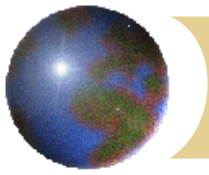


Cultural Comparative Advantage in the Global Economy

John Hooker

Carnegie Mellon University

November 2015



Today's agenda

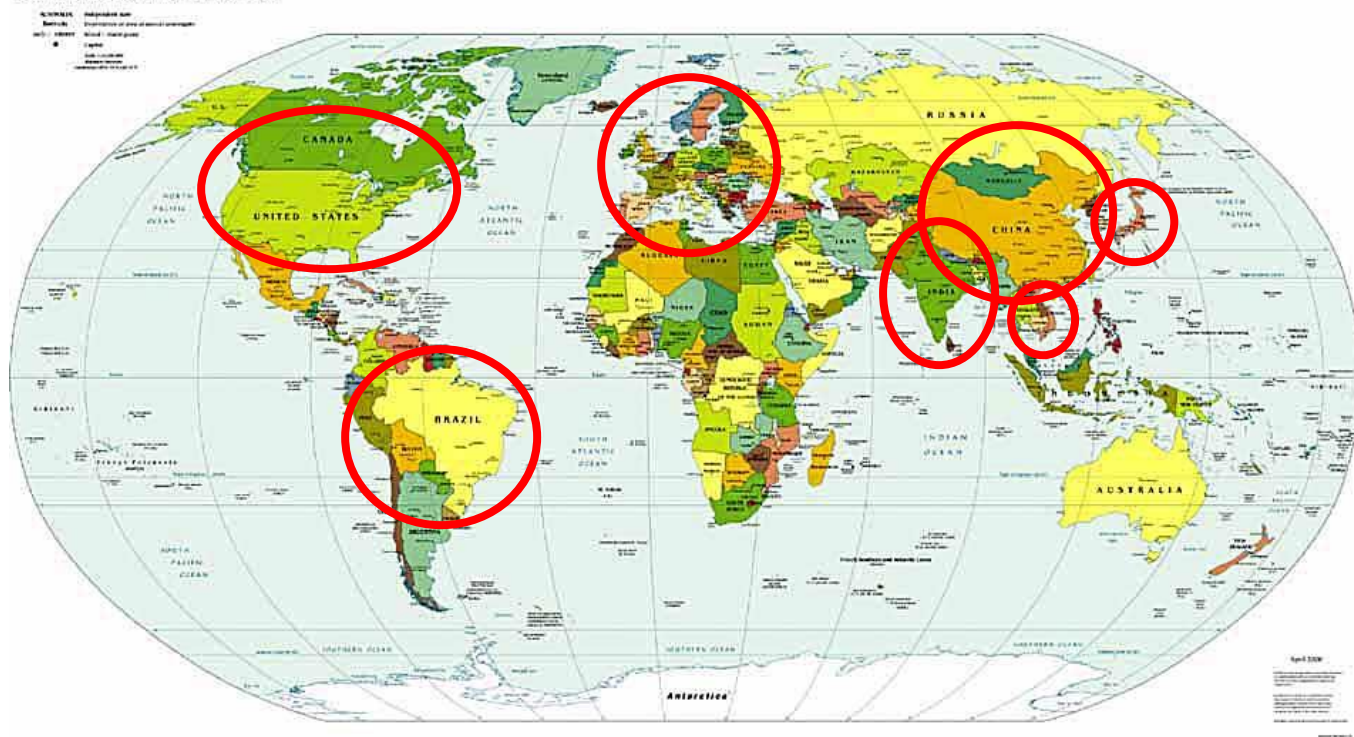
- ⊕ A new economic order.
 - ⊠ Based on cultural comparative advantage.
 - ⊠ Japan, India, Korea, China, the West
- ⊕ Ethical finance.
 - ⊠ A distinctive advantage of the Islamic world.
 - ⊠ ...in an age of financial instability.



