Big Shifts in the Global Economy

Speaker:
Professor Michael Spence

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Transcript

Professor Spence, winner of the 2001 Nobel Prize in Economic Sciences, has just published *The Next Convergence: the Future of Economic Growth*, which examines how emerging economies are reshaping the global economy and the international order.

Justin Yifu Lin, Senior Vice President and Chief Economist of the World Bank, described it as one of the most profound analyses of the new world economy yet written, while Mohammed El-Erian, author of When Markets Collide, called it the best book he had read on today's epochal economic transformations..

Moderator: Professor John Daley, CEO, Grattan Institute
Speaker: Professor Michael Spence

AUDIO: This is a podcast from Grattan Institute, www.grattan.edu.au.

JOHN: Good evening ladies and gentlemen. My name is John Daley. I'm the Chief Executive of Grattan Institute and it's my pleasure to welcome you here to this event tonight at the University of Melbourne. If the first thing I could do is ask those people, particularly in the back third of the room, if you could perhaps shuffle up to the end. As you can see this is at the moment a relatively crowded theatre. Inevitably we will have a few people who arrive late and if people could shuffle up a little so that those people can get in, that would be much appreciated. So if I can ask those particularly towards the end up the back if you can shuffle up, that would be much appreciated.

It's our great pleasure this evening to welcome you here to the University of Melbourne. Our thanks obviously to the University of Melbourne for the loan of this theatre. The University of Melbourne is one of the founding members of Grattan Institute, along with BHP, the Victorian Government and the Commonwealth Government.

It's our privilege this evening to welcome Professor Michael Spence. Professor Michael Spence did his first undergraduate degree at Princeton. He then studied at Oxford, which is where I studied. His education then went downhill and he went to Harvard. And after about 10 years or so of higher education, he obviously learned a great deal. Indeed it occurred to him that one of the major reasons that people went to university was not so that they could learn anything, but so that they could show future employers that they were worth employing. And this signalling insight, unfashionable as it is to point it out in a large university like this, is what, amongst many other things, won him a Nobel Prize for economics in 2001.

Not content with one substantial contribution amongst many others to the field of economics, he then chaired a Commission on Growth and Development, an international commission of economists around the globe, looking at what it was that really made a difference to growth, what it was that drove growth in both developed and developing economies. He also embarked on a quantity of academic research looking at the shifting shape of economies in both the developing world and the developed world, as well as trying to understand what it was that governments did or didn't do, what it was that businesses did or didn't do that led to that kind of growth. And I think it says a lot about the kind of person that Michael Spence is, that not content with writing that up in places like foreign affairs or the various other places, he wrote it up into a book, *The Next Convergence: the Future of Economic Growth in a Multi-Speed World.* And for those of you who are interested, there are copies available at the rear at the conclusion of tonight's event. So he's someone who is uniquely well qualified to talk to us in a world which is clearly changing very, very fast. We didn't engineer the gyrations in the world stock market last week purely to generate interest in this talk, although that was one of the motivations for doing so. But they illustrate the fragility of the world we live in, the way that that world is ever more interconnected, the way that the relationship between the developing world and the developed world is an increasingly complex one, and what happens to our economy, to our society is very much influenced by what happens in developing worlds and economies and societies.

Professor Michael Spence today holds appointments in Milan, at Stanford University and at New York University. We are extremely privileged to have him here this evening and I'd ask you to welcome him here this evening. Thank you.

MICHAEL: Good evening ladies and gentlemen. It's a pleasure and an honour to be here. I'm slightly jet lagged, but I think I'm okay. And I'd like to devote a few minutes now to talking about the book I wrote and the evolution of the global economy and speculate a little bit about the future.

