

RESEARCH

# Do Free Markets Hurt the Poor?



Dan Dry

Raghuram Rajan, Joseph L. Gidwitz Professor of Finance, joined the GSB faculty in 1991. In 2003, he published *Saving Capitalism from the Capitalists* with Luigi Zingales, Robert C. McCormack Professor of Entrepreneurship and Finance. Last July, Rajan was named economic counselor and director of the research department for the International Monetary Fund.

*The following is an excerpt of professor Raghuram Rajan's speech at the New York Alumni Celebration last spring.*

In the midst of a war against terrorism, while stock markets have crashed, corporate scandals have besmirched business, and the world has sunk into a recession, it's important to ask, Is the system of free enterprise failing us? Has globalization gone too far? Is it increasing the gap between the rich and the poor to politically unsustainable levels?

These are big issues that I cannot address here in detail, but I want to make three points.

First, the free market system is undoubtedly the best way to bring the poor out of poverty. Even if it does not always reduce inequality, it makes it more tolerable.

Second, the reason markets don't work well in much of the world is because there

**"The free market system is undoubtedly the best way to bring the poor out of poverty."**

is too little of the right kind of governance. Perhaps the strongest force pushing it in the right direction is globalization.

Third, while we live in a society where markets work reasonably well, free markets are not all-conquering. They are fragile, and it's precisely at times like these that their freedom is most threatened.

Do markets work for the poor? Let's take Sufiya Begum, a Bangladeshi villager who needs 22¢ to buy the raw material for the

stools she makes. For lack of better alternatives, she has to borrow money from a middleman, who forces her to sell the stools back to him as repayment for the loan. He sets the price, leaving Sufiya only two cents for a hard day's labor.

This appears to be an example of the worst evil of capitalism—the inevitable exploitation of labor by capital. But what keeps Sufiya's labor captive is her lack of access to a competitive financial market or a friendly financial institution where she could borrow at a reasonable rate. These markets and institutions don't emerge in much of the world because a sound financial system needs a bedrock of infrastructure, which needs government support. For example, in the United States, most people can borrow money because they have transparent credit histories and because lenders can repossess collateral if a borrower defaults. As a result, many small businesses here are started with home

equity loans. But in much of the world, that kind of infrastructure simply does not exist. In fact, laws actively prohibit creditors from sharing information or from seizing assets upon default.

Government's role in encouraging and even implementing the infrastructure has to be a "Goldilocks" government—not too interventionist and not too passive. But as Chicagoans like **George Stigler** and improbable predecessors like Karl Marx have often warned, governance is often captured by incumbent players in industry—small, focused groups with the power to influence regulations, even in democracies. And in much of the world, they typically

use that influence to limit access to, and competition in, markets. The world's poor do not realize that what they experience is a corrupt version of the markets.

Chicago's response has traditionally been to advocate less government. But if too little law and too little regulation also can hurt competition, then this response is the incorrect one in many parts of the world.

So what accounts for the spread of markets in the last three decades in countries as diverse as France, Germany, Korea, and India? The answer, I believe, is that open borders make powerful domestic players who press politicians for rules that will make domestic markets function well.

In the Indian software industry, for example, the little government legislation that was passed was often enabling, and the industry took off. It also became internationally competitive. Rather than suppressing domestic competition, dominant players like Narayan Murthy, the head of Indian software giant Infosys, are pressing for better infrastructure—better corporate governance that will let them raise finance more cheaply and more educational institutions that will allow them to train their personnel.

That push in India and China has led to the greatest increase in human wealth for the largest number of people in the history of mankind.

But where borders have opened, they can close again. Foreign com-

petition is now touching areas like services that previously were immune. An accountant in the Philippines can now do your taxes via the Internet as effectively as someone from H&R Block across the street. This is already prompting reactions, with some states here threatening to blacklist businesses that outsource processes to other countries.

An economic downturn with many cheated of prosperity that seemed to be within their grasp, corporate scandals that suggest the unlimited greed of the rich, a chance of a prolonged war, and a backlash against open borders: We have seen such conditions before. Markets did not come out well from the encounter 70 years ago.

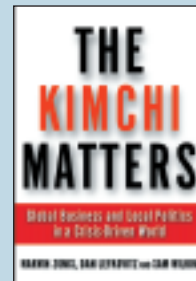
But we are still much better off today than we were even five years ago, let alone before the explosion of markets in the last 30 years. We also have one big advantage today that we did not have in the 1930s: we know what can happen if we give up on markets and competition.

Thirty years ago, the problem capitalism faced was the overexpansionary government. Chicago answered with powerful ideas that stopped the expanding state in its tracks. Times have changed and the problems capitalism faces are different. I am confident, however, that Chicago will rise again to the challenge.

**ON THE WEB** To learn more about Rajan's research, visit [gsbwww.uchicago.edu/news/gsbchicago/facultylinks.html](http://gsbwww.uchicago.edu/news/gsbchicago/facultylinks.html).

