Cultural Comparative Advantage in the Global Economy

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Today’s agenda

- A new economic order.
  - Based on cultural comparative advantage.
  - Japan, India, Korea, China, the West

- Ethical finance.
  - A distinctive advantage of the Islamic world.
  - ...in an age of financial instability.
A new economic order

Movement toward a multi-polar equilibrium.
A new economic order

Based on **comparative cultural advantage**.

- Much more than “outsourcing.”
- Many countries have cheap labor.
- Only a few have become economic powerhouses.
A new economic order

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Such as...

- Japanese quality.
- Indian information technology.
- Korean manufacturing.
- Chinese entrepreneurship.
- Western technological innovation.
A new economic order

Japanese quality

Continuous improvement
- Group oriented, rather than requiring individual reward.
- Maintain group harmony by honoring everyone’s ideas.
- Long time horizon.
- Nemawashi

Hanko stamp
Traditionally a part of nemawashi
A new economic order

- Superior operations management
  - Just-in-time inventory management
  - *Kanban* systems minimize rework, maximize flexibility.
  - Lean manufacturing, reduced setup times.

Toyota factory in Japan
A new economic order

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- Outgrowth of *keiretsu* (formerly *zaibatsu*).
  - Old-boy networks, trust relationships.
  - *Keidanren*.

Toyota factory in Japan
A new economic order

- Indian information technology
  - Pantheism vs. secularism
    - No need to maintain & manipulate nature.
    - Other coping mechanisms
  - Inner discipline
    - Get control of one’s mind rather than the environment.
    - Modern form: intellectual discipline, academic competition.
A new economic order

Networking.

- Efficient way to absorb technical knowledge.
A new economic order

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A new economic order

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- Example: Software development.
  - No need for technology, but well equipped to create it.
  - Create an orderly world of the mind rather than externally.
A new economic order

- Indians see themselves as Westernizing/globalizing
  - There is a reliance on rationality, as in the West.
  - But Indians are leveraging their own cultural traits.
A new economic order

- Korean Manufacturing
  - Initially an imitation of Japanese *zaibatsu.*
    - High power distance culture allowed Park Chung Hee to create the *chaebol.*
A new economic order

- Korean Manufacturing
  - Initially an imitation of Japanese zaibatsu.
    - High power distance culture allowed Park Chung Hee to create the chaebol.
  - Cozy relationship between leading industrial families and the government
    - Allowed Korea to build major private corporations in a relationship-based culture.

Park Chung Hee
Korean dictator 1961-79
A new economic order

Loyalty to the boss.

- Paternal relationship.
- Bottom line and short-term profitability are secondary.

Korean chaebol
A new economic order

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- Highly disciplined, hierarchical groups.
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Korean chaebol
A new economic order

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- Highly disciplined, hierarchical groups.
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- Highly competitive, masculine culture.
  - Strong national solidarity.

Korean chaebol
A new economic order

Chinese entrepreneurship

- A cultural trait of coastal Chinese
  - Particularly speakers of *Yuè* (Cantonese), *Mǐn* (Fujianese), and *Wú* (Shanghaiese) dialects.

Guangzhou
A new economic order

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Guangzhou
A *new economic order*

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- Self-esteem tied to wealth and status.
  - “To be rich is glorious” (Deng Xiaoping).

Guangzhou
A new economic order

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Masculine culture, competitive.
A new economic order

Relationship-based business.

- Family-based investment financed Chinese economic growth.
- Guānxì is a time-tested mechanism.
- World’s largest economy for 8 of last 10 centuries.
- Now world’s largest again (in PPP) as of January 2015.
A new economic order

Making inroads into South America, Africa, Middle East.

- More comfortable with Chinese relationship-based business style than Western rule-based transparency.

Qatar Chamber Acting Director General Saleh Hamad Al Sharqi receives Chinese business delegation, Sept 2015
A new economic order

- Western technological innovation
  - Disenchantment of nature.
    - Opened the way to manipulation of a secular world.
    - Greek rationality.

Max Weber
Father of sociology
A new economic order

Western technological innovation

- Disenchantment of nature.
  - Opened the way to manipulation of a secular world.
  - Greek rationality.

