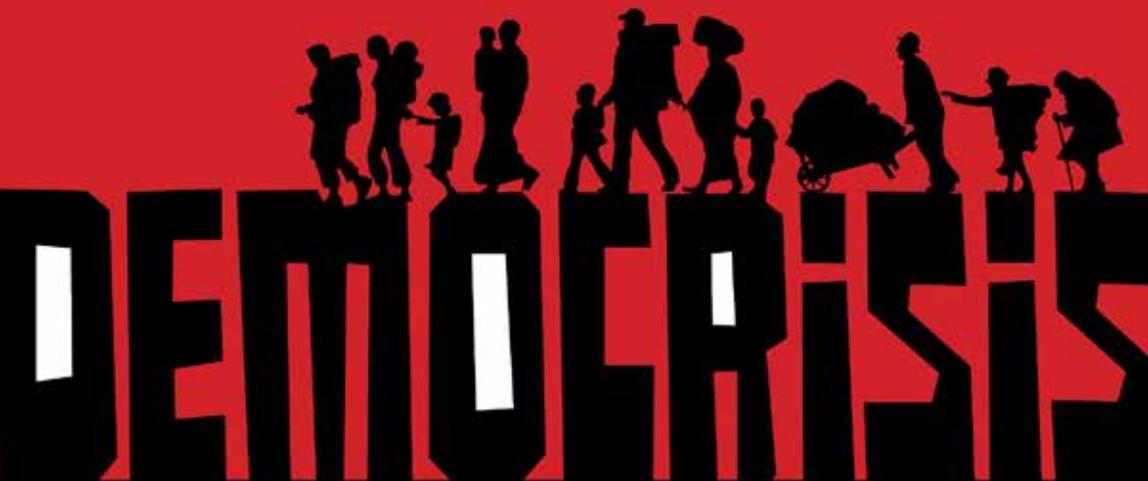


**More debt and more crisis;
can democracy cope?**

A re-examination of our 2012 book



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

by David Roche, Bob McKee and Nick Kennedy
An Independent Strategy publication

THE AUTHORS

David Roche is President and chief global strategist of Independent Strategy, a global investment consultancy based in London, Hong Kong and Zurich. He has worked in the investment business for over 40 years. He predicted the Fall of the Wall and the end of the Soviet era in the 1980s; the emergence of global disinflation in 1990s with purchasing power going from corporations to the people; and for forecasting the Asian financial crash of 1997-8. In 2006, he developed the theory of New Monetarism that predicted the global credit crunch. Since 2012 David and his colleagues have developed the Democrisis thesis about societal breakdown and its consequences.

Bob McKee is chief economist at Independent Strategy. He is a regular contributor to business broadcasting including TV with CNBC, BBC, Bloomberg and others, as well as for various printed journals. He worked with David in developing the theory of New Monetarism and its prediction of the credit crunch.

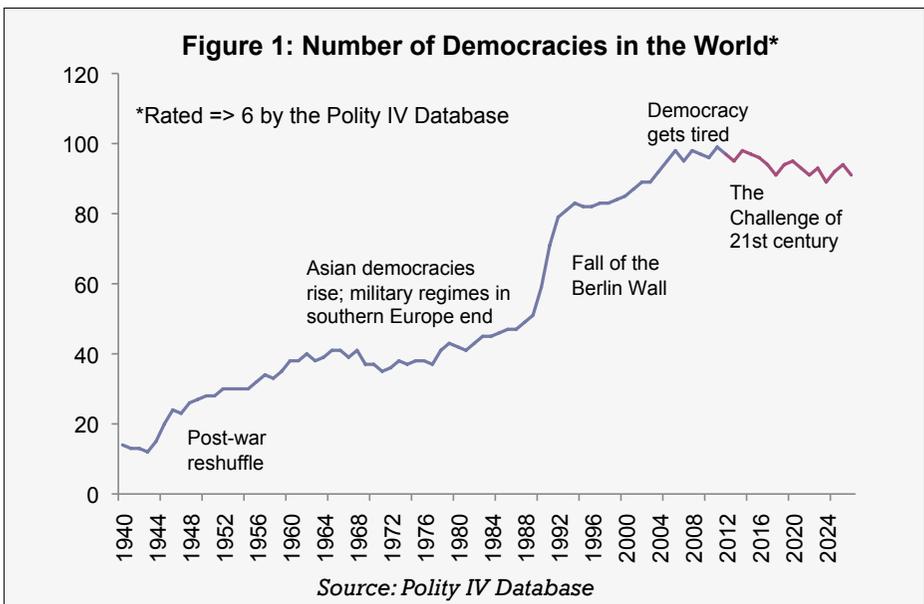
Nick Kennedy is chief analyst at Independent Strategy. He has worked in financial markets for over twenty years and with David and Bob since 2012. His work focuses on the secular shifts underway in the global economy, including those that manifest themselves in Democrisis, through to the longer-term (and positive) effects of disruptive technologies.

THE GLOBAL CRISIS OF DEMOCRACY

We are in a period of history when politics matters more than economics. Nationalism and populism — expressions of the global ‘anger’ vote — are gaining strength due to the tepid performance of most economies over the last ten years and the failure of official institutions (central banks, governments and politicians) to deliver improved living standards.