A new economic order

- ✚ Movement toward a **multi-polar equilibrium.**

Political Map of the World, April 2000





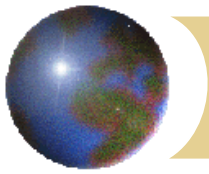
A new economic order

- ✚ 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

- ✚ Based on **comparative cultural advantage**.
 - ✚ Much more than “outsourcing.”
 - ✚ Many countries have cheap labor.
 - ✚ Only a few have become economic powerhouses.
- ✚ Such as...
 - ✚ Japanese quality.
 - ✚ Indian information technology.
 - ✚ Korean manufacturing.
 - ✚ Chinese entrepreneurship.
 - ✚ Western technological innovation.



A new economic order

✚ Japanese quality

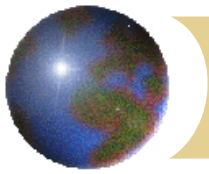
✚ Continuous improvement

- 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

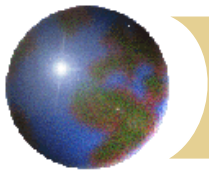


A new economic order

- 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

❏ Superior operations management

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

❏ 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.



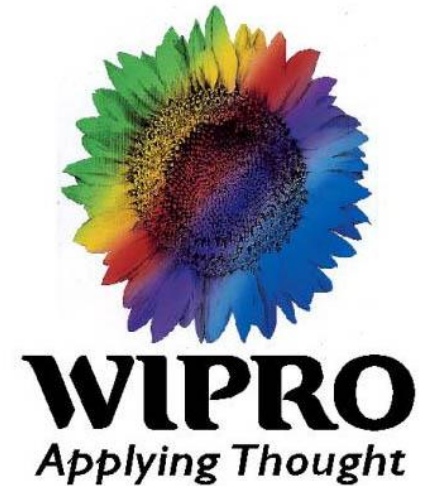
IIT Mumbai



A new economic order

❏ Networking.

- Efficient way to absorb technical knowledge.





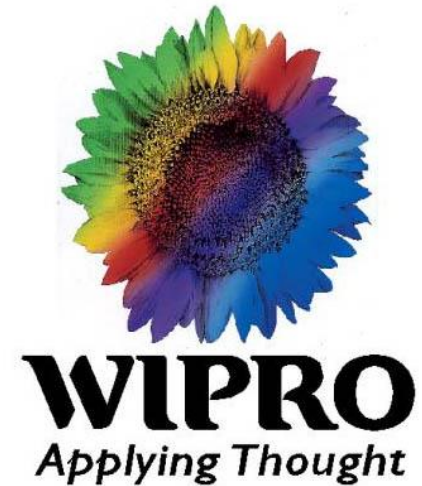
A new economic order

❏ Networking.

- Efficient way to absorb technical knowledge.

❏ A verbal culture.

- Well suited to information age.





A new economic order

❏ Networking.

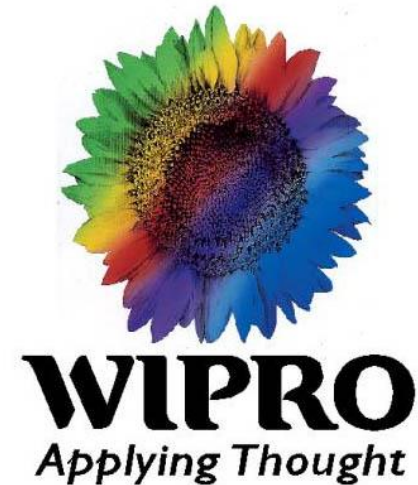
- Efficient way to absorb technical knowledge.

❏ A verbal culture.

- Well suited to information age.

❏ Example: Software development.

- No need for technology, but well equipped to create it.
- Create an orderly world of the mind rather than externally.

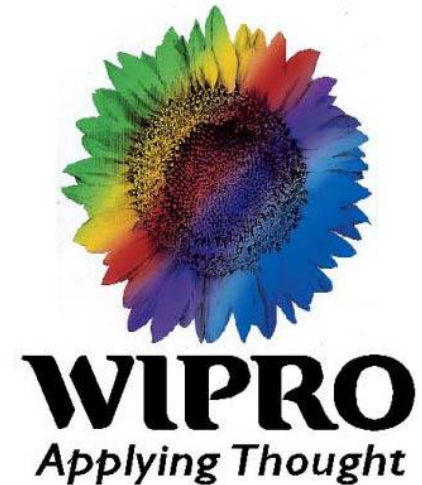


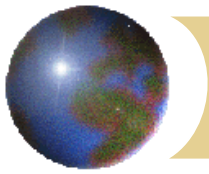


A new economic order

■ Indians see themselves as Westernizing/globalizing

- There is a reliance on rationality, as in the West.
- But Indians are leveraging their **own cultural traits**.





