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The Great Degeneration in Brief: European and Hungarian perspectives*

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Since the turn of the new millennium, the world has grown fond of oppositions: humanity versus technology, corporations versus disruptors, planners versus the people, governments versus innovators.

Hungary is the perfect place to think about such oppositions because this kind of dualistic thinking seems to be in Budapest's DNA.

As every tourist soon learns, Budapest consists of two cities, Buda and Pest, joined by bridge. It is a city that has lived between two religions at least; it lived through more than one hundred and forty years of Ottoman occupation after 1541. It is also a city that experienced a kind of semi-independence as part of the Austro-Hungarian dual monarchy until 1918. It is a city that lived in the middle of the twentieth century between fascism and communism. It is a city that was up to a quarter Jewish until the catastrophe of the Holocaust struck in 1944. It was a communist city from 1949 until 1989. But it was also the scene of the biggest of all the revolts in Eastern Europe against communism in 1956. "If you come from Paris to Budapest, you think you are in Moscow. But if you go from Moscow to Budapest, you think you are in Paris." Those were the words of the avant-garde composer György Sándor Ligeti.

Today, Budapest is still a city with a split personality, somehow undecided, or doubly committed, between West and East. It is part of the European Union now, but not, it seems, a wholly comfortable part of it. In the summer of 2015 there were scenes of mayhem in Hungary, as asylum seekers from Kosovo, Afghanistan, Syria, Pakistan and Iraq poured into the country. For many, Budapest's railway stations were gateways from East to West. When the trains would not carry them, thousands opted to walk to the Austrian border.

For all these reasons, Budapest is the perfect place to ask the question: what is Europe in the 21st century? What are its problems? Where is it going? How does it need to change? In my eyes, the European integration in 2015 is an incomplete and maybe an uncompletable process. There is a confederation called the European

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Union, which has a Monetary Union at its core, but not all the members of the European Union are members of the monetary core. The country I come from, the United Kingdom, is a member of the European Union, but it is not a country that has adopted the euro as its currency. Partly because of this half-in, half-out status, Britain is a country that conceivably as soon as next year will be holding a referendum on whether or not to leave the EU. Certainly this is an incomplete project when a key member, one of the biggest economies in the European Union, is at least contemplating the possibility of leaving it altogether.

The near death of the euro and the near collapse of the Monetary Union in the crisis years 2011 to 2013 has revealed something very important: namely, that the critics of the original design of Europe's Economic and Monetary Union (and I was one of them) were right about the fundamental mismatch between monetary unity and fiscal decentralisation. Let me take you back in time, all the way back to 2000. In that year, my good friend Laurence Kotlikoff and I published an article in the American journal *Foreign Affairs*.[1] In that article we argued that Europe's monetary union would degenerate--that was the term that we used. And this degeneration would happen, we claimed, because there was a fundamental incompatibility between creating a monetary union but leaving the member states to do their own thing in terms of fiscal policy.

We got this right, because we claimed that it would work for about ten years, and then fiscal imbalances would cause the whole thing to come apart. That very nearly happened. The enormous disparities in public debt, with Greece at one extreme with the largest of all public debts, very nearly blew the monetary union up. Indeed, if you go back to 2012, the vast majority of economists who wrote on this subject predicted that Greece would leave, there would be "Grexit" and the monetary union would quite possibly fall apart. It did not happen, but at this moment, the possibility of Grexit is still being discussed and it remains unclear whether or not a solution will be found to the fundamental crisis in Greek public finances that will allow Greece to remain inside the monetary union.

Now we have, as a crazy solution to this problem, a fiscal compact. And this fiscal compact essentially requires all members of the euro area to become more and more like Germany in economic terms, if not in any other respect. What does that mean exactly? Well, it means first of all that they all have to run more or less balanced budgets. No more of those enormous deficits that we saw particularly in the period of economic crisis after 2008. If you look at the International Monetary Fund's projections running to 2020, by that year only one country in the European Monetary Union—Slovenia—will have a bigger deficit than 1.5 percent of GDP.

