

15th Anniversary Lehman Collapse Conference

Wednesday, September 13, 2023, 9:30am – 5pm

KEYNOTE: What's at Stake in Solving/Ending the Threat of TBTF?

Dennis Kelleher, Better Markets

Now I want to introduce Martin Wolf, the Chief Economics Commentator at the Financial Times. Martin has had a long and storied career and has authored numerous books, including his most recent must-read book *The Crisis of Democratic Capitalism*. This is really the only book that captures and details, what is at stake and financial reform, and in making sure that the financial system is stable, doesn't threaten the economy, and causes catastrophic crashes like 2008.

However, now, too often, we have a financial system that acts as a wealth extraction mechanism for the few rather than a wealth generation system for the many as those few increase their wealth year after year, too many of them are using their economic power to buy political power to increase their economic power. Martin connects this to the erosion of democracy, which he shows flows in substantial part from the inability or unwillingness of governments to deliver economic stability and progress for the vast majority of people. While that very small segment not only gets richer, but when they get in trouble, they get bailed out. He demonstrates how our economy has destabilized our politics, and how our politics has destabilized our economy.

The financial crisis was a key turning point. that made all of these trends worse and starkly visible. Everyone saw how Wall Street got bailed out, and Main Street got the bill in the economic suffering. Just a few data points. And October of 2009, just 13 months after the crash of Lehman Brothers, the U6 unemployment rate was 17%, meaning almost 27 million Americans were out of work. Just a few months later, in January of 2010, Wall Street showered itself with \$20 billion in bonuses for the calendar year of 2009. That was a 17% increase over the bonuses they paid themselves for 2008. At the same time, those banks received hundreds of billions of dollars in TARP money and trillions of dollars from the federal reserve, to bail them out of the consequences of their reckless if not illegal misconduct. It's shocking, but true. The very people who caused the crash caused massive unemployment. 16 million foreclosure filings, the loss of savings and retirements and so much more rewarded and enrich themselves while the country suffered. That and similar episodes are the fuel that have ignited widespread discontent that is lashing out in the political process, creating dangerous economic, financial and political conditions. Those are the stakes in getting finance and financial reform.

With that, I give you Martin Wolf.

Martin Wolf, Financial Times

Thank you, Dennis, for that very kind introduction. It's a great pleasure and honor to be allowed to present at least the essence of my book, *The Crisis of Democratic Capitalism*, to this audience. And what I can do is only outline the basic ideas about what I think is the biggest challenge of our time, which is to ensure the survival of this extraordinary experiment of democratic capitalism. And I'd like to start with a quotation. And the quotation is as follows.

“It is clear then that the best partnership in a state is the one which operates through the middle people (or in contemporary parlance the middle classes), and also that those states in which the middle element is large, and stronger if possible than the other two together, or at any rate stronger than either of them alone, have every chance of having a well-run [democratic] constitution.”

Remarkably, this quotation is 2500 years old. It comes from Aristotle's Politics, and he was discussing the experience of the Greek city states, the dawn of the democratic experiment. And he was saying something, which I think is absolutely fundamental importance in our time, and it is that the middle classes, the independent middle classes, their strength, their vigor, they are the basic foundation of democracy. And the second quotation I have is also Greek one. It's from the temple of Apollo at Delphi. It was a very important motto for the Greeks perhaps because they mostly ignored it. And it is “μηδὲν ἄγαν,” which means nothing in excess. And for me, that means they will if we are to have a democracy, we need to remember that it's about getting the balance right. One can never win decisively and forever in a democracy. One can never have everything one wants. It's about compromise.

In 1937 my father left Vienna for England, on his own. His immediate family managed, by a miracle, to escape to Palestine in 1939. But their entire wider family was stuck in Poland and, apart from one young woman, they all perished in the Holocaust. In May 1940, my mother's father, a self-made Jewish fish merchant, hijacked a trawler, to take his family to England, as German armies poured across the Dutch frontier. He was one of nine children. He asked all his brothers and sisters to join him, with their families. None came. Their families also all perished in the Holocaust. I am not certain of the numbers. But essentially all my parents' aunts, uncles and cousins, about 40-50 men, women and children, were slaughtered.

This catastrophe was of course the result of the collapse of civilisation in Europe. There were many reasons for this collapse. But important among them was grim economic failure, above all the Great Depression. That brought Hitler to power. From this I learned that if people cannot gain a decent standard of living, a peaceful and stable democratic order becomes hard to sustain.

That is why the theme of this book of mine, which I began to write as Donald Trump became president of the US and the lies of the Brexit campaign transformed my country, has seized me. I am certainly not saying that what happened then will happen again, but I am saying that one must never assume the stability of a civilized democracy, not even the most powerful, not even the United States.

