

STRUCTURAL SHIFTS AND CHALLENGES IN THE GLOBAL ECONOMY



MICHAEL SPENCE
NEW DELHI
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Edited by Jeffrey D. Sachs

The Growth Report

Strategies for Sustained Growth
and Inclusive Development



THE NEXT CONVERGENCE

THE FUTURE OF ECONOMIC GROWTH
IN A MULTISPEED WORLD

MICHAEL SPENCE

WINNER OF THE NOBEL PRIZE IN ECONOMICS



下一个发展

[美] 迈克尔·斯宾塞 (Michael Spence) 著
王青 刘其岩 译

THE NEXT CONVERGENCE

The Future of Economic Growth in a Multispeed World



机械工业出版社
China Machine Press

What is the Next Convergence?



- Before the Industrial Revolution
- 200 years of divergence
- Post World War II: Reversal of the Divergence Pattern
- Now mid way through a century of convergence of developing and advanced economies





September 2011

FOREIGN AFFAIRS

On
Romanian Journalist
Michael Palanu

NATO After Libya

Andrew Ross
Barnett

Settlements Are
Not the Problem

David Abrams

The Drone Wars

Paul Brinkley
Catherine Tachman

Why Middle East
Shuffles Moved

the Arab Spring
F. Gregory Gause III

What China Wants

Andrew Nathan

The Coming Crisis
in Clean Energy

David T. Evans Jr.
Kendra Tomoko

Volatile Oil Prices
Are Here to Stay

Robert M. Kelly Jr.
Michael Lora

How America Can Compete

Globalization and Unemployment
Michael Spence

The Risks and Rewards of
Health-Care Reform
Peter Orszag

Learning From the Germans
Steven Rattner

Does Obama Have a Grand Strategy?

Daniel Drezner

Council on Foreign Relations

WORKING PAPER

The Evolving Structure of the American Economy and the Employment Challenge

Michael Spence and Sandile Hlatshwayo

March 2011

Key Elements in Sustained High Growth



- The global economy
 - Knowledge transfer and catch up growth
 - Market Size and specialization
- Very high rates of overall saving and investment
- An effective government that supports and complements the private sector dynamics
- Structural change and economic diversification
- Inclusiveness and a reasonable degree of equity
- Powerful employment engines in the modernizing part of the economy in both the tradable and non-tradable parts of the economy
- Leadership

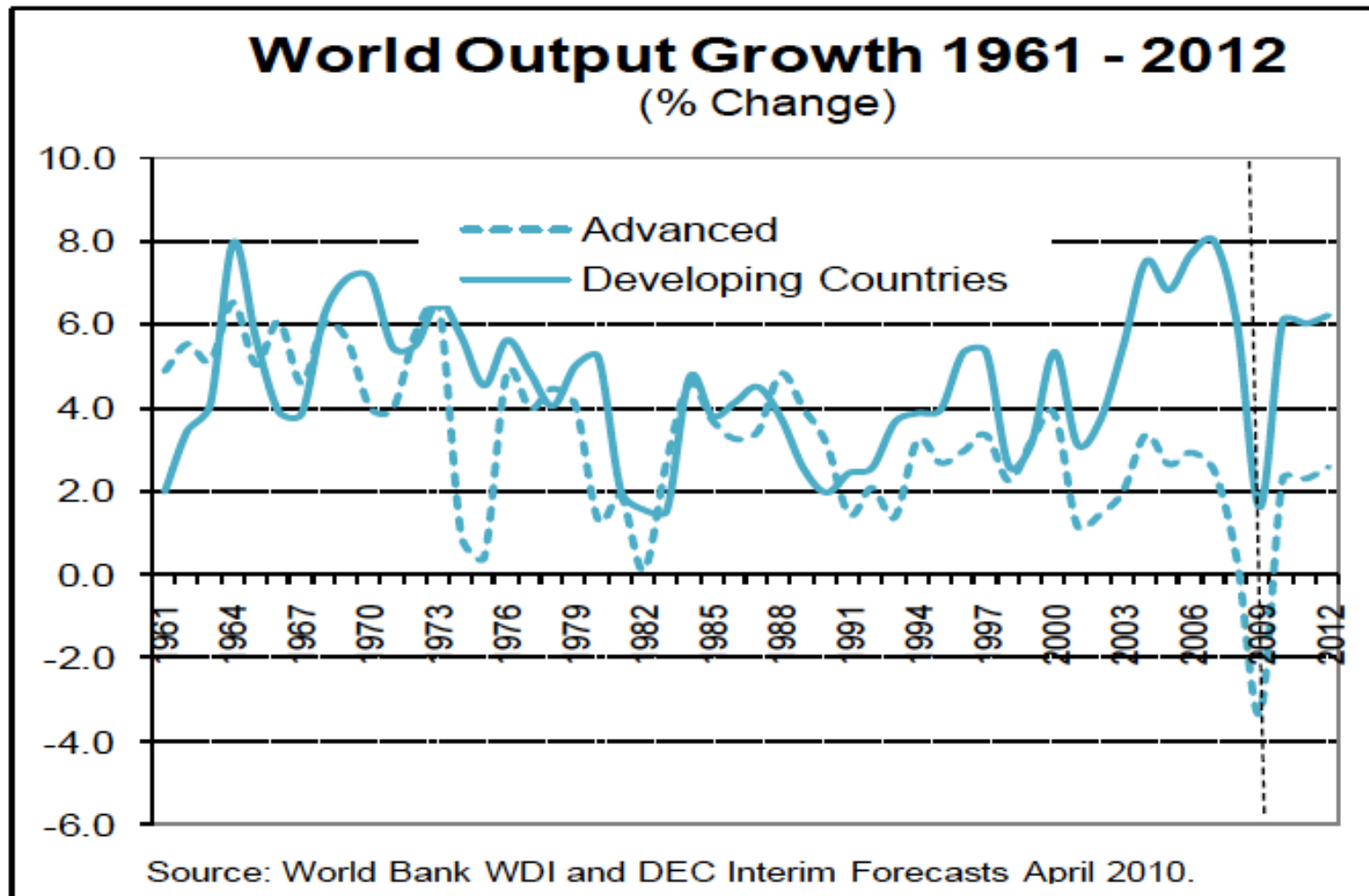
When Does It Fail?



- Leadership
- Failures of governance
 - But the form of governance is not highly correlated with economic performance
- Pursuit of other objectives than growth
- Natural resource distortions of political
- National identity not formed
- Low rates of public sector investment
- “Bad,” meaning misguided strategy
- Inclusiveness failure

