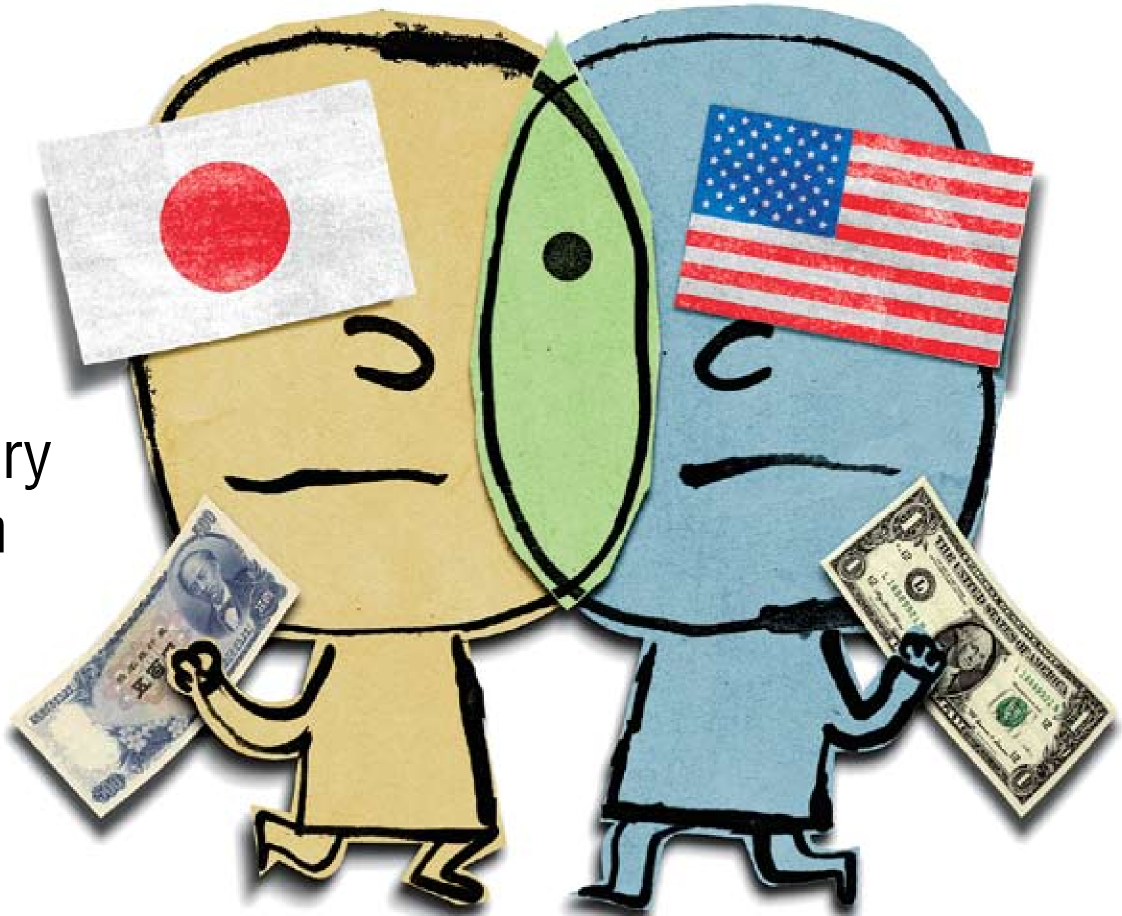


America's economic prospects—and cautionary lessons from Japan

After *Our* Bubble

by Jonathan Shaw

Saving more. consuming less. Paying down debts. Making sacrifices. Most Americans have not experienced austerity in a long time, so the decade ahead may come as a shock. Expect continued high unemployment, slow wage growth, the possibility of social and political unrest, higher taxes, cuts in government services. Hope for moderate inflation to help reduce public and private debt loads. And be happy if all that is the only price this country must pay as part of the financial hangover from the party that began in 2001.

As the United States recovers from the "Great Recession," economic stimulus has so far masked the austerity ahead. The U.S. government, like others around the world, has solved the post-housing-bubble banking crisis by issuing debt—in effect trading one set of problems for another to create what Cabot professor of public policy Kenneth Rogoff calls "an illusion of normalcy." But, says Rogoff (coauthor of *This Time Is Different,* a study of eight centuries of financial crises; see "What This Country Needs," January-February, page 18, for a review), history shows that waves of banking crises are typically followed by waves of debt crises two or three years later.

