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Do Western Societies need an Impairment-Writedown?

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From Subprime to Banks to Sovereign Debt – Dealing with the Crisis: Comparison of Policies and Approaches in the US and EU

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The spoken word prevails!

Ladies and gentlemen

In times when economic axioms are called into doubt, when fundamental questions are being posed and when so many situations have "never been like this before", it's no wonder that the stock exchanges – those excellent indicators of public mood – are wallowing around like a ship that has lost both keel and rudder, and whose sails are in shreds.

When perplexity reigns in the markets, across all institutions and at all levels, this cries out for some effort at explanation. Pictures are sometimes worth a thousand words – if they are the right ones. Let's try. The Russian wildfires of this year provided many images that exemplify "perplexity in the face of overwhelming events": Burning steppes and smouldering tundra; the Kremlin swathed in acrid smoke, and a strangely detached President looking on from afar.

The most striking image of all, though, was that of a volunteer, a young student facing a wall of fire not a hundred yards off, yet armed with just a trickling hose and a shovel. Only the outlines of his face were visible, on account of the clouds of smoke, but they revealed perplexity, hopelessness, resignation and also grief. It's a shattering portrayal of helplessness in the face of the forces unleashed by nature.

So, where are the parallels with the prevailing perplexity in the economic and financial systems; how far does the metaphor work? Firstly, the image of a wildfire seems to be entirely appropriate. In Russia, the fire did not start in one place only; numerous fires broke out across vast areas of the country. This happened because the structural preconditions were in place – after weeks of heatwave and continuing drought, the land itself was dry as tinder. Every individual fire no doubt had its own specific cause. In the overall conflagration, however, these are really of no further interest, no more than the hopeless efforts to contain the fires. They are all futile, given the scale of the overall problem.

There are situations that are simply no longer manageable, even for nuclear powers. The dismissal of regional governors, the deployment of vast numbers of volunteers, the mobilisation of fire brigades and fire-fighting helicopters – these are all to no avail when the heat becomes more unbearable day by day and there seems no end to the drought. Tinder remains tinder. It must be unbearable for an authoritarian country to be dependent on the heavens above – or at least rain falling from them – for relief from disaster.

Tinder remains tinder: This is the heart of our chosen image. In the crisis of 2008/2009, wildfire broke out in the financial system of the Western nations. The flames first erupted in the highly exposed, enormously large, extremely complex and closely interlinked financial institutions. But after such a long period without any danger of fire, they had got rid of their fire-fighting reserves. What first appeared to be a problem for one sector revealed itself in the wake of the crisis as an overwhelming global problem: the tinder of excessive debt was fanned into flame by the heat of the ongoing low-interest-rate policy.

"Excessive debt": what does that mean from an economic perspective? It means that a particular deployment of capital is not matched by any real, feasible project. Real, in the sense that it can reasonably be expected to generate a positive cash-flow that can cover the cost of interest and principal. In the microeconomic context of a company, excessive debt means that it is overextended. If the accumulated liabilities are matched only by worthless assets, the company is insolvent. Insolvency is followed by restructuring, bankruptcy or the finality of liquidation. In all three events, creditors are obliged to write off some of their assets.

In the build-up of excessive debt in the financial system, it was the increasingly unfeasible projects in the American real estate market – state-sponsored homes for the economically challenged – that served as the basis.

On this tinder devoid of intrinsic value, a gigantic structure of largely illusory character emerged: business activity fuelled by lucrative commissions and based on assets of little or no real value. All this activity was endowed with dynamic stability by a central bank renowned for its efforts to ensure so-called systemic security. This was the tenous situation at the start of the financial crisis.

We know the results of the crisis. There has been restructuring – which is to say, write-offs. The figure for the American commercial banks is currently USD 1,200 billion. This represents about half the estimated real damage. With the TARP programme and quantitative easing, a large amount of risk simply found its way into the supposedly safe haven of the state. Without the breathtakingly expensive support of Fannie Mae and Freddie Mac by the US exchequer, far greater write-offs would have been needed. Tinder remains tinder; it's just that now it's state tinder.

Since then, the crisis over Greece and the euro shows that the wildfire has spread to national budgets. The budget situation in Greece is a prime example of a "real but unfeasible project". There seems little probability that Greece will be able to service its high level of debt from its own resources – that is, to manage interest payments, repayments and refinancing. Even after the eurozone rescue package and the far greater emergency parachute for Portugal, Ireland, Spain and Italy, Greek bonds are still trading at prices that indicate the likelihood of debt rescheduling. Now though – for tinder remains tinder – part of the tinder has been shifted from the individual countries to the eurozone itself.

