The world quartered? A view of the global situation

1. No point in assessing the situation?

Between 1932 and 1936 stock market prices rose by about 250 percent, on a globally diversified index basis. And this despite a deep and widespread economic depression, despite the unfortunate monetary policy of the USA, despite the growing despair of large sectors of the population, despite the prevalence of extreme political ideas on both sides of the Atlantic, despite the foreseeable drift towards a major war. No-one who had made a roughly accurate forecast of the social, economic and international developments would have come anywhere near a plus of 250 percent as an estimate of the level of the stock markets in 1936. So, it would be entirely understandable if, faced with such a crass disparity between real developments and the behaviour of the financial markets, one were simply to wring one's hands in resignation, and conclude that all such reflection was anyway pointless. One might as well save oneself the bother of assessing the situation, give up publishing investment commentaries, and at least benefit the forests by saving all that paper.

However, such resignation might not be an adequate response, for two reasons. Firstly, the 250 percent rise must be regarded in the light of the drop in prices due to the events of 1929. Share prices fell globally by about two-thirds, as a result of the exodus of speculative money and the disappointed withdrawal of investors with no appetite for risk after the bubble of excessive price rises on Wall Street had burst. The recovery could be interpreted as a sort of normalisation of capital allocation within the financial markets after the overheating and the collapse of 1929. Dramatic occurrences on the stock markets are accompanied by equally dramatic changes in investors' portfolios. There then follows a return to a "reasonable" asset allocation that reflects long-term circumstances and experience. Thus, today too, it may well be expected that, after the 50 percent fall in prices since Spring 2000, investors such as the major Swiss life insurers will be obliged to increase the extremely low proportion of shares in their portfolios, as they will otherwise never be able to achieve their investment targets. They will have to do this even though their gut feelings about future developments in the world and the global economy may not be much better than those of their colleagues in 1933, 1934 and 1935.

The second reason seems to us to be even more important. Even if the outlook for the world and the global economy were as miserable as in the 1930s, the question would still arise of whether a concentration on so-called risk-free investments like large accounts with banks, time deposits, government bonds and suchlike would invariably represent the correct asset allocation. For what ultimately matters is ensuring the preservation of assets, given conceivable developments. What sorts of institution best survive periods of conflict – governments, countries, currencies or companies in all their variety and geographical diversification? In the light of such considerations, was it really so absurd for investors in the thirties to turn increasingly to shares, in the expectation of the worst of all possible developments? Is it indeed conceivable that it was precisely because of the predictable future perils that funds were reallocated to equity? If this were the case, then an assessment of the situation, far from being superfluous, would appear to be essential for survival.

2. Preservation, value creation and the dangers to them

What ultimately matters is ensuring the preservation of assets, given conceivable developments. But what does preservation mean in specific terms? What is its economic significance? What factors of influence must be taken into account?

It may sound trivial, but for an asset to be preservation, it must be possible to possess, use or dispose of it with the necessary certainty. Goods or assets that can be confiscated, by whomever and on whatever grounds, do not meet this criterion. Goods and assets may be confiscated physically, through theft, robbery, seizure, successful lawsuits, blackmail and the like. There are also more subtle forms of confiscation, such as a tax on assets (i.e. an attack by the state on possessions) or a tax on income (i.e. an attack by the state on utilisation) or a tax on profits (such as capital gains tax, or property gains tax, i.e. an attack by the state on the right of free disposal). Yet more subtle is deprivation of preservation through a reduction of the purchasing power of money. Such an attack is aimed at financial investments, and is elegant to the extent that it affects a large and undefined number of citizens, so that the damage is socialised in an ideal fashion, and the incentive for political countermeasures remains small. For this reason, inflation has, historically speaking always been a favourite means of concealed confiscation – that is, redistribution to the benefit of debtors, and the disadvantage of creditors. And the greatest debtor has always been the state.

In other words, preservation has a great deal to do with the question of how far property rights are guaranteed. The theory here covers *usus* (possession and use), *usus fructus* (utilisation, acquisition of income) and *abusus* (free disposability); these must all be fully guaranteed for it to be possible to speak of "property". Naturally, every social order and every historical development has been accompanied by greater or lesser infringements of such property rights, and such infringements have always been more or less legitimated, and more or less legal. When making a global assessment of recoverability the differences in the probability that property rights will be guaranteed under various conceivable scenarios becomes a matter of considerable interest.