The recession that is now slowly ebbing is often compared to an earlier crisis in Japan, which was also precipitated by the collapse of a massive asset bubble in real estate and stocks. That crisis didn't end well. The Japanese have been contending with a declining gross domestic product (GDP) and increasing debt in the two decades since (see "An Aftermath to Avoid," page 40). But Japan's experience is not the only instructive example of what lies ahead for the American economy—that is the central message of Rogoff's recent book. From a purely quantitative perspective, the American experience of recession is *not* different at all. The book aggregates data from many meltdowns, from Argentina to Austria and Finland to France, finding that they are very similar on a variety of measures. "Typically," he says, "housing takes five years to recover; equities, three to four; unemployment, five years; GDP falls for 1.7 years."

How has the United States fared compared to these averages?

Illustration by Miguel Davilla

"It has been driving right down the tracks of a typical postwar deep financial crisis—it's incredible," Rogoff reports. Unemployment typically rises 7 percent; "We went up 6." The average fall in housing prices is 36 percent. "The U.S. went down 33 percent and clearly has more to go." In equities, the average fall was 56 percent, which is "exactly what the S&P [500 index] did. "The only dimension in which the U.S. did better," Rogoff says, "is in the *depth* of the recession, which appears to have been less" [deep than usual.]" GDP typically drops 9 percent from peak to trough. "We were about minus 4 percent" (based on preliminary numbers). But there is one dimension on which the United States was worse than average: the rise in government debt. In a typical crisis, that goes up 85 percent in three years, Rogoff reports. "We are going to blow through that," he says.

"In some sense," Rogoff explains, "our aggressive response cushioned the drop in GDP."

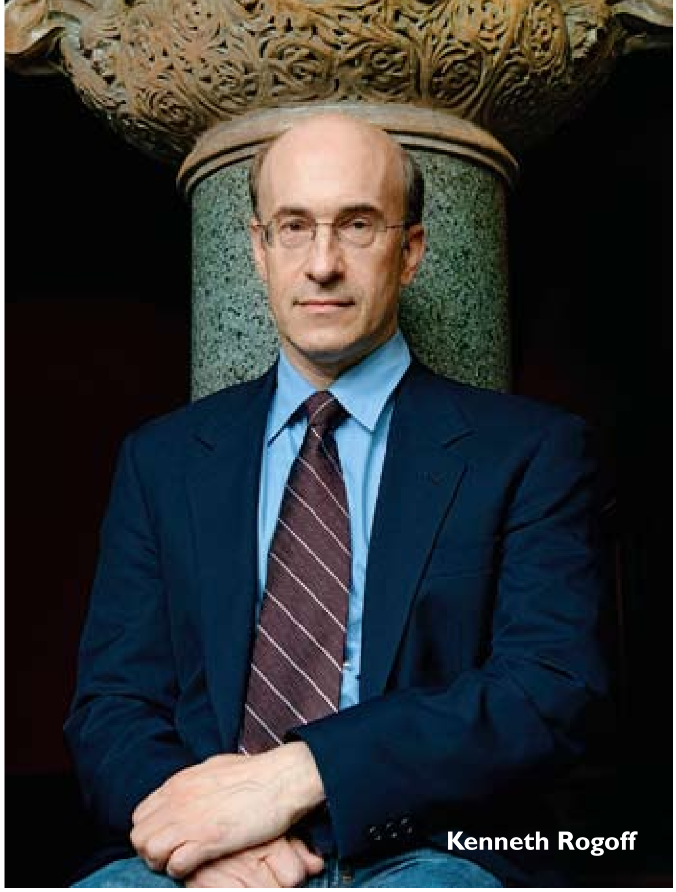
But that tradeoff—rescuing the economy by assuming lots of debt—is not without risks, especially for a debtor nation. This country's debts include the *international* debt (determined by what is known as the current account deficit [see page 42]; see "Debtor Nation," July-August 2007, page 40) and the *national* debt (determined by the federal deficit). "Both were on unsustainable pathways before the recession, says Harpel professor of capital formation and growth Jeffrey A. Frankel, of Harvard Kennedy School. President Obama's economic stimulus package represents even more debt, "but is a relatively small part of the total picture" that doesn't even make Frankel's list of the top three contributors to the total debt path: the rise in the cost of Medicare and Medicaid; Social Security (which he says is solvable with "minor" but politically difficult adjustments); and the fiscal path that President George W. Bush put the country on in 2001 ("which was not only tax cuts, but also a sharp acceleration in the rate of spending, both military and domestic," says Frankel, who served on the Council of Economic Advisers in the Clinton administration, and on its staff during the Reagan administration, under Martin Feldstein, now Baker professor of economics).

As early as March 2007, discussing the nation's escalating debt, Frankel told this magazine, "I don't blame Bush for the 2001 recession, but I blame him for the severity of the next recession,"

The U.S. government has solved the banking crisis by issuing debt—trading one set of problems for another.

explaining that the president had been right to cut taxes as a stimulus after the 2001 recession, but shouldn't have allowed the tax cuts and spending increases to continue once the economy recovered—because then there would be inadequate room for fiscal expansion when the *next* recession hit. Without the option of cutting taxes, future policymakers would be forced to increase spending as the only option for economic stimulus.

