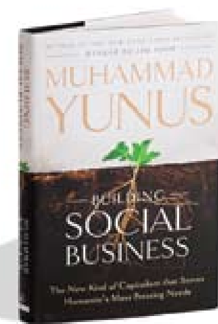
To Profit or Not to Profit: Is That the Question?

Muhammad Yunus

Building Social Business

The New Kind of Capitalism That Serves Humanity's Most Pressing Needs

Public Affairs, New York, 2010, 226 pp., $25.95 (cloth).



The poor are disconnected: from gainful employment, access to clean water, electricity, roads, transportation, calories and micronutrients, health care, education, banking, telecommunications, the Internet, justice, security. Their willingness to work remains the largest wasted resource on earth.

Connecting the poor to opportunity can be self-sustaining. More productive work will enable them to buy solutions to the challenges they face and bring them financial self-sufficiency. Moreover, these solutions involve jobs the poor can do themselves. Prosperity is thus an autocatalytic process: work creates wealth that can then be appropriated by those who work.

Building Social Business is full of examples of business ideas to overcome poverty by enhancing the value of the poor's willingness to work and by designing effective and self-sustaining solutions to their most pressing problems. (The author is the founder of Grameen Bank—one of the first microfinance organizations. Since the late 1970s it has been making small loans to entrepreneurs in some of the poorest areas of his native Bangladesh. Its lending activities now extend worldwide.) In this, his most recent publication, Yunus shows how child malnutrition can be addressed by hiding crucial micronutrients in a pleasantly flavored yogurt (Grameen Danone); how affordable shoes for the rural poor (Grameen Adidas) combat worm infections; how health services can be offered for a prepaid fee or cataract surgery for those who are losing their eyesight (Grameen Health Care).

This book is not just inspirational. It aims to create and brand a new social movement based on an entrepreneurial and self-sustaining way of addressing the problems of the poor, clearly distinguished from charity or from corporate social responsibility, neither of which is self-sustaining. But he also wants to distinguish it from garden variety capitalism—hence the book's subtitle. The point is not just to build businesses that address the problems of the poor, but to create "social businesses," where "everything is for the benefit of others. It is built on the selfless part of human nature."

Yunus carefully distinguishes his new brand of capitalism, and his enemy is the profit motive, which he says sooner or later gets in the way of serving the poor. He believes it should be banished. Just as a smoker who wants to quit must avoid even one puff or a Muslim during Ramadan must forgo the smallest snack, businesses must turn their back on profit. "Making a complete break from the for-profit attitude creates a huge and important difference for the businessperson who really wants to commit himself or herself to social change."

Yunus claims to have invented a new form of social organization in the realm of not-for-profit businesses geared toward solving the problems of the poor. He is careful to distinguish it from for-profit capitalism, cooperatives, socialism, government, charity, communism, or corporate social responsibility. He claims intellectual property rights on microcredit, although Accion International preceded his Grameen Bank by more than a decade. With an intelligent mix of donations and profit motive Accion created organizations such as Compartamos, MiBanco, and BancoSol, which have grown much more dynamically than Grameen Bank, precisely because, unlike Yunus, they did not insist on group lending or oppose profits.

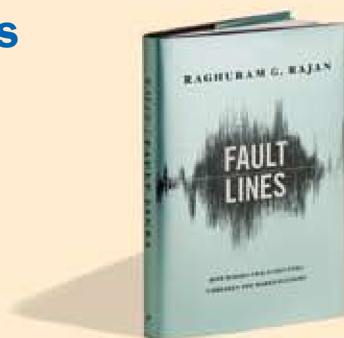
The not-for-profit brand does buy goodwill. Grameen has partnered with major corporations such as Danone (for the yogurt) and Adidas (for the shoes), whose association with Grameen has been good for their own brand. However, as things stand, these companies are limited to quaint programs managed by their corporate social responsibility departments. New billion-dollar markets would be transformational for the poor. Avoiding the profit motive restricts these solutions from truly scaling up, and passing up donations limits subsidization of activities that cannot be organized in a sustainable way.

Readers are likely to find inspiration, but should take the social movement Yunus is trying to brand with a pinch—or a pound—of salt.

