

INVESTORS are getting restless. With the world economy still in the doldrums, people want to know how to pick the winners of the 1990s.

Globalisation of the markets means that financial advisors are talking increasingly of which country or region, rather than which firm or sector, should benefit from the massive funds that they control. Recent favourites have been Latin America and the Asian Tigers.

The looseness in this thinking is exposing people's savings to unacceptable risks. For, according to the IMF/World Bank economists, luck plays a major part in the fortunes of countries. And financial gurus do not have a special Hot-Line to Lady Luck!

But what does the IMF mean by "luck"? The conclusion of an exhaustive trawl through the economic literature, and the performances of a large number of countries over a long period of time, arrives at the conclusion that random shocks are vital ingredients of an economy's record:

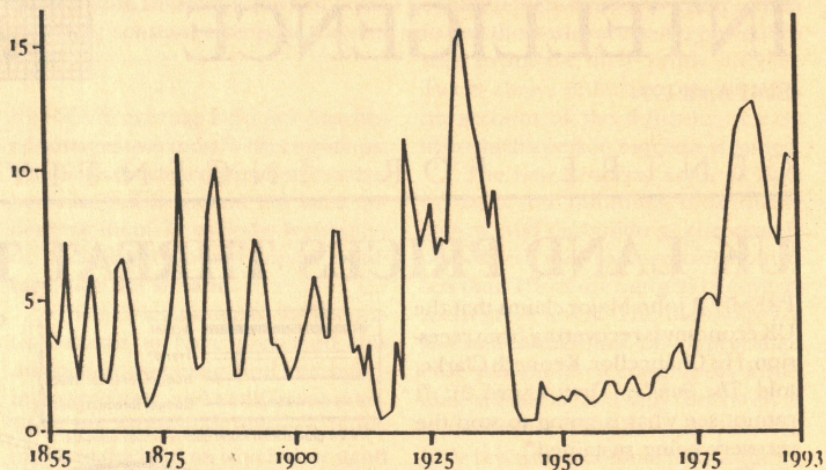
"The find that much variation in growth rates is due to random shocks should induce caution in attributing high growth rates to good policy (or to a good 'work ethic')...some so-called economic miracles are likely due to random variation."¹

The problem with random shocks, of course, is that you cannot see them coming! This is bad news for economists, who rely heavily on extrapolating the future from the data garnered over the previous three or four years. Which explains why they fail lamentably, when it comes to pinpointing turning points.

THE MAJOR problem is that economists still cannot agree on what makes the economy tick. They can describe the components of an economy, but their explanatory theories have become increasingly remote from reality. This is a central criticism levelled by Paul Ormerod, the former Director of Economics at the Henley Centre for Forecasting:

"It was only with the onset of the marginal revolution that the habit of deducing logically, from a set of rational principles, how the world OUGHT to behave, with little or no

THE SEARCH FOR LADY LUCK



British unemployment rate, 1855-1993 (%)

reference to how it did in reality, began to permeate economics."²

During the 19th century, when governments did not presume to think about how the economy ought to behave - they adjusted action on the basis of how it DID behave - the fluctuations in activity were predictable and regular. This is illustrated in Ormerod's graph of UK unemployment rates (above).

In the 20th century, however, governments decided that they were competent to "manage" the economy. Result: the booms and slumps increased in amplitude. State intervention, on the advice of economists, proved to be one of the key factors in aggravating an already unstable system.

THE STARTING point for a new approach is to figure out what causes the booms and slumps.

These crises ought to be the focal point for research because, again according to the IMF/World Bank economists, "There is a surprisingly large volatile element - transitory 'booms' and 'busts' - that has a significant effect on growth rates over periods of a decade or more."³

This "volatile element", which transforms economic fortunes and scuppers all attempts at predictions, "can be described simply as 'luck,'

[and] includes internal shocks, such as droughts, as well as external shocks, such as sudden shifts in terms of trade".⁴

This "luck" - usually, of course, bad luck! - is the Joker in the pack. A country may have durable characteristics of a cultural or resource kind, but sooner or later, it seems, these are undermined by shocks. And it is bad luck for the reputations of economists that they often make confident predictions that are falsified by the facts. Here are some examples:

- A World Bank team to Korea in the early 1960s rubbished the government's development programme as "ludicrously optimistic" because the country had performed badly in the 1950s. Korea could not achieve the 7.1% target to which it aspired, said the experts. In fact, Korea turned in a growth rate 7.3%.

- The World Bank experts took the pulse of both the Philippines and Burma, claiming that the former would be "second only" to Japan, and that "Burma's long-run potential compares favorably with that of other countries in South East Asia". Outcome: both countries were among the few that did not experience the East Asian "miracle".

- Another team of distinguished economists visited Sri Lanka in the 1960s and concluded that it would exceed Taiwan's per capita growth rate

over a 14-year period. Outcome: Sri Lanka barely grew at all (0.3%), while Taiwan clocked up a 7.3% rate.

These embarrassments did not prevent economists from building up the literature on economic development during the '60s and '70s. From on high, they read the indicators and pronounced their judgments. One of them, in a standard textbook, said that Africa had a bright future compared with Asia!

