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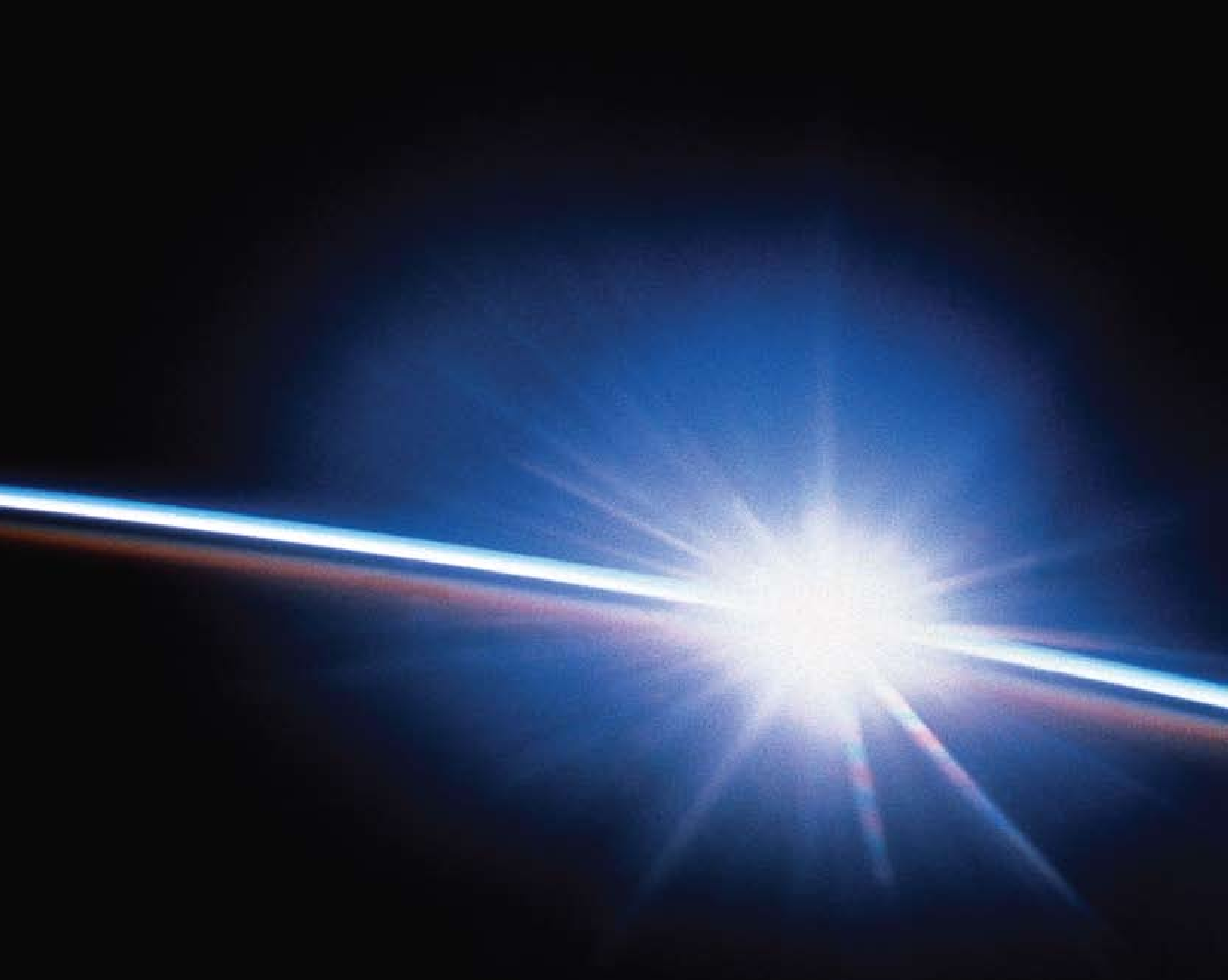

brave new world?

issues in the new decade

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strategy insights | issue two

“The future’s not
what it used to be”

Mickey Newbury[1]

[1] Song title from the album *Frisco Mabel Joy*, 1971.

brave new world?

issues in the new decade

- At the beginning of a new year, predictions abound. But 2010 marks the beginning not just of a new year but of a new *decade*. In this report, we examine some of the key themes that may dominate economic, political and market events in the coming years.
- Longer-term trends are not eliminated, even if they are masked, by short-term turbulence. Our core thesis is that the world is dominated by a series of "dangerous exponentials", which consist of accelerating growth both in financial indicators (such as money supply and debt) and in critical non-financials (such as population, energy usage and resource depletion).
- The critical linkage here is the energy-economy axis, and our concerns focus less on energy availability in the absolute than on a worsening surplus equation between energy extracted and energy consumed in the extraction process. In short, an economic system predicated on perpetual growth might be about to collide with the realities of a finite physical world.
- Environmental issues are clearly poised to be one of two dominating issues, and have significant implications both for wealth transfer to the emerging economies and for fiscal policy.
- The second key issue will be the need for a replacement for the dominant economic ideology of the last quarter-century, the free-market economic system often described as "the Anglo-American economic model" or "the Washington consensus". Has the model really failed, or has its application simply been bungled? And, if the model has reached its 'sell-by date', what might replace it? We conclude that, whilst bungling has abounded, the model is indeed faulty. Its replacement might look a lot like the more interventionist and strategic "European social model".
- The financial system remains prone to *sequential* bubbles, and patch-and-mend reforms (with an excessive reliance on the 'one-trick pony of capital ratios) are no substitute for root-and-branch reform, which, we believe, should include re-imposition, along modernised Glass-Steagall lines, of the distinction between commercial and investment banking. President Obama's recent initiative, though flawed, might be a step in this direction.
- Issues such as environmental funds transfer and better bank regulation are dependent upon global co-operation, but the future outlook may be for increased competition rather than closer co-ordination. The swing in the balance of economic power from west to east has been accelerated by the weakening impact of the 2008-09 crisis on major western players such as the US and the UK.

brave new world? – issues in the new decade

"A week", as Harold Wilson famously (if rather fatuously) remarked, "is a long time in politics"[3]. On the same principle, a year can seem an aeon in economics and in markets. In early 2010, things look very different from this time last year, when investors and policymakers alike were gripped by the continuing uncertainties of the 2008-09 financial meltdown. Since then, the banking system has pulled back from the brink, equity and commodity markets have rebounded significantly, and the general perception is that a modest economic recovery is under way. What is the general shape of things to come in 2010 and beyond?

The very first point that investors should bear in mind is that longer-term structural trends are not cancelled out, even if they are sometimes masked, by shorter-term noise. For us, long-term trends focus primarily on a set of "dangerous exponentials" which will be addressed in a forthcoming report[4]. These exponentials include population growth, resource constraint, and worrying expansions in money supply and indebtedness. The energy-money axis, to be described in that report, is, in our judgement, *the single most important long-term issue*.

This "dangerous exponentials" thesis can be summarised, very briefly, as follows. The established structure of the economy assumes permanent growth because, if growth ever ceases, accumulated debts become impossible to service, whilst meeting the needs of a world population growing by about 70 millions annually becomes a huge challenge. Yet an economic system predicated upon continuous growth may, very soon, collide with the limits of a world of finite resources. Above all, today's economy is a function of surplus energy. Even if top-line energy availability does not top out soon – which is possible – the real danger lies in *a worsening relationship between energy extracted and energy absorbed in the extraction process*.