Ricardo Hausmann

Director of the Center for International Development and Professor of the Practice of Economic Development at Harvard University

Between the Cracks



Raghuram G. Rajan

Fault Lines

How Hidden Fractures Still Threaten the World Economy

Princeton University Press, Princeton and Oxford, 2010, 272 pp., $16.95 (cloth)

A remarkable feature of the financial crisis is the sheer number of things that went wrong and the large number of people and institutions that made mistakes. (In Washington, D.C., the previous sentence would likely be posed as the question, who do we blame?) Former IMF chief economist Raghuram G. Rajan, of the University of Chicago Booth School of Business, in his new book, *Fault Lines*, brings together and explains the diverse failings that contributed to the crisis—the fault lines, as he puts it, that were exposed by the events of the past several years. Rajan then puts forward broad policy recommendations to ward off a future problem. Some of them, such as rectification of global imbalances, are familiar conventional advice, but others, such as an improved social safety net, are novel in the context of the crisis.

The book covers a broad group of such fault lines—indeed, this is virtually a treatise on recent macroeconomic policy issues. The problems include excess leverage and overuse of credit by Americans, global savings and capital flows imbalances, loose monetary policy, financial innovations that led to a lack of transparency, faulty compensation plans, poor lending standards, failures by the rating agencies, and inadequate government supervision of banks—and more. Rajan has particular credibility, given that in 2005 he was an outspoken voice for caution about the potential dangers of financial innovation.

Rajan adds political economy factors to the list of explanations for the crisis. He sees the spread of credit and increased household leverage as a driving force in reaction to widening inequality in the United States. Unless they were highly skilled, families suffered from stagnant incomes, which they made up for by overextending themselves.

Political factors also contributed to the overuse of leverage. In Rajan's view, the relatively weak safety net in the United States makes politicians especially keen to avoid a weak job market and thus trigger-happy with fiscal and monetary stimulus. Problematic policies, according to Rajan, include both the extended period of exceptionally low interest rates following the economic slowdown of 2000–03 and ongoing policies such as hidden government subsidies to Fannie Mae and Freddie Mac before they were placed into conservatorship by the U.S. government in September 2008. Easy monetary policy and the implicit guarantee on Fannie and Freddie debt contributed to excessive borrowing and the housing bubble and thus to financial sector fragility and the crisis. The second half of the book discusses reforms to prevent these problems, including changes to financial regulation and to market structures such as compensation incentives.

Notable among Rajan's proposed solutions is a more effective social safety net in the United States that would reduce the fear of recession and head off unduly stimulative policies that engender bubbles. If workers—that is, voters—were less worried about job loss and dislocation, politicians might have more leeway to avoid risky policies. Some say the crisis resulted from policies during 2000–03 that tried to compensate for a collapsed high-tech bubble by creating a bubble in housing. The recently enacted health care legislation in the United States would fit Rajan's broad recommendation for an improved safety net. As the health care law takes effect, it will be interesting to see if it affects Americans' sense of financial security and the direction of public policy.

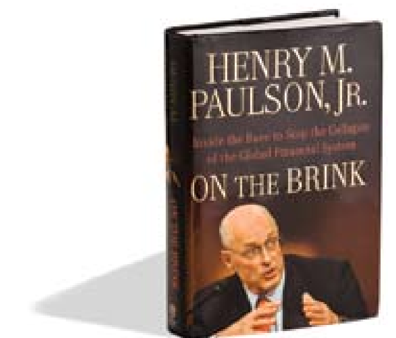
Looking further ahead, Rajan focuses on better education and training to deal with the root causes of inequality. Improved skills will mean better job opportunities and higher incomes—and less anxious policymaking to pump up economies.

Rajan's book takes a comprehensive look at what got us into the crisis and offers an intriguing approach to avoiding another one.

Phillip Swagel

McDonough School of Business, Georgetown University

In the Eye of the Storm



Henry M. Paulson, Jr.

On the Brink

Inside the Race to Stop the Collapse of the Global Financial System

Business Plus, New York, 2010, 496 pp., $28.99 (cloth).

