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*The boxing ring and the boxers: What is
globalisation really doing to the world economy?
And how might it matter for markets?*

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2017 OECD BUSINESS AND FINANCE OUTLOOK

KEY FINDINGS

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The Boxing Match and the Boxers

1. Think of global free trade as the right freely to enter the boxing ring.
2. This is a necessary but not sufficient condition for globalisation to work.
3. It doesn't work without rules—about SOEs, subsidies, exchange rate manipulation, capital account management, pricing to market with state backing, irresponsible business conduct, cartels, banking collusion.
4. You cant bring weapons into the ring if you want globalisation to work.





Its not the middle class as such being hollowed out

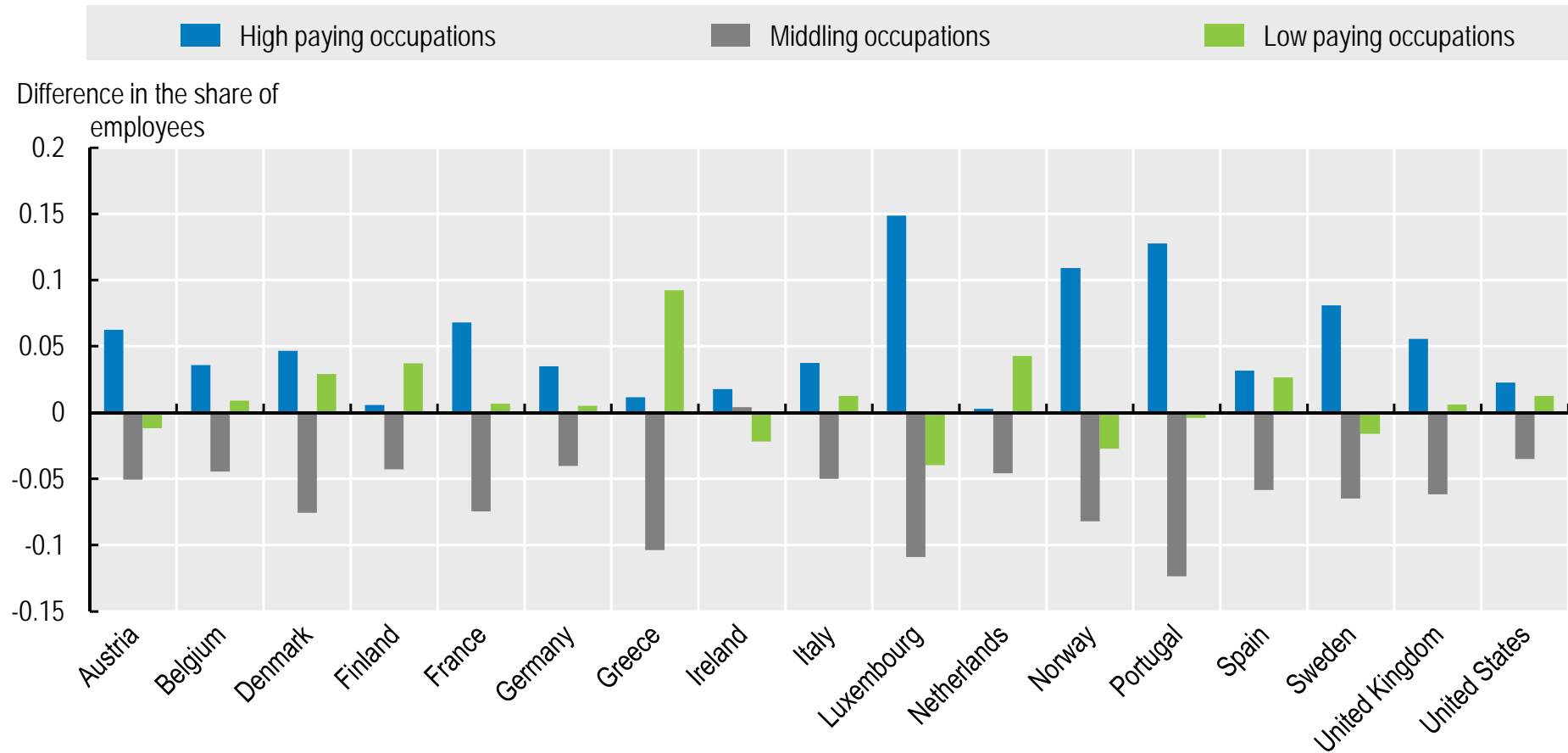
- The idea that its technology not trade comes from the observation that jobs are disappearing in the middle class—technology affects all companies equally.
- The losers in this story (those workers affected by reduced hours, innovative work contracts and compressed remuneration) belong to companies that are scattered within their own industry (it's not workers of one industry versus those of another).
- It is not the middle class as such that is being hollowed out—rather, these ranks are swelled by those that work for middle-paying companies that are forced to restructure or exit.
- Wages in incumbent “once were great” firms are being compressed painfully towards the leaner global adapters as their productivity falls.





Hollowing out of the middle class is happening (thought to be robots, software, etc.; but is it?)

