

RUN AWAY CAPITALISM

WHEN THE WRONG MEASURES OF SUCCESS DRIVE DECISIONS, STRENGTHS CAN MUTATE INTO SERIOUS LIABILITIES. JUST LOOK AT THE PEACOCK.

BY CHRISTOPHER MEYER AND JULIA KIRBY

Capitalism, as it is practiced in rich countries, has taken two brilliant ideas too far. The first is return on equity (ROE), one way of measuring value creation that has managed to eclipse many other, and broader, ones.

The second is competition, which has come to be seen as an end in itself rather than as a tool for promoting growth and innovation.

Both ideas began as effective solutions to a pressing problem—how to allocate resources to produce, as Jeremy Bentham would have it, “the greatest good for the greatest number.” Centuries on, the advanced economies cling tightly to these approaches, but the problem has changed. The mismatch has caused difficulties of such urgency that many people are now declaring capitalism a failure. The whole system has been indicted, not only because of the financial crisis but particularly since that event, as inherently unworkable.

It isn’t true. Capitalism—broadly, private ownership and resources allocated by markets—remains the most powerful, flexible, and robust system for driving society’s prosperity

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and enhancing quality of life. But keeping it on track will depend on our ability to rethink the priorities that guide everyone in the system, from entrepreneurs to regulators to investors. Together the practitioners of capitalism will need to throttle back the headlong pursuits of ROE and competition, and that process begins with recognizing those ideas for what they are. They are runaways.

The Peacock Effect

The concept of “runaway” selection comes from the field of evolutionary biology, and to explain it, biologists most often cite the peacock’s tail. That ornamental feature has grown ever more flamboyant across the centuries thanks to a simple fact: Peahens show a preference for large-tailed peacocks. In the earliest days of the species, this made sense. A showy tail was a marker of a healthy male that knew how to feed himself. (Think of it as something like a Ferrari—at least before easy credit.) Consequently, well-feathered males had more frequent opportunities to breed and to pass along that trait. The next generation had, on average, larger tails. Initially, this would have weeded out the weak; but after many generations, it created a problem for the strong. That tail is expensive (again, like a Ferrari). It requires nutrients to grow and maintain. And it’s heavy, slowing down its owner (OK, not so much like a Ferrari) and making him easier prey.

Past a certain point, the peacock population began to decline, even as the tails kept getting longer. The Cornell economist Robert Frank, in his book *The Darwin Economy*, notes how the same phenomenon led to the extinction of a certain large-antlered elk, as its great rack increasingly got caught up in forest branches. Evolutionary theorists say that the species succumbed to “biological suicide”—a fate that

might well have claimed the peacock if not for human interventions to prop up a species that was too beautiful to fail.

You might wonder how it is that other species escape their own runaways. Why does the giraffe’s neck not become impossibly long? Why no towering rabbit ears? That’s because what went on with the peacock is an aberration: an interesting mismatch in the processes of natural selection (the criteria by which nature decides what makes an individual fit enough to thrive and reproduce) and sexual selection (the criteria by which the opposite sex of the species makes that call). In species that remain viable across millennia, these two selection processes are aligned—they have to be. Any misalignment serves to run a species into the ground, sooner or later.

Let’s think now about how runaways might work in a social system like a business. Certainly we humans have the ability to create incentives for bad choices that do not contribute to the long-term health of our enterprises. Any manager who has had to design a compensation scheme knows this; as often as not, bonuses wind up rewarding behavior contrary to the organization’s espoused mission and values. (Steven Kerr summed up this problem nicely in his classic article, “On the Folly of Rewarding A, While Hoping for B.”) The problem is reinforced when large bonuses result in prestige for individuals, rather than in increases in some harder-to-trace sense of overall value. The more this feedback loop self-reinforces, the harder it is to change.

In most cases, whether in nature or in man-made systems, misalignments are easy to spot and don’t persist for long. The more insidious problems arise when the proxy for the health of the system starts out valid but then becomes increasingly obsolete as conditions change—and no one tells the peahens,

Idea in Brief

Capitalism, as many have noted, has succumbed to some troubling excesses. Getting it back on track will require that its “runaway effects” be reined in.

In evolutionary biology, the classic example of a runaway is the peacock’s tail: Because females show a preference for flamboyant plumage, the tail continues to grow even to the point that it makes the birds more susceptible to predation and compromises the sustainability of the species.

