THE IMPOVERISHMENT OF NATIONS

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THE ISSUES FACING THE GLOBAL ECONOMY

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Contents

Figures

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PUT NOT THY TRUST IN FIAT MONEY

Fiat money is paper money declared by a government to be legal tender, despite the fact that it cannot be converted into gold, silver or another currency, and is not backed by reserves. Fiat money achieves value only from a government's order (or 'fiat') that it must be accepted as a means of payment. It is costless to produce, so governments have caused public distress by issuing too much fiat money throughout its history.

'Paper money eventually returns to its intrinsic value – zero.'

Voltaire

'You have to choose between trusting to the natural stability of gold and the natural stability of the honesty and intelligence of the members of the Government. And, with due respect for these gentlemen, I advise you, as long as the Capitalist system lasts, to vote for gold.'

George Bernard Shaw

'It is well enough that people of the nation do not understand our banking and monetary system, for if they did, I believe there would be a revolution before morning.'

Henry Ford

Introduction

Two hundred and thirty-three years after the publication of *An Inquiry into the Nature and Causes of the Wealth of Nations*, Adam Smith would have been intrigued by the 60-odd years of rising prosperity after the Second World War – the longest unbroken boom since the beginning of the 17th century. Now, unfortunately, the nature and causes of this extraordinary boom are shifting into reverse and the risk of an impoverishment of nations demands attention.

Any belief that globalisation combined with modern know-how and policies alone created this amazing period of rising wealth is misplaced. World trade and global mobility of capital were higher before the First World War than today because the gold standard employed capital more effectively than fiat money (money created by government decree). The Great Depression, the Second World War and the post-war reconstruction suppressed consumption for two decades, creating enormous pent-up consumer demand. In addition, an unparalleled baby boom started after the war and meeting the growing needs of all those babies as they grew up and entered the labour force meant that strong consumer demand would continue for a long time.

But demand cannot become consumption unless people can pay for what they want. Those who could repaid their debts in the Depression, and those who could not defaulted, so household and business debt was extremely low at the end of the Depression. Incomes were high during the war, but few could buy anything more than absolute necessities. Private-sector savings were very high and the financial system was very liquid at the end of the war. This enabled high levels of investment during and after the post-war reconstruction. The only restraint on growth was the availability of raw materials and labour, so a long period of prosperity was inevitable. Its very length imbued people with the idea that prosperity is the birthright of everyone.

Those who believe this will continue to be the case are destined to be disappointed because all the factors that created that remarkable period of prosperity have now reversed. Historically, each new generation was substantially larger than the preceding one but, since 1971, each new generation in the OECD has been about 60% of the size of its predecessor. Growth rates of population, labour forces and gross domestic product (GDP) are falling in many nations, while excessive borrowing, consumption and investment have created credit bubbles that have burst and threaten significant credit liquidation. In addition, unsustainable international imbalances of saving and investment must be corrected and the rising relative costs of energy, water and food will hinder efforts to promote the expected growth in living standards.

Obese governments will be an added problem

Governments are the biggest beneficiaries of inflation because a fiscal multiplier makes their revenues expand and contract more than nominal output, so they happily mandated fiat money in order to inflate as much as they wanted (as will be explained in Chapter 4). High global growth in the last quarter of a century and capital gains taxes from the serial asset booms multiplied government revenues in most developed nations. Revenues greatly exceeded forecasts; yet spending grew even faster, so governments ran up big fiscal deficits in the good years, leaving nothing for support in lean years. Falling output and asset prices have increased spending and reversed the fiscal multiplier, so fiscal deficits are soaring even higher and are now crowding out the more efficient private sector.

Two big problems stand in the way of slimming obese governments. First, most nations could greatly reduce their fiscal problems by not supporting unprofitable businesses. This would free savings for investment in profitable businesses that would increase government revenues. Subsidising business is unnecessary in many industrial nations because business saving is the biggest component of saving. Even so, government subsidises big business because it employs lots of voters and contributes generously to election campaign funds. Political parties dare not jeopardise these institutions. Second, people are now looking to governments to ease the pain of the credit bubbles bursting and the recession. Although this may be legitimate in short-term crisis management, in the longer term they are looking in the wrong direction.

The great danger is that governments will prove to have seized this golden opportunity to increase their long-term powers of meddling and influence, and, having rushed in with big fiscal and monetary stimulation packages as well as bailouts or guarantees for financial and non-financial institutions, pushing them out of this position will be a major challenge. This is unfortunate because a lot of research shows small government is better government. The journal *Public Choice* concluded from American figures from 1929 to 1986 that maximum productivity growth occurs when government expenditures total about 20% of GDP, yet all OECD governments spend far more. Government spending was 33% higher in the 15 European Union (EU) nations than in the US, yet American economic output per head was more than 40% higher. Real economic growth in the US was over 50% faster and the percentage of unemployed without a job for more than 12 months was 11.8% in the US compared with 41.9% in the EU 15.

