

The Marginalization of the State

1. Noteworthy Non-Consequences

The end of 1995 nears. In the past few weeks, three events of highly disparate range but remarkably similar implication have occupied the interest of this Investment Commentary's author: the struggle to reach a budget agreement in the USA, the renewed turbulence in the English monarchy, and the recent election of the President of the Swiss Confederation. I anticipate the reader's concern that in analysing the two latter topics, the House appears to have turned its attention to issues of lesser importance. But let me offer a counter-argument at the outset: The critical events of an era are seldom to be gleaned from statistics and mountains of numbers. Rather, they tend to be foretold in particular, seemingly unimportant, events.

The interesting thing about the conflict between U.S. President Clinton and the Congress is not necessarily the nature of the compromise to which both sides will ultimately agree. Nor is it, under the circumstances, particularly noteworthy that the proposals being put forward by the President and Congress are actually quite similar. In contrast to Europe, the parties in the United States generally agree on the need for a fiscal contraction. What demands our attention in the current budget battle are the consequences of the fact that three months ago, when the established debt-ceiling was reached, the U.S. Congress effectively blocked further funding for government administration. Phenomenally, this has had no noteworthy consequences!

Years ago, it would have been unthinkable for the U.S. to simply shut down a portion of its administration, for it to have to do a juggling act in order to pay its debts, and for a superpower to face temporary insolvency! The financial markets - among others - at least would have reacted with panic. In fact, such events might have initiated one of the much feared system crises. But nothing of that sort is happening today. The whole affair has provoked little more than a tired muscle twitch in the markets. The financial markets appear to be concerned with more important things, as the Dow Jones Index reaches record heights and the U.S. dollar actually stabilizes.

What we must concern ourselves with is the relative insignificance of the nominally very important budget process. Specifically, how can such a budget impasse come about and continue for a significant amount of time without provoking grave consequences? For now, let us provisionally conclude that state actions, or inactions, have evidently experienced a decline in significance.

That monarchies experience scandals was not first discovered in conjunction with Princess Diana. Stories from the Court at Versailles are evidence that the general public has long been fascinated by such royal troubles. What is fundamentally new in the current situation is the manner in which the English sovereign is making itself laughable. Of greater importance to us, however, are again not the scandalous stories themselves, but rather their failure to be reported in the international section of serious newspapers. If these events are printed at all it is under "other news". Let us hold onto this fact: What once had at least national representative authority, has now degenerated into an embarrassing object of gossip columns.

Finally, one certainly does not want to begrudge Minister of Economic Affairs, Pascal Delamuraz', second election to the post President of the Swiss Confederation. (For our international readership: The President of the Swiss Confederation is chosen each year from the members of the Government and elected by parliament.) But the fact that the Federal President has to undergo a heart operation that puts him out of commission for at least eight weeks, warrants consideration. Can Switzerland afford such a vacancy? Hard to say - but in any case, a corporate leadership, facing a competitive market, would have had to choose differently. It appears, and let us provisionally conclude, that today the leader of a nation state plays a role that is of lesser significance than that played by the director of a corporation.

2. The Phenomenology of a Demise

Three casualties - one state budget, one monarchy, and one national leader - and nothing happens. The world continues to turn without a problem. This is reason enough to consider whether the evident reduction in the importance of the state is temporary, or whether it instead signals the beginning of a longterm trend. It is apparent that grappling with this question does not only delight the commentator interested in political systems, but is of significant interest to the investor as well. One simply has to consider the enormous number of government bonds that are held in the portfolios of our private clients and especially in pension funds. If it is the case that the state has experienced a general decline in significance,

and that the change is lasting, then we may also anticipate a similar downgrading in the sphere of national debt.

Superficially, the situation may appear contradictory. We observe with consternation the emergence of new nation states, specifically in the East, and worry about their insatiable desire to expand. This reborn (or recovering?) nationalism could not stand in more stark contrast to the decline in significance of state authority in the industrialized region of the world:

a) Few if any industrialized nations can still consider themselves defense alliances - one of the earliest and most important motivators for state formation. Modern security problems are complex, supra-regional, and often not even locationally identifiable (terrorism!). As a result, political security efforts have to be similarly interconnected and integrated. This is as true for Switzerland as for any industrialized nation.

