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SPECIAL REPORT

STATE CAPITALISM

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The visible hand

The visible hand

The crisis of Western liberal capitalism has coincided with the rise of a powerful new form of state capitalism in emerging markets, says Adrian Wooldridge

BEATRICE WEBB grew up as a fervent believer in free markets and limited government. Her father was a self-made railway tycoon and her mother an ardent free-trader. One of her family's closest friends was Herbert Spencer, the leading philosopher of Victorian liberalism. Spencer took a shine to young Beatrice and treated her to lectures on the magic of the market, the survival of the fittest and the evils of the state. But as Beatrice grew up she began to have doubts. Why should the state not intervene in the market to order children out of chimneys and into schools, or to provide sustenance for the hungry and unemployed or to rescue failing industries? In due course Beatrice became one of the leading architects of the welfare state—and a leading apologist for Soviet communism.

The argument about the relative merits of the state and the market that preoccupied young Beatrice has been raging ever since. Between 1900 and 1970 the pro-statists had the wind in their sails. Governments started off by weaving social safety nets and ended up by nationalising huge chunks of the economy. Yet between 1970 and 2000 the free-marketeers made a comeback. Ronald Reagan and Margaret Thatcher started a fashion across the West for privatising state-run industries and pruning the welfare state. The Soviet Union and its outriggers collapsed in ruins.

The era of free-market triumphalism has come to a juddering halt, and the crisis that destroyed Lehman Brothers in 2008 is now engulfing much of the rich world. The weakest countries, such as Greece, have already been plunged into chaos. Even the mighty United States has seen the income of the average worker contract every year for the past three years. The Fraser Institute, a Canadian think-tank, which has been measuring the progress of economic freedom for the past four decades, saw its worldwide "freedom index" rise relentlessly from 5.5 (out of 10) in 1980 to 6.7 in 2007. But then it started to move backwards.

The crisis of liberal capitalism has been rendered more serious by the rise of a potent alternative: state capitalism, which tries to meld the powers of the state with the powers of capitalism. It depends on government to pick winners and promote economic growth. But it also uses capitalist tools such as listing state-owned companies on the stockmarket and embracing globalisation. Elements of state capitalism have been seen in the past, for example in the rise of Japan in the 1950s and even of Germany in the 1870s, but never before has it operated on such a scale and with such sophisticated tools.

State capitalism can claim the world's most successful big economy for its camp. Over the past 30 years China's GDP has grown at an average rate of 9.5% a year and its international trade by 18% in volume terms. Over the past ten years its GDP has more than trebled to $11 trillion. China has taken over from Japan as the world's second-biggest economy, and from America as the world's biggest market for many consumer goods. ▸▸

ACKNOWLEDGMENTS

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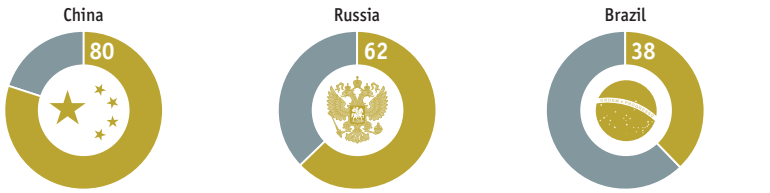
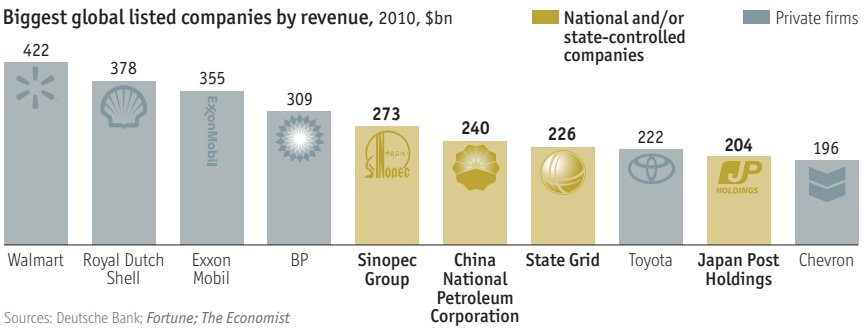
The power and the glory

Share of national/state-controlled companies' capitalisation on MSCI national stockmarket index
June 2011, % of total

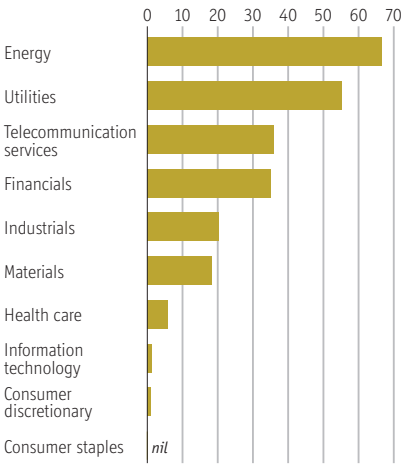


Biggest global listed companies by revenue, 2010, $bn



Sources: Deutsche Bank; *Fortune; The Economist*

Share of national/state-controlled companies in MSCI emerging-market index by industry sector
June 2011, %



The Chinese state is the biggest shareholder in the country's 150 biggest companies and guides and goads thousands more. It shapes the overall market by managing its currency, directing money to favoured industries and working closely with Chinese companies abroad.

State capitalism can also claim some of the world's most powerful companies. The 13 biggest oil firms, which between them have a grip on more than three-quarters of the world's oil reserves, are all state-backed. So is the world's biggest natural-gas company, Russia's Gazprom. But successful state firms can be found in almost any industry. China Mobile is a mobile-phone goliath with 600m customers. Saudi Basic Industries Corporation is one of the world's most profitable chemical companies. Russia's Sberbank is Europe's third-largest bank by market capitalisation. Dubai Ports is the world's third-largest ports operator. The airline Emirates is growing at 20% a year.

State capitalism is on the march, overflowing with cash and emboldened by the crisis in the West. State companies make up 80% of the value of the stockmarket in China, 62% in Russia and 38% in Brazil (see chart). They accounted for one-third of the emerging world's foreign direct investment between 2003 and 2010 and an even higher proportion of its most spectacular acquisitions, as well as a growing proportion of the very largest firms: three Chinese state-owned companies rank among the world's ten biggest companies by revenue, against only two European ones (see chart). Add the exploits of sovereign-wealth funds to the ledger, and it begins to look as if liberal capitalism is in wholesale retreat: New York's Chrysler Building (or 90% of it anyway) has fallen to Abu Dhabi and Manchester City football club to Qatar. The Chinese have a phrase for it: "The state advances while the private sector retreats." This is now happening on a global scale.

This special report will focus on the new state capitalism of the emerging world rather than the old state capitalism in Europe, because it reflects the future rather than the past. The report will look mainly at China, Russia and Brazil. The recent protests in Russia against the rigging of parliamentary elections by Vladimir Putin, the prime minister, have raised questions about the country's political stability and, by implication, the future of state capitalism there, but for the moment nothing much seems to have changed. India will not be considered in detail because, although it has some of the world's biggest state-owned companies, they are more likely to be leftovers of the Licence Raj rather than thrusting new national champions.

Today's state capitalism also represents a significant advance on its predecessors in several respects. First, it is developing on a much wider scale: China alone accounts for a fifth of the world's population. Second, it is coming together much more quickly: China and Russia have developed their formula for state capitalism only in the past decade. And third, it has far more sophisticated tools at its disposal. The modern state is more powerful than anything that has gone before: for example, the Chinese Communist Party holds files on vast numbers of its citizens. It is also far better at using capitalist tools to achieve its desired ends. Instead of handing industries to bureaucrats or cronies, it turns them into companies run by professional managers.

The return of history

This special report will cast a sceptical eye on state capitalism. It will raise doubts about the system's ability to capitalise on its successes when it wants to innovate rather than just catch up, and to correct itself if it takes a wrong turn. Managing the system's contradictions when the economy is growing rapidly is one thing; doing so when it hits a rough patch quite another. And state capitalism is plagued by cronyism and corruption.

