

The continued economic decline of the West

Diagnosis and prognosis

Jon Moynihan

23 February 2012



The continued economic decline of the West

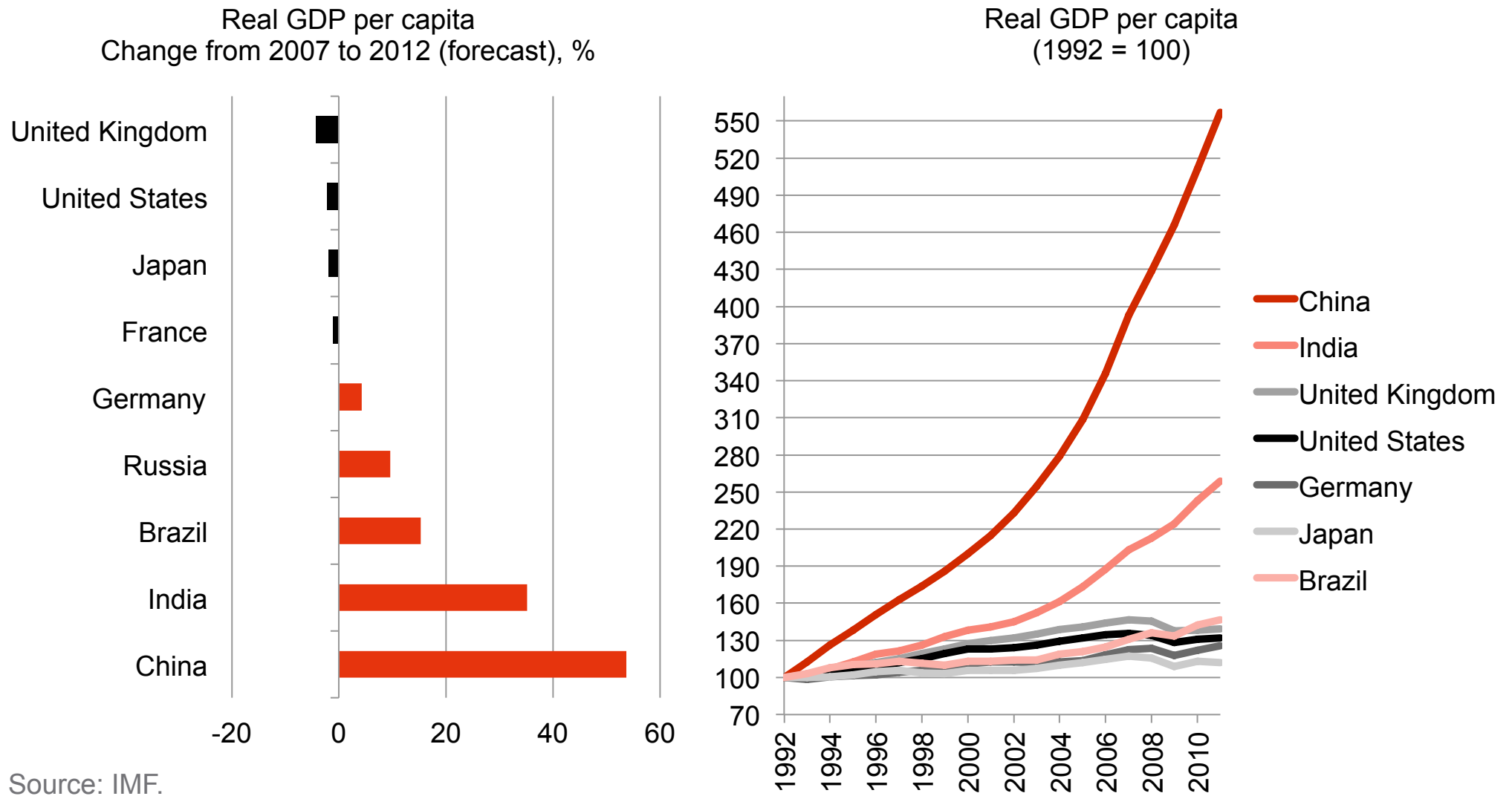
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graph TD; A[The continued economic decline of the West] --- B[The challenge]; A --- C[Potential actions]; A --- D[Likely outcomes]
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The challenge

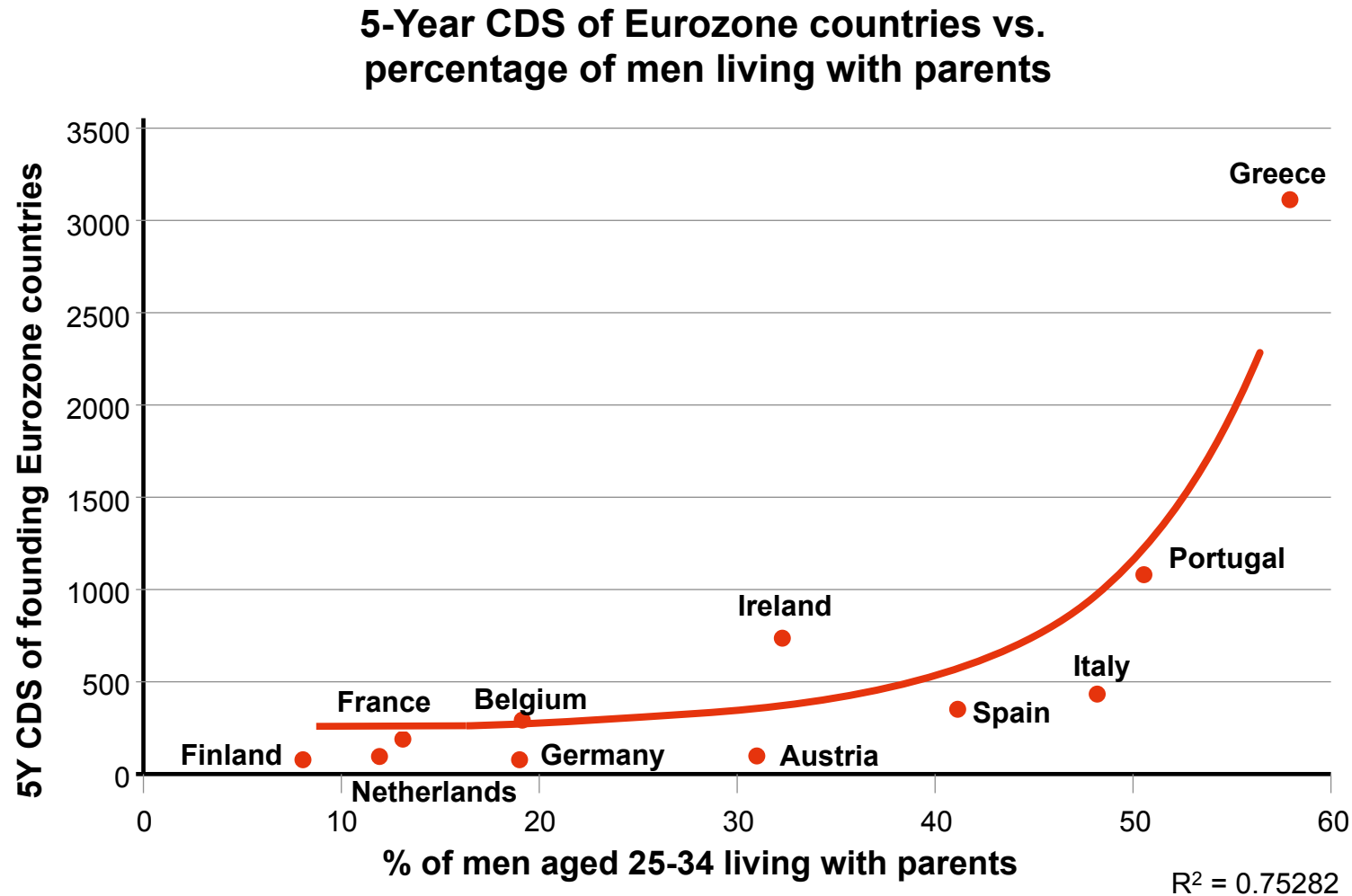
Potential actions

Likely outcomes

How has the West's economic decline happened? Will it continue?



There are many competing explanations, some more persuasive than others:



Source: EuroStat, Bloomberg, via Boaz Weinstein, Saba Capital.

The central dilemma facing 'Western' economies:

	The paradigm for the 1900s	The paradigm for the 2000s
Average annual growth in number of jobs:	2%	Negative
Average annual growth in real wages:	3%	Negative

The continued economic decline of the West

The challenge

Potential actions

Likely outcomes

Global wage
disparity

Ineffectual
governments and
credulous voters

‘Entitled’ groups

Poor allocation of
tax monies

The global wage disparity, potentiated by the global adoption of capitalism, is driving an unprecedented loss of wealth and growth for the Western economies.

Wage disparities between OECD and emerging countries result in an almost insuperable competitive advantage for the 'East'*.

As a result, a job drain continues and is indeed accelerating.

The jobs drained are not returning; rather, more will be lost.

With no job supply, i.e. less demand for labour, wages in the OECD must inevitably fall.

* Includes Brazil etc.

This jobs drain is taking place, driven by the wage disparities that exist between West and East:

	Advanced Economies ¹	Developing Economies (urban) ²	Waiting to urbanise (rural) ²
Labour pool	500 million	1.1 billion	1.3 billion
Average daily wage	\$135 (OECD, 2010)	\$12 (China, 2008)	\$1-2?

“Alarmist” worries about this were dismissed as overblown, even as many millions of jobs migrated (indeed continue to migrate) from OECD to Third World 1995-2011.

Sources: ¹ OECD; ² Estimated: UN *World Urbanization Prospects*, 15-64 year olds, assuming 65% LFPR.

The global wage disparity, potentiated by the global adoption of capitalism, is driving an unprecedented loss of wealth and growth for the Western economies.

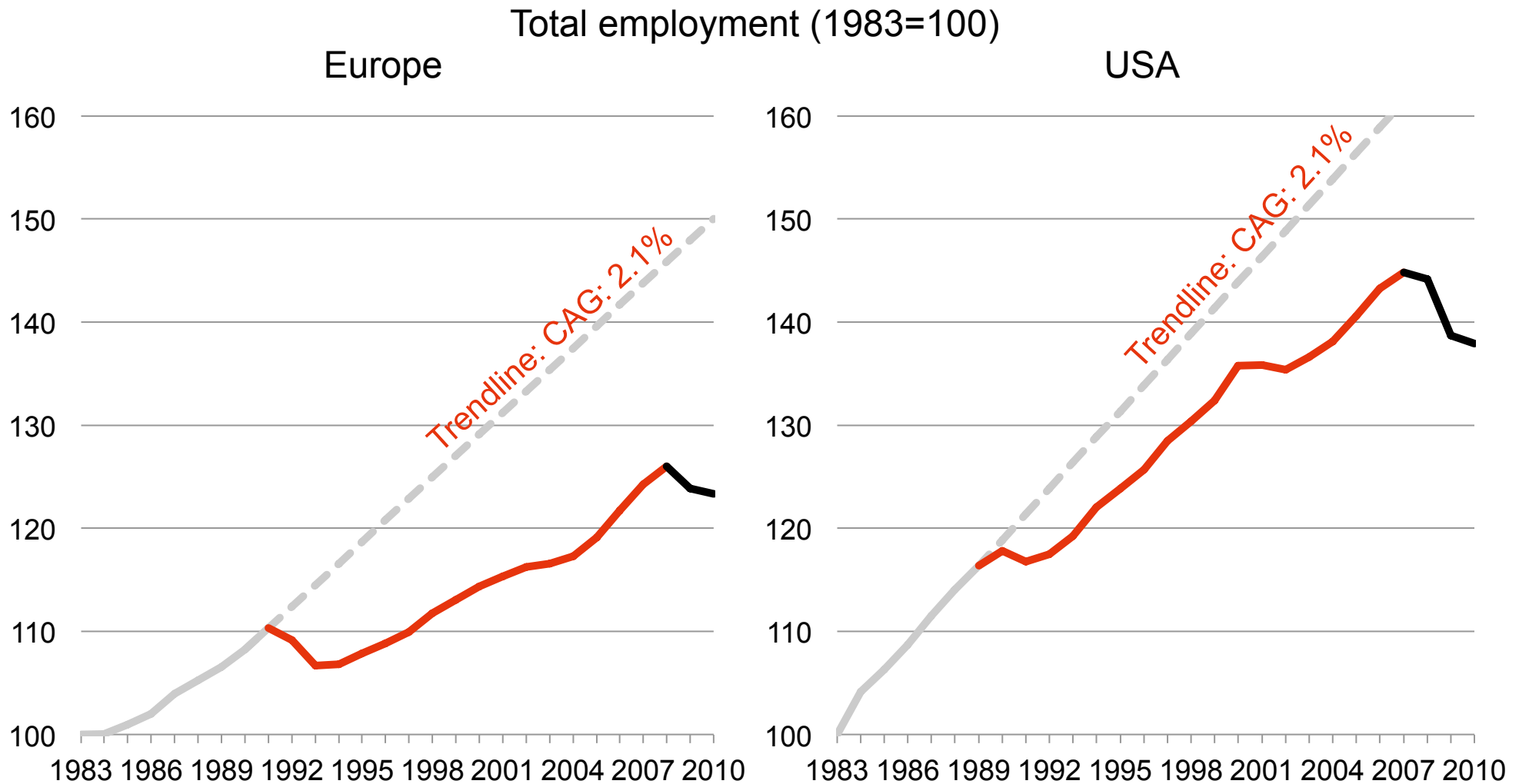
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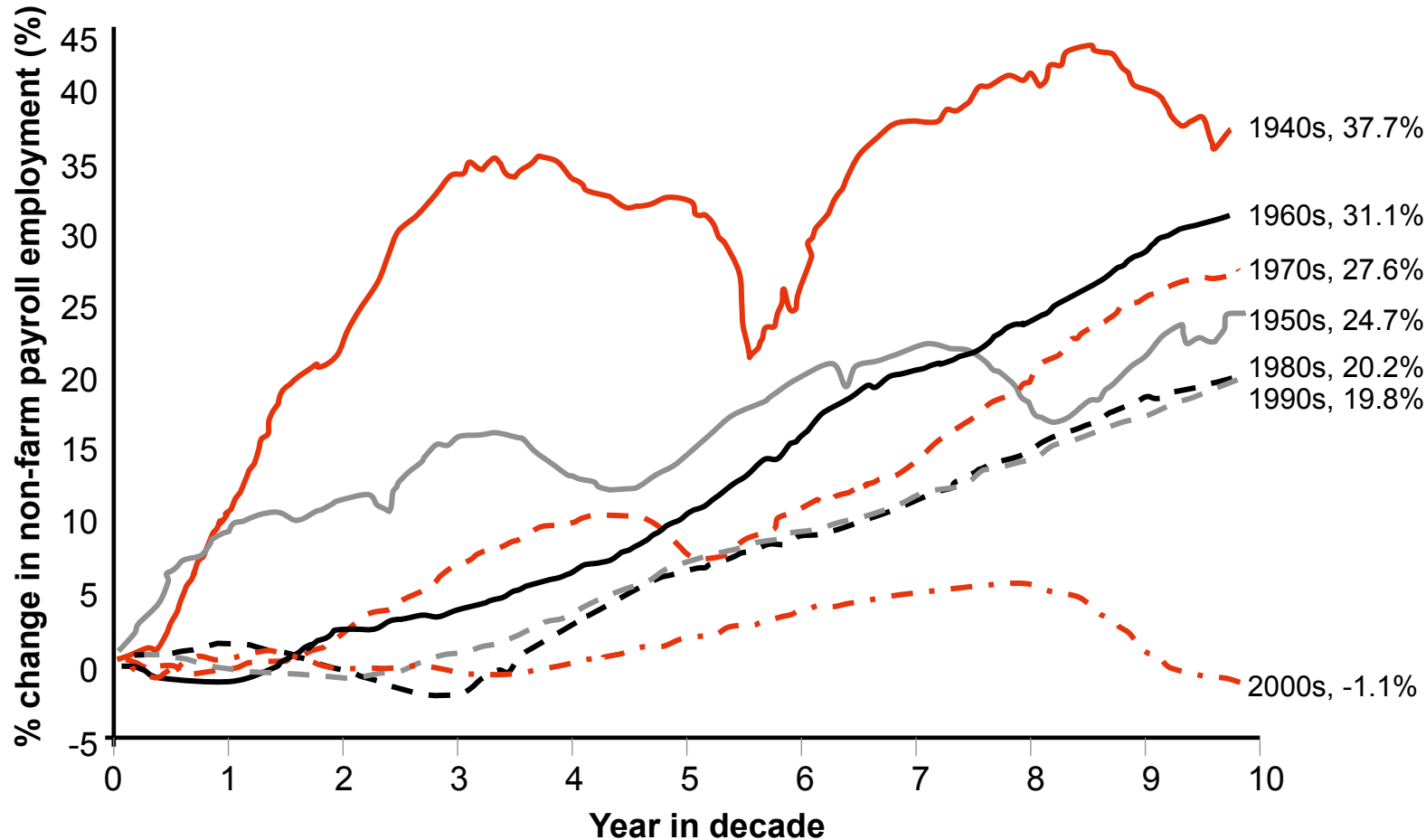
Since globalisation began in earnest in the 1990s, OECD economies have, despite government stimulus policies, been unable to sustain rates of job growth:



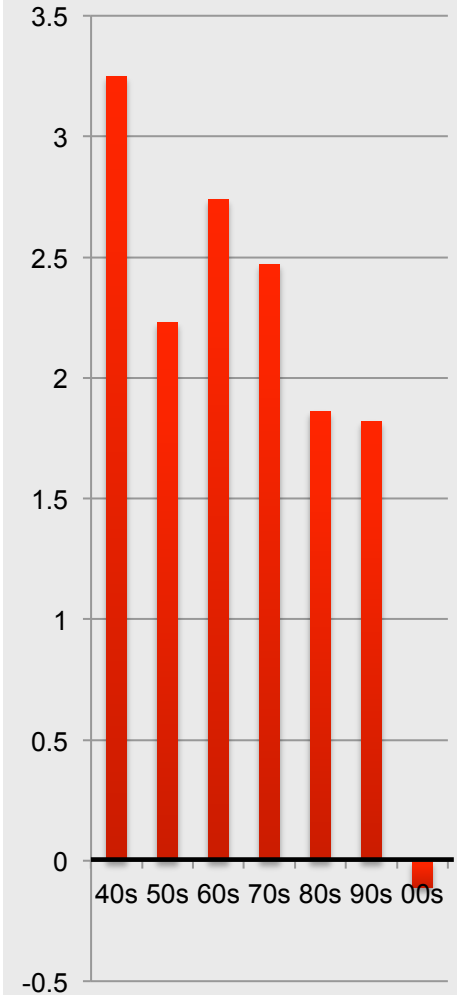
Source: OECD

The last decade was the first decade since the Great Depression to see no net job creation in the US:

US job growth by decade, 1940s – 2000s

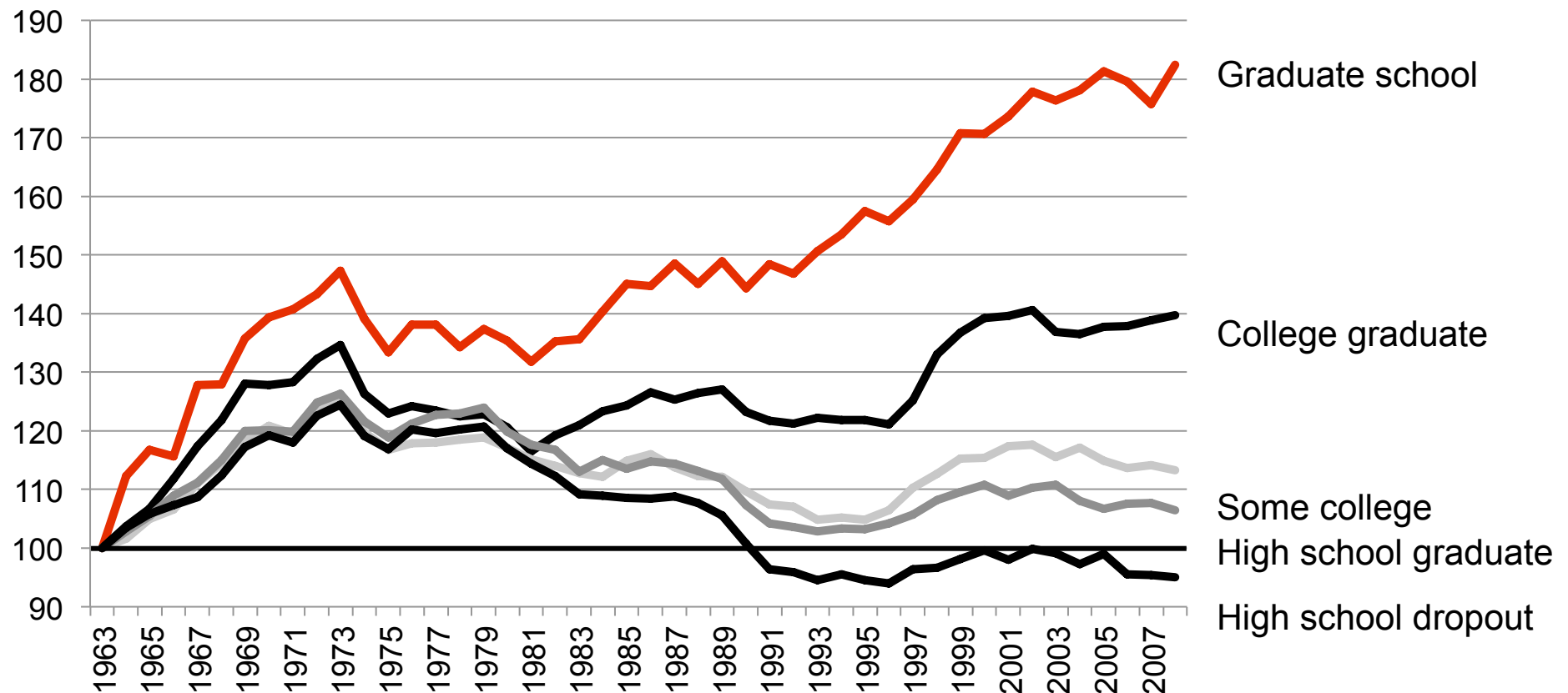


Compound annual jobs growth by decade (%)



Wages have increased for those with the most education,
while falling for those with the least:

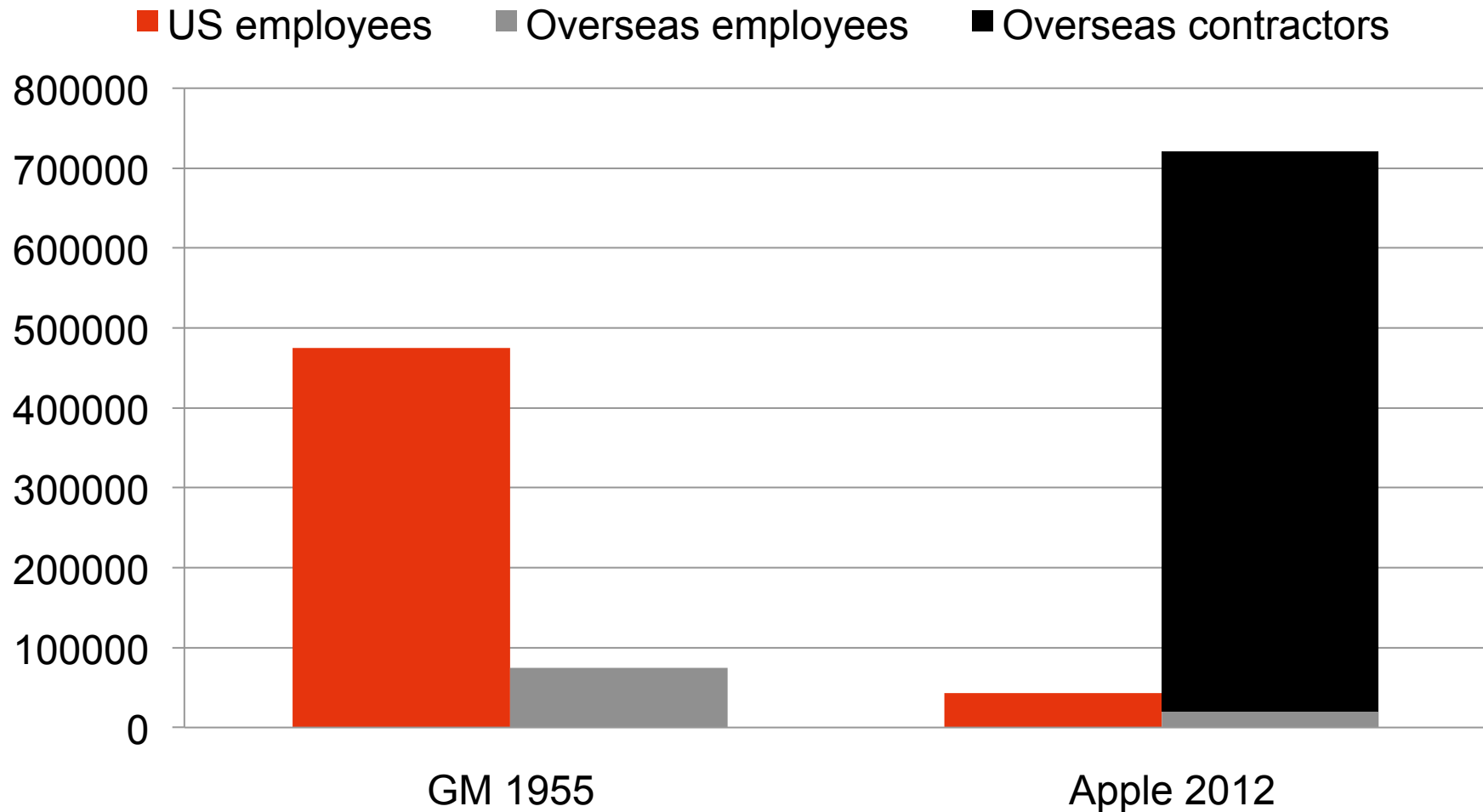
Changes in wages for full-time, full-year male U.S. workers 1963-2008



Source: Acemoglu and Autor (MIT), *Skills, Tasks and Technologies: Implications for Employment and Earnings* (2010).

In 1955, the biggest company in the world by value was GM (revenues: \$105bn).* Today it is Apple (revenues: \$108bn). Employment patterns have, however, changed somewhat:

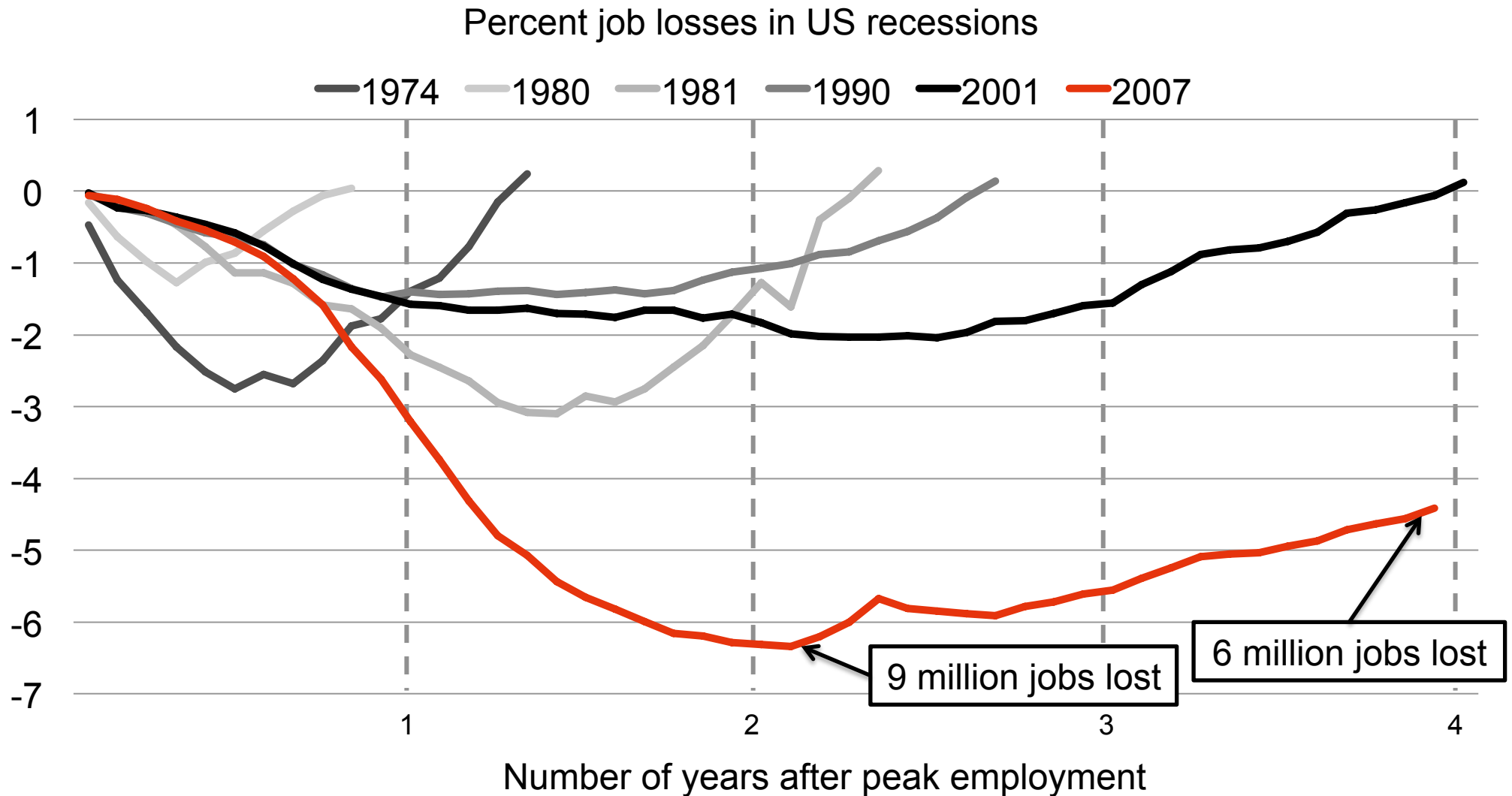
A jobs drain continues...