When someone is able to possess, use and dispose of something, this becomes a source of enjoyment. If all or part is taken away from him, this is less enjoyable. This may also appear trivial, but it describes the connection between property rights and the incentive to commercial activity. Limitations on property rights, or even the mere expectation that property rights might subsequently be (still further) limited, provide a negative incentive to commercial activity. Social orders and historical circumstances are distinguished, among other things, by differences in the incentives they offer to commercial activity.

And here we have the link to value creation. Preservation is connected with value creation to the extent that the value of an economic good or asset can only be expressed in terms of the value of another economic good, and is thus dependent on the economic performance of the local environment. This applies just as much to physical goods as to money. A currency is only worth the productive power that stands behind it. And productive power – value creation – is only found where there is sufficient incentive to productive activity. Which brings us back to property rights.

Accordingly, we shall now attempt an assessment of the global situation in terms of the differences in the expected property situation and future value creation. The aim will be to provide elements with which to review capital allocation in terms of the available financial instruments and the areas of the world where investments might be considered.

3. From a bipolar world to an American empire?

Fifteen or twenty years ago, it would have been easier to divide the world into zones of differing economic development – on one side the USA with, more or less closely associated, the OECD states; on the other, the Soviet Union with its satellites. And in the middle, a group of countries that described themselves as non-aligned, inclined politically towards Russia, and linked economically with the West. As ever, it is all too easy to take a romantic view of the past. But this bipolar global system was indeed distinguished by a very high degree of stability. The mutual potential for nuclear destruction resulted in a stalemate in regard to major strategic actions, and also considerably restricted the freedom of action for "minor cases". Nevertheless, two things should not be overlooked in retrospect. Firstly, the bipolar global system was not free from dangerous disturbances, such as the Cuba Crisis or the Vietnam War. Secondly, the relative stability came at a high price. A significant part of the world's population was condemned to an existence of dull despair and subjection. Periodical eruptions, such as those in Hungary in 1956 and Czechoslovakia in 1968, were liable to endanger the authoritarian system as a whole, and had therefore to be brutally suppressed, with the amicable assent of the West.

After the breakdown of the bipolar division of the world it now appears, to judge by media comment, as if a new system has established itself – a globalised world ruled by the USA. Superficially, this is clearly the case: McDonalds and Hiltons all around the globe, Coke bottles in waste bins all over the world, American soldiers in Afghanistan, Serbia, Columbia, and soon in Baghdad. The economic power of American companies seems to be linked to foreign policy and military might. And of course, there is always the suspicion that there is a CIA agent behind every Internet connection and every mobile call. The result is a monopolar world, with governments, international organisations, global companies, secret agents operating under cover, and all with one common aim – to act to the greater benefit of the USA. The anti-Americanism that can be detected in many European comments derives from just such a view of the world, or from the fear that it might be so.

Now, it can certainly not be denied that goods and services of American origin are present and highly visible all over the world. It is also true that the USA possess the only effective, globally deployable military power, and it may also be true that fairly comprehensive information can be collected via agent networks and satellites. However, the monopolar view of the world also assumes that all this can somehow be managed – that it is in fact possible to control the world according to one's wishes and expectations.

Nothing could be more absurd than this notion. However American they may be, American companies primarily pursue their own interests. Coordination with Washington is not on the agenda, or if it is, only in third or fourth place. The ability to manage two simultaneous theatres of war is one of the great strategic objectives of the USA. With all respect to the American military presence, America clearly has problems coping with a second area of conflict – in the Gulf – in addition to Afghanistan. And there is certainly no capacity left for North Korea. An omnipresent American secret service? A vast amount of information is no doubt being gathered, but is it being properly evaluated? Is the sheer volume indeed manageable? The fight against international terrorism has shown how illusory the concept of "total control" really is.

In our view, a geographic view of the world divided into quarters provides a better basis for a systematic approach to assessing the situation. The first, and unquestionably most important world power is of course the USA. But it would be wrong to throw the NATO allies in Europe in together with the USA. Europe, as the second block, is different now, and is likely to become ever more different in the future: we will come back to this. A third "block" is increasingly taking shape in the form of China and India, two countries that are very different, but in a similar position with regard to some of their interests and their level of development. And then there remains the fourth quarter – the residue, so to speak – inclining to differing degrees to one or another of the other blocks, and mostly inefficient, poor, corrupt and violent. This fourth block could be defined as the "Belt of Crooks", were one not to feel that this came rather too close to President Bush's favourite description of "outlaw states" This fourth block is not an "axis of evil", but is made up of the many many people in the world who, despite democratic constitutions, are governed by crooks.

