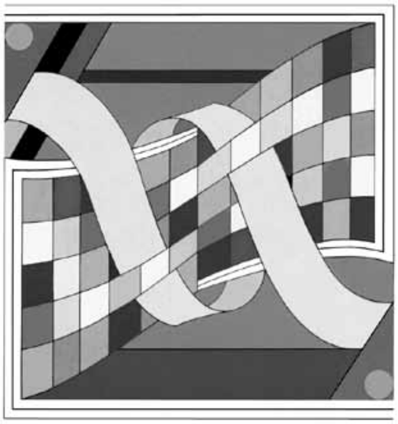

Not All Forms of Capitalism Are Created Equal

By Robert W. Merry

A review of

The Great Equalizer: How Main Street Capitalism Can Create an Economy for Everyone by **David M. Smick,** PublicAffairs, 2017

My longtime friend David M. Smick expressed misgivings when I offered to review his forthcoming book in his own magazine—the one in your hands at the moment. Dave Smick of course is the publisher, editor, and founder of *The International Economy* (in addition to his extensive consulting and investment activities), and he suggested that devoting magazine space to his latest musings on the financial state of the world might appear a bit immodest or perhaps too self-promotional. I countered that his readers deserved an exploration of the book's thesis and underlying arguments and shouldn't be deprived of such an exploration simply because he owns the magazine. He wavered, then relented.

I'm glad he did because I surely was correct in thinking this particular readership would want to know about this particular book, entitled *The Great Equalizer: How Main Street Capitalism Can Create an Economy for Everyone.* It is a fitting sequel to his 2008 bestseller, *The World Is Curved: Hidden Dangers to the Global Economy,* which warned that the world's financial situation was at a tipping point and could collapse at any moment. It promptly did collapse, and 40 percent of the world's wealth evaporated almost instantly. Not surprisingly, Smick won a highly deserved reputation as a particularly percipient economic analyst and seer. *New York Times* columnist David Brooks called *The World Is Curved* "astonishingly prescient."

But all that now is what Smick calls "old news." The question for today is what has happened since the so-called Great Recession, and why global growth rates—including U.S. growth rates—have never managed to catch up to historical norms. That is the subject of *The Great Equalizer.*

It's not a treatise for the faint of heart. In surveying the economic scene in America and around the world, Smick sees powerful dangers lurking. The U.S. economy, he writes, is "a horror show that can take us all down." He adds, "America's future is at serious risk." And the country's economic disease is infecting its politics, as always happens when people feel helpless in the face of financial travail. "Today," writes Smick, "large parts of the American workforce are so angry that the long-term future of American politics is beyond prediction." Further, it isn't just the American economy that is raising alarms. "The global monetary system," he warns, "has become a high-risk casino."

But, true to his past association with that great supply-side optimist of the 1980s and 1990s, Jack Kemp, Smick perceives a solution to what ails the national economy.

Robert W. Merry, author of books on American history and longtime Washington journalist and publishing executive, is editor of The American Conservative.

Kemp, the New York congressman and cabinet secretary in the George H. W. Bush administration, persistently hailed the underlying economic force and energy that is unleashed when ordinary folk can apply their entrepreneurial zeal and risk-taking bravura in a world unfettered by artificial barriers erected by government, often in league with Big Business, Big Labor, and Big Finance. Some thirty years after Smick's stint as Kemp's congressional chief of staff, he still finds inspiration in the Kemp vision. "The innovators," he writes, "are the secret to long-term prosperity."

But the innovators, dreamers, discoverers, and risk-takers—Smick's economic heroes—aren't driving the U.S. economy today. They are hunkered down, shackled by economic uncertainty, regulatory intrusion, inaccessible capital, and a scourge of Bigness. "The system," writes Smick, echoing Donald Trump, "has been 'rigged.'"

