

## Better able to act

### 1. Various levels of perception

The difference between the headlines about a month ago and those today could not be greater. Whereas in mid-March, Iraq was the dominant subject in virtually every section of the newspaper apart from the sports section, today one has to leaf through a paper once or twice to keep up to date on developments in the Middle East. It's as if the events of the actual war were infinitely more important than the direct or indirect consequences of the war. And as if then, in the flood of images from the war zone, there were no other subjects that might have been of some importance. The spread of the new disease SARS reached its first perceptible peak just at the end of March: who knows, perhaps greater attention at that time might have been able to contain the further spread of the virus. Or at least have encouraged airlines to make timely reductions in their capacity...

Of course it is not a matter for criticism when the reality of cannon fire occupies people's complete attention, often simultaneously linked with fear and fascination. But in making any considered analysis of the situation it is essential to keep a clear view – whatever the noise generated by current events. To try to set the images of war-damaged children and looted operating theatres in relation to whatever else is going on in the world is not to be indifferent, or to show contempt for humanity. Nor is it being cynical to observe at the end of the fighting that this war, regarded in advance by almost everyone as the coming apocalypse, turned out to be a remarkably short one with, overall, very few casualties. The bloody house-by-house combat in Baghdad forecast by prominent experts did not materialize, nor did the much feared deployment of weapons of mass destruction. Rather, the Hussein regime imploded so unspectacularly, that already voices can be heard proclaiming that this shows that the war was unnecessary. If we're going to have a war, then let's have a proper one

– a fairly cock-eyed argument, particularly when it comes from the anti-war camp.

The shrill and strident dominance of the topic of “war” in the perception of events, and the displacement of all related, further-reaching questions to the level of distanced analysis and review, is probably connected to the almost breathtaking global change that has, in our view, been triggered by the outbreak of hostilities. What cannot be true cannot happen and so one would rather not acknowledge it. This must have been the attitude in many government offices around the world and in many international bodies, which explains the strenuous efforts to hook up with the *status quo ante* and to carry on as if nothing had happened. But it has.

Understandably enough, acknowledgement of the obvious and comprehensive success of the Americans and their allies has been particularly difficult. The war was, as already mentioned, brief, and involved relatively few casualties. The war aims were essentially achieved. The new operational approach – the renunciation of the large-scale commitment of men and material required by the air-land battle approach in favor of flexible and simultaneous combat in several areas – may well become the military doctrine of the coming decades. In many European capitals in particular, there was a wish, at least surreptitiously, that the Americans might have encountered greater ill-fortune. It is awkward when one's own military inadequacy is rendered so patently obvious. The success of the military part of the operation cannot, of course, distract us from the extensive problems involved in the subsequent activities. We need be under no illusions concerning the enormous problems confronting the installation of even somewhat constitutional and democratic structures in a previously completely terrorized society. The senseless looting was a small taste of all that may lie ahead, and sadly suggests that Iraqi society may be predisposed to fanaticism and explosive convulsions. Nevertheless, and this cannot be denied, however malicious the analysis of the many systematically wrong strategy experts, the

Iraq campaign has so far gone better than expected or hoped, including the few weeks since the fighting stopped.

It has proved no less difficult to come to terms with the impressive steadfastness displayed by the Americans, but above all by the British Prime Minister, Tony Blair. Opposition to the Allied strategy was virtually global and was supported in many places by the broad mass of the populace. Few media were bold enough to present the Allies' position even somewhat objectively, never mind to endorse it. Accusations of stubbornness and sectarianism were of course quickly raised. But is that the whole, or indeed the real truth? At all events, the contrast with the opportunism of the German Chancellor, Gerhard Schröder, or the French President, Jacques Chirac, as they chased after the least fraction of popularity, could hardly have been greater.

Lastly, the effrontery with which the Allies disavowed the usages and institutions of the international community is also being repressed. This concerns important and expensive organizations, such as the UN or NATO. Repression of the reality of their insignificance – at least in the case of Iraq – corresponds to a self-preservation reflex. However, it is not possible to undo history. Whether we like it or not, the USA as a global power has over-ridden and flouted a dense network of international structures. The question of the significance of various international organizations is bound to be raised when the issue of their further financing arises. If we interpret the views expressed in American newspapers correctly, there may be hard times ahead here.