The failure of Lehman Brothers triggered a run on the global financial system. A sharp reduction in credit availability set off a severe global economic downturn. In the United States, the downturn led to 10 percent unemployment, a 3.7 percent drop in real GDP, and a 15 percent decline in industrial production. Henry Paulson's book addresses a number of key questions raised by the collapse of the global financial services firm: why was the disorderly failure of Lehman Brothers allowed to happen? Did the authorities anticipate the risks and, if so, could they have intervened? If early intervention was impossible, could the authorities have bailed out Lehman at the last moment, as they did another investment bank, Bear Stearns, six months earlier or insurance giant AIG the following day?

Paulson was U.S. Treasury Secretary from July 2006 to January 2009: for two years in the run-up to the crisis and during the four months of initial response. This book describes that experience.

A primer of the financial crisis

The narrative offers a historical primer. Key mileposts range from the start of the credit turmoil in August 2007 and the failure of Bear Stearns in March 2008, through the conservatorship (nation-

alization) of government-sponsored enterprises (GSEs) Fannie Mae and Freddie Mac, to the collapse of Lehman Brothers on September 15, 2008 and the rescue of AIG the following day. The book also covers the policy response, notably Troubled Asset Relief Program (TARP) legislation—budgetary authority to purchase bad assets and inject equity into banks and the creation of numerous Federal Reserve facilities designed to provide liquidity for a distressed financial system.

Although the primer is useful, the book's unique contribution lies in the insider's view of the policy process surrounding the crisis. Four important issues—lessons for the future on making financial stability and crisis-resolution policy more effective—stand out.

Learning the lessons

The undesirable implications of segmented financial regulation make up the first lesson. Although the U.S. Treasury had overall responsibility for domestic finance, it could not override the operational independence of sectoral regulators. This complicated macroprudential supervision: strikingly, the news of major insurer AIG's significant distress reached the Treasury Secretary only days before its collapse, which undermined financial stability policy. Paulson recalls how the regulator of GSEs was reluctant to acknowledge their extreme undercapitalization and impose conservatorship. Similarly, he describes how the specialized regulator responsible for the troubled thrift (savings and loan) institution Washington Mutual elected to have it recapitalized—preserving its authority over the institution—rather than see it sold to a stable bank, JPMorgan. Six months later Washington Mutual became the largest U.S. bank failure in history.

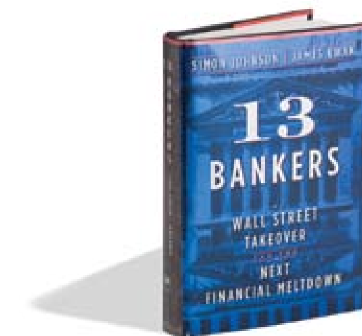
The second lesson concerns the importance of the legislature in shaping financial policy. Paulson describes how Congress was loath to acknowledge the accumulation of financial vulnerability in the run-up to the crisis, partly because of the financial sector's considerable political influence, especially the clout of GSEs—"the toughest street fighters in Washington." These observations are mirrored in recent academic literature linking political contributions to congressional votes on economic issues.

The third lesson relates to the complexities of international coordination in crisis management. It is generally acknowledged that the resolution of international banks is probably the weakest link in current global financial stability frameworks. The failure of Lehman Brothers is a case in point. The investment bank had a globally integrated business, yet its international subsidiaries had to file for bankruptcy under the rules of their respective jurisdictions. In bankruptcy, Lehman's London administrator, PricewaterhouseCoopers, froze all the firm's U.K. assets, including third-party collateral from customer accounts. That action shook investors' confidence, even in jurisdictions where customers' investment bank accounts were segregated and protected in bankruptcy, such as in the United States. Paulson describes how an unforeseen idiosyncrasy of bankruptcy rules was one of the triggers of the global financial system ruin: "Suddenly everyone felt increasingly wary of dealing with any counterparty, no matter how sterling its reputation or how long a relationship one firm had with another."

