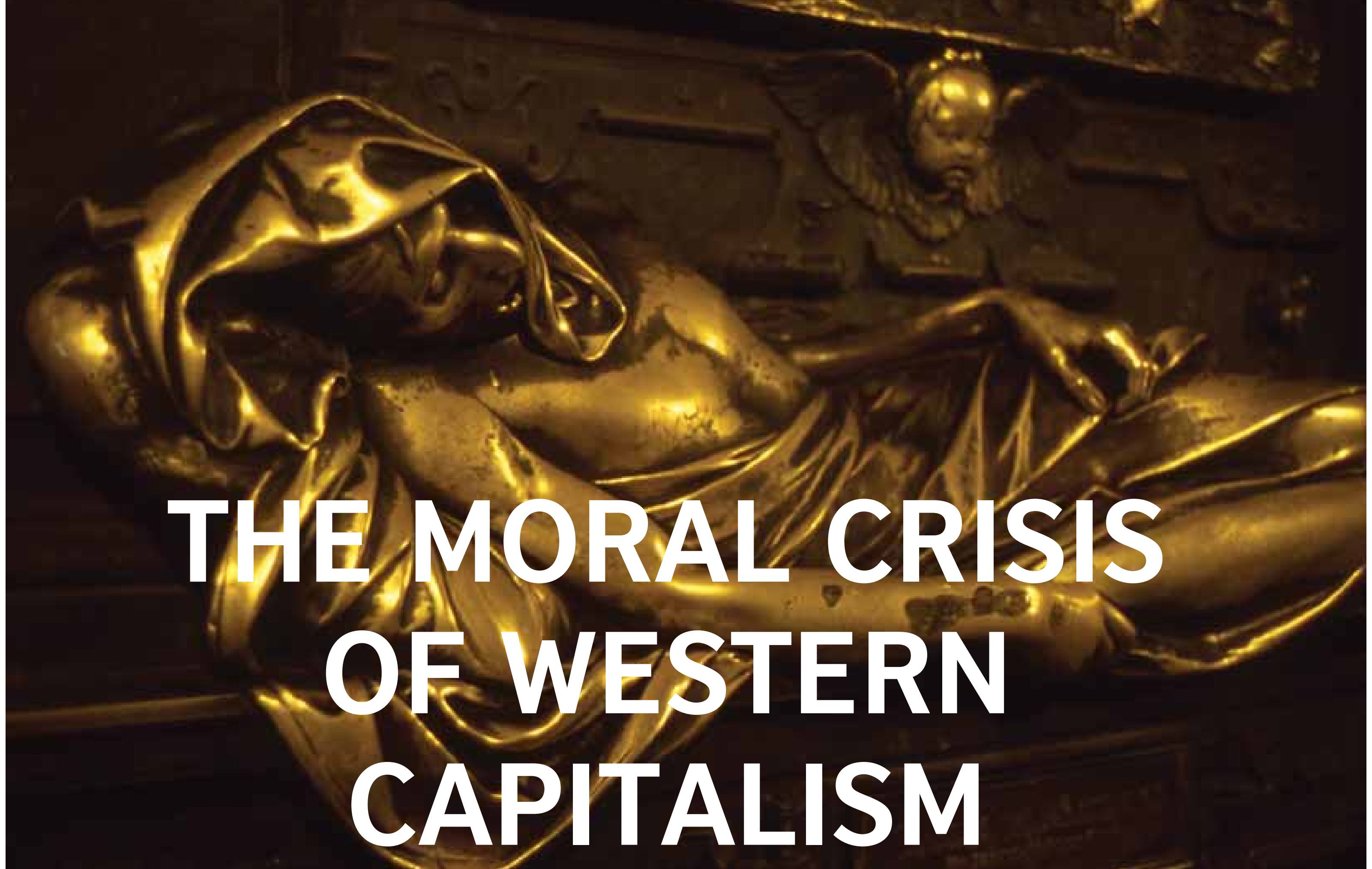

THE MORAL CRISIS OF WESTERN CAPITALISM

By Edward Lucas

Capitalism certainly requires crises — what the great economist Joseph Schumpeter called "creative destruction". Every time a business fails, or an employee is sacked, or a product flops, or a factory closes, it is a mini-crisis: sad for the people involved, but necessary for the economy as a whole. It is only through these mini-crises that the factors of production (land, labour and capital) are freed from unproductive uses and thus become available for more productive ones. The alternative to lots of small crises is stagnation followed by collapse: the Soviet Union under Brezhnev proved that. But the task for policymakers is to make sure that the crises are not too big and not too harmful to society; they also (in an ideal world) use prudent monetary and fiscal policies to dampen booms and pep up the economy when it slumps.

