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THE GREAT DEGENERATION

HOW INSTITUTIONS DECAY *and* ECONOMIES DIE

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for
Thomas

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Introduction

Beyond 'Deleveraging'

Almost a quarter of a century ago, in the summer of 1989, Francis Fukuyama could boldly predict 'an unabashed victory of economic and political liberalism . . . the Triumph of the West' and proclaim that 'the end point of mankind's ideological evolution' was 'the universalization of Western liberal democracy as the final form of human government'.[1] How different the world looks now. 'Economic liberalism' is a tarnished brand, while the proponents of 'state capitalism' in China and elsewhere openly deride Western democracy. The West is stagnating, and not only in economic terms. In 2013 the World Bank expected the European economy to contract and the US to grow by just 2 per cent. China would grow four times faster than that, India three times faster. By 2017, according to the International Monetary Fund, the gross domestic product of

China would overtake that of the United States.* Those who invested in the West in 1989 have been punished (they have made nothing since 2000), while those who invested in the Rest have been richly rewarded. This 'great reconvergence' is a far more astonishing historical event than the collapse of communism that Fukuyama so astutely anticipated. At the time he wrote, the world's centre of economic gravity was still firmly in the North Atlantic. Today it is beyond the Urals, and by 2025 it will be just north of Kazakhstan – on roughly the same line of latitude as it was in 1500, on the eve of Western ascendancy.[2]

The voguish explanation for the Western slowdown is 'deleveraging': the painful process of debt reduction (or balance sheet repair). Certainly, there are few precedents for the scale of debt in the West today. This is only the second time in American history that combined public and private debt has exceeded 250 per cent of GDP. In a survey of fifty countries, the McKinsey Global Institute identifies forty-five episodes of deleveraging since 1930. In only eight was the initial debt/GDP ratio above 250 per cent, as it is today not only in the US but also in all the major English-speaking countries (including Australia and Canada), all the major continental European countries (including Germany), plus Japan and South Korea.[3] The

* On a purchasing-power parity basis, adjusting for the fact that non-tradable goods and services are much cheaper in China than in the United States. In current dollar terms, the Chinese economy will still be 60 per cent the size of the American in 2016 – compared with just 8 per cent in 1989.

deleveraging argument is that households and banks are struggling to reduce their debts, having gambled foolishly on ever rising property prices. But as people have sought to spend less and save more, aggregate demand has slumped. To prevent this process from generating a lethal debt deflation, governments and central banks have stepped in with fiscal and monetary stimulus unparalleled in time of peace. Public sector deficits have helped to mitigate the contraction, but they risk transforming a crisis of excess private debt into a crisis of excess public debt. In the same way, the expansion of central bank balance sheets (the monetary base) prevented a cascade of bank failures, but now appears to have diminishing returns in terms of reflation and growth.

Yet more is going on here than just deleveraging. Consider this: the US economy created 2.4 million jobs in the three years beginning in June 2009. In the same period, 3.3 million Americans were awarded disabled worker benefits. The percentage of working-age Americans collecting disability insurance has risen from below 3 per cent in 1990 to 6 per cent.[4] Unemployment is being concealed – and rendered permanent – in ways all too familiar to Europeans. Able-bodied people are classified as disabled and never work again. And they also stay put. Traditionally around 3 per cent of the US population moves to a new state each year, usually in pursuit of work. That rate has halved since the financial crisis began in 2007. Social mobility has also declined. And, unlike the Great Depression of the 1930s, our 'Slight Depression' is doing little to reduce the yawning inequality in income distribution that has developed over the past three decades. The income share of the top 1 per cent of households rose from 9 per cent in 1970 to 24 per cent in 2007. It declined by less than 4 percentage points in the subsequent three years of crisis.

You cannot blame all this on deleveraging. In the United States, the wider debate is about globalization, technological change, education and fiscal policy. Conservatives tend to emphasize the first and second as inexorable drivers of change, destroying low-skilled jobs by 'offshoring' or automating them. Liberals prefer to see widening inequality as the result of insufficient investment in public education, combined with Republican reductions in taxation that have favoured the wealthy.[5] But there is good reason to think that there are other forces at work – forces that tend to get overlooked in the slanging match that passes for political debate in the United States today.

The crisis of public finance is not uniquely American. Japan, Greece, Italy, Ireland and Portugal are also members of the club of countries with public debts in excess of 100 per cent of GDP. India had an even larger cyclically adjusted deficit than the United States in 2010, while Japan faced a bigger challenge to stabilize its debt/GDP ratio at a sustainable level.[6] Nor are the twin problems of slow growth and widening inequality confined to the United States. Throughout the English-speaking world, the income share of the top '1 per cent' of households has risen since around 1980. The same thing has happened, albeit to a lesser extent, in some European states, notably Finland, Norway and Portugal, as well as in many emerging markets, including China.[7] Already in 2010 there were at least 800,000 dollar millionaires in China and sixty-five billionaires. Of the global '1 per cent' in 2010, 1.6 million were Chinese, approaching 4 per cent of the total.[8] Yet other countries, including Europe's most successful economy, Germany, have not become more unequal, while some less developed countries, notably Argentina, have become less equal without becoming more global.