Four years ago, we wrote a short story arguing that there were new challenges for democracy in the 21st century. Democracy had flourished in the post-war period, spreading from a handful of nations to nearly half the member states of the United Nations by the turn of the millennium (Figure 1).

But, in **Democrisis**, we argued that democracy was getting “tired” and “trivialised”. The end of ideological competition accounted for the former trend. And, more recently, the advent of social media substituted debate for soundbites and (often) unsubstantiated opinion. Consequently, the relevance of democratic institutions to people’s lives has waned.



DEMOCRISIS RE-EXAMINED

According to Freedom House, 2016 was the tenth consecutive year of decline in global freedom. And the number of countries showing a decline — 72 — was the fastest pace yet.

The Journal of Democracy surveys show that *“Citizens in a number of supposedly consolidated democracies in North America and Western Europe have not only grown more critical of their political leaders, they have also become more cynical about the value of democracy as a political system, less hopeful that anything they do might influence public policy and more willing to express support for authoritarian alternatives.”**

Economic recovery since the Global Financial Crisis (GFC) has not only been weak, but the distribution of this growth has been skewed. Real incomes have in fact fallen for both the poorer sections of society and (critically) the middle classes while buoyant asset prices have enriched the top 1%. This has produced even more alienation.

Democratic institutions have failed to deal with rising debt, both private and public, and the looming issue of inequality, which has been glossed over by the combination of democratisation of credit and asset (principally housing) bubbles. The ethic of thrift and economic probity has given way to excess and moral hazard. The social contract between the haves and have-nots through the ‘welfare state’ and social entitlements has frayed at the edges.

The old democratic leadership is challenged and losing its grip. It has failed to carry the people with it on: economic reform to heft living standards; supra-national projects to deepen globalisation; geopolitical military intervention; dealing with the diaspora from failed states; or even climate change.

The last four years have confirmed these trends and, in many ways, they have accelerated.

Take Turkey. Just four years ago, it was a nation that had ended its penchant for military coups, had elected a political party that had previously been banned

from partaking in government and was engaged in moving towards accession to the European Union.

Now, after a failed military coup, there has been a massive purge of opposition forces by an autocratic President Erdogan, determined to reduce Turkish democracy and impose religious-led rule of a version friendly to him. Accession into the EU is a dead letter and the implementation of the proposed deal with the EU on Syrian refugees fleeing from the widespread Middle East nightmare is in deep peril.

And Turkey's coup comes just minutes after the momentous decision of the British people in a referendum for the UK to leave the EU. Democracy ruled here, but not through its representatives in parliament, but through just one vote in a ballot on a single issue, the consequences of which were pretty unclear to all who voted. Now the oldest modern democracy faces uncertain negotiations with the EU and with various bilateral trade deals that could set back living standards for years.

Brexit could also launch a thousand other ships with 'copycat' demands for referenda in other countries, though for the moment the British vote to leave the EU has shocked the populations of remaining EU states into dramatically higher support for the EU itself to the detriment of their own populist parties.**

In the longer term, Brexit, plus the democratic deficit of the European project, have the potential to strike at the architecture of the European project far to a greater extent than the sovereign debt crisis.

The story of the last four years since we wrote Democrisis can be summed up by:

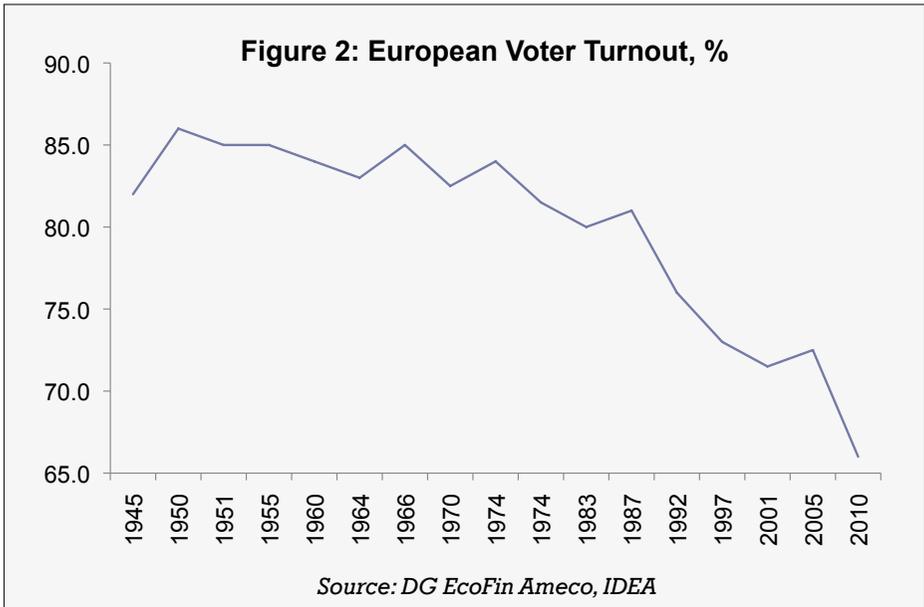
- Increasing political fragmentation
- Widening demographic deficit and migration
- Slowing productivity and rising low-skill, low-pay employment
- Worsening inequality
- Growing nationalism globally

Increasing political fragmentation

Back in 2012, we wrote that the failure to tackle Europe's economic crisis was a real and present danger for the political elite. Voter disillusionment was growing well before the crisis broke (Figure 2). In the first 'post-crisis' phase, incumbent governments were ousted as electorates reacted to the economic suffering caused by the GFC, and were replaced by traditional opposition groups (or unstable coalitions that sought to preserve centrism).