John mentioned I chaired a commission for four years on development and growth in the developing countries. I worked with a group of very senior experienced political and policy leaders from developing countries, mostly they're enormously impressive people and I learned a ton of things from them about what this means and how it's done. And the way I framed it in the book is something like this. If you go back in history, with the help of Angus Madison who studied these things more carefully than most people, what you discover is that up until about the middle of the 18th Century, there was … by modern standards there was relatively little growth in the world. Societies consisted of people who were mostly relatively poor, living in what we would now call traditional sectors. There was a small commercial class but mostly there were wealthy people who combined the wealth with power because that's the way the world worked. And they fought with each other and there were important changes. There were scientific advances and so on. But they didn't show up in the performance of economies until the British industrial revolution. And then there was a major, major inflection point. And for reasons that people still study, there are literally thousands of books written about this, we embarked on a 200 year journey in which 15% of the world's population started to experience increasing incomes and wealth. And that period ended after World War II. What happened to the other 85%? Not much. Their lives didn't change. They are the occupants of what we call the developing world, now roughly five and a half billion people.

And then the world changed again. And I think we understand that part better, that after World War II some very wise people in the advanced countries decided not to repeat the enormous mistakes of the post World War I period, the crushing of the vanquished and so on. And so they started to build what they hoped would be a much more inclusive, prosperous global economy, what we came to call a global economy. And they did that in two ways. The main one was to start to open the global economy and I guess the primary purpose was to facilitate the post war recovery of Japan and Germany and others. But it has the ancillary side effect of bringing the developing world into the global economy. And at the same time, perhaps fortuitously, perhaps inevitably, the colonial empires that had been hanging on up through World War II essentially collapsed. And so the built in asymmetries associated with those colonial empires were abolished.

And then another follow on to those 200 years of technological advance and growth, just an enormous tailwind from technology, from information, transportation and so on, technology, and you put those all together and you created an environment in which the first … for the first time these developing countries could start to grow. And they did, slowly, with lots of false starts, but accelerating and with the arrival of China and then India in the last 30 years we have the two future economic giants.

A fair amount of the book is devoted to how does this growth work. Most people in this room have not lived in an environment in which the economy's growing at 10%. That 10% per year growth, you double every seven years, in size and incomes and so on. It's a very chaotic, complex, uncomfortable process but it does make massive differences in peoples' lives. Even at those growth rates, a country going from poor to the lower end of the advanced income scale, the OECD countries, will take a minimum of 50 to 60 years.

So the way I framed this is we started that journey without really knowing, frankly, at the end of World War II and we're a little more than halfway through a century at the end of which we'll have something on the order of 75, maybe 80, maybe even more per cent of the world's population who live like we do in the advanced countries. How does this growth work? Well, there's a complex story and you'll be very happy to know I don't propose to tell it to you tonight, but I thought people would be interested. And the key ingredients I will just simply mention are, one, knowledge transfer. It's often ignored in economics, but what really happens is that that enormous gap in knowledge, technology and productivity that developed in those 200 years, started to close not on auto-pilot but because that technology and know-how started to get transferred through multiple channels into the developing countries, increasing their productive potential. So that's enabling item one.

Advanced countries grow by building the new technology and sharing it. And we grow on average at two and a half per cent in real terms. Not now, unfortunately, and I'll come to that in a minute, but on average. Developing countries are in catch up mode in this dimension. The other critical thing about the global economy is that for most countries for most of this long journey to … from relatively poor, through sustained growth to advanced country status, they're small in relation to the global economy. That means basically that they can grow at almost any speed you can imagine and not really make a dent in the global economy. If you have 5% of the world's market share, and you grow at 20% and nothing happens outside, meaning the global economy doesn't grow, you have 6%. So what? So what feels like enormous growth in the developing world doesn't really have a big impact on the global economy in terms of prices. And so you have these two enabling conditions. One is rapid in-bound knowledge transfer and the second is the ability to grow more or less as fast as you can invest. And that's the third key ingredient. The countries that succeed have two crucial characteristics: they are governed well, and I think this is a very general principle; and the failures, and there are many, are most often, not always but most often a failure of governance, in some form or other. A country whose governing elite essentially doesn't care, is pursuing some other objective, usually more self-interested, is corrupt in a destructive way. And the second one is under-investment. It takes investment rates on the order of 25 to 30% of GDP to sustain these kinds of growth rates. And in a poor country, not spending on today's needs, something approaching a third of your income is a major, major inter-temporal choice. And so people hear the statistics and they say oh that sounds interesting. But what it means, what it really means is if your per capita income is $400, or your family income is $400 a year, you're not spending $130 of it on yourself. That means you've got 270 left. And yet that's what these countries in high growth mode are doing. Now it gets easier as they get richer, but that's the other key ingredient.

