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A RETREAT FROM GLOBALISATION?

In conversation with Stephen King, Senior Economic Adviser, HSBC

– THOUGHT LEADERSHIP

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Stephen King, HSBC's Senior Economic Adviser and author of 'When the money runs out. The end of western affluence' says "The Brexit story is not a one off. It's the beginning of a slightly more disturbing world where the west is retreating from globalisation," In this extract from a talk he gave at Clifford Chance, King outlines the global impact of Brexit and some of the complex issues we will face in the years ahead.

If you search through history for a precedent for Brexit you have to go back to Henry the Eighth and the English reformation. The Tudor equivalent of Brexiteers and Remainers can loosely be described as Protestants and Catholics, the Catholics being quite keen for a strong relationship with Europe and the Protestants having some deep concerns about their relationship with the rest of Europe. It resulted in 150 years of incredible instability and uncertainty. Today there is a similar sense of division – 52% of the population wanted Brexit and 48% didn't – so effectively the UK is split right down the middle. How we resolve that in the years ahead will be tremendously difficult. There are two completely different views of how we should think about ourselves and our relationship with the rest of the world and yet those two views have to somehow coalesce and come together into a coherent set of policies over the next decade.

We also have to think about what type of Brexit we will get. While it is important to recognise that people who voted for Brexit agreed that they didn't want to be part of the EU, they did not agree on what it was that they did want. I think there are two distinct models. The first we might describe as the Theresa May model: a cosy return to the 1950s with a reasonable social welfare state and the UK protected from the uncertainties and evils of the rest of the world and we can celebrate that by having a warm beer and watching a bit of county cricket. The other, probably embraced by Liam Fox and David Davis, is a kind of hyper globalisation – the premise of which is that if the UK is thrown to global forces of competition it will have to become more productive, more competitive and more dynamic along the lines of Hong Kong or Singapore. But the problem is that Hong Kong and Singapore are small city states in the most dynamic part of the world. They have a very different attitude towards social welfare compared with the UK and although Hong Kong and Singapore don't tend to win many Nobel prizes, the level of educational attainment on average is very high indeed. In OECD standardised tests of numeracy and literacy eight out of the top ten countries are Asian. The UK is in 24th place. What we are likely to find in this hyper globalisation version is an increase in the gap between winners and losers and I'm not sure that many Brexiteers actually voted for this particular model.

There is also the issue of the timing of Brexit. The UK has a number of economic difficulties but the one that doesn't tend to get much press coverage is the huge balance of payments deficit. The current account deficit – the trade in goods and services and investment income from abroad – is between 5% and 7% of GDP – one of the biggest deficits in the world.

The UK is borrowing heavily and relying on investment from the rest of the world to sustain our current living standards. Companies from around the world have chosen to come to the UK because it is a member of the single market and part of the Customs Union. It is cheaper for Japanese car companies to make things in the UK and sell them into the rest of Europe than it is to make cars in Japan, export them to Europe and pay large tariffs. However, if access to the single market becomes difficult, then the chances of these companies pouring their money into the UK are significantly reduced. That means that the current account deficit will be much more difficult to finance and as a consequence, sterling is likely to fall quite a long way. Before the referendum the value of the dollar against sterling was US$1.50. Now it is at about US$1.22 and my colleagues at HSBC are forecasting US$1.10 by the end of next year.

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— Stephen King
HSBC's Senior Economic Adviser

The last time that sterling fell steeply was at the start of the financial crisis. Many people said it was an opportunity for the UK economy to re-balance itself and focus on an export-led recovery. It didn't happen. What is striking about the UK's performance since 2008 is that the initial competitive gain it got from the fall in sterling was completely offset by a sustained and significant deterioration in UK productivity performance compared with countries elsewhere in the world. What does a fall in sterling do to the UK economy? It raises import prices and that's likely to raise inflation. In the years post-2008 even as inflation rose, there was no significant response in terms of wages so a lot of people experienced a very big squeeze on their spending power. I think we're likely to see exactly the same thing over the next two or three years and many of the people who voted for Brexit are right in the firing line. People without much in the way of financial assets who depend on a wage income and who live in parts of the UK that may struggle to gain foreign investment will be hit hard and that's going to be very difficult to explain to people.

Mark Carney, the governor of the Bank of England says that 2018 is going to be a very difficult year for the UK and Iwouldn't disagree with that. I think that we are going to be facing some really complex issues over the next few years.