So, I'd like to start by talking about what my friend Larry Diamond, the great scholar of democracy at Stanford, calls the democratic recession, which is one of the great and horrifying stories of our time.

Remember, in a liberal democracy — a democracy characterized by individual civil rights, the rule of law and respect for both the rights of the losers and the legitimacy of the winners — fair elections determine who holds power.

Any attempt by a head of government and state to subvert the election or overturn the vote are treason. Yet that is of course what Donald Trump attempted to do both before and after the last presidential elections.

He failed. Decent and brave people ensured that. But to this day, despite the mid-terms, Trump continues to hold the loyalty of his party's base and, willing or not, of nearly all its presidential candidates, as well.

Meanwhile, such conservative stalwarts, such as Liz Cheney, were defenestrated. Her crime? Stating that Trump's Big Lie that the outcome of the election was a lie is indeed a Big Lie.

Thus the Republican party — one of the two main parties in the world's foremost democracy — is no longer committed to the most fundamental of all democratic norms: fair and free elections.

Yet how can any democracy survive if people think the *only* thing that matters is winning. Democracy must be founded on certain moral values: the belief that we are all citizens; the belief that we govern through debate; and the belief that we argue honestly. With those values gone, what is left but simple and brutal violence?

Trump is, alas, far from alone. *Freedom in the World*, from the independent US watchdog, Freedom House, published every February, has reported a 18th consecutive year of decline in the health of liberal democracy. The “democratic recession” noted by Larry Diamond more than one and a half decades ago is close to a “democratic depression”.

This decline has occurred in all regions of the world, notably in the fragile democracies that emerged after the Cold War. But, most significantly, it is also observable in core western democracies including the US, the most important of all. Indeed the country that saved democracy in the 20th century.

So let me turn now to how this extraordinary system of democratic capitalism was born. According to the Polity IV database, remarkably *there were no democracies in the world at all some two centuries ago*. Even where republican institutions did exist, as in the US, the franchise was highly restricted, on the grounds of sex, race, and wealth.

Then, as this chart shows if you look at the brown line shows the proportion of countries in the world at that time that had democratic governments, franchises as we can see were widened and slowly, but surely universal suffrage democracy emerged and spread in fits and starts to cover half of the world's countries after 1990, before that rise stopped and in fact began to decline. And this transformation towards democratic systems was a true political revolution. And the other thing that is remarkable, is that this occurred in rhythm with what was happening to the world economy. So, the other lines, the blue and the orange line, show the ratios of world trade to global output. And you can see that when democracy rose in the late 19th and early 20th century the trade was rising. The collapse of democracy occurred at the same time as the collapse in world trade. And the final surge in democracy occurred at the same time as the world economy became more open. I am not suggesting some simple cause and effect. I am just suggesting that in optimistic times, times when trade is booming, when economies are becoming open, when people are getting better off, then democracy itself also seems to become stronger. The big question obviously is why did democracy arise at all? What motivation, what engine, drove the shift towards democracy in so many countries? Not every country ever, but to so many countries.

It is worth remembering, the normal way for our ancestors to structure the economies and politics of complex societies has been so to speak for power to marry wealth and wealth to marry power. Quite simply, *the most powerful people in society were the richest and vice versa*. And absolute monarchs, where they existed, effectively owned everything.

So, why did this revolutionary change towards democracy occur? And what did it have to do with the progress of the liberal economy. The answer lies with the emergence of a marriage between these two

very different partners: a liberal economy and a democratic polity. Market capitalism and democracy are, I argue, “complementary opposites”.

The market economy and universal suffrage democracy both reject ascribed hereditary status. They embrace instead the idea that people are entitled to decide important things for themselves, even their place in society.

Market capitalism rests on ideals of free labor, individual effort, reward for merit and the rule of law. Democracy rests on ideals of free discussion and debate among citizens when making those laws. Both then are deeply rooted in ideas of freedom.

Historically, the market economy also brought greater prosperity, urbanization, demand for a more educated workforce, the organization of the working class, and with prosperity opportunities for what might be called a “positive sum” politics. A politics in which everyone could get better off.

Democracies rest on the existence of an economically independent citizenry. That was Aristotle’s point. A fully socialist society is inevitably a dictatorship, since the ownership of productive assets, and the control over them, is then vested entirely in the state. In the absence of co-ordination through competitive markets, that state is then responsible for the allocation of all these valuable resources. It has too much power and those who control it can never be forced to give up that power.

