

POPULISM AND ECONOMICS

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Contents

<i>List of figures</i>	vii
Introduction: neo-Luddite discontents	i
1. Globalisation, technology and demographics	13
2. What is a savings glut?	20
3. Financial crisis as excess saving boosts debts	31
4. Savings glut hobbles recovery	36
5. Recovery recovers – but is trend growth slower?	44
6. Income distributed away from the lower middle	58
7. Keynes vs Friedman, the bogus dilemma	69
8. The failure of monetarist solutions	76
9. The folly of inflation targets	80
10. Inflation targets threaten boom–bust	82
11. Tax distortions and avoidance worsen the savings glut	86
12. Japan – fertile ground for populist revolt	89
13. Can China dodge the ‘middle-income trap’?	101
14. Euro Area – growing now, but still divergent	113
15. Will Britain muddle through Brexit?	132
16. Euro-populism – to worsen or to cure global imbalances?	144
17. Summary: Can/should the tide of populism be turned?	152
<i>Appendix 1: Time to switch tax from income to assets</i>	161
<i>Appendix 2: Time to limit limited liability?</i>	166
<i>Bibliography</i>	175
<i>Index</i>	177

List of figures

Figure 1	Gross world saving, % of GDP (GWP)	21
Figure 2	Japanese private saving, % of GDP	25
Figure 3	Japanese and Asian 'Tigers', current-account balance	26
Figure 4	EA current account balances, \$ billion	27
Figure 5	Shares of Chinese GDP, %	28
Figure 6	World gross saving and real US Treasury yields	33
Figure 7	US output/hour-worked, non-farm business, period averages, %	47
Figure 8	Growth of real net capital stock, % pa, 7-yr moving average	50
Figure 9	Gross world saving, excl. China, % of GDP	51
Figure 10	US real gross capex on construction, 2009 = 100	54
Figure 11	Tech-product price deflation – official estimates and revised view	56
Figure 12	Major countries' GDP and personal disposable income growth, per capita, pre- and post-euro	59
Figure 13	Gini coefficient of inequality, %	61
Figure 14	US mean household income by fifths	63
Figure 15	US median household income by educational attainment	63
Figure 16	Top 1% – income	65
Figure 17	Top 1% – wealth	65
Figure 18	Certain private and public flows, % of GDP, 2015	90
Figure 19	20-year averages of growth and capex	92
Figure 20	Japan: real FX rate and export market share	94
Figure 21	Export performance vs target markets, 1992 = 100	95

Figure 22	Real FX rates, 1973–2017 average = 100	96
Figure 23	Chinese growth slowdown achieved, but debt escalated	102
Figure 24	Chinese non-financial companies, net income as % of total assets	106
Figure 25	Chinese non-financial debt, % of GDP	107
Figure 26	Real GDP growth, % YoY, with TS Lombard recalculation	109
Figure 27	Steadily less reliance on monetary growth since the crisis, %	111
Figure 28	Current account balances, \$ billion	113
Figure 29	EA car sales, monthly	115
Figure 30	EA retail volume, 2010 = 100	115
Figure 31	North-central Europe (NCE) and other GDP, \$ billion, 2016 current prices	116
Figure 32	Real GDP, 2008 Q1 (pre-crisis peak) = 100	118
Figure 33	Relative unit labour costs, long-run average = 100	119
Figure 34	Labour-force growth, % pa, actual vs forecast	123
Figure 35	Savings-glut current accounts, % of world GDP	126
Figure 36	Real FX rates, producer-price basis, long-run average = 100	153

Introduction: neo-Luddite discontents

Here we are, a quarter-century after the ‘end of history’, contemplating a possible end to the new world order, while large swathes of middle-income jobs are being taken over by robots.

The decisive discrediting and collapse of communism in 1989–91, with the dissolution of the Soviet Union, appeared to sanctify the world economic order based on democracy and free markets. It left the United States as the sole effective superpower. A blend of capitalism and democracy seemed the ideal political and social system, ending ‘history’. Yet the resulting globalisation, with increasingly free worldwide trade and capital movements, and rising migration flows, was followed within seventeen years by the worst financial and economic crisis since the 1930s Great Depression (that in turn had spawned World War II). And that crisis is now followed by the apparent disavowal by the United States itself of the system in which it has been paramount.

