last year, don't match up.

No wonder, then, that the current-account deficit is expected to hit $20 billion this year. In addition to FDI, Egypt has financed such shortfalls in recent years with handouts from Gulf states eager to support its military regime. But these are likely to dwindle as the low oil price diminishes the revenues of Egypt's benefactors. The government has announced new loans worth $1.5 billion from the African Development Bank and the World Bank, and is negotiating a separate $3 billion loan, over three years, from the latter. More dollars may come from the sale of land to Egyptians living abroad, which the government hopes will earn $2.5 billion. But there is still a sense that the country will have to tighten its belt.

So it did not come as a total surprise when the central bank allowed the Egyptian pound to hit a record low on October 18th. As *The Economist* went to press, the pound sat at 8.03 to the dollar, 11% weaker on the year. The black-market rate is still over 5% cheaper, so a further decline is expected. "It probably needs to fall a lot further to restore Egypt's external competitiveness," says Jason Tuvey of Capital Economics, a research firm. He expects a dollar to buy 8.25 pounds by the end of this year and 8.50 pounds by the end of next year. Others are more bearish.

The central bank's reluctance to allow the pound to fall faster stems from a fear of stoking inflation. Egypt imports many staples, which would jump in price if there were a sudden depreciation. That would cause widespread pain and might stir social unrest. "They won't want to risk another revolution," says Mr Sandeep. But it is possible that a new head of the central bank, announced on October 21st, will adopt a more decisive policy.

In the meantime, the prospect of further devaluation has put off investors, as have the capital controls intended to bolster the pound. Last year the government limited transfers abroad to $100,000 a year. Earlier this year, in an attempt to squeeze the black market, deposits in foreign-currency accounts were capped at $10,000 a day and $50,000 a month. Those moves, together with the government's rationing of foreign currency, have hurt business. Firms complain of a lack of cash for imports. Mr Tuvey believes this has contributed to a sharp slowdown in growth in the first half of the year.

If Egypt can muddle through the crisis, there is some cause for optimism. The government has invested in manufacturing in the hope of boosting exports. More importantly ENI, an Italian oil firm, has discovered a vast gasfield off the Egyptian coast. According to some estimates, the Zohr field could turn Egypt from an importer to an exporter of gas by 2020. That should bring in a dollar or two. ■

Debt in China

Deleveraging delayed

SHANGHAI

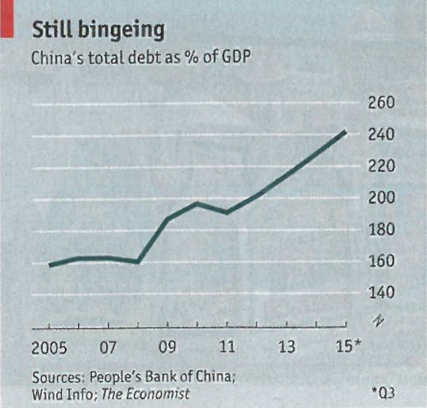
Credit growth is still outstripping economic growth

IN MOST respects, double-digit growth is a relic of the past for China. In the third quarter the economy grew by just 6.9% year-on-year according to official data, and probably by a percentage point or two less in reality. Yet bank loans increased by 15.4% in the third quarter compared with the same period in 2014. Having released a torrent of credit to buoy the economy during the financial crisis, China was supposed to have started deleveraging by now. Instead, banks are continuing to pump debt into the economy, while the authorities, apparently worried about the damage a contraction in credit might do, coax them on.

Growth in credit has at least slowed in recent years. A broad measure is "total social financing" (TSF), which encompasses bank loans, corporate bonds and a range of shadowy loan-like products. TSF growth soared to 35% in 2009 when the government called on banks to open the taps and support the then-faltering economy. It has since decelerated: it rose by 13% in the third quarter from a year earlier. The problem, though, is that nominal GDP growth has fallen much lower, to 6.2%.

This means that China's overall debt-to-GDP ratio is continuing its steady upward march (see chart). Debt was about 160% of annual output in 2007. Now, China's debt ratio stands at more than 240%, or 161 trillion yuan ($25 trillion), according to calculations by *The Economist*. It has risen by nearly 50 percentage points over the past four years alone, with slowing growth only serving to magnify indebtedness.