Meanwhile the current recession, by further depressing tax revenue and increasing payouts for unemployment insurance and other benefits, is a fourth contributing factor to the U.S. debt.



Kenneth Rogoff

"Number five" he adds, "is the Obama stimulus package, which pales in comparison to all these other factors."

But when a debtor nation keeps borrowing, the question arises: How long can that continue? Frankel says, "Many people assert that the world's investors had a limitless willingness to buy U.S. assets," for a variety of reasons. "One version of this view is that we earned the privilege because we have such a good financial system. That one is looking a little tarnished." Another version hinges on the role of the dollar as the international currency. "I think there could be a limit to foreigners' willingness to absorb dollars," he says, alluding to the long-term possibility of a currency crisis: a run on the dollar that would lower its value suddenly.

"PEOPLE TALK about the declining role of the U.S. in the world economy," says Boas professor of international economics Richard Cooper, but at the moment, "It is hard to find a big economy that is not in the same boat." Some differences in the details are significant, he notes, but "the fact is that Germany, Britain, Italy, France, even China are running budget deficits now that are way above what they would like them to be—and that's certainly also true of Japan" (which was affected even more than the United States by the current recession: its GDP dropped 6 percent).

In a *relative* sense, therefore, the U.S. economy looks strong in what has been a global recession, at least among developed nations. (Even the dollar, which has been in slow decline since the late 1990s, looks strong in comparison to the euro, for example.) Cooper points out that the country is not only better positioned demographically than other rich countries, but is also an inevitable choice for international investors. "If I'm sitting in Zurich," he says, "and have some financial investments I want to make and

Photograph by Stu Rosner

I look around at what is actually available to me, the U.S. is about half the world's marketable financial economy."

To err on the conservative side in papers he has written about global financial imbalances (in which foreigners' "excess savings" end up being loaned to American consumers at low interest rates), Cooper uses the U.S. share of gross world product (GWP), which stood at about 27 percent in 2006-2007. "But a metric which, in a sense, would be even more appropriate," he says, "is share of marketable securities in the world" (about half of which are in the United States). That's because, internationally, as much as 70 percent of the publicly traded stock in many corporations is in fact owned by national governments. "For example, in China," he explains, "there are now about 1,000 listed companies, mostly state enterprises, and the government owns 70 percent of the shares." National governments aren't sellers, so that means "a maximum of 30 percent are available for trading." In other words,

An Aftermath to Avoid

Looking back to 1989, it seems incredible that when the grounds of the Imperial Palace in Tokyo were valued at more than the entire state of California, no one recognized the bubble in Japanese real estate. Instead, the economic juggernaut in the Land of the Rising Sun extended its impact on the U.S. psyche when a Japanese conglomerate bought Rockefeller Center that fall. The Nikkei index rose to its all-time high of nearly 39,000 that December.

What happened to Japan during the subsequent two "lost decades" is a cautionary tale. Since 1995, that nation's economy has shrunk, while the Nikkei recently stood at 10,365, or 73 percent below its high of more than 20 years ago.

Ever since the American housing bubble burst in 2008, economists have drawn comparisons between Japan and the United States: in both cases, an easy monetary policy helped feed asset bubbles in stocks and real estate while the absence of inflation hid the danger. As the crises developed, both countries became caught in a liquidity trap, in which government infusions of money into the economy failed to lower interest rates, says Jeffrey A. Frankel, Harpel professor of capital formation and growth at Harvard Kennedy School. "There was also a reluctance to recapitalize failed banks," he adds, "thus producing 'zombies'"—banks with no intrinsic net worth that were propped up by government credit. Later, both countries adopted a strategy of "quantitative easing" as their crises intensified—essentially printing money in order to buy financial assets from banks.

"I always explain that the U.S. is making the same mistakes Japan made," says Takatoshi Ito, Ph.D. '79, a professor of economics at the University of Tokyo, "but everything is faster—probably four times faster." He describes the same tolerance for excesses and then, once financial institutions got in over their heads, an initial refusal to use taxpayer money for bailouts. But once bailouts do begin, says the former Harvard visiting professor (who has also served in the Japanese government), the government creates "lots of liquidity without addressing the moral hazard question or tackling long-term financial architecture." Kenneth Rogoff, Cabot professor of public policy, says that during the recent U.S. bailout, the federal government was "so nice to the financial sector, investors rightly believed that no bank would be allowed to go under"—encouraging more of the same risk-taking that contributed to the crisis in the first place.