Like any model, this division of the world into four quarters has its disadvantages. There are elements that cannot easily be allocated. Will Russia become more European over time? Or will it relapse, and become part of the fourth block? Where does Japan belong? Will a China–India–Japan triad develop? What of Australia?

4. Economic vitality, political action...

Over the past two and a half years there has been much talk of a dramatic economic decline in the USA. Indeed, in the aftermath of 11 September 2001, there was talk of a sustained recession. Objectively considered, it is now clear that the real surprise with regard to the USA is not disappointing figures, but rather the almost inexplicably consistent appetite for consumption and construction among Americans. An economic growth rate of three percent cannot with the worst will in the world be described as an economic disaster.

It is true that the crisis is far from over in some particular sectors, and generally in the area of investment. And it is also true that company profits in particular are experiencing a deep recession. The reasons for this were explored at length in previous investment commentaries. After the investment hype of the late 1990s, companies now need to save money, and put their balance sheets in order. It is quite clear to us that shareholders will have to suffer under this market-dictated cost-cutting until such time as there is sufficient evidence of the health of the balance sheets in question. And probably not only of the state of the balance sheets, but also of the situation within the companies themselves – management bonuses, for example, or the effectiveness of internal controlling and auditing.

The greatest economic strength of the USA lies in the flexibility of its structures. This surely is ultimately the reason why the investment crisis – and after all, several thousand high-tech companies have gone bust – and the drastic drop in stock market prices have not spilled over into the rest of the economy. American employees are highly mobile, American families often rely on two wage-earners, and Americans are attuned to the idea that they may lose their jobs. This flexibility in the labour market is combined with, in global terms, a highly permeable business sector: companies come and go continually, so that obsolete jobs disappear more quickly than elsewhere, but more importantly, there is a continual supply of new jobs. Work is seen not as something to hang on to, but as something that has always to be re-invented. We shall return to this when looking at Europe.

A second strength of the USA is the high level of liquidity on the capital markets. Nowhere else in the world is risk capital so easily available, or on such a scale, and nowhere else in the world are the right instruments available to hedge against any conceivable risk. This major advantage of the USA is currently totally underestimated, at a time when the investment crisis, which of course affects exactly this sector, has caused the markets to dry up temporarily. But a new upswing, and particularly a new technology boom, would quickly lend the appropriate weight to this advantage. Apart from the restrictions due to the Patriot Act in the wake of 11 September 2001, the American capital market is open unrestrictedly to the international public. This is something that should be borne in mind by all those who can already envisage parity between the greenback and the Swiss franc.

This economic vitality is accompanied by what appears from a European perspective to be an amazing capacity to take political action. This affects both foreign policy and also, most surprisingly, domestic policy. The taxation package presented by President Bush is bold, and is heading in exactly the right direction, economically speaking. The USA is (together with Switzerland, by the way!) one of the four last OECD countries with complete double taxation of company profits. The abolition of tax on dividends can be expected to achieve three things: firstly, it will put more money into consumers' wallets, particularly for those pensioners who live partly off dividends. This should further stimulate consumer demand. Secondly, it will provide an incentive to buy and hold shares. This will make more capital available to business. Thirdly, it will remove from company managements a powerful argument for retaining profits within the company. The money released through the payment of dividends is likely to be reallocated by investors more efficiently than it would be used by management within the company. America will thus do away with an important structural reason for abuses in corporate governance.

5. ... but: imperial obligations, worm-ridden legal system

The picture would, however, look too positive if no mention were to be made of the USA's major deficits. In our view there are two elements that, at least in the longer term, raise serious questions about the success of the American way. Nolens rather than volens perhaps, but the USA has slipped into the role of the only global policeman. For decades, the political elite failed to do away with the USA's highly vulnerable Achilles heel – the supply of oil. The success of any American government, of whatever political colour, appears to depend on whether it manages to keep energy prices down. It is obviously not possible to finance election campaigns without the involvement of the oil industry. The result is that the USA is obliged, at very great cost, to ensure its oil supply routes by means of a massive array of military bases and naval fleets. The strategy applied is an imperial one: massive strikes wherever they seem most necessary, or most opportune, with little regard for (third-party) losses, and few scruples about international law (mainly a matter of getting the UN to sanction the American standpoint).

