Global Complexity Requires a Strong Analytical Framework

Brian J. Friedman, CFA
December 31, 2015

In an earlier less globalized era, American investors could ignore a debt default in Greece (population 11 million). Similarly, European investors could disregard subprime mortgages in the United States. We did not care whether China devalued its currency or manipulated its stock market. Today, however, investors ignore global events at their peril. American subprime mortgages brought the global financial system to its knees. Greek debt not only rocked other Eurozone countries, but created tremendous financial volatility around the world. Last August as well as now, China’s modest currency devaluation and stock market crash spooked U.S. equity markets.

We believe a better understanding of global markets can be achieved by the framework in Figure 1. Like all tools it merely helps to sort complex information into a simpler format. Our goal is to apply systems thinking to better understand the complex interactions among countries and financial markets. We organize information about each country into four major categories: Economic System, Financial System, Legal System and Political System. The country examples below will help illustrate how we use this framework to place details from the news into a bigger picture context.
## Figure 1

<table>
<thead>
<tr>
<th>Economic System</th>
<th>Financial System</th>
<th>Legal System</th>
<th>Political System</th>
</tr>
</thead>
<tbody>
<tr>
<td>Monopoly vs. Competition</td>
<td>Bank Dominated Government vs. Private</td>
<td>Civil Law French vs. German</td>
<td>Democracy Presidential vs. Parliamentary</td>
</tr>
<tr>
<td>Economies of Scale vs. Constricted Scale</td>
<td>Capital Markets Dominated</td>
<td>Common Law</td>
<td>Federal vs. Unitary</td>
</tr>
<tr>
<td>Labor Market Mobility</td>
<td>Central Bank Independence?</td>
<td>Efficient vs. Corrupt</td>
<td>Balanced vs. Corrupt</td>
</tr>
<tr>
<td>Macroeconomic Fundamentals</td>
<td></td>
<td>Independent Judiciary?</td>
<td></td>
</tr>
</tbody>
</table>

## United Kingdom

The U.K.’s **Economic System** does not limit economies of scale and business firms operate in a competitive environment with few barriers. British labor markets are more liberal than Continental European countries but not as flexible as the United States. The British **Financial System** is oriented toward capital markets with a heavy reliance on stocks, bonds and non-bank financial companies. Almost all financial institutions in the U.K. are private.

Britain is the birthplace of the Common Law **Legal System**. Common Law differs fundamentally from Civil Law. Although America is a Common Law country, Civil Law is by far the more dominant legal system on earth. Only 9 developed countries have a Common Law system (U.S., U.K., Canada, Australia, New Zealand, Ireland, Hong Kong, Singapore and Israel). Every country in Continental Europe has a Civil Law system, every Latin American country, China, Japan and most of Asia and Africa. Surprisingly, most professional investors – even supposed global experts – are unaware of this important fact.

Civil law assumes that all activities are illegal unless specifically authorized by legislation. The Common Law ethos is the opposite. All activities are assumed legal unless specifically prohibited by the courts or the legislature. Civil law countries do not recognize court decisions as law-making precedents, whereas Common Law is at core a precedent based system. These differences have huge economic and financial implications.

Many of the differences in the Financial and Economic Systems among countries can be traced to divergences in Common vs. Civil legal principles. All Civil Law countries are bank dominated while capital markets are much more important in all Common Law countries. Bank dominated Civil Law countries tend to finance hard asset industries at the expense of information technology, biotech or other businesses without bankable collateral.
Civil Law countries are not only bank dominated, but they typically lack alternative financial institutions. Unlike Common Law countries they cannot rely on redundant financial systems in a banking crisis. The recent experience in Spain is a case in point. Bank failures restricted credit, but firms did not have many non-bank alternatives. Unable to obtain funding firms slashed payrolls to survive pushing unemployment to 25%.

Common Law countries such as the United Kingdom and the United States have much more variegated financial ecosystems where capital markets play a dominant role. Widely distributed credit cards, asset-backed securities, junk bonds, and other alternative financial products and services are plentiful in Common Law countries, but much more restricted in Civil Law countries.

The British Political System is a parliamentary democracy and the British state is unitary (i.e. almost all significant government power resides at the national level rather than shared with regional, provincial or state level governments) and quite strong.

Italy

Italy’s Economic System tends to limit economies of scale, raising production costs for most firms. Large Italian companies often exercise a degree of monopoly power protected from vigorous competition. Workers in Italy are highly protected. Firing an employee can be very expensive and litigious.