* At 2011 prices. At 1955 prices, revenues were \$12.5bn.

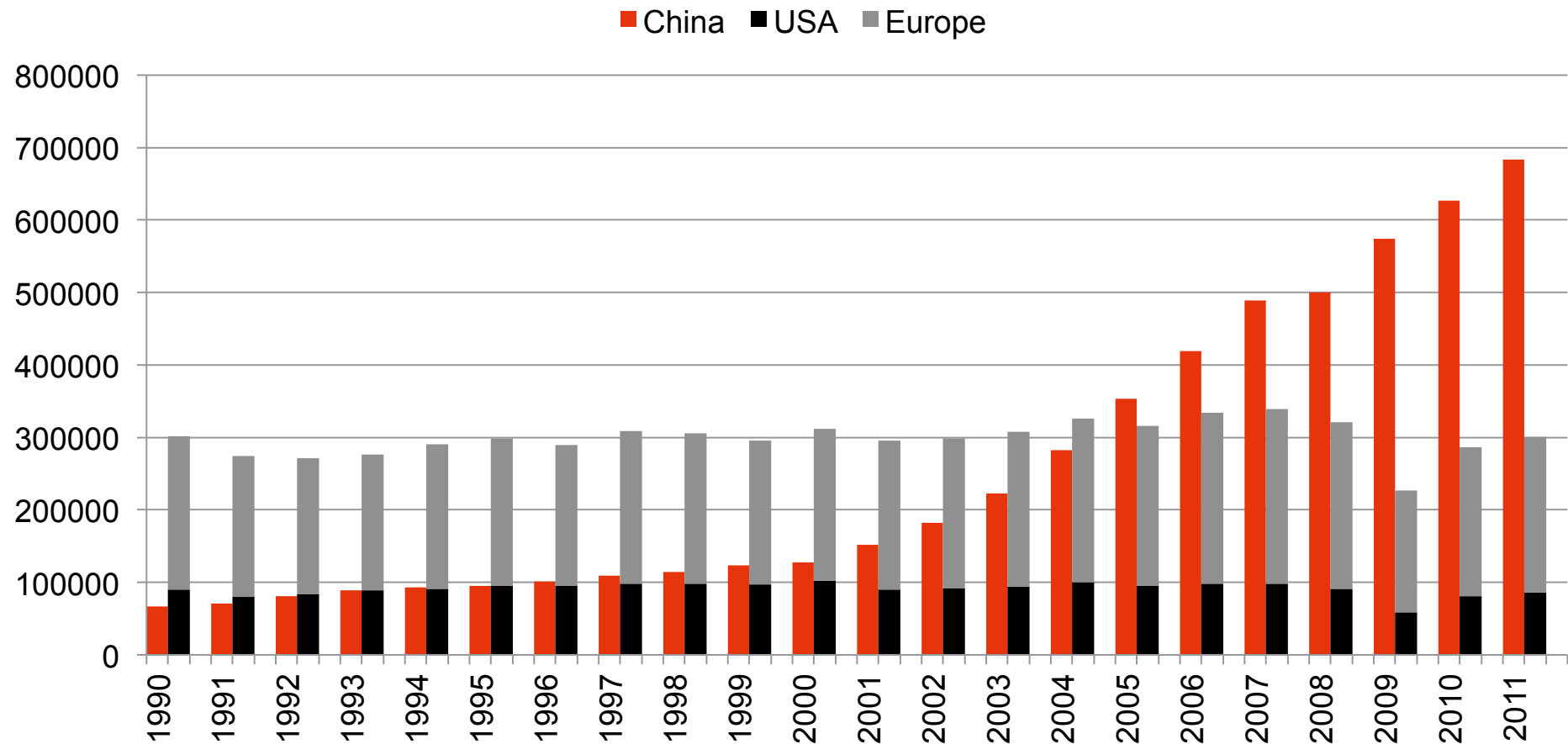
A jobs drain continues...

The US labour market is the most flexible in the world. Unlike in previous recessions, it looks as if lots of these jobs are not coming back:



Whole industries – the ones the West was built on
– are disappearing to the East:

Crude steel production (megatons)

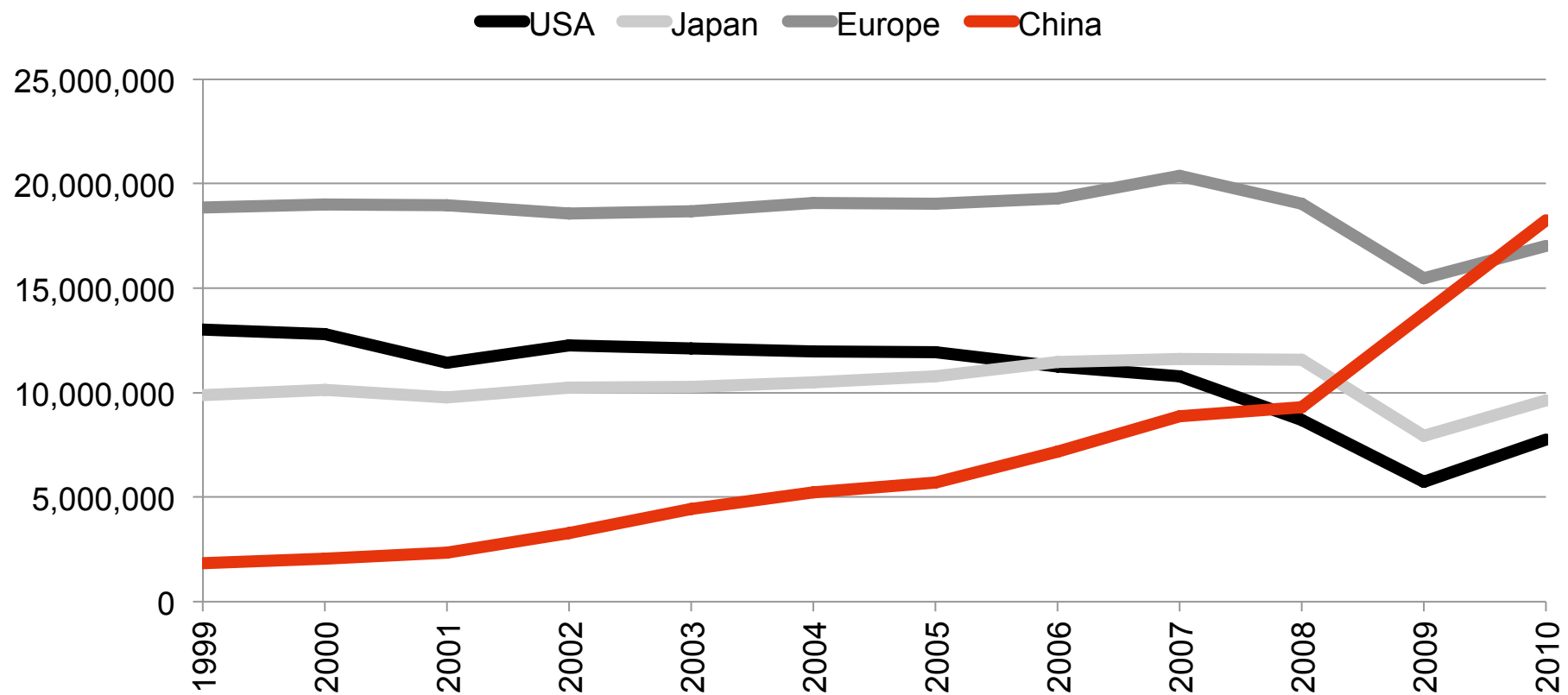


Source: World Steel Association.

Whole industries – the ones the West was built on
– are disappearing to the East:

The commodity car industry is going the same way.
Luxury cars will take slightly longer:

Car production

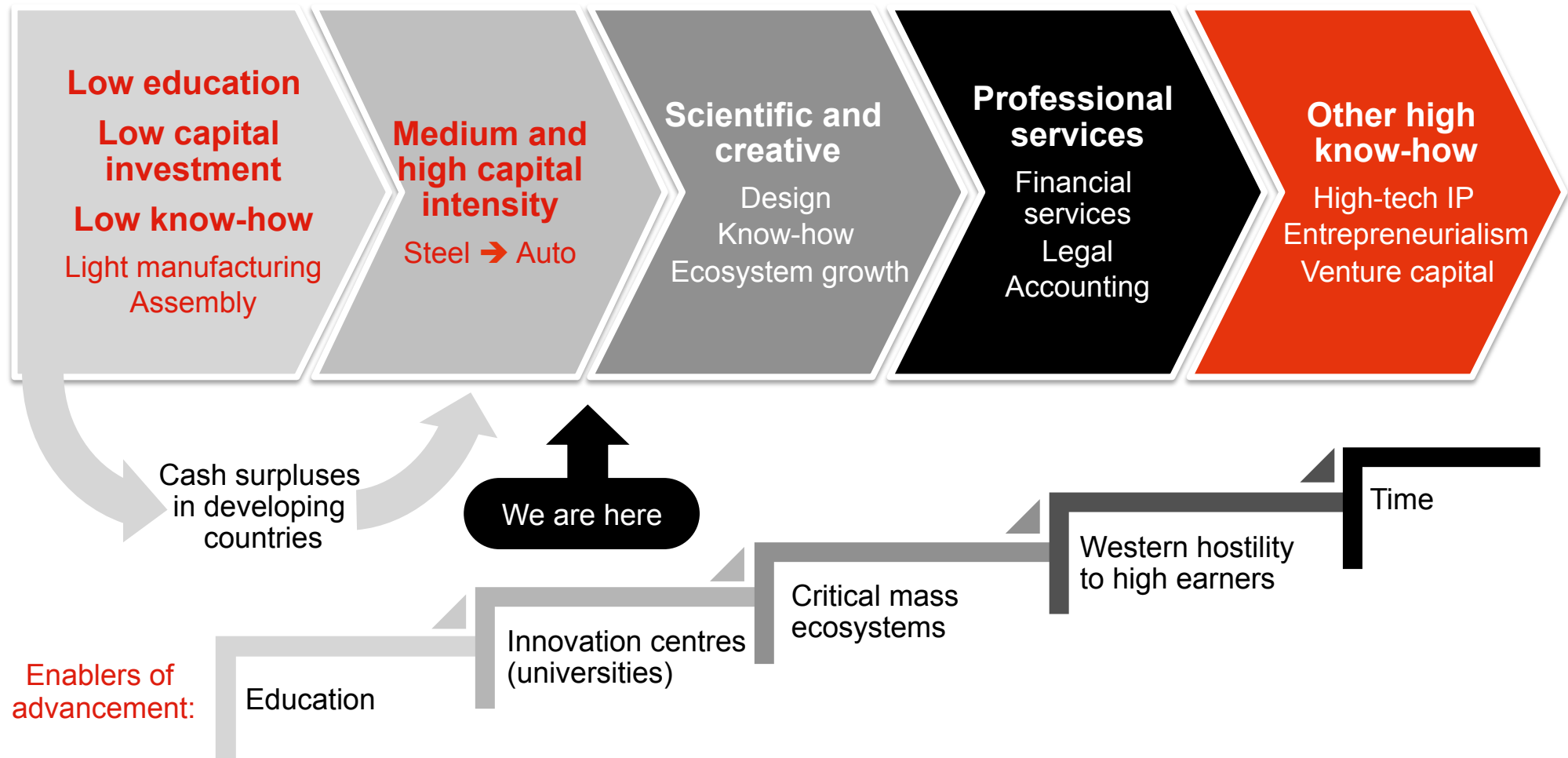


Source: International Organization of Motor Vehicle Manufacturers.

A jobs drain continues...

With each stage of advancement up the industrial ladder in the East, there is a corresponding jobs drain from the West:

The industrial development cycle: *from delivery to creation*



The global wage disparity, potentiated by the global adoption of capitalism, is driving an unprecedented loss of wealth and growth for the Western economies.

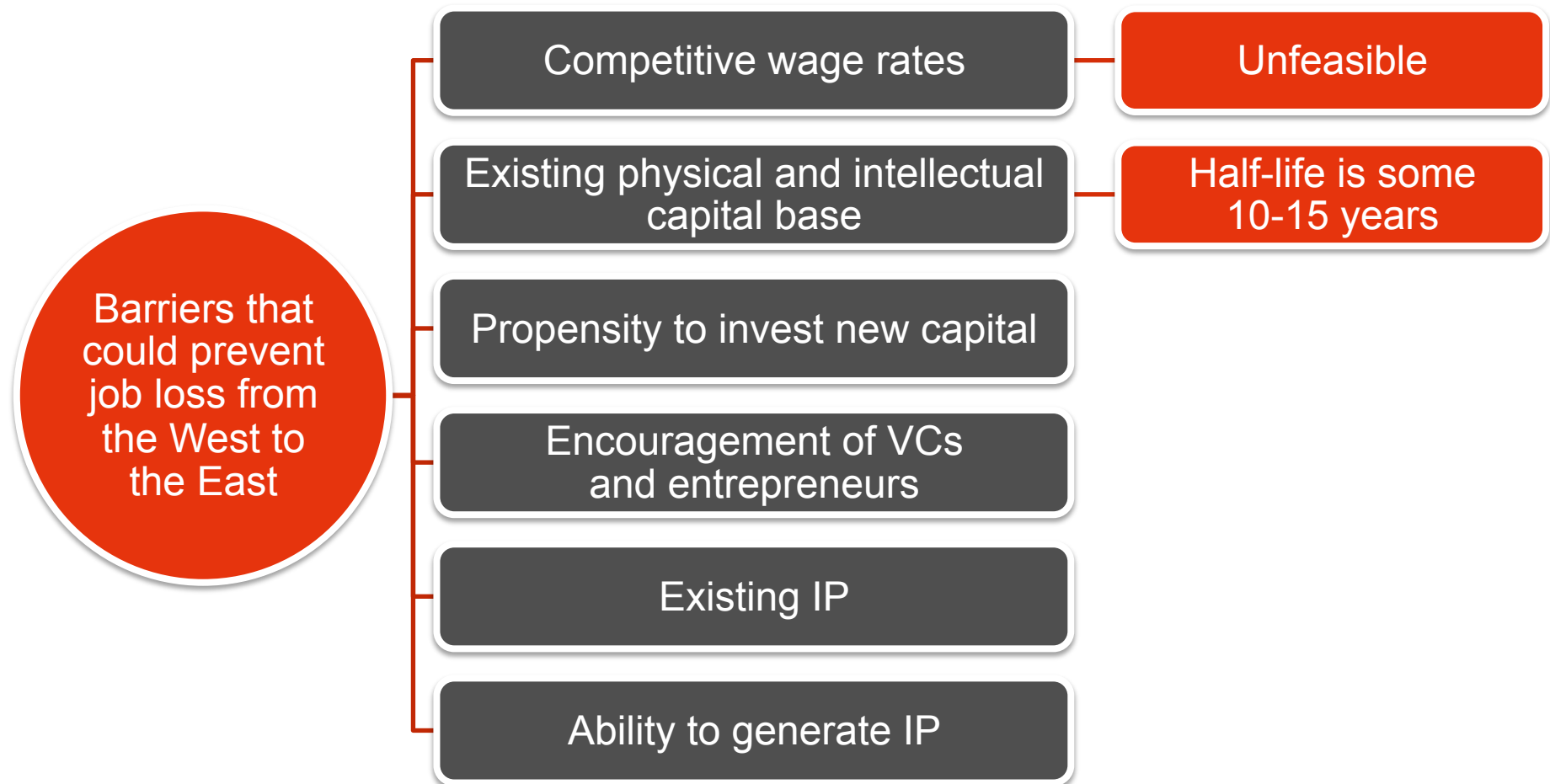
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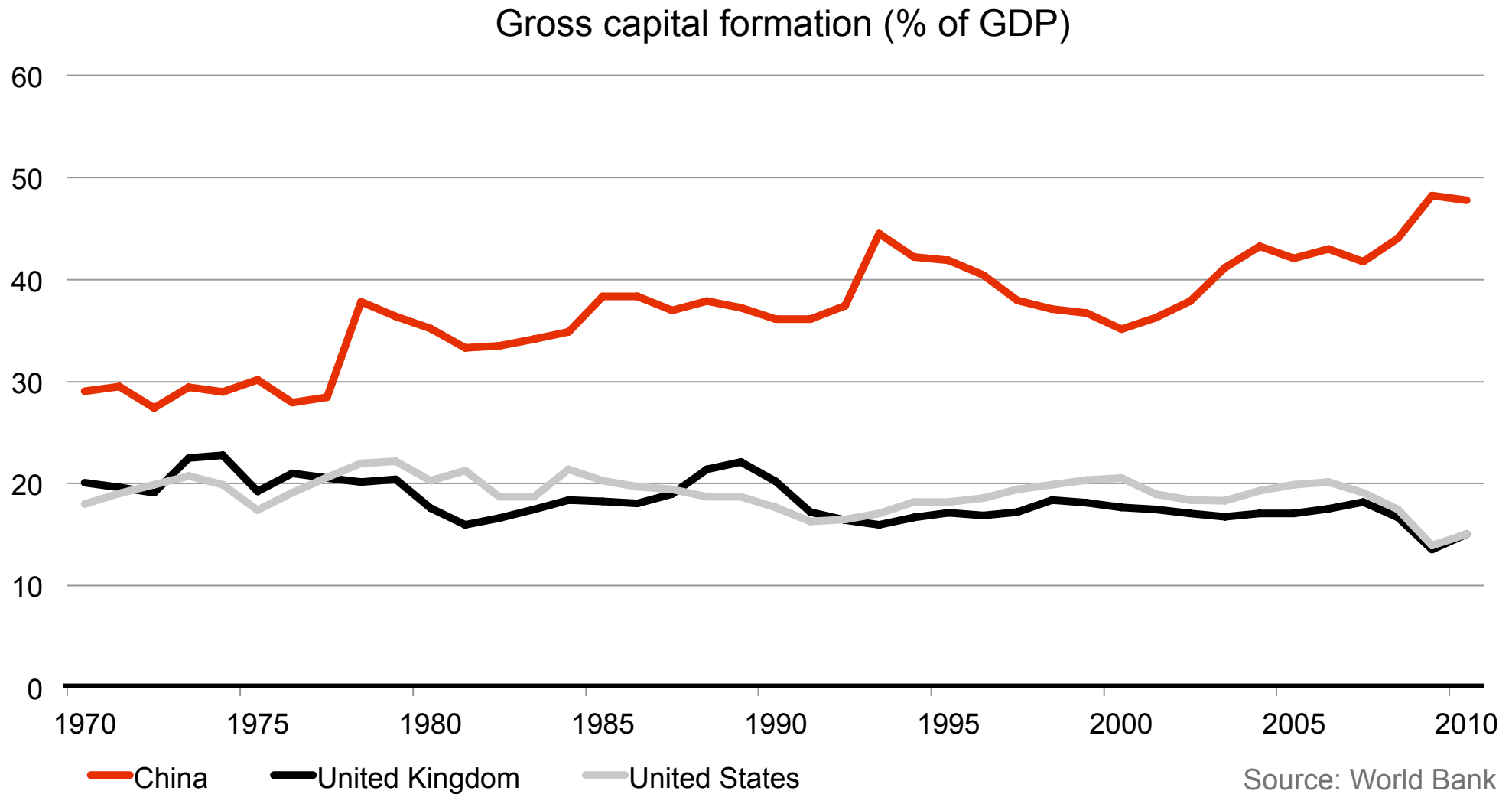
The jobs drained are not returning; rather, more will be lost.

With no job supply, i.e. less demand for labour, wages in the OECD must inevitably fall.

At the same time, our own competitive advantages are steadily crumbling:



The jobs are not returning...
China has been investing almost half its GDP, while the West barely invests a fifth:



The jobs are not returning...

“Just catching up”?



Wuhan



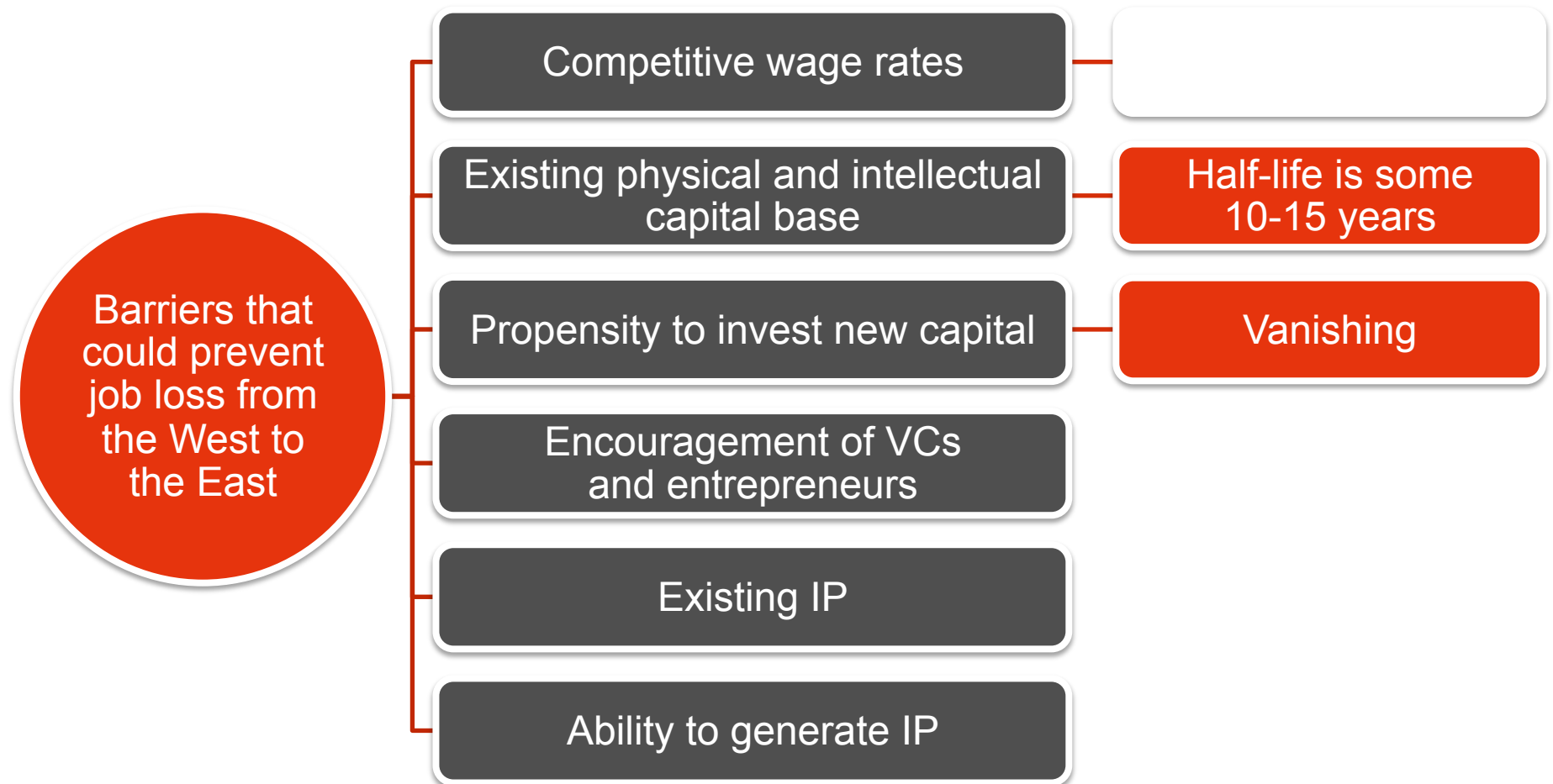
Liverpool St



Hongqiao



King's Cross



Western attitudes to high earners contrasts with some other countries:

“We need to get tough on irresponsible
and unjustified top remuneration”

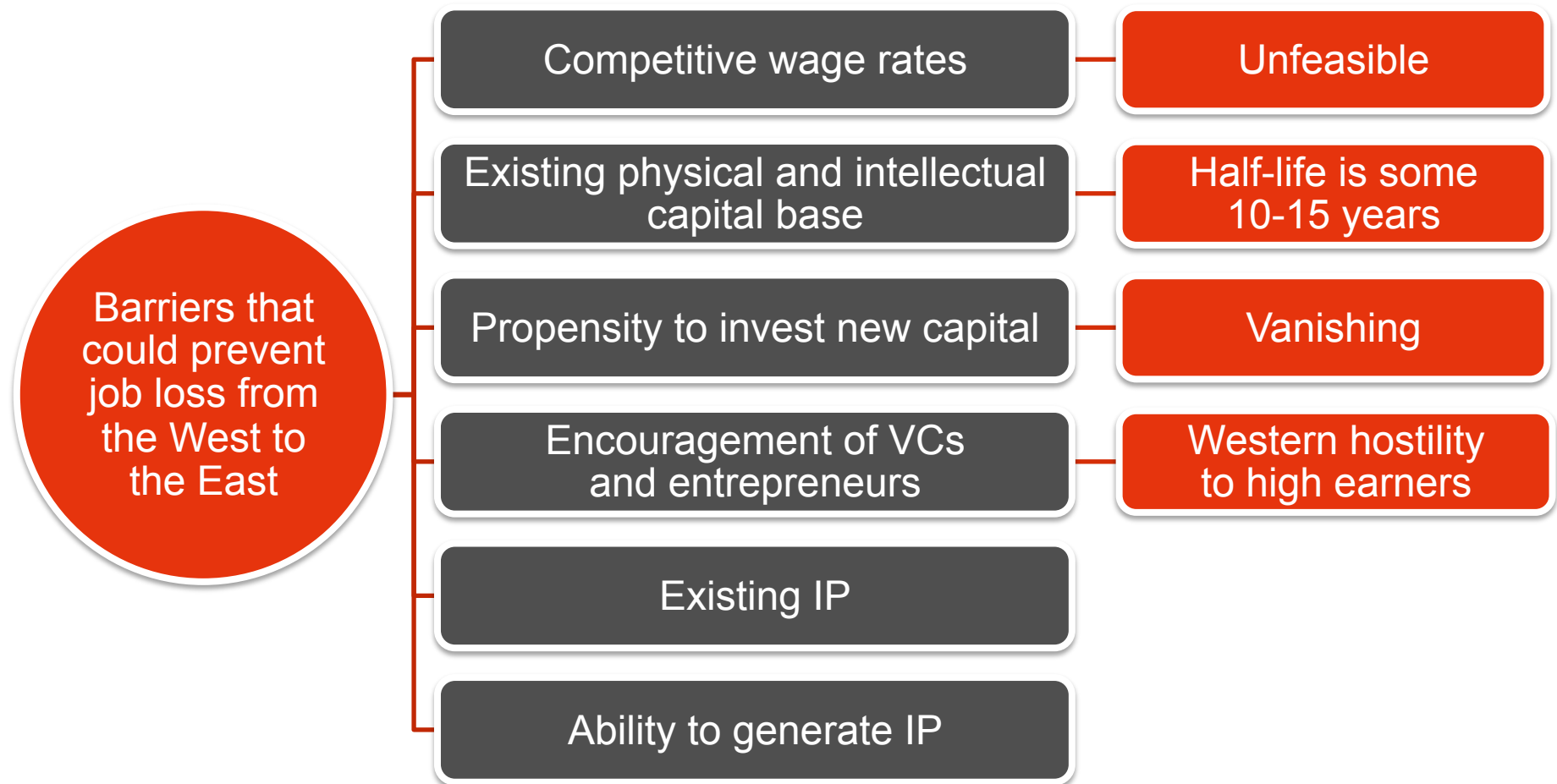
Nick Clegg, UK Deputy Prime Minister

“To get rich is glorious”

致富光荣

zhìfù guāngróng

Deng Xiaoping, Former Leader of the People's Republic of China



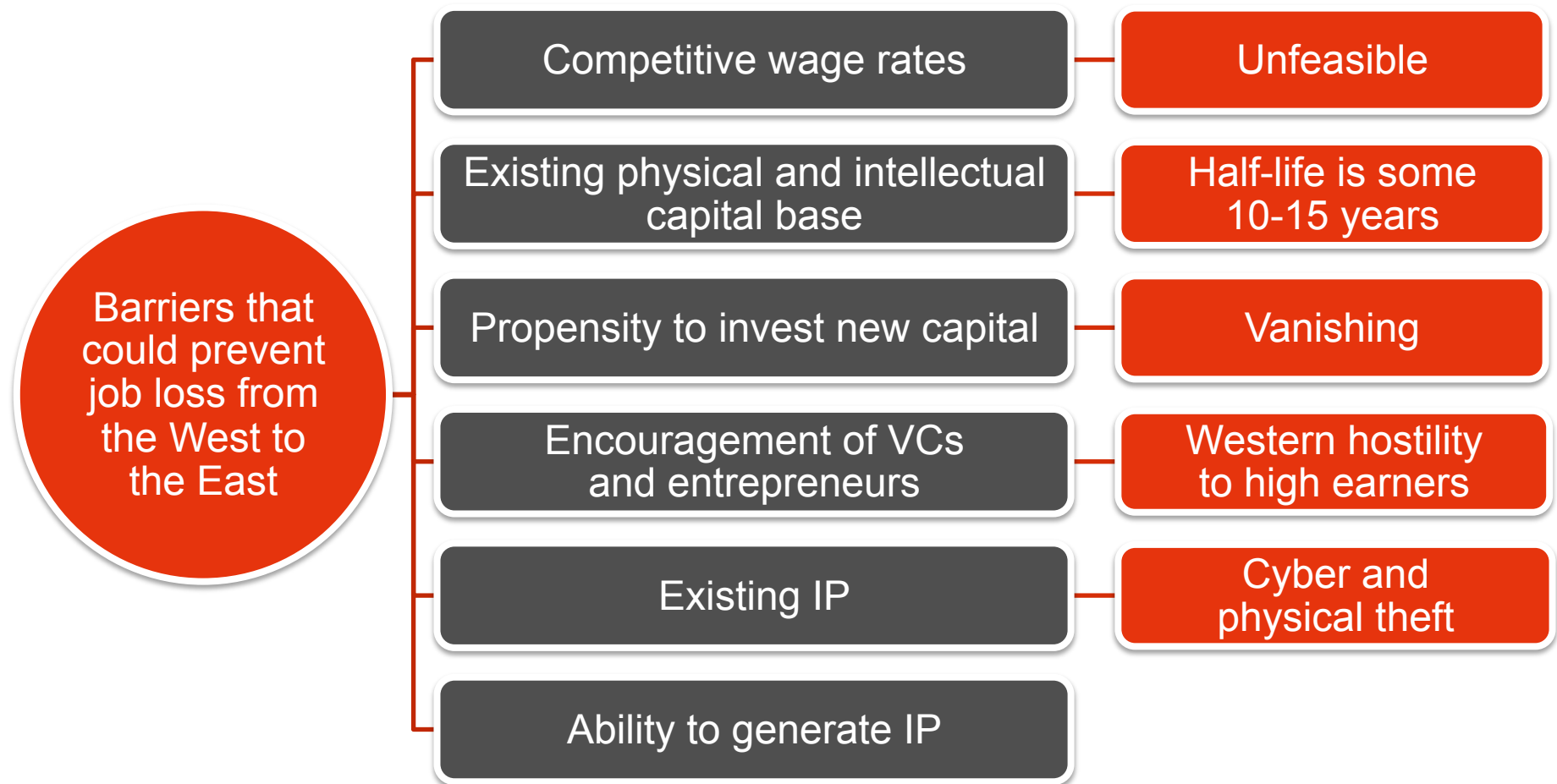
The West has been haemorrhaging intellectual property,
with little sign of abatement:

Global value of counterfeit and pirated goods (2015): \$1.5 trillion...
Known jobs lost due to counterfeiting and piracy: 2.5 million.

