***"What is going on with the global economy and the business landscape? Some key insights"***
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This session is motivated by the observation of the meeting organizers that "a number of well-established assumptions about the global business environment and the way the global economy functions have been turned on their head in the last few years." I want to flag five such game-changing, upending trends.

1. **China's (re)emergence**

What is the largest economy in the world? If you answer that question the way economists typically compare the size of economies, the answer is China (and has been since 2014). In PPP (purchasing power parity) terms, China comprised about 19% of global GDP in 2019 and the US was 15%. PPP takes into account how far a dollar goes in terms of what it buys in another country. Comparing the two in nominal terms (nominal GDP and market exchange rates), the US share was about 25% compared to China's 16%.

More to the point, if China is able to continue on its economic development path (some would say that's a big "if"), its economy is set to become an increasingly large share of the global economy over time. In PPP terms, China's per capita GDP is about one-third that of the US (about $20K versus $65K) and in nominal terms is about one-sixth (about $10K versus $65K). Rising per capita GDP multiplied by a huge population makes for an increasingly formidable global economic presence.

The world of the 21st century is going to have to grapple with a situation of there being two powerful countries whose economic systems are based on very different political and ideological systems.

That is starting to matter for the US and the rest of the world, as evidenced by the recent US-China trade frictions. That trade "war" traces to the August 2017 Section 301 investigation of China's intellectual property practices launched by the Trump Administration and the ensuing March 2018 215-page USTR (US Trade Representative) report identifying four problematic areas.

That said, decoupling is likely to go only so far, given how interconnected the US and China have become, and how large and magnetic the gains from trade are. There were about 370,000 Chinese students studying in the US in 2018-19, which was a four-fold increase in a decade. These human connections matter too.

## 2. The macroeconomic policy framework

If I asked you to lend me $100 for a year, and you agreed, how much would you expect to be paid back when the year was up? What if said, lend me a $100 now and I will give you back $99 next year? I'm pretty sure you would say "thanks, but no thanks."

But that is the macroeconomic world we now live in: a world of widespread "negative interest rates" or at least very low interest rates, and widespread "quantitative easing" (the consolidated government changing the form of its liabilities from treasury-issued bonds into central bank money).

The Federal Reserve's target policy (overnight) interest rate is currently 1-1.25% and the size of its balance sheet is about $4.5 trillion; prior to the financial crisis, the federal funds rate reached 5.25% (a normal level in the old days) and the Fed's balance sheet was about $900 billion in size. The European Central Bank's main policy interest rate is minus 50 basis points and the Bank of Japan is targeting the 10-year government bond yield to be around zero percent and the overnight rate to be minus 10bp; both central banks are doing significant QE.[1] Something in the vicinity of $17 trillion of government debt has been trading in negative interest rate territory.

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[1] Since I delivered these remarks, these central banks and others have implemented dramatic monetary easing measures in response to the economic contraction triggered by the COVID-19 pandemic.

Economists analyze this situation as reflecting the fact that the "natural rate of interest," or the "equilibrium real interest rate" (that associated with, in national accounting terms, savings equaling investment at full employment under price stability), has fallen dramatically in recent years (Larry Summers, resurrecting a term from the 1930s, calls this "secular stagnation"). Whereas the natural rate of interest used to be reckoned to be in the vicinity of 3% (implying, with a two percent inflation target, a "neutral" policy rate of about 5% for central banks), it is now widely thought to be around zero or even slightly negative.

Looking ahead, and assuming this situation will persist (reasons why it probably will next), this means that the traditional macroeconomic policy framework, resting as it does on a strict conceptual and operational separation of monetary and fiscal policy, is no longer fit for purpose, and needs to be revamped.

## 3. Technological innovation and disruption

We are living through a period of what early twentieth century economist Joseph Schumpeter famously termed "creative destruction," this time driven by the digital revolution and what Klaus Schwab calls the "Fourth Industrial Revolution." Schumpeter's insight was that technological innovation drives increasing prosperity but leaves a destructive trail in its wake (the former because it allows society to do more with less, the latter because it renders existing capital and organizations obsolete and needs to command their resources).

Moore's Law (the observation, dating back to 1965, that computer processing power tends to double every 18-24 months) seems to be continuing unabated, and "everything" is becoming digitalized. Here is a simple anecdotal example of this: the combined market capitalization of Amazon, Apple, Facebook, Google (Alphabet), and Microsoft is about $4.8 trillion, whereas that of such icons of the twentieth century economy as General Electric, General Motors, Goldman Sachs, Kraft-Heinz, and IBM, at about $335 billion, is just 7% of that.[2]

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[2] As of the time of this writing (market close on March 24, 2020), these numbers are: $4.4 trillion, $266 billion, and 6%, respectively. What a difference 18 days make!