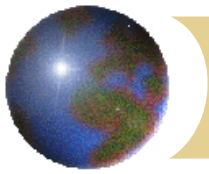
A new economic order

✚ Korean Manufacturing

- ✚ Initially an imitation of Japanese *zaibatsu*.
 - High power distance culture allowed Park Chung Hee to create the *chaebol*.



Park Chung Hee
Korean dictator 1961-79



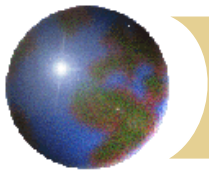
A new economic order

✚ 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.



LG



DAEWOO



HYUNDAI



SSANGYONG

Korean *chaebol*



A new economic order

- ❏ Loyalty to the boss.
 - Paternal relationship.
 - Bottom line and short-term profitability are secondary.
- ❏ Highly disciplined, hierarchical groups.
 - Organized by age.



LG



DAEWOO



HYUNDAI



SSANGYONG

Korean *chaebol*



A new economic order

- ❏ Loyalty to the boss.
 - Paternal relationship.
 - Bottom line and short-term profitability are secondary.
- ❏ Highly disciplined, hierarchical groups.
 - Organized by age.
- ❏ Highly competitive, masculine culture.
 - Strong national solidarity.



LG



DAEWOO

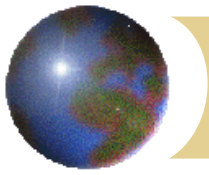


HYUNDAI



SSANGYONG

Korean *chaebol*



A new economic order

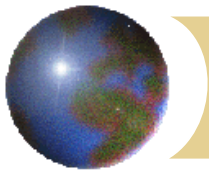
☉ Chinese entrepreneurship

☒ A cultural trait of coastal Chinese

- Particularly speakers of *Yuè* (Cantonese), *Mǐn* (Fujianese), and *Wú* (Shanghaiese) dialects.



Guangzhou



A new economic order

☉ Chinese entrepreneurship

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



Guangzhou



A new economic order

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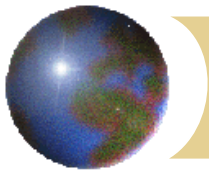
☒ Uncertainty tolerant culture.

☒ Self-esteem tied to wealth and status.

- “To be rich is glorious” (Deng Xiaoping).



Guangzhou



A new economic order

☉ Chinese entrepreneurship

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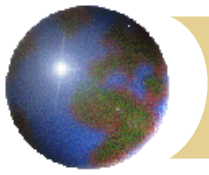
☒ Self-esteem tied to wealth and status.

- “To be rich is glorious” (Deng Xiaoping).

☒ Masculine culture, competitive.



Guangzhou

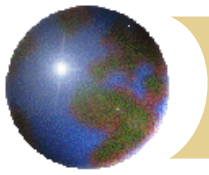


A new economic order

❖ Relationship-based business.

- Family-based investment financed Chinese economic growth.
- *Guānxi* 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.

关系

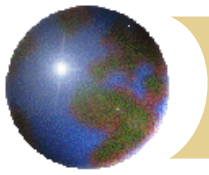


A new economic order

- ❖ 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

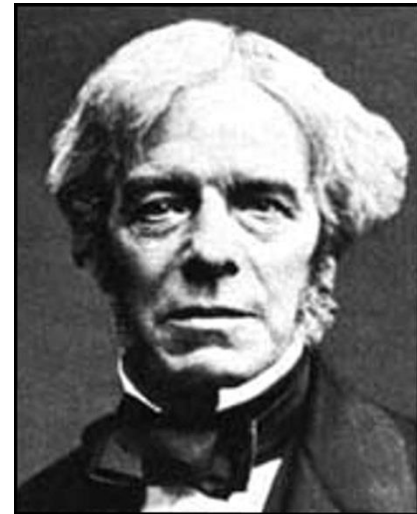


A new economic order

❖ Individualism.