But the report will also argue that state capitalism is the most formidable foe that liberal capitalism has faced so far. State capitalists are wrong to claim that they combine the best of both worlds, but they have learned how to avoid some of the pitfalls of earlier state-sponsored growth. And they are flourishing in the dynamic markets of the emerging world, which have been growing at an average of 5.5% a year against the rich world's 1.6% over the past few years and are likely to account for half the world's GDP by 2020.

State capitalism increasingly looks like the coming trend. The Brazilian government has forced the departure of the boss of Vale, a mining giant, for being too independent-minded. The French government has set up a sovereign-wealth fund. The

South African government is talking openly about nationalising companies and creating national champions. And young economists in the World Bank and other multilateral institutions have begun to discuss embracing a new industrial policy.

That raises some tricky questions about the global economic system. How can you ensure a fair trading system if some companies enjoy the support, overt or covert, of a national government? How can you prevent governments from using companies as instruments of military power? And how can you prevent legitimate worries about fairness from shading into xenophobia and protectionism? Some of the biggest trade rows in recent years—for example, over the China National Offshore Oil Corporation's attempt to buy America's Unocal in 2005, and over Dubai Ports' purchase of several American ports—have involved state-owned enterprises. There are likely to be many more in the future.

The rise of state capitalism is also undoing many of the assumptions about the effects of globalisation. Kenichi Ohmae said the nation state was finished. Thomas Friedman argued that governments had to don the golden straitjacket of market discipline. Naomi Klein pointed out that the world's biggest companies were bigger than many countries. And Francis Fukuyama asserted that history had ended with the triumph of democratic capitalism. Now across much of the world the state is trumping the market and autocracy is triumphing over democracy.

Ian Bremmer, the president of Eurasia Group, a political-risk consultancy, claims that this is "the end of the free market" in his excellent book of that title. He exaggerates. But he is right that a striking number of governments, particularly in the emerging world, are learning how to use the market to promote political ends. The invisible hand of the market is giving way to the visible, and often authoritarian, hand of state capitalism. ■

Something old, something new

A brief history of state capitalism

IN SEPTEMBER 1789 George Washington appointed Alexander Hamilton as America's first ever treasury secretary. Two years later Hamilton presented Congress with a "Report on Manufactures", his plan to get the young country's economy going and provide the underpinnings for its hard-fought independence. Hamilton had no time for Adam Smith's ideas about the hidden hand. America needed to protect its infant industries with tariffs if it wanted to see them grow up.

State capitalism has been around for almost as long as capitalism itself. Anglo-Saxons like to think of themselves as the perennial defenders of free-market orthodoxy against continental European and Asian heresy. In reality every rising power has relied on the state to kickstart growth or at least to protect fragile industries. Even Britain, the crucible of free-trade thinking, created a giant national champion in the form of the East India Company.

The appetite for industrial policy grew with the eating, and after the second world war intervention became a mark of civilisation as well as common sense. The Europeans created industrial powerhouses and welfare states. The Asians poured resources into national champions.

This long era of state activism has left a surprisingly powerful legacy, despite the more recent fashion for privatisation and deregulation. The rich world still has a large number of state-owned or state-dominated companies. For example, France owns 85% of EDF, an energy company; Japan 50% of Japan Tobacco; and Germany 32% of Deutsche Telekom. These numbers add up: across the OECD state-owned enterprises have a combined value of almost $2 trillion and employ 6m people.

The new kind of state capitalism started in Singapore. Lee Kuan Yew, its founding father, was prime minister for more than 30 years and a tireless advocate of "Asian values", by which he meant a mixture of family values and authoritarianism. He rivalled Beatrice Webb in his faith in the wisdom of the state. But he also grasped that Singapore's best chance lay in attracting the world's most powerful corporations, though he rejected the laissez-faire ideas that flourished in Asia's other great port city, Hong Kong.

Singapore could easily have remained a tiny oddity but for a succession of earth-shaking events. The first was the oil embargo imposed by the Arab petrostates in the wake of the 1973 Yom Kippur war, quadrupling the price of oil and shifting the balance of power in the world economy. Arab governments tightened their control over the newly valuable oil companies and amassed growing financial surpluses. For them the economic shock was proof of the power of their oil weapon. For the Chinese it demonstrated the importance of securing a safe supply of oil and other raw materials.

The second event was Deng Xiaoping's transformation of China. Deng borrowed heavily from the Singaporean model. He embraced globalisation by creating special economic zones and inviting foreign companies in. He espoused corporatism by forcing state enterprises to model themselves on Western companies. And he concentrated resources on national champions and investment in research and development. By doing all this, he plugged

1.3 billion people into the world economy.

The final event was the collapse of Soviet communism. This was initially seen as one of the great triumphs of liberalism, but it soon unleashed dark forces. Communist apparatchiks-turned-oligarchs grabbed chunks of the economy. Between 1990 and 1995 the country's GDP dropped by a third. Male life expectancy shrank from 64 to 58. Once-captive nations broke away. In 1998 the country defaulted on its debts.

The post-Soviet disaster created a craving for order. Vladimir Putin, then Russia's president, reasserted direct state control over "strategic" industries and brought the remaining private-sector oligarchs to heel. But just as important as the backlash in Russia was the one in China. The collapse of the Soviet Union confirmed the Chinese Communist Party's deepest fear: that the end of party rule would mean the breakdown of order. The only safe way forward was a judicious mixture of private enterprise and state capitalism.

State capitalism's global reach

New masters of the universe

How state enterprise is spreading

THE HEADQUARTERS OF China Central Television, designed by Rem Koolhaas, a Dutch architect, looks like a monstrous space invader striding across Beijing. The headquarters of the China National Offshore Oil Corporation resembles an oil tanker emerging from a shimmering sea. It was designed by Kohn Pedersen Fox, an international firm of architects, and sits directly opposite China's ministry of foreign affairs. All over central Beijing you see state companies erecting giant monuments to themselves, reflecting their huge power and their vision of themselves as agents of modernisation.

That vision is not confined to Beijing. Petronas, Malaysia's state-owned oil company, has built an 88-storey tower in the heart of Kuala Lumpur. In Moscow's spanking new Moskva City Business Complex two sleek glass skyscrapers sit side by side—the headquarters of Sberbank and VTB, Russia's largest and second-largest state banks.

The most striking thing about state-owned enterprises (SOEs) is their sheer collective might in the emerging world. They make up most of the market capitalisation of China's and Russia's stockmarkets and account for 28 of the emerging world's 100 biggest companies. True, the state-owned sector as a whole has been in rapid retreat. It now makes up only about a third of China's and Russia's GDP, against almost all of it two decades ago. But this decline is the result of selective pruning rather than liberalisation. Governments have been letting go of the small in order to strengthen their hold over the large.

This has resulted in a couple of paradoxes. The SOEs are becoming wealthier and more powerful even as the overall state sector shrinks, and governments are tightening their grip on the commanding heights of the economy even as the private sector grows. The concentration of power in an inner circle of SOEs has been gathering pace over the past decade: China's 121 biggest SOEs, for example, saw their total assets increase from $360 billion in 2002 to $2.9 trillion in 2010 (though their share of GDP has declined). And it has been given an extra boost by the 2007-08 financial crisis: in 2009 some 85% of China's $1.4 trillion in bank loans went to state companies.

Governments are becoming more sophisticated owners. Only a handful of SOEs are still reporting directly to government ministries. Most governments prefer to exercise control through their ownership of shares: they have become the most powerful shareholders across much of the developing world from China to Thailand and from Russia to Saudi Arabia. Sometimes they hold all the shares, particularly in oil companies like Malaysia's Petronas, transport firms like China's Ocean Shipping Company and quasi-military outfits like Russia's United Aircraft Corporation. But increasingly they prefer to dilute their shareholdings. The United Nations Conference on Trade and Development defines a state-owned company as one in which the state owns more than 10% of the shares. Some governments have mastered the art of controlling companies through minority stakes: in Russia, for example, the state has retained golden shares in 181 firms.

