by global gains in efficiency and productivity. But the rise of state capitalism has introduced massive inefficiencies into global markets and injected populist politics into economic decision-making.

PRINCIPAL ACTORS

State capitalism has four primary actors: national oil corporations, state-owned enterprises, privately owned national champions, and sovereign wealth funds (SWFs).

When thinking of “big oil,” most Americans think first of multinational corporations such as BP, Chevron, ExxonMobil, Shell, or Total. But the 13 largest oil companies in the world, measured by their reserves, are owned and operated by governments -- companies such as Saudi Arabia’s Saudi Aramco; the National Iranian Oil Company; Petróleos de Venezuela, S.A.; Russia's Gazprom and Rosneft; the China National Petroleum Corporation; Malaysia's Petronas; and Brazil's Petrobras. State-owned companies such as these control more than 75 percent of global oil reserves and production. Some governments, on discovering the leverage that comes with state dominance of energy resources, have expanded their reach over other so-called strategic assets. Privately owned multinationals now produce just ten percent of the world's oil and hold just three percent of its reserves. And in much of the world, they must now manage relations with governments that own and operate their larger and better-funded commercial rivals.

In sectors as diverse as petrochemicals, power generation, mining, iron and steel production, port management and shipping, weapons manufacturing, cars, heavy machinery, telecommunications, and aviation, a growing number of governments are no longer content with simply regulating the market. Instead, they want to use the market to bolster their own domestic political positions. State-owned enterprises help them do this, in part by consolidating whole industrial sectors. Angola’s Endiama (diamonds), Azerbaijan’s AzerEnerji (electricity generation), Kazakhstan’s Kazatomprom (uranium), and Morocco’s Office Chérifien des Phosphates -- all of these state-owned firms are by far the largest domestic players in their respective sectors. Some state-owned enterprises have grown particularly enormous, most notably Russia's fixed-line-telephone and arms-export monopolies; China's aluminum monopoly, power-transmission duopoly, and major telecommunications companies and airlines; and India's national railway, which is among the world’s largest nonmilitary employers, with over 1.4 million employees.

A more recent trend has complicated this phenomenon. In some developing countries, large companies that remain in private hands rely on government patronage in the form of credit, contracts, and subsidies. These privately owned but government-favored national champions get breaks from the government, which sees them as a means of competing with purely commercial foreign rivals, and they are thus able to
carve out a dominant role in the domestic economy and in export markets. In turn, these companies use their clout with their governments to gobble up smaller domestic rivals, reinforcing the companies' strength as pillars of state capitalism.

In Russia, any large business must have favorable relations with the state in order to succeed. The national champions are controlled by a small group of oligarchs who are personally in favor with the Kremlin. The companies Norilsk Nickel (mining); Novolipetsk Steel and NMK Holding (metallurgy); and Evraz, SeverStal, and Metalloinvest (steel) fall into this category. In China, the same applies, albeit with a wider, less high-profile ownership base: the AVIC empire (aircraft), Huawei (telecommunications), and Lenovo (computers) have all become state-favored giants run by a small circle of well-connected businesspeople. Variations of the privately owned but government-favored national champions have cropped up elsewhere, including in still relatively free-market economies: Cevital (agroindustries) in Algeria, Vale (mining) in Brazil, Tata (cars, steel, and chemicals) in India, Tnuva (meat and dairy) in Israel, Solidere (construction) in Lebanon, and the San Miguel Corporation (food and beverage) in the Philippines.

The task of financing these companies has fallen in part to SWFs, and this has greatly expanded those funds' size and significance. Governments know they cannot finance their national champions simply by printing more money; inflation would eventually erode the value of their assets. And spending directly from state budgets could leave a shortfall in the future if economic conditions deteriorated. Thus, SWFs have taken on a greater role. They act as repositories for excess foreign currency earned from the export of commodities or manufactured goods. But SWFs are more than just bank accounts. They are state-owned investment funds with mixed portfolios of foreign currencies, government bonds, real estate, precious metals, and direct stakes in -- and sometimes majority ownership of -- a host of domestic and foreign firms. Like all investment funds, SWFs look to maximize returns. But for state capitalists, these returns can be political as well as economic.

