Principles for Dealing with the Changing World Order: Why Nations Succeed and Fail by Ray Dalio

A detailed summary and review of the more interesting first part!

The decline of an empire (USA) and the rise of another one (China) have never happened in our lifetime. But they have happened many times before in a series of events called a Big Cycle, lasting roughly 250 years.

The Big Cycle produces swings between:

1. Peaceful and prosperous times
2. Depression, revolutions, and war periods

Depression and war periods mark the transition from one world order to another. While they create a lot of suffering, they also get rid of the weaker elements and excess (debt, bad behaviour, etc). The Big Cycle includes the long-term debt cycle which lasts 100 years; and the short-term debt cycle which lasts around eight years. When cycles align, the world order changes.

- The peaceful and depression periods come once in a lifetime, which explains why they always surprise people.
- No system of government, no economic system, no currency, and no empire lasts forever. Yet everyone is surprised when they fail.
- Dealing with the future comes from understanding how things change. You can understand how things change by studying how they changed in the past.

The world order changes when all cycles are aligned. When wealth and value gaps are large, conflict often ensues. The author studied the Dutch Empire, the US Empire, and the British Empire at large. Then he looked at the French, German, Chinese, Japanese, Indian, and Russian empires. He noticed that they all rose and fell in the same way, which are outlined in the book.

The biggest thing that impacts people is the struggle to make, take, and distribute power. Wealthy people are those who own the means of production. They work in symbiosis with politicians to set rules. This happened equally in all empires. In the long term, fewer people own more and more wealth and power. Then they overextend and fail. This hurts the poor and leads to revolutions and civil wars. The empire disappears and a new empire takes over, which leads to a new world order, and the cycle starts again. The Big Cycle governs the rising and decline of empires and influences everything about them.

The next three important cycles are:

1. **The Long-Term Debt and Capital Markets Cycle**: debt has never been neither so low (in terms of interest rates) nor so abundant.
2. **The Internal Order and Disorder Cycle**: Wealth, values, and political inequalities are larger than they have ever been since the 1950s.
3. **The External Order and Disorder Cycle**: China is becoming as strong, if not stronger, than the US.

The Big Cycle evolves with the three cycles. These cycles don't change, because human nature doesn't change: we still deal with fear, greed, and jealousy as we did since the dawn of time. What changes is technology. Countries still rise and fall, but in the long term, people are getting richer. Why? Because of evolution. Evolution is the single force that persists across time – and across all of these empires.

Wealth rises over time due to human productivity. The more we produce, the richer we get. Productivity in a system depends on the capacity of said system to turn ideas into economic outputs. Evolution drives the trend up. As time goes by, we produce more, so our wealth increases. Learning and productivity don't cause major big shifts in society. They are not the cause that lead to important events. So, what is?

Booms, busts, revolutions, and wars. These are driven by the cycles we have talked about. Throughout time, the formula for success has been a system in which people would borrow money, innovate, and turn these innovations into means of production, then reap the profits. Capitalism, while responsible for creating enormous wealth, also created gaps in wealth and over indebtedness that have led to economic downturns, depressions, etc.

All fights that ever happened, happened due to fighting over wealth and power. These events, and natural events, have been the ones that influenced the course of history the most. Countries that fail in these moments are weak countries. Countries with large savings, low debts, and a strong reserve currency can resist better than those with low savings, huge debts, and no reserve currencies.

Throughout history, various groups of people (tribes, countries, etc) have gathered power. When they got more power than anyone else, they became world leaders and established a world order. When they lost their wealth and power, the world order changed. Empires' power and wealth can be measured with the help of eight determinants:

1. Education
2. Competitiveness
3. Innovation and technology
4. Economic output
5. Share of world trade
6. Military strength
7. Financial centre strength
8. Reserve currency status

These determinants usually rise and decline at the same time. The Big Cycle starts with a new order, then follows with the rise, the top, and the decline, until a new world order is established. The rise is the period of building. It happens because of:

1. Low debt
2. Low social-economic inequalities and low value and political gaps
3. People work together: This includes the government, businesses, and the military
4. Education and infrastructure are good: There is innovation and invention and people are open-minded
5. There is good leadership: Strong characters and work ethics taught in schools, families, or religious institutions.
6. Peace

The result is that people in the country earn more, hence become less competitive. The technology is copied by other countries, so innovation declines. Since people are richer, they get lazier. People borrow more, thinking that it will help them do better.