Partial Decoupling

Figure 1

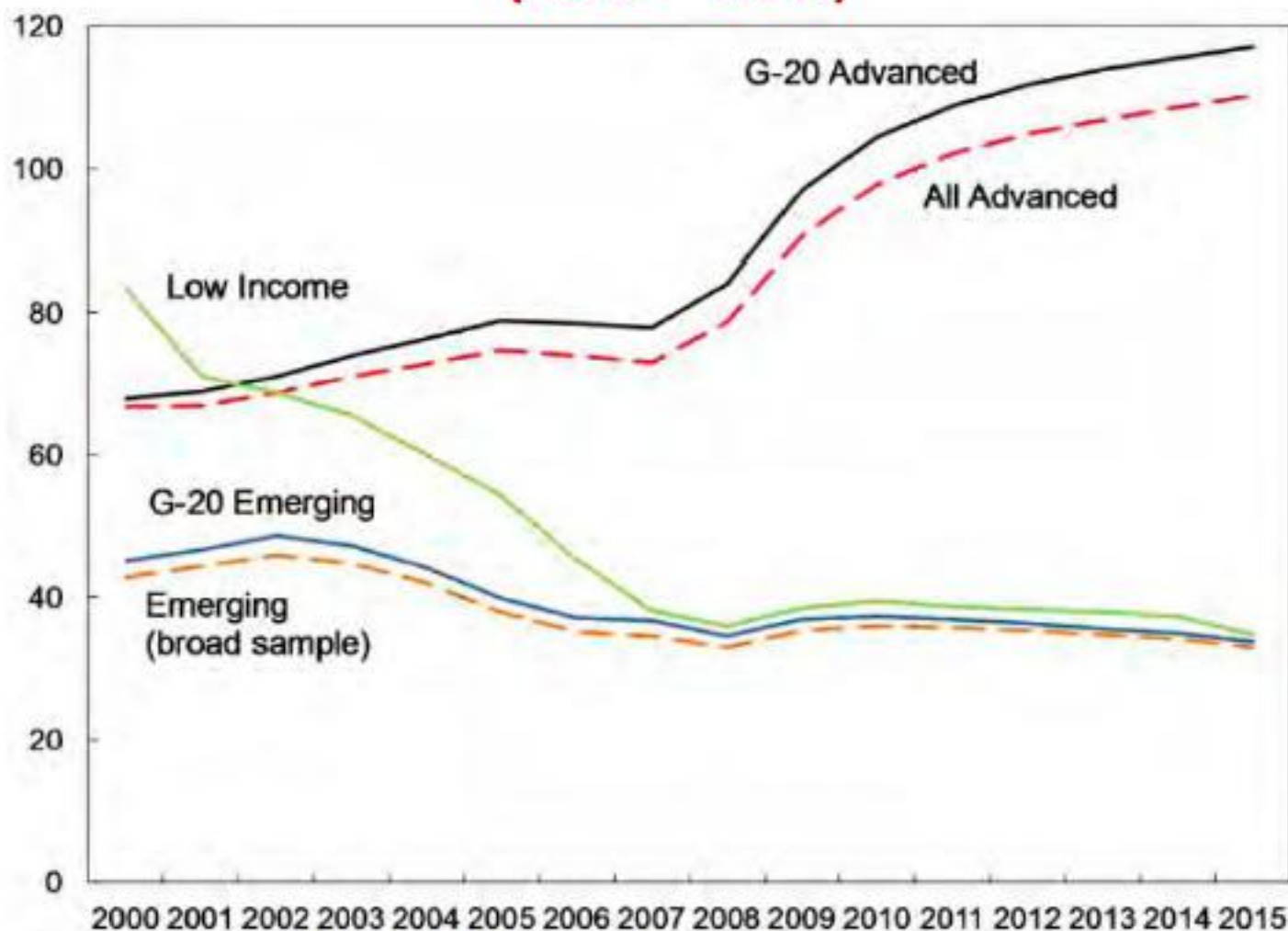


Sustainability of Growth in EM's

12

- In the context of a difficult, extended slow growth in advanced economies
- It looks like the growth is sustainable
 - EM growth dynamics still in place
 - structural change and supporting policies deeply embedded
 - Economic size of EM group
 - Trade within EM group
 - Higher incomes and closer match between demand and supply sides of the economy
 - China's growth has become an important engine
 - Main export partner for Japan, Korea, India, Brazil, Australia,
 - The network structure of global has shifted
- Downside Risks to Baseline Case
 - Another major downturn in advanced countries – probably coming from Europe
 - NOW TURNING INTO A REALITY
 - Inability of advanced countries to deal effectively with structural growth challenges
 - Serious outbreak of protectionism
 - Growth slows down in China

G20 Countries: General Government Debt to GDP Ratios (2000 – 2015)



Source: IMF, *Fiscal Monitor*, May 2010

Eurozone as Epicenter of Global Macro Risk



- **Mostly likely scenario**
 - Eurozone core holds together
 - Periphery (Greece and Portugal) exits
 - ✦ No growth model without a reset
- **Less likely but possible**
 - The eurozone core comes apart
 - Key is Italy
- **Reasons**
 - The eurozone core has the resources and the competence
 - The big question mark is the political will – at both national and EU levels. And they are linked.

Euro-dollar Exchange Rate



EUR/USD

■ EURUSD=X

Dec 13, 2011



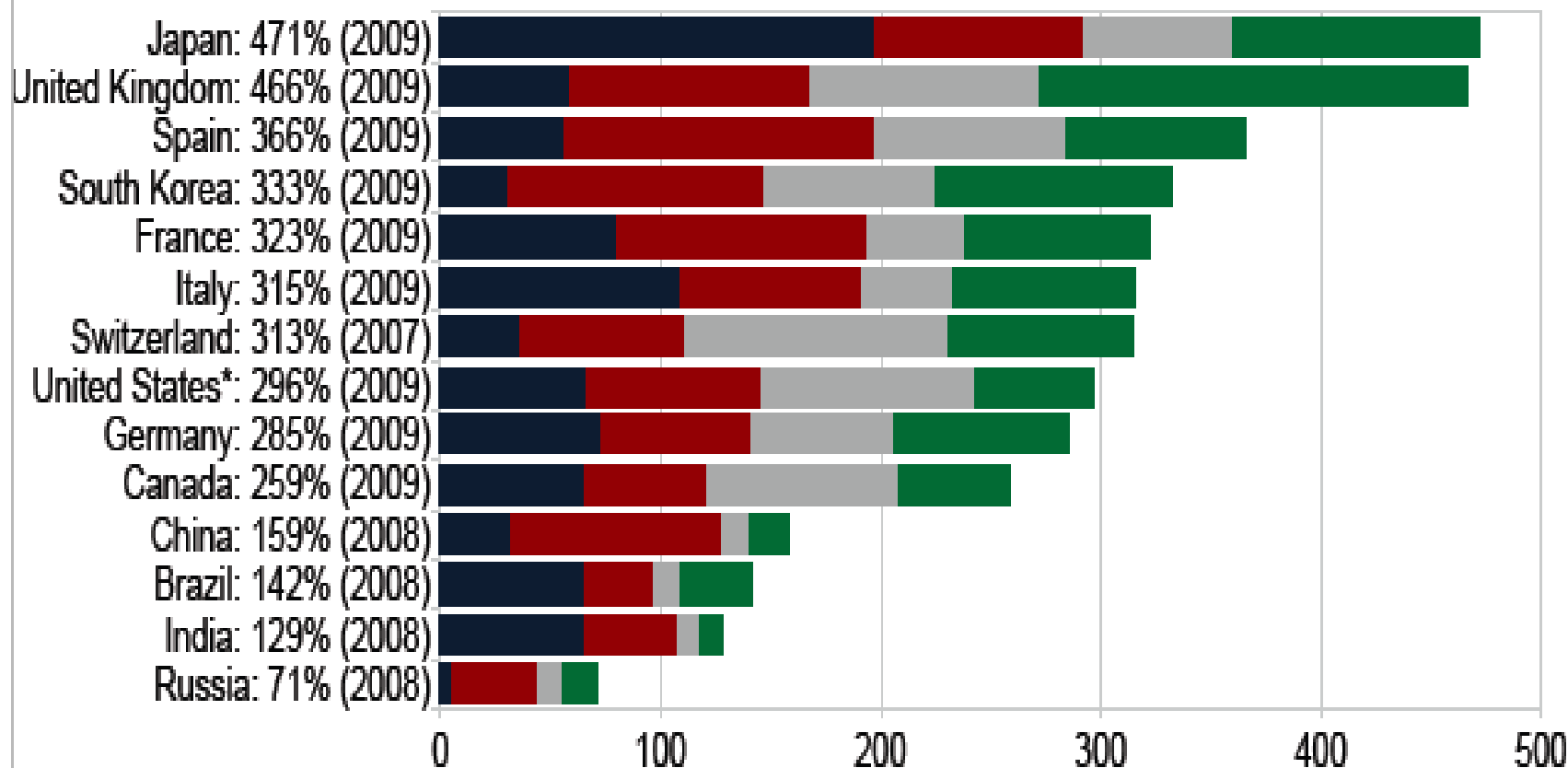
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Italy and Eurozone Stability



- Third largest sovereign debt market in the world
- Debt to GDP 120% (second to Japan)
- Highly vulnerable to escalating yields
- But (see graph) overall debt OK
- Household debt low
- Household net worth high
- Dynamic northern economy
- New government is highly competent
- The issues are political will and support from the ECB as implement reforms
 - Market sentiment and the equilibrium shifted dramatically in the summer of 2011
 - Even if reforms are likely to succeed, the rising yields could kill the benefits, and defeat the effort
 - Tension between political moral hazard and avoiding a very bad equilibrium outcome
- I will say more about this last part at the end

Total Debt in Selected Countries around the World, latest data available, as percent of GDP, by sector



