



**Democracy caused the debt crisis.
Will it survive it?**

**by David Roche and Bob McKee
An Independent Strategy publication**

DEMOCRISIS

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Will it survive it?

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David Roche and Bob McKee

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PREFACE

This book describes the new challenge for democracies in the 21st century. Our first book, *New Monetarism*, dealt with the causes of the credit-fuelled asset bubble that burst in 2007. Our second book, *Sovereign DisCredit!*, explained the next stage of the crisis, the unprecedented explosion of sovereign debt in the major developed economies, as governments stepped in to bail out a collapsing banking sector and alleviate the social consequences of the ensuing Great Recession.

Democracy as an institution operated in a tiny minority of nation states after World War II. By the end of the 20th century nearly half of all states were democratic. But the expansion of both private and public sector debt now poses a major challenge to the survival and expansion of democracy in the world in the 21st century. The old democracies are losing global leadership. The question for investors and others alike is whether the new global leaders in the emerging economies will stimulate and support the democratic model or not.

We would like to thank our clients and other contacts for their feedback on our first two books. They inspired us to write this new one.

April 2012

DEMOCRISIS

“Writing long books is a laborious and impoverishing act of foolishness: expanding in five hundred pages an idea that could be perfectly explained in a few minutes. A better procedure is to pretend that those books already exist and to offer a summary, a commentary.”

— Jorge Luis Borges

Jorges Luis Borges was a great short story writer. His view was that most novels shouldn't have been written because they would have been better short stories.

Our books have always been written with this in mind. We try to make them the short stories of finance and economics. This one is too. But it looks into societal plate shifts rather than just economics.

This book is about the deeper implications of the global financial collapse and the ensuing sovereign debt crisis. Our first book, *New Monetarism*, dealt with the forces behind the global credit bubble of the last decade and the ensuing credit crunch. Our second book, *Sovereign DisCredit!*, explained how private sector leverage had migrated into a public sector debt explosion that has set an environment of deleveraging and slow global growth for years ahead.

DemoCrisis deals with the underlying issue that the global credit crisis has exposed: the crisis of democracy in the 21st century. The 20th century was the century of the triumph of democracy globally. The century started with most of the world either ruled by imperialist powers in the developed economies of the West or by autocratic regimes in Tsarist and then Soviet Russia, the Austro-Hungarian and Ottoman empires. Then there was the rise of fascist governments in Europe and Latin America and military-autocratic powers in Japan, China and most of the rest of Asia and Africa.

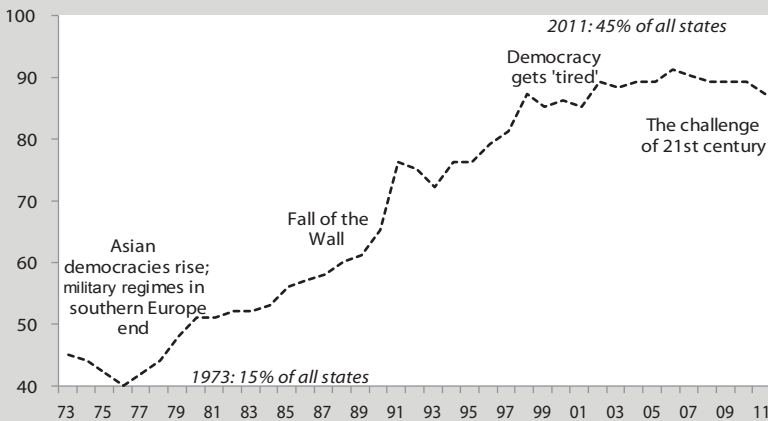


However, by the end of the century, nearly all these foes of democracy had been overturned. Imperialism and autocracy had crumbled. Fascism and militarism had been defeated in world wars. Democracy ruled in all parts of Europe, many parts of Latin America and Asia — and had even begun to appear in Africa. And in the last decade of the 20th century, the divide in Europe between the democratic west and the Stalinist east ended with the fall of the Wall (Figure 1).

Yet the triumph of democracy laid the seeds of a democratic crisis. Democracy became less vital; it became tired; the leaders of democracy lost their vision; the democratic world became complacent. Democratic regimes sought to bridge the gap between winners and losers with increased spending and credit bubbles, both unsustainable in the long term. Now the rich democracies are in a deep financial crisis. The social contract that bridged the gap between the winners and losers of the last two decades with the elixirs of social transfers and credit bubbles is dead.

The current global sovereign debt crisis will eventually be overcome in the

Figure 1: The rise of democracy (number of countries considered free)



Source: Freedom House, Independent Strategy

developed economies precisely because most are democratic countries and so can bear the pain better than autocratic or totalitarian regimes.

In that sense, this 'depression era' will be different from the 1930s, which gave way to the rise of undemocratic regimes in key countries: Germany, Italy, Spain, Portugal, Greece, parts of Eastern Europe and, of course, Russia and Japan. None of this applies now. Indeed, simultaneously with the current crisis in rich countries a fragile extension of democracy is happening: the Arab Spring. There is no sign of a return to autocracy or to the populist state in Europe, east or west.

There are many unanswered questions for rich democracies. Will the euro survive this crisis or will Europe break into bits; will Japan's democracy finally grasp the nettle of excessive debt that is crippling growth; and will America's elected politicians ever reach consensus on how to deal with the US' weakening public finances and halt the decline of the country's global influence?

It is inevitable that some emerging economies will vie with the developed countries for global leadership. But this will be because they have become more democratic. They could include China. But if China resists democracy, the rapid convergence of Chinese living standards with those of advanced economies could come to a halt. This is because the next stage of economic development in China needs the development of a vastly different economy and society. These are steps that can only happen if the state withdraws from many of its inhibiting functions and allows for democratisation and the rule of law.

For China and other emerging economies to continue to converge with rich democracies, the next stage of economic development requires the emergence of a middle class and the integration of its values into the social and economic model. This entails a radical break with the past.

This book outlines the stresses and uncertainties ahead and how investors should plan for overcoming the crisis of democracy in the 21st century. ●

THE CRISIS OF DEMOCRACY

All the richest countries are democracies. This is not an accident. They are so because they combine competing and open political and economic systems that maximise economic welfare.

Their excellence is systemic and includes a wide range of self-optimising systems, such as civic society, rule of law, representative political systems and meritocracy.

No other system, except the open and competitive economic and social-political systems inherent in democracy, has produced equivalent levels of widely distributed wealth and welfare in history.¹

Democracies that don't achieve wealth fail because they don't develop the self-optimising systems that are pre-conditions for wealth and welfare maximization. This is normally because they lack the critical mass of the middle class that keeps the political system relatively clean and provides the entrepreneurial motor for the economy.

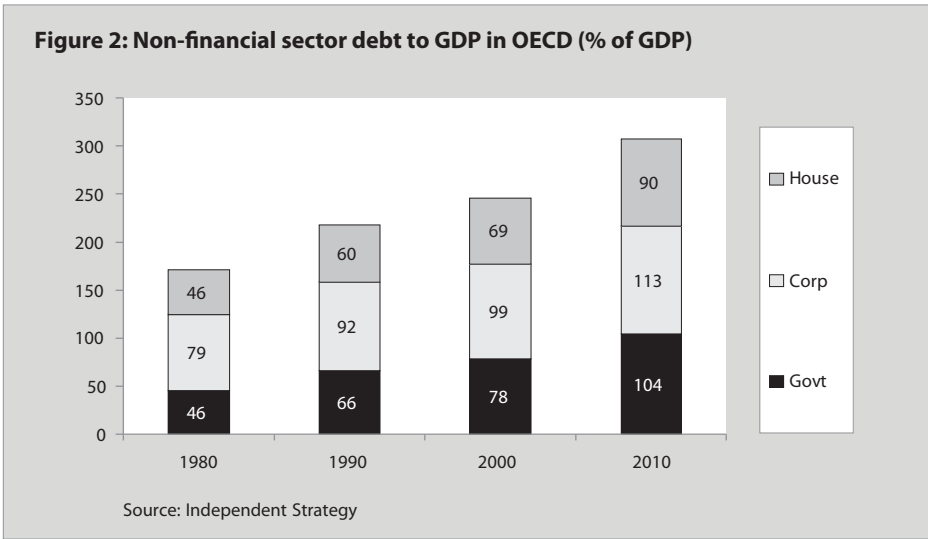
This observation of history is now challenged in two ways.

First, the richest democracies are in synchronised economic crises caused by excessive leverage and insufficient thrift as well as policy failure to address the fundamental reasons for both. As an example, economies accounting for 50% of global GDP will have sovereign debt levels equal or greater than 100% of GDP by 2012 and total private and public sector leverage greater than 300% of GDP. In each case, the ratio has doubled in the last 30 years (Figure 2).

Such excessive levels of leverage are the proximate causes of the crisis of democracy. The present focus of the crisis is sovereign debt. But its tentacles, as we shall see, spread far beyond.



THE CRISIS OF DEMOCRACY



However, the future of democracies and their superlative living standards are threatened by the solution to their debt problems. This has to involve deleveraging of both the state and the private sector. The process, if mishandled, could damage economies beyond repair and cause democratic states to fail.

Societies collapse, not because of the size of the challenges they face, but because of the choices they make in dealing with them. The outcome depends on the quality of the decision-making and thus on the systems that craft the responses to challenges. History is replete with examples of civilizations that are no more because they failed at this bar.²

Developing economies are outgrowing the developed economies. Will they debunk the rich democracies as the global paradigm? Some of the fastest growers, particularly in Asia, have societal systems based upon values that are almost antithetical to those of the rich democracies. Some version of their many alternative political models may replace democracy at the top of the global scale of wealth and welfare betterment. It is hardly an exaggeration to call this a crisis of democracy.

These are some of the questions that should be the focus here. The result should yield a map of the consequences, with an emphasis on intendant risks of various outcomes. ●

1. *Dougal C North, Joseph John Wallis, Barry R Weingast: (NBER working paper 12795: Dec 2006) — A Conceptual Framework for Interpreting Recorded Human History.*

2. *Jared Diamond: Collapse: how societies choose to fail or succeed — Guns, Germs and Steel.*

THE CRISIS OF DEMOCRACY

DYSFUNCTIONAL DEMOCRACY

The sovereign debt crisis is symptomatic of the democratic crisis. But it is a proximate, not an ultimate, cause of it. The ultimate cause lies in dysfunctional political systems and society itself.

Some time around the Fall of the Berlin Wall, democracy lost its vitality. Once the ideological debate about communism and capitalism was resolved, democracy became less vital. It became an argument about how to slice up the pizza and not about whether we should be eating pizza or borscht. Even massive terrorist attacks on democracy failed to change that because the perpetrators presented no feasible economic and political alternatives to that of rich democracies. But the process of democracy became a soft system, like an antivirus system working in the background of your computer screen — useful but not something you have to think about a lot. The big choices were over. The machine was on automatic pilot. The world got richer as globalisation, technology and huge pools of newly-liberated labour made it cheaper to live well and cheaper still to borrow to do so.

Our children went through university without ever discussing politics, a thing impossible in our day. Today, they only vote in elections if they face a fine if they don't. They do not consider the democratic process as relevant to their lives as it was critical to ours at their age.

At the same time, the way technology changed communication also changed politics. We take our information in increasingly condensed and immediate forms: the bullet point is the new book; the sound bite is the surrogate for debate.



DYSFUNCTIONAL DEMOCRACY

There is nothing wrong with this; the mass communication of ideas was instrumental in destroying the Soviet dictatorship by exposing it as an edifice of lies to its own citizens. It has done some good work in the Arab Spring too, where it has been a factor in organising the popular uprisings that defeated dictatorships. Arguably, none of this could have happened without the creation of communications technologies that cannot be effectively politically controlled. Even in China today, political malfeasance, from rural land confiscation to attempted cover-ups of high speed train crashes, can no longer be suppressed thanks to Twitter, Weibo and the mobile phone camera.

But technology also changes the way we elect leadership. First, the degree of scrutiny to which candidates for office are subjected is only possible given the freedom of access to information and its dissemination — both facilitated by technology. While it is good that this helps weed out people who are really unfit for office, there is another aspect. Smoking pot, employing an illegal Mexican maid and having an extra-marital affair are all disqualifiers for office. This ensures that at the outset candidates are bland and have no blemishes — the two going together — not the sort of people who produce great ideas. Trees that grow high in the sky have roots deep in dark earth. Shrubs don't.

Candidates today come to the electoral process as blank sheets of paper and are elected in marketing campaigns, expressed in sound bites, which write their 'content' on the basis of its appeal to whatever pockets of the electorate are targeted. Karl Rove's crafting of President Bush's electoral campaigns to capture the votes of religious extremists is a case in point: brilliant from an electoral standpoint, but bad for democracy.

The electoral process excludes 'big picture' people and big ideas. That suits an essentially disinterested electorate, which wants its narrow 'issues' dealt with, but is unmoved by the big picture. Big picture ideas can be right or wrong. Not all the ideas of Kohl, Thatcher, Brandt, De Gaulle, Spaak, Monet and Kennedy were good. But they were put to the electorate as policy choices representing the firmly held beliefs of the candidates, then selected and implemented or rejected by democratic process. Elections with no candidate actually saying what he or she is going to do to deal with well-known challenges are the rule today.

The process also encourages a political system that becomes increasingly an insiders' game absorbed in furthering its own interests. The result is visionless politics whose key to survival is hurting the least number of its special group interests, not in doing what is needed in the electorate's own best interest.

Sub-optimal policy is the inevitable result. So is the re-emergence of rentier interests as policy determinants (the dilution of post-crisis banking reform being a good example). This point is important, as one factor in hefting democratic economic performance above that of autocratic peers was the dismantlement of rentier economic systems.

Economic rentiers are characteristic of a social order that falls short of, and often precedes, democracy, where political power is concentrated in an autarky that holds on to power by doing deals with the economically affluent in return for protecting their economic privileges, ensuring social stability and undertaking defence of the realm.

By definition economic rents are a source of economic inefficiency. They impede the competition within and between economies and political systems. Socially they prevent the sort of open society that is fundamental to rich democracies. But it can be argued that, at a certain stage of economic development, economic rents permit the accumulation of capital in the hands of rentiers that focus it on the development of the economy, while promoting social and political stability at the same time. The chaebols' contribution to industrialisation of Korea in the time of dictatorship might be an example. So is the development of Malaysia's economy, particularly its infrastructure, under Mahathir in the long period he held office after the ethnic troubles of the 1970s.

The point in all these countries is that the period during which the positive effects of rentier society outweigh the costs have a 'use-by-date' set by the rise of the middle classes who want a more open society, an independent legal system and an economy that is closer to a level playing field. Yet rich democracies, in their fatigue and confusion, have reverted to a greater presence of rentier groups — none more so than in the case of bankers.

Bankers have been allowed to accumulate risks that endanger the state and economy, but make profits that they pay themselves and private shareholders without counting the costs of the risks they incur for society. By definition, banks earn economic rents because they do not cover the cost of the risks they represent for the state, the economy and society. Yet so intertwined are the bankers with the state and so powerful is the common interest in keeping the banks afloat at any cost, that most efforts to curtail the risks that banks represent for economies and governments look like failing, at least through the legislative process of most rich democracies (Figure 3). ●

WHAT IS REGULATION?

Since the banking crisis, the cry has been for better regulation. The international banking body, the Basel Committee, aims to strengthen capital adequacy ratios and lending ratios for banks

The problem with the recent regulatory measures is that they have focused on the formally regulated financial sector, while the financial crisis erupted in the unregulated shadow banking sector that played an increasingly large role in OECD economies.

Shadow banking is the system of finance that exists outside regulated depositories, investment banks, or bond funds. This sector finances more than 30% of assets in the US. Very little has been done to regulate it. Several half-hearted measures try to address the problems.

Under an agreement at the Group of 20 summit meeting in 2009, regulators across the world agreed to require clearing and exchange trading for derivatives. In the US, the Dodd-Frank financial regulatory law puts restrictions on derivatives trading. Those measures are designed to ensure better-defined margin requirements, planning for an orderly liquidation and removing counterparty risk. However, the implementation is lagging for this limited initiative designed to reduce counterparty risk due to global trading in derivatives.

Paul Volcker, former chairman of the Federal Reserve, wants the regulators to get banks out of the business of betting on the markets, including a requirement that trader compensation not be tied to speculative risk-taking. US regulators have ignored the breadth of the Volcker statute and focused instead on only a narrow slice of the bank's balance sheet — just what the bank says is for 'trading' purposes.

Figure 3. Source: *Independent Strategy*

THE MORAL FAILURE OF DEMOCRACY

The ultimate cause of the rich democracies' crisis today is the ethic of allowing living standards to be determined by what can be bought on credit, or granted by the state, rather than earned by work. This is tantamount to saying that a society should not produce enough to supply and pay for what it consumes and invests. The same characteristic was a hallmark of the decline of empires. Like a degenerate gene it affects the whole workings of society. The weakness of rich democracies today is ample and widespread enough to call into question their ability to continue to deliver superlative living standards.

Why does this book lay such store by thrift? It's an economic concept. But it is used here as an ethical anchor too. It may seem obvious, but thrift matters because it encourages behaviour that is a social good and lack of it produces inferior patterns of behaviour. It also underwrites the freedom of the individual.

The economic concept is simple. Savings are needed to fund investment. Too much saving and demand will be inadequate, causing the economy to contract. That's the famous 'deflationary' gap. Too little savings and demand exceeds the capacity of the economy to satisfy it, leading to inflationary imbalances and trade deficits.

But thrift is more than an economic accounting identity. It has a moral value. Thrift is a measure of an individual's economic freedom. Without it the individual depends on someone else to live. With it he is economically self-reliant.

Everybody splits his or her income between spending and saving. The income comes from work or investments (past savings). Taken together (income from



THE MORAL FAILURE OF DEMOCRACY

work and investments, savings and spending), these “allocation” decisions define everyone’s economic identity.

If thrift is too low, or if people dis-save, they consume more than their income — more than they earn. There are only two ways of doing that. One is to borrow. The other is to bridge the deficit with resources from the state.

In moderation both are not bad. In excess they both are.

The economic identity of people should be defined by income from work and savings. If it depends on the state, the state is being empowered at the expense of the individual. Ultimately the state becomes over-empowered relative to the individual. Individual freedom is the loser.

A culture of entitlements also makes the state hostage to those who depend on such entitlements. This is very clear in certain weaker Eurozone states (WES) suffering from the Euro crisis. So numerous are the beneficiaries of entitlements that it is hard for democratically elected governments to push through reforms that are needed.

The economic problems associated with a culture of entitlements are well known. It means that we expect from the state more than we are prepared to pay it for. If the resultant budget deficits represent a higher percentage of GDP than GDP growth, it will ultimately build up unsustainable levels of debt, which will cause the social contract to collapse. That’s what today’s sovereign debt crisis is about.

Similarly damaging is a culture that allows the individual to consume consistently more than he or she earns by borrowing. This is not a loss of individual liberty to the state, but when it happens on a mass scale, it is an equally grave threat to society. This is because it builds up mountains of private sector debt that ultimately cannot be serviced and which boosts living standards to unsustainable levels. Ultimately, the banks and their bad loans become a threat to the state.

The ultimate causes of the crisis of rich democracies are thus:

THE MORAL FAILURE OF DEMOCRACY

- The lack of thrift of individuals that raised living standards to unsustainable levels and built up debt levels that were bound to lead to financial and economic collapse.
- The lack of thrift of governments that used deficit funded entitlement spending to palliate the relative decline in the work income of households and then incurred further debt to impede a return to thrift by individuals.

That all becomes clearer when examining the policies to deal with the Great Recession caused by the bursting of the credit bubble. The US policy solution was not to address the ultimate causes of the crisis, but to reinvigorate the conditions that caused it and then to return to the same pattern of behaviour as before. Sovereign debt was added to private sector debt and the proceeds used to boost consumer spending. Practically speaking, curing a debt junky with more free dope (credit) is hardly likely to produce a healthy economy or society.

But denial is the US policy. Not one US central banker or politician of sway has offered the American people a clear vision of what is wrong. This is hardly the result of stupidity, but of the extent of the social damage done by the degenerate gene of lack of thrift. It promises a trend decline in the standing of the US in the world.

We shall, however, spend the rest of our lives living tomorrow and we must start from where we are. The fact that the burgeoning stocks of debt could survive for so long without crisis was because the world economy enjoyed a momentary, two decade-long, growth spurt caused by globalisation, a massive boost to the labour force stemming from the death of communism, technology and disinflation. These bonuses are now spent.

We have accumulated stocks of private and public sector debt that may not be supported by the meagre global economic growth rate going forward. If that turns out to be the case, these debts will have to be reduced. Who will pay? The answer is that the burden would have to be shared between the debtors, creditors, such as banks and the other owners of the debt (your

THE MORAL FAILURE OF DEMOCRACY

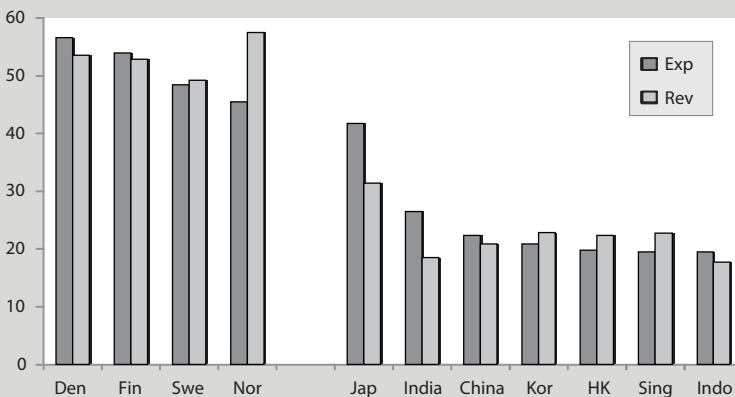
pension fund and mine) and, of course, the taxpayer.

The challenge for the rich democracies is to produce leaders that will tackle the job of achieving growth sufficient to make debt burdens fall and to face the challenge of reducing the debts. Over and above that, the virtues of thrift need to be re-implanted in populations used to the opposite.

Moreover, we need to re-define the role of the state and the individual's relationship to it. The sovereign debt crisis has one clear lesson in this respect: the state is paying for more of our lives than we are prepared to pay the state for. As the state creates no added value, what it gives is what it gets. The gap between the two is funded by debt. Thus the present role of the state is unsustainable because it is unaffordable. We can either choose to have Swedish welfare and taxes or Asian welfare and taxes. But we cannot have Swedish welfare and Asian taxes (Figure 4).

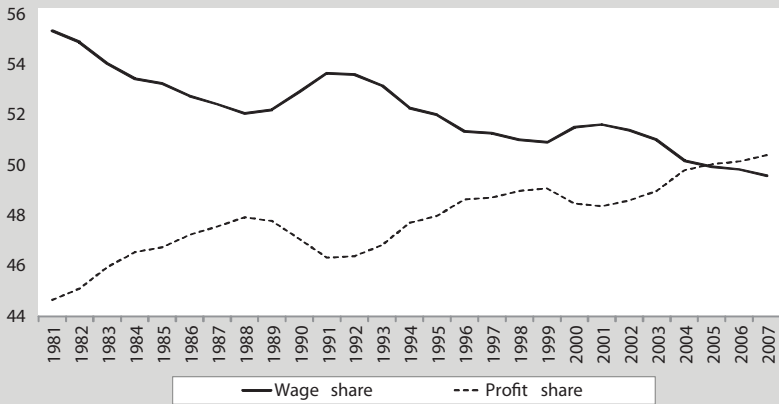
Denial of these challenges is not a political vision that will do anything but make matters worse in the long term. DemoCrisis has described the challenges for the rich democracies. Can democracies cope with them and still remain the richest economies on the planet? Probably. The UK has fiscal

Figure 4: Government spending and revenues (% of GDP): Scandinavia versus Asia



Source: Independent Strategy

Figure 5: G7 profit and wage shares (% of GDP)



Source: EU Commission, Independent Strategy

arithmetic cousins with that of Greece, but is dealing with it. The Baltic States did so. And Ireland is the first of the Eurozone patients to show that it is politically possible to take the pain of austerity and that the economy does respond positively to it. So far, we have more 'can dos' than 'won't dos'.

Painful as resolution of the debt crisis will be, it is not the most important or difficult challenge facing rich democracies. That is the rupture of the social contract of a quarter of a century's standing. For a quarter of a century, the wage share of national income fell in most advanced economies. This was compensated for by illusory wealth gains fuelled by credit bubbles; by real wealth gains generated by disinflation; and by increases in social transfers (Figure 5).

None of these panaceas will apply in the future. It is clear that the new social paradigm will have to differ from the old in two vital aspects. People will have to be paid in accordance with their productivity. And they will have to save out of their own earnings to get their American (or alternative) dream instead of buying it on credit. The relationship between the individual and the state will have to be redefined. What is less clear is how democracy makes these U-turns.

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The immeasurable advantage of democracy is its flexibility and tolerance for pain. This far outweighs the brittle insecurity of totalitarian regimes and their stifling policies to safeguard their privileges. But do not expect things to go that smoothly in all democracies. Certainly, politics will get real again and we will have new conviction leaders to deal with hardship in rich democracies. The alternative is denial, populism and collapse.

