No Economic Growth Without Clear Property Rights

WASHINGTON – The almost unanimous mission statement of key International Financial Institutions (IFIs) devoted to development, along with national development agencies and their many private and public sector partners is that they are all united in a major effort *"to fight poverty"*, or at least *"reduce poverty"* around the world. Well, may be so. But if this is indeed their goal, they are not focusing on one of the most important issues –may be the most important– that prevents poor countries to get out of poverty.

Not what you think

And it is not what you think. The issue is not insufficient health care services, poor education facilities, or gender inequality. Nor is it insufficient resources devoted to international aid. It is something completely different –and perhaps surprising for both analysts and practitioners.

The issue is property rights, in fact lack of properly defined, universally recognized and enforceable property rights.

Such property rights are clearly defined and codified in modern capitalistic economies. But in most emerging countries their legal status is uncertain, very messy and confused. This creates huge impediments in buying and selling property.

Indeed it is hard and in most cases outright impossible to sell what you do not legally own. Furthermore, all these assets with no legal standing cannot be used as collateral when requesting commercial loans.

The problem is not poverty

Simply stated, in poor countries the main impediment to economic growth and therefore higher standards of living, is not lack of wealth, as in crushing poverty.

The problem is instead that most emerging markets lack the recognized legal frameworks and regulatory arrangements regarding property and its legal status that are common place in most modern countries.

According to economist Hernando de Soto, (*The Mystery of Capital*, published in 2000), the key to understanding under performing economies and therefore continuing poverty is not lack of wealth as an objective impediment.

The problem is that the existing real estate and industrial/commercial ventures assets –and the not insignificant wealth they contain– in most cases are not legally owned by those who control them. Therefore they cannot be mobilized and leveraged by their "owners" in order to spark new investments and thus additional growth. They are therefore "dead assets". And for this reason they cannot be mobilized to obtain financing that would promote significant new economic development.

A big deal

Is this lack of modern property laws and regulations shared by most developing countries really a big deal? Yes, it is.

Let me expand on this. In the U.S. in Europe and elsewhere there are clear laws that provide a legal framework for real estate ownership and related transactions. These laws regulating property rights (with universal applicability within a country) created accessible inventories of all real estate assets. They prescribe how deeds held by property owners should be formulated, what a title to a property is and how it is legally obtained. They also clearly indicate which public agencies are the official repositories of all deeds and titles. As a result, all the real estate existing within any country’s borders is properly accounted for, while all transactions (buying, and selling and more) related to it are a matter of public record.

A uniform legal system regulates property rights

The point here is that in developed countries all records of who owns what are compiled according to one standard formula, this way creating one system that captures all assets and all transactions involving them. These standardized records in turn become accessible public documents that clearly define the nature and boundaries of a property and allow anybody to reliably trace its lawful owners.

Legally owned property can be mobilized

But this is only half the story. The truly important consequence of this uniform legal treatment of property is that, by virtue of having such a system in place, real estate becomes a “live asset” that can be easily bought and sold and rented at market prices.

Most critically, property becomes an asset that can be used as guarantee and collateral for commercial loans and mortgages. Lenders can determine the market value of these assets on the basis of publicly available information regarding their size, locations and other attributes.

Furthermore, owners of large businesses can sell parts of their assets and receive fresh capital by creating corporations that own the assets and therefore can legally issue shares. This way, new shareholders can “own” a fraction of the assets controlled by the corporation without any need to subdivide the assets controlled by it.

None of this in emerging countries

In emerging countries, almost none of this exists. There are some rules regulating property; but they are not uniform and not universally enforceable. They are murky and usually recognized only in a specific locality within the country. Outsiders do not know them and do not understand them.

All this means that property cannot be easily and reliably bought and sold on the basis of market prices. Hard to buy from someone who has no clear legal title on the asset in question. The buyer has no guarantee that henceforth he will indeed be recognized as the lawful owner.

Given all this, most loans that require real estate as collateral, as well as other transactions based on the ability to offer solid guarantees to lenders or business partners, are off-limits to most property "owners", for the simple reason that most people do not "legally" own what they have.

Squatters have no rights

Let me explain. The "owners" do occupy and use property, a building for instance. May be they built it themselves. But they have no legal title to the land on which the building sits, or to the building itself. In most instances they are squatters who built something illegally. Therefore, since they did all this outside any prescribed law, they cannot use the wealth they do have and control –however modest this may be– as collateral that would be accepted by banks in order to get a loan. De Soto correctly calls these assets "dead capital'.

This is critical

Now, how important is all this? very important. Indeed, we all know that commercial credit is the yeast of all modern capitalist economies. It is really hard to think of economic growth without the lubricant and fertilizing power of commercial loans.

But almost all loans that require collateral are beyond the reach of most would-be borrowers in emerging countries. This has the effect of a huge wet blanket on economic growth. How

can a small entrepreneur borrow from a bank to finance its expanding business if he/she cannot offer any collateral? Very simple: they cannot.

Informal sector does not help

Of course, other means to obtain credit may be available within the informal economic sector, (think "loan sharks"), but they are generally extremely onerous in terms of short repayment terms and exorbitant interest rates. Therefore these instruments are in most cases unappealing.

It is clear that these types of "loans" can hardly become the main engine of economic growth serving the purpose of funding promising new enterprises, as is the case in most advanced economies where commercial loans are routinely provided by established banks.

How much "dead capital"?

And how much "dead capital", (meaning capital that does exist but cannot be leveraged), are we talking about? Well, according to de Soto's book cited above, an enormous amount:

"By our calculations, [de Soto and his team worked in several countries in order to conduct their research] *the total value of the real estate held but not legally owned by the poor of the Third World and former communist nations is at least $ 9.3 trillion".*

"This is a number worth pondering: $ 9.3 trillion is about twice as much as the total circulating U.S. money supply….It is more than twenty times the total direct foreign investment into all Third World and former communist countries in the ten years after 1989, forty-six times as the World Bank loans of the past three decades, and ninety-three times as much as all development assistance from all advanced countries to the Third World in the same period".

(NOTE: Data cited in de Soto's book goes up to the year 2000. Since then the picture may have shifted somewhat. But there has been no dramatic transformation, because in most developing countries property is still held mostly without proper legal title. Therefore, it still cannot be used as collateral for commercial loans and/or any other form of financing).

These are truly amazingly large figures. Yes, poor countries are poor. But not as poor as we would generally think. The problem is that whatever wealth most individuals hold in these countries, it cannot be used as a legally recognized asset; and therefore it cannot be leveraged. This is a major impediment to growth.

Working hard is not enough

It should be stressed that this impediment originating from lack of legal status of so much property has nothing to do with how much or how hard people work in these countries. In poor countries many people do work hard, and they do acquire assets.

