tullett prebon

armageddon usa?

america at the crossroads

Dr Tim Morgan Global Head of Research

strategy insights | issue eight


REGULAR
CARS
Sorry WE'RE
CLOSED

tullett prebon

armageddon usa?

america at the crossroads

contents

> "The US and China are carrying out competition unprecedented in history. The US must realize that it cannot stop the rise of China"
>
> The *Global Times*, 6th January 2012[1]

[1] http://www.globaltimes.cn/NEWS/tabid/99/ID/691074/Pentagon-plan-changes-game-in-Asia.aspx

armageddon usa?

america at the crossroads

Commenting on President Obama's new defence strategy, the Chinese newspaper *Global Times* lambasted the new emphasis reportedly being placed by the US on South East Asia, and concluded that America "cannot stop the rise of China".

Whilst the rise of China may be subject to caveats, the decline of the US seems undeniable. According to official figures, America is mired in debt and, despite a recent modest upturn, her economic trend growth is lacklustre. The reality, stripped of statistical obfuscation, is even worse than this. Reported federal debt excludes enormous off-balance-sheet quasi-debts. The reported deficit excludes huge annual increments to these obligations. Reported gross domestic product (GDP) includes $2.3 trillion of non-cash "imputed" dollars that do not really exist. Both inflation and unemployment are understated in the official numbers, and the reality may be that the economy has been drifting for a decade.

Why has this happened? The explanations are both foreign and domestic. At home, America is wrestling with the ending of a quarter-century "credit super-cycle". Americans have borrowed, not for productive investment, but to inflate the value of the nation's housing stock. Since houses are non-earning capital sinks, this process has gravely undermined the productiveness of the economy. Capital has been poured into vanity projects and property price escalation whilst America's decaying infrastructure needs at least $2 trillion in restorative investment. Where China's brightest young people study engineering and technology before moving into industry, America's brightest study law before moving into Wall Street.

Abroad, America is the naïve victim of blatantly one-sided globalisation which destroys American jobs whilst racking up ever higher levels of private and government debt. America has bought into the Ricardian logic of "comparative advantage" without realising that this model is predicated on others playing by the rules, and on assumed scope for infinite growth. Today, neither assumption is valid.

In addition to cutting waste, ditching unaffordable federal programmes and owning up about un-payable pension and welfare promises, the United States needs to take immediate action on two fronts. At home, regulation needs to be tightened to prevent the mispricing of risk which underpinned the subprime disaster. Abroad, America needs to get real, and get tough. The US needs to demand the free float of the renminbi, the elimination of all tariff and informal trade barriers, and the cessation of all technology appropriation. If these demands are not met, Washington should have no compunction about threatening selective default and the introduction of protective tariffs. It is high time that the US woke up to the realities of a one-sided globalisation process which has impoverished America and has resulted in the haemorrhaging of American jobs.

The United States remains the world's most innovative economy, but time is running out.

"The heat is on you. Poised outside this chamber are the denizens of darkness. Those are the groups waiting out there in the temples of this city, waiting to shred this baby to bits."

Former Senator (R) Alan Simpson[2]

[2] Talking about the Federal deficit, December 2010. http://www.bbc.co.uk/blogs/thereporters/markmardell/2010/12/simpson_slaps_washington_with.html

introduction

powers of darkness

Commenting on the new defence strategy outlined on January 5th by Barack Obama, the Chinese newspaper *Global Times* lambasted the new emphasis reportedly being placed by the Pentagon on South East Asia. The newspaper argued that competition between China and America was on a scale "unprecedented in history". It added that China should "strengthen its long-range strike capabilities and put more deterrence on the US". Thwarting US policy on Iran might be seen as a valid tactic, it suggested, concluding that America "cannot stop the rise of China".

The rise of China may be subject to caveats, but the decline of the United States seems undeniable. Three questions need to be addressed:

- ***What*** is the American problem?
- ***Why*** did this happen?
- ***How*** can America respond?

Following the publication of the final report of our *Project Armageddon* analysis of the economic outlook for Britain, it was suggested that we should conduct a similar assessment of the United States. Both countries, it was pointed out, are caught in the same basic high-debt, low-growth trap, and in neither country has government produced wholly credible answers to the gravity of the national economic malaise.

Britain and America have been described as "two countries divided by a common language", and this is particularly true where metaphors are concerned. Where an Englishman procrastinates by "knocking the ball into the long grass", an American "kicks the can down the road".

The idioms may differ, but the meanings coincide. And, be it a cricket ball or a can, procrastination is precisely what the governments of both countries have been doing about their huge economic challenges. In Britain, 2010's change of government has brought at least some resolve to the issue, though time alone will tell whether this resolve will prevail. By contrast, American policymakers seem paralysed.

This lack of action is not for want of warning. In December 2010, former Senator (R) Alan Simpson, co-chairman (with former Clinton chief-of-staff Erskine Bowles) of the President's bi-partisan committee on fiscal responsibility, did not mince his words when he warned the committee that the Federal deficit was a "cadaver [that] will rise from the crypt"

"This is it", continued Sen. Simpson. "No more fun and games. No more smoky mirrors. They [the American people] have wised up. They're mad. They're tired of the bluster and the blather and the ego and the BS that has worked so well for all of us, including me, a master of it. So yes, times have changed."

Simpson was warning the committee, in the starkest possible terms, that the federal deficit which, at an official \$1.4 trillion, equated to 8.9% of America's reported gross domestic product (GDP) in fiscal year (FY) 2010[3], was no longer sustainable. Needless to say, Simpson and Bowles are right. And, equally needless to say, no-one seems to be listening within the American corridors of power.

Beyond political paralysis, one of the reasons for the failure to address America's economic problems is a lack of appreciation of quite how bad those problems really are. Under a process which began in the early 1980s, reporting methodologies have been massaged to the point where the true scale of the economic malaise is masked from most Americans. As this report explains, debt, the deficit, inflation and unemployment are understated, whilst both growth and absolute GDP are flattered, and not to a minor but to a fundamental degree. The first imperative for anyone who wants a comprehensive understanding of the US economic and fiscal situation is to look behind the statistical camouflage.

[3] The American fiscal year ends on 30th September

Even on the reported figures, the situation is bad enough. Critically, the US is at the end of a quarter-century "credit super-cycle" which has seen aggregate debt soar to 358% of GDP, a level which is unprecedented in modern times. Over the last decade, the US has added $5.58 of debt for each $1 of expansion in GDP. To be sure, the US – unlike most other OECD countries – has made some very modest inroads into this debt ratio, but the reduction achieved thus far makes no significant difference to the overall position.

The US, then, is stuck in a high-debt, low-growth economic trap. How did this happen? In part, America's woes reflect a naïve approach to globalisation. The 'comparative advantage' paradigm which underpins economic openness assumes, first, that others play by the rules, and, second, that the scope for expansion is limitless, such that the growth of one country need not be at the expense of another. **Neither assumption is true**. China and others have *not* played by the rules – after all, international competition is not a parlour game – and resource constraints are now demonstrating that the scope for global economic growth is *not* infinite.