What then is being repressed at the analytical level? Two things: first, that the USA as a global power has catapulted itself into a state of enhanced ability to act, and second, that such a pluralistic democracy has also shown itself to be willing to act. This is breathtaking, for it represents a major paradigm shift. It not only affects global politics, but will also affect local political issues and the economy. Both ready and willing to act: if this approach catches on, what will be the consequences? And what might it mean, specifically for us as investors interested in a wide range of economic and business issues? That is the subject of this investment commentary.

## **2. Structural inability to act**

The bookshelves are full of literature on the optimum size for businesses. There is no definitive answer to the question as there is always a

trade-off between economies of scale (falling average costs due to greater output) and the problems related to the greater difficulty of managing larger, increasingly complex organizations. The number of cross-connections in a polygon increases not linearly but disproportionately. Thus, larger structures are not fundamentally superior to smaller ones.

The matter of size, however, is only one of the interesting questions. The other is: how do larger and smaller organizations behave over time; what changes occur in their internal structures? There is undoubtedly something like an ageing process for organizations. The initial dynamism, or perhaps even recklessness, that prevails to start with gives way bit by bit to a system of finely weighed checks and balances for the various interest groups. The reconciliation of interests thus achieved may produce the desired stability, but it generally results in stasis based on the existing structures. It becomes impossible to react in good time to changed situations, and either the organization will be radically renewed, or it is doomed to disappear. The history of many older companies presents cycles of new dynamism and structural stasis. External economic pressure regularly puts an end to the prevailing coziness and imposes renewal. And it regularly turns out, to general amazement, that beneath the shelter of this coziness, a whole range of undesirable plants, mostly parasitic, has grown up and blossomed. We shall come back to this point.

What is true of economic structures is even truer of social structures. How lean and agile were the young liberal democracies in 1848! And how cumbersome and unwieldy the same bodies appear today! In young liberal states, competencies were still clearly allocated – some matters were dealt with by the federated members, others by the central authority. One source of income was available to the communities and the cantons, another to the federal state. Powers were divided, and the power of the state indeed controlled, though not cutting across legislative and executive responsibilities, but on the pattern of the French political philosopher Montesquieu.

And today? Germany, to start with an extreme example, is ruled simultaneously by the trades unions and the opposition, as well as by the government. By the trades unions in that by means of more or less explicit blackmail they nip in the bud any attempts at the urgently needed reform of the social and healthcare systems; by the opposition in that with a majority in the *Länderkammer* they are able to hinder any more or less

sensible innovation (that thus promises success for the current government). Responsibility rests on many shoulders, but ultimately no-one is really responsible.

Nor is the situation in Switzerland and many other states much different. We live in a nominal federation, a federal state, and are proud of the way state power is decentralized. We advocate decentral taxation and the associated competition over tax rates. We believe that health and education are better handled by the cantons than by the central federal authority. And we feel more comfortable with cantonal police forces than with a federal police force. The problem, however, is that this idyllic picture of Switzerland contains more lies and deception than reality. All honour to the financial competency of the cantons – but without federal financial support nothing would function at all. And when the responsibility for a particular area is with the cantons, but central government discerns a lack of activity, then recourse is had to “kick-off financing”, as recently happened over the provision of more creches. Picture this: in a federal state, central government finances and regulates a matter that should be settled at most at community level, if not entirely within the private sphere.

More of the same: the proudly independent cantonal health and education ministers are naturally unable to manage without their own central offices, and maintain in the federal capital their own organizations, staffed by civil servants – a kind of shadow federal administration, outside direct parliamentary control. What results is an exceedingly fine-meshed network in which everyone is involved in all the issues; what does not result is representatives of the federation and the cantons with clearly differentiated responsibilities. Each level of the hierarchy complains about tied funds, about financial directives from higher levels of the hierarchy. The freedom of action on financial issues is regrettably small. At community level, teachers’ salaries are the largest cost block – but in many cases it is the canton that determines the size of the salaries. Groans are heard at cantonal level about hospital costs, and in the university cantons about the steadily growing burden of their educational institutions – but health and education policies are determined at federal level. Then the Federal Council prepares a savings program that is almost immediately torn apart in Parliament – no point in annoying the voters in an election year, is there? In all honesty it must be admitted that no-one is any longer in a position to understand the com-

plexities of the system. Changes occur only by way of attempts to deal with the symptoms. In the shade of this cozy stasis, abuses flourish, and a paralyzing inefficiency rules.