Black – government

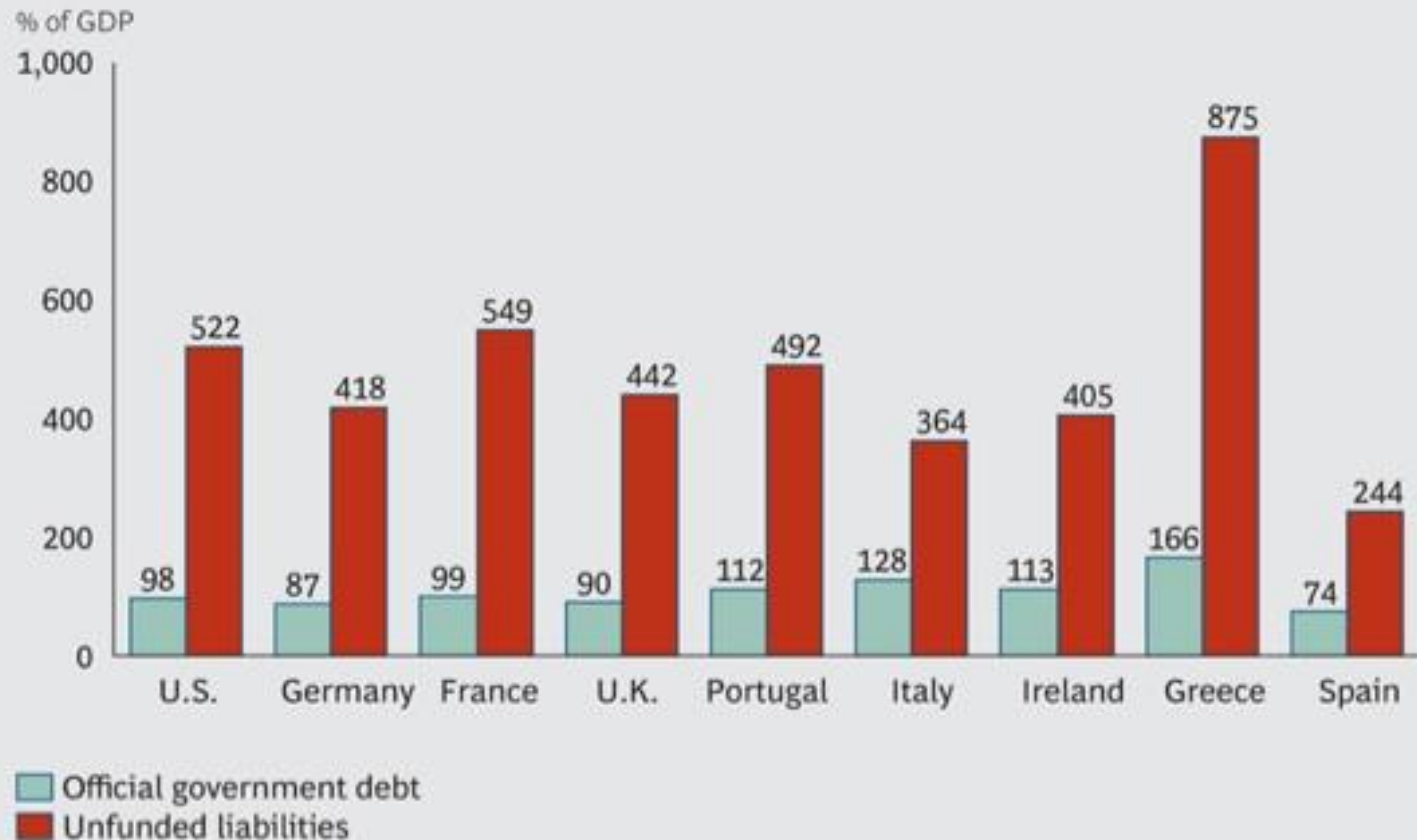
Red – non-financial corporate

Grey – household

Green – financial institutions

EXHIBIT 1 | Net Expected Tax Revenues Are Not Adequate to Continue Funding Current Social Policies

Unfunded liabilities and official government debt



Sources: Jagadeesh Gokhal, "Measuring the Unfunded Obligations of European Countries," 2009; OECD.

Note: Unfunded liabilities are the difference between the projected cost of continuing current government programs and net expected tax revenues. Government debt based on 2011 forecasts from the OECD.



% Job Losses
Relative to Peak
Employment Month

Percent Job Losses In Post WWII Recessions

— 1948 — 1953 — 1957 — 1960 — 1969 — 1974 — 1980 — 1981 — 1990 — 2001 — 2007

Source: calculatedriskblog.com
(11/04/11)