Markets protect democratic politics from such an excessive concentration of power, but democratic politics also protect markets from an excessive concentration of wealth and market power.

And this then is how the market economy and liberal democracy are complementary.

Yet they are also in important ways opposites. Capitalism is by its nature cosmopolitan, it looks for opportunity everywhere but the democratic state is territorial. The market is the domain of “exit”; democracy is the domain of “voice”. The market economy is inegalitarian (one dollar, one vote); democracy is egalitarian (one person, one vote).

Tensions between capitalism and democracy will then inevitably emerge.

If the economy fails to serve the interests of the majority, the sense of shared citizenship needed by the democratic polity will fray and populist demagogues will inevitably emerge. Such populism is not necessarily lethal for democracy, so long as it takes the form of a justified (even fruitful) hostility to elites. But often it transforms into hostility to pluralism itself, and that is an attack on an essential element of any democracy.

Democracy will then be transformed into, what we might call, a “plebiscitary dictatorship” or just a dictatorship, in which the dictator insists that *“le peuple, c’est moi,” I am the people*. Alternatively, the concentration of wealth can lead to plutocracy as wealth is once again transmuted into power. Indeed, it is quite likely that one will end up with a predatory autocracy and corrupt plutocracy in uneasy tension. That was the governing system of the Roman Empire. And it clearly has contemporary echoes.

In sum, democracy and the market are married to each other. But it is a difficult marriage. Many marriages are.

Let me turn to where the high-income democracies are today.

Large rises in inequality and the deteriorating prospects of the old “respectable” working and middle classes in core democracies have been eroding its very foundations.

The fear of downward mobility has created “status anxiety” and political cynicism. These have then been diverted by skillful propagandists into cultural and racial resentments, especially in ethnically diverse societies.

This is not new. It has long been the foundation of the political culture of the American South. And it was of course the foundation of interwar European fascism, too.

Those resentments have been greatly aggravated by the emergence of a large and discontented class of university-educated “clerics” dedicated to a “progressive” cultural and racial politics. The identity army of the left then clashes with (and of course motivates) the majoritarian (“silent majority”) identity army of the right.

The emergence of our “new media” social networks have facilitated all these trends. But in my view they did not create them.

The fundamental question is what has happened to create this “status anxiety”, especially in people who did not go to college.

In the long run, the most important phenomena, I argue, have been economic: deindustrialization, rising inequality, falling productivity growth, financial instability, and slowing economic growth, especially after the Great Recession.

It is an intriguing fact that the US and UK appear to be the most unequal of the big high-income democracies and they have also had some of the potent right-wing populist politics. Is that an accident? I doubt it.

The Chicago University economist, and former Governor the Reserve Bank of India, Raghuram Rajan, argued that easy credit papered over these trends before 2008. But that blew up in the financial crisis, which turned out a decisive transformation economically and politically. The scale and visibility of the crisis and the subsequent rescue of the banks and then bankers convinced many ordinary people that the elites were both corrupt and incompetent. The unexpected shock of this crisis shook trust in the wisdom and probity of those running the affected countries’ financial, economic, and political systems. Most policy mistakes in economics are invisible to the bulk of the voting public. But nobody could possibly fail to realize that those in charge had failed to recognize the risks they were allowing the financial sector to run. The emperors turned out to be naked.

Many members of the public came to believe that these failings were the result not just of stupidity but of intellectual and moral corruption among decision-makers and opinion formers at all levels – in the financial sector, regulatory bodies, academia, media and politics.

They also saw the resources of the state used to rescue both banks and bankers – the architects, as they saw it, of the disaster – while they (and those they loved) suffered large losses through foreclosure, unemployment, a prolonged period of stagnant or falling real wages, and fiscal austerity. Finally, they also saw that while institutions were forced to pay huge fines, essentially nobody (or nobody of any importance) was punished for what happened.

And that, I believe, is why the Republican establishment became so ripe for a populist take-over. But in truth what happened discredited the establishment in both parties, as it did in the UK in the Brexit referendum.

Of course, there were other things at work. The shift towards skill-intensive sectors and technologies, de-industrialization, globalization and the rise of China were also powerful underlying economic forces.

Yet there is also, as I argue at length, substantial evidence of the emergence of “rentier” capitalism, with declining competition, rising monopoly, and unbridled self-seeking by corporate executives. (speech got messed up and this paragraph was played twice)

And, furthermore, the role of money in politics, especially in the US, has eroded the tax base and the effectiveness of regulation.

No wonder people are cynical about politicians!