Source: Frontier Economics, *Estimating the global economic and social impacts of counterfeiting and piracy* (Feb 2011)

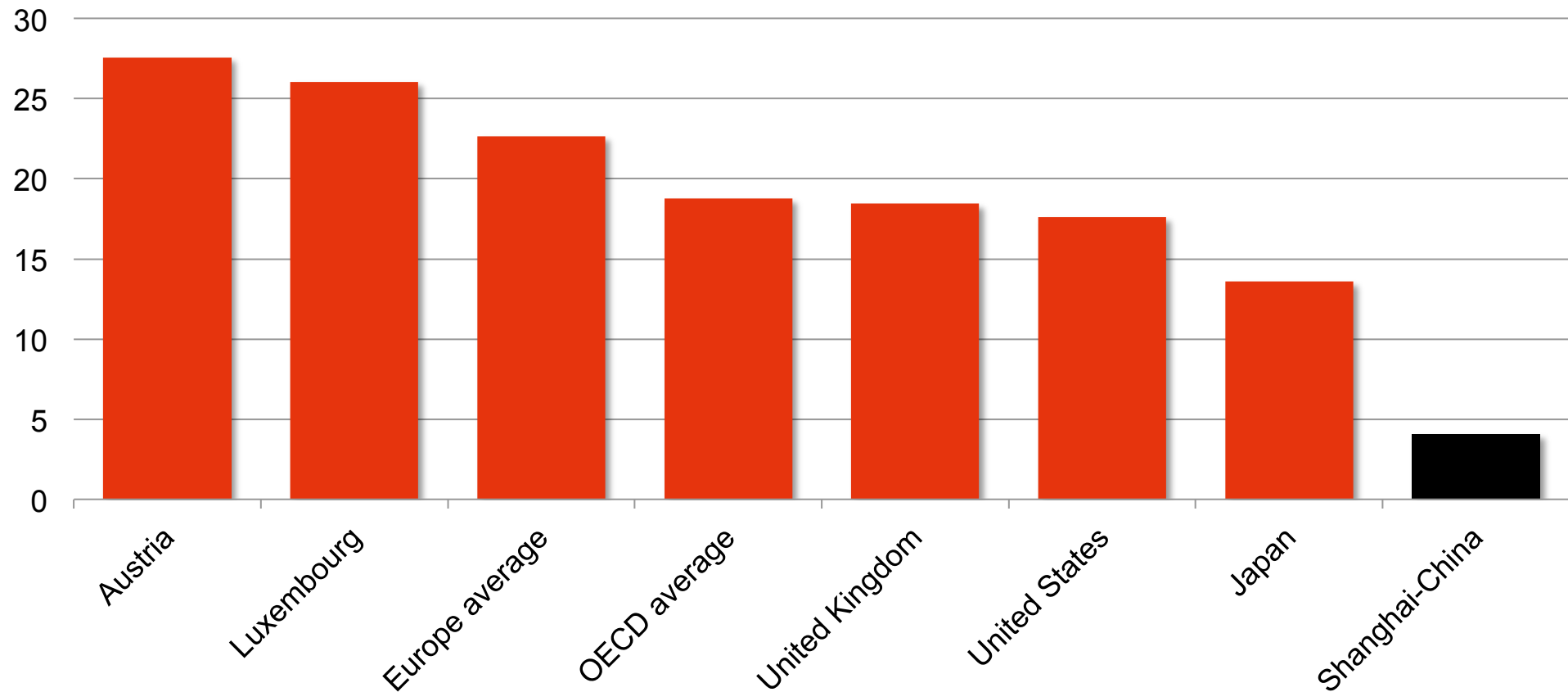
“The Chinese government has a national policy of economic espionage in cyberspace... Although a rigorous assessment has not been done, we think it is safe to say [this] easily means billions of dollars and millions of jobs. ”

Source: Mike McConnell, Director of National Intelligence (2007-09), Michael Chertoff, Secretary of Homeland Security (2005-09), William Lynn, Deputy Secretary of Defense (2009-11), *Wall Street Journal* (Jan 27 2012)



A fifth of Western school leavers are functionally illiterate:

Percentage of students who do not attain the essential reading skills needed to participate productively in society



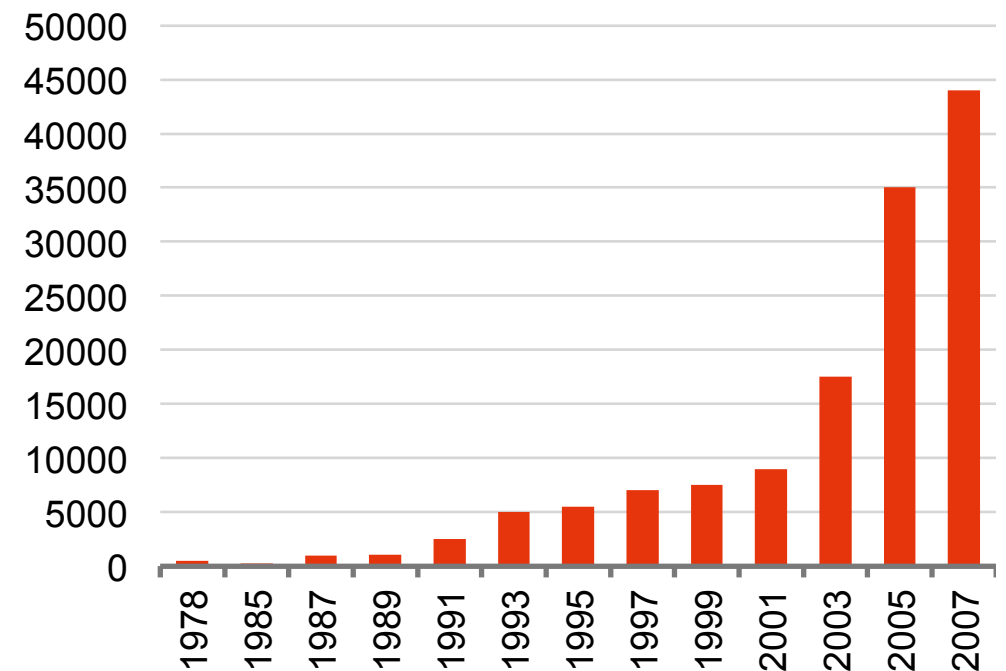
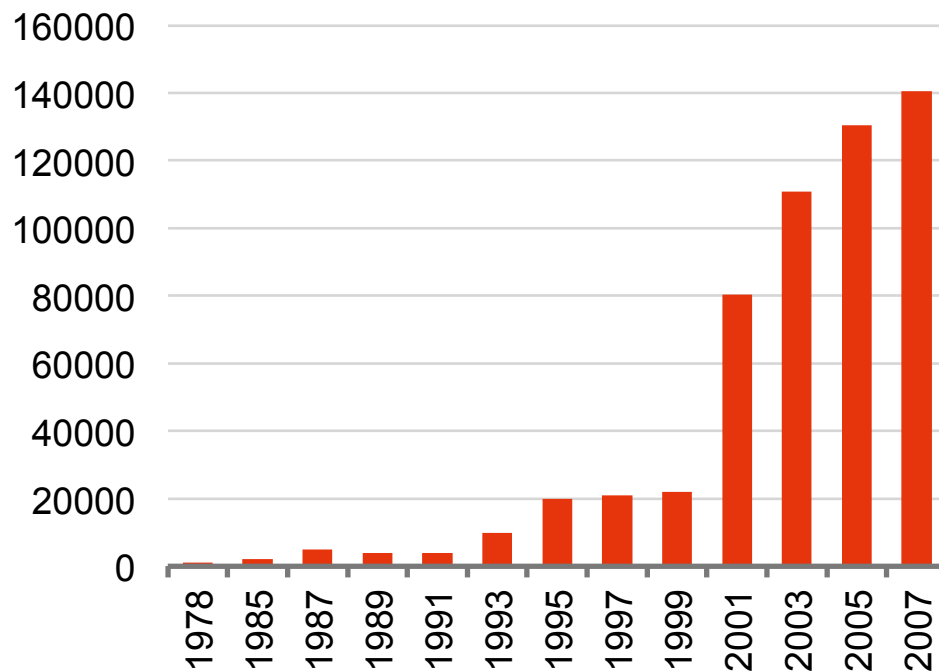
Source: OECD PISA 2009.

The Chinese take advantage of the best education in the West:

1978 - 2007

Number of Chinese students studying abroad

Number of Chinese students returning home

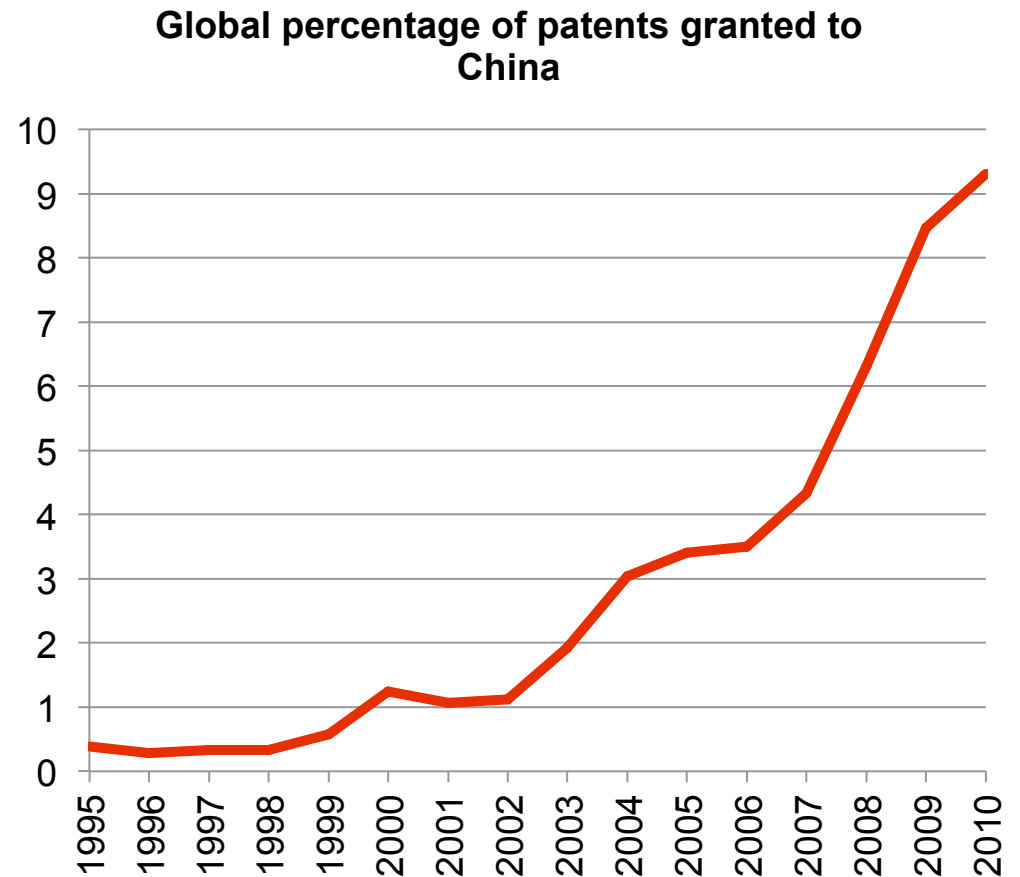
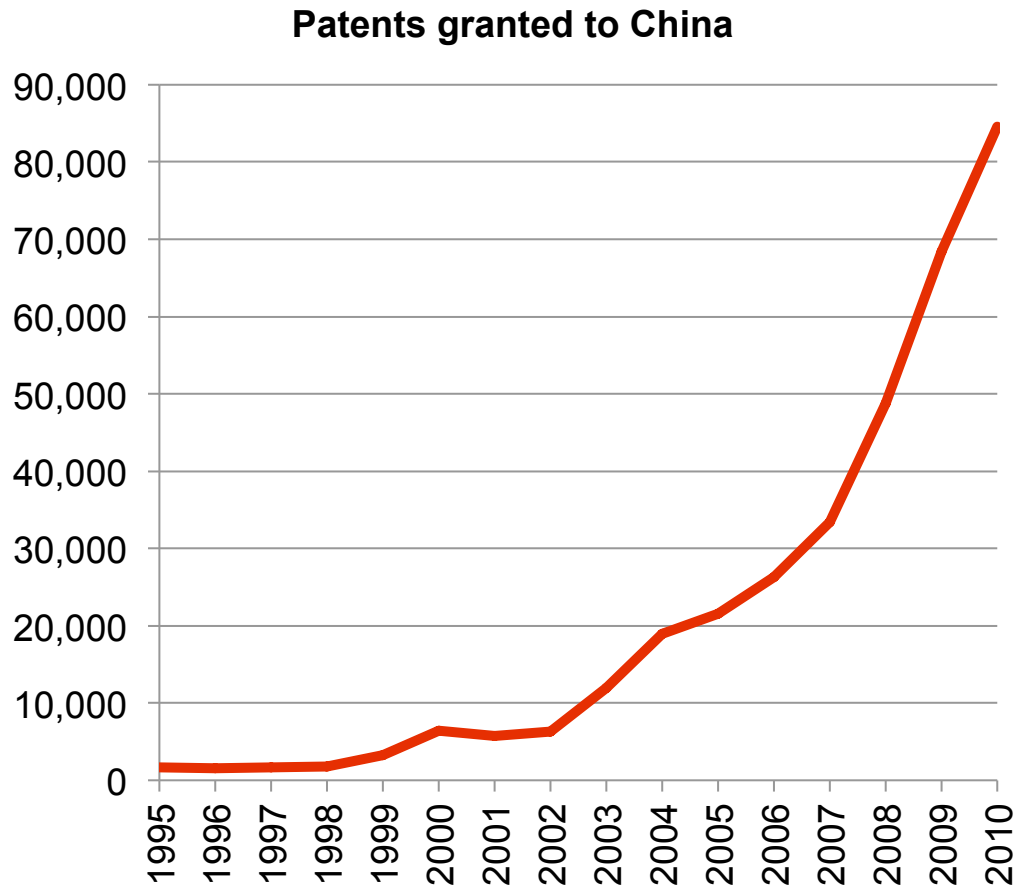


Source: National Bureau of Statistics of China, 2009; Tina Hsieh and Ershad Ali, Auckland Institute of Studies.

“When our thousands of Chinese students abroad return home, you will see how China will transform itself.”

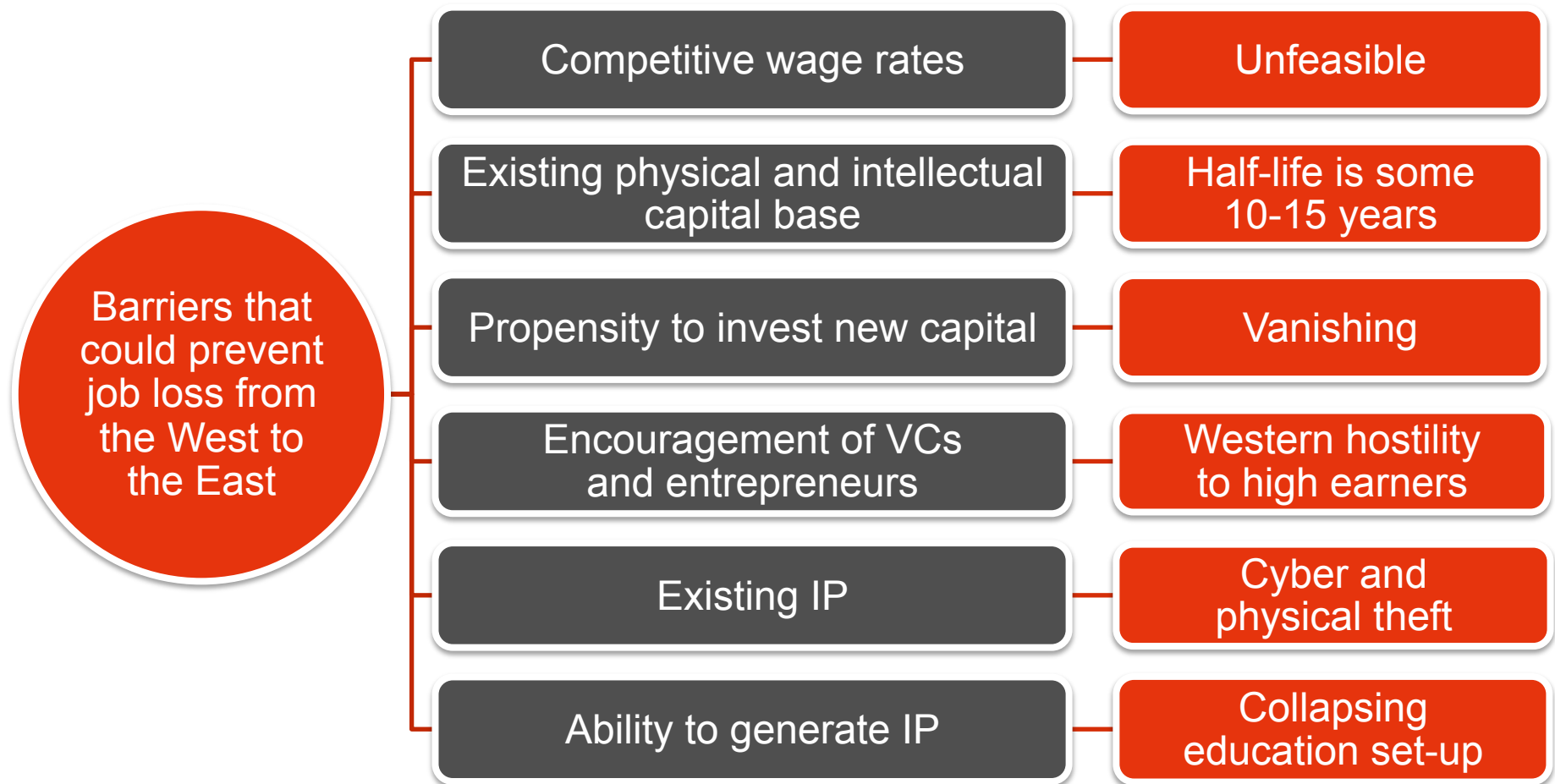
Deng Xiaoping, Former Leader of the People's Republic of China

And, indeed, they are innovating:



China's universities graduate more than 10,000 science PhDs each year.

Source: World Intellectual Property Organization, McKinsey Quarterly.



A global wage disparity...

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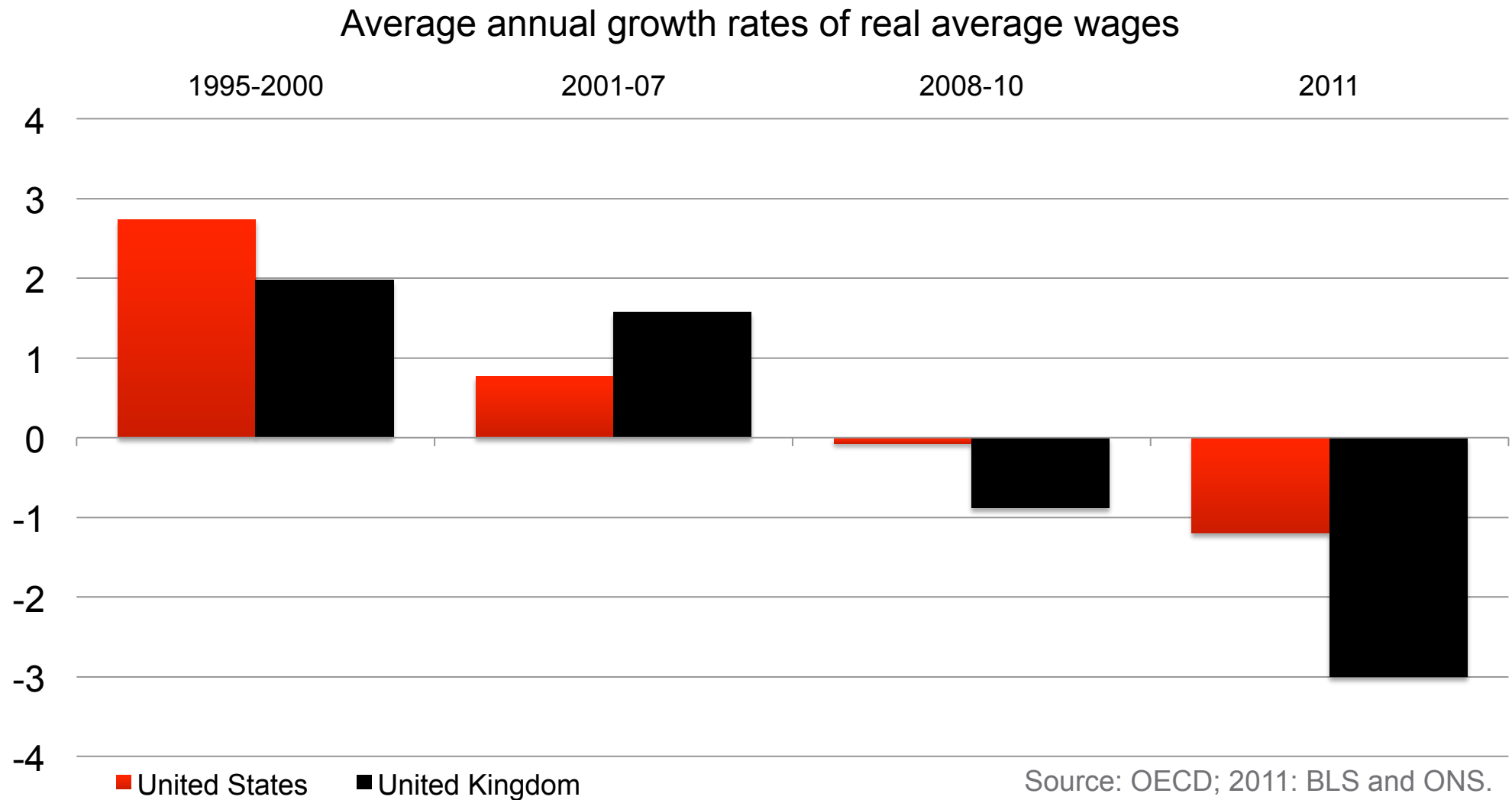
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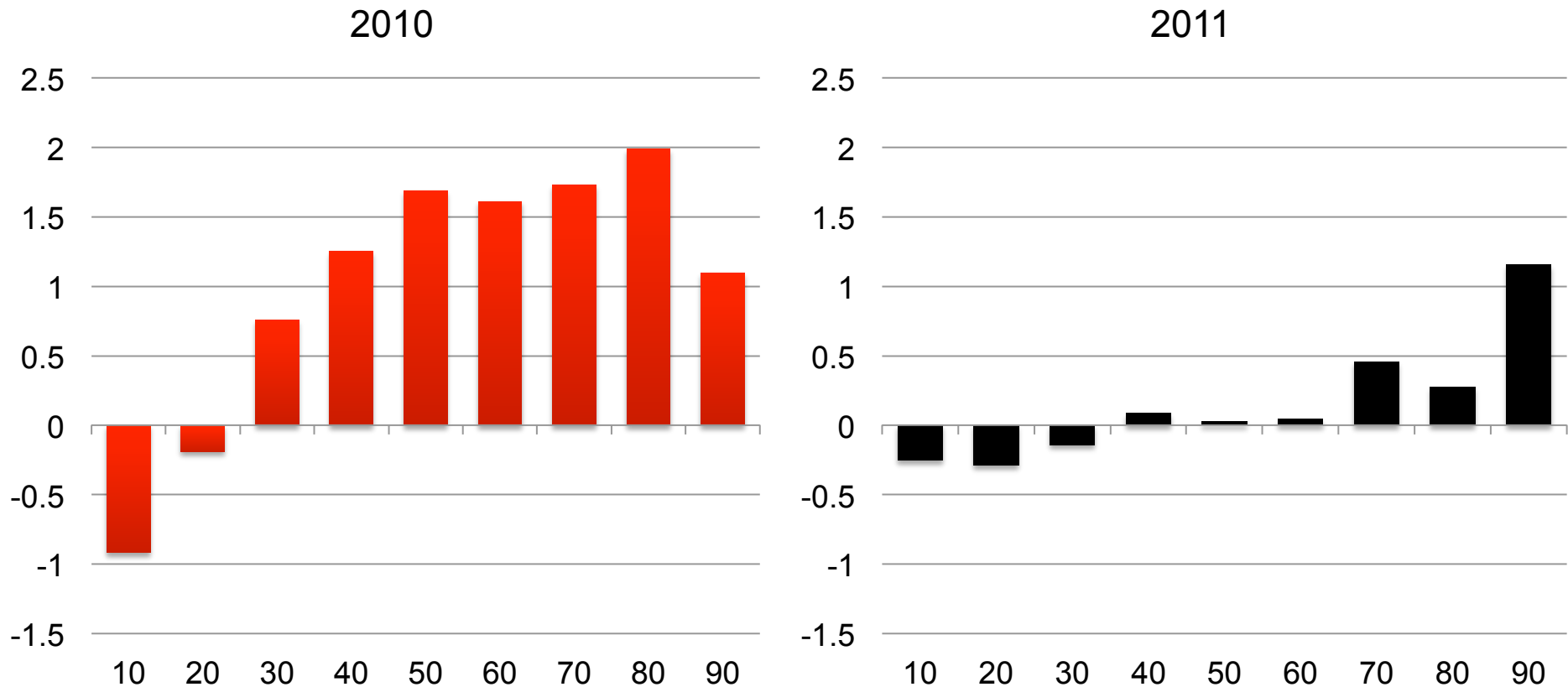
With no job supply, i.e. less demand for labour, wages in the OECD must inevitably fall.

In the West, average wages have plummeted
- from 3% real annual increases to 3% real annual declines:



Precisely as one would expect, it is the low- and medium-skilled workers who are losing out, while the most skilled retain their comparative advantage:

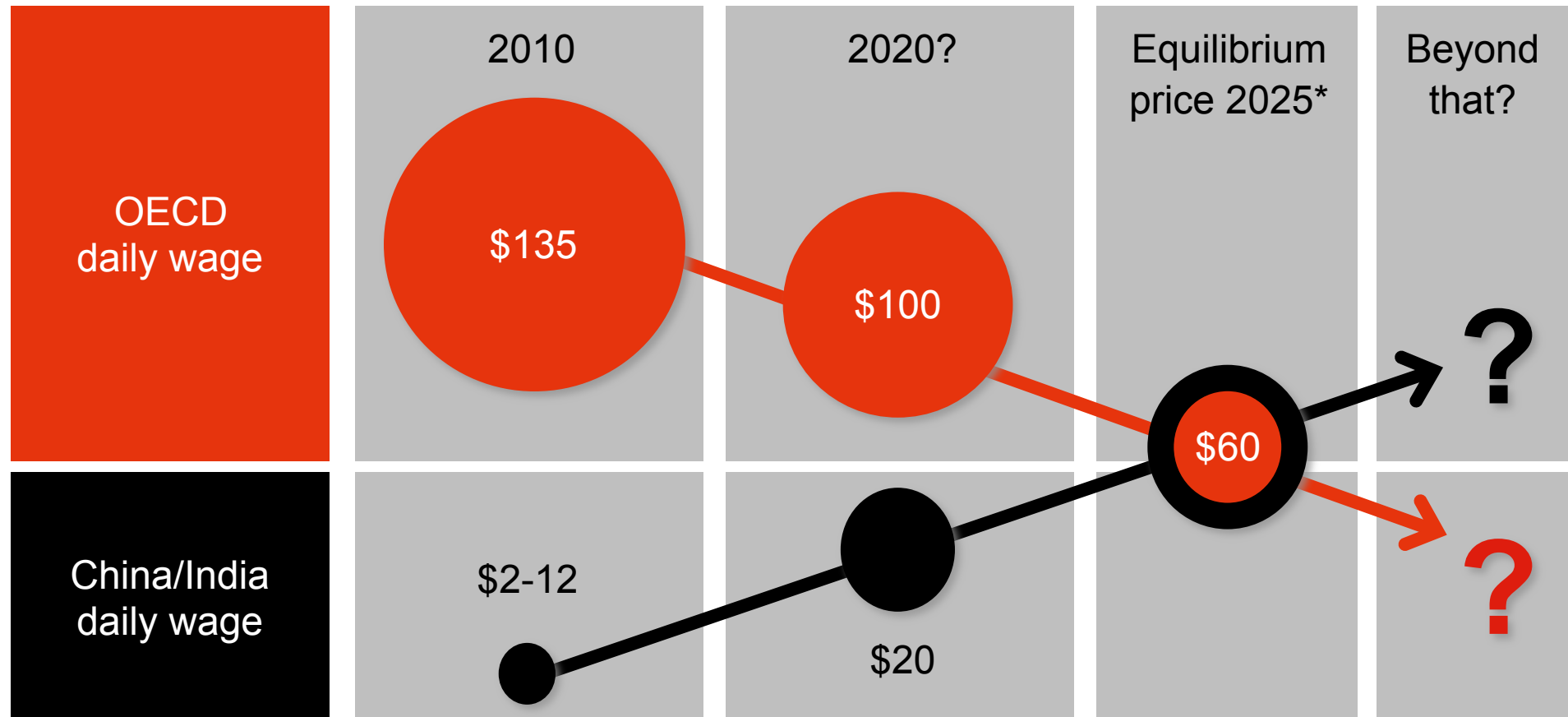
Annual percentage change in nominal weekly pay in UK by pay percentile



Note that inflation in the UK has been 5%, so wages are in fact plummeting.