At issue is whether the United States might face a fate similar to Japan's: a long period of economic stagnation. Japan's unemployment is more than double what it was in the boom years, and real wages have fallen steadily, hitting a 20-year low in 2009. Repeated, drawn-out attempts at monetary and fiscal stimulus, including increasingly questionable spending on roads and bridges in a country that already had a history of massive infrastructure investment, have eventually led to a potentially crippling debt load for the nation.

"The Japanese debt-to-GDP ratio"—now nearly 200 percent—"is already catastrophic," says Ito. "It is just that the zero interest rate [that the government pays on its debt to bondholders] is keeping the budget pressure concealed." If interest rates rise, paying the interest on the national debt will become a problem. If, on the other hand, the current trend of deflation continues, a larger and larger amount of debt will accumulate, still without any alarms going off. And "when you realize it," Ito adds, perhaps when interest rates finally do rise, "it will be too late." Either way, "very soon Japan is going to have to address the problem."

Although the United States has a much lower ratio of debt-to-GDP, and moderate annual inflation of 2.3 percent, the debt is nevertheless "rising faster than GDP," says Frankel: "the definition of an unsustainable and explosive path." All else being equal, the country would appear to be at risk of entering a lost decade of its own.

All is not equal, however; there are many important differences between Japan and the United States. In stark contrast to the latter, for example, Japan is the "number one or number two creditor nation" says Ito, maintaining a trade surplus with the rest of the world. As a consequence, it has accumulated a lot of foreign assets, and therefore runs very little risk of a currency crisis despite its debt load.

On the other hand, the aging of the Japanese workforce is a significant demographic drag on the economy that explains much about the economic doldrums that have gripped the country. "The ratio between working-age people and retirees is now about 4 to 1, but it will be 2 to 1 in 20 years," notes Ito. "This will put a strain on everything from economic growth to finding enough talented people for various professions, to social security and pensions. It is going to be very hard."

Demographics also explain the continuing decline in the Japanese savings rate. "Those who are retired are now spending down savings to maintain their standard of living," he says. "It is the consequence of an aging society."

One particular problem rooted in this demographic difference is that most Japanese retirees' savings are in the form of domestic government debt. As retirees cash in these bonds, "Who is going to redeem them?" Ito asks, and answers, "Taxpayers of the next generation. So it is the same thing as taxing the future generations." This reliance on internal debt to fund an increasingly larger for a hypothetical investor operating without home bias (the tendency of investors to keep more of their money in their own national economies), the United States should be the recipient of far *more* inflows of foreign capital than it is already.

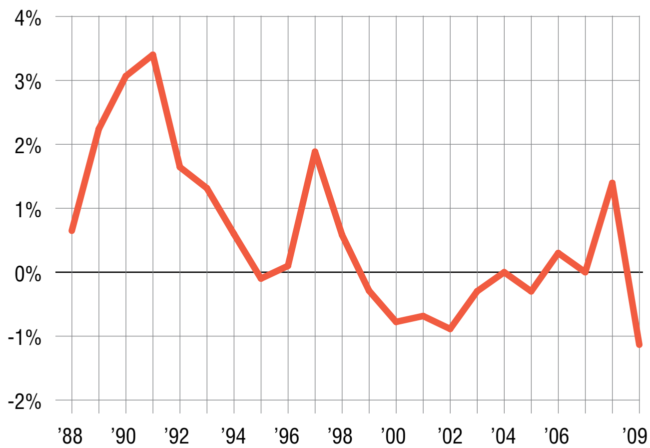
Foreign investment in the United States now stands at just 12 percent, not 27 percent (which would reflect the U.S. share of GWP) or 50 percent (the U.S. portion of marketable securities worldwide), so if Cooper is right, the global imbalances could last for a very long time, or even grow. Indeed, he has written a paper projecting, in a ballpark way, which countries will contribute most to GWP through 2030. "The U.S. share declines a little, but not a lot. The big gainer, not surprisingly, is China. India doubles its share, but from 2 percent to 4 percent, so it still remains a small economy in the world. The big losers are Japan and Europe, largely for demographic reasons." The U.S. role as net consumer in global imbalances could therefore persist for a long time, he believes.

proportion of retirees among the population creates a "classic fiscal problem," he says, and sets the stage for "generational conflict" that will only exacerbate the debt crisis.

Ever since the bursting of its asset bubble, Japan has tried to export its way out of the economic slump. Because the crisis at that time was not global in nature, the tactic seemed to make sense. But Japan was already exporting a lot, relative to the size of its economy. Further growth in exports proved difficult. In retrospect, says Stanfield professor of international peace Jeffry Frieden, "Japan probably should have reoriented its economy toward more domestic consumption, rather than putting all its resources into an export push."