As Jared Diamond³ teaches, the societal outcome is determined by the decisions taken, not by the size of the challenges. Democracy with all its warts and pimples is likely to continue to reign economically supreme. But global economic leadership may accrue to new democracies! ●

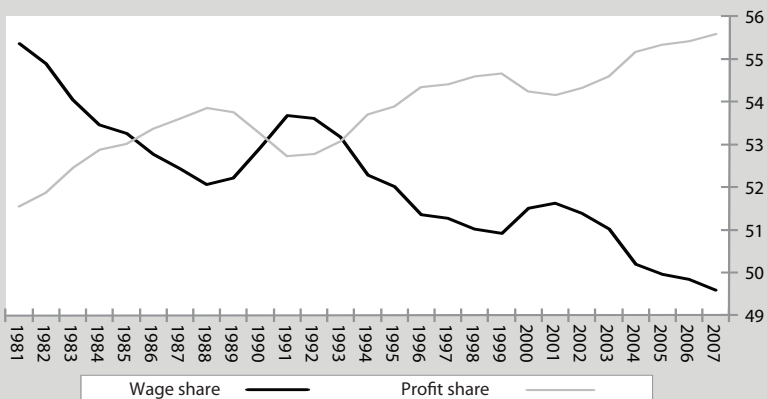
3. Jared Diamond: *Collapse: how societies choose to fail or succeed* — *Guns, Germs and Steel*.

THE FATAL DEMOCRATIC SOCIAL CONTRACT

Sub-optimal policy has weakened the rich democracies' economies over the last two decades. As a result, rich democracies are now confronted by extremely hard choices at the worst possible time, because all the economic policy cushions (counter-cyclical fiscal and monetary policy) that could offset the pain of adjustment are exhausted. That fact alone could mean that the rich democracies have passed the 'fail-safe point' in economic growth and could be inevitably dethroned as systemically superior economic and political models.

How did this come about? Long before the credit and sovereign debt crises, by some vital metrics, the masses were losing out. Wage shares in the rich democracies were being compressed by the arrival on the global economic scene of a massive supply of cheap labour in newly-liberated economies. Wage share in national income in rich democracies fell (Figure 6). Profit share headed for unprecedented summits, where it stands today.

Figure 6: Average wage share of national income in G7 economies (% of GDP)

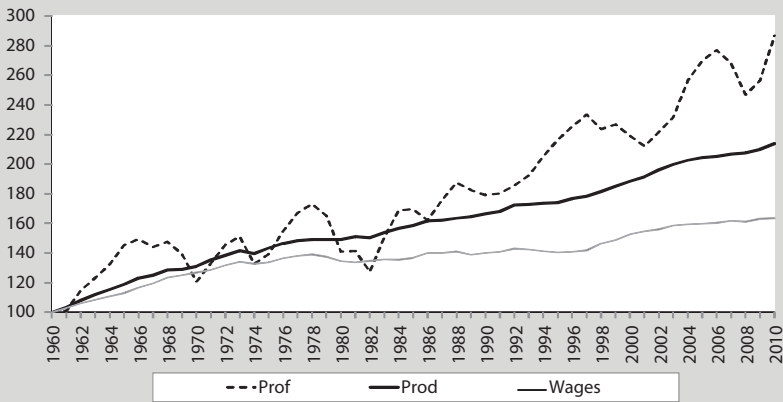


Source: EU Commission, Independent Strategy

THE FATAL DEMOCRATIC SOCIAL CONTRACT

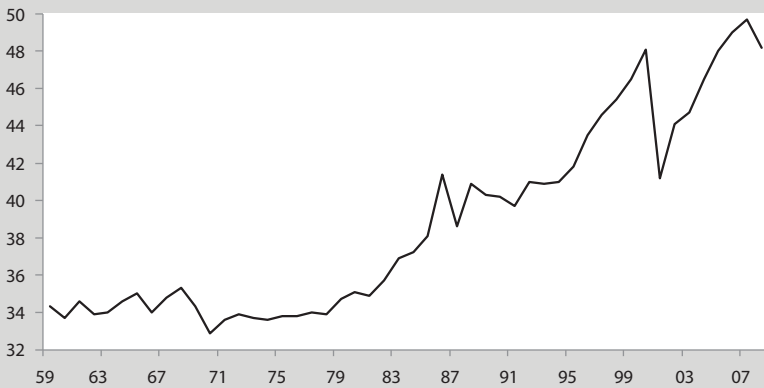
This means that the fruits of economic growth were being taken from labour and given to capital. That would be fine if it matched differentials in productivity performance. But it didn't (Figure 7). So wages failed to keep pace with labour productivity. As wage shares declined and profit share rose in the rich democracies, the social contract was preserved only by increased net social benefits to employees and easy borrowing by households.

Figure 7: US profits, productivity and wages in real terms (1960=100)



Source: Independent Strategy

Figure 8: The share of the top 10% income holders in US household income (%)



Source: Saez, Piketty, IRS

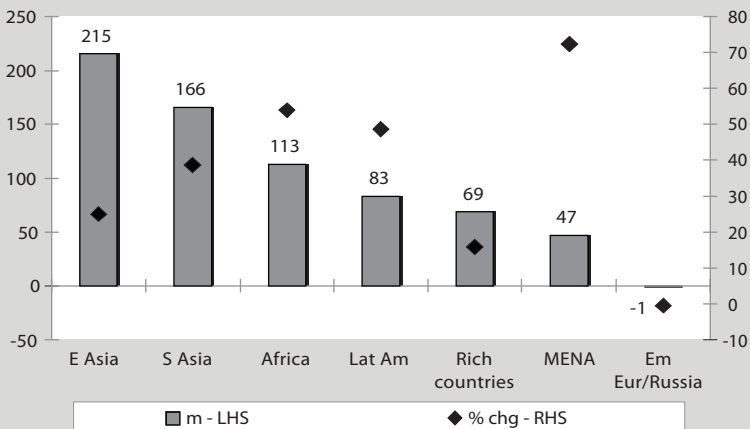
Throughout the quarter century of disinflation, the equality of income and wealth distribution just got worse and worse (Figure 8). And yet the decades of disinflation felt like a stable world of unending increases in prosperity. This was made possible because of five factors: globalisation, monetary policy, financial market liberalisation, real disinflationary wealth gains and government spending on social entitlements.

Globalisation

For two decades, things, manufactured goods in particular, got cheaper and cheaper to buy. This made poor nominal wage gains in rich economies tolerable. It made the excesses of the rich less obscene. After all, the workers were getting richer too, albeit slowly, and despite the gap between them and the affluent widening consistently.

Things got cheaper because a lot of good things were happening at the same time: globalisation, trade liberalisation and technology — something we dealt with in a previous book, *New Monetarism*.

Figure 9: Increase in free-world labour force, 1990-2006 (millions and % change)



The free-world's labour force rose 690m from 2.4bn to 3.1bn, but only 10% of that rise was in rich countries, while 55% was in Asia (inc India and China). In 1990, 18% of the world's workforce was in rich countries; in 2006, it was 16%.

Source: ILO, Independent Strategy

THE FATAL DEMOCRATIC SOCIAL CONTRACT

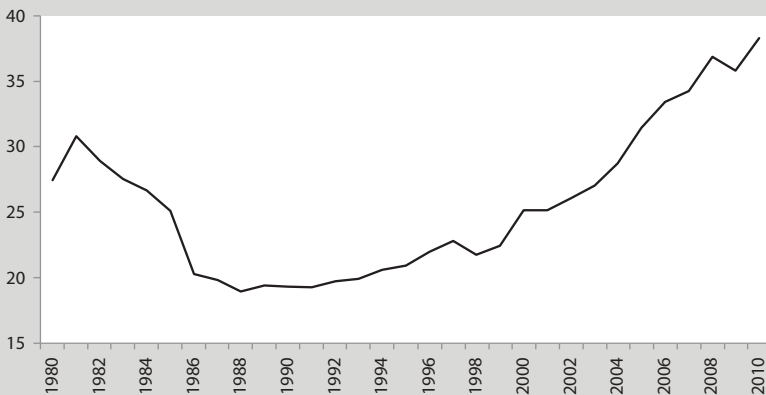
But the most important underpinning of the twin decades of disinflation was the increase in the world's workforce by 25% due to the integration into the world economy of labour forces previously locked away in communist countries. Only 10% of the increase in the world's workforce from 1990 was in rich countries. Asia's workforce rose by over 400m (Figure 9).

Such abundant supply of cheap labour meant that exports from emerging markets declined in dollar price consistently for 25 years. Being so competitive they gained market share (Figure 10); China's exports went from 11% of GDP in 1989 to 35% of GDP in 2007. This made emerging economy exports a big contributor to disinflation in advanced economies — an impact that was magnified by the ripple effect of emerging economy export prices holding down the prices of competing domestic goods in advanced economies. In a sense, it was emerging economy exports that kept disinflation in place for so long in rich democracies (Figure 11).

Monetary policy

Central bank policy was also a big contributor. Since Mr Volker's accession to the helm of the Fed in 1979, central banks around the world had become ideologically committed to squeezing inflation out of the system, just as the Bundesbank always had been. The fact that the central banks were

Figure 10: Emerging market share of world exports (%)



Source: IMF, Independent Strategy

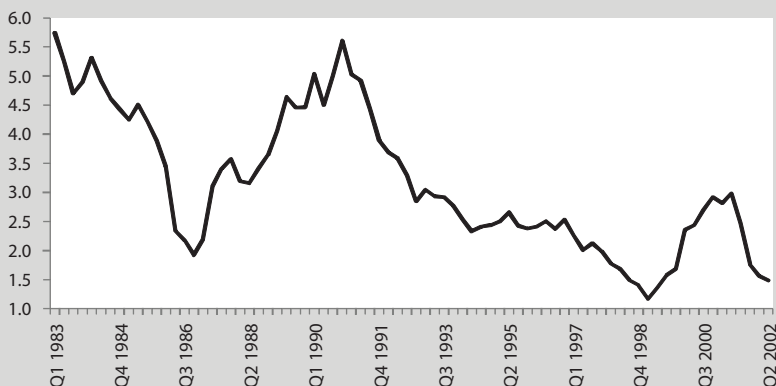
so successful in taming inflation meant that credit got cheap in both real and nominal terms. That enabled people to borrow more. The economic cycle, in particular the inflation cycle, became a thing of the past. It almost disappeared from the economic psyche. The result was that the risk associated with leverage was perceived to have all but vanished. It was OK to borrow far more of the value of an asset than before. This was because the cost of borrowing, the value of the asset and the revenue it produced were no longer subject to the volatility of the economic cycle. Ultimately, of course, this all went too far and the under-pricing of credit and the ignoring of burgeoning asset bubbles by central bankers contributed to the difficulties we now face.

Democratisation of credit

Liberalisation and lack of adequate regulation of financial intermediaries and markets, mispricing of capital by central banks as well as democratisation of credit, combined to create credit and asset bubbles.

Asset bubbles allowed households to forego thrift, defined as saving part of what you earn, due to the illusion of wealth fed by rising asset prices. Why would you save from income if the value of your home rose consistently to do your saving for you? As savings from rising wealth replaced savings from

Figure 11: OECD CPI inflation rate (%)



Source: OECD, Independent Strategy

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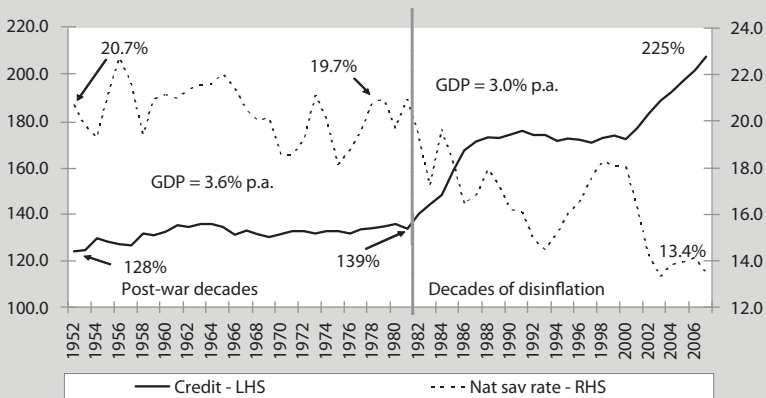
income, thrift died as people learned to forego savings and live a life style that was borrowed on the back of rising wealth (Figure 12).

This process, combined with the democratisation of credit, allowed lower income groups to get a stake in the wealth game and concomitantly boost their spending in excess of earnings by borrowing money beyond their means to service. As the value of their over-mortgaged homes rose, home owners could take out a second or third mortgage on the increased equity, so effectively turning inflating asset prices into spendable income. And spend it they did!

Household debt exploded (Figure 13). People could buy more than they earned and own unaffordable homes. They did just that and it was those who could afford it least that did it the most. Only the very rich have seen their debt burden fall in the last 20 years, while the so-called middle classes took on the heaviest burden (Figure 14).

For as long as it lasted, this bit of the social contract made the excesses of the rich more tolerable for the less-than-wealthy: they become objects of ambition rather than social resentment. The corollary to growth in borrowing was the expansion of the lenders — banks, shadow banks and bonds.

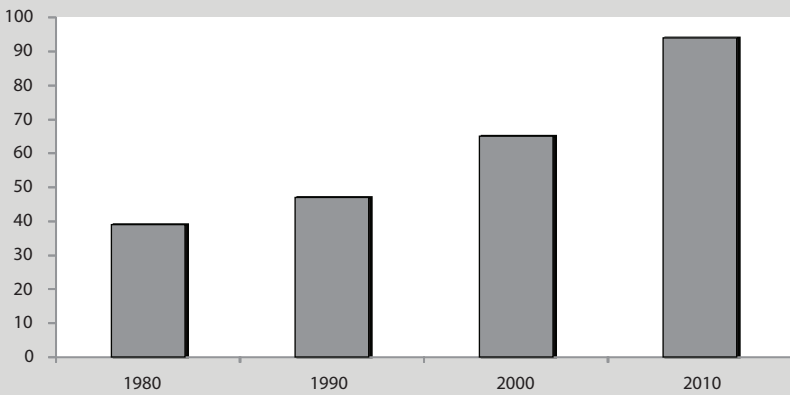
Figure 12: US non-financial debt to GDP (%) and national savings rate (%)



Source: Federal Reserve, Independent Strategy

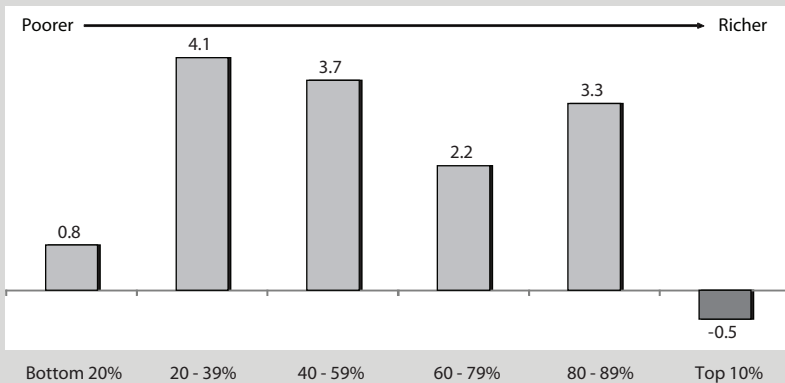
This expansion was facilitated by two other factors, other than the appetite of individuals and corporations to take on excessive levels of debt. One factor was financial sector liberalisation, which removed prudent constraint on credit creation. The other was globalisation, which fuelled the growth of the financial sector through unregulated international capital flows.

Figure 13: G7 median average household debt to GDP (%)



Source: Independent Strategy

Figure 14: Change in US household debt to assets by income group, 1998-08 (% pts)



Source: Federal Reserve

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The result was that growth in countries' financial sectors dwarfed growth in the economy and, in many instances, dwarfed the size of individual countries' economies (Figure 15). Once the latter happens, another democratic flaw is created; the inability of national governments to protect their citizens against the collapse of their financial sector.

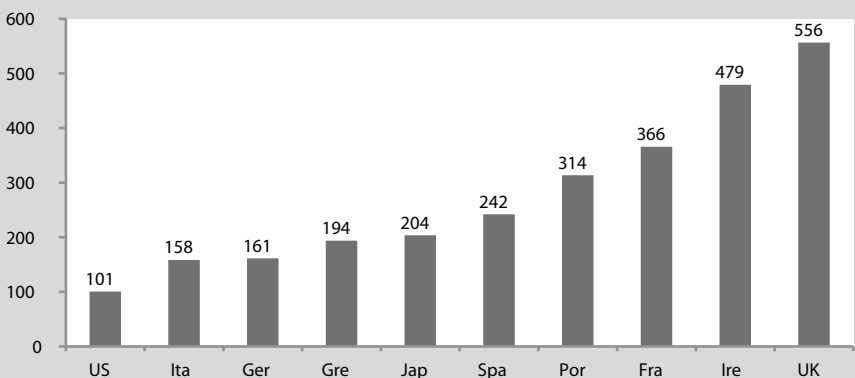
Real disinflationary gains on capital

Fourth, of course, not all asset price gains were illusory bubbles. Disinflation, defined as sustained reductions in the rate of inflation (but not deflation or falling prices) over longer periods, increases the asset value today of any income stream tomorrow because it reduces the erosion of future earnings by inflation (Figure 16). This is akin to expansion of a societal P/E. Even a house, like a stock, has a P/E (its price-to-rental income equivalent) that benefits from lower inflation and consequent reduced cost of financing. But for the societal multiple to go on expanding, and for wealth to be created as a result, inflation rates have to go on falling.

Government spending on social entitlements

The final factor was the big increase in rich democracies' social entitlement spending, such as pensions, medical care and unemployment benefits. This resulted in a trend of rising budget deficits and sovereign debts that was well

Figure 15: Bank assets to GDP (%)



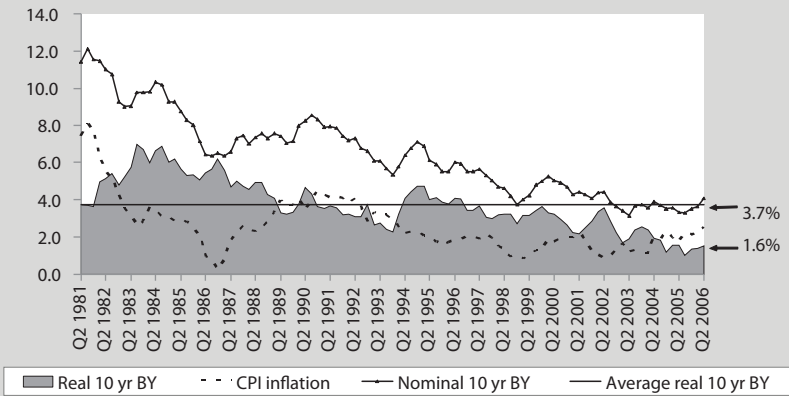
Source: Independent Strategy

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established long before the present sovereign debt crisis.

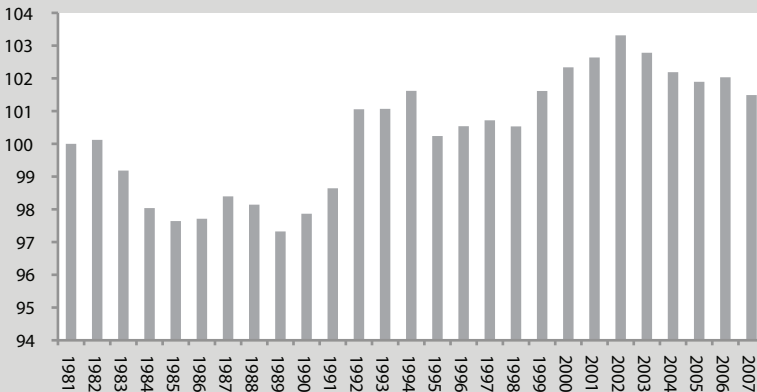
Social entitlement spending was vital to the social contract because public transfers meant that employee purchasing power rose even though the share of work income in GDP fell (Figure 17). That was the new social contract!

Figure 16: OECD average ten-year bond yield (real and nominal) (%) during the period of disinflation



Source: Independent Strategy

Figure 17: Social wages* in the OECD as % of GDP, indexed 1981=100



Note: * wages plus social benefits

Source: AMECO, Independent Strategy

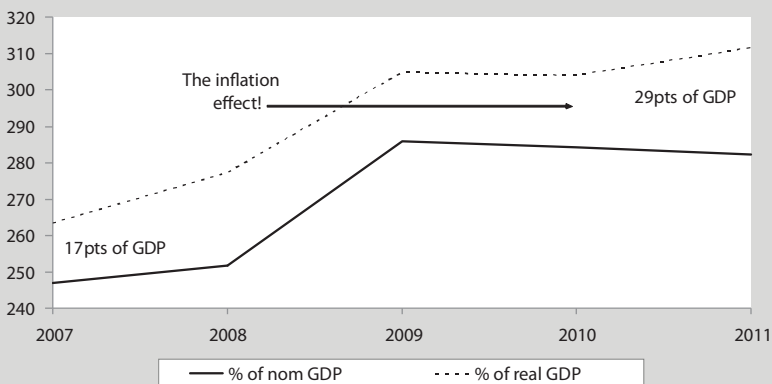
THE FATAL DEMOCRATIC SOCIAL CONTRACT

Emerging economies are now generating inflation, not disinflation. So the cheapness of things made there, which contributed to making falling wage shares in rich democracies tolerable, is finished.

The disinflationary cycle is now over in the developed economies too. Several of the world's major central banks (the Fed and the BoJ inter alia) are targeting more inflation not less. Inflation is now widely seen as a hidden virtue that will help reduce debt burdens. In order for this to work, compliant central bankers have to rig the debt market to prevent them reflecting higher inflation expectations. This they do by buying the bonds themselves and holding down yields.

This can be done as part of a policy of Quantitative Easing (QE), as in the case of the Bank of England (BoE) and the Fed, or like the ECB, as support for the functioning of the sovereign debt markets of the weaker Eurozone states (WES) or for banks. When a central bank buys government bonds, it prints money in an attempt to boost the economy and inflation. The result is the same; the policy impedes credit markets from reflecting rising inflation in increased bond yields or pricing markets for default risk. It is an 'ideal' world for policy makers in over leveraged societies; inflation reduces the real debt burden while central bankers stop markets compensating for inflation.

Figure 18: OECD average non-financial debt as % of nominal and real GDP



Source: IMF, Independent Strategy

So 'virtuous' inflation is already at work. As a result, the sum of private and public sector debts has risen in the OECD since 2007 in nominal terms. But debt has shrunk as a percentage of nominal GDP, while rising in relationship to real GDP (Figure 18). The difference is due to the erosion of the real value of debt by higher inflation. Expect to see much more of this with higher inflation targeted by the authorities as a way out of the debt dilemma.

Nevertheless you can't fool all of the markets all of the time. Higher inflation means that disinflationary multiple expansions, which created real wealth gains from rising asset prices, are a thing of the past.

Unsustainable and illusory wealth gains from asset price inflation were a function of excessive credit growth and mispricing of debt. That is no longer an option.

Despite rear-guard actions by central banks such as the Fed and the BoE to keep asset prices inflating, the party is over. Gains from asset bubbles are part of history and not the future.

That won't stop central banks from trying, of course. But any return to rising asset prices as a result of stimulative monetary policy is likely to prove moderate and unsustainable. It was the first two times quantitative easing (QE) was used in the US. It is more than likely to be so the next time. Despite rising asset prices being a stated objective of the Fed's QE, the tool seems to be suffering from marginal reductions in potency!

Creation of bubble credit conditions by commercial banks in order to boost asset prices are also unlikely, given the dysfunctional state of financial intermediaries and the secular trend of household deleveraging.

The dysfunctional state of financial institutions has two sources. One is that they are still stuffed with bad legacy loans. The other is that, being able to borrow limitless free money from the Fed or the other central banks, they are motivated to look no further than making short-term gains in buying government bonds or doing financial market deals for their profits. They have ceased to fulfil their societal role as allocators of savings to productive investment. In other words, the credit multiplier is broke — not least because

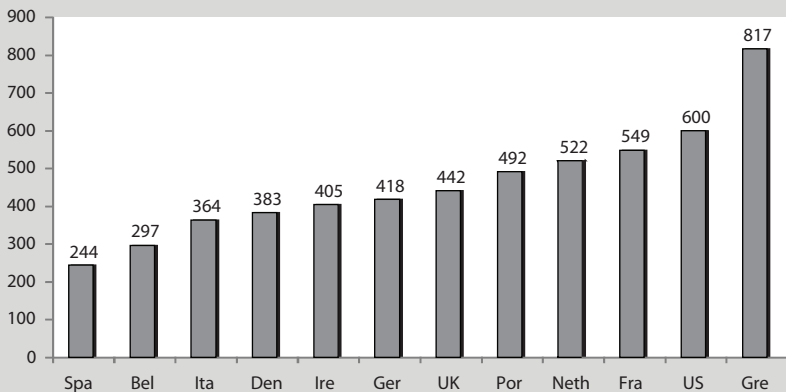
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in many parts of the world, like Europe, banks have to deleverage.

The current fiscal crises in the US, Europe and Japan, focused as they are upon excessive budget deficits, spending and sovereign debt, means that governments will no longer be able to 'bridge the income and wealth gap' with increased entitlements and social transfers. Indeed, many of the existing commitments will have to be reneged on. The fiscal machine as social equaliser is also well and truly broke.