Close behind the economy-energy axis comes concern over the environment. The scientific validity of the global warming debate lies outside our remit, but it is the economic and financial dimension which concerns us here, in two key respects. First, it seems probable that a mechanism will be found to shift financial resources from the developed to the emerging economies. Second, concerns about environmental issues seem certain to be one of the two strands informing fiscal policy. We expect a significant increase in the proportion of taxes which are predicated on environmental concerns.

The other trend which is likely to inform fiscal evolution is the issue of the taxation of banks. Whilst the idea of a 'Tobin tax' on financial transactions remains on the table, President Obama has moved the debate on with his Financial Crisis Responsibility Fee (FCRF), designed to recover the $117bn cost of the Troubled Asset Relief Program (TARP) over a twelve-year period. Though this may be emulated elsewhere – and seems a better idea than a Tobin tax – this levy does not provide a complete solution to the problem of a financial system which has developed a mechanism for creating *sequential* bubbles.

Where the financial system itself is concerned, our view – to be set out in more detail in Issue Three – is that the response to the banking crisis has, thus far, taken the form of patch-and-mend repair rather than structural reform (though recent proposals from President Obama may represent hesitant progress towards separation). As we shall explain in that report, we believe that reliance on the 'one-trick pony' of capital adequacy is mistaken, and that separation between commercial and investment banking will, in due course, come to be recognised as essential (though it might require another crisis for this lesson to be learned).

Many of these issues – including financial regulation, the environment, energy and, of course, "dangerous exponentials" – are global in nature, which raises the broader question of "globalisation". Globalisation has been

[2] *Compensation*, 1841

[3] This remark, attributed to Mr Wilson, was probably said in a 1964 lobby briefing.

[4] Tullett Prebon Strategy Insights Issue Four – *Dangerous Exponentials – A Novel Take On The Future*

“You must pay at last your own debt. If you are wise, you will dread a prosperity which only loads you with more”

Ralph Waldo Emerson[2]

one of the two ideological ‘givens’ of the last two decades, the other being the orthodoxy of the Anglo-American free market economic model. Whilst the latter, clearly, is in greatest need of major reconstruction or replacement, globalisation assumptions, too, should not be taken for granted. One influential commentator has argued, persuasively we think, that the trend towards globalisation is already in retreat.[5]

Our view is that the world needs to be seen not in terms of consistent globalisation but, rather, in terms of shifting economic (and political) power blocs. The truism of a west-east shift of power is an over-simplification, but it does focus attention on the comparative decline of a long-established western economic and political supremacy. This shift is amply signalled by the transition of leadership from the G7 (42% of the global economy, and falling) to the broader G20 (83%).[6]

One problem shared by many regions of the world is the fraught relationship between policymakers and bankers. This relationship, which remains very much in flux, reflects the intrinsic characteristics of both participants. Many politicians are instinctive blame-shifters, and have tried to persuade the public that almost all of the responsibility for the 2008 financial crisis can be laid at the door of bankers, an approach which neatly side-steps the role played by systemic failures in monetary and regulatory policy. Bankers, on the other hand, have often shown themselves to be insensitive to the concerns expressed by the public outside the ivory (or, rather, the plate-glass) towers of their own rarefied world. If politicians need to own up more often, bankers need to get out more.

Within these longer-term contextual issues, the outlook for the global economy can best be described as ‘mixed’. Though recovering modestly, the US remains in the grip of a recession which differs fundamentally from those of the past. Whereas earlier recessions can be described as ‘inventory unwinding’ events, the key characteristic of the post-2008 recession is *deleveraging*. Inventory and deleveraging recessions are very different phenomena, which means that the lessons of the past have limited applicability in the current situation. Europe, meanwhile, seems to us to be revealing ‘OLOP’ characteristics, a term which will be explained later, but which describes an economy consisting of a solid centre ringed by a periphery of basket-cases.

Amongst the peripheral strugglers, the dire situation of Greece has been most prominent of late, but similar characteristics – an unrealistic level of public spending, an unsustainable deficit and escalating debt – also characterise The UK, Spain and Portugal.

Where markets are concerned, recent progress strongly suggests that our old friend “irrational exuberance” is alive and well. In a forthcoming report, we shall call attention to the two factors which have artificially inflated asset (and commodity) markets over the last year. One of these factors is new whilst the other is long-established. The established (albeit newly important) factor is the declining status of the dollar, which has created a market-inflating USD carry trade. The newer phenomenon is quantitative easing, an unlovely pseudonym for a process well known to earlier generations of Germans, Hungarians, Yugoslavs and Latin Americans – and to present-day Zimbabweans – as the old-fashioned printing of money.

These, then, are some of the issues which will confront market participants in 2010 and beyond. The aim of this report is to look at these issues, and to explore the nature of the relationships between them.

[5] See *The Collapse of Globalism and the Reinvention of the World*, John Ralston Saul, 2005

[6] Based on PPP GDP data for 2008. Source: *CIA World Factbook*

1. long-term trends have not gone away

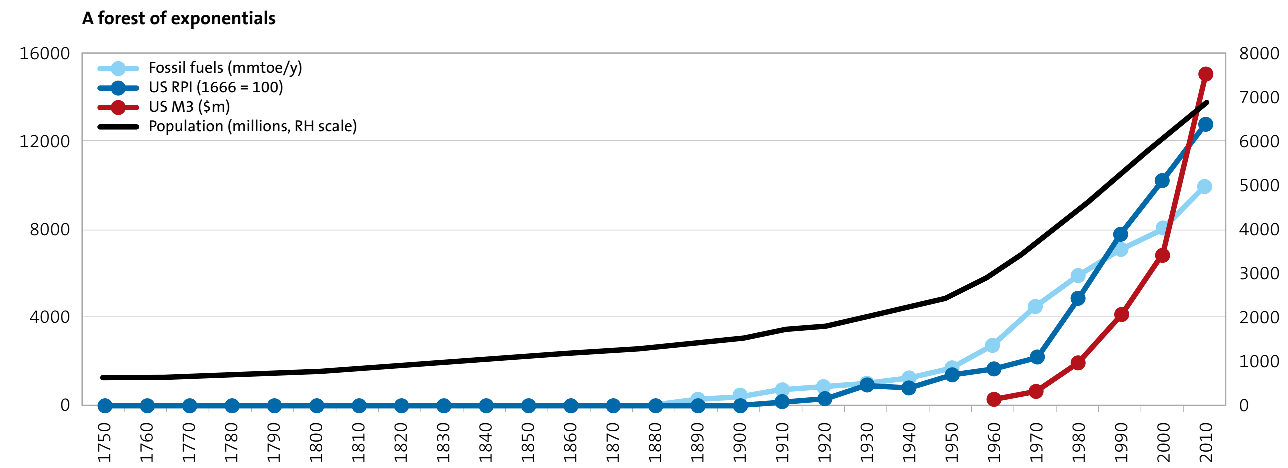
In the midst (or indeed in the immediate aftermath) of any economic crisis, the maintenance of a longer-term perspective, though obviously of primary importance, can be difficult. Investors need to remember that *none of the medium- and longer-term trends which were in place before 2008 has disappeared as a result of the financial crisis*, even if some of these trends have been masked or modified.