b) Interestingly, the state is also markedly reducing its role in preserving domestic security. If life and limb do not happen to be at stake, then the average citizen basically has to do without protection from the state. Property crimes go unpunished. It is not for nothing that private security organizations are sprouting up like mushrooms. In the United States, there are now residential developments that are surrounded by protective gates, reminiscent of the walls which enclosed cities in the Middle Ages.

c) The states have also lost their role as points of convergence for communication. Modern technologies, from the Fax, to computer networks, to satellite television have made territorial boundaries obsolete. There are more communications exchanged between Zurich and New York than between regions within Switzerland. The state media organizations (and monopolies) are relics of the past. When they will finally disappear from the scene altogether, is only a matter of time and the amount of political allegiance there is to this old form.

d) States have lost their importance as units of economic activity. There are hardly any Swiss firms above medium size that are not also anchored in a foreign country. That anchor might involve production, marketing, or the processing of specialized tasks. This globalization of the economy is evident even in the larger countries: Germany, France, and yes, in the United States as well.

e) The state is also losing its significance as a law making entity. In part, this is the result of the unquestionable increase in the significance of supra-national norms. More importantly, it reflects the de facto law making (habits of exchange, "rules of the game", Gentlemen's Agreements, etc.) of non-state organizations operating trans-nationally. But in the end, it is the actual demise of the law - by which we mean the use of law to regulate every life-activity, and the degradation of the law into cookbook directions for social co-existence -

which has had the most to do with the reduction of the nation state's significance as a law making entity.

f) Even as a psycho-social object, the state has lost its dignity and status as source of ultimate authority. Nothing remains that cannot be questioned or even pulled through the dirt. The difficulty that public agencies have in finding citizens to fill positions has nothing to do with the pay-scale or the lack of available workers. These difficulties are a direct result of the decline in social prestige associated with such jobs. Who still dares to be proud of his position as parliamentarian, judge, officer, or policeman?

g) What remains are nations that serve as the receivers of all sorts of demands. State remains relevant in requests made of subsidies, calls for social spending, and in welfare provision. We recently carried out an evaluation of the requests made of Swiss parliamentarians, with respect to these subjects. While the findings were not surprising, they were nonetheless threatening: Even using a conservative calculation, at least 80 % of all requests can be included in the category "demands".

Reduced to playing only the role of demand-receptor, the state will not, in the long-term, be able to retain its legitimacy!

3. Political and Economic Structural Transformation

Let us search for the sources of what has clearly been a fundamental change. From a political perspective, a critical factor was the demise of the Soviet empire and the consequent end to the bi-polar system of world power. How many institutional arrangements for decades justified their existence by the very real threat from the East? In Switzerland, for example, during the course of the Second World War, a number of mixed-economic (i.e. half state, unionized, or even entirely state run) institutions were created. They made a good deal of sense as a form of economic national defense for a completely surrounded country. In the face of the Cold War, these institutions subsisted much longer than would have been warranted from an economic perspective. There is hardly a "strategic" import or export product with which the state is not partially or completely involved.

The histories of the Swiss "Cheese Union", of the white wine import sector, or the watch cartel speak volumes. Today, we are witnessing the dissolution of these old structures, as their external justification has definitely disappeared. That the dissolution process has brought to light some banana republic like disarray is not surprising. Nor is it surprising that for some it is painful to say goodbye to fifty years of state protected benefits.

The end of the bi-polar system of world power has yielded a change in the function, and a reduction in the

significance, of the political arena. These changes will endure for some time. What is true of the Cheese Union is analogously true for the state as a whole. Part of the enormous growth in semi-state or state sponsored activities, since WWII, is attributable to the fact that the threat from outside provided a justification for all efforts aimed at creating greater social and political cohesiveness. Presumably, in today's climate, it would no longer be as easy to create, for example, the kind of social insurance found in Switzerland and other Western nations. The pressure to reach consensus has decreased. It is indicative that precisely these social welfare institutions are the ones that are now under massive pressure to justify themselves.

This political structural transformation is accompanying the economic changes that have been described in detail in previous commentaries. The modern technological opportunities in the computer and communications sectors have inspired an internationalization of the world economy that far exceeds all previous expectations. The transfer of development, production, and marketing capacities around the globe no longer indicates a crisis driven response to unusual circumstances. Instead, this global capacity distribution reflects the use of a now well established instrument for achieving entrepreneurial success.

The release from territorial ties has consequences. Essentially, firms are now much less dependant on state authorities. Increasingly, lobbying is being traded in favor of migration: When the business climate is no longer suitable in one place, firms simply relocate to another. The ability of firms to easily relocate produces, whether one wants it or not, a competition among nations to offer the best business climate. This, in turn, further limits the options of political authorities.