International organizations are often, in contradistinction to the originally simple structures of the liberal democracies, structured right from the start so that they are simply incapable of functioning properly at the decisive moments. A typical example of this is the UN, whose supreme body, the Security Council, is only capable of action in absolutely exceptional cases, because that is exactly the point of the right of veto granted to the great powers (which include some has-beens). No group of these states should be able to oblige a minority to follow a particular course of action, even when it is a case of ensuring respect for the basic principles of the UN. Admittedly the UN survived the Cold War with this structure, and has remained an important forum at all times. But it has never been capable of upholding basic principles of international law, or ensuring a minimal “rule of law” on a global basis. On the contrary: under the shelter of the cozy stasis brought about by the right of veto, more and more lawless regimes spring up, so that today we must sadly conclude that well over half of humanity knows democracy and the rule of law only in a nominal, empty and cynical form.

### **3. The illusion of collective ability**

Now, it might be argued that the other, undeniable achievements of the UN, and particularly of its sub-organizations (UNESCO, Unicef, WHO, etc.), are so important that the structural inability to act at the highest level is of little concern – the main thing is that people talk together at this level. Yes indeed, were it not for the remarkable belief in the competence of large organizations. Even more remarkably, this belief also prevails in circles that otherwise utterly reject the concept of globalization. The peace demonstrations against the intervention in Iraq by America and its allies were closely linked to the belief that in some wonderful fashion the UN weapons inspections would indeed bear fruit, and the Hussein regime could be domesticated.

This belief in the ability of the collective is almost universal. UNESCO will fight, and win, the battle against illiteracy – will it really, or will it not rather attempt to extend its position and expand its importance through redistributory measures? The OECD will take care of equitable taxation across the industrial nations – will it really, assuming this is indeed a sensible goal, or

will it not rather endeavor to ensure that the high-tax regimes of most of its member countries are not endangered? The EU will ensure competition in all the factor markets of its members – will it, or will it not rather ensure that where the internal market might really do some good, namely in the ossified labor market, everything remains as it was?

The irreligious spirit of our times has replaced the almighty governor of the universe with a belief in the competence of the superior collective. And it is the intellectuals in particular who have fallen for this pseudo-religion. Why? Because, as successors of Descartes, they believe in reason. Because they believe that it only needs a little more knowledge of how the system works to make it manageable. The belief in *ratio*, combined with the science of cybernetics and voilà: the world can be wonderfully well organized, with the just distribution of goods, no more hunger, no more criminality, and peace – provided that the superior collective possesses sufficient power and means. In statements that sound, and are surely meant to be, harmless, such as “The world today is much too complex for any one person to make any difference” or “We can only solve this together” are to be found the rudiments of this erroneous intellectual approach, which ultimately is almost impossible to distinguish from the economic planning of the totalitarian regimes of both right and left.

The assumption of the controllability of social processes and systems by superior collectives is erroneous for two reasons. Firstly, it requires that complete knowledge of the nature and functioning of the processes and systems must be in place, or at least achievable. Secondly, it demands that the processes and systems may not change, neither in continually nor in unpredictable ways. Neither of these preconditions can be met, which is why the attempts to achieve controllability should really be abandoned. The more so, as the empirical evidence makes it very clear that the effectiveness of systems declines the more hierarchical and collective their structures are.

The paradigm shift described above as “breath-taking” appears to be linked to this empirical insight. For the USA, it had been clear for some time that certain strategic goals could not be achieved with the collective international security structures provided by the UN, NATO and other organizations. The opportunity costs of waiting for a consensus, which then cannot be achieved, are simply too high. This is why the decision was taken to cut through the Gordian

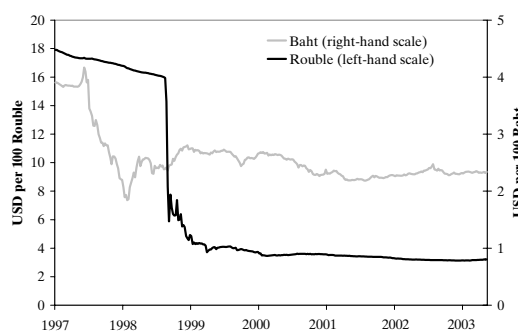
knot of interlocking systems, and safeguard one’s own interests oneself. A first snip at the knot had already been taken with the cancellation of the ABM treaty on defense against ballistic missiles.