[1] *Fergusson, N. – Laurence, K. (1999): The Degeneration of the EMU. Foreign Affairs. March/April Issue, pp. 110–121.*

Seven member states will actually be running budget surpluses. So this is the first step in the direction of what Angela Merkel has called the "Bundesrepublik Europa", the Federal Republic of Europe: a European Union that looks more and more like the Federal Republic of Germany, at least in the way that it handles its public finances. No big deficits, a more or less permanently balanced budget.

But that is not the only way that Europe is becoming more like Germany. In the past, member states sometimes ran quite large current account deficits. But those days are gone. Partly as a consequence of doing what is often described disparagingly as austerity, fewer and fewer euro zone member states now have current account deficits. In fact, looking once again the IMF's projections, by 2020 only three members of the euro zone will have current account deficits, and they will be really small ones.

Moreoever, everybody, it seems, is going to have low, maybe even negative inflation if they want to be part of the "Bundesrepublik Europa". This year, Austria (of all countries) will be the member state with the highest inflation rate and that will be just 1.1 percent per annum, according to the IMF. Furthermore, five countries inside the euro zone now have negative inflation rates—they actually have deflation.

If these are the economic consequences of solving the problem of fiscal imbalance, then the big question is whether or not this solution is going to be conducive to economic growth and the creation of jobs.

The answer to that question seems to be, only if this policy is mitigated by the European Central Bank's doing quantitative easing (QE). This strange phrase has come into usage by economists, sometimes I think, mainly in order to baffle the public. What exactly does it mean? Well, some naïve critics say that it just means printing money, but that is not quite true, or at least it involves the creation of a special kind of money: not the money you or I are able to carry around in our pockets or keep in bank accounts, but the money that banks can keep in their accounts at the central bank. These reserves, a special kind of money, are the thing that is created when the European Central Bank does quantitative easing. And what it does when it creates this new money is to buy assets, to buy bonds to be precise, although other assets could conceivably also be purchased.

What is the effect of quantitative easing then? Well, it seems to be to drive down already low interest rates, lowering already quite low borrowing costs. A side effect is to expand the balance sheet of the central bank. That was probably a good idea if only because the balance sheet of the ECB had been shrinking, while the Bank of England's or the Federal Reserve's had been growing in the aftermath of the financial crisis. When the ECB adopted QE it was essentially playing catch up, adopting an unconventional monetary policy that had already been taken on by the other major central banks of the developed world. Now, one thing is clear: quantitative easing is not about to cause runaway inflation. The question really is whether it can suffice to avoid runaway deflation and on that question, I think, the jury is still out, although the outlook--at least as far as the projections I have already referred to--is reasonably good. The problem is that it is not yet clear that quantitative easing at the time of fiscal austerity is going to produce growth. And it is growth that matters for ordinary Europeans, because without economic growth it is highly unlikely that Europe is going to be able to solve its chronic problem of unemployment, and particularly youth unemployment, much less to absorb hundreds of thousands, if not millions, of refugees from the Middle East, North Africa and South Asia.

Now let us shed more light on growth. At the moment there is no question that Europe is underperforming. The IMF is currently predicting that the European Union as a whole will grow by just 1.8 percent this year. What is more worrying is that it does not expect that rate to go above 2 percent all the way down to 2020. So, for the foreseeable future, Europe is in low growth mode. Moreover, that means that unemployment rates, which are extremely high on the periphery of the European Union, are likely to stay high. Right now unemployment rates range from 4.9 percent in Germany, which is the lowest, to 23 percent in Spain, an amazingly high figure that implies that quarter of the workforce are in fact unemployed.

The unemployment data require close scrutiny. There is a problem of youth unemployment, which is well known to everybody, particularly if one looks at Southern European countries. The extent to which young people are struggling to find work is really quite extraordinary. But there is something that is also important, and I want to underline it because it gets much less attention in public discussion. That is the differential in unemployment rates between native-born Europeans and those born abroad. Foreign born workers are not significantly more likely to be unemployed in the United States than native born workers. That is also true of my own country, the United Kingdom. But when you come to the European continent, you notice something very remarkable. That is that foreign born workers are much more likely--more than twice as likely in some countries--to be unemployed than people born in the country in question. That is a problem. Why? Because if a society cannot offer employment prospects to immigrants, and this also applies to the children of immigrants and even their children, then it is highly likely to fail at one of the most important things a modern society has to be able to do. That is to assimilate, to integrate new comers into the host society.