Capitalism’s equivalents are its obsessive pursuit of return on equity and its determination to preserve competition. Both began as valid proxies for healthy trade, but conditions have changed to the extent that those proxies now misdirect our priorities.

Capitalism has the opportunity to adapt and develop in the green fields of emerging economies new rules that are more suited to today’s environment. Those rules will take hold globally, to the benefit of us all.

whose pecking order has grown to depend on having the mate with the largest tail.

This notion of a proxy that becomes obsolete, even dangerous, over time brings us to return on equity.

The Obsession with Return on Equity

There is no more powerful question in a U.S. corporation than “What’s the ROE on that?” Social media spending? Wellness checkups? Better working conditions? Elimination of bribes overseas? Return-on-equity hurdles threaten them all. Conversely, why market cigarettes? ROE justifies the means.

How did this criterion come to dominate not just investment decisions but then business as a whole and now political culture? It’s because, a hundred years ago, squeezing every drop of return out of equity capital made great sense. As the industrial revolution progressed, society was enjoying enormous benefits from mass production, which brought luxuries within reach of the middle class. Just as electronic commerce would later transform business, mass production swept into one industry after another. But unlike websites, factories were capital intensive. The revolution ran on equity capital, which was in short supply. Any manager would have been right to conclude that allocating capital according to expected return on equity would produce the greatest good.

This doesn’t mean that ROE was the *point* of business—the overall objective of commerce in society was then, like now, to better people’s welfare. But the opportunities to put capital in the service of that goal were numerous. Investors, playing the role of the peahens and determining which enterprises would continue to the next generation, needed a proxy variable with which to quickly and objectively size up their options for financial mates, and ROE filled the bill very well. Thus was born the feedback loop that to this day drives the mania

for managing quarterly earnings to meet investor expectations.

The feedback frenzy rose to a new level in 1917, when General Motors was in financial difficulty and DuPont took a major position in the company. (GM represented an important channel for DuPont’s lacquer, artificial leather, and other products, and Pierre du Pont sat on GM’s board.) DuPont sent Donaldson Brown, a promising engineer-turned-finance staffer, to Detroit to sort things out, and sort them out he did.

Brown noted a simple fact: Return on equity can be broken down into a three-part equation. It is the product of return on sales times the ratio of sales to assets times the ratio of assets to equity. By parsing ROE into the DuPont Equation (very rapidly to become a business school mainstay), he provided the financial basis for organizations’ dividing into functions, each with their own objectives. He reasoned that if marketers worked on maximizing return on sales, production managers were rewarded for the sales they wrung out of their physical plant, and finance managers focused on minimizing the amount of equity capital they needed, ROE would take care of itself.

Thus Brown laid the foundations of today’s hated silos. Incentives spurred managers down paths that became treacherous. In their pursuit of margin, marketers sought market power even to the point of monopoly, prompting Congress to strengthen antitrust laws. Production engineers treated their factories royally and their labor like serfs, spurring unions to amass strength and force new labor laws into effect. Financial managers, supported by their bankers, increased their debt-to-equity ratios until capital requirements were imposed—wait, strike that, until there was a catastrophic financial crash and a Great Depression. Then banking regulations were imposed. (Apparently unconvinced of the causal link, we reran the experiment in the 1980s. Once again the outcome was near fatal.)

SOCIETY BEGAN TO FIND MANY CRITERIA FOR ALLOCATING CAPITAL UNSUITABLE, YET THE HEADLONG PURSUIT PERSISTED.

In each case a runaway was at work. Managers were prized according to their performance on one dominant criterion—and because it was so clearly defined, so objectively measurable, so useful in management, and so reliably rewarded, the feedback loop was powerful indeed. In evolutionary biology terms, natural selection was at odds with sexual selection; society—the environment in which firms lived—was finding the proxies unsuitable and insisting that capital should be allocated using broader criteria. Yet the components of ROE outlined by Brown continued to be pursued single-mindedly, and the ROE runaway continued.

