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THE GLOBAL ECONOMY: RECENT CHANGES, UPCOMING CHALLENGES AND POLICIES TO AVOID

"The man who meditates not, lives in blindness; the man who meditates lives in darkness."

VICTOR HUGO

Bruno Desgardins ***June 2017***

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Economic growth is something of a Janus. Without it there can be no increase in wealth, no alleviation of poverty in the world. Yet with it, inequalities increase, as not everyone can march to the rhythm of the implications of the technological changes taking place, as Nobel prize winner ***Angus Deaton*** has made clear. Despite all the pessimism, however, it is interesting to note that the planet's GDP has more than doubled since the year 2000. It is also extraordinary that we can observe, with ***Max Roser***, that life expectancy has increased twice as much in one century as it did in the previous 200,000 years. At the time of Napoleon, life expectancy was hardly more than 40 years; today, it is not below that figure anywhere in the world. It is also encouraging to note that whereas in 1900 there were only slightly over 300 million people in the world who were able to read, today there are 6 billion.

In line with the Victor Hugo quote above, which comes to us by way of Edgar Morin, we will here successively attempt to analyse the changes observed since the 2008 crisis, three major challenges we face, and lastly four policies that should be avoided.

1. Changes observed since 2008:

There are many issues at play, but the focus here will be on three trends: worsening debt, the structural slowdown in economic growth, and low inflation.

a. ***Worsening debt encouraged by low interest rates:***

Just eight years ago in the United States, many banks were in a state of bankruptcy, credit dried up, high-yield bonds were at over 17%, property prices were down more than 30%, car sales were down 50%, and the S&P had dropped to 800. In 2008, governments took over the liabilities of certain banks whose nationalisation became necessary, and tried, often unsuccessfully, to stimulate growth through budget deficits. Monetary liquidity injections staved off the risk of deflation in many countries, but have now become a trap. Grappling with heavy demands on their budgets, governments are resorting to increasing public debt, but this is hardly a policy. Between 2008 and 2015, global debt increased by some $60,000 billion to $225,000 billion, nearly three times world GDP, whereas between 2001 and 2008 it only grew by $15,000 billion. Never has the rise in debt been so strong, and never has economic recovery been so weak. The capital efficiency of each additional $ of debt has proved to be mediocre.

Today’s dilemma is clear: keeping rates low means pursuing investments that are only weakly productive, yet abandoning this policy would also mean causing increases in long-term rates that could be fatal for several players, whether States or corporations.

Private agents have been forced to reduce their debt because, as a study by the ***Stern School of Business*** at the University of New York rightly points out, almost half the world's listed bonds are classified as "high yield," and more than half of US debt is considered "junk."

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b. ***The slowdown in global growth:***

Between 1960 and 1974, annual growth in GDP was 5.2%. Between 2008 and 2015, despite multiple fiscal and monetary stimulus efforts, it did not exceed 2.8%. We will attempt to identify the causes of this slowdown, and then focus on the slowdown in productivity gains, and finally examine the palliative of fiscal stimulus.

<u>Three causes:</u>

- *China's growth rate has been cut nearly in half:* for years, China invested almost 50% of its GDP, but today it is facing overcapacity in many sectors and has played the corporate debt card since 2008 in a desperate attempt to maintain its growth. The country's debt has risen from 1.4x GDP in 2008 to 2.8x, but China accounts for 30% to 40% of all global growth. For example, China has seen more than 24 million cars sold compared to 17.5 million in the United States, and accounts for almost 50% of the global consumption of many commodities.

- *The slowdown in the growth rate in the United States*: the magnitude of the post-2009 recovery has been half the size of previous cycles. Private and public debt, the driver of the growth in household consumption in the 2000s, could no longer go on accumulating. When the crisis in the real estate sector erupted, it put a stop to this dangerous dynamic of debt, which was little more than a substitute for stagnating incomes and a palliative for the eroding purchasing power of the middle classes, which has been observed for about the last thirty years. In a study of twenty-five high-income countries, ***McKinsey*** found that two-thirds of households were suffering from stagnation, or even decline, in their real income. The pressure is the same on corporate debt, which has increased from 80% of turnover in 1980 to 93% in 2016, as Moody's observed in its analysis of US non-financial corporations.

- To all this we may add another cause - *low growth in investment*, resulting either from overcapacities in several sectors or the consequence, for SMEs, of the difficulties faced in obtaining bank loans.