A rapid increase in debt in a short space of time has historically been a good predictor of financial trouble, from Japan in the 1990s to southern Europe in the 2000s. But there is no level that automatically triggers



Sources: People's Bank of China; Wind Info; *The Economist*

*Q3

crises. Since most of China's debts are hel
within the government-controlled bits
its economy (state-owned firms are the bi
gest debtors and state-owned banks the
biggest creditors), the country has th
means to avoid an acute crisis. It can, in e
fect, roll over bad loans as they come du
or abstain from calling them in. Howeve
although that spares the economy shor
term pain, it leaves it with a chronic a
ment. Ever more credit is needed to sustai
growth. Loans that should have gone
sprightly companies with promising ne
ideas go instead to corporate zombies.

There are worrying signs that China
heading in this direction. In the six yea
before the global financial crisis, eac
yuan of new credit brought about fi
yuan of national output. In the six yea
since the crisis, that has fallen to just ov
three yuan. It is not hard to find exampl
of companies on life support that in oth
countries might have perished by now.
September China National Erzhor
Group, which makes smelting equipmer
received a bail-out from its parent. Inve
tors in Sinosteel, a metals conglomerat
are now hoping for the same after it d
layed payment on a bond this week.

It is not too late for China to bring
debts under control. Regulators have take
steps in the right direction. They have o
liged local governments to provide bett
data on their debts and have forced ban
to bring more of their shadow loans on
their balance-sheets, providing a clear
picture of liabilities. One reason that ban
have been issuing loans so quickly th
year—faster than overall credit growth—
that they are replacing shadowier forms
financing. China has also used both mon
tary easing and a giant bond-swap pr
gramme for local governments to redu
the cost of servicing debts. The weighte
interest rate on existing liabilities has falle
from roughly 6% to 4.5% this year.

But some worry that these measur
are just pushing risks elsewhere. A bon
market boom is the newest concern. N
bond issuance in the first nine months
2015 reached 8.7 trillion yuan, up 67% fro
the same period a year earlier. At the sa
time, the gap between funding costs f
companies and the government has na
rowed sharply. The one-year yield on go
ernment bonds has fallen by nearly a pe
centage point over the past year, where
corporate yields have fallen by 1.5 percer
age points. In other words, investors a
lending to companies as if they were b
coming safer borrowers, even as their
abilities increase. Yang Chen of Bank
America Merrill Lynch notes that some i
vestors are buying bonds with borrowe
cash, believing that the government w
wade in to spare them from any big d
faults—as it has done in the past. If that i
pression persists, China's debt mounta
could grow bigger still. ■

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Business and corruption

Robber barons, beware

SHANGHAI

A crackdown on corruption has spread anxiety among China's business elite

"PROBLEMS that occur in business ...should not be politicised." So said President Xi Jinping before leaving China for London on a state visit this week (see page 52). He was referring to foreign critics of Chinese investment in Britain's infrastructure. At home, however, his words had resonance too. Mr Xi's fierce and unusually sustained crackdown on corruption has led to much anxiety among businessmen—especially those with close ties to political leaders and other officials.

Mr Xi's campaign against graft has ensnared some prominent business figures. Last month it was announced that Song Lin, a former chairman of China Resources Group, a state-owned conglomerate, was being prosecuted. On October 7th came news that Su Shulin, a former chairman of Sinopec, a state-run oil company, was under investigation. Mr Su had been serving as governor of Fujian province, making him the first incumbent of that rank to be targeted in this campaign. Five days later Jiang Jiemin, the former head of PetroChina, another state-controlled petroleum firm, was sentenced to 16 years in jail. On October 13th Chinese media reported the arrest of Sam Pa, a middleman in resource deals done in Africa by Chinese state-owned firms.

As Mr Xi's purge expands, the anxieties of some businessmen are growing. *Hurun Report*, a rich list, shows there are now more dollar billionaires in China (596) than in the United States (537). According to its research, carried out after this summer's stockmarket plunge and currency devaluation, China added 242 of its billionaires just this year. Some of these fortunes were earned honestly, but some surely were not. A Chinese property tycoon (who has not been accused of wrongdoing) says many fellow billionaires are akin to corrupt robber barons in America over a century ago.

SOE worrying

Crooked businessmen have reason to be nervous. But some analysts worry that the recent arrests of business leaders signal a broader anti-corporate campaign. Some believe that Mr Xi is taking a leaf out of Vladimir Putin's playbook, learning from his campaign against Russian oligarchs. They see the recent arrests as the possible start of a long-running reign of terror waged by an anti-business regime.