The Depression only intensified the need to get returns from scarce equity and tightened the focus on performance markers that could be measured with motivating precision, even if they were not quite the point. In the 1930s people not surprisingly

wondered how the Depression had come about. What is surprising, perhaps, is that there was no system of economic measurement that could provide an answer. At the behest of the U.S. Department of Commerce, Simon Kuznets, of the National Bureau of Economic Research, proposed one—the National Income and Product Accounts (NIPA)—to the Senate. His recommendations led to the apparatus that generates the overall measure of GDP. For 70 years now, NIPA has summed up for us how well we're doing and has served as the model for economic measurement around the world.

Winston Churchill observed that “First we shape our buildings; thereafter they shape us,” and the same is even more true of our performance metrics. Enormous political weight is given to GDP, and GDP per capita, but very little to the many other indicators of value creation. Rankings of crime, education, health, and happiness have only recently become available, and no one's bonus depends on them. In indices that track the performance of world economies, the U.S. routinely fails to make the top 10 on nonfinancial dimensions but continues to make choices on the basis of GDP impact.

To an even greater degree, financial measurement shapes thinking and action at the enterprise level. Since the 1980s—the decade of deregulation and economic value analysis—business leaders in the U.S. (and to a lesser extent the rest of the G7)

have focused ever more narrowly on ROE as the gauge of success.

But globally, value measurement is on the cusp of change, for two reasons. First, a new measurement infrastructure is taking shape, owing in significant part to technology. Second, the segment of the world's population that cares about nonfinancial performance indicators is growing.

In 1972 the King of Bhutan announced that “gross national happiness is more important than gross national product,” and therefore that “happiness takes precedence over economic prosperity in our national development process.” The idea met with bemusement on the world stage. Happiness is too subjective, many experts protested—too “soft” to be the basis of national economic management. Undeterred, and lacking its own National Bureau of Economic Research, the Bhutan government created the Centre for Bhutan Studies and tasked it with developing some kind of national happiness account. The resulting system has nine dimensions, of which living standard is one, along with education, health, governance, and the especially challenging to measure psychological well-being.

Bhutan's effort, by now, is just one of many. In 2008 Nicolas Sarkozy created a commission, headed by two Nobel Prize-winning economists, to analyze which components of happiness France should measure. Today 41 countries, including the UK, a bastion of U.S.-style capitalism, have initiatives under way

related to measuring happiness. The Legatum Institute, an NGO based in London, has done “hard” econometric work to analyze the roots of happiness and has created an index driven by some 40 variables, sorted into eight dimensions that are not unlike Bhutan's. (For more on GDP's limitations and a discussion of alternate measures of progress, see “The Economics of Well-Being,” by Justin Fox, beginning on page 78.)

If this sounds pie-in-the-sky, consider how hard it must have been to develop NIPA using only the information systems of the 1930s. It's a lot easier today to get data on happiness—think of Facebook and the many other technologies available to help us sense, survey, query, and measure—than it was for Kuznets to get information to feed NIPA.

Back to biology. Runaway effects are curbed to the extent that other criteria for selection counterbalance the fixations that led to them. In nature, this can sometimes happen because of a shock to the ecosystem. If honey badgers are introduced into the peacocks' habitat, for example, the fact that a large tail is an imperfect proxy for health becomes immediately obvious: Peahens are soon left with nothing but truly fit peacocks to pair up with. All the gaudy tails become badger breakfast.

In a man-made system like capitalism, the shock necessary to derail runaway effects shouldn't have to be so great. With intelligence, we can perceive the difference between purpose and proxy and make



GE Learns to Look Beyond ROE

GE is a renowned management machine, well disciplined in executing on the rules of capitalism. When it set its sights on maximizing ROE, the firm did it better than just about any. But our recent conversations with GE people working in the company's largest growth markets convince us that GE now has got its hands on not just a new playbook for competing under the old rules but on a new rule book.

More products at more price points. A decade ago it would have been anathema to launch products of similar functionality at different price points.

That might work in consumer businesses, as when a CPG firm decides to monopolize a retailer's shelf with a range of shampoo offerings. But in the

realm of industrial equipment, it's a recipe for cannibalization—hardly the best strategy for high ROE.

But GE is doing just that with its new MACi electrocardiograph, because the reality in growth markets like India and China is that few health-care providers can afford the \$5,000 machine it sells to major hospitals in developed countries. Making sales in emerging economies demands a version at a tenth of the price

and an acceptance that, in a flat world, the product will steal sales from the high-end model in mature economies. (Indeed, GE's CMO, Beth Comstock, told us that some 40% of MACi sales come from Europe.)