Defined simply, the sovereign debt crisis is caused by the imbalance between what we expect from the state and what the state can afford to pay, given its finite tax base. The state cannot create 'added value' so the gap can only be bridged by borrowing. This is made more stark by adding to existing sovereign debt, the unfunded liabilities incurred by rich democracies as part of the social contract (Figure 19). These relate to unfunded pension funds, social security and healthcare. They are made worse by the demographic ageing of rich democracies, which reduces their ability to grow fast enough and generate income to pay their bills. Such unfunded sovereign promises will be broken.

Figure 19: Unfunded liabilities of public sector (% of GDP)



Source: J Gokhale: 'Measuring the unfunded obligations of European countries'

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In sum, the social contract of the last 25 years is unsustainable. The social contract augmented poor wage income with social transfers, asset price inflation generated by credit bubbles and real wealth gains created by the disinflation.

Going forward, extended deleveraging of past debt excesses will hold down economic growth, jobs and wage income. Credit bubbles will no longer generate illusory wealth gains from rising asset prices. And disinflation as a driver of real wealth gains is dead. So the biggest challenge facing rich democracies is: how do you give back to the masses what they have lost? How do governments tell the people that what was promised won't be delivered? ●

THE FATAL DEMOCRATIC SOCIAL CONTRACT

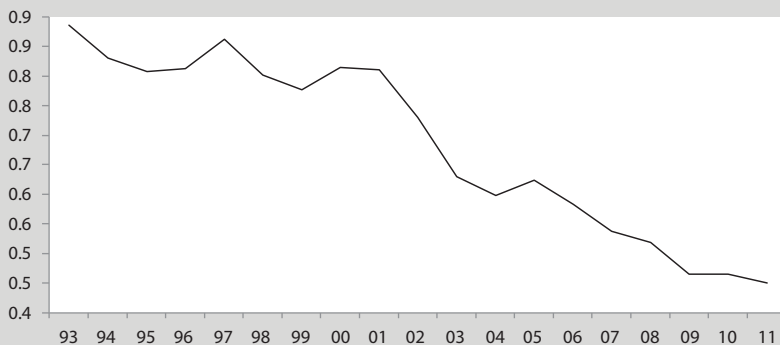
STATES IN TROUBLE

Of all the challenges that rich democracies face today, the sovereign debt crisis has the shortest fuse. The seeds of this crisis were sown a long time ago when government debt-to-GDP ratios started to rise as a result of increased budget deficit spending, importantly on social entitlement programmes.

When debt-financed fiscal spending pushes up the debt-to-GDP ratio, it means that money is being spent unproductively. If it were being spent productively, GDP would rise by more than the debt incurred (Figure 20).

Not all fiscal spending is bad. If a government spends money on a bridge linking two halves of a country previously separated by an insuperable chasm, trade between them will grow and efficiencies will be achieved. GDP will be boosted and living standards will benefit. That's a good investment — a productive public investment and use of taxpayers' money. It would also be a good private investment. Actually, it doesn't matter whether it is private or

Figure 20: The marginal efficiency of OECD public debt*



* change in real GDP to change in OECD debt to GDP

Source: IMF, Independent Strategy

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public — it is the quality of public and private expenditure that determines its positive or negative impact on GDP, and if financed by debt, its positive or negative impact on solvency.

Let us assume the bridge is financed by debt and charges a toll. If the toll (net of maintenance expenses and depreciation) represents a higher yield on investment than the cost of debt, then whether the investor is a public or private entity, it is making a profit or a positive return to taxpayers (if it is a public entity).

Moreover, the investor's solvency will have improved because net worth will have risen as a result of the investment. The present value of future toll income will be greater than the present value of the debt, with both being discounted by the cost of debt. Again, if it's a government at the wheel, net debt-to-GDP will have declined as a result of the investment.

If successful investment in the bridge goes to the leadership's head and it builds 50 bridges across the chasm, each bridge will add progressively less GDP. The law of diminishing marginal returns on investment kicks in. Eventually, new bridges will contribute nothing with the investment being wasted. Japan was once the world leader in building bridges to nowhere. Now China is.

In contrast, if fiscal spending is directed to consumption, it disappears once spent, after multiplier effects (which are generally considered small or even negative). There is a school of thought that believes kick-starting consumption with government transfers will set up a virtuous chain of animal spirit reactions that will create sustainable growth. But there are reasons why fiscal spending or transfers destined to sustaining consumption, rather than being invested productively, may not boost the economy durably.

If government deficit spending causes an equal and opposite reaction in private sector spending, the result is zero impetus to the economy. All that has happened is that government dissaving is matched by increased private saving. This can happen because citizens know that government debts must ultimately be paid for by the private sector. And if the government spending

does not add to sustainable economic growth, they must be paid for from a stagnating or declining flow in private sector income.

The tendency for changes in private spending to offset shifts in government spending is called the Ricardian equivalence theory. It can be enhanced to include the 'crowding out' of productive investment by state borrowing and the absorption of monetary stimulus by shifts in financial asset prices rather than the provision of credit to the real economy and productive investment. We call that Financial Market Behavioural Transformation (FMBT). The Ricardian and FMBT principles are the desert sand into which much monetary and fiscal stimulus disappears without trace.

The focus here is sovereign debt. But that isn't the only debt that matters. We know from the credit crisis that preceded the sovereign debt crisis, private sector debt can destroy GDP and thus worsen sovereign solvency dramatically. They are flip sides of the same coin.

Much research into debt crises focuses on sovereign debt⁴. But recent research points to the linkages between excessive private and public sector debt⁵. The two sorts of debt are joined at the hip and tend to march in step. At moderate levels, both can boost growth. But when corporate debt exceeds 90% of GDP; household debt 85% of GDP and sovereign debt 80-100% of GDP, each category of debt acts, individually and collectively, as a drag on GDP⁶.

Oddly, the contractual nature of debt financing makes excessive borrowing more damaging to growth than equity financing. When a bad investment is equity financed it is cleared through markets much more rapidly, and with less of a hit to growth, than when the investment entails insolvent debts. This may be the true economic cost of the legal profession!

But why does excessive debt tax growth? After all, if I owe you money and I fail to pay, you lose and I win. My gain equals your loss and vice versa! So why is debt not a zero sum game?

- When debt is as big as GDP, small negative exogenous demand and output shocks create bigger solvency concerns than if debt was 10% of GDP. Imagine two corporations making the same product and selling

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it at the same price with the same cost structure — except for interest expenses. The only difference between both companies is that one has debt at 10% of its sales and the other at 200% of sales. If something happens that causes demand for both companies' product to fall 5%, there is little doubt that the lowly leveraged company has not seen its solvency deteriorate much. But there is reason to worry about the highly indebted producer. That highly leveraged producer will have difficulty accessing credit. Economies are the same. When a nasty exogenous shock — even a little one — hits a highly leveraged economy, it's in trouble. Credit contracts. The economy shrinks. Also, higher debt levels mean the economy is more volatile and average growth is lower.

- As debt rises towards 100% of GDP, more debt is being used to produce less extra output. Capital productivity is falling. So is the potential growth rate of the economy. This in turn worsens solvency.
- Debt service transfers income from spenders to savers. Less gets spent. Demand gets taxed by the transfer. When the ratio of debt-to-GDP is high, the transfer saving effect can be bigger than GDP growth. The danger increases as the cost of debt and economic growth converge.
- Economic systems are not closed. Non-domestically held debt transfers income out of the economy. This depresses growth.

In sum, it is the quality (productivity and profitability) of government spending that determines whether it betters or worsens sovereign solvency and how much it contributes to, or detracts from, growth. Government spending to support consumption will, more often than not, boost debt permanently and growth temporarily, leading to worsening solvency. Productive public sector investment can boost growth permanently and improve solvency.

Private sector counter-reactions to government and central bank stimuli can dilute, and even negate, their impact on GDP.

It is total private and public sector leverage that matters, not just sovereign debt. A bad stock of debt-financed investments in the private sector will hit GDP growth, worsen budget arithmetic and increase the burden of sovereign debt.

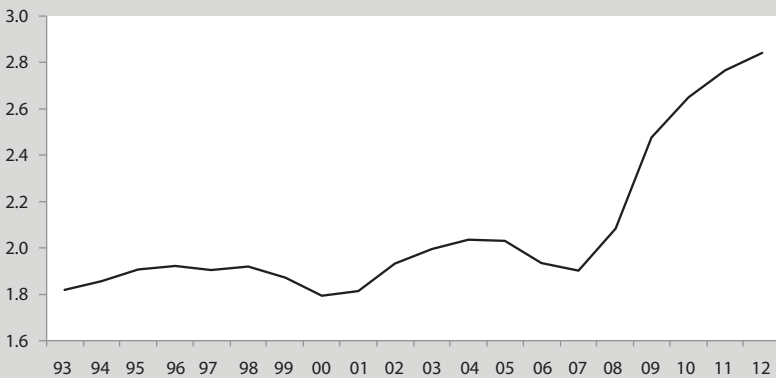
Sovereign debt picks up the burden

The rise in global sovereign debt in rich democracies as a proportion of GDP started as long ago as 1980. It rose from 42% back then to 73% of GDP by the year 2000. After the credit crisis, it exploded towards 100% of GDP and is heading higher. Expressed as a percentage of tax revenues, which is what government gets to service its debts, debt ratios are 2-3 times higher (Figure 21). Adjusted for unfunded government liabilities, they are higher still.

The policy to counteract the Great Recession was to add sovereign debt to a virtually unaltered stock of private sector debt, which had been the cause of the credit crash. Sovereign debt as a percentage of GDP in the OECD has risen by around one-third since 2007. Recapitalisation of the banks cost 7% of OECD GDP (3.3% in direct support and 3.7% in net lending and stock flow adjustments (e.g. takeover of bad bank assets)). Fiscal stimulus costs another 7% of GDP and another 9% in automatic stabilisers to sustain government transfers to households (Figure 22). These measures yielded a temporary boost to GDP, but created a permanent increase in sovereign debt.

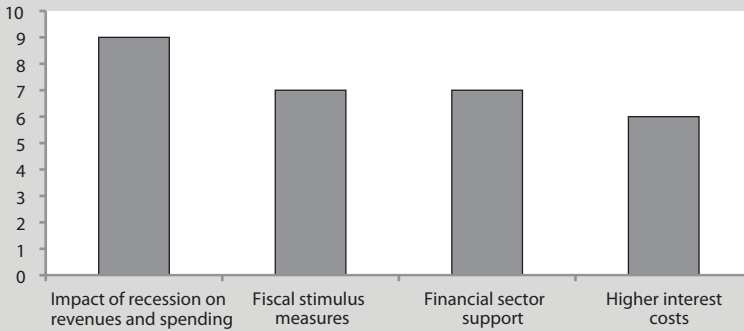
That outcome is not a surprise, given that nearly all fiscal stimuli violated every condition for achieving a durable boost to GDP and improving public

Figure 21: Ratio of OECD gross government debt to revenue (%)



Source: OECD, Independent Strategy

Figure 22: Composition of rise in OECD public debt to GDP (2007-10)



Source: IMF, Independent Strategy

debt sustainability. To match our criterion for successfully and durably boosting GDP, the stimulus programmes would have to have focused spending on infrastructure investment, encouraging thrift and cleansing banks of bad assets at market clearing prices, while recapitalising or liquidating insolvent financial institutions.

The argument for the massive policy stimulus used to fight the Great Recession was that governments and central banks had to do something. Even if that were so, two mistakes were made. The quality of fiscal policy was awful. And fiscal stimulus should have been removed sooner to create a cushion needed now. The same can be said for the failure to normalise monetary policy. A greater trust of the ability of the economy to find a natural bottom, with a greater reliance on markets to clear dud assets and loans out of the system, would have produced a far more sustainable recovery. Instead, the recovery from the Great Recession has been far from natural, with the rise from the trough more L-shaped than U-shaped (Figure 23).

Today, the advocates of fiscal spending want more deficit spending. They claim not enough was done and not for long enough. They have not explained why their medicine did not work in the first place.

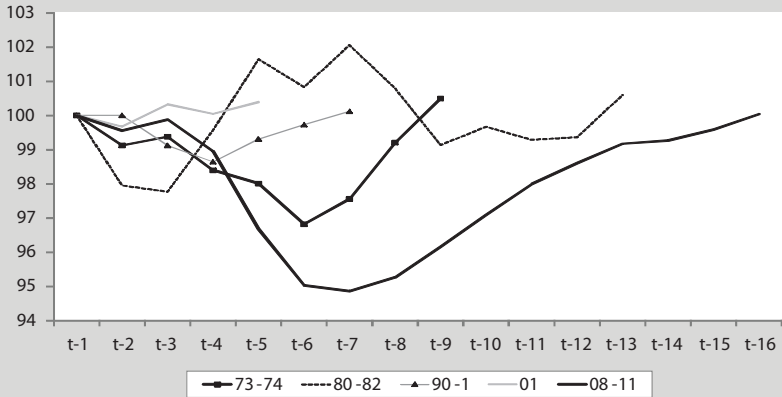
Even those moderate fiscal activists who advocate more fiscal spending now in return for greater austerity later don't explain why this will not inspire the private sector to save more now to pay for higher taxes later — the Ricardian and Financial Market Behavioural Transformation mechanisms at work.

But the tide of thinking has turned against the interventionist school, at least against its more extremist protagonists. Sovereign debt deleveraging is the new fiscal consensus and will be implemented in all of the three major economic blocs — albeit often in a piecemeal and legalistic, rather than in an economically logical, manner.

There is a dilemma about bringing sovereign debt back to sustainable levels. It is called the Kerryman's answer: when asked how to go somewhere he responds: "better not start from here at all".

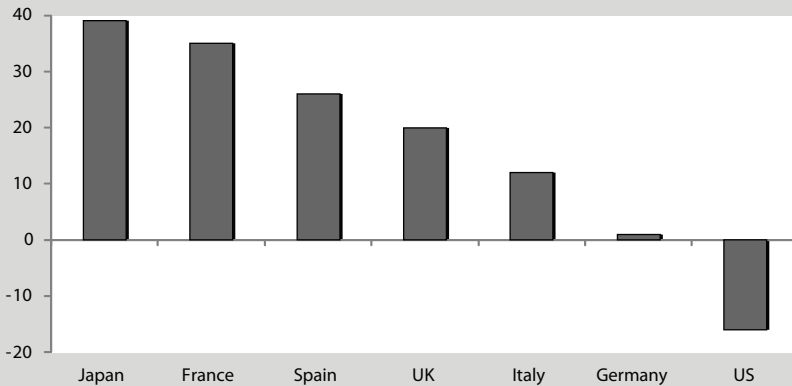
The fiscal Kerryman would say: we have excessive levels of sovereign and private debt. The state can only deleverage by making the private sector pay for it to do so. Private sector deleveraging is a work-in-progress for US

Figure 23: US economic recessions: from peak to bottom to recovery (100=peak of previous cycle)



Source: Independent Strategy

Figure 24: Change in domestic public and private debt to GDP, 2008-11 (% pts of GDP)



Source: Independent Strategy

households, but much less advanced in other countries (Figure 24). If both deleverage together, the economy could enter a deflationary savings trap.

This risk is not confined to the US. Corporations in the Eurozone are three times more dependent on bank financing than their US peers. So the Eurozone is more leveraged than the US. Many of its governments are in fiscal crisis. That raises the risks of the double jeopardy of both public and private sectors deleveraging at the same time. As Europe's banks are in a parlous state (because much of their assets are in poor quality sovereign bonds), they may also shrink their loan books to meet new core equity capital ratio targets set by the European Banking Authority, and to cope with the writedown of their holdings of sovereign debt and other loans. That would hinder the productive sector as European banks lend the equivalent of 50% of GDP to corporations compared to 20% for US banks.

The fail-safe growth rate

One more concept is needed here: the Fail-Safe Growth Rate (FSGR) of the economy. GDP growth above the FSGR reduces the burden of sovereign debt (expressed as debt as a percentage of GDP). Growth rates below the FSGR increases the burden of debt.

As economic growth rates fall below the FSGR, fiscal austerity measures, such as increased taxes or cuts in government spending, increase the burden of sovereign debt. This happens because the austerity measures depress GDP and tax revenues, boosting government spending on hidden stabilisers (such as unemployment benefits) by more than they redress the budget deficit.

An important determinant of the FSGR is the relationship between interest rates and GDP growth (the others being the primary budget balance and the level of sovereign debt-to-GDP). Both growth and interest rate variables can be stated in either real or nominal terms. Once debt is as big as GDP, in the absence of a primary budget surplus, debt sustainability is a function of interest rates and GDP growth. If the economy's growth rate lies above the cost of debt, this reduces debt-to-GDP relatively painlessly. If the GDP growth rate lies below the cost of debt, debt-to-GDP will tend to rise inexorably. Primary budget surpluses can be used to negate the effect of a growth deficit relative to the cost of debt.

The achievement of debt sustainability ultimately needs growth and is always facilitated by growth⁷ (Figure 25). You can't rely on fiscal austerity alone to do the job because it depresses GDP in the early years and electorates will only tolerate it for a time.

The real and present danger for the advanced, highly leveraged, democracies is that their accumulated debt burdens lock in economic performance below the FSGR. If so, increased fiscal austerity will result in higher budget deficits and sovereign debt. Austerity will then fail. And so could democracies.

The FSGR growth rate (at which debt to GDP will stabilise) for the rich economies is 3-5% in nominal terms (Figure 26). We focus on nominal GDP because it allows us to calibrate how much inflation can reduce debt burdens.

Japan has little hope of achieving this rate of growth and has the worst sovereign debt-to-GDP ratio in the world (230% gross). It is doomed to fail. Its high stock of savings and large pool of foreign assets provide a cushion, but not a solution.

THE DYNAMICS OF DEBT

The dynamics of public debt depend on three factors: the level of real interest payments; the primary budget balance (the balance of government spending less interest payments on debt and government revenues); and changes in the nominal value of the stock of government liabilities, often called seignorage.

If the real interest rate on debt is higher than real output growth, the debt to GDP ratio will increase even if a government manages to maintain its primary budget in balance. For the debt to GDP ratio to stay constant, the difference between the real interest rate and real GDP growth must be matched by a primary budget surplus. If new debt is added, interest payments will increase, thus leading to ever greater amounts of debt, unless a primary budget surplus is run. This spiral of debt from rising interest rates is in effect a 'Ponzi' scheme, where more borrowing is raised to service what has been already borrowed.

What is a country's sustainable debt level? That will depend on the fiscal capacity of a country (how far tax revenues can be raised without causing the tax base to shrink or how far public spending can be cut without social disruption). It will also depend on the response of bond markets to government policy and the state of public finances. One good way of measuring the sustainability of public debt levels is to measure the magnitude of the primary budget surplus required over time for its debt ratio to be stabilised at some suitable level.

If real GDP growth rises faster than the real interest rate, then the debt-to-GDP ratio will fall as long as the primary budget is in balance. But if the primary budget is in deficit,

faster growth may not be sufficient to get the debt ratio down. A big problem for many governments is that the primary budget deficit is structural and is not reduced by faster economic growth because government spending is in 'mandatory' areas like health, education or pensions. Over three-quarters of the primary deficit is structural in many OECD countries.

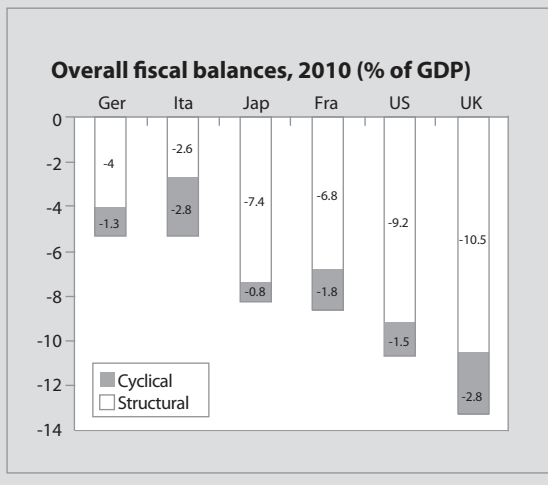
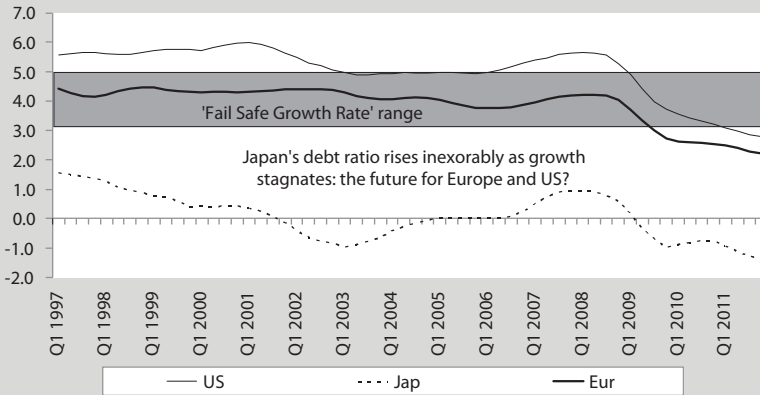


Figure 25. Source: BIS, Independent Strategy

Figure 26: 'Fail-safe' growth rate: five-year trend average nominal GDP growth (%)



Source: Independent Strategy

The US, with its greater tolerance of inflation as the price of growth, could scrape by, but not without a return to thrift, which will be a long and painful process.

The Eurozone has a dilemma: the ECB has a low tolerance for inflation with a CPI target just below 2%. Fiscal austerity implemented in the peripheral countries will depress growth in the whole Eurozone to well below the 4% nominal rate needed to even dream of stabilising sovereign debt to GDP. Much higher rates of nominal growth are needed in the WES.

To achieve debt sustainability of its weaker members, the Eurozone will need to move from just being a monetary union to become a fiscal union and a banking union in order to break this link between sovereigns and banks. That will take time. So the immediate task is to beef up its capacity as a transfer union.

Adequate (€1.2-1.6trn) funding of the EFSF/ESM to back weak sovereign issuers and to refinance banks can hold EMU together for longer. But the real battle for the euro, which is the lynch pin of European integration and the anvil of Europe's history as a peaceful, prosperous region, will be if economic growth

remains below the stall speed after all the EFSF/ESM and ECB funding for the highly indebted states is exhausted.

Let us chart what the shift in the nature of sovereign debt implies for developed and emerging economies.

Developed economy implications

Developed economies' sovereign debt is no longer risk-free (though we would claim it never really was risk free). Left to its own devices (without central banks rigging the market), the cost of sovereign debt would rise, lifting the stall speed of the economies (FSGR) and making the sovereign debt burden more difficult to stabilise.

Moreover, there is no longer any "risk-free" rate for valuation of other financial assets. For example, equity versus bond valuations no longer tell an investor anything.

Fiscal policy is neutralised from a Keynesian standpoint because austerity is on automatic pilot (balanced budget amendments, automatic spending cuts etc.).

Also, sovereign debt traditionally offers a safe haven in uncertain times. Governments have been able to use safe-haven flows into sovereign debt markets to fund counter-cyclical fiscal deficit spending. At current low yields safe-haven bond markets, such as the US, UK and Japan are no longer very attractive fundamentally — except as safe havens from the immediate European crisis. Therefore, in future moments of crisis, there may be less reflux of capital into safe-haven sovereign bonds. This will hamstring counter-cyclical fiscal spending as these are the same countries (US and Japan) that have massive budget deficits to be funded.

Monetary policy is now integrated with fiscal policy to prevent market pricing of sovereign debt, credit risk and the risk of higher future inflation. This suppression merely transfers volatility from price-rigged to market-priced assets. But central bank buying of sovereign debt will be a durable part of policy aimed at boosting debt sustainability by reducing the cost of debt below nominal GDP growth rates.

The sovereign debt backstop to the financial system is degraded, making banks riskier and capital more expensive. This will increase bank deleveraging and shrinkage of loan books.

It is often thought that emerging economies can decouple from the debt crisis in developed economies. This is not so, for the following reasons.

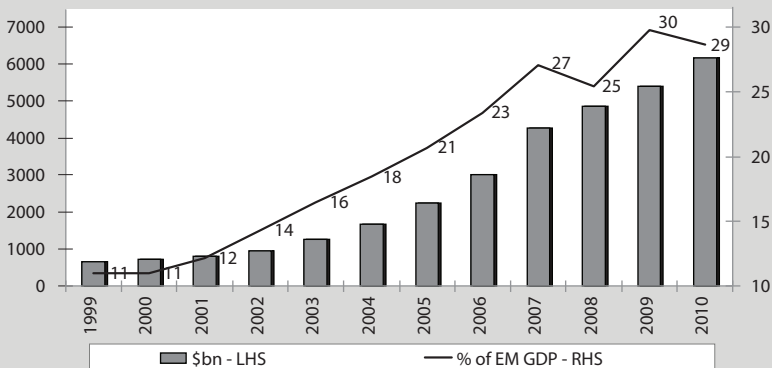
Emerging economy implications

Emerging economies have been major investors in sovereign bonds of the developed economies, particularly US debt, as the means of recycling their current account surpluses and maintaining the competitiveness of their exchange rates. Emerging economies currently hold about the equivalent of 30% of their GDP in such instruments (Figure 27).

