# The Prospects for Global Growth: Diagnoses and Prognostications

***The extent of economic and political uncertainty has risen, and the likelihood of outcomes more negative than the one in the baseline has increased.***

**IMF, World Economic Outlook Update, July 2016**

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The IMF revised its global output projection between October 2015 and April 2016, and again between April and July. Why has global recovery from the financial crisis eight years ago been so slow and so subject to downside risk? And what are the prospects for the next five or ten years.

Four views offer competing diagnoses and prognostications, each associated with a prominent American economist. Before the financial crisis, Ben Bernanke put forward the view that there has been a *global savings glut*, in which desired savings exceeds desired investment. This situation has a contractionary effect on output, as aggregate expenditure contracts. A sign of the glut is hoarding. At the national level, this takes the form of building up reserves for precautionary reasons. At the corporate level, it takes the form of increased cash reserves on balance sheets.

The other views have emerged since the financial crisis. Kenneth Rogoff has put forward a *debt supercycle* view[1]. He argues that the years immediately before the financial crisis created a bubble which, once burst, lead to a harsh reverse, including debt deleverage. This phenomenon is not new: it is an instance of what has happened before. The United States has more or less completed adjustment, while Europe is still in the middle of it. The global economy will recover and enter a new rising phase.

Referring back to Keynes, Paul Krugman regards the world as stuck in a *liquidity trap*. In the 1930s, Keynes observed that monetary policy was becoming increasingly ineffective as interest rates approached zero and prices were falling. Krugman takes the view that the same is true now.

Lawrence Summers proposes a *secular stagnation* view[2]. Desired savings and desired investment are equalised at an interest rate known as the natural rate. This rate varies over time and Summers's thesis is that it has been in a falling trend since the mid-1990s. Why is this so? An increase in inequality increases savings, longer life and uncertainty about retirement benefits spur increased savings and that (in line with Bernanke) accumulation of assets by central banks and sovereign wealth funds increases savings. On the other hand, reduced investment is a consequence of slower growth in the labour force, reduction in the cost of capital goods and the introduction of macroprudential policies. Macroprudential policies, designed to reduce the risk in financial systems as a whole, have been the subject of attention in recent years, since overextension was a major contributor to the financial crisis. They have put constraints on borrowing, despite low interest rates. Moreover, some forms of investment in modern technologies require relatively little financial capital.

There are overlaps in these views. Thus Summers:

> So my judgment is that whether we call it a savings glut, a debt supercycle, secular stagnation, or a quacking duck, we need to recognise the reality that the defining challenge is going to be absorbing all the savings in a satisfactory way in the global economy in the next decade[3].

*Charles Goodhart and Philip Erfurth have pointed out that the growth in the population of working age is slowing in advanced industrial countries, apart from the United States, and in China. While this will have a negative effect on growth globally, it will also lead to lower savings, as the old consume more, and make up a higher share of the overall population.*

Though graphically put, this conclusion brushes over some key issues. On the debt supercycle view, progress will depend on the speed that Europe, constrained by national divisions and increasing political pressure on the European Union, will be able to complete its deleveraging adjustment. And adjustment will be hostage to a financial crisis coming out of China. The Bank for International Settlements currently has China on red alert on two out of four early warning indicators for a domestic banking crisis and on yellow alert for a third[1,2], . The debt supercycle view focuses on managing these two major problems, as a condition for progress, which would ease, and finally move, the liquidity trap. In short, the debt supercycle view implies that there may not be a problem of absorbing savings over the next decade.

There is another line of attack on the expectation of low interest rates over the next decade. Charles Goodhart and Philip Erfurth have pointed out that the growth in the population of working age is slowing in advanced industrial countries, apart from the United States, and in China. While this will have a negative effect on growth globally, it will also lead to lower savings, as the old consume more, and make up a higher share of the overall population. This implies that a twenty year decline in real interest rates will be reversed. Goodhart and Erfurt suggest that real interest rates should rise from 2.5% to 3% by 2025, their historical equilibrium value.

In the mix is productivity growth. Total factor productivity growth refers to the growth in output not accounted for by expansion in the factors of production – labour and capital employed. In the long run, it is the source of growth once labour reserves have been fully mobilised and the capital-output ratio has reached its equilibrium level. Barry Eichengreen and his collaborators observe that productivity growth is slowing round the world and that growth in total factor productivity has dropped from 1 per cent in 1996-2006, 0.5% in 2007-12 and around zero since then. The current productivity slump is by no means unprecedented but, if maintained, would be a further source of secular stagnation. Eichengreen finds that high educational attainment and stronger political systems are negatively correlated with TFP slumps. On the other hand, countries with high investment shares of GDP are more susceptible to TFP slumps.