The problem is all about the failure to create a modern property laws system that would allow citizens in developing countries to gain legal title to what they own, this way transforming large amounts of *"dead capital"* into *"live capital".*

Priority one

In the light of de Soto's remarkable findings, a legal/regulatory/administrative effort leading to clear and enforceable property rights should be priority one for both governments and donors who want to enhance economic growth in developing countries.

You want to eliminate poverty? Well, begin with breathing real life into (now anemic) commercial lending backed by real estate as collateral.

And this starts with creating a rational and transparent property rights legislation and system that will allow business people to **a)** gain title to what they own, and **b)** be able to borrow in order to grow their enterprises, offering their now *“live assets”* as acceptable collateral.

No Real Development Without Economic Growth – Part 2

WASHINGTON – International development practitioners focus on policies through which they can eliminate or alleviate poverty, the visible manifestation of underdevelopment, rather than planting the seeds that may foster self-sustaining economic growth and therefore true development –which is, by the way, the only proven way for any society to really get out of poverty. This *“poverty alleviation is our goal”* approach, while well intentioned, encourages the misallocation and outright waste of limited financial and human resources, all in the name of the noble cause of the “*fight against poverty*”.

Non sustainable projects

For instance, it is considered good policy to create “economic” activities in poor countries, whatever they may be, that will generate some new income for the poor. However, in the haste to make some positive changes happen now, donors all too often leave out any solid analysis of the reasonable chances for such activities to become self-sustaining after the donor initial funding and assistance is gone.

The consequence of incomplete analysis is that very substantial resources have been squandered in supporting non sustainable activities –all of them justified as honest, good faith efforts to reduce poverty. Unfortunately, quite often when the donors leave the poorly planned and under resourced activities collapse.

Focus on what it takes to produce sustainable growth

In fairness, absolute poverty creates so difficult an environment that it may very well be impossible to engineer within its confines any kind of meaningful economic enterprises. Indeed, there can be a legitimate debate about what is really at issue: "*Poverty as lack of economic development*", or "*The dreadful condition of poverty that, as such, prevents building the foundation for economic development*".

True enough, it is obvious that the sick and the hungry, societies without clean water or electricity, along with refugees displaced by conflicts, cannot possibly engage in any meaningful economic development activity.

Relief alone will solve nothing

Still, if we focus most of our resources on improving what are very bad, sometimes horrible living conditions without recognizing the absolute necessity to create at the same time indigenous economic wheels and help them turn as soon as possible, at best we have delivered some measure of humanitarian relief. To be sure, relief has a positive impact in reducing the impact of poverty, or at least its worst consequences in terms of disease, malnutrition and overall hopelessness.

But in so doing we will not have caused any meaningful qualitative transformation. Qualitative change leading to real development must include the creation of a workable process through which societies are able to chart a path towards self-

sustaining economic growth.

Poverty is reduced through self-sustaining enterprise

Contemporary examples reinforce this fact. Structural changes encompassing laws and incentives rolled out by governments in some important poor countries greatly improved the "*enabling environment*" for wealth creating activities, some of them supported by foreign investors. These policy changes have had the consequence of allowing millions (tens of millions in some large countries) to be more productive ***and thus lift themselves out of poverty through their very own engagement in wealth creation activities that in preceding times were not accessible to them***.

China and India

The different stories of economic growth in China and India in the past twenty to thirty years have been told many times.

***But it is important to stress here that the activities of donors and aid programs have had very little impact on the gigantic, systemic policy changes which fostered growth in both India and China. The key factors that unleashed huge creative energies have been economic liberalization policies that allowed and indeed encouraged people in China and India to become more productive, to invest in education and new enterprises, and make money without penalties or fear of being dispossessed*.**

in China and India significant poverty reduction has been the byproduct of almost unprecedented rates of economic growth made possible by policies that fostered the creation of new enterprises. It has nothing to do with donor-assisted policies which had poverty reduction as their primary goal.

It is all about successful wealth creation.

Donors do not like to focus on economic growth

But, somehow, the notion of economic growth as the primary goal of development does not appear to be a noble enough purpose. At least for some development practitioners, economic growth conveys the images of rapacious businessmen, outrageous profits, corrupt practices, wheeling and dealing, profiteering, cronyism, child labor, domestic and foreign exploitation perpetrated by the unchecked powerful; and –worst of all– it means accepting growing economic disparities within societies.

Some of these critiques are justified. Unfortunately, some of these problems are often part of the picture within struggling societies that just embraced entrepreneurship, at least to some degree.

It is true that economic development, while crucially important, rarely occurs in a linear, harmonious fashion, with gradual, well-distributed benefits for all. To the contrary, it is a messy affair, especially in developing countries that usually lack the well-oiled framework of laws and effective institutions that should at least limit excesses and protect people from injustice.

Economic growth is a messy process

However, the existence of significant flaws in how economic development occurs does not disqualify the basic proposition of wealth creation as a precondition for any lasting improvement in the human condition.

In fact, unless we postulate really large-scale, donor-led activities ***in perpetuity***, there is no other way to reduce and eventually eliminate poverty. There just isn’t.

But many development practitioners are unconvinced. Many of them, contemplating the negative aspects of uneven economic growth, affirm that, unless this process can be properly regulated to ensure harmonious growth and fairness, then it is better not to have it all. So there you have it: better all

poor but equally poor, if the alternative is wealth, but just for some.

Development practitioners often lack a business background

The inability to put economic growth front and center in the framing of development agendas in part can be explained by the cultural make-up of the practitioners.

The development industry is managed mostly by civil servants and functionaries who work for public donors: state-run development agencies or multilateral development institutions. In the U.S. many of them are former Peace Corps volunteers, essentially lay missionaries who see development as moral duty to help the poor.

These professionals are flanked by large, religious or lay, private charities. For all of them, development is a mission, not a policy goal that requires the mobilization of indigenous resources in an economically productive way.

Bottom line: most of them are not business people.

As a rule, all these practitioners do not know or understand business and what it takes to make economic growth happen and flourish. For many of them, their primary mission is fighting poverty. They view this as a moral, noble endeavor for the good of mankind.

Teaching people how to make a profit in a competitive environment – the indispensable lever for economic growth– is viewed as promoting self-centered and egotistical drives, therefore not at all a laudable effort. In fact many see it as morally questionable.

Poverty reduction alone will not do it

However, lacking a clear focus on economic growth as the paramount strategic objective, the goal of achieving development through poverty reduction is likely to be an

endless and quite frankly fruitless task. True, with all these efforts, the poor may become a little less poor, but they will not learn much about how to become self-sufficient through engagement in money-making enterprises.