The question that arises in the long term is whether the burden of resolving these situations in such an imperial fashion can be reconciled with a democratic form of government, an open pluralist society and free capital markets. The great unity among Americans after 11 September 2001 and the support that President Bush enjoys for his foreign policy – support that appears almost unnatural to Europeans – cannot last indefinitely (unless Osama Bin-Ladin, who is generally reckoned to be highly intelligent, is stupid enough to let loose a new series of unity-generating terrorist attacks…). The USA should basically be interested in the rise of new global powers, for a multipolar sharing of power could be more cost-efficient in the longer term than a monopoly of power. But more of this when we come to the fourth block, the "Belt of Crooks".

A second, and ever more threatening deficit of the USA lies in its legal system. Hardly a day now goes by without some class action being launched against a company or a whole group of companies. The announcement of class actions has now become a key topic on the stock exchange – and the legal system has become the greatest factor of uncertainty. What first strikes European observers is of course the horrendous size of the claims, which would be inconceivable in Europe. The difference in the conditions under which lawyers practise is often offered as the main reason for what appear to us to be absurdly high sums. In most states, American lawyers are allowed to charge success-based fees, and this naturally provides an incentive for high claims. However, the real reasons for the obvious abuse of the legal system as a means of blackmail lie deeper.

With its orientation to individual cases, American law is much less familiar than continental law with generally accepted principles that can provide guidance for judges in cases of doubt and prevent them from reaching absurd judgments. In our legal system, concepts such as "proportionality", "equitableness", "morality", "good faith" and suchlike play an important role – not so much explicitly, perhaps, but more implicitly and subcutaneously. Basic legal principle made up the content of the first chapter of the great codifications of civil law at the beginning of the twentieth century. American law was never codified, but developed from individual case to individual case, and when legislators did make law, this usually occurred in response to a particular problem (for example, the banking legislation in the wake of the stock market collapse in 1929, and now the corporate governance regulations as a reaction to the recent crisis on the financial market).

Thus, over time, the American legal system has become more and more of a threat to property rights as defined above. Large sums can be extracted by means of contract and liability suits and, if need be, class actions, most recently particularly with the help of powerful media. The targets of such action possess sufficiently attractive sums of money. And recently, foreign victims in particular have revealed themselves to be particularly suitable targets, as they are inexperienced, generally react naively, and also have no local lobby.

The result is a confiscatory system, characterised by great arbitrariness and many contingencies, and a legal profession that is far too large, too greedy and too powerful. It imposes a kind of special tax on the economy, which by contrast to state taxation is anything but predictable, and is thus, in Hayek's terms, particularly damaging. And there is a second consequence: interactions between Americans are increasingly characterised by mutual mistrust. A doctor concentrates, not on the right diagnosis, but on the question of how he can avoid potential liability claims by the patient. A garage will refuse to repair the brakes on a car for fear of possible legal action on the part of its owner. And because the fear is justified, even the simplest business transaction must be accompanied by a large pile of contractual stipulations that no normal person can understand, but that will provide a greedy legal profession with plenty of fodder if the case comes to court.

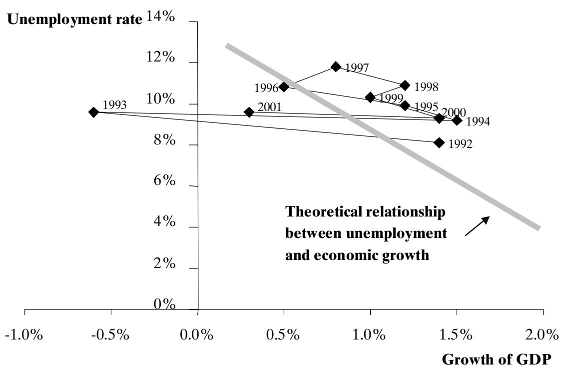
America is in danger of becoming a society, an economy, a capital market without mutual trust. In economic terms, such social structures generate high information and transaction costs. The depressing effect on future investments is plain enough.

6. Limping, aging, encrusted – but fairly civilised

Economic growth in Europe in 2003 will not be much above 1 to 1½ percent. This is not much; not enough to satisfy the hunger of the national exchequers, and not nearly enough for the financing of the longer-term welfare state obligations to appear credible. Europe, by which is meant particularly its core – Germany, France and Italy – is stuck in bottom gear. Not only the politicians, but also a good number of voters still suffer from the illusion that their high comfort level – short working hours, high social benefits, annual pay rises, high job security or, if anything goes wrong, enormously generous social plans – can be maintained in the long run. If one takes international competition into consideration, this is obviously completely impossible. Even when the last, expensive worker had been replaced by a machine, the future burden of the welfare state would still be too high for competitive production to be possible.