Inflation Rate (Consumer Prices)

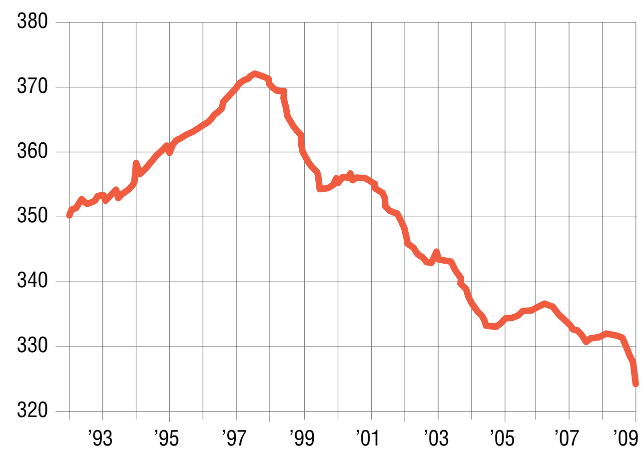
Annual percent change



SOURCE: Japan Ministry of Health, Labor, and Welfare

Monthly Wages

Yen per month (in thousands)



SOURCE: Japan Ministry of Health, Labor, and Welfare

Deflation and falling wages have been features of Japan's downward economic spiral.

But an aging society is not one predisposed to increasing consumption. And that has contributed to deflation, a recurring problem in Japan since 1995. Because it leads to an increase in the real value of money, debts become more difficult to pay off (and consumers hold off spending, retarding economic growth). But that is just the first-order problem, Ito explains. During the inflationary period of the early 1980s in the United States, he recalls, there was a lot of talk about bracket creep: as incomes rose with inflation, people were shifted into higher tax brackets. But because their real, inflation-adjusted income had not gone up, it simply meant that more of their income was going to taxes. "What Japan has been going through in the last 10 or 15 years," Ito says, "is a *reverse* bracket creep." Employers are cutting nominal wages because of deflation, so taxpayers are falling into *lower* tax brackets. That, along with shrinking GDP, depresses government revenue, making it even harder to pay down the national debt. Combined with deflation's role in increasing the real debt burden, these factors make Japan's fiscal situation appear increasingly precarious.

Japan faces "a lot of challenges," Rogoff adds: "a shrinking labor force" and—often forgotten in the discussion of Japan's two-decade malaise—"competition with China." That competition undermined the Japanese export strategy. In contrast, U.S. exports in the current global downturn have actually *increased* on the strength of demand from growing economies in Asia and a weaker dollar.

Thus, whereas Japan's contracting work force has become part of a self-reinforcing downward spiral of deflation, lower consumption, and lower real wages that makes the country's debt burden look increasing difficult to manage, the United States has room to grow. "Not only do we have land," says Rogoff, "we have a society that is very accepting of immigrants. Culture is a huge advantage for the U.S.; it is part of our ability to be flexible."

In addition—uniquely among the large advanced economies, explains Boas professor of international economics Richard Cooper—the United States has fertility on its side. Because the birth rate is slightly higher than replacement level, the population is growing. This will lead to a larger workforce in the future, which will in turn make it relatively easier to pay retiree benefits.

American workforce growth is expansionary, giving the economy a bias toward growth in the long-term that makes deflation less likely to take hold. That means overall debt—provided it does not continue to increase faster than economic growth—will slowly become a smaller proportion of GDP. There is no reason to think the United States will inevitably suffer Japan's fate, provided sound fiscal policies are adopted once the recovery is assured.

Graphs by Miguel Davilla

> "Unless people are aware of the kinds of risks that we face, we are really in serious danger of compounding the lost decade that we just lived through with another lost decade."

Another gauge of the U.S. imbalance in trade and capital flows with the rest of the world is the *current account deficit*, an annual measure of the amount by which consumption exceeds production. In 2006, the U.S. current account deficit (CAD) reached 6 percent of GDP, a level most economists felt was unsustainable. Cooper disagreed then and still does.

In general, he doesn't see a strong link between such global imbalances and the financial crisis. Even though the willingness of foreigners to lend Americans the money that funded U.S. consumption habits clearly played a part in keeping this country's interest rates low and, by extension, in fueling the housing bubble, Cooper thinks that mass euphoria—psychological factors—combined with a "lax or totally absent regulatory framework," played a more important role.

Now, with the recession dampening American demand for foreign imports, and with exports gradually rising with help from a slowly declining dollar, the CAD has fallen to about 3 percent of GDP. But whether this measure of capital flow with the rest of the world goes up or down from here is a big question mark. Cooper thinks it will rise back to the 4 or 5 percent range—and that eventually, barring a dollar crisis (which he cannot rule out), it will decline slowly over decades.