Source: Annual Survey of Hours and Earnings (2009, 2010, 2011) UK Office for National Statistics.

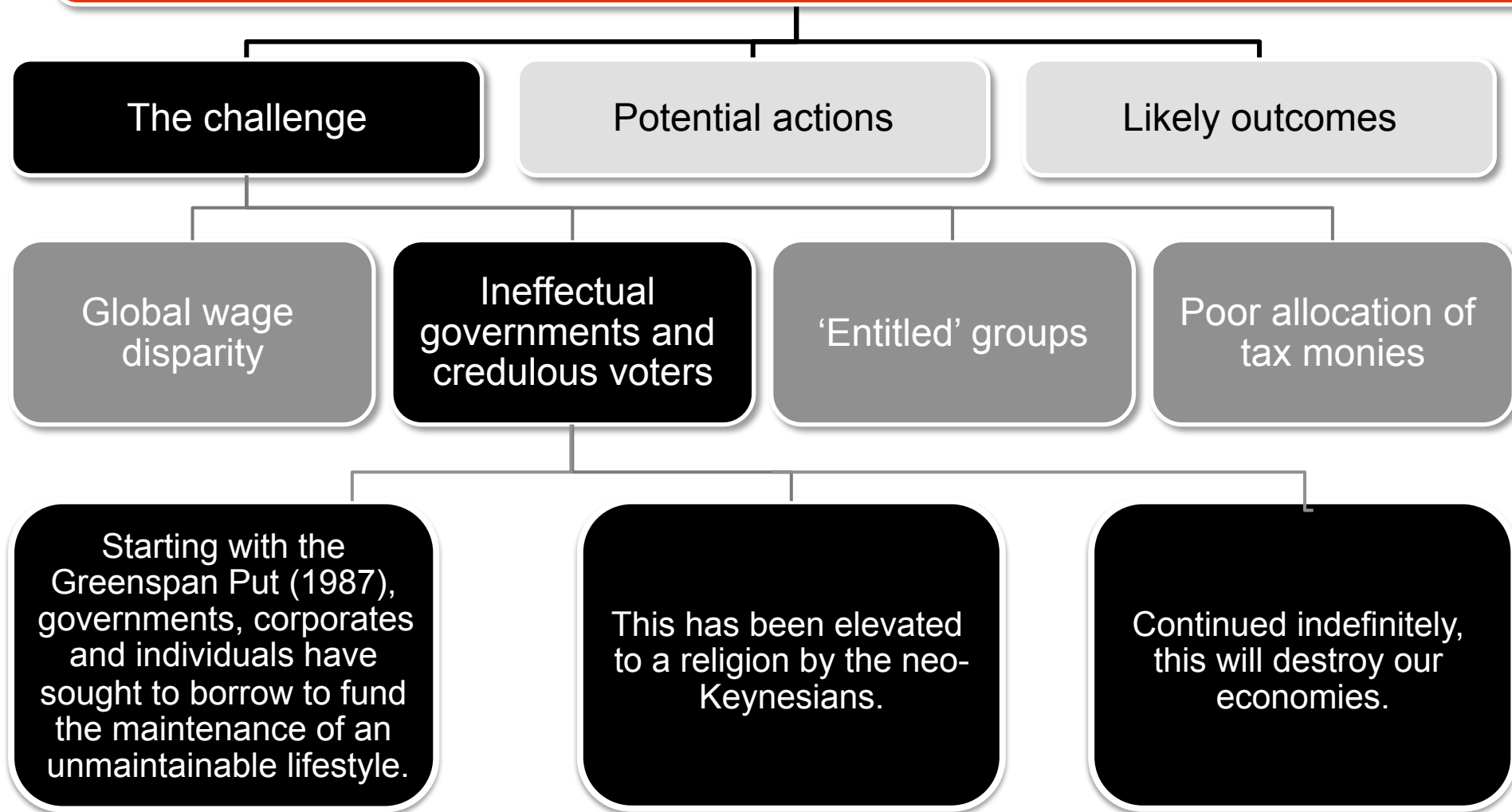
We have every reason to think the trend will continue, leading to enormous downward adjustment, disruption and dislocation for Western workers:



Inflation and currency collapse seem to be the most likely ways by which this process will be managed in the medium term

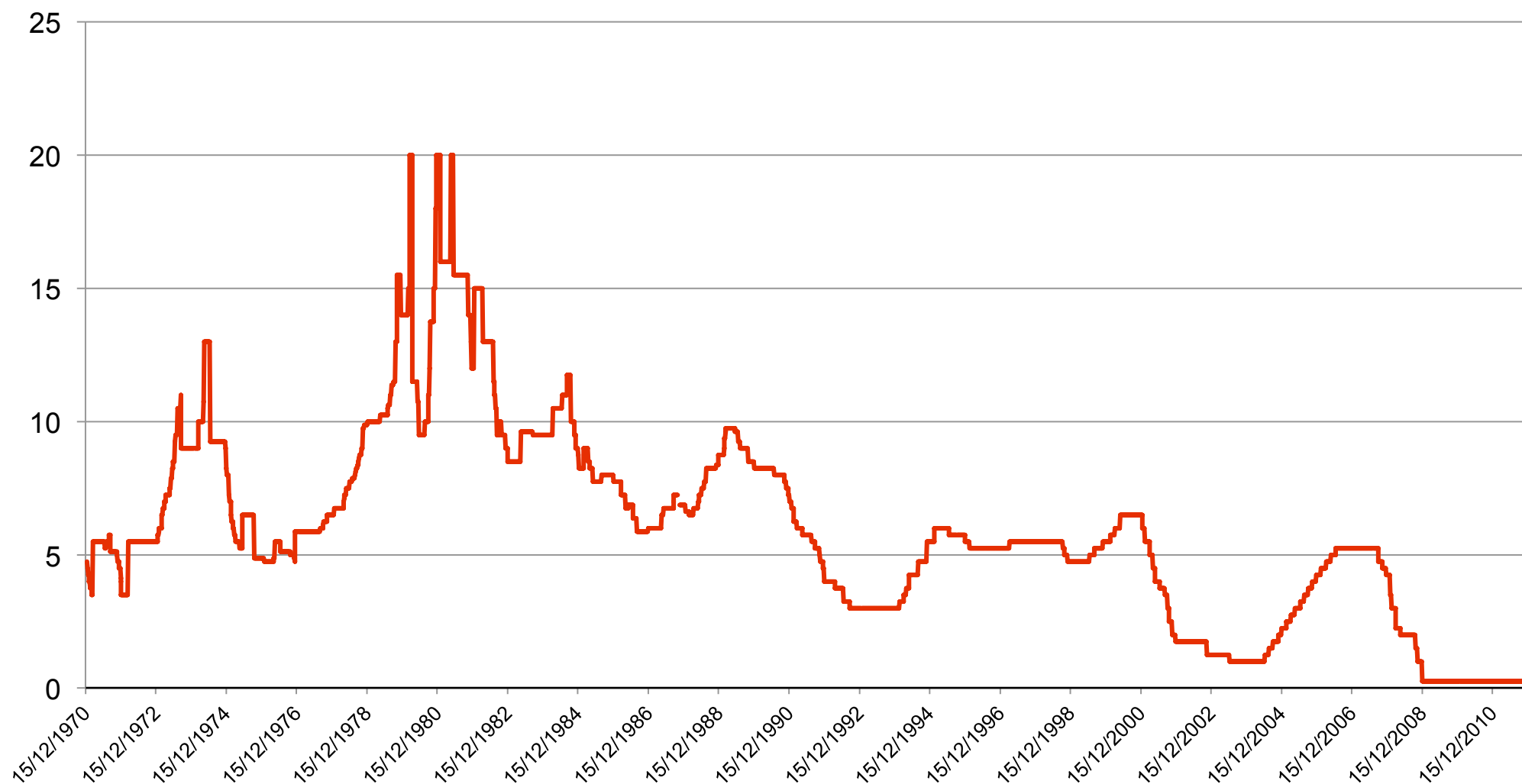
* Assumes annual world GDP growth rate of 5%; constant prices.

The continued economic decline of the West

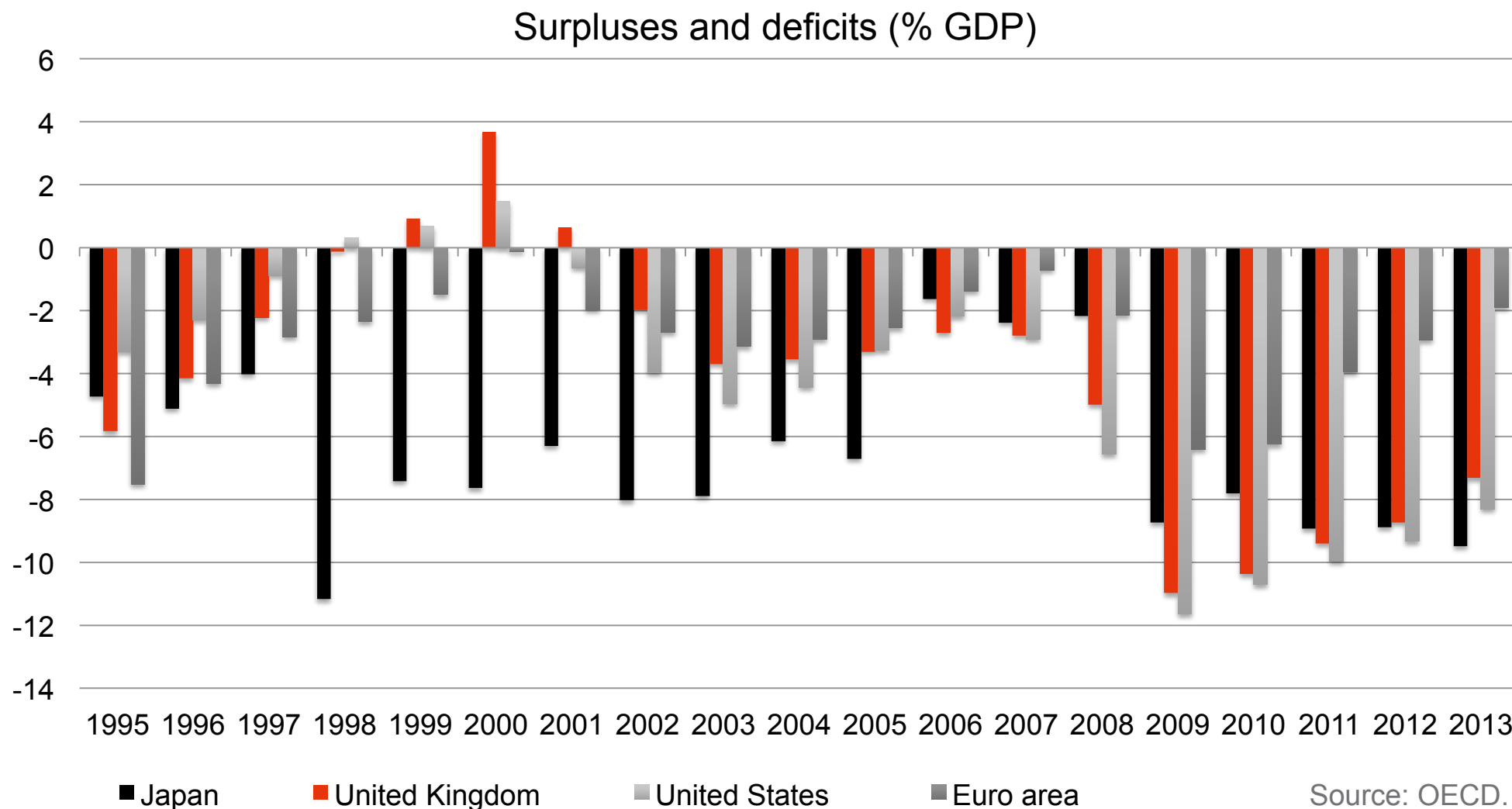


Since 1987, the response to any economic downturn has been to flood the system with cheap money:

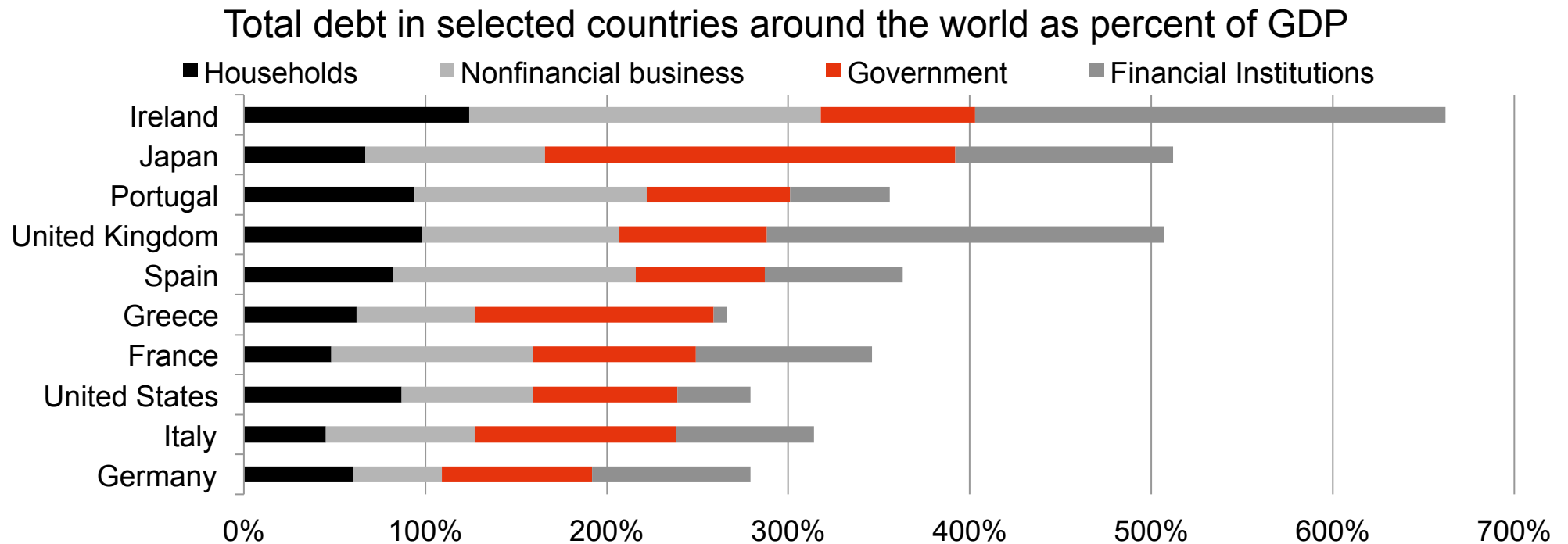
Fed Rate



For today's Keynesians, there seems never to be a good time to run a surplus:



The result of low interest rates ('easy money') and government deficits is staggering levels of debt:



Source: McKinsey Global Institute (MGI), "Debt and deleveraging: Uneven progress on the path to growth," January 2012.

"The relationship between government debt and real GDP growth is weak for debt/GDP ratios below a threshold of 90 percent of GDP. Above 90 percent, median growth rates fall by one percent, and average growth falls considerably more."

Reinhart and Rogoff, 'Growth in a Time of Debt', *American Economic Review* (May 2010)

All are agreed: we should spend our way out of this.

“Unfortunately, with savings going up to 5, 6, 7 percent, aggregate demand is going to be weak. **The only thing to fill it is government.**”

Joseph Stiglitz, Aug 4 2010

“Standard macroeconomic analysis, applied in a standard way, says that **aggressive tightening of fiscal policy**, of the kind we are seeing now, is **inappropriate and unnecessary.**”

Jonathan Portes, *New Statesman* Aug 24 2011

“The idea, amazingly widely accepted, that the UK cannot **borrow any more** seems **quite absurd.**”

Martin Wolf, *Financial Times* Nov 24 2011

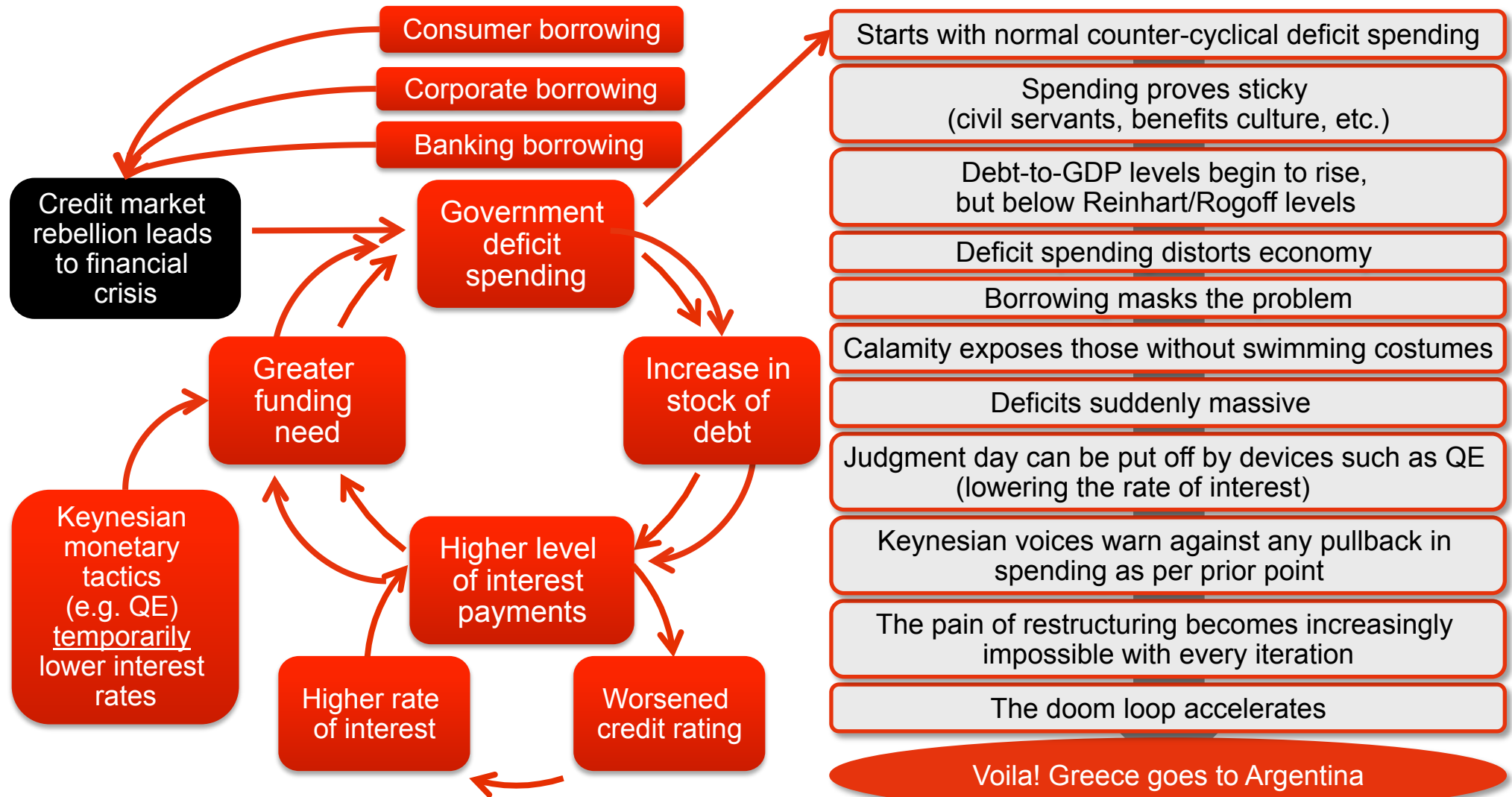
“Isn't the truth of the matter, Mr Alexander, that you are collaborating in a **doctrinaire Conservative experiment** which is not working?”

Jeremy Paxman, *Newsnight* Jan 25 2012

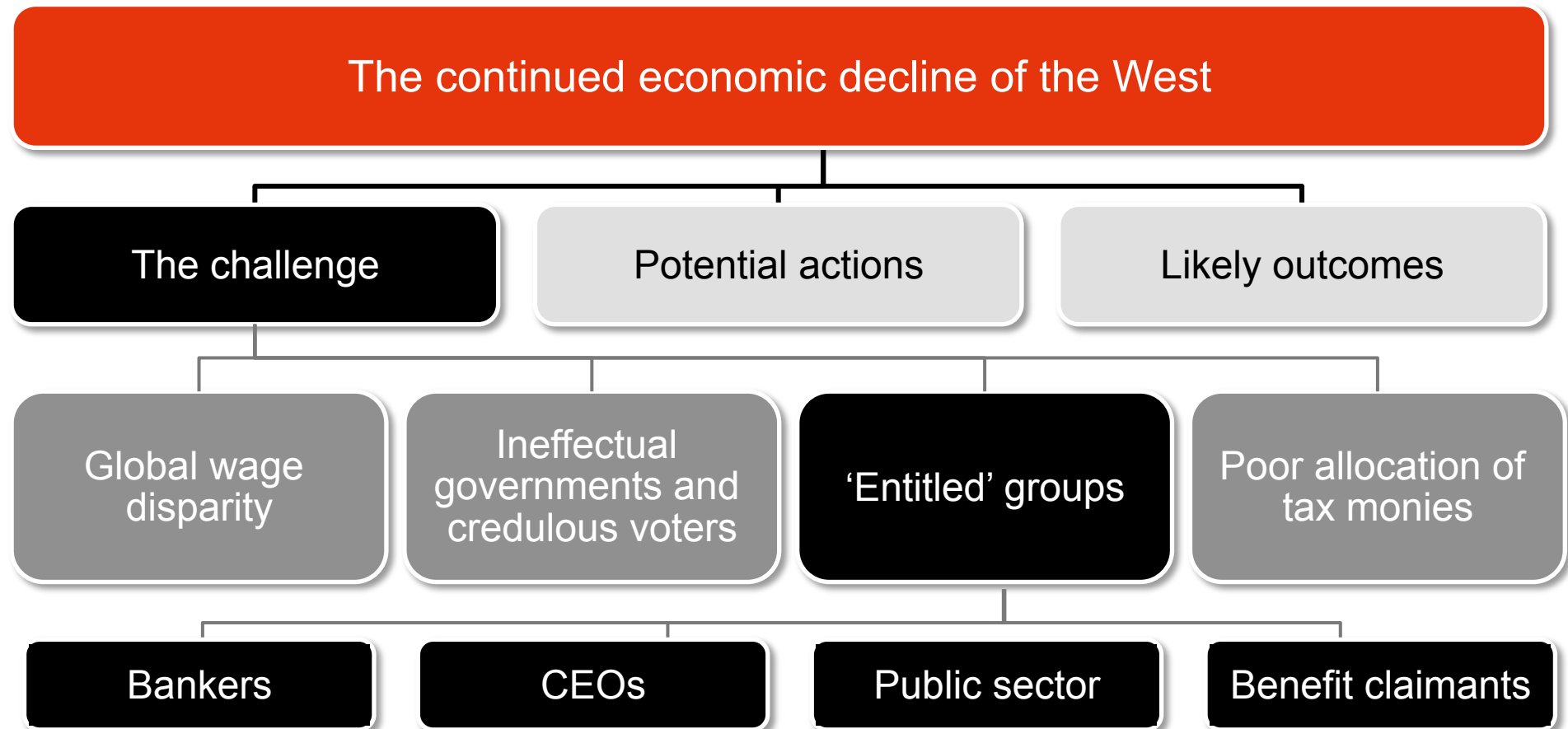
“That which cannot go on forever... won't.”

Herb Stein's Law

Indebtedness becomes a vicious downward spiral, Keynes à la grecque



The problems are exacerbated by the claims made on shrinking Western economies by an oddly disparate set of 'entitled' groups:



The problems are exacerbated by the claims made on shrinking Western economies by an oddly disparate set of 'entitled' groups:

Bankers' sources of excess profits (that also lead to massive socialised losses)

Cheap funding from government stimulus

Oligopoly in many markets (corporate lending, mortgages, credit cards)

Foolish acceptance of high prices by customers where oligopoly does not exist

Excessive leverage

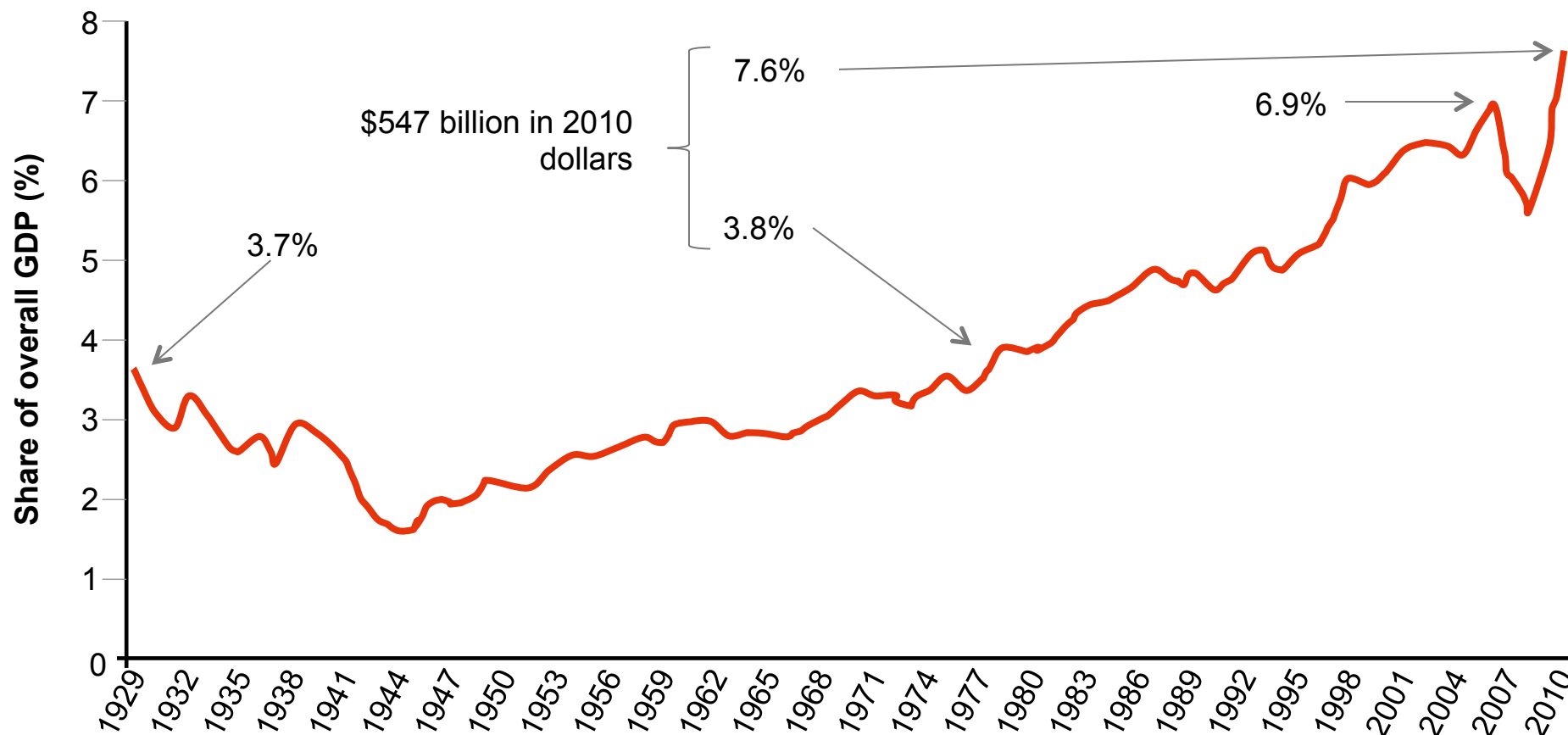
Inside trading knowledge

Big bet culture

Willingness of boards and shareholders to countenance excessive rewards, in particular, because the previous points create excessive profits

The financial sector has claimed a growing share of Western economies:

**Financial sector compensation and profits as share of GDP
1929 - 2010**

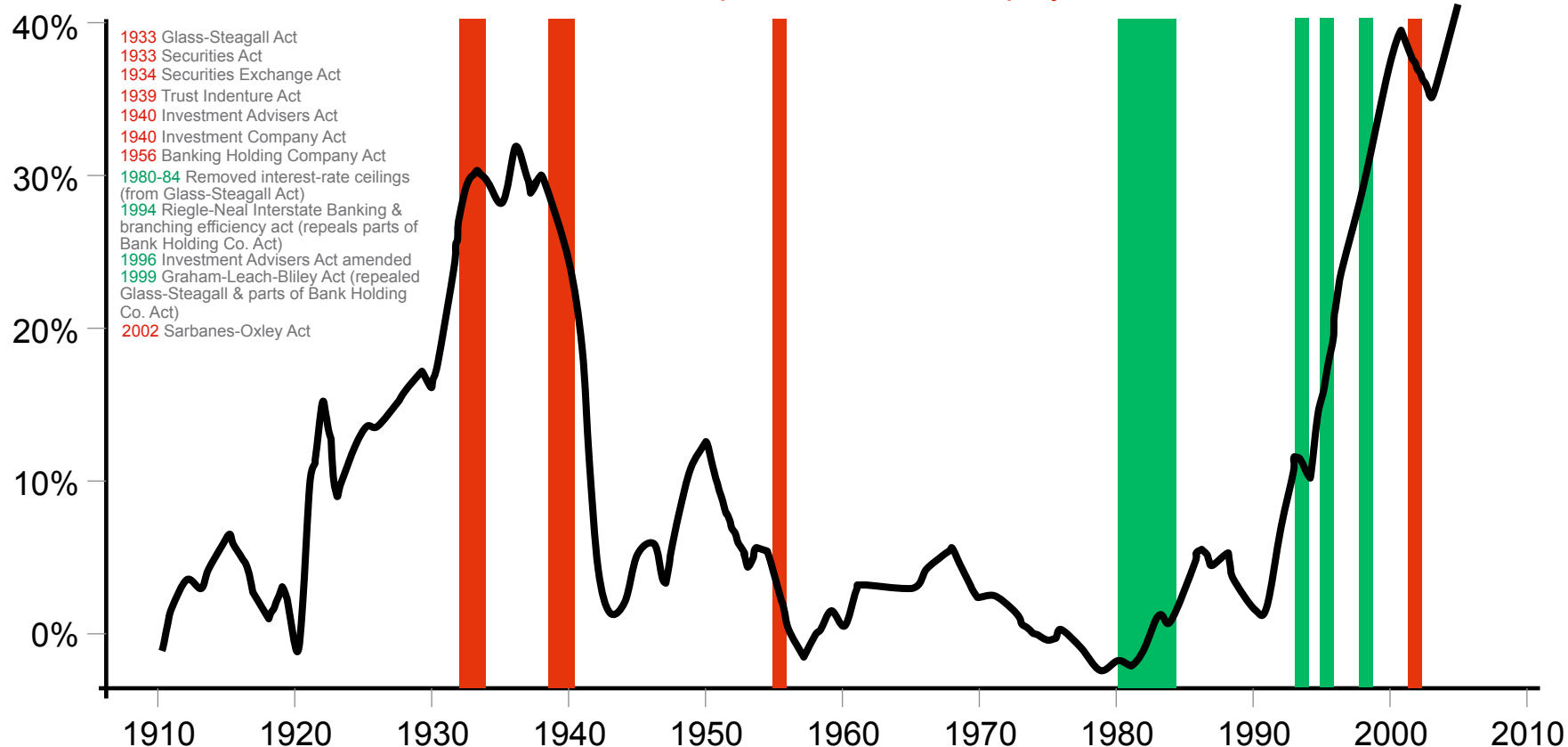


Source: Bureau of Economic Analysis (BEA) data on National Income and Product Accounts (NIPA), tables 1.1.5 and 1.1.4.