But America's woes cannot be blamed wholly, or even primarily, on others. The regulatory climate in the US seems, with hindsight, to have been unduly relaxed during the latter stages of the credit super-cycle. The authorities ignored the starkest possible warnings in supinely allowing the proliferation of instruments which no less a luminary than Warren Buffett had long warned were "weapons of financial mass destruction". The Federal Reserve's default assumption, which was that regulation can be minimised because banks can be trusted to act responsibly in the long-term interests of their shareholders, was breathtakingly naïve. All of this was compounded by allowing low interest rates to drive America into a downwards monetary ratchet.

This report is written from a pro-market perspective, but we cannot but conclude that an excessive reliance on inadequately-regulated markets has compounded many other adverse trends in the American economy. The build-up of debt has reflected a growing consumption recklessness which the authorities have done nothing to counter. Investment has been diverted into capital sinks, most notably property, whilst vanity projects have channelled further capital away from vital infrastructure reconstruction. America's education system produces far too many lawyers and far too few engineers, whilst the cream of the country's young people have been drawn into Wall Street and the law rather than into more economically-productive sectors.

Politicians have allowed America's once-famed capabilities in R&D to be undermined, and have stood by and watched much of the nation's knowledge capital being either appropriated by other countries or, worse still, handed to them on a plate in pursuit of narrow short-term gain. Much of American industry (exemplified by the auto-makers) has followed blind alleys.

And, whilst all of this has been happening, America's political leaders have done......well, nothing constructive about it. George W. Bush somehow managed to believe that he could combine two hugely costly (and, we believe, mistaken) wars with tax-cuts for the very rich whilst not creating a fiscal deficit. He also presided over the build-up of the shadow banking system and the near-fatal undermining of the capital markets, to the point where Congress had to be arm-twisted into handing over $700bn of taxpayers' money to bail out the banking system. It is too early to judge the Obama presidency, but the economy is flat-lining and debt continues to escalate, whilst grid-locks in Congress do not encourage us to believe that resolute and effective action will be taken.

What should that action be? First and foremost, the job of leaders is to lead. The greatest single requirement now is for honesty. Many of America's fiscal promises, such as those on pensions and welfare, are un-payable – certainly without massive tax increases – and it is about time that someone admitted it. The current fiscal deficit is wholly unsustainable, which probably means that both spending cuts *and* tax increases are inevitable if disaster is to be averted. The widespread dislike of government, whilst understandable, rather overlooks a pretty creditable historic record on nationally-led projects, from the TVA[4] to victory in the Second World War and the Apollo programme. There is an urgent need to channel investment into essential infrastructure and away from capital-sinks and vanity projects. There needs to be tougher regulation of the financial markets, including derivatives.

Abroad, **America needs to toughen up**, most notably with regard to China. America is entitled to make a lengthy list of demands and, for the time being, remains strong enough to back these up. America should require a free float for the renminbi, the removal of all tariff and other import barriers, and an immediate and complete cessation of all technology appropriation.

The US has two big sticks which it can threaten to wield. Selective default could hit China where it hurts. China's employment-driven pursuit of volume maximisation over profit is critically dependent on free access to American (and other Western) consumer markets. Protectionism could deal China's leaders a devastating blow, and America should not be afraid to use this as a threat in the national interest. Since globalisation has in any case worked to the detriment of middle America, the US should have no compunction whatsoever about waving a very big stick in pursuit of a fairer deal. For so long as this is not done, America will watch her economic power drain away.

Has the US the leadership, at all levels – federal, congressional, local and corporate – to turn around a truly dire economic situation? It can only be hoped that it has, because the alternative is frightening.

Dr Tim Morgan
Global Head of Research
Tullett Prebon plc

[4] The Tennessee Valley Authority

“Who profits from a low-growth U.S. economy hidden under statistical camouflage[?] Might it be Washington politicos and affluent elites, anxious to mislead voters, coddle the financial markets, and tamp down expensive cost-of-living increases for wages and pensions?”

Kevin Phillips[5]

[5] “Numbers Racket”, *Harper’s* Magazine v.316, n.1896 1st May 2008

part one

what is the American problem?

One of the central challenges identified in this report is that **the United States has been accumulating debts at a rate which now threatens to overwhelm the carrying capacity of the American economy**. At all levels – federal and local government, corporations and individuals – debt has been added at rates which have far exceeded expansion in economic output. Going forward, the fundamental problem lies less in the absolute level of indebtedness, frightening though it is, than in the weaknesses of an economy which looks incapable of generating robust growth.

Though the markets tend to focus on federal (public) indebtedness, the real problem is very much deeper than this. Over the last ten years, whilst federal debt has increased by $6.7 trillion other forms of American indebtedness have risen by an aggregate of $17.8 trillion, lifting the overall total from $29 trillion to $54 trillion (see fig. 1).

Within the total increase in debt over that ten-year period, the federal government has accounted for 27%, and state and local government for a further 7%. Almost two-thirds of the increase in American indebtedness has been accounted for by banks, by businesses and by individuals. American debt is not, then, a purely government phenomenon. Borrowing has become the new American way of life.

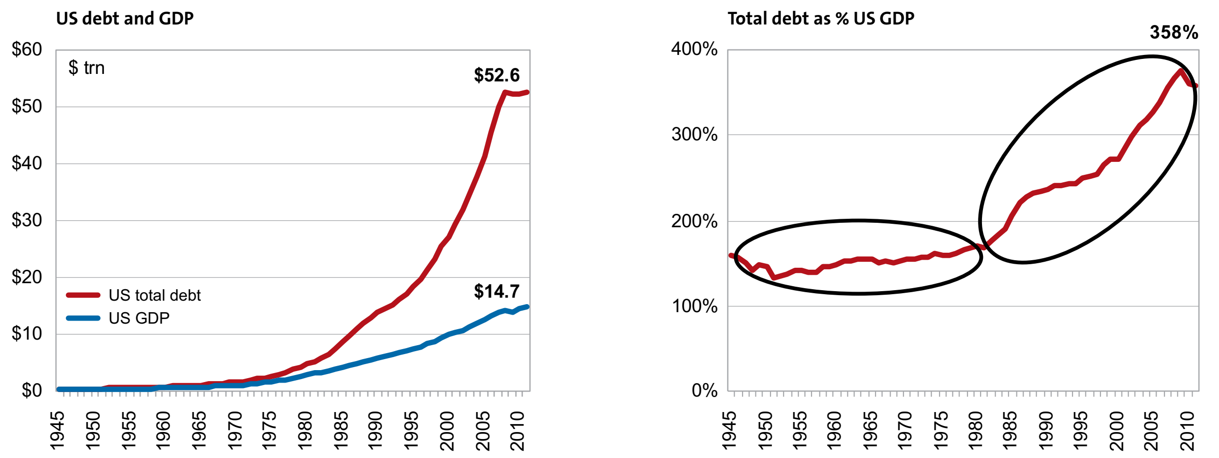
No particular level of debt is, in itself, 'a bad thing'. Borrowing can be a cost-effective source of productive investment, and affordable growth in private debt can be economically beneficial. But the escalation in US borrowings has far exceeded these safe parameters.