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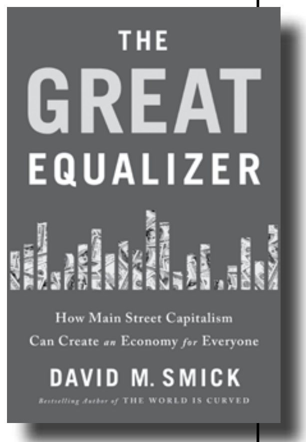
How did this happen? Smick's book answers that question by dissecting the works and actions of economic policymakers over the past decade and then laying bare the results—and the follies—of their complex ministrations. And the timing couldn't be more propitious, with the emergence of a new presidential administration that seems unshackled by conventional rubrics and prevailing habits of thought. In that sense, *The Great Equalizer* calls to mind George Gilder's 1981 *Wealth and Poverty,* published just as another politician with unconventional economic views, Ronald Reagan, was entering the Oval Office. It served as a kind of philosophical underpinning for Reagan's supply side revolution—making the case, as Kemp said at the time, "for the moral as well as practical merits of capitalism." It's premature to suggest *The Great Equalizer* will play a similar role in today's pregnant politics, but it should.

In assessing the response to the 2008 financial crisis, Smick doesn't fault the world's governments and central banks for injecting massive amounts of liquidity into the economies of the world's industrial nations. It amounted to a mind-boggling $17 trillion in current and potential future resources, nearly a quarter of global gross domestic product at the time. As Smick points out, the result was that "the global economy avoided depression. The immediate free fall in global aggregate demand was arrested. Stock markets rebounded." We can't know for sure, but it seems likely that these policies staved off the emergence of that most deadly of economic threats—deflation, or inexorably falling prices.



But then the major central banks around the globe—most particularly the U.S. Federal Reserve—sought to stimulate ongoing growth by continuing the policy of massive infusions of liquidity into their economies. The Fed brought short-term interest rates down to near zero, then followed up with massive bond buying, called "quantitative easing," design to keep long-term interest rates low as well. This policy cocktail merits two observations. First, it didn't work. Economic growth in America slowed to a snail's pace—just 1.4 percent annually on average during President Obama's first seven years in office. The result in America, as Smick points out, was that for most people, "the American dream began to slip away." And the malaise spread well beyond U.S. borders. The global growth rate plummeted to about 2.5 percent in 2015 from 4.3 percent in 2010, according to World Bank data. But growth has slowed further since, and if China's growth numbers are adjusted to account for that country's habitual dissembling on such numbers, "the world economy is barely growing at all."

Worse, top economic policymakers have essentially thrown up their hands in acknowledgement of their failure, while insisting there simply isn't anything they can do beyond what they have already done. Fed Chairman Janet Yellen calls today's slow growth "the new normal," while International Monetary Fund chief Christine Lagarde calls it the "mediocre normal." No wonder U.S. voters summarily rejected every conventional politician during the 2016 presidential primaries and general election. They don't want their reduced lives to be considered simply the best that anyone can do.

The second point that needs attention is that this policy of goosing liquidity massively has generated what Smick calls "ugly unintended—and unfair—consequences." It has driven a powerful wedge through the American body politic—between the country's financial and corporate elites, who have benefitted spectacularly from the approach, and ordinary Americans, who have been hit hard by the ongoing decline in Main Street capitalism.

By keeping short-term interest rates so low, the Fed bestowed upon Wall Street banks a great tool for repairing their balance sheets, which had been damaged by the 2008 crisis. The big banks could borrow at next to nothing, then purchase longer-term, higher-yielding debt on the open market. This gave them a guaranteed, risk-free profit stream on the spread between the two interest rates. The money poured in. And quantitative easing added a special boon to Wall Street's private equity firms, giving them an opportunity to refinance the troubled companies they had purchased at bargain-basement prices during the crisis. When the stock market recovered, the private equity managers took their freshly refinanced companies public. Again, the money poured in.

Further, the Fed's low-interest rate initiatives also gave corporate America a huge opportunity for cashing in—by borrowing funds at the Fed's low interest rates to buy back stock in their companies just as the Fed's policies were about to generate a stock market boom. Massive amounts of cash flowed into corporate coffers, sizable chunks of it funneled to top executives in bonuses earned through such fancy maneuvers.

But notice, as Smick urges us to do, that hardly any of this largess from artificially low interest rates flowed to Main Street America, where ordinary working families lost income from their money market funds and savings accounts. And notice that these transactions were all financial transactions, divorced from the traditional American passion for building things, for innovating and taking risks—the kinds of activities that spur entrepreneurial zest, generate new enterprises, and create jobs.