A lot of government spending is counterproductive. For example, since New Zealand abolished all 30 agricultural subsidies in 1985, farm productivity has grown and farming's share of GDP has risen spectacularly. Similarly, in the US President Clinton signed the Welfare Reform Act in 1996. It limited receipt of welfare benefits from the federal government to a lifetime maximum of five years. The number claiming benefits shrank by 60%, the number of single mothers at work rose by 30% and the incomes of these families rose dramatically. The Index of Child and Youth Well-being has improved almost every year since 1995. In 2000, the number of children being placed for fostering fell for the first time since 1980 and has continued falling. Even cases of child malnutrition have fallen.[1]

Nevertheless, public perceptions and popularity trump results and even the most counterproductive programmes persist. Government programmes do not go through markets so no one can know their value, and government accounting systems do not reveal their true cost. Governments do not worry about such niceties as cost effectiveness and efficiency as they can always extract more money from taxpayers. Chapter 1 will show that demographics in developed nations have become a negative influence on growth and exposed the pyramid scheme aspects of welfare states. As a result, most developed nations are experiencing more immigration than their citizens want and, often, their infrastructure can cope with.

Reducing government improves the economy

Dramatic improvements in national well-being from cutting government spending in Estonia, Ireland, Latvia, New Zealand and Russia prove many, perhaps most, government programmes are counterproductive. For example, Ireland slashed government spending from 52% of GDP in 1986 to 32% in 2000 and transformed the country from 'the sick man of Europe' to the 'Celtic Tiger.' Research by Ludger Schuknecht and Vito Tanzi for the European Central Bank found that expenditure reform in the 22 industrialised countries coincided with improvement not only in fiscal and economic indicators but also in human development and institutional indicators. The percentage of working-age people in jobs rose, whereas it fell in non-reformers. Moreover, cutting spending helped the poorest people. Faster growth and targeted spending more than offset the minor effects on income distribution.[2]

Flatter tax gradients penalise saving and investment less and so raise revenue much less destructively than steeply graduated taxes. For example, the highest federal marginal tax rate in the US dropped from 91% in 1961 to 70% in 1965. Income tax revenue not only rose at a much faster rate in the years following the tax cut but also greatly exceeded expectations. The taxes paid by the highest earners exceeded expectations by the greatest amounts. The discovery that lower tax rates change people's economic behaviour, stimulate growth and create more tax revenues has led to reduced tax rates and flattened bracket gradients in many nations.

Slim governments are more likely to embrace beneficial policies, such as a stable monetary regime, which encourages economic activity. Obese governments are more likely to indulge in loose money and the resulting inflation can destroy confidence and cripple investment. Lightly regulated markets encourage efficient allocation of resources, whereas heavy regulation results in inefficiency and needlessly high costs. Similarly, free trade raises productivity and boosts living standards, but protectionism saddles nations with high costs and bottlenecks. Obese governments own and allocate resources; slim governments let tradition and law secure private property, so owners can utilise their resources efficiently.

Lowering the level of dishonesty in the ruling elite has raised living standards in many nations, for example China. Bribery, lying, favouritism and letting noisy minorities impose on the majority are obvious forms of dishonesty; secretiveness, excess regulation, inflation, arbitrariness and protectionism are more complex forms of dishonesty that disrupt markets and inhibit entrepreneurship.

Governments are running into major problems

The rich have enjoyed the lion's share of the income gains, so rises in living standards have been disappointingly small for many people. For example, US Census Bureau figures show the median real income for male, full-time, year-round workers in the US was lower in 2006 than in 1972. The gap between the rich and the poor is high and rising in both developed and emerging nations. Urban incomes are much higher than rural ones, especially in emerging nations (over triple in China) and the disparities are widening. The growing difference between expectations and reality is creating growing social tensions, and special interest groups are adding to these tensions by predicting poverty, crime, chaos or terror when proposed fiscal reforms threaten their perks.

Governments are trying to paper over these tensions by emphasising public fears of social disintegration, external aggression and economic adversity, but governments are the means by which minorities impose their will on the majority. The beneficiaries strenuously oppose every proposal to cut benefits even if, like the New Zealand farmers, they would be better off accepting the reform. Strikes and rioting are rising again as high unemployment and widening income gaps cause dissatisfaction over the way governments are handling today's problems. Competition to retain 'benefits' is forcing governments to placate the most powerful special interest groups, regardless of how badly this favouritism affects the rest of the nation.

Negative demographics and the rising costs of energy (see Chapter 1) and economic growth moving from developed to emerging nations (see Chapter 2) have slowed growth in developed nations. Lower growth is raising government spending while the fiscal multiplier is reducing revenues even more than the reduction of output growth. Fiscal stimulation and bailouts are adding to already soaring government deficits. Sovereign debt is rising rapidly and governments have begun to reduce benefits and services, for example by increasing the age at which pensions become payable and reducing the frequency of garbage collections.