Such fears are overblown. Businessmen targeted so far are mostly senior managers of state-owned enterprises (SOEs), not private firms. In China powerful SOE bosses are also important figures in the Communist Party, so there are likely to be political reasons as well as economic ones for many of the arrests. Some of those detained are linked to Zhou Yongkang, a former security chief and head of a corrupt network of officials known as the "petroleum mafia" (he was sentenced to life in prison in June). Of more than 100,000 people indicted for graft since Mr Xi became leader in 2012, most are politicians and officials—not private businessmen.

Some of them, like Mr Pa, have been caught up in the crackdown. But the purge has so far mostly steered clear of the private sector. Indeed, Mr Xi's government has been rather supportive of Chinese business. Internet giants have been encouraged to expand into the provision of government-related services, such as booking hospital appointments and processing utility bills. They have been kept largely clear of antitrust scrutiny. The government has slashed red tape and made more credit available to startup firms. This may reflect a degree of understanding of the private sector's importance: it produces perhaps two-thirds of economic output and almost all new urban jobs.

In his dealings with business, Mr Xi is no Putin. His campaign is very clearly an effort to clean up the party; going after crooked SOE bosses is a necessary part of that. When Mr Putin attacked Russia's oligarchs—handing over their assets to his cronies—it had nothing to do with putting his political party on the straight and narrow. Mr Xi is different. His crackdown is an effort to "get rid of the thugs at the SOEs," says an adviser to multinationals in China.

Economic growth has been hurt by bureaucratic paralysis. Fearful of being branded corrupt, officials have become reluctant to facilitate deals. In the long term, however, a cleaner and more predictable business environment will help. The property tycoon says he believes Mr Xi will soon have no need to keep lashing out, having already made it clear that he will not tolerate corruption. "You can't even give a bribe these days," he says. ■

Reinventing the deal

America's startups are changing what it means to own a company

ATTENDING a baby-shower is not an obvious means of contributing to the vigour of American capitalism. But when thrown for one of 24 investors in Julia Jacobson's small startup, NMRKT, which enables boutiques and small manufacturers to create appealing electronic marketplaces for their products in half an hour, it is vital. Since 2013 the company has amassed 150 clients and is now considering its fourth round of financing. Attending social events helps Ms Jacobson and her equivalent at other startups to take stock of what investors want. This enables them to confront an enduring inefficiency of the market: aligning the interests of investors and owners.

Investors' opinions matter hugely to young firms like Ms Jacobson's. Judgments abound and diverge on the value of a startup without the ability to test it in an open market. One investor pushed Ms Jacobson to think about a dreaded "down-round", basing new fund-raising on a reduced valuation of the company. Others were eager to invest at a higher valuation or buy the company outright. By controlling the purse strings, investors have a great deal to say about the future growth of tiny endeavours like hers.

The personal touch may be useful but it is not the main way that startups stand apart from traditional firms. The most distinctive aspect of America's vibrant startup sector is the way the ownership of companies is structured. A new breed of firms such as Uber, a taxi-hailing app, or Airbnb, a website that lists properties for short-term rental, is establishing a novel type of corporate arrangement. Investors, founders, managers and, often, employees have stakes that are delineated by carefully drawn contracts, rather than shares of the sort that trade on exchanges.

For people like Ms Jacobson these contractual arrangements provide an experience of ownership that sidesteps the concerns of public companies, by avoiding the contentious regulations and politics that surround big businesses. That should make for better-run firms if managers are fully focused on transforming a concept into a successful company.

Working this way is not easy. Conflicts between the parties arise all the time, over valuations and much else. But it allows such firms to reach pools of capital that an old-fashioned family business would not have got its hands on. Startups typically begin with savings, or money from family and friends, but then tap outside investors for seed funding through a variety of channels, including lawyers, accelerators (in essence, schools for startups) and other "angel" investors with cash to back founders with ideas. These increasingly include entrepreneurs who made money from their own startups and now invest in others. Indeed, the number of small deals has increased substantially in recent years (see chart 1 on next page).

Jerry Schlichter's day-to-day experience untangling questions of ownership is less uplifting. Mr Schlichter is a lawyer who works not on heading off conflicts in small firms but on attempting to get better deals for investors in larger ones. He specialises in suing firms and financial institutions over their management of 401K pension accounts, through which a large number of Americans save for retirement. The money invested is automatically removed from pay cheques by employers, making workers, in the words of Leo Strine, chief justice of the Delaware Supreme Court, "forced capitalists".