Let us go back to the image of the young Russian volunteer facing the sea of flames. The problem is not the presence or absence of water to extinguish the fire. The problem is the incalculably large area of land threatened by the fire; the excessive amount of tinder that makes every attempt to contain individual fires seem hopeless.

In our comparison, I have defined "tinder" as the excessive debt that was created in the developed nations through the financial crisis and its consequences.

But this perspective – ultimately an accounting one – may be too limited. The real problem is not the shortfall, expressed in dollars, euros or yen. These are at most the visible symptoms of a much more fundamental structural problem. The underlying structural problem of developed social systems lies in the extraordinarily extensive claims and entitlements they must maintain. In most systems, old-age pensions, healthcare and redistributions are being counterbalanced by increasingly few feasible real projects. Among other things, this relates, particularly when we think of Japan and Europe, to the inevitable decline in the number of young people who could carry out such real projects. The effects of the demographic challenge on the existing social systems are half-way understood, but, unattractive as they are to the current electorate, they are having far too little impact on everyday politics. The tinder of excessive debt is being built up, slowly, year by year, layer on layer. The mechanisms of democracy are not in a position to master the asymmetry between short-term political realism and the demands of long-term sustainability.

Going beyond the demographic problem, the developed social systems, including the USA's, also seem to be generally overwhelmed by the task of managing all the various claims and entitlements. For over 30 years now, the political sociologists have been pointing out the defect inherent in democratic decision-making mechanisms – that the benefit derived from lobbying for specific advantages far exceeds the costs incurred for the tax-paying collective. When state institutions conceal these costs by taking on more debt, and when it is also possible to keep the cost of interest on these debts artificially low, then there is great danger that the result will be a practically irreversible downward spiral into yet more debt.

It seems to me that the financial crisis and the euro-crisis have revealed this problem, to some extent at least. It is no coincidence that the risk premiums for state debt, observable in the Credit Default Swaps, are, for the first time in history, higher than those for corporate debt.

Unease at a situation can hardly be more effectively expressed than through the prices paid in the market. To this extent, what we see here is an explicitly expressed unease. More important to me, though, is the hidden, implicit unease – in other words, the general sense of misgiving and uncertainty, particularly in the West. In my view, this is what lies behind the rising rate of savings in the USA, despite all the efforts to stimulate consumption. Moreover, it lies behind the low level of credit provided by the banks; it lies behind the sluggish private-equity situation; it lies behind the inability, on both sides of the Atlantic, to get on top of the unemployment situation. The perplexity in the markets becomes a good deal more explicable if we include the variable of "general unease" in the equation. More and more citizens, business people, and investors can't help feeling that things can no longer work out right. Our social and economic system has become so large and so complex that it defeats its own ends; the whole problem is so large and so complex that ultimately failure is inevitable. Or, in terms of the metaphor, there is far too much tinder, and it is far too widely spread.

The management of this build-up of tinder is what is known as "system stability". This concept has developed into an apparently unlimited free pass for the contravention of principles and guidelines, almost as pernicious as the "public interest" or "raison d'état" of days gone by. Let us consider a few examples. When the Swiss Confederation maintains a big bank in its original structure, instead of putting it through an orderly restructuring process, when this same Swiss Confederation allows its banking secrecy laws to be broken retroactively in full disregard of due legal process; when the European Union first saves Greece from bankruptcy and then organises a bail-out for other affected member countries in explicit contravention of legislation passed for precisely this situation; when the American government directly subsidises individual businesses via the "Recovery Act"; this all is being done in the name of system stability. It has become a free pass for the expansion and delivery of further, ever more exorbitant individual claims and entitlements.

There are of course, some proponents – apparently academic – of such unconstrained claims management. Take, for example, J. K. Galbraith: On the limits of state stimulation, he remarked, and I quote: "… there is no operational limit. The federal government can, and does, spend what it wants" *unquote*. Casual creation of debt simply reflects energetic saving by others at home and abroad. As to what the expenditure is used for – for real, feasible projects, or actually not, as the money ends up being socially redistributed or in misinvestments – on this, the professor from Austin, Texas has nothing to say. In Europe too, there are a large number of advocates of activist state economic policy. They all make the same mistake. They believe that a large collective is in a position to meet and manage claims, entitlements and activities in an effective fashion. They refuse to see that the planned-economy misconception has resulted in the extensive accumulation of tinder. With increasingly desperate and interventionist actions, they keep attempting to put out individual fires, and in doing so fuel the system with further supplies of tinder.