Fig. 1: Deep in the hole – the escalation of American debt*

$bn	2001	2011**	vs 2001
Federal	$3,380	**$10,123**	+$6,744
State & local	$1,303	**$3,014**	+$1,711
Corporate	$6,963	**$11,499**	+$4,536
Mortgages	$5,306	**$9,875**	+$4,570
Other individual	$2,346	**$3,333**	+$986
Banking & other	$10,021	**$16,013**	+$5,991
Total debt	$29,319	**$53,857**	+$24,538
Memo:			
GDP	$10,642	**$15,065**	+$4,423
Debt/GDP	275%	**358%**	

* Sources: Federal Reserve Board, Data excludes quasi-debt obligations
** 3Q 2011

Figs. 2 and 3: America and the credit super-cycle*



* Sources of data: Bureau of Economic Analysis and Federal Reserve Board

As fig. 2 shows, total US debt has expanded much more rapidly than GDP, such that current debt (of $53.9 trillion) equates to almost 360% of GDP ($15 trillion). Just as importantly, it is clear that a decisive new trend emerged from the early 1980s (fig. 3). Between 1945 and 1980, the ratio of debt to GDP was remarkably consistent, ranging between 130% and 170%. Thereafter, however, the debt ratio took off, reaching 200% of GDP in 1985, 250% in 1996 and 300% in 2003. The current (358%) debt-to-GDP ratio is unprecedented, exceeding even the levels reached in the Great Depression (when the ratio was driven upwards not by debt escalation but by deflation and by a slump in economic output).

We believe that **the period since the early 1980s** – in other Western countries as well as in the US – **represents a "credit super-cycle"**, an overall pattern which lurks behind, and informs, successive bubbles in asset classes ranging from equities and real estate to commodities. The driving logic of the US economy seems to have switched from moderation and balance to excessive debt-fuelled consumption. Like many other Western economies, the US has now reached the point at which further debt escalation has become impossible to sustain. **But no-one seems to have worked out how to manage an economy that is *not* debt-propelled.**

The snags with soaring debt are three-fold, and America has all three kinds of problem. First, debt can be a problem if it out-grows the ability of the borrower's income to sustain it. This has certainly been the case in the US. Over the same ten-year period in which debt grew by $24.5 trillion, nominal GDP increased by $4.4 trillion.

The last decade, then, has seen $5.55 of debt taken on for every $1 increase in economic output. As a result, total debt has risen from 275% of GDP in 2001 to 358% today.

The second way in which debt escalation can be damaging is if the extent of leverage is disguised in the balance sheet of the borrower. This, too, has been the case in the United States. The official number for federal debt excludes huge off-balance-sheet 'quasi-debts' such as commitments to future employee pensions and to public benefits such as health and social security. Corporations, too, are committed to enormous, unfunded forward employee welfare commitments.

The third way in which debt can pose a problem is if the proceeds are invested in unproductive ways. The jargon here divides borrowings into 'self-liquidating' and 'non-self-liquidating' debt. Borrowing to expand a successful business is an example, at the individual level, of 'self-liquidating' debt, which can be paid off using income from the expanded enterprise. Borrowing to pay for a new car or a holiday, on the other hand, are examples of 'non-self-liquidating' debt, because these do not add to the future income of the borrower.

America's borrowings have, overwhelmingly, fallen into the unproductive, 'non-self-liquidating' category. Little of America's huge borrowing has gone into infrastructure improvement or investment in productive capacity. Government has borrowed for purposes which have included fighting wars and handing tax cuts to the very rich. Individuals have borrowed for perhaps the most futile purpose of all, which is to inflate the values of existing, *unproductive* assets, in this instance America's housing stock.

At the same time, America's economy has languished, growing at far lower rates than those at which debt has expanded. The US economy is now doing little better than flat-lining, and it is the prospect of sluggish growth which threatens to crystalise excessive indebtedness from a theoretical into a dangerously pressing problem.

Almost all macroeconomic levers have been tried, and have failed. Given the high levels of existing debt, Washington has no realistic scope for fiscal stimulus. Interest rates have been kept at minimal levels since 2008, negating any further ability to inject conventional monetary stimulus. That "quantitative easing" (QE), which is the contemporary euphemism for the printing of money, has now been tried not once but twice is an indication of the desperate straits in which policymakers now find themselves.

One of the side-effects of the credit super-cycle has been the creation of **a 'monetary ratchet' which has now reached end-game**. The monetary ratchet process is simple in principle – rates are kept too low, a debt-driven bubble ensues, the bubble collapses, and rates are cut again to shore up the economy. Whilst the ratchet process is capable of straightforward description, what no-one seems to know is what happens when the process reaches its zero-rate termination, which is where the US (and most of the rest of the OECD) have now arrived.

economic data – pollyanna creep

Taken at face value, then, America's economic and fiscal problems look pretty bad. Federal debt owed to the public stands at $10.1 trillion, or 67% of reported GDP. States and local governments owe a further $3 trillion (20%), and households $13.2 trillion (88%) within total credit market debt which stands at $53.8 trillion, or 358% of GDP[6]. Unemployment is stubbornly high, at a reported 8.5% of the workforce. Controversially, ratings agency Standard & Poors last year stripped the United States of its AAA credit rating. After some unedifying

[6] Source: Federal Reserve Flow of Funds z1 report, 2nd quarter 2011

brinkmanship between the White House and Congress, the federal debt ceiling was lifted just in time to stop government grinding to a halt, but no-one has come up with a really convincing plan for curbing the deficit or stimulating growth.

If this was a true description of the situation in which America finds herself, it would be bad enough. But the reality is even worse, because the data on which this generally-believed snapshot is based are very far from reliable. A process of incremental obfuscation, stretching over decades, has made official economic data extremely unrealistic.

We should be clear that the debauching of US official data did **not** result from any grand conspiracy to mislead the American people. Rather, it has been an incremental process which has taken place over more than four decades. It also seems to have happened in other Western countries, though only in the US is the underlying data sufficiently transparent for the effects to be quantified.

In the early 1960s, JFK tampered with unemployment numbers to exclude "discouraged workers". The Johnson administration introduced the "unified budget", which incorporated what was then a big Social Security surplus to hide part of the underlying federal over-spend. Richard Nixon tried, with only limited success, to peddle the concept of "core inflation", an inflationary measure which excluded energy and food (the very items whose prices were rising most strongly at that time).

"Owner-equivalent rent", a concept to be explained later, was introduced under Ronald Reagan. Convoluted changes to the measurement of CPI inflation, recommended by the Boskin Commission, were drafted under George H.W. Bush but implemented by the Clinton administration (and, as respected strategist Kevin Phillips has remarked[7], there is a certain irony to the introduction of "hedonic adjustment" by the Oval Office's ultimate hedonist). A further four million out-of-work Americans dropped out of the unemployment totals under a redefinition of "discouraged workers" introduced in 1994.

Though statistical manipulation has been gradual, it has reached the point at which most official economic data is now very misleading. The analyst who wishes to understand what is really going on in America needs to unwind these distortions. The results are disturbing.

Let's start with **gross domestic product**, the number usually accepted as defining the output of the economy. In 2010, the GDP of the United States was reported at $14.53 trillion, a figure which most Americans probably assume consists entirely of 'real' dollars which can be counted. This, in fact, is very far from being the case, because close to 16% of the reported number consists of "imputations". These imputations are dollars which do not really exist. Stripped of them, GDP totalled $12.3 trillion in 2010, which automatically means that all debt ratios are even worse than they look.