We shall identify some of the most important of these trends in a forthcoming report, Issue Four, which will set out Tullett Prebon's core thesis[7]. This thesis centres on an understanding of "dangerous exponentials", just four of which are pictured in fig. 1. A long-term review of historic trends reveals that a whole string of critical determinants have adopted classic 'hockey-stick' exponential trajectories. Amongst non-financial parameters, this applies to population growth, hydrocarbon consumption, resource (and especially water) depletion and species destruction.

Where financial indicators are concerned, money supply, inflation and debt are all on 'hockey-stick' trajectories. Although exponential trajectories do not matter in themselves unless there is a collision with a physical constraint, such constraints *do* exist where many of these exponentials are concerned. In short, there are solid reasons to be concerned about a global economic model which combines huge population growth and rapid resource depletion with escalating quantities of indebtedness and of *fiat* money.

In Issue Four, we shall explain that the money-energy axis is the critical equation. Many commentators believe that we are approaching the 'Peak Oil' moment, at which output of petroleum goes into decline because half of all originally-recoverable reserves have been extracted. Whilst we do not accept this interpretation – because, if non-conventionals are included, much more than half of all original oil remains in the ground – we also think that this argument misses the point. The critical issues here are *deliverability* and *energy returns*. Naturally, the industry has had first recourse to the cheapest and most readily-accessible oil, which means that future deliverability (which expresses output as a percentage of reserves) is likely to come under pressure even if reserves remain substantial.

Fig. 1: Dangerous exponentials



[7] See forthcoming report Tullett Prebon Strategy Insights Issue Four – *Dangerous Exponentials – A Novel Take On The Future*

Second – and even more importantly – energy returns on energy investment (EROEI) are declining. EROEI is measured by equating energy extracted to the energy inputs required for extraction.

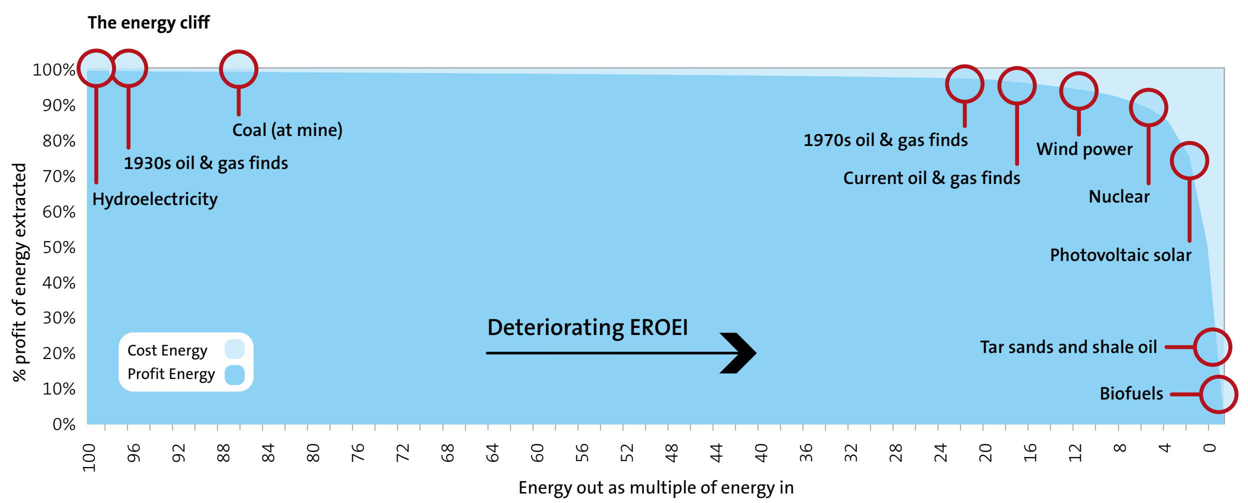
Essentially, society as we know it today has evolved because of the availability of cheap exogenous energy inputs. To grasp the importance of this, it is necessary to appreciate that, whilst resource energy displaces human labour, *money represents a quantification of labour*, be that labour present or future, and be it human-based or exogenous energy. Debt, meanwhile, is a claim on future money. This means that *debt is a claim on future energy*, be that energy human labour or exogenous inputs.

What this in turn means is that *energy availability underpins the entirety of the financial system*. Even if resources remain volumetrically substantial, movement towards the 'energy cliff' represented by declining energy returns could have a seriously deleterious effect on future economic performance. This is so important that we have anticipated here a second chart from Issue Four, demonstrating the nature of the EROEI 'cliff' (fig. 2).

Whilst we do not, then, believe that depletion-based 'Peak Oil' is likely to be reached for some years yet, we do, very strongly, believe in the concept of 'resource constraint'. Resource constraint can be described as a situation in which deliverability becomes pressured, the ability to increase energy supplies becomes restricted, and costs (and, hence, prices) rise very significantly.

Some countries (such as China) are keenly aware of this process, and are accustomed to seeing the world in competitive terms. The accumulation of resource ownership by these

Fig. 2: The energy cliff



countries not only guarantees their future access to resources, but can also deny such access to others. Where global resource distribution and access is concerned, the hard-headed and far-sighted strategies pursued by China and others are in the starkest possible contrast to the woolly, short-term and non-strategic thinking adopted by many other countries. In particular, the assumption – implicit in the Anglo-American economic model – that market forces alone will ensure continued resource access is both naïve and dangerously misguided.

Resource accumulation by China (and others) is likely to accelerate, not least because such countries see compelling reasons for converting their dollar reserves into physical assets. This process is likely to be accelerated by a recognition that, in the longer term, the status of the dollar as the global reserve currency may not be tenable.

2. the environment – the road from Copenhagen

Being, famously, the city of fairy stories, Copenhagen was an appropriate venue for a global environmental conference from which far too much was expected. From an environmental point of view, the conference actually yielded some positives, at least in the sense that both China and America were fully engaged. It is almost impossible to imagine that the Bush administration could have delivered the positive engagement offered by Mr Obama, and it was equally notable that China did not use the Copenhagen conference as the pretext for a lecture on the wickedness of western capitalism. (It must have been sorely tempting).

Commenting on the validity or otherwise of global warming concerns is outside our remit. From an investment perspective, the issues that matter are that scientific opinion overwhelmingly (though by no means unanimously) backs the global warming argument; that governments are likely to act on this basis; and that the environmental issue has undoubted financial implications. These implications fall into two categories – resource transfer, and taxation – and it would be prudent to assume that these two issues will converge over time.

The resource transfer issue involves a series of linked propositions. The first is that, if past human activity has indeed created global warming, then the responsibility for that warming logically rests with the developed economies. Second, and again on the premise of man-made global warming, it is imperative that emerging economies do not follow the same route to development. Third, and also within this premise, emerging countries, rather than following the historic development model, need to be compensated or, to put it more positively, assisted in the pursuit of a minimally-polluting route to development.

Therefore, campaigners have postulated (and most governments have, at least in principle, accepted) the need to create a mechanism for the transfer of funds from the developed to the emerging world. The issues, of course, are of scale, of timing and of mechanism. Investors should assume that funds transfers from the developed to the emerging world are a probable feature of any future environmental accord.

Second, it should also be assumed that taxation will become increasingly environment-related. If there is anything that most politicians like more than taxation, it is taxation with a seemingly-moral dimension. For example, it is one thing to raise fuel duties in order to increase government revenue, but quite another to do so in order to "save the planet".