Where are we now? I think we're at a crossroads in the global economy. The developing countries are within a very small number of years of passing 50% of the global GDP. It's pretty clear now that China and India will be the future economic giants. The dominance that the United States and to some extent Europe has enjoyed is going to vanish. China's the second largest economy in the world. Asia has 60% of the world's population. The global GDP is about 60 trillion dollars. It will double and probably triple in the next 20 to 30 years, putting massive pressure on the earth's natural resources to the point that these developing economies are basically are starting to realise they cannot use the old growth model in the way it uses natural resources. It simply doesn't add up. And so one of the challenges they face in completing this journey, along with all the rest of us who live on the same planet, is inventing a growth model that makes a very different kind of use of natural resources, including energy, in order to get there.

There are lots of challenges associated with the rest of this journey. One of them is governance. We have countries that now, and this is honoured in the sudden change to the G20 from the G7/G8, that need to be part of maintaining global stability and participants of global governance. It's an interesting process to watch actually. I spend, as I think John mentioned, a fair amount of time in China, trying to be helpful when I can. I find it fascinating to see a country of 1.3 billion people growing at 10% and sort of managing that process with lots of challenges including lots of future challenges. But China has a per capita income $4,500, and they're systemically important in the global economy. That means they have global impacts and global responsibilities. That's never happened before. There's never been a country that, you know, had global systemic importance at anything like a $4,500 income per capita before, 'cause there's never been a country of 1.3 billion people in high growth mode. And so China's wrestling with this, among other … among many other things, this balancing act of sort of with one group internally saying oh look, you know, it's way too early for us, we'll just pay attention to the domestic growth and development agenda, and another group saying no, we can't do that actually, it's unfortunate, there isn't any historical precedent for this, but it's in our interest to focus on this.

India is kind of amazing. It's 13 years of high growth, you know, eight, nine per cent, behind China. That's a big difference in income, you know. Probably somewhere between $1,500 and

$2,000 versus $4,500 to $5,000 now in China. Those are not adjusted for purchasing power. But India with its complex democracy and lots of challenges on the public investment front, which is crucial to sustaining this kind of growth, seems to be in high growth mode. Brazil took a sabbatical. Brazil is one of the countries that has grown at 7% a year for 25 years or more. I talk about this in the book. So we did it in the Growth Commission as a way of kind of getting at what … how this kind of growth works. And Brazil's one of those countries, in fact, it's one of the two early ones in the post war period, along with Japan, and then followed by Korea, Taiwan and a host of other countries, including Botswana, a little country in southern Africa that is a workable democracy on the border of South Africa. But anyway, they … Brazil then essentially stopped around the mid '70s and took a 25 year sabbatical from growth. And then under the leadership of Presidents Cardoso now and Lula da Silva who just stepped down, and I think continuing under the current administration, this is a country that's accelerating and while it's not on the scale of a China and India, and it is dependent like almost everybody else in the emerging world on China's growth, it's very important. It's systemically the largest most important country in Latin America and it is pulling the rest of Latin America along with it. And Africa, which has traditionally been viewed as the most troubled, is actually experiencing a growth acceleration that started probably 10 years ago. Its resilience has proved fairly high in the context of the crisis. And so there's a … in the developing world, assuming the rest of us, meaning the United States and Europe don't blow it up in the next year or two, things are looking pretty good. It's interesting … I want to say something that will cause you to dismiss everything I said. So, let me do that now.

The economists who were supposed to be knowledgeable about development were asked in the early post war period how the developing world would develop. And they said well it's … we're not sure but it's going to be pretty tough. And then they were asked to sort of talk about it in terms of regions. And they said the star performer would be Africa, and the basket case would be Asia. Now that's as close to dead wrong as you can get. Although now I think everybody's joined the party. The question is why didn't we say that? And the answer I think is that we overestimated the importance of natural resources as a durable basis of the creation of growth and wealth, not that natural resources are unimportant, I hastily add, in this country. And we underestimated the importance of human resources as the long run, very long run basis of the creation of income and wealth and improving standards of life.