#### 4. Paradigm shift already four years ago?

Interestingly, with the benefit of hindsight, it is possible to see that business, or more exactly the currency markets, had already abandoned their belief in the superior collective some four years earlier. In 1998, as is well known, the global currency system was rocked by a sharp crisis. Previously, currencies such as the Thai baht, the Russian rouble or the Turkish lira had been tied to the US dollar by means of a fixed (“guaranteed”) devaluation rate. The “guarantees” were based on the assumption that the International Monetary Fund (IMF), itself a superior collective, would always be able to straighten out any balance of payments problems occurring in these countries or other similarly placed ones. Reliance was placed on the “bailing out” of problem cases by the IMF and the World Bank. And such bailing out had indeed taken place successfully on previous occasions, as for example with Brazil in 1984 and Mexico in 1995.

But in 1998 too much happened at once. At a stroke it became quite clear that even the best-endowed monetary fund could not provide guarantees for half the world. Since 1998 many of the previously explicitly or implicitly tied currencies have been exposed to the free market. And what happened? Not only did they stabilize surprisingly quickly, but their exchange rate even rose at times against the currencies of the most important industrial countries. In other words, stabilization has since been achieved, no longer through the dirigiste measures and planning of a superior collective, but through exposure to all those forces that safeguard their own financial interests themselves on a daily basis in the currency markets.

#### Stability through instability



Source: Bloomberg; own presentation

Reforms of the sort that have taken place in Russia over the last four years would hardly have been possible with the old regime of convenience, under the shelter of assumed guarantees. Since 1998 Russia's GDP has risen by 7% p.a. In other words, it is absolutely not the case that a situation in which the systems are not under control – which at first glance looks more unstable – need produce worse results than a planned economy oriented on artificially organized stability. What applies for currencies may also be true for international politics on the grand scale. Let us look at this more closely.

### **5. Cooperative or uncooperative?**

Safeguarding one's own interests on one's own account. Among other things this sounds as if it might be dangerous, and perhaps it is dangerous. For the threshold for intervention against other countries by other larger and smaller powers in the world has been lowered. If America can intervene, then so can others, is the fear. But: the old order of things was also dangerous, because under its shelter of coziness and the virtual ineffectiveness of the superior collective all those dangerous poisonous plants sprang up that now threaten the civilized world.

We believe that we are now really entering a new era of international coexistence, and that this new era will be characterized by significantly sharper competition over security. In previous commentaries, we forecast a division of the world into four blocks for the coming ten or twenty years: the USA and its strategic peripherals, Europe (including Russia), China and the poverty-stricken rest of the world. A study has now been published that categorically denies Europe the capacity to form a bloc, and puts Russia in its place. The reasons for this are the unfortunate demographic conditions on the Old Continent, as well its structural inability to take action (sic!).

Safeguarding one's own interests, exploiting the newly won ability to act, need not necessarily take a destructive form. Game theory distinguishes between competition of cooperative and non-cooperative character. They differ principally in the costs incurred by the players. The Cold War was a typical example of a non-cooperative competition. The costs of this non-cooperative competition were enormous, the arms race consumed vast sums of money, and ultimately brought one of the competitors to the limits of its resources. Interestingly, the result of the "game" was not complete destruction, but

one of the more stable phases in the history of the world.

More cooperative types of game than those that prevailed in the Cold War are entirely conceivable in the new world order. One of the most powerful reasons for this belief is the utterly unequal equipment that the players bring to the competition. One party possesses every conceivable and desirable form of space equipment: satellites in space equipped with devices that can locate a cigarette packet on the ground. It is also provided with ultra-modern material by an armaments industry whose performance exceeds all expectation. However, it must unfortunately always take its own people into consideration, and is particularly exposed to the danger of being shot in the back by the media. The other party is technologically more backward, but has an inexhaustible reserve of people, enjoys breathtaking economic growth, and can largely act as it sees fit. The third party is also technologically backward, but essentially commands the most important sources of raw materials in the world, and contains in its reserves of people suicide bombers prepared to do anything. As it were, one party is blind, one has only one leg, and the third is deaf: the probability that the game in some way will be cooperative is accordingly relatively high. But, and this is the decisive point, the game will at all times be characterized by the attempt by all parties to safeguard their own interests themselves. The ability to act will be both a precondition and also the goal continually striven for.