between 2000 and 2015 by pay category

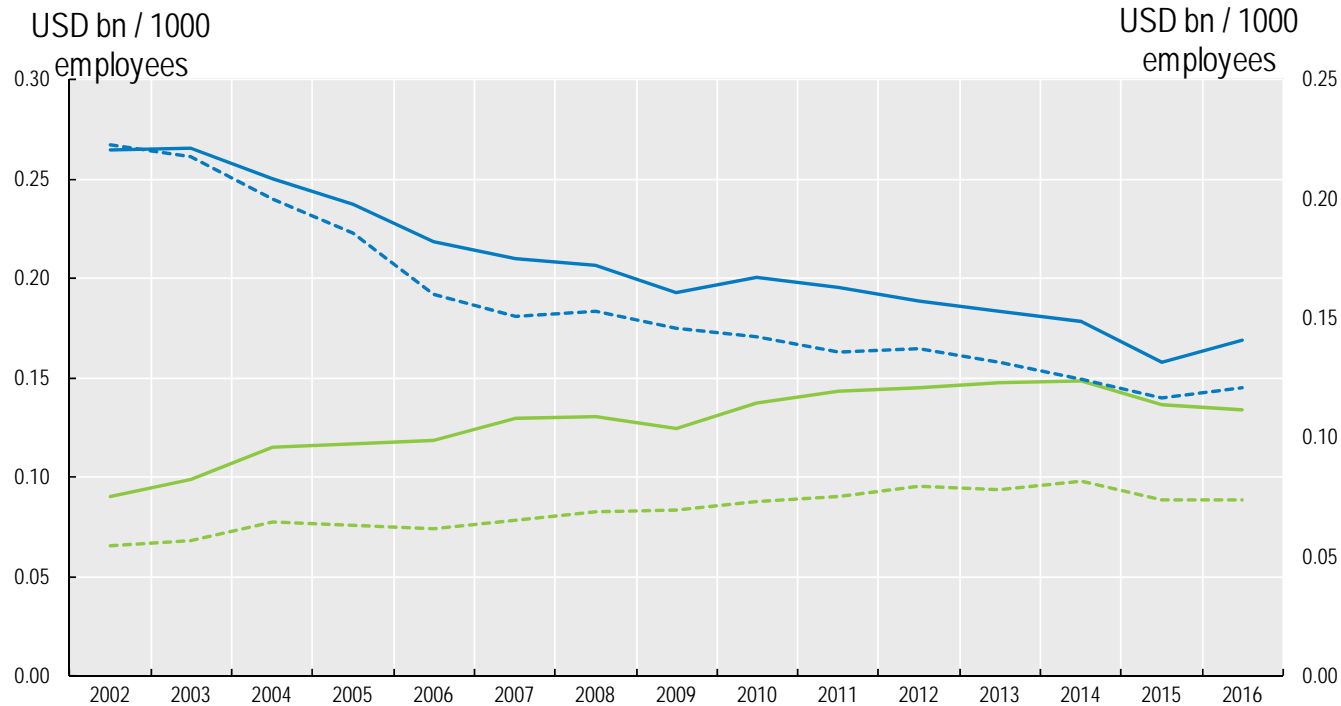




The micro data tells us its “middling” firms that are swelling the ranks of middleclass job cuts & wage pressure

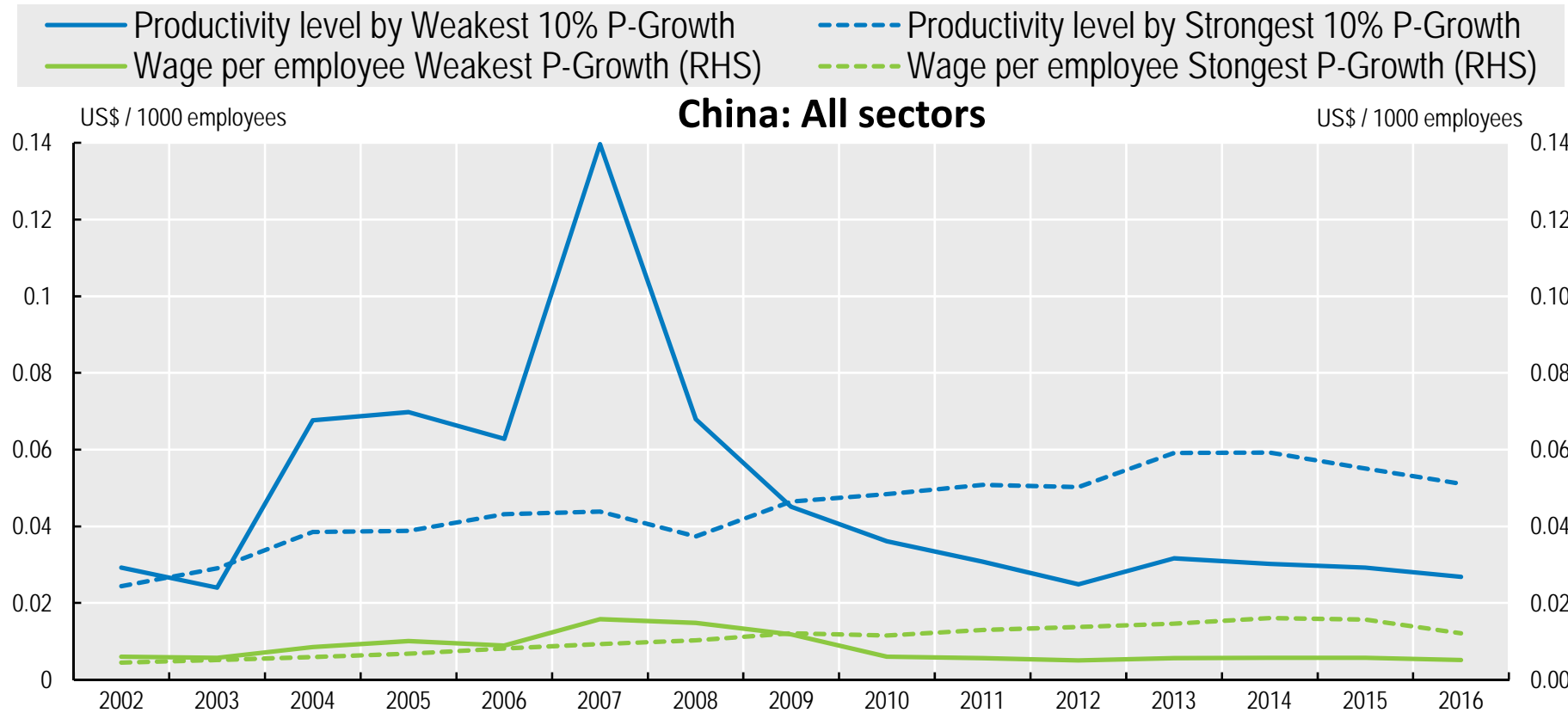
- Productivity level weakest 10% of Co's by productivity growth
- Productivity level strongest 10% of Co's by productivity
- - - Wage per employee weakest 10% (RHS)
- - - Wage per employee weakest 10% (RHS)

Productivity & Wages: Best 10% vs Worst 10% of Companies





And in China—a Different Story





Trade vs Technology: faster productivity growth and trade/investment are linked

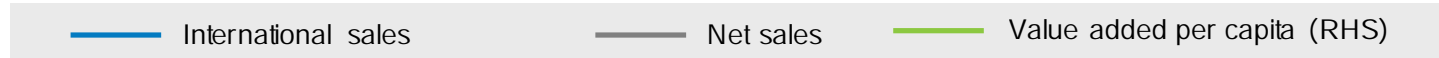
- The fastest productivity growth companies are those that take advantage of foreign sales, whether by exporting or by setting up subsidiaries that produce abroad to serve foreign markets.
- They succeed in their home markets, force the exit of less competitive firms and have the means to invest and innovate further as they take advantage of scale economies in the global economy.
- It does not matter where firms sit in the value chain. Maquiladoras are just as likely to face global competition as any advanced-economy company, forcing them too to restructure and enhance technology to remain competitive.
- But there is a problem: not all economies are open to the same extent and the playing field for doing business is by no means level.



