

Saving Capitalism from the Capitalists: Unleashing the Power of Financial Markets to Create Wealth and Spread Opportunity

Raghuram G. Rajan and Luigi Zingales

New York: Crown Business, 2003, 369 pp.

This is an excellent book. It concerns a crucially important and poorly understood subject; it is timely; it is clearly and interestingly written; and its main argument is in all significant respects correct. These virtues are all the more noteworthy now that one of the coauthors, Raghuram Rajan, has become chief economist of the International Monetary Fund and thus can exert some practical influence over the policy questions the book addresses.

At the heart of any economic system are the decisions about how to allocate capital among rival uses. *Saving Capitalism from the Capitalists* makes a powerful case for entrusting those decisions to competitive financial markets—as opposed to the alternatives of outright government control or clubby “relationship capitalism” that predominate around the world in rich and poor countries alike. The book carefully analyzes both the benefits and the risks of financial liberalization and concludes that market-driven financial sectors offer sizable net benefits. In so doing, it provides an excellent synthesis of recent scholarship, including several important contributions by the authors themselves. This survey of some of the best recent work in financial economics is alone worth the price of the book.

But Rajan and Zingales do not stop with demonstrating the superiority of financial markets over more centralized decisionmaking systems. They proceed to wrestle with the fascinating question of why, despite that superiority, financial markets are so routinely suppressed and underdeveloped. Their thesis (hence the title of the book) is that market incumbents frequently use their political muscle to throttle financial markets because they fear the competitive uncertainties caused by open access to financing. In other words, the problem with capitalism is that, too often, the capitalists don’t want it. Only under exceptional conditions—such as when new markets arise due to technological change, or existing markets are opened to foreign competition—do incumbents find existing financing channels inadequate and switch to support for liberalization.

Rajan and Zingales tell a fascinating and little-known story of financial development’s ups and downs over the past century. They document a “great reversal” in financial openness that occurred during the interwar period: in major economies around the world, the percentage of national investment financed by equity markets dropped precipitously between 1930 and 1980. This setback for market forces was, of course, part of a larger trend, of a piece with the steep decline of international trade between the wars and the rise to power of central-planning ideologies.

One of the truly admirable things about *Saving Capitalism from the Capitalists* is the unusual combination of talents it features. The authors,

who were colleagues at the University of Chicago's Graduate School of Business until Rajan moved to the IMF, are brilliant scholars with an impressive record of highly sophisticated, ingenious, and elegant economic analysis. In writing this book, though, they wear their learning very lightly. They are able to present extremely complicated ideas in a very clear and reader-friendly way, and they succeed in situating contemporary policy issues in an extremely broad, centuries-long historical context. It is rare indeed in policy books to have authors who really know what they are talking about *and* really know how to say it.

The book also deserves credit for its exquisite timing. A sturdy defense of financial markets is badly needed at present—in the wake of emerging-market financial crises, the dot-com bust, and a string of accounting scandals. It was relatively easy to sell the superiority of arm's-length, transparent, high-liquidity financial systems over insider capitalism during the boom years of the 1990s; it is important to do so today when such systems have suffered reverses and are under attack. All supporters of free markets should be grateful that champions as capable as this book's authors have risen to the challenge.

After piling up the praise, allow me to make some critical comments. First, the concluding policy recommendations in *Saving Capitalism from the Capitalists* do not live up to the overall strengths of the book. These proposals are not fleshed out in sufficient detail to be really persuasive, and in some cases they are ill-considered. In particular, the authors call for a kind of political antitrust law that targets companies so big that they can distort the political process. Such a “big is bad” policy is fraught with dangers, as the U.S. experience amply demonstrates. The tendency is to target aggressively competitive giants while giving a pass to those who rest on their market-power laurels or even encourage industry-wide collusion. The differential treatment of Standard Oil and U.S. Steel a century ago is a case in point. The likely result of politicized antitrust enforcement is to create a policy bias in favor of inert and slothful oligopolies. Meanwhile, the lobbying power of big business will continue unabated.

It is also possible to take issue with the authors' assessment of the relative roles of ideas and interests in explaining the oscillations of political economy. Rajan and Zingales emphasize overwhelmingly the threats posed to financial market development by anti-market interests—most especially insiders, or incumbents, but also the distressed, or victims of economic turbulence. In their view, markets get suppressed by incumbents for all the usual reasons of concentrated benefits and dispersed costs that we know from public choice economics. In addition, and this point is less familiar, incumbents are able to stifle competition because they are opportunistic enough to ride the coattails of sympathy for people dislocated by market downturns. Thus, according to the authors' analysis, financial markets are in maximum danger when incumbents can make common cause with anti-market sentiments that flare up during hard

times. In the model of historical change presented in *Saving Capitalism from the Capitalists*, ideas play a very limited role—not quite window dressing, but certainly subsidiary to the main drivers of incumbents’ perennial hostility to competition and the cyclical hostility occasioned by market volatility.

While the influence of interests is obvious, I would contend that the authors give short shrift to the importance of the climate of ideas. Anti-competitive scheming by insiders and recurrent waves of anti-market sentiment on the part of the dislocated are more or less constants throughout the economic history of the past several centuries; they alone cannot explain the huge global swing away from markets and competition during the early to mid-20th century and the impressive swing back over the past quarter century. The missing variable is the climate of informed opinion, which has over the past century tilted dramatically against market competition and then, rather less enthusiastically, back again. This species of public opinion is not simply a rationalization for this or that interest; it is, to some degree, an autonomous force in social affairs that is guided by perceptions, however flawed or acute, of the larger social good.

Throughout the first half of the 20th century, informed opinion was strongly inclined to see competition as chaotic and inefficient by comparison with central planning and top-down control. In this climate of ideas, it was much easier for incumbents to pass off their special pleading as public-spirited and gull the dislocated into providing the political muscle they needed to obtain special privileges from the state. By contrast, decades of bitter and disillusioning experience with central planning and top-down control have brought about a reappraisal of the market’s overlooked virtues, and it has become harder for incumbents to play their anti-competitive games.

The very act of writing this book demonstrates that the authors put more stock in the power of ideas than perhaps they realize. Consider this line from the book’s final paragraph: “If books like ours can raise public awareness, they reduce one important cost of collective action—the cost of understanding the issues—and force politicians to pay attention.” The realization of similar hopes explains the truth of Keynes’s famous dictum: “The ideas of economists and political philosophers, both when they are right and when they are wrong, are more powerful than is commonly understood. Indeed the world is ruled by little else.” The understanding of economic life took a terrible wrong turn during the 20th century and then righted itself; the detour reduced the costs of special-interest lobbying, while the recovery has raised those costs significantly. For their sterling contribution to the ongoing zigzagging progress of ideas, Rajan and Zingales are to be warmly congratulated and thanked.

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