<u>How should the issue of slowing productivity gains be addressed?</u>

- *The numbers show a slowdown in productivity gains*:

Productivity is one of the keys to wealth creation. In the United States, according to the ***IMF***, productivity has tripled since 1915, i.e., the average American today earns in 17 weeks what it took a year to make in 1915. But this is a difficult notion to grasp. In a recent study on developed countries,

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the IMF pointed out that total productivity went from 1% before the 2007/2008 crisis to 0.3%/year, costing them 5 points of GDP growth.

In 2016, in the USA, the world's most innovative nation, hourly productivity increased by only 0.5% while wages increased by 2.5%, thus impacting corporate margins. The paradox is that productivity gains have never been so low, at a time when the spread of the digital revolution has been particularly rapid compared to that of the first and second industrial revolution, impacting the whole of the planet in just a few years, and affecting all professions, including the organization of production.

- *Six causes of slowing productivity gains*:

Weak investment, according to ***Larry Summers,*** who speaks of "secular stagnation."

Gordon's thesis is that the recent innovations have no ripple effects on growth.

Low interest rates, since they have allowed uncompetitive companies to invest and sometimes build up overcapacities.

The decline in the relative weight of industry.

The development of services employing a low-skill workforce.

The decline in social mobility in the United States, no doubt imposed by the housing crisis of 2008 and the reduction in market fluidity.

- *Questions about measuring productivity gains*:

How should digital productivity gains be measured? How should the contribution made by free information be appraised? Previously, in predominantly industrial economies, quantitative criteria had more meaning; today, in service economies, quality has primacy. The analysis does require caution, however, and economists such as ***K. Rogoff*** or ***Martin Feldstein*** have not hesitated to question this decline in productivity.

<u>Fiscal stimulus as temptation:</u>

To raise potential growth, many turn to the notion of public investment. Though excessive government spending hinders growth, targeted investments may increase potential growth, provide positive externalities to firms, and help increase their competitiveness. This is the intent of Trump's plan to invest $1,000 billion in infrastructure; before him, Shinzo Abe took the initiative of devoting 1% of GDP to such a policy; and the same spirit drives the Juncker plan and Franco-German considerations. But we have to be clearer about what is meant, because the notion is still somewhat vague. These may

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include investments in roads, digital, research, education, renewable energy, or military equipment. The spectrum is broad and financial resources limited.

c. ***Low inflation:***

Overcapacities in many sectors, the uberisation of the economy, the loss of trade union influence, the growth in the number of self-employed workers, the replacement of humans by robots in certain cases, and globalisation are all powerful disinflationary factors.

Today the apparent full employment seen in Japan, the United States, Great Britain and Germany has not led to an increase in wages. Abe's entreaties to companies to increase wages have had no effect, and neither the introduction of a guaranteed minimum wage in Germany, nor the increase in the minimum wage enacted by the Obama administration, nor that applied in the United Kingdom have had a ripple effect.

The enormous injections of liquidity conducted have thwarted monetarist approaches binding currency quantity to inflation - indeed, they have on the contrary contributed to deflationary pressures by permitting the survival of "zombie" companies. Not to mention that capital at low rates means substituting capital at the expense of labour. Inflation thus still poses no threat.

2. Stakes and solutions:

The first section revealed that States' room for manoeuvre is reduced by debt levels and decreased potential growth levels. Let us now analyse three challenges: firstly, demographic ageing and pension funding; secondly, the effects of robotisation and the importance of education; and thirdly, welfare protection inequalities and funding.

a. ***Demographic ageing and pension funding:***

By over-focusing on government debt, we might almost forget the serious challenge of underfunded welfare provision and pensions, and the impacts of the downturn in the populations of many countries. In 1900, the population was 1.6 billion. Today it is 7.5 billion and is expected to increase slightly to 9.2 billion in 2050. The population has grown by 1.6% per year over the past 65 years and will only increase by 0.6% per year over the coming 65 years. The population is still ageing, therefore, and there will be 1.2 billion over-60s in 2025, and two billion in 2050. The population of over-60s in China will

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grow from 290 million to 450 million between these dates. In India, the figures will increase from 155 to almost 300 million, and from 200 to 240 million in Europe.

<u>Ageing and pensions:</u> public and private pension expenditure already represents 11 to 13% of the GDP in developed countries. More than 10% of GDP in health expenditure can be added to this, given the importance of end-of-life care. France is one of the very few developed countries to continue to post demographic growth. However, even though there was one pensioner for five workers in the 50s, there was only one for 3.5 in 2010 and there will only be one for two in 2040. A recent study revealed that unfunded social security and Medicare liabilities in the US are nearing $70,000 billion, far outweighing the government's $20,000 billion in debt. For pensions alone, a recent ***Hoover Institute*** study calculated the underfunding of cities and federal entities to come to some $4,000 billion.