Karl Marx saw it coming, but he saw it wrong. Financial bubbles, he argued, were inevitable in capitalism and would eventually bring it crashing down. He was right on the first point, wrong on the second, and missed a much bigger point. Capitalism depends on a moral framework to survive — and it is this that has so fatally eroded in the past two decades. The principal reason is the West's failure to stand up to the challenge of the post-cold war era and the growth of Russian crony capitalism.

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Of course the world's economic management has been imperfect. The growth of global imbalances over the past ten years, plus the added toxic ingredient of leveraged financial systems fuelled by short-term thinking have been a scandal.

But what Marx failed to understand was that politicians in the capitalist world would prove able on the whole to manage and limit these crises. Even now, amid the worst financial meltdown for nearly 80 years, nobody is offering a fundamental and serious alternative to the model of capitalism that has grown up since the end of the war. The arguments that are raging now are essentially about details: how to protect low-paid workers from the economic dislocation caused by free trade? What kind of banking and financial regulation will keep the risks private and the benefits public, rather than vice versa? What sort of international coordination is needed to manage global imbalances? What will be the price in lost output if Americans save more and spend less, while China does the opposite? Closer to home in Europe, what sort of regulator do we need for cross-border banks?

These are all tough questions, and the next two or three years will be exceptionally painful. We may still be paying for the mistakes of the past decade in 20 years' time (it took Japan 20 years to digest its bubble, which popped at the end of the 1980s, and Japan is not out of the woods yet). Politicians will certainly pay a high price. Populism with the accompanying danger of chauvinism and unrest is on the rise.

But the gloom, however deep, is not matched by a feeling of fundamental doom. How will the world look in ten or 20 years' time? Maybe a bit more green-minded, maybe a bit more protectionist, maybe with rather tougher regulation of finance and maybe with a more egalitarian approach to salaries and bonuses. And maybe rather cross about the huge debts still being paid off for the banking rescue packages now so gaily being voted through. But there is not the slightest sign of a return to full-scale economic planning or national autarky. Deglobalisation will be on the margins, not the central story.

The much tougher question about the future is not the future of markets but the future of morals. As Adam Smith noted in his works (often quoted by free-market economies, but rather more rarely read in full) capitalism is at heart a moral rather than a commercial system. The pursuit of self-interest is mediated by the application of conscience. When that fails, the whole system loses its legitimacy. Capitalism does not require conscious benevolence, but it does require honesty and trust.

It is on this front that moral capitalism is facing its severest challenge. Every pillar of the system has been weakened in recent years, corroded by a combination of greed naïveté and cynicism. No country is immune from criticism but the most striking examples come from the ex-Soviet region, in particular from companies connected to the corrupt businesses that have taken root there: a kind of economic Chernobyl, spewing out invisible toxins across the whole continent.

These semi-criminal businesses are hard to categorise precisely: in every industry there are examples of decent, honest people whose success is due to talent and hard work rather than connections and kickbacks. But as a crude characterisation it would be fair to say that oil and gas production and transit has attracted the lion's share of criticism, along with businesses closely linked to the state (such as selling advertising time on state television, those involved in air, sea and rail transport, and anyone involved in the vital business of giving out permits and licences).

These companies were founded by a rum mixture of people. Some had links with Soviet-era organised crime. Others had a background in the Communist Party, particularly the Young Communist League (Komsomol). Some had engaged in "normal" but technically illegal business. The big new element, since 2000, has been the prominence of people connected with the old KGB.