Let me just illustrate a few of these points in the following slides. So, my first slide shows what has happened to the share of industry in employment. And with countries ranked by the decline in that share between 1970 and 2019. And this is shown by the major developed countries. And the really important point, it's nothing special happened in the US. There has been a large decline in the share of people working in industry in every economy. And this is simply because there have been very rapid rises in productivity in these countries. And the US is bang slap in the middle. And here is a second really crucial feature of what has happened. And this is the decline in productivity growth in these economies over time, particularly in the countries that have very rapid productivity growth in the 1950s, and 1960s. And the decade of the 2010s, there seems to be a temporary improvement now has been particularly bad in many, many countries, notably in the UK, and in Italy. So, productivity growth has been really disastrously poor in the last decade.

This chart shows what has happened to economic performance since the financial crisis, and therefore it illuminates the politics of that crisis. And for these countries, the same countries, it shows how far GDP per head had fallen really just before COVID, and as a result of COVID. But you can see it already before COVID. For the set of countries below what would have happened if GDP per head had continued to rise as the 1990 to 2007 trend suggested. And here we can see that with the exception, perhaps of Germany, every country is well below trend. The US, for example, has GDP per head in 2021, which was 20%, between 20% and 25%, about 23%, below what it would have been in the pre-crisis trends continued. And in other countries, like the UK and Spain and Italy, the performance has been even worse. So, it's not surprising people are so concerned about what's happening to their lives. And with that realization, we have to think about how democratic capitalism fits into today's world.

In a very well-known book, Branko Milanovic, formerly of the World Bank, argues that capitalism is “alone”: it has won.

But the question we have to ask, particularly in the light of the performance I have just discussed, what sort of capitalism has won? Is it what Milanovic call “liberal capitalism” and I call “democratic

capitalism” or is it to what he calls “political capitalism”, and I would call quite simply “authoritarian capitalism”?

Now if we look at the world today, we see there are in fact two forms of authoritarian capitalism that are the rivals of democracy.

The most common version derives from a hostile takeover of democracies from within. The would-be autocrat eats it out. Usually, he starts as a populist demagogue, and it’s always a he. Features of such regimes include: a narrow circle of trusted servants, promotion of members of the family and “power ministries” whose members are personally loyal to the leader. Plutocrats may well find it necessary to support the gangster in charge. But, ultimately, however, they survive only as his cronies. Putin’s Russia is a pretty good example.

The other challenger, and very different challenger of democratic capitalism, is what I call “bureaucratic authoritarian capitalism”: or in brief the Chinese system. A communist bureaucracy operating a capitalist economy can it appears self-disciplined, long-sighted, technocratic and rational.

Even so, bureaucratic capitalism also suffers from the great vices of authoritarianism, especially the tendency towards corruption, and crony capitalism. These failings damage both the economy and political legitimacy.

Now, bureaucratic authoritarian capitalism has appeared to be a significant challenger to the western democratic version. Yet, we must not despair.

Autocracies remain bad systems: they do not have a structure of accountability; they do not have open debate; they cannot ensure the peaceful transfer of power; and they tend towards unbridled cronyism and corruption. Indeed, corruption too often *becomes* the system.

And moreover, we must remember, liberal democracy has come through many challenges over the past century.

And, most fundamentally, it is the right system. It rests on the magnificent belief in the capacity of people to make up their own minds and lead the lives they choose within societies whose decisions are taken with the active consent of the governed.

So finally, how do we renew democratic capitalism? The renewal must in my view be animated by a simple, overriding, and powerful idea: that of shared citizenship.

If democracy is to work, we cannot think only as consumers, workers, business owners, savers, or investors.

We must think of ourselves citizens.

And citizenship must have three aspects if democracy is to work: loyalty to democratic political and legal institutions and the values of open debate and mutual tolerance that underpin them; concern for the ability of fellow citizens to live a fulfilled life; and the desire, the passion, to create an economy that allows all citizens hope of a better future.

In conclusion, my view is that we cannot go back to any sort of past, be it on the right or the left. This is a fantasy. Nostalgia is not the basis of a sound politics. Yet some things have to remain the same. Human beings must act collectively as well as individual, acting together within a democracy means acting and thinking as citizens. And if we cannot do that, democracy will simply fail.

But I remind you that the UK very recently had Boris Johnson, and then Liz Truss as Prime Ministers, one was a fraud, the other a fanatic, but we managed to get rid of them peacefully. And that is what democracies do. Contrast this with the fate of Vladimir Putin or Xi Jinping. Both are dictators and both, in my view, are also manifestly incompetent or worse. Is there any way of getting rid of them? None short of mass violence. And that is the difference. It is the difference between rule by consent and rule by coercion. It is the duty of us all to renew the foundations of our hard-won democracies. Lest they fail.