Asia grows, while donor-supported Africa does not

Asia reduced poverty largely through the elimination of artificial barriers to economic activities, while at the same time promoting education as the ticket to gaining marketable skills, and therefore access to better jobs and a better life.

On the other side of the divide, we have the sad story of Africa as the paradigm of what has gone consistently wrong, ***despite decades of well-meaning, donor-led efforts aimed at reducing poverty and improving overall conditions.***

Whatever has been tried, it failed to create, (with few exceptions, of course), an environment in which enterprises could flourish, with the attendant positive outcomes of sustainable wealth creation activities and consequent diminution of poverty.

This massive failure, compared with the success stories driven from within Asian societies, should provide enough material for reflection on the validity of the current approach.

Still, as yet, this reappraisal has not taken place. Donors are still "*fighting poverty*"; instead of creating solid foundations for sustained economic growth.

No Real Development Without Economic Growth – Part 1

WASHINGTON – International development is generally defined by practitioners of this craft as "*the fight against poverty*". I totally disagree with this approach that focuses on poverty, the practical manifestation of lack of economic growth, instead of dealing with the real problem that I define as: "*What does it take to get sustained growth, since growth is the prerequisite for economic and social progress in all societies*"? Fighting poverty is about fighting the symptoms, the practical manifestation of a lack of economic growth. What we want is healthy, productive societies that will create more wealth, and thus more widespread well-being. More growth means less poverty.

Fighting poverty

Indeed, how an issue is defined goes a long way in shaping the nature of the efforts aimed at dealing with it. And, in this instance, the definition of both the problem and the solution is wrong. As I said above, the broad objective of the international development community vis-a-vis poor countries, (politely described as lesser developed countries), has been defined as "*poverty reduction*", or "*the fight against poverty*".

The World Bank, the most important multilateral lending institution focusing on development, is "*Working for a World Free of Poverty*". Its Mission statement is "*To fight poverty with passion…*"

So, poverty as a condition, rather than promoting sustainable policies that will allow societies to get out of poverty for

good, is the focus of donors' attention.

Public relations

To some extent, this emphasis on "*fighting poverty,* or *"poverty alleviation*" is simply public relations. It is an attempt to deflect the critiques of the anti-global movement that, years ago, while elaborating its bizarre conspiratorial theories that would capture the root causes of all the planet's ailments, bunched together the World Trade Organization, the International Monetary Fund, the World Bank, and Multinational Corporations. It defined all of them as a clique of demonic players working together to further mankind's misery in general, and the exploitation of the third world in particular.

Hence the pressure on the maligned "*development industry*" to do something in order to improve its image. It tried to do this by presenting to its critics noble institutional objectives that would humanize their institutions. *"Hey, Mr. & Ms. No Global, you are mistaken. We are the Good Guys. We are with you. We are fighting poverty. We are completely focused on helping the poor. There is no other agenda*".

Christians ethics encourage giving

Undoubtedly there are other cultural/religious factors that can help explain this "*fight against poverty*" focus. At least to some extent, the Good Samaritan attitude stems from religiously derived ethics formulated by the Christian cultures that shaped the values, and therefore policy propensities, in many of the Western countries which "invented" the development industry.

Indeed, if we go back to the roots of this humanitarian approach, we see that over the centuries within Christendom we have seen the proliferation of a vast universe of charitable initiatives –many of them organized and run by religious institutions– aimed at aiding the poor.

Within Christianity, the moral obligation to give to the poor is the other side of a parallel moral bias against excessive wealth ever present in Christian ethics. The remedy to social inequality is for the rich to give away some of their (ill-gotten?) excess wealth to the poor, sometimes called “the less fortunate”.

But, in general, the Christian moral obligation to give to the poor was never aimed at having a truly transformative economic and social impact. It was meant as a good deed that would somewhat alleviate the painful conditions deriving from a state of poverty which was, however, considered to be a permanent feature for some segments of society.

Plenty of relief activities that are not transformative

At a different level, it is difficult to evaluate the deep motives of modern day wealthy philanthropists who contribute to relief initiatives, whether defined as “poverty reduction” or otherwise. But it would appear that the likes of Bill Gates fall pretty much in the same category of those who attempted to redress and alleviate.

For instance the children immunization goal pursued, no doubt very competently, by the Bill & Melinda Gates Foundation, noble as it is, taken by itself, is not transformative. True enough, immunized children in Africa will not die of common diseases. But chances are that, unless other critical changes will take place within their societies, they will be alive but still condemned to a miserable (and short) life of abject poverty.

(This approach based on partial interventions that do not help economic development may be changing. The Gates Foundation and other wealthy donors are now shifting to initiatives aimed at fostering the creation of opportunity in poor countries, for instance through upgrades in education. They begin to appreciate that a new mind set, new values and new skills can and should be the foundations for wealth creation activities that will help transform these societies).

Poverty as "bad luck"

More broadly, the issue of poverty is really not well understood in Western Christian culture. So much so that it has been explained away. Historically poverty has been regarded as a product of bad luck for some that can and should be somehow mitigated through faith-inspired charity performed by the rich. Indeed, even today in polite company in the Western World the poor are often described as "*the less fortunate among us*".

Let's think about it. We, the well off, "*have*" because we have been fortunate. The poor, alas, less so. Again, words have meaning. According to this definition, our economic station in life is determined by having been more or less *"fortunate".* Which is to say that the possession of material wealth is all about random distribution of luck. The poor happen to be poor because –look at that– they have been less fortunate than we have.

Successful capitalism has nothing to do with luck

At some level this is true, especially in the case of children. Some are born in rich circumstances and some are born poor. Clearly those who were born in privilege have an enviable head start in life.

But this is only a small slice of reality.

***Please, consider this. Most millionaires in the U.S. are self-made people, as opposed to being mostly "lucky" beneficiaries of inherited wealth*.** This means that an open economic system, protected by laws and independent courts, free institutions, transparent rules and no artificial barriers to entry, encourages people to try and forge a better life for themselves.

It is abundantly clear that all this has nothing to do with "*being fortunate*". And yet the use of these misleading definitions distracts us from confronting the real issues.

Poverty will be eliminated through successful enterprise

Poverty is mostly about the bad combination of lack of education, lack of capital and economic opportunity, and lack of entrepreneurial drive – all of them necessary preconditions to start and fuel wealth creating activities.

If we do not tackle these issues –education, opportunity, entrepreneurship– by creating at least an embryo of the institutional eco-system that opens up opportunity and by instilling the will and the ability to create enterprise, we shall continue to provide humanitarian relief to the poor, without offering a realistic new path to growth.