Contract and expand

As in Ms Jacobson's world, there is a distinction between what it is to be an owner and an investor. But unlike the contract-heavy world of the startup, that distinction is not well defined and indeed in many ways it is denied. The language used, and the law applied, seems to treat such forced capitalists as owners. But they lack almost all the rights and freedoms that privilege might normally afford.

Interests are misaligned along the entire chain. An employer running a 401K selects a committee which selects an investment provider which in turn selects fund managers who select companies whose—selected—board members appoint managers. Each step is swathed in regulation that, ▸▸

even if well-intentioned, is shaped by lobbyists to benefit one or other of the parties rather than the system as a whole.

This layer-cake provides ample scope for mischief, as Mr Schlichter's business attests. But even if it were to operate without added complications, the different interests of the different layers would impose large and inescapable costs. Fees, such as those charged by mutual funds, are unavoidable at every level. More insidious is the "agency problem" that arises from conflicts of interest between people who provide money and all the parties through which it travels to and from investments.

Agency problems make the idea that a company is actually owned feel almost illusory. The link between the interests of the forced capitalists in 401KS (and federal-government pension schemes that are broadly similar) and the management of the assets they purportedly own is, at best, compromised. The experience of owning a company no longer accords with what is normally meant by ownership.

The new model of capitalism practised by Ms Jacobson and thousands of other startups is an attempt to get around the inefficiencies and costs imposed by the agency problem. The allocation of rights in a public company is unarticulated and ambiguous. Attempts to fix this through demands for more transparency and regulatory changes, such as the Sarbanes-Oxley reforms introduced in the wake of the Enron scandal, may have helped in some ways but have added to the costs and complications by adding another level of bureaucracy and more red tape.

The fragmentation of ownership is an unintended consequence of the rise and development of the public company. In the 19th century, American limits on banks' ability to lend restricted credit, but a strong legal system supported contractual agreements, notes Robert Wright of Augustana University in South Dakota. That enabled capital to be raised through direct public offerings, which were instrumental in the early development of American industry.

Over time, mechanisms emerged to trade these direct offerings in regional and national financial markets. Stockmarkets were not the only source of finance and the joint-stock company not the only model of ownership. But big public companies became the capitalist norm.

A result of this democratisation of ownership was its dilution and the loss of one of its components—control. Shareholders lost their grip on ownership and the collective strength to manage their agents, who ran companies. In 1932 Gardiner Means and Adolf Berle argued in "The Modern Corporation and Private Property" that the outcome was that companies became akin to sovereign entities, divorced from the influence of their "owners" by retained earnings that allowed managers to invest as they chose. As companies became ever larger and more powerful, government felt the need to constrain them.

Laws and regulations have increasingly limited what companies can do, including, most recently, the amount of profits they can return to shareholders. To help owners evaluate whether to buy or sell shares, companies are forced to disclose ever more of what they are up to, but the usefulness of this information is undermined by the layer-cake of agency issues.

Individuals have been net sellers of shares for decades; in their place institutions have expanded relentlessly. Financial institutions now hold in excess of 70% of the value of shares on America's stock exchanges (see chart 2). The leaders include such familiar names as BlackRock, Vanguard and JPMorgan Chase.

Their size gives the biggest financial firms a great deal of influence. But just as managers of a company may not find their interests aligned with those of shareholders, so the managers of these investment firms may not share the interests of their investors. This creates what John Bogle, founder of Vanguard, calls a "double-agency" society in which the assets nominally owned by millions of individuals are in the hands of a small group of corporate and investment managers whose concerns may differ from those of the masses.

Surprisingly, given America's litigious nature, few, if any, legal actions emerged in this area until 2006 when Mr Schlichter initiated a string of cases that accuse American companies of not acting in the best interest of their employees who participate in 401K plans. His first court victory came in 2012. This year he has won settlements from Boeing and Lockheed Martin. His extensive briefs provide a window into a complex world with layer upon layer of hidden costs and conflicting interests.