If you listen to (some) economists, you might not know that this technological revolution is happening, as economists lament the low productivity growth of recent years or, in a redux of Robert Solow's famous 1987 quip in the *New York Review of Books* that "you can see the computer revolution everywhere except in the productivity statistics," mull over the "productivity puzzle."

To link this back to the previous point, I suspect it is the digital revolution that is most responsible for driving down the natural rate of interest, a phenomenon associated with (desired or ex ante) savings exceeding (desired or ex ante) investment (ex post they have to be equal and it is a falling real interest rate that makes them so). The digitalization of large parts of the economy and construction of an extensive on-line world mean that investment is becoming increasingly resource-light or commodity-non-intensive, taking the form of software engineers tapping on keyboards, and that consumption is becoming increasingly information-intensive and focused on "social media," leaving more income over to be saved.

This has implications for macroeconomic policy management. From the national accounting identity, (at the global level) savings equals investment plus the government's budget deficit (spending minus net tax revenue). If (desired) savings goes up and (desired) investment goes down (or up but not as much), the budget deficit *must* go up, the only question being the level of output (GDP) at which it does so. An increasingly digital world with a low (or even negative) natural rate of interest is one in which governments can and should spend much more freely, particularly to build infrastructure (if the private sector is not going to do enough of that).

## 4. Income and wealth inequality

French economist Thomas Piketty elevated this issue in the public consciousness and discourse with his 2013 opus magnum *Capital in the Twenty First Century*.[3] Piketty argued that the return on capital tends to exceed the rate of economic growth and so there is a natural tendency for wealth to become more

[3] It was originally published in French; the English translation appeared from Harvard University Press in 2014.

concentrated over time; it is only the occasional large-scale destruction of capital by wars or natural disasters, or the redistribution of its ownership by revolution or government policy, that arrests this trend (Piketty recommends the very last one).

I would identify three more proximate reasons for the recent increase in income and wealth inequality within developed economies in particular.[4]

One is the increasing impact of "winner-takes-all" effects in a period of transformative technological innovation, particularly involving digital platform businesses with global reach. Because of "network economies," a small number of firms (in extremis even just one) can dominate global markets in their segment or niche. If you happen to be the smart and lucky entrepreneur to start one of these businesses, that is, to be in the vanguard of Schumpeterian creative destruction in the digital age, and to succeed, you can amass a mind-boggling amount of financial wealth. Last time I checked, the net worth of Amazon's founder Jeff Bezos was said to be about $121 billion, that of Microsoft's founder Bill Gates was $108 billion, that of Facebook's founder Mark Zuckerberg was $71 billion, and that of Telsa's founder Elon Musk was $37 billion.[5]

Consumers benefit mightily from these new products and services – that is the source of the entrepreneurs' off-the-charts wealth – but workers, whose jobs directly or indirectly are made redundant by computer software, tend to lose out.

A second driver of income and wealth inequality, I would submit, is the way corporate governance and executive compensation works in a shareholder-value-maximization-driven financial world. When corporate governance operates on the principle that top management should run the corporation for the better of shareholders and therefore should seek to "maximize shareholder value," in order to align the incentives of management with those of shareholders, it is quite

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[4] There is a debate about whether income and wealth inequality has been increasing at the global level in the past few decades, given the rapid and sustained rise in per capita income in China and other developing economies, including notably populous India.

[5] As of the time of this writing (market close on March 24, 2020), these numbers are: $119 billion, $104 billion, $57 billion and $29 billion, respectively.

rational for the system to be set up in such a way that top management is paid what, to ordinary folks, appears to be an exorbitant amount.

Consider the following example of a company whose market capitalization is $50 billion. It doesn't matter how many shareholders the company has; assuming that all they care about is financial return, they can be treated as if they were a single "representative shareholder." In order to ensure that the CEO's over-riding interest in managing the corporation is to increase shareholder value, it might be quite rational for this representative shareholder to pay the CEO annually the equivalent of, say, 0.1% of the company's market cap. For the shareholders, this would be a trivial amount, akin to a rounding error, but it translates into annual compensation of $50 million for the CEO!