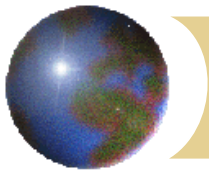
- Individuals have the right to rethink everything.
- Students asked to reason from first principles.
- Do experiments, prove theorems.
- Individual expression, originality valued.

❖ Payoff: new ideas for technological coping mechanism.



Michael Faraday

Discovered
electromagnetism,
basis of modern
world

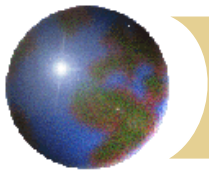


Cultural deglobalization

- ✚ 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

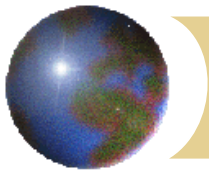


Cultural deglobalization

- ✚ Driven by economics
 - ✚ Successful countries tap into their distinctive cultural traits for economic success.
 - They may **see** themselves as Westernizing.
 - ✚ What about the Islamic world?



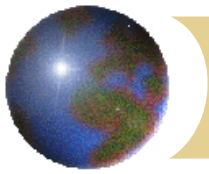
Infosys, Electronics City,
near Bangalore



Islamic finance

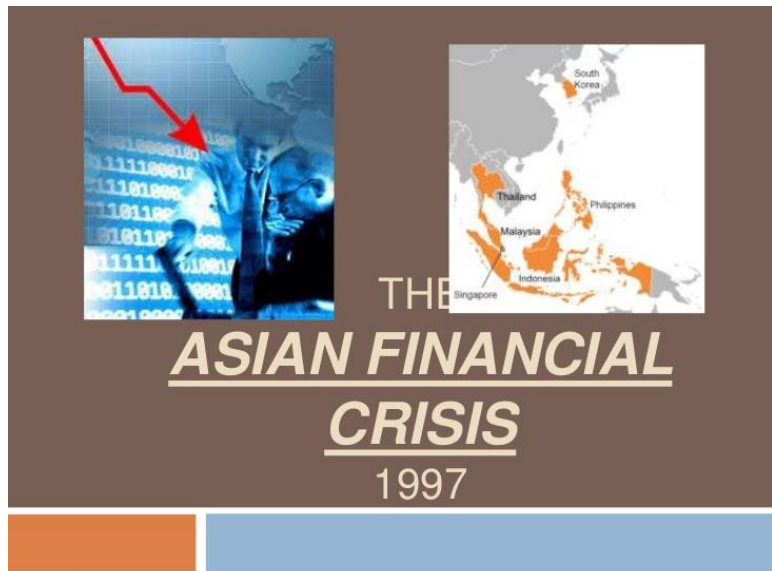
- ✪ A more stable system based on ethical principles.





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.





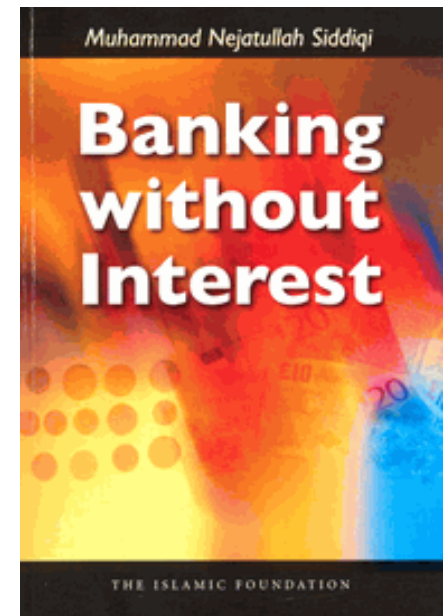
Growth of Islamic finance

- ✿ 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.

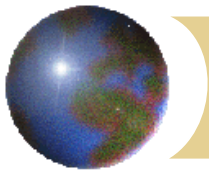




Risk sharing

- ❖ 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.