In most developed economies, taxation has long had a moral or quasi-moral dimension. Thus, alcohol and tobacco are taxed on grounds of health rather than of revenue, whilst 'progressive' taxation is preferred, even when it is fiscally inefficient, because it pursues the supposedly moral aim of transferring resources from the rich to the poor. It is not our intention to comment here on the often spurious nature of these 'moral' cases for taxation, though this debate will doubtless recur in future *Strategy Insights* reports. For now, it is sufficient to note that policymakers are likely to leap with glad cries upon taxes which can be levied on the moral platform of "saving the planet".

Investors should, then, factor both resource transfer and environmental taxes into their composite view of the future. Furthermore, it is likely that these issues will be linked, with some of the proceeds of 'green' taxes (and of carbon permit issuance) being channelled into the transfer of resources to the developing world.

It is likely – and it may, indeed, be desirable – that policymakers will try to channel the fiscal and transfer process to national advantage. America (for instance) seems to be waking up to the scale of new business opportunities that are likely to result from enhanced environmental awareness. Therefore, the proceeds of green taxes might be transferred to emerging countries with 'strings' attached in terms of, for example, obligations to purchase American technology. The greatest stumbling-block to progress on resource transfer is likely to lie in an inability to co-ordinate the process on a global basis. This leads us to believe that there may be a role for the WTO (World Trade Organisation) within the resource transfer process.

3. changing the model

In the fierce heat of the financial crisis, it became logical to wonder whether the flirtation with catastrophe had fatally undermined the long-standing Anglo-American economic model (which is sometimes also referred to as *laissez-faire*, 'the market economy' or 'the Washington consensus').

It is easy to argue that the crisis attached a 'sell-by date' to the Anglo-American economic model, but it is much harder to predict what might replace it. Many critics believe that the undermining of the Anglo-American model will usher in a return to the earlier Keynesian consensus which, they argue, delivered stability and prosperity in the three decades after the Second World War.

We, however, believe that a 'return to Keynesianism' is very unlikely. For a start, the post-war decades were very far from being the Keynesian utopia that they are often presented as. It is at least arguable that monetary stability (under the Bretton Woods system) was far more important than Keynesian management, and that the 'halcyon days' of the post-war era really came to an end when Richard Nixon 'slammed the gold window' by ending dollar convertibility in 1971.

This, and the oil crises of the 1970s, dragged the world into an economic mess in which the Keynesian consensus was fatally undermined, thereby clearing the way for a new orthodoxy. Anyone who looks back fondly to, say, the pre-Thatcher era in Britain, ought to consider the "winter of discontent" in which organised labour brought the economy to a stand-still whilst excessive public spending had already taken government finances to the brink of collapse. Much the same was happening elsewhere in the world, albeit to a lesser extent.

More fundamentally, and whilst economic and political orthodoxy has always developed in episodic fashion, we can think of few (if any) instances in which the overthrow of an economic or a political system has resulted in a reversion *in toto* to a previous orthodoxy. The emergence of a new consensus thus seems far more likely. But what is this new consensus likely to be?

To grasp this, we need to understand the process by which new economic orthodoxies come into being. Essentially, two processes are involved. One of these is the practical failure of the old economic orthodoxy, and the other is the capture, by a new ideology, of the commanding heights of the intellectual, cultural and political debate.

British writer Paul Mason has ably chronicled the process by which the Anglo-American model succeeded Keynesianism from the 1970s.[8] Economic ideas originally propounded by Hayek and Freidman were by no means new in the 1970s, but the free market model received its opportunity because, by the middle of that decade, the existing orthodoxy was palpably failing. What was needed, then, was a combination of (a) new ideas, and (b) the evident failure of the previous orthodoxy.

Where the Anglo-American model is concerned, evidence of failure is surely abundant, and has been examined and described by many able and respected commentators. Indeed, some observers actually *predicted* this outcome, perhaps most notably John Gray in his *False Dawn: The Delusions of Global Capitalism*, a remarkably prescient work first published in 1998.[9]

[8] *Meltdown: The End of the Age of Greed*, Paul Mason, 2009
[9] *False Dawn: The Delusions of Global Capitalism*, John Gray, 1998 and 2009

More importantly, the necessary second element – public disenchantment with the existing orthodoxy – has now arrived. This disenchantment is most evident in the public opprobrium heaped upon bankers. Whilst over-paid (and, often, incredibly insensitive) bank executives are an easy and obvious target for this wrath, our view is that bankers were, essentially, bit-players in a fundamentally flawed system. Beyond public vilification (be it of bankers or of politicians), what is needed is a recognition of the failures of the model.

The term 'Anglo-American model' is, like all such labels, necessarily vague, but what it describes is a free-market orthodoxy which is usually traced back to Thatcherism in Britain and Reaganomics in the United States. The fundamental tenet of this orthodoxy is that unencumbered markets are the best generators of wealth and, more controversially, of well-being and of harmony.

In the 1970s, this idea was by no means a novel one. It is arguable (though by no means wholly convincingly so) that this thesis can be traced all the way back to Adam Smith's "invisible hand" (which free marketeers like to contrast with the 'dead hand' of the state). Britain operated a remarkably free-market economic system between, very approximately, 1835 and 1870. Though monopoly capitalism was an increasing problem, it is nevertheless a reasonable generalisation to say that free market economics continued to dominate the global system between 1870 and 1914. The latter period was an era in which international capital and trade flows expanded remarkably, to the point where many believed that the economic interdependence of nations rendered war impossible.[10]

Although the interdependence illusion was shattered in August 1914, the belief of many policymakers was that the aim, in the aftermath of the First World War, should be a return to something that Winston Churchill had described as "business as usual".[11] In Britain, the public seem to have been far from wholly convinced about this – and Labour's share of the vote increased dramatically, to 22% from 7%, at the 1918 general election – but, political undercurrents notwithstanding, the British economy, like that of America, remained remarkably pre-war in structure until the Great Depression struck after September 1929.

There was no such desire for "business as usual" in the aftermath of the Second World War. On the one hand, memories of the 1930s were too bitter and, on the other, it was widely believed that the state tools which had won the war could similarly be harnessed to 'win the peace'. Even before the war was over, the fundamental architecture of the post-war economy had been established at the Bretton Woods conference in 1944. The Bretton Woods system, combined with the highly interventionist Marshall Plan, established the framework for an essentially Keynesian economic orthodoxy that was to prevail until the arrival of free-market fundamentalism in the 1970s.

[10] See *The Ascent of Money*, Niall Ferguson, 2009

[11] Churchill actually said this on 9th November 1914, signifying an intention that the British way of life should not succumb to the exigencies of war

4. a matter of choices

This historical digression has been necessary in order to explain that the Anglo-American free-market model is by no means the natural economic order of things. It is critically important to note that all economic frameworks are, ultimately, a result of political choice. Free market orthodoxy, as it prevailed in Britain in the 1835-1870 period, was not, as some have argued, a 'natural' state of economic affairs. Rather, it resulted from political decisions taken by the 'middle class Parliaments' which governed Britain between the First (1832) and Second (1867) Reform Acts. One of the most able opponents of franchise extension, Robert Lowe, used the importance of free market economics as part of his opposition rhetoric, arguing that a more democratic franchise would pave the way for interventionism.[12]

In his prescient analysis, John Gray argued that free market economics are inconsistent with democratic government,[13] where the popular impetus is instinctively towards intervention. If this is true – and it probably is – then, far from being normality, the ascendancy of the Anglo-American free market model since the 1970s has been the largely accidental outcome of the crises of the 1970s.