The accumulation of developed economies’ sovereign bonds as international reserves by emerging economies creates a solvency and liquidity risk for them almost as serious as their vulnerability to a drying-up of foreign capital inflows.

The private sector in emerging economies need \$1.6trn foreign funding every year. All their private sectors have large net foreign liabilities. The build-up in

**Figure 27: Emerging market economies:
FX reserves (\$ bn) and as % of emerging market GDP**



Source: IMF, Independent Strategy

STATES IN TROUBLE

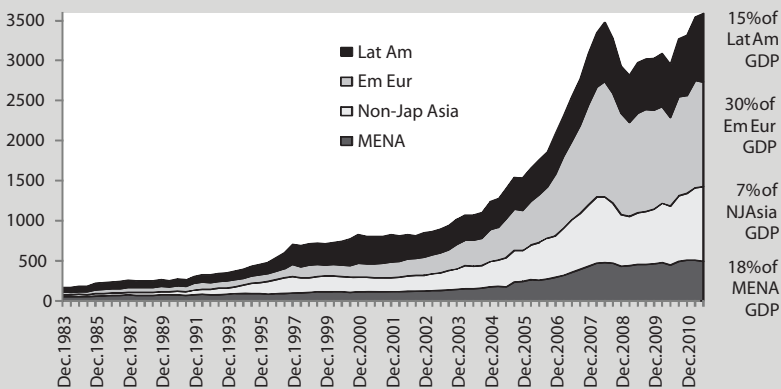
foreign assets is in the central banks not in the private sector. The risk is that contagion from the financial sectors of the developed economies causes these inflows to dry up.

This is a risk as Eurozone financial institutions deleverage. Indeed, European banks are the biggest lenders to emerging economies (Figure 28). Any reduction in such lending could lead to credit starvation in many emerging economies.

It is very likely that Eurozone banks will deleverage — not only domestically but also in international markets and emerging economies. The banks will have to do so in order to meet the new 9% CTI ratios imposed on Eurozone banks by the European Banking Authority. The only alternative is for the banks to raise tier one capital from the financial markets, sell assets or accept state money from their own governments, or failing that, from the EFSF/ESM. Any public money injected into the banks would come at a price: a required focus on domestic lending that would accelerate the reduction in Eurozone banks' €3.5trn of gross assets in emerging economies.

Of course, the central and commercial banks of emerging economies could use their foreign exchange reserves to cushion the blow. But their capacity

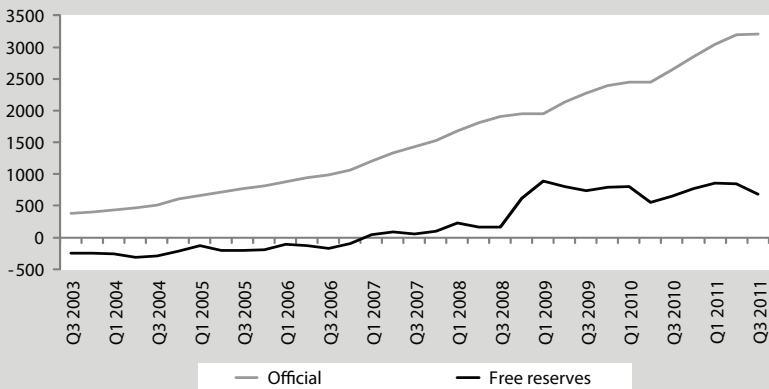
Figure 28: European bank loans to emerging market regions (\$bn)



Source: IMF

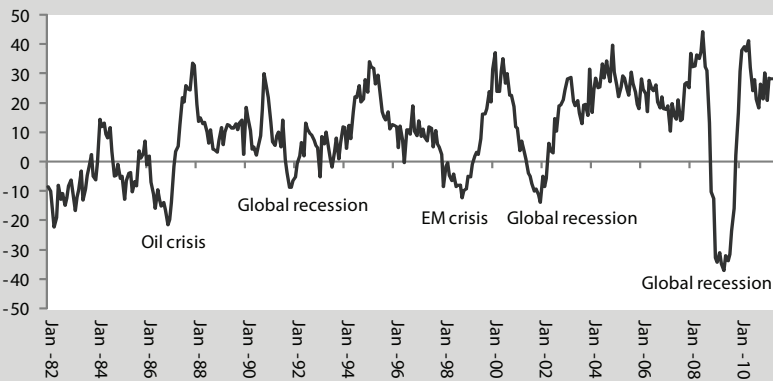
to do so is more limited than imagined, given the need to back money supply with international assets, provide cover for imports and hold a reserve to bail out their own often fragile financial systems. China's 'free reserves' are much less than the headline figure (Figure 29), once deductions are made for these factors.

Figure 29: China FX reserves and free reserves (\$ bn)



Source: Independent Strategy

Figure 30: Developing countries' exports to world % yoy



Source: IMF, Independent Strategy

The export growth model of emerging economies is also under threat from the impact of deleveraging in developed economies, which will reduce demand for emerging economies' exports at a time when their domestic demand-driven development models are insufficiently developed to take up the slack (Figure 30). ●

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4. Carmen M. Reinhart & Kenneth Rogoff, *This time is different — eight centuries of financial folly*
 5. Carmen M. Reinhart & Kenneth Rogoff, *Growth in a time of debt*;
Stephen G Cecchetti, M S Mohanty and Fabrizio Zampolli, *The Real Effects of Debt*, BIS, 5 August 2011;
 6. Stephen G Cecchetti, M S Mohanty and Fabrizio Zampolli, *The Real Effects of Debt*, BIS, 5 August 2011
 7. *Will it Hurt? The macroeconomic effects of fiscal consolidation*, IMF World Economic Outlook, October 2010;
Fiscal Adjustments in OECD Countries: Composition and Macroeconomic Effects, Alesina, A. and R. Perotti, IMF Staff Papers, Vol. 44, 1997;
A New Action-based Dataset of Fiscal Consolidation, Devries, P., Guajardo, J., Leigh, D. and A. Pescatori, (2011), IMF Working Paper, No. 11/128;
Expansionary Austerity: New International Evidence, IMF Working Paper, No. 11/158. Guajardo, J. Leigh, D. and A. Pescatori, (2011)

EUROZONE: A CRISIS APART

The European crisis has both proximate and ultimate causes. We'll examine both in turn because they are relevant to understanding where EU democracy has failed and why. Also, it will help to see if EU democracy can be improved as a result of the crisis.

Proximate causes

The proximate causes are that nearly all European governments have too much debt and some are very over-indebted. Many states where solvency is an issue are in the Eurozone and thus the existence of the euro is called into question by the crisis.

The flip side of the dilemma is the ownership of debt issued by the Weak Eurozone States (WES). About 80% of it is owned by banks and insurance companies. The average bank holding of sovereign debt in the WES is equal to between 20% and 30% of country GDP. Ownership of WES debt by Eurozone banks equals 100% of their tier one capital.

If WES sovereign debt were marked to market prices today much of the banks and insurance companies' capital would be wiped out. Bank capital was inadequate before the Eurozone sovereign debt crisis began. The tangible common equity of Eurozone banks was only 4% of risk assets. That of the US banks is above 8%. It doesn't take much for 4% to be lopped off the price of risk assets, which would be 100% of the banks' tangible equity (Figure 31).

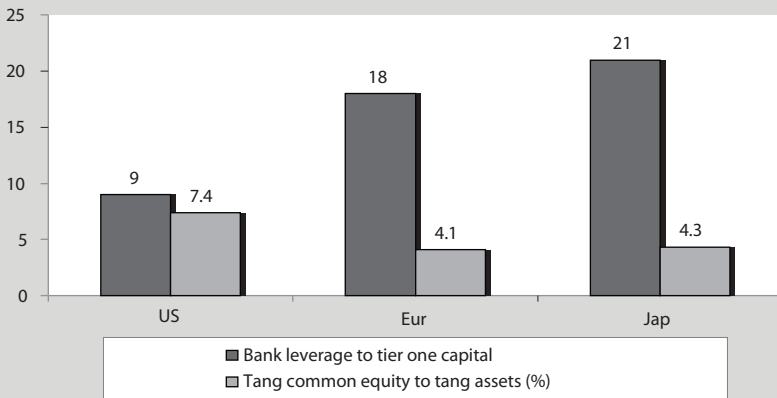
Risk of insolvency on the debtor's side creates a commensurate risk of insolvency on the (bank and insurance company) creditor side. Both matter, of course, as they threaten society in two ways: budgets will have to be reined



EUROZONE: A CRISIS APART

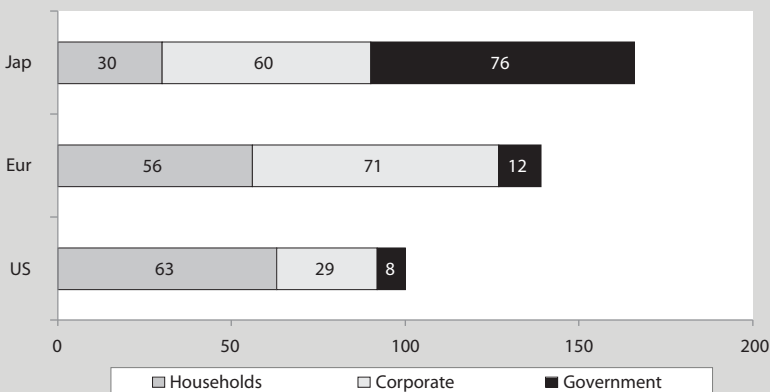
in to reduce debt and painful reforms will have to be taken to boost growth (growth being the only long-term way to reduce debt burdens). Without adequate capital, banks have to reduce their loans. This matters enormously in Europe because so much of the economy is dependent on bank borrowing (Figure 32). Bank credit is equal to nearly 150% of GDP compared with 100% in

Figure 31: Bank leverage (x) and equity to asset ratios (%), 2011



Source: IMF, Independent Strategy

Figure 32: Bank lending by sector (% of GDP), 2011



Source: IMF, Independent Strategy

the US, with European corporations being particularly dependent. Eurozone banks lend the equivalent of 71% of GDP to corporations compared to 29% in the US.

What turbocharges this sovereign debt/financial sector issue is contagion. Contagion means that when people start to question the solvency of Greece, they will soon do so for other highly indebted states. But contagion means something else too. It can migrate across sectors creating negative loops as it goes. If WES debt is risky, so are the banks. So they won't be buying WES debt. Risky banks stop lending to other sectors too. They will cut lending to households (56% of GDP) and the corporate sector. This makes WES sovereign debt riskier still because financing the budget deficit can't be done in the financial markets. And, of course, if banks react to being riskier by shrinking lending, that makes economic activity weaker. Then tax revenues fall, automatic stabilisers kick in, and budget deficits worsen.

The immediate task confronting the Eurozone authorities is to break the circuitry of contagion. That will take mega sums of money (Figure 33) (around €1-1.6trn to ring-fence WES budgetary and sovereign debt rollovers through 2015 and another €0.2-0.5trn to recapitalise the banks). Once it is clear that

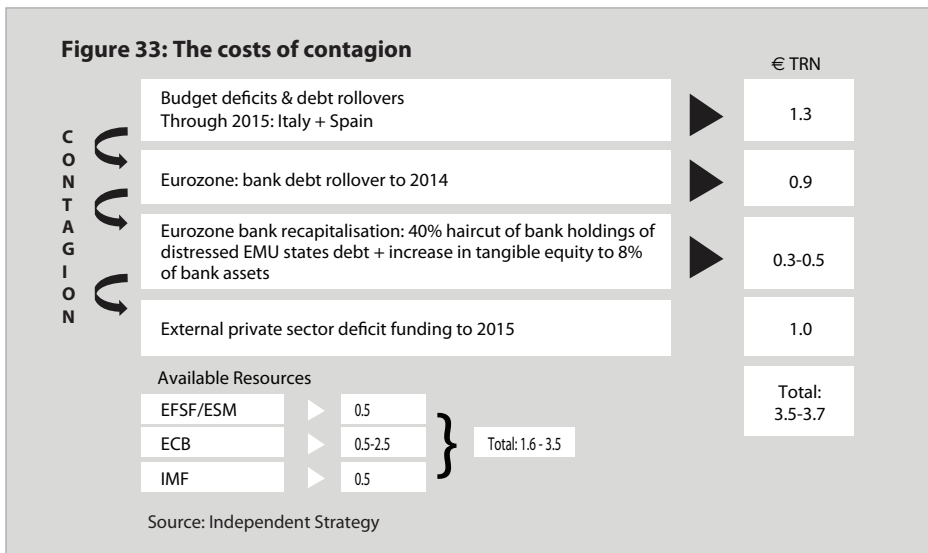
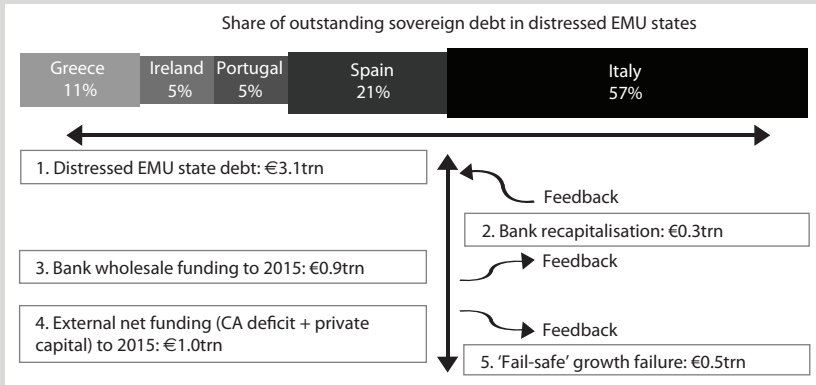


Figure 34: Compartments of Contagion



Source: Independent Strategy

these resources are on the table, contagion goes into reverse. If you fix the WES sovereign debt problem, the banks have to write down less of their assets, need less recapitalisation and may be able to roll over their own debts in the financial markets. As a result, far less of the money made available would be needed. Such is the nature of contagion.

But there is another way of short-circuiting contagion. First, we have to understand contagion: it rises exponentially with fear and wanes as fast as fear does. We have seen how it spreads from the sovereign borrower to the banks that own the sovereign debt and onwards to the economy if the banks are to contract their balance sheets. And from there the whole process starts again.

So contagion causes the cost of resolution of a debt crisis to rise by spreading through financial and economic compartments. Think of this as vertical or economic contagion. But contagion is also distributed among the countries that are victim (or causes) of the credit crisis. Think of this as horizontal or geographic contagion. Put together, the two forms of contagion form a 'T' (Figure 34).

Here is where the hope for short-circuiting contagion comes in. There is a geographical circuit breaker: Italy. It represents more than half of every form

of measurable economic contagion of the Eurozone sovereign debt crisis. Yet Italy has a primary budget surplus and could stabilise its debt-to-GDP with a relatively small additional shift of 3% of GDP (versus 9% required shift in primary budget balance of the US and UK and 12% for Japan).

Italy has unencumbered assets that could be turned into demand in the form of rich and modestly indebted households as well as low levels of corporate leverage. It has no domestic imbalances like excessive bank credit or housing bubbles (or their aftermath). And its current account deficit is a manageable 3% of GDP.

The reason Italy has a sovereign debt crisis is because the level of public debt is high (120% of GDP), productivity is low (output per capita is lower than a decade ago) and governance is poor (it ranks with Albania in terms of the World Bank's 'ease to do business' and with Rwanda for transparency).

If the markets believe Italy to be 'saveable', a virtuous outcome is possible as contagion will go into reverse. There is a chance that a reformist government will increase the growth rate of the economy relatively easily and correct the budget balance. Were it to do so, or be seen to be able to do so, half of the euro crisis would evaporate.

Beyond the immediate fire fighting mission, the euro needs re-engineering. Fiscal integration is a must, as is a radical ongoing agenda of reform to improve growth prospects throughout the Eurozone and particularly among the southern WES. All such measures mean that sovereign power has to be abandoned by members of the Eurozone to a supra-national institution. It also means that the Eurozone must transform itself from what was initially a purely monetary union, to which has now been added the role of fiscal austerity and transfer union, into a full fiscal union, with funds to finance growth flowing from the richer countries to the weaker ones. That raises a host of issues that go to the democratic heart of how the euro got itself into a mess in the first place. This leads to the ultimate causes of the euro crisis.

Ultimate causes

We have two distinct sorts of euro-crisis (Figure 35). The first is when a credit bubble bursts, causing asset prices to collapse and the risks of the banking

EUROZONE: A CRISIS APART

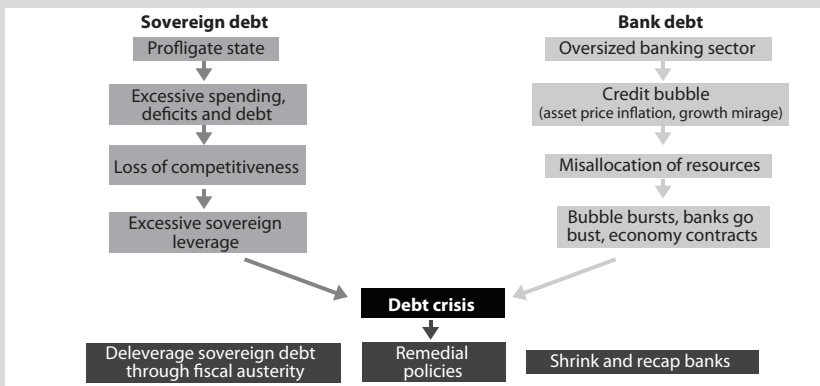
sector are transferred to the balance sheet of the sovereign state. The risks of the financial sector then overwhelm the sovereign balance sheet, causing a sovereign debt crisis on top of a banking one.

The second type of crisis is when years of excessive public spending and budget deficits produce a debt-to-GDP figure that spells future or present insolvency. The debt markets get roiled and the sovereign debt of the state is shunned.

These two types of crisis are interlinked by common factors, such as the need to address budget deficits, taxation (often overly dependent on property taxes in the case of the credit bubble crisis), loss of competitiveness due to misallocation of resources, and inevitable banking crises due to bursting credit bubbles in the former case or ownership of the sovereign's debt in the latter case.

But the two types of crisis are distinct in two key aspects. The bubble economy crisis can be resolved by the sale of assets and paying down debts associated with the state's acquired ownership of bank assets and collateral. The task is easier if these assets and liabilities have been acquired at adequately marked down prices. Once the assets are sold, the proceeds serve to reduce sovereign debt in chunks like the descending steps of a staircase. If they can be sold at a profit, the tax payer directly benefits too.

Figure 35: The twin sources of the euro debt crisis



Source: Independent Strategy

However, the state that has got itself into a mess by spending more than its revenues for decades and spending it badly faces a much tougher task. This is because most of the fiscal spending will have been on people's entitlement programmes, such as education, healthcare, pensions and unemployment payments. Such spending is part of the social contract. Reducing entitlements tears up the social contract. It's a major challenge for any democracy. It also means that consumer spending, the largest part of the economy, will be squeezed by falling household income as entitlements are reduced over a long period. Ireland and Spain fall into the credit bubble category. Greece, Portugal, Italy and Belgium fall into the bloated state category.

The next thing on the list of ultimate causes of the Euro crisis is in the arithmetic of excesses (Figure 36). The Eurozone is more leveraged than the

Figure 36: Comparing debt

Chart A: Total national gross debt by sector (% of GDP), 2011

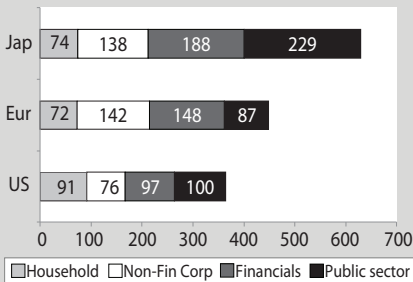


Chart B: Public sector debt to GDP (%), 2011

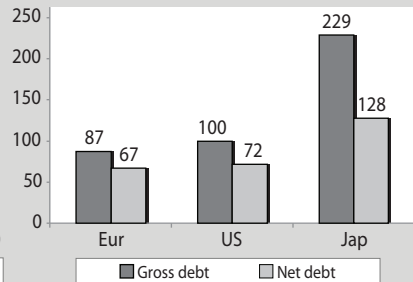


Chart C: Net public debt to government revenues (%), 2011

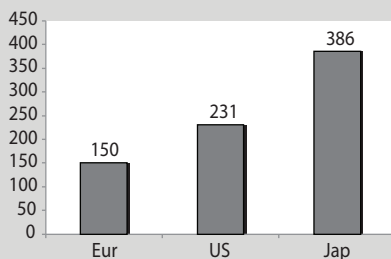
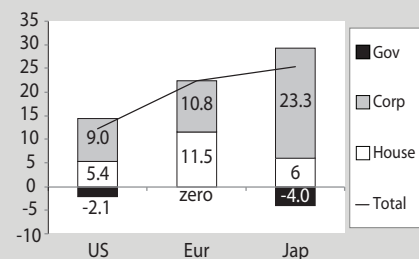


Chart D: Gross national savings by sector (% of GDP), 2011



Source: Independent Strategy

EUROZONE: A CRISIS APART

US, but less so than Japan (Figure 36A). The Eurozone's aggregate sovereign debt to GDP ratio is way lower than the US and dwarfed by Japan (Figure 36B). The Eurozone's ability to service its sovereign debts from government revenues is the best of all the economic blocs (Figure 36C). Despite being more leveraged than the US, the Eurozone has fatter savings rates (Figure 36D) and no overall external deficit. How do we tie all this together?

The first observation to make is that the US and Japan are just as prone to sovereign debt crises as Europe. When they have them is when the markets decide they have them, not when the statistics say they should have them. Greece's debt statistics were just as bad five years before its crisis when it was borrowing at quasi-German rates. One morning the markets woke up and said what was okay yesterday is sooo not okay today! This can happen to Japan, the US or the UK in just as random a fashion.

The second point is that the Eurozone crisis is a local debt crisis. The aggregate debt figures for the Eurozone look okay. But the WES debt figures look way worse than any of the component parts of the US body politic. So divergence is much greater in the Eurozone than in the US. Such divergence works like the tiny subprime market on the massive stock of US housing debt — the small bad gene has the potential to destroy the bigger, relatively healthier, whole. This is particularly true as the healthy core may not bail out the weak periphery.

The third point is that the US and Eurozone share the common disease of overleverage. But in America, lack of household thrift lies at its heart. In Europe, the core of the crisis is government leverage and the ownership of sovereign debts by a bloated and undercapitalised banking system. In both cases, leverage has created unsustainable living standards. In Europe, the rot is in WES indebted states and in the US it's in households. In Europe, the ultimate cause is in the political culture of individual states. In America, it is in the lack of thrift among people and the culture of political denial of this at federal level.

Analysing how the WES states got themselves into this mess throws up one economic reason, one cultural reason and two democratic flaws. The economic reason is that the euro gave the WES German interest rates and this sparked

credit bubbles, particularly in Ireland and Spain. More seriously, it allowed corrupt governments, like Greece, to borrow more and buy more votes.

The cultural reason is that many of the WES, but not all, are characterised by popular disrespect for the state. The state responds by corrupt vote buying with populist measures. As in human relationships, money is a good alternative for love in procuring favours. Normally, all of these states have weak coalition governments that fail to tackle structural issues. Governments survive by assembling political parties with conflicting interests in temporary and shifting alliances. Such governments' prime objective is to stay in power by pandering to local interest groups. In each of the WES states that have these characteristics, there are historical reasons why the culture is as it is (traditions of being colonised and governed by foreigners, ethnic divides, corrupt monarchies etc). It is tempting to find a European north-south cultural divide as a determinant. But it is false. Belgium is one such WES. Ireland, before its current painful political cleansing, definitely was. And Spain is not, though its governance has another limiting factor: regional autonomy, fiscal decentralisation and disparate local governments. In Portugal, political corruption played a minor role as the cause of its debt crisis.

The democratic flaws stem from the unaccountable nature of most EU policy making. The Greeks never signed off on the Maastricht criteria, which were enshrined in the Treaty setting up EMU, and were supposed to police fiscal behaviour of Eurozone member states. And the criteria were promptly abrogated once Germany and France saw fit to do so, again without any accountability. So the bottoms-up democratic approval and control of the euro never happened. And the top-down (indirect democratic) control failed when it suited the big states that had signed up to it⁸.

If the euro is to survive, its structural flaws need to be addressed. The remedies proposed so far are sound enough (balanced budgets, fiscal integration etc). But compliance with the goals has to be implemented by laws passed in individual member states. In other words, a framework for economic compliance with conditions for membership of EMU that is approved by national electorates and cannot be changed by politicians at their whim. The inclusion of national fiscal stability laws in the new proposed European

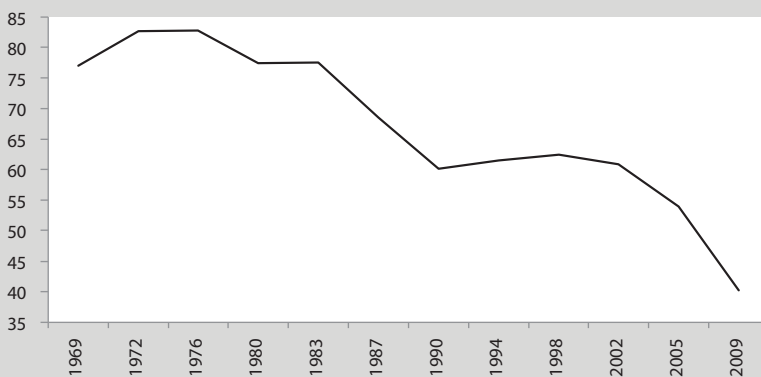
EUROZONE: A CRISIS APART

Stability, Coordination and Governance, agreed in principle in December 2011, may be a step in this direction — if it is implemented.

