COLLECTIVIZED RISKS

Intro copy:

This week we are in for a very special edition of the Millennium Wave Online. I have persuaded my good friend Bill Bonner of Daily Reckoning fame to give us a special preview of his new book “The Soft Depression of the 21st Century: How to Survive the Crisis of Degenerate, Mass Capitalism,” (working title) due out in September. In it, he and fellow Daily Reckoneer Addison Wiggin, argue that popular democracy, aging populations and bad economic theories doom the US and other Western economies to follow the Japanese model, with recession, bear markets and failing consumer spending over the next 10 to 15 years. (Heavy stuff, I know…)

I read The Daily Reckoning almost every day. It’s part of my morning ritual. In fact, I wrote to Bill last year to tell him that there are times when I feel like a house painter in front of a Rembrandt as I read his commentary. He is that good. In the following essay – which he tells me will comprise a portion of the finished book - he takes issue with economist Paul Krugman’s position that America’s current economic malaise has been caused by a return to pre-Depression free-market capitalism. “Au contraire,” says Bonner, “today’s markets with their collectivized risks are anything BUT the capitalism enjoyed by the world’s capitalists prior to the 20th century.”

It’s a strong read, worth your time and I hope you’ll enjoy it.

After the essay, I will show you how to get The Daily Reckoning for free – no strings attached. Now, let’s see what Bonner and crew have worked up for us:

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COLLECTIVIZED RISKS
by Bill Bonner

Few popular economists have written as much about Japan's troubles as Princeton professor Paul Krugman. His views appear regularly in the New York Times and other media.

"Here is a hypothesis," he suggests, offering an explanation for the strange events of the last 12 years, "the world became vulnerable to its current travails, not because economic policies had not be reformed, but because they had. That is, around the world, countries responded to the very real flaws in the policy regimes that had evolved in response to the Depression by moving back toward a regime with many of the virtues of pre-Depression, free-market capitalism. However, in bringing back the virtues of old- fashioned capitalism we also brought back some of its vices, most notably a vulnerability both to instability and to sustained economic slumps."

Krugman imagines a kind of social contract after the Great Depression in which voters agreed to tolerate capitalism, but only with safety nets and regulations to make sure no one got hurt. In his mind only, these restraints produced a stable prosperity in which the benefits were shared out among the population during the '50s, '60s and '70s.

"The America I grew up in -- the America of the 1950's and 1960s," he says, “was a middle class society. Yes, of course, there were still some rich people, he admits, but [thank God!] "there weren’t that many of them. The days when plutocrats were a force to be reckoning with in American society, economically or politically, seemed long past."

Krugman was writing to an appreciative audience in the NY Times magazine in October of 2002. Typically, he then lets himself get distracted, worrying that the rich may be making a comeback. The nation's top 100 CEO's compensation rose from an average of just $1.3 million in 1970 (in 1998 dollars) to $37.5 million in 2000. There are not enough of these super-rich to fill a zoning department in a mid-sized town, yet Krugman is so indignant about it he misses the important point altogether: the triumph of laissez-faire capitalism, which conservatives celebrate and Krugman rues, was a sham.

By the close of the 20th century, true capitalists had almost disappeared from the face of the earth. “Capitalism,” was a pejorative term invented by Marx to describe a system in which the rich owned the means of production and exploited the masses. The system Marx described never really existed the way Marx imagined, though a casual observer with a chip on his should may have been tempted to see it that way. Marx then made a prediction: that the inevitable grind of history would put the means of production in the workers' hands and cut out the capitalists.

Marx's economics were as fanciful as his history. But at least one of his predictions proved correct - though not at all in the way he thought. As the champagne glasses were hoisted and the new millennium rung in, it was the Marxist vision that had triumphed, not the laissez-faire vision of Smith and Turgot; the means of production were owned by the workers. (Curiously, the most laissez-faire economy in the world in 2001 was in Hong Kong -- a city under the direct control of still-communist China.)

Even the very rich CEO's that galled Krugman were only hired guns – not genuine capitalists. Their extravagant pay levels was testimony not to the victory of raw capitalism, but to its defeat. Real capitalists would never allow managers to take so much of THEIR money.

Modern corporations are owned by small shareholders, not big ones - usually through collectivized holdings in pension funds, mutual funds and so forth. These small holders have neither the gumption, power nor the incentive to resist absurdly high executive salaries. Even CEOs of companies whose earnings were falling - or who were approaching bankruptcy - were paid as if they were star quarterbacks in the super-bowl.

Maybe they were especially talented and maybe they weren't. But the mere fact that they are paid so much, and appeared on magazine covers, seemed to awe the little shareholders and impress the analysts. The great mob of investors takes up the stock of these celebrity managers with no serious thought about them - and too small an interest to justify serious investigation.

Mass capitalism not only produced mass delusions, but also a new shareholder arithmetic. It may make sense for Warren Buffett to look carefully at executive compensation. As a substantial shareholder, much of the money that went to over-compensate key employees would have otherwise have gone to him. But the two or three cents a small stockholder might have at stake makes serious investigation not worth the trouble.

Still Krugman is so outraged he doesn't even notice. The nature of capitalism changed dramatically in the 20th century. In America and Japan, free-wheeling laissez-faire capitalism of the 19th century gave way to a consensual, collectivized, capitalism of the 20th century -- a *Kapitalismus Leicht*, with massive state involvement and mass participation by people who wouldn't know a balance sheet from a bed pan.