Equally paramount have been US firms and interests in generating the hi-tech revolution that has during that same quarter-century transformed the way we all live, with great benefit to aggregate human welfare and potential. But hi-tech effects on jobs, lifestyles and the distribution of wealth and income have been an important source of US discontents – arguably more important than globalisation. As China develops its own tech sector, the role of hi-tech in undermining traditional jobs in advanced countries will increasingly

predominate over low-wage emerging-market competition. Nonetheless, hi-tech being home-grown for Americans, their politicians prefer blaming the rise of China, rather than hi-tech. Yet we are nowhere near the end of the story when it comes to jobs rendered obsolete by automation and robots.

What these discontents and problems should remind us of is not often raised in economic texts and analysis. Supposedly it was Winston Churchill (always a risky man to quote) who said: ‘democracy is the worst system of government – except all the others’. To this truth might be added: capitalism is the worst system of economics – except the alternatives. Crucially, both democracy and capitalism, as systems, come under the heading of ‘least bad’, rather than ‘best’ (or even particularly good). Seeking heaven on earth generally creates hell, as centuries of experience of religious and more recently communist rule have reminded us.

This book is chiefly about the problems that have arisen for the democratic parts of the world as a result of the peculiarities of global capitalism. To a modest degree it is also about what we should do about it.

Hi-tech and globalisation have reinforced one another. How could huge swathes of hi-tech jobs have been established in Bangalore, India (rather than the US), were not that same hi-tech available to transmit the services around the world? How could international supply chains be tuned up to the refined, ‘just-in-time’ discipline of modern production flows and supply chains without hi-tech?

This confluence of massive change has been completed by the global savings glut – more accurately, the Eurasian structural excess of saving in Germany, the countries surrounding it to the north, west and south, plus China, Japan and the Asian Tigers. This vast section of the world economy can only sustain its saving addiction if other countries or sectors run deficits and/or raise their debt levels. Both the financial crisis itself – and its successor, the euro crisis – as well as the sluggish subsequent global recovery, were clear results of

these deficits and debts. In the (non-)recovery, deficit-country belt-tightening reinforced the shortage of demand that is the very nature of a savings glut.

This book will describe how this turn of events arose, explaining and putting in context the discontents expressed by the Brexit vote and subsequent British general election, and the November 2016 election of President Trump. It continues from the series of books I wrote before, during and after the crisis, broadly relating it to global financial imbalances. But here we go beyond those earlier analyses by interrelating the effects of globalisation and its imbalances with the forces of technology – in both its beneficial and its threatening aspects – and demographic shifts.

Only by understanding the interplay between the four key elements – globalisation, technology, demography and imbalances – can recent events be fully analysed, and future consequences, along with desirable policy changes, be described. This book continues a series that started with the 2006 publication of *The Bill from the China Shop*, which detailed the meaning of the savings glut and forecast how the global imbalances it gave rise to would cause a US household debt crisis. That book dealt mostly with this fundamental cause of the crisis, rather than covering the financial shenanigans that were its contingent trigger.

The concept of a savings glut was aptly named in March 2005 by the US Federal Reserve's Vice Chairman, Ben Bernanke. I had introduced the idea earlier, in September 2004, referring to 'Eurasian saving excesses' rather than Mr Bernanke's 'global' glut. (It never has been global.) Aside from the name, my major difference with Bernanke was my forecast that continued excessive Eurasian saving could *cause* a US household debt crisis, as indeed happened in 2007–8. What is especially regrettable about Bernanke's failure to drive through to that conclusion in 2005–7 was that he could then have handled the crisis much better, from his vantage point as Chairman of the Fed (from 2006 – and before that Vice Chairman).

After an interim, mid-crisis look at the same issues in *China and America* (May 2008, pre-‘Lehman’), my 2010 *Globalisation Fractures* was a definitive analysis of both the origins and the effects of the imbalances. In 2011, *The American Phoenix* exposed the fallacy of widespread distortions arising from premature faith in China’s coming economic supremacy.

Do we now have to contemplate a possible retreat from globalisation itself, rather than merely dealing with its flaws? The neo-Luddites amongst those that voted for Brexit and Trump have been joined by a wave of populist voters in continental Europe. It is vital that the label ‘populism’ does not become a sneer. To be sure, demagogues have readily exploited widespread discontent with quack remedies. But centrist politicians and commentators have shown equally widespread lack of empathy with the legitimate grievances that underlie this neo-Luddism. The way combined globalisation, technology, demographics and financial imbalances are developing could only too easily aggravate neo-Luddism in future, as well as false ethnic and/or regional divisions.