The message is that EMU's democratic deficits are as big as its economic ones and must be addressed together. Unless there is democratic accountability of any institutions set up to rectify the Euro's economic flaws, it won't work.

This will not be easy. The lack of decisive political leadership and vision in the strong states, Germany in particular, is one vital ingredient that is lacking. And it is no accident that it is so. Once politics lost its vitality after the fall of communism, the German political spectrum started to fragment as the unifying element to counter the Soviet threat. Germany literally lost its *raison d'être*. Since then, dominance of the traditional political parties has continued to decline (Figure 37). This opened the way to progressively weaker coalition governments. Leaders of such governments spend their time managing the mechanics of coalition that, by definition, are antithetical to the visionary thing. Europe's dilemma needs that visionary thing, but the German political system cannot produce it.

Figure 37: Share of eligible vote going to two main German political parties (CDU and SPD) in federal elections (%)



Source: Electoral Commission, Independent Strategy

The most likely scenario is that the Eurozone will survive in more or less its present shape. At most, Greece may leave. Euro survival will be because the money will eventually be found to stop the crisis, greater fiscal (and thus political) integration happens and policies that regain competitiveness are implemented by those states that need them.

The alternative would be a break up of the Eurozone, as we know it. Most southern states would go their own way. It is unlikely that they would form a second tier 'new Eurozone'. The initial cost to the weak states would be high (Figure 38).

Germany and the Northern EMU states would remain in the super-euro. Rather than leave and set up a new eurozone, they would inherit the old. France would be part of this group. Without it, the euro would be too strong. A super strong euro would cause loss of export markets for German industry. It would also mean devaluation and losses on foreign assets for German banks, necessitating recapitalisation. France's interest would also be to stick to Germany as it has done since 1945. Leadership of a disparate group of weak southern economies would be a poor alternative, economically and politically.

It is more than likely that Italy would be part of the super-euro group. There are three reasons for thinking so. It is unthinkable for the Italians not to be part of the Euro and they will be prepared to pay the price of inclusion. Italy's fiscal problems are fixable and the private sector is financially sound but growth-bereft because of past policy failures to free up markets. Monetary unions are not made for economic reasons alone (or the euro wouldn't be there) but by an ineffable cultural bonding. Any euro structure that excluded Italy would be in cultural and psychological disequilibrium.

The other smaller European states that have the euro currency today would opt to maintain their membership of the Eurozone. This goes for Austria, Finland, Estonia, Slovakia, Slovenia, Ireland, Belgium, Luxembourg and the Netherlands.

It is not impossible that states that are not members of EMU today would be, if it were reformed around a German core. This could include certain

Scandinavian countries and Eastern European ones that are not currently members of EMU. Candidates might include Denmark, Norway, Poland, the Czech Republic, Latvia and Lithuania. ●

EURO BREAK-UP COSTS: AN ESTIMATE

There have been a few studies on the cost of a euro break-up. UBS have estimated that if Germany left the euro, the cost to its economy would be a one-off 20-25% of GDP with ongoing annual costs of 10% of GDP. This assumes a 40% appreciation of the new deutschemark against the euro and major bank recapitalisation. If Greece were to leave, the cost to the Greek economy would be 40-50% of GDP with ongoing annual losses of 15% of GDP. These estimates are based on the assumptions of a 60% devaluation in the new Greek currency to the euro, a consequent rise in private sector debt and defaults, a 700% bp rise in interest rates and major bank recapitalisation.

But the estimates are founded on unrealistic outcomes of how the Eurozone would break up. And they assume that any country that leaves the Eurozone would also exit the European Union, an outcome that is unlikely, even if it is a current legal consequence. Dropping those assumptions would make the losses incurred on leaving less, but still substantial.

The cost to Greece of leaving the euro would be huge but assuming it stayed in the EU, we estimate the one-off cost would be 30-40% of GDP with ongoing annual losses of 8-10% of GDP. For the SuperEuro economies, the loss would be minimal, mainly relating to a super-strong euro reducing the contribution of net trade-to-GDP and bank losses on a Greek default — about 1% of Eurozone GDP.

We estimate that, if any one large EMU state like Italy or Spain were to leave the euro or be exited, but not leave the EU, the initial cost to GDP would be about 20-25% of GDP for Italy, with ongoing annual losses of 4-6% of GDP. If Germany left, there would also be losses incurred from a more competitive remaining Eurozone and bank recap costs — a one-off hit of 5-10% of GDP, with ongoing losses in annual GDP of 1%.

But our central case assumptions are different, namely that a SuperEuro club would be formed, including Germany, France, Italy and Spain along with Belgium, the Netherlands, Austria and other northern European EMU states (including Ireland).

Figure 38. Source: *Independent Strategy*

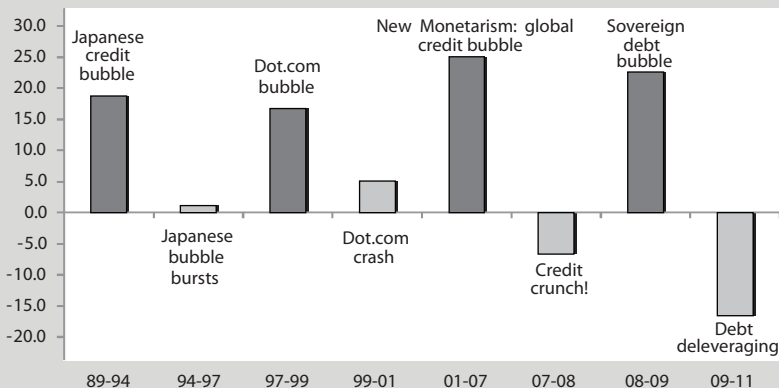
US: FISCAL GRIDLOCK

Somewhere in the disinflationary decades, the US became hooked on debt; the American dream was henceforth bought on credit and not by dint of hard work and saving. It happened first in the private sector. Then around the time of the Iraq invasion it spread to the public sector. From then on, the economy could only expand by dint of credit bubbles (Figure 39).

Writing at the time of the Iraq invasion, we called the process the start of the End of Empire. That's the point when empires start to wane, because the centre produces less and less of what it consumes and depends increasingly on its far-flung components to supply its needs and fund its deficits.

Of course, the US was not an empire in the traditional sense, but it stood at the centre of the world order economically, ideologically and by dint of its military power.

Figure 39: Change in global debt (% pts) of world GDP



Source: Independent Strategy

It held ideological sway. Supply-side economics and free markets were the accepted wisdom spread by the US to every successful corner of the emerging world. US liberal economics constituted the loadstone for measuring the shortcomings of Japan in the lost decades, and of sclerotic 'old' Europe. After the collapse of communism, there was no alternative ideology: the US way of thinking and doing things was the right way. History, according to some, had ended! Well, not quite — a new chapter had merely begun.

Then came the credit crisis. US policy makers spent more than any other country on seeking to sustain the economy by sparing it the pain of deleveraging. There has never been an attempt to address the fundamental causes of the crisis — a lack of thrift. Instead, sovereign debt was increased to offset any deleveraging that might occur in the private sector. We know the result: a temporary boost to output and a permanent increase in total debt. Excessive credit caused the credit cycle and was the prescription for curing it.

It is no coincidence that this period goes together with the decline of US global influence. A decade ago, US ideas ruled the world. Now they are blamed for causing economic collapse and for providing free licence to bankers to all but cause the demise of capitalism, leaving the tab for citizens to pick up. Nowhere has the reversal of the free market ideology been more radical than at home. In the US today, the predominant economic ideas of incumbent policy makers would do credit to a European socialist.

More critically, the US's ability to project its power is being eroded. In the course of the next few years, the US will declare victory and withdraw militarily from many unstable areas of the world. It has little power or influence over the Middle East at a critical juncture. Its attempts to contain China look increasingly puny. This trend is likely to continue; the military machine is likely to bear the brunt of spending cuts, as the US struggles to deal with its massive fiscal deficit and sovereign debt burden, without addressing the social contract and entitlement spending which cause both.

Fatal fiscal arithmetic

On a comparison of debt dynamics, the US comes off worse than many of the WES: whether it's the size of public sector debt burdens, budget deficits, foreign

ownership of debt, dependence on foreign financing, or banking ratios. And what's worse, is that unlike the WES where fiscal austerity is the order of the day, in the US little attempt is being made to stabilise public finances.

The debt dynamics of the US are little better than the Eurozone. The IMF forecasts that US non-financial debt (both public and private) in 2012 will reach about 282% of GDP compared to 303% for the euro area average. Within Europe, Germany's total debt ratio will be much lower at 205%; Italy's nearly the same as the US; while bust-up Greece will have a higher total debt burden of 313%.

When we compare public sector debt alone, the US looms large. In 2012, US gross public debt to GDP ratio is expected to reach 107%, compared to the euro average of 94%, Spain at 91%, Germany at 83%, France at 90%, Portugal at 119% and Ireland at 118%.

Even more worrying is the capacity of the tax system to service US sovereign debt (after all government doesn't 'own' GDP — just taxes). In 2012, the ratio of net public sector debt to government revenues will reach 262% in the US compared to 220% in Spain, 160% for the euro area and just 131% in Germany. Indeed, as a share of US GDP, tax revenues for the last three years will have been at their lowest since 1950. Another big issue is who holds US government debt. The dollar's role as a global reserve currency means that creditor nations tend to hold their surpluses mostly in dollars. That means buying US treasuries and notes. Indeed, US treasuries have also become a safe-haven from euro contagion, with ten-year yields near all-time lows.

And the US central bank has taken up a lot of the slack: the Fed has become the largest single holder of US government debt through its programmes (QE1, QE2 and operation Twist). The Fed, along with the official authorities in China and Japan, now control three-quarters of the stock of US sovereign marketable (!) debt.

Apart from the Fed, the biggest investors in US government paper are foreigners. Non-resident holdings (which includes official sectors) of US debt stand at 30% (40% of treasuries) compared to 25% in the UK, and 25% for all euro area government debt (of course, the non-resident share of each

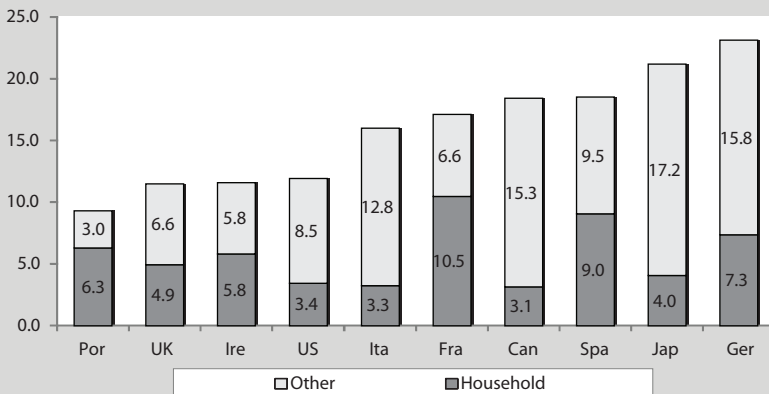
US: FISCAL GRIDLOCK

individual Eurozone government debt is much higher because it is owned by others in the euro area).

The domestic private sector does not provide a savings cushion to replace foreigners. A big cushion of domestic thrift has been the main reason for low JGB yields, despite public sector debt at 230% of Japan's GDP. But US household savings rates are well below those in the euro area, while the national savings rate (household, corporate and government combined) is lower than Ireland and barely higher than Portugal's (Figure 40).

The US government is also surprisingly more vulnerable to market pressure. Average term-to-maturity for US government debt is just five years, the lowest among the major OECD economies and lower than for any of the WES (Figure 41). As a result, US government debt maturing in 2011 is nearly 20% of the total stock, with only Japan higher. That would make funding more difficult if credibility should weaken. In 2012, the US government has gross financing needs of 26% of GDP, higher than all other advanced economies except for Japan (59%).

Figure 40: Household and national savings rates (% of GDP), 2010

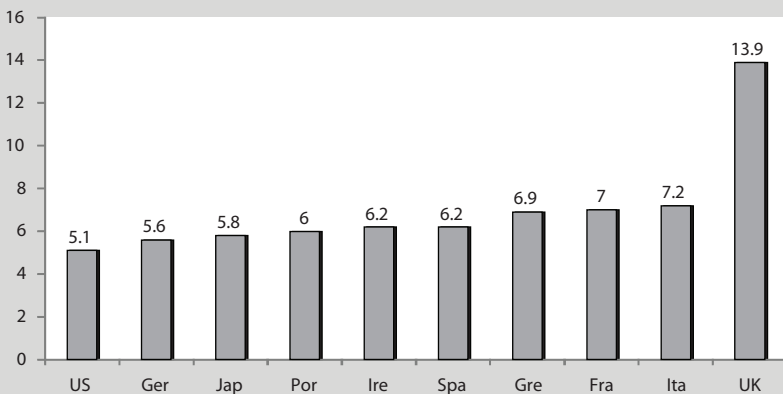


Source: IMF

When debt ratios reach the level of the US government they will exert a damaging downward pressure on economic growth and raise the risk of a debt default. Following Rogoff and Reinhart's historical study⁹, which found that 90% of GDP was the threshold debt level to start damaging the economy in advanced economies, BIS economists also concluded that at 85% of GDP, government debt begins to destroy economic growth¹⁰. US government debt is already there.

The task is huge and compelling to get US debt ratios down. The US federal government primary deficit (i.e. excluding interest costs on debt) is 7% of GDP. That must improve by 9.5% of GDP to just stabilise the debt-to-GDP ratio. The primary balance would need to reach a surplus of 5.5% of GDP by the end of the decade and be maintained for another ten years to get the ratio down to 60%. And yet the best that the US has ever achieved in any ten-year period since 1970 is a 1.7% primary US budget surplus! Italy could do the same job with a 4% point of GDP swing in its primary government budget balance and by running a 3% of GDP primary budget surplus from 2020 to 2030. Italy today demonstrates the political will to do so. The US does not.

Figure 41: Average maturity of government bond stock (years)



Source: IMF

US: FISCAL GRIDLOCK

According to the Congressional Budget Office, if there is no policy action in the US, then net federal debt (which subtracts federal assets from gross debt) will be over 100% of GDP by 2020 from its current 70%. That estimate assumes quite significant economic growth, including average real GDP growth of 4.5-5.0% in 2014 and 2015. If that spike in growth does not materialise and average growth is only around 2.5% a year, then net debt would be closer to 110% in 2020.

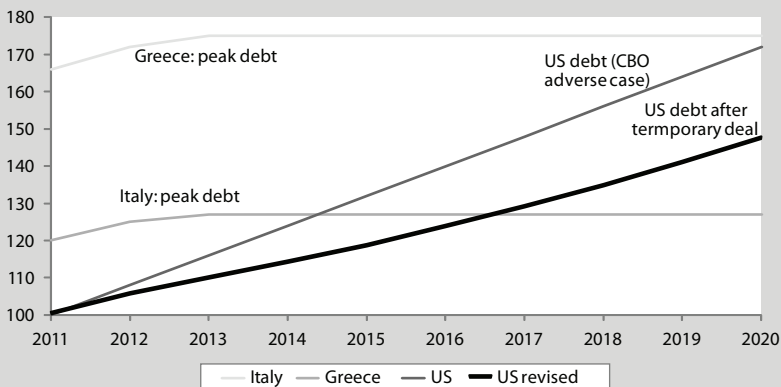
The so-called automatic cuts will come into play for the budget beginning October 2012, to reduce the deficit by \$1.2trn. But this is way short of the required \$5trn in deficit reduction measures that would achieve a reduction in government debt towards 60% of GDP by the end of the decade.

Indeed, we reckon that if there is no policy action in the US, its public sector gross debt would surpass the current level of sovereign debt to GDP in Italy by 2014 and even the current level of Greece by 2018 (Figure 42)!

Politics, dysfunctional politics

Progress is unlikely given the political battle between a Democratic President

Figure 42: US public debt projections to 2020 (% of GDP)



Source: IMF, CBO, Independent Strategy

and a Republican Congress, with a presidential election in 2012. Even without this factor, finding the necessary public spending reductions is fiendishly difficult. All the discretionary programmes that can be cut already have been. What is left to cut are the mandatory programmes like social security, healthcare entitlements, farm subsidies and unemployment benefits — political dynamite precisely because these are the fabric of the social contract. The percentage of government revenues not already committed to mandatory programmes is zero — to finance anything else requires borrowing i.e. more debt.

The government can find deficit reductions in 2012. It is counting \$1.1trn in savings from troop withdrawals from Iraq and Afghanistan. But this is a one-off. And one-offs do not set a plan for fiscal balance through to the end of the decade.

Nothing demonstrates more the growing democratic deficit in the US than the failure of Congress to tackle this sovereign debt crisis. In a way, the real problem for America is the challenge to its democratic process. Congress is more polarised than it has ever been by any measure of partisanship. In the 2010 mid-term Congressional elections, barely 40% of Americans eligible to vote did so. The electorate is disillusioned, but the politicians cannot or won't lead.

Does the US sovereign debt debacle herald a collapse in US treasury prices and a sharp fall in the dollar as foreign investors flee US assets? Well, no — at least not yet. US treasury yields are well below 2% and the dollar is holding its own against the other major currencies as investors seek US assets as a safe haven from potential meltdown in the Eurozone. Official sources in Japan and China continue to buy US debt as well.

But this hides the reality of the fault lines beneath. The sovereign debt crisis will come to the US — but only when market decides. Successive downgrades of US government paper by credit rating agencies could be the trigger. So could any return of inflation, forcing the Fed to reverse course and causing the US treasury market to collapse.

US: FISCAL GRIDLOCK

Another trigger could be a disorderly default in the Eurozone. US banks have about \$150bn of assets in the WES That's a lot less than German banks (\$530bn), French banks (\$650bn) and UK banks (\$350bn). French, German and UK banks are far more exposed to a WES default than US banks, with WES assets constituting nearly 95% of the capital and reserves of German and French banks, over 30% for UK banks and just 12% for US banks.

But default and meltdown in the WES, causing losses and bank defaults in Europe would soon ricochet back to the US, in ways which contagion maps find hard to quantify in advance of crises. If US banks get into renewed trouble, it would place the US sovereign right back into focus too. ●

9. Carmen M. Reinhart & Kenneth Rogoff, *This time is different — eight centuries of financial folly*

10. Stephen G. Cecchetti, M Mohanty and F Zampolli, *The future of public debt*

JAPAN: AN ENIGMA WRAPPED IN A MYSTERY

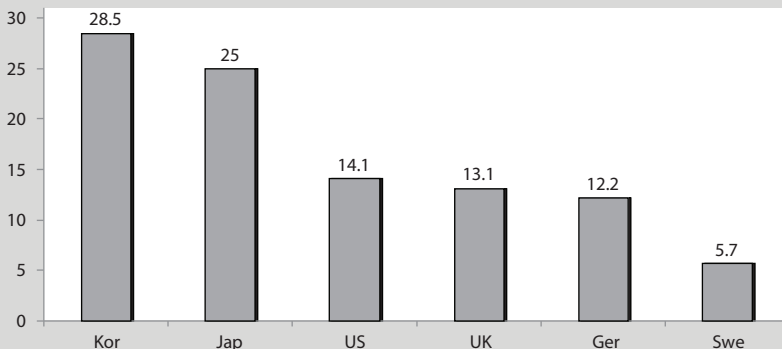
Japan is the largest rich democracy in Asia. It is also the richest country in Asia. And its political system is one of Asia's most dysfunctional. It is an enigma wrapped in a mystery. The enigma is how Japan is: the mystery is how it is perceived. There is no doubt that Japan is a democracy. But it is a dysfunctional one. It also has great civic values. And there is rule of law. Yet, faced with challenges, it avoids change.

The culture of denial

For example, Japan has a low growth rate because it is getting old. It accepts this as a *fait accompli*. But it has the greatest pool of highly educated women who are not meaningfully integrated into the workforce. It has the worst female participation rates and relative (to men) female pay scales of any of the rich democracies.

The participation of women in the workforce in Japan is 25% less than men, compared to 12-14% less for the other non-Asian rich democracies (Figure 43). Only Italy keeps as many *mamas a la casa!* (and Italy has been about as

Figure 43: Participation gap between male and females of working age (% pts)



Source: ILO, Independent Strategy

JAPAN: AN ENIGMA WRAPPED IN A MYSTERY

dynamic an economy as Japan for a decade). When women work in Japan, most of them simmer around in dolly uniforms serving tea to corporate guests. When they are not in the labour force, they live frustrating housebound lives with the odd relief of a tennis coach. If Japanese women played to their full economic potential, Japan's GDP would be hefted 15% and potential growth by 0.5% a year — not bad when the demography-impaired potential growth rate is 1.2% p.a. at best!

The best interpretation of Japan today comes from its writers of fiction. One, Kazuo Ishiguro (who loves the place so much he lives in England and has taken UK citizenship) writes of realities where, if life is a lake, the surface is always to be kept smooth as a mirror. But beneath, the terrible cost of doing so is fought out among the monsters of the deep.

One of his books, *The Artist of the Floating World*, is set just after World War II in Japan. It describes the destruction of two families with children set to marry in the post-war world, where one of the families is tainted by its association (artistic) with the Japanese war regime. The tea ceremonies remain impeccable and calm. Beneath, the families are destroyed.

Another, *Remains of the Day* portrays the same theme in an almost faultlessly described pre-World War II English landscape. Here, maintenance of impeccable social order condemns the most worthwhile people in the book to barren lives of loneliness because of the over-weening need to maintain social convention.

You have to face up to things. Japan has become bad at doing that. This was not always the case. The late 19th century Meiji Restoration resulted in the radical modernisation and industrialisation of Japan. It gave the country a modern prefecture structure under a central bureaucracy. It disarmed and placed its Samurai feudal warrior class in an isolation chamber of ritual or bureaucratic jobs, having first crushed its revolts. And it integrated women into the workforce. So Japan is capable of achieving radical change.

Or it was. It doesn't seem to have the heart for it any more. Maybe it is because it is an ageing conservative society. Maybe denial became an engrained

political culture due to denial of its World War II crimes, which were cleansed by other nations by facing up to them. Maybe it is because the Americans wrote a Japanese constitution (and encouraged the Japanese to sign it by flying B52s over their heads during negotiations) that purposely created a paralytic political system. The Americans thought they were writing a constitution that would prevent any return to a war footing. In reality, it prevented the political system being capable of doing anything radical. It remains in force today.

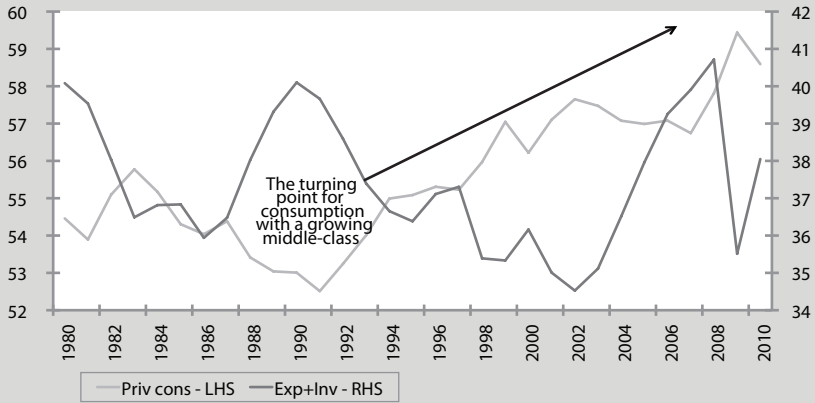
Japanese political architecture is characterised by a bureaucracy that is stronger than the politicians. And the bureaucratic aim is always to maintain stability — Japan's is not alone in that. Prime ministers rise and fall at the whim of factions and not by the will of the people. Policies come second to factional interests. There are really no political alternatives to choose from — for the parties or for the people. When a high profile prime minister with popular appeal finally appears through the grey fog and fug of political committee rooms, he achieves little. The only durable reform of all of Koizumi's reign was a reform of the Post Office! He did nothing about the rot in Japan's fiscal affairs.

Japan's political culture did not stop it migrating successfully from a post-war development model (based on suppression of consumption, massive savings rates and external surpluses channelled by government into investment in legendary export manufacturers) to being a consumer-based and service-based modern economy. But that happened in the 1980s, due to the rise of the prosperous middle classes and not by dint of policy intervention (Figure 44). The share of private consumption in national income rose and the export-led model of growth waned.

There is nothing wrong with having a stability-seeking system if there is no need for change. Switzerland lives that way. Luxembourg's motto is *Wij blijven wat wij sind* — we stay as we are. This does not apply to Japan. There is radical need for change. Japan is fiscally bankrupt and economically growthless: a pretty fatal combination — even if the time of death is difficult to forecast. The democratic system as it is currently configured is incapable of confronting this reality. So there will be upheaval to achieve change. The question is when?