The most important of these imputations are summarised in fig. 4. The largest single such imputation – worth over $1.2 trillion in 2010 – concerns "owner-equivalent rent". If a person owns his or her home outright, no mortgage or rent is payable, and no money changes hands in respect of the property. But the reporting methodology for American GDP assumes that such a property has a utility which a purely cash-based measure fails to capture. Therefore, GDP contains a sum representing the rent which the owner would have paid (presumably to himself) if he had not owned the property. Interest expense is backed out, but the net result remains a major (and non-cash) uplift to GDP.

[7] See "Numbers Racket", Kevin Phillips, op cit.

Fig. 4: GDP – the impact of imputations*

$bn	2005	2006	2007	2008	2009	2010
Reported GDP	$12,623	$13,377	$14,029	$14,292	$13,939	**$14,527**
Including imputations of:						
Imputed rental income	$1,057	$1,125	$1,153	$1,191	$1,213	**$1,215**
Employment-related imputations	$529	$543	$565	$581	$593	**$594**
Financial services not charged	$371	$391	$426	$451	$443	**$501**
Other imputations, net	($69)	($78)	($50)	$9	($2)	**($32)**
Total imputations	$1,888	$1,980	$2,093	$2,231	$2,246	**$2,277**
GDP excluding imputations	$10,735	$11,397	$11,935	$12,061	$11,693	**$12,249**
Imputations as % GDP	15.0%	14.8%	14.9%	15.6%	16.1%	**15.7%**

* Source: Bureau of Economic Analysis

The replacement of actual expenditure with a notional ('imputed') rent applies not just to that minority of Americans who own their homes outright, but also to the many millions with mortgages. For example, a person with 50% equity in his home is assumed to pay rent on 100% of it rather than, as is actually the case, mortgage interest on half of it.

The second-largest imputation concerns employee benefits (principally medical insurance, but also items such as meals and accommodation) which are provided to workers either freely or on a subsidised basis. A sum of $594 billion was imputed in this category in 2010. Financial services (for example, checking accounts) which are provided free of charge by banks are treated similarly. Here, the 2010 imputation (of $501 billion) reflects what the cost to the customer would have been if the bank had charged him or her for services which, in reality, were provided free.

There is a legitimate debate about the 'production boundary', which refers to the inclusion, or otherwise, of services provided free of charge, a good example being care provided to children, to the elderly and to the infirm by family members. But the sheer scale at which "imputations" are now used in the compilation of American GDP surely introduces grave distortions into the generally-accepted number for US economic output. Moreover, non-existent (imputed) dollars obviously cannot be taxed, which means that imputations make the American incidence of taxation look a great deal smaller than it really is.

Serious though it is, the imputations distortion of GDP is a pretty minor matter compared to the debauching of **inflation** data over the last three decades. Imputations, used to increase reported economic output, also have a significant impact on reported inflation, because they edge out real rates of increase in the cost of housing.

The biggest single distortion of official inflation data results from the application of "hedonic adjustment". The aim of hedonic adjustment is to capture improvements in product quality. The introduction of, say, a better quality screen might lead the Bureau of Labor Statistics (BLS) to deem the price of a television to have fallen even though the price ticket in the store has remained the same, or has risen. The improvement in the quality of the product is equivalent, BLS statisticians argue, to a reduction in price, because the customer is getting more for his money.

One problem with hedonic adjustment is that it breaks the link between inflation indices and the actual (in-the-store) prices of the measured goods. Another is that hedonic adjustment is subjective, and seems to incorporate only improvements in product quality, not offsetting deteriorations. A new telephone might, for example, offer improved functionality (a hedonic positive), but it might also have a shorter life (a hedonic negative) and, critics allege, the official statisticians are all too likely to incorporate the former whilst ignoring the latter.

The failure to incorporate hedonic negatives is particularly pertinent where home-produced goods are replaced by imports, a process which has been ongoing for two decades. An imported airbrush might be a great deal cheaper than one made in America but, if the imported item is of lower quality, is this factored in to the equation?

A second area of adjustment to inflation concerns 'substitution'. If the price of steak rises appreciably, 'substitution' assumes that the customer will purchase, say, chicken instead. As with imputations, the use of substitution breaks the link with actual prices (a process exacerbated by 'geometric weighting'), but it also turns the index from a calibration of the cost of living to a measurement of the price of survival.

Since the process of adjustment began in the early 1980s, the officially-reported CPI-U number has diverged ever further from the underlying figure calculated on the traditional methodology. Some of those who have researched the issues of hedonic adjustment, geometric weighting and substitution reckon that these methodologies now strip out at least six percentage points from inflation calculated on the traditional basis. On this basis, true inflation might be at least 9%, rather than the 3.4% reported in December.

If critics are right – and we are convinced that they are – then the implications are enormous, because inflation calculations reach into every aspect of economic life. The significance of distorted inflation reporting has impacts on:

- Americans' cost of living, and the purchasing power of the dollar over time.
- Wage rates and settlements.
- Benefit levels, and the cost of social payments to government.
- Economic growth.
- Real interest rates.

According to official figures, aggregate inflation between 2001 and 2011 was 27%, meaning that the dollar lost 21% of its purchasing power over that period. But, if we accept that real inflation may have exceeded the official number by 6% in each of those years, the loss of dollar purchasing power was about 55% between 2001 and 2011. Between the third quarters of 2001 and 2011, average weekly wages increased by 31%, fine if the dollar lost 21% of its purchasing power over that period but evidence of very severe impoverishment if the dollar in 2011 was worth only 45% of its 2001 value. In short, **if millions of Americans feel poorer now than they did ten years ago, the probable explanation for this is that they are**.

By the same token, those Americans in receipt of index-related pensions and benefits, too, have seen the real value of their incomes decline as a result of the severe (and cumulative) understatement of inflation. This process, of course, has saved the government vast sums in benefit payments. Rebasing payments for the understatement of inflation suggests that the Social Security system alone would have imploded many years ago had payments matched underlying rather than reported inflation.

In other words, **the use of 'real' inflation data would have overwhelmed the federal budget completely**.

Another implication of distorted inflation, an implication that may have played a hugely important role in the creation of America's debt bubble, is that **real interest rates may have been *negative* ever since the mid-1990s**. Taking 2007 as an example, average nominal bond rates[8] of 4.6% equated to a real rate of 1.8% after the deduction of official CPI-U inflation (2.9%), but were heavily (4.2%) *negative* in real terms if adjustment is made on the basis of +6%-underlying inflation (of 8.9%) instead.

Logically, it makes perfect sense to borrow if the cost of borrowing is lower than the rate of inflation. Whilst most Americans may not have been aware of the way in which inflation numbers had been subjected to incremental distortion, their everyday experience may very well have led them to act on a gut instinct that borrowing was cheap.

We believe that misreported inflation, together with irresponsible interest rate policies and woefully lax regulation, may have been a major contributor to the reckless wave of borrowing which so distorted the US economy in the decade prior to the financial crisis. Indeed, **understated inflation may have been the smoking gun where the flood of cheap money was concerned**.

what **growth,** ***what*** **jobs?**

Understated inflation, then, has depressed wage growth, impoverished those in receipt of benefits, masked the decline in the purchasing power of the dollar, and very probably contributed to a reckless monetary policy which has mired the United States in excessive debt. But it may also have resulted in economic **growth** being reported when, in reality, the American economy has really been shrinking, not growing.