The model of business they pursued inside Russia partly resembled western-style enterprise, with all the trappings of normality, such as shareholders, boards of directors, accounts and dividends. But there were big differences. Political connections counted for a lot: gaining access to land and capital and most crucially for regulatory favours (and persecution of competitors) that tilted the playing field towards the insider and away from outsiders. Since 2000, that political dimension has increased in importance. Those who challenged the Kremlin are now almost all in exile. Those who stay are notable for their servile attitude towards the state's interest.

The outside world has profited hugely from this. Although individual shareholders have lost out (for example in the confiscation of Yukos, the oil business that was founded by the now-jailed Mikhail Khodorkovsky) and foreign investors in oil and gas have had to accept much tougher terms than they enjoyed in the 1990s, the overwhelming consensus is that Russia's business is Russia's business. Perhaps the business model will go bust. Perhaps it will prosper. Perhaps the people running it will evolve, like the American robber barons, into "normal" public spirited, law-abiding businessmen. The best thing that the West could do was to give them a wary but friendly hand: trade and invest where possible, sell them professional services, and wait to see what happened.

In retrospect, that looks as if it was a dangerously complacent and short-sighted approach. What westerners failed to appreciate was that taking on the new business from the east was not a one-way street.

It would be dangerous for legal and other reasons to go into specifics here.[1] But an illuminating way to see the problem is to take a fictional example. So, dear reader, please cast your mind back to the mid-1990s and imagine a company called something like Neftekhimeksportpromstroitransbank [literally, the Petrochemicalexportproductionconstructiontransit-bank]. NEPS-Bank, as it is known, was first registered in the early 1990s in Kalmykia, a republic of Russia famous for its Buddhism, its chess-playing, and for its status as an off-shore jurisdiction inside the Russian Federation. NEPS-Bank claimed to offer a complete range of commercial, personal and investment banking services to national and international clients. It was in reality a piggy bank and bureau de change and holding company for three individuals: Mr Chekistov, Mr Gebistov and Mr Zhulik. The first two are shadowy ex-KGB types, who worked in the state foreign-trade organisations in the Soviet era, funnelling KGB and Communist Party money abroad for purposes both legitimate and nefarious. If you had wanted to buy, say, some scandium from the Soviet Union in the 1980s, or sell some second-rate wheat, it is gentlemen like these that you would have been dealing with, perhaps in a coffee house in Vienna, or in a hotel somewhere in West Berlin.

That gave them the ability to travel, to practise foreign languages, and to engage in their other professional duties. A highlight of Mr Chekistov's career, for example was when he recruited a resentful and underpaid commercial attaché at the British consulate in West Berlin; information obtained from him helped set a honey trap for a rather more important official, and eventually a slew of priceless secrets about Western security in Germany (the source, known as Tallboy, committed suicide in 1992, fearful that his treachery would come to light).

Mr Gebistov's first big triumph was to make friends with an Austrian journalist, to whom he fed "scoops" about American misbehaviour in Europe in

[1] One British author, who goes under the pseudonym of Alex Dryden, used to be a journalist in Moscow specialising in researching the "oligarchs" (politically well-connected tycoons). He was so frustrated with the difficulties of covering this story properly that he ended up writing a novel (Red to Black, Headline Books 2008) describing the way in which ex-KGB types go into business in order to gain political and economic power in the west.

the early 1980s. The Austrian rose to a senior position on a West German daily paper where he continues to denounce American arrogance and encourage German-Russian rapprochment. At a later stage Mr Gebistov also snagged a bright young academic, eager to make high-level contacts with the new Soviet regime. That man, now grizzled, is an eminent expert in the thinktank world and has published a well-received book about modern Russia. Both men have healthy private pensions accumulated in discreet Liechtenstein trusts as a reward for their efforts.