The excess profits in turn lead to excessive remuneration:

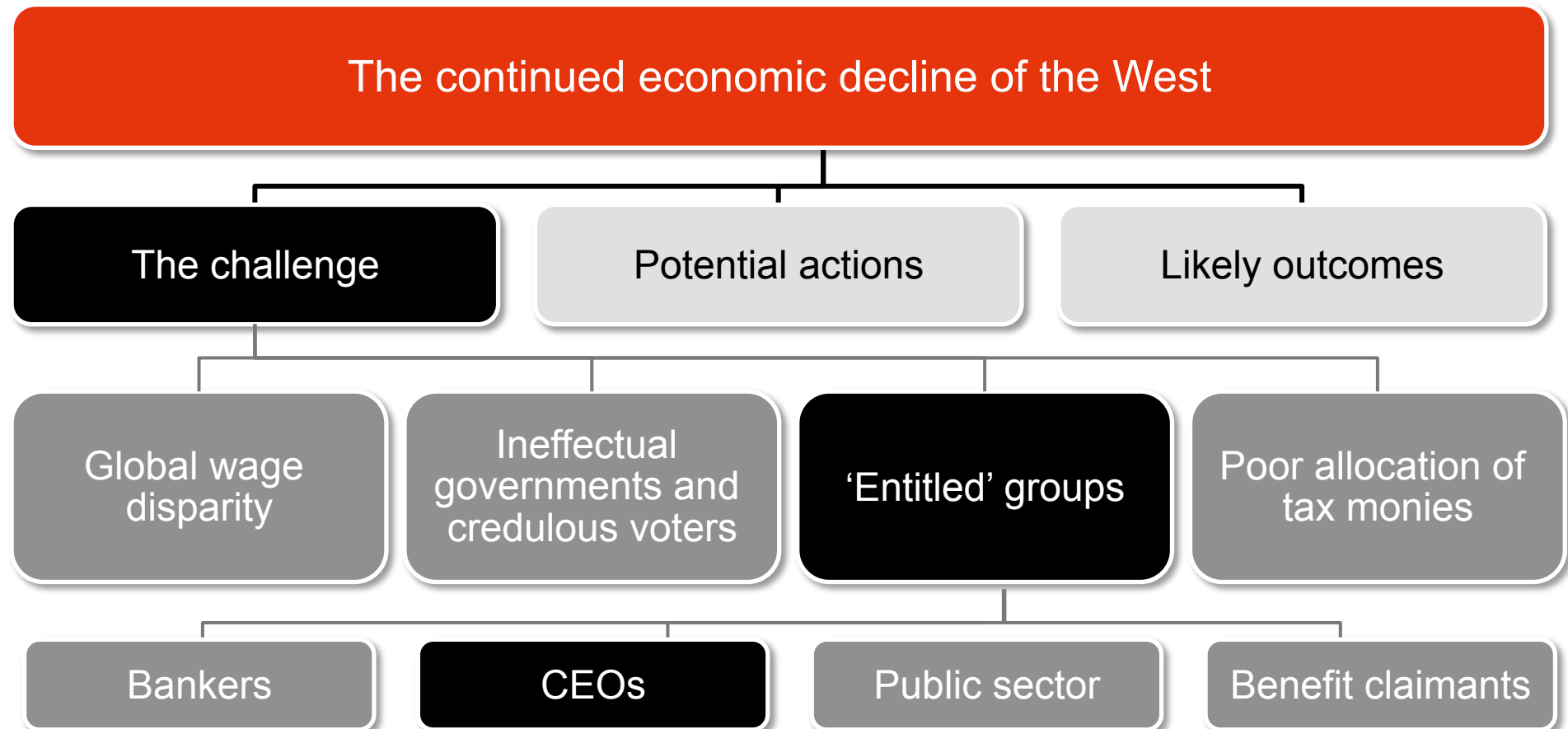
Historical excess wage in the financial sector

relative to nonfarm private sector, accounting for
education level, skill premium and unemployment risk



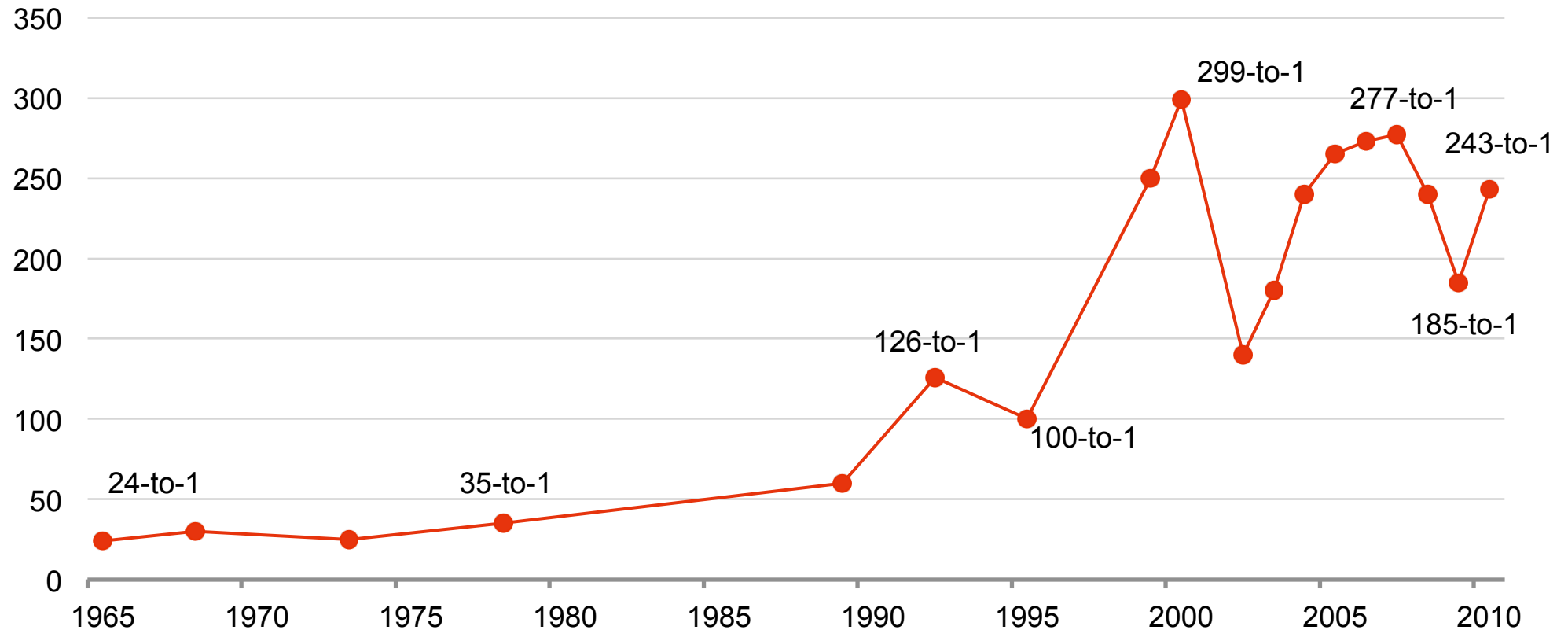
Source: Philippon and Reshef, *Wages and Human Capital in the U.S. Financial Industry: 1909-2006* (2008).

The problems are exacerbated by the claims made on shrinking Western economies by an oddly disparate set of 'entitled' groups:



CEOs in the US and the UK have also 'captured' their companies' remuneration processes:

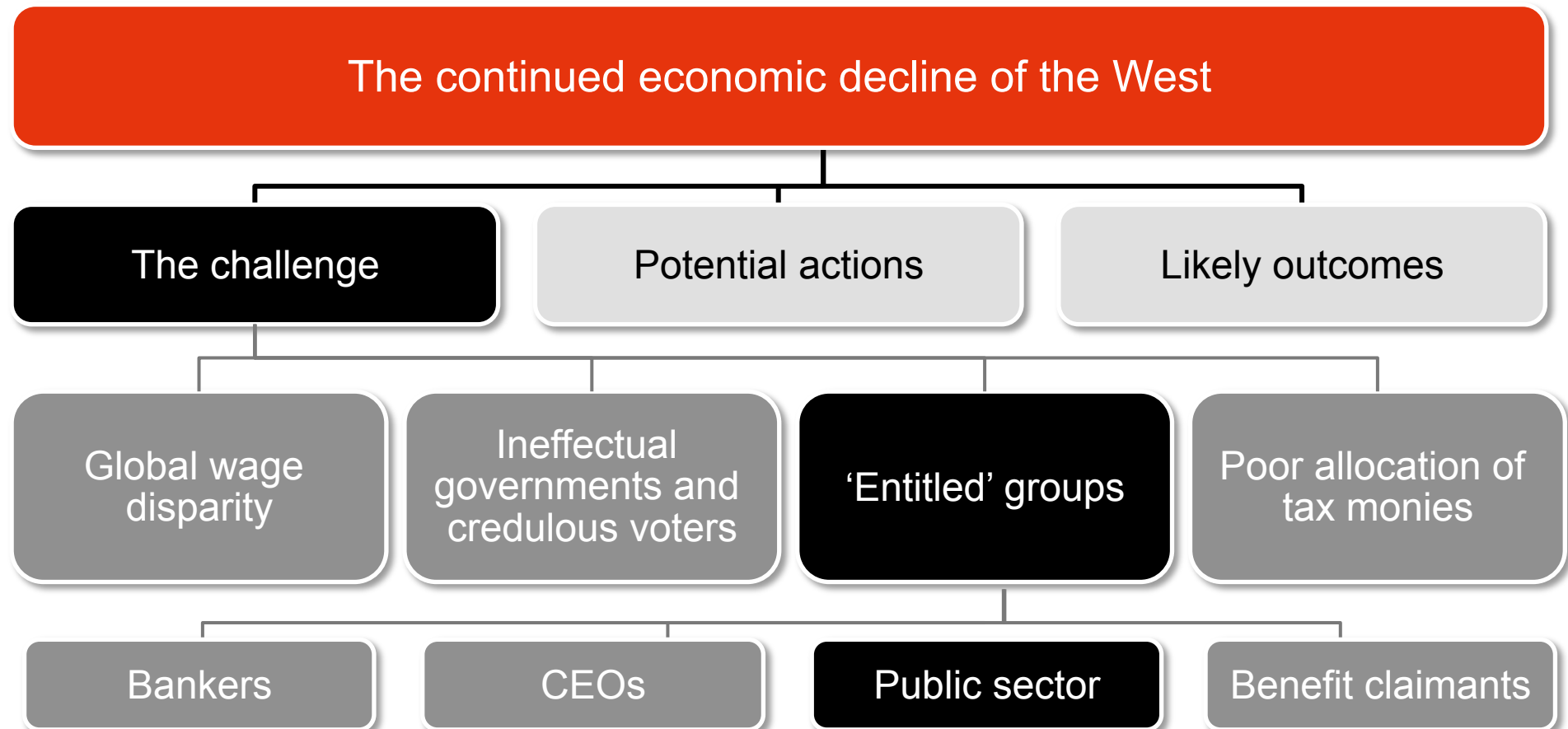
Ratio of average annual CEO compensation to average worker compensation, 1965-2010



Rectifying this would be important to ensure a cohesive society,
but the impact will be limited (too few CEOs).

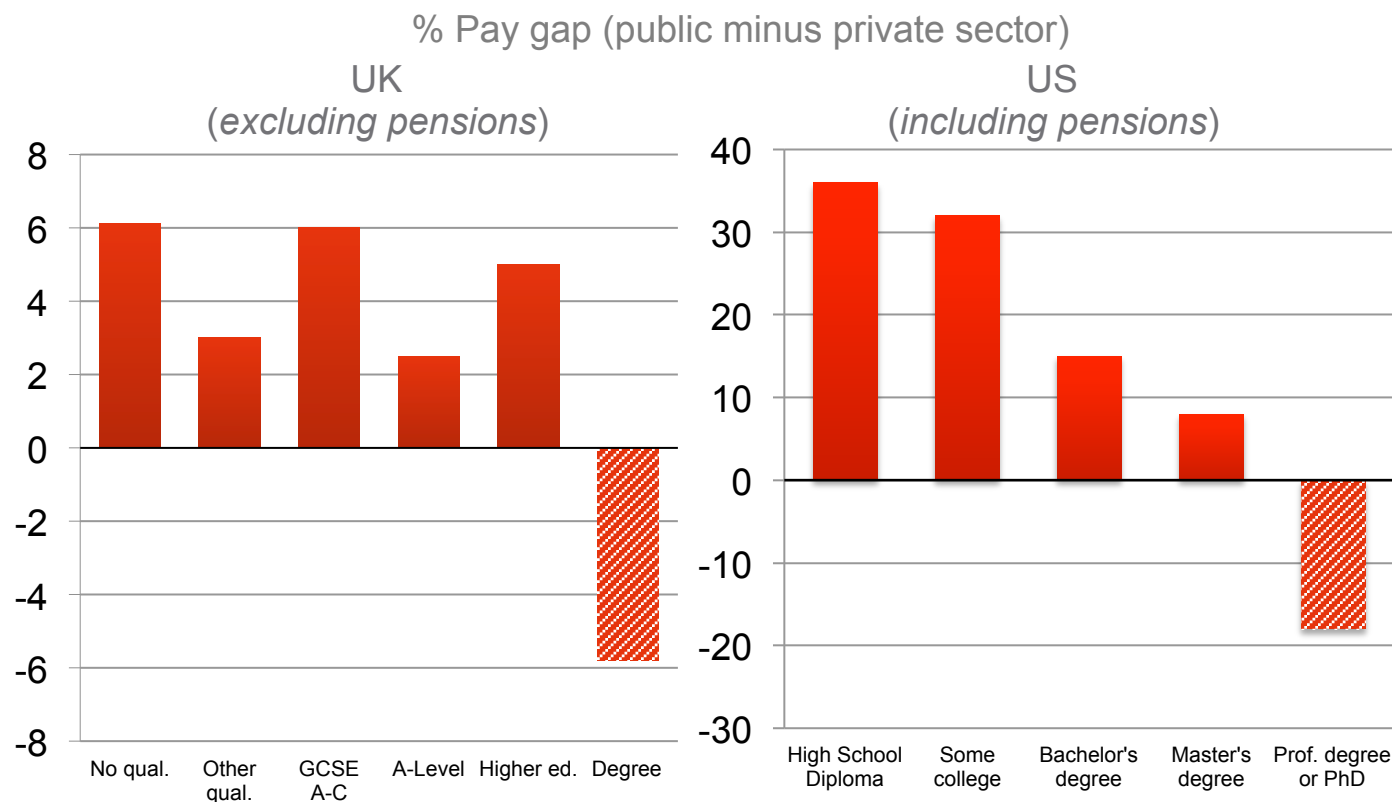
Source: Adapted from Lawrence Mishel and Josh Bivens, Economic Policy Institute *Briefing Paper #331* (2011).

The problems are exacerbated by the claims made on shrinking Western economies by an oddly disparate set of 'entitled' groups:



With the exception of the highest skilled,
public sector workers are significantly overpaid:

Average public/private sector pay gap by qualification



NB: UK analysis excludes pension contributions, so greatly understates the already large pay gap (private sector companies mostly no longer have DB schemes).

Source: ONS, Estimating differences in public and private sector pay (July 2011);
CBO, Comparing the compensation of federal and private-sector employees (Jan 2012).

The government's
own conclusion:

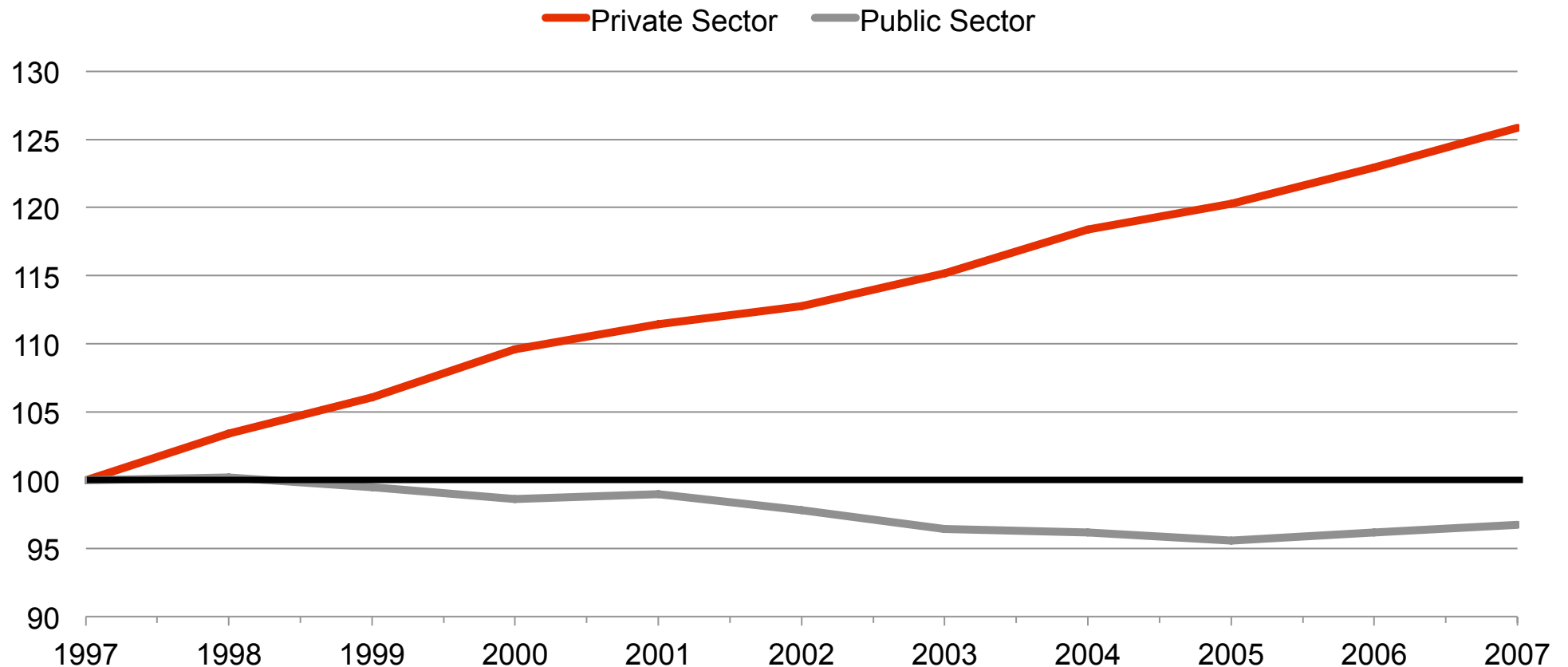
“Allowing for [job] differences as far as possible, in April 2010, public sector employees were paid on average **7.8 per cent more** than private sector employees.”

Source: ONS.

Public sector workers are also getting less productive, while the private sector company necessarily finds improvements, or closes down. Thus the public sector is becoming a heavier and heavier drag on the public purse:

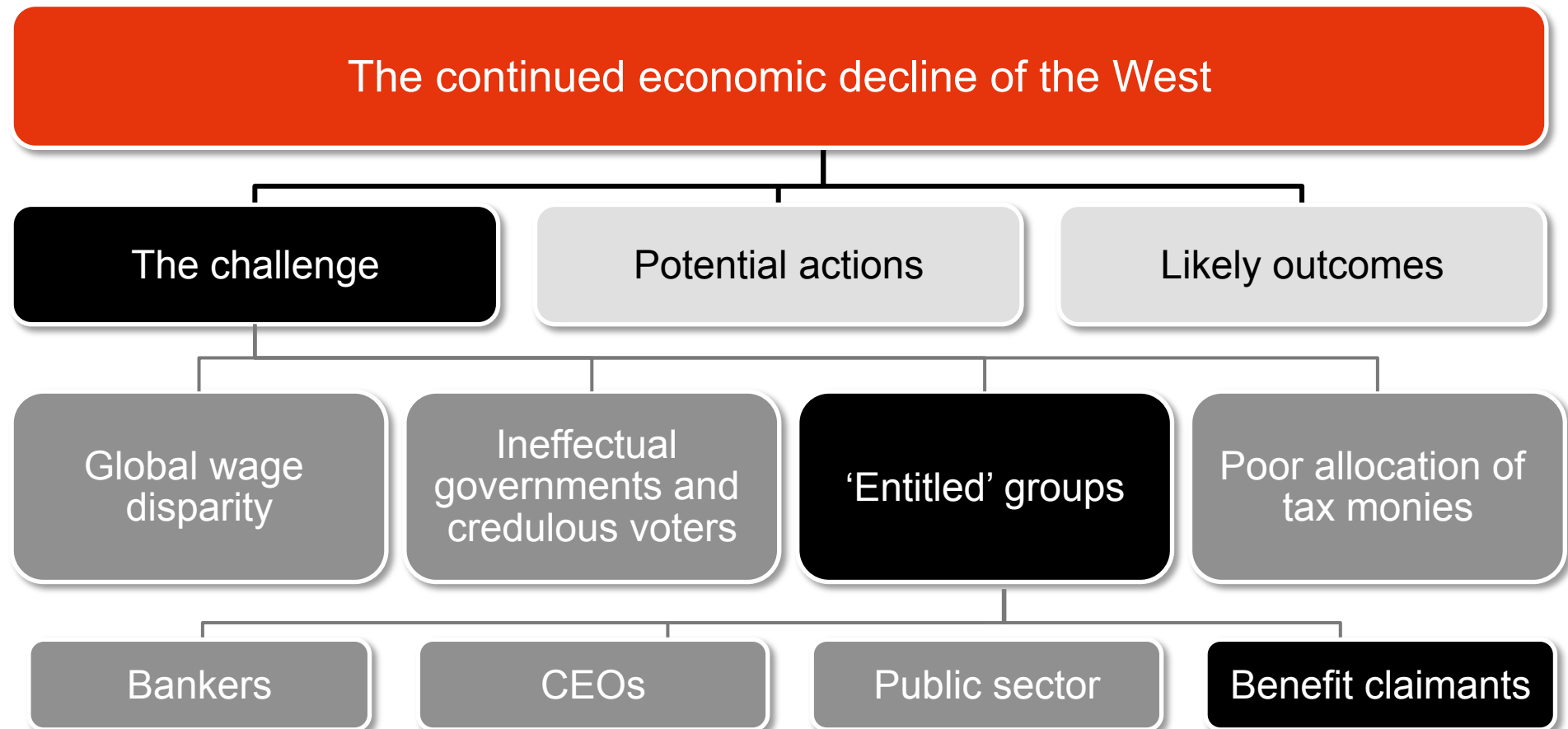
Public sector...

Annual growth in productivity in the UK (1997 = 100)



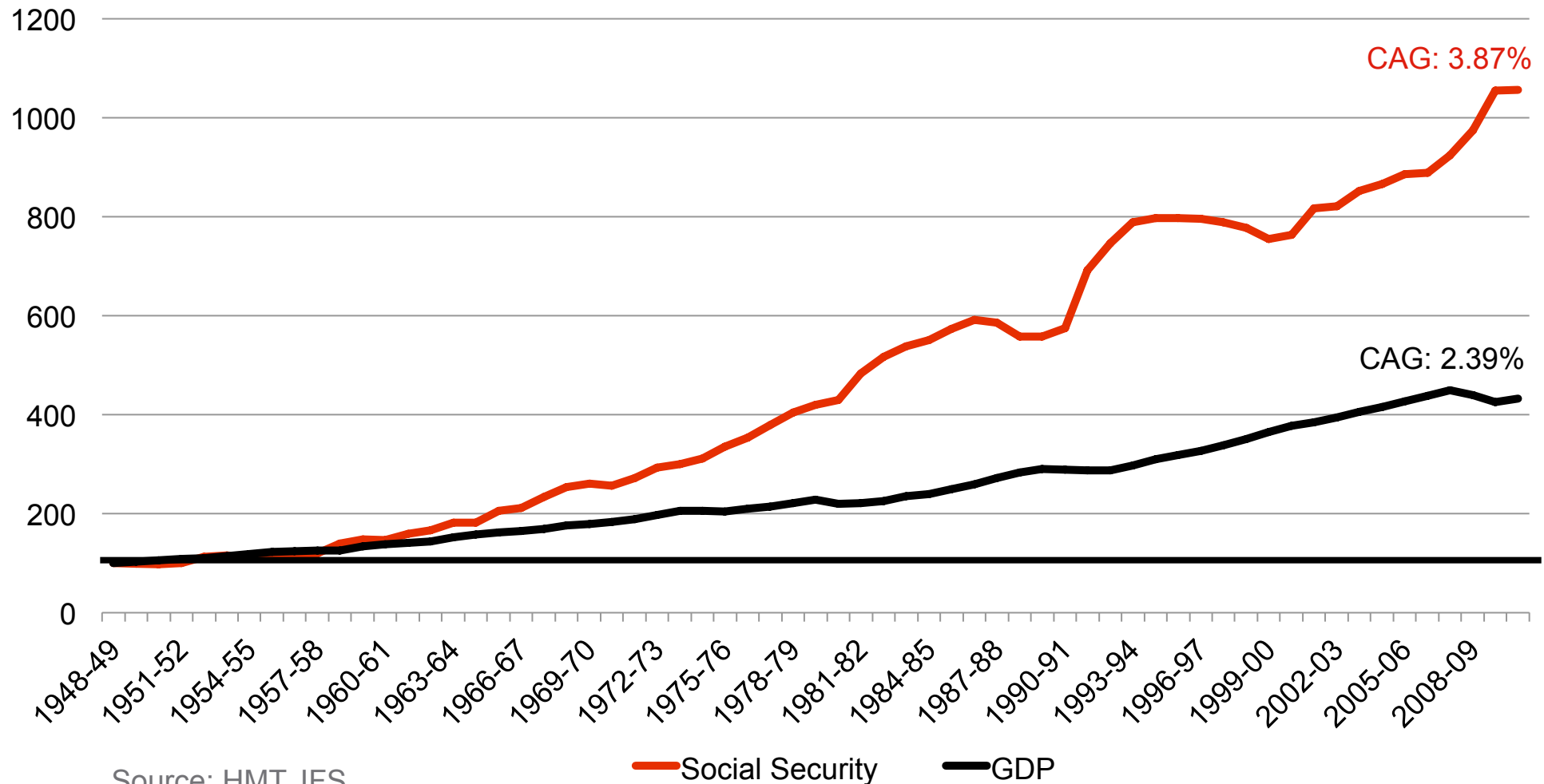
Source: ONS, *Estimating differences in public and private sector pay* (July 2011).