4. European Anachronisms

From this perspective, it is difficult to understand certain aspects of European integration policy. To the extent that the policy focuses on opening borders to promote trade in goods and services, it is very much consistent with the global restructurations described here. But the European Union wants more. Despite the fact that the "principle of subsidiarity" is firmly anchored in the Maastricht treaty, officials in Brussels are hard at work trying to create a super-state. This super-state is supposed to regulate everything from the proper bend in the "Euro-Pickel", to various forms of cooperative research. But above all, its role is to coordinate a giant redistribution exercise. This exercise is called "monetary union", as the politicians understand the concept.

Since our Commentary No. 168, in which we explored several scenarios for the implementation of the European monetary

union, a number of things have happened as we anticipated they would.

The divergence between the economic and political understandings has intensified. Essentially, the choice is between a "political" monetary union, based on (very) weak convergence criteria, and which includes numerous EU states, or an "economic" monetary union which has almost no members. Since the strikes in France - which, by the way, are a perfect example of how difficult transformation can be in the face of an over-developed state apparatus - the situation has become even more problematic; France is less and less able to maintain its place in the "stable core" of member countries.

The efforts to create a European super-state are, both from economic and political perspective, anachronistic. The factual integration of the world economy is far outpacing all efforts at creating political integration through coercion and collectivist notions of community potential.

5. Government Bonds vs. Coca Cola

It is, in our opinion, high time to consider what the decline in significance in state institutions will mean for financial markets. One thing seems clear from the outset: the reduction in state institutional significance will impact the soundness of state debt. The less the state is able to justify itself through objective accomplishments, the more difficulty it will face in attempting to extract taxes from citizens. In other words, it is doubtful that the financial situation of the public sector will improve significantly, even if, starting today, rigorous savings programs are initiated. And since the pressure of the structural transformation will likely minimize economic growth for some time, this avenue does not appear likely to relieve states of their budgetary problems either. In other words, a fiscal contraction is imminent and governments, regardless of political orientation, will be unable to avoid it.

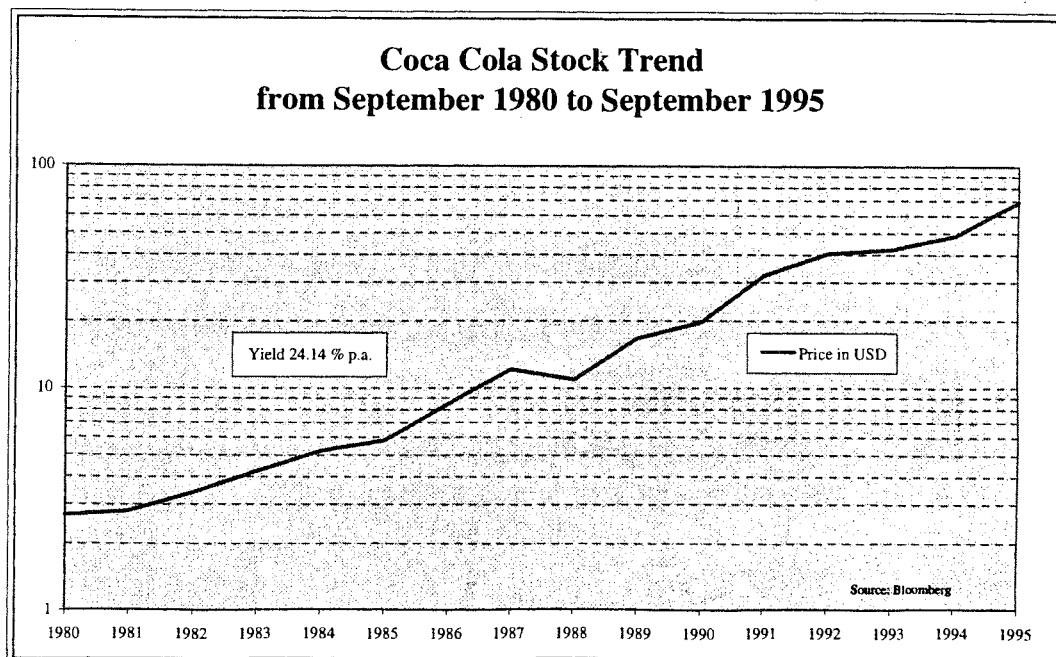
We do not believe in crash scenarios. Instead, we are convinced that the financial markets, thanks to the rational basis of their expectations, will anticipate a great deal and accurately assess the comparative advantages of the state as debtor. This could be a slow process, and might not affect just debt in the narrow sense. Currency and/or interest rates might be affected as well. Thus, one is well advised to consider where in the world the institutional crisis will weight most heavily. Our fear, which cannot easily be dispelled, is that it is more likely to be in Europe than in America.

