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## Notes for remarks at Reception and Dinner

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I thought it might be useful to you if (1) I took a quick look at the state of the US and world economies, (2) commented on the political state of play in America, and its policy implications, and (3) shared with you my reactions to recent political developments in the UK, including both domestic and foreign policy. Painting with the broadest of brushes.

There is no question that the economic outlook has changed recently, and with a speed that has taken almost everyone by surprise. It seems that investors have discovered risk, and gotten the idea that bundling several high-risk bits of paper into one security doesn't eliminate the risk of each of the components. It seems, too, that model-driven investment strategies contained a flaw -- they failed to assume that other models would produce

similar results, producing a herd-like response usually attributed only to human beings. To add insult to injury, it seems that the rating agencies, reassuring in their appraisal of the quality of various securities, have serious economic incentives never to “just say no”, as Nancy Reagan advised when confronted with an offering of illegal drugs that would produce a temporary “high”. The question now before us is one that had the singer Kris Kristofferson wondering whether “the goin’ up was worth the comin’ down.”

That depends, of course, and just how far down we will come. There are reasons to believe that things will get worse before they get better. In America, it seems that we have not reached the bottom of the housing-market downturn. Sales remain sluggish, inventories of unsold houses remain high, prices are softening, builders are in despair, and foreclosures are mounting.

This seems to be having some effect on consumers, although that is not entirely clear. Some reports suggest that spending is slowing; others -- from Wal-Mart to swanky Saks Fifth Avenue and swankier still Cartier’s -- suggest that consumers continue to spend. So I am forced to rely on anecdotal evidence. Wal-Mart reports that customers who in the recent past bought

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the stores' \$7 towels are now buying the \$3 line, and higher-income customers who never before shopped at Wal-Mart, have now moved down-market and are moving over from their traditional high-end suppliers to Wal-Mart's \$7 line. Make of that what you will.

In Europe, nervousness is the order of the day. According to its finance minister, France is bankrupt; in Germany, Italy, the Netherlands and Belgium business confidence is on the wane, and in Germany consumers are turning as gloomy as the business executives; in Britain, pictures of the run on Northern Rock have shaken consumers and sent regulators back to the drawing board, and caused lending institutions to become hoarders of cash and deniers of corporate credit; euroland is in tears as the \$1.40+ euro dries up export markets, sucks in imports, and shrivels profit margins.

Then there is China, the new engine of world economic growth. Rising inflation is spurring the regime to increase its efforts to cool the economy, and my guess is that after the Olympics -- before which China wants to project an image of domestic tranquillity -- the regime will be more willing to risk the social upheaval that might occur if the economy slows sufficiently to drive up the unemployment and poverty rates.

And around the world private-equity deal-makers are finding that they are not as popular in the corridors of the investment banks and other lenders as they once were. Instead of focusing on creative ways to finance ever-larger deals, investment bankers are concentrating on ways to wriggle out of the deals they once competed for with every muscle in their brains and balance sheets. Loans they expected to parcel out to others, are now stuck on their own balance sheets -- not what they intended. What might say that their new ability to find the famed "greater fool" has taken them by surprise, and made them very unhappy.

But before despairing, consider this.

The world's economies have generally grown at a rate of at least 3% in the last quarter. A slow-down is not a recession, although it might feel like one. Credit markets are easing a bit, witness the fact that most banks decided not to take the Bank of England up on its offer of credit, because the one-percentage-point premium seemed too high -- meaning they are not quite as strapped as they were a few weeks ago.

In America, new data suggest that the jobs market is stronger than the earlier jobs report led us to believe. Earnings remain relatively good, even at the troubled investment banks -- and very good at Goldman Sachs. Retail sales are not all shopkeepers would like, but back-to-school and luxury goods

have moved smartly off the shelves. Exports are rising at an annual rate of about 15%, offsetting some of the slack created by the decline in housing.

Indeed, some economists are still worried that the economy remains strong enough for Ben Bernanke's recent rate cut to trigger inflation. After all, oil, food, and other commodity prices are rising, as are labour costs. All of this has added to fears that Bernanke, who once joked that the way to end a recession is to toss money from helicopters, has won instant popularity by storing up future inflation.

Perhaps: but consider the fate of Mervyn King, who Larry Summers would surely include in his list of "moral hazard fundamentalists". He struck a different balance between attacking the seized up credit markets and avoiding the sort of bail-out that might encourage a repeat of improvident lending -- and now is unlikely to be reappointed to his job as Governor of the Bank of England.