By gaining ascendancy in the US, the free market model then became a global paradigm because of US influence over institutions such as the World Bank and the IMF. (This influence led to the Anglo-American model being dubbed "the Washington consensus"). Though in part political, this influence owed at least as much to the status of the dollar as the global reserve currency.

This reserve status, once natural and obvious, is becoming ever more anomalous, for three reasons. First, when the dollar was established as the global reserve currency, the US accounted for a far higher proportion of the global economy than it does today. Second, America has long since ceased to be a creditor economy, and it is at least arguable that the currency of a heavily indebted nation is unsuited to the global reserve role.

Third, and perhaps most importantly, the US money supply has expanded exponentially in recent years. The government ceased publishing M3 data during 2006, but independent sources suggest that this broad monetary measure has, since then, expanded by at least 45%, to $15 trillion from $10.3 trillion. Once gold convertibility ended in 1971, the US was always, at least in theory, at liberty to create dollars out of thin air, but recent trends suggest that this has now been done on a scale which threatens major dilution of the value of the dollar.

The continuing status of the dollar as the global reserve currency is, clearly, now open to debate.

With America's economic primacy also under threat, both the ideological and the practical dimensions of the 'Washington consensus' model have been weakened.

This weakening in the credibility of the Anglo-American model reflects two key factors – the first of these is failure, and the second is disenchantment. Where failure is concerned, and put very simply, the more closely economies have pursued the *laissez-faire* Anglo-American economic model, the greater has been the degree of failure exposed by the events of 2008-09. This is a topic to which we shall return shortly. Second, there is an increasing belief – expressed intellectually by writers such as Oliver James,[14] but more emotionally and viscerally by anti-capitalism campaigners – that the ultra-free-market system may be as socially and emotionally damaging as it is economically flawed.

There is, then, very substantial evidence to support the proposition that the Anglo-American model has failed, both practically and ideologically. To understand what might replace it, we need to assess the intrinsic flaws in the model as demonstrated by recent events. But, before doing that, we need to ask this question – is the model itself really flawed, or is it simply that its operation has been bungled?

[12] Robert Lowe, first Viscount Sherbrooke, 1811-92, led Liberal opposition to the Reform Act of 1867
[13] See Gray, op cit
[14] Oliver James, *Affluenza*, 2007

5. systemic failure, or simple bungling?

Given that those countries whose failings have been most ruthlessly exposed by the financial crisis – countries which include the US, the UK, Ireland and Iceland – correlate closely with the application of the Anglo-American model, it is tempting to assume that the model itself has been at fault. But this may be too temptingly simplistic – could it simply be that, perhaps no more than coincidentally, these countries also happen to have been the worst-managed?

This thesis is, superficially at least, persuasive. Let's start with the US. America's economy appears to have been very badly managed by the Bush administration, which inherited a modest budget *surplus* from the out-going Clinton team, yet presided over a massive escalation in government indebtedness. Mr Bush combined tax cuts with the simultaneous conduct of not one but two major wars, a strategy which can, at the very best, be described as fiscally irresponsible. Derivatives – famously described by Warren Buffett as "financial weapons of mass destruction"[15] – proliferated on Bush's watch. During the Bush years, regulators failed to regulate (if indeed they even noticed) both this derivative proliferation and the associated rise of the shadow banking system. Sub-prime, which was to prove both the catalyst and a major cause of the crisis, was a feature of the Bush years. Are America's travails simply the consequence of bad economic management, not just by the Bush administration but also by the Fed? (Alan Greenspan may have noticed "irrational exuberance", but the Fed did precious little about it).

The same question – faulty model, or simple incompetence? – can be posed about the United Kingdom, where the evidence for the 'bungling' thesis is at least as strong as it is in the US. Labour inherited a relatively robust economy in 1997, and seemed determined to distance itself from previous 'tax and spend' Labour administrations by adopting an avowedly pro-business approach characterised by the much-vaunted "light-touch regulation" (which was extensively presented to other countries as an inspired approach to the financial sector). Politically, this was sensible, because Labour had been out of office since the fiscal crises of the 1970s. The guiding idea seems to have been that the financial sector, liberated to prosper, would pay for a new welfare state modelled on "the third way".

The case for 'bungling' – for blaming simple bad management rather than a flawed model – seems pretty strong in the case of the UK. Certainly, huge mistakes were made. The tri-partite regulatory structure – which was introduced in 1997, and which divided supervision between the Bank of England, the Treasury and the FSA[16] – fatally weakened regulation, whilst monetary policy was linked to an inflation definition which wholly ignored the very concept of *asset* inflation.

The subsequent property-driven bubble – and the increases in consumer spending and indebtedness which followed from it – was mistaken for *real* economic growth. Irresponsible lending went unchecked, "light-touch" turned out to mean 'negligent' where regulation was concerned, and no aspect of the Anglo-American model dictates the bungled (because pre-announced) sale of a huge proportion of the nation's gold reserves at the bottom of the price cycle.

[15] 2003 Annual Letter to shareholders of Berkshire Hathaway Inc.

[16] Financial Services Authority

[17] 'The business department said: "We take costs to business seriously and have sought to timetable the introduction of any new measures to avoid extra costs during the recession

In any case, the UK system has been at best a hybrid of the free market model. Whilst "light-touch regulation" accords with the model, massive increases in public spending most certainly do not. The freedom given to financial market participants contrasts starkly with rapid increases in regulation in other parts of business and social life. The government itself quantifies the cost of regulation to businesses at more than £13bn annually.[17] The free market model calls for market-led development, not for the top-down imposition of a new social order based on wholly subjective notions of "fairness".

Much the same thing – that bungling might be a better explanation than a flawed model – might, superficially at least, be said of the reckless expansion of debt obligations in Iceland (where, by late 2008, the very name of the Icelandic Financial Supervisory Authority came to seem surreal), or of Ireland at the height of its almost equally reckless "Celtic tiger" hubris.

Unfortunately, the defence of the Anglo-American economic model on grounds of simple incompetence of execution is, ultimately, flimsy, because *the model enabled this incompetence to take place in the first instance*. One aspect of the model is the ideological belief that government should allow markets to 'get on with it', and that longer-term strategic direction is not required. This was certainly practised in each of the worst affected economies. A belief in market forces underpinned lax regulation both in the UK and in the US. Clear routes to subsequent trouble are discernible in the US before Bush, and in the UK before Brown. The requirement to offer home loans to those manifestly unable to keep up repayments long pre-dated Bush, and there were worrying aspects to the evolution of Britain well before 1997. The slackening (and subsequent abandonment) of the Glass-Steagall regulations on banking separation occurred *before* George Bush was elected in 2000.