When the Soviet empire collapsed, Mr Chekistov and Mr Gebistov rekindled a previous friendship with Mr Zhulik. He had run lucrative rackets providing hard-currency prostitutes to visitors to the main hotels in St Petersburg: something that regularly overlapped with the KGB's interest in creating honey traps. His sidelines had grown, including trafficking icons out of the Soviet Union and importing pornography for favoured clients. He lacked the other two men's polish, but he had a raw ruthlessness in dealing with commercial partners that they lacked. The three men all had dachas — part of an old Soviet Foreign Trade Organisation complex — on a lake near Leningrad, shortly to be renamed St Petersburg. Mr Chekistov, then working in the municipal administration's foreign-relations department following his recall from Germany, was easily able to arrange the transfer of ownership. They turned their attention to business. Their working capital came from part of the old regime's nest-egg, billions of dollars in KGB and Communist Party funds which flowed out of the Soviet Union in the system's dying years. Banks in Vienna and Cyprus helped disguise the source of the funds and parcel them up into investments held by anonymous trusts and nominee companies in discreet offshore jurisdictions.

It was a small portion of this that came back, via a loan from an investor in the Isle of Man, to found NEPS-Bank. It was a great investment, soon repaid. NEPS-Bank developed a lucrative business exporting natural resources from mines, oilfields and refineries that lacked the commercial savvy to do the business themselves. The profits were colossal, even after bribes to the managers of the companies concerned, and to the rail authorities and customs officials. Competitors who tried to muscle in on the business found life discouragingly difficult. The "Krysha" (roof) for the business was the St Petersburg division of the FSB, the Federal Security Service which took over most of the functions of the old KGB. The gangsters, tax police and other predators who made life so difficult for most businesses in Russia knew better than to tangle with a business whose headquarters were guarded by the state's own protectors.

Though the founders of NEPS-Bank bought limousines, dachas, mistresses and every other one of life's comforts, they never forgot where their money had come from originally and to whom — ultimately — they owed their allegiance. Russia was in a mess in the 1990s. The time would come to sort it out — and to strike back at the arrogant Westerners who had taken advantage of the country's weakness.

NEPS-Bank recorded very little profits inside Russia: schemes inside the bank skimmed off the cash to a bank in Riga, whose advertising slogan was "we're closer than America". Mr Chekistov maintained his day job in St Petersburg. Mr Zhulik created and executed the trades inside Russia. Mr Gebistov moved to Geneva and organised sales to western customers. The three men were rarely seen together.

Then NEPS-Bank started buying the businesses that they had been previously looting: bit by bit, smelters, refineries, oilfields and ports began to fall into their hands. Sometimes the owner was NEPS-Bank, sometimes they made the acquisition with another vehicle. Cross shareholdings mushroomed. Money piled up in account after account. None of the three quite knew which bit of their empire owned what and how. But profits were so plentiful that this was hardly a worry.

Their problem, they soon discovered, was that money alone did not open every door. Rudimentary accounts, money in a Latvian bank, and dire press coverage made it hard for them to move their money and influence further west.

That task should have been a formidable one. If the system was working properly, NEPS-Bank would have had to transform itself, with proper accounts, proper banking relationships, a proper corporate structure, a real business model and clear ownership. In short, if you want to count as clean, you have to be clean.

The moral crisis of the western capitalist model lies in the fact that this task proved not formidable, but pathetically easy.

The first culprits were the accountants. Their job is to provide a "true and fair" picture of a company's business. Every time anyone buys a share or puts a penny in the bank, they are doing so, ultimately, because they believe that accountants are not just bean counters but moral arbiters. In the 1990s, western accountancy firms poured huge amounts of time and money into Russia, rightly seeing it as a great new opportunity. The culture clash was huge: many Soviet managers had little idea about definitions of working capital or return on equity. Conditioned by decades of shortages, they tended to work on a "just in case" rather than "just in time" basis, so inventories were huge. Information technology was rudimentary. The idea that accounts were a vital tool for managers, rather than a bookkeeping formality, was unfamiliar.

If the accountants had stuck to that, the effect would have been wholly beneficial. But they soon got sucked into something else: putting a nice western façade on some highly unusual and often illegal business practices. The justification was usually that Russian law was so perverse and complicated that there was nothing actually immoral in trying to get round it. If the marginal tax rate on a particular activity was over 100%, then nobody could be blamed for making sure that it never actually appeared on the company books. Businesses would have multiple accounts: one for the taxman, one for the shareholders, and one for the managers — each giving a different picture of what was really going on.