And so, the Asians, who are relatively on balance resource poor, has looked around and said well we don't have anything else here, but there's a lot of people, maybe we ought to take a shot, I'm being a little flippant, at using ourselves to do this. And Africa, unfortunately, got caught in a kind of pathological political dynamic in many resource rich countries and Africa has way more resource wealth than any other continent. I mean, you know, Australia comes the closest. At least a third, probably 40% of African countries have significant resource wealth and they fell to fighting over it. And they played out as a zero sum game in which the winners were the ones who got their hands on and kept their hands on the income from the natural resources and growth and the future and the wellbeing of our children and grandchildren, which is what motivates growth, high growth when it's working well and motivates the investment that sustains it, just sort of went away. That's turning around now. There's a young generation of leaders in Africa that are doing pretty well.

Let me conclude by saying a little bit about where we are. And this is why I think of this as a crossroads. The emerging markets are big enough, they trade with each other enough and their incomes are high enough because their demand to shift closer to what they actually make, that they can sustain this growth even if we grow slowly. They cannot sustain this growth if we have a major downturn which would be precipitated best, they can't replace that much aggregate demand if we take a dive. Many of you know, probably not all of you, that in the crisis when GDP started to fall and growth went negative, trade went off a cliff. And it didn't last forever, which was fortunate, 'cause it would have produced a much bigger dent in the emerging market growth. So they're vulnerable right now because we're all vulnerable.

The other thing that I've spent, as John said, a fair amount of time on in the last year is that the impact of the developing countries on the advanced countries, on the structure of our economy, on the distribution of income, the distribution of employment opportunities is starting to get larger and larger. I don't have time to sort of spend a lot of time on this but I will tell you one fact that I discovered in the course of this research. I looked at the American economy for the 20 years up to the crisis, starting around 1990, and asked where did we … how much employment did we generate and where did we generate it? And I divided, using a methodology that's not perfect, but I think good enough, divided the economy into two parts. I mean we did it sector by sector, but into two parts. A part that we call tradeable, that means goods and services that can be traded internationally. Most people think of exports and imports. It's not quite the same thing. Exports and imports have to be in the tradeable sector or they wouldn't be exports and imports. But in a big economy, a big advanced economy, a fair amount of tradeable output, whether it's goods or services, goes to the domestic economy and not all of it comes in or goes out. So focusing on exports and imports only picks up a part of the tradeable sector. The United States' economy in those 18 to 20 years generated 27 million jobs and almost none of them were in the tradeable sector.

Now the tradeable sector grew, it was a growth engine, but it didn't generate any employment, and most of us just didn't notice it. So what happened? So we moved everybody, mainly middle income people whose jobs were moving out of the economy on the tradeable side, over to the non-tradeable side and it's a bit of a miracle that the economy absorbed 27 million people on the non-tradeable side. Admittedly it's big, it's on the order of 65 to 75% of the economy. Where? In government, health care, and because we were running an economy on excess consumption in an asset bubble, on hotels, restaurants, food, retail, construction, because we had a housing bubble, and so on. And the crisis caused that all to collapse. And now people are … people have slowly, unfortunately slowly, realised this is not a conventional cyclical recession with a normal recovery. We're actually … we have a deep structural problem of restoring the employment generating capacity on the tradeable side. It's an economy, and this is to some extent characteristic of Europe, but there's enough differences that if I start to get into them, we'll be here all night, only you won't, you'll leave and I'll be here all night.

It's an economy that's demand short because we stopped overspending. That stops the non-tradeable side of the economy because those … because that's the only place demand can come from. And on the tradeable side it stops, a part of the tradeable side, namely the domestic consumption part and that leaves the part that's doing quite nicely, thank you, dealing with the high growth parts of the world, namely the emerging economies. Now they may slow down and that'll hurt, but unfortunately the tradeable side doesn't generate employment. So we're sitting there with the middle income group having experienced more than a decade, probably more like two decades of flat income growth as they competed for the jobs on the non-tradeable side and now we're growing in one part of the economy that doesn't generate jobs. It's a major, major problem and it has to be solved in the context of an unfortunate and relatively difficult fiscal situation. Not as difficult as some of the European countries.