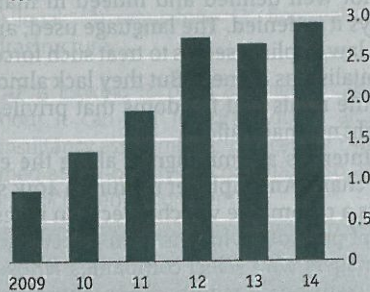
The disparity between the fees some institutions charge and their performance has recently received much attention, in part because, as an issue, it is both understandable and relatively transparent. Less easily quantified bones of contention may matter as much or more. For instance, a disparity between the pressure investment firms place on companies to perform in the short term and the time-horizon of investors, which may be much longer, has given rise to complaints voiced by Mr Bogle and others about a destructive "quarterly capitalism". And Jamie Dimon, head of JPMorgan Chase, has criticised investment managers as "lazy capitalists" for farming out decision on crucial shareholder votes to consultancies. Those consultancies, working as they do for many investors, are open to conflicts of interest themselves.

No fund to be with

Agency issues are particularly acute in the fastest growing part of the money-management business: the index funds which now represent a third of all the money in mutual funds. They are popular because in an efficiently priced market they are hard to outperform and can be managed at almost no cost. But they do not make their own decisions about when to buy and sell but simply seek to match the holdings of the index, such as the S&P 500, that they track. This low-maintenance approach does not generally include employing stakes to intervene in company decision-making.

Large index managers such as Vanguard, BlackRock and State Street, along with Legal & General in Britain, are acutely aware of this issue. They are responding by trying, in the words of Vanguard's Glenn Booraem, to be "passive investors but active owners". Each firm has created a department to consider shareholder motions and management issues, and to interact with activist investors. It is unclear how this will work or what will be considered. As their power grows, so will controversy.

As huge funds ponder the agency problem, New York's startups are trying to do away with it. In years gone by, entrepreneurs in small businesses would have existed in an informal state. Now the terms of ownership for investors, founders and employees are being defined ever more tightly almost at the time of the creation of new businesses. Clarifying issues of ownership along with innovations in finance is encouraging the availability of capital and ex- ▸▸



pertise, once harder to come by for the small business.

Visit 85 Broad Street in downtown Manhattan to see this in action. Until 2009 it was the headquarters of Goldman Sachs and at the beating heart of American finance. WeWork, a firm that houses young companies, has now taken over six of its 30 floors to house 2,000 of what the firm likes to call its members. The stream of limousines with blacked-out windows that surrounded the building during Goldman's tenure has thinned, replaced by swarms of people in an array of startup-wear, from tartan shirts to hoodies.

WeWork has 30,000 members in over 8,000 companies in 56 locations in 17 cities. A number of other co-working spaces exist, such as the Projective, which housed early incarnations of Stripe, an online-payment system, and Uber. Demand is booming for the desks that served as launching pads for firms that now flourish. Apartments in Williamsburg, Greenpoint, Bushwick and other newly fashionable neighbourhoods are filled with startups.

In at the startup

Startups with appealing ideas and driven employees but with no contacts, business expertise or capital can receive all those through institutions such as Techstars and Dreamit Ventures, which receive thousands of applications every year. The handful that are selected get money, advice on strategy, marketing, leadership, legal help and access to investors—all functions large firms either provide internally or through pricey consultancies. In return, the nurturers receive small equity stakes and, if they have chosen the right startups and given them the right boost, a reputation that will attract further promising corporate youngsters into their orbit.

New companies have always suffered because commercial banks cannot lend to firms lacking assets and revenues, nor can the firms pay the high fees and retainers demanded by traditional investment banks and law firms. But an elaborate system has begun to emerge for both. Some will be able to get initial capital at effectively no cost from crowdfunding sites like Kickstarter and Indiegogo. An enthusiastic reception can attract bigger investors. This was the route taken by Oculus VR, a virtual-reality startup acquired in 2014 by Facebook for $2 billion.

More common is the creation from the outset of a company that can receive more usual forms of investment, albeit in a novel way. Law firms with experience in the older startup culture of the west coast, such as Cooley and Gunderson Dettmer, do a lot of business setting up such things in New York; so, perhaps unsurprisingly, do a number of law firms that are startups themselves. Spencer Yee left a career at Simpson, Thacher & Bartlett, an established law firm, to work from home on Manhattan's Lower East Side but has since moved to a co-working space.

Lawyers in the startup world play a vastly different role from those who advise—or sue—large companies. This is in part because of the nature of their clients; often tottering between failure and success they rely more heavily on outside advice. But it is also because lawyers, in the early stages, have replaced banks as the key intermediary for financing. But most importantly they negotiate directly with investors and physically maintain the "cap structure"—the all-important legal contract noting who owns what.