JAPAN: AN ENIGMA WRAPPED IN A MYSTERY

Figure 44: Japan — private consumption, investment and exports (as % of GDP), 1980-2012



Source: Independent Strategy

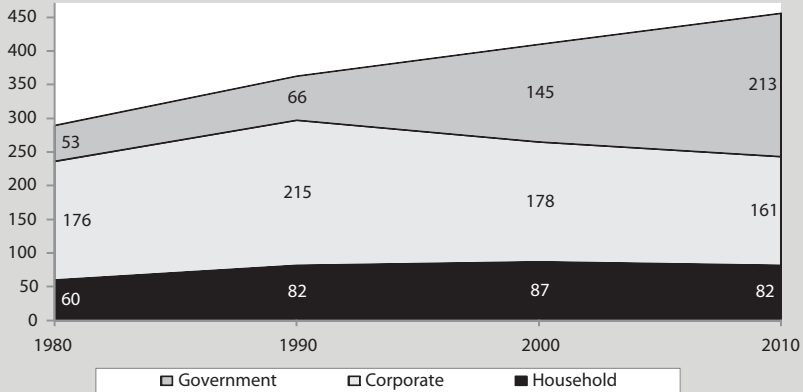
Japan's fiscal dilemma

Japan has the highest rate of sovereign debt among rich democracies with gross sovereign debt amounting to 236% of GDP. Even its net debt would not reduce this burden to the same level as Italy's gross debt of 120% of GDP. In fact, Japan's net debt-to-GDP is about the same as Greece's. Japan has the lowest chance of achieving an FSGR economic growth rate that could stabilise its debt. And it would need to adjust its primary budget balance by more than 10% of GDP for the rest of this decade to have a hope of doing so. And there is no prospect of that — the best that Japan has ever achieved in any ten-year period since 1970 is 7% of GDP adjustment.

So Japan has a sovereign debt crisis — except it doesn't. Its government bonds yield less than 1% and it has the most stable and strongest currency of all the rich economies. It has a fiscal mess, but no crisis. To unravel that enigma we need to delve further.

Let us go back to the Japanese bubble economy. In the 1980s, the bubble was driven by corporate leverage. When it burst, state leverage was swapped for

Figure 45: Japan debt: from private to public



Source: IMF, Independent Strategy

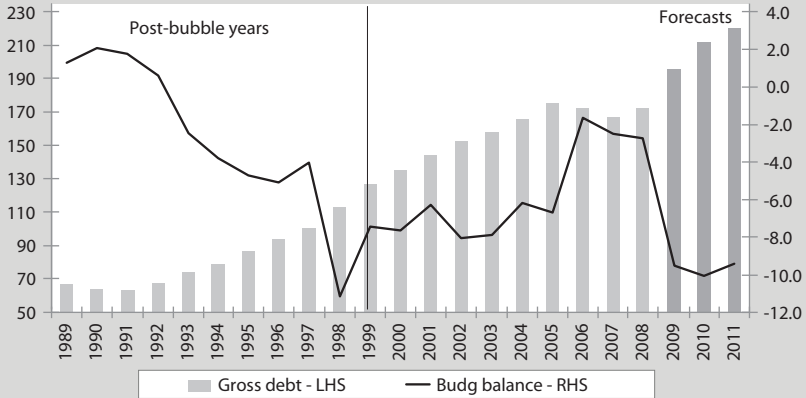
corporate leverage. Japan never deleveraged — it just shifted private debt to the sovereign (Figure 45). The result has been levels of debt that drive down growth. And growth was further weakened by demographics.

This explosion in debt was caused by budget deficits of 4-10% of GDP every year in order to raise economic growth (Figure 46). The policy failed. Running these budget deficits was only possible because bond yields kept falling. The strength of the yen also made Japanese government bonds (JGBs) the strongest performing bond instrument in the world in yen terms. So investors made money in two ways — from falling yields and the rising market value of JGBs, as well as from the currency.

So the risk-averse Japanese had no motivation to put their savings abroad. They placed them in (often insolvent) banks instead (knowing the government would not allow the banks to go bust). The banks put together their deposit money, which they hardly remunerated at all, with free money borrowed from the Bank of Japan (BoJ) and ploughed the lot into JGBs. So naturally, the bond yields fell.

JAPAN: AN ENIGMA WRAPPED IN A MYSTERY

Figure 46: Japan: government budget balance and gross debt to GDP ratios (%)



Source: OECD, Independent Strategy

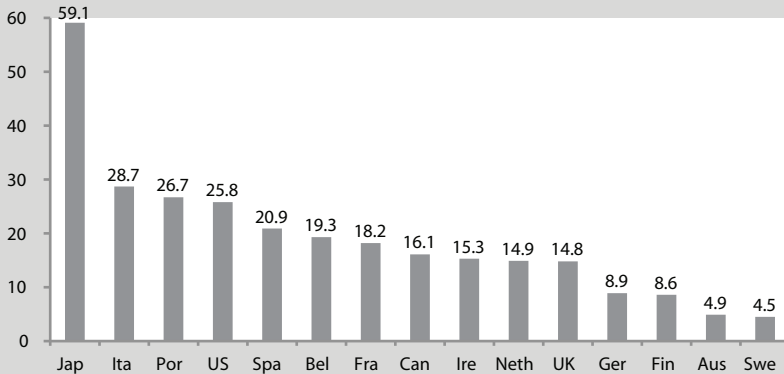
Falling JGB yields generated big capital gains for the banks. This came on top of the interest-rate margin they earned by borrowing money from households and the BoJ at virtually zero interest rates and investing in JGBs. That was how the Japanese banks were saved and it is how the Fed seeks to refinance US banks today.

It helped, of course, that Japanese households at that time had savings rates of 20% of disposable income and the largest stock of household saving relative to GDP (5-6 times) in the world. And it mattered little that the banks paid depositors almost nothing because deflation saw to it that the real value of deposits rose year after year.

But the result is a shocking fiscal dilemma: nearly 60% of GDP has to be borrowed each year to finance the public sector (Figure 47) and out of every 100 yen the government spends each year, nearly 25 yen has to be borrowed.

It is not that there are no solutions available to politicians. It is that the politicians are incapable of deciding and implementing them.

Figure 47: OECD countries' gross public sector funding needs, 2012 (% of GDP)



Source: IMF

The fiscal problem in Japan is not about spending, despite an ageing demography and its associated costs. Total public spending in Japan is about 40% of GDP. In France it is about 56%! Japan's fiscal dilemma is about tax receipts, which are way too low (30% of GDP) compared to other OECD peers. If Japan were to raise its consumption tax to the same level as the EU, it would have both a primary and total budget surplus. Japan has made timid steps in this direction. This will not be good for the economic cycle, of course. But the point is that there are ways out that don't quite fit the inevitable Armageddon scenario. There always are. It all comes down to the political will to tackle the crisis.

The miracle of perception

Now we come to the miracle. The miracle is perception: how international investors see Japan.

With total debt standing at 450% (excluding financial sector debt) of GDP, mainly due to the excesses of the public sector, Japan is by far the most leveraged rich democracy (Figure 48). Japan has potential economic growth

JAPAN: AN ENIGMA WRAPPED IN A MYSTERY

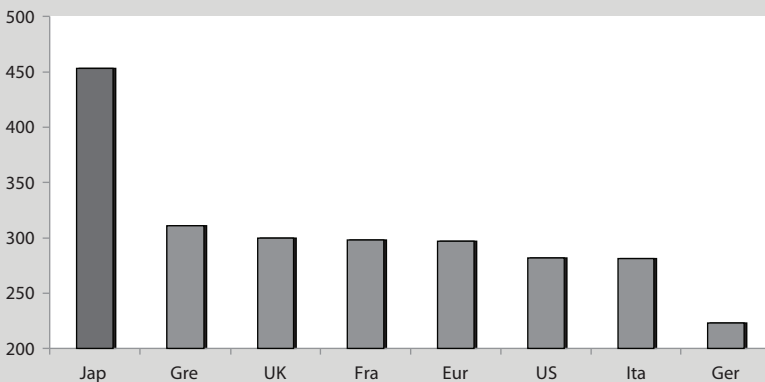
rates well below the failsafe level. So it has all the arithmetic of a debt crisis. But debt crises only happen when the market says so. Timing this is impossible. That does not make it less inevitable.

The miracle is that Japan is seen as a safe haven. Its bond and currency markets are the most stable in the world. The miracle of perceived safe-haven status that underpins this stability depends on some misplaced perceptions.

Japanese households have massive savings. And individuals have a home bias in investment (only 5% of household assets are invested overseas) and are risk averse. So they have always put their savings in their banks or in government paper. Household deposits in the banks are worth 150% of GDP and the banks in turn hold 43% of all JGB stock. Japanese households only own 5.1% of JGB's directly.

But the stock of household savings is already invested in JGBs. The question is: are there enough new savings to buy the new issuance of JGBs corresponding to high annual budget deficits?

Figure 48: Non-financial sector debt in selected OECD countries (as % of GDP)



Source: IMF

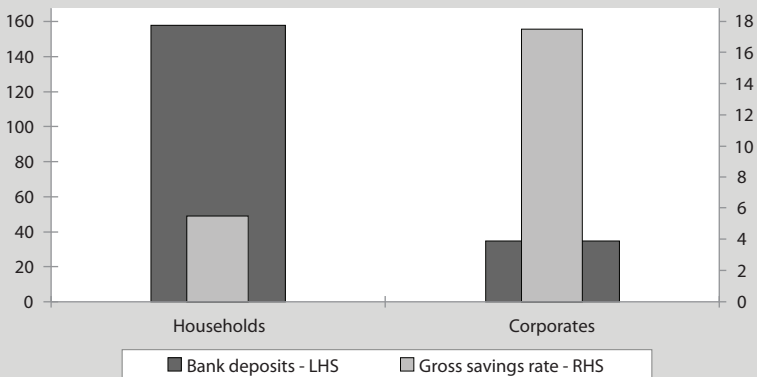
Budget deficits are set to run at 8-10% of GDP a year. So Japan needs a flow of new savings equal to that. But instead, the flow of household savings has sunk to 3% of disposable income and less of GDP. In an ageing society, people save less and spend their wealth to survive.

Of course, there are also corporate savings, amounting to 18% of GDP, but mostly these are not channelled into bank deposits (only 30% of deposits are corporate compared to 65% from households), so they don't get reinvested by banks into JGBs (Figure 49) to the same extent. And corporations themselves would be foolish to buy JGBs at yields that are well below the return on assets of their own businesses.

The banking sector is gradually running out of scope to invest in JGBs too. Banks' available cash to buy JGBs (excess of deposits over lending) would be exhausted by 2016 at the current rate of increase in JGBs outstanding.

So how come disaster has not already struck? After all, if all JGBs were repriced to yield the same as Italian debt does currently, the cost of servicing

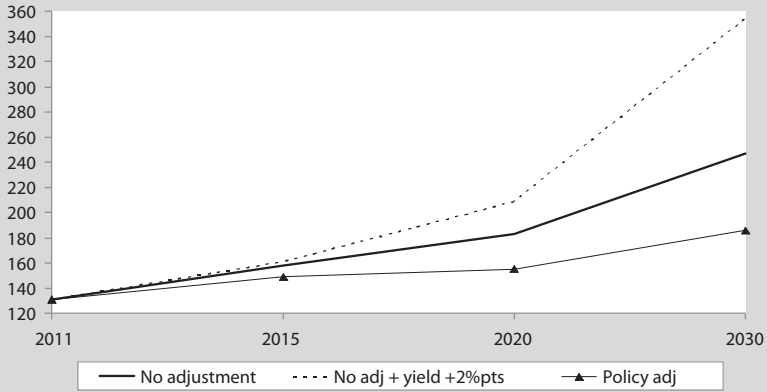
Figure 49: Japan: sector savings rates and bank deposits (% of GDP)



Source: BoJ, Independent Strategy

JAPAN: AN ENIGMA WRAPPED IN A MYSTERY

Figure 50: Projections for Japan's public sector net debt to GDP ratio (%)



Source: IMF, Independent Strategy

Japanese debt would rise from 4% to 10% of GDP (Figure 50). That would leave the Japanese government with grim choices: default, monetisation or shutting down swathes of government.

There are reasons why the Armageddon scenario can be postponed. One is that the BoJ can buy bonds. There are rule-based limits on how high JGB ownership by the BoJ can go. The BoJ cannot hold bonds that exceed the sum of notes and coins in circulation. But such rules are made to be broken in an emergency. More fundamentally, the BoJ as a source of demand for JGBs is vulnerable to any tightening of monetary policy. This would make the BoJ a seller of JGBs.

Life insurance companies and pension funds also buy JGBs. Together they own about 34% of outstanding bonds. They have to buy long-term JGBs to match the maturity of their liabilities. The duration gap between life insurance companies' assets and liabilities is still about three years (liability duration is 13 years and asset duration about 10 years). This source of demand for long-term JGBs will last another 3-5 years. Thereafter, societal ageing works the other way; the old will cash in on their savings and spend their pensions. And the oldies start to subtract from life insurance and

pension fund resources that currently buy JGBs. This is already starting to happen in public pension funds (Figure 51), which own about a tenth of the stock of JGBs.

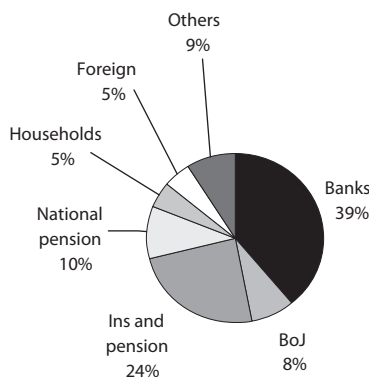
So the writing is on the wall for the supply of new savings to fund deep budget deficits and to cover the rollover of the stock of JGBs.

Foreign assets to the rescue?

But there is also cross-border demand that must be considered. The yen has been awarded safe-haven status by foreign investors because of Japan's big stock of foreign assets. It does seem odd, doesn't it, that the country with the highest rate of domestic indebtedness among rich democracies is also the world's greatest international creditor.

A current account surplus is always recycled back abroad either by the private sector in the form of capital outflows, which are invested in foreign assets, or by the accumulation of foreign exchange reserves (also invested in foreign securities) by the central bank and the Ministry of Finance. The current account also includes income on such foreign assets.

Figure 51: Holdings of JGBs by sector (%), 2010



Source: IMF

JAPAN: AN ENIGMA WRAPPED IN A MYSTERY

The sum of the current account, private sector capital flows and changes to international exchange reserves always adds up to zero. So a country that runs current account surpluses year after year, as does Japan, automatically has capital outflows that accumulate foreign assets. Thus the country becomes a net foreign creditor.

Could the Japanese repatriate their holdings of foreign assets to buy JGBs? External assets are the result of current account surpluses earned by Japanese exports. Exports are paid for in foreign currency. When changed into yen, the foreign currency ends up as international exchange reserves in the BoJ and Ministry of Finance. These reserves are public sector foreign assets. When the foreign earnings are kept by corporations and invested abroad, they become private sector foreign assets. When domestic savings are channelled abroad, foreign assets are also accumulated.

Today, Japan's foreign assets, net of foreign liabilities, amount to 52.4% of GDP. Of these the equivalent of 28.3% of GDP are public sector net assets, of which 18.6% of GDP are foreign exchange reserves, with the rest being in public sector loans etc. That leaves an amount equal to 24.1% of GDP as net foreign assets in private sector hands.

In a sovereign debt crisis, private domestic capital flees. Private foreign assets do not flee home to bail out bankrupt governments. That means that only the 28% of GDP in public sector foreign assets could be repatriated to redeem sovereign debt. That would only be enough to reduce Japan's stock of gross debt today to just north of 200% of GDP, or some 40% of GDP higher than Greece today.

And not all these public foreign assets could be used. Two-thirds of them are foreign exchange reserves and at least two-thirds of these would be needed to provide essential cover for imports and to recapitalise the banks and insurance companies suffering heavy losses on their holdings of JGBs. So there would be scant spare resources to buy up JGBs being dumped in the market. It is even doubtful that repatriation of foreign assets would keep the yen up for long, as there would be flight of private capital from Japan in a crisis.

And there is another problem. Japan's public foreign assets include the equivalent

of 16.6% of Japan's GDP invested in US treasuries. This is 12% of the stock of marketable US public debt. If sold, there would be unfortunate consequences that would not make things in any way safe for holders of Japanese assets. The US bond market would join the sovereign debt crisis. China would suffer heavy losses on its stock of US debt, which are even bigger than Japan's. Consequently, there would be a global economic and political crisis.

Wrap!

Japan has the fatal fiscal arithmetic of an inevitable fiscal crisis to dwarf all those we have seen so far. But it cannot be timed. Sovereign debt crises happen when the market says so and not when the fiscal arithmetic does. The necessary changes in the flawed democracy of Japan will probably result from the crisis and will not be the cause of avoiding it.

There are two events that could trigger Japan's crisis. One is quite gradual. It is the slow decline in savings rates that go with an ageing society that concomitantly pushes up government spending. The best measure of this is the decline into structural deficit of the Japanese current account — the most accurate and timely measure of the balance of savings and investment in an economy. The evidence is that Japan is approaching a structural current account deficit. This would indicate that there is a savings deficit in the making. This will, however, be a gradual process.

The other is North Korea. North Korea represents an external danger that could destabilise Japan and cause capital flight, so precipitating the debt crisis. North Korea's new regime will not achieve stability. Tensions will rise between the US and China about how this failed state will be 'saved' and whose vassal state it will become. This will spill over into trade conflict and problems with Taiwan and the rest of the region.

We see three potential outcomes on the Korean peninsula.

(1) Reformist-type government takes over and moves to a China-style economy (of 15 years ago in architecture). North Korea remains a separate state from South Korea, but effectively a China client or vassal state. China sets the reform agenda and finances it. This outcome would be a real problem for South Korea,

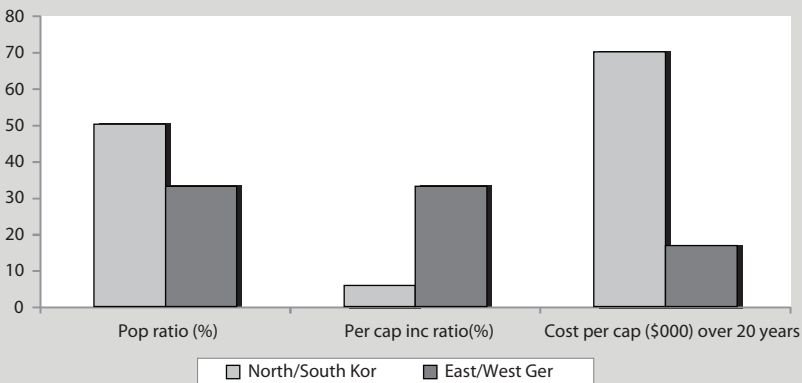
JAPAN: AN ENIGMA WRAPPED IN A MYSTERY

which would be abandoning their brothers to a Chinese vassal state. We don't think the US could go along with it willingly either. This has a 40% probability.

(2) Transition fails and the North Korean state collapses. The immediate collapse of the North Korean state would be the worst outcome. It would entail immense costs for South Korea, which would incur four times the costs per capita that German unification generated for West Germany (Figure 52). So huge international aid would be needed. This is the flipside of (1), with North Korea becoming unified with the South and, therefore, falling into the US ambit. The Chinese won't stomach that easily. This has a 25% probability.

(3) Continuation of a non-reforming dictatorship under a hard-core junta (with Kim Jong-Un as the puppet head of state with his uncle Jang Song Thaek as the man behind the throne). Eventually (say after three to five years), this experiment would fail. A hard line junta with 'no change' policies will lack Kim Jong-Il's legitimacy; fail to deliver the economic goods and be weakened by rival factions in the army competing for influence and spoils. Such a regime could be very aggressive externally as its end approached. It might use international tension as a means of gaining patriotic support at home. This outcome would ultimately lead to the enactment of outcome (2), but with a delay. This has a 35% probability. ●

Figure 52: The costs of unification: Germany versus Korea



Source: Independent Strategy

EMERGING ECONOMIES: FROM STATE CAPITALISM TO DEMOCRACY

Many emerging economies have lately been knocking the socks off the developed economies in terms of growth. Not all of them are democracies. But most that matter are. In the rather silly groupie term applied to the biggest emerging markets — BRICs — only the C for China is not a democracy. Of course Brazil, Russia and India have democratic systems that are flawed to varying degrees but they still don't represent an alternative model to democracy. So the question we grapple with here is whether China, which embodies the concept of 'State Capitalism' represents a better way for poor countries to get their living standards to converge with rich democracies.

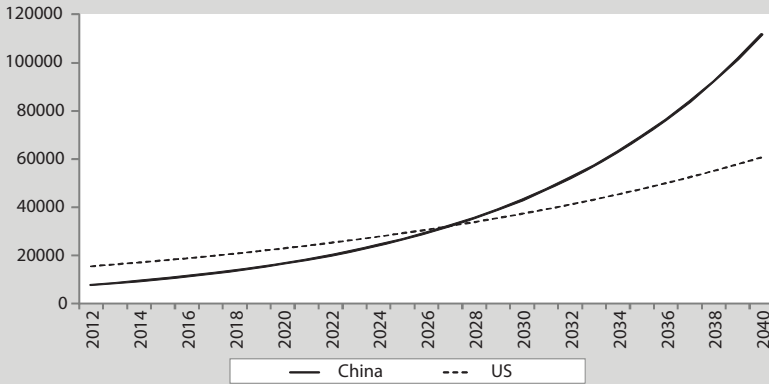
Will the non-democratic emerging economies of the world replace the rich democracies as the world's richest nations and thus as the new global political and social paradigm? In other words, will non-democratic emerging economies overtake rich countries, without having to transform themselves into democracies in order to do so? The non-democratic emerging economies are principally in Asia (also home to some of the biggest democracies), but can also be defined to include flawed democracies like Russia, Ukraine, the Asian ex-Soviet Republics, Thailand and the Philippines. Latin American economies are mainly democratic. So are those in former Eastern Europe.

The argument that well-run, non-democratic emerging economies, such as China, represent superior economic models is weakened by the fact that most successful emerging economies are democracies. They may not match China in scale, or in economic performance, but they do across a broader range of social values. Brazil, India, Korea and Taiwan stand as democratic



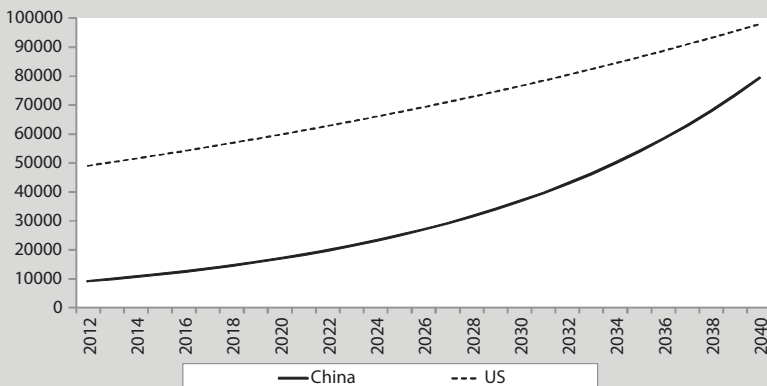
Figure 53: China: overtaking the US?

Chart A: GDP as at US\$ market prices



At what point China overtakes the US as the world’s largest economy depends on how their respective gross domestic product is compared. The IMF projects US GDP in current dollars will be US\$15.5trn this year, while China’s will be US\$7.7trn. Assuming China’s nominal GDP grows at just 10% a year, double the trend rate for the US, then China’s GDP will be larger than that of the US by 2027.

Chart B: GDP \$ per capita (PPP)



However, US living standards will remain much higher than that of China for the foreseeable future. Based on purchasing power parity measures, China per capita GDP is less than one-fifth of that of the US. Even by 2040, it will still be 20% lower.

Source: IMF, Independent Strategy

and economic successes in their own right. In order for the non-democratic system to be superior, China would have to prove itself against its peer group and have the potential to surpass the living standards of the rich democracies in the future. It fails the first test. Now on to the second.

There is no doubt that a broad range of emerging economies, such as the BRICS (Brazil, Russia, India, China, South Africa), have outgrown rich democracies for a considerable time or that they have got bigger relative to developed economies. The hefting of China's living standards out of poverty is one of the great economic achievements of all time. So because it is non-democratic, big and economically successful, China is central to the idea that societal systems other than democracy will provide living standards that will lead the world. It is appropriate to focus on China to see what needs to happen for this to be true (Figure 53).

State capitalism as an alternative model

A related question to that of the economic superiority of dictatorship or democracy is whether State Capitalism is superior to liberal market capitalism. State Capitalism is defined as the ownership or control of a substantial part of the economy by government. The context in which State Capitalism is discussed here is as an alternative economic development model for emerging economies.

We are not dealing with the history of nationalised industry in post-war Europe and elsewhere. Countries such as France used economic models that resembled State Capitalism very successfully to reconstruct their economies and indeed have continued to embody some of the characteristics and thinking in their economic policy today. Post World War II, France undertook economic planning and owned or controlled key industries, selected national champions and controlled senior management appointments while state owned banks allocated capital. There was scant reference to free markets, the Anglo-Saxon model of the UK or US, or even to the Sozial-Markt Wirtschaft across the Rhine!