Two mechanisms are at play here. First, there is the growth of productivity in frontier firms – firms at the leading edge of innovation – and secondly, there is the diffusion of productivity gains to other firms. A Brookings Institution study finds that both have slowed, with diffusion slowing to a greater extent than innovation in frontier firms. As with the slowing of TFP generally, this trend was present in the years before the financial crisis, but low growth following the crisis has made it worse, since technological change is often embodied in new investment. Productivity growth will recover as growth in general recovers, but is likely to fall short of pre-crisis levels unless structural impediments are tackled.

And again: Donald Trump has been vociferous in his insistence that jobs return to America. But a large number of routine jobs are disappearing everywhere. Robots are able to conduct many manufacturing tasks which people once did, and computers are able now to write company reports setting out the results of their work. Reshaped and more extensive education and training are potential solutions to the problem, but there are limits. One cannot change the educational level of an entire workforce at once, there are personal difficulties (How do I decide on the optimal level of education? How do I finance it, given that credit markets are imperfect? How do I deal with the risks of educational investment?), and educational system financing difficulties, especially in the post-school sector. The result will be either dropping wages of the lower skilled, or higher unemployment among them, or both.

If monetary policy is becoming increasingly ineffective, what about fiscal policy? Summers has been the most forceful advocate of government borrowing in the United States with the aim of strengthening the country's infrastructure. On the liquidity trap view, this would also be desirable, as Keynes agued in the 1930s. It would be a response to a savings glut, if it still exists. And it would help even on the debt supercycle view during the period in which the deleveraging still has to be completed.

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The IMF has urged expansionary fiscal policy in countries which are able to undertake it. But there are two difficulties. First, not every country can. And not every country which can, wants to. Germany is a case in point, resisting policies which will stimulate the rest of the world while saddling future generations of Germans with increase public debt. And the United States is notorious for not being able to deal with fiscal policy coherently.

So where does this leave us?

1. 'We are proceeding in the trenches. But where the trenches will eventually lead remains unclear.' Thus wrote Olivier Blanchard, a distinguished macroeconomist, in the concluding chapter of a set of essays written by a number of other distinguished macroeconomists. The meta-conclusion is that we are crossing the river by feeling for stones, to use Deng Xiaoping's famous and more pleasing metaphor. We have to rely on experiment when theory fails us. With hindsight, the American New Deal looks coherent to us, but it was the outcome of experiments, some of which worked, and some of which didn't.

2. Despite the confusion, the level of globalisation achieved by the middle of the last decade has been largely maintained . Past performance is not necessarily a guide to future performance, as they say in the fine print of unit trust contracts, but at least the financial crisis has not closed down globalisation as the First World War did.

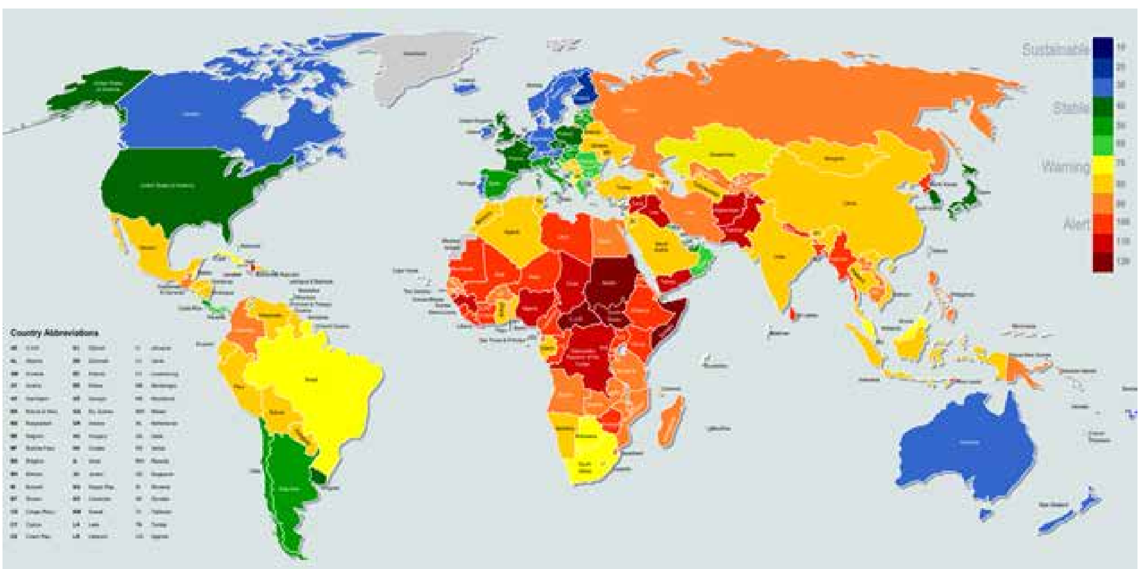
3. The world cannot rely indefinitely on East and South East Asia as a major growth locomotive. In a landmark analysis , William Easterly and collaborators demonstrated that regression of economic growth to the mean was a standard feature of the post-war experience across countries. Herman Kahn's The emerging Japanese Superstate, published in 1971, is a dead duck now. Pritchett and Summers have returned to the theme more recently warning that forecasters and planners looking at the region would do well to contemplate a much wider range of outcomes than are typically considered.

