The Economic Future of Egypt’s Revolution

By Mark Roe

For Egypt, the question of the day is whether the country will build an open, democratic political system or relapse into some form – new or old – of autocracy. But an equally important question – above all for Egyptians, but also for other developing countries (and for development experts) – is the economic impact of its revolution.

For the past quarter-century, a major agenda item for the international development organizations, such as the International Monetary Fund and the World Bank, has been to bolster developing nations’ financial markets. Stronger financial markets can move savings to where they can do the most to spur economic growth. And that capacity has been seen as one of the handful of key prerequisites for economic development. Making finance work should boost economic development significantly.

Economic historians point to financial revolutions as setting the stage for strong economic development in England (in the seventeenth and eighteenth centuries, following the Glorious Revolution), in the United States (after Alexander Hamilton in the 1790’s built up major financial structures in a primarily agricultural country), and in Japan (after the Meiji Restoration).

The World Bank, the IMF, and dozens of academics have studied long and hard what makes financial markets grow and what holds them back. Many focus on the quality of institutions, such as courts and tax authorities. Others emphasize the quality of corporate law. Still others look at policies, like trade openness or lightness of taxation. Everyone extols property rights.

Yet, when one looks at what actually happens in developing countries, the lessons are disappointing. Though some countries have fixed their court systems, streamlined their tax administrations, and begun to get a handle on corruption, the impact on financial markets has been uneven.

Worse still for some theories of what makes financial markets flourish are the examples of the US, Great Britain, and Japan. Financial markets leaped forward in eighteenth-century Great Britain, and in the nineteenth and early twentieth centuries in Japan and the US – a time when several key institutions, such as corporate law and the court system, were woefully substandard.

American courts in the nineteenth century were notably corrupt, sometimes incompetent, and often irrelevant, yet stock and bond markets grew, and continent-spanning firms rose up and got the financing they needed to operate, expand, and industrialize the US economy. The core protective legal institution for outside finance, the federal securities laws, didn’t fall into place until the 1930’s – decades after US financial markets had grown to finance America’s economic rise.

Britain and Japan seem to have followed the same sequence: finance first, protective institutions later. Japan had no corporate law until complex business finance started developing at the end of the nineteenth century. Yet that sequence is the opposite of what one might have expected: only after financial markets developed did those with a stake in them press for better legislation to protect investors.
So, in Britain, Japan, and the US, something more foundational must have been in place before financial markets started operating. Something else must affect which countries are most likely to get strong finance, which won’t, and when it all happens.

That “something” now usually seems to be basic political stability, preferably of the democratic kind. In a stable political environment, informal mechanisms – such as reputations for reliability, trade associations, and stock exchanges – can develop and facilitate financial dealings. Investors and businesses don’t fear that a new regime can take power and call off all, or too many, bets, leading to losses on their investments.

The data linking democratic political instability and financial backwardness in the modern era, which Jordan Siegel of the Harvard Business School and I analyze in a forthcoming article, show unmistakably that instability powerfully predicts an inability to develop financial markets. Democratic political stability is the most important harbinger of financial development.

There is a deep logic to this finding. Even if all of the rules for finance are right, few will part with their money if they fear that an unfavorable regime change might occur during the lifetime of their investment.

More importantly, the grim stability of the type displayed by Hosni Mubarak’s Egypt is oftentimes insufficient for genuine financial development. Authoritarian regimes, especially those with severe income and wealth inequality, inherently create a risk of arbitrariness, unpredictability, and instability. They are themselves arbitrary. And everyone knows that beneath the stability of the moment lurk explosive forces that can change the regime and devalue huge investments. Because financiers and savers have limited confidence in the future, such regimes can’t readily build and maintain strong foundations for financial development.

By contrast, democratic regimes with widespread property ownership typically best protect property rights over the long term, because enough people in the polity want to protect property.

Yes, the rules of the game count for finance. But what counts even more is that the polity has a continuing, stable stake in keeping those rules in place and making them work for finance and economic growth.

So, what does this mean for Egypt? The Egyptian revolution is political thus far, not economic. Yet, if the revolution leads to a more open, democratic, middle-class-oriented political system, in which enough people believe that they have a stake in the government’s continuity, the economic benefits for Egyptians could be large. Financial markets will more likely flourish, and more rapid and equitable development will more likely follow.

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