Innovating in country, for country. The old GE would never have assumed that the greatest product ideas could be conceived and developed in the least-sophisticated environments where it was doing

business. Chairman Jeff Immelt changed that when he established a corporate fund to support “in country, for country” innovation. The same engineers in India who developed the new MACi had previously worked on refining products designed in the U.S. to be sold globally; this machine became theirs to envision. They understood the constraints of the local market: The MACi would be transported from rural clinic to rural clinic, most likely on the back of a

scooter over dusty, bumpy roads. Electric power at the clinics would be dodgy at best. And considering the amount that could be charged for tests, it would be hard for doctors to justify a purchase of a machine priced higher than \$500.

Not invented here. Designing under such constraints meant defying the traditional “GE Way” in other respects. Normally every component of a new product would be developed in-house. But to

save money and time, the MACi team repurposed a printer used by Indian Railways to spit out passengers' tickets.

What makes us think the new approach is actually delivering more value to GE? Oswin Varghese, a member of the design team, described for us the positive change he saw in his colleagues when they switched from tweaking mature-market products to creating transformational solutions for their own hometowns. “There is a

passion, because we are taking the best thing available in the developed market and delivering it in an affordable way in India and other emerging markets.” In an era when workers are highly portable, and people want their work to have meaning, GE's new strategy helps the company attract the best talent.

course corrections deliberately. We can refuse to succumb to a runaway.

The Fixation on Competition

What is the source of an economy's vitality? An economy can grow simply by investing savings in productive capacity, to a point. But for the most part, vitality comes from innovation. And what gives rise to innovation? If you think the answer is "competition"—full stop—you are part of capitalism's second dangerous runaway.

It's true, of course, that competition can spur innovation—witness the battle between Apple and Android, which actually has buyers excited about how one will outdo the other next. It's also true that lack of competition stifles innovation: Verizon and AT&T, essentially a duopoly, have no one excited about anything. It's easy to conclude, therefore, that competition is a good-enough proxy for innovation and therefore a prerequisite for economic value creation.

And again, at the dawn of capitalism, it was surely a better proxy than it is today. In Adam Smith's world, "atomistic competition"—to use the economists' term—yielded steady increases in the value consumers got for their money. Competitors were price takers, because the market was large relative to producers. Technology changed slowly and capital was scarce, so innovation was less of a driver of growth than were the efficient allocation of resources and the tendency of prices to fall because of that investment. And the scope of a business was circumscribed within a small organization—the hostler and blacksmith were distinct businesses, dealing at arm's length, unlike GM and DuPont.

But that era ended when, as chronicled by Alfred Chandler in *The Visible Hand*, industrialization al-

lowed organizations to reach unprecedented scale. Producers became price makers, raising profits and reducing output. When they grew so powerful that society rebelled, legal action broke up the trusts. The newly created competitors, however, encountered the same incentives, and learned to signal and collude to limit markets to two or three oligopolistic "competitors." In many industries these players have become sufficiently large and powerful that they influence not just markets but policy.

In the U.S. economy today, the curious effect of advocating "free markets"—free, that is, from regulation—is to strengthen the ability of companies that already possess market power to pursue even more of it. It's important to note that no firm actually wants to compete. Individually, all firms seek a so-called sustainable advantage, which is to say the kind of relief from competitive pressure that allows for ample margins, innovation on their own schedule, the pick of the graduating class, and many other perks. Thus the effect of empowering alpha competitors is not to make an economy more competitive.

Instead, what arises might be called pseudo-competition. Look at the mobile technology sector, which, with the exception of the carriers, is one of the innovation bright spots at the moment. In 2009, Verizon spent \$3.7 billion on advertising, AT&T \$3.1 billion. What were their respective messages? Really, stop and think. What were they spending so much money to tell you? Each claimed to be better, faster, and cheaper than the other, on the basis of data that had to be deciphered with a magnifying glass. There was a pattern to be discerned in the advertising numbers, meanwhile. No surprise: They are as similar as the two carriers' revenues, amounting in each case to about \$35 a year per subscriber. By contrast, Bharti Airtel, the leader in India, is adding tens of millions of customers each year, each of whom pays, on average, less than \$15 a year for (admittedly less robust) service.