Our policy makers and politicians haven't gotten around to sort of accepting that this has been addressed. So what we saw in the last two weeks, and I'll conclude on this, is the combination, this is a judgement on my part, some of you may violently disagree in a couple of minutes. First of all we have a downward reset in growth expectations, just based on the fact that people are starting to realise it's not a normal cyclical recovery and that we do have the structural problems and some continued deleveraging and fragility in the housing market and balance sheet damage on the household side that's inhibiting the restoration of consumption. And that's causing asset prices to go down. But the really … the thing that really caused the fear in the context of these fiscal challenges, stability challenges, is the feeling in both sides of the Atlantic that the policy makers are paralysed, and that they required aggressive, bold, possibly with mistakes along the way, action wasn't going to be forthcoming, for different reasons in different places, inattention, obliviousness, philosophical differences so large that nobody can agree on anything. And to be honest with you, the near- default and the downgrade were, in some sense, non-events in the sense that the downgrade didn't tell anybody any sophisticated investor didn't already know, but they put a stamp on something that really worried people and that is the United States put the integrity of the sovereign debt at risk. And nobody ever thought that would happen. And so they wonder, well what are they going to do next? That's why decisive and bold action in the case of the Euro zone and on the American side is important. It's hard in Europe because it's a multi-country operation and it's hard to reach an agreement on burden sharing to really take care of the fiscal things and the contagion that goes along with the bouts of scrimp.

Well one piece of good news is that by mid … somewhere in the early part of last week, the yield on Spanish and Italian debt had gotten close to 7%. Now that's dangerous, right. So what was happening in these countries is they were cutting deficits and cutting deficits, but people didn't think it was enough. The government really wasn't sort of paying attention, certainly in the case of Italy, and so the investors got worried, the sovereign debt yields rose, that made it more dangerous, so more people bailed out. This is a downward spiral. We've seen this now several times. And we certainly saw it in the crisis where we didn't know where it was going to stop. And that requires intervention, just to break the cycle and the ECB did that. That is the European Central Bank. So those yields are down to 4% and it buys time, doesn't solve the problem, but it buys time for these countries to put in place something that really is convincing.

What we really need on both sides of the Atlantic is a convincing fiscal stabilisation and growth oriented plan. And the balancing act between fiscal stabilisation on the one hand and doing things that are likely to create at least the opportunity to produce growth is difficult. If we had one of those problems without the other, it'd be easier. Growth helps with fiscal stabilisation, and fiscal stabilisation is easier, you know, if you're not, excuse me, and growth oriented investments are easier if you have the flexibility to do it. But most of the developing world doesn't, Australia does, Canada does. These are the star performers. Germany is still in relatively good shape because of a major, major effort started in 2000 to restore its competitiveness and productivity. But that's about it. So this is a world of extreme correlated macroeconomic systemic risk that we're living in. And best advice I can give from an investment point of view is take cover and wait to see what happens. But listen, why don't I stop there. That's a bit about what I've at least been thinking about and I'm sure you have lots of thoughts and issues that you'd like to express at this point. Thank you.

JOHN: Thank you very much. As Michael indicated, he'd be very happy to take questions. So let me, while you're thinking of your question, exploit the Chair's prerogative and ask: one of the issues that's clearly on a lot of Australians' minds is how long is the boom going to last? And as you indicated, one of the crucial things around that is China. And we see very rapid growth rates in China but we also see a one child policy demographic bomb that seems to be ticking away, how do you think that will play out?