The western accountants were adopting and endorsing practices that were not just questionable but outright shameful. Russian companies such as NEPS-Bank discovered the joys of the "ofshorka" (offshore account) and transfer pricing. In some cases they may have worked this out for themselves. More often, it was their supposedly respectable Western accountants who showed them how to trick and tweak the system. It was not just private-sector entities that were involved. Money lent by the IMF to the Central Bank of Russia turned out to have been placed, strangely, in an off-shore account in Jersey. A top western accountant was asked to investigate, but found nothing wrong (the report was placed briefly on a public website, but then withdrawn for reasons that nobody was able to state clearly).

Based in Moscow in the late 1990s, I used to harry the western accountants with questions about their conduct. The answer was always the same: Russia was just too lucrative to ignore. Each of the big five (as they were then) would explain that if they turned business down, one of the others would snap it up. Each claimed that they had quite high standards and did turn down the dodgiest businesses — but that one of the others had no "smell test" at all.

But the result of this blindness and greed was that NEPS-Bank and the like were able to take the first step towards gaining respectability. I was threatened with legal action by one oligarch in 1998 when I queried the sincerity of his corporate makeover. The first argument in his defence was that he was audited by one of the then "big-five" accountancy firms. What could be clearer evidence of probity than that? I knew, from my own sources, that the company was still deeply dodgy. A clever dodge, all but buried from outside view, meant that a large chunk of the profits were siphoned off to a mysterious trust in Liechtenstein (far more subtle than the crude old arrangements in Riga). The accountants could have protested about that and refused to sign what purported to be a "true and fair" picture of the company's business. Instead, they put in the usual weaselly, well-buried disclaimer about being unable to verify certain aspects of the company's activities. But as far as the outside world was concerned, that company now had kosher accounts.

It was the same story with the banks. First, NEPS-Bank was able to open correspondent accounts simply to perform routine international transfers. But the prospect of a "more developed banking relationship" with this rich Russian customer was hugely tempting. Western investment banks began looking for ways in which they could see their new clients as respectable. This led to all sorts of contortions. NEPS-Bank was told to acquire some independent directors and (even better) an advisory board. That could include retired ambassadors and politicians or industrialists. Payment was generous. The real job of these directors was not to scrutinise the books or decide on company strategy. It was to give their good names, and if necessary make the odd phone call or help make an introduction. On top of that came perhaps four board meetings a year, accompanied by lavish hospitality (and sometimes, rumour has it, exceptionally beautiful and accommodating female companionship).

For Mr Gebistov and the others, it was all quite familiar. They had been trained to gain westerners' confidence and then manipulate them into betraying secrets and professional ethics. The end goal was slightly different but the means were the same. If anything it was a bit easier. Even the most polished appeals to help the cause of world peace and international understanding, accompanied by well-honed flattery and carefully targetted pressure would fall flat sometimes. People targetted by the KGB would sometimes have a twinge of conscience that they were helping a regime that had murdered millions and incarcerated its opponents in psychiatric camps. Now the "pitch" was rather different. "Please help us overcome western stereotypes about Russia: we are trying to build your system on the ruins of the old." Accompanied by inducements that the Soviet system could rarely provide, it proved all too effective.

Alongside the banks were the management consultancies, the PR outfits and the law firms. All had their part to play in sprucing up NEPS-Bank. A big western consulting company — call it McGemini — charged millions to examine every aspect (it said) of NEPS-Bank's business. It suggested a radical reorganisation, slimming down costs and spinning off non-core activities (NEPS-Bank owned several luxury yachts and private jets, a lavish holiday complex near Sochi, luxury hotels and countless limousines, all of which made life comfortable for its top managers but had nothing to do with its business). Some of the recommendations made sense. The company pruned back the barnacled structures of cross shareholdings and managed its cash more rationally. McGemini was paid promptly. But the most central of its recommendations were ignored. Speaking privately, one of the top consultants recalled that the decisionmaking at NEPS-Bank was a "black box with three people in it", quite separate from the normal board meetings and management structures. But who cared. NEPS-Bank was now able to say that it had hired McGemini.