The problems are exacerbated by the claims made on shrinking Western economies by an oddly disparate set of 'entitled' groups:



Real spending on welfare continues to outstrip GDP growth:

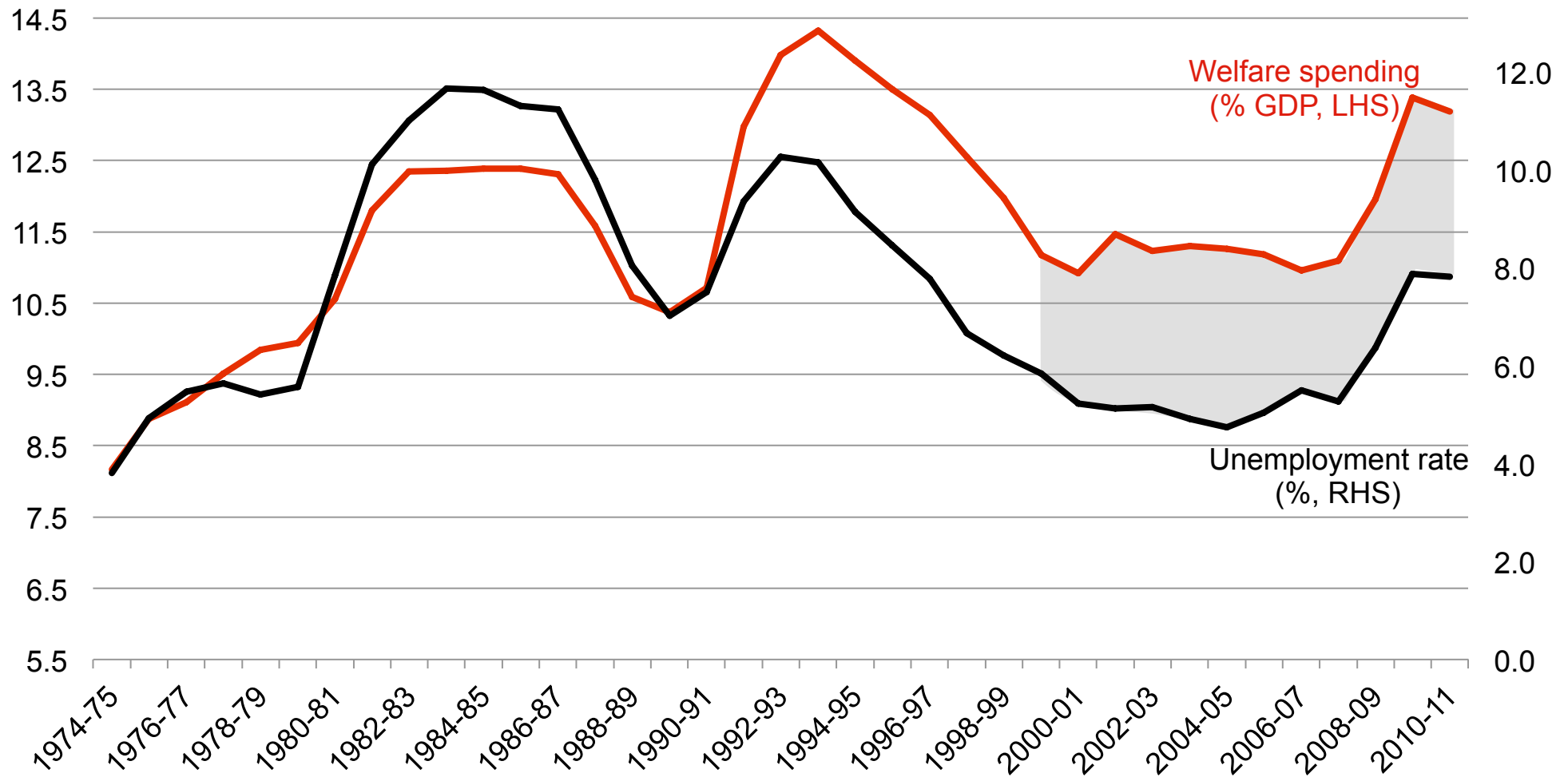
Growth rates in GDP and welfare spending



Under Blair and Brown, spending on benefits should have fallen as the economy boomed. It didn't – becoming a redistribution rather than a safety net.

Benefit claimants...

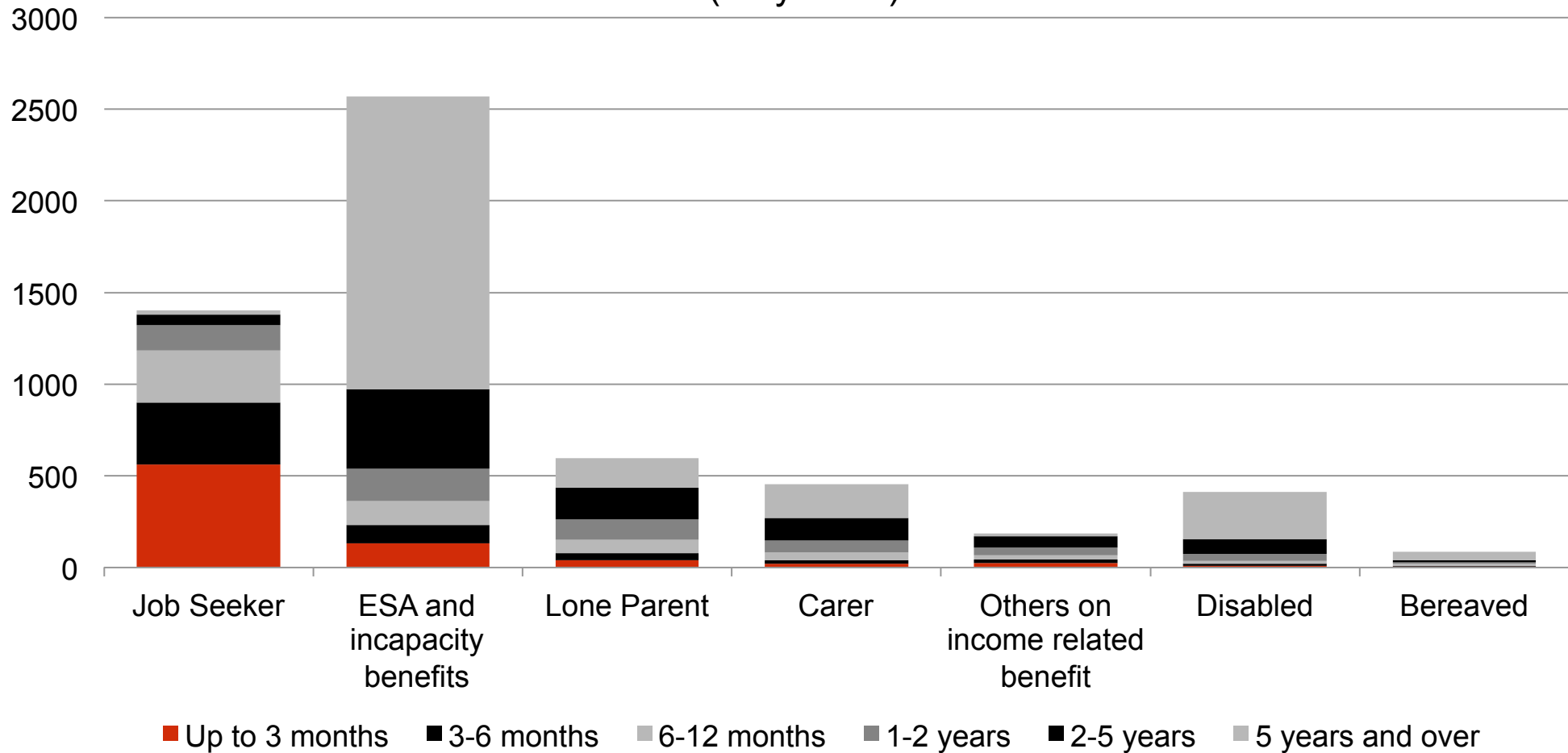
UK welfare spending and unemployment 1974 - 2011



Source: HMT, IFS.

The system really has broken:

Caseload (1,000s) of working age clients by type of claim and duration
(May 2011)

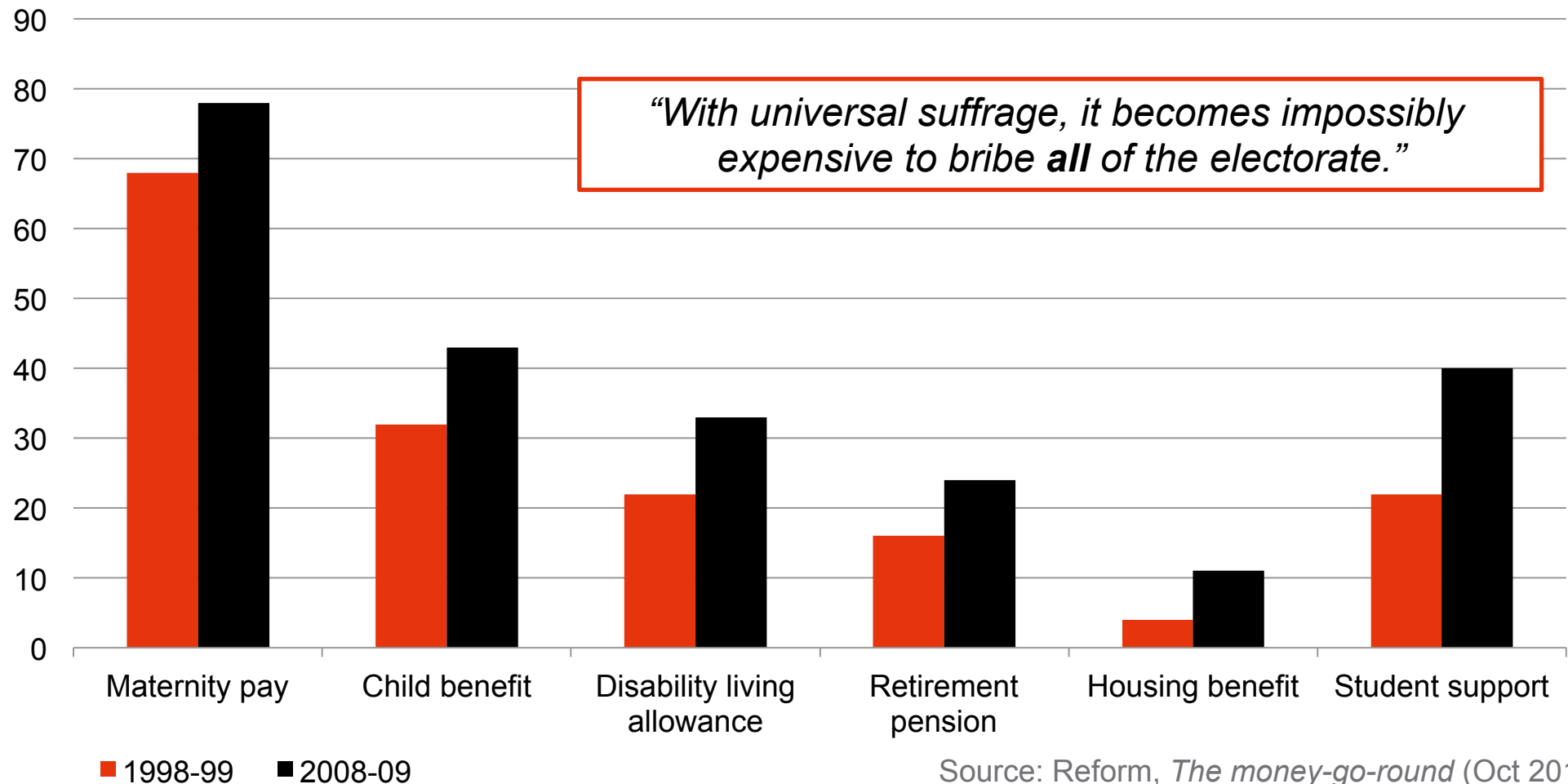


Source: DWP.

The cost is exacerbated by the large amount of money spent on those not in need, as the state seeks to develop a dependency mentality in its clients:

Benefit claimants...

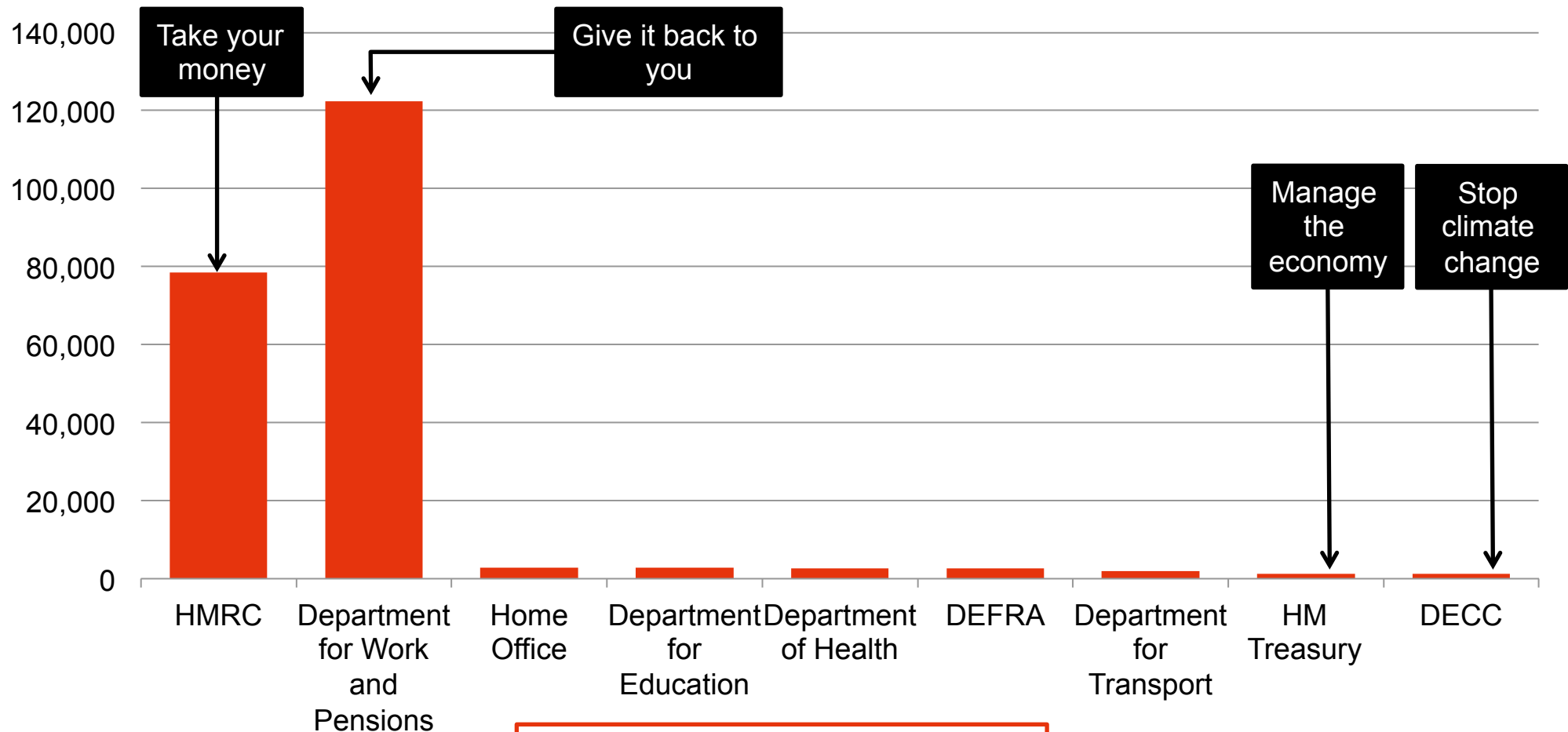
Percentage of benefit expenditure going to middle class households



Source: Reform, *The money-go-round* (Oct 2010).

Managing the welfare state is, in itself, a very expensive operation:

Employees by Government Department (2011)



Source: ONS, DWP.

DWP salaries in 2011: £3.5bn

The continued economic decline of the West

The challenge

Potential actions

Likely outcomes

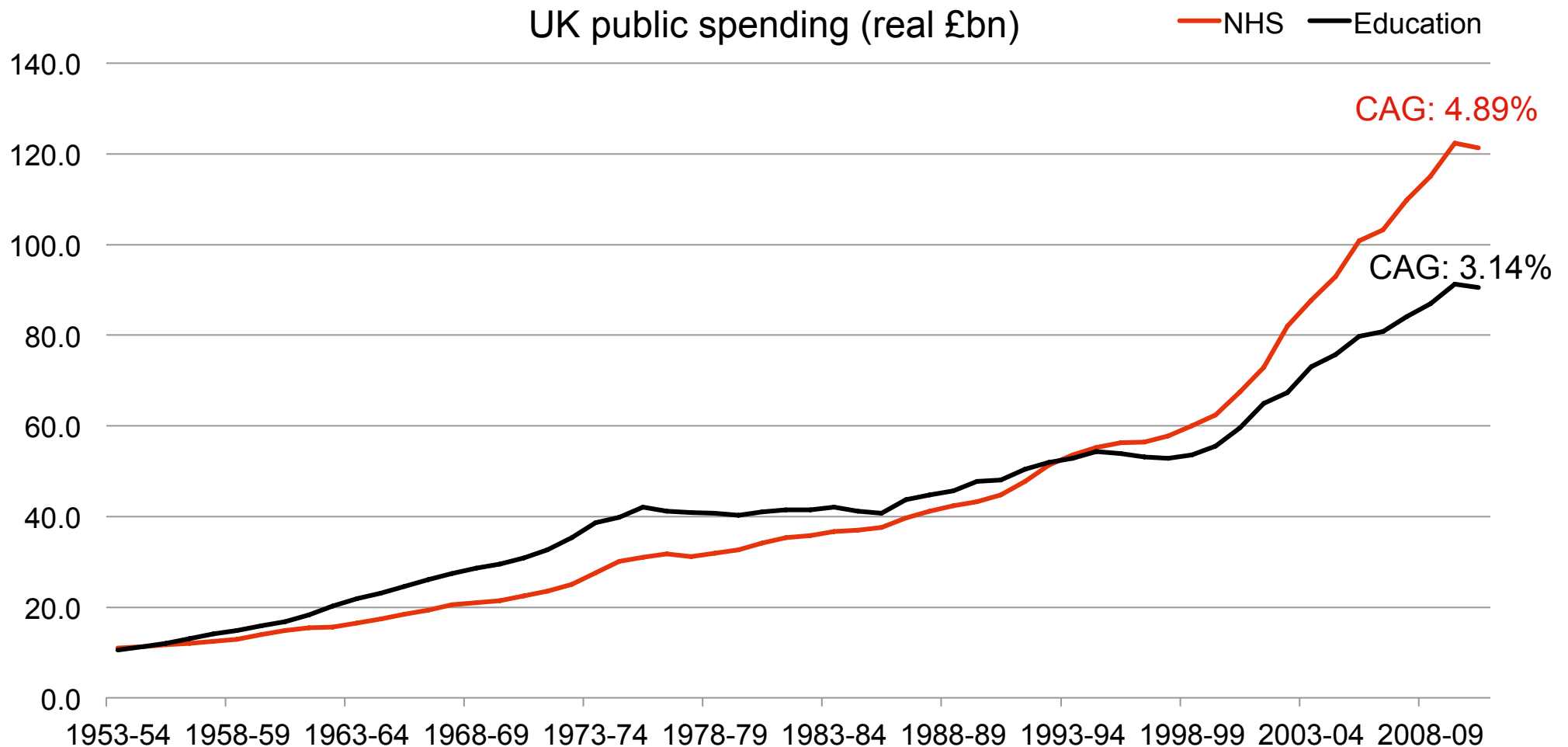
Global wage
disparity

Ineffectual
governments and
credulous voters

‘Entitled’ groups

Poor allocation of
tax monies

Since 1992, spending on health has ballooned (mostly on salaries), while growth in education spending has fallen behind:



Source: ONS. Compound annual growth calculated from crossover point (1993).

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The challenge

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Likely outcomes

Reorient
government
spending

Reform the
banks

Tax properly

Develop new
technologies

Accept
immediate cuts
in living
standards

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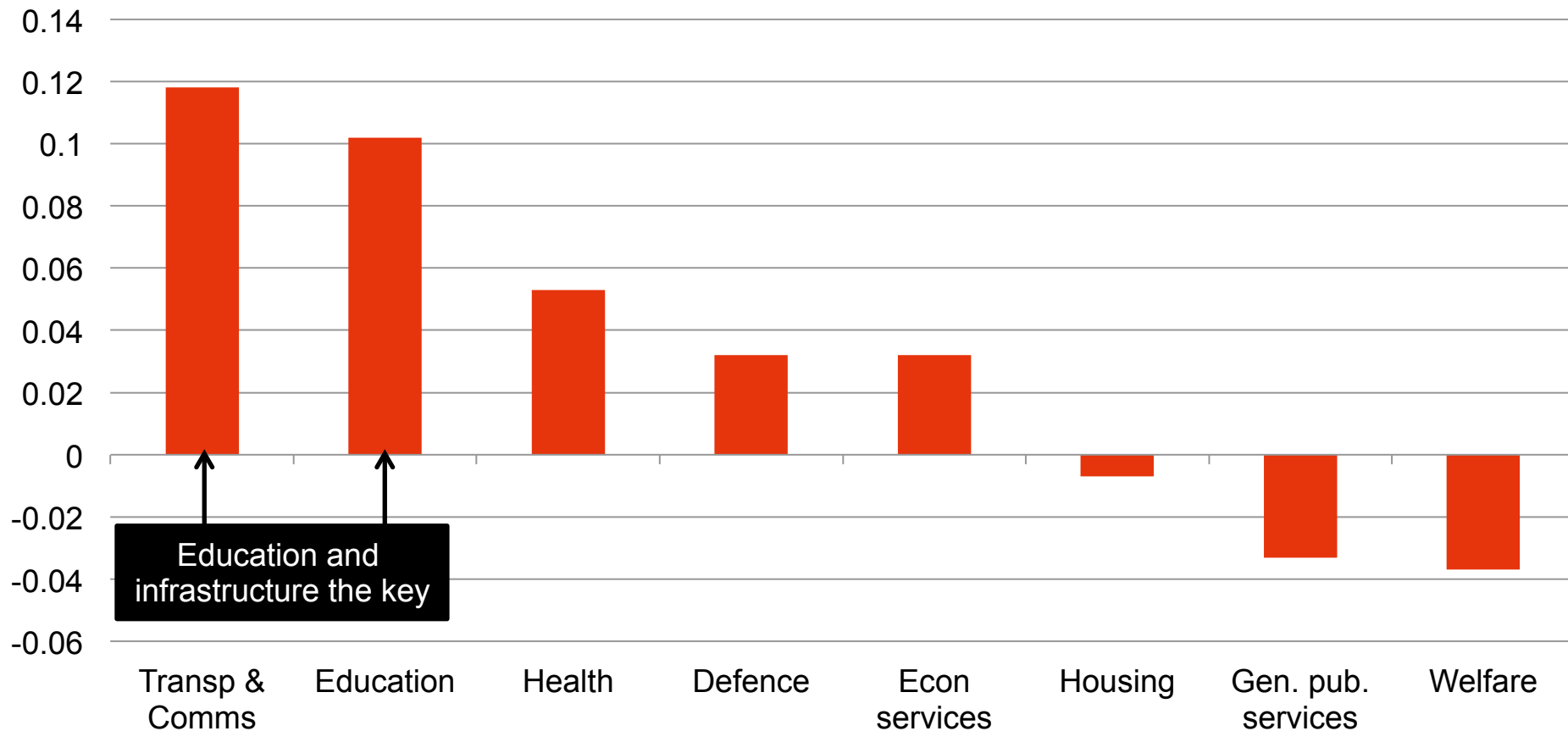
Education

Infrastructure

Reallocating public spending towards infrastructure and education has a large and highly statistically significant effect on the long-run growth rate.

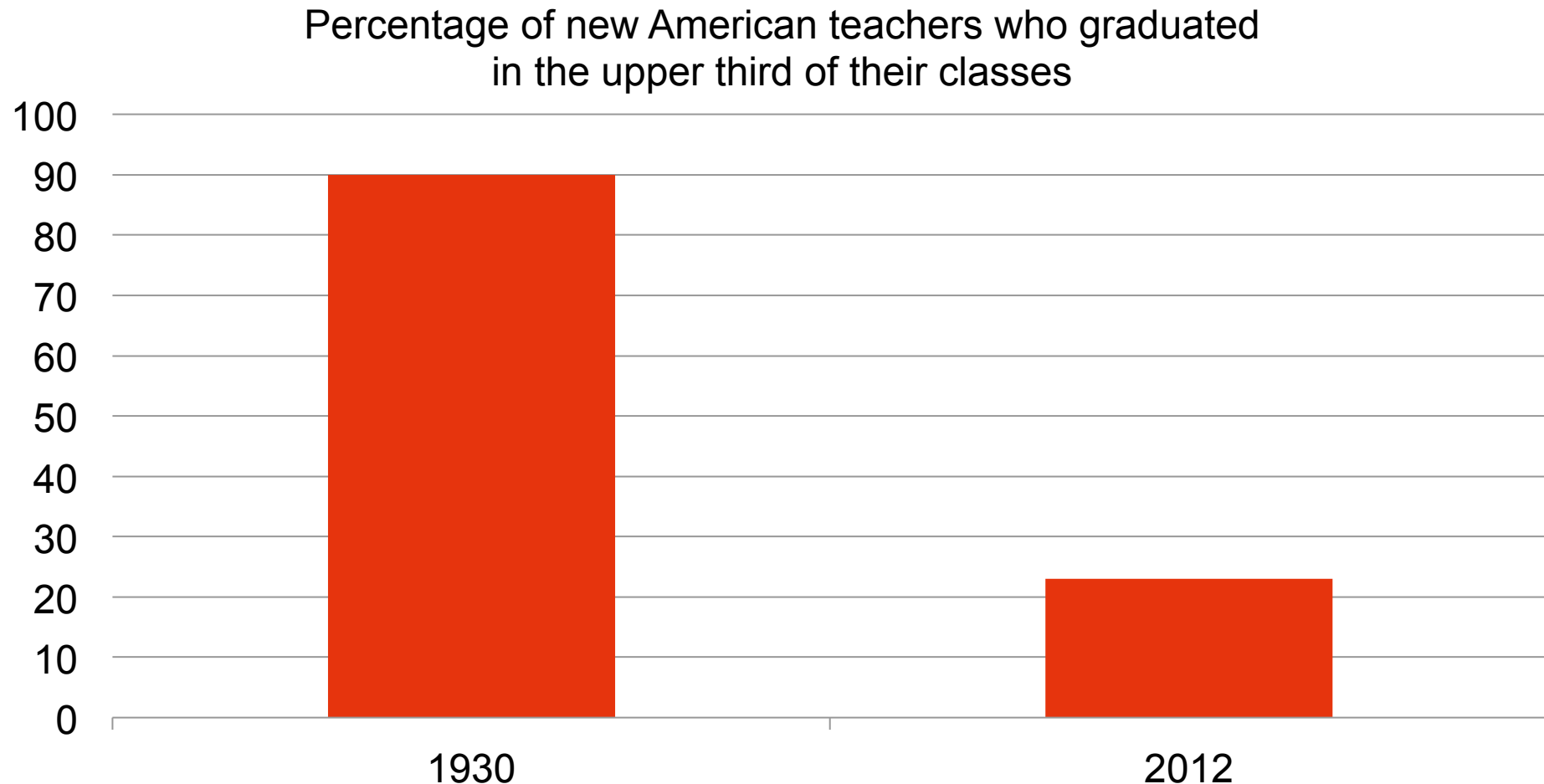
Reorient spending...

Effect of public spending mix on the long-run growth rate



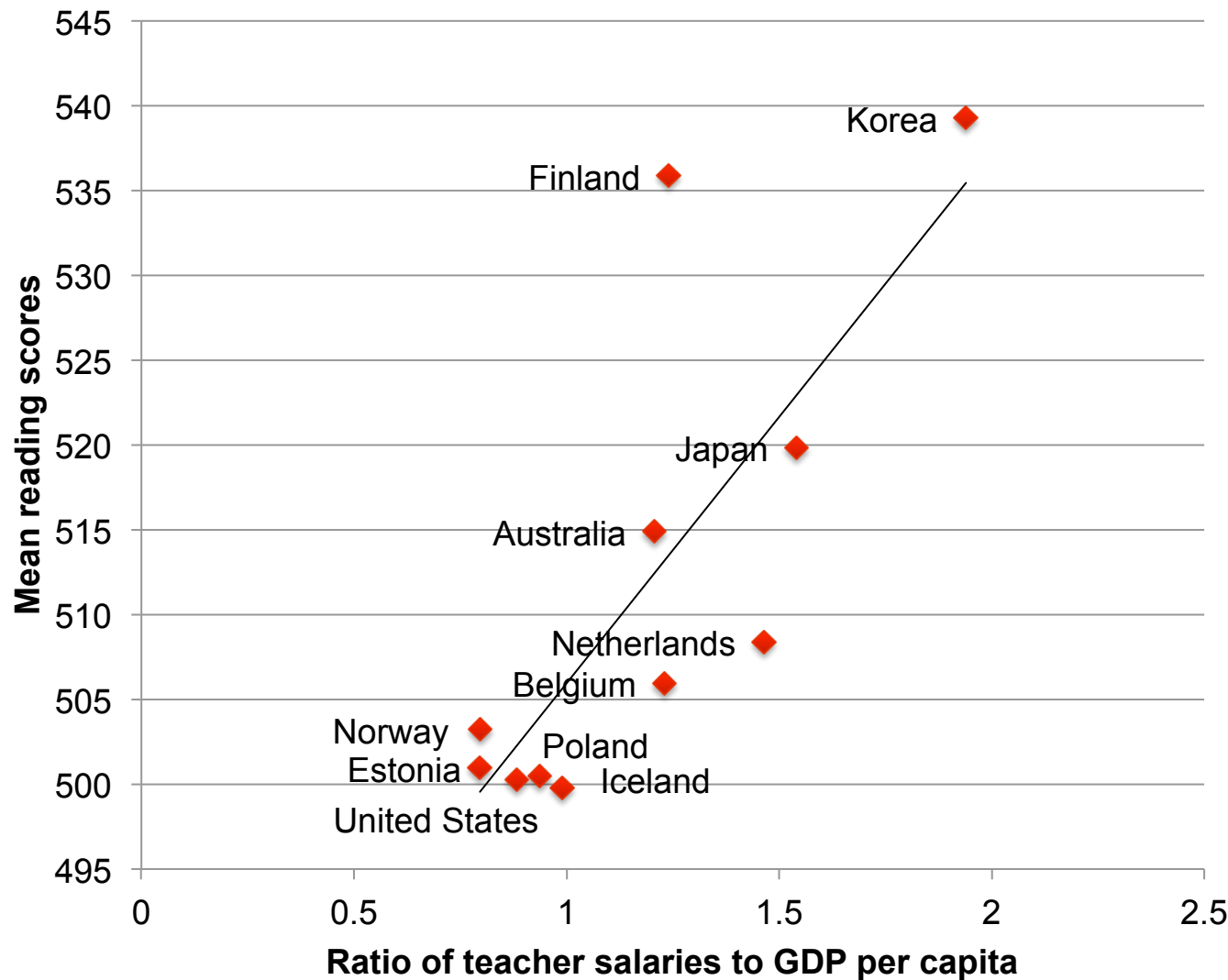
Source: Gemmell, N., Kneller, R. and I. Sanz, "The Composition of Government Expenditure and Economic Growth: Some Evidence from OECD Countries", *European Economy* (2008).