MICHAEL: Let me take the first part of that first and just try to be brief. If we have this kind … if this goes badly, this last part that I was just describing, it will slow the emerging economies down. And all you've really got to do is slow China down and then you'll slow everybody else down, so that the transmission mechanisms I think are pretty clear. That will produce a softening in terms of a natural resource crisis, but not permanent. So the growth in these economies, unless it's permanently derailed, is going to continue to drive these prices up. So I think you're talking in the context of an Australia, about a softening and maybe having to tide through it and nobody knows how long it would last, could last three or four years. But long term I think you can count, literally count on rising relative prices. I think the days of declining natural resource prices in real terms, including energy and lots of the minerals, are over. You'd really have to derail emerging economy growth. You cannot trip up the size of the global economy, which is I think the long run path we're on, and not expect these relative prices to increase. So I'm not pessimistic.

On the one child policy, the Chinese view many things that we view as personal choices in a different way. And that includes the demographics. So there aren't any countries other than China, that I'm aware of, that have a one child policy, and tell you that's it, folks. It's a little actually more complicated than that. The one child policy does not apply much in the rural areas, and that's still on the order of five to six hundred million people. And it doesn't apply to the children of … each from a one child family. Now this is Chinese accounting, right. You got one child of one child, you can put them together and you can have two. That's supposed to sort of level out the demographics. But if they start to have a problem, you know, and they think that the ageing problem, which is serious, it's not the way it is in Europe or America, but if they start to have a problem, they'll change the parameters somewhat. And so I'm not terribly worried about that. I don't think it'll strip the country of its dynamism.

The most interesting example of this I ran into recently is, you know, I was talking to Asian friends, Chinese, and they were talking explicitly about this challenge of completing this amount of growth in Asia with China in the lead on the natural resource and environmental base that we've got, and thinking that the old growth model wouldn't work and over time they'd have to invent a new one. And that was in their self-interest. They couldn't complete the journey, regardless of what the rest of us do. So most of us think things like global warming and other things, to the extent we believe they're important, are global problems. In China, there's a tendency to internalise a good deal of this. But they talk about it in terms of lifestyle. I thought lifestyle? Where I live lifestyle is where they wear pink socks, you know, or drive a Motorino or something like that. It's not what they mean at all. They mean how cities are built and whether you drive a car or whether you really need to ride the public transportation. The boundary between what is private, reserved for private choice and what is legitimately constrained by public intervention is simply drawn in different places in the West and in the East, in part because there's so many people. And not only is it drawn in a different place but they feel free to redraw it if they need to. So actually that's an asset. That means, you know, I mean it's not an asset if you really like driving as many cars as you want with as large an engine as you want, and living 50 miles from where you work and a bunch of other things, but they can't do … so they're not. So they'll tell you you can't do it. Or they'll make it so expensive that you can't make that choice. And so, the communication across the global economy and the government structures is going to be complicated by these very, very fundamental differences in the way we think about the world. Thank you.

JOHN: Thank you. I'm afraid we're going to have to call proceedings to a halt there. I know that there are a large number of other questions that people would like to ask, but Professor Spence did arrive on a plane late last night and has yet to do a Lateline interview this evening, live to air, so I'm afraid we do have to let him go. We work our visitors very hard, as you can see. In summing up, Michael, can I just draw out one little theme that, amongst a huge number of things you talked about in a large number of countries, and that was the way that you talked about governance in a whole series of these countries, saying the difference in Africa is ultimately that of a new young leadership. The difference in China was the preparedness to invest at 30% year after year and that that was a decision that the government had made, that many of the issues in America and Europe at the moment can actually be sheeted home to decision makers in government deciding or not deciding to do things, that one of the reasons that Germany is doing as well as it did is decisions that its governmental leaders made very consciously a decade or more ago. And I guess I'd just like to say it's refreshing to hear an economist talk about the importance of political economy in that way. And of course I guess it reflects what we believe at Grattan Institute in terms of the fact that public policy does make a difference, decisions as a country to make or not make wise decisions in the long run will make a huge difference to our prosperity as a country. And I'd like to thank you very, very much for coming all this way to give us those insights tonight. I'd also like to thank again the founding members of the Grattan Institute, the Australian government, the Victorian government, BHP and the University of Melbourne, the University of Melbourne for the opportunity to use this lecture theatre, the University of Western Australia Press, who have published Michael's book in Australia and who have made his visit possible. And finally to all of you tonight for coming, for such an engaged and fascinating evening's conversation, Michael Spence, thank you very much.

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