Borrowing from the old story about the qualitative difference between giving somebody a fish and teaching them how to fish, to date the fish hand outs continue, while the fishing schools are scarce, or non existent.

The eco-system

Even the most superficial analysis shows that wealthy societies did not become wealthy because of random circumstances; because people who live there won a major lottery.

Leaving aside all the defects of capitalism, at a macro level capitalistic economies have been successful because the institutions created by capitalistic societies allowed –or better yet promoted– a reasonably good functioning of the engines of wealth creation mobilized and run by private initiatives. As a result of the productive activities created through these engines, poverty, at least extreme poverty, has been eliminated.

Which is to say that prosperity is the outcome of a mind set focused on wealth creating activities on the part of many inventors, innovators and risk taking capitalists. They create the businesses that create employment and therefore more prosperity. The aggregate outcome of all these efforts, consisting in a vastly improved standard of living for most, has nothing to do with "being fortunate". it is all about being creative, industrious and persistent.

Relief as opposed to growth

But this is not how the issue is framed by the development community. The development practitioners have identified *"poverty elimination or reduction"* as the core development mission.

In so doing, wittingly or unwittingly, they focus (*and make us focus*) mostly on the effect of lack of economic development (poverty) and what we should do about alleviating it through donations and relief activities, rather than on a credible way out of it that can only be centered on a viable economic development agenda fully owned and promoted by the people who live now in poor countries.

(*See the rest and conclusion in Part 2, to be posted tomorrow*)

How The US Fed Damaged The American Economy

WASHINGTON – I indicated a while back that whoever would be elected President of the United States on November 8 –Clinton or Trump– it was unlikely that she or he would have the fortitude and the political backing enabling her/him to seriously focus on the real, yet silent systemic crisis affecting the U.S. economy: ***artificially depressed interest rates***. I still hold this opinion.

Financial and economic distortions

Let's look at the issue. We are now dealing with the consequences of several years of Fed-mandated zero interest rates policies, or ZIRP. These policies have created enormous distortions affecting now the entire fabric of the American economy, its economic policy making process, and financial markets. What started as extraordinary monetary easing in order to mitigate the risks of a post-2008 financial meltdown, morphed into a real monster.

Unprecedented predicament

No, we are not necessarily on the proverbial edge of the abyss. The world is not coming to an end. At least not today. Nonetheless, a sad combination of wild (and prolonged) experimentation on the part of the Federal Reserve –way beyond the limits of reason– and a mixture of political cowardice, ideological infighting, and intellectual void on the part of the Congress and the Obama White House created this truly unprecedented hazard.

Fed policies now drive markets

After years of zero interest rate policies, the US Federal Reserve managed to accomplish something quite unique. Its policies on interest rates –and not economic fundamentals– now determine in large measure investment decisions, and therefore assets valuations.

Disconnect between the economy and markets

Put it differently, prices of major assets, stocks first and

foremost, no longer depend mainly on how the U.S. economy and the world economy are actually performing. They are largely dictated by Fed's policies and its perceived future moves on interest rates. Which is to say that Fed moves now determine asset prices. And so we have had and are still having today an almost total disconnect between the actual conditions of the economy and the valuations of basic economic assets. Investors follow Fed mandated interest rates. They base their investment decisions on Fed moves, and not on corporate performance. This is most unhealthy.

This obvious divorce between market valuations and underlying economic realities this time is not about market speculators. This is not yet another bubble created by crazy investors. This is a Fed-engineered disconnect between the real economy and financial markets. The Fed did this. yes, the Fed, the once revered custodian of national financial integrity.

Markets follow the Fed

Simply stated, several years of interest rates repression induced (forced?) most investors seeking a return on their capital to migrate to stocks, whose valuations are now inflated, because that's what everybody is buying, since there are no other realistic investment choices.

As a result of this unprecedented distortion, stock prices now are not affected –as they should be– by expectations on future corporate performance and sector strength. No, they are affected mostly by speculations on what the Fed may do next. It is now accepted as a "normal" phenomenon that US stocks respond with sudden swings to any hint of significant changes in interest rates policy by the Fed.

In other words, these days stock valuations respond mostly to developments that have nothing to do with the real economy.

How did all this begin?

Well, and why did the U.S. Fed get into this crazy game? At the beginning, in the immediate aftermath of the Great Recession of 2008, it was all done with good intentions. Fed officials were hoping that by pushing interest rates down to zero, and keeping them at zero for a while, both corporations and individuals would gain confidence and have an extra incentive to borrow more and therefore kick-start into higher gear the wounded US economy struggling to come back after the horrible 2008 financial debacle.

Strong medicine

It was hoped that this strong monetary medicine would help, giving time to the slow-moving US Government to concoct market-friendly reforms, (such as lower corporate taxes, streamlined regulations), aimed at creating a more pro-investment, pro-growth policy environment.

And here is where everything went wrong. The U.S. Government, torn apart by bitter partisan politics, has done practically nothing. Since the end of the Great Recession nothing, absolutely nothing, has been done to reform federal spending, this way "bending' the curve. Likewise, nothing to reform and simplify the horrendously complicated U.S. tax code, with the goal of making it more business friendly. Nothing to improve the fundamentals of the U.S. "economic eco-system" in order to encourage new enterprise creation.

Sure enough, after massive stimulus ordered by Washington financed mostly by issuing bonds, (read: more debt creation), the U.S. economy rebounded. But it has been a feeble recovery, with unimpressive growth.

Weak economy, strong markets

And yet, despite all this, the stock market shot up. While this year Wall Street growth has been modest, it is clear to most observers that current valuations are not justified by the performance of the real economy.

While consumer spending is relatively healthy, the fundamentals of the U.S. economy are not good. There is very little new investment, while increased amounts of regulations affecting practically every economic sector suffocate existing small businesses, at the same time creating disincentives to new business formation.

Here is the monster

And so, here is the monster. America has at best a mediocre "doing business" environment. Our public finances are in a dreadful state, with more debt added to already historically high debt. There is little new investment, while more small businesses close down than new ones are established. In other words, the real economy is either stagnating or slowly declining, (at least in some sectors). And yet, the stock market has done great, mostly because of Fed policies.

What we got, after years of ZIRP, is a horrible distortion, whose ramifications we do not even begin to appreciate.

Gradual adjustment?

The rosy scenario is that the Fed finally would see the danger of the effects of its policies. Therefore it will slowly jack up interest rates, this way allowing time for investors to devise and implement a gradual and orderly reallocation of capital. While this readjustment takes places, the stock market will experience some corrections. But nothing terrible will happen, as investors will have time to make the appropriate portfolio diversification.

But what if it all happens in a sudden big burst? What if the hoped for incremental correction turns into a stampede? What if trillions of dollars now invested in obviously inflated stocks are vaporized in a matter of hours?