The result, writes Smick, was "the greatest wealth transfer from Main Street to Wall Street in the history of the country." Some years ago, writing in this magazine, Smick put it more starkly, suggesting that this phenomenon amounted to "the greatest transfer of middle-class and elderly wealth to elite financial interests in the history of mankind." Either way, it represents a huge development with ominous ramifications for the American economy and for American politics. The current state of affairs can't continue because it isn't politically sustainable, even if it were economically sustainable, which it isn't. If you don't believe it, just count up the votes accumulated by Vermont Senator Bernie Sanders and New York billionaire Donald Trump in the political season just past. Trump's election surely is tied in part to this ominous wealth transfer.

Smick doesn't stop there, for he sees many other signs of danger in the current global economy, many of them products of the unprecedented debt burden spreading across the globe. In the United States, public debt has grown to $19 trillion, exceeding current GDP. Only once before has the country had such a lofty debt—at the end of World War II. And the projections of unfunded liabilities for federal entitlement programs are truly scary. Harvard's Jeffrey Miron speculates that over the next seventy-five years, the present value of all U.S. government expenses, including entitlements, will exceed future revenue by $118 trillion. "Put in context," writes Smick, "U.S. GDP for 2015 was only $18 trillion."

But America is only a small part of the problem. Worldwide, corporate debt in emerging markets has more than doubled, and the world's total debt has skyrocketed to a level unimaginable even a decade ago—to $180 trillion as of 2015 and rising. Meanwhile, China has allowed its public debt to balloon to 237 percent of GDP, up from 150 percent as recently as 2007, according to the *Financial Times.* The cost of merely servicing China's debt, reports Smick, consumes fully 20 percent of the country's GDP. He warns that this massive and growing debt, tied to China's overheated real estate market and "a dubious shadow banking system," may have become "all but unserviceable." It appears that China is building up new debt merely to service its old debt. Smick minces no words in describing the implications of this: "China's debt is a potential global disaster in the making."

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In part that's because China is trying to get control of this ominous situation through explosive boosts in production—increasingly surpassing worldwide demand for its products. This excess supply capacity, seen in other emerging markets as well, is putting downward pressure on prices and posing a risk of disinflation or even deflation.

As for America, it has only three options in dealing with its massive debt threat, and two of them would prove disastrous. First, it can weaken the currency and inflate. "Not a good idea," writes Smick, because inflation kills the livelihoods of most people while greatly benefitting the rich creditor class. The wedge that is dividing America would grow wider. Second, it can default on its debt "like a third-world country." That would destroy America's economic position in the world, which is why any default strategy would lead inexorably right back to the inflate strategy. Finally, it could encourage innovation, entrepreneurial zeal, and job creation by fostering a flow of capital to ordinary Americans throughout the nation, by opening up the economy to Main Street as well as Wall Street, and by ensuring that growth rates are maintained at levels higher than interest rates. This third option would have to entail reforms to achieve fiscal discipline as well, but it would eschew austerity policies that squeeze the economy and thwart business activity.

Such an approach also would have to address two other developments posing serious dangers to the U.S. economy and body politic. The first is the grip of what Smick calls "corporate capitalism," sometimes described as "crony capitalism." The financial elites not only took nearly all the largess from the government's panicked response to the 2008 financial crisis and lingering embrace of liquidity infusion as the economic weapon of choice. They also grabbed hold of official Washington to ensure that they would continue to dominate policymaking and hence the economic playing field. Smick quotes a business analyst named Bill Frezza as saying that the big Wall Street banks "perfected the art of privatizing gains while socializing losses." They manipulate the government to ensure profits and if, perchance, blustery market forces should somehow threaten those profits, they turn to the government for bailouts. Capitalism be damned. Or, as Smick puts it, "The world has become a collection of winners and losers, and the winners—usually large established institutions—are manipulating the system at the expense of the entrepreneurial newcomers."