Germany, economically speaking the most important country in Europe, suffers particularly seriously from the home-made lack of adaptability of its structures. The figure below shows the change in the unemployment rate in relation to economic growth. What is particularly alarming is that even with high economic growth, the unemployment rate does not fall, and it also does not rise when economic conditions cause the demand for labour to fall. In other words, German companies do not disturb their workforces – they do not reduce numbers when business conditions would make this advisable, and nor do they employ more people when this would be justifiable.

Germany's inflexible labour market



Source: Bundesanstalt für Arbeit, own presentation

The workforce is a key economic factor, which must be part of entrepreneurial freedom of manoeuvre, the decencies being preserved, naturally, and in compliance with the social welfare system. Inflexibility affects not only hiring and firing, but also operational reorganisations, such as the introduction of a night shift, and suchlike measures.

In previous commentaries, we have often commented on the extremely unattractive tax incentive situation with regard to company start-ups. The high tariff-related hurdles are supplemented by a Kafkaesque regulatory situation. The frustrations involved in dealing with the German regulatory authorities have to be experienced to be believed – one immediately abandons forever the idea of doing business there. (Those who are interested may consult our report on dealings with the Bundesamt für Kreditwesen. Its size far exceeds the limits of an investment commentary.)

The result is a serious question mark over the possiblity that Germany, and consequently Europe, can ever return to healthy value creation. The reform of the social system and the fossilised factor markets, under the deteriorating demographic conditions, is an extremely challenging precondition for economic survival in a world that will demand one thing above all others: adaptability to continually changing conditions. The programmer in Bombay and the textile worker in Shanghai will have no regard for Herr Schulze who doesn't want to work a night shift.

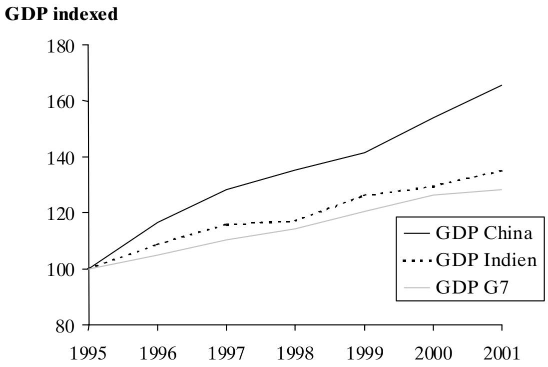
Europe could have one important advantage over the rest of the world; over America with its increasingly dangerous legal system, over China and India, with their shortfalls in the area of the rule of law, and very clearly against the "Belt of Crooks", where the rule of law is anyway an unknown quantity. Europe still possesses a functioning civil society, in which decency, respect and mutual trust represent the normal basis for social interaction. These qualities can be maintained as the members of that society become older – perhaps then in particular. The rule of law and civil society are interdependent. Their immense economic advantage lies in the much lower information and transformation costs. Where deals can be sealed with a handshake, trade can flourish.

7. Vital, pragmatic, dangerous

The prophecy that an independent economic power deserving of respect is arising in the Pacific and on the Indian subcontinent is becoming increasingly convincing. It is of course problematic to name China and India in the same breath, or indeed to represent them as a coherent economic block. Their historical and cultural backgrounds are far too different, and their geostrategic positions necessitate different approaches. India borders on a fairly uncomfortable neighbour to the north and west, so that military issues will invariably play a significant role. China's great inland rival has disappeared without trace; all that remains is the Taiwan question and relatively diffuse conditions in the Pacific. For China, then, the maintenance of internal cohesion will always be the more important issue, so that we may expect an orientation to strong police and secret service power.

China has a Confucian background, tending to hard work and economic success, while Hinduism in India, with its fatalism and acceptance of social divisions, tends rather to hinder economic growth. But nevertheless: what both countries have in common is the almost breathtaking vitality with which they are asserting their place in the global economy, and the pragmatism they display in dealing with their historical legacy. The political elegance with which the the Party boss, Deng, initiated the reform of the hopelessly inefficient structures of the state enterprises, and the way this process has been sustained into the present demonstrate what seems to us, with our principle-based intellectual categories, the almost shocking duplicity of a non-ideological ideology. India is noteworthy for the unproblematic coexistence of utterly archaic structures with the most modern, exceedingly efficient enterprises. In front of the software company in Bombay, the sacred cow lies across the customers' parking spaces, chewing the cud. That is India.