4. Looking ahead twenty years from 2015, projected growth of the working age population is as follows:

| | Growth in 20-59 age group 2015-2035 |
|---|---|
| High income countries | -3,2% |
| Upper middle income countries | 1,0% |
| Lower middle income countries | 35,1% |
| Low income countries | 82,8% |

Source: United Nations Population Projections, 2015 revision

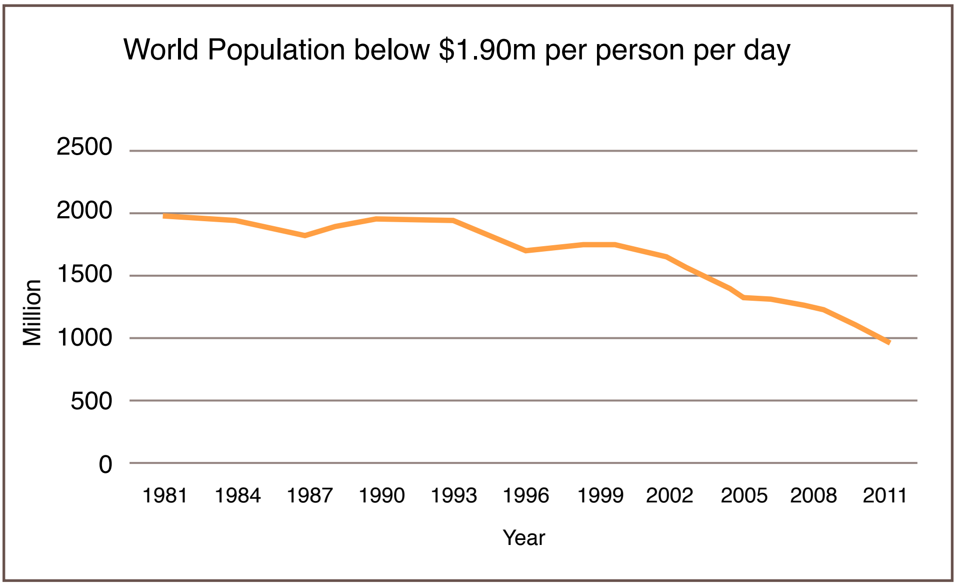
The population of working age is expected to decline in high income countries and to barely grow in upper middle income countries. On the other hand, it is expected to grow fast in lower middle income countries and to explode in low income countries. World growth will depend on matching capital to labour across countries. One way of doing this is moving capital to lower middle and low income countries, but the institutional constraints on doing so are formidable. As the map below shows, state failure and low income status are highly correlated. The other way is moving labour, but large scale international migration has problems of its own. Finding ways around this problem is the task of the next phase of globalisation.