Although SWFs have gained prominence in recent years, they themselves are nothing new. The Kuwait Investment Authority, now the world's fourth-largest SWF, was founded in 1953. But the term "sovereign wealth fund" was first coined in 2005, reflecting a recognition of these funds' growing significance. Since then, several more countries have joined the game: Dubai, Libya, Qatar, South Korea, and Vietnam. The largest SWFs are those in the emirate of Abu Dhabi, Saudi Arabia, and China, with Russia playing catch-up. The only democracy represented among the ten largest SWFs is Norway.

New York City used to be the world's financial capital. It no longer is even the financial capital of the United States -- Washington is.

CLOSE TIES

One essential feature of state capitalism is the existence of close ties binding together those who govern a country and those who run its enterprises. Russia's former prime minister, Mikhail Fradkov, is now chair of Gazprom, Russia's natural gas monopoly. Gazprom's former chair, Dmitry Medvedev, is now Russia's president. This client-patron dynamic has brought politics, politicians, and bureaucrats into economic decision-making to an extent not seen since the Cold War. And it is this dynamic that raises several risks for the performance of global markets.

First, commercial decisions are often left to political bureaucrats, who have little experience in efficiently managing commercial operations. Often, their decisions make markets less competitive and, therefore, less productive. But because these enterprises have powerful political patrons and the competitive advantages that come with state subsidies, they pose a great and growing threat to their private-sector rivals.
Second, the motivations behind investment decisions may be political rather than economic. The leadership of the Chinese Communist Party, for example, knows that generating economic prosperity is essential to maintaining political power. It dispatches China’s national oil corporations abroad to secure the long-term supplies of oil and gas that China needs to fuel its continued expansion. Thanks to state funding, these national oil corporations have more cash to spend than their private-sector competitors -- and they pay above-market rates to suppliers to lock in long-term agreements. If the national oil corporations need additional help, the Chinese leadership is able to step in with promises of development loans for the supplier country.

Such behavior distorts the performance of energy markets by increasing the cost that everyone pays for oil and gas. It also deprives privately owned energy multinationals of the additional income they may need for expensive long-term projects, such as deep-sea exploration and production. This slows the development of new hydrocarbon reserves since few state-run oil corporations have the equipment or the engineering expertise needed for this kind of work. State capitalism ultimately adds costs and inefficiencies to production by injecting politics, and often high-level corruption, into the workings of markets.

If business and politics are closely linked, then the domestic instabilities that threaten ruling elites -- and, more specifically, their definition of the national interest and their foreign policy goals -- begin to take on greater importance for businesses. For outsiders, better understanding these political motivations has become a coping strategy. Many private companies doing business in emerging markets have learned the value of investing more time in closer relations with both the government leaders who award major contracts and the bureaucrats who oversee the legal and regulatory frameworks for their implementation. For multinationals, this expense of time and money might seem like a luxury at a time of global recession, but to protect their overseas investments and market share, they cannot afford to do otherwise.

ENTER THE STATE

State capitalism began to take shape during the 1973 oil crisis, when the members of the Organization of the Petroleum Exporting Countries (OPEC) agreed to cut oil production in response to the United States’ support of Israel in the Yom Kippur War. Almost overnight, the world’s most important commodity became a geopolitical weapon, giving the governments of oil-producing countries unprecedented international clout. As a political tool, OPEC’s production cuts served as embargoes against specific countries -- in particular, the United States and the Netherlands. As an economic phenomenon, the oil crisis reversed the previous flow of capital, in which the oil-consuming states bought ever-larger volumes of cheap oil and in turn sold goods to the oil-producing countries at inflationary prices. From the perspective of OPEC’s members, the crisis put an end to decades of political and economic impotence and the colonial era itself.

The oil crisis showed oil producers that through unified action, they could both control levels of production and capture a much larger share of the revenues generated by the major Western oil companies. This process proved easier in cases in which national governments could use domestic companies to extract and refine their own oil. In time, national oil companies came under greater government control (Saudi Aramco, for example, was not fully nationalized until 1980) and eventually eclipsed their privately held Western counterparts. The oil crisis gave birth to the modern national oil corporation, a model that has since become widespread and has been applied to the natural gas sector as well.

A second wave of state capitalism began during the 1980s, driven by the rise of developing countries controlled by governments with state-centric values and traditions. At the same time, the collapse of governments that relied on centrally planned economies for growth caused a surge in global demand for entrepreneurial opportunity and liberalized trade. That trend, in turn, sparked rapid growth and industrialization in several developing countries during the 1990s. Brazil, China, India, Mexico, Russia,
and Turkey, along with countries in Southeast Asia and many others, moved at different speeds along the path from developing to developed.