<u>Ageing and growth:</u> a decrease in the active population may possibly result in upwards pressure on wages and a resulting drop in competitiveness. Decreasing populations is not simply a Japanese or European issue. Russia is also affected by this as the population has been decreasing since 1991. The 20 to 64 year-old active segment is expected to drop from 72 million to 68 million between now and 2035 and even by over 20 million between now and 2050. China will be the most seriously affected: with only 1.6 children per woman the 20-64 population segment will decrease by almost 200 million between now and 2050. Some specialists, such as ***Yi Fuxian*** from Wisconsin University, think that the situation may be even worse given that the recent birth rate is not even 1.6 but 1.05!

Immigration aside, the German population has been decreasing since the beginning of the 70s, in Italy since the beginning of the 90s and in Japan since 2006. It is no coincidence that these countries' growth is slower than others. Between now and 2050, the UN predicts a 5.5 million decrease in the Polish population, a 4.3 million decrease in the Romanian population and a 1.5 million decrease in the Bulgarian population. A vital raising of the retirement age, combined with a decrease in pensions and increased immigration, is therefore to be expected.

b. ***Innovation and robotisation impacts and necessary investments in education:***

In 1900, almost 80% of the world population was illiterate. Today, this figure is less than 15%. Huge progress has been made, but the question has been raised as to the efficiency of education policies. To take just two examples, the US is home to more than 30 million illiterate people, representing 10% of the national population, and 150,000 pupils leave school in France every year with poor reading or writing skills. There is a similar picture in other countries, except for Scandinavia. Whilst education expenditure represents 5.8% of the OECD countries' GDP, it is 7.3% in Sweden and 8.7% in Denmark. Emerging countries understand the need to make an effort, and education expenditure in China has therefore increased from 2.5% of GDP in 2000 to 4%.

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Never before have all countries and sectors (from industry to services, automobile to finance, transport and tourism) been so immediately affected by a wave of innovation. It is also the first time that such innovation has so greatly affected employees, from the least qualified carrying out repetitive tasks to a growing number of highly-qualified professionals such as lawyers and surgeons. When you stop to think about it, Uber, Airbnb and suchlike were only created about ten years ago. We are now being given a sneak preview of the extent of the possibilities provided by 3D, autonomous cars, biotechnologies, robotics and artificial intelligence.

<u>Is robotisation the enemy of employment?</u> An ***OECD*** study predicts that 50% of jobs will disappear over the coming years. This has yet to be proven. In the meantime, let us consider the statistics from the International Federation of Robotics. There are 127 robots for 10,000 employees in France and 301 in Germany. The German unemployment rate, however, is almost twice as low as that of France. Similarly, the countries with the most robots - Japan, Germany, South Korea and Switzerland - have the most developed and competitive industrial sectors. In other words, robotisation is a key to competitiveness and taxing robots would be heresy. A recent ***Deloitte*** study to this effect, in Switzerland, revealed that automation has created more jobs than it has cut over the past 25 years. Given international competitiveness, robotisation is an opportunity for developed countries and provides potential for the relocation of industries.

The structural unemployment arising from technological changes can be tackled by actions against education inequalities and in favour of continuing education or retraining aid. Education will also be a key element in controlling African demographic growth. A third of children do not finish primary school education and the fertility rate is still 7.5 children per woman in Niger and 6.8 in Mali. Elsewhere, in Vietnam for example, the percentage of 10 to 14 year-olds in employment dropped from 45% to 10% between 1993 and 2006, thanks to education.

c. ***Inequalities and financing welfare protection****:*

Angus Deaton showed that inequalities are now greater than they were two centuries ago, but at that time the majority of the population was living in poverty. China provides a more recent example. On Mao's death, inequalities were low but 90% of the population had nothing. Since then, inequalities have widened, but hundreds of millions of people have been lifted out of poverty. The same applies on a worldwide scale, as the percentage of the population living on less than $1.9 per day has fallen from over 40% of the world population in 1981 to 10% today. The fact remains, however, that the impoverishment of the middle classes in certain countries may foster the rise to power of populist parties at a time when governments have little to redistribute due to sluggish growth. The election of

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Donald Trump is both an illustration of, and a reaction to this trend, as the percentage of US wealth held by the richest 1% has risen from 9% in 1980 to 34% recently.

Education and meritocracy are responses to inequalities, as is the preservation (to the extent possible) of welfare protection. We should not forget this wise approach promoted by such enlightened conservatives as Bismarck and Churchill.