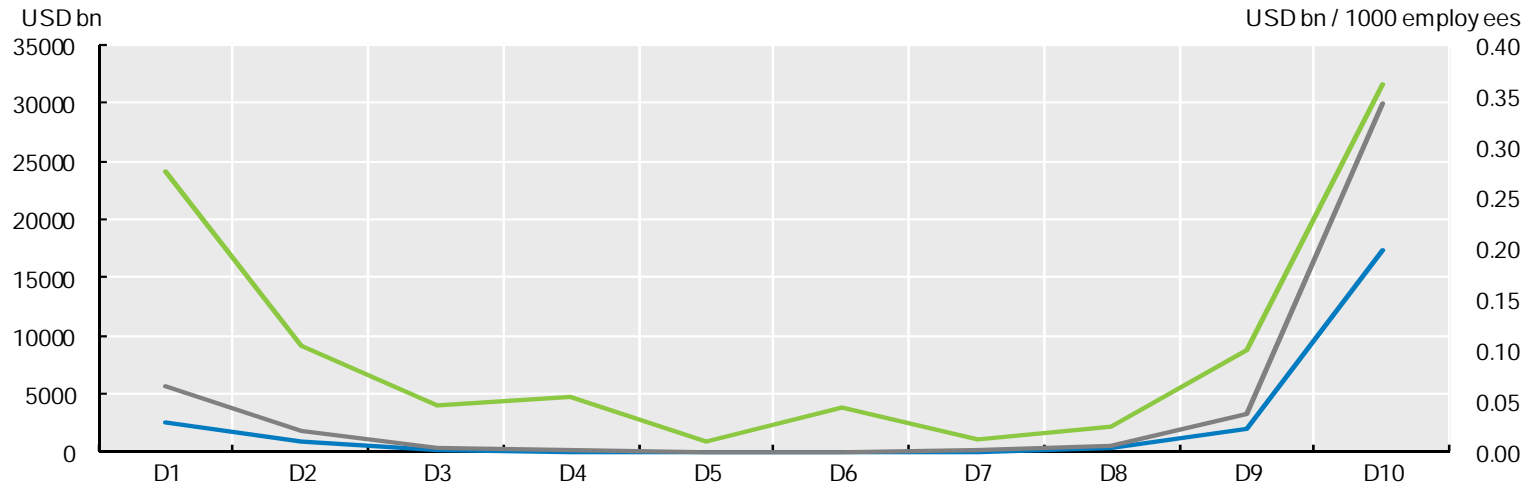


Company productivity levels vs. international sales: market share matters

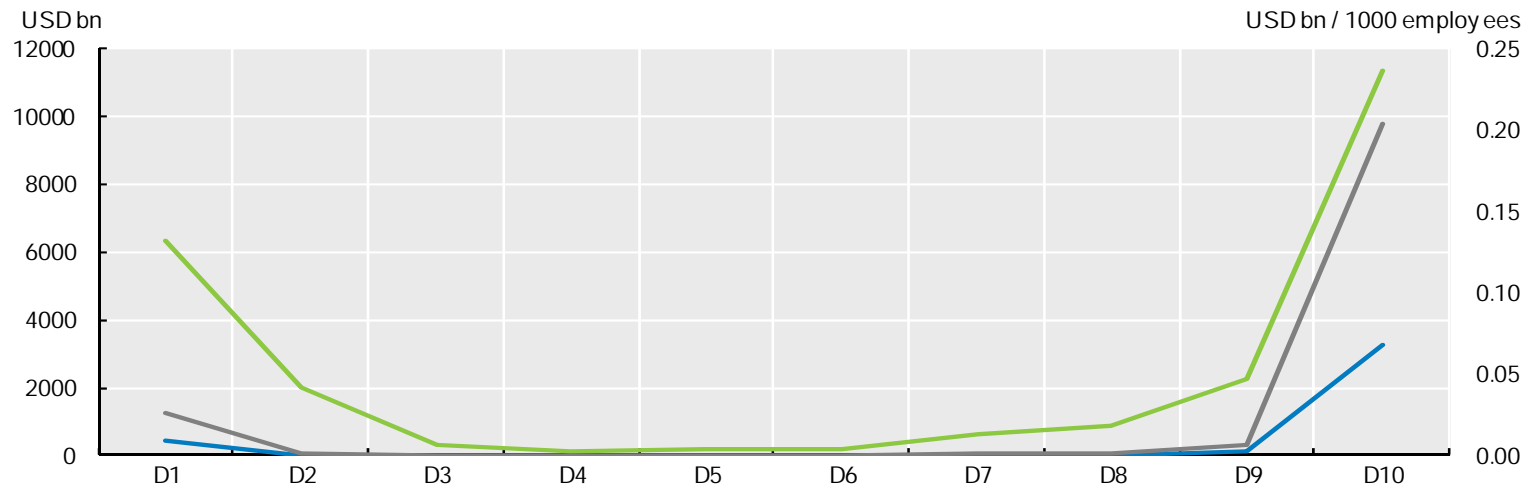
by company productivity growth decile, 2002-2016 (D1 worst D10 best)



Advanced



Emerging





The spectacular takeover of trade by Asia

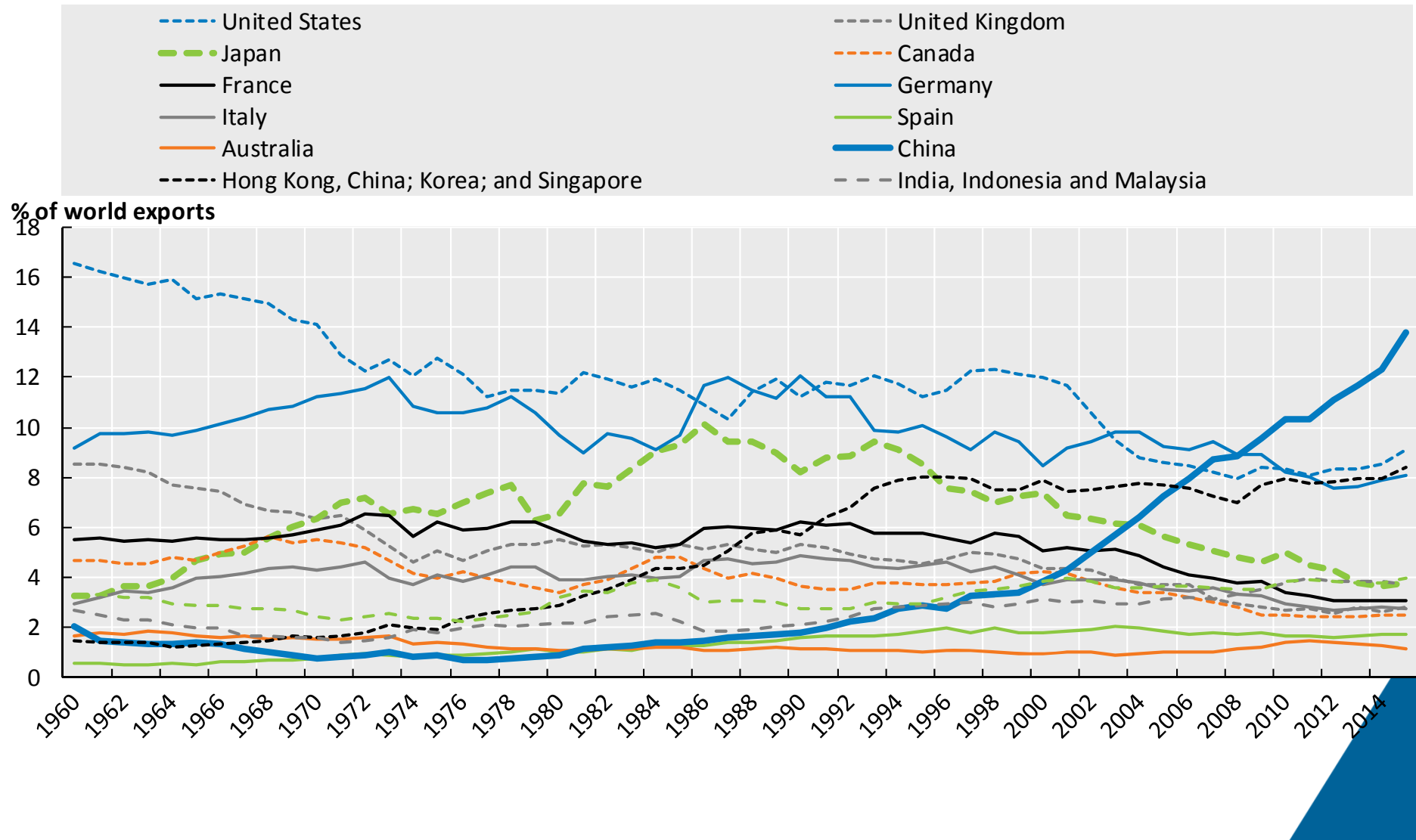
- Since entering WTO in 2001, China has quickly become the largest exporting nation in the world, with 14% of merchandise exports and 18% of manufacturing.
- Hong Kong (China), Singapore and Korea together export as much as the United States or Germany (see figure).
- Instead of exporting from home, companies can also set up production abroad closer to foreign markets.
- China is now responsible for 11% of world M&A outflows in 2016 while inward M&A has declined to a low of 2% of the global total.
- Who is in the Boxing Ring?