Italy’s Financial System is dominated by commercial banks with a limited role for stock, bond and other capital markets. Many commercial banks are government owned. Italy’s Legal System is based on the French version of Roman Civil Law, and can be quite inefficient (a typical business contract dispute requires more than 1000 days on average to litigate in court) as well as corrupt.

The Italian Political System is Parliamentary with a significant degree of political corruption. The Italian state is weak relative to its European partners such as Germany or France (for example tax collection remains problematic). Italy is a unitary state.

Our Framework Helps Us Understand Details Others Might Ignore

A seemingly unimportant (to Americans) news item earlier this year was an executive decree by Italian Prime Minister Renzi converting the undercapitalized “Popolari” savings banks into joint stock companies. Because of the framework in Figure 1 we immediately understood the significance for the Italian economy. It is a step toward privatization of a large percentage of the Italian banking system. Private capital will strengthen the Popolari and ease government liability, reducing the likelihood that Europe’s most indebted country will default. Our framework helps us connect the dot from this single detail to the larger view that the Eurozone will remain intact.
Germany

Germany’s **Economic System** also limits economies of scale, but less so than Italy. Germany even has a special word for its middle sized companies called “Mittelstand”. German companies operate in a more competitive environment than many other European countries, but with more market barriers than the United States or the United Kingdom. About 10 years ago Germany liberalized its labor markets, improving their flexibility and lowering the cost of terminating employees.

Germany’s **Financial System** is dominated by commercial banks with a limited role for stock, bond and other capital markets. A large percentage of German banks are government owned (Landesbanken and Sparkassen). Germany’s **Legal System** is a German version of Civil Law, and is very efficient. There is very little corruption in the German legal or political systems. The German **Political System** is Parliamentary and the state is a strong federal system.

**Our Framework Helps Us Identify Potential Risks Where Others Only See Strength**

Unlike Spain or Italy, German banks remain relatively solvent and the German government is unwilling to enact Financial System reforms. The German economy is near full employment and will soon face constraints if the government does not promote capital market development or reform the Landesbanken. The Landesbanken are undercapitalized with limited profitability. Much of their lending is subsidized and based on relationships or politics rather than commercial considerations. Current German strength is breeding complacency and anemic reforms could pose a growing risk in the coming years.

China

The Chinese **Economic System** fosters economies of scale for state-owned enterprises while inhibiting the growth potential of private enterprise. Large state-owned companies tend to be monopolies while small private companies are more competitive. The Chinese government tries to restrict the labor market, but in practice it is quite free and flexible for most private employers. Firing workers from state-owned companies is very difficult and expensive.

China’s **Financial System** is dominated by government owned banks. China authorized only a small number of privately capitalized banks. Stock and bond markets are restricted to state-owned companies and a small percentage of private companies. Shareholder rights are very restricted and “ownership” of public companies is often unclear. China lacks a private “market for corporate control” (for example, buyouts or takeovers from private investors, proxy battles and other mechanisms to assert shareholder rights).

The Chinese **Legal System** is based on German Civil Law. The courts are highly politicized, inefficient and corrupt. Western legal concepts such as contracts or property rights are recognized by the courts, but
often not enforceable. The judiciary lacks independence since it is subordinate to the government and the Communist Party.

The Chinese **Political System** is an authoritarian and centralized one party state. The Communist Party controls the political system in a hierarchical structure similar to the organizational chart of a large corporation. A great deal of political control exists at the regional and local levels, but regional and local officials answer to national Communist Party leaders. China is a strong state with significant governmental authority.

**Our Framework Helps Us Understand that Current Chinese Reforms are Modest**

China recently announced that private companies will be allowed greater access to stock and bond markets. This will improve access to capital, allowing many larger private firms to emerge. China needs to authorize more private banks and alternative financial institutions, as well as improve the efficiency and fairness of its courts. At present, China is not moving toward an independent judiciary. The government said it will not break up state-owned monopolies or privatize them further. The government is encouraging private enterprise in many service industries other than finance, telecommunications and transportation. Without more significant economic, financial and legal reforms Chinese economic growth will continue decelerating.

**Our Framework Helps Make Our Complex World Easier to Understand**

The world is never going back to a simpler time. Globalization enhances the opportunities available to investors as well as the risks. As with all complex systems the best way to handle the problem is to simplify. Our goal is to understand a tractable number of key fundamentals which help us distinguish important information from noise. We are constantly astonished that many global experts are unaware of basic international differences such as Common vs. Civil Law or bank vs. capital markets oriented financial systems. Understanding these basic fundamentals helps us gauge risk and reward in global financial markets.