State enterprises have become more productive, thanks to a mixture of judicious pruning and relentless restructuring. In China their return on assets increased from 0.7% in 1998 to 6.3% in 2006 (though some say the figures are misleading). They have also become more international: companies that once served only their domestic market, such as Baosteel and Shanghai Electric, are striding onto the global stage. These three developments—more sophisticated methods of control, more productive use of assets and rapid globalisation—are going hand in hand.

The hard core of the state-owned sector are the national oil companies: the 13 giants that control more than three-quarters of the world's oil supplies. Governments continue to keep a heavy hand on this industry. The Chinese state owns 90% of the shares in PetroChina and 80% of those in Sinopec. Even so, the national oil companies are being transformed by the same forces that are transforming the state-owned sector in general.

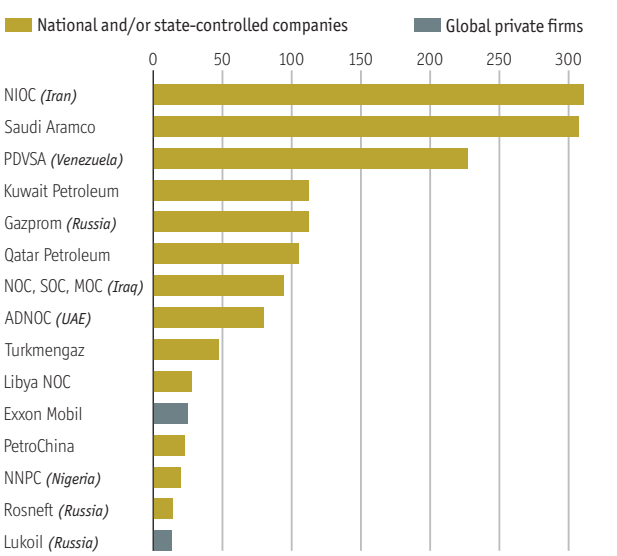
A few companies preserve the great tradition of state-sponsored incompetence and overmanning. Venezuela's Petróleos de Venezuela, which is central to the patronage machine of the country's president, Hugo Chávez, is an obvious example. More surprisingly, so is Mexico's Pemex, which has successfully resisted numerous attempts to reform it. Malaysia's Petronas has improved dramatically over the past five years. Saudi Arabia's Aramco, which controls more than a tenth of the world's oil and with it the fate of the world economy, is almost as well managed as private-sector oil companies such as Exxon Mobil. The Saudi monarchy has slimmed the company's workforce, brought in professional managers, contracted out ancillary work and formed alliances with international companies.

The world is their oyster

More generally, national energy companies are no longer content just to sit at home and pump the oil or gas. They are increasingly venturing abroad in order to lock up future energy supplies or forming alliances with private-sector specialists to increase their access to expertise and ideas. Gazprom has been buying up oil and gas companies across eastern Europe and Asia. In 2008 it bought a 51% stake in Naftna Industrija Srbije, a Serbian energy giant. Chinese oil companies have been striking deals across Africa: in 2006 Sinopec bought a huge Angolan oil well for $692m. The multiplying alliances between national and in-

Too precious to let go 1

Proven oil and gas reserves, 2010
Billion barrels of oil equivalent



Sources: Oliver Wyman; *The Economist*

The acquisitive state 2

Biggest IPOs since 2005 — National and/or state-controlled

Company	Industry	Year	Value, $bn
Agricultural Bank of China	Finance	2010	22.1
Industrial & Commercial Bank of China	Finance	2006	21.9
AIA *(Hong Kong)*	Insurance	2010	20.5
Visa *(United States)*	Finance	2008	19.7
General Motors	Automotive	2010	18.1
Bank of China	Finance	2006	11.2
Dai-ichi Life Insurance *(Japan)*	Insurance	2010	11.1
Rosneft *(Russia)*	Oil & gas	2006	10.7
Glencore International *(Switzerland)*	Mining	2011	10.0
China Construction Bank	Finance	2005	9.2
Electricité de France	Utility & energy	2005	9.0
VTB Group *(Russia)*	Finance	2007	8.0
Banco Santander Brasil	Finance	2009	7.5
China State Construction Engineering Corporation	Construction	2009	7.3
Iberdrola Renovables *(Spain)*	Utility & energy	2007	6.6

Source: Dealogic

ternational companies are not always successful: BP, for example, will not rush into any future deals with Russia's Rosneft. But they are plugging national energy companies into the global market for people and ideas and closing the gap between the state-run and the private sector.

State capitalism also has a collection of companies that sit at the opposite end of the ownership scale from national energy companies: national champions that formally are privately owned but enjoy a huge amount of either overt or covert support from their respective governments. Sometimes such governments prefer to exercise their patronage at arm's length because they have little experience of the sector; this is often true of the IT industry in China. Sometimes they offer their patronage to a private company after it has become a winner. Either way the end result is the creation of a new class of state companies: national champions that may not be owned by governments but are nevertheless closely linked to them.

China's Lenovo likes to think of itself as a private-sector computer company, but the Chinese Academy of Sciences provided it with seed money (and still owns lots of shares), and the government has repeatedly stepped in to smooth its growth, not least when it acquired IBM's personal-computer division for $1.25 billion in 2004. Brazil's Vale also considers itself a private-sector mining company, but the government treats it as a national champion and recently forced its boss, Roger Agnelli, to step aside because it did not like his plans to sack workers. There is a long list of national champions that operate in the shadow of the state, including China's Geely in cars, Huawei in telecoms equipment and Haier in white goods.

The wealth of nations

State capitalists are not just running companies; they are also managing huge pools of capital in the form of sovereign-wealth funds (SWFs). Leviathan is becoming a finance capitalist as well as a captain of industry.

The sovereign-wealth business was pioneered decades ago by the petrostates and by Singapore. The Kuwait Investment Authority was set up in 1953. But more recently the business has been turbocharged by two developments: the surge in energy prices and China's accumulation of a vast current-account surplus. Today's SWFs account for some of the world's biggest pools of capital. The Abu Dhabi Investment Authority controls $627 billion, putting it in the same league as some of the largest American mutual funds. Saudi Arabia's SAMA foreign-holdings company in December 2011 controlled $473 billion, China's SAFE Investment Company $568 billion and China Investment Corporation $410 billion. In all, the world's sovereign-wealth funds control about $4.8 trillion in assets, a figure that is likely to rise to $10 trillion by the end of this decade.

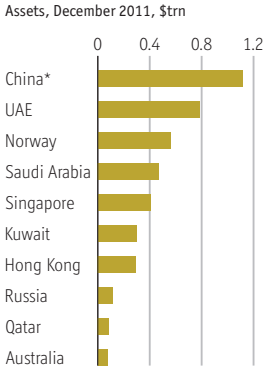
Sovereign-wealth funds come in two varieties: "savings" funds intended to find productive homes for investments, and "development" funds that also promote economic development. China Investment Corporation has focused on producing a portfolio of financial assets, for example, whereas Abu Dhabi's various investment funds have been more interested in funding the region's economic development to prepare for the day when the oil runs out. In 2008 Abu Dhabi created a fund that specialises in investing in high-tech companies, both at home and abroad. In its first big deal it formed an alliance with Advanced Micro Devices, an American chipmaker, to create a local semiconductor manufacturer, GLOBALFOUNDRIES.

The financial crisis of 2007-08 shifted the argument in favour of the second kind of fund. Soon after China Investment Corporation was set up in September 2007 it saw the money it had put into American investment banks turn to ashes. Petrostate SWFs have increased their emphasis on investing in science and research. Sovereign-wealth funds in Kuwait, Qatar, Russia, China, Kazakhstan and Ireland have been asked to support domestic financial institutions. Almost all funds are taking a more active interest in the way the companies they own are managed, for example by demanding a seat on the board.

Nasser Saidi, chief economist of the Dubai International Financial Centre, argues that the rise of the emerging world will inevitably force the global financial system to change, from a hub-and-spokes model (with London and New York acting as the hubs) to a spider's-web model of many interconnected hubs. The 2007-08 crisis has dramatically speeded up this process: SWFs now like to do much of their business with each other rather than going through rich-world intermediaries. In 2009 China Investment Corporation and the Qatar Investment Authority signed a joint-venture agreement. In the following year a consortium of nine funds, including the Government of Singapore's Investment Corporation, China Investment Corporation and the Abu Dhabi Investment Council, invested $1.8 billion in BTG Pactual, a Brazilian investment bank spun off from UBS, a Swiss bank.