The savings glut has continued to be a major cause of trouble. In Chapter 2 below, the meaning of ‘savings glut’ will be fully explained, as well as its strange form in today’s world. In no way is this savings glut a necessary (or natural) accompaniment of globalisation, nor is it even indirectly caused by hi-tech breakthroughs. But remarkably, the excess of saving well beyond the scope for needed or profitable investment in the world economy has not just played a major role in provoking the crisis itself (as detailed in my earlier books). It has contributed mightily to

- the poor recovery since the crisis, especially in 2011–16
- key aspects of the increased inequality of income that has accompanied and contributed to the weakness of recovery
- the apparently sharp supply-side drop in potential growth, as well as slower actual growth of Western economies

- the threat that current global financial imbalances may lead to a further economic downswing in late 2019 and 2020, reinforcing disenchantment with globalisation in a crucial US election year.

Combined post-crisis demand constraint, increased inequality, loss of jobs and professional pride as technology renders obsolete many traditional functions has already imposed huge strains. With slower potential growth in future years, this could continue to fuel the dangerous wave of political discontent threatening the world economic order.

One peculiarity is that discontent has been most vigorously expressed in the ‘Anglo-Saxon’ countries, the US and UK – yet these two countries’ people have had larger gains of real after-tax incomes this century than have the Japanese or continental Europeans. That these two countries have run the deficits and debt escalation that offsets globally the savings glut points to the latter’s central role in causing present discontents.

This book thoroughly analyses Japan’s economy, and its social and political ramifications. Likewise, it examines the euro area (EA), whose institutional flaws led to crisis in 2010–13 and drove out discussion of weak real income growth (even in the relatively successful economies like Germany). Political commitment to the euro has meant that shoring up the EA has had priority in EU councils over objective analysis of poor economic performance. The continental elections of 2017 have revealed deep discontent there too, without quite the disruption (yet) of Brexit and Trump. As for the United States, it is the one with the greatest increase of inequality in recent decades, and the largest disruption so far of traditional work patterns by hi-tech, suggesting diversity in the sources of neo-Luddite discontent.

The interaction of hi-tech and globalisation is complicated further by demography. For twenty-five years from 1990 the primary demographic point was that the rapidly developing and/or transforming ‘second world’ effectively entered the world economy.

This included the Soviet Union and eastern Europe, China (as it swung into a positive reaction to the near-fatal Tiananmen trauma) and India (which was abandoning the ‘Harrovian socialism’ of the Nehru dynasty dominated by unsuccessful academic development theories). This added 3 billion people to the 1 billion of the first world, with south-east Asia, the ‘Asian Tigers’, also enthusiastic participants. This massive surge in the supply of labour vis-à-vis capital, together with the peculiarity of the Eurasian savings glut, dominated the unstable economics of 1989–2009.

In the ‘third world’, with the Middle East undergoing its own traumas, Latin America remained a world on its own – with only the Mexican–US border to create first-world proximity – and Africa remained far from centre-stage, if not off-stage. But since 2015 Middle Easterners and Africans have engaged in major attempted migration to next-door Europe. While Europe’s reaction to this has not been quite as negative as Trump’s views on the Mexican border, the pressure of this very different group of left-behinds combines with Europe’s potential population decline to create potentially both major economic upside and serious social strain.

This story therefore concerns the interaction of four great forces – globalisation, demography, hi-tech and the savings glut – in generating first of all financial instability, but more importantly demand-side weakness, supply-side distortions and peculiarities, slower underlying growth in the West and greater inequality of income in all countries, though not in the world considered as a whole. The faster growth of poorer than wealthier countries has meant that *globally* the distribution of income has become more equal. Yet within virtually every major country, both rich and poor, it has become more unequal.

First therefore, this book will cover the parallel development of globalisation from the ‘fall of the Wall’ (1989) to 2016, and the emergence of rampant hi-tech with its disruption of traditional industries. We will then see how global imbalances gave rise to the financial crisis

of 2007–8, with the resulting Great Recession of 2008–9. Next, the continued distortion of global demand patterns by excessive saving is shown both to have hobbled the world's recovery from that recession, and distorted it towards seriously excessive dependence on dynamic but grotesquely unbalanced China. This demand-orientated analysis explains the bulk of what has happened in 2010–16, including the euro crisis, as well as what did not happen that should have.