Share of world merchandise exports

for selected economies, 1960-2015





Without a level playing field Questions of fairness arise

- Some large emerging economies have managed to pull millions of people out of poverty—and the long-term future of every country lies with continued success in this regard.
- Competition too is to be welcomed. Like any sporting match, let the best teams win.
- But also like any sporting match, the game needs to be played with the same rulebook. If the same rules do not apply to all, then fairness is put into question.
- If fairness is questioned, then sustainability of open trade and investment in the global economy is also put at risk.
- What are the weapons brought into the Boxing Ring?





Exchange rate targeting and pricing for market share

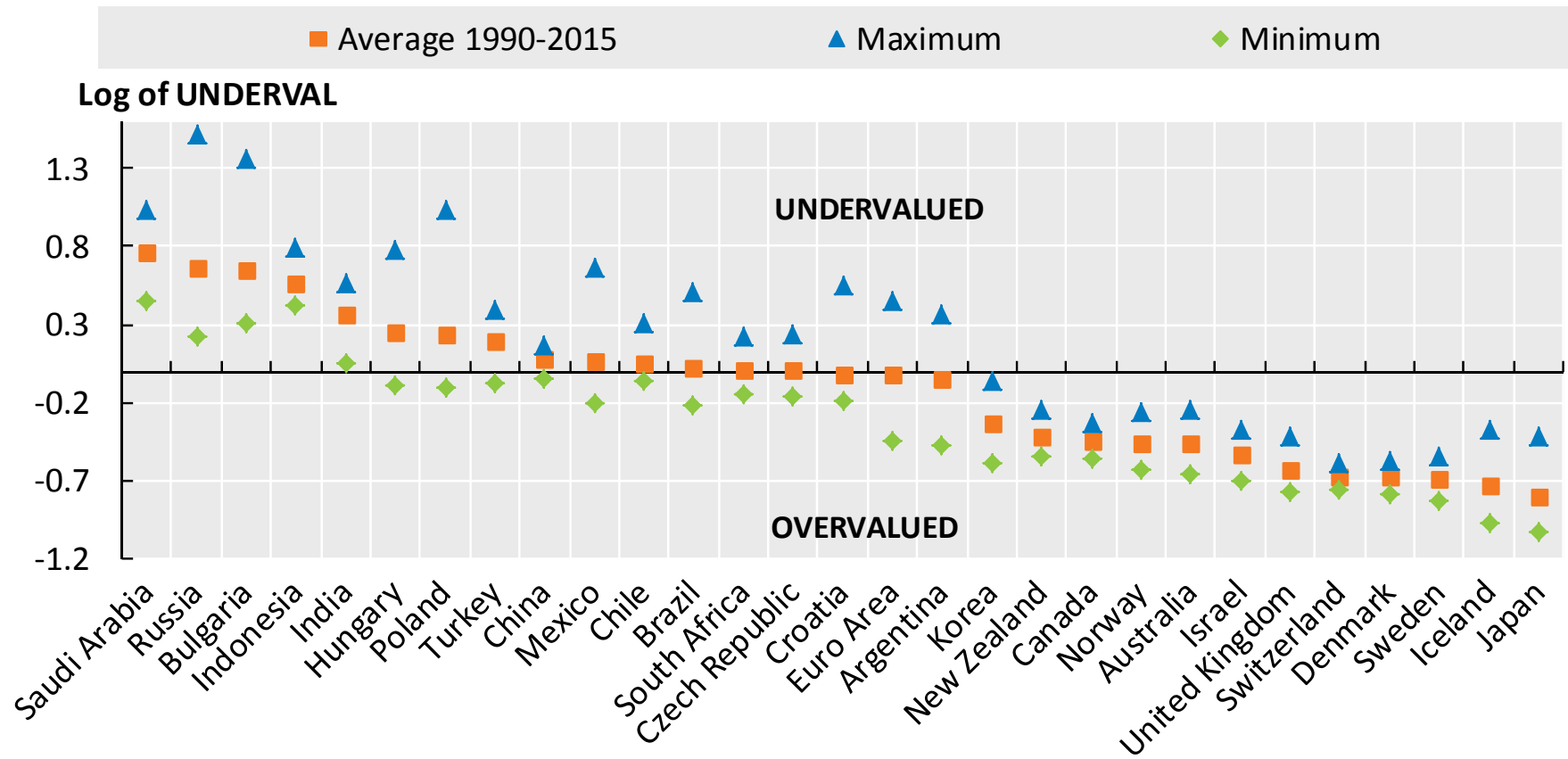
- The level of the playing field is affected by capital account and exchange rate management of emerging economies.
- Advanced economies generally have overvalued real exchange rates—even after allowing for a country's level of economic development.
- Some large emerging economies also price to market to ensure they obtain and maintain large global market shares.
- This requires variable mark-up in pricing, particularly when exchange rates are permitted to move.





Advanced country exchange rates are overvalued, BUT...