"Rewired markets"

So, here is the thing. Just like a sorcerer apprentice, after 2008 the Fed went into uncharted territory, hoping that zero interests would work like the magic trick that would revive the moribund U.S. economy. Worse yet, even though the magic did not happen, The Fed kept on this ZIRP course for many years. This prolonged intervention “rewired markets”. It created new, and truly unhealthy, incentives for financial markets. They now respond mostly to Fed signals, as opposed to economic fundamentals.

And there is more. Corporations now respond to short term financial incentives. Many of them do not make long term investments. Indeed, it is a lot easier to support your market valuations through stock buy backs funded by money borrowed at practically zero interest than to plan growth strategies that require real capital investments.

How do we get out of this?

And now, to make a bad situation really treacherous, the Fed does not know how to extricate itself from the trap it created for itself and the entire U.S. financial system. Leaving interest rates near zero for much longer is a really bad idea. However, the danger now is that any action that may be read by the market as a quick return to historic interest rates may give the signal to a chaotic exit from artificially priced shares.

No help from policy-makers

As for getting any real help from policy-makers, forget about it. On November 8 we had the end one of the most acrimonious and divisive presidential campaigns in recent American history. President-elect Donald Trump, the uncontested winner, should realize that almost half the country is still against him.

This is not an auspicious beginning for a new President who should instead have the political flexibility deriving from a strong mandate. Trump needs to engage both the Nation and the Congress in order to put in place, as soon as possible, a new fiscal, economic and tax policy environment finally conducive to real investments and real growth.

What is the end game?

While few policy-makers will say this in public, it is clear that the U.S. economy looks reasonably healthy mostly because it is on Fed-administered monetary drugs. The current high stock market valuations are illusions. At some point this whole thing will fall apart. How fast and how dramatically, is anybody's guess.

First Comes Growth Then New Jobs

WASHINGTON – Every day I walk by a giant banner hanging from the U.S. Chamber of Commerce imposing building in Washington, DC., located near the White House. The banner says: *"Jobs & Growth"*. On the face of it, nothing wrong with this statement. Of course we all want to have more jobs and more growth. if both things happen, we shall all be better off as a nation.

Jobs and Growth

So, we all agree. Still, the way in which the proposition is phrased reveals a profound error which, I believe has been purposely introduced in this "Jobs & Growth" slogan purely for political reasons.

Let me explain. Of course we want "Jobs and Growth". But in the real world the two elements are sequenced exactly in

reverse order. First you have economic growth, and then, because of additional demand and additional capital becoming available thanks to higher growth, companies can create more jobs.

First growth and then Jobs

In the real economy, real jobs do not just happen because someone wants to. In the real economy new jobs are justified by new demand usually tied to an expanding economy, i.e. *the new jobs come along because of higher growth.*

But the U.S. Chamber of Commerce, (whose motto is, by the way, “The Spirit of Enterprise” and not “The Spirit of Jobs Creation”), chose to put “Jobs” first on its gigantic banner, even though this is illogical and untrue. And why did they do this? Because this is the politically correct phrasing.

In our distorted world the social benefits of higher growth –new jobs– have to come first, before growth itself. And so, “jobs creation” becomes a political imperative, somehow disconnected from the economic fundamentals –new growth– that should instead be at the foundation of new jobs.

Politically correct

And so the U.S. Chamber of Commerce, this bastion of free market capitalism and rugged enterprise, has now joined the herd of the politically correct who have to tell you that their primary policy goal is of course to have better social outcomes –more jobs– irrespective of the economic fundamentals.

In the USSR everybody had a job

Well, unless we all forgot, in the good old Soviet Union there was full employment. Everybody had a job. Officially in the old Workers’ Paradise there was zero unemployment. And yet, as we all know, things did not go so well under Communist Party mandated full employment. And this was because most jobs were fake, unproductive jobs. Yes, you can create jobs. But, unless they are tied to real demand for more high quality products and services, they will add nothing to the economy, while salaries paid to unproductive workers will waste scarce resources.

Government jobs in Saudi Arabia

In our time, we have the example of Saudi Arabia, an oil rich country in which almost the entire population has a government job or subsidy. Most of these "workers" do practically nothing. But it is politically expedient for the Saudi government to burn cash (derived from its gigantic oil revenue) paying salaries for fake jobs. This is viewed as a way to keep the population reasonably happy, and therefore quiet.

Governments create fake jobs

Despite the gigantic failures of all socialist systems, in western societies politicians and interest groups routinely try to get on the good side of voters by proclaiming that before anything else they are committed to better social outcomes: i.e more jobs, whatever the underlying economic fundamentals.

And, in many cases, if the private sector fails to deliver this socially desirable outcome, the government will step in, creating fake (subsidized government) jobs that will make at least some people happy. Needless to say, unproductive jobs are a drain on society's resources. But who cares anyway? the goal is to create more employment, making more people happy.

Much to my surprise, a quick internet search proved that this U.S. Chamber political correctness about jobs first, growth later is by no means an isolated phenomenon. Variations on the "Jobs & Growth", with "Jobs" always placed first, are common place.

Deliberate efforts to place jobs ahead of growth

Interestingly enough, a major EU Commission initiative was promoted under the banner of *"Jobs, Growth and Investment"*. Think of that: *Jobs* come first, while *Investments* come last. Really? Is this how things happen in the real world?

However, the second line of the title reversed the sequencing to its proper order. Indeed, the second line, said "*Stimulating investments for the purpose of jobs creation*". So, the first line (in big, bold letters) is the crowd pleaser: *"Jobs for everybody, folks! That's what we are going to deliver".* So jobs first then growth and then investments.

Mercifully, the language in the smaller print of the second line recreates the proper sequencing: first you need investments, investments lead to higher growth, and, yes, higher growth leads to more jobs. So, in the same headline two mutually exclusive propositions. This is the EU way to make everybody happy, I guess.

Interestingly enough, the World Bank convened a high level meeting to determine which comes first, jobs or growth. And I thought that the place was run by sophisticated economists. Well, in that meeting it was observed that, especially in emerging countries, quite often more growth does not create more jobs. And this is true.

Sometimes growth does not create jobs

Indeed, when I was working in Mozambique, many years ago, there was the case of a brand new large investment that led to the construction of Mozal, a state of the art aluminum smelter. For poor Mozambique this seemed a big deal. A new large smelter. Except that this large investment created practically no new jobs for a horribly poor country with massive unemployment. Which is to say that higher growth does not necessarily lead to more jobs, especially in poorer countries.