Some governments will be unable to fulfil the commitments they have made. Bank guarantees have not yet been fulfilled by Iceland, are causing Ireland significant problems and have caused credit downgrades elsewhere. The fast growth of some small nations resulted from rapidly growing current account deficits and the associated import of capital. Credit Suisse estimated the total current account of eastern Europe (excluding Russia) fell from a surplus of 6% of GDP in 2004 to a deficit of 6% of GDP in 2008. The end of the credit cycle cut off the inward flow of capital to these nations. Those with slimmed down governments are readjusting rapidly; others need international agencies to bail them out.

The resurgence of big government is a major negative for world growth. This, together with the reversal in the factors underlying output growth and the end of the credit bubble, may bring more changes in the next quarter-century than were seen in the last half-century. The changes will affect all sectors of the economy and of society. This book explains how we got into the mess we are in and what is being done about it, and predicts probable outcomes.

- Chapter 1 explains basic economic concepts and describes two structural impediments to the efforts to raise living standards: demographic changes and the rising relative prices of the three basic necessities of life – energy, water and food.
- Chapter 2 examines the international context, showing that economic leadership has gravitated towards emerging nations but financial leadership has not. It also shows how political leadership is evolving and the effects of geopolitical tensions.
- Chapter 3 traces the evolution of the credit bubble and its collapse. It analyses the problems the collapse has created and the deflationary forces it has unleashed, and goes on to examine whether or not a little inflation is a good thing.

- Chapter 4 shows why the gold standard was a better monetary system than fiat money and the problems high leverage has caused. It shows that we have ignored the major source of risk in financial markets and suggests a way to eliminate irresponsible lending.
- Chapter 5 explains why the main problem is private-sector solvency, not liquidity or lack of bank lending. It shows economies are weaker than most people think, populist solutions do not work and emerging nations will not bail developed nations out of their problems.
- Chapter 6 looks at how monetary policy affects financial markets, the rise of risk aversion, the problems caused by structured finance and derivatives, the role of hedge funds and private equity, and the outlook for fixed income investments, equity markets, commodities, real estate and currencies.
- Chapter 7 discusses the long-term effects of government interference in the economy. It goes on to show that more saving is essential for growth in developed nations. It explains fundamental changes that are occurring and shows a way forward.

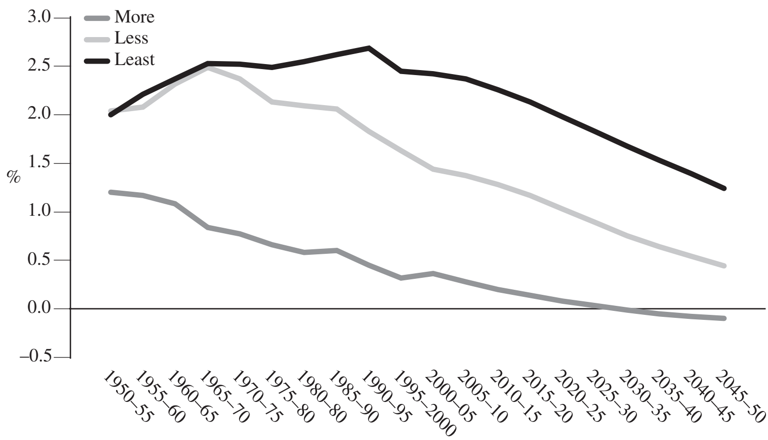
1

Structural impediments to rising living standards

The UN International Conference on Population and Development in Cairo, Egypt, in September 1994 revealed that global fertility rates were half of what they had been in 1972. The *2006 Revision of the Official United Nations Population Estimates and Projections* shows that global fertility rates continued to fall in the next decade. Fertility levels are below replacement level in all 45 of the more developed countries, which account for 19% of the world's population, and in 28 developing countries with 25% of the world's population. Immigration is projected to double the natural increase (births less deaths) in Belgium, Canada, Hong Kong, Luxembourg, Singapore, Spain, Sweden and Switzerland, and to offset an excess of deaths over births in Austria, Bosnia, the Channel Islands, Greece, Italy, Portugal, Slovakia and Slovenia.

Figure 1.1 shows population growth in less developed and least developed nations will be faster than in more developed nations, but a downward trend is clear in all three. It started in the early 1950s in the more developed nations, in the late 1960s in less developed nations and in the early 1990s in the least developed nations. Emigration notwithstanding, the populations of both less and least developed nations will keep growing throughout the forecast period, but at ever slower rates. Population growth is important to the economy

Figure 1.1 **Population growth by degree of development**



Source: World Bank

because no nation has found a way to prosper in the long term with a falling population. Japan's ageing population and falling labour force are sufficient to explain its minimal growth in the past 19 years, and Russia's falling population was a major cause of the break-up of the Soviet Union.

Ageing populations slow output growth

The average age in a nation rises as the rate of growth of the population slows, so average ages are highest in the more developed nations, lower in the less developed nations and lowest in the least developed nations. The most important effect of an ageing population is the falling growth and then decline in the working-age population, people aged 15–65. Changes in the working-age population are important for two reasons.