3. The wrong policies:

Among the different policies that are being recommended or implemented, four should be ruled out: protectionism, Brexit, the corporate tax cut in the US, and closing the doors to immigration.

*a. **Protectionism**:*

<u>History shows that countries that withdraw into themselves decline</u>:

According to the calculations of ***Angus Maddison***, 15th-century China generated 20% of world GDP and had invented a number of the products that were to be the key to development in Europe: the gunpower required for military domination, the compass that was so useful to trade, and printing to disseminate knowledge. Ming-dynasty China then shut itself off from the world, declined and was unable to prevent the signature of one-sided treaties imposed on the country by Great Britain in 1842 in Nankin, then the forced opening up of its ports in 1860.

<u>International trade as the driver of growth</u>:

There have been two periods of strong growth in international trade: between 1870 and 1914 it swelled from 18% to 32% of world GDP, and then from the 1950s, after falling to 10% of world GDP in 1945, it grew to 60% of world GDP in 2007. Protectionism struck at the time of the crisis in the 1890s (the Méline tariff in France, etc.) and in the 1930s (Smoot-Hawley Act in the United States, followed by similar measures in other countries). In recent years, growth in international trade has lessened, dipping below that in world wealth in 2016. There are 4 structural causes for this slowdown:

- The determination of the Chinese authorities to favour growth in their domestic market.
- The increased weight of services in economies.
- The impact of robotisation or 3D techniques making offshoring less necessary.
- The loss of competitiveness of certain emerging countries in the wake of wage increases.

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To these causes should be added the protectionist measures pushed by Donald Trump during his campaign, the risks of which should be pointed out for the standard of living and for growth.

<u>The mistrial of globalisation</u>:

To denounce industrial job losses, pointing out that industrial employment represented over 13% of US jobs in 1990 and just 8.5% today and blaming offshoring and globalisation, and to stress that the US manufacturing industry balance of trade has slipped from being balanced in 1990 to a deficit in excess of 3.5% of GDP, is to ignore the great productivity gains achieved in industry and the fact that two-thirds of the reindustrialisation supposedly underway since 2009 concerns shale oil, a sector that is capital intensive but low on jobs. To be clear, US industry today employs some 12 or 13 million people, as it did in 1950, but production has been multiplied by six. Industry represented 30% of jobs at the time, however, against 8.5% today, because 100 million jobs have been created in services.

To point the finger at Chinese competition is to overlook the fact that just five million of the jobs lost by American industry between 1999 and 2011 are down to that Chinese competition.

To blame Mexico is to weaken the Mexican economy and underestimate the contribution that country makes to American competitiveness. To take the automotive sector as an example, the Mexican car industry represents 30% of the country's exports and close to 20% of its industrial output. Mexico produces 3.5 million and exports 2.7 million cars, of which over 80% to the United States. Outsourcing to Mexico by US companies is a factor in their competitiveness, in the same way that Germany outsources production of its components to Eastern Europe, as Mexican wage costs are much lower than costs in the US. The country should therefore not deprive itself of this competitive edge.

The introduction of customs duties (Donald Trump has mentioned a figure of 45% for China) will in no way resolve foreign trade problems, although American consumers will lose purchasing power. Donald Trump must drop the protectionist option and encourage China to show greater respect for free trade.

b. ***Brexit:***

It is always possible to laud the current low unemployment rate of 4.8% and 2.2% growth in GDP, but Brexit has not even started and Teresa May's position is incoherent. She may well declare that she is in favour of free trade, but in that case why leave the European free-trade area that is the world's biggest trading power. 51% of British exports go to Europe. They represent 13% of GDP and nine million jobs, and there is little point in looking to the Commonwealth nations to offset that, as the latter are marginal at just 10%. The special relationship mentioned with Donald Trump is a mirage. Finally, European exports to the United Kingdom weigh no more than 2.5% of EU GDP, allowing the latter to adopt a tough stance in the negotiations. Tomorrow, a British market of just 65 million consumers will be of

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less interest to the international investors who have been setting up factories there to export throughout the single market. The automobile sector is a topical example, since half of UK output is exported.