Normally, in a classical business cycle recession, that would be enough to tide things over while the economic situation recovered. But in Democrisis, we thought that the damage inflicted by the GFC through spiralling sovereign debt indicative of government over-reach and poor uses of debt financed resources was more substantial, requiring deep and sustained policy steps to correct. Mainstream parties were ill-equipped to deliver these changes, being beneficiaries of their own excesses, at least in a manner that was electorate-friendly.

While this phase took time to evolve due to the diktats of electoral cycles, our forecast of increasingly dysfunctional democracies has been confirmed. This has been most evident in Europe, but not just there. The same disillusionment with



the mainstream solutions to the impact of the GFC has emerged in the US, Japan and in many emerging economies. This is particularly the case among Europe's youth, where under-25s unemployment is close to 50% in several southern European countries.

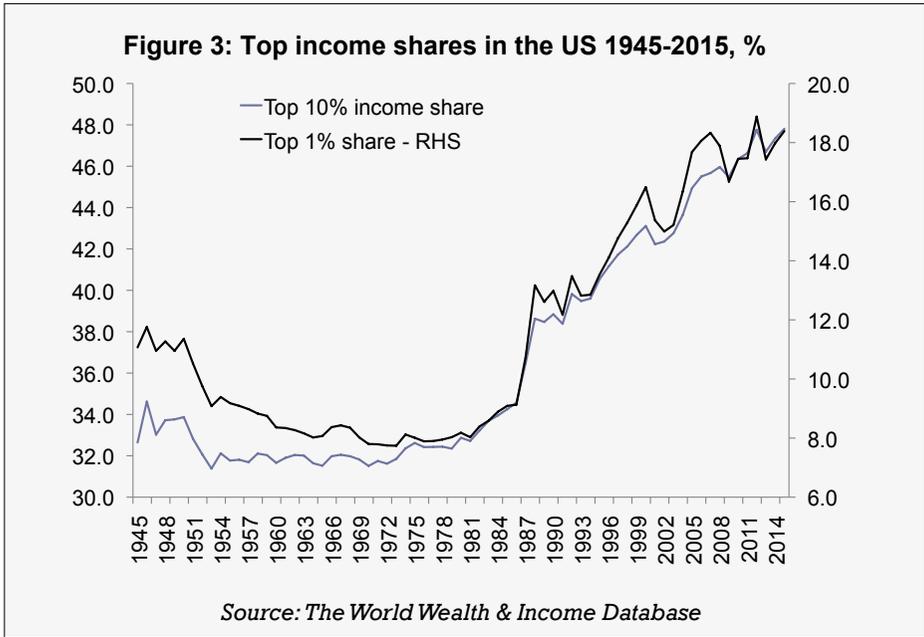
In Europe, populist fringe groups like Syriza in Greece, or Cinque Stelle in Italy or Podemos in Spain, or the Front National in France, or UKIP in Britain have evolved from sideshow status to mass appeal (and electable) parties.

At the heart of the divide between this growing populism and the current political culture in Europe lie the objectives of the European Union itself. The liberal, middle-class and better educated (middle aged) feel that the EU project is about cementing civilisation and economic prosperity in a region with a disastrous history of blowing itself up. For that, they are happy to see people like themselves achieve stability in indirect ways.

The populist parties see such pursuits as vanity projects and view "Europe" as the embodiment of globalisation, threatening the masses by imposing austerity (which they wrongly believe is a frontal attack on their privileges). Austerity is seen more as an elitist retribution, imposed by the core states, rather than reform that will benefit the man-in-the-street in countries undergoing austerity.

This trust deficit reinforces intra-regional divisions and runs contra to the political objectives that were the foundations of the European project. It also consigns structurally-deficient states to an even more prolonged period of indebtedness, which acts as a further retardant on growth potential. These centrifugal forces drive voters towards the political fringes, sometimes to the point where social morality blacks out, as in the more blatantly racist articulation of the Brexit campaign.

In a similar way, in the US, trust in the democratic mainstream has evaporated as middle-class incomes stagnate and the richest 1% of the population reaps the lion's share of the recovery (a similar pattern to the UK), Figure 3. Meanwhile politicians continue to agree to yet more 'globalisation' in the form of new trade treaties for outsourcing jobs in the north and allowing inward cheap labour from the south.



The Trump phenomenon of opposition to immigration, Muslims, free trade and the US's engaged geopolitical role mirrors the populists of Europe — even more crudely. Trump is dangerous because he has the power to reverse globalisation and remove the US as the security umbrella under which, deservedly or not, the rest of the world currently prospers.

In Asia, Japan may not have brought to prominence a populist party or leader, but the Abe premiership exhibits a much more nationalist and xenophobic agenda aimed at expanding Japan's old militarist approach than at any time in the post-war period. And in the rest of Asia, there are new militarist (Thailand) or populist leaders (Philippines, Indonesia) in charge.