Employment in the US 1990-2008

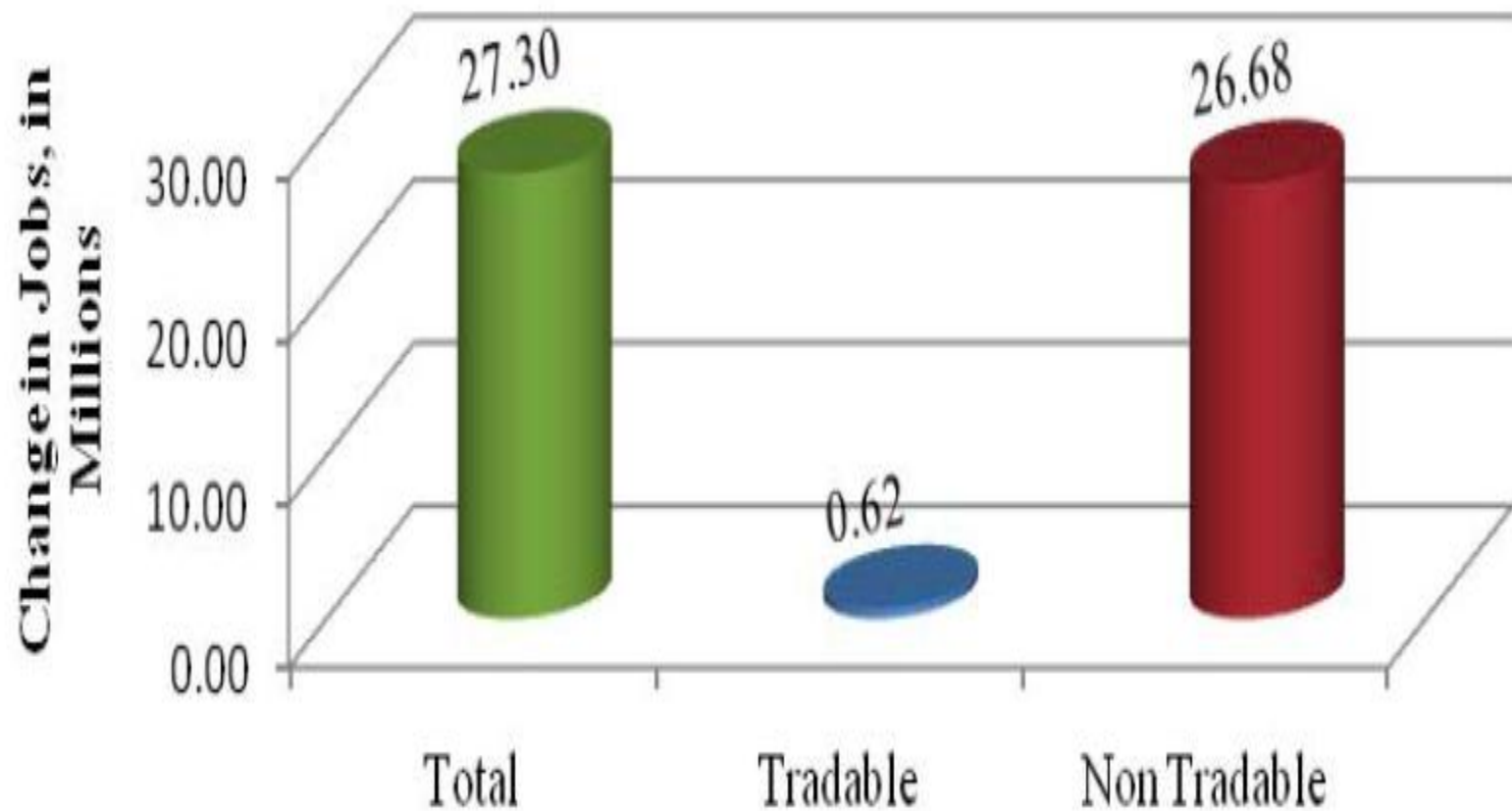
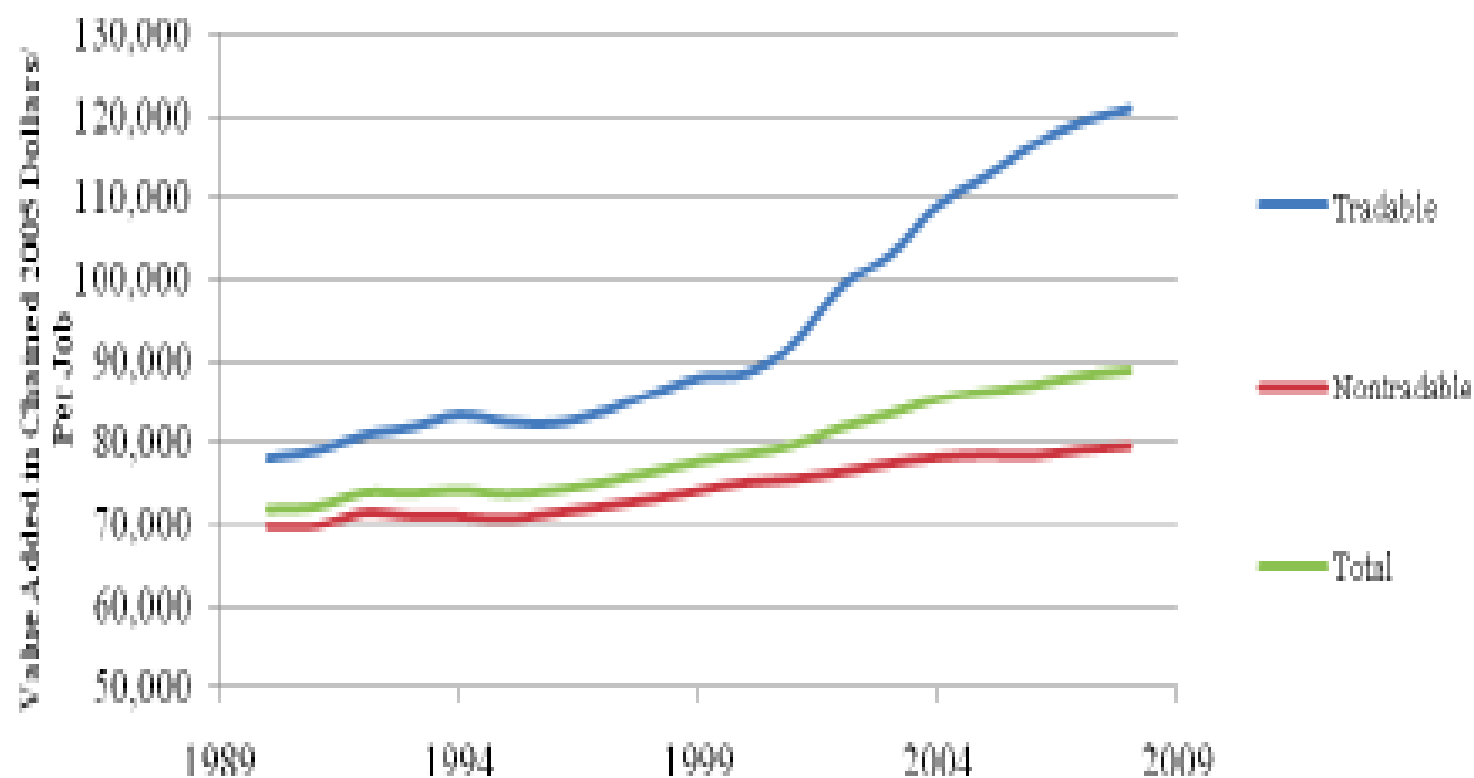
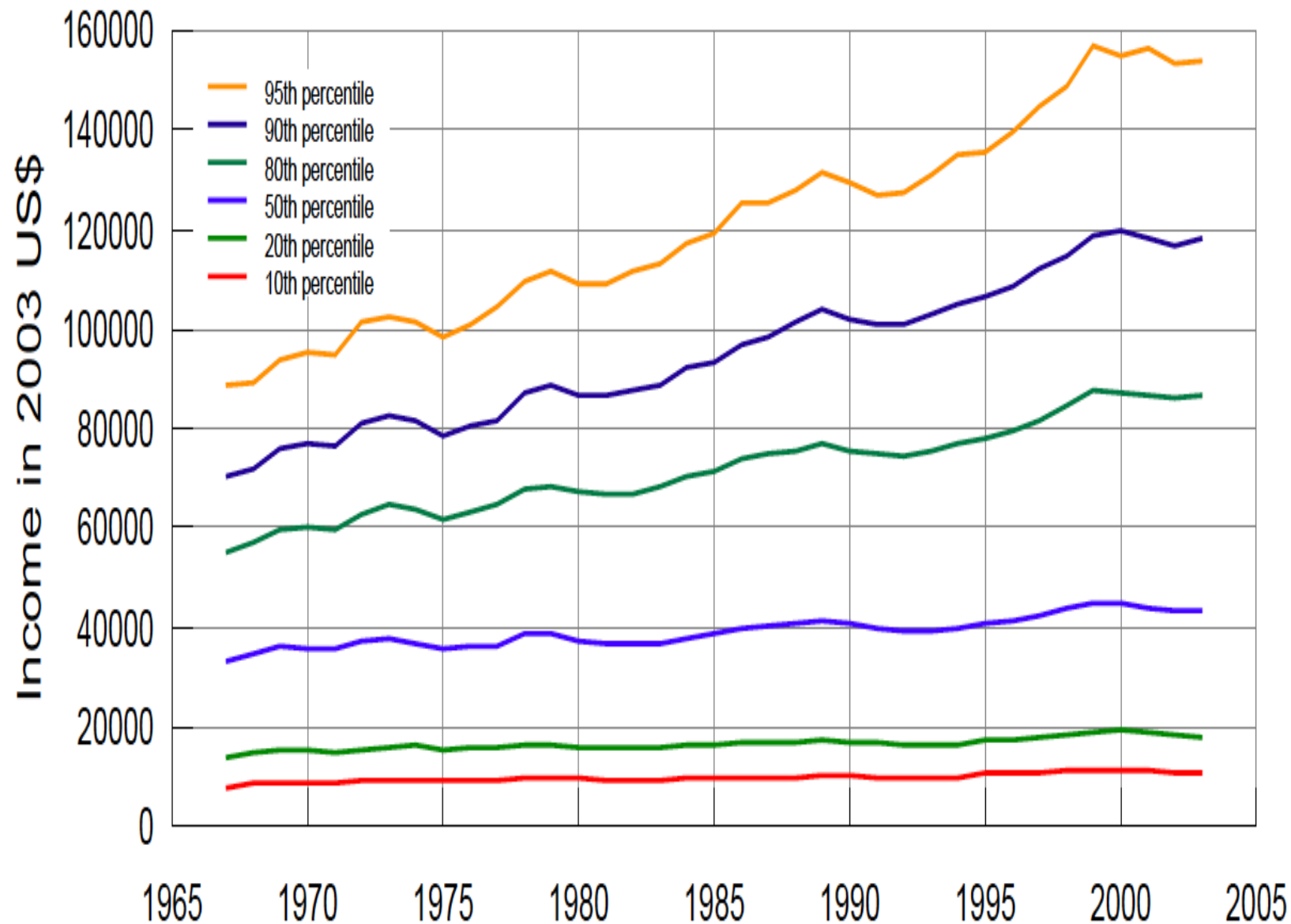


