Emerging-market multinationals

The rise of state capitalism. The spread of a new sort of business in the emerging world will cause increasing problems

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OVER the past 15 years striking corporate headquarters have transformed the great cities of the emerging world. China Central Television's building resembles a giant alien marching across Beijing's skyline; the 88-storey Petronas Towers, home to Malaysia's oil company, soar above Kuala Lumpur; the gleaming office of VTB, a banking powerhouse, sits at the heart of Moscow's new financial district. These are all monuments to the rise of a new kind of hybrid corporation, backed by the state but behaving like a private-sector multinational.

State-directed capitalism is not a new idea: witness the East India Company. But as our special report this week points out, it has undergone a dramatic revival. In the 1990s most state-owned companies were little more than government departments in emerging markets; the assumption was that, as the economy matured, the government would close or privatise them. Yet they show no signs of relinquishing the commanding heights, whether in major industries (the world's ten biggest oil-and-gas firms, measured by reserves, are all state-owned) or major markets (state-backed companies account for 80% of the value of China's stockmarket and 62% of Russia's). And they are on the offensive. Look at almost any new industry and a giant is emerging: China Mobile, for example, has 600m customers. State-backed firms accounted for a third of the emerging world's foreign direct investment in 2003-10.

With the West in a funk and emerging markets flourishing, the Chinese no longer see state-directed firms as a way-station on the road to liberal capitalism; rather, they see it as a sustainable model. They think they have redesigned capitalism to make it work better, and a growing number of emerging-world leaders agree with them. The Brazilian government, which embraced privatisation in the 1990s, is now interfering with the likes of Vale and Petrobras, and compelling smaller companies to merge to form national champions. South Africa is also flirting with the model.

This development raises two questions. How successful is the model? And what are its consequences—both in, and beyond, emerging markets?

The law of diminishing returns

State capitalism's supporters argue that it can provide stability as well as growth. Russia's wild privatisation under Boris Yeltsin in the 1990s alarmed many emerging countries and encouraged the view that governments can mitigate the strains that capitalism and globalisation cause by providing not just the hard infrastructure of roads and bridges but also the soft infrastructure of flagship corporations.

So Lee Kuan Yew's government in Singapore, an early exponent of this idea, let in foreign firms and embraced Western management ideas, but also owned chunks of companies. The leading practitioner is now China. The tight connection between its government and business will no doubt be on display when the global elite gathers in the Swiss resort of Davos next week. Among Westerners there, government delegates often take the opposite view to those from the private sector: Chinese delegates from both sides tend to have the same point of view, and even the same patriotic talking-points.

The new model bears little resemblance to the disastrous spate of nationalisations in Britain and elsewhere half a century ago. China's infrastructure companies win contracts the world over. The best national champions are outward-looking, acquiring skills by listing on foreign exchanges and taking over foreign companies. And governments are selective in their corporate holdings. Overall, the Chinese state has loosened its grip on the economy: its bureaucrats concentrate on industries where they can make a difference.

Let a thousand mobiles bloom

Yet a close look at the model shows its weaknesses. When the government favours one lot of companies, the others suffer. In 2009 China Mobile and another state giant, China National Petroleum Corporation, made profits of $33 billion—more than China's 500 most profitable private companies combined. State giants soak up capital and talent that might have been used better by private companies. Studies show that state companies use capital less efficiently than private ones, and grow more slowly. In many countries the coddled state giants are pouring money into fancy towers at a time when entrepreneurs are struggling to raise capital.

Those costs are likely to rise. State companies are good at copying others, partly because they can use the government's clout to get hold of their technology; but as they have to produce ideas of their own they will become less competitive. State-owned companies make a few big bets rather than lots of small ones; the world's great centres of innovation are usually networks of small start-ups.

Nor does the model guarantee stability. State capitalism works well only when directed by a competent state. Many Asian countries have a strong mandarin culture; South Africa and Brazil do not. Coal India is hardly an advertisement for efficiency (see article). And everywhere state capitalism favours well-connected insiders over innovative outsiders. In China highly educated princelings have taken the spoils. In Russia a clique of "bureaugarchs", often former KGB officials, dominate both the Kremlin and business. Thus the model produces cronyism, inequality and eventually discontent—as the Mubaraks' brand of state capitalism did in Egypt.

Rising powers have always used the state to kick-start growth: think of Japan and South Korea in the 1950s or Germany in the 1870s or even the United States after the war of independence. But these countries have, over time, invariably found that the system has limits. The Chinese of all people should understand that the best way to learn from history is to look at its long sweep.

But it may take many years for the model's weaknesses to become obvious; and, in the meantime, it is likely to cause all sorts of problems. Investors in emerging markets, for instance, need to watch out. Some may be taking a punt on governments as much as companies. State-capitalist governments can be capricious, with scant regard for minority shareholders. Others may find their subsidiaries or joint ventures in emerging markets pitted against state-backed favourites.

Another concern is the impact of the model on the global trading system—which, at a time when the likely Republican nominee for president wants to declare China a currency manipulator on his first day of office, is already at risk. Ensuring that trade is fair is harder when some companies enjoy the support, overt or covert, of a national government. Western politicians are beginning to lose patience with state-capitalist powers that rig the system in favour of their own companies.

For emerging countries wanting to make their mark on the world, state capitalism has an obvious appeal. It gives them the clout that private-sector companies would take years to build. But its dangers outweigh its advantages. Both for their own sake, and in the interests of world trade, the practitioners of state capitalism need to start unwinding their huge holdings in favoured companies and handing them over to private investors. If these companies are as good as they boast they are, then they no longer need the crutch of state support.