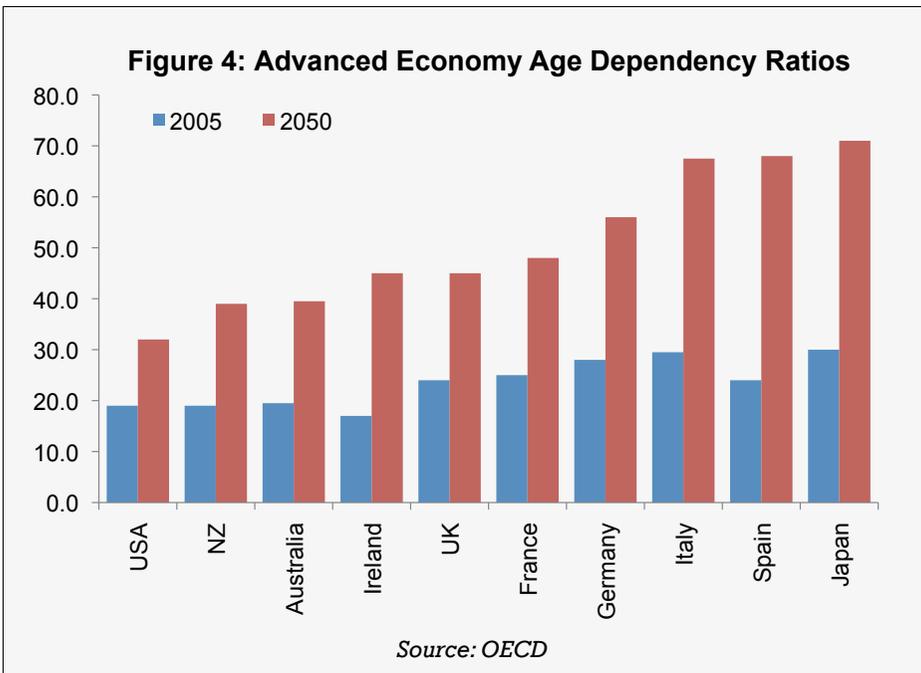
In China, President Xi seeks to prolong Communist party rule by invigorating the economy through reforms and eliminating corruption, while reinforcing the party's control at the expense of the development of civic society. Xi's tools are the re-imposition of Marxist ideology, a personality cult, xenophobic nationalism and geopolitical confrontation. The fact that China's ability to project power is

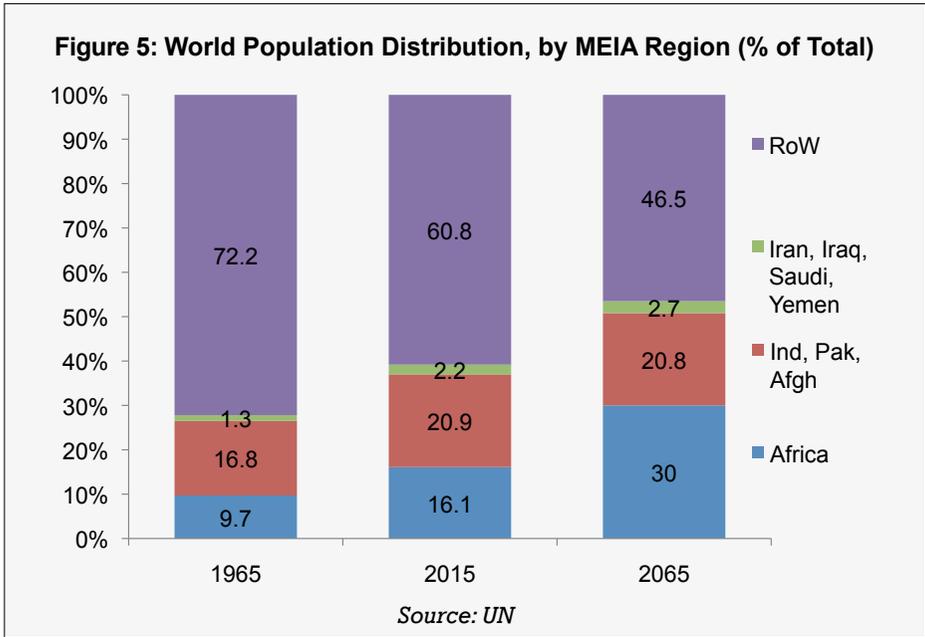
ultimately dependent on its success in continued integration into the global economy is the fault-line in his thinking. But that is hardly a recipe for smooth transition to the new domestically-driven economic development model. The most benign outcome is that China remains stuck in the middle-income cohort of developing economies and fails to converge with rich economies. That, as we discuss below, is critical.

The demographic deficit

One of the new aspects of the global crisis of democracy since 2012 is the demographic deficit. One of the great achievements of the 20th century was a dramatic rise in life expectancy. In the US, it increased from 45 years in 1902 to 75 in 2004.

However, increased life expectancy combined with declining birth rates has created 'a demographic time bomb' where future generations will struggle to meet the funding of an ever-increasing number of retired workers and their pensions (Figure 4). In Democriasis, we highlighted this risk to the social contract





between the electorate and the democratic state. That risk has increased in the four years since.

Politicians talk about austerity, economic reform and institutional changes as the key to achieving growth and thus maintaining the democratic model. In *Democrisis*, we argued that it was reform of an unsustainable social model that otherwise demotivates and overburdens the private sector, which is the key to growth. Without growth, the whole democratic edifice collapses.