The ambiguities and obfuscation of public companies contrast sharply with the new corporate structures set out by legal contracts that make the rights of both investors and owners more explicit. These legal agreements tackle two fundamental difficulties. The first is the need to mitigate agency problems. This is handled by detailed agreements that include control issues, such as the allocation of board seats. Investors usually insist that management, and often employees, own large stakes to ensure their interests are aligned to the success of the venture.

The second difficulty concerns enabling investment in the absence of an important detail: a plausible valuation. Startups are pioneering a novel answer: an agreement at the early investment stages that enables an investor to buy a proportion of the venture, but at a price determined at a subsequent round of fund-raising, typically a year or two in the future.

The website of Wilson Sonsini, a California-based law firm, offers a 47-step process for generating such contracts; it is free to use as long as you tick a box promising not to claim Wilson Sonsini is your lawyer.

The growth of Mr Yee's tiny firm—he has closed six rounds of financing and two company sales—depends on the need to negotiate each term carefully.

Typically, after initial funding, a founder will retain as much as 60% of the company, with 10-20% reserved for employees and the rest for outside investors. But terms are fluid. Each subsequent round of financing usually dilutes the original stakes by a fifth. That may sound harsh but if the firm's value is growing fast it can transform a large stake worth nothing into a small one worth a fortune.

The more appealing the idea and the more plausible their record as mangers, the better the terms founders can demand. Annie Lamont, a venture capitalist, points to a management team which, for its first startup, raised an initial $25m and held 10% of the equity by the time the venture was sold. Its most recent startup raised $160m and the team held 18.5% of the company when it was sold. Success lets you raise more money and negotiate a better deal in subsequent rounds of financing. There is no shortage of individuals and institutions straining for a chance to invest in some of the more successful but yet-to-go-public startups like Uber and Airbnb, which have done a series of fund-raising rounds on increasingly attractive terms.

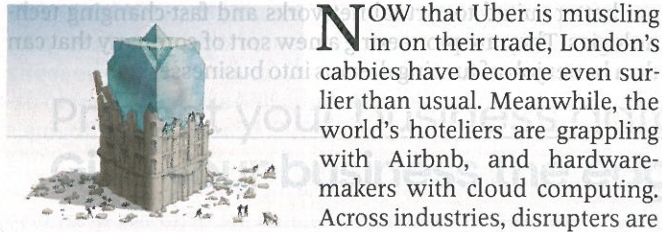
This new way of doing business does not mean there is no role for conventional finance. For all the startups that promise they will never go public—Kickstarter is one—others are keen to do so at some point. Some hope to follow the trajectory of Facebook and Google—vast enterprises, led for a time by their founders, whose shares trade on public markets.

At the moment, however, successful businesses find raising money quick and easy through private means, which gives them no incentive to rush. Using technology to create a secondary market for shares might also means that the biggest no longer need to go public because the ability to extract liquidity from private firms is becoming much simpler. For now, at least, public markets are seen less as a place to raise money and create enterprises than as a mechanism to cash out if and when the time is right.

The flow of money into the startup world is, to some extent, for want of a better alternative. Low interest rates have undermined returns from "safe" investments and encouraged speculation. It would not be surprising if the current upheaval in equity markets curtailed this flow. A similar dampening will be felt if lots of the new firms fail, or if down-rounds become common. Even so, the new structure pioneered by startups is likely to endure as long as it serves as an effective response to the flaws of the public markets. Ms Jacobson is unlikely to have visited the last baby-shower in honour of an investor. ■

Reinventing the company

Entrepreneurs are redesigning the basic building block of capitalism



NOW that Uber is muscling in on their trade, London's cabbies have become even surlier than usual. Meanwhile, the world's hoteliers are grappling with Airbnb, and hardware-makers with cloud computing. Across industries, disrupters are reinventing how the business works. Less obvious, and just as important, they are also reinventing what it is to be a company.

To many managers, corporate life continues to involve dealing with largely anonymous owners, most of them represented by fund managers who buy and sell shares listed on a stock exchange. In insurgent companies, by contrast, the coupling between ownership and responsibility is tight (see pages 23-26). Founders, staff and backers exert control directly. It is still early days but, if this innovation spreads, it could transform the way companies work.