If anyone has encapsulated the retrospective recognition of the weakness of the model, it is surely Alan Greenspan, who, in a famous *mea culpa*, admitted in October 2008 that the system had failed, in part because banks had not, as doctrine dictated, acted in the best interests of their shareholders. One has to wonder whether Mr Greenspan (or many other policymakers) had actually heard of "the divorce of ownership from control", which occurred at a very early stage of the industrial revolution, when businesses became too large and too complex to be managed by the people who actually owned them. The clear implication – that managers' interests might not be the same as those of essentially-passive shareholders – alone counselled strongly against a blind and naïve reliance on enlightened self-interest.

but we are also clear that we want a proper balance between work and family life which is good for both employers and business." It said the department was on target to deliver a 25 per cent reduction in administrative burdens by 2010, saving business and third sector organisations £3.4bn'. FT on-line, 19th November 2009

6. a better model – renaissance from Europe?

In stark contrast to the failed Anglo-American model, the European variant of capitalism looks far more effective when seen through the prism of recent hindsight, and may represent the model which is likely to be adopted in the future. Though free-market in principle, the European system is markedly different from the Anglo-American model. Companies in important sectors are governed less through the anonymity of the equity markets than through a strategic approach which recognises both the ownership-control divorce and a need for planning which goes beyond the next quarter's EPS figures.

Credit is controlled in a much more hands-on way than it has been in the US or the UK. Governments openly covet national champions in strategic industries (which is why neither the French electricity industry nor Spanish airports could ever have become British-owned). Governments are far more accustomed to looking ahead where key strategic issues (such as the security of energy supply) are concerned.

The European system cannot be regarded as a throwback to Keynesianism, not least because deficit financing is restricted by the Maastricht treaty, which contains specific clauses to limit fiscal deficits to a maximum of 3% of GDP. Far from being Keynesian, this is simply prudent, as is the emphasis on keeping control of strategically important industries. This prudence still needs to be learned in countries such as the UK, where quantitative easing is, in our judgement, being used for the back-door monetisation of government deficits. Past lectures on "light-touch regulation" and free market economics, periodically given by Britain to her European partners, simply add some piquancy to a situation in which the Anglo-American model has been extensively discredited, and is likely to be succeeded by something much closer to the continental European model.

Prudence is reinforced by the recognised independence of the European Central Bank (ECB). Despite the modest degree of autonomy exercised by the Fed in America and by Britain's Bank of England, both, ultimately, are perceived as serving the interests of a single government, and both have been prepared to use quantitative easing to dilute the currency in response to short-term national problems. The collegiate nature of the ECB – and the recognised problems which attend a 'one-size-fits-all' monetary policy – are sometimes portrayed as paralysing ECB activity, but the end result is a welcome conservatism. Europe has a significant problem – described later in this report as an 'OLOP economy' – but the collegiate nature of the ECB is a valuable attribute.

So if investors wish to look ahead to the next orthodoxy, they could do worse than study the European social model. They should expect more hands-on management of important industries, tougher regulation, tighter banking control, more central bank independence, and tighter credit management.

What is “the European social model”? The European Trade Union Confederation defines it as follows:

“The European Social Model is a vision of society that combines sustainable economic growth with ever-improving living and working conditions. This implies full employment, good quality jobs, equal opportunities, social protection for all, social inclusion, and involving citizens in the decisions that affect them. In the ETUC’s view, social dialogue, collective bargaining and workers’ protection are crucial factors in promoting innovation, productivity and competitiveness. This is what distinguishes Europe, where post-war social progress has matched economic growth, from the US model, where small numbers of individuals have benefited at the expense of the majority. Europe must continue to sustain this social model as an example for other countries around the world”.[18]

Obviously, there is a great deal more to it than this. In contrast to the Anglo-American model, European governments pursue a more hands-on, strategic and interventionist economic approach. There are several variants of the model, with differing emphases, practised in the Nordic, Mediterranean and Central regions of the continent. In stark contrast to the UK, countries following this model tend to be far less centralised, with significant powers devolved to regional governments.

The system is not without its faults, and sustainability may be an issue given the economic challenges identified elsewhere in this survey. But the model contains comparatively little that would jar with those emerging countries which strongly dislike the Anglo-American model. So the European model is a philosophy which stands a decent chance of eventual adoption, obviously in much-modified form, by countries (such as China, Brazil, India and Russia) which would never conceivably have accepted the Anglo-American model, even had that model not so comprehensively self-destructed in 2008-09.

[18] European Trade Union Confederation, http://www.etuc.org/a/111

7. towards practical banking

In a forthcoming report, we shall explain our view that the ultimate destination of the regulatory reform process is the re-imposition of a separation between commercial and investment banking along the lines of the Glass-Steagall Act.[19] At present, and most notably in the US and the UK, taxpayer guarantees, intended to underpin the economically-vital commercial banking system, are being used to under-write investment activities which have been described as "socially useless".[20]

We are very sceptical about definitions of social utility – which, ultimately, are subjective – but we certainly believe that the use of taxpayer guarantees to support investment banking activities is inappropriate. At present, governments are largely relying instead on the 'one-trick pony' of capital adequacy, but we are convinced that nothing short of complete separation will suffice, though this lesson may not be learned without the catharsis of another crisis.

Fundamentally, we believe that the most effective allocation of capital requires minimal interference with the functioning of free markets. Accordingly, we are not in favour of *ad hoc* restrictions on the activities of investment banks, which should be free to innovate, and to undertake whatever activities they see fit. But free market logic also dictates that they should be equally free to fail, which manifestly is not the case whilst they are backed by a taxpayer guarantee designed to protect the economically-vital commercial banking system. For this reason, we favour the re-introduction of a modernised version of Glass-Steagall separation, whilst also acknowledging the merits of ideas such as Limited Purpose Banking (LPB), as proposed by Niall Ferguson.[21]

Ultimately, one of most serious flaws in the global financial system is that a bubble-forming *mechanism* has become in-built. Bubbles are by no means a new phenomenon – they have occurred throughout financial history – but a new (and alarming) feature of the economy in recent years has been the way in which bubbles have become *sequential*. This issue is of such importance that it will be addressed in much greater detail in Issue Three. Essentially, the sequential occurrence of bubbles in a string of asset classes (such as dotcoms, real estate, derivatives and commodities) suggests that a systemic weakness, rather than simple human folly, has been in play.

Whilst re-implementing some form of Glass-Steagall separation is our preferred response, another possibility is a restructuring of the way in which banks are taxed. America's FCRF, though retroactive in its declared aim of recovering the taxpayer cost of the TARP intervention, is nonetheless a useful contribution to the forward-looking debate on financial sector regulation. The core logic is that banks should pay for the hitherto-free 'insurance policy' provided by governments which, in the last analysis, cannot stand back and watch the commercial banking system collapse. Whilst not a solution to the bubble-prone nature of the financial system, the 0.15% asset fee levied by the FCRF on all banks whose assets exceed $50bn looks a better idea than a "Tobin tax" on financial transactions.[22]

Mr Obama has followed his FCRF proposal with a new initiative which, if implemented, would limit the overall size of banks whilst preventing them from using equity capital in activities such as hedge fund finance, private equity and proprietary trading. Whilst falling a long way short of complete separation along Glass-Steagall lines, this initiative could represent a movement in that direction, and a retreat from a policy which had hitherto rested almost entirely upon capital adequacy.