By definition, globalization has affected all countries to some degree. So, too, has the revolution in information technology. Yet the outcomes in terms of growth and distribution vary hugely. To explain these differences, a narrowly economic approach is not sufficient. Take the case of excessive debt or leverage. Any highly indebted economy confronts a narrow range of options. There are essentially three:

1. raising the rate of growth above the rate of interest thanks to technological innovation and (perhaps) a judicious use of monetary stimulus;
2. defaulting on a large proportion of the public debt and going into bankruptcy to escape the private debt; and
3. wiping out of debts via currency depreciation and inflation.

But nothing in mainstream economic theory can predict which of these three – or which combination – a particular country will select. Why did post-1918 Germany go down the road of hyperinflation? Why did post-1929 America go down the road of private default and bankruptcy? Why not the other way round? At the time of writing, it seems less and less likely that any major developed economy will be able to inflate away its liabilities as happened in many cases in the 1920s and 1950s.[9] But why not? Milton Friedman's famous dictum that inflation is 'always and everywhere a monetary phenomenon' leaves unanswered the questions of who creates the excess money and why they do it. In practice, inflation is primarily a *political* phenomenon. Its likelihood is a function of factors like the content of elite education; competition (or the lack of it) in an economy; the character of the legal system; levels of violence; and the political decision-making process itself. Only by historical methods can we explain why, over the past thirty years, so many countries created forms of debt that, by design, cannot be inflated away; and why, as a result, the next generation will be saddled for life with liabilities incurred by their parents and grandparents.

In the same way, it is easy to explain why the financial crisis was caused by excessively large and leveraged financial institutions, but much harder to explain why, after more than four years of debate, the problem of 'too big to fail' banks has not been solved. Indeed, despite the passage of legislation covering literally thousands of pages, it has got markedly worse.[10] Today, a mere ten highly diversified financial institutions are responsible for three-quarters of total financial assets under management in the United States. Yet the country's largest banks are at least $50 billion short of meeting new capital requirements under the new 'Basel III' accords governing bank capital adequacy. Again, only a political and historical approach can explain why Western politicians today call simultaneously for banks to lend more money and for them to shrink their balance sheets.

Why is it now a hundred times more expensive to bring a new medicine to market than it was sixty years ago – a phenomenon Juan Enriquez has called 'Moore's Law* in reverse'? Why would the Food and Drug Administration probably prohibit the sale of table salt if it were put forward as a new pharmacological product (it is after all toxic in large doses)?[11] Why, to give another suggestive example, did it take an American journalist sixty-five days to get official permission (including, after a wait of up to five weeks, a Food Protection Certificate) to open a lemonade stand in New York City?[12] This is the kind of debilitating red tape that development economists often blame for poverty in Africa or Latin America. The rationale for the FDA's rigid standards is to avoid the sale of a drug like thalidomide. But the unintended consequence is almost certainly to allow many more people to die prematurely than would have died from side-effects under a less restrictive regime. We count and

* Moore's Law, formulated by Intel co-founder George Moore in 1965, predicted a doubling of the number of transistors that can be packed on to a computer chip every two years.

recount the costs of such side-effects. We do not count the costs of not allowing new drugs to be made available.

Why exactly has social mobility declined in the United States in the past thirty years, so that the probability has more than halved that a man born into the bottom 25 per cent of the income distribution will end his life in the top quartile?[13] Once the United States was famed as a land of opportunity, where a family could leap from 'rags to riches' in a generation. But today, if you are born to parents in the bottom income quintile, you have just a 5 per cent chance of getting into the top quintile without a college degree. What Charles Murray has called the 'cognitive elite', educated at exclusive private universities, intermarried and congregated in a few 'super zip codes', looks increasingly like a new caste, equipped with the wealth and power to override the effects of mean reversion in human reproduction, so that even their dimmer progeny inherit their lifestyle.[14]

The Stationary State

In two seldom quoted passages of *The Wealth of Nations*, Adam Smith described what he called 'the stationary state': the condition of a formerly wealthy country that had ceased to grow. What were the characteristics of this state? Significantly, Smith singled out its socially regressive character. First, wages for the majority of people were miserably low:

> Though the wealth of a country should be very great, yet if it has been long stationary, we must not expect to find the wages of labour very high in it . . . It is in the progressive state, while the society is advancing to the further acquisition, rather than when it has acquired its full complement of riches, that the condition of the labouring poor, of the great body of the people, seems to be the happiest and the most comfortable. It is hard in the stationary, and miserable in the declining state. The progressive state is in reality the cheerful and the hearty state to all the different orders of the society. The stationary is dull; the declining melancholy.[15]

The second hallmark of the stationary state was the ability of a corrupt and monopolistic elite to exploit the system of law and administration to their own advantage:

> In a country too, where, though the rich or the owners of large capitals enjoy a good deal of security, the poor or the owners of small capitals enjoy scarce any, but are liable, under the pretence of justice, to be pillaged and plundered at any time by the inferior mandarins, the quantity of stock employed in all the different branches of business transacted within it can never be equal to what the nature and extent of that business might admit. In every different branch, the oppression of the poor must establish the