Deep pockets 3

Largest sovereign-wealth funds
Assets, December 2011, $trn



Source: Sovereign Wealth Fund Institute
*Estimate

It is possible for a country to have any or all of these institutions in place without being a member of the state-capitalist club. Norway boasts the world's 13th-biggest oil company by revenue, Statoil, and its third-biggest sovereign-wealth fund, the Government Pension Fund, with $560 billion in assets, but requires both of them to behave like regular companies. These various elements can also be put together in a variety of ways. The next section will look at some of the different forms that state capitalism can take. ■

A choice of models

Theme and variations

State capitalism is not all the same

IT IS EASY for a casual visitor to China to be fooled into thinking that he is in a normal capitalist country. The big cities are dotted with Starbucks and Kinkos. The newspapers run stories about small businesspeople falling prey to loan sharks. Business executives are whisked around in Mercedes cars with blackened windows. Their wives and mistresses idle their afternoons away in doga classes—yoga that includes the pet dog.

But the form of capitalism on display is highly idiosyncratic. Company bosses are routinely moved to rival companies without any explanation. Company headquarters have space set aside for representatives of the armed forces. And the deeper you look, the queerer things become. In his indispensable book, "The Party", Richard McGregor points out that the bosses of China's 50-odd leading companies all have a "red machine" sitting next to their Bloomberg terminals and family photographs that provides an instant (and encrypted) link to the Communist Party's high command.

What might be called "the party state" exercises a degree of control over the economy that is unparalleled in the rest of the state-capitalist world. The party has cells in most big companies—in the private as well as the state-owned sector—complete with their own offices and files on employees. It controls the appointment of captains of industry and, in the SOEs, even corporate dogsbodies. It holds meetings that shadow formal board meetings and often trump their decisions, particularly on staff appointments. It often gets involved in business planning and works with management to control workers' pay.

The party state exercises power through two institutions: the State-Owned Assets Supervision and Administration Commission (SASAC) and the Communist Party's Organisation Department. SASAC, which holds shares in the biggest companies, is the world's largest controlling shareholder and the state-capitalist institution par excellence. It has been spearheading the policy of creating national champions by consolidating and pruning its portfolio: the number of companies under its supervision has declined from 198 in 2003 to 121 today. It has also been implementing the party's policy of creating a "harmonious society" by regulating pay. In 2009 the average SOE boss earned $88,000 and the highest-paid, the chairman of China Mobile, $182,000. High pay in SOEs has been a big source of disharmony.

SASAC can be something of a paper tiger. It has been trying for years to force the SOEs to pay higher dividends to the government, with only limited success. Similarly, nobody believes that the SOE bosses' nominal pay bears any relation to their real remuneration. However, nobody would apply the term "paper tiger" to the Organisation Department. Created by Chairman Mao in 1924, it has become the world's mightiest human-resources department. It appoints all the senior figures in China Inc. In 2004 it reshuffled the heads of the three biggest telecoms companies. In 2009 it rotated the bosses of the three biggest airlines. In 2010 it did the same to the chiefs of the three biggest oil companies, each of which is a *Fortune* 500 company. Even the most successful top executives of China's SOEs are cadres first and company men second. They care more about pleasing their party bosses than about the global market.

The party state has reinforced its power by creating "vertical" business groups. In most emerging markets (including Hong Kong next door) business groups are "horizontal": companies sprawl into adjacent businesses—telecoms companies into hotels, shipping companies into property—in order to exploit their local connections. In China business groups focus on particular industries. The party state encourages companies to band together into industry clusters by giving them preferential access to contracts and stockmarket listings. It also encourages them to establish subdivisions such as a domestic holding company, a finance company, a research institute and a foreign division. SASAC typically owns 100% of the shares in the holding company. The holding company in turn owns a smaller proportion of ▸▸

shares—say 60%—in the foreign division. This makes it possible for business groups to present lots of different faces—for instance, an inward-looking one in the form of the holding company and an outward-looking one in the form of the international division. It also allows the party state to exercise control of an entire chain of companies. Thus PetroChina might look like a regular Western company, with a listing on the New York Stock Exchange. But in fact it is the international division of a huge group called China National Petroleum Corporation, the foreign head of a dragon whose body and raison d'être lie in Beijing.

The Kremlin as capitalist-in-chief

In Russia the past decade has seen a remarkable strengthening of the power of the state, which during Boris Yeltsin's period of "wild privatisation" looked as if it might crumble. The Kremlin has turned scattered companies into national champions. Aeroflot reabsorbed regional airlines spun off in the 1990s. Russian Technologies rolled up hundreds of state companies, many of which had little to do with technology, into a vast conglomerate. The government has also renationalised industries that were privatised in the 1990s. Rosneft, an oil company, took over most of Yukos from Mikhail Khodorkovsky, once Russia's richest man, and Gazprom bought Sibneft from Roman Abramovich.

As a result the Russian state once again controls the commanding heights of the economy—only this time through share ownership rather than directly. The state holds huge chunks of the shares of the country's biggest and most strategic companies, including Transneft, a pipeline company; Sukhoi, an aircraft-maker; Rosneft; Sberbank; Unified Energy Systems, an electricity giant; Aeroflot; and Gazprom.

The Kremlin has also established control over Russia's oligarchs, reducing once-mighty rottweilers to shivering chihuahuas and transforming supposedly private companies into organs of the state. The brutal persecution and imprisonment of Mr Khodorkovsky helped to instil obedience, and periodically the state waves a bloody stick at the oligarchs to keep them in their place. They dutifully pick up the tab for public works (such as the 2014 Winter Olympics) and keep out of politics.

These varieties of state capitalism all have one thing in common: politicians have far more power than they do under liberal capitalism

The private-sector oligarchs have been replaced at the heart of the economy by state-sector bureaugarchs, most of them former KGB officials who have close ties with Vladimir Putin and have spent the past decade steadily accumulating power (though not personal stakes in the businesses). Mr Putin, currently the prime minister, is chairman of the supervisory board of Vnesheconombank, a state development bank. Igor Sechin, the deputy prime minister, was chairman of Rosneft until Dmitry Medvedev, Russia's president, ordered government ministers to step down as chairmen of state companies' boards of directors last year to tidy things up. Such people form the board of Russia Inc, a company that is headed by Mr Putin, dominated by the KGB and dedicated to controlling the country's most lucrative assets, from oil and gas to nuclear power, diamonds, metals, arms, aviation and transport.

The result is a highly unusual form of capitalism, dominated by a handful of gigantic firms and controlled by a clique of security officials. Two state-controlled compnaies, Sberbank and Gazprom, account for more than half of the turnover of the Russian stock exchange. Russian capitalism would have been concentrated even if the Kremlin had not been so ruthless. Oil and gas companies, which account for 20% of the country's GDP and 60% of its exports, thrive on economies of scale and scope. Poor infrastructure encourages vertical integration; for example, metal companies have been buying ports to ensure that they can get their goods out on time. Still, having so much political power in so few hands has enormously increased this concentration.

This quintessentially Russian form of state capitalism has nevertheless been embracing the global market. Oil and gas companies have been buying similar firms abroad or listing on foreign stock exchanges. In July 2006 Rosneft raised $11 billion by selling 15% of its shares on the London stock exchange. Russia's sovereign-wealth funds have been particularly keen on buying foreign companies, in part because Russia's own business practices are so murky. And Russian businesspeople have bought lots of property abroad, particularly in London.

Petrostate capitalism

Oil and water may not mix, but oil and royalty mix very well to create petrostate capitalism. Middle Eastern monarchs have been using oil to keep themselves in funds for decades. But these days some of them are taking a remarkably sophisticated approach to managing their economies, embracing professional management.