Now, let's take a longer view. Our age of increasing affluence -- and as a long-run matter that is the age we are in -- is seeing the satisfaction of basic consumer wants, freeing up disposable income for use in the sorts of markets in which Britain and America excel -- financial services, creative design, audio-visual products -- and in America's case, aircraft and agriculture.

Millions of people have been raised out of poverty in recent decades -- and that progress is on-going. Millions of people have become literate -- between 1970 and the early 2000s global illiteracy rates dropped from 46% to 18% and the percentage of people around the world enrolled in tertiary education increased from 6.8% in 1965 to 25.6% in 2001. Worldwide child labour has more than halved since 1960.\*

Consider this: in China alone more than 1.3 billion people have joined the international labour force. That not only provides a force that will help keep labour costs and inflation lower than it would otherwise be. It means millions of consumers for products manufactured in the West.

I should perhaps add that there is a bleak side to this development. Three bleak sides, in fact. The first is downward pressure that the massive Chinese labour force is placing and will continue to place on the wages of unskilled workers. The second is the upward pressure that the growth of China's demand places on commodities prices, including the price of oil. Third, the Chinese -- and they are not alone in this attitude -- are no respecters of intellectual property rights. And it is intellectual property that is the basis of Western prosperity. I can't foresee at the moment how the balance between owners of intellectual

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\* Data from Indur M. Goklany, [The Improving State of the World](#), Washington, D.C.: Cato Institute, 2007, pp. 46-47.

property, and pirates of that property will finally be struck, but I am not optimistic that the creators and owners will win out.

In America it is almost certain that a Democrat will move into the White House in January of 2009. Note the “almost” please, as it is a long, long way from now until the first voter casts the first ballot, which is a long time in politics, especially one now dominated by a war that by the time of voting will have been largely wound down. Still, it is certainly likely that the Democrats will win the presidency, and quite possible that they will win control of both houses of congress as well.

That will certainly mean that taxes will go up -- I am not guessing, they have said they will raise taxes. The rises will be concentrated on people on the upper end of the income scale, in part because of a pervasive sense that inequality has gotten a bit out of control. In addition, more costs will be laid on businesses, especially the costs of more universal health care. Note that I am neither supporting nor attacking such developments, merely reporting that they are very likely to occur.

A Democratic administration will also lean towards protectionism, both because the trade unions are demanding it, and because we have failed to develop policies to share the benefits of free trade in a manner in which society considers fair.

Let me spend a light moment on the question of who that Democrat will be. Hillary Clinton -- unless she makes a mistake, or Al Gore enters the race, or Bill has another incident, or “events, dear boy, events”.

In Britain, we have gone through a most interesting period. You've heard so much about the dithering over whether to call an election that I won't spend any time on it here. Instead let's consider just what the state of play is in politics today. Judging from the Prime Minister's speech at the Labour Party conference in Bournemouth earlier this week, and the statements of Chancellor Darling earlier today, the Labour Party is moving left, back towards more centralised control of the public services, and in the direction of still higher spending. Which certainly means no relief from high taxes, and might mean still higher taxes, with an emphasis on high earners and on businesses benefiting from what are called “loop-holes.”

So Britain is at a crossroads (here I draw on an article that will appear in tomorrow's Telegraph). “I came to a fork in the road and I took it,” baseballer Yogi Berra is alleged to have said. So, too, the British people -- except that unlike the New York Yankee star they have to choose -- the left fork, with Gordon Brown as their guide, or the right fork, following David Cameron. No need for an immediate decision, as the Prime Minister, having studied

the polls, has decreed that voters be given some time to consider where each path leads, and which they prefer.

Brown's is the more thoroughly trodden in recent years. The past decade in which he has been in charge of domestic policy has seen the state expand so that the public sector now consumes well over 40% of the wealth generated by the private sector, taxes and spending on public services rocket up, and the Treasury running deficits at a point in the economic cycle when even John Maynard Keynes called for a surplus. Some of this spending has paid off in improvements in the NHS: more MRI equipment, reduced waiting times for cataract surgery, more doctors and nurses. But even Sir Derek Wanless, the former banker selected by Brown to recommend an increase in NHS funding now says the taxpayer has not gotten value for money.

A traveller down this path will feel a bit uncomfortable as darkness closes in, as violent crime has increased, in part because Gordon Brown's refusal to fund prison construction has forced the early release of dangerous criminals. He will also be hoping that he doesn't confront hostile forces, as his nation's military has been reduced to a mere shadow of its former self, and the special relationship with America is in such disrepair that calls to Washington for help are likely to go unanswered. Finally, he might find his British passport useless, as Britain will have

signed onto a European constitution that will eventually submerge his country in an EU superstate, one that is moving down the road charted for it by the real power in the Foreign Office, Mark Malloch-Brown, who wants the UK to cede its Security Council seat to the EU.