Ageing is both highly deflationary and costly for the state. The combination is quasi-fatal for the fiscal and sovereign debt sustainability of most rich countries, unless growth can be boosted.

The real expansion in population will not be in Europe, Asia or America. On the contrary, by 2065, 30% of the world's population will be in Africa (Figure 5), where democracy is a rare, fragile flower — and where there is little sign of a leap forward in prosperity for most. That will increase the likelihood of mass

emigration towards the rich nations of the North, accentuating the very fault-lines already there.

The world is already running the historically highest global levels of displaced persons (both within and outside national borders). And, linked to this, democracies are dealing with a rising tide of terrorism (both domestic and international).

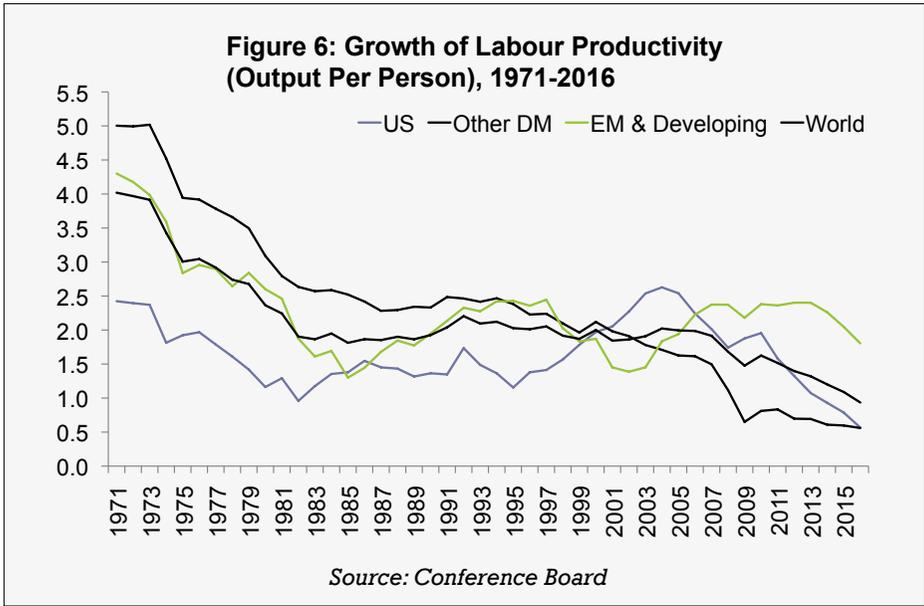
Migration is not a zero-sum game. Countries that fail to grasp the nettle of reform risk losing their brightest talent. Immigration is a fine thing for ageing rich countries if it can replace their dwindling workforces. But that is not a given. Inflows of poor-quality labour into either non-reforming or reforming economies become self-reinforcing. They could compound the impact of rising entitlement costs, adding to education and healthcare expenditure and further undermining productivity growth.

Also, democracy will only survive in emerging economies if these nations can reform sufficiently to break out from the middle-income trap. Those that fail to provide opportunities for their increasingly well-educated middle classes will suffer from an exodus of skilled labour. As a rule of thumb less than 10% of emerging economies successfully manage the transition.

Sluggish productivity

The other side of the coin of the demographic deficit is the productivity slowdown in the major democracies. Low productivity growth has been a persistent feature of the years since the GFC and started as a trend well before that (Figure 6).

In the last four years, jobs created in the major economies have been mainly low skill and low wage. Low end/contingent jobs represented 36% of the total US labour force in 1990 and today it is 42% (or around 52m jobs vs. 33m in similar occupations in 1990). High end jobs used to be 45-46% of total employment in the US. Today the number is closer to 43%. Declining productivity growth reflects an increasing proportion of the labour force essentially “warehoused” in lower productivity occupations. These have not been worth automating and low income work has only contributed to the inequality divide.



The legacy of the elevated debt — both private and public — highlighted in Democrisis, has been sluggish growth. Credit booms tend to undermine productivity growth by misallocating labour into lower productivity sectors and the effects of this are long drawn out, particularly if the credit boom has ended in a bust. This is hysteresis: the loss of potential growth capacity after the financial crash is over. Of course, low productivity seems locked in for some time in the future too. Poor demographics also limit capital investment and thus productivity.

Since 2012, central bank policies, designed to avoid a financial meltdown and restore liquidity, have become the main weapon for economic recovery. They result in ultra-low or negative yields. This has created the problem of a surplus of savings as oldies save more and yields on their savings fall. Excess savings have contributed to a chronic lack of demand, which in turn erodes the desire to make capital investments in new technology.