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Of course the famous Dodd-Frank legislation of 2010 was supposed to protect the country from the big banks and any financial fallout of faulty economic decisions. But that's essentially a sham. Those banks and their global counterparts have become heavily regulated, highly risk-averse organizations—"not unlike," writes Smick, "the lackluster town water or electric utility company." On the surface, Dodd-Frank was billed as a stringent action on the part of government to rein in the banks; in reality, it was a bureaucratized takeover that left the banks free to consolidate, grow, and thrive—unhampered by competition from any upstart entities that might have a better idea of how to provide financial services to the entrepreneurial class. Of course, federal regulators have extracted huge sums in penalties from the banks based on allegations of wrongdoing before and during the Great Recession. But in essence that was the government's cut after providing so much protection and security to these behemoth institutions.

And government offers further inside deals to elite institutions as well through other mechanisms, most notably the tax code. Writes Smick,

> *Washington has fully embraced the culture of the inside deal, the plugged-in exception, the brazen point of inconsistency where nobody bats an eye. The system "is rigged," as Bernie Sanders accurately argued in the Democratic presidential primary campaign. It is less and less fair for outsiders, and most insiders haven't a clue how destructive this culture is to their nation's spirit of, and sense of, fair play. The culture is killing the concept of Main Street Capitalism's level playing field for competition.*

The other development contributing to the country's economic stagnation is the federal government's powerful push to regulate the economy, much of it perpetrated without any congressional action at all. This isn't a partisan matter. As Smick points out, George W. Bush expanded the regulatory state considerably during his two terms as president, and then regulation of the private sector "zoomed to unprecedented highs under Obama." Among Smick's policy recommendations is an assault on the regulatory state, with a two-year holiday on most new regulations and a roll-back of the fifty most egregious instances where corporations used lobbying pressure to influence the regulatory process to the disadvantage of their competitors or potential competitors.

Having offered his intricate diagnosis of the country's, and the world's, economic malaise, Smick offers his solution for America. Like his analysis of what can be done about the debt crisis, it comes down to innovation, unleashing the animal spirits of human nature and of the American ethos upon the world. The key is new ideas, new technologies, new products, new distribution methods. All this requires that we shake up the powerful and unfair Wall Street-government combine and send capital and more economic freedom to Main Street. "Innovation," writes Smick, "is the economy's turbocharger." It boosts productivity, which in turn impels economic growth, which then generates broad-based prosperity and improves the lot of wage-earners. "It is the magic formula for growth," writes Smick. "It has the capability to be the economy's Great Equalizer."

Smick acknowledges that innovation has a down side. It is a "powerful disrupter," as Schumpeter captured so succinctly in his famous phrase, "creative destruction." Innovation wipes away many of the old ways of doing things, and that can generate discomfort and anxiety. But humans, and perhaps most particularly American humans, are adaptable, and there is no alternative in today's world to boosting productivity and generating economic growth through the entrepreneurial spirit. That requires innovation, which in turn requires upending the financial elites and getting capital and incentives back to Main Street.

That is the central focus of what Smick calls "Main Street Capitalism's 14-Point Plan," a comprehensive matrix of economic goals, financial rearrangements, political compromises, tax reforms, deregulation plans, infrastructure initiatives, and more. He writes, "The goal: to create a climate more welcoming of greater business startups in all sectors of the economy, propelled by greater innovative daring." That sentence harks back to the optimism and faith in the human spirit so enthusiastically embraced by Jack Kemp—and nurtured down to the current era by his most famous associate, Dave Smick.

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Can it work? Some may harbor doubts. But we know the current approach of succoring Wall Street to the detriment of Main Street certainly isn't working. A reflate strategy can't work. A debt default would be disastrous. Austerity in the current crisis atmosphere probably would lead to revolution in the streets. Bernie Sanders's democratic socialism, while it identifies much of the problem, would thwart economic activity as thoroughly as the current dysfunctional and destructive policies. That leaves innovation, Main Street capitalism, placing faith in human ingenuity in a free society and a relatively open economy. That's what Smick expostulates here, with great economic wisdom and depth of knowledge, with an earnest regard for his country's future, and with his characteristic intellectual breadth.

We're told that Donald Trump doesn't read books, but he should read this one. Barring that, he should distribute it to his economic advisers and tell them to incorporate it into their plans for the country's economic future. ◆