Listing badly

The appeal of the insurgents' model is partly a result of the growing dissatisfaction with the public company. True, the best public companies are remarkable organisations. They strike a balance between quarterly results (which keep them sharp) and long-term investments (which keep them growing). They produce a stream of talented managers and innovative products. They can mobilise talent and capital.

But, after a century of utter dominance, the public company is showing signs of wear. One reason is that managers tend to put their own interests first. The shareholder-value revolution of the 1980s was supposed to solve this by incentivising managers to think like owners, but it backfired. Loaded up with stock options, managers acted like hired guns instead, massaging the share price so as to boost their incomes.

The rise of big financial institutions (that hold about 70% of the value of America's stockmarkets) has further weakened the link between the people who nominally own companies and the companies themselves. Fund managers have to deal with an ever-growing group of intermediaries, from regulators to their own employees, and each layer has its own interests to serve and rents to extract. No wonder fund managers usually fail to monitor individual companies.

Lastly, a public listing has become onerous. Regulations have multiplied since the Enron scandal of 2001-02 and the financial crisis of 2007-08. Although markets sometimes look to the long term, many managers feel that their jobs depend upon producing good short-term results, quarter after quarter.

Conflicting interests, short-termism and regulation all impose costs. That is a problem at a time when public companies are struggling to squeeze profits out of their operations. In the past 30 years profits in the S&P 500 index of big American companies have grown by 8% a year. Now, for the second quarter in a row, they are expected to fall, by about 5% (see page 57). The number of companies listed on America's stock exchanges has fallen by half since 1996, partly because of consolidation, but also because talented managers would sooner stay private.

It is no accident that other corporate organisations are on the rise. Family companies have a new lease of life. Business people are experimenting with "hybrids" that tap into public markets while remaining closely held. Astute investors like Jorge Paulo Lemann, of 3G Capital, specialise in buying public companies and running them like private ones, with lean staffing and a focus on the long term.

The new menagerie

But the most interesting alternative to public companies is a new breed of high-potential startups that go by exotic names such as unicorns and gazelles. In the same cities where Ford, Kraft and Heinz built empires a century ago, thousands of young people are creating new firms in temporary office spaces, fuelled by coffee and dreams. Their companies are pioneering a new organisational form.

The central difference lies in ownership: whereas nobody is sure who owns public companies, startups go to great lengths to define who owns what. Early in a company's life, the founders and first recruits own a majority stake—and they incentivise people with ownership stakes or performance-related rewards. That has always been true for startups, but today the rights and responsibilities are meticulously defined in contracts drawn up by lawyers. This aligns interests and creates a culture of hard work and camaraderie. Because they are private rather than public, they measure how they are doing using performance indicators (such as how many products they have produced) rather than elaborate accounting standards.

New companies also exploit new technology, which enables them to go global without being big themselves. Startups used to face difficult choices about when to invest in large and lumpy assets such as property and computer systems. Today they can expand very fast by buying in services as and when they need them. They can incorporate online for a few hundred dollars, raise money from crowdsourcing sites such as Kickstarter, hire programmers from Upwork, rent computer-processing power from Amazon, find manufacturers on Alibaba, arrange payments systems at Square, and immediately set about conquering the world. Vizio was the bestselling brand of television in America in 2010 with just 200 employees. WhatsApp persuaded Facebook to buy it for $19 billion despite having fewer than 60 employees and revenues of $20m.

Three objections hang over the idea that this is a revolution in the making. The first is that it is confined to a corner of Silicon Valley. Yet the insurgent economy is going mainstream. Startups are in every business from spectacles (Warby Parker) to finance (Symphony). Airbnb put up nearly 17m guests over the summer and Uber drives millions of people every day. WeWork, an American outfit that provides accommodation for startups, has 8,000 companies with 30,000 workers in 56 locations in 17 cities.

The second is that the public company will have the last laugh, because most startups want eventually to list or sell themselves to a public company. In fact, a growing number choose to stay private—and are finding it ever easier to raise funds without resorting to public markets. Those technology ▸▸

companies that list in America now do so after 11 years compared with four in 1999. Even when they do go public, tech entrepreneurs keep control through "A" class shares.

The third objection is that ownership in these new companies is cut off from the rest of the economy. Public companies give ordinary people a stake in capitalism. The startup scene is dominated by a clique of venture capitalists with privileged access. That is true, yet ordinary people can invest in startups directly through platforms such as SeedInvest or indirectly through mainstream mutual funds such as T. Rowe Price, which buys into them during their infancy.