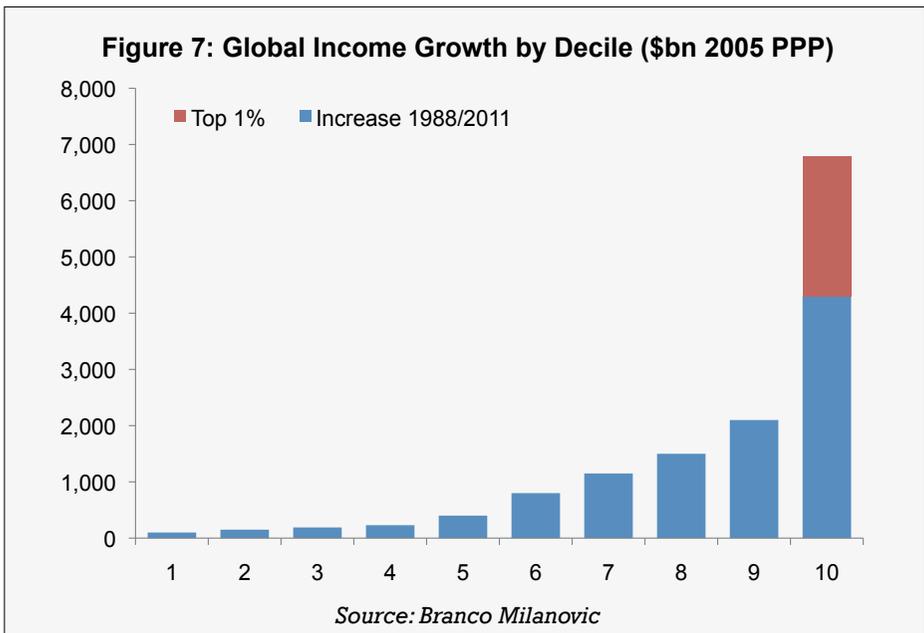
But in all likelihood, this only postpones a dramatic technology revolution that is under way. Disruptive Technologies (DTs) will eventually kick in

and heft productivity and growth. But DTs will attack middle income jobs and could add to populist reaction. However, on balance, DTs will prove complementary — rather than substitutive — to labour. Or so we hope!

Worsening inequality

Another of the themes of Democrisis was the growing failure of the democratic social contract towards the end of the 20th century as wage shares in the rich democracies were compressed by globalisation in the emerging economies. In other words, 500m of the world's workers exited the gulag to join the free(ish) market system.

The fruits of economic growth were shifted from labour to capital because labour supply became copious and capital more profitable. A simple equation: as labour supply expanded, output could be boosted without incurring increased wage costs (per unit of production). Increased output earned more profits because the increase in labour supply limited labour costs and boosted capital returns.



Since 2012, there has been growing evidence of rising inequality or income and wealth in the rich democracies — and amid already wide disparities in global incomes and wealth (Figure 7).

And the recovery since the GFC has not lifted most boats. In the last ten years two-thirds of households in the top 25 rich countries of the world suffered falls in their real income levels — that's 540m people. This compares with less than 2%, or fewer than ten million people, who experienced this phenomenon between 1993 and 2005. Today's younger generation is at risk of ending up poorer than their parents.***

In the UK, half of all households have seen no material recovery in their real disposable incomes since 2005 — a “lost decade” of income, the longest period of flat or falling real wages since at least the middle of the 19th century.****

A big reason for Brexit majorities in the UK referendum outside London now becomes clear. The largest gains in household income have come in regions where income was already high — London (incomes more than 30% above the UK average); while some of the largest losses have been in regions where income was already low — Northern Ireland (18% lower) and Yorkshire and Humberside (14% lower). And it was the lower-income areas that voted for Brexit.

So rising inequality in wealth between generations and regions and between labour and capital, have left their mark on the trust that the have-nots have with democratic institutions and their leaders. The ‘anger vote’ has gained across the board. Not only in the UK, but globally; in the US, the same arithmetic applies.

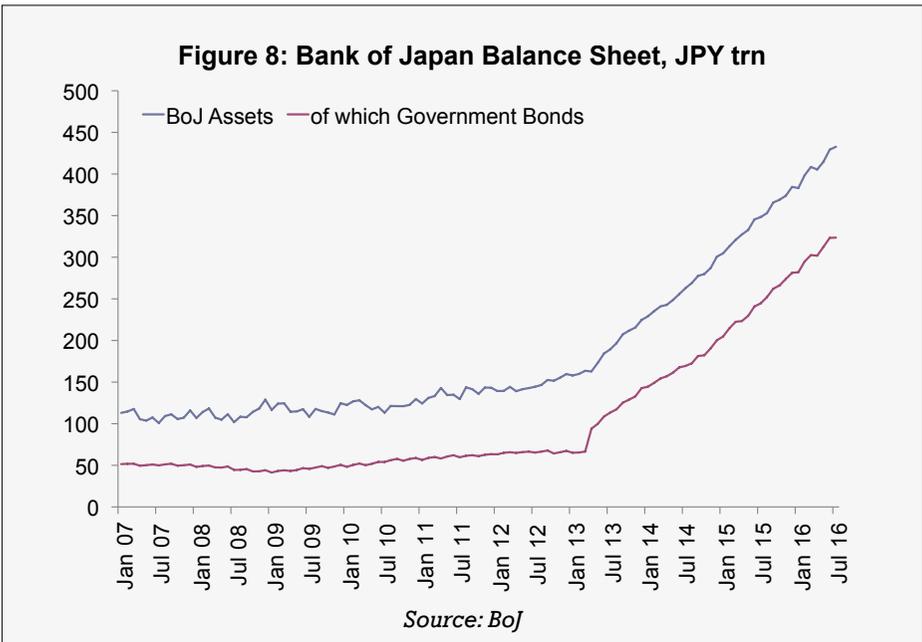
Japan: the slowburn to crisis

Outside Europe and the US, in Asia and in the emerging economies of the South, the same disparities and growing disillusionment appear. In Democrisis, we made the point that Japan exemplified the crisis of democracy everywhere: an unsustainable level of public sector debt and budget deficits; a very low growth rate; a fast-ageing society; a lack of involvement in the workforce of women and negligible levels of immigration.