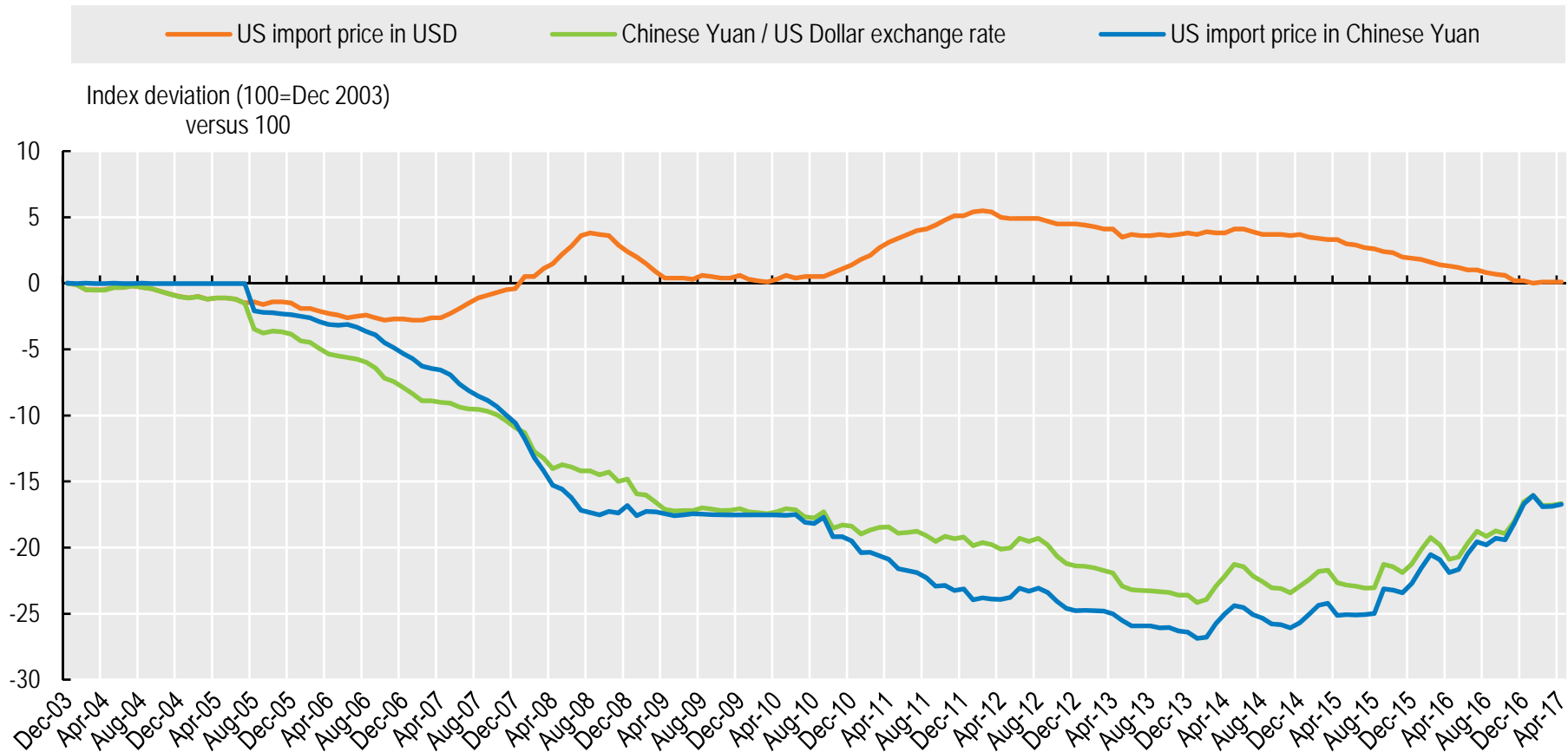
for selected economies, 1990-2015





Advanced country exchange rates are overvalued, BUT...pricing to market

for selected economies, 1990-2015





Development via SOEs and subsidies: above the laws of economics?

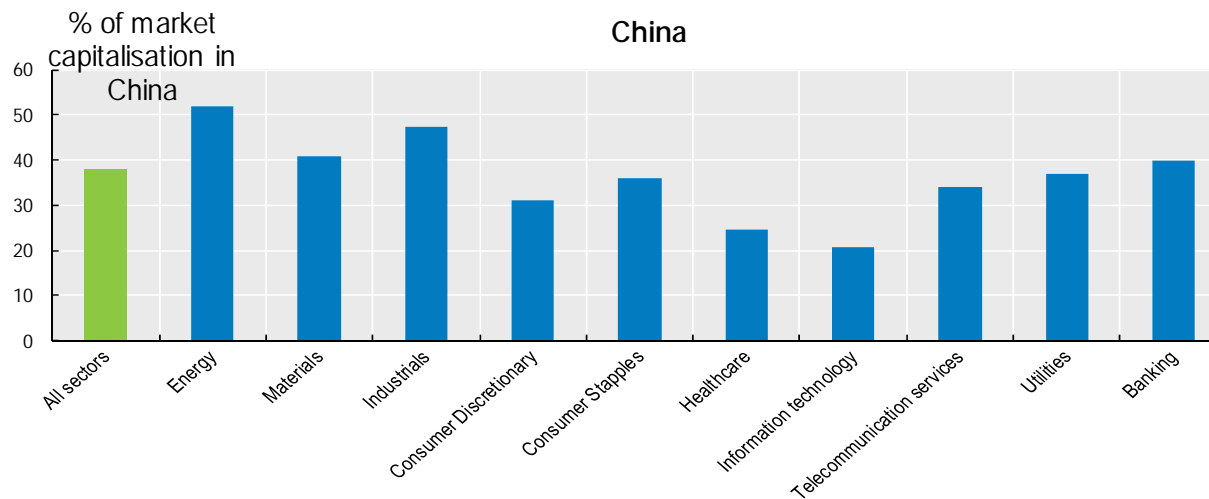
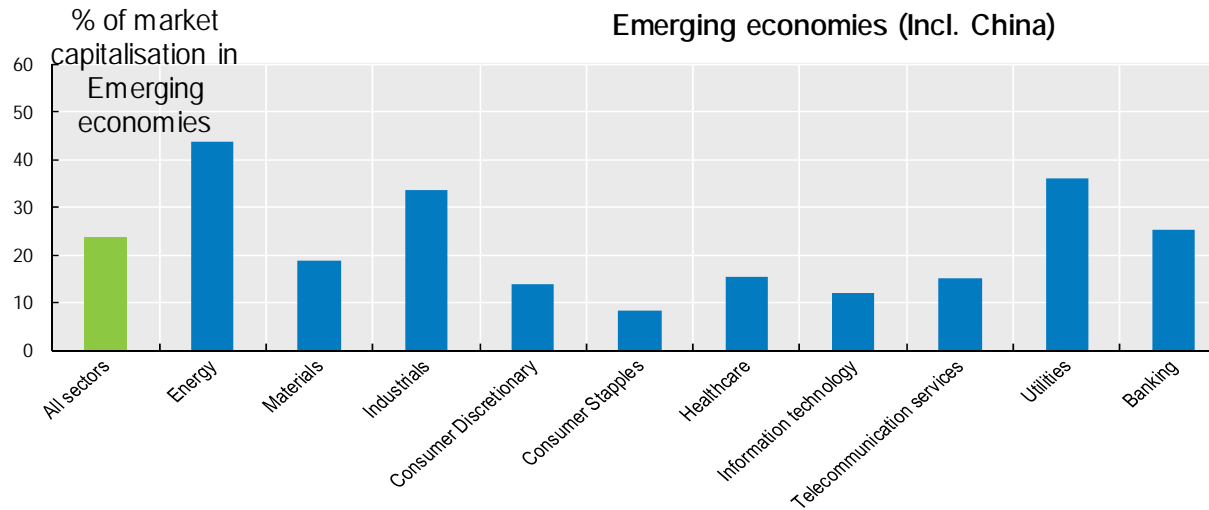
- These SOEs have become a force to be reckoned with. The number of SOEs amongst the Fortune Global 500 companies grew from 9.8% in 2005 to 22.8% in 2014.
- The largest of these are Chinese banks that play an important role in funding state-owned firms in all industries, subsidising the cost of capital and facilitating state-driven industrial strategies.
- Emerging market SOEs have greatly contributed to the current excess capacity in key materials, energy and industrial sectors. This is contributing to a decline in the average return on equity in many sectors and countries.