The importance the West assigns to good teachers has plummeted:



Source: McKinsey & Company, "Closing the talent gap" (2010); Milken Institute.

The strongest performers among high-income countries tend to invest more in teachers:



OECD analysis

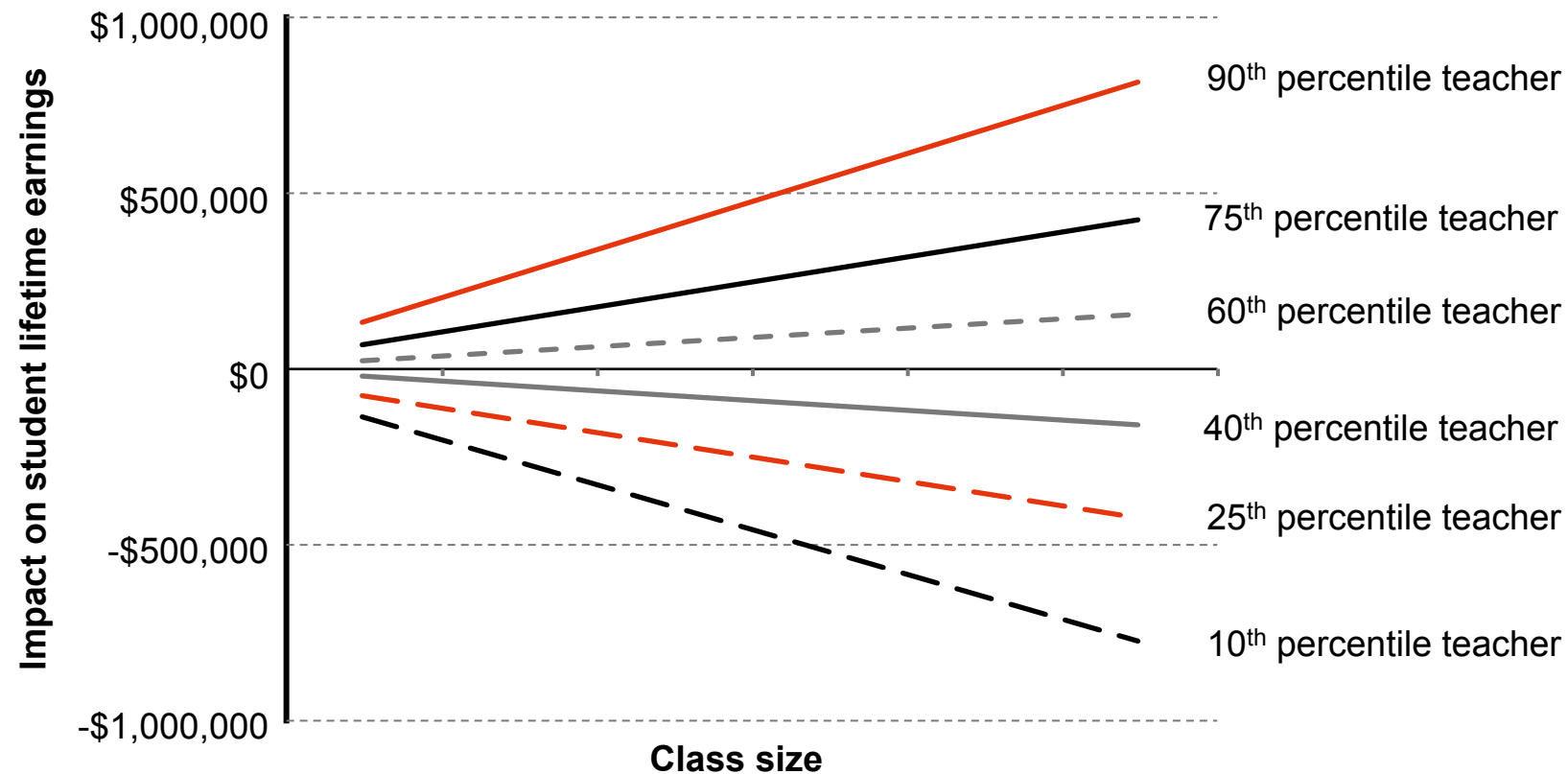
“In general, the countries that perform well in PISA attract the best students into the teaching profession by offering them higher salaries and greater professional status.

High-performing countries tend to prioritise investment in teachers over smaller classes.”

Source:
OECD *Does Money Buy Strong Performance in PISA?*

Quality of teaching matters above all:

Impact on student lifetime incomes by class size and teacher effectiveness
(compared to average teacher)



Source: Raj Chetty (Harvard), John N. Friedman (HKS), and Jonah E. Rockoff (Columbia), *The Long-Term Impacts of Teachers: Teacher Value-Added and Student Outcomes in Adulthood*, NBER Working Paper No. 17699 (Jan 2012).

Quality of teaching matters above all:

A teacher **one standard deviation above the mean effectiveness annually generates marginal gains of over \$400,000** in present value of student future earnings with a class size of 20 and proportionately higher with larger class sizes. Alternatively, replacing the **bottom 5-8 percent** of teachers with **average** teachers could move the U.S. near the top of international math and science rankings with a **present value of \$100 trillion**.

Source: Eric A. Hanushek (Stanford), *The Economic Value of Higher Teacher Quality*, NBER Working Paper No. 16606 (Dec 2010).

Quality of teaching matters above all:

Replacing a teacher whose value added is in the bottom 5% with an average teacher would increase the present value of students' lifetime income by more than \$250,000 for the average classroom.

Source: Raj Chetty (Harvard), John N. Friedman (HKS), and Jonah E. Rockoff (Columbia), *The Long-Term Impacts of Teachers: Teacher Value-Added and Student Outcomes in Adulthood*, NBER Working Paper No. 17699 (Jan 2012).

Quality of teaching matters above all:

With an annual discount rate of 5%, the parents of a classroom of average size should be willing to pool resources and pay an 84th percentile teacher considering quitting approximately \$130,000 (\$4,600 per parent) to stay and teach their children during the next school year.

Source: Raj Chetty (Harvard), John N. Friedman (HKS), and Jonah E. Rockoff (Columbia), *The Long-Term Impacts of Teachers: Teacher Value-Added and Student Outcomes in Adulthood*, NBER Working Paper No. 17699 (Jan 2012).

Potential actions

Reorient
government
spending

Reform the
banks

Tax properly

Develop new
technologies

Accept
immediate cuts
in living
standards

Education

Infrastructure

Opportunities for high-return infrastructure investment abound:

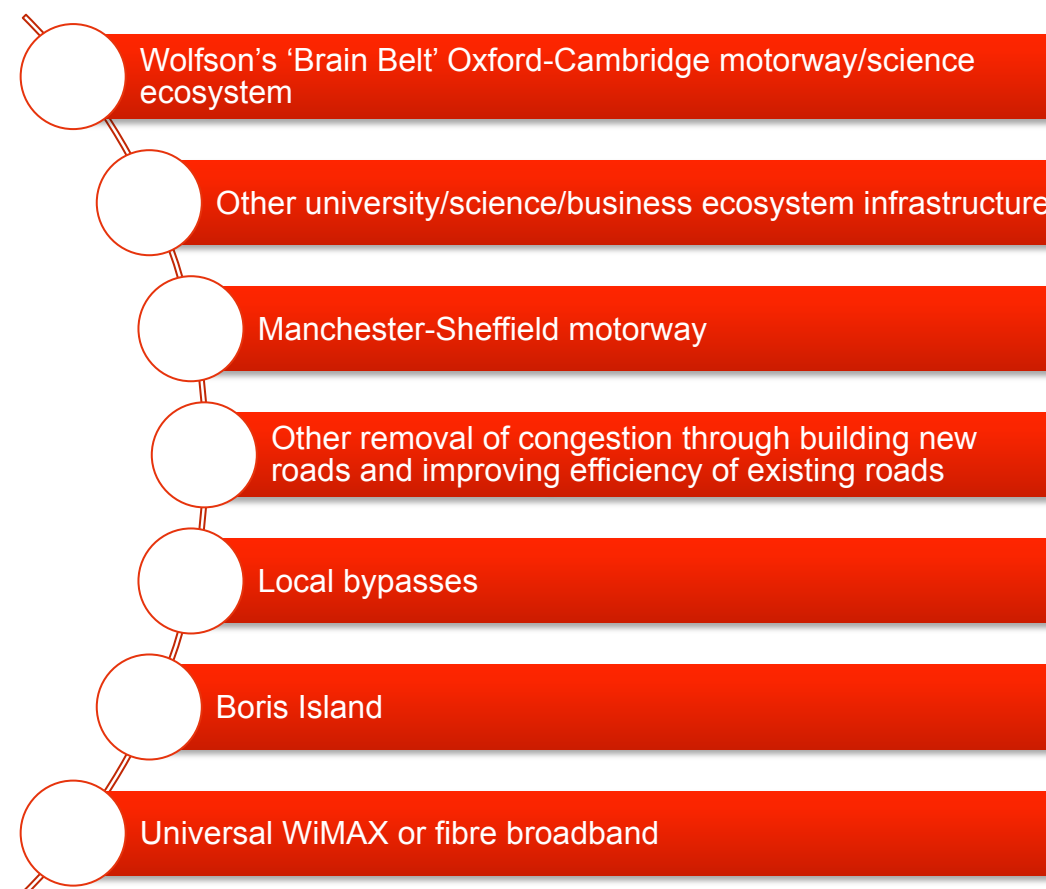
Infrastructure needs in the US

US infrastructure 'GPA'

A	B	C	D
<i>nil</i>	<i>nil</i>	Solid waste (+) Bridges Public parks and recreation (-) Rail (-)	Energy (+) Aviation Dams Hazardous waste Schools Transit Drinking water (-) Inland waterways (-) Levees (-) Roads (-) Wastewater (-)

Source: American Society of Civil Engineers.

Exemplary infrastructure needs in the UK



Potential actions

Reorient
government
spending

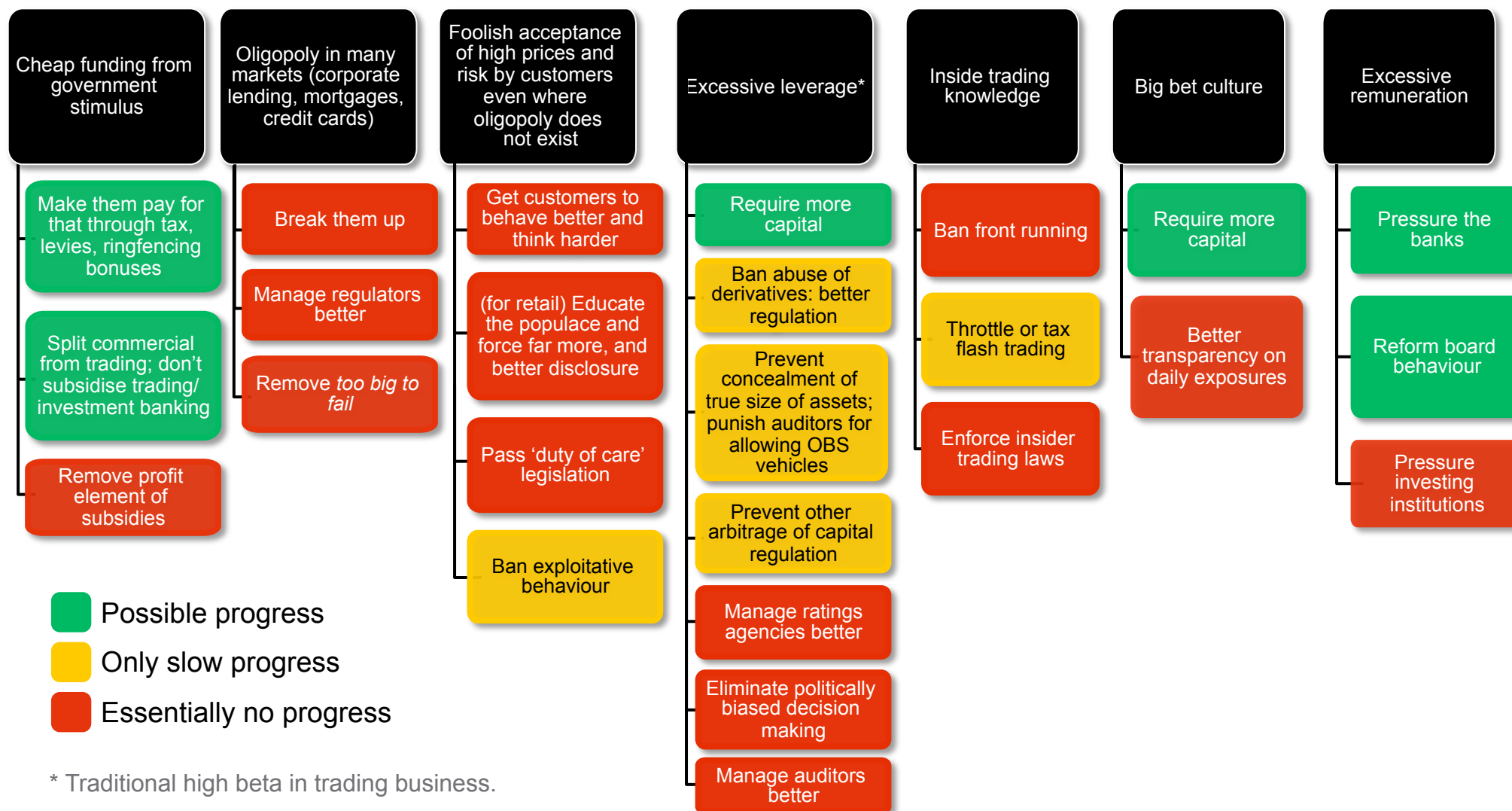
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The multiple ways in which banks make excess profits, and how that might be reversed:



Potential actions

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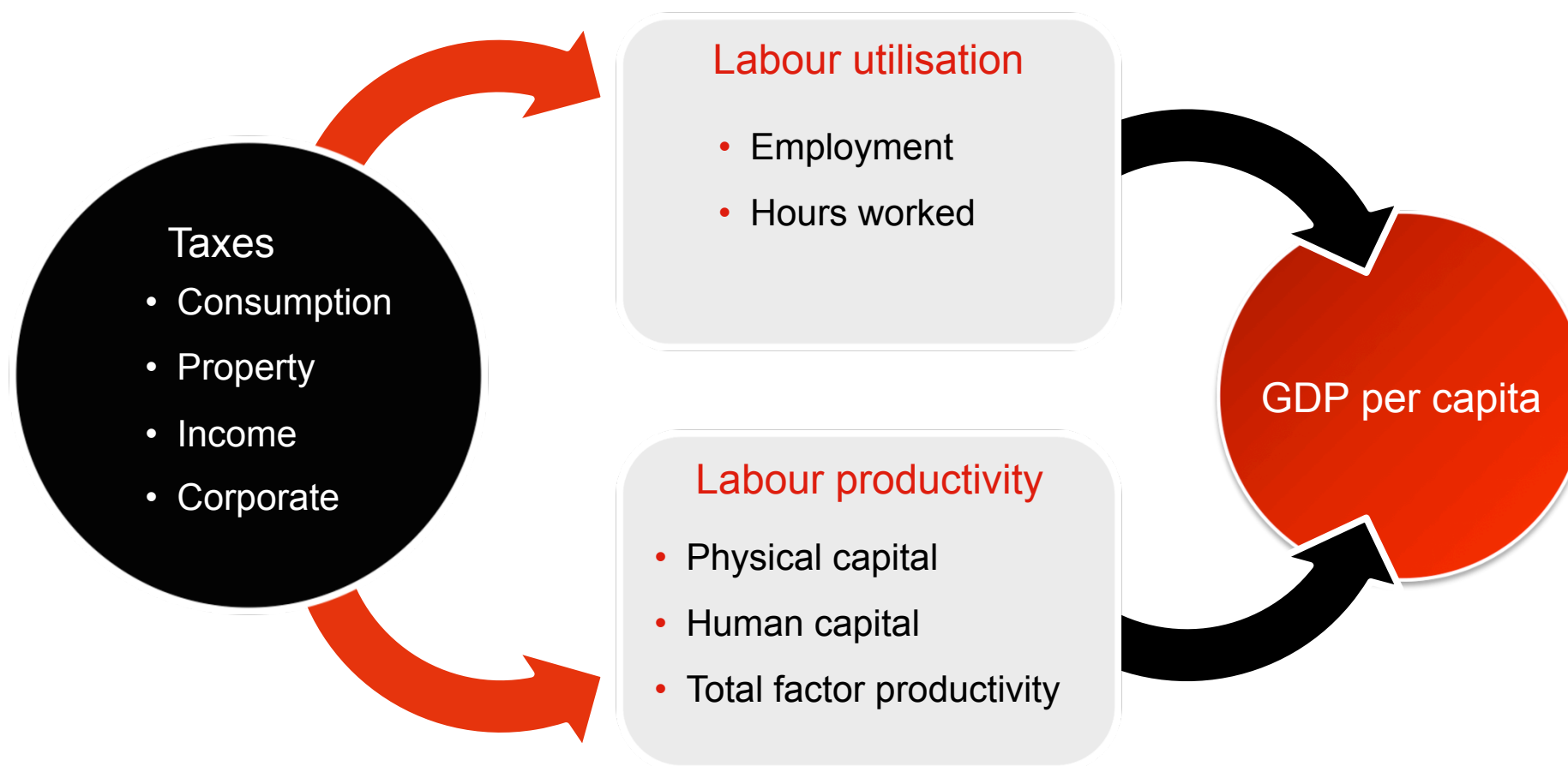
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banks

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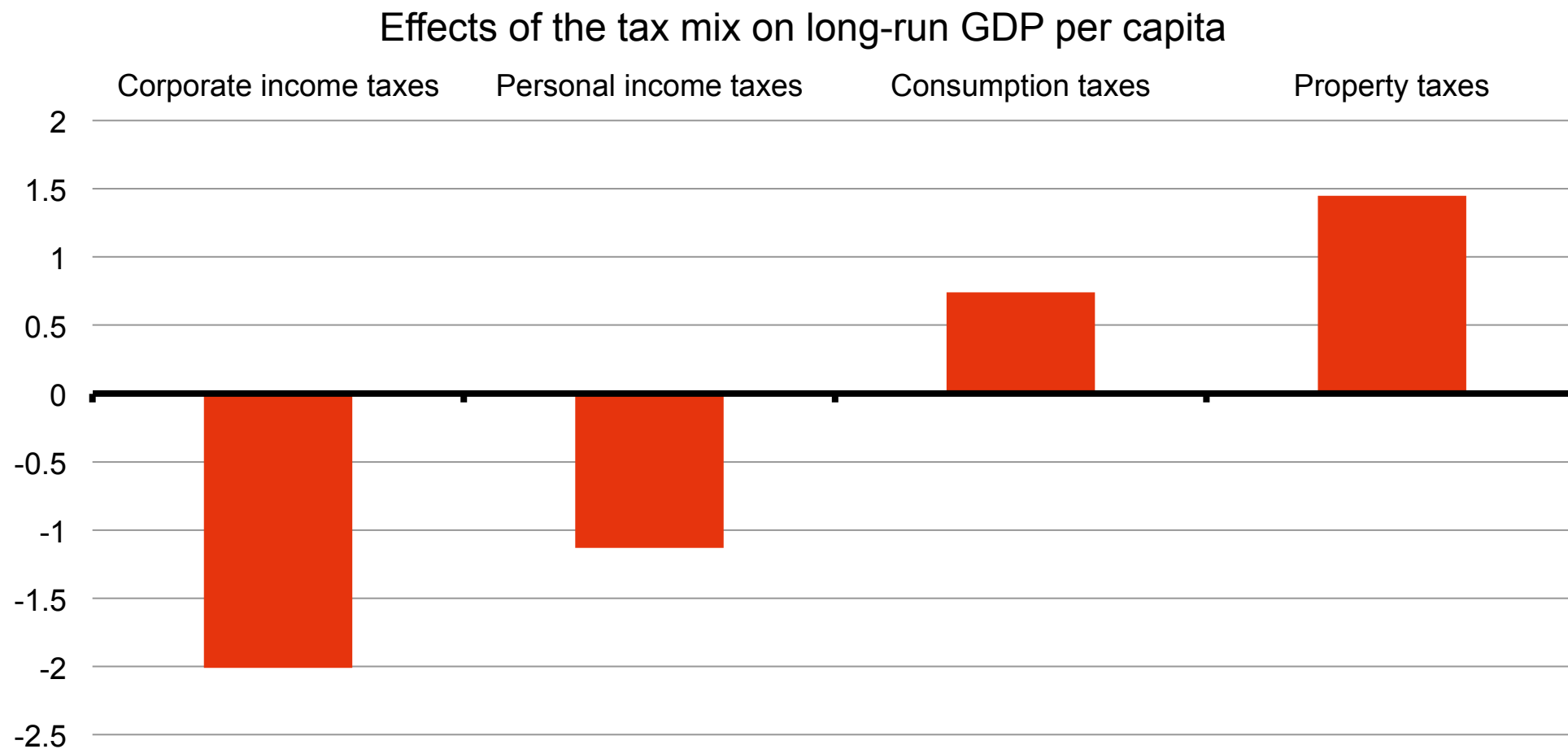
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Taxes affect the determinants of growth:



A significant reorientation of tax policy to less populist methods is needed:



Source: OECD

* Note that punitive taxes on the richest don't help much as the base is always relatively small.

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Support manufacturing

Help industry ecosystems
to flourish

Encourage development
of new technologies

Consensus states that manufacturing is no more important than any other sector of the economy:

“Obama’s surrender to the ‘manufacturing fetish’ is a disaster.”

Jagdish Bhagwati, Professor of Economics, Columbia University

Financial Times, 6 Feb 2012

“A persuasive case for a manufacturing policy remains to be made.”

Christina D. Romer, Professor of Economics, UC Berkeley

New York Times, 5 Feb 2012

But in fact, manufacturing is crucial to economic growth:

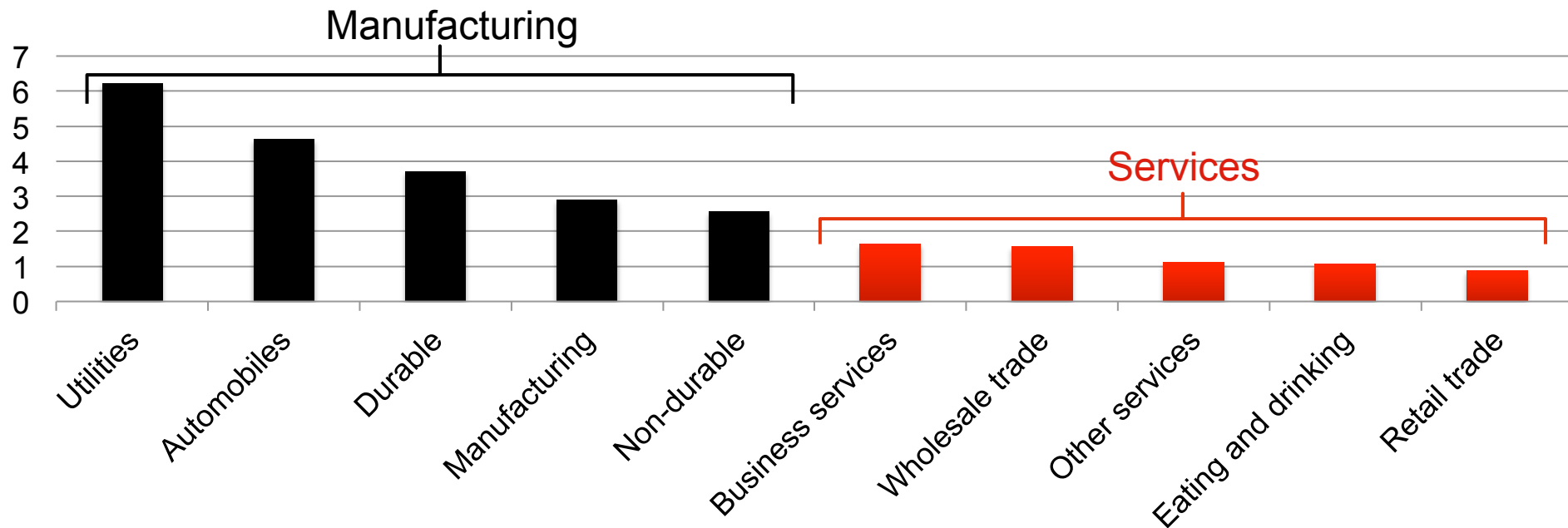
Economies of scale
more likely to be
realised

Substantial and
disproportionate role in
innovation

Primary source of
middle-class jobs
(especially for workers
without a college
degree - 75% of UK
workforce)

*It's also vital that we **rebalance** growth away from consumption
and **imports** financed by foreign borrowing toward **exports**.*

The proof: employment multipliers



Every job in **manufacturing** supports **2.91** jobs elsewhere in the economy, compared to only **1.54** in **business services** and **0.88** in **retail trade**: **Supplier effects** (e.g. car plant sustains jobs in steel industry); **Responding effects** (where workers spend their paycheques); **Government effects** (taxes that support jobs in government).

“Almost every industry within manufacturing supports much more secondary employment than other sectors.”

Source: Economic Policy Institute, *Updated Employment Multipliers for the U.S. Economy* (2003).

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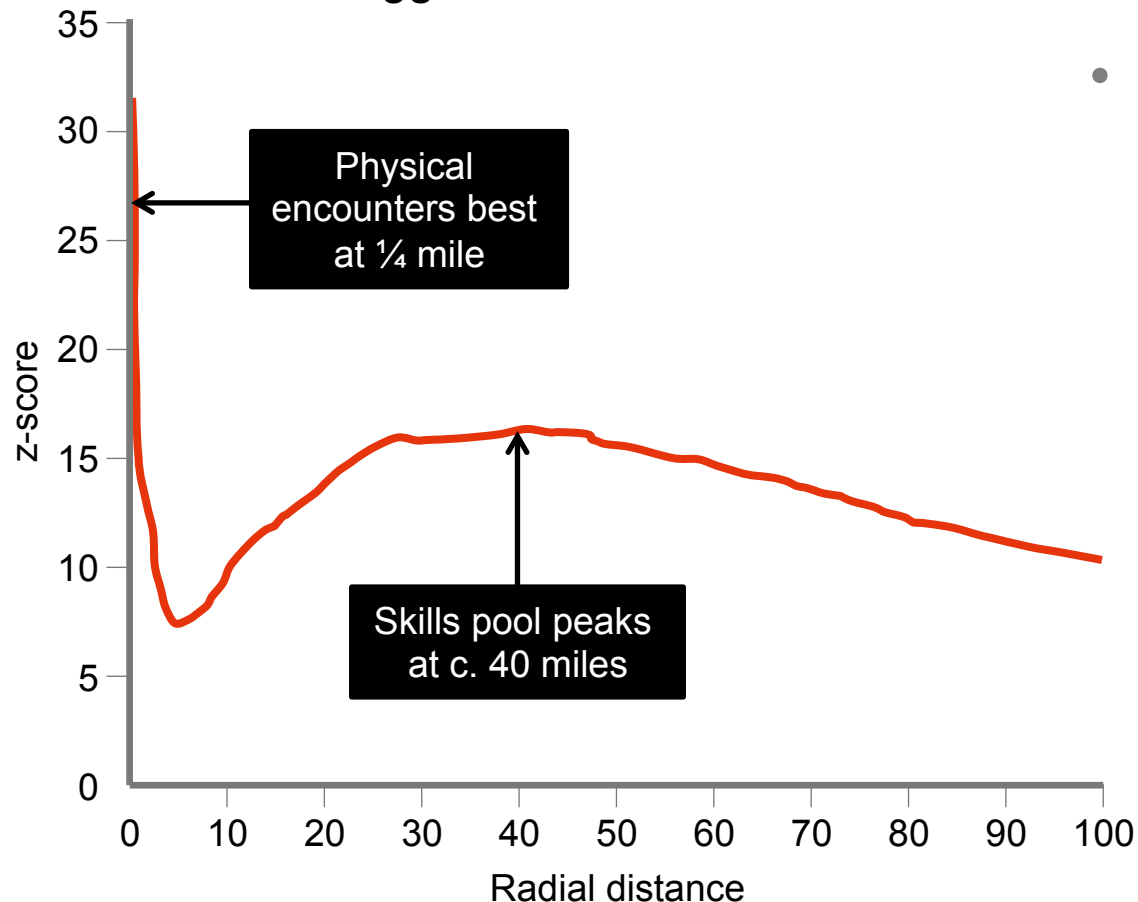
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Policies need developing to support existing ecosystems, and develop new ones:

Agglomeration economies



- **Local** micro-industry ecosystems drive innovation:
 - London's **Square Mile**: bankers, lawyers, accountants.
 - **Birmingham's F1** ecosystem: a huge 'driver' of innovation and economic success.
 - **China** found concentration key for e.g. **semiconductor** success.