The UK is going to have to negotiate some fifty or so trade agreements with third countries, and that is going to take a long time. London's banks will lose their European passports, causing many jobs to be transferred, with consequences for the real estate market. As an illustration, of the 300,000 finance jobs in London, 10% are linked to the Euro and therefore have no reason to remain there when it is no longer in Europe. Nor should we forget the risk of seeing the UK break up and Scotland (8% of UK GDP) and Northern Ireland, great beneficiaries of European funds, taking their independence and attempting to join the EU. Since the referendum, Sterling has slipped by over 10%, the prices of imported products have therefore risen and inflation has worsened to 2.8%, outstripping the rise in wages and forcing households to take on more debt. Caution is therefore necessary towards the UK market.

c. ***The corporation tax cut in the US****:*

Since 2003, the tax rate on companies around the world has fallen by one third and the average rate was 22.5% at the end of 2016. Traditionally, smaller countries such as Eire, the Baltic States and more recently Hungary, which opted for a rate of 9%, have lower corporation tax rates to make up for the fact that their markets are less attractive. The bigger countries (the US at 35%, Germany at 30%, France at 33% and Italy at 31%) have higher rates. If the United States were to cut the rate to 15%, they would force the others to follow suit and engage in "fiscal dumping", hitting not only the smaller countries, but also the financing of welfare protection.

d. ***Closing the doors to immigration****:*

Migration is ill perceived and ***Warren Buffett*** was right to issue a reminder at his last annual meeting of the contribution made by immigrants to the wealth of the United States, and he could have said the same thing of other countries, too. The new arrivals are often of working age, meaning that their education costs are lower and that they finance welfare protection. Contrary to what people think, in fact 80% of migrants head for other emerging countries. In the United States (as in France) annual immigration represents just 0.3% of the population. Focused as they are on Syrian migrants, governments are ignoring the African issue. It should be remembered that by 2050, the population of Africa is set to increase from 1 to 2.5 billion. Between the effects of climate change driving migration, and the weakness of industry and therefore of job creation in many of these countries, there will be many factors pushing Africans to emigrate. To lessen these pressures, investment is required in these countries today in order to boost their growth potential.

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Conclusion: *Who will be tomorrow's powers*?

"When I examine myself, I worry. When I compare myself, I am reassured."

What about Europe? This quote attributed to ***Talleyrand*** could well apply to Europe. Until 1914, it was the centre of the world. In 1960, it represented 13% of the world population, today it is less than 7%. In 1980, it represented 30% of world GDP, against 18% today. Although it will remain one of the world's richest regions, it must and can cope with competition.

Or perhaps Russia? The bipolar post-war world is long gone. Russian GDP is just one-twelfth that of China, its population is in decline and its technology is not exactly to the fore.

China, then? Per capita GDP has grown in 25 years from \$300 in 1980 to over €8,000, China has doubled its GDP over the past 7 years (when it took Great Britain 58 years to do the same thing when it took off in 1780), over 700 million Chinese have been lifted out of poverty and China continues to boast an enviable growth rate, but this has all come at the expense of worryingly high debt: +\$4,500 billion last year, twice the amount for the US, five times the growth in outstanding debt in Japan and nine times the figure for the Eurozone which has a similar level of GDP.

Or India? Per capita GDP has been multiplied by five since 1950. The population is set to increase by 400 million by 2050 and growth in GDP is now higher than all the major countries, but it lacks the savings to fund infrastructures, and creating 13 million jobs a year will be difficult in this not very industrial country.

Africa? Highly dependent as it is on commodities and with little job creation, Africa remains something of a mirage in this respect, with almost 550 million people still living below the poverty threshold and infrastructure that is insufficient.

Or Japan? Although the trade deficit of \$120 billion in 2013/14 gave way to a surplus of \$35 billion in 2016, growth remains weak and demographic trends worrying.

So, does that just leave the United States? The population continues to grow, the country's military budget (\$620 billion) exceeds the cumulative figure for the next nine biggest spenders, the US Dollar remains the reserve currency, the new technologies are of US origin and English is the universal language. The Chinese, meanwhile, have never had the feeling of being the chosen people or shown a

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desire for domination beyond their regional scope. Western civilization may sometimes give rise to frustrations, but there is no other alternative.

Alongside the various States, mention should also be made of the power of the *major technology firms* that are shaping ways of life all over the planet. The market capitalisation of the Big Five has topped $2,800 billion, which is almost equivalent to German GDP and more than the whole of the German stock market. The liquidities they can generate to fund research and thus the innovations of the future largely exceed State research budgets, and as all these firms are American, we can expect US domination to continue. ***Shimon Peres*** was quite right when he declared that the revolution launched by Facebook and Mark Zuckerberg was having a bigger impact than the Communist revolution.

We should of course be modest in making such forecasts and accept that ***"Everybody looks at what I look at, but nobody sees what I see"***, as Chateaubriand said.

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