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State capitalism and the crisis

Despite massive state interventions in economies around the world, many corporate leaders and investors act as though globalization remains the dominant paradigm. That is a mistake.

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It's been nearly three decades since Antoine van Agtmael coined the term “emerging market” to describe the waking giants of the developing world. During that time, we've come to think of emerging markets—including the so-called BRIC nations of Brazil, Russia, India and China—as immature states in which political factors matter at least as much as economic fundamentals for the performance of markets. As globalization came to seem more and more like a historical inevitability, the assumption among wealthy nations was that the injection of politics was a temporary stage, that these developing economies would mature (each at its own tempo) into a state of grace in which economic balances, not politics, would drive local markets.

The financial crisis has turned this assumption on its head. Today, political battles weigh on economic policy making, even in the world's richest economies. Nowhere is this shift more obvious than in Washington, DC, where debates over bailouts for the auto industry, new financial rules, and individual elements of a \$787 billion stimulus package have become fodder for the partisan political blogosphere and have created complicated sets of risks and potential rewards for lawmakers and investors alike.

Both the growth of emerging markets and the determination of political officials around the world to avoid the social upheaval that the global financial crisis might generate have injected politics and political motivations into the performance of global markets on a scale we haven't seen in decades.

The rise of state capitalism

As the Cold War stumbled to a close, the belief that governments could micromanage national economies and generate prosperity seemed dead. The dynamism and market power of Japan, the United States, and Western Europe—fueled by private wealth, private investment, and private enterprise—appeared to have fully and finally established the dominance of the liberal economic model. As these countries' governments privatized businesses and pensions, companies such as Exxon Mobil, Microsoft, Toyota Motor, and Wal-Mart Stores feverishly sketched out global expansion plans. *Globalization* became a household word.

But even before the still-developing global financial crisis had shaken the foundations of faith in free markets, the determination of a new generation of emerging-market heavyweights (many of them politically authoritarian) to chart their own courses toward prosperity and power ensured that public wealth, public investment, and public enterprise would make a stunning comeback. Over the past several years, an era of state capitalism has dawned, one in which governments are again directing huge flows of capital—even across the borders of capitalist democracies—with profound implications for free markets and international politics.

State capitalism is an economic system in which governments manipulate market outcomes for political purposes. Governments embrace state capitalism because it serves political as well as economic purposes—not because it’s the most efficient means of generating prosperity. It puts vast financial resources within the control of state officials, allowing them access to cash that helps safeguard their domestic political capital and, in many cases, increases their leverage on the international stage. But state capitalism also stems the rise of globalization, because to varying degrees it hampers the flow of ideas, information, people, money, goods, and services within countries and across international borders.

The engines of state capitalism

Yet, despite the massive state interventions in economies across both the developed and developing worlds, many corporate leaders and investors act as though globalization remains the dominant paradigm. That is a mistake. In fact, the new importance of the state had become obvious well before the onset of the current crisis. Energy markets provide a good example.

The world’s 13 largest oil companies, measured by the reserves they manage, are now controlled by governments. Saudi Aramco, Gazprom (Russia), China National Petroleum Corporation (CNPC), National Iranian Oil Company (NIOC), Petr leos de Venezuela (PDVSA), Petr leo Brasileiro (Petrobras), and Petronas (Malaysia) are all larger than any international oil company. Exxon Mobil, the largest of the multinationals, ranks 14th in the world and collectively, multinational oil companies produce just 10 percent of the world’s oil and gas and hold about 3 percent of its reserves. State-controlled companies now are in charge of more than 75 percent of global crude oil reserves. Multinationals continue to hold competitive advantages in development and production of deep-sea and other technically difficult projects, but this advantage is eroding as the better-managed of the national champions learn from the industry leaders.

The story extends well beyond energy. Across a broad range of economic sectors, China and Russia are leading the way in the strategic deployment of state-owned enterprises, and other governments have begun to follow their lead. In defense, a growing number of emerging-market governments—power generation, telecom, metals, minerals, and aviation—not content with simply regulating markets, are moving to dominate them.

Such state-corporate activity is fueled in part by the emergence of a new class of sovereign wealth funds. States with large holdings in the currencies of other countries are establishing ever larger risk-taking funds meant to maximize their return on investment—and their political influence. With the global credit squeeze making funds harder to come by, sovereign wealth funds have become even more important for the financing of state capitalism.

The global recession has accelerated the trend of state involvement in markets as governments around the world spend billions to stimulate growth and bail out vulnerable domestic industries and companies. The need for political leaders of the G-20 nations to build consensus behind the establishment of new rules for financial institutions and more reliable international oversight will add to the trend. These governments may be reluctant state capitalists, forced into the role by political necessity, but the effect is the same: a bigger dose of politics in the financial markets.