The system obviously worked, or France would not be a rich democracy today. But in becoming so, France has abandoned most of its tools of

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State Capitalism, while retaining control over some key industries (nuclear, aerospace, defense etc) and over management appointments in them. Also still very present is the dual role of senior mandarins who regularly interchange between bureaucratic and corporate roles.

Nevertheless for all its similarities there is huge difference between this brand of State Capitalism and that proposed as an alternative system for the economic development of emerging economies today. One such key difference is that State Capitalism in post-war Europe was subject to legal and democratic controls.

There are several reasons why State Capitalism is attractive as an option for the development of poor economies. It allows social and economic goals to be managed harmoniously without the Darwinian harshness of markets with all their potential for creating social disorder. Accumulation of savings and allocation to development priorities can be politically controlled to meet multiple targets. Economic rents of state-controlled enterprise help the accumulation of capital (Figure 54). The political system earns the wherewithal to reward achievers of its aims.

This is all true to an extent, although it ignores the opportunity cost it incurs of ignoring alternative development models. But the evidence is that State

ECONOMIC RENTS

An economic rent is defined as 'payment for goods and services beyond the amount needed to bring the required factors of production into a production process and sustain supply'. In other words, economic rents are about paying someone more than the job is worth.

Economic rent typically accrues to monopolists and oligopolists who can control supply in markets that lack competition. Economic rents are also often associated with emerging economies and cronyism where people close to the seat of political power enjoy privileges that allow them to participate in state-controlled economic activities that earn them economic rents. Infrastructure investment is a common example of a sector in emerging economies often characterised by economic rents. Typical examples of economic rentiers are the Chinese 'princelings', the offspring of senior political figures.

Figure 54. Source: Independent Strategy

Capitalism only works if you have really talented executors of it and there is no systemic guarantee that State Capitalism will produce such leadership. And the system itself has a use-by date beyond which it has to be allowed to fade. Today, state ownership of corporate entities is worth less than 5% of GDP in rich democracies but up to ten times that figure in developing economies that adhere to State Capitalist models.

State Capitalism in emerging economies; particularly China, has for its objective establishing political control over the economy. In China, it does this by creating an alternative Communist party system of control, which runs parallel to corporate management, extends beyond it and subjugates corporate management decisions to party goals. The structure of control is the same as the parallel system of party organs that mirror political institutions in all communist states. Unlike State Capitalism in post-war democracies, this system is not subjugated to democratic scrutiny and legal challenge.

Thus, what differentiates State Capitalism in rich democracies from that in emerging economies is that in the former it was a transient tool to develop the economy that was progressively dissolved as this was achieved. In the latter, it is an instrument to perpetuate party control of the economy that must achieve prosperity in order to legitimise single party political control. The justification is that State Capitalism gives you the best of both worlds: the benefit of the market and its efficiency, coupled with the social aims and stability of the state.

The popular attractiveness of State Capitalism has grown because of the manifold failures of free market capitalism in rich democracies demonstrated by credit bubbles and their collapse, together with the widespread social hardship these have caused. Democratic governments failed to protect their citizens from the excesses of the free market system, including the unbridled growth of banks, which the taxpayer and jobless must now pay for. So, if the state had controlled the errant banks, corporations and regulated borrowing more prudently, all the malpractice could have been avoided or palliated.

Such arguments for State Capitalism are very flawed, as we shall see, but first we must recognize they are nothing more than an overlay of propaganda

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justifying dictatorship as a superior political system to democracy and to liberal market economics for the development of emerging economies.

To demonstrate this, consider the following. In a full dictatorship, such as North Korea, the state controls 100% of economic activity. In China, an economically more liberal dictatorship, SOEs account for 40% of GDP and the state controls 80% of listed corporations (based on MSCI stock market indices). In Russia, a highly flawed democracy, the state controls just over 60% of listed corporations and in Brazil, a slightly flawed democracy, the state's control is 38%. In the rich democracies, the figure is only a few percent.

What this proves is that, as states become more democratic, State Capitalism fades away. In other words, State Capitalism is a concept that coexists with dictatorship at an early stage of economic development and ceases as prosperity introduces political democratisation. State Capitalism progressively disappears as dictatorship transits to flawed democracy and ultimately to full democracy and the civic state. State Capitalism is simply the gift of economic power to the political power. To defend State Capitalism is ultimately to defend political dictatorship.

There are three reasons for this fading of State Capitalism with the transition to higher states of democracy and prosperity.

First, as we set out in chapter one, the economic success of rich democracies is due to the competitive coexistence of open political and economic systems. The coexistence of State Capitalism and dictatorship has neither ingredient.

Second, State Capitalism or centrally-planned economies are quite good at achieving the initial lift-off of poor economies because they can manage the big things like infrastructure investment and can dictate the savings required to achieve them. But this sort of economy is characterised by non-complexity: the strands of economic activity run like thick, ropey arteries from savings to investment in infrastructure and in national champions (such as SOEs) and manufacturing of exports. Once the economy moves on to consuming Starbucks, Hermes and Apple, it becomes complex and the linkages change from thick arteries to complex webs like the face of a computer processor.

At that point, the state-controlled model cannot cope any more. Thus the achievement of prosperity and economic complexity requires jettisoning State Capitalism as a model.

An anecdote illustrates this. When the Soviet Union fell apart the Gosplan computers (which planned output and resource allocation to achieve it) were running five years behind the present year. In the jargon speak of economics, Hayek's critique of socialism is valid here: complexity and scale engender unaffordable costs in command economies compared to market economies.

The third reason why the achievement of prosperity and democracy spelled the end of the state capitalist model is because civic society and the middle classes won't accept the social values it encompasses: lack of democratic and legal scrutiny, control of individuals' savings, investment and consumption preferences, as well as the perpetuation of a political elite.

The claim that wise, paternalistic state control of the economy lessens excesses and improves corporate social behavior is also doubtful, to say the least. For a start, corruption is rife in all state capitalist systems today. In the rich democracies, politicians and regulators and central banks were as guilty of creating the credit crisis and the Great Recession as private sector participants such as banks and borrowers. If that holds for the rich democracies, why would the politicians and bureaucrats behave better in emerging markets if they were given economic licence to control wider swathes of the economy, and in doing so, earn mega bucks for themselves?

A more likely outcome is that state-controlled enterprises become economic rentiers and epicentres of poor resource allocation and low productivity.

Among the reasons for this happening are :

- The state confuses the enterprise's mission of efficient resource allocation (judged ultimately by profitability) by substituting multiple goals (provision of social services, employment etc) and interfering in decision-making and personnel appointments.
- The enterprise is stability-seeking and fails to innovate.

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- Managers are ultimately successful within the political apparatus, which controls their career prospects, to which corporate success is subjugated.
- State Capitalism is always supported by privileged access to credit, which needs politicised banks and distorts allocation of capital (savings) throughout the economy.
- The system encourages and fails to police corruption.

In China, the banking system directs credit at the diktat of the state to the SOEs and local government financing vehicles. Policy, not efficient resource allocation, is the driver of such lending. Given the very poor profitability of the SOEs, without this access to underpriced capital, many would collapse. It is hard to imagine how this does anything but detract from the performance of the Chinese economy.

In Russia, the dominance of state-controlled banks such as Sberbank plays much the same role: obey what politicians tell you to do or your access to credit will disappear.

In Brazil, the state development bank BNDES and its investment arm BNDESPAR control 60% of all credit to the corporate sector dominated by national champions such as Petrobras.

The observation here is that State Capitalism relies upon a financial system that involves fusing together non-financial enterprises and banks so that the transfer and pricing of resources (capital/credit) is not driven by markets. The result is a low productivity solution because capital resources are mispriced and misallocated. It also puts the private sector at a disadvantage. Its productivity suffers too. So the whole economy pays a price in terms of lower growth.

India — the antithesis of State Capitalism

India is the world's biggest democracy. Democracy has conditioned India's economic development model. Instead of being based on excess savings, heavy investment in manufacturing and exports, India's economy depends on domestic demand and has achieved excellence in services, which are also

its outstanding export.

The reason why democracy tailored the Indian economy in this way is because it never experienced dictatorship — as did Korea and Taiwan. Nor did it suffer the ravages of the second world war, as did Japan.

In the case of Asian dictatorships, economic decisions that suppressed consumption could be taken without reference to the people, with savings directed into state-championed manufacturing, export sectors and infrastructure. Japan's new-found democracy post-1945 followed the same economic model through social consensus.

Indian democracy was a far more creative and chaotic affair. It produced a political system, a bureaucracy and a system of economic patronage that act as a social equaliser between a myriad of ethnic and vested interest groups. While this cemented democracy, it left few resources for a capital-intensive state-driven development model. It also makes political power too diffuse to pursue the single goal of economic development. This ruled out the standard Asian 'top-down' development model, which is still China's today.

India's model produced political stability and has many economic achievements to its credit — such as high-tech clusters. Looking forward a decade, India has much better demography than China (because for democratic India a one-child policy was out of the question). This could promise superior Indian growth rates. But there are obstacles to overcome.

India's brand of democracy also resulted in big economic flaws. Indian infrastructure is terrible compared to China and exerts a heavy economic cost. Apart from hi-tech and knowledge service exports, Indian exports are weak and the economy is not internationalised or particularly competitive. It runs a chronic current account deficit. Its savings rate has dropped by 10% of GDP in recent years; low savings now call into question its development model.

Government is both big and wasteful. It incurs constant deficits, around 10% of GDP on a consolidated basis. Funding this deficit is an unproductive use of savings. In fact, household savings rates were once as high in India as in China. But much of this was zapped by the government sector. As a

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result, productive investment is relatively low as a proportion of GDP. In the past this, plus bureaucratic interference in markets, has meant that India's potential growth rate was way below China's.

It is tempting to say that this proves that dictatorship is superior to democracy when it comes to achieving convergence with the living standards of the rich countries. This is certainly true at the initial stages of industrial development when an emerging market is poor. It is a short-hand way of saying that an economically efficient way to achieve initial economic lift-off is to accumulate savings and export surpluses, investing them by diktat in manufacturing and infrastructure.

But this is not the case when the limits to industrial development are reached and the task is to create a consumer-based and service-based economy. Then the surplus savings, investment and export model hits the wall and a middle-class consumer society is needed to take up the running. At that point the relative chaos of market-based consumer and service economies have distinct advantages — provided they can generate a critical mass of a middle-class people to work the service industry and consume its products. India is still a long way from proving that it can. And China has a way to go to prove it can achieve the changes needed to do so.

A surprising conclusion

One rather politically incorrect conclusion jumps out from the analysis: as much as economic convergence with rich democracies needs the middle-class as driver, democracy only works when the middle classes reach a critical mass as a proportion of society. When poor countries go democratic, the democracy rarely works. Usually it becomes a prisoner of a narrow range of influential families who are corrupt economic rent seekers. This retards or stops the convergence process as is still the case for countries such as Thailand, the Philippines and Indonesia.

Unfortunately, the same yardstick makes the outlook for establishing democracy in the Middle East and North Africa (MENA) problematic. A middle-class can establish democracy in the teeth of a long history of dictatorship. But it is a struggle to do so without such a driver. None of the

MENA countries of the Arab Spring have developed a critical mass of middle-class citizens or a civic society that goes with it. Thus a return to dictatorship or the development of flawed or failed democracies is probable.

Some Asian economies will probably overtake the living standards of rich democracies. But if they do, it will be because they become like them. That is because only the development of civic states releases the creativity needed to progress beyond the factory economy. Flawed Asian democracies, like the Philippines, Thailand and Indonesia are most unlikely to do so because they will fail the test of the civic state. Even the indisputably lawful Singapore currently lacks the civic freedoms to do so, although recently hotly contested elections point the way to progress in the right direction. ●

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The vertebra of control

China's model of State Capitalism reflects most of the characteristics, strengths and weaknesses of the system. But it has some specific aspects of its own that have ensured its success and survival so far. China wants an economy characterised by 'market socialism with Chinese characteristics.' That is not an empty slogan. It is policy. Behind the market economy is a political control system that ensures that the Communist party controls the 'commanding heights of the economy'.

STRUCTURE OF CHINESE STATE OWNERSHIP

China's state sector consists of SOEs reporting to central, provincial, and local levels of government. The Chinese government defines SOEs as enterprises in which all assets are owned by the state. SOEs are either centrally owned or owned by provincial or local governments. Centrally owned SOEs include entities managed by the State owned Assets Supervision and Administration Commission of the State Council (SASAC); state owned financial institutions supervised by the China Banking Regulatory Commission (CBRC), China Insurance Regulatory Commission (CIRC), and China Securities Regulatory Commission (CSRC); and entities managed by central government ministries such as the Ministry of Commerce, Ministry of Education, Ministry of Science and Technology and other ministries. Central SOEs have been increasing in importance relative to local SOEs.

The SASACs are analogous to holding companies; they hold the shares of SOEs that previously were held directly by the state. The SASACs were created by the State Council in March 2003 via Decree 378 (2003). Amended legislation in 2009 formally 'assigned SASACs the legal liabilities and rights of investors holding SOE shares on behalf of the state and the responsibility of guiding and supervising further SOE reforms.' In all, there are approximately 300 SASACs in China. In addition to the central government SASAC, there are about 30 provincial SASACs overseeing provincially controlled SOEs, and scores of municipal SASACs supervising local SOEs.

Figure 55. Source: *Independent Strategy*,¹¹

There are two ways in which the Chinese government controls the commanding heights of the economy: through ownership of assets and through control of the people in charge of them. Let us start with ownership¹¹. How is state ownership structured (Figure 55)?

Estimates of the size of the state-controlled sector in China vary wildly and are a function of how many layers of direct and indirect state ownership are taken into account, as well as according to the variable used to measure the size of each (value added, gross output, investment, employment, wages, etc). Estimates range wildly from 20% to 70% of GDP. A reasonable figure would put the state-owned sector at 40-50% of GDP and 70% of all quoted non-financial corporations.

So, by this measure, the state does control the commanding heights of the economy. However, the diversity of ownership of the SASACS split between central, regional and local governments does not give the Communist Party uniform control. For example, regional and central government objectives often conflict and central government decisions are resisted by SOEs owned by local governments. The more effective means of Communist Party control lies elsewhere.

The political structure to deliver party control mirrors that of communist states everywhere; the party institutions duplicate the political institutions and control their functions at every level¹². In China, the party structure is duplicated in the corporate structure.

There are party organisations within every corporation that employs more than three Communist Party members. Each party organisation elects a party secretary. It is the party secretary who is the lynchpin of the alternative management system of each enterprise. This extends party control beyond the SOEs, partly privatised corporations and village or local government-owned enterprises. The party's also present in the private sector or 'new economic organisations' as these are called. In 1999, only 3% of these had party cells. Now the figure is nearly 13%. The reality is that almost all Chinese companies employing more than 100 people have an internal cell-based party system of control.

Thus, almost every significant corporation has a parallel political governance system to its business one. This comprises a Communist Party committee, headed by a secretary, which centralises information and exercises control through Communist Party cells throughout the enterprise. The secretary advises the management on critical decisions, can initiate his or her own decisions and can overrule or bypass management, the CEO and the board.

It might seem that this would be analogous to having a trade union operating among the employees of a rich democracy corporation. But it is not, and for one good reason. The system is controlled by the organisation department of the Communist Party (CCP OD), which is the biggest and most effective human resource department in the world — yet it is one so secretive that it has no listed telephone number. This is no relic of the Maoist era. It is a thoroughly modern institution set up specifically to maintain party control in parallel with marketisation of the economy.

Its functions are mind-boggling: The CCP OD manages all senior promotions throughout all major banks, regulators, government ministries and agencies, SOEs and even many non-SOE enterprises. An ambitious young cadre might begin in a government ministry, join middle-management in an SOE bank, move to a senior Party position in a listed enterprise, be promoted into a top regulatory position, accept appointment as a mayor or provincial governor, become CEO of a different SOE bank, and perhaps ultimately rise into upper echelons of the central government or CCP — all by the grace of the CCP OD.

This is not theory. It is practice (Figure 56).

PARTY CONTROL

In April 2011, state media reported the promotion of Su Shulin from chairman of China Petroleum and Chemical Corp (SINOPEC) to Fujian provincial Party leader. The CCP OD announced that Fu Chengyu, then chairman of China National Offshore Oil Corp (CNOOC) was replacing Su at Sinopec, and that Wang Yilin, the former top manager of China National Petroleum Corp (CNPC), the parent of PetroChina, was replacing Fu at CNOOC. When the music stopped, much to the consternation of foreign suppliers and customers, the CCP OD had rotated the top managers of all China's major oil companies.

Figure 56. Source: Independent Strategy,¹²

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This system has lifted China from absolute poverty to a \$2,000 per capita economy in a few decades. It has been an economic success. That tells us that: (1) whatever the rights or wrongs of political control, it does prioritise economic success and punishes failure; (2) The Party has successfully created a meritocratic system that is relatively effective at rewarding the right measures of success (achievement of prosperity) and punishing under-achievement. The CCP OD is closer to the ancient meritorious imperial civil service in pre-modern China than a self-serving, stagnant Communist bureaucracy.

That is not to say that there is no corruption in the system. There is. But when the overall debits and credits of the party-executed 'market socialism with Chinese characteristics' are added up, the balance so far has been one of great achievement.

It invites another conclusion: 'market socialism with Chinese characteristics' is not just a slogan white-washing savage capitalism with corrupt money grabbing by party officials. Of course, this goes on a lot. But it does not invalidate the fact that 'market socialism with Chinese characteristics' is a self-standing architecture of an economy with its own ideology and institutions.

Nevertheless, whatever its merits, such a system has to fade and disappear as a result of economic success. The reasons for that are examined above. But key among them is misallocation of resources and the inability to cope with the economic complexity of prosperity.¹³

A simple example demonstrates this. If the system were allocating capital efficiently, it would be directing it to the entrepreneurial sector because that is where productivity and growth is highest. Instead, this sector gets almost no official credit and is thrown back on its own retained earnings (for about 90% of investment). For credit, it has to resort to usurious bad practice borrowing from the shadow banking system, which has now grown to nearly 50% of China's GDP. Bank lending goes to state-owned enterprises and local government vehicles, which are the least productive users of capital. Capital flows between party political cadres as both borrowers and lenders are linked

by the political control system of the economy. By extension, when it comes to cleaning up bad debts, this is done, if at all, in under-the-table operations so that the same people are spared pain.

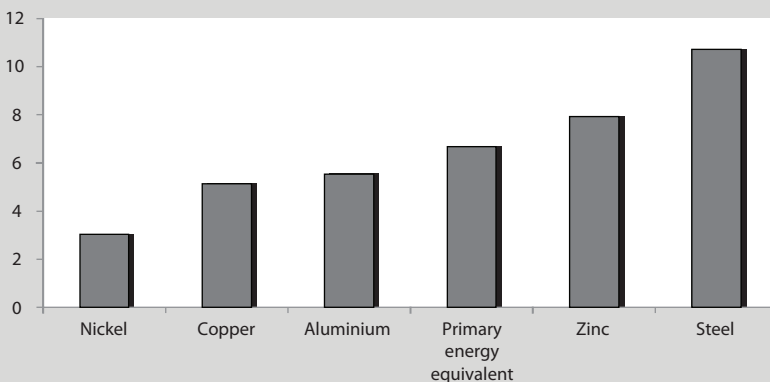
If the party control system is misallocating capital, when faced with the challenge of economic diversity that constitutes the road to prosperity, its days will be numbered.

Efficiency of resource usage

China is producing more steel, aluminium and cement than the US, Japan or Europe and buying more cars and mobile phones too. This is widely seen as signposts for a future world economic and political order where China (and Asia) dominates. Between that conclusion and its achievement stand challenges — both economic and societal.

The much-lauded massive use of industrial raw materials and commodities may indicate weaknesses rather than strengths. China is an extremely wasteful economy using more water, energy, cement and capital per unit of GDP than rich democracies by a big factor (Figure 57). Worse, it is progressively using more and more of such inputs, including capital, to achieve progressively

Figure 57: China: ratio to the OECD of natural resources consumption per unit of GDP



Source: Independent Strategy

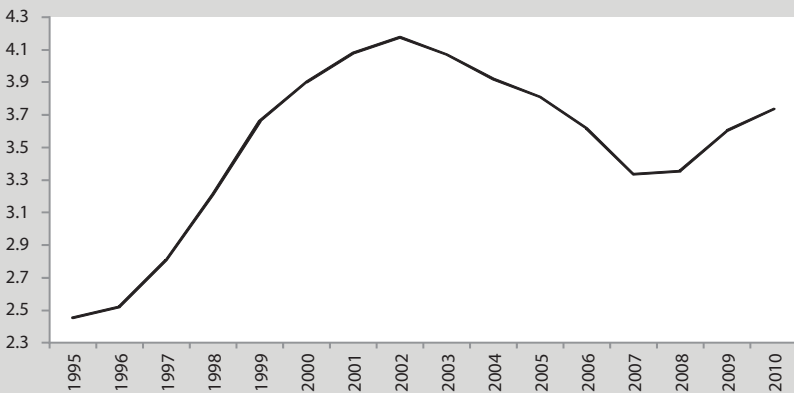
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smaller gains in output. China's total factor productivity — the amount of extra output generated by capital and labour (excluding increases in the inputs of both) — has also been declining (Figure 58). So China's development has produced an economy that is more capital-intensive and more dependent on manufacturing than any other (Figure 59).

An economy whose growth rate depends on ever-increasing inputs will never catch up with a rich country that is an efficient user of the same resources. The inefficient users' costs of resources will rise to match the efficient users as it closes the output gap, a function of increasing living standards. And as the inefficient producer uses more resources, it becomes more costly and uncompetitive, causing growth to slow down. The gap in living standards stops closing. The challenge is for China to get efficient in resource utilisation. This is achievable if markets are allowed to price resources and the state sacrifices much of its powers of economic control.

China has a lousy banking system that is politically controlled, regularly used for fiscal spending purposes, systematically underprices capital, misprices risk and socialises losses.

Figure 58: China: ICOR (incremental capital output ratio i.e. increase in investment to achieve 1% GDP growth), 5-yr rolling average



Source: Independent Strategy

The fiscal stimulus programme launched in 2009 by China to combat the fallout from the global credit crisis on its domestic economy was in reality monetary policy stimulus of 25% of GDP in forced loans by banks to local government and their off-balance sheet financing vehicles (LGFVs).

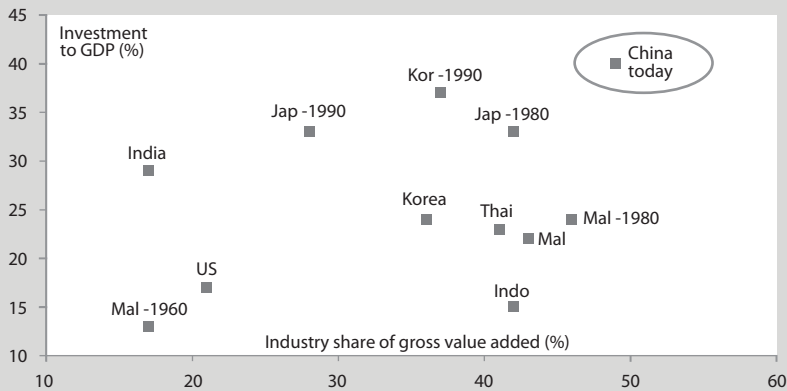
LGFVs are off-balance sheet borrowing vehicles set up by local governments to fund their deficits, as they are not allowed to borrow. The security used to capitalise the LGFVs was land often expropriated from peasants and citizens by local government.

LGFV borrowings were destined to fund infrastructure development but often went elsewhere, to real estate developers and to officials.

It was rare for LGFVs to have cash flow to service their loans. Most are insolvent and rely upon rising real estate prices to service their debt burdens. Bad LGFV loans are 40-60% of the total, or 12% of GDP.

Adding these local government borrowings (along with other non-consolidated borrowing such as railway bonds) to central government

Figure 59: Weight of investment and industry in economies (%)



Source: Independent Strategy

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borrowing, raises China's public debt to GDP to 70% (Figure 60) — the threshold at which, historically¹⁴, additional borrowing stops boosting growth and sovereign credit problems start in emerging economies¹⁵.

Not only that, but China's official bank lending, already 120% of GDP, is duplicated by a shadow banking system which is a dark pool of malpractice. Shadow banking includes off-balance sheet lending and credit creation by non-financial companies, such as state-owned enterprises (SOEs), with access to cheap capital borrowed from politically-controlled banks. The extent of the rot appears clearly as SOEs have accounted for 60% of land auction purchases since 2010 — a business which is not supposed to be part of their activities. Bank-sponsored trust funds and mutual funds also play a major role. But they remain off banks' balance sheets.

China's shadow banking system has taken total domestic credit to GDP to more than 180% of GDP (Figure 61), the highest ratio by far in emerging economies and reminiscent of Japan and Korea on the cusp of their credit busts¹⁶. Shadow banking loans have advanced by 30-40% of GDP in a few short years¹⁷. More than 60% of loans charge interest at more than official lending rates, often with rates as high as 60-100%. The borrowers are often

Figure 60: China public debt (as % of GDP)



Source: National Audit Office, Moody's, Independent Strategy

property developers that, in turn, rely on ever-rising real estate prices to pay the piper. Such a financial system is generically incapable of efficient resource allocation¹⁸. It will also inevitably experience bust after boom.