In describing the failure of Lehman, Paulson keeps returning to the gaping holes in the U.S. regulatory framework—the fourth lesson. Procedures for winding down commercial bank operations are well defined by the Federal Deposit Insurance Corporation Improvement Act, but there was no comparable authority for investment banks, insurance companies, and large hedge funds. The government could not intervene by injecting more capital if one failed, even in the event of systemic consequences. The Federal Reserve could in theory make an emergency loan to any institution, but only if the loan was "secured to its satisfaction," meaning there was only minimal risk of credit losses. So why was Lehman allowed to fail while Bear Stearns and AIG were saved? Paulson maintains that Lehman's genuine lack of collateral it could have pledged to the government in exchange for rescue distinguished it from other institutions. This analysis remains controversial, but Paulson's view from the center of the breaking crisis provides an important perspective.

Lev Ratnovski
Economist, IMF Research Department

Who's Afraid of Big Bad Banks?



Simon Johnson and James Kwak

13 Bankers

The Wall Street Takeover and the Next Financial Meltdown

Pantheon Books, New York, 2010, 320 pp., $26.95 (cloth).

"Our goal today is to change the conventional wisdom about enormous banks." That's the authors' conclusion toward the end of their highly readable and provocative book. At the heart of the text is a question that is perplexing economic policymakers—what will it take to make the financial system safer and steer clear of a repeat of the enormous public intervention that was necessary to prevent a collapse of the financial system? The authors target the predicaments created by financial institutions that are considered too big to fail. The moral hazard problems are well known, and Johnson and Kwak suggest that a sinister undercurrent is at play—bordering on corruption of the political and institutional mechanisms that have shaped the development of, and exercised oversight over, global financial systems—and it favors large financial institutions.

The authors tell a good story, one that features its fair share of villains and a hero here and there. Foremost among the villains are the major banking institutions. The book portrays them as the new oligarchs. They wield excessive economic power and political influence and have reaped the benefits of their too-big-to-fail status, all the while taking excessive risks with the expectation that the taxpayer will bail them out. The popularity and support for economic liberalization, the revolving door culture that propels people of influence from the public sector to major financial institutions and back again, and the presence of a few people in key positions at the U.S. Treasury and Federal Reserve helped grease the wheels of exploitation. The IMF is not spared in this critique.

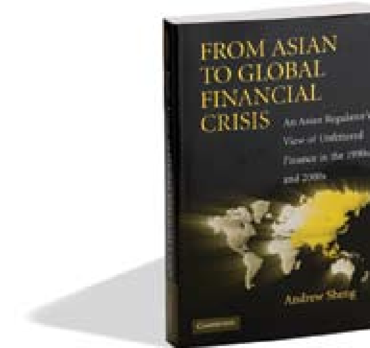
However, the authors would do well to acknowledge that many of the villains were at one time considered heroes in handling earlier financial crises and helping promote strong economic growth. No one would deny that there were mistakes along the way, and if we could scroll back and replay history, it's certain that some decisions would be retracted. The decision highlighted in the book on the regulation of over-the-counter derivative transactions is a case in point. The book suggests that these decisions may reflect the ability of the powerful self-interest of a few to sway the many, but they may have simply been the consequence of poor judgment and ignorance—we are wiser after the fact.

The timing of the book's publication couldn't have been better. Policymakers the world over have been debating how best to reform the regulatory framework for global finance, and detailed regulatory reforms are now in the works. What makes *13 Bankers* valuable is its independent perspective. A central thesis of the book is that almost everyone involved in financial regulation is captured by the nature of the process and is likely to angle the reforms in favor of major financial institutions. This argument, if true, would not augur well for achieving fundamental reform that would lead to lasting improvements. The jury is still out, and there is no doubt those responsible for crafting the reforms will challenge the authors' views.

The last section of the book, which proposes solutions, is the least developed, and that's too bad, because this is the part that could influence the policy debate. The authors favor hard limits on the size of financial institutions, prohibiting them from exceeding a certain percentage of gross domestic product. They propose even stricter limits on the size of more risky institutions. These limits would be added to the numerous other regulatory initiatives that are under consideration (on capital, liquidity, etc.). However, the book does not go into detail on the pros and cons of using size limits instead of (or in addition to) proposals to deal with systemically important institutions by imposing systemic risk charges, placing limitations on proprietary trading, and enhancing the resolution mechanisms for large institutions. How to formulate the proposed size limits and what to cover are not addressed. More in-depth analysis and discussion of these issues would have enhanced the operational value of this stimulating book and strengthened the case for including the recommendations as part of the reforms.