To remark on this is not to allege collusion—rather, it's to note that in our competition-obsessed business culture, the way to defend an oligopoly is to spend money to deter entry by new competitors. Innovation only suffers as a result. In classic runaway fashion, mistaking competition for a reliable proxy for vitality leads to choices that undercut that vitality.

As industry after industry becomes concentrated to the point of oligopoly, fixating on the preservation of competition loses its meaning. It also leads to a

failure to notice—and to cultivate and preserve—an equally rich source of innovation in our newly connected world: collaboration.

Microsoft's behavior with regard to the Kinect, an add-on to its Xbox 360 game console, provides a striking example of conversion from competitive to collaborative behavior. The product incorporates new 3D-sensing technology so that any movement—say, a tennis swing—can be "seen" by the game without the player's holding a controller. The Kinect also understands spoken commands. The technology is of great use to robotics tinkerers and other do-it-yourself types, especially at a consumer-game price point. The problem is, it's buried deep in a proprietary product.

The day the product was released, Adafruit Industries, an open-source hardware company led by the charismatic hacker Limor "Ladyada" Fried, announced a reward of \$1,000 for anyone who could hack the Kinect and post the software online. Microsoft's knee-jerk reaction showed its competitive reflexes: It threatened legal repercussions for unauthorized use. That inspired Fried to double the bounty. Within 48 hours the code was online, and innovators worldwide started posting amazing applications of the Kinect's sensors, from reading X-rays to mapping caves. To its credit, Microsoft shifted its stance and embraced the new openness, realizing that doing so would not only benefit society but also enlarge its business opportunities. Last we heard, a team in Japan was adding Kinect technology to robot dogs to create robotic service animals for the blind.

Reining in Runaways

With some simple shifts in perspective, capitalism can evolve and center on new pursuits that reflect society's broader goals—and in doing so, bring its selection pressures back into alignment. It can adapt and continue to thrive. Imagine, for example, that people decide that something they consider to be the core of capitalism—competition—is actually not so central. Imagine that they give innovation that pride of place. Suddenly initiatives like Wikipedia and Linux don't seem so unlikely. Competition, still very much part of the system but unseated from its central position, moves over to allow for collaboration. Or suppose the pursuit of financial gain were not really the heart, much less the soul, of capitalism. Suppose capitalism really centered on the pursuit of value—the greatest good for the greatest number. That's also a formulation that does not reject finan-



P&G Flexes Its Collaborative Muscle

When a company like Procter & Gamble, rabidly competitive for most of its history, embraces collaboration as a source of innovation, there is hope for capitalism.

P&G's "Connect + Develop" program, which sources product innovations from all over the world, is widely known. But more recently the company leveraged its collaborative capabilities to achieve a different kind of goal: brokering a cooperative effort among firms to address an operational challenge.

The impetus for its action was clear. P&G's leadership team recently went public with an intention to reduce the amount of P&G packaging going into landfills to zero. In the Philippines, however, the firm faced a major impediment: The country lacked the capability to deal with 100% of the solid waste stream. While a recycling industry existed for materials such as metals, type 2 plastic, and paper, the residual waste stream (organics, plastic bags, clothing, and so on) was simply dumped in landfills. Using its global clout, P&G was able to bring three companies to the table to form a business to handle the entire waste stream, recycling whatever could be recycled and converting the rest to electricity and other forms of energy.

It isn't that P&G sees recycling as a revenue opportunity; it has no stake in the business. Rather, it saw how a collaborative effort could remove a barrier to reaching a strategic goal and wasted no time in making that happen.

cial profitability but allows it to sit easily beside the pursuit of other kinds of gains.

It sounds simple, but such a change in thinking will come hard. Clayton Christensen, in his writings on disruptive innovation, has taught us that it's almost impossible to change habits of mind in an incumbent firm even when there's a compelling logic to do so. Now scale that difficulty up to an entire economy and beyond, to the culture of G7 capitalism.

Happily, the economist Paul Romer thinks on this scale. His theory is that economies change for two, and only two, reasons. Developments in technology are the first, changing the relationships between inputs and outputs, requiring new skills, and perhaps migrating economic power from one geography to another. (It was a killer for Indonesia

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when ice replaced spices as a preservative, and again when synthetic rubber was developed for tires.) The other changes that reshape economies are those that modify rules. Romer cites the example of how society changed its treatment of debtors—from throwing them in prison to restructuring their finances in bankruptcy courts. It was a nonobvious rule change in any community focused on retributive justice, but it clearly held benefits for all involved: In response to a sunk cost, it put the focus on moving forward as productively as possible instead of expending even more of society's resources on incarceration and allowing no possibility for repayment.