According to official figures, the GDP of the United States increased by 18%, in real terms, between 2001 and 2011. But such numbers, of course, are a function of two calculations which, as we have seen, are not in themselves reliable. First, the reported GDP number (of $14.5 trillion in 2010) is highly questionable, because it includes non-cash "imputations" totalling $2.3 trillion. Second, and much more seriously, since the way in which official inflation is calculated is open to very serious question, so, too, is the GDP deflator, the adjustment which is employed to back out the effects of inflation from changes in the nominal monetary value of economic output. Ritual claims that the deflator is worked out by comparing simple chained volumetric (that is, non-monetary) measurement of GDP should not be taken too seriously, because the reality is that it is impossible entirely to de-link the GDP deflator from other measures of inflation.

[8] Annual average interest rate for 10-year Treasuries. Source: *Economic Report of the President*, 2011 datasets

Once adjustment is made for the distortion of inflation, the evolution of American real GDP over the last decade presents a gravely disturbing picture. Adjusting reported growth downwards to reflect the understatement of inflation suggests that **the United States has been in almost permanent recession for ten years**, with real GDP falling year after year, and declining very materially since 2001.

This picture of economic deterioration is reflected in the unemployment statistics or, rather, it would be, if these were not so heavily massaged by reporting methodologies. The official (U-3) number, currently 8.4%, excludes the millions of unemployed Americans who are defined as "discouraged workers".

If these people were included, together with other "marginally attached" workers, and those who are in part-time work because they cannot find full-time employment, *the BLS itself* concedes (on its broader U-6 measure) that the unemployment rate would be over 15%. Analysts who have unpicked all of the various methodological changes (including alterations to sampling techniques) argue that the real rate of unemployment is even higher.

In the face of persistently high levels of unemployment (even on the basis of the understated U-3 definition), Americans have been asked to believe in the concept of "jobless growth" as a way of reconciling weak job data on the one hand with reported growth in GDP on the other. The real explanation is simpler. It is that *most of the economic growth of the last decade has been illusory*.

The explanations for negative growth, combined with high unemployment, are not particularly difficult to ascertain. First, America's acceptance of one-sided globalisation has seen American jobs transferred to lower-cost labour pools in the emerging economies, a point so obvious that it is remarkable that anyone even tries to deny it.

Second, related structural change has seen the increasing displacement of labour-intensive industries (such as manufacturing) with activities which, intrinsically, have very low labour intensity.

"another day older, deeper in debt....."

The statistical manipulation which has distorted GDP, growth, inflation and unemployment has implications, too, for federal debt and the deficit, both of which are much worse than they at first sight appear. The main reason for this is that the American government has taken on huge quasi-debt commitments, most of which are excluded from the federal balance sheet (though it is to the credit of the US that transparency over this issue is far better than it is in Britain, let alone in the Eurozone).

At the end of FY (fiscal year) 2010, official statistics showed debt "owed to the public" – that is, excluding debt held by other departments of government – at $9,060bn, a figure which in itself reveals a huge increase over four years, since the equivalent figure was $4,868bn at the end of FY 2006. Federal Reserve data shows that debt owed to the public has risen still further, now exceeding $10 trillion. But the reported numbers exclude two very material lines of quasi-debt. The first of these, included in the official balance sheet, is a $5,720bn commitment to pay pensions to government employees. The second is a $4,577bn pool of federal debt owed to other parts of government.

The significance of the latter number is that it forms the principal asset of the Social Security and Medicare systems, both of which have liabilities which far exceed their accumulated assets. At the end of FY 2009, net liabilities were stated at $52.2 trillion in respect of closed system claimants, a figure which is offset by $6.3 trillion which, it is assumed, will be the net positive contribution of future scheme participants. Within the $52.2 trillion FY 2009 figure, $33.5 trillion was attributable to Medicare and $18.6 trillion to OASDI (old age, survivors and disability insurance), with the balance relating to railroad pensions ($140bn) and black lung provisions ($6bn).

During FY 2010, the outstanding Medicare commitment was reduced by about $15 trillion, reflecting the assumption that the Obama healthcare package will result in a very material reduction in future claims on Medicare. Whilst this is true, it is somewhat disingenuous, in that the funding for healthcare will still need to be sourced from taxpayers, such that the future financial obligation has been shifted further off-balance-sheet, not eliminated altogether.

What, then, is the true level of federal government debt and quasi-debt? Inclusion of the entire off-balance-sheet liabilities associated with OASDI and Medicare would be excessive, because these sums are calculated on the basis of liabilities stretching out 75 years into the future. Few governments (or other institutions) measure their commitments that far ahead.

If we apply standard net present value (NPV) techniques to the official net liabilities for FY 2009 but limit the capture to 30 rather than 75 years, the quasi-debt total for closed scheme participants declines from the reported $52 trillion to $41 trillion. This number falls further, to $34 trillion, based on the FY 2010 computation in which the Obama healthcare system is assumed to eliminate major forward Medicare liabilities. This number, of course, is net of the assets held by OASDI and Medicare, comprising federal debt of $4.6 trillion which OASDI, at least, is likely to start drawing upon in the near future (some estimates suggest as soon as FY 2013). It also excludes forward pension and welfare commitments to federal employees.

Taken in aggregate, then, federal debt and quasi-debt can be put realistically at $53.3 trillion, comprising debt owed to the public ($9.1 trillion), debt held by other government agencies ($4.6 trillion), pension commitments to employees ($5.7 trillion) and the 30-year portion of net quasi-debt commitments ($34 trillion)[9].

[9] The detailed numbers are:
- debt owed to the public: $9,060bn
- debt held by other government agencies: $4,577bn
- pension commitments to employees: $5,720bn
- 30-year portion of net quasi-debt commitments: $33,977bn

Total: $53,334bn

Based on the official number for 2010 economic output ($14.5 trillion), this estimate of federal debt and quasi-debt equates to 367% of GDP. If we strip out the non-cash "imputations" component of GDP ($2.3 trillion), the federal debt and quasi-debt ratio rises to 435%. Both numbers exclude private, corporate, bank and state debt, which total either 300% of GDP or 356%, depending upon whether the imputed component of GDP is left in or excluded.

We should be clear that off-balance-sheet liabilities are **not** the same thing as debts. Congress could eliminate future liabilities by a simple legislative initiative. But is Congress likely at any point to admit that future benefits promised to the public cannot be paid? We do not envisage that this will happen any time soon.

Just as an assessment of federal off-balance-sheet commitments produces debt ratios large enough to scare small monkeys, much the same can be said of the federal deficit. This number was reported at $1.29 trillion in FY 2010, equivalent to 8.9% of official GDP.

But annual increases in quasi-debt commitments are running at an underlying rate of about $2.1 trillion, meaning that the real deficit is arguably $3.4 trillion, equivalent to 23% of official GDP, or 28% if imputations are excluded from the GDP denominator.

An underlying federal debt and quasi-debt total of some $53 trillion, on top of private, bank, state and local government debt of $44 trillion, could be used by America's critics to demonstrate that the United States is bankrupt. Any such inference, if not fundamentally mistaken, most certainly would be premature. America may be technically insolvent (in the sense that her collective liabilities far exceed any remotely realistic calculation of the net present equivalent of future income streams), but she is not illiquid. The bulk of America's obligations are quasi-debts owed to the American people, which essentially means that forward welfare and pension commitments cannot be honoured (though few politicians are likely to admit this). In the nearer-term, the blue-chip rating of American government paper, reinforced by the reserve status of the US dollar, means that Washington can continue to live beyond America's means for some years yet.