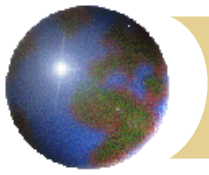
Risk sharing

❏ Why is interest wrong?

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

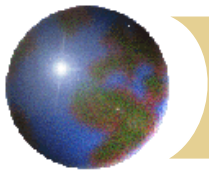


PHOTO: MATT ROUSSE/REUTERS



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

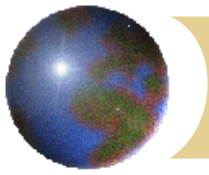
⊕ Time value of money is recognized.

⊞ 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.
- \neq interest.



بنك دبي الإسلامي
Dubai Islamic Bank



Risk sharing

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

COMMON SHARES
VS
PREFERRED SHARES



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

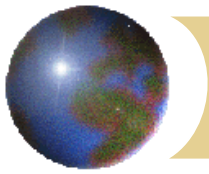
✚ Life is unfair enough already.

- It is fundamentally unfair for wealth to be distributed on the basis of chance.

✚ Speculation is unproductive.

- Merely transfers wealth.





Unnecessary risk

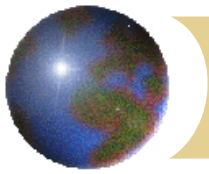
✚ Transactions should be based on known prices.

✚ 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.

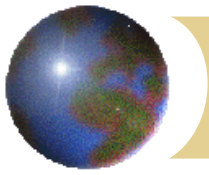




Socially Responsible Investment

- ❖ 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.

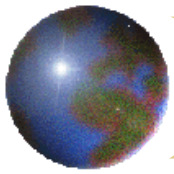




Socially Responsible Investment

- ✪ 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*.

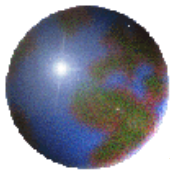




Financial Crisis of 2008

- ❖ A study of what can go wrong in Western finance.
 - ❖ Lack of risk sharing.
 - ❖ Excessive risk.

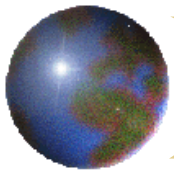




Financial Crisis of 2008

- ❁ Began with subprime mortgage loans in U.S., early 2000s.
 - ❁ 20% of mortgage market
 - **Interest-bearing** loans.
 - Borrowers failed to meet normal standards.

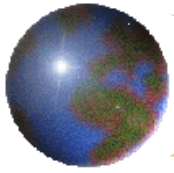




Financial Crisis of 2008

- ❖ 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.**





Financial Crisis of 2008

❖ Big banks were already highly “leveraged.”

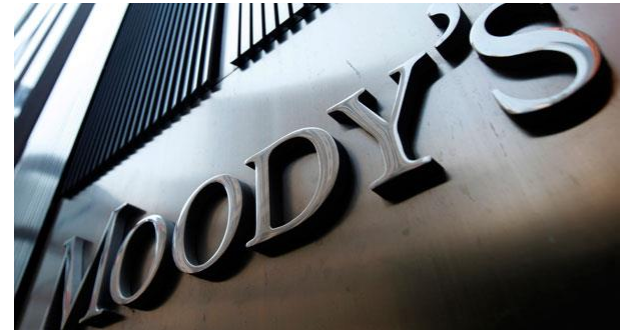
- ❖ Made risky investments with other people’s money, or borrowed money.
- ❖ If market values declined slightly, banks could fail.
- ❖ **Unnecessary risk** on speculation.

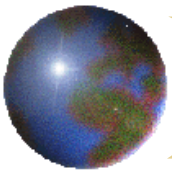




Financial Crisis of 2008

- ✚ 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.