The al-Maktoums, who rule Dubai, created Dubai World, a huge state-owned holding company, to run their projects. The Saudis have handed the day-to-day management of their biggest companies, Saudi Aramco and Saudi Basic Industries, to professional managers. The petro-royals have also become enthusiastic practitioners of state-sponsored modernisation. The al-Maktoums have been trendsetters because they never had much oil to begin with. It now accounts for under 5% of the emirate's GDP. They have provided Dubai with a world-class airport, an important financial hub and a scattering of "knowledge villages" and "silicon centres". Even conservative Saudi Arabia claims to be building four tech-enabled cities.

But the Gulf model of modernisation from above has been plagued by two familiar curses, cronyism and bubbles. There is only so much that professional managers can do to prevent the local royals from damaging the region's companies. Bahrain's Gulf Air and Kuwait Airways have been albatrosses. Dubai World accumulated $80 billion in debt building the world's tallest skyscraper and a palm-shaped artificial island. The state of Dubai had to be rescued by neighbouring Abu Dhabi.

The problems of cronyism and corruption have proved even more toxic in other parts of the Middle East. In Egypt Hosni Mubarak, the president until the Arab spring, handed the management of the state companies to incompetent people while making sure his cronies did well out of privatisation. In Algeria SOEs are notorious dens of patronage and typically run at only 50% of capacity. In Syria the overwhelming majority of the country's top 250 SOEs have been in the red for many years.

Leviathan as a minority investor

Brazil is the most ambiguous member of the state-capitalist camp: a democracy that also embraces many of the features of Anglo-Saxon capitalism. But it is worth examining for two reasons. First, it is a weather vane for state capitalism, a leading privatiser in the 1990s that is now forcing its biggest mining com-

pany, Vale, to keep workers it does not need, and obliging a bunch of smaller companies to embark on subsidised consolidation. And second, it has invented one of the sharpest new tools in the state-capitalist toolbox.

Brazil has spent most of its modern history in pursuit of state-driven modernisation. A survey in the early 1980s showed that it had more than 500 SOEs. Brazil launched a privatisation drive in the 1990s to deal with hyperinflation, surging deficits and general sclerosis. But more recently it has moved in a new direction. The government has poured resources into a handful of state champions, particularly in natural resources and telecoms. It has also produced a new model of industrial policy: replacing direct with indirect government ownership through the Brazilian National Development Bank (BNDES) and its investment subsidiary (BNDESPar); and swapping majority for minority ownership by acquiring shares in a broad spectrum of different companies. Sergio Lazzarini, of Brazil's Insper Institute of Education and Research, and Aldo Musacchio, of Harvard Business School, have christened this model "Leviathan as a minority shareholder".

This minority-shareholder model has several advantages. It limits the state's ability to use SOEs to reward clients or to pursue social policies. Private shareholders have just enough power to kick up a fuss. But it also gives the state more influence for its money. By 2009 BNDESPar's holdings were worth $53 billion, or just 4% of the stockmarket. Yet the state spoke with a loud voice across corporate Brazil. Messrs Lazzarini and Musacchio have also shown, in a detailed study of 296 firms traded on the São Paulo stock exchange between 1995 and 2003, that this model can increase firms' returns on their assets. Brazilian companies typically underinvest in productivity-boosting equipment because the capital markets are so underdeveloped. State holdings provide them with money that they cannot get elsewhere.

Yet this clever version of state capitalism is currently in danger of overreaching itself. Petrobras's discovery, in November 2007, of huge deposits of oil buried deep beneath the Atlantic seabed has filled politicians' heads with dreams of grand projects. The shift in the world's balance of power from America to China has also helped to persuade many Brazilians that the future lies with state capitalism. The result has been a burst of unwise interventionism. The government is trying to force Petrobras to use expensive local equipment suppliers despite doubts about their competence. It removed Roger Agnelli from his post as CEO of Vale despite his outstanding record. It has also taken to creating national champions through forced mergers: BRF (Sadia and Perdigão) in the food sector; Oi (which was made to buy Brasil Telecom) in telecoms; Fibria (VCP and Arucruz) in pulp and paper. Even the most sophisticated models of state capitalism are not safe from over-zealous politicians.

The new elite

These varieties of state capitalism all have one thing in common: politicians have far more power than they do under liberal capitalism. In authoritarian regimes they can restructure entire industries at the stroke of a pen. Even in democratic ones like Brazil they can tell the biggest companies what to do. In China party hacks can find themselves running the country's biggest companies (and SOE bosses sometimes get big jobs in the party). In Russia they may be running the biggest companies while also sitting in the cabinet. But there are nevertheless limits to Leviathan's power.

State-owned enterprises often have a good deal of operational freedom. Edward Steinfeld, a professor at the Massachusetts Institute of Technology who spent many years serving on the board of China National Offshore Oil Corporation, recalls that the company's relationship with its political bosses had "less to do with rigid top-down control than with mixed signals, ambiguity and even outright silence".

Such enterprises can also wield a lot of influence over their supposed political masters. China's SOEs have successfully frustrated attempts to make them pay more dividends. State-owned energy companies arguably have more influence over energy policy in state-capitalist countries than private energy companies have in liberal countries. Over a drink Russians will happily speculate about whether the Kremlin runs Gazprom or Gazprom runs the Kremlin.

State-owned enterprises are also producing a more sophisticated generation of managers: people who have learned about business in the world's best business schools, who have worked abroad and have a far less blinkered view of the world than their predecessors. Katherine Xin, of China Europe International Business School (CEIBS) in Shanghai, says that many SOEs want their managers to have a world-class business education. Baosteel has been sending its senior managers on executive MBA courses for more than a decade. It also brings in academics from Switzerland's IMD business school to provide tailor-made courses. CNPC has been sending high-flyers to get MBAs in America since 1999. Ms Xin points out that the Chinese version of the *Harvard Business Review* is a must-read in the upper echelons of state-owned companies.

Members of this new generation of managers are changing the management of the public sector, too, as they alternate between the corporate domain and government. There are currently 17 prominent Chinese political leaders who have held senior positions in large SOEs. Conversely, 27 prominent business leaders are serving on the party's Central Committee. If state capitalism allows politicians to shape companies, it also allows companies to shape politicians. ■

Pros and cons

Mixed bag

SOEs are good at infrastructure projects, not so good at innovation

THE HIGH-SPEED train journey from Beijing to Shanghai is a revelation to a visitor used to Britain's dilapidated railway system. Young women in neat red uniforms take pity on a foreigner and guide him to his seat. The train quickly accelerates to its cruising speed of 300km an hour and reaches Shanghai, 1,318km (820 miles) away, in under five hours. The new station there is a festival of sweeping curves.

The feeling of travelling so fast for so long is disconcerting. The countryside whizzes by in a blur, though the ride is impeccably smooth. Even more disconcerting for a Westerner is the feeling that he is being left in the dust. This is no prestige project for the Chinese elite. The queue to get on the train is more like a scrum. The smell of last night's alcohol hangs in the air. For many Chinese people high-speed trains are becoming a normal convenience.

A visit to the headquarters of Russian Railways can feel a bit like a voyage back in time. The guards wear the peaked hats and gruff manners of the Soviet era. A display shows the children of railway workers triumphing in chess and athletics. Vladimir Yakunin, the company's boss, started his career with the KGB. He concedes that his company is a giant of an organisation: it has 1.2m employees, 20,000 stations, 86,000km of track, a network of schools and health clinics and even an equestrian school. He also agrees that the state's influence is all-pervasive. Three white telephones next to his desk provide him with direct access to the Kremlin (he says he has a separate line to his old friend, Mr Putin). He cannot even sell one of the chairs that surround his vast table without the government's permission.

Yet Mr Yakunin is a dynamo of a man who has changed recruitment policies to attract high-flyers, introduced total quality management and brought in Ernst & Young, an international firm of accountants, to audit the books. He also points out that some of the oddities of his company, such as its schools and clinics, have been around for a century and derive from the difficulties of running a railway in the middle of nowhere. There is no such thing as pure capitalism or pure socialism, he argues; only more or less sensible solutions to practical problems.

Not as simple as it looks

State capitalists like to set China's recent successes against America's mounting failures. They add that Uncle Sam was quick to nationalise General Motors when it needed to. Anti-state capitalists argue that Russia is a Potemkin village and China a paper tiger. For instance, China's high-speed rail looked less wonderful last year when 39 people were killed and about 200 injured in a collision in China's eastern Zhejiang province, after which maximum speeds were reduced across the country.