Today's startups will not have it all their own way. Public companies have their place, especially for capital-intensive industries like oil and gas. Many startups will inevitably fail, including some of the most famous. But their approach to building a business will survive them and serve as a striking addition to the capitalist toolbox. Airbnb and Uber and the rest are better suited to virtual networks and fast-changing technologies. They are pioneering a new sort of company that can do a better job of turning dreams into businesses. ■

China and Britain

Friends in need

Britain has rolled out the red carpet for Xi Jinping. It must not forget its better friends

XI JINPING'S procession down the Mall towards Buckingham Palace, with the queen sitting alongside in a resplendent gold-roofed carriage drawn by six grey horses, is a scene that the Chinese president will have relished. Never mind that a year ago a state-run newspaper in China had derided Britain as the relic of an "old, declining empire" given to "eccentric acts" to hide its embarrassment over its fading power. British pomp, as laid on for Mr Xi in its full gaudiness during his first state visit to London this week, was relayed at fawning length to television viewers back in China.

Britain is not the only Western country to court China. Mr Xi was welcomed in Washington, DC, last month. The leaders of France and Germany will soon travel to Beijing. Mr Xi is head of the world's most populous country, second-largest economy and fastest-rising military power.

But China is also secretive and authoritarian. Mr Xi has been harder-line than even his two immediate predecessors, suppressing an emerging civil society, tightening controls over the internet and flexing muscle in Asia's disputed seas. China's intentions towards the rest of the world are hard to fathom (they may not even be clear to China itself).

For Britain, and all Western democracies, the dilemma is over how to deal cordially and profitably with China, as they must, while encouraging it to develop in a way that neither oppresses its own people nor destabilises the world. Ostracism would be counterproductive. China is strong enough to go it alone and treating it as an enemy would be the best way to turn it into one. Yet kowtowing is damaging, too, because it encourages China to demand concessions (only to take mighty offence when they are refused) and to think that, with a little ingenuity, it can weaken the Western alliance.

The West thus needs a nuanced policy that includes trade and investment; widespread engagement; and when necessary a readiness to defend its principles and security interests.

On this measure David Cameron, Britain's prime minister, has failed the test of statesmanship. This week Mr Xi was asked to address both houses of Parliament, an honour normally accorded only to leaders of democracies. He was to be hosted at Chequers, the prime minister's country residence—again a first for a visiting Chinese president. Organised pro-Xi crowds were allowed to drown out protesters. Given Mr Cameron's public silence on human rights, his talk of a "golden age" suggests he is subordinating his principles to the lure of China's gold.

That is a miscalculation. China is sitting on the world's largest pile of foreign exchange. As its economy slows it is eager for its companies to find opportunities abroad. Britain has them aplenty, whether in financial services or in building infrastructure (at which China excels). It does not have to bow before Mr Xi. As part of the European Union, the world's largest market, it can wield economic heft by acting with its allies instead of scrambling separately.

However, not all the criticism is well aimed. The idea that Chinese acquisition of stakes in firms (or whole companies) in the West damages the economy is wrong-headed. One eye-catching deal was for China to take a one-third stake in Britain's first new nuclear-power plant in a generation, possibly leading to the construction of more using China's own technology (see page 52). There are grounds for questioning the economic logic of this deal—the power would be bought at guaranteed prices far above current market rates. But if the project is subject to the full rigour of safety and security reviews then there is no reason to think that it will give China a strategic stranglehold on Britain any more than, say, the stake it owns in London's water supply.

Trading with China is doubly beneficial: both for the British economy and by binding China into the Western system of international rules. More than 150,000 Chinese are studying in Britain; a similar number come annually as tourists. If they return to China with a better understanding that stability and prosperity—China's oft-stated goals—do not require omnipresent police, thugs and spies, that is all for the good. So it makes sense to facilitate visas and to help train Chinese judges.

Feet on the ground, please

The worry is that the new golden friendship with Beijing will endanger the old "special relationship" with America. China's assertiveness in its backyard may not affect Europeans—yet. But they have a vital interest in a peaceful, well-ordered world. If China clashes with America, still East Asia's foremost power, Europe will not be spared the consequences.

So once Mr Xi has gone, Mr Cameron should be sure to talk about the problems in China, not just the promise. He should support America when it challenges China's claims in the South China Sea. Even better, he could send along a ship. ■