The PR firm (call it Hill & Burston) suggested a change of name to something solid and unsoviet — Red Square Capital. Charming in four languages and beautifully-dressed, its highly paid staff would wine and dine journalists and try to portray the bank's bosses as thoughtful, likeable, public-spirited people — the epitome of the friendly, businesslike new Russia. That was sometimes a hard sell. Intellectually, NEPS-Bank's founders knew that the PR effort was necessary. Emotionally, it was difficult. Mr Chekistov had a new job in Moscow and disliked showing his connection with the bank at all. Mr Gebistov loathed journalists' nosey questions about his activities in the Soviet era. Trained to work in the shadows, both men flinched at the limelight.

Mr Zhulik was a particular disaster: lacking the others' polish, he regularly turned up late to meetings with journalists, used gangster slang, and rudely took mobile phone calls in the middle of interviews. Soon all three men they were shunted into the background, and a presentable, English-speaking chief executive, and a foreign chief financial officer, were hired for big salaries from blue-chip employers. They were accessible and likeable figures, who did a lot to make Red Square Capital (as NEPS-Bank was now called) look good. Only those who scrutinised it really closely noticed that they did not seem to make any of the real decisions. Late at night at a dinner party in London, the CFO confided to startled guests that if he could change one thing, it would be to discourage Mr Zhulik from taking a gun to business meetings.

The law firm (call it Clifford Case Smithlaters) played a big role too. It made sure (at a rate of $300 an hour) that every dot and comma of Red Square Capital's contracts and company documents were within the strict letter of the law. Furthermore, the early ramshackle structure in Kalmykia was now expunged from every archive: those trying to find it would find only a shrug. Those who persisted could expect a polite but firm request to back off. In its place was a leak-proof structure of interlocking trusts, holding companies and nominee shareholders in jurisdictions ranging from Cyprus to Liechtenstein. "It is not just 100% legal. It is 110% legal", Mr Gebistov liked to boast. The result was that nobody could know for certain who the ultimate beneficial owner of Red Square Capital was. It was clear that the three founders held a stake. But who, or what, was behind them? It was not even clear what the company actually owned. Red Square Capital — the one that the western partners did business with — rented the trademark and other tangible and intangible assets from a series of offshore companies, paying a hefty price each time. Someone, somewhere, was charging too much, and someone else was paying much too little. But working out how big the profits were or where they flowed was impossible even for a big western secret service, let alone for an ordinary private-sector investigator.

Yet what was clear was that Mr Chekistov and his colleagues, their friends and relatives were all fantastically wealthy. And what was wrong with that?

All this came at a time when the western banks were under intense pressure to comply with anti-money laundering rules. Yet this proved little obstacle. New banks wanting to deal with Red Square would ask a corporate investigator to scrutinise the client as part of what was described as "due diligence". Based at discreet offices in Mayfair, its senior figures had spent most of their careers in what they euphemistically describe as "government services overseas": what they wanted to get across was that they had been Mr Chekistov and Mr Gebistov's counterparts in western secret services. Rather smoother and less flashily dressed, the ex-spooks radiated mystery and omniscience in equal measure. They would charge their customers — such as a western bank's due diligence department — £10,000 per day to search for obvious clues of wrongdoing. Unsurprisingly, they found none. If there were question marks (such as the ultimate beneficial ownership, or the business model), the CEO, CFO and independent directors would all say that they were in no doubt that everything was entirely legal and above board. It might be a bit complicated — but that was for tax reasons. Reassured by this exercise, the bank's "due diligence" department would report that it had found no reason why the lucrative new business should be turned down.

Just to make sure, Red Square Capital would occasionally commission an investigator anonymously. One of these firms would be given the lucrative commission to find out everything it could about Red Square, ostensibly for a Japanese hedge fund. The resulting dossier would be scrutinised closely by Mr Gebistov and his most trusted advisors, to see if any chink in their armour had been found. The only real weakness was historical documents in western archives. Mr Gebistov, before his move to Switzerland, had lived in a Scandinavian country where he had failed to pay for some building work. When the tradesman took legal action to recover the debt, Mr Gebistov threatened him. The tradesman went to the police and though no action was taken (the debt was hurriedly paid) the incident showed up on a trawl through law enforcement databases.