High growth – *de profundis*



Source: Bloomberg, World Bank, OECD

Starting from a low level, and naturally with the reservation that the figures are hardly likely to be accurate, the economies of both China and India have, over the past years, accelerated away from those of the industrial countries in terms of growth. The greatest contribution to reducing poverty in the world is clearly being made by these two regions. Apostles of equality will of course immediately point to the simultaneous growth in disparity of incomes. This accusation is particularly delightful when directed at the (nominally) still communist China. Nevertheless: prosperity is increasing rapidly in both countries, and not only for the rich.

There are shortcomings – the old, well-known ones and new ones too. Property rights, as defined above, hardly apply, and the rule of law is virtually an unknown quantity, at least as far as China is concerned. It is thus not entirely surprising that it is obviously extremely difficult to make any progress as a shareholder in China. Most investments in the country that attracted the second most capital, after the USA, in the 1990s, come via Hong Kong, Singapore and Taiwan (!), that is, via companies that are working in or for China. This means that both China and India will remain dangerous territory for investors. The shortcomings are institutional, but the potential is immense.

8. Offside

There remains the fourth block – the millions and millions of people, at least one-third of the world's population, who are ruled, and bullied, by crooks of varying strength and ability. Mostly put into power on the back of pseudodemocratic structures, the ruling class, often organised as a clan, does nothing else than fill their pockets during the time they are in power. There is hardly a country in Africa that is not governed in this way. There is hardly a country in Latin and Central America that does not function like this. And there is hardly a country in the Near and Middle East where these rules of the game are not applied. These countries usually maintain totally over-dimensioned armies, and are thus welcome customers for the relevant Western companies (and governments). Legitimated by (nominally) democratic structures, the delegates of these states are entitled to sit with, and speak with, the leaders of the most important states. The fact that they are a collection of criminals apparently disturbs no-one.

There is little hope for the masses of people thus oppressed. On account of the monopolar world order, no-one has any real interest in bothering about them. And the USA, the monopolist of power, does no more than what is absolutely necessary; when for example, one of these countries becomes a threat, as is currently the case with Iraq. Beyond this, these countires are at best of interest for individual deals, and in individual geostrategic situations. Only if they were to become pawns in the game between two or more centres of power would the situation become any more permeable. The problem with international terrorism is closely related to the hopelessly uninteresting position of these fourth-block countries. It is possible to demonstrate, with game theory models, that a bipolar or multipolar global system would generate less terrorism, as the various forces in these downtrodden countries would then have the possibility of forming serious coalitions.

In terms of their potential, the countries of the fourth block represent the most interesting investment targets that the world has to offer. There is, however, no question of portfolio investments. One can, however, become an indirect investor in these countries, as a shareholder in companies that know how to cope with the specific local conditions and which operate subsidiaries in these countries. Such companies include Holcim, IBM, Nestlé, Pfizer, Siemens, Unilever, and others.

9. Disadvantages all around. What then?

As we stated at the beginning of this investment commentary, it is a matter of ensuring the future preservation of investments. Accordingly, we selected as criteria for an assessment of the global situation the extent to which property rights are assured and the potential for future value creation. The result is fairly sobering. *None* of the four blocks has *no* significant disadvantages. In the USA it is the over-mighty legal system and the burden of a monopolar world order. In Europe, it is the inability to achieve structural reform and the threat of an aging population. China and India may be thrusting forward, but they do not really enable investors to participate. And the fourth block lies prostrate, used from time to time as the red light district of the world, and kept in order rather less than more. The pimps and crooks are allowed to go about their business, as long as they do not get too dangerous.

Conclusion: it is not possible to feel good about investing anywhere. But it is anyway not a matter of feeling good. Investing is always about risk and return; in the best case there are only better and less good feelings. Property rights are, under various guises, thereatened here and there. Value creation may, for various reasons, come to a halt here and there. In our view, there could be no better argument for sufficient global diversification. For that the lights should go out everywhere – really everywhere – around the world at the same time is not something that we can bring ourselves to believe, not even after the catastrophes of 2001 and 2002.

KH, 13.1.2003