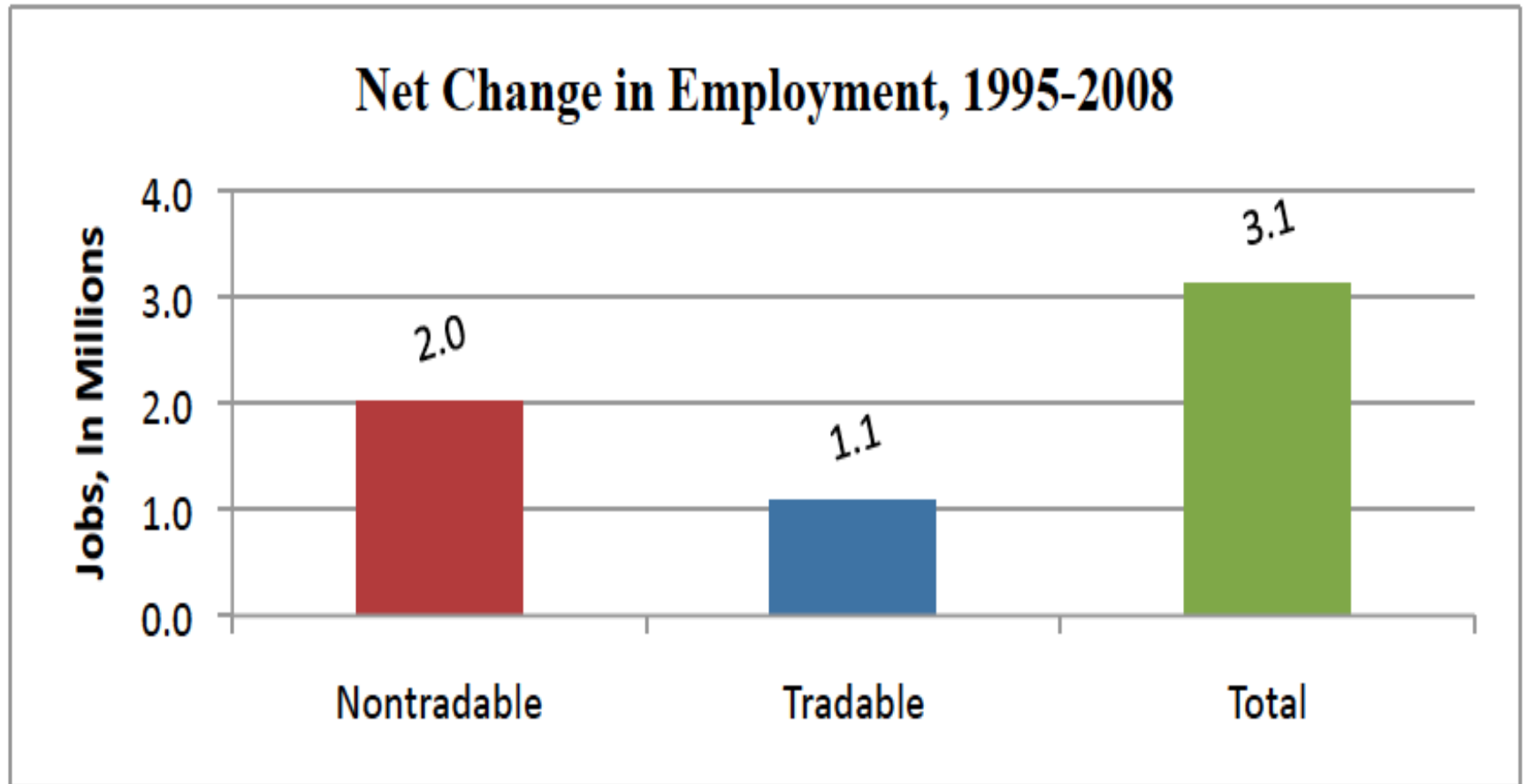
Figure 15. Value Added per Job, 1990-2008



Source: Authors' calculations using Bureau of Economic Analysis and Bureau of Labor Statistics historical data series



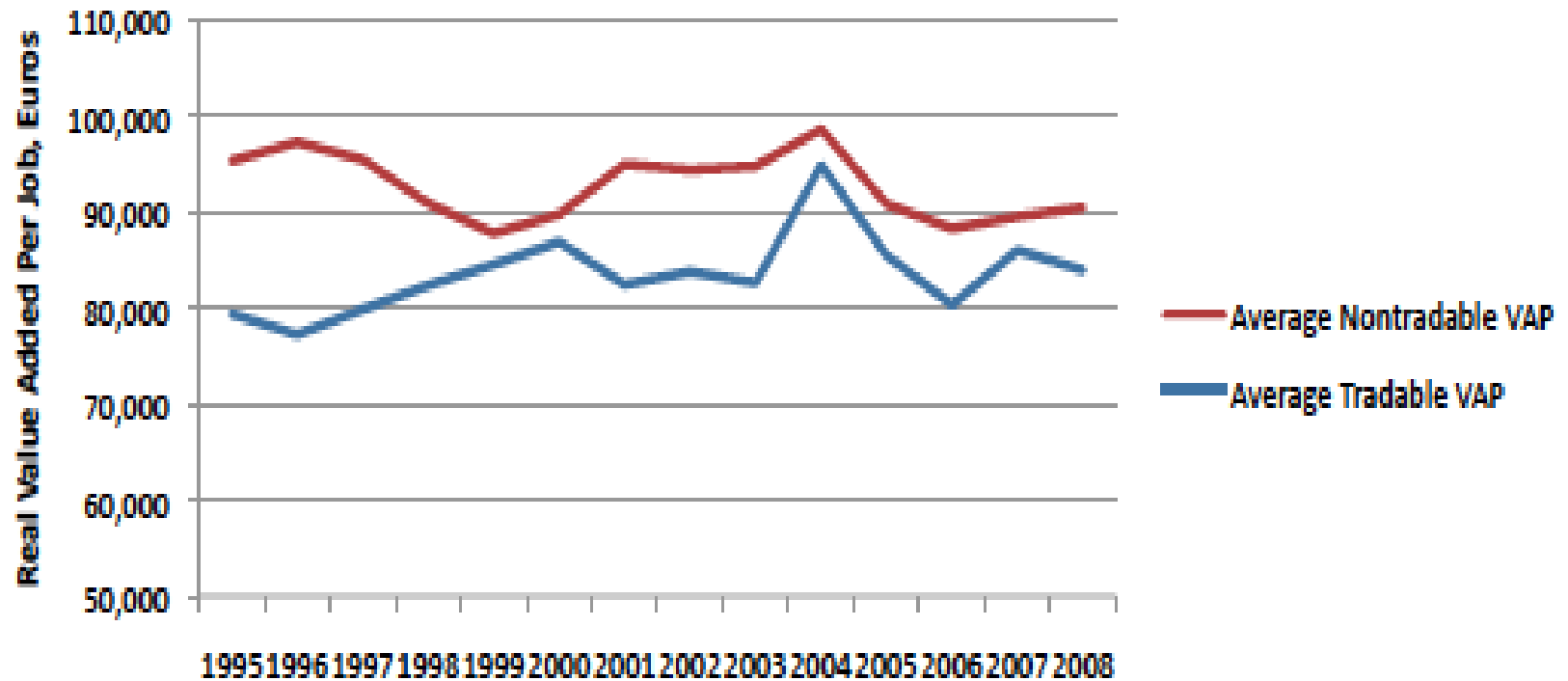
The Effects of Structural Reform in Germany