It looks to us as though for quite some time investors have been veering away from the debt side and toward making their resources available to the market. The long and uninterrupted climb of American stock-exchange indicators

cannot be explained as being a reflection of a lack of alternative investment opportunities; U.S. interest rates, by comparison to those available in the Swiss Francs realm, remain at a respectably high level. Instead, the explanation appears to lie in the fact that in America the general population, either directly or through funds, has begun investing in stocks. In conjunction with the marginalization of the state, there has been a depoliticization of work. The power of unions has decreased significantly. The worker of today counterbalances the collectivist push for wage increases by participating in the prosperity of the enterprise.

Of course, actually passing-on enterprise profit is a prerequisite for bringing about the triumphal procession of popular capitalism. There is a reason that in Switzerland today everyone is talking about "shareholder value". For too long the shareholder was treated *quantité négligeable*. Even today, when a shareholders group questions the achieved level of corporate revenues, there are many who are unable to see it as anything other than part of a backhanded take-over bid by a corporate raider.

Under the assumption that efficient financial markets will pass on a sufficient portion of corporate profit to stockholders, one must seriously consider whether, in the long run, it isn't preferable to put one's money into healthy firms rather than into more or less exhausted fiscal entities. The following graphic shows a longer-term investment in one of the American blue chip stocks, Coca Cola. Through all the ups and downs on the stock market and in interest rates over the last fifteen years, an investment in Coca Cola shares yielded an average return of 24 %. Furthermore, Coca Cola showed a relatively narrow range of variation in terms of yearly returns - the amount of volatility averaged just 16 %.



6. The Outlook, A Ray of Hope? Reservations

The consequences of the marginalization of the state cannot be overestimated. An entire epoch of uninterrupted growth in the state's share of the economy appears to be coming to an end. This is fundamentally good news for those who, over time, have invested in the value creation process. However, we must consider the question of just how stable a system can be in which states play a less significant role. How will a new equilibrium between economy, society and state institutions take shape? These are weighty questions, with few answers. We must consider them carefully in the years to come.

Our analysis of the tendency toward a diminution in the significance of the state would not be complete without some discussion of possible alternative scenarios and their implications for financial markets. It is, of course, not at all clear that the collectivist establishment forces, especially in Europe, will not, for whatever reason, ultimately triumph. Worldwide protectionism is a possibility that cannot be excluded, even though modern communications technology and resource mobility make it unlikely.

The collectivist nomenklatura, with their many "thought-prohibitions", are not likely to surrender terrain without a fight. The reaction to the recent publication, by a group of Swiss entrepreneurs, of a "White book" on deregulation and privatization was indicative of this. Critics launched a vicious media attack against the authors, whom they called "social-saboteurs". It remains an open question whether collectivist-thinking Europe will ultimately be capable of adapting to the realities of the new situation.

A more far-reaching scenario is currently being modelled for us in France. It is not as if the demise of the state can't be tied to serious social and political problems, on the contrary! France is a perfect example of how painful structural adjustment can be for a bureaucratically bloated state. Chaos and civil war-like conditions can't be excluded from the realm of possibility, especially when inhuman conditions prevail like those in the largely immigrant suburbs in France. If we are not successful early on in allowing multiple population segments to reap the benefits of structural adjustment, then social tensions are inevitable.

Finally, it can't be disguised, that the demise of state significance has created a world-wide power vacuum. The United States remains, but with ever increasing reluctance, the nation which holds the global military initiative. The world-wide and regional power questions will require an enormous amount of thought.

There are great advantages to living in an epoch whose fundamental changes are occurring. First of all, life is somewhat more interesting. Secondly, if one regularly subjects the situation to a disciplined and unbiased assessment, one can avoid being swallowed up by the structural changes. As it appears today, competition and economy will push aside the received, collectivistic, "gimme" mind-set. And when the market wins and the state loses, the investor cannot, in principle, go wrong.