The last line of defence in the western system was the ratings agencies. It was their job to act as impartial arbiters of creditworthiness. A triple-A rating was the gold standard: that meant that lenders could assume that the borrower was as sound as a government. Junk ratings meant a high risk of default. Everything in between was nuance. But those ratings were the true currency of global finance. The dollar could rise and fall; the D-Mark might give way to the euro. But ratings from Moody's or Standard & Poor's retained an eternal, almost transcendent value. Their people crawled over the borrowers' books so that we, the consumer, did not have to worry.

That system was not quite ideal (it would have been good to have rather more rating agencies). But it worked. Until, that is, greed got in the way and the ratings agencies realised they could make more money if they sold their services not only to the consumers of ratings (ie savers) but to the company being rated. So what happens if it asks a ratings agency — for a fat fee — to take a look and provide a rating?

Time was when a responsible ratings agency would have laughed at something like NEPS-Bank. To protect its own reputation it would give only a poor rating or none at all. After all, the customers of the ratings agency expect the truth. Even if NEPS-Bank made some efforts to clean up its act superficially, the ratings agency would see through it. Freshly laundered accounts, a few independent directors on high salaries and swanky offices are not equivalent to respectability. But in the mid-1990s, one ratings agency did give a cautious rating to NEPS-Bank, which promptly tapped the capital market for a small syndicated loan, punctiliously repaid. More followed. When NEPS-Bank survived the 1998 financial crisis it moved up another notch. With the surge in oil prices after 1999 it gained an investment grade rating and issued a Eurobond. As Red Square Capital it has been able to borrow billions of dollars in short-term and long-term debt.

Most importantly, it was allowed to list its shares, first in Berlin — one of Germany's tiny regional stock exchanges that was desperate for business. Then in Vienna, then in an over-the-counter market in New York and then as the most lightly-regulated form of American Depositary Receipts. The founders considered a full listing in New York, but found the disclosure requirements too onerous. The juice company Wim Bill Dann had taken this route — and had to list the most embarrassing and confidential details of its founding shareholders activities, as well as admit that its business model rested to some extent on unorthodox foundations.

Instead, Red Square Capital found London highly accommodating. All three founders attended a glitzy reception (held, thanks to Mr Chekistov, in the Kremlin) to mark the London Stock Exchange's "road show" to Moscow, where its officials highlighted its "flexible" listing requirements. Red Square Capital floated 5% of its shares in London, in addition to a further 5% already listed in exchanges elsewhere. The IPO was at the height of optimism about Russia in 2006. Billions flooded into its coffers. Red Square then moved to the next phase of its plan, buying shares in blue-chip western companies. Whatever happened in Russia, the future of its founders was secure. So, more worryingly for the West, are the interests of its shadowy backers: the men who pumped the Kremlin's money abroad in that half-forgotten era 20 years ago.

In reality, the westerners who had bought Red Square's shares and bonds had acquired nothing except paper promises: promises that they actually owned part of a real business. Promises that the debts would be serviced and redeemed. It is those promises that rely on the morality which is at the heart of the western capitalist system: the promise that lawyers serve, ultimately, the law, the court, and the principles of justice rather than the immediate interests of their client. That accountants truly believe what they promise to be true. That bankers ultimately put the health of the financial system above the possibility of immediate profit. That stock exchanges are interested not just in going through the motions of testing a new listing's respectability, but are truly interested in making their exchange a place where savers can invest in confidence.

All those promises have been destroyed and emptied by Red Square. The outsiders who dealt with it paid a lot for the shares and bonds, but ultimately bought nothing. They have sold a great deal too: chiefly respectability. As a result, two ex-spooks and an ex-gangster have turned themselves into multi-billionaires. So have many others like them. And we have been the accomplices.

This morality tale concludes here. But the consequences for western capitalism are still filtering through. Why should ordinary voters and savers tolerate a system that bends the rules for the super-rich and leaves outsiders as mugs? If we cannot trust our banks, accountants, ratings agencies and lawyers to deal firmly and honestly with Mr Chekistov and his pals, why should we trust them to deal properly with us?

EDWARD LUCAS is the author of "The New Cold War". A revised paperback edition is published this month.