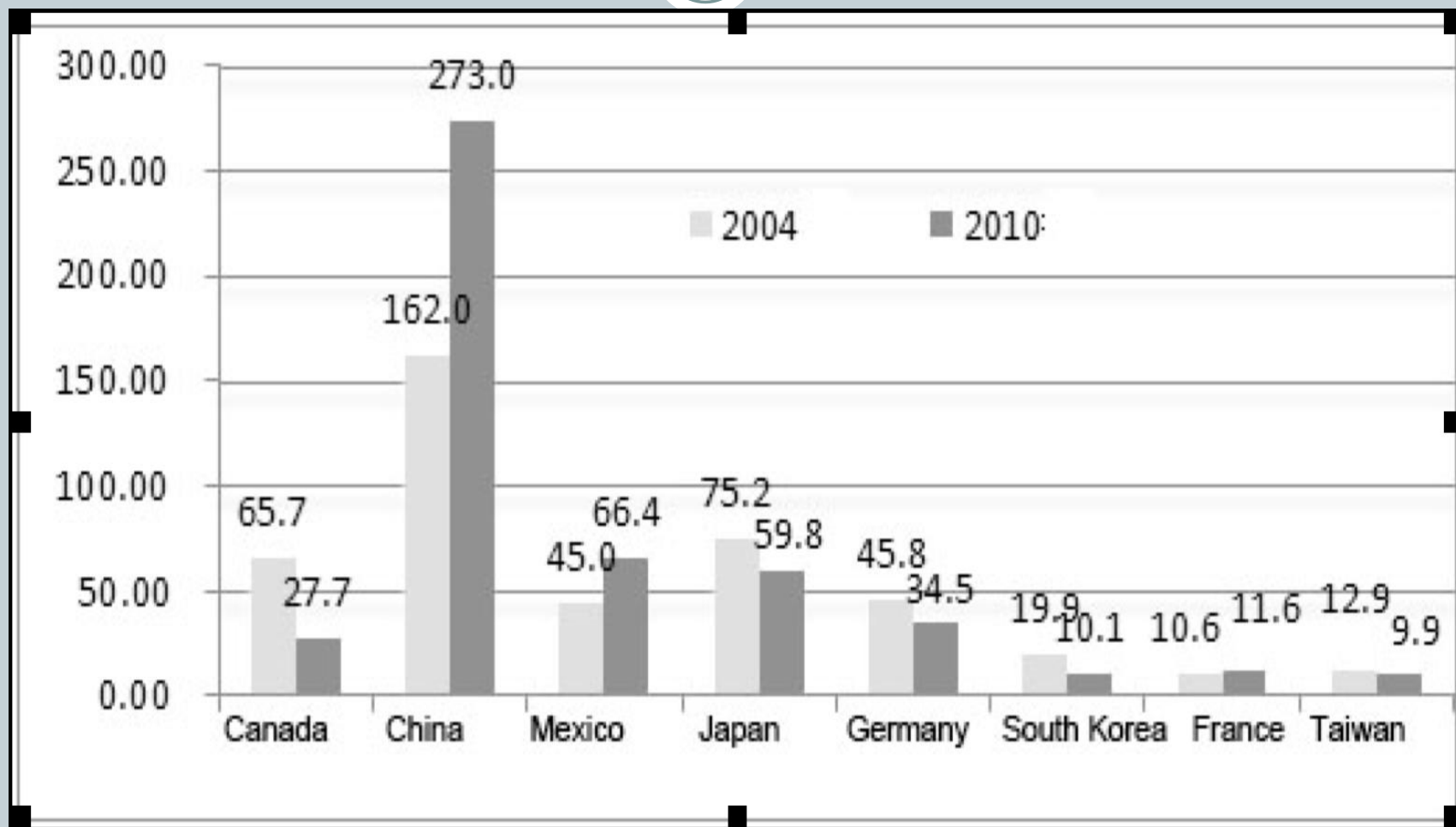
German



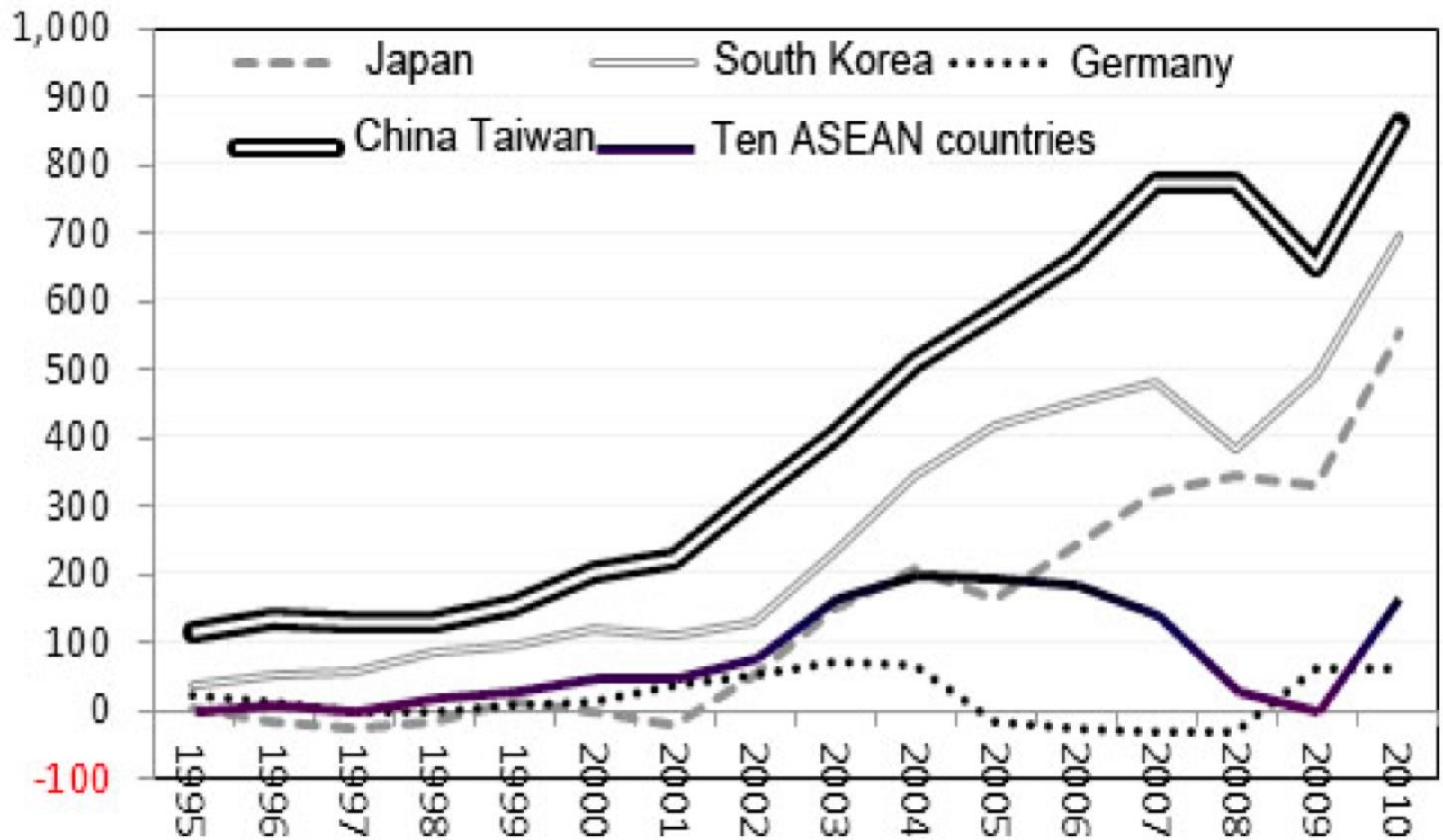
Value Added Per Job, 1995-2008



US Bilateral Trade Deficits



China Trade Deficits with Selected Countries

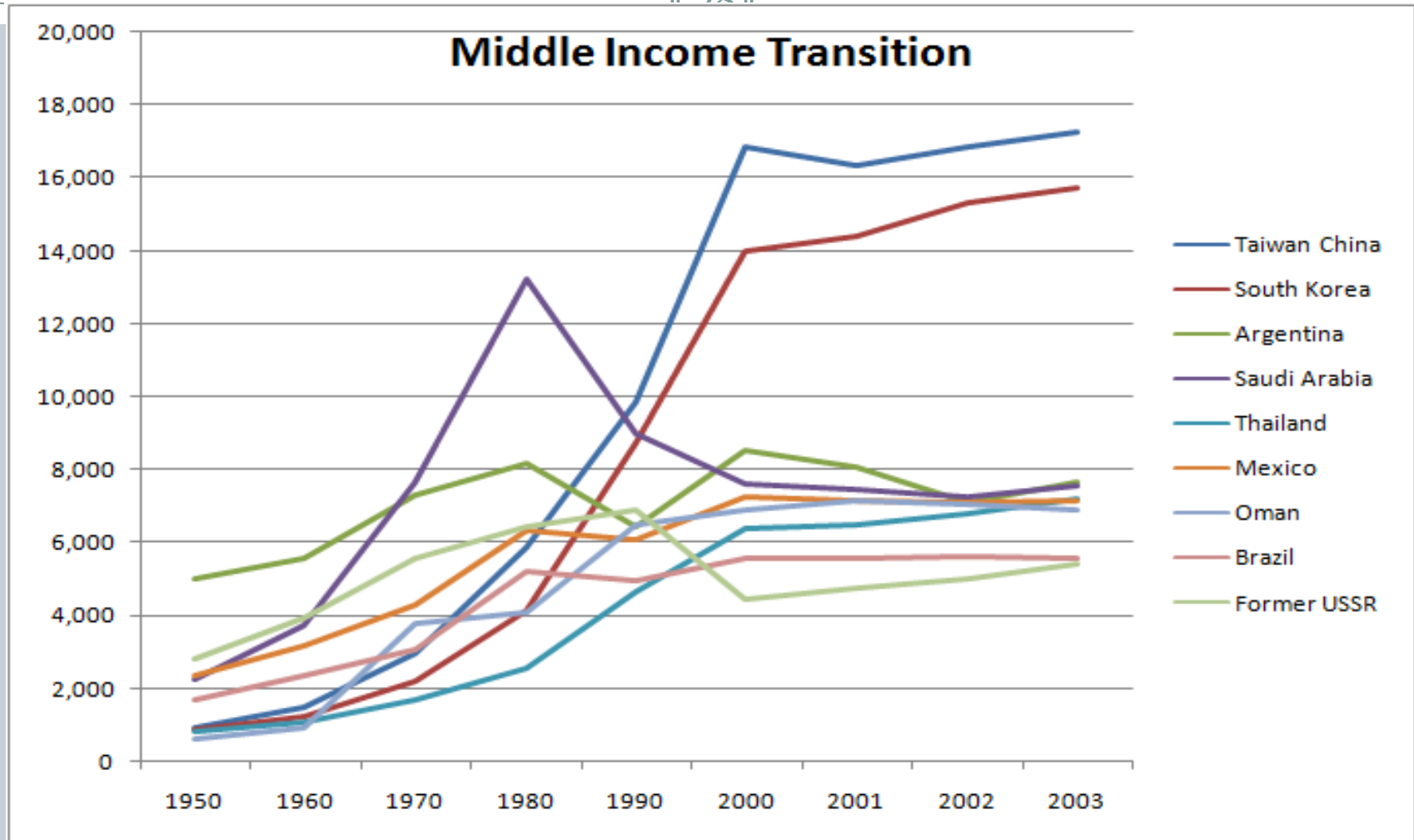


China is Entering the Middle Income Transition



- In a very fragile global economy with significant downside risks
- It is a complex set of structural changes on the demand and supply sides of the economy
- Driven by market forces
- And by government that changes its role to creating the hard and soft infrastructure that supports the market driven economic diversification and productivity growth
- Low value added labor intensive economic components of global supply chains will necessarily migrate to lower income countries
- It has been done before in other countries and it is not easy to sustain the growth