But if the traveller to Brown's England of the future is a single mom, or poor, or earning a minimum wage, or claiming to be disabled, or a beneficiary of any one of the multiple tax credits that Brown uses to redistribute income from the middle class to lower-income groups, and from traditional mom-pop-and-kids families to families more broadly defined, he and she should hum a merry tune as they step smartly along.

Those who choose to follow David Cameron will not have as clear a view of the road ahead. They know that they will be rejecting many of the policies of the past decade -- no easy thing, since it has been one of unbroken prosperity that has seen them grow richer, at least until very recently when taxes began to take such a large bite out of pay checks that disposable incomes fell. Still, they are being asked to follow a new guide when the old one seems more reassuring, less flighty.

So the Cameron path is a bit chancier. Indeed, until recently the guide who is asking the voters to follow him seems to have had a roadmap strewn with exits that lead to strange destinations:

towns in which supermarket parking spaces are taxed; airports at which low-fare vacations to Spain are limited to one per year; neighbourhoods in which hugging hoodies is considered a good idea but there is no clear view what sort of schools are to be built.

But the new guide now assures prospective travellers that all that is behind him. His and their destination is a place where first-time home buyers will find life a bit easier, and older homeowners will be able to leave their newly valuable homes to their children, free of inheritance tax. The road will be safer as soon as the new prisons he promises are built, being British will still matter if foreigners are encountered along the way, even if those foreigners are unhappy because Britain has decided to remain an independent nation-state rather than sign on to its proposed constitution.

But all of these are details. The fundamental choice facing voters when it comes to domestic policy is between travelling in the direction of more state control over their lives, or in the exact opposite direction of freedom to choose one's own doctors and schools, and to spend more of one's own hard-earned money. In his speech describing just what life would be like at the end of the Brown road, the Prime Minister made it clear that he feels the state is best positioned to decide what individuals need. If the NHS is slow to innovate, there will be a central Health Innovation

Council to champion “change”, the new Brown buzzword; city academies, established by Tony Blair to be freer of bureaucratic control and therefore a source of innovation, will be put under central control; the state will continue to claim an every larger portion of the nation’s income and wealth. And the threat of globalisation will be met by a host of government entities designed to improve Britain’s sagging competitiveness.

Cameron’s inclination is different: he would like to see parents choose the schools best suited to their children’s needs, and health care that responds to the demands and desires of individual patients. Unlike Brown, who offers certainty and a state that is prepared to take responsibility for the care and feeding of its citizens, Cameron offers a future in which individuals will have to take more responsibility for their own affairs and the nature of their communities. For people accustomed to the paternalistic policies of the past decade, that is the road less travelled by. But it is the only one that represents real change, if that is what you are after.

My impression after sitting through both parties’ conferences is that Labour is intellectually exhausted, witness Alistair Darling’s need to steal the Tories ideas on inheritance tax, taxation of non-doms, green taxes, and their plans to lower corporate taxes, while the Tories are now the source of policies that are both new and, if

recent polls are to be believed, voter-friendly. Never mind that their biggest idea -- ending inheritance tax for most people -- provides a windfall for the already comfortable and is subversive of the Tories stated goal of fostering equality of opportunity. Or that they have yet to specify just how they will shift the tax burden from incomes and jobs to pollution.

The important thing is that voters finally have a choice: the reassuring certainty of the known, or the risks and rewards of a more thorough break with the past. And a good long while to decide which fork in the road to take.

During that time, until the next general election, the fundamental question will be whether the intellectually exhausted Labour Party can recover its intellectual footing, and the Tories can whip their policies into coherent shape.

When it comes to foreign policy, it is not quite so clear that British voters have a choice. Gordon Brown has shown his desire to distance himself from America by his performance when visiting President Bush in America, and by withdrawing Britain from the coalition that has been fighting to bring some form of order to Iraq. Press reports are correct: the Bush administration feels seriously undermined by Brown's actions.

But then we have the Tories, with William Hague and David Cameron using the anniversary of the September 11 attack on the

United States to call on Britain to distance itself from American foreign policy.

Whether the special relationship will survive I do not know: I like to think that it runs so deep, especially on the operational level of military and security operations, that no action by politicians seeking temporary advantage can damage it. But I am not certain whether that is wish or analysis on my part.

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