There are three chinks in America's armour which investors need to watch. The first of these is the federal credit rating, which last year (and controversially, though surely realistically) was downgraded from triple-A by S&P. The second is the reserve status of the dollar which, again, is beginning to look increasingly anomalous. But the third – and by far the most worrying – dimension of America's parlous fiscal and economic state is the severity of economic underperformance.

Accordingly, as we turn to an assessment of quite how America got into her current parlous condition, the primary focus must be on the causes of the fundamental weakening of the US economy.

"We live in an economy that rewards someone who saves the lives of others on a battlefield with a medal, rewards a great teacher with thank-you notes from parents, but rewards those who can detect the mispricing of securities with sums reaching into the billions".

Warren Buffett[10]

[10] Bloomberg, June 16, 2010

part two

why did this happen?

As we have seen, then, the economic and fiscal status of the United States lies somewhere between bad (if you believe the official data) and horrendous (if, like us, you do not). This is not, or at any rate not yet, cause for despair. America remains not just the world's largest economy but also its most technologically-innovative.

But, to paraphrase Sen. Simpson, this is the end of the line. The United States needs to conduct a thorough and forthright appraisal of its economic weaknesses, and to take urgent remedial action. Failure to do so would be a recipe for absolute as well as relative economic decline and, sooner or later, for a full-blown debt disaster.

Our analysis suggests that there are four principal economic problems which confront the US:

1. Faulty capital markets, compounded by weak regulation.
2. An excessive emphasis on consumption over investment.
3. Grave misallocation of capital.
4. Blithe acceptance of a form of globalisation which works to the detriment of America.

The Western (and, in particular, the American) economic system has become chronically debt- and bubble-prone. Consumption has been favoured over investment, and, within the investment pool itself, capital has been disastrously misallocated, with funds being steered not into productive uses but into vanity projects and, worst of all, into the inflation of the value of existing, *unproductive* assets.

Just as importantly, America needs to wake up to the reality of competition from emerging countries, most notably China. The long-standing economic assumption of 'comparative advantage' has led the US, and the West in general, into an acceptance of a form of globalisation that has worked to its grave disadvantage.

The economic model has failed, both at home and abroad. How has it failed? And why?

a failed paradigm

Essentially, the US, and the West more generally, have, certainly since the collapse of the Soviet Union and arguably since the end of the Second World War, operated a variant of the free-market system based on the Ricardian assumption of 'comparative advantage'. Associated with the British economist David Ricardo (1772-1823), the comparative advantage model argues that everyone becomes better off if each country specialises in those activities at which it enjoys the greatest comparative advantage. If the logic of this model is accepted, it is natural that America should cede manufacturing to lower-cost competitors such as China, concentrating instead on higher-added-value sectors such as technology and financial services. The Ricardian model assumes that such specialisation enriches everyone because it maximises the efficiency of the global economic system. Geopolitically, the economic interdependency of nations is also assumed to make the world more secure.

On paper, the logic of this argument seems compelling. In reality, however, Ricardian comparative advantage makes two basic assumptions, both of which are fundamentally flawed. First, it assumes that everyone plays by the rules, which manifestly has not been the case in recent times. Second, it assumes infinite scope for growth, so that the economic success of one country is not achieved at the expense of another. In a world which is beginning to butt up against resource constraints, the 'infinite growth capability' assumption isn't true, either.

The US has followed a Ricardian model since the Bretton Woods conference which established the post-War economic settlement. The dollar, then pegged to gold, became the global reserve currency within an assumed preference for free trade and the unrestricted movement of capital. Essentially, Bretton Woods tied the global financial system to a gold standard via the dollar. In 1971, Richard Nixon famously “slammed the gold window”, ending gold convertibility (though the dollar remained the reserve currency). Latterly, after the collapse of the Soviet Union, the US led the West into the acceptance of a globalised free trade model in which US, European and Japanese markets were almost wholly open to trade and investment from emerging countries.

Over the last twenty years, this model has worked to America’s grave disadvantage, because one of the two Ricardian assumptions – free and fair competition – has been abrogated, most conspicuously (though by no means only) by China. With the second assumption – unlimited scope for growth – now about to prove unfounded as well because of resource constraints, the continuation of unfettered, one-sided globalisation can only exacerbate America’s economic problems.

Fundamentally, China realises that she is in a competitive situation. *America does not*.

un-american activities: have competitor strategies undermined the US?

China, and other emerging countries, operate a radically different economic model from that accepted in the US. In contrast to the negligently-regulated variant of capitalism that did more than anything else to lead America, Britain, Ireland, Iceland and others into financial disaster, China’s version of capitalism is a state-directed hybrid, aimed at maximising national advantage rather than the income of individual corporations. China has kept the renminbi at an artificially-depressed level in order both to boost exports and to deter imports. China also operates blatant tariff and informal barriers against manufactured imports.

Where American businesses are profit-maximisers, China’s main aim is volume-maximising, the objective being to boost levels of employment, not corporate profitability. Logically, a volume-maximiser will always out-compete a profit-maximiser, particularly where wage costs are low and the terms of trade are distorted.

Furthermore, China is engaged in the wholesale appropriation of American and other Western technologies – *often with Western connivance*.

China is often accused, probably rightly, of using cyber-espionage, but we need to be clear that **international competition is not a parlour-game for children organised under playground rules**. China is entitled to pursue what she regards as the policies most advantageous to her own interests. The real question has to be why America, and the West more generally, have failed to react.

In any case, **the transfer of American technology to China and other emerging countries has been at least as much the result of home-grown negligence as of competitor strategy**. Lured by market size and cheap labour, American companies have all too often entered into inward investment agreements with technology transfer strings. Though, at least in the short term, these deals can be beneficial to companies themselves, they have been extremely harmful to the overall competitive position of the United States. This underlines the point that Western short-sightedness has played as much of a role as competitor behaviour in undermining Western economic interests.

By lending huge sums to the US, China has funded, and thereby encouraged, excessive consumption and the misallocation of capital in the US, whilst at the same time exerting an ever tighter grip as America's creditor-in-chief. But it is the US which has allowed this to happen.

As the Chinese economy has grown, and as global resource constraints have emerged across a range of commodities including energy, minerals, food and water, China and other emerging countries have engaged in a policy of using their huge dollar reserves to buy up resources across the globe, often co-operating with regimes regarded as distasteful in the West. The recent commissioning of China's first aircraft carrier is highly symbolic, indicating that China intends to develop the global military reach required to defend its commercial interests[11].

Blithe acceptance of this one-sided form of globalisation has harmed America in many ways. First, of course, it has made possible the huge build-up of debt, and has encouraged a tendency towards capital misallocation which was already implicit in the American financial system.

[11] It is particularly symbolic of the global power shift that, just as China is moving decisively into carrier aviation, Britain's government has stripped the Royal Navy of its fixed-wing capabilities.

Second, it has contributed both to ever-widening income inequalities in the US, and to stubbornly high (though under-reported) unemployment.