### **6. The doctrine of enhanced ability to act**

The pessimists of this world will naturally shirk no effort to fundamentally question both the relatively cooperative character of the future game and its probably not so negative results. One of the major question marks occurs in the area of international trade. After "Iraq", will there be a wave of protectionism? Will unilaterally imposed, bilaterally effective measures challenge the laboriously achieved goals of the World Trade Organization (WTO)? Will the smaller players in international trade regularly draw the short straw?

The impact of "Iraq" will doubtless be felt for a while to come. France and Germany will for some time continue to receive painful reminders that they ended up on the losing side. In particular, the USA will try to manage the repayment of some USD 130 billion of Iraqi debt so that as little as possible flows in the direction of the prominent Hussein creditors France, Ger-

many and Russia. But what of a general wave of protectionism, unrelated to this individual issue?

In our view, important reasons argue against this. Firstly, the global economy is already so closely interlinked that it is hard to imagine how a serious and drastic protectionist regime could function. There is hardly an internationally active business, of whatever origin, that is not represented on most continents and in all important countries. Coca-Cola, ABN-AMRO, Daimler-Chrysler, TotalfinaElf, Nestlé or Lukoil: they all have their interests everywhere. There is hardly a country in the world, with the possible exception of North Korea and Cuba, that is still really internally oriented.

Secondly, powerful communication tools – including in particular the Internet – have been in place for some time now. While in earlier times the possibility of arbitrage, that is the exploitation of price differences in different parts of the world, was reserved to a few specialists, this possibility is available to literally everyone today. New protectionism would generate new, and large price differences. The Internet would always do away with these differences, though naturally at the cost of an immense black market. The political system would try to combat this, and the result would be a loss of efficiency. But in the long run, the market would always triumph, on account of the superior power of modern communications systems.

We earlier discussed a paradigm shift in the direction of greater ability to act, using the example of major international politics to discuss the idea. The example of Internet communication would have served equally well, if not better, as a basis for the discussion. At individual level too, there is a shift towards radically enhanced ability to act, for since the introduction of the Internet, all information is open to anyone who can in whatever way gain access to a computer linked to the web. No-one is any longer dependent on a superior collective of whatever variety to satisfy his communication requirements. The revolution of enhanced ability to act comes at least as strongly from below as was the case with the unilateral action of the USA and its Allies in the Iraq conflict.

Before we pursue these thoughts about the overall economic impact of the enhanced ability to act, let us conclude the topic of protectionism. In our view there is no doubt that there will in the near future be opposition to international free trade and the free movement of capital. However, we believe that global networking is now too far advanced, and communication possibili-

ties too powerful and decentralized for this to be more than a temporary disturbance. We would indeed go as far as to say the highly protectionist regime of the Patriot Act enacted by the USA after 11 September 2001 will become a thing of the past. Thanks to the Internet, the world has become still less controllable.

## **7. Action and the ability to act**

On reflection, in the world of business and the financial markets the paradigm shift towards greater ability to act probably also occurred some time ago, without this having been explicitly noticed. Readers of this commentary are familiar with our reservations concerning so-called “alternative investments” or hedge funds. They are based on the mostly non-existent transparency of these vehicles, and their illiquidity. There is, however, also a thoroughly positive aspect to this category of investments, and that is their deliberate exploitation of the ability to take action – of what can actually be done with financial instruments.

“Normal” investment is restricted to holding or not holding money market instruments, stocks and bonds, and perhaps rights to property and raw materials. Alternative investments offer the freedom to hold such instruments negatively, or in the jargon, to “go short”. In falling markets, or with the stock of companies whose quality no longer justify their price, it is possible to earn a great deal of money with such strategies, and this is particularly attractive inasmuch as it can be done at precisely the point when the vast majority of investors, who hold positive positions, are losing money. In the long term, however, “short” strategies would hardly be advisable, because returns on the financial markets tend on average to be positive; furthermore, “short selling” is naturally very risky, inasmuch as the potential loss in the event of unexpected price rises can be more or less unlimited. Howsoever: the hedge funds that follow this sort of strategy are infinitely more capable of taking action than investors with “normal” strategies. The effect of this ability to act is that certain stocks can be driven into the ground with spectacular price changes in a matter of hours. We have experienced this in our own market, and partly at our own expense, with Swissair, Swiss Life, Zurich Financial Services and ABB.