Capitalism in America was not the same after the Roosevelt Administration finished with it. But this was merely part of the bigger trend - toward a capitalism directed by government for its own purposes…and for the interests of government's beneficiaries. Share ownership became increasing widespread. In America by the end of the century enough people owned shares to elect a president. Share ownership rose from under 5% of the population at the beginning of the 20th century to fully 56% at its end.

Like any large group of people removed from the facts or from direct experience, shareholders were as subject to mass emotions as a group of football fans or a lynch mob. With only 'public' knowledge to go by, they could be readily whipped up by the financial media, and were ready to amplify any fad to the point of absurdity.

The first large movement of mass capitalism took place in America in the 20s. Share ownership was uncommon in 1900. There were only about 4000 stockbrokers in the whole country. Thirty years later, the number of brokers had increased more than 500%. Stocks became such a popular subject that even shoe-shine boys had an opinion on them. The Dow shot up from 120 on the first day of business in 1925 to 381 at the peak in '29.

Then, after the bubble burst, America experienced its first bout of mass-depression. Unlike previous busts, the '30s brought suffering to the entire nation, not just a handful of rich capitalists. A quarter of the workforce lost its jobs. In ’31 and ’32 more than 5,000 banks failed. The bear market on Wall Street dragged on and on…with the Dow not returning to its '29 high until 1954.

For the first time too, voters demanded that their government 'do something'! The Roosevelt Administration did something, of course. It rushed to the scene with a program of monetary and fiscal stimulus, following the most recent fads in macro-economics. Never before had such forceful intervention been attempted. And never before was an economy so unimpressed. Instead of bouncing back as it had following the Panic of 1873 or the Bust of 1907, the nation lay down in a gutter of recession, bankruptcy and sluggish growth. - and stayed there for the next decade. Even then, it seemed to take the biggest war in world history to pry the poor fellow up again.

"Too little, too late," was the professional opinion of the leading economists. Government had made a good attempt - but not massive enough, or fast enough.

Another interpretation, out of step with the fashions of the day, was that the government's own efforts to help the economy out of its funk had actually made the situation worse - by stretching out the painful readjustments that needed to be made over a long period of time and at much greater cost.

Either way, it was a New Era in capitalism. For now, government - often acting through its bureaucrats at the Federal Reserve - promised to soften capitalism's rough edges; to put into place safety nets that would protect people from serious injury, on or off the job, and to manage the nation's monetary and fiscal policies so as to ease the pain of the downward slope of the business cycle. Henceforth, budget deficits would become an economic tool, and not merely a convenience for pusillanimous politicians, unwilling to raise taxes to pay for their programs. And henceforth, interest rates would not be determined by the market, based on the supply of savings and the demand for it. Instead, interest rates - at least at the short end of the interest-rate curve - would be set by the central bank for the good of the economy!

Krugman believes that during the '80s a neo-conservative push to “deregulate” loosed the capitalist dogs from their leashes while also reducing inflation levels in most developed countries. This return to pre-Depression policies inevitability led to Depression-era economies, he thinks, which explains Japan in the '90s - and America in the early 00s.

If anyone can figure out how the shallow deregulations in '80s America produced the long malaise in '90s Japan, he is not working on this book [sic]. Capitalism was adopted by the Japanese following the war – almost grudgingly. But Japan's collective capitalism never bore much resemblance to the raw capitalism of Krugman's imagination. And even in America, the Reagan-era reforms hardly changed the nature of late-20th century capitalism. Barely a single thread in the massive public safety net was unraveled.

Government spending went up by every measure -- as a percentage of personal income, in nominal dollars and in real ones. The fundamental trend towards mass, collective capitalism accelerated. By the end of the century fully half of all American households were little pseudo-capitalists. And of them, nearly half counted the majority of their wealth in the form of shares in public companies!

By the end of the century, America had become the Shareholder Nation - every bit as obsessed with stock prices as Japan had been ten years earlier. Risk has been collectivized - so that hardly anyone feels immune from slump. Investors have lost money. Salarymen have lost (will lose) their jobs - almost unthinkable in Japan. And the government, too, has lost revenue.

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Scarcely noticed by economists of any persuasion was the way in which government became a partner in the managed, risk-averse capitalist systems of the late 20th century. By fits and starts, governments throughout the developed world have increased their share of GDP during the entire century.

In short, government is no longer a spectator. It has become the biggest participant in the, supposedly, free markets of the western world. It has become the biggest spender in consumer economies… and the biggest borrower. It controls money and credit. It is the watchdog on the capital markets, its chief observer, and its chief beneficiary.

In America, following the collapse of the stock market bubble in 2000, the effects were visible almost immediately on government budgets at ever level. In Japan, the nation's budget went from a surplus of 2.9% of GDP in 1991 to a deficit of 4.3% in 1996, as interest came down.

In Japan, as in America, neither the government nor the central bank could sit by idly as the wealth and economic power of the Japanese imploded. Instead, they took the action Krugman and others urged on them - and made the situation worse.

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You can get Bill's Daily Reckoning for free by clicking on http://www.dailyreckoning.com/sub/MWave.cfm I suggest you read him for at least a few weeks to see why I am such a fan. When his book is out, we will make sure you get a chance at a pre-publication special just for my readers.

I am on my way back from Mexico, rested and ready to start on my New Year's resolutions. Monday I start writing my 2003 predictions and they will be in your email box next week. This is going to be an exciting year, and I am glad you can share it with me.

(For more information about me, my book in progress or other services you can go to www.johnmauldin.com.)

Have a great week,

Your still pondering what he is going to predict analyst,

John Mauldin