The global implications of Brexit

Globally I think there are some questions about the purpose of international institutions like the European Union, the IMF, the World Bank and the OECD. They were all created at roughly the same time after the Second World War with similar philosophies – to create a level of economic interdependence which would make war an impossibility for the future and to make the world a wealthier, safer, happier place. For many years these institutions did a fantastic job. They set the rules of the game, they stopped countries from doing stupid things and they created an international environment which allowed trade to flourish, incomes to rise incredibly quickly and made the world, particularly the western world, a much happier, more contented place. It's a great sadness that that now seems to be over. In 1989 Francis Fukuyama wrote 'The End of History and the Last Man' which coincided with the fall of the Berlin wall and the collapse of Soviet communism. His two big claims were that western liberal democracies had emerged triumphant and that other countries would naturally fall in line and that free market capitalism had emerged triumphant.

But it wasn't quite like that in reality. Some of the bids for democracy have returned to autocracy pretty quickly, and China, the most successful country in terms of growth over the last 30 to 40 years has never been a democracy. And, I would argue, international capital markets have got out of control over the last 30 or 40 years. In 1900 foreign capital ownership as a share of total GDP (i.e. capital that's owned by a foreigner in a particular country as opposed by being owned by domestic residents), was about 20% of global GDP. By 1945 that figure had fallen to 5% as globalisation imploded thanks to two world wars. By 1980 the figure was up to 25%, by2000 it was over 100% and by 2007 over 200%. This has created an enormous problem. As long as capital markets worked and delivered continuous growth then the relationship between the domestic debtor and the foreign creditor or the domestic creditor and a foreign debtor was relatively smooth but when the financial crisis hit, those relationships became incredibly unstable and mistrust started to rise between countries and people within countries as happened in the Eurozone.

Another big change is in global wealth and equality. The economist Branko Milanovich has traced the story of changes in incomes around the world over the last 30 years and it demonstrates a striking and uncomfortable feature of globalisation. Incomes have risen fast in East Asia and particularly China and there has been a huge spike in the top 0.001% of people in the US and Europe who have done incredibly well from globalisation but in between we have the middle and working classes in the US and Europe for whom globalisation hasn't really worked. They're not the dispossessed – they haven't got worse off, but they haven't enjoyed the benefits of globalisation, of technology or of hard work. As a result, an increasingly populist narrative begins to develop that blames the rest of the world for domestic difficulties. I would argue that the Brexit story is not a one-off, it's the beginning of a slightly more disturbing world where the west is retreating from globalisation, as we have seen with the US election.

The word globalisation is in favour among autocracies in Asia but Europe is in a dilemma. For the last 60 or 70 years we've always thought of ourselves being under the US protective military umbrella but with President Elect Trump that is looking uncertain and Europe looks a little more distant from the US than it has done for quite some time. There are opportunities in China and central Asia but the question is, does Europe go with a democracy that has left it behind, namely the US, or does Europe suck up to autocracy elsewhere in the world? I think what we're beginning to see is a reset of the global economy, away from a westernised post-Columbus world towards a pre-Columbus world where Europe always looked east for prosperity and in those circumstances I would question whether Europe can easily hang together over the next 30 or 40 years.

Stephen King is HSBC's Senior Economic Adviser. He is a Special Adviser to the House of Commons Treasury Committee and writes regularly for the Financial Times and The Times. He is the author of 'When the money runs out. The end of western affluence.'

> **"The middle and working class in the US and Europe haven't enjoyed the benefits of globalisation."**
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> — **STEPHEN KING,**
> **HSBC's Senior Economic Adviser**

CONTACTS

Phillip Souta
Head of UK Public Policy
London
T: +44 20 7006 1097
E: phillip.souta@cliffordchance.com

Chris Bates
Partner
London
T: +44 20 7006 1041
E: chris.bates@cliffordchance.com

Kate Gibbons
Partner
London
T: +44 20 7006 2544
E: kate.gibbons@cliffordchance.com

Jessica Gladstone
Partner
London
T: +44 20 7006 5953
E: jessica.gladstone@cliffordchance.com

Simon James
Partner
London
T: +44 20 7006 8405
E: simon.james@cliffordchance.com

Malcolm Sweeting
Partner
London
T: +44 20 7006 2028
E: malcolm.sweeting@cliffordchance.com

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www.cliffordchance.com

Clifford Chance, 10 Upper Bank Street, London, E14 5JJ

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