Middle Income Slowdowns are Common



Five High Speed Transitions

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- Japan
- Korea
- Taiwan/China
- Hong Kong/China
- Singapore

- None at China's scale

Major Structural Changes



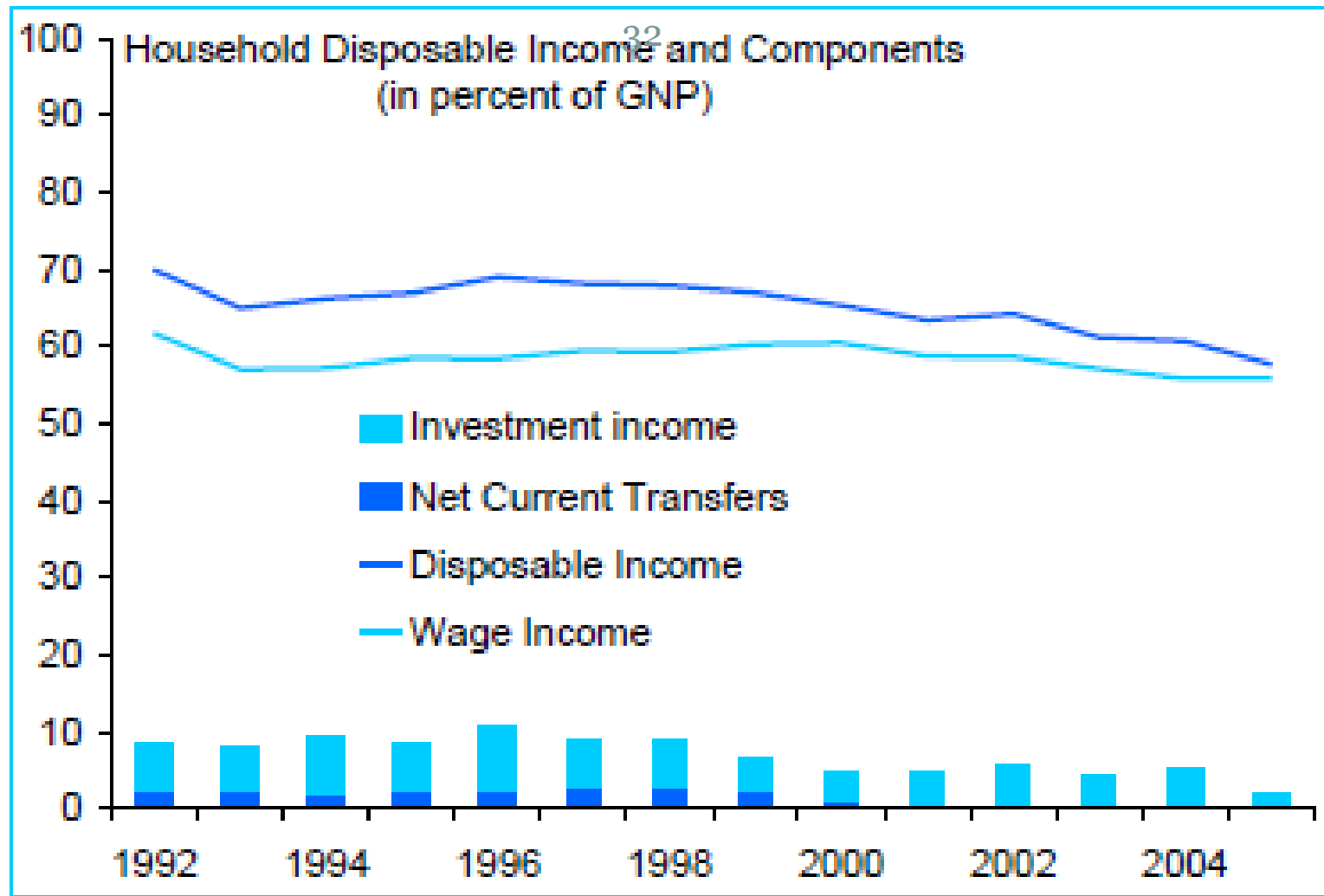
- Movement up value added chain to match income growth
 - The Smile
- Movement of labor intensive process manufacturing and assembly inland and eventually offshore
 - 85 million jobs
- Increases reliance on domestic demand (consumption and high return investment)
- Expanded role for markets and private sector
- Policy shift toward system reform and deepening the human capital and technology base of economy

Requirements are Understood and Embedded in the 12th Five Year Plan

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- Significant change in the investment system
 - Shift from investment led to rate of return led growth
- Shift in structure of income side of the economy – shift toward the household sector
 - The Lewis turning point
- Elimination of low return investment
- Market takes larger role in driving structural change
- Government role shifts to innovation and human capital investment and the knowledge and technological underpinnings
- Financial sector development to expand savings options and recycle savings to productive (high return) investment
- Corporate governance
- Expansion of social insurance and services – with a focus on inclusion
- Urban service sector needs to take over from labor intensive process manufacturing as main entry level employment engine

Disposable Income Declining as Percentage of GDP



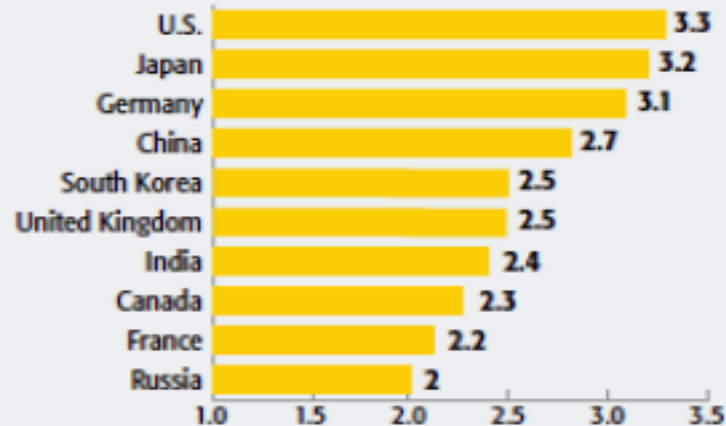
Graph 1: Labour Share in OECD Countries, 1960-2000



Labour participated fully in rising productivity in the pre-globalization era, but under globalization productivity gains and trade have first and foremost benefited capital - eroding labour shares in industrialized countries.
Source: Gasolina (2006), based on OECDSTAN database.

		INCOME OF THE RICHEST 10% OVER THE POOREST 10%	INCOME OF THE RICHEST 20% OVER THE POOREST 20%		
	COUNTRY			GINI COEFFICIENT	
	Australia	12.5	7	35.2	
	Austria	6.9	4.4	29.1	
	Belgium	8.2	4.9	33	
	Brazil	51.3	21.8	57	
	Canada	9.4	5.5	32.6	
	China (PRC)	21.6	12.2	46.9	
	Denmark	8.1	4.3	24.7	
	Finland	5.6	3.8	26.9	
	France	9.1	5.6	32.7	
	Germany	6.9	4.3	28.3	
	Greece	10.2	6.2	34.3	
	India	8.6	5.6	36.8	
	Israel	13.4	7.9	39.2	
	Italy	11.6	6.5	36	
	Japan	4.5	3.4	24.9	
	South Korea	7.8	4.7	31.6	
	Mexico	24.6	12.8	46.1	
	Netherlands	9.2	5.1	30.9	
	New Zealand	12.5	6.8	36.2	
	Norway	6.1	3.9	25.8	
	Russia	12.7	7.6	39.9	
	South Africa	33.1	17.9	57.8	
	Spain	10.3	6	34.7	
	Sweden	6.2	4	25	
	Switzerland	9	5.5	33.7	
	Turkey	16.8	9.3	43.6	
	United Kingdom	13.8	7.2	36	
	United States	15.9	8.4	40.8	

Perceived Country by Country Technical Strength (2010)



Perceived Country by Country Technical Strength (2015)



Source: R&D magazine, December 2010.