But the parallel slide in the growth rate of productive potential is also partly caused by the savings glut. Record-high rates of global saving are mirrored by identical rates of investment. (At the global level investment equals saving by definition.) Normally, more investment means faster growth. Yet the growth of the real net capital stock in the US and Europe has slowed radically. While this partly *reflects* the sluggish recovery (itself a function of the savings glut), it also *helps to slow* potential growth, as capital input is a major supply-side factor generating potential growth. (As with much of this introduction, this summary statement is more fully argued in later chapters.)

How do we explain the paradox of inadequate US and European investment alongside recent record global ratios of capital spending (capex) to output (GDP)? The answer lies partly in the 'crowding-out' of Western investment by China's exorbitant and wasteful capital spending, averaging an inordinate 46–7% of China's GDP in the eight years 2009–16. This has undermined existing industrial capacities worldwide and has slashed the return on capital globally. The crisis and weak recovery had anyhow created a Keynesian liquidity trap, where the rate of interest that would induce recovery was well below zero. China's downward pressure on the return to potential new investment operated in parallel with and contributed to the collapse of interest rates, both nominal and real. So advanced-country capex, already depressed by the 'liquidity trap', had its potential profitability further eroded.

Excessive Chinese capex partly reflects the over-investment and

relatively low return on capital typical of Pacific Rim countries for much of the post-World War II period. But it also arose as China in the financial crisis responded to the collapse of its export-led growth model not by reducing its absurd national savings rate of 50% of output, but by stepping up even further its domestic capex extravagance.

Slower potential growth results from a number of causes – the savings glut is one amongst many. Slower growth and slower productivity gains are functions of globalisation – as massive expansion of the world supply of cheap labour naturally tends to expand low-income, low-value jobs – of different countries' population shifts, and of other country-specific behaviour patterns or policies.

In all probability, the measurement of the benefits of hi-tech to the real economy, and particularly consumer welfare, is in any case understated. This reduces the significance of the growth slowdown, but increases the importance of rising inequality. Widespread fears of, or excitement about, such phenomena as self-driving cars, and the huge changes in production and consumption patterns arising from the internet and other hi-tech developments, are not only deployed as explanations of output and productivity trends. They also are credited with undermining conventional output measures – with more and more convincing evidence that the true value of economies is increasingly understated. Hi-tech frequently increases inequality in the very process of advancing the economy.

These thoughts are prime reasons for comparing the current hi-tech breakthroughs with the original Industrial Revolution (1780–1830, say), in which the lift-off from millennia of broadly unchanged average mass incomes started with a gigantic accumulation of capital by the rich, while the condition of the bulk of the population arguably worsened for fifty years – hence the original Luddites.

Increasing inequality of income distribution has worsened economic performance in some respects, as well as aggravating social tensions for much of the past twenty years. A worldwide tendency has been the build-up of business savings rates – depreciation

reserves and retained profits. This has been a major inhibition of demand. It has not necessarily raised inequality of wealth or income between *people*, as the immediate alternative to such retention of profit is its distribution as dividends, and the value of the shares held tends to be unaffected by such distribution decisions. Meanwhile, higher retained profits mean a lower rate of distribution, which *reduces* inequality of incomes in the short run.

As explained below, however, whereas excessive retention of profit appears to be simply a cultural norm in Pacific Rim economies (China, Japan and Korea), amongst US and European companies it is closely associated with tax avoidance, which clearly has contributed to greater personal inequality.

Corporate income retention thus breaks down into two separate phenomena. The more important is huge, bottled-up saving of corporate business in Japan, Korea and increasingly China, where capital market disciplines are weak or non-existent for correcting poor business management and the hoarding of unneeded cash. But alongside this, corporate tax structures in many Western countries have led to hoarding of cash in tax havens, when the economy would be better served by its distribution, either as dividends, after payment of tax due, or as repurchase of stock. Analysis of inequality, therefore, has not only to examine the effects of interpersonal inequality, but also the division of income between companies and households, both considered collectively.

After this three-part survey of the global issues – demand-side, supply-side and distributional – the particular contribution to current discontents of individual countries will bring the analysis into focus in relation to the historic, social and political forces at work. This starts with Japan, ‘first mover’ in the economics of decline, and then China. The last of the savings ‘gluttons’ is continental Europe, which has slipped into the role almost by accident, through the malignant effects of European monetary union foolishly yoking together highly disparate countries.

The international policy context has been over-emphasis on monetary solutions to economic problems. So-called 'Keynesian' policies were discredited by the great inflation of the 1970s. Beneficial structural, supply-side reforms meet political resistance, as they tend to be painful for key interest groups. The result has been undue dependence on central banks, and this has been damaging in a number of ways. It has contributed to the increasing disaffection of middle-income, 'working-class' voters that was a big source of 2016's UK Brexit vote and the election of President Trump in America.