Although many of these emerging-market countries had not been part of the communist bloc, they did have histories of heavy state involvement in their economies. In some of them, a few major enterprises, often family owned, enjoyed virtual monopolies in strategic sectors. After World War II, Nehru’s India, post-Atatürk Turkey, Mexico under the Institutional Revolutionary Party, or PRI, and Brazil under alternating military and nationalist governments never fully subscribed to the capitalist view that only free markets can produce durable prosperity. Political beliefs predisposed these regimes to the idea that certain economic sectors should remain under government management, not least to avoid exploitation by Western capitalists.

When they began to liberalize, these emerging-market countries only partially embraced free-market principles. The political officials and lawmakers who introduced partial reforms had spent their formative years in educational and government institutions that had been created to propagate national values as defined by the state. In most of these countries, economic progress was accompanied by far less transparency and a much weaker rule of law than was the case in established free-market democracies. As a result, it is hardly surprising that the new generation’s faith in free-market values has been limited. Given the relative immaturity of their governing institutions, emerging-market states are those in which politics matters at least as much as economic fundamentals for the performance of markets. Rich-world governments once took little notice of them, since these countries had little or no influence in international markets.

A third wave of state capitalism was marked by the rise of SWFs, which by 2005 had begun to challenge Western dominance of global capital flows. These capital reserves were generated by the huge increase in exports from emerging-market countries. Most SWFs continue to be run by government officials, who treat the details of their reserve levels, investments, and management of state assets as something close to a state secret. As a result, it is not clear to what extent these funds’ investment and acquisition decisions are influenced by political considerations.

The International Monetary Fund is now leading efforts to mandate higher levels of transparency and consistency in SWFs, but such attempts will enjoy no more success than do most voluntary arrangements. Those SWFs that are especially opaque will remain opaque, and political leaders will continue to run them in order to gain both political and financial returns. As a justification, the funds’ managers can point to the avowedly political calls for divestiture from Darfur or Iran by the Western equivalents of SWFs, such as Norway’s Government Pension Fund or the California Public Employees’ Retirement System.

A fourth wave of state capitalism has now arrived, hastened by the recent global economic slowdown. But this time, the governments of the world’s wealthiest countries, and not just those of emerging-market countries, are the ones intervening in their economies. In the United States, lawmakers have intervened in the economy despite the public’s historic mistrust of government and its faith in private enterprise. Australia, Japan, and other free-market heavyweights have followed suit. In Europe, a history of statism and social democracy makes nationalization and bailouts more politically palatable.

Still, the world’s leading industrialized powers have not embraced state capitalism without reservations. In the United States and Europe, the power of the invisible hand remains an article of faith. Governments on both sides of the Atlantic know that to maintain popular support, they must keep their promises to return the banking sector and large enterprises to private hands once they have been restored to health. But as long as economic stimulus is at the forefront of political consideration in Washington, across Europe, and in China, India, and Russia, political policymakers will remain at the center of the global financial system. To pump-prime the economy, finance ministries and treasuries will rescue private banks and companies, inject liquidity, and print money simply because no one else can. Central banks, few of which are truly independent, are no longer the lenders of last resort, or even of first resort; they are the
only lenders. This development has produced a sudden and important shift in the center of gravity of global financial power.

Until very recently, New York City was the world’s financial capital. It no longer is even the financial capital of the United States. That distinction now falls to Washington, where members of Congress and the executive branch make decisions with long-term market impact on a scale not seen since the 1930s. A similar shift of economic responsibility is taking place throughout the world: from Shanghai to Beijing, from Dubai to Abu Dhabi, from Sydney to Canberra, from São Paulo to Brasília, and even in a relatively decentralized India, from Mumbai to New Delhi. And in London, Moscow, and Paris, where finance and politics coexist, there is the same shift occurring toward government.

HIGH STAKES

State capitalist economies are likely to emerge from the global recession with control over an unprecedented level of economic activity, despite having taken large financial hits, along with everybody else, during 2008 and 2009. China and Russia are bailing out both their state-owned enterprises and their private national champions. Both favor consolidating major industries to cut costs. Following the fall in oil prices from $147 a barrel in July 2008 to less than $40 in February 2009, Russia is facing its first budget deficit in a decade. China, a major oil importer and consumer, got some relief from the price drop, but the global slowdown has left the governments of both countries vulnerable to rising unemployment and accompanying social unrest. Both governments have responded, for the most part, by exerting still tighter state control over their economies.