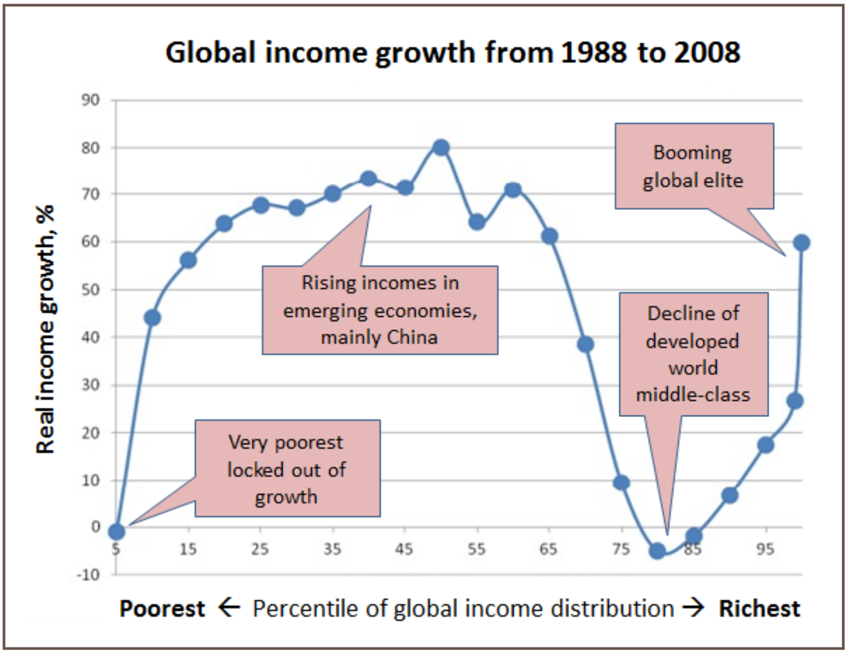

Source: Fund for Peace, Fragile States Index, 2015

5. The implications of the rise of the knowledge based economy have yet to be fully worked out. Knowledge-based capital comprises computerized information, innovative property and new forms of management competencies and brand building. The definition of property rights appropriate for a knowledge based economy have become increasingly important, but proprietary knowledge is likely to coexist with open source knowledge, as any sophisticated user knows. A T Kearney suggest that the knowledge economy may reduce trade in global goods, as industrial robotics and additive manufacturing become more widespread, eroding the case for outsourcing production. But international services trade is likely to expand.

6. Apart from persistent macroeconomic uncertainty, geopolitical conflict and heightened nationalism and protectionism are threats to global growth. The figure below shows that the number of people living below the World Bank poverty line (of $1.90 per person per day in purchasing power parity terms in 2011) halved between 1990 and 2011. This is the great achievement of the second wave of globalisation and it has extended beyond the financial crisis.




But the gains from globalisation have not been evenly spread. Branko Milanovic has produced a graph of the distribution of real income growth by percentile of the global income distribution.




The rancour of the losers in the second wave of globalisation may well derail growth, either through national conflict or populism within countries. The gung-ho 1980s 'greed is good' approach to growth will no longer do.

NOTE

1 Kenneth Rogoff, Debt supercycle, not secular stagnation, in (eds) Olivier Blanchard et al, Progress and confusion: the state of macroeconomic policy, MIT Press, 2016
2 Lawrence Summers, The age of secular stagnation: what it is and what to do about it, Foreign Affairs, February 2016
3 Lawrence Summers, Rethinking secular stagnation after seventeen months, in Blanchard et al
4 Nikola Tarashev, Stefan Avdjiev and Ben Cohen, International capital flows and financial vulnerabilities in emerging market economies: analysis and data gaps, Note submitted to the G20 International Financial Architecture Working Group, Bank for International Settlements, August 2016
5 The potential seriousness of disorderly adjustment can be seen from the fact that IMF projections in April 2016 imply that China alone is currently expected to provide 34% of the increase in world output between 2016 and 2021, compared with 32% of all the advanced industrial countries combined.
6 It may seem imprecise to refer to interest rates without mention of particular economies. But long term real interest rates around the world have been increasingly correlated with the US long term rates over the last decade. Moreover the term premium (the difference between short term and long term interest rates) has been declining. On this, see Peter Hordahl, Jhuvesh Sobrun and Philip Turner, Low long-term interest rates as a global phenomenon, Bank for International Settlements Working Paper 574, August 2016.
7 Charles Goodhart and Philipp Erfurth, Demography and economics: look past the past, Centre fot Economic Policy Research Portal, 4 November 2014
8 Barry Eichengreen, Donghyun Park and Kwanho Shin, The global productivity slump: common and country-specific factors, National Bureau of Economic Research Working Paper 21556, September 2015
9 Karim Foda, The productivity outlook: pessimists versus optimists, Brookings Institution, 26 August 2016
10 For some indicators supporting this conclusion see the HSF brief entitled: Have we passed peak globalisation III – indicators
11 William Easterly, Michael Kremer, Lant Pritchett and Lawrence Summers, Good policy or Good Luck: Country Growth Performance and Temporary Shocks, Journal of Monetary Economics, 1993
12 Lant Pritchett and Lawrence Summers, Asiaphoria meets regression to the mean, National Bureau of Econoic Research Working Paper 20573, October
13 A T Kearney, Globalisation appears to be on a hiatus, but divergent forces at work make the future very uncertain. What will the next global economic order look like? Council Perspective, January 2016
14 Branko Milanovic, Global inequality: a new approach for the age of globalisation, Harvard Press, 2016