Winners and losers

As the landscape shifts around them, international companies and investors will discover that the large-scale injection of politics into market processes will produce its own set of winners and losers. Because political factors unique to each state will determine the response to each domestic economic slowdown, countries with relatively strong political fundamentals will have a better shot at a quick recovery. Three decades of heady growth, for example, has given the Chinese Communist Party elite deep reserves of political capital, and a surge of national pride has helped the leadership ease public fear, fend off criticism, and shift blame for the slowdown onto corrupt Western capitalists. Given the vast sums its government can spend on fiscal stimulus, China will likely emerge from the global recession before most of the developed world. This will further persuade the Chinese leadership that state control of much of the country's economic development is the most reliable path toward prosperity—and, therefore, domestic tranquility.

In Brazil, President Luiz Inácio Lula da Silva has over the past several years forged a durable consensus in favor of disciplined macroeconomic policy. His ability to maintain both high approval ratings and strong fiscal balances will help his government stimulate Brazil's economy through both state spending and openness to foreign investment.

Other governments face a rockier road. In Russia, a sharp economic slowdown could expose fault lines within the ruling elite, which may polarize policy debates and trigger large-scale capital flight. We've already seen limited levels of unrest in the Russian countryside, where some workers have lost their jobs and others continue to work without regular paychecks. In Ukraine, toxic rivalries among the president, prime minister, and primary opposition leader have largely paralyzed the country's parliament. In Pakistan, a coalition government with far more rivals and enemies than partners and friends won't have the time or space to implement needed reforms that would save an already demoralized public from still more near-term hardship.

What else can investors and business leaders expect from this trend? Many economists suggest the recovery from the global slowdown will be a slow one—and there are political factors that favor this view. As Democrats and Republicans in Washington, fractious lawmakers in Brussels, the champions of competing industry groups in Beijing, the leaders of powerful Kremlin factions in Moscow, and political officials in Delhi make more of

the key decisions on how, when, and where assets will be valued and resources allocated, we're bound to see a higher level of policy incoherence that will weigh on future growth. There are plenty of good reasons for political leaders to intervene these days in domestic economies. If nothing else, we can hope for better-crafted rules for future flows of cash, goods, and services. But this acknowledgment cannot obscure the fact that markets do these things more efficiently and effectively than politicians do.

Second-order effects

There are other implications of these trends worth considering. We're likely to see new restrictions on the access to certain foreign markets for some companies. The politicians trying to help rescue their domestic economies aren't making choices with the global economy in mind. They're primarily interested in bolstering their personal stores of political capital by serving and protecting their most powerful constituents—be they local voters, political benefactors, or powerful industries and interest groups. They will have plenty of opportunities to favor local companies at the expense of their foreign competitors.

This is precisely why the risk of tit-for-tat protectionism will remain a serious threat until the global recession comes to an end. In the past several months, we've seen dozens of individual protectionist initiatives from the very governments that pledged during G-20 summit meetings over the past few months to avoid such moves. As governments throw up barriers to trade and investment meant to keep local workers employed through the next election, global companies doing business in those countries may find themselves at a disadvantage. Some may even face the expropriation of their assets.

In addition, given the global meltdown's potential to trigger large-scale social upheaval within several countries, politicians will turn increasingly toward a familiar and reliable tool: subsidies. Never mind that many governments may no longer be able to afford them, political officials will protect well-connected local companies, particularly while access to cash is at a premium, depriving foreign companies (and the less-well-connected domestic firms with which they sometimes partner) of their competitive edge. We've already seen this phenomenon in Russia, where the government has used state-controlled commercial banks to bail out preferred companies.

Finally, the financial crisis will encourage governments around the world to reshape their regulatory environments, changing the rules of the game for both foreign and domestic companies. Some of these changes will favor domestic firms. Even where new regulations are meant only to clarify existing rules, it will be crucial for investors and corporate decision makers to think through their implications with care.

How long can it last?

Will state capitalism completely reverse globalization's progress? That's highly unlikely. Whatever Chinese political leaders may argue, the global financial crisis has not proven

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that government-engineered growth can outstrip the expansion of well-regulated free markets over the long term. States like China, Russia, and even the very stable Persian Gulf monarchies will face tremendous pressures as internal contradictions in their development—the environmental price China continues to pay for its growth, Russia’s reliance on Vladimir Putin at the expense of credible governing institutions, and demographic challenges facing the Saudis and other Gulf states—put their economic resilience to the test. Globalization does not depend on the wisdom of political officials for its dynamism. That’s the primary reason it will almost certainly withstand the state capitalist challenge.

But the financial crisis and America’s apparent responsibility for it will ensure the growth of state capitalism over the next several years. The arc of its trajectory will depend on a range of factors: any wavering of Western faith in the power of free markets, the Obama administration’s capacity to kick-start US growth, the ability of governments dependent on oil exports to withstand the pain inflicted by lower prices, the Chinese Communist Party’s ability to create jobs, and dozens of other factors. In the meantime, corporate leaders and investors must recognize that globalization is no longer the unchallenged international economic paradigm—and that politics will have a profound impact on the performance of markets for many years to come. [○](#)

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