A balanced assessment of state capitalism has to allow for three caveats. The first is that there is no clear dividing line between state-owned and private companies. "Private" champions such as Huawei, the telecoms giant, have repeatedly been given government help. This makes it hard to produce precise calculations about the productivity of the two sectors. Second, ownership is not the only thing in play. Some of the problems, and the successes, of state capitalism have more to do with rapid development than with state ownership. Third, everything depends on context. It is quite possible for state capitalism to work well in some areas (eg, infrastructure) and badly in others (eg, consumer goods). It is also possible for it to boost growth at one stage of development and impede it at another.

State capitalism's most obvious achievements are in infrastructure. China has produced a large number of world infrastructure records, such as the largest hydroelectric project, the Three Gorges dam, and 6,400km of high-speed rail. It has also scattered new airports and railway terminals across the land. Even Russia's more rough-and-ready railway system works pretty well, despite punishing weather.

BCG, a consultancy, argues that this infrastructure boom will continue for some time yet. Over the next 20 years the BRIC countries will account for more than half of the growth in road travel and more than 40% of the growth in air travel. The consultancy also points out that state institutions are well placed to feed this boom. Sovereign-wealth funds are favouring infrastructure projects to avoid the volatility of the stockmarket. Chinese companies are building roads and railways in Africa, power plants and bridges in South-East Asia and schools and bridges in America. In the most recent list of the world's biggest global contractors, compiled by an industry newsletter, Chinese companies held four of the top five positions. China State Construction Engineering Corporation has undertaken more than 5,000 projects in about 100 different countries and earned $22.4 billion in revenues in 2009. China's Sinohydro controls more than half the world's market for building hydro power stations.

It is quite possible for state capitalism to work well in some areas (eg, infrastructure) and badly in others (eg, consumer goods)

State capitalism has also enjoyed some success in tackling second-generation infrastructure problems such as building the information superhighway and mandating higher environmental standards. China's mobile-phone network is the world's largest, yet it suffers from fewer dropped calls or areas with no signal than America's. China has the world's biggest number of internet users, 420m, of whom 364m have broadband. It has also turned itself into a pioneer in some areas of green energy: it is the world's largest exporter of solar panels, for example. Big bets on green technology can easily turn into big mistakes. But generally infrastructure belongs on the positive side of the ledger.

State capitalism has also been successful at producing national champions that can compete globally. Two-thirds of emerging-market companies that made it onto the *Fortune* 500 list are state-owned, and most of the rest enjoy state largesse of one sort or another. Governments can provide companies with the resources that they need to reach global markets. They can also insist on mergers that produce global giants.

The obsession with national champions can be dangerous: mating two dinosaurs seldom produces a gazelle. But champions have their uses. They can boost national pride, they can ensure that local companies can compete for the best and the brightest with foreign multinationals and they can help emerging countries to establish global standards rather than playing by ▸▸

other people's rules. The Chinese are determined to do this with the growing market for the "internet of things".

The most interesting argument in favour of state capitalism is that it makes it easier for emerging countries to learn from the rest of the world. National champions are the corporate world's greatest learning machines. To produce them you need to study the best of the breed. And once you have them you can deepen your learning still further—by listing them on foreign exchanges (which introduces you to the world's sharpest bankers and analysts), or by taking over foreign companies (which can provide you with rare expertise). China's Geely International got access to some of the world's most advanced carmaking skills when it took over Volvo for $1.8 billion. Shanghai Electric Group enriched its engineering knowledge by buying Goss International for $1.5 billion and forming joint ventures with Siemens and Mitsubishi. Saudi Basic Industries Corporation has become more cosmopolitan by purchasing companies in dozens of countries.

All this success is producing much I-have-seen-the-future-and-it works euphoria. The bosses of state industries like to argue that they have the best of both worlds—the ability to plan for the future but also to respond to fast-changing consumer tastes. Even outsiders can sound giddy. Ms Xin of CEIBS points out that the best state companies are infinitely better than their predecessors just five years ago. China Mobile, she says, is as good as almost any of its rivals in the West. Edmund Tse, of Booz & Company, argues that the system is much more flexible than it looks at first sight.

In October 2007 China's president, Hu Jintao, unveiled his highest priority for the future at the 17th National Congress of the Communist Party in the Great Hall of the People: improving the country's "capacity for independent innovation". China had already been working hard at this. The government had invited Western champions such as Microsoft and Google to establish research facilities, instructed domestic champions to be more innovative and poured money into science and technology clusters (Beijing's Zhongguancun Science Park was already home to nearly 20,000 high-tech enterprises as Mr Hu spoke). But it needed to redouble its efforts in the future.

Other state-capitalist countries are equally keen on independent innovation. The Russian elite is excited about Skolkovo, a high-tech park-cum-enterprise-zone just outside Moscow. Skolkovo is supposed to act as a factory for indigenous technologists and entrepreneurs, a magnet for foreign multinationals, an inspiration for young people, an insurance policy against over-reliance on energy and a bridge between the scientific and the business worlds. Dubai contains a knowledge village, a media city, an IT corridor and a huge finance centre.

The downsides

Yet the odds on any of these efforts succeeding are low. Governments are good at providing the seedcorn for innovation: America's, for instance, provided some of the funding for Stanford University and even helped to found the first venture-capital company. But they are bad at turning seedcorn into bread. Josh Lerner, of Harvard Business School, describes state-sponsored innovation as a "boulevard of broken dreams", a term more often applied to the entertainment industry. Malaysia's $150m BioValley, which opened in 2005, is now known as the "Valley of the Bio Ghosts". Dubai has produced more red ink than new products. The architects of Skolkovo worry that Dmitry Medvedev's impending retirement from the presidency will doom their project before they have opened the first building.

Dan Breznitz and Michael Murphee, of the Georgia Institute of Technology, argue that the pursuit of indigenous innovation could prove to be a distraction. Foxconn, a huge Taiwanese-registered electronics group, has an unrivalled ability to mass-produce iPads and the like; it employs 270,000 people in its factory complex in Shenzhen. Huawei is a master of improving on other people's technology and bringing it to market at lightning speed. China's Pearl River delta is swimming with small companies that dominate tiny market niches. China's universities mass-produce graduates in disciplines that have been forgotten in the West, such as mining and heavy engineering. China would be better off exploiting these advantages rather than trying to build the next Silicon Valley.

Of productivity and power

There is striking evidence that state-owned companies are not only less innovative but also less productive than their private competitors. The Beijing-based Unirule Institute of Economics argues that, allowing for all the hidden subsidies such as free land, the average real return on equity for state-owned companies between 2001 and 2009 was -1.47%. Older studies suggest that productivity decreases with every step away from 100% private to 100% state-owned. An OECD paper in 2005 noted that the total factor productivity of private companies is twice that of state companies. And a study by the McKinsey Global Institute in the same year found that companies in which the state holds a minority stake are 70% more productive than wholly state-owned ones.

But poor productivity has not stopped them from making lots of money. In 2009 just two Chinese state-owned companies—China Mobile and China National Petroleum Corporation—made more profits ($33 billion) than China's 500 most profitable private companies combined. In 2010 the top 129 Chinese

SOEs made estimated net profits of $151 billion, 50% more than the year before (in many cases helped by near-monopolies). In the first six months of 2010 China's four biggest state commercial banks made average profits of $211m a day.

State companies have been gobbling up private ones. They have also been gobbling up capital. State-owned companies in China pay interest of only 1.6% when they borrow from state banks, but private ones are charged 4.7%—if they can get a loan at all. In 2009 private firms accounted for only 2% of China's official outstanding loans. The result has been an epidemic of bankruptcies and suicides in the private sector even as state companies are splurging out on extravagant new headquarters.