Source: Reserve Bank of Philadelphia Working Paper No. 11-42, 'The Agglomeration of R&D Labs'.

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Technology holds the promise of massive, early breakthroughs:

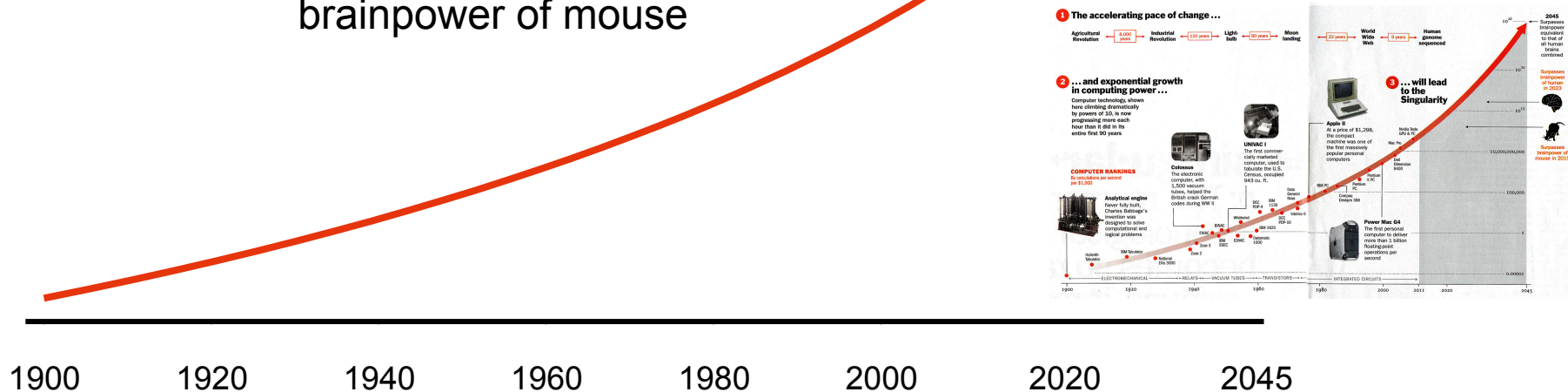
The accelerating pace of change

2045: Computer that surpasses
brainpower equivalent to that of all
human brains combined

2023: Computer that surpasses
brainpower of human

2015: Computer that surpasses
brainpower of mouse

The
Kurzweil
prediction



Source: Adapted from Raymond Kurzweil, *The Singularity Is Near: When Humans Transcend Biology*.

Technology is subsidised by every government. In Europe and the UK, the process seems to be ineffective and insufficient:

Bio	Nano	Info	Neuro/ Cogno	Anti-carbo
<ul style="list-style-type: none"> • Neuroceuticals • Genetic engineering 	<ul style="list-style-type: none"> • Thin films • Fine particles • Chemical synthesis • Advanced microlithography 	<ul style="list-style-type: none"> • Networking • Telecommunications 	<ul style="list-style-type: none"> • Humanoid robotics • Humanoid computation • Human cognition • Human emotion 	<ul style="list-style-type: none"> • Energy storage • Electric cars • Battery tech • Renewables

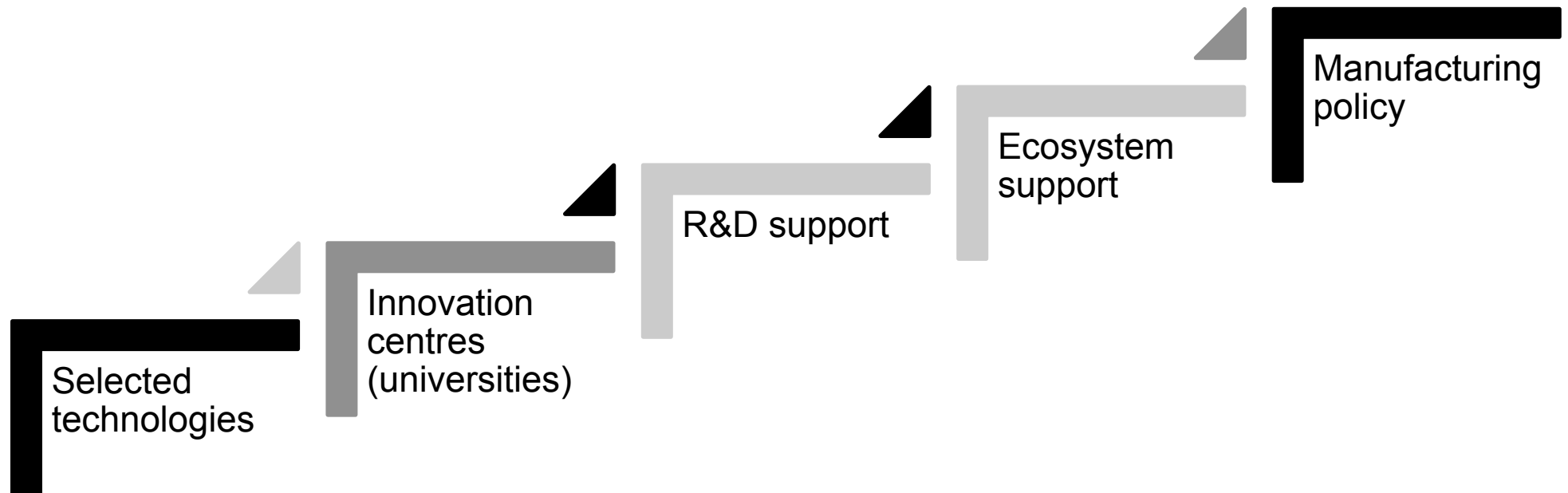
“Today, a car emits less pollution traveling at full speed than a parked car did in 1970 from leaks.” Matt Ridley, *The Rational Optimist*

“State Capitalism is on the march, overflowing with cash and emboldened by the crisis in the West.” *The Economist*, January 21st 2012

“Our industrial policy was meant to be the government picking winners. Instead, the losers picked government.” Peter Mandelson, *Today*, January 26th 2012

A 20-50 year view, and a cross-party consensus that this is needed, is essential:

An integrated industrial policy



Potential actions

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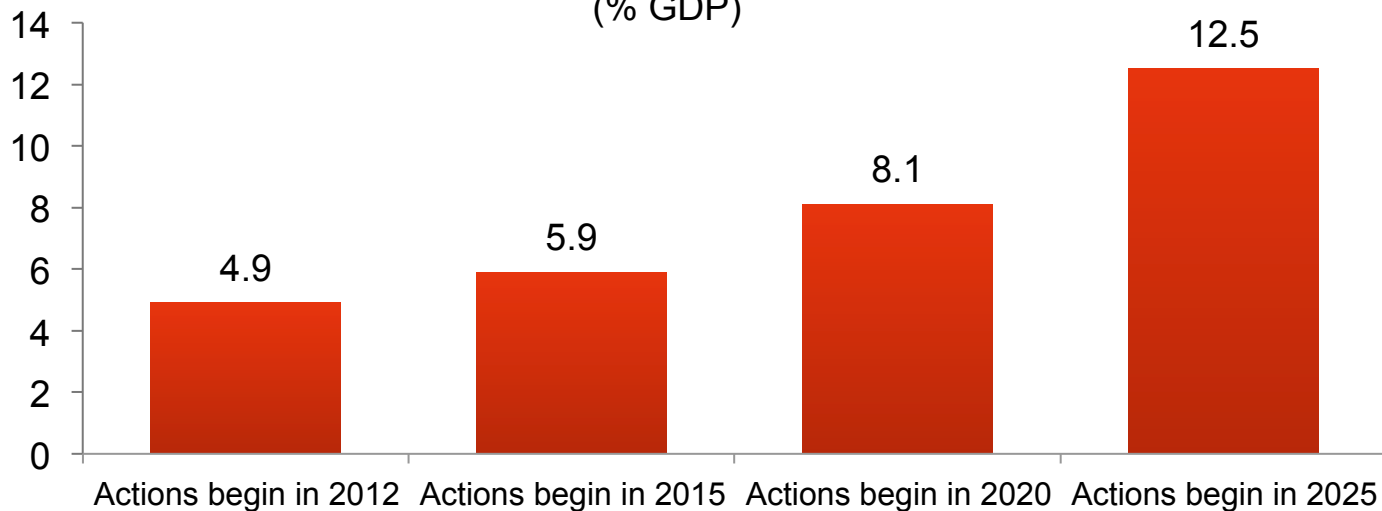
Accept
immediate cuts
in living
standards

Accept lower living standards:

Potential actions



Reductions in primary spending or increases in revenues in various years needed to close the 25-year fiscal gap in the US (% GDP)



Source: Congressional Budget Office.

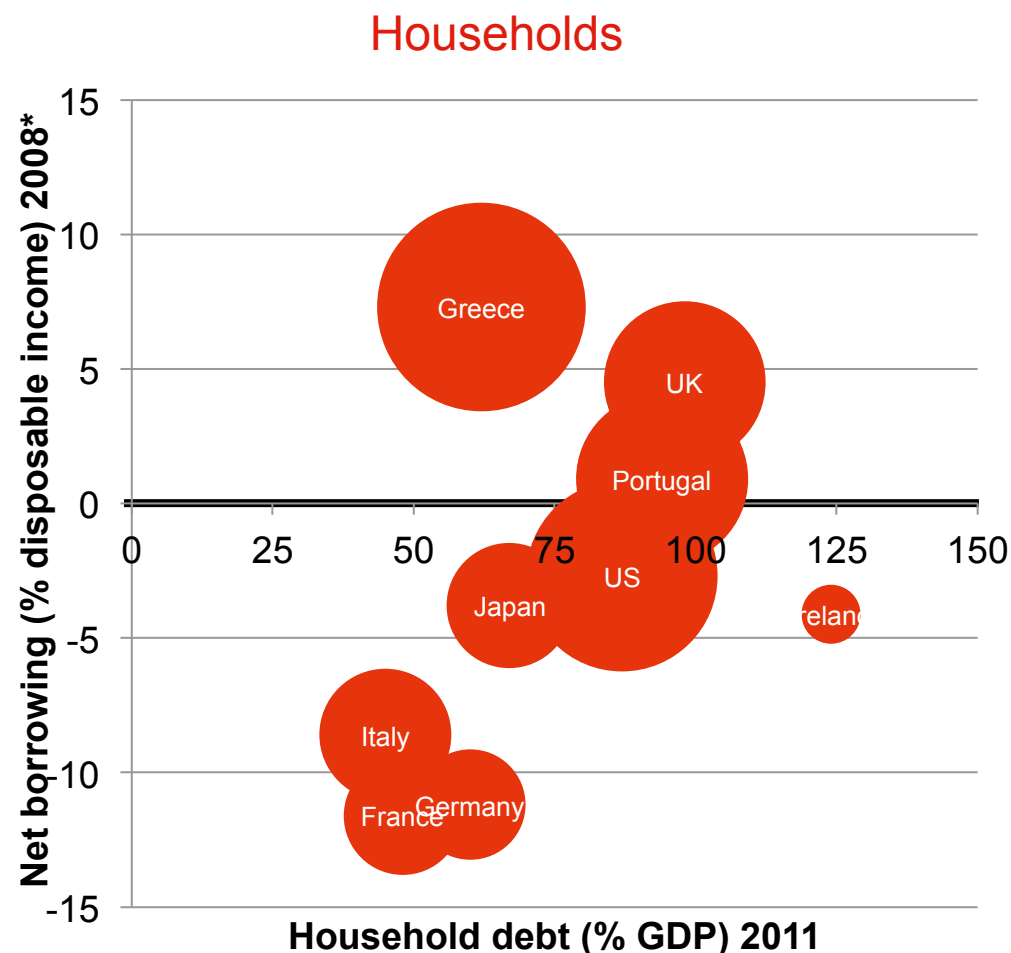
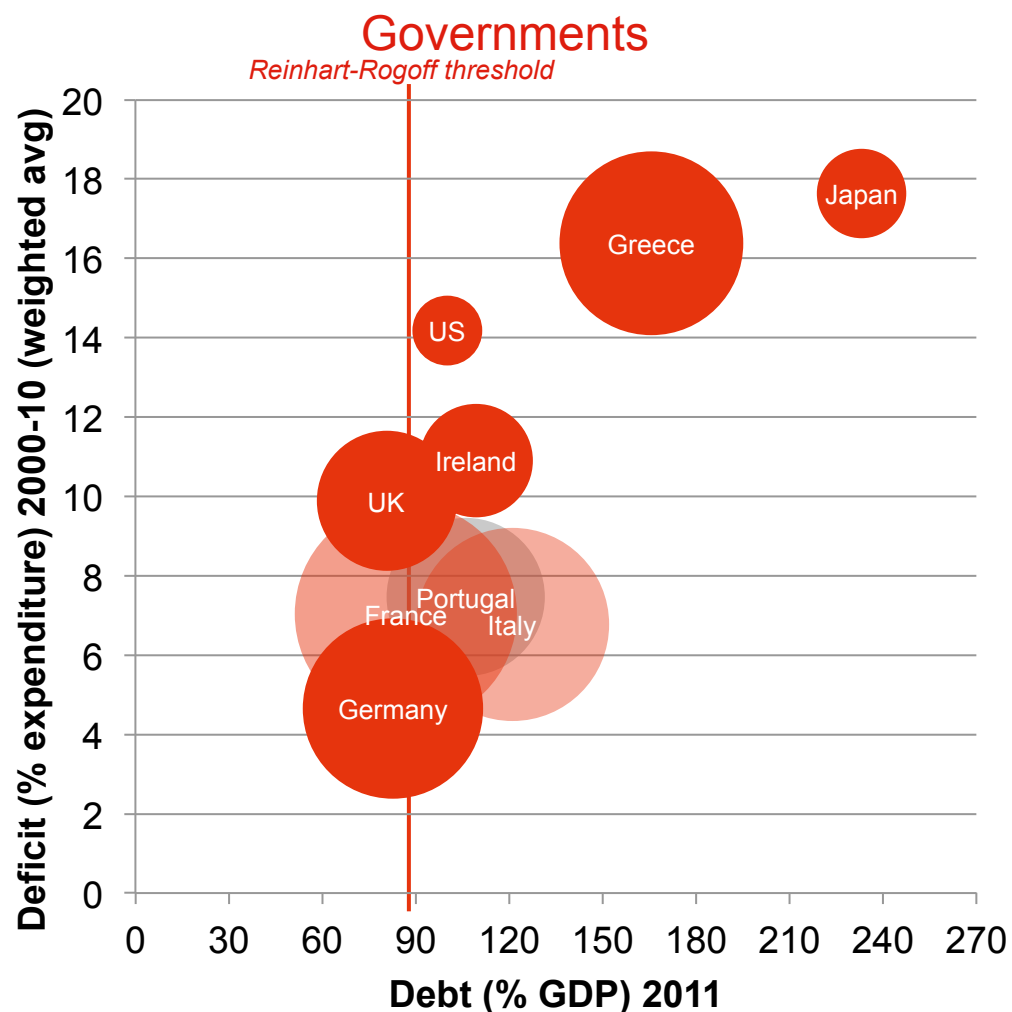
The bureaucrats' own conclusion

“The relentless increase in the sustainability gaps suggests the **urgency** in considering in earnest **profound** reforms in social protection systems.”

Source:

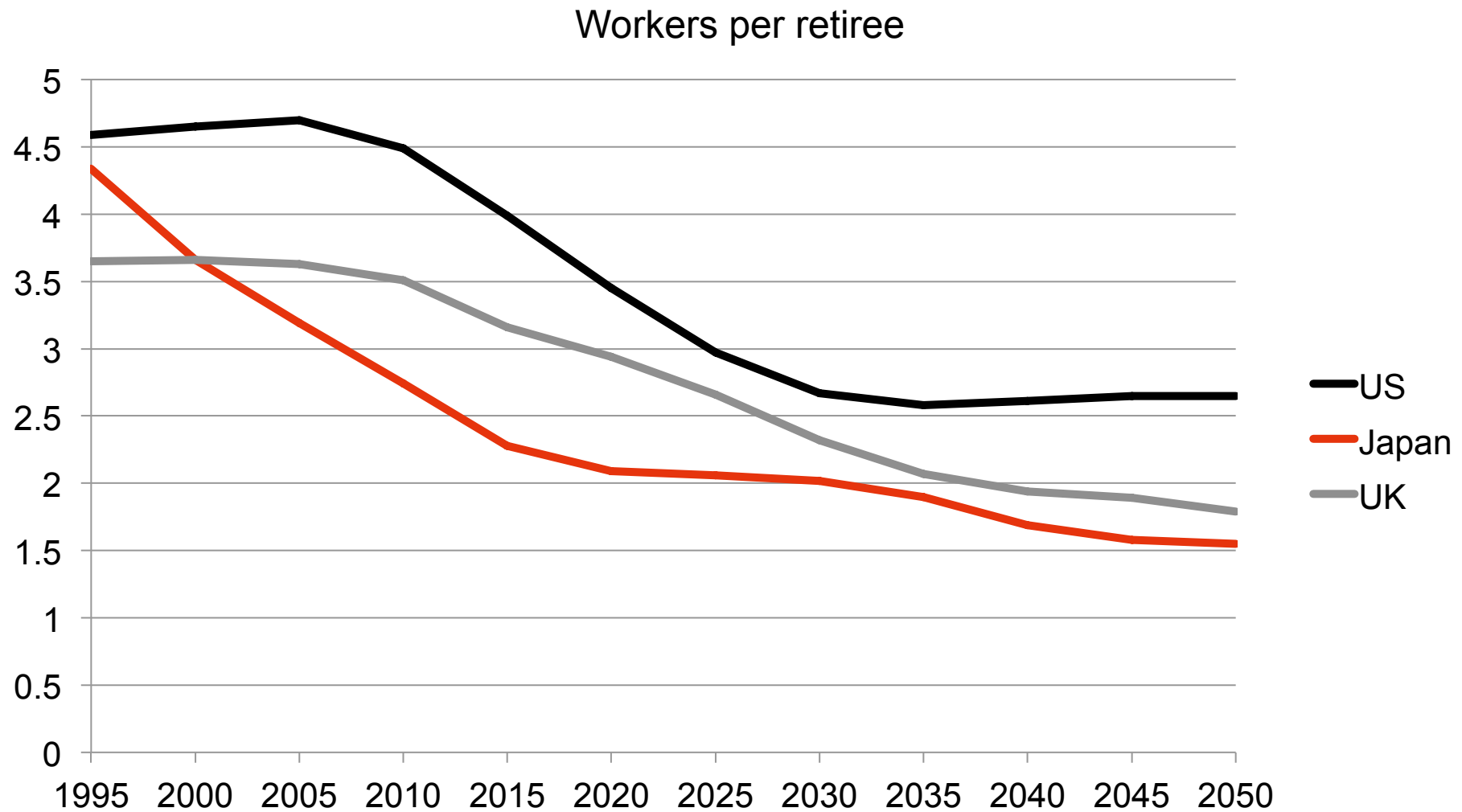
European Commission,
Sustainability Report 2009

A decline in living standards of between 10 and 15% is needed to rebalance Western economies today. Tomorrow's continued job loss and wage pressure will mean more of that pain in the future...



Size of bubble, non-proportional but directionally correct, represents (L) overall size of government expenditure 2011 (% GDP); (R) household final consumption expenditure 2010 (% GDP). Source: IMF, OECD, MGI, World Bank. * Greece 2006, Japan 2007 (latest available).

...as will demographic challenges.



Source: UN Population Projections.

In the short term, America is better positioned to recover:

America has successfully kicked the can down the road:

It has the firepower

It is more resilient

Much less is nationalised

The nationalisations are less political

Debt restructuring (reduction) has been far more responsive and swift

Much smaller government so less impact

Europe (incl. the UK) has not:

Less firepower

Deeper and different problems

More public ownership

Germany unwilling to socialise the problem

Less ability to restructure

Less determination to restructure*

* Automatic 'stabilisers' = big unrestructured government that continues to batten on the corpse.

The biggest challenge – to transcend wanting and acquiring:

Economic growth and the future of the West: 'happiness' studies

Neuroscience shows that wanting, striving and acquiring are major and fundamental drivers of human behaviour.

An equilibrated world would have few Western 'necessities' (cars, flat screens, etc.) per capita [at current prices]

Continued growth means further strain on global resources.

Can insights from neuroscience, coupled with education, reengineer human behaviour towards less consumption?

The continued economic decline of the West

The Challenge

Potential actions

Likely outcomes

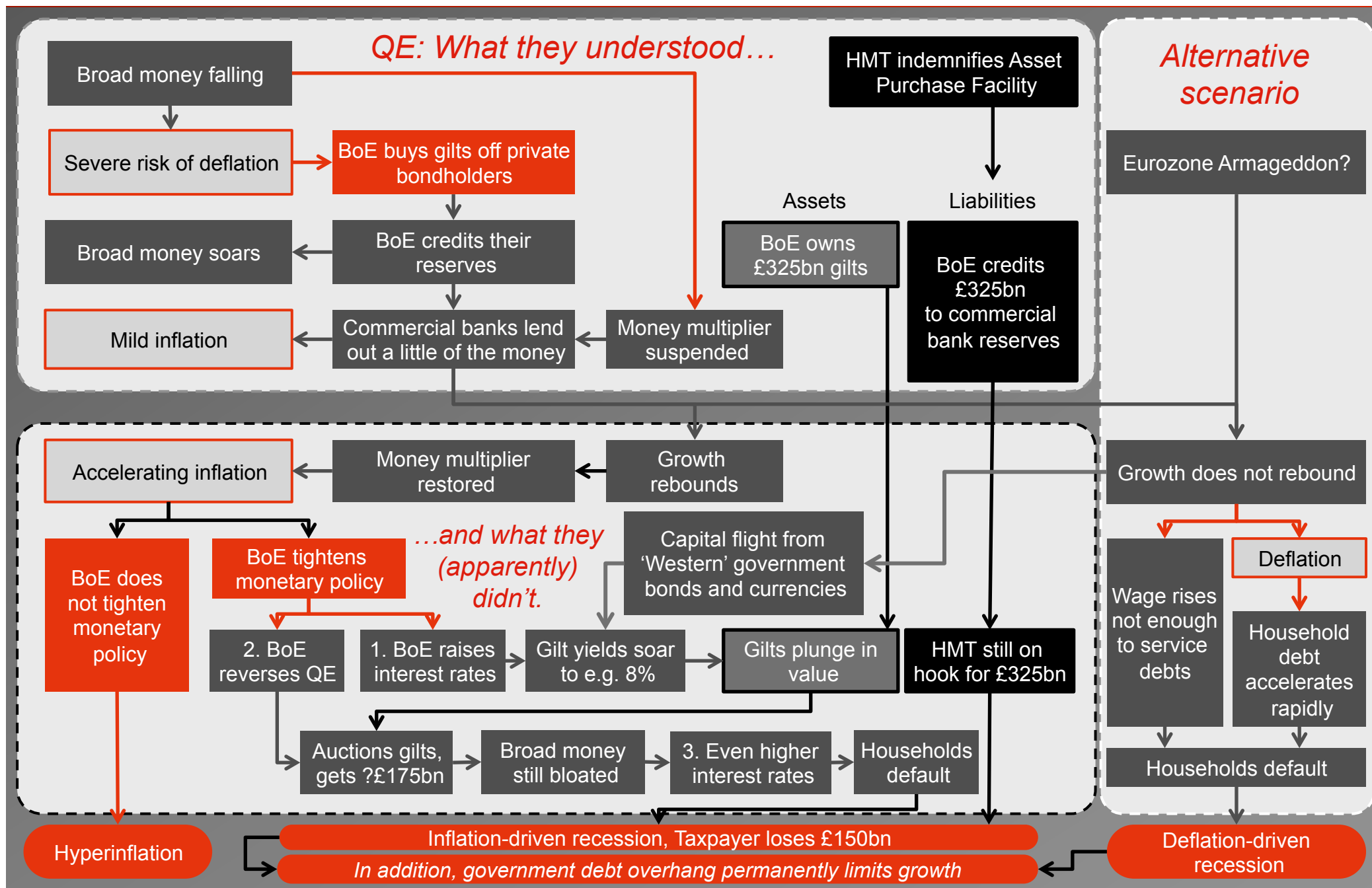
Short term

Long term

The continued economic decline of the West

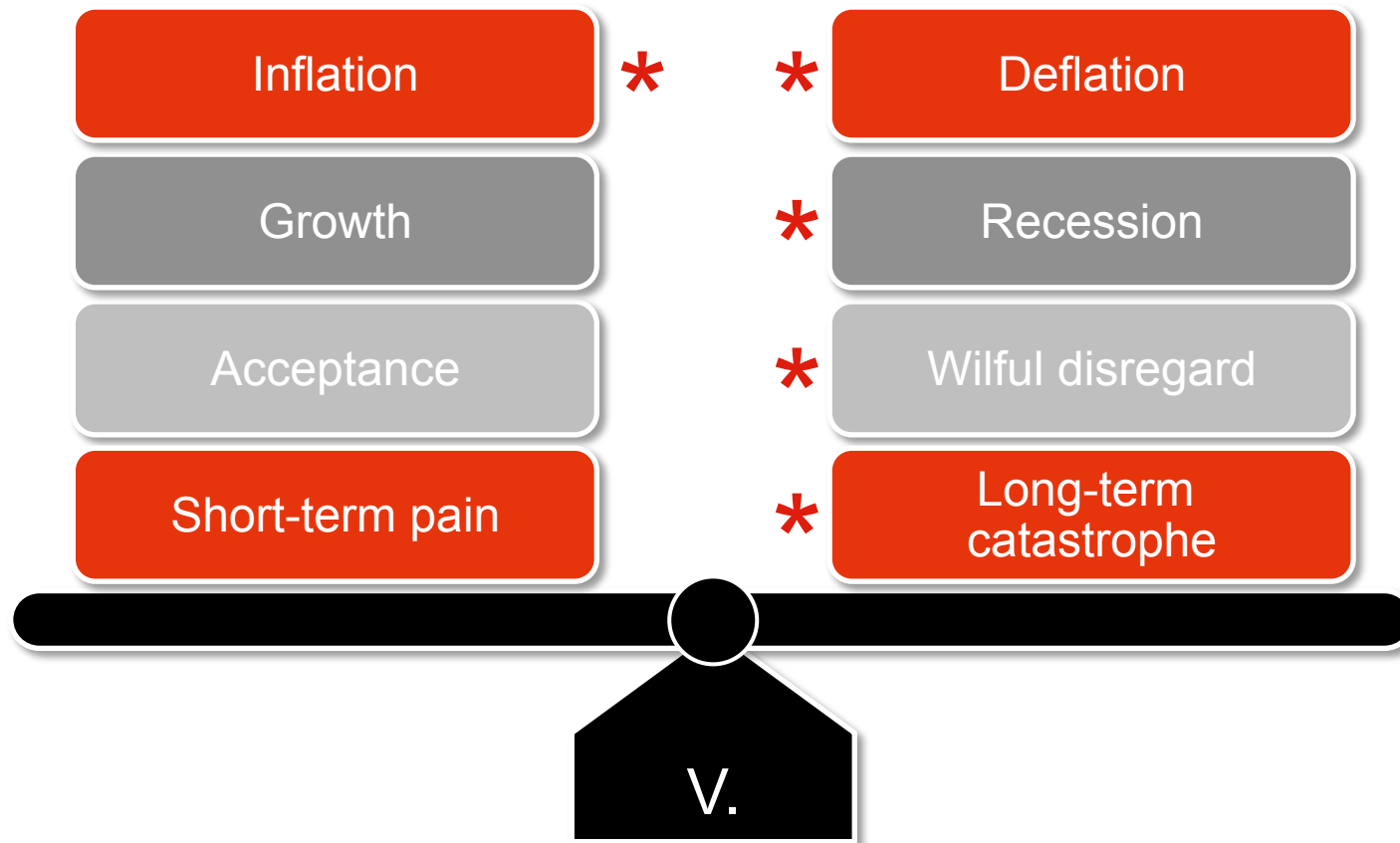


The pressing short-term issue is whether the neo-Keynesian disaster can be avoided. Probably not...



In summary: things don't look great.

We're teetering on a balance between:



...In the short term, the outcomes are unknowable. For the long term, as things stand, the continued economic decline of the West is highly predictable.

Further reading

- ***“The Modern Industrial Revolution, Exit, and the Failure of Internal Control Systems”***, Presidential Address to the American Finance Association, originally published in the *Journal of Finance* (July, 1993) pp. 831-880 – Michael C. Jensen
- ***Lost Victory*** – Correlli Barnett
- ***This Time is Different*** – Carmen Reinhart, Ken Rogoff
- ***Once in Golconda*** – John Brooks
- ***The Big Short*** – Michael Lewis
- ***World on Fire*** – Amy Chua
- ***Shall the Religious Inherit the Earth?: Demography and Politics in the Twenty-First Century*** – Eric Kaufmann
- ***The Rational Optimist*** – Matt Ridley
- ***Stumbling on Happiness*** – Daniel Gilbert