This is when we've reached the top. The top is characterised by:

1. High debt
2. High social-economic and value gaps
3. Conflict between people
4. Bad education and low-quality infrastructures
5. Struggle between countries

The decline comes with economic weakness and social conflicts. It happens when, internally:

1. Debt becomes large, the country may default so it prints excessively.
2. Great internal conflicts between the poor and the rich -> political extremism.
3. The rich get taxed -> they flee.

These internal changes don't necessarily lead to a new world order. They need to be aligned with external characteristics such as:

1. Another great power rising
2. A conflict emerges and weakens even more the declining power
3. Poverty increases
4. The decline is achieved when those that own the debt of the former empire which was the world reserve currency, sell those debts.

Everyone wants wealth and power. The rise of wealth and power is heavily influenced by money and credit. To understand how the system works, you need to understand money and credit. This is how it works: everyone has money coming in (revenue) and money going out (expenses). Revenue – expenses = net income. If your net income is positive, you have bigger savings. If it's negative, you have to borrow money, or take it from your savings. If you have a lot of assets, you can spend more than you earn and sell your assets to make up for the difference. If you have more liabilities than debt, you'll have to cut your expenses or restructure your debt.

The way entities collectively handle their finances is the biggest driver of changes in internal and world orders. If you look at everyone's finances and link them to each other, you will see how the whole system works. One's spending is someone else's income. As a result, if one decreases spending, someone else earns a lower salary. By the same token, one's debt is someone else's asset. If one defaults on his debt, someone else's net worth will decrease, hence, he will be forced to decrease spending too. When spending is widely cut, there is economic contraction.

The amount of debt is not capped but can be created infinitely by banks and the central bank. Everyone in the economy loves it when the state prints money as it enables them to spend more. Asset value increases, so people feel richer. What they ignore is that at some point, the debt must be repaid – meaning that at some point, they will have to spend less money. This explains how the economy is essentially cyclical. But…what if the debt is not repaid? Then, the interest rate is really low, so it hurts those who own cash and bonds, as it means they are not getting any return. The situation we are in at the moment is one where:

1. The expenses of governments are way bigger than their revenue.

2. Their debts are way bigger than their assets.

While they are financially weak, they look rich because they're spending so much. These basic economics work for everyone, except countries that create money out of thin air – those with reserve currencies. Debt eats equity…but central banks can avoid the debt crisis dynamic by printing money and giving it to borrowers so they can refund their debt. Not all money from all governments is equal. Money from reserve currencies is worth much more. At this moment, the USD is the main reserve currency, followed by the euro, then the British pound, the Chinese renminbi, and the Japanese Yen. A reserve currency gives you enormous buying and spending power. Because of this power, the country is going to borrow and spend much more than it should, and will eventually lose its reserve currency status. If you are another country with debt in the reserve currency, then you'll need that reserve currency to refund the debt (you won't be able to print it). If you somehow don't get it, you'll go bankrupt.

Money is a medium of exchange that can also be used as a store of wealth. Money and credit are often associated with wealth because they can buy wealth, but they're not the same. You can't create more wealth by printing money. Wealth is created when you *actually make stuff*. You have to be productive and create things. The relationship between money creation and wealth creation is often confused. One is the financial system. The other is the real economy, with real things. On the right, the real economy that makes stuff. On the left, the financial economy that dictates who receives and enjoys the stuff that is made. When the demand for goods is higher than the supply of goods, the price rises (it often happens due to too much money in the economy), this is the phenomenon of inflation. So the central bank raises interest rates to limit the volume of money and curb inflation. When there is not enough demand for things, the central bank decreases interest rates to put more money in the economy and stimulate growth. This is the short-term debt cycle.

The problem of the central bank is that it does not control where the money goes. If people use it to buy stuff, good! But if they use it to buy foreign currencies or stocks, it doesn't stimulate the economy. And it's a problem. The excessive supply of money makes money lose its value; hence, prices rise. Since there is little demand for goods, people that make the goods aren't earning much money. Prices rise, salaries decrease. This is called inflationary depression. Cash is losing value, and no one is buying anything.

People also confuse the price and the value of things. When the government prints money, prices go up because people are buying more. Two things need to be highlighted.

1. They're buying with debt, and the debt will have to be paid back (which will decrease the economic activity).
2. The price is rising, but the intrinsic value does not change.