Is this bad? Is it harmful? Should it be forbidden? No! In all these cases, a management believed itself safe under the shelter of the structural inability to act, dictated by a financial community dominated by institutional investors

all investing in the same index. In the coziness of this multilateral non-aggression pact, incompetence, arrogance, excess, even criminal practices, began to flourish, and it is thanks to the sewer rats of the hedge funds, with their highly effective investment behavior, that the clean-up could be started off, carried through and completed relatively quickly.

Over the past three years, a storm has raged through the financial markets that has left virtually no management unaffected, and that has obliged practically every company to take measures that would otherwise never ever have been taken. Without the reinforcing effect of these highly effective investors, this process would have taken longer, or might perhaps never have happened at all. Coziness is over and done with; the umbrella of structural inability to act is now closed for a while, and companies are out in the cold rain of their investors' profound skepticism.

Often in this connection, the inadequate effectiveness of shareholder democracy is bemoaned, when, as is now fashionable, the subject of discussion is "corporate governance". Interventions at annual general meetings are indeed of little use, or serve at best as public entertainment, as often neither the questioner nor the Chairman or CEO who replies are the least bit gifted as rhetoricians. The banks' block votes are also rightly criticized, for they provide the existing management with an almost unchallengeable safety margin when voting takes place.

This may all be so, but it does not go to the heart of the problem. Better shareholder democracy will never solve the problem of better control over companies – in the same way as modern politics can no longer be conducted by debates in the village square. Rather, what is needed is the combination of two instruments that must both function. Firstly, it is necessary to ensure a completely free, liquid capital market, that permits the most extreme price changes. Sewer rats must not just be tolerated, but welcomed. Secondly, shareholder democracy must at least be so designed that a majority at any time can get rid of a management and the board of directors it hides behind.

The mere knowledge that the danger of such unpleasantness was ever-present would be entirely sufficient to nip any resurgence of coziness in the bud. What is needed is not action itself, but simply the possibility that action can be taken. The knowledge that market players are able to act has a prophylactic effect. Healthy corporate governance is, in our view, not to be sought in complex regulations, behind which an

established management and "its" board of directors can again find shelter, nor in additional regulatory bodies, with their inevitable tendency to generate their own momentum (superior collectives!). The highly-praised transparency, and uniformity of accounting standards, are also dangerous Trojan Horses for the bureaucratization of corporate governance. It would be much better to design stock corporation law so that market players – including all the sewer rats – were at all times able to take action. The rest would look after itself – there would be competition of a more or less cooperative character, resulting in greatly enhanced efficiency.

### **8. A bumpy transition period**

The paradigm shift from a coziness that still prevails in many areas, due to the structural inability of those involved to take action, to a system in which people safeguard their own interests themselves cannot be made without significant discontinuities. We are witnessing such discontinuities now. In global politics, in which a war has just been concluded and new strategic positions have been taken. In the global economy, where an attempt is being made to define and safeguard national interests, but where the already existing market forces will probably quickly put an end to such cameralism. In global currencies, where the USA appears to be driving what looks like a competitive devaluation of its dollar. On the financial markets and in companies, where the dramatic events of the last three years have necessitated strategic turnabouts and savings programs that would previously have seemed utterly utopian.

The recovery of the ability to take action on social and domestic political issues will probably take a good while longer. The coziness beneath the shelter of structural ineffectiveness is all too great, and the problems all too far off. When, for example, it is possible to shift the pension gap of a whole population on to the next generation, then the perceived need for action is far too small for there to be any hope that anyone will ever cut through this Gordian Knot. Meantime, younger, leaner regions, with more advantageous conditions and trades unions less obsessed with existing structures, are gaining ground.

Investors, for whom after all this analysis is written, would be well advised, in our view, to expect the bumpy road to continue. But there is no reason for absolute pessimism. On the contrary; whatever wrong turnings the players in the game may take, one thing is sure: the paralyzing coziness of structural ineffectiveness is a thing of the

past. This opens up new opportunities as well as new risks. Secondly, it seems to us, and precisely for this reason, that the new world order will give rise to both winners and losers. This makes the international diversification of portfolios even more important. Bumpy roads may from time to

time make one wonder if one is on the right track. So it is even more important to have – and to use – the really big, long-term strategy map.

KH, 12.5.2003