Those state companies have a vast appetite for talent, too. Two Chinese with recent MBA degrees explain that they chose jobs with state-owned companies because they pay more than private ones and as much as multinational ones and offer shorter hours and cast-iron job security. But they were shocked by the extravagant perks and widespread corruption they found. A Russian who is currently studying for an MBA tells remarkably similar stories. The SOEs are recreating the old "iron rice bowl" (jobs and perks for life) with modern materials.

Yet there is little chance that state companies will be reformed soon. They provide comfortable berths for leading politicians and their children and hangers-on. Institutions that are nominally owned by the people have been taken over by ruling elites—the Communist Party in China, the security high command in Russia and the royal families in the Arab world. The 99% who do not benefit from these arrangements are getting increasingly angry with the 1% who do. But unlike their contemporaries in the West they have few ways of showing it. ■

Going abroad

The world in their hands

State capitalism looks outward as well as inward

IT IS FITTING that China's national symbol should be an animal that spends 16 hours a day eating bamboo. China is an energy panda that is obsessed by the question of where its next mouthful of bamboo will come from. The Chinese elite sees the world in terms of brutal competition for limited resources. And it has no truck with Western ideas about relying on the market. ("Western countries can feel secure purchasing oil internationally because they created the system," says one diplomat. "China did not.") China is utterly convinced that it needs to use all the elements of national power—its companies and banks, its aid agencies and diplomats—to get its rightful share.

China's obsession with going out in search of raw materials has been growing for almost two decades. In 1993 the country became a net importer of oil. In 2003 it interpreted America's invasion of Iraq as a grab for oil. And in 2010 it became the world's biggest consumer of energy. This obsession has dominated foreign policy and reinforced state capitalism. A country that had been turned inward for millennia has started popping up everywhere, and has found that it can change the rules of the game. An economy that had been focused on domestic growth has engaged in a flurry of international acquisitions.

China has been striking deals across the world, often in difficult places that are shunned by the West, in order to lock up supplies of oil and other raw materials. It has an estimated 10,000 workers in Sudan alone. It has provided Russia with a $25 billion export-backed loan to help Rosneft and Transneft to supply it with 300,000 barrels per day of crude, for example, and signed a $1.7 billion deal with Iran to develop parts of the North Azadegan oilfields. China National Petroleum Corporation is one of only two companies to win contracts to develop Iraq's oilfields. And in December Pakistan named the Industrial and Commercial Bank of China to lead a consortium that will finance a $1.2 billion natural-gas pipeline from Iran to Pakistan.

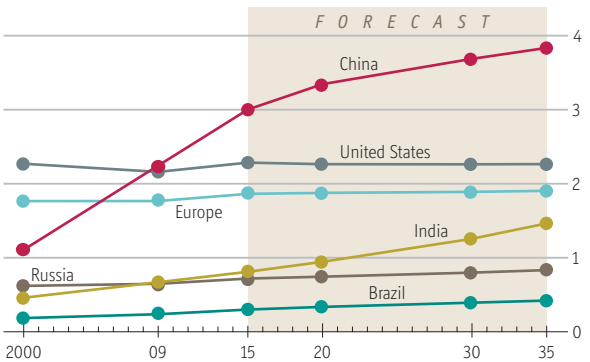
State capitalism has been at the heart of all this activity. State companies have funded four-fifths of the foreign direct investment. State banks have woven a web of soft loans. And government bodies such as Eximbank, China's foreign-aid bank, have made no bones about their enthusiasm for tying foreign aid to commercial advantage. One of China's favourite tools is oil for infrastructure. China offers to provide poor countries with schools, hospitals and the like (usually financed by soft loans and built by China's infrastructure giants) in return for a guaranteed supply of oil or some other raw material. Eximbank supplied a $2 billion low-interest loan to help China's oil companies build infrastructure in Angola.

The axis of statism

Trotsky always insisted on the impossibility of "socialism in one country". The same logic applies to state capitalism. State-capitalist powers inevitably look outward as well as inward. China is the world's biggest exporter as well as its biggest energy consumer. Russia and the Gulf states are energy superpowers. But they are also conscious that they are newcomers in a global market that was created by America and Europe. So they frequently stick together, striking deals among themselves and forg-

Voracious 4

Primary energy demand, billion tonnes of oil equivalent



Source: International Energy Agency

ing ever closer ideological links.

China and Russia have found it easier to get on with each other as state capitalists than they ever did as communists. Over the past decade they have increased bilateral trade, concluded a range of economic and trade agreements and forged a new political institution in Central Asia, the Shangai Co-operation Organisation. Energy giants such as Gazprom and PetroChina are intertwined in various convoluted ways.

China has also strengthened its links with the Middle East. The old Silk Road is being rebuilt. In 2009 the Middle Kingdom became the biggest single importer of oil from the region and the biggest single exporter of manufactured goods there. The two biggest investors in China's Agricultural Bank are the Qatar Investment Authority ($2.8 billion) and the Kuwait Investment Authority ($800m). And China is becoming a popular destination for Middle Eastern businesspeople and tourists: every year the region sends 200,000 visitors to a single Chinese city, Yiwu in central Zhejiang Province, to go shopping. The city does a roaring trade in *hijabs*, prayer rugs and electronic Korans.

More people are also taking the road in the other direction. The UAE is home to 200,000 Chinese, and Dubai boasts one of the world's biggest Chinese malls, DragonMart, built in the shape of a dragon, with 4,000 Chinese businesses.

After King Abdullah of Saudi Arabia ascended to the throne in 2005 his first visit abroad was not to America, his country's longstanding ally, but to China. President Hu, for his part, is a frequent traveller to the Middle East.

This "axis of state capitalism" is gaining an ideological edge as the emerging world goes from strength to strength, America pulls in its horns, Europe implodes and the G20 takes over from the G7. Politicians across the region feel sure they have a formula that can combine economic dynamism with order, taking in the best of capitalism (those sleek modern corporations and clever wealth funds) without unleashing the havoc that devastated Russia in the 1990s and threatened to consume America in 2007-08. Proponents of this ideology revere Lee Kuan Yew as a founding father, see America as a wounded giant and dismiss Europe as self-indulgent and lazy. But they also admire Silicon Valley and Google, MIT and General Electric, Harvard Business School and McKinsey.

The power of the axis is easily exaggerated. The Russians resent the fact that their former junior partner in the communist enterprise, China, has become so successful. They are also suspicious about China's activities in Central Asia. China, which has more than 20m Muslims, worries that the Gulf states may export radical Islam as well as oil. Some Africans fret about China's enthusiasm for building roads and railways across Africa, just as the Europeans once did. But Fu Chengyu, the chairman of China National Offshore Oil Corporation, points out that the Chinese are rooting around in Sudan and Angola only because the Western companies have nabbed the best oilfields. They are adding to the global supply of oil while putting their own people at risk (dozens of Chinese oil workers have been killed or kidnapped).

Xenophobia plays a part, but state capitalism is also finding it hard to evangelise. Indeed, many state capitalists are in denial about it. Mr Putin pooh-poohs the whole idea. "If we concentrate on certain resources, we do it only to support the industry until the companies stand firmly," he insists. The Chinese argue that their free-trading credentials are as good as those of any other WTO members.

State capitalism may not turn into a popular movement, in the way that communism and socialism did, but it nevertheless confronts Western policymakers with some difficult questions. How can you ensure that business deals involving state-backed companies are fair? In 2005 CNOOC's unsolicited bid for Unocal, one of America's largest oil companies, briefly shifted the American government's attention from the Middle East to China. Politicians thought it was a thinly disguised takeover of an American company by the Chinese government, part of a wider plot to control the world's oil supplies. The House of Representatives voted 398 to 15 for a non-binding resolution against the purchase. Six months later politicians were up in arms again when DP World, a company owned by Dubai's government that has ports in almost 30 countries, tried to add six American ones to its portfolio. DP World backed down.

Western worries

The tensions that were on display in those dramatic six months continue to operate. Western businesspeople are increasingly concerned about Chinese trade policies. Two years ago the heads of 19 of America's biggest industry associations wrote to their government to complain about China's "systematic efforts" to build its domestic companies "at the expense of US firms and US intellectual property". In July 2010 Peter Löscher, the chief executive of Siemens, and Jürgen Hambrecht, then chairman of BASF, personally complained to Wen Jiabao, the Chinese prime minister, about the way that Western companies were being forced to hand over intellectual capital in order to gain access to China's markets. The American Chamber of Commerce in China in its 2010 survey reported that a third of its member companies in China felt that they were being held back by discriminatory policies.