- Technology as coping mechanism
  - Controlling the environment rather than oneself.
  - Support from family, friends less important.

Max Weber
Father of sociology
A new economic order

- **Individualism.**
  - Individuals have the right to rethink everything.
  - Students asked to reason from first principles.
  - Do experiments, prove theorems.
  - Individual expression, originality valued.

- **Payoff:** new ideas for technological coping mechanism.

Michael Faraday

Discovered electromagnetism, basis of modern world
Cultural deglobalization

Driven by economics

- Successful countries tap into their distinctive cultural traits for economic success.
  - They may see themselves as Westernizing.

Infosys, Electronics City, near Bangalore
Cultural deglobalization

Driven by economics

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- What about the Islamic world?

Infosys, Electronics City, near Bangalore
Islamic finance

- A more stable system based on ethical principles.
Islamic vs. Western finance

Problems with Western finance.
- Instability due to short-term speculation.
- Instability due to complex derivatives.
- Capital flight.
- Banks that are “too big to fail.”
Islamic finance

The basics of Islamic finance.

- The aim is not to propose or endorse any specific interpretation of Islamic finance.
- ...but to focus on the underlying ethical motivation.
Islamic finance

The basics of Islamic finance.

- The aim is not to propose or endorse any specific interpretation of Islamic finance.
- ...but to focus on the underlying ethical motivation.
- There is no claim that Islamic finance as normally interpreted is optimal.
- But it’s helpful to take a snapshot of current practice...
Growth of Islamic finance

- There are at least 300 Islamic banks and investment firms in 51 countries.
  - Manage assets according to principles of Shariah.
  - At least 250 mutual funds.
  - Growing 10-15% a year.
- Western banks now offer Islamic services.
Growth of Islamic finance

- Increased attention after financial crisis of 2008.
  - The crisis almost certainly could not have occurred under Islamic principles.
  - Islamic banks fared somewhat better than Western banks, but many had problems.
  - They had to operate in a depressed world economy.
**Principles of Islamic finance**

- Islamic finance is based on 2 related principles:
  - Risk sharing.
  - Avoidance of unnecessary risk.

- Source: *fataawa* attached to Islamic banking websites.
Risk sharing

Prohibition of *riba al-nasiah* or interest.

- It is wrong to collect a fixed and guaranteed interest rate on a loan.
  - Even to cover inflation.
  - According to most scholars, equally wrong to pay interest if it is avoidable.

- It is wrong to make money from money.
Risk sharing

Why is interest wrong?

- Lenders take too little risk and accumulate too much power.
  - Banks become “Too big to fail.”
Risk sharing

Underlying justice argument.

- Those lucky enough to be wealthy are *stewards* of the wealth rather than *owners*.
  - They are given wealth so that they can *use it* to benefit others.
  - This requires sharing risk with others.
Risk sharing

Investment is good.

- Assets should not sit idle.
  - But investment should be productive.
- Capital gains are OK.
- Stocks and mutual funds are OK.
  - If they represent halal companies
Risk sharing

Time value of money is recognized.

For example, Islamic mortgage.

- A type of *murabahah*.
- The bank buys the house you want.
- It sells the house to you at a higher price.
- You pay the bank in installments.
- ≠ interest.
Risk sharing

Avoid preferred stock.
- Priority in payment of dividends.
- Not enough risk.
Risk sharing

Don’t hold liquid assets.

- Plant and equipment OK.
- Avoid excessive cash, accounts receivable and short-term investments.
  - These make money from interest.
Unnecessary risk

Avoid unnecessary risk and speculation (gharar).

- Risk that is part of life is OK.
  - Starting a business, raising a family, etc.

- Unnecessary risk is wrong.
  - Casinos, betting on horses.
Unnecessary risk

Underlying justice arguments

Life is unfair enough already.
  • It is fundamentally unfair for wealth to be distributed on the basis of chance.

Speculation is unproductive.
  • Merely transfers wealth.
**Unnecessary risk**

_transactions should be based on known prices._

- No futures.
- No options.