Since then, under the promotion of PM Abe, Japan’s democracy has been riding on three arrows to solve the crisis: monetary easing; fiscal expansion; and structural reform. There is nothing new about the first two arrows; for one and a half decades the Japanese have been trying to boost growth by the state (and central bank) boosting fiscal spending (and printing money). It didn’t work then. And it is not working now.

The key to Abenomics was “making Japan a good place to do business”; in other words, economic reform that empowered the private sector. But the third arrow has turned out to be more of a rhetorical idea than an actionable plan, though there have been meaningful reforms in corporate governance and agriculture.

Nearly three years into this great experiment, the Abe government is no closer to reaching its goal. And the public sector balance sheet continues to bloat (Figure 8). Instead, Abe has opted to focus his reform efforts on the constitution, seeking to allow Japan to exercise “collective self-



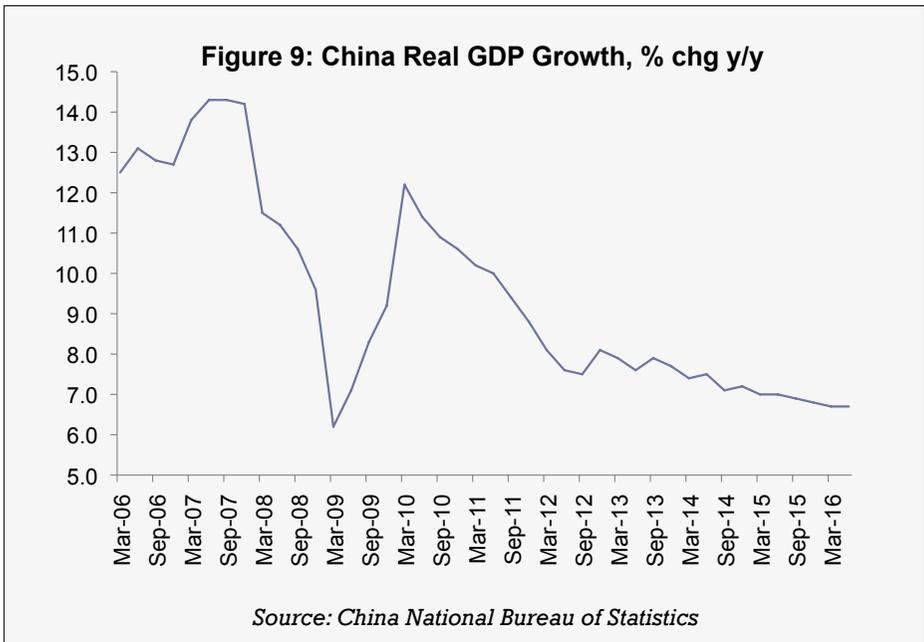
defence”, to act ‘pre-emptively’ if either Japan or its allies are threatened. This is music to nationalist ears but does nothing to stop Japan’s slow-motion to crisis and sovereign debt unsustainability.

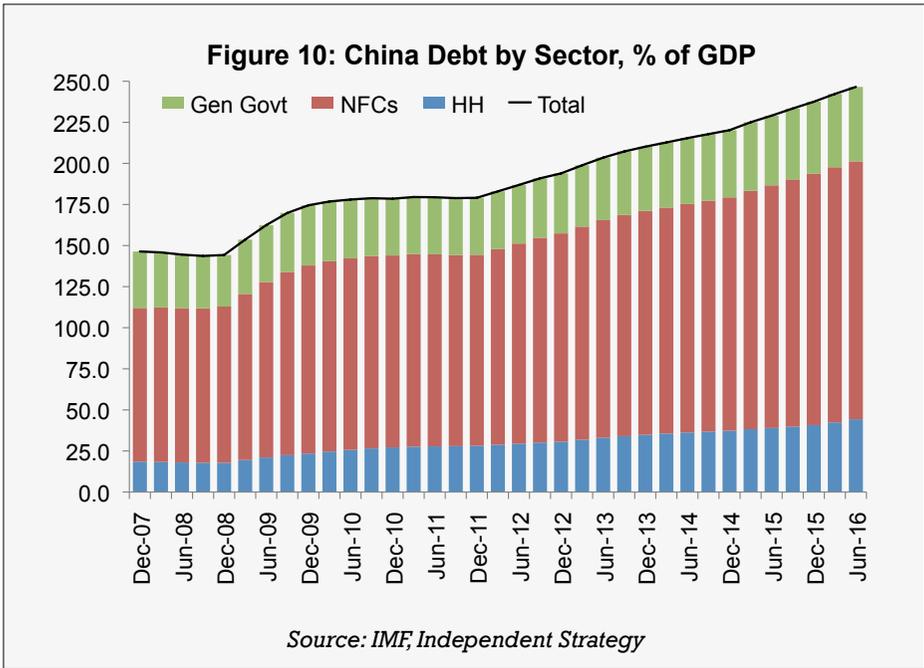
China: the end of state autocracy?

A major section of Democrisis was devoted to China. We argued that China could not sustain the growth rates of the past with a largely unproductive state sector, party control over resource allocation and a failure to convert from a heavy investment industrial economy into a consumer-led services economy.