Despite the global recession, SWFs, already major global economic players, are here to stay for the near future. Although their total net value fell from an estimated high of about $4 trillion in 2007 to less than $3 trillion by the end of 2008, this latter figure still approaches the total global holdings in foreign currency of central banks and exceeds the combined assets held by all hedge funds worldwide. SWFs account for about 12 percent of global investment, twice the figure of five years ago. That trajectory is set to continue, and some credible forecasts put their likely value at $15 trillion by 2015.

In short, despite the global financial crisis, national oil companies still control three-quarters of the world’s primary strategic resources, state-owned enterprises and privately owned national champions still enjoy substantial competitive advantages over their private-sector rivals, and SWFs are still flush with cash. These companies and institutions are truly too big to fail.

Deeper state intervention in an economy means that bureaucratic waste, inefficiency, and corruption are more likely to hold back growth. These burdens are heavier in an autocratic state, where political officials are freer to make commercial decisions without scrutiny from a free press or politically independent regulatory agencies, courts, or legislators. Nonetheless, the ongoing global recession has undermined international confidence in the free-market model. Whatever the true cause of the crisis, the governments of China, Russia, and other states have compelling reasons to blame American-style capitalism for the slowdown. Doing so allows them to avoid responsibility for rising unemployment and falling productivity in their own countries and to defend their commitment to state capitalism, which began long before the onset of the current crisis.

In response, U.S. policymakers must try to sell the value of free markets, even though this is a difficult moment to do so. If Washington turns protectionist and keeps a heavy hand on economic activity for too long, governments and citizens around the world will respond in kind. The stakes are high, because the large-scale injection of populist politics into international commerce and investment will obstruct efforts to revitalize global commerce and reduce future growth. Protectionism begets protectionism, and subsidies beget subsidies. The Doha Round of world trade talks in 2008 failed in part because of the United States’ and the European Union’s insistence on continued high agricultural tariffs and China’s and
India’s desire to protect both their own farmers and some of their still-nascent industries, which cannot yet compete on their own. The Doha stalemate has already cost hundreds of billions of dollars in potentially increased global trade.

Other protectionist initiatives have begun to weigh on global commerce. China has reinstated tax relief for certain exporters. Russia has limited foreign investment in 42 “strategic sectors” and imposed new duties on imported cars, pork, and poultry. Indonesia has imposed import tariffs and licensing restrictions on over 500 types of foreign products. India has added a 20 percent levy on soybean oil imports. Argentina and Brazil are publicly considering new tariffs on imported textiles and wine. South Korea refuses to drop its trade barriers against U.S. auto imports. France has announced the creation of a state fund to protect domestic companies from foreign takeover.

There is already a push by several countries in different regions to raise tariffs to the maximum levels permitted under the Uruguay Round of the General Agreement on Tariffs and Trade. Comprehensive global agreements and dispute mechanisms are being superseded by a patchwork of about 200 bilateral or regional agreements. (Another 200 or so are in the works.) This fragmentation inhibits global competitiveness, disadvantages consumers, and weakens the multilateral system -- all at a time when the global economy needs a new stimulus.

THE ROAD AHEAD

A growing number of Americans have come to believe that globalization moves their jobs to other countries, depresses their wages, and exposes U.S. consumers to shoddy foreign products. By 2012, there is likely to be at least one major U.S. presidential candidate who stands on a neo-isolationist, "Buy American" platform. If U.S. lawmakers are to avoid this protectionist trap, they would do well to relearn the lessons of the 1930 Smoot-Hawley Tariff Act, which raised tariffs on 20,000 imported goods to record levels, prompted retaliation in kind, and thus deepened and lengthened the Great Depression.

The global financial crisis has created an illusion of international unity based on the mistaken fear that everyone is sinking in the same boat. A year ago, the talk in policy circles was of “decoupling,” the process by which emerging economies develop a domestic base for growth broad enough to free them from dependence on consumer demand in the United States and Europe. Predictions of decoupling have proved premature. Economic problems originating largely in the United States have forced a hard landing in dozens of developing countries by crushing demand for their exports.

But beneath the surface, decoupling is still apparent in the growing domestic markets of Brazil, China, India, and Russia; in the investments these countries’ governments are making abroad; in the regionalization of capital flows; and in the longer-term possibility that the Gulf Cooperation Council, members of the Association of Southeast Asian Nations, and some South American governments will launch viable regional currencies and become more self-sufficient.