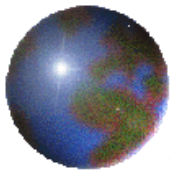




Financial Crisis of 2008

- ✚ 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.**

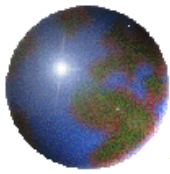




Financial Crisis of 2008

- ✚ CDOs became “poison” in 2008.
 - ✚ Credit froze worldwide because assets could not be valued.
 - ✚ Highly-leveraged banks collapsed, or threatened collapse.
 - ✚ Banks were **too big to fail**.
 - ✚ Massive bailout by taxpayers and U.S. Federal Reserve Bank.
 - ✚ **No risk sharing.**

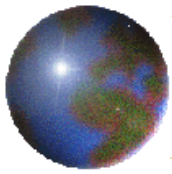




Financial Crisis of 2008

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

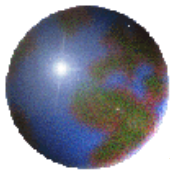




Financial Crisis of 2008

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

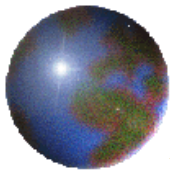




Sustainable finance

- There is a small sustainable finance movement in the West, but...
 - Also known as “ethical banking.”

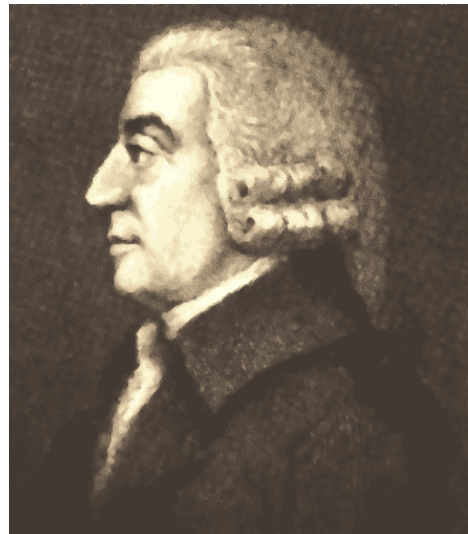




Ethics and business

✚ Basic Western assumption:

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



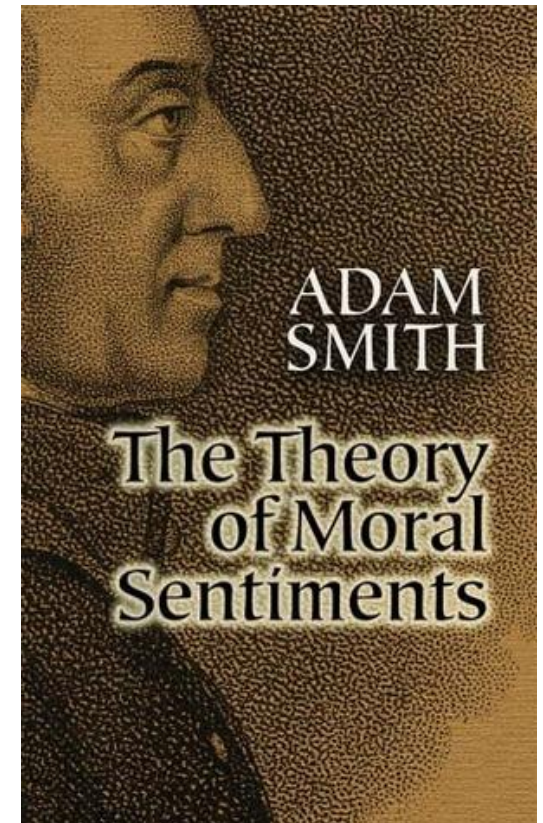
Adam Smith
1723-1790

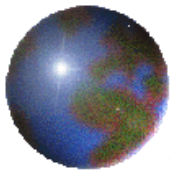




Ethics and business

- 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

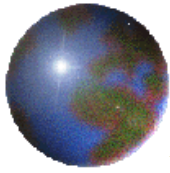




Ethics and business

✚ However:

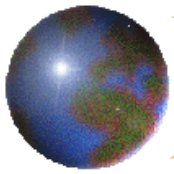
- ✚ **There is no market without rules.**
- ✚ The question is: **which rules?**



Ethics and business

✚ However:

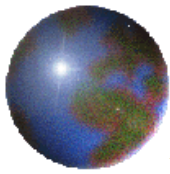
- ✚ **There is no market without rules.**
- ✚ The question is: **which rules?**
- ✚ Adam Smith's answer: **ethical rules.**



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.