Listed state-owned enterprises (SOEs)

by sector in emerging economies, average 2002-2016

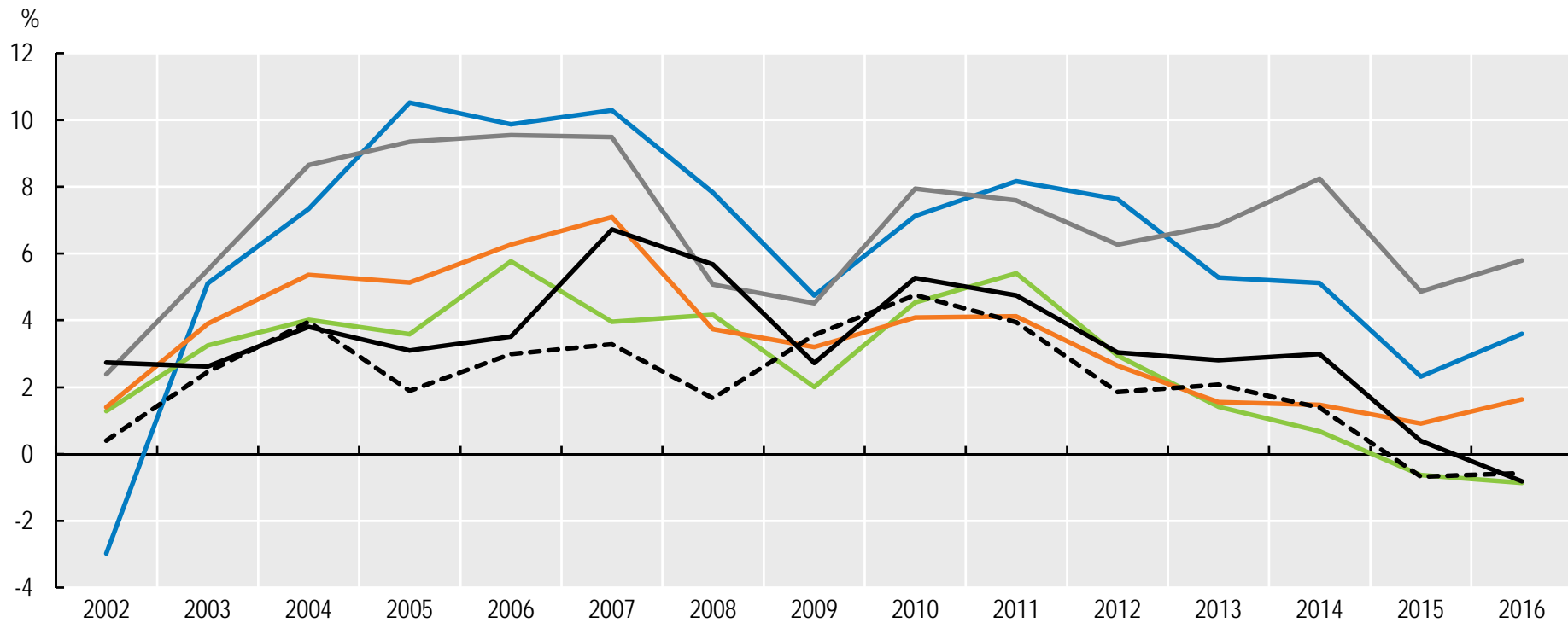




ROE minus the cost of capital for private companies versus SOEs

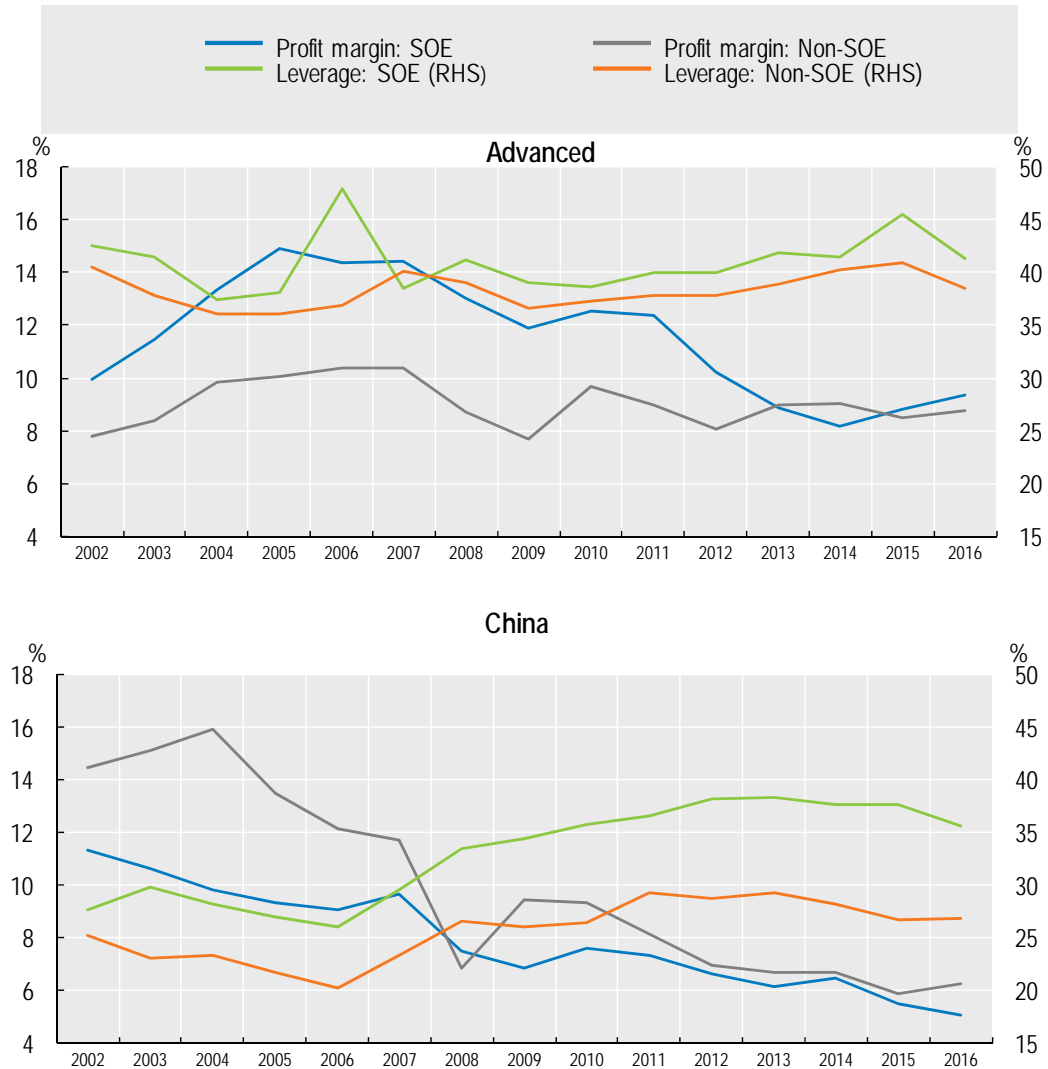
2002-2016

Advanced SOE
Emerging Non-SOE
Advanced Non-SOE
China SOE
Emerging SOE
China Non-SOE