Third, it would not be too much to state that one-sided globalisation has hollowed out the American economy, stripping the US of many of its former staple industries.

domestic errors – the follies of ideological extremes

It would be all too easy for policymakers to attribute America's economic woes to unfair competition from China and other low-cost economies, and to leave it at that. But this would be a fundamentally mistaken stance, because it would mean overlooking the fact that the economic decline of the US owes at least as much to mistakes at home as to foreign competitor behaviour.

As we have been at pains to explain in several previous reports, economic outcomes result from decisions, not from the vagaries of a capricious economic deity. The current weaknesses in the American economy result from a multiplicity of failed decisions. Investment has been wasteful, both the financial system and structure of corporate governance are faulty, regulation has been negligent, and political leadership has all too often been wanting.

The root cause of so much of America's failings has been blind reliance on the assumption that market forces are always benign. Under Alan Greenspan, the Fed assumed that banks would behave responsibly simply because it is in the best interests of their shareholders that they do so. This was breathtakingly naive, not least because it ignored "the divorce between ownership and control" which means that banks (and corporations more generally) are run by their managers, not by their largely passive owners. A preference for risk is in-built, particularly in a banking sector where a government back-stop was always implicit and has, since 2008, become explicit as well. Interest rates were kept far too low for far too long, even when there existed unmistakable evidence of an asset (property) bubble. Trends over the last decade and more amount to a grave mispricing of risk.

Additionally, a specific mistake has been stirred into the mix. This was the failure of regulators to prevent both the emergence of the shadow banking system and the proliferation of dangerous instruments which no less a luminary than Warren Buffett had called "weapons of financial mass destruction" as long ago as 2003. Bearing in mind the way in which Enron (and others) were brought down by off-balance-sheet leverage and by failures of oversight, it is gravely disturbing that the regulators were asleep at the wheel during the creation of what was almost certainly the worst bubble in financial history.

Where folly is concerned, the proliferation of subprime lending is in a class of its own. It almost beggars belief that regulators could allow an appetite for mispriced risk to spread to the point where mortgages could be pedalled to those who were both too poor to afford them and too unsophisticated to resist the blandishments of bonus-motivated salesmen. Far from regulating this distortion of the system, government actually exacerbated it, not least by forcing lenders to direct more than half of all new mortgages at those on low incomes.

capital sink investment: betting the house

In part, the subprime crisis reflected a long-standing, misplaced obsession with spreading home ownership. This obsession had long entered the American psyche, and perhaps nothing symbolises this state of mind more than the 1946 Jimmy Stewart movie *It's A Wonderful Life*, in which S&L boss George Bailey (Stewart) is lauded for his motivating desire to help Americans get on to the property ladder. Politicians of both parties have long argued that home ownership is a social good, and have backstopped the mortgage system with federal guarantees.

From a strictly pragmatic perspective, governments should cultivate *low* rather than high property values. Low prices would enable young people to find homes, would preclude the creation of damaging bubbles, would drive middle class Americans into greater investment diversity and, most important of all, would liberate capital for more productive investment.

From a fixation with home ownership it is just a short step to a belief that rising house prices are positive for society. In fact, this is very far from being the case, for at least four reasons. First, of course, rising property values can price young people out of access to homes, and can impair labour mobility. Second, rising property values can, and often have, created speculative bubbles. Third, middle class Americans have tended increasingly to have their assets over-allocated to the housing sector. Fourth, and worst of all from an economic perspective, houses are capital sinks, which **absorb investment without generating a return**.

In other words, tying up capital in property reduces national productivity. Borrowing to do this is folly, and borrowing *from abroad* for this purpose is the economics of the mad-house. There is nothing implicitly wrong with borrowing, particularly if the borrowed funds are invested productively. Also, borrowing for consumption can, within reason, boost economic activity and help create jobs. But, tragically, this is not what America has been doing over the last decade and more. Borrowed capital has been put into asset value escalation, not into productive investment, whilst borrowed consumption has created jobs in Shanghai, not in Schenectady.

The high proportion of Americans' wealth which is invested in property poses a major social and economic risk going forward, because of the ongoing retirement of the baby boom generation. The first boomers have now reached the age of 66, whilst even the youngest will reach retirement over the coming twenty years. Millions of these people expect to rely for their security in old age on monetising their assets, but no-one has explained quite *how* this is supposed to happen when the following generation is not only fewer in number but individually poorer. This argues for a further secular downtrend in property prices, undercutting millions of Americans' assumed ability to enjoy a good quality of life in retirement.

Even where the limited pool of non-housing investment is concerned, funds have all too often been channelled into vanity projects rather than into essential investment.

According to various expert studies, the level of investment required to restore America's infrastructure to a safe and competitive condition is well in excess of $2 trillion. Little has been done despite the tragic 2007 collapse of the I-35W bridge over the Mississippi, in which thirteen people died.

New York, for example, has its share of ageing power supply systems, roads and bridges, and has no real idea about how to pay for replacements, yet, within the last decade, has found $2.5 billion to build new stadia for its principal sports teams (the Mets, the Jets and the Giants[12]). The tragedy of New Orleans in part reflected a failure to invest in improving the levees built by earlier generations to protect the city from devastating floods of the type tragically unleashed by Hurricane Katrina in 2005.

If America has grave problems with capital allocation, it has equally significant problems with its labour pool. Both the president and the prime minister of China are graduate engineers, whereas Barack Obama is a lawyer. American colleges produce 41 law graduates for every engineer. Each year, the brightest young Americans are lured into careers in investment banking and the law, rather than into activities such as technology and manufacturing.

[12] The MetLife stadium, shared by the Jets and the Giants, was completed in 2010 at a cost of $1.6 billion. The Mets' City $900m Field stadium was completed in 2009.

Fig. 5: Financialization – percentage contributions to US GDP, 1950-2009*

	1950	1960	1970	1980	1990	2000	2005	2009
Manufacturing	29.3%	26.9%	23.8%	20.0%	16.3%	14.5%	11.9%	**11.2%**
Finance	10.9%	13.6%	14.0%	15.9%	18.0%	19.7%	20.4%	**21.5%**

* Sources: *Economic Report of the President*, 2011, table B-12, and Kevin Phillips, *Bad Money*, 2009 edition, page 31

These trends are reflected in the growing financialization of the American economy, by which is meant the increasing shift from productive activities (such as manufacturing) into the essentially unproductive activity of simply moving money around.

This process of 'financialization' is an established end-of-era phenomenon, and was associated with the latter days of global supremacy in Spain, the Netherlands and Great Britain. In Spain, the accumulation and movement of New World bullion and of government paper became more important than productive activities, putting the country into inexorable decline. Much the same happened when international financing activities displaced industry and trade in nineteenth century Britain.

Is this 'end of era' process now taking place in America? It certainly seems that way. As fig. 5 shows, manufacturing has declined from 29% of GDP in 1950 to just 11% in 2009, whilst the banking, real estate and insurance sectors' share has increased from 11% to 22% over the same period.

Of course, financial services play a hugely important role in the economy, and markets are by far the best mechanism for the effective allocation of capital. But Americans may be right to wonder whether an appropriate balance has been lost when the financial sector becomes almost twice as large as the manufacturing industry which propelled America to global economic and political pre-eminence. The solution, of course, is not to downsize financial services, but to support other parts of the economy.

> "The potential for the disastrous rise of misplaced power exists and will persist. We must never let the weight of this combination endanger our liberties or democratic processes".

