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BREXIT, TRUMP AND OTHER SHOCKS TO THE SYSTEM

IN CONVERSATION WITH ECONOMIST GEORGE MAGNUS

– THOUGHT LEADERSHIP

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George Magnus is an independent economist and commentator, an Associate at the China Centre, Oxford University, and former Chief Economist at UBS Investment Bank. He is widely credited with having identified the trigger points for the financial crisis in 2008. In this extract from a talk he gave at Clifford Chance he explores populism, Trumponomics, the impact of Brexit and the influence of China on the world order.

The rise of populism

"What is populism? We could debate this for a long time and still not reach a conclusion. One of the phrases used frequently, over the last year or so, is the "will of the people." What does this mean? I thought that representative parliamentary democracy expressed the will of the people, but clearly the "will of the people" means something different. Is populism about nationalism and identity politics? Is it about citizens rebelling against established institutions? Whatever it is, it's clear that there is a great deal of voter support for "populist parties," however that might be defined.

What we do know about populism is that it has nothing to do with the World Economic Forum in Davos, which this year celebrated globalism, openness, inclusive institutions, tolerance and equality. Research from the Pew Organisation demonstrates that the faster the growth in per capita income over the last five or six years, the greater is the support for globalisation; and the converse holds true as well. Support for globalisation has shifted East. Xi Jinping, the President of China, was hailed as the saviour of globalisation at Davos, which is an interesting phenomenon. Another example of this global shift is trade. World trade grew twice as fast as world income over the 1990s and the 2000s but that pretty much stopped in 2008. Now it's growing no faster than world income and sometimes even a little more slowly. This is particularly problematic for emerging economies for whom trade is the centre of their development models, but it's also important for developed countries.

Populism is anti-elite; suspicious of liberals, professionals and experts; it is nationalist, not globalist; it is unilateralist not pluralist; and it is about a closed rather than an open approach to trade and international engagement. It also focuses on issues such as jobs – and the quality of those jobs, labour force participation rates, income inequality, immigration, communities and the impact of globalisation. For many people, the financial crisis of 2008 was the final straw. Trust in institutions and in the governance system has broken down and has changed the way in which people think and vote. Research from two distinguished economists; Ann Case and Nobel prize-winner Sir Angus Deaton, provides some food for thought. They examined a surge in deaths from suicide, overdoses and alcohol-related diseases among middle aged, white working class Americans. Case and Deaton call it the "deaths of despair" and the result of a long standing process of "cumulative disadvantage for those with a less than college degree." It is something that is uniquely American and not just about income, but also about a sense of accumulating desperation.

The US unemployment rate is about 4.6 per cent, which is about as low as it has ever been, even during the 1950s and the 1960s. By this measure, the US seems to have full employment; but if

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you look at the labour force participation rate – the percentage of people in the workforce who are eligible to work – people have dropped out of the workforce. This is quite specific to people in their 30s, 40s and 50s, and also to women. In the US, for reasons which are not clear, female job participation has gone backwards in a way that has not happened in most European countries. In Japan, where female participation has traditionally been very low, the Abe government has made it one of its priorities to try to get more women into work, and they’ve succeeded to the point where female participation in Japan is now marginally higher than it is in the US.

Trumponomics

Donald Trump came into office on an “America first” platform, but Trumponomics is a strange mixture of political positions. There are some traditional Republican policies such as deregulation, cutting income taxes, state taxes and changes to the healthcare policies of the Obama administration, but also some traditionally Democratic programmes such as infrastructure spending. Trump said, during the election campaign, that he would spend a trillion dollars over ten years on infrastructure. However, there is the question of how it is going to be financed. Many economists think that financing in the form of tax credits to private corporations is not efficient because companies want to be involved in the most lucrative infrastructure projects, and they may simply bid for things that local and state governments would have done anyway. Nobody wants to do anything about the pot holes in the road, they want to be involved in major projects.

The most important thing from a global perspective is what will happen to trade. The first thing that President Trump did was to withdraw the US from the Trans-Pacific Partnership: a multi-lateral treaty. The Transatlantic Trade and Investment Partnership (TTIP), a proposed trade agreement between the US and the EU is now dead, and Trump says that he wants to renegotiate the North American Free Trade Agreement with Mexico and Canada (NAFTA). Bilateralism is in, multilateralism is out.

If a fair wind blows for the Trump administration and it manages to get some reasonable tax and infrastructure programmes through this year, it may well succeed in pushing economic growth for a limited period of time. However, we are now counting down until the next US recession. We are currently going through the third longest economic expansion since the Second World War (95 months to May 2017). If Trump succeeds in pushing up the economy late in 2017, then it’s quite likely that in 2018 US interest rates will go up and inflation could pick up, which could make the Federal Reserve concerned. We may be looking at the next recession or the next downturn, sometime around 2019.