Stanfield professor of international peace Jeffry Frieden has a very different view of the way the CAD, the housing bubble, and the current recession are linked—and of the implications for Americans. "The U.S. is in the midst of a classic foreign-debt crisis," he says. "Between 2001 and 2007, we borrowed between half a trillion and a trillion dollars each year from the rest of the world. Over the course of those years we built up about five trillion dollars in new foreign debt."

That influx of money had all the effects that classical economics predicted it would, including fueling a housing boom. But this was not just an American problem, he emphasizes: "This is an international economic pattern, with the United Kingdom, Ireland, Spain, Portugal, Greece, the Baltics, central and eastern Europe, and developing countries all borrowing heavily from the rest of the world." Meanwhile, another group of countries—China, East Asia, Germany, Northern Europe, and the OPEC nations—were exporting heavily. "There is a well-established script to what happens next," Frieden explains. When a lot of money is available, people start spending it on housing, which drives a huge run-up in housing prices. In Spain, which borrowed 12 percent of GDP in a *year*, more housing was built between 2004 and 2006 than in France, Germany, and Italy combined. Likewise, says Frieden, "Latin America in the 1970s, or East Asia in the '90s, experienced the same thing before their crises: a big real-estate bubble." (His book about the current financial crisis, *Lost Decades*, co-written with University of Wisconsin macroeconomist Menzie Chinn, will appear early next year.) This happens because banks are flooded with more money than they know what to do with, so they "move down the quality chain," Frieden explains. "You are already lending to people who are credit-worthy, so you start lending to riskier borrowers."

"We know what the aftermath of a debt crisis looks like," he continues. The United States is now through the immediate aftermath, a period called the stabilization phase, in which countries are just trying to stabilize their economies. Recalling the 1970s, Frieden notes, "If you are a Latin American country, you are trying to get inflation down from 5,000 percent and deal with huge budget deficits that are the result of trying to ameliorate the effect of the crisis," Frieden notes. The United States is lucky enough to be able to issue debt in its own currency, so its citizens don't have to deal with hyperinflation. But *all* countries emerging from a foreign debt crisis, Frieden says, must adjust to a new reality: they can't continue running their economies on funds borrowed from the rest of the world.

He allows *some* room for arguing that the United States is a special case: "This country is probably going to continue to be a borrower from the rest of the world, running a current account deficit that is 1 to 1.5 percent of GDP for a long time." The dollar's role as a reserve currency is part of the reason, and the fact "the U.S. is underrepresented in the rest of the world's investment portfolio is the other." So there is "a germ of truth" to Cooper's arguments, Frieden believes. But he is adamant that "going back to borrowing 5 or 6 percent of GDP from abroad is completely implausible—for a variety of reasons."

He believes "the American appetite for debt is much reduced" among both "private American households, the government, taxpayers, and financial institutions as well." On the supply side, he expects much more wariness on the part of international investors about lending to this country during the next three to seven years. (He spoke with this magazine before the Greek debt crisis erupted, which led to a surge of investment in the United States as a safe haven, in turn driving down interest and home mortgage rates.)

When their nation borrowed money from 2001 to 2007, Americans were able to consume more than they produced and invest more than they saved, and the government was able to spend more than it took in. Once the borrowing stops, those relationships have to turn around, Frieden says: "We are going to have to produce more than we consume, save more than we invest, and the government will have to take in more than it spends. That translates into austerity, a lower standard of living....Every country that has gone through the crisis successfully has done so by imposing fairly stringent austerity measures. That means real wages are stagnant or declining, the standard of living is stagnant or declining, you have to increase exports, decrease imports, increase saving, and reduce consumption. That is the macroeconomics of dealing with a debt crisis."

There are also political ramifications, because no one likes austerity measures. And often "the people who benefited from the boom are not those who are asked to make the biggest sacrifices during the adjustment period," Frieden points out. In the United States, two-thirds of the income growth during the boom of 2001-2007 went to the top 1 percent of the population. "That is about a 60 percent increase in the average income of that segment of the population, while there was a 6 percent increase for the rest of the population," he explains. "It is not that things were bad for the rest of us, but they were a whole lot better for the very wealthy. Now the crisis is having a much more serious negative effect on people in the bottom half of the income distribution than on those in the top half."

Job losses tell the story. Unemployment in the country as a whole today is 9.5 percent to 10 percent, but in the bottom 40 percent of the labor force it is 17 percent, while in the top 30 percent it is just 4 percent. "There is a widespread feeling that the borrowing boom of the 2001-2007 period primarily benefited the wealthy," while the impacts of the crash and austerity measures will affect primarily the lower and middle classes, he says. "This is not an inaccurate perception, and is a formula for a lot of political discontent."