Let us add all this together, and try to work out what it means in the great historical scheme of things. Europe is not quite stagnating, but it is certainly not growing dynamically. Europe is failing to create jobs, and it is failing especially to create jobs for young people and for immigrants.

If one sets this in a broad historical perspective, it tells me at least that the great shift from the West to the Rest is continuing apace. Now, this is the biggest economic change the world has seen in five hundred years.

Let me explain what I mean by that. Five hundred years ago, if you had gone on a world tour, you would not have been especially struck by Western Europe compared with some of the other great civilizations you could have visited. Five hundred years ago, it would not have been obvious to a traveller that for the next five centuries there would be a huge divergence in living standards between the West and the Rest. Five hundred years ago, Ming China was in many ways the most sophisticated civilization in the world. It certainly had some of the biggest cities. If you take Nanjing or Beijing, those cities were far larger than Paris or London, for example. But beginning in around 1500 to 1600, a great divergence occurred that saw living standards, measured in almost every conceivable way, dramatically improve in Western Europe and in places where West Europeans settled in large numbers, notably North America, relative to living standards in China but also in the rest of the world. This great divergence is the most striking feature of modern history.

To give you an example, in around 1600 there was no huge difference in living standards between Eastern China and Western Europe. Indeed, Eastern China was probably richer in terms of per capita GDP than North America on the eve of large-scale European settlement. In statistical terms, the ratio of per capita GDP in North America to that in China was around about unity, one. As a result of the great divergence, by the 1970s, the ratio of North American per capita GDP to Chinese was twenty two to one. The average American, when I was a teenager, was more than twenty times richer than the average Chinese. That was the great divergence.

It was a divergence that manifested itself not only in economics. Life expectancy by the middle of the twentieth century was double in the West what it was in most of the rest of the world. In other terms too, the West dominated the world of the early 20^{th} century. The great empires that emerged from Europe together dominated the world's geopolitical landscape. They may have accounted for a relative minority of the world's population, but those European empires controlled a huge proportion of the rest of the world's people.

In our time all of this has changed. In our lifetime the great divergence stopped and it went into reverse. Let me give you an example. In the late 1970s, the average American was twenty-two times richer than the average Chinese. Today that ratio is down to four to one. From twenty two to one, to four to one in just the space of my adult life. And we see this convergence manifesting itself in all kinds of different ways. Let me give you just one example. China's GDP back in the late 1970s, when the People's Republic first embarked on economic reform, was a really small percentage of the world's total and the European Union's was a really big percentage. But next year, unless the projections turn out to be wildly wrong (which seems unlikely as it is only a year away) China's GDP will exceed that of the European Union. It will become a bigger share of the world economy than the EU is right now.

Let me focus a little bit on what I mean by "the West." In a wonderful book called *The Clash of Civilizations*, Samuel Huntington, the late great Harvard political scientist, defined the West essentially as being Western Europe and those places where West Europeans settled in large numbers: North America, for example, or Australia. Back in 1950, when Sam Huntington was just beginning his academic career, Westerners, according to his definition, were around a fifth of the world's population. By 2050, according to the United Nations' projections, that share will be down to ten percent, or a tenth. That is a halving of the Western share of the world's population in the space of a century. These are huge shifts. What they mean is that people like me, white men from Northern Europe, are much less important and much less powerful than they used to be. We are still richer than most people, and in relative terms we are still quite powerful, but we are declining. We are a bit like the Elves in Tolkien's *The Lord of the Rings*. Our time is passing. Our time has, in many ways, passed and the future belongs not to the West but to the Rest.