The impact of Brexit on trade

It is very unlikely that the UK will get a trade deal with the EU in two years even if the Article 50 negotiations succeed. The Comprehensive Economic and Trade Agreement (CETA) between the EU and Canada took seven years to negotiate. Typically, trade agreements take four-to-five years to complete. There are only really three possible outcomes: a “soft” Brexit – a satisfactory divorce agreement where both sides will compromise and an agreement in principle for a transition period that could be five, six or seven years, during which the UK will gradually phase out of the EU; a “hard” Brexit – a divorce but no transition agreement, where the UK would tumble out of the EU probably in 2019; or neither a divorce agreement nor a transition agreement which I call a “rock hard” Brexit.

In the case of either hard Brexit or rock hard Brexit, the UK would fall back on membership of the WTO, so would have to reapply and come up with the terms on which it trades with the rest of the world. Tariffs are not the biggest issue; the major issue is the choice of regulatory regime and the jurisdiction which is established under that regime. This can be quite complex in the case of advanced manufacturing and intellectual property, for example.

It will be challenging for the UK to leave the biggest free trade area in the world because trade is geographically concentrated. Asian economies such as South Korea, Taiwan, Malaysia and Indonesia, mostly trade with Asia and with China. South America, Canada and Central America, mostly trade with the US. Eastern Europe and Africa are part of Europe's sphere of influence. It is often said that the UK can do a trade deal with Australia or New Zealand but commonwealth countries, including Australia and New Zealand, only account for about 9 per cent of UK exports. The BRICS countries still only account for 8 per cent of UK exports, so geography matters. It is very difficult to imagine that any reasonably expected amount of trade with the rest of the world will compensate for leaving the EU.

However, in my view, the UK government shouldn't obsess about trade. There are other, much more important, things it needs to do if the whole Brexit experience is to be successful. It needs to focus on the domestic economy; on organisational prowess; technology; and how to mix labour and capital together to get something that's bigger than the sum of its parts. For most advanced economies, multi-factor productivity is what generates most of the growth, and this is what the UK government needs to take account of. A mitigation strategy would concentrate on offsetting the trade and immigration and investment losses which the UK is likely to face, by bolstering the parts of the economy that the government is in control of. What difference would it make, for example, if the UK had ubiquitous and rapid broadband in every part of the country? Trade is important, but if that's all the government focuses on then it will miss the big trick over the medium-term.

The role of China

China is increasingly important, particularly in the context of its inter-relationship and inter-dependence with the rest of the world. In China, the working age population (traditionally defined as people between 15 and 64) pretty much ground to a halt in 2014, and this trend will continue relentlessly for the foreseeable future. By 2050, China will be an older country than the US, measured by the proportion of older citizens aged over 65. This is not an immediate problem for China, as it still has lots of people living in the countryside who can migrate to the cities; but it is an increasingly important constraint on China's growth rate. The expression "getting old before you get rich" is often used in the context of China and a number of other emerging countries. Western countries have a social security infrastructure and social insurance pension structure developed over decades, but in China such a structure doesn't exist.

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China is going to have to put something in place or face a great deal of social dislocation.

The other big issue for China is debt. Household debt isn't a huge problem – most of the debt is owned by non-financial corporations, predominantly state-owned enterprises, local and provincial governments, and the agencies that local and provincial governments have set up in order to build infrastructure and housing and for land development.

The Chinese printed a lot of money and created a lot of debt in response to the financial crisis. What's less known is that this has continued, particularly since 2013/2014. Banks usually get into trouble when they become illiquid rather than insolvent. No bank in China is going to become insolvent because the state will ensure that doesn't happen, but the funding structure of those liabilities could become a very big problem in the next two or three years. These liabilities have grown quickly from between 10 per cent of total liabilities to about a third in the space of five years.

The 19th Party Congress which will be held at the end of this year is hugely important, as President Xi Jinping has ambitious goals not just for the constitution of the Communist Party, but for himself. He's amassing a lot of control and it will be interesting to see how China might change after the Congress. Also, the reform agenda which was introduced with great fanfare at the end of 2013, with the exception of financial regulation, has pretty much run aground.

So who does the world order belong to? We talk about a number of countries sharing world power, but if you look at the size of the world by continent and by country, you can see really there are only two key players – China and the US. A multilateral world order without a benign leader is a recipe for chaos. If the US doesn't want to fill this role any more, then it is left to China. At the World Economic Forum, Xi Jinping was hailed as the protector of globalisation, although in reality China is not very open and global. It benefits from globalisation, but it doesn't really contribute very much to it in terms of openness and by example.

That said, things change, and China is promoting its own free trade area within Asia. It was a founding member of the Asian Infrastructure Investment Bank and the 'One Belt One Road' program is about China going out into the world and spreading its influence economically and through infrastructure. It is also about gaining kudos and friendship in other countries. My best-case suggestion is that the relationship between the US and China will be one of tense equilibrium. Both countries have political and/or economic problems at home, and the issue, over the medium-term, is whether either side uses the distraction of international tension and friction as a way of deflecting attention away from domestic issues, which brings us neatly back to populism."

George Magnus is former Chief Economist at UBS and now an Associate at Oxford University's China Centre. He is also a well known broadcaster and author of 'Uprising: Will emerging markets shake or shape the world economy?' a detailed study of China's growing influence and 'The age of aging: How demographics are changing the global economy and our world.'

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