Furthermore, unemployment is not likely to improve soon, Frieden says. Roughly 44 percent of those currently unemployed have been unemployed for more than six months, and 25 percent have been unemployed for more a year. "That is way out of line with prior experience," in which "people usually get jobs after six weeks," he notes.

"There is no question," he continues, "that we should be worried about a Japan-style stagnation. Even if we avoid that, we face a very difficult period of adjusting to a new macroeconomic reality: dealing with the $5 trillion to $7 trillion we borrowed to get ourselves into this mess, and the $5 trillion to $7 trillion we borrowed to get ourselves out. We are going to come out of this $10 trillion to $15 trillion in debt to the rest of world, and servicing that is going to be expensive." Kenneth Rogoff's book paints the same picture statistically, Frieden adds. There is a "clear time path of recovery for high-debt countries that includes slow growth, high unemployment, and higher inflation than normal five, seven, nine years afterwards. That is just a statistical relationship," he acknowledges, but one "for which there are good analytical and theoretical underpinnings. We understand why this happens."

Will American taxpayers be the only ones to pay, literally and figuratively, for the crisis? Might creditors also be forced to pay? In the case of Brazil, Thailand, or Argentina, creditors took a hit when those countries renegotiated a lower interest rate or spread their payments out over time. "In the U.S., we do it the old-fashioned way," says Frieden, "by inflating away the debt. I anticipate one of the ways the burden of adjustment will be dealt with is by running a moderate inflation, which is not necessarily a bad thing. That will reduce the real debt burden by a little or a lot. And the dollar will decline, which will also reduce the real debt burden by a fair amount."

There are other bright spots—if the prospect of inflation can be called that. American exports have been up thanks to demand from Asia—particularly China and its neighborhood, an area that continues to grow. American companies export software and energy-related technologies, as well as complicated machinery like aircraft. Educational, medical, and legal services are also big exports, but Frieden believes that the real unexploited opportunities lie on the manufacturing side, in the underutilized industrial belt of the Midwest. He hopes for a resurgence in the export of complex goods such as heavy machinery, building equipment, agricultural implements, controlled machine tools that automate component production from start to finish, and so on. But such transitions are never easy, and Americans have not experienced a period of true economic malaise since the late 1970s and early '80s.


Jeffry Frieden

"I try to impress on people that we lost a decade," Frieden says, "because if you look at the overall rate of growth in real per capita personal income from 2000 to 2010 [3.7 percent since 2000], it is essentially flat. Now we are in danger of losing *this* decade...because of the debt overhang. Unless people are aware of the kinds of risks that we face, we are really in serious danger of compounding the lost decade that we just lived through with another lost decade of very serious economic, social, and political problems to come. That is a very depressing prospect and one that I think everybody in the U.S. and the world should be focusing on."

Says Cooper, "We knew as soon as the Federal Reserve did all of the very imaginative things that it did [to rescue financial institutions and free up credit markets], starting in 2008, that there was going to be an exit issue. The Fed's balance sheet went from $900 billion to $2.4 trillion: it nearly tripled. That represents a huge change in base money. That didn't translate into the money supply because banks were being super-cautious about lending. But the Fed staff's memos on an exit strategy have already been written," he says, and now everything hinges on "gauging the timing on when it is appropriate to begin withdrawing the fiscal stimulus. One thing you can be sure of. When the Fed begins to tighten, there will be howls."

Jonathan Shaw '89 is managing editor of this magazine.

Photograph by Stu Rosner

In 1979, Andrew Wylie '70 was trying to get a job as a book editor. "They would ask what I was reading," Wylie says, "and I would say, 'Thucydides.' They would say, 'Huh? What about James Michener, James Clavell?' I would say, 'No, no. Sorry.' People felt that if you did not read bestsellers, you could not operate effectively in the contemporary publishing world. I thought: if that's true, then this is not the business for me, because I'm not going to sit around reading the bestseller list—the bound form of daytime television."

Wylie's publishing credentials were promising. At Harvard, he would have graduated *summa cum laude* in French literature but for his brash political blunder of trashing one of his thesis advisers in the thesis itself. Fluent in French and Italian, he can read manuscripts in those languages when needed. During his twenties, in beret and black leather jacket, he hung out in the New York arts-and-lit world and the avant-garde scene that swirled around Andy Warhol. Wylie's father, Craig Wylie '30, had been editor-in-chief at Houghton Mifflin in Boston. "But my uncles were bankers," he says, "and I wanted to combine the two disciplines." That drew him toward the business side of publishing; Wylie decided to apprentice himself to a literary agent.