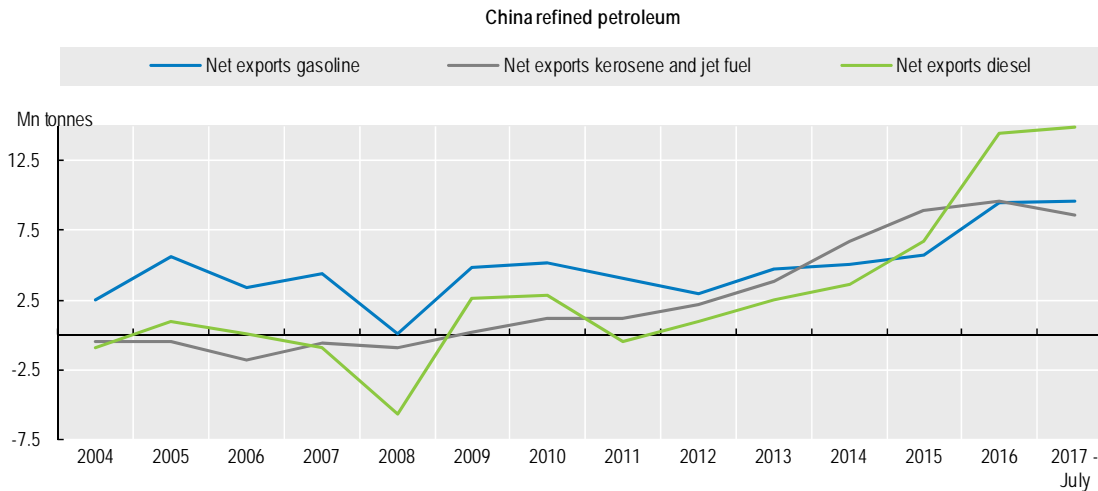


Profit Margins and Leverage





China Excess Capacity Issues (July at an annual rate)



Source: World Steel Association, China Customs, OECD calculations.





One Belt One Road: the New World Order?

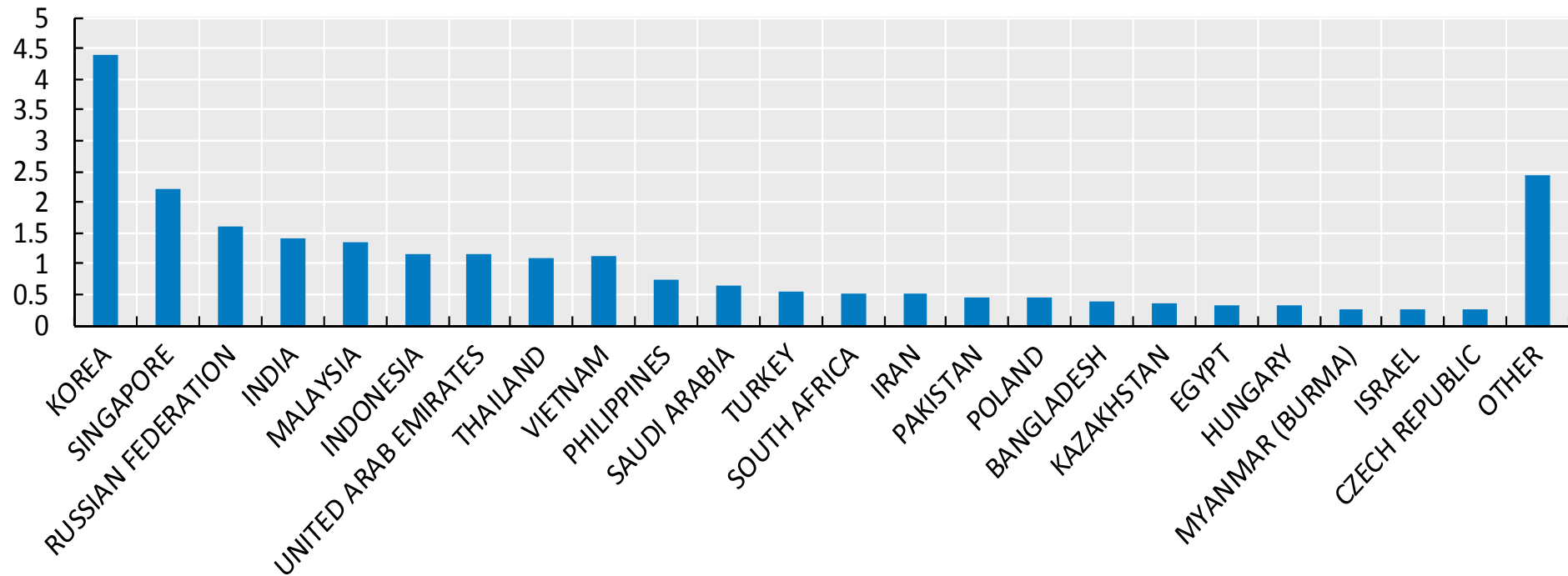
- Infrastructure building throughout China's neighbouring countries.
- Build this to facilitate exporting China's excess capacity along the belt and road in countries with similar closed economy philosophy & no anti dumping as with the West.
- Migrate lower-tech China factories move up the value added—needs markets for scale economies.
- Political hegemony.