■ Figure I. ■

COMPARING COUNTRIES' AND ECONOMIES' PERFORMANCE

	Statistically significantly above the OECD average
	Not statistically significantly different from the OECD average
	Statistically significantly below the OECD average

	On the overall reading scale	On the reading subscales					On the mathematics scale	On the science scale
		Access and retrieve	Integrate and interpret	Reflect and evaluate	Continuous texts	Non-continuous texts		
OECD average	493	495	493	494	494	493	496	501
Shanghai-China	556	549	558	557	564	539	600	575
Korea	539	542	541	542	538	542	546	538
Finland	536	532	538	536	535	535	541	554
Hong Kong-China	533	530	530	540	538	522	555	549
Singapore	526	526	525	529	522	539	562	542
Canada	524	517	522	535	524	527	527	529
New Zealand	521	521	517	531	518	532	519	532
Japan	520	530	520	521	520	518	529	539
Australia	515	513	513	523	513	524	514	527
Netherlands	508	519	504	510	506	514	526	522
Belgium	506	513	504	505	504	511	515	507
Norway	503	512	502	505	505	498	498	500
Estonia	501	503	500	503	497	512	512	528
Switzerland	501	505	502	497	498	505	534	517
Poland	500	500	503	498	502	496	495	508
Iceland	500	507	503	496	501	499	507	496
United States	500	492	495	512	500	503	487	502
Liechtenstein	499	508	498	498	495	506	536	520
Sweden	497	505	494	502	499	498	494	495
Germany	497	501	501	491	496	497	513	520
Ireland	496	498	494	502	497	496	487	508
France	496	492	497	495	492	498	497	498
Chinese Taipei	495	496	499	493	496	500	543	520
Denmark	495	502	492	493	496	493	503	499
United Kingdom	494	491	491	503	492	506	492	514
Hungary	494	501	496	489	497	487	490	503
Portugal	489	488	487	496	492	488	487	493
Macao-China	487	493	488	481	488	481	525	511
Italy	486	482	490	482	489	476	483	489
Latvia	484	476	484	492	484	487	482	494

The Long Term Sustainability Challenge



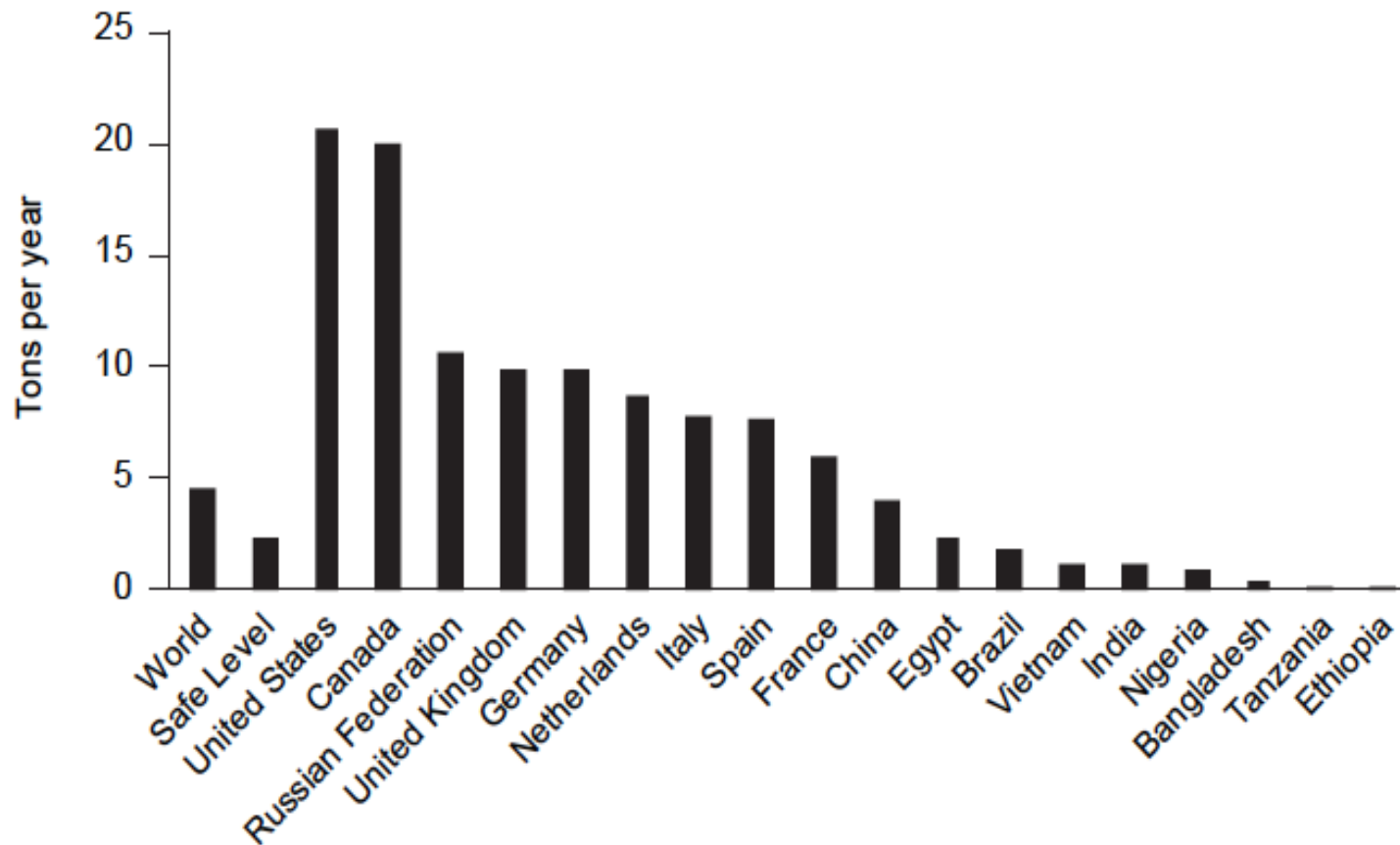
- Global economy will triple in next 25 years
- Most of the growth in absolute terms will be in Asia
- Asia contains the two future economic giants, China and India
- The natural resource base of the planet will not support this
- The old growth model will not scale
- Lifestyles and new growth patterns

Carbon Mitigation



"Sorry, Harold, but I'm reducing our carbon footprint."

Figure 1. CO₂ Emissions per Capita



Markets and the Evolving Role of the State



- **Market strengths**
 - Efficiency, innovation, growth
 - ✦ With qualifications for externalities, informational asymmetries and coordination/multiple equilibrium issues
- **Vulnerabilities**
 - Stability, equity, sustainability and structural adaptation
 - ✦ Networks and local optimization
 - ✦ Global labor supply and rising return to capital, including human capital
- **Substantial and Healthy State Balance Sheet**
 - Capacity to respond to shocks
 - Recycle income when distributional trends are adverse
 - Capacity to invest in structural change
 - Capturing some of the return on public investment in knowledge and technology base of the economy

Two Scenario World



- Signaling theory
- Endogenous expectations and multiple equilibria
 - Beliefs/expectations determine equilibrium outcomes
 - Not so much accurate as self-confirming in the context of the structure
- Example
 - If something triggers a shift in beliefs, the equilibrium can shift suddenly
 - Sudden shift in expectation around Italy and Spain
 - Migration of instability to eurozone core
 - Right now, institutional investors are placing increasingly restrictive guidelines on eurozone sovereign debt holdings, for asset managers, except for Germany
- Which equilibrium?
 - Linked to policy response or its absence
 - Hence to political functionality or distraction
- Uncertainty about that creates the two scenario case and bimodal distributions
 - Very difficult to handle from an investment point of view

Policy Frameworks



- Too narrow for the present stage of evolution of the global economy
- There are new structural issues domestically and internationally
- Frameworks need to be lengthened
 - Beyond the cyclical view
- And expanded to modify market outcomes and vulnerabilities
 - In the areas of stability, distribution, and identifying unsustainable patterns
 - Irony is that US needs to shift the balance away from consumption lead growth with underinvestment and China needs to do the reverse and avoid the low return investment trap