The experience of the last four years has only served to confirm that thesis, as China’s overall debt levels reach unprecedented proportions to prop up the state capitalist model; economic growth has slowed sharply (Figure 9) and productivity growth has slumped.

In China, debt is currently rising at more than twice the rate of GDP. Because the stock of debt is currently 240% of GDP (Figure 10), this means that debt is



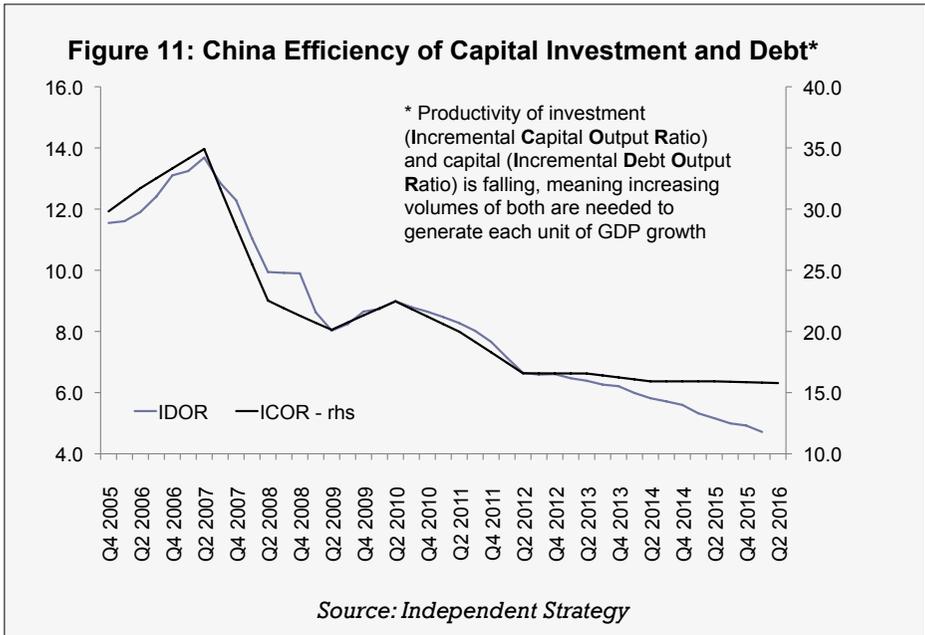


rising by 30% points of GDP per year. No economy with this sort of unbridled credit expansion has escaped meltdown.

China may be different for three reasons. The debt is owed to itself. There is a massive stock of savings which cannot flee the country easily. And the state owns or controls the lenders and the borrowers. That may prevent ruin.

But it cannot avoid the stark truths that the marginal GDP gain from every extra unit of debt is plummeting (Figure 11) and that the stock of bad assets, financed by excessive leverage, will burden growth (which we estimate at 4%, declared as 6%) for the next decade.

Ultimately, this is unlikely to fulfil the terms of the Chinese social contract: the party delivers permanently higher living standards and you, the people, remain quiescent politically. Put simply, the legitimacy of the regime relies on rising living standards as the price of dictatorship. It will fail to deliver. But realisation of this is probably five to seven years away.



The current Communist administration under President Xi has reacted by re-asserting the influence of the Chinese Communist Party, clamping down on corruption and trying to promote nationalism. And China is following an aggressive expansion of China’s regional influence, e.g. with the battle over disputed waters in the South China Sea.

All of this speaks long of Xi’s rule: less social freedom with absolutely no tolerance for questioning the supremacy of the Party and more economic focus. China lacks a civic society based on rule of law and with the subjugation of the growing middle class to the diktat of the Party.

The kernel issue remains: how “reformable” is an economic system that will continue to be dominated by a one-party state that has little faith in markets and a high conviction in its own ability to direct them, for the greater good of the masses? The upshot will be enough reform to keep the party in the driver’s seat for a while but not enough to allow China to exit the middle income trap, which it needs to do in order to satisfy social expectations.

The need for democracy

Since we wrote *Democrisis*, the themes in it have intensified. Democracy is on the back foot everywhere. But all is not lost. The key to a revival in democracy is economic growth. And that depends on higher productivity through productive investment.

The new disruptive technologies of robots and artificial intelligence offer opportunities to make a step-leap in productivity growth to overcome the burden of funding ageing societies. In turn, that depends on political leadership that can deliver structural reforms freeing up the forces of technological change; reducing the social disparities and inequalities in the process.

If that does not happen, it is quite possible that the major advanced economies will enter a 'post-growth' state with shrinking working age populations, which has a chronically damaging impact on financial systems and debt burdens.

If the major democracies of the world are unable to meet these challenges, then the decline of democracy globally that we have seen in the last decade or so will accelerate. But, as we argued in *Democrisis*, democracy remains the most flexible and responsive system of governance to produce the necessary leadership. The saviour of democracy may well be democracy itself. ●

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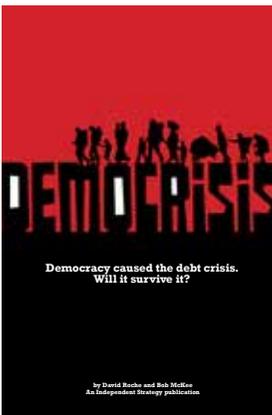
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