But what he had seen of "literary" literary agents did not appeal. "They were in small offices covered in dust, with dying spider plants in the windows," he explains. "The whole thing was absolutely depressing. And you got the feeling that the best writers had the worst representation, and the worst writers had the best representation. If I wanted to enjoy my life, I had to read good books. But how do you turn that into a business, if people who write well aren't well paid? Yes, the best writers *do* make money over time—so in the long run, the most valuable author of all is Shakespeare. But publishing is constructed as if the most valuable author is Danielle Steel."

Nevertheless, 30 years later, Wylie's project of creating a business based on the books he wanted to read seems to have panned out. The Wylie Agency, founded in 1980, with offices today in midtown Manhattan and in London, is a mighty force in publishing. It represents more than 700 clients, including Martin Amis, David Byrne, Dave Eggers, Louise Erdrich, Ian Frazier '73, Al Gore '69, LL.D. '94, William Kennedy, Henry Kissinger '50, Ph.D. '54, Elmore Leonard, W.S. Merwin, Lou Reed, David Rockefeller '36, LL.D. '69, Philip Roth, Salman Rushdie, Oliver Sachs, and Nicolas Sarkozy. Wylie's deceased clients are even more illustrious than his living ones: W.H. Auden, Saul Bellow, Roberto Bolaño, William S. Burroughs '36, Italo Calvino, Allen Ginsberg, Arthur Miller, Vladimir Nabokov, Hunter Thompson, John Updike '54, Litt.D. '92, Andy Warhol, and Evelyn Waugh, for example.

Mega-agencies like William Morris and ICM have film divisions, which the Wylie Agency does not, but "I believe we have a larger *literary* agency, in terms of global reach, number of clients, and perhaps also revenue," says Wylie. John "Ike" Williams '60, a principal of the Boston literary agency Kneerim & Williams, says Wylie "is a formidable agent, particularly on foreign rights. The guy has incredible taste." The *Guardian* recently described the Wylie Agency as "the most feared and most influential authors' representatives in the world of Anglo-American publishing."

Despite the well-documented travails of the contemporary book business, Wylie remains sanguine about its future, both technological and commercial. He believes that "a combination of online booksellers like Amazon.com and independent bookstores will be the future of bookselling. The chains will go out of business—their model doesn't work. Mall stores evolved into superstores that push new books hard but devote acres of high-rent space to backlist books that sell very slowly. Amazon has one copy of every book available on a revolving belt; they actually have a larger investment per copy in their backlist than the chains do. Independent bookstores will come back because they know their neighborhood and are selling to those local readers."

In his personal reading, Wylie has little use for e-book devices like Kindle, although e-book rights are currently a topic of intense discussion among all publishers and agents. "We spend 96 percent of our time talking about 4 percent of the business," he says (e-books' current share of publishing revenue). "That 4 percent will climb slowly, and I think it will grow first for frontlist," he continues. "I suspect that the trashier the book, the more likely it is to be converted to an e-book. You don't have a desire to save James Patterson in your library. Those who want to keep a book for a long time will buy a physical book."

The music-industry lawyer John Eastman, who represents his brother-in-law Paul McCartney as well as other musicians, has advised the Wylie Agency in discussions with publishers concerning e-book rights. "John saw the destruction of the music business, and didn't miss the meaning," Wylie says. "The music industry did itself in by taking its profitability and allocating it to device holders. Manufacturing and distribution accounted for roughly 30 percent of the music industry's profit. These were conveyed to Apple in the deal for iTunes. But why should someone who makes a machine—the iPod, which is the contemporary equivalent of a jukebox—take all the profit? If the jukebox manufacturers had taken all the profits of all the records played on jukeboxes in the 1950s, we'd have a very different-looking music business. The device holder—Apple—couldn't have *sold* the device without the music that was on it. Instead, why didn't the music industry say to Apple, 'We want 30 percent of your iPod sales?' Or 'How about paying us 100 percent of your music revenues—you keep your device profits, and give us our music profits?' That's not the deal that was made. And that is why the music industry hit the wall."

Wylie's negotiations with publishers on the book industry's version of the iPod, e-books, are currently on hold across the board. He's dissatisfied with the terms publishers have been offering for e-book rights, which were not widely foreseen and are not allocated in most extant book contracts. In fact, Wylie threatens to monetize those unassigned rights by going outside the publishing business entirely: "We will take our 700 clients, see what rights are not allocated to publishers, and establish a company on their behalf to license those e-book rights directly to someone like Google, Amazon.com, or Apple. It would be another business, set up on parallel tracks to the frontlist book business." Such a heretical strategy would likely meet with stiff resistance from publishing houses, which have invested years, even decades, and millions of dollars in establishing their authors as brand names in the marketplace by printing, promoting, and selling their books.

Portraits by Robert Adam Mayer