China's ability to make huge strategic investments, even to the point of creating entire new industries, puts private companies at a severe disadvantage

Western policymakers are worried, too. Charlene Barshefsky, America's trade negotiator at the time when China's entry into the WTO was being considered, fears that the rise of state capitalism may be undermining the post-war trading system. China's ability to make huge strategic investments, even to the point of creating entire new industries, puts private companies

at a severe disadvantage.

Peter Mandelson, a former EU trade commissioner, thinks that "the huge and very real benefits of globalisation are being undermined by the distorting interventions of state capitalism from one direction and by the anxious politics of an increasingly defensive and fearful developed world from the other." The European Union has hinted that it may block future takeovers of European companies by Chinese state-owned enterprises on the ground that all SOEs are, in fact, part of a single economic entity. And Western policymakers routinely complain that China's refusal to let its currency appreciate to its "natural" level is in effect subsidising China's domestic industry, penalising American and European companies, destroying American and European jobs and fuelling dangerous global imbalances.

It is easy to overstate the case against state capitalism. State capitalists harm mainly their own consumers when they subsidise exports, and they depress their own country's overall competitiveness when they pour money into state champions at the expense of the rest of the economy. But they have been playing increasingly rough in recent years: witness China's willingness to imprison three Rio Tinto executives for supposedly taking bribes, and Russia's treatment of BP. Learning to live with state capitalism will be a serious challenge for the rest of the world. ■

The long view

And the winner is...

For all its successes, state capitalism has fatal flaws

THE RISE OF state capitalism constitutes one of the biggest changes in the world economy in recent years. Twenty years ago state firms were nothing more than parts of the government machine. Ten years ago there was widespread doubt about whether they could succeed. Today they include some of the world's biggest companies, sucking up profits at home and taking on the world market with a will. Between 2005 and 2011 four of the world's top ten stockmarket flotations involved Chinese state companies (and collectively raised $64.5 billion).

Is state capitalism the wave of the future, or is it simply one in a long line of state-sponsored failures? Some commentators have seized on the riots in Russia in December as evidence that it is already on its way out. Others point to the continuing problems with global capitalism, arguing that the state variety is winning the war of ideas. Andy Stern, a former boss of the powerful Service Employees International Union, argues that China's economic model is superior to America's and quotes Andy Grove, the founder of Intel: "Our fundamental economic belief …is that the free market is the best of all economic systems—the freer the better. Our generation has seen the decisive victory of free-market principles over planned economies. So we stick with this belief largely oblivious to emerging evidence that while free markets beat planned economies, there may be room for a modification that is even better."

This special report has argued a different case. State capitalism is sufficiently good at mimicking the market to ensure it has plenty of life left in it. It is learning how to manage ideas from the West and impose some discipline on its favoured companies. It is also putting down ever stronger roots. There are state-capitalist banks, billionaires, bureaucrats and even paid-up ideologues (one Chinese analyst, having listed all of the system's inefficiencies, says that he gives it "no more than 50 years").

But state capitalism nevertheless suffers from deep flaws. How can the state regulate the companies that it also runs? How can it stop itself from throwing good money after bad? How can it remain innovative when innovation requires the freedom to experiment? MIT's Mr Steinfeld argues that state capitalists are learning to play "our game" by listing their shares and engaging in mergers and acquisitions. That, he says, makes them a "self-obsolescing" ruling class. But state capitalists are surely playing "our game" in order to strengthen their political positions.

The future shape of state capitalism will be determined by two things. The first is rent-seeking on the part of the corporate elite. Management theorists have long agonised about the "principal-agent problem"—the tendency of managers to run companies to suit their own interests rather than the interests of their owners or customers. Under state capitalism this problem is as acute as anywhere. Politicians are too distracted by other things to exercise proper oversight. Boards are weak and disorganised. And the company's mission tends to be a confusion of the commercial and the social.

There are plenty of examples of good practice for state capitalists to draw on. Singapore's sovereign-wealth fund, Temasek, is a model of good management. Brazil has pioneered the use of the state as a minority shareholder. Norway has successfully

shielded its sovereign-wealth fund and state oil company from political interference. But in both China and Russia the principal-agent problem is powerfully reinforced by the idea that state owned companies are great sources of jobs and patronage.

Secondly, state capitalism suffers from the misfortune that it has taken root in countries with problematic states. China combines admirable mandarin traditions with a culture of *guanxi* (connections) and corruption. Russia has the nepotism and corruption without the mandarin traditions. Brazil puts all the cards in the hands of insiders from both capital and labour. Transparency International, a campaigning group, ranks Brazil 73rd in its corruption index for 2011, with China 75th and Russia an appalling 143rd. State capitalism often reinforces corruption because it increases the size and range of prizes for the victors. The ruling cliques have not only the government apparatus but also huge corporate resources at their disposal. The People's Bank of China estimates that between the mid-1990s and 2008 some 16,000-18,000 Chinese officials and executives at state-owned companies made off with a total of $123 billion.

The defining battle of the 21st century will be not between capitalism and socialism but between different versions of capitalism. And since state capitalism is likely to be around for some time yet, Western investors, managers and policymakers need to start thinking more seriously about how to deal with it.

Too visible, too strong

Investors are currently infatuated with emerging markets because they are growing rapidly at a time when rich markets are stagnating. But for the most part those investors are blind to the risks posed by the excessive power of the state there. Companies are ultimately responsible not to their private shareholders but to the government, which not only owns the majority of the shares but also controls the regulatory and legal system.

This creates lots of risks for investors. SOEs typically have poorer cost controls than regular companies. They also routinely pursue social as well as business goals. Investors can probably live with all this because at least it is predictable. More worrying is the potential for capriciousness. Politicians can suddenly step in and sack the senior management or tell companies to lower their prices.

Western managers also find it hard to deal with state-controlled firms. They tend to fall into one of two traps. Either they treat state companies as if they were exactly the same as private ones, and get caught out when policymakers swap company bosses around or redefine industries. Or they treat state companies as irredeemably second-rate—and may find themselves bought out by them or having their markets swamped.

In the past Western firms have been on the offensive; today they are increasingly warding off emerging champions. They used to have their pick of the best and the brightest people when they went into emerging markets; now they have to compete with local champions that can offer not only similar salaries but the chance to play for the home team.

CEOs in particular will have to start paying more attention to politicians in countries with state capitalism. Over the past 30 years bosses there gained greater freedom to run their own affairs. Some of them even began to imagine that they were "running a sovereign entity", as Indra Nooyi, the boss of Pepsi-Cola, has put it. But in China and Russia ultimate sovereignty lies with the political class.

Western policymakers face even more difficult decisions than businesspeople. They will find their voices diluted as China and other state-capitalist countries play a more active role in multilateral institutions. And the rise of state capitalism in the East may encourage imitation in the West. The European Commission's directorate for enterprise and industry has mused on the need to create European champions to fight "unfair competition" from overseas. Nicolas Sarkozy, the French president, has created a French sovereign-wealth fund. Alexandre de Juniac, as chief of staff to Christine Lagarde, then France's finance minister, ascribed his country's renewed enthusiasm for dirigisme to China's influence. Japan's Ministry of Economy, Trade and Industry in 2010 named the rise of state capitalism as one of the drivers of a newly interventionist industrial strategy. Worse, the rise of state capitalism in the East may encourage a trade war as liberal countries attack subsidies and state-capitalist countries retaliate.

But state capitalism's biggest failure is to do with liberty. By turning companies into organs of the government, state capitalism simultaneously concentrates power and corrupts it. It introduces commercial criteria into political decisions and political decisions into commercial ones. And it removes an essential layer of scrutiny from central government. Robert Lowe, one of the great Victorian architects of the modern business corporation, described businesses as "little republics" that operate as checks and balances on the power of the big republic of government. When the little republics and the big republic are one and the same, liberty is fatally weakened. ■