This game of printing money and then hiking interest rates due to inflation is called the short-term debt cycle, and it lasts eight years on average (understand: you'll have an economic crisis every eight years).

The long-term debt cycle plays out for 50-75 years. They happen once in a lifetime, so people don't pay attention to them – and always get surprised. These tend to happen when the economy only grows by means of printing, which artificially inflates the value of assets. Holders of these assets want to sell, and the whole system collapses. The 6 stages of the long-term debt cycle:

1. Little or no debt, money is "hard"

After the restructuration of the last cycle, there is a return to hard money such as gold, silver, copper, or the money is linked to another currency. Because the money is backed by something (linked to another currency, or backed by gold) or *is* that *something*, there is trust. People use gold as means of exchange. Gold is valuable.

2. Claims on hard money

Carrying gold is annoying, so the gold is stored away and money ("paper money") is issued. Now credit can also be created, this is the beginning of banks. The paper money is actually a claim on gold, but people forget that and soon treat the money as gold itself. This system is called a linked-currency system. The paper money is directly backed by gold. That means it can be exchanged for gold.

3. Debt increases

Those who have money lend it to the banks which lend it to other people at a higher interest rate to make a profit. The borrowers buy stuff with that money, which leads to the stimulation of the economy and increases asset value. Everyone likes debt! Problems arise when:

- Borrowers aren't earning enough to refund debt
- The volume of debt increases faster than the services and goods available in the economy for purchase.

When lenders realise that they may not be enough money in the bank because the bank lent too much of it, there is a "run". Everyone tries to exchange the debt they hold for money.

4. The central bank prints money to remedy the debt crisis, default, and devaluation. This breaks the link between the currency and the "hard money"

The central bank prints money to enable debt holders to exchange their debt against money and keep interest rates low. The key is to create enough money to offset the devaluation, but not too much so that it creates inflation. If the bank prints too much, then people will not be able to exchange their money for the hard money (gold) that backs the currency, or for goods and services in the economy.

5. Then comes fiat money

When the amount of money is too big for the amount of hard money due to an extensive borrowing cycle, then the government debased the currency which becomes "fiat currency".

- We shouldn't rely on the government to protect us financially.
- When one can manufacture money and credit and pass them out to everyone to make them happy, it is very hard to resist the temptation to do so.

Printing money devalues the value of the asset (debt). It's a way to shift the wealth from those who have it (the lenders) to those who don't (the borrowers), and it's much more efficient than taxing (rich people don't like getting taxed). All currencies devalue or die, and when they do, cash and bonds (which are promises to receive currency) are devalued or wiped out. Once the debt burden is eliminated, the whole credit/debt expansion begins again.

There are four levers that countries can use to decrease debt:

1. Austerity -> deflationary + painful.
2. Debt default and restructuring -> the borrower goes broke and has his assets seized, and the lender also loses his asset. Too painful.
3. Transfer of wealth (taxes) -> politically challenging.
4. Printing money -> the easiest, in appearance.

6. Flight back into hard money

When the money printing scheme is taken too far, people fly away from cash (as it devalues fast) and debt (that will never be repaid, or repaid with cash worth nothing) to go into hard assets, like gold. At this stage, there are great social-economic differences. The state tries to tax the rich who flee, so the state prevents them from doing so by establishing control of capital. Devaluation and default have become so extreme that to re-establish trust, the government goes back to hard money.

Now, what do they devalue against? Debt. The money is devalued to make it easier to repay debt. When devaluation hurts the lender too much, the lender sells the debt and invests in another asset. So, the best time to hold cash is at the very beginning, when cash is backed by gold and interest rates are quite high. Once cash starts to get devalued against gold, then the link to gold is broken. Cash becomes a fiat currency, and holding it isn't interesting (and so it goes for holding debt).

The cycle of money is highlighted by the fact that out of 750 currencies that have existed in 400 years, 80% disappeared due to being worthless.

Concluding comment:

I could share so much more of the book with you but will end my review here as I think the rest is somewhat repetitive and less interesting.

This book makes you realise that just like the Cycle of Life, the Big Cycle demonstrates fundamentals in life never change, they just go round in circles in a natural order. Power, wealth and money are no different but we are rarely aware of this because each cycle will last hundreds of years and none of us are around long enough to recognise them!