The final, and most important link in maintaining system stability in such economies is the central banks. And since the financial crisis they have – along with many commercial banks – either been nationalised or are in a state of extensive regulatory and economic dependency on the state. With low interest rates and the financing of state debt via their balance sheets, the central banks ensure that stability is not only talked into being, but is genuinely brought into existence. The over-indebted developed nations and communities of states need the low interest rates and "quantitative easing" to prevent the fact that it is all tinder from becoming glaringly obvious. In the name of system stability, the central banks have largely forfeited their independence. They, and the big commercial banks, have degenerated into aiders and abettors of excessive debt – they have become suppliers of tinder.

The problem is that every step in this direction generates more of what we have described as "general unease": the anxiety that the system in which the developed societies have entangled themselves has become so big, so powerful, so complex and so uncontrollable that it is bound to fail.

This of course raises the question of how it was possible to play this game for so long, and entirely unnoticed – especially by the creditors. Or, put differently, we can ask how long this low-interest period – miserably devoid of returns – can last. The answers are highly relevant for investment activity.

In normal circumstances, that is, when a currency's interest level and external value are closely correlated, this sort of monetary and fiscal policy should have come to an end long ago. The value of the currency concerned would have come under strong pressure to depreciate, high import prices would have fuelled inflation, and interest rates would have had to be raised. But these are not "normal circumstances". Rather, a sort of lowest-interest-rate cartel has come into being, led by the US dollar, yen and euro.

This provides the over-indebted societies with the necessary liquidity. The other global trading currencies are not relevant enough to be able to challenge this monopolistic equilibrium. And the only ones who might, as creditors, be able to rock the boat are the Chinese. Yet they have little interest, due to their own dependence on export activity, in changing this situation at all.

The long-term consequences for the developed world could hardly be more negative. The "general unease" at the excessive size and complexity of the system is threatening the depth of value-added and the capacity for innovation in the West. Core processes and research and development – once closely guarded business and production secrets – are being transferred to countries characterised by confidence and hope. What is being saved by companies on both sides of the Atlantic is being developed in Asia and Latin America.

The economic policies adopted by the developed nations are causing the centre of gravity to shift more rapidly towards the emerging economies of the world. What will be left will be geriatrics.

This might sound a bit exaggerated, too negative, too bleak a picture. On the other hand, we can argue that it is equally bold to assume that these highly complex, highly indebted, enormously large, and ultimately self-paralysing social systems have any chance of survival. It seems strange that intellectual circles in particular find it hard to think in terms of structural hiatuses. In a recent collection of essays on Switzerland's relationship to Europe by the Swiss think-tank Avenir Suisse, the possibility that Europe could come apart as a result of the crisis is only considered in passing. Concerns that the financial crisis might trigger "compulsion or collapse" in Europe finds little reflection. Is it intellectually honest to deliberately avoid thinking the "impossible", or even the merely politically incorrect? Can recommendations based on such a blinkered perspective have any strategic relevance?

The social systems of the developed world have become too big and too complex not to fail. The only government in the Western world that has understood both the problem and its urgency is the British. The programme that David Cameron, the Liberal Democrats and the Chancellor of the Exchequer have put together deserves our attention. Firstly, the savings targets are extremely challenging: the budget deficit is to be reduced from 11 percent of GDP to 2.1 percent by 2014. But the structural proposals are still more important. Cameron is striving for decentralisation, because the central decision-making bodies have got themselves into a state of highly complex inefficiency. The ideas and the programme of the new British government go beyond those of Margaret Thatcher. They turn the assumption that difficult questions can only be solved by higher-order bodies literally upside down.

But one English swallow does not make a summer, and the government has to survive long enough to achieve success. Nevertheless, when we consider the enormous influence of Thatcherism on Europe and the USA – nowadays dismissed as "neoliberalism" – then it is conceivable that the British reversion to discipline and decentralisation might develop into a zeitgeist that renounces the love of scale and complexity. The opposite of too big and too complex not to fail is small, flexible, efficient, private and individual.