To their credit, World Bank economists Easterly and Pritchett acknowledge the record, and warn:

"The recent optimism inspired by Latin America's rapid growth in the 1970s and early 1980s, for example, led many to underestimate the risk of a debt crisis. Such mistakes could be repeated today, given the euphoric expectations for East Asia and gloomy predictions for Africa and the states of the former USSR."

Investors who want to keep some control over their money ought to be asking fundamental questions that appear to contradict conventional wisdom. Questions like: Have we seen the end of the German miracle? Is the USA misjudging its impact on Japan (see page 4)? Is Russia really the sleeping economic bear that many commentators would have us believe?

AS FOR GOVERNMENTS, they need not abandon hope of constructing policies that would smooth the economy. They need to try, but the problem is in deciding which of the policy options are appropriate.

"Our findings suggest that luck and temporary policy mistakes - as opposed to permanent policy differences - are important factors in explaining sudden changes in growth," conclude Easterly and Pritchett.

Unfortunately, the process of appraising the failures of the past has not even begun. And that is one of the

key problems for investors. If they pay too much attention to the good intentions of government - such as responding to minute changes in interest rates, or worrying about ministerial statements on inflation - they are likely to commit serious errors.

A longer-term strategy is necessary for the treacherous '90s in which the impact of deflation has changed the rules from the ones that operated in the high inflation postwar years (inflation is now down to just over 2%). And in trying to calculate trends over the rest of the decade, particular attention ought to be given to the IMF and the World Bank, whose influence has now become one of the determinants of economic uncertainty. Because of their control over loans to struggling countries, they have been instrumental in developing a standard global approach to policy formation. This is leading to a homogenised global economy, which means that if the policies are wrong, the errors are significantly magnified. You do not have to be a Darwinian to understand that competitive diversity is essential for survival. The absence of these ingredients - diversity and competition - explain the demise of the Soviet approach to life.

But the global bankers are determined to hold onto their influence through the dictation of on-the-ground policy to countries than need financial credit. Their strategy is to ring the world with a single philosophy of how the market economy works - even if that view is seriously defective.

IMF economists are embarrassed at the consistent failure of their efforts to help countries to develop onto paths of sustainable growth. So what is their response? Well, they plead for at least a weak form of international coordination. They are now talking about the need to adopt "simple, nonactivist rules" in the face of uncertainty. But

this does not seem to lessen the uncertainties, for the rules themselves serve to restrict the freedom for nations and investors to test alternative strategies that just might be more profitable than the theories that guide the advocates of orthodox economics.

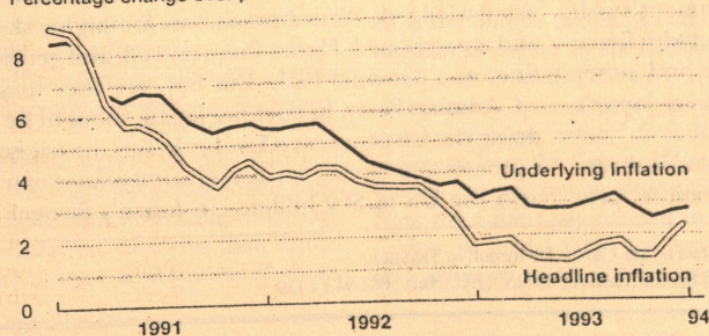
The IMF bureaucracy, of course, has contingency plans to survive, whatever happens in the 1990s. It recognises that cooperation will be dogged by the unwillingness of some countries to abandon their interests for the sake of less efficient partners; and that the failure to agree frequently stems from genuine differences of opinion on strategy and goals. But as one of the IMF economists (Paul Masson) put it:

"The problems of bargaining over the exact outcome of a coordinated agreement when there is asymmetric information about beliefs or preferences are in fact so severe that a coordinated regime may be unattainable. Again, it may be important in achieving coordinated policy agreements for a respected unbiased organization to confront various theories and evaluate the empirical evidence, narrowing the extent of differences in views."

And who might that "unbiased organization" be? "As for the obstacles to achieving coordination, international organizations such as the World Bank and the IMF can play a role in making them less severe". Naturally!

EI is worried by the failure of the Washington DC-based financiers to recognise that their participation in strategic planning is now one of the principal causes of uncertainty. Policies now being imposed by the IMF will add significantly to the deflation of the world economy in the 1990s, as debt-laden countries go cap-in-hand to the bankers for bail-out loans. Investors will have to analyse the policies favoured by the bankers, for these will significantly determine the rate and course of growth not just in individual countries, but on a geopolitical basis; and will therefore shape the prospects for profits.

Percentage change over previous 12 months



Source: CSO

1 William Easterly et al., "Good policy or good luck?", *J. of Monetary Economics*, 1993, p.481.

2 Paul Ormerod, *The Death of Economics*, London: Faber, 1994, p.170.

3 William Easterly and Lant Pritchett, "The Determinants of Economic Success: Luck and Policy", *Finance & Development*, Dec. 1993.

4 *Ibid.*, p.38.