[19] This will be discussed in greater detail in Tullett Prebon Strategy Insights Issue Three – *Forever Blowing Bubbles*

[20] See *Prospect*, September 2009

At this stage, Mr Obama's proposals are just that – proposals – and, before they can become law, are likely to encounter intensive lobbying opposition and a tough fight in Congress, particularly after the Democrats' shock loss of the late Edward Kennedy's Massachusetts Senate seat. Bankers' criticisms of the Obama plan have been intense, and have included the accusation that the President is playing the populist card (something which would be hardly unusual in a democracy). It has been argued that the proposals are over-complicated, because they attempt to impose black-and-white definitions into areas that are necessarily composed of shades of grey. Our belief remains that outright separation between 'utility' and investment banking is both (a) desirable, and (b) the ultimate end-game of the regulatory reform process.

Together, FCRF and the Obama bank reforms comprise a much more comprehensive and hands-on approach to banking regulation. Part at least of this initiative might be emulated in other countries, most notably in the UK, where the opposition Conservatives have, since July 2009, been advocating something not dissimilar in principle. For the UK, some form of banking tax might also look like a windfall answer to one of the worst deficits in the developed world. Moreover, the UK seems to look at these issues through a moralistic prism which has already led to the imposition of a tax on banking bonuses which even the government itself believed at the time was unlikely to realise serious income for the Treasury's depleted coffers. But will Mr Obama's ideas be welcomed by other major players?

On the whole, we doubt it. Britain's European partners might look sympathetically at some aspects of the Obama initiative, but the stumbling-block is likely to be the European preference for a more informal approach to regulation. Other countries are even less likely to follow the Obama route. China, for instance, would simply argue that it is has a better regulatory regime than the US or the UK anyway. Much the same response is likely from other Asia-Pacific countries and from India, not least because the Asian financial centres are the biggest potential beneficiaries should western financial services industries decide to relocate part of their activities.

In any case, nothing yet proposed provides a complete answer to the debt spirals which have fuelled the succession of bubbles which have blighted the global financial system over the last decade. Ultimately, separation along Glass-Steagall lines seems imperative. Before that happens, however, piecemeal reforms – involving more pro-active regulation – seem likely.

The worst of the bubbles have concerned real estate, so this is where, in our analysis, reform needs to start. Here, moreover, individual governments can act without causing themselves too much competitive detriment. Again, European best practice provides a guide to the type of checks that are required. Essentially, governments need to impose limits on price/earnings multiples and loan-to-value (LTV) ratios in mortgage issuance. Taking the UK as an example, had the time-honoured formula (an earnings multiple of 3.0x and a maximum LTV of 85%) been retained, the disastrous bubble in notional value[23] would not have taken place, huge wholesale borrowings would not have been sucked in from overseas, and a debt-fuelled illusory boom would not have led government into a deficit spiral built on wholly unsustainable levels of public spending.

[21] See niallferguson.com, 15th December 2009

[22] So called because it was first suggested in 1972 by American economist James Tobin (1918-2002)

[23] The important concept of *notional value* will be explained in a forthcoming report on the state of the UK

8. global solutions, fractured world

A number of common threads run across many of the issues addressed so far, but perhaps the most important of these threads is the need for global co-ordination. Financially, for example, the essential re-imposition of Glass-Steagall-type separation can work much more effectively if it is implemented in many countries rather than in a small number. More broadly, responses to environmental issues obviously need to be co-ordinated because, if they are not, they will be easy to evade. The same will apply to resource management if, as we strongly believe, the energy returns equation is set to deteriorate.

Yet co-operation on the required scale looks to us most unlikely, because of the big structural tilts that are taking place now, and are likely to continue in the future. The global sway of the G7 countries is clearly in decline, the future viability of the reserve status of the dollar is obviously questionable, and at least one major western economy (the UK) is in very deep trouble.

On the other hand, several of the BRIC[24] countries have more problems than is generally recognised. China, for instance, is uncomfortably exposed to the dollar (though conversion of dollar holdings into physical assets seems likely to be a major future trend). China's savings ratio is too high, and the development of domestic demand will be a challenge in a world in which China's customers struggle to wean themselves off a dangerous cycle of debt-fuelled consumption. Russia has problems of her own, not least the rate of decline in the Russian population. We are not the first to observe that Brazil – with vast agricultural (and water) resources, a young population, and huge offshore oil discoveries – looks to be extremely well-positioned where future economic trends are concerned.

But the biggest challenges are political and structural rather than financial. Hitherto, globalisation was widely assumed to mean a free trade system based on 'the Washington consensus'. Under this arrangement, western corporations could out-source their activities to cheaper and more efficient locations, whilst emerging countries would benefit from inward investment. In fact, what actually happened was that western consumption was funded by Asian savings, creating an ever-greater global imbalance between trade and capital flows. The underpinning logic of the Anglo-American model has, in any case, fractured.

With the economic and political clout of America and Europe waning, other countries are becoming more assertive. If our expectation of 'resource constraint' proves to be correct, the almost inevitable implication is greater competition for resource access. China seems to have been ahead of the game in anticipating this and, if we were prepared to venture one hard-and-fast geopolitical forecast here, it would be that China will strain every sinew to create a blue-water navy strong enough to protect her essential trading interests. In short – and especially in the context of forthcoming 'resource constraint' – the world looks set to become more competitive rather than more co-operative.

9. divergent paths

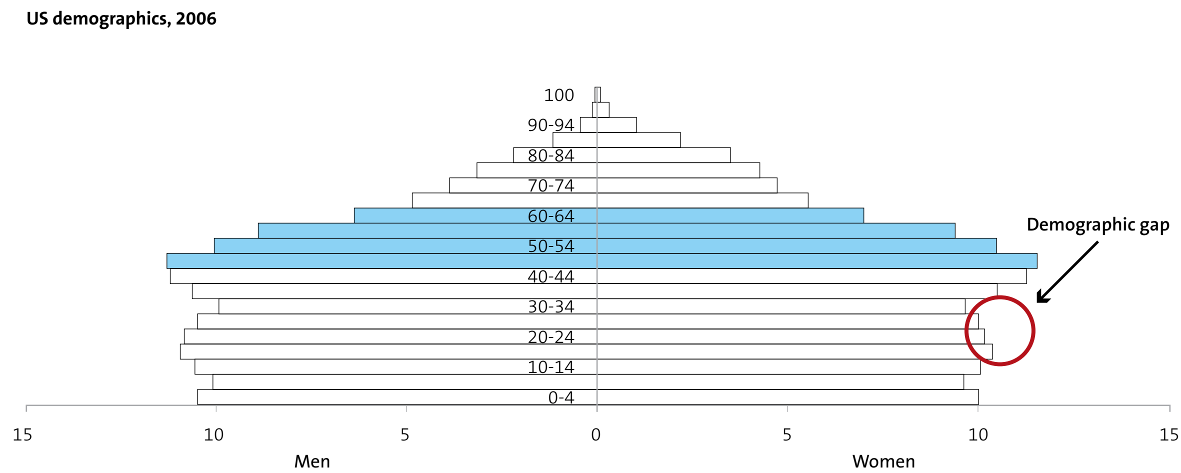
At the beginning of this analysis, we pointed out that short-term crises do not eliminate underlying trends, even if theses trends become temporarily masked. One of the biggest global trends – the shift of economic and political influence from west to east – has actually *accelerated* as a result of the crisis, because at least two leading western economies (the UK and the US) have been very badly damaged by the fall-out from the spending-and-borrowing binge that was the route cause of the events of 2008-09.