Dwight D. Eisenhower[13]

[13] Farewell Address to the Nation, 17th January 1961

part three

how should america respond?

Unless radical and timely changes are implemented, historians of the future are likely to regard the 2008 banking crisis as a decisive tipping-point, the moment at which America lost her long-standing global primacy as economic power lurched dramatically from a complacent West to a brashly confident East. If America does indeed surrender the economic power upon which all other forms of global influence are based, those same future historians are likely to include a failed economic model, failed financial regulation, failed corporate structures and, above all, a failure of leadership amongst the factors which allowed America's primacy to go by default.

Thus far in this report, we have addressed two key issues. First, we have sought to look behind the statistical camouflage to reveal quite how dire America's economic and fiscal problems really are. Second, we have explained the key weaknesses which have led America into its current parlous state. Here, we conclude by setting out some of those measures which, we believe, can reverse the adverse trends which have been undermining the United States for at least two decades.

No analysis such as this is written from a position of perfect neutrality. The view taken here is that prosperity and cohesion are products of balance and of responsibility, and that checks-and-balances are imperative. Capitalism is the most potent wealth-generating system ever created, and free markets can alone deliver the optimum allocation of capital. But a *completely unfettered* free market system can also produce distortions and anomalies, not just in the distribution of economic rewards but also in structures and in strategic directions.

At the institutional level, America's founding fathers incorporated their recognition of the need for checks-and-balances into the Constitution of the United States, which established the critical separation of power between the executive, the legislature and the judiciary. Bond markets operate as a financially-equivalent balancing mechanism, checking the wilder irresponsibility of governments. But internal economic and financial balancing mechanisms are necessary too, and a lack of such balance has been the single most damaging factor in the weakening of the American economy. The objective now should be to restore balance and direction to the American economic system.

When Dwight D. Eisenhower warned Americans about "the disastrous rise of misplaced power", the threat that he had in mind was "the military-industrial complex". He would have shown more prescience if he had he warned instead about a "*finance*-industrial complex". Just as lax corporate regulation led to the Enron and WorldCom scandals, excessive deregulation of the banking system led directly to the financial catastrophe which erupted in 2008 and which, in our view, has yet to reach a final denouement which now may be imminent.

America's single most pressing domestic need is to restore the balance between probity and innovation in its banking system. The essential problem has been a disastrous mispricing of risk. It was surely obvious from the outset that regulators' failure even to notice, let alone to prevent, the weakening of the link between lender and borrower would have catastrophic consequences.

Historically, mortgage lenders exercised caution because eventual repayment depended upon the viability of the borrower. Over the last fifteen years or so, this all-important link has been allowed to weaken, enabling lenders to issue mortgages in the comforting knowledge that, if the borrower failed to meet his commitments, someone else would bear the loss. This distortion of the relationship between lender and borrower led not just to the mispricing but to the *reverse* pricing of risk, such that lending to the riskiest borrowers became a high-returns process because risk could be unloaded. This process ran its wholly predictable course in the subprime disaster. In the future, far greater transparency is imperative. A key recommendation of this report is that the securitization of mortgages should be **subjected to tighter regulation**.

America also needs to address issues of financialization by encouraging industries, such as manufacturing, which increasingly have been outsourced to cheaper competitors. The free functioning of the market system is an economic imperative, but something has become misbalanced when the manufacturing sector has dwindled to barely half the size of financial services. Neither sixteenth-century Spain nor nineteenth-century Britain learned this critical lesson, and the economies of both were undermined when they became dominated by *rentiers* rather than by entrepreneurs and producers.

Curbing the excesses of the banking system will, of course, require concerted action by government, and it is imperative in this context that America's leaders take the electorate with them. Though simple in principle, tighter regulation would need to be implemented in the teeth of formidably-funded opposition.

In this context, the contempt in which government (irrespective of party) is held by Americans is both remarkable and disturbing. After all, the government of the United States implemented such far-reaching initiatives as the Tennessee Valley Authority, won the Second World War, and put Neil Armstrong and Buzz Aldrin on the moon. But America seems now to have lost almost all belief in national, collective action. America's leaders need, as a matter of urgency, to gain greater credibility by putting the interests of the country above their own partisan ambitions.

America can afford to get tough, because China's stability depends entirely upon the creation and maintenance of hundreds of millions of jobs, and this has been accomplished all too often at the expense of businesses and jobs in America.

Just as America's government needs to get tough abroad, it needs to get truthful at home. Like other Western countries, an America lulled into complacency by post-War prosperity got into the habit of making forward promises to its citizens which, it is now clear, cannot be honoured. It is about time that someone admitted this. America also needs to cut bureaucracy, eliminate wasteful programmes and contemplate tax increases in order to bring its budget back into balance.

The triple-A question now is whether America has the leadership which will enable this to happen.

America's friends must hope that she has.

Dr Tim Morgan
Global Head of Research
Tullett Prebon plc

Tullett Prebon is one of the world's largest inter-dealer brokers, and acts as an intermediary in the wholesale financial markets, facilitating the trading activities of its clients, in particular commercial and investment banks.

For more information please go to: **www.tullettprebon.com**

about the author

Tim Morgan read history and political philosophy at Emmanuel College, Cambridge before joining stockbrokers Wood Mackenzie as a trainee in 1982. He moved to Montagu Loebl Stanley the following year, shortly thereafter assuming responsibility for the firm's oil and gas research.

In 1985, he joined the stockbrokers WI Carr, which became part of Banque Indosuez in 1986. After a short period with a boutique broker, he established an energy sector research consultancy in 1990. During the 1980s, he had made two important decisions. First, that the prevalent earnings-based investment analysis was out-dated, and that the emphasis of research needed to shift to cash-based measurement of shareholder value creation. The second was that single-country research was inappropriate in an increasingly globalised economy. These decisions led him to develop the value-based VVM™ analysis system.

Between 1995 and 2006, Tim was consultant energy analyst at Collins Stewart, a stockbroking firm which achieved rapid growth on a platform of research originality and technological excellence. He joined Shore Capital Group, again as a consultant energy analyst, in May 2007, but, in February 2009, was invited to formalise a role that he had been carrying out for some time – that of economic and market strategist.

In this role, he attracted considerable notice for a report in which he warned that a decade of economic mismanagement had taken Britain to the brink of a "debt vortex". This built upon an earlier report which contended that recent UK economic growth had been largely illusory, being based upon debt escalation and the understatement of inflation. He also pioneered the three-part Matrix™ approach to investing in periods of high systemic risk.

Whilst retaining a keen interest in energy, his current research focus is on the implications of an accelerating process of change in the global economy. He believes that this process is exposing a series of major economic, financial and political imbalances, and that it is imperative that financial market participants be keenly aware of the structural implications of this process.

Tim's extra-curricular interests focus on defence issues, the environment, music and community involvement. He has a particular interest in warships, has published a book on the subject, and has relished time spent at sea with the Royal Navy, believing that few experiences can equal taking off from an aircraft carrier or participating in amphibious exercises with the Royal Marine Commandos.

Tullett Prebon Group Ltd

155 Bishopsgate
London EC2M 3TQ

Tel: +44 (0)20 7200 7000
Fax: +44 (0)20 7200 7176
www.tullettprebon.com