## READINGS

### Zonis Publishes on Global Business



**Marvin Zonis, professor emeritus of business administration; Dan Lefkowitz; and Sam Wilkin**  
*The Kimchi Matters: Global Business and Local Politics in a*

*Crisis-Driven World*, Agate, 2003

To nearly every Korean, kimchi, a fermented mix of cabbage and spices, is the unofficial national dish. In *The Kimchi Matters*, Marvin Zonis and coauthors use it as a symbol for the local dynamics—culture, stories, politics, economics, and struggles—that uniquely characterize a particular country or region, demonstrating that in the age of globalization, understanding these dynamics is more important than ever. They write, “An ironic side-effect of globalization is that these relatively small, local stories—the budget policies of Argentina, the corruption of Indonesia, the stability of Saudi Arabia, among many others—matter more than ever before. They are played out in distant countries, but with the click of a mouse or the boarding of a plane their effects are transmitted around the world.” *The Kimchi Matters* offers a look at how political risk is manifest in different countries and the impact that has on business and international relations.—A.R.

**ON THE WEB** To read more about Zonis's research, visit [gsbwww.uchicago.edu/news/gsbchicago/facultylinks.html](http://gsbwww.uchicago.edu/news/gsbchicago/facultylinks.html).

## BOOKSHELF

### From Baseball to Biotechnology: What Faculty Are Reading

GSB faculty read more than research in their areas of expertise. Here's a look at what three professors had on their bookshelves recently.



Kevin Weinstein

**Austan Goolsbee,**  
professor of economics

***Atlantic Crossings: Social Politics in a Progressive Age*** by Daniel T. Rodgers (2000, Harvard University Press) “My friend Bill Novak in the history department recommended this book about the origins of progressive policies in Europe. I study technology diffusion, and it was interesting to see the spread of these ideas along the same lines.”

***Moneyball: The Art of Winning an Unfair Game*** by Michael Lewis (2003, W. W. Norton) “Not a deep book, but a fun account of how the Oakland A’s are a good baseball team despite having no money. Basically, it’s a book about people trying to act rationally to improve the efficiency of the team. How could an economist not like that?”

***History of the Peloponnesian War*** by Thucydides (2003, Penguin Classics reprint) “Though more than two-thousand years old, this book still strikes a chord. Major powers and former allies slowly descend into a conflict that destroys the world as they know it. Great stuff.”



Mark Estes

**Steven N. Kaplan,**  
Neubauer Family  
Professor of Entrepreneurship and Finance

***DNA: The Secret of Life*** by James Watson (2003, Knopf) “A very clear explanation for the layperson of the history, techniques, and terms of genetics and biotechnology.”

***The Skeptical Environmentalist: Measuring the Real State of the World*** by Bjørn Lomborg (2001, Cambridge University Press) “A systematic and relatively unbiased appraisal of environmental issues by a statistically accomplished environmentalist. The book will leave you more optimistic about the earth’s present and future state, as well as more skeptical about what you read in the popular press.”



Matthew Gilson

**Ann McGill,**  
Sears Roebuck  
Professor of General  
Management,  
Marketing, and  
Behavioral Sciences

***Stiff: The Curious Lives of Human Cadavers*** by Mary Roach (2003, W. W. Norton) “It’s an incredibly interesting (and not at all creepy or weird) account of what becomes of cadavers and, sometimes, where scientists ‘acquired’ them. It features examples of both great science and wildly bad science. Funny and wry, but not at the expense of others.”

***The Partly Cloudy Patriot*** by Sarah Vowell (2003, Simon & Schuster) “Vowell is a regular contributor to public radio’s *This American Life*. I enjoy her angst and humor, so I thought I would read her essays. They were amusing and informative, but not as engaging as when delivered in the spoken voice of the author. Her earlier book *Take the Cannoli: Stories from the New World* contains an essay called “Michigan and Wacker” that links much critical history of the United States to that corner, which she describes as a vortex. It’s great reading for any Chicagoan; I think we should hand it out at orientation.”—A.R.

## Faculty Appointed to Named Professorships

### Sanjay K. Dhar

Dhar, professor of marketing, was appointed to the David W. Johnson Professorship beginning September 1, 2003. The one-year professorship is awarded to a tenured or tenure-track faculty member who teaches in the Singapore program and who does not already hold a named professorship. A faculty member since 1992, Dhar has researched retail management, consumer promotions, brand management, new products, and marketing and e-commerce strategy.

### Anil K. Kashyap

A faculty member since 1991, Kashyap has been named Edward Eagle Brown Professor of Economics and Finance. His major areas of interest include Japan, business cycles, and corporate finance. He is the coauthor of *Corporate Financing and Governance in Japan: The Road to the Future* (MIT Press, 2001).

### Canice Prendergast

Prendergast has been named W. Allen Wallis Professor of Economics. A member of the faculty since 1990, he has

researched bureaucratic efficiency and how incentives can be provided for police forces, social workers, and prison officers.

### Lars Stole

A faculty member since 1991, Stole has been named Eli B. and Harriet B. Williams Professor of Economics. He previously received the David W. Johnson Professorship for the 2001–02 academic year. His current research focuses on price discrimination, intra-organizational resource allocation, and nonmonetary exchange.—A.R.

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