Still, while this is true, in most cases new “real” jobs are the result of higher growth. I fail to see how it can be possible to create more sustainable jobs without new growth. Who will create these new jobs not tied to increased demand? Where will the money necessary to pay salaries come from? How would a for profit private enterprise justify paying for new jobs divorced from real demand? jobs that cost money without producing any real value?

Political jobs

It cannot be that hard to come to the conclusion that jobs untied to objective economic circumstances are essentially political jobs. Therefore they are a gimmick. And if we want this gimmick to be the economic new policy, I cannot see how this can be a good thing.

Still, the large interest groups, including bastions of capitalism such as the US Chamber of Commerce, have to say the “right political thing”, even though it is both false and misleading. However, in so doing, they help perpetuate a state of intellectual confusion among the general public.

Give me a job, now

Of course, if you are not an economist and you are told by supposedly smart people that it is perfectly possible to have jobs first and growth later, then you will demand that politicians will make jobs happen, now.

And if they don’t, they will be punished at the next election. And this is how populism undermines capitalism, the only system that –with all its shortcomings– over time can deliver both: growth and jobs.

Can Brexit Be Reversed?

WASHINGTON – Looking at the reactions of sadness and disbelief in Britain to the results of the Brexit vote, I am beginning to feel that the end of this England/EU tragedy (farce?) has not been written, yet. (On this, see also Gideon Rachman's reflections in The Financial Times). By that I mean that a new London-Brussels compromise may be negotiated and struck that will allow Britain to stay in the EU, albeit with a few new qualifications regarding its membership.

What have we done?

I say this because the British are clearly not that happy about the outcome of their vote. Based on the widespread consternation now pervading the UK, (*"My God! What have we done?*"), my hunch is that many among those who voted Leave had no idea about they were doing, and of the dire consequences of a vote that would take Britain out of the EU.

Even worse, many truly believed all the lies told by the Leave leaders regarding all the British money earmarked for Brussels that from now on would stay in Great Britain, and about how wonderful everything would be, once the UK regained its "independence" from Brussels. Most of that talk was just brazen, totally irresponsible propaganda.

No triumph

Well, what do you know, in the aftermath of this clear victory, the language of the Leave leaders all of a sudden has become very nuanced, almost timid. *"Well, there will be some financial gains, but not too many." "Yes, we shall regain control over immigration, but not total."*

In other words, no atmosphere of triumph. In fact it looks like: *"And now, what do we do? Getting out of the EU looks a lot more complicated than we thought"* .

Looking at all this, many voters are getting the feeling that by voting for Brexit they bought a dream of a “new independence” that would make everybody rich that has no basis in reality.

No more Great Britain?

Besides, the Leave front probably did not consider adequately the domestic political repercussions of the referendum outcome. With England in favor of leaving, while Scotland and Northern Ireland are strongly in favor of remaining, we have the elements of a major national dispute that may very well lead to the breakup of the United Kingdom. The possible end of Great Britain seems to be too much of a price to pay in the context of a vote that was supposed to assert British independence from Brussels.

Not a super majority

And, last but not least, while the 52% to 48% vote in favor is Brexit is clear, it is far from overwhelming. In other words, almost half the people in the UK voted to stay in the EU. And if you look at the actual number of votes cast, (only 72% of all voters participated in the referendum), in the end only 36% of the British citizens went for Brexit. A strong plurality, to be sure; but not a convincing majority.

Can this be undone?

Well, given all that, can something be done to reverse the outcome of this referendum? Something is indeed possible. It is not inconceivable that we can see in the coming weeks and months a fresh round of negotiations between London and Brussels aimed at reaching a new compromise that may satisfy a majority of British voters.

If we can assume a new arrangement whereby the UK gets a few more concessions from Brussels, especially on the number of EU immigrants it is willing to accept, it is entirely possible to have another referendum justified by the fact that the situation has changed, because now there is a new, more “favorable” UK-EU deal on the table.

If the victory for the Leave camp had been much more decisive, with a larger voter turnout, any idea of starting new negotiations leading to a new compromise and a new vote would be totally implausible. But the fact is that only 36% of the voters affirmed their wish to leave the EU. And it seems that now many of them regret that vote.

Compromise, anybody?

Can there be a face-saving compromise? Imagine a new, more favorable (for the UK) deal followed by another referendum. Great Britain decides to stay in the EU on the basis of a new arrangement with Brussels. The Brexit camp can still claim victory because better terms were obtained on account of their successful agitation. This second act may not be easy. But it is entirely possible.

I still believe that the EU is mostly a turbocharged Chamber of Commerce with vain glorious and ill-defined political unification aspirations. And I still believe that this vote in the UK highlights the lack of genuine buy-in in the “Idea of Europe” on the part of large segments of European public opinion. But tearing the whole thing down without any plan whatsoever for a post-EU Great Britain is not the best way to move forward.

The EU is not the source of all problems

Here is the thing. The UK and other EU members have deep problems. But most of them do not stem from Brussels. They are rooted in large and frankly non affordable social programs, lack of labor mobility, low levels of investments and productivity, and declining fertility rates.

The notion sold to a majority of the British public before this referendum that the country's difficulties originate from its EU membership is false and totally misleading. True enough, Brussels does not help much. But, no, it is not the source of the widespread economic suffering affecting the UK and the rest of Europe. Therefore, getting out of Europe is no cure.

Unrealistic Plans To Stop African Migration Into Europe

WASHINGTON – How can Europe stop the endless tide of poor migrants arriving daily from Africa? Very simple, argues Matteo Renzi, Italy's Prime Minister. The EU will offer a "Migration Compact" to the poor African states. Europe will provide about 60 billion euro in fresh funds for new infrastructure and other worthy economic and social development projects that will dramatically improve economic conditions, and therefore opportunities at home for the African poor. In exchange, the African governments will promise to enact measures aimed at preventing this endless migration of the poor towards what they perceive as better places to live in Europe.

A good plan?

Sounds nice, doesn't it? Since we all understand that poverty and lack of opportunity are the main drivers of this potentially endless migration, let's finance genuine economic growth and jobs in Africa, so that the poor will have an incentive to stay, rather than leave.

Yes, good plan indeed. Except that it is a really silly idea destined to fail. In fact it is so unrealistic that we can only call it dumb. I have no idea why this Migration Compact idea is even under consideration in Brussels; but it is obvious that it cannot be implemented. And even if it could be implemented, it would not produce the intended results: i.e. stop migration.

The numbers are daunting

First of all let’s look at some numbers. Africa’s total population is about 1. 1 billion people, most of them poor. Even if only a small percentage want to emigrate to Europe, that is several million. Second point, this proposed EU fund would amount to about 60 billion Euro, to be disbursed over a number of years. 60 billion Euro sounds like a lot of money. But it isn’t, given Africa’s size and population and the prevailing horrible conditions when it comes to the insufficiency or complete lack of the basics: electricity, clean water, schools, hospitals, roads.