The question that we need to ask ourselves is what are the real drivers of this shift? Why is this happening? I think there are two answers to that question. One of them is a good news story, and one of them is a not so good news story. The good news story is, as I have argued in the book called *Civilization*, that the Rest have essentially downloaded the West's killer applications. These were the things that after 1500 made the West so successful. You may wonder what those were. One was the idea of competition in economic as well as in political life, a very Western idea that you would not really have even encountered in Ming China. Another was the notion of science in the sense of the Scientific Revolution of the 17th and 18th centuries. That was an essentially Western project. There were no Newtons in the Ottoman Empire.

Number three: the notion of the rule of law based on private property rights. That was a Western innovation, especially deeply rooted in the English-speaking parts of the West. And then, number four, modern medicine: that branch of the scientific revolution that doubled and then more than doubled life expectancy. Killer app five was the consumer society, the notion that we should all have a great many clothes in our wardrobes. (There is no point, by the way, in having an industrial revolution if people do not a great many clothes because the main achievement of the industrial revolution was radically to reduce the unit costs of things like the shirt and the suit that I am wearing. In addition, if my demand for shirts and suits was not really price elastic, if I did not buy more the cheaper they got, then the industrial revolution would not have succeeded.)

Finally, we have the sixth killer app: the work ethic, the thing that got me out of bed at 6 o'clock this morning to write the final version of this essay. If I did not have the work ethic, I really would not have bothered, and this essay would be significantly worse than it actually is.

Those killer applications for around five hundred years were monopolized by people in the West. They really did not exist in the rest of the world. But in our time that has changed. A hundred years ago there was really only one non-Western society that understood the importance of my killer apps, and that was Japan. It was the first non-Western society to download everything that I have just listed, from the notion of competition in economic life through to the work ethic. But Japan was an outlier. Most non-Western societies did not do that. Indeed, they spent much of the 20th century trying other models. Think for example of what Chairman Mao tried to do to China. He had killer applications all right, but they actually killed people, and killed them in their millions. Only in the late 1970s, after Mao's death, when Deng Xiaoping was in charge, in China did that change. Only then did China begin to download the killer apps that had made Western civilization so prosperous. And, lo and behold, as soon as he did that, China's growth rate dramatically increased. Prosperity came and hundreds of millions of people were pulled out of poverty.

So part of what we have seen in the world today, is a belated adoption by the rest of the world of the institutions and ideas that really worked well for the West. That is great news. That is a cause for celebration. It can only be good news that more and more Asians and now Africans too are leaving poverty behind and discovering the benefits of competition, of science, of the rule of law, of modern medicine, of the consumer society, of the work ethic. Get the champagne out: history turned a corner, in our lifetimes. That is the good news.

The bad news? Well, the bad news is that, even as the rest of the world is getting better institutionally, that is to say getting better in its thinking, we in the West appear to be getting worse. You can download the killer applications if you are a non-Western society, but you can also delete them, or at least fail to update them, if you are a Western society. That is the problem that concerns me the most today. We in the West, in Europe, also in the United States, are suffering from a strange institutional degeneration. Let me give you some insights into the four aspects of degeneration that I see today.

The first is generational, in the sense that our policies in nearly all Western states are calculated to create enormous imbalances between the generations. The way our welfare states and pension systems work, in the context of an aging population, is bound to create burdens for the next generation that they will have to shoulder to finance our retirements. The Baby Boomers are exiting the workplace. They are putting their feet up and looking forward to a long and cushy retirement. But who is going to pay? Their children, their grandchildren, their great grandchildren.

Let me focus on Hungary since this essay is being published in a Hungarian journal. Well, right now just around ten percent of the Hungarian population is aged between fifteen and twenty four. Those are the crucial years educationally, in many ways they are the formative years, the years that produce great creative minds. It is all downhill from your late twenties in my experience. So just one in ten Hungarians are in that magical age group we call “youth.” Meanwhile, we have the percentage, aged sixty five or over, rising from 17 percent to, perhaps, as high as 27 percent by 2060. And that is by no means the worst example. Germany, Italy, Portugal, Spain are all ageing more rapidly. By the middle of this century, in those countries, the population aged 65 or over will be one third of the total; one in three of retirement age and older. In Hungary, by the end of this century, one in ten people are projected by the UN to be 80 or older. This huge demographic shift, which has its roots in changing patterns of fertility and mortality, is making Europe an old and ageing society. But we are still set up with welfare states that were designed in the post-war period for youthful societies, with relatively large proportions of the population in employment. Either we fix these systems radically, or young people are going to be shouldering a rising burden of taxation to support the entitlements of the elderly.