Romer and Christensen agree: People tend to cling to the rules they grew up with. That's why both thinkers advise cultivating change in a green field. For Christensen this means a skunkworks in a company. Romer is experimenting with what he calls charter cities, taking a vacant piece of land and founding a new community on the basis of best-practice rules and a commitment to legal measures to enforce them. Along the same lines, PayPal founder Peter Thiel has launched the Seasteading Institute to establish floating nation-states that operate according to their own social, political, and legal systems.

The notion these innovators have independently conceived is a smart approach to effecting big-system change. But let us point to another set of fields not so artificially created but just as green and much, much larger: the world's emerging economies.

Capitalism's Changing Environment

We don't claim, obviously, that emerging economies are vast empty spaces. We mean that thanks to their projected growth rates, they will offer plenty of fertile ground for new rules to take hold, ones that are more appropriate for an information-era economy.

What's more, these economies will have enough clout to influence the rest of the world.

Consider the BRIC countries and the Goldman Sachs-designated "Next Eleven." Those 15 economies grew 22% between 2004 and 2009. The G7 economies grew 1%. In 2000, more than three-quarters of world GDP was accounted for by the rich countries. By 2050, this number is expected to fall to 32%. Meanwhile, the penetration of connectivity in countries around the globe is approaching parity. Fully 85 cell phones per hundred people sounds like a G7 number, but it's not—it's the emerging economies'. (The G7 average is 109.) In other words, the emerging economies have access to information and every opportunity to use it. Finally, we're expecting the global population to expand by three billion people before 2050—another source of growth—but only 90 million of them will be in the rich countries.

What model will the emerging economies embrace? Ten years ago, no one doubted that the Washington Consensus, with its emphasis on unfettered, "efficient" financial markets enforced by the IMF and other institutions of the West, would be the blueprint for countries climbing the economic growth tables. That instruction manual has now been discarded. What will replace it is for these rapidly growing societies to determine. But some elements are foreseeable.

Industrial production introduced new rules into the agriculture economy—for the organization of work, for accounting, and so on—largely due to the high investment in plant and equipment needed to support mass production. Hence graveyard shifts, standard costing, variance analysis, and budgeting became part of business culture. Information-based production is yet more different, because information is not scarce in the same sense that goods are.


Economists call information assets nonrival, because they can belong to many people at once, unlike, say, a pair of shoes. For scarce assets in a market economy, prices are set, at least implicitly, in an auction among rivals. But the next Wikipedia entry means more Wikipedia for everyone. This is the basis of one of the battles the information-economy consumer is waging against the entrenched practices of the industrial economy: the latter struggles to maintain an intellectual property law that will make no more sense in the future than debtor's prison.

Here's how capitalism will shake free of its runaways, then: Capitalists can be relied on to follow the money, which means that no matter where they're from, they will find themselves doing business in the emerging economies, where much of the world's growth will occur. Because those economies are growing rapidly, they will convert much sooner to modern infrastructure; because they are youthful, they will become digital native cultures before the aging societies of the West. They are poised to discover the economic rules that will define the information age. But they will make their choices unfettered by many of the assumptions taken for granted in the West—the two runaway fixations described

here among them. They will be the first to fully embrace new technologies, and they will be the ones to develop the rules for exploiting them. And because these economies will have so much clout, their rules will spread.

The importance of the emerging economies for capitalism, then, turns out not to be that they are a source of lower-cost labor for global firms, or even that they are exciting markets in which those firms can grow revenues. It is that they will reveal what kind of economy is suitable for an information technology world. As trade is increasingly conducted in new lands and by new hands, new mechanisms for measuring and learning from new successes will emerge. Those of us who believe capitalism can adapt and should not succumb to the excesses that are crippling it will keep looking for the new markers of fitness and sharing the new rules. Collectively we are capable of setting a new course for capitalism. We are, in the end, not peahens. ♡

HBR Reprint R1201C

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"If it doesn't budge this time, we'll try knocking."

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