In other words, 60 billion Euro, while not negligible money, is simply not enough to move the migration needle. Third and crucial point, several decades of failed or under performing development assistance programs aimed at Africa provide ample evidence that it is impossible to plan, organize, manage and efficiently implement large-scale initiatives involving multiple partners with diverse agendas.

Mission impossible

And this Migration Compact mega project would combine all the problems encountered in earlier occasions. Let me name just a few. There will be a huge fund managed by a bureaucracy that will be hampered by byzantine, made in the EU procedures, rather than focus on substance: i.e. funding projects. Add to this the need to create a Master Plan involving multiple backward countries that would identify projects to be funded and related time lines –all this with the full cooperation of chronically inefficient and usually corrupt African governments.

Then you would need the creation of a robust monitoring and evaluation system that would identify execution problems at every point of the continuum, (planning, project design, environmental impact assessments, buy-in by local communities, creation of project implementation units at the ministerial and local government level, and so on), and craft appropriate and timely corrective measures.

And, last but not least, you would also need the creation of a workable mechanism that would allow disbursements only to the government that are in full compliance with the rules of this Migration Compact. This means that if a government does not actively discourage migration, funding to its project would stop.

it will not work

Now, anybody who knows anything at all about the challenges involved in designing and implementing even modest development projects in Africa would tell you that this horrendously complicated mechanism will never work as intended.

Creating a Master Plan with so many stakeholders involved would take years. Many projects agreed upon, however worthy, would make no real difference in creating economic opportunity, and therefore would not create a real incentive for poor people to stay home. Disbursements would be messy and untimely. There would be a lot of waste due to poor planning and execution. There would be additional waste due to the lack of proper monitoring. And of course endemic corruption would guarantee that a significant portion of all these new money would end up elsewhere. Last but least, whatever they pledged to do, most African governments will not be willing or able to stop migrants. They simply do not have the resources to do this.

A bad idea

Anyway, you get the picture. This Migration Compact idea is a monumentally ill-advised plan. The fact that someone proposed it as a practical tool to address an endless migration crisis is bad enough. The fact that the EU is looking at it shows that in desperate times desperate people are willing to believe anything, including magic.

Endless migration wave

Here is the thing. Europe is unfortunately on the receiving end of a massive secular migration. Poor Africans want to go to Europe in the hope of finding a better life. They'll keep coming. However, slow growth Europe, unable as it is to take care of its own citizens, simply does not have the additional resources to receive and assimilate these illiterate masses. And yet, it has no solutions.

Having no solutions its leaders are inclined to debate and may be even approve the crazy dreams of a hapless Italian Prime Minister in charge of a country in which even garbage collection is often an insurmountable challenge.

Regulations Kill Enterprise

WASHINGTON – Jim Tankersley reports in The Washington Post, (May 23, 2016), that "*The recovery from the Great Recession has seen a nationwide slowdown in the creation of new businesses, or start-ups. What growth has occurred has been largely confined to a handful of large and innovative areas, including Silicon Valley in California, New York City and parts of Texas, according to a new analysis of Census Bureau data by the Economic Innovation Group, a bipartisan research and advocacy organization.*"

Death of the U.S. small company

Holman W. Jenkins writes in The Wall Street Journal (*Trump for Blow-Upper in Chief?*, May 21-22, 2016) that the Kauffman Foundation noted that there is a marked *“decline in small business entrepreneurship”* in America. Jenkins also cites a Brookings Institution report pointing out that business closures now exceed business starts in the U.S.

Well, what could be the reasons behind this rather ominous trend in what used to be the land of private enterprise? May be the cause of all this is in another fact cited by Jenkins in his WSJ piece. According to the Competitive Enterprise Institute, last year Congress passed 114 laws. But it issued 3,410 new regulations. These amounted to 80,260 pages in the Federal Registry, close to a historic record.

Regulations suffocate small enterprises

So, here is my simple theory. Whatever its intentions, the Obama administration in its effort to regulate and restrict almost every economic or commercial activity is slowly strangling U.S. enterprises, especially small and medium-sized companies that simply lack the resources to ensure compliance with this myriad of confusing federal rules. Please, do keep in mind that these companies are the true engines of the U.S. economy. These are the innovators and the jobs creators.

Killing capitalism

So, here is the thing. You do not need a proletarian or a social-democratic (Bernie Sanders-style) revolution to kill capitalism. A death by a thousands cuts inflicted by federal regulators will do just fine. It seems that government bureaucrats are quite capable of destroying capitalism on their own.

And so the most successful economic system ever devised in human history will wither and die not because of a popular uprising staged by the angry masses, but because of the suffocation caused by an avalanche of regulations that make it almost impossible for small businesses to stay viable and grow.

Italian Prime Minister Talking Nonsense

WASHINGTON – Yes, there is something to be said about optimistic political leaders who inspire their people to hang on and do the impossible, even when things do not look so good. Sometimes convincing leadership can perform miracles. Think of Winston Churchill during WWII, or Ronald Reagan in the 1980s.

The South comes back to life

Well, so what do we make of this statement by Italian Prime Minister Matteo Renzi during a recent visit to Naples? This is what Renzi said; *"If the South* [of Italy] *restarts, Italy will restart, this way becoming Europe's locomotive"*. Think of that: Italy (11% unemployment, practically zero growth for a decade) transformed into Europe's engine. And all this because of the South, (one of the most depressed regions within the EU), all of a sudden roaring into action. What do you know, in the blink of an eye Italy will be ahead of Germany!

Laughable

Is this sunny optimism or laughable stuff? Please pick the latter. The South of Italy has been and is a perennial tragedy of malinvestment, corruption, stupidity, apathy and desperation leading young people to emigrate. And please do not forget the almost complete dominance of organized crime, (Mafia, Camorra and N'drangheta), in practically all matters.