The United States can no longer count on strategic partners to buy its debt, as it did on Japan and West Germany in the 1980s. It must now rely on strategic rivals, particularly China, which does not believe that the United States can indefinitely retain its role as the global economic anchor. Hoarding dollar reserves has helped Beijing keep the value of the Chinese currency low, boosting China’s exports and generating record trade surpluses. But China’s priority now lies in building its domestic market to create a new model of economic growth that depends less on exports to the United States and Europe and more on demand from Chinese consumers. When and if China succeeds, “decoupling” will become a more meaningful term, and China will have less incentive to buy U.S. debt. If fewer countries want U.S. Treasury bills, the interest rate will have to be raised to make them attractive to buyers, and this will mean longer-term U.S. indebtedness. The United States' economic recovery, once it begins, will thus be slower, and the erosion of the dollar’s position as the world’s reserve currency will accelerate.
The U.S. government might conclude that its power to set and enforce global economic rules is on the wane. It cannot, in any case, have much faith in playing a leadership role in the G-20 (the group of major economies). This forum includes emerging powerhouses, such as China and India, which have been excluded from the G-7 (the group of highly industrialized states), and the natural divergence between their economic interests and those of the developed states will make it difficult to build any consensus on the toughest economic challenges. The problem is amplified by the tendency of politicians, in both the developed and the developing worlds, to design stimulus packages with their constituencies, not the need to correct macroeconomic imbalances, in mind.

In the long term, state capitalism’s future will likely prove limited, particularly if it cannot provide even its two leading practitioners with a working model for sustainable economic growth. Managing China’s looming social and environmental challenges will ultimately prove beyond the capacity of bureaucrats; they will eventually realize that the free market is more likely to help them feed and house the country’s 1.4 billion people and create the 10-12 million new jobs needed each year. In Russia, faced with a declining population and an economy too dependent on the export of oil and gas, policymakers may conclude that future economic prosperity requires renewed free-market reforms. The United States should reassert its commitment to expanding trade both with the European Union (the world’s largest and most cohesive free-market bloc) and with growing economic powers, including Brazil, India, South Africa, Turkey, members of the Gulf Cooperation Council, and emerging-market countries in Southeast Asia, not least to ensure that these countries do not creep toward state capitalism, thereby adding to the inefficiencies in the global market and limiting U.S. commercial opportunities.

At the same time, U.S. policymakers should push for new commercial opportunities in state capitalist countries, while also helping U.S. companies active in China, Russia, the Persian Gulf, and elsewhere develop hedging strategies against the risk that market access may be lost to more favored domestic companies. As a model of effective hedging, U.S. multinationals should look to Japan’s "China plus one" diversification strategy of investing in other countries in addition to China. Instead of betting too heavily that Chinese markets alone will provide the bulk of their future earnings, U.S. companies should broaden their investment targets to include a range of emerging-market countries across Asia and beyond.

Now is the time for the United States to welcome new infusions of foreign investment, including from SWFs. Some proposed investments already require careful review to ensure that they do not compromise U.S. national security. As long as such a review is genuine, rather than a political effort to discourage foreign investment, it need not dissuade investment proposals. The need to protect their investments will give foreign governments and companies a greater stake in the stability of the U.S. financial system. Mutually assured financial destruction will ensure that state capitalist countries understand that it is also in their interest for the United States to remain economically successful.

Whether free-market capitalism will remain a viable long-term alternative will depend in large measure on what U.S. policymakers do next. Success will depend not just on making good economic policy calls but also on continuing to make the overall U.S. brand compelling. Washington must preserve the United States’ huge comparative advantages in hard power -- an area in which the United States still outspends China ten to one and outspends all the other states of the world put together -- and soft power, which the Obama administration has, so far, improved by enhancing the United States' image worldwide.

State capitalism will not disappear anytime soon. Throwing up walls meant to deny access to U.S. markets will not change that. Instead, profiting from commercial relations with state capitalist countries is in the United States’ near-term economic interests. For the sake of the United States’ and the world economy’s long-term prospects, defending the free market remains an indispensable policy. And there is no substitute for leading by example in promoting free trade, foreign investment, transparency, and open markets, in order to ensure that the free market remains the most powerful and durable alternative to state capitalism.