The second way in which we are degenerating as a society is that excessive regulation is tying our economy up in knots. It is a distinctive feature not just of the United States, but also of the European Union, that it is staffed by bureaucrats who like nothing better than to draw up enormously complicated regulations and impose them on the rest of us. That is what bureaucrats live to do. This excessive regulation is going through a boom right now in the wake of the financial crisis. Why? Because the idea has taken root--an idea that I think is quite wrong--that the financial crisis of 2008 happened because of deregulation. Because deregulation caused the crisis, reason the bureaucrats, we now need regulation and plenty of it to prevent another crisis from occurring. The great Viennese satirist, Karl Kraus, famously claimed that psychoanalysis was the disease of which it pretended to be the cure. Well, the same is true of regulation. It is the disease of which it pretends to be the cure. The more we regulate our financial system, the more unstable it becomes, in just the way that complex systems tend to be more unstable the more complex they become.

Third, the rule of law, which I am strongly in favour of, is something less good when it becomes the rule of lawyers. And regulation, in all its complexity, is a gravy train to lawyers. The one part of every business that is rapidly expanding at the moment on both sides of the Atlantic is the compliance department, staffed by people with law degrees.

Fourthly, and finally, I think we see a degeneration of the institutions of civil society. By civil society I mean the voluntary non-governmental agencies that used to do so much in Western civilization, and which today have largely been marginalized by the ever expanding public sector, the all-powerful state.

I do not think it is too much to write that we are witnessing a slow, creeping crisis of the Western civilization. And there is also, in addition to the threats from within that I have just described, a threat from outside.

Radical Islam is the ideological epidemic of our time, just as Bolshevism was an ideological epidemic a century ago. It is an astonishing fact that up to four and a half thousand Europeans have left the European Union to join the Islamic State in Iraq and in Syria. Think of it: four and a half thousand people opting to join the Caliphate in a misguided and murderous attempt to turn the clock back to the times of the prophet Mohamed.

Or consider the fact that by 2030 Muslims may account for as much as 10% of the populations of Belgium, France and Sweden, 9% of the population of Austria, 8% of the Dutch, Swiss and British populations, and 7% of all Germans and Greeks.

I have a number of remedies for the institutional degeneration of the West that I have described to you. You can improve public financial accounting to end the phenomenon of vast off-balance-sheet liabilities. You can introduce “sunset” clauses for laws and regulations so that they are expiring rather than accumulating. You can reform legal systems, simplify the laws as well as the regulations. And, to upgrade our civil society, you can do a lot worse than to found new and better independent schools.

All of these things can do much to halt our institutional degeneration. But I do not believe that reforms like these alone will suffice to solve the fundamental imbalance or imbalances that I see today. The imbalance between an aged and an ageing Europe and a youthful Muslim world. The imbalance between a wealthy Europe and a poor Muslim world. The imbalance between a post-Christian Europe – a secularized, unbelieving Europe – and an increasingly devout Muslim world. The imbalance between a disarmed Europe and an increasingly militarized Muslim world.

In its long history, Budapest has experienced first-hand what these tendencies can lead to. Our best solutions to the challenges that we face, from the challenges of public financial overstretch to the challenges of mass migration across the

Mediterranean, may well come from technology But if we do not address the issues of institutional degeneration that I have mentioned in this essay, then technology alone will not save us. The early 20th century saw staggering technological advances, much greater than the ones in our time (compare Twitter with the atomic bomb). But what the great technological innovations of the 20th century did not do was to inoculate us against fascism and communism.

That seems to me to be a very, very important lesson to learn in Budapest.