How The Economist sees it

If you want details, here is how The Economist put it a while ago:

"The south [of Italy]*grew more slowly than the north before the financial crisis. But the main source of the divergence has been the south's disastrous performance since then: its economy contracted almost twice as fast as the north's in 2008-13—by 13% compared with 7%. The Mezzogiorno—eight southern regions including the islands of Sardinia and Sicily—has suffered sustained economic contraction for the past seven years. Unicredit, Italy's biggest bank, expects it to continue. […]"*

"Of the 943,000 Italians who became unemployed between 2007 and 2014, 70% were southerners. Italy's aggregate workforce contracted by 4% over that time; the south's, by 10.7%. ***Employment in the south is lower than in any country in the European Union, at 40%;*** [bold added] *in the north, it is 64%. Female employment in southern Italy is just 33%, compared with 50% nationally; that makes Greece, at 43%, look good.* ***Unemployment last year was 21.7% in the south, compared with 13.6% nationally.*** [bold added]. *The share of northern and southern families living in absolute poverty grew from 3.3% and 5.8% respectively in 2007, to 5.8% and 12.6% in 2013."*

"Downward pressure on demand is exacerbated by the south's lower birth rate and emigration northward and abroad. The average southern woman has 1.4 children, down from 2.2 in 1980. In the north, fertility has actually increased, from 1.4 in 1980 to 1.5 now. Net migration from south to north between 2001 and 2013 was more than 700,000 people, 70% of whom were

aged between 15 and 34; more than a quarter were graduates. Marco Zigon of Getra, a Neapolitan manufacturer of electric transformers, says finding engineers in Naples, or ones willing to move there, is becoming ever harder. According to Istat, Italy's statistical body, over the next 50 years the south could lose 4.2m residents, a fifth of its population, to the north or abroad."

Add African immigrants to the mix

And let us not dwell on the dislocation and additional problems created by the tens of thousands of poor African immigrants who land in the South of Italy every year. They cause huge frictions, while straining modest resources. And, by the way, youth unemployment in the South reaches 60% in some regions.

OK, now we have some context within which to place Renzi's optimistic comments. Think of it for a moment: *"If the South restarts"*. This is total and utter nonsense.

Stupid statements

Given the bleak picture presented above, talking about such a *"restart"* as if it were achievable, and practically around the corner, is a bit like saying *"In a little while, when Afghanistan will be a modern industrial economy"….;* or *"Next year, after Venezuela's economy will be back on track""…;* or *"in 2017, after all of Africa will have electricity and clean water"…* For any of these highly desirable scenarios to materialize, every sane observer knows that we are talking generations, even assuming good policies and strong perseverance over decades.

Yes, it would be nice if overnight, magically…*"Pufff"*…the South of Italy became a modern Region, this way energizing the rest of the country, leading Italy to unimaginable new heights.

This is not going to happen

But no, this is not going to happen. The South is trapped in its culture of short termism, thievery, corruption, organized crime, and unbelievable levels of maladministration. The notion that one or two initiatives, and a sprinkle of investments will trigger a systemic transformation of this perennial economic swamp is not just naive, it is frankly stupid.

I am not sure why the Italian Prime Minister said this. But I find it remarkable that nobody called him on this. Nobody pointed out how preposterous all this is. No media comments. No requests for clarifications as to how this magic "restart" will materialize itself.

The Dream Of A Modern Saudi Arabia

WASHINGTON – Bloomberg Businessweek placed Saudi Arabia's Deputy Crown Prince Mohammed bin Salman on its cover (April 25 – May 1) underneath a caption that says he is *"preparing Saudi Arabia for the end of oil"*. The lengthy cover story is all about this energetic young Prince who –all alone– is determined to spearhead a series of bold initiatives and reforms aimed at re-engineering a country whose vast richness come from gigantic oil revenues, and not the skills of its citizens. Of course, being the son of the King helps a bit in what is still a top-down, absolute monarchy.

Plan to diversify the economy

The long article explains how the Deputy Crown Prince plans to diversify the economy. He wants to start selling shares of Saudi Aramco, probably the single largest oil company in the world. He would then invest the proceeds in a number of global companies. After this diversification, in the future Saudi Arabia’s economic fortunes will be less tied to the ups and downs of oil prices.

No more subsidies

At a different level, the Prince wants to cut back the vast web of subsidies provided by the Royal Family to almost every Saudi citizens. But this may be a bit tricky. It is an open secret that direct or indirect payments to millions of people are the means through which the Saudi government keeps a lid on Saudi society. In a region marred by unrest and civil wars, not much anti-government unrest in Saudi Arabia, since almost every citizen gets a regular check from the government.

Problem: no real middle class

Well, so far so good. Except for one thing. Even assuming that all these reforms will work, at best Saudi Arabia can become more efficient. But it simply cannot become a modern society the way we understand it. For the very simply reason that Saudi Arabia does not have basic political freedoms and a modern middle class that can act as the engine of self-sustaining growth.

Here is the simple truth. Except for vast amounts of easy to extract and therefore highly profitable oil, Saudi Arabia does not have a real economy. Saudi Arabia does not have a sizable educated middle class with a fair number of entrepreneurs engaged in profitable, innovative businesses.

Monarchy controls oil

Saudi Arabia is an oil Kingdom (second largest crude reserves in the world) essentially “owned” by a mostly parasitical elite. This elite, (the extended Royal Family), controls all the oil wealth. The same leadership distributes some of the oil revenue proceeds to the rest of the country, in many cases via bogus government jobs that produce no value. It is fair to say that most Saudis do not do any real work. In the Kingdom real labor is provided by foreign workers.

No modern middle class

Now, given this picture, I submit that unless these fundamentals are drastically transformed it is essentially impossible to re-engineer the Saudi society. Capitalistic economies succeed mostly because of the existence of basic political freedoms and because of a solid, entrepreneurial middle class. By that I mean large numbers of reasonably well-educated, driven individuals who engage in money-making enterprises. Their activities are supported by bankers, lawyers, accountants, marketers, public relations professionals and what not.

In other words, modern competitive economies do not exist without a vibrant middle class that can produce at least some capable entrepreneurs. These entrepreneurs understand the value of innovation. They understand competition within a rules based system fairly managed by an independent judiciary that can act as a reliable referee in case of disputes.

Oil is the only productive sector

Well, guess what, none of this exists in Saudi Arabia. And I sincerely doubt that any of this can be created –essentially out of nothing– by an energetic Crown Prince eager to modernize a rent based economy in which, with the exceptions of the few skilled people who are in charge of the highly profitable energy sector, nobody has done anything even remotely approaching real, productive work for decades.

Rules based democracy

You want modernity? Well, then you need a rules based democracy in which people really understand and agree upon the proper balance between private and public, in which all players agree that the private sector is the driver of economic growth, while all economic actors appreciate the need to have and follow clear rules. You also need a government that is efficient, open, transparent, and fully accountable. Finally, you need basic freedoms, including laws that guarantee freedom of expression, and therefore truly free media.

Tinkering is possible; but no transformation

I see none of this in Saudi Arabia. Despite formidable constraints, I can see that some tinkering is definitely possible within the existing environment. If his reforms work, Prince Mohammed may be able to make the existing system less wasteful, less corrupt, and less dependent on the price of oil. And this is a good thing.

But he cannot create a brand new country and a new Saudi society. And without these two prerequisites in place, there will be no modern country.