In principle, demand stimulus by purely monetary means operates to a great extent through boosting wealth, almost inevitably raising inequality – of wealth at least, and subsequently income. By contrast, fiscal stimulus would add political and distributional factors to the policy decisions. Also, over-reliance on monetary rather than fiscal stimulus has been inherently less effective in spurring economic recovery in a deflationary global context.

One immediate problem facing the world is that the search for a rules-based monetary policy – inflation targets for the most part – has become perverse or even self-defeating (as happens in time to most fixed rules). Partly through the weakness of the past ten years' growth, and partly through the supply-side deflationary impact of hi-tech, the natural rate of inflation would appear to be roughly nil in the United States, continental Europe and Japan (see Chapter 9).

Yet central banks are persevering in trying to raise it to 2%. In the process they are boosting asset prices further – further aggravating the inequality of wealth. And if successful, they could provoke a surge of inflation that may well blow through the 2% targets and be followed by a relapse into recession that will be squarely the responsibility of the central banks. What authorities will we respect then?

Lastly, the analysis in this book will attempt to describe what needs to be done to solve the problems described here, as well as what realistically might be done in the likely economic context of the next couple of years. Economic growth since 2009, though

weak, has created one of the longest up-cycles on record. How will it end, and how will we cope with it ending?

*

The original Luddites (1780s to roughly 1810), though energetically supported in their day by Lord Byron, have had a bad rap from economists (as well as the then establishment, anyhow no lover of the great poet). As a general historical matter, giving free rein to technical gains and international trade has vastly improved the living conditions of *everybody* over the long term, including the poorest. But both at the time of the original Industrial Revolution and to some degree in our present era of globalisation and hi-tech transformation, large groups of people – the ‘left-behinds’ – had or have their lives blighted or even ruined by these forces of general progress.

Is/was Luddite behaviour – originally, smashing the machines – a justifiable reaction to this?

Economics is not such a narrow, technical subject as is sometimes said, and neither is it a province of purely utilitarian materialism. Welfare economics is not a branch of left-wing political thought, but simply an attempt to achieve the best *entire* consequences of an action, or policy, or situation. This requires more than some utilitarian ideal of the greatest aggregate benefit for the greatest number of people. Optimal welfare at least requires that changes to the disadvantage of some people, but with overall benefit to the population as a whole, should be accompanied by some compensation for the losers – though probably not full compensation. And if the pace of disruptive economic and/or social change is excessive, this can arguably be a bad thing, even if the changes are ultimately desirable. Judging what is excessive is, of course, the key.

The original Luddites lived in an era when there was no

compensation for the losers. Their skills were rendered obsolete by newly developed machines that were typically operated by fewer, less skilled workers (sound familiar?). When Lord Liverpool was Britain's prime minister (1812–27), in the difficult period after the Napoleonic Wars, fears of insurrection along the lines of the French Revolution led to repressive social policies that even the far from politically ardent Jane Austen drew attention to. *Habeas corpus* was temporarily suspended in 1817.

The British army had before that crushed the Luddites. But with difficulty. The number of soldiers fighting them at one time exceeded those fighting Napoleon's armies in the Peninsular War (1807–14) – the phase of the Napoleonic Wars that secured the emergence of Wellesley, later Duke of Wellington, as Britain's leading soldier. This is a fair indication of the strength of feeling that uncompensated loss of livelihood can induce.

A major difference between 1780–1830 and today's discontents – aside from the much nastier ordinary condition of so many people's lives back then – is today's universal suffrage. The concentration of wealth during the eighteenth century had seriously shrunk the size of the electorate – votes being obtained by dint of property qualifications. Britain's Great Reform Act of 1832 mostly just eased the property qualification; it fell far short of introducing universal suffrage, even for men. Indeed so shrunken was the electorate by land enclosures during the eighteenth century that even after the 1832 reform the electorate was only raised from 500,000 to 800,000, and from a little over 3% of the population to about 5%.

By contrast, the two original modern democracies, the United Kingdom and the United States, have recently engaged through the ballot box in what appears to have been (amongst other things) a collective neo-Luddite revolt against recent radical transformations of Western market economies. These transformations also, as it happens, have involved a major concentration of wealth, if not quite as extreme as in the eighteenth century and the early nineteenth.