What, then, is the outlook for individual economies? In what can only be the briefest of surveys, we start by observing that the recession in America has been very different in nature from previous recessions, so past history is a limited guide to future prospects. Most previous American recessions have been characterised by inventory downsizing, but, in stark contrast to this, the latest downturn has been *a de-leveraging recession*.

Total US consumer debt is now declining briskly, for the first time since the Second World War, whilst the availability of credit card debt is shrinking rapidly in the face of very high levels of default. Residential delinquencies have risen sharply, in part reflecting a level of unemployment which, when discouraged workers are included, is arguably around 17%[25] rather than the officially-reported 10%. Even if the economy continues to recover, job creation may not keep pace with growth in the size of the workforce.

Though official publication of M3 money supply data ceased in 2006, unofficial sources suggest that this measure of broad money has risen by more than 40% since then. Even on the administration's own numbers, high federal deficits are likely to persist through the coming decade.

Fig. 3: The US demographics gap, 2006*



*Source of data: U.S. Census Bureau

And America faces another major threat as the boomer generation retires. This problem is set out in fig. 3, in which the population is divided into five-yearly age increments. The striking features of this chart are the baby-boom bulge – now nearing retirement – and the 'demographic gap' behind. This has two implications – one obvious, one less so – and neither is positive.

The obvious implication is that the ratio of workers to retirees is poised to worsen. In the post-War years, each American retiree was supported by seven workers. This number, currently about five, could decline to three within the next two decades. This ratio may simply be too small to function effectively, particularly given the extent of debt to be carried by younger and future generations.

The more subtle implication of the demographic gap concerns wealth. The baby boomer generation, collectively, has very substantial wealth, but most of this takes the form of non-cash assets such as stocks and real estate. As they retire, boomers will need to monetise this wealth by selling it – but *to whom*, if the following demographic groups are not only poorer but fewer in number?

Turning to Europe, most readers will be familiar with the Polo mint, first marketed by British confectioner Rowntree's in 1948. Since 1955, this mint has, famously, had a hole in the middle. The reverse of this – 'OLOP' – is an apt description of the European economy, which is characterised by a solid centre ringed by fragile and damaged economies. One such – and the most obvious and longest predictable – is Greece. Others include the UK, Ireland, Iceland, Portugal several countries to the east of the European core, and, at least arguably, Italy and Spain. Ireland has taken action through resolute budgets involving major cuts in public spending. Britain has an urgent need to follow the same path, but will be incapable of doing so until after the forthcoming general election. Iceland faces a long, bleak slog back to even reasonable prosperity. There are issues with the Spanish and Italian economies which might form the subject for future TPSI research.

[25] Bureau of Labour Statistics, definition U6, "total unemployed, plus all marginally attached workers, plus total employed part time for economic reasons, as a percent of the civilian labor force plus all marginally attached workers"

10. emerging trends

Based upon the foregoing assessments, what trends and events should investors be aware of in the coming years?

The first such trend has to be a debt burden – public, corporate and private – which is manageable only on the assumption of sustained economic growth. Since there are reasons why an economic future that is ever bigger than the economic past is *not* a safe assumption, we suspect that the debt burden, or, rather, parts of it, may become unsustainable. In recent months, it has become fashionable to believe that 'sovereign debt is the new sub-prime'. Whilst hopelessly over-generalised, this may yet be an apt prophecy where the countries with the biggest deficits – most notably, the UK and the US – are concerned.

Since governments which own money printing presses are unlikely to go bankrupt *in their own currencies*, the corollary risks must include 'soft default' (where debts are repaid, but in a currency devalued by inflation). Currency weakness poses obvious additional threats in terms of trade balances, interest rates and, above all, inflation. The danger to the US is obvious, and could be crystallised by the dollar's loss of its reserve status, but America does have the elbow-room to address the deficit by increasing a (currently modest) tax-to-GDP ratio. Whether this is politically feasible is a wholly different question, recalling our earlier observation that economic outcomes are, ultimately, matters of choice.

The UK position is worse than that of the US, not least because both tax and spending are higher in relation to GDP, giving much less room for manoeuvre. The jury will be out on this issue until the results of the election are known, but we would caution against the apparent market conviction that the Conservatives will win a workable majority. A quarter of the workforce is employed directly by government, and almost one household in six depends on benefits, so voters who, by abstention, deserted Labour in the May 2009 elections, may return to the party in the general election. The potentially unpleasant outlook for the UK will be the subject of a forthcoming Strategy Insights report.

In the medium and longer term, by far the biggest challenge is likely to be a collision between a string of "dangerous exponentials" – rapid growth in population and in resource usage – with a physically finite world. Some observers believe that an economy which, by its structure, *must* grow, may be heading for a collision with a resource set which, by definition, *cannot* grow.

The energy returns equation is so vital that we shall address it in detail in a future research report. The resource/labour equation, too, may be beginning to change, such that labour becomes cheaper in relation to resources within individual economies. If this happens, it will amount to a sharp reversal of a trend which has moved in precisely the opposite direction for many decades. Its implications would be profound.

There are certainly interesting times ahead.

Dr Tim Morgan
Global Head of Research
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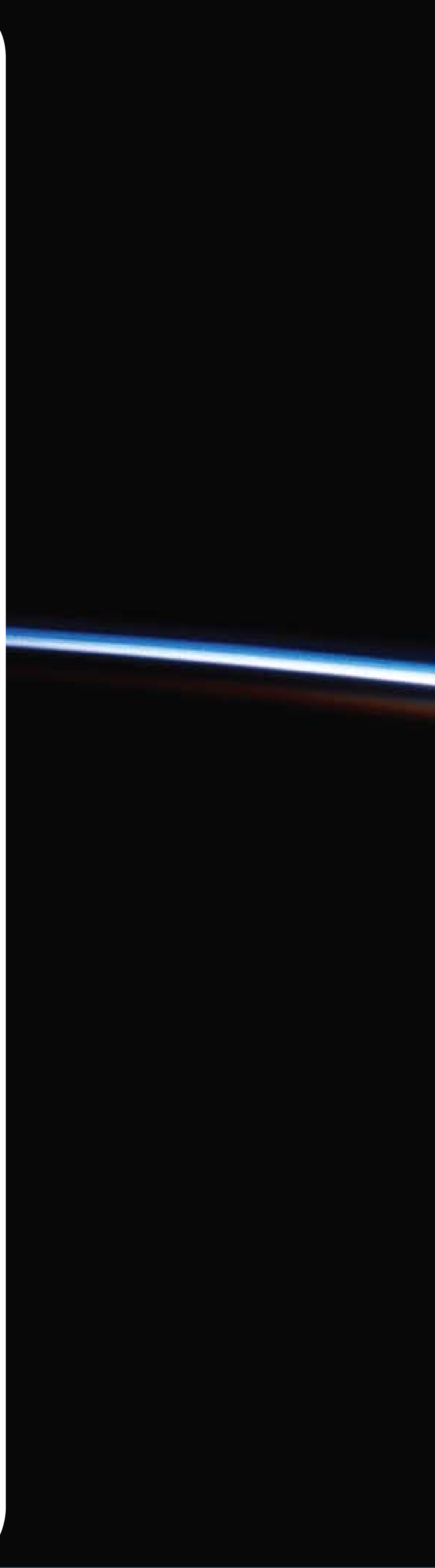

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