R. Barry Johnston
Assistant Director
IMF Monetary and Capital Markets Department

New Crisis, Old Problems



Andrew Sheng

From Asian to Global Financial Crisis

An Asian Regulator's View of Unfettered Finance in the 1990s and 2000s

Cambridge University Press, Cambridge, United Kingdom, 2009, 204 pp., $26.99 (paper).

Andrew Sheng's new book has arrived just when people need answers most. Sheng's experience in the West and East, coupled with his background as a Hong Kong financial regulator and scholar, set the stage for this deep, broad analysis of the financial crisis, seen through Asian eyes.

Unlike many analysts, Sheng injects a personal perspective that touches on comparative history, macroeconomics, and microeconomics and sets the book's framework. In my experience as an Asian journalist, I have never read a clearer nor more complete story of the 1990s Asian financial crisis, nor a more convincing analysis of the intrinsic links between that period and the current global crisis. But some readers may find Sheng's coping with the crisis as a regulator more interesting than his theoretical explanations.

Sheng shows how and why current tools and institutional structures are outdated. Among the most important topics he tackles: the relationship between financial intermediaries and regulators or governments. In his view, unfettered finance is at the core of these crises.

But the real picture is far more complex. Governments tend to over- and underregulate the financial sector simultaneously. This is especially true in Asia, the author says. The financial system needs not more but better regulation.

"Regulatory cycles must include constant reviews of outcomes against objectives. These reviews must examine how the strategy, priorities, incentives, standards, structures, processes and execution have been done in the right

dimensions and context," Sheng writes. His argument is reasonable. But how can we guarantee that this happens?

In China, such reviews may be impossible at this stage of financial system development. Regulatory capture—that is, when a state regulatory agency created to act in the public interest instead acts in favor of the commercial or special interests that dominate in the industry or sector it is charged with regulating—is common in China. What is needed now are regulators who focus on making and implementing rules, not making market choices. They should improve the trading system, monitor special interest groups, ensure adequate information disclosure, penalize offenders, and educate investors.

For posterity's sake, the Asian side of the story deserves to be told.

Yet Chinese regulators show little interest in these tasks. On the contrary, having been hijacked by powerful interest groups, they implement excessively protectionist policies in the name of safeguarding investor interests. This leads to artificial control of stock supply and demand and market distortion, which creates conditions that foster rent-seeking by listed companies, turning investors into speculators. Sheng argues that "transparency is necessary but not sufficient." That's putting it mildly. In China, transparency is only a dream.

As Sheng points out, "The key structural problem faced by Asian economies is the legacy of a relatively closed, top-down silo governance structure faced with an open, rapidly changing and complex global market." Exactly.

Sheng tells us that after the Asian crisis and the bursting of the dot-com bubble, the financial world undertook its most thorough overhaul since the 1930s in areas that spanned accounting, corporate governance, regulation, and national financial sectors. But these measures were not enough to stem the latest crisis. In fact, some of these measures may have contributed to the crisis. And the world is still seeking answers to critical questions, including those surrounding the problem captured in the expression "too big to fail."

Still, there is hope for the future of financial oversight, even though events of the recent past do not portend well for the future. The logic of the rescue plan enhances the factors that create financial crises, including the current crisis. For example, the incentive mechanism in the financial sector and the principal-agent problem are all intact, if not worse, in the rescue plans. However, Sheng is hopeful. "No financial crisis is exactly alike, but there are common elements that would, I hope, help us identify and mitigate the next one," he writes.

Our challenges are especially serious in Asia, so Sheng's Asian regulatory perspective is particularly welcome at this juncture in market history. "There are very few books about the Asian crisis by senior Asian officials who were in place during the crisis," he notes. "For posterity's sake, the Asian side of the story deserves to be told."

Sheng deserves praise for being conscious of his responsibility to history. But his most valuable contribution is that he identifies some of the major barriers to a sound financial system and points the way toward future solutions.

Hu Shuli
Editor-in-Chief, Caixin Media, and Dean, School of Communication and Design, Sun Yat-sen University

IMFSurvey

News and analysis about globalization and its impact on economies around the world.

Visit IMF Survey magazine online at
www.imf.org/imfsurvey