A third factor contributing to the concentration of financial wealth in the modern economy, I believe, is what British economist John Kay and others have called excessive "financialization" of the economy.[6] Akin to the winner-takes-all phenomenon and to what I call the "dimension mismatch" between the representative shareholder and the individual CEO above, it is possible for talented, hardworking and lucky individuals to make huge fortunes by dedicating themselves to investing in financial markets.

Financial markets play an essential role in the functioning of a complex modern economy and there is no doubt that financial market innovations in the past couple of centuries have helped to fuel economic development and growing prosperity. But, unlike markets for consumption goods and services, there is no reason to expect that the amount of financial market activity will be socially optimal. In fact, it will exceed that by a large margin, implying that a significant amount of financial activity is little more than wealth disparity-increasing rent seeking.[7]

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[6] See John Kay, 2015: *Other People's Money: The Real Business of Finance* (Public Affairs: New York) and also Mariana Mazzucato, 2018: *The Value of Everything: Making and Taking in the Global Economy* (Public Affairs: New York), ch.6.

[7] To see this point, consider the following thought experiment. Take a profitable mid-sized hedge fund employing 50 highly educated and smart people somewhere in the world and imagine that it is closed down and the 50 people are deployed to productive tasks in the real

## 5. The social purpose of business

Keying off the previous point, the fifth economic factor I would like to flag as likely to have a big impact on the business landscape in years to come is the mounting pressure on corporations to play a bigger social role. In recent years, interest in Corporate Social Responsibility, ESG (Environment, Social, Governance) investing, Sustainable Investing, and Impact Investing has grown, as has the pressure on corporate management to up its game in these areas. Most emblematic of this trend perhaps was the US Business Roundtable's August 2019 "Statement on the Purpose of a Corporation." The statement was signed by 181 leading CEOs, who "[committed] to lead their companies for the benefit of all stakeholders – customers, employees, suppliers, communities and shareholders." [8] The pressures on, and challenges for, corporate executives will be acute.

The shareholder-value-maximization view of the purpose of the corporation is most closely associated with Milton Friedman's 1970 article in *The New York Times Magazine*: "The Social Responsibility of Business is to Increase its Profits." The stakeholder-oriented model of the firm seems to be steadily displacing the shareholder value-oriented one. It may not be that simple, however.

I am a little more sympathetic to the basic thrust of the Friedman view than many, although I would concede that its more zealous adherents have been prone to push it to an extreme from time to time. Friedman made two basic points. One was an application of Adam Smith's "invisible hand" theorem: in a decentralized

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(as opposed to financial) economy. Being vanishingly small relative to financial market activity, removing this hedge fund would have no deleterious effect on financial markets in terms of lessening their efficiency; yet real resources in the real economy would increase. Continue this thought experiment until the removal of the marginal investor had a negative impact on financial market efficiency. How much financial market activity you would have to close down to reach that point? I suspect an awful lot. Or take another example: how many data-watching traders would be needed to ensure that the information in the monthly US employment report is efficiently reflected in financial market prices? Answer: a lot fewer than the many who hang on its release on the first Friday of every month.

[8] Somewhat oddly, creditors didn't get a look in.

market economy, firms using the maximization of profits as a decision rule for what and how much to produce is integral to efficient resource allocation and to firms fulfilling their role in the economy as the producers of goods and services desired by consumers.

The second plank of Friedman’s argument was that it is not a good idea to place extraneous burdens on corporate management that go beyond their expertise, weaken managerial accountability, and open the way for abuse of management’s considerable power. Rather, he argued, questions of social responsibility should be settled, and the rules of the game set, at the societal and political level, and codified in laws, regulations and social norms. Corporations would need and be expected to follow these, but otherwise would be free to get on with the business of business.

What might be termed the constrained shareholder-value-oriented model has the virtue of being clear, simple and parsimonious. The stakeholder-oriented model sounds attractive and compelling, but begs more questions than it answers. Which stakeholders are to be included and how wide should that net be cast? Who decides the weights to be assigned to the respective classes of stakeholders and within different categories of stakeholder? What decision rule should corporate managers use in deciding how to mediate the tradeoffs between the interests of different categories of stakeholder? How is the performance of top management to be judged and poor performance dealt with? What checks and balances will be introduced to guard against corporations becoming the battlegrounds for societal and political change or rent-seeking under the guise of pursuing corporate social responsibility?

The shareholder-oriented model has its problems, but corporate executives may be making a rod for their own backs if they too readily embrace a stakeholder model, without first thinking through exactly what that means and how they intend to implement it.