- These give the right to buy or sell an asset in the future at a fixed price when future market price is unknown.
Unnecessary risk

- No short selling.
  - Don’t sell what you don’t own.
  - Short selling = selling stocks owned by your broker, in hope that price will decline.
Unnecessary risk

Insurance is OK

- But should not involve interest earnings
- Insure only against necessary risk.
  - Avoid credit default swaps, etc.

- Islamic insurance (*takaful*) follows these principles.
Unnecessary risk

Invest in stocks rather than speculate.

Too much churning in the stock market.

- Day trading increases volatility.

Capital flight from developing countries.

- Asian financial crisis.
Socially Responsible Investment

Avoid companies whose “main business” is *haram*.

- Liquor, gambling, collection of interest, pork and other *haram* meat, pornography, night clubs
- In practice, some *haram* behavior is tolerated.
Many scholars recommend *purification*.

- Give to charity the portion of your earnings that is based on *haram* activity.
  - But should not count it as part of *zakat*. 
A study of what can go wrong in Western finance.

- Lack of risk sharing.
- Excessive risk.
Financial Crisis of 2008

Began with subprime mortgage loans in U.S., early 2000s.

- 20% of mortgage market
- Interest-bearing loans.
- Borrowers failed to meet normal standards.
Financial Crisis of 2008

Lenders immediately sold mortgages to big banks.

- To be repackaged as mortgage-backed securities & “Collateralized debt obligations” (CDOs)
- Lenders took little risk and neglected due diligence.
- No risk sharing.
Big banks were already highly "leveraged."

- Made risky investments with other people’s money, or borrowed money.
- If market values declined slightly, banks could fail.
- **Unnecessary risk** on speculation.
Financial Crisis of 2008

- Ratings agencies gave CDOs triple-A ratings.
  - Banks pay agencies for ratings, resulting in conflict of interest.
  - Banks sold AAA-rated CDOs to unsuspecting funds worldwide.
  - Standard & Poor’s finally indicted in January 2015.
Financial Crisis of 2008

Credit default swaps gave the illusion of security.

- $62 trillion outstanding.
- Form of insurance, but not regulated as such.
- Sold without regard to adequate capital reserves.
- **Derivatives, unnecessary risk.**
Financial Crisis of 2008

CDOs became “poison” in 2008.

- Credit froze worldwide because assets could not be valuated.
- Highly-leveraged banks collapsed, or threatened collapse.
- Banks were **too big to fail**.
- **No risk sharing.**
Financial Crisis of 2008

- Housing market collapsed.
  - Homeowners were “under water.”
  - No bailout for them, they bore all the risk.
  - Banks foreclosed on mortgages.
  - No risk sharing.
Financial Crisis of 2008

Result: Worst recession since Great Depression of 1930s.
- International scope.
- Still recovering.
Sustainable finance

There is a small sustainable finance movement in the West, but...

Also known as “ethical banking.”
**Ethics and business**

- **Basic Western assumption:**
  - Business works best when we let the **laws of the marketplace** govern.
  - Attributed to **Adam Smith** and his “invisible hand.”

Adam Smith
1723-1790
Ethics and business

Adam Smith vs. neoclassical economics

- The “invisible hand” philosophy actually developed in the 19th century.
- Smith saw ethical conduct as an essential element of markets.
- Western culture has moved away from this insight.
Ethics and business

Similar attitude toward finance.

- Italian Renaissance: Medici family overcame “antiquated” Roman Catholic prohibition of interest.
  - Built interest payments into currency exchange rates.
  - Ushered in modern era of finance.

- Finance is more efficient when market mechanisms operate.

Lorenzo de’ Medici
1449-1492
Ethics and business

However:

There is no market without rules.
The question is: which rules?
Ethics and business

However:

- There is no market without rules.
- The question is: which rules?
- Adam Smith’s answer: ethical rules.
Ethics and business

Our survival depends on ethical rules.

- Ethics is not just "being nice."
- Ethics provides the social infrastructure that make human communities possible.
- The same goes for business and financial markets.
Finance of the future

Islamic finance is unique in that it is self-consciously grounded in ethics.

- Provides a starting point for finance of the future.
- Adjustments are necessary as the world changes, of course.
- Basic requirement: a cultural recognition that finance relies on voluntary adherence to ethical norms
- ...as does everything else in life.