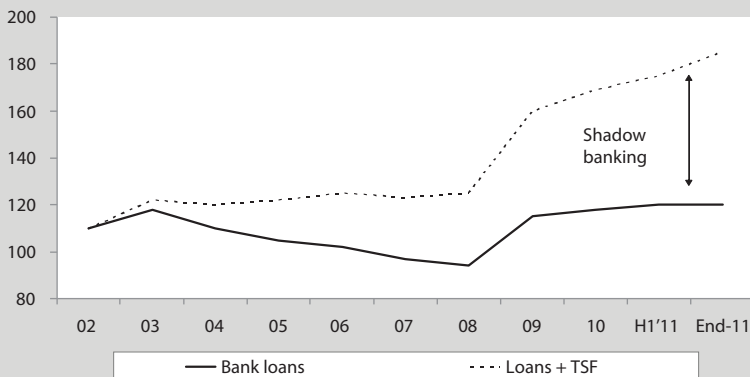
The architecture of China's development model

The architecture of China's economic development model was similar to that of Japan, Korea and Taiwan at an earlier stage of their development, but more extreme and of longer duration. The components are common to all these countries: suppression of consumption and wages, accumulation of savings surpluses and direction by the state of those savings into the manufacture of exports and infrastructure.

Such models work well for a time but have a use-by-date when export growth reaches a limit and efficiency of resource utilisation starts to decline. China has passed that point and knows it. Its major comparative advantage of cheap labour is reversing due to a declining workforce (Figure 62). Its ability to drive its economy with cheap exports is on the wane, while demand for Chinese goods in rich democracies, caught in a prolonged bout of deleveraging, will be sluggish.

But there are also structural flaws in the Chinese economy that may slow economic convergence with the rich democracies. One of them lies

Figure 61: China: bank loans to GDP and total social financing (% of GDP)



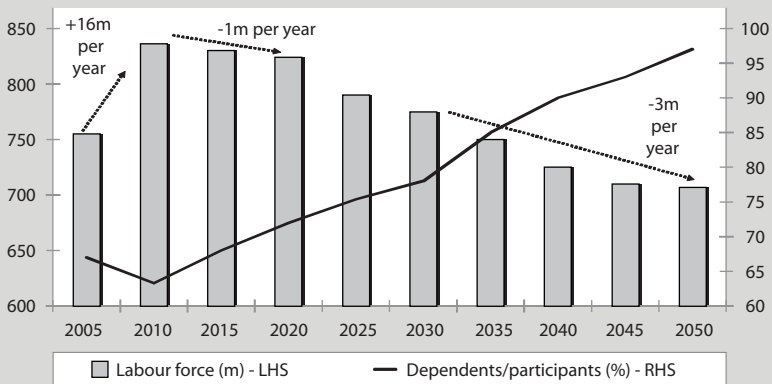
Source: PBoC, Fitch

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hidden in the awesome figures for production and consumption of heavy metals and concrete. The hidden story here is that such figures imply a lot more than economic growth. They also speak for unbalanced growth that wastes resources and does enormous damage to the environment. The tolerance for this destruction is high because the Chinese see it as the price of getting rich — a higher goal than a clean environment or pleasant society.

Indeed, as the work of Jared Diamond¹⁹ points out, in comparing attitudes towards natural resources throughout history, absence of land ownership rights for peasants in China encouraged a lack of respect for the land. In contrast, in Japan, village land ownership rights encouraged respect for the land. In Japan, this broadened out into environmental policies, implemented hundreds of years ago, to protect resources like forests. By the early 18th century, Japan had a sophisticated environmental policy to protect its forests and much of China had no trees left. Indeed China even waged war against the Vietnamese to grab their forests so that they could be cut down for the emperor's pleasure!

Figure 62: China: labour force (m) and dependency rate (%)



Source: Independent Strategy

Of course, Chinese policymakers are now talking and doing a lot about achieving more balanced and cleaner growth. But the extent of environmental damage will not be reversed and will probably get worse, albeit at a slower pace. This is because China will reduce the level of pollution per unit of output, but output will continue to grow at a fast rate. This will overwhelm the reduction in pollution per unit of output. Consequently, the absolute level of pollution will continue to rise.

Let us assume that pollution per unit of output is reduced by 33% in one fell swoop. For the year that happens, total pollution falls by one-third. Now assume that the economy grows at 8% annually. After six years, pollution will have surpassed the old level before the 33% cut was implemented. This fatal arithmetic can only be reversed if pollution per unit of output continues to be reduced every year by a greater percentage than that of economic growth.

There is a distinct possibility that at some point China's dirty growth model will produce natural disasters, epidemics or resource scarcity (e.g. lack of clean water) that will severely damage prospects for China's living standards to overtake that of rich economies. Even today the cost of pollution damage to public health and the environment is estimated to cost 2% of GDP a year. Much of this cost is hidden. It does not subtract from growth. Some day it may do so dramatically.

The challenges

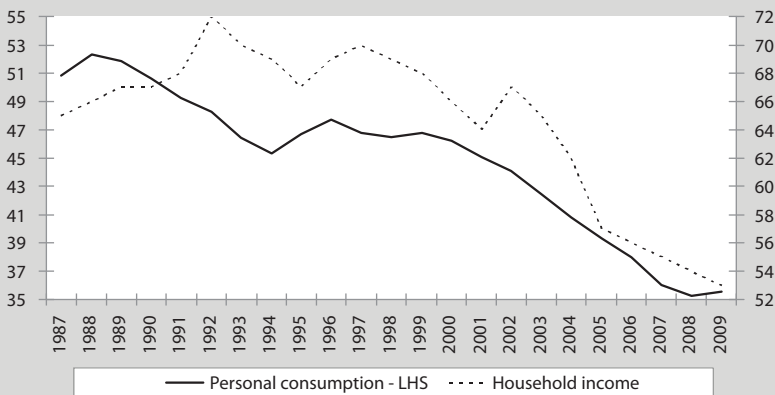
Let us examine the economic challenges that have to be overcome if China is to achieve the sort of productivity that facilitates convergence of its living standards with those of advanced economies. These challenges can be condensed into two over-arching ones: creating a domestic demand-driven development model and maintaining productivity growth in a service economy sufficient to drive convergence of living standards with those of rich democracies.

Transforming China's growth model to one driven by domestic consumption on the demand side is one kernel challenge. This involves a long drawn-out process of reversing the fall in the share of wages and consumption

spending from low levels of national income and GDP (Figure 63). On the supply side it means switching resources towards the service industries and away from manufactures and exports. A complete reform of the financial sector towards prudent, market-based allocation of savings is also a must for this transformation to happen. A rising real exchange-rate, partly due to increased wages and a greater emphasis on production of non-tradable services, is a part of the process. But exchange-rate adjustment will be hampered by policy, due to the massive existing commitment in terms of sunken costs and capital to the manufacturing/export sector. China may well achieve a domestically-led economy, but it will take a decade and there will be many bumps and crises along the way.

The concept of convergence means that a poorer country's living standard rises to meet that of a richer one. Convergence of living standards is a concept that is 100% driven by productivity — not by the desire to consume and own as many nice things in a poor country as in a rich one. Only if a poor country's productivity outpaces that of rich democracies and hefts output per unit of labour and capital, while paying people more for their enhanced productivity, will living standards converge.

Figure 63: China: personal income and consumption (as % of GDP)



Source: PBoC, Independent Strategy

So convergence can only happen if the poorer country's productivity rises faster than the richer one's. Convergence of living standards actually means convergence of relative productivity of labour and capital. When thinking about China this concept is important.

China's growth model was not what it should have been to succeed. State Capitalism, a rigged exchange rate, mispricing of capital and massive market interference are not the usual ingredients of success. In many ways, China's success story was partly due to serendipity. It boomed at a time of fast global growth, trade liberalisation and globalisation.

However, there is more to China's economic success story than that. Research into convergence of rich and poor country living standards shows that the correlation is very low between the implementation of free market recommendations for successful development and rapid convergence. In other words, the usual western cornucopia of liberalisation of the economy has not always worked for emerging economies and doesn't explain China's rise from poverty.

Recent research indicates that emerging economies converge fastest with advanced economies when they are successful at focusing their resources on manufacturing sectors that use advanced economy technology, often imported as Foreign Direct Investment (FDI). Firms enabled with foreign technology enjoy superior levels of productivity compared to their domestic peers. Repeating the exercise in many locations and sectors spreads the technology in clusters of economic excellence and hefts living standards more broadly in society.

A nutshell example of this is the automobile sector. If an efficient foreign producer from an advanced economy invests in a poorer developing country to make cars, this causes productivity in the foreign designed plants to be closer to that of an advanced economy and far superior to the surrounding developing economy. If enough labour can be employed in the technology importing industry, local living standards will converge rapidly with those of rich economies because wages will reflect superior productivity. The key is getting enough human labour into the high productivity sector.

China succeeded in doing this on a massive scale in manufacturing (particularly by drawing on foreign direct investment and technology). This raised living standards for those workers in the high productivity sectors dramatically. And there were enough of these high-productivity centres to heft living standards for the whole country, even ultimately in the backward and geographically isolated agricultural sector. India's hi-tech sector is just as productive as China's manufacturing, if not more so. But it is too narrowly focused to achieve the same miracle of raising living standards for all Indians.

Can China repeat the productivity miracle in services that it experienced in manufacturing? And how do societal conditions have to change for it to do so?

For China, changing to an economy dominated by domestic services, rather than manufacturing and exports, may undermine productivity and thus the speed at which living standards converge with those of rich countries. In advanced economies, manufacturing has levels of (labour) productivity that are 50-60% higher than in the service sector.

If China's living standards are to continue to converge with those of rich democracies at the same pace as over the last decade, China has to achieve the same levels of productivity in services as in manufacturing. Otherwise, overall productivity will fall. This has never been done in other developing economies. It won't be in China either. And the likely outcome will be a considerable slowdown in the pace of convergence.

A synopsis of China's challenges

China's economic transformation from an export-driven to a domestic-driven economy also presents a political challenge. Creating a consumer society is synonymous with creating a middle-class society. But a middle-class society will demand the rule of law (not a political justice system), property rights and political representation. This may not sound like a revolution, but it is in a single party state.

China faces obstacles in terms of resource allocation, education system and personal freedom. The network of linkages between corporations, their suppliers, customers and banks are relatively simple in an economy

dominated by big infrastructure spending and heavy investment in export manufacturers. For example, take capital allocation. As long as the economy is simple, allocation of credit can be achieved by state-directed capital through state-owned banks. Once the complexity of a consumer- and service-based economy takes over, the system stops working.

The switch to a consumer society complicates the network linkages and makes resource allocation impossible to achieve except by a market-driven system. That requires a big reduction in bureaucratic control and corruption, as well as rebasing China's financial system upon market systems.

Finally, a service-based economy requires levels of individual freedom and creativity that are quite different to the assembly line mentality of a factory economy.

If these conditions have to be satisfied for the next stage of development, then when they are in place, China will be far closer to a civic society and no longer so different from the societal framework of a rich democracy. Of course, at that point, China's societal architecture may look more like Singapore's, an inchoate democracy at best, rather than Belgium's — a dysfunctional civic state.

But the lesson would be that economic convergence with rich democracies necessitates societal convergence that invalidates the claim that dictatorship and autarchy can make you as well off as rich democracies. ●

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18. *Michael Pettis, Financial reform and liberalization in China, March 30, 2011*

19. *Jared Diamond: Collapse: how societies choose to fail or succeed — Guns, Germs and Steel*

COPING!

Predicting a duller future than his corpse littered past, Macbeth said gloomily; *“Tomorrow and tomorrow and tomorrow creeps in this petty pace from day to day”*... For a start, he was dead wrong. Having violated the Elizabethan world order, nature and society convulsed, chewed him up and spat him out. Then things did return to normal; a new normal that had nothing to do with Macbeth’s prediction of dull murderous monotony.

‘Normal’ is our comfort zone. We want the extreme events that are not part of it to be low probability and on the edges of our awareness, like bogey men hidden in the bushes of a safe, well trodden footpath. Our perception of normal also excludes transition to a new normal in the way that a well-trodden path can lead over the edge of a 300 metre cliff and continue as a new path on the beach.

The future displays a range of scenarios or outcomes generated by the societal shifts that are likely to occur but have nothing normal about the chance of their occurrence. It is quite futile to ascribe rational probabilities to the scenarios. The outcomes are not normally distributed. We are dealing with ‘unknown unknowns’ and not with ‘known unknowns’. We are dealing with uncertainty, not measurable risk.

Contrary to conventional wisdom, life in its rhythms does not correspond to any normal distribution of events (Figure 64). Earthquakes, forest fires and wars seem to follow the mathematical laws of power curves. Pandemics follow a pattern of their own. Even life expectancy is way off a normal distribution. These days, the distribution of financial market returns is closer to a Levy flight distribution than a normal distribution of a Gaussian curve.



Figure 64:

Chart A: Probability distribution of life expectancy at birth

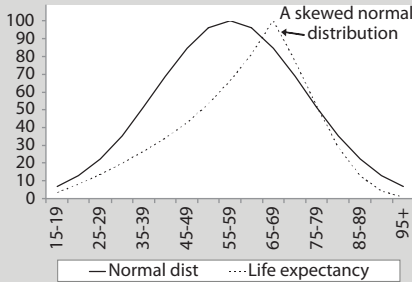


Chart B: Probability of death from pandemics (%)

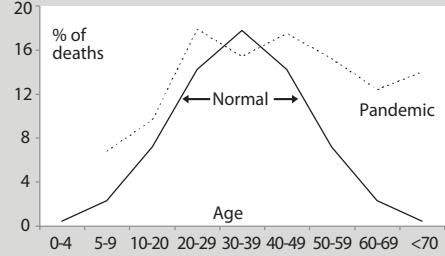
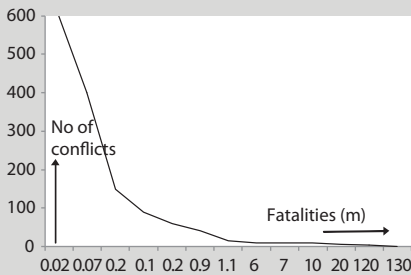


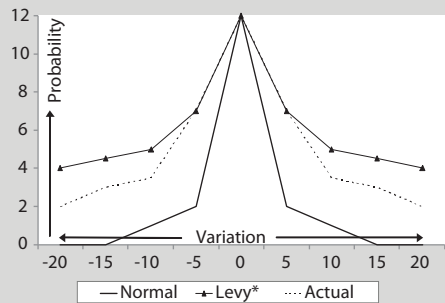
Chart C: Distribution of deadly conflicts according to the number of people killed



Distribution is not a normal bell curve but a power law. The power law implies that when a war starts out, there is a number of indications of how big it will become. Double the number of deaths and wars become four times less common.

Source: Independent Strategy

Chart D: Probability distribution for fluctuations in S&P-500 index



A Levy flight distribution is a random distribution punctuated by occasional big leaps i.e. 'fat tails' — fluctuations in stock markets are closer to the Levy flight distribution than a normal distribution.

So we must not expect to make decisions based upon a central scenario with the contrarian extremes having a nice low probability of upsetting our plans.

Among the plate-shifts we have discussed there are some pretty striking examples of things that won't happen normally. Here are some examples.

The euro will either exist or not exist. In the longer term, there is no muddle-through option that will work. The measures needed to make it sound are either taken or not taken. Thus the distribution of outcomes for the euro is binary. The

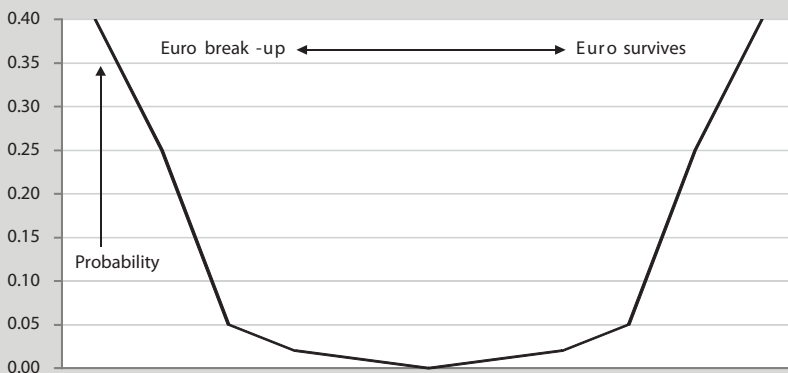
future of the euro is an upended Gaussian curve with only fat tails (Figure 65).

Another example is the global economy and how it adjusts to past excesses of leverage. Post credit crisis, there are at least three feasible scenarios: debt deflation and debt reduction; a long slow grind of deleveraging with growth rates just above failsafe rates; or the mass monetisation of debt and the possibility of rampant inflation.

If things were to happen normally, then the probability distribution of these outcomes should be normal. But uncertainty makes the probability distribution look more skewed. This is called having fat tail risks. That means that the central comfort zone scenario of the long slow grind has less chance of happening than would be the case if a normal distribution of probabilities were applied. It is just as feasible that a rational distribution of probabilities cannot be ascribed to these outcomes at all. Every outcome has an equal chance of happening. And that's before you try and plug in the binary future of the Eurozone that has the potential to be a major deflationary or risk-reduction shock to predictable global economic outcomes.

This means two things. The first is that increased volatility is baked in the cake.

Figure 65: Probability of Eurocrisis — binary!



Source: Independent Strategy

COPING!

Even if, in the case of the global economy, we take the path of the long slow grind, this scenario will be made up of much flip-flopping of expectations between the extremes of deflation and halcyon days. One day the markets will believe one outcome and the next day the other. The centre scenario and the world it represents have become inherently unstable.

The second is that long-term decisions based on fundamentals will fail because the fundamentals are not long term. To give an example, it would be foolish to commit money to investing in a bull market and go to the beach for five years without a smart phone. You might get wiped out on the beach making your stay there unaffordable. Volatility could vastly reduce your wealth before your conviction came through, even though your fundamental conviction was right in five years.

Thus investing in strategies based on long-term convictions alone cannot make money. That is why there are so many rich hedge fund managers and penniless strategists around. The hedge fund managers get it. The strategists fall in love with their ideas or worse with some dogmatic economic doctrine. Both act like blinkers on a mule.

Of course, in order to invest you need to believe in an outcome. But these days, investments representing that outcome have to be hedged so that profits are locked in as they are made and losses are stopped out before they get big. Great convictions are only as good as market belief in them.

Knightian Uncertainty: “Uncertainty must be taken in a sense radically distinct from the familiar notion of Risk, from which it has never been properly separated. The essential fact is that ‘risk’ means in some cases a quantity susceptible of measurement, while at other times it is something distinctly not of this character; and there are far-reaching and crucial differences in the bearings of the phenomena depending on which of the two is really present and operating. It will appear that a measurable uncertainty, or ‘risk’ proper, as we shall use the term, is so far different from an unmeasurable one that it is not in effect an uncertainty at all.” — Knight, F.H. (1921) *Risk, Uncertainty, and Profit*. Boston, MA: Hart, Schaffner & Marx; Houghton Mifflin.

Figure 66. Source: *Independent Strategy*²⁰

Running a portfolio is the easy part. Running a company is more difficult because long-term commitment of capital is usually part of the business. There are only three tools that can help manage corporate assets in a world of Knightian probabilities and outcomes naturally characterised by high volatility (Figure 66).

One is to split the business between short and long cycle businesses, so that at least part of it can adapt to changing and unpredictable outcomes. The second is to diversify assets among a range of businesses that make money under the diverse conditions of each potential outcome. And the last is to define the planning function as a process of flexible response to diverse outcomes rather than allocating resources to the most probable scenario. ●

20. Knight, F.H. (1921) *Risk, Uncertainty, and Profit*, Boston, MA: Hart, Schaffner & Marx; Houghton Mifflin

COPING!

WRAP

This book is about loss. About democracy losing its way. The bind that democracy is in calls for a new social contract between the state and its citizens and for new leadership to achieve that.

What went wrong is straightforward. We can only expect from the state what we are prepared to pay for it to deliver. That defines and limits its role to doing the necessary things that cannot be achieved otherwise. Such things include the rule of law, a competitive economy that maximizes opportunity, access to education for all and a social safety net, including healthcare, for the truly needy. It's a short list — *de minimis* by definition — because so many of the state's functions today are superfluous to its mission.

The result has been a loss of thrift as the anchor of economic freedom. Loss of thrift is more than just an economic term for savings. It is all about economic freedom and freedom beyond that. If the state spends more than it earns consistently, so that its debts rise faster than the economy grows, the result is a build up in debt that ultimately defeats its mission. If the individual foregoes thrift, living beyond his means reduces economic freedom by making the individual a slave of either governments or banks or both. And it reduces the freedom of government too because the state becomes the provider for the rising mass of its dependents, a role which hampers the enactment of corrective policies — as much as it curtails the ability of individuals to shape their own lives.

The combination of overdependence on the state and lack of thrift ultimately produces a double jeopardy. If debts get too high in relation to the economy, the economy stops growing. Even without incurring debts, an oversized state



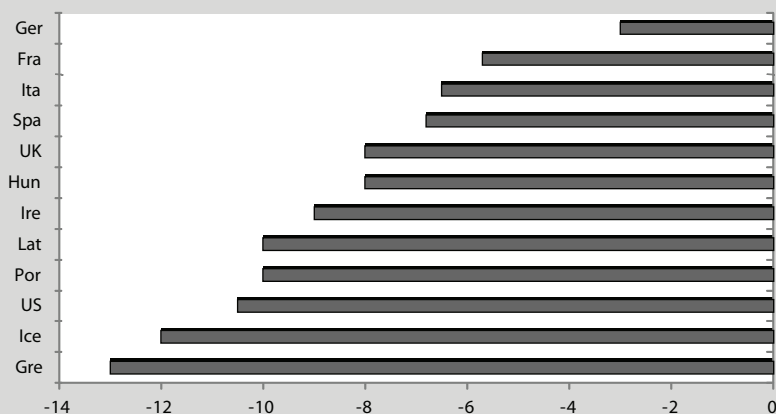
‘spend’—even if balanced by excessive taxation revenues—saps growth and incurs a loss of living standards. And the reduction of growth makes debt sustainability a fleeting chimera. There is solid evidence that rising debt beyond a threshold around 80-90% of GDP in the private sector is equally deleterious for growth and welfare as a similar state debt burden. It is not hard to see why. If debt grows faster than GDP, every unit of it is producing less output and revenue to meet its cost: the marginal productivity of capital is falling. Capital is being wasted. But debt being debt, its cost does not fall in line with the output it produces. By definition debt sustainability is being eroded. Solvency is being damaged.

That’s where most democracies are. The implementation of corrective policies will destroy years of economic achievement (Figure 67). The process is only beginning. Deleveraging is a part of it. Rethinking our relationship to the state is the core of it.

It is perhaps extraordinary that the credit crisis and the ensuing sovereign debt crisis are common to all the major rich democracies. But the means of getting there is different. In the US it is anchored in loss of thrift by households and the state combined. The UK is similar. Ireland’s crisis has its genesis in excessive leverage by individuals and banks. In much of the Eurozone it is about corrupted states with households saving to protect themselves against them. In Japan the over-leverage has its locus in the state not in households. In all cases the governments have failed to control or regulate the events that shaped their individual crises. But in all cases, the road forward is the same: government must shrink and individuals will have to be more responsible for themselves.

It would be nice to provide a potted solution. Or a painless one. But there aren’t any. To cut to the quick: austerity is the only way to prune the state of superfluous activities. There have to be losers. Beyond austerity, the only path to debt sustainability is growth. If we cannot grow our way out of the debt trap, the only choice will be to cut the debt and force sacrifices upon the owners of it — a highly disruptive thing to do socially as it penalises savers.

The growth solution is achievable: empowering the individual by renouncing the nanny state will make the economy more dynamic. The real deficit is the

Figure 67: The Proust index: years lost from economic crisis*

Source: Independent Strategy

* In order to assess how much economic progress it has undone, The Economist constructed a measure of lost time from the recession. It shows that Greece's economic clock has been turned back furthest. Britain, has lost eight years. America, where the trouble started, has lost more than ten. The clock uses seven indicators of economic health: household wealth, financial-asset prices and property prices; annual output and private consumption; real wages and unemployment. A simple average of how much time has been lost in each of these categories produces the overall measure.

democratic one. Political leadership has to embrace the message and lead. But the democratic process has evolved in ways that make it more difficult to produce such leadership.

However democracy is by far the most flexible, responsive system of governance and is thus most likely to produce the leadership it needs. And it has a proven track record of maximizing economic welfare, albeit with intermittent deep crises such as we are experiencing today. Beside it, the alternatives of State Capitalism, rule by oligarchs and rent seekers and outright dictatorship, pale.

The flexibility and responsiveness of democracy are the key reasons why we believe it will continue to be the global winner—the preferred operating system of the global system—with other systems converging towards it. The unpredictable nature of future outcomes of the debt crisis, makes democracy much more likely to be able to cope than any other political model. ●

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