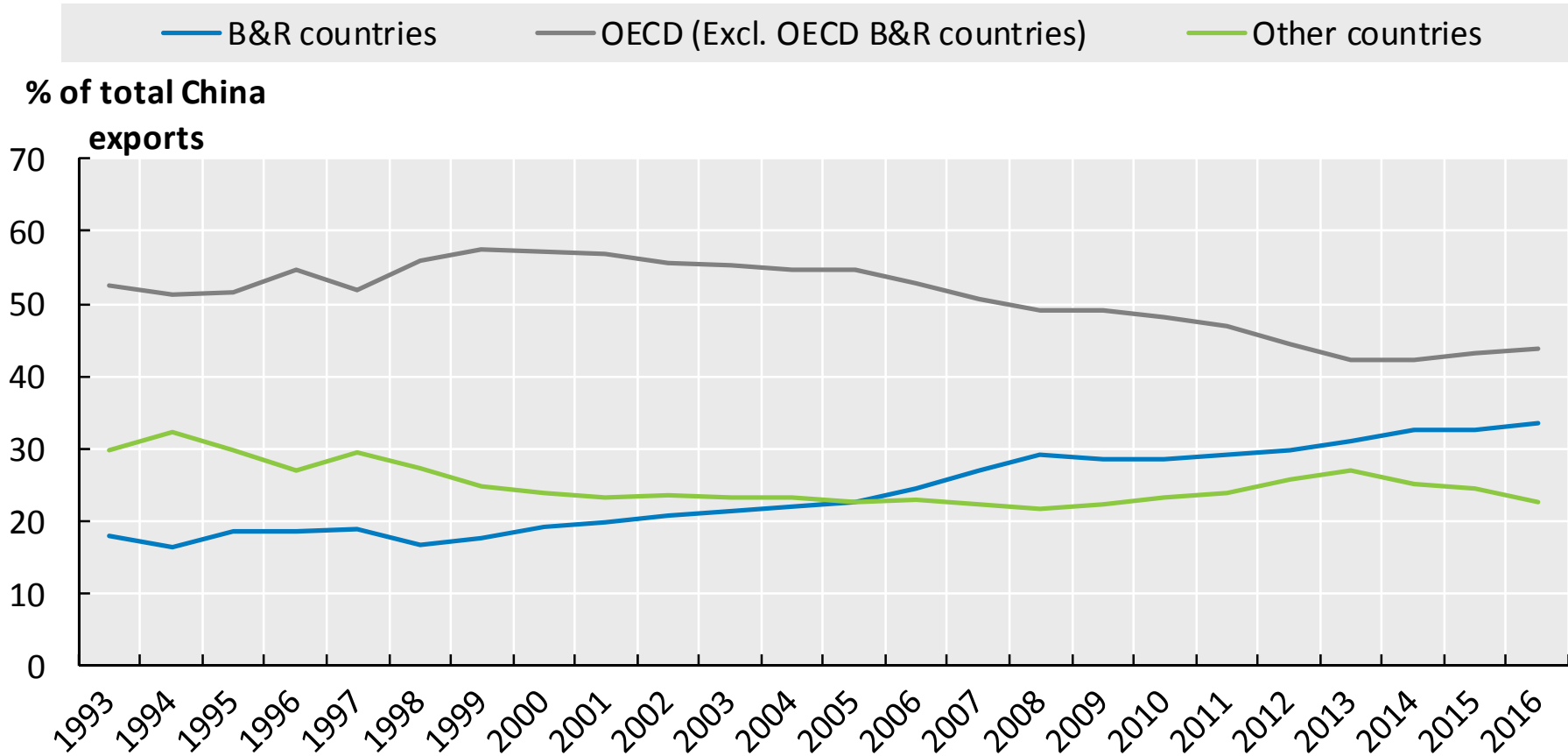
Belt and Road Partners of China

% of total China exports
(average 1993-2016)





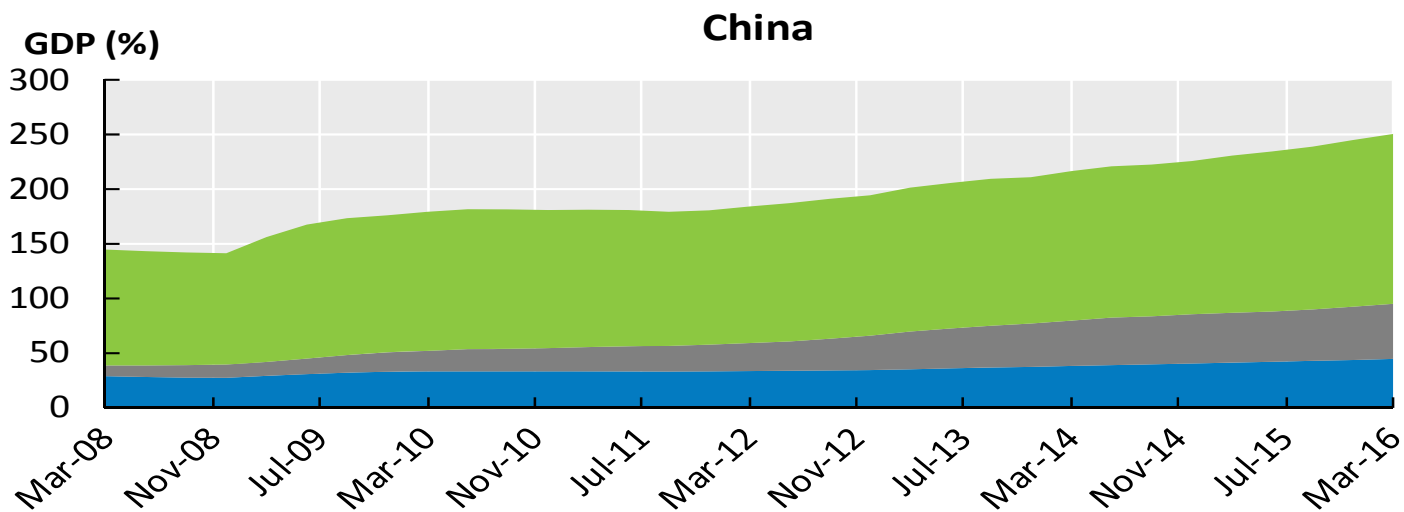
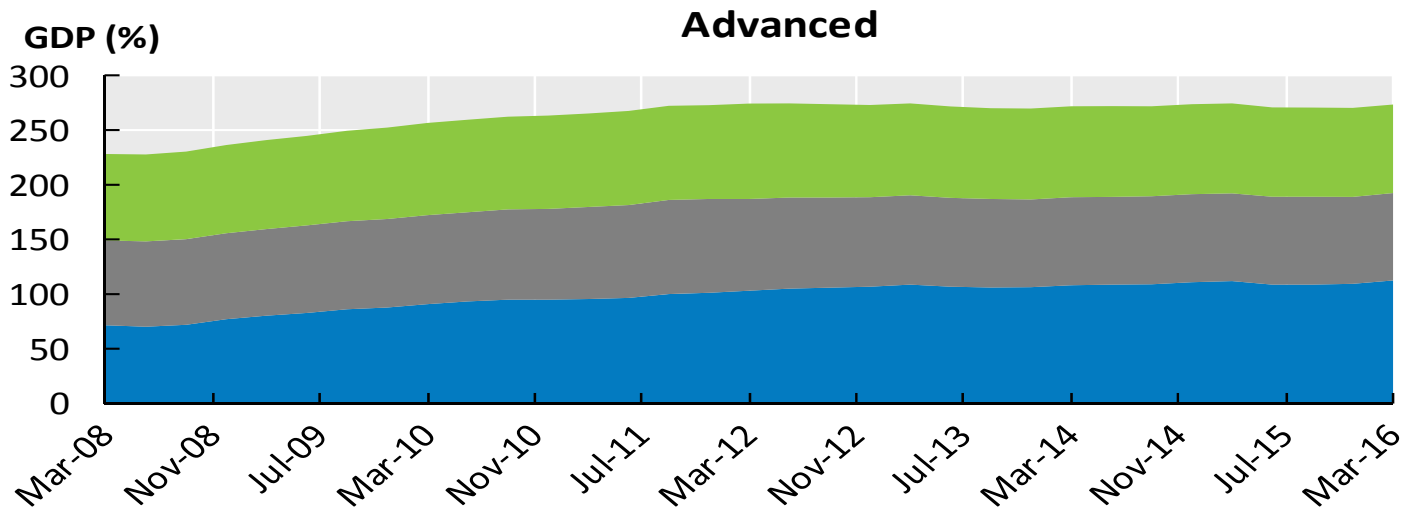
Belt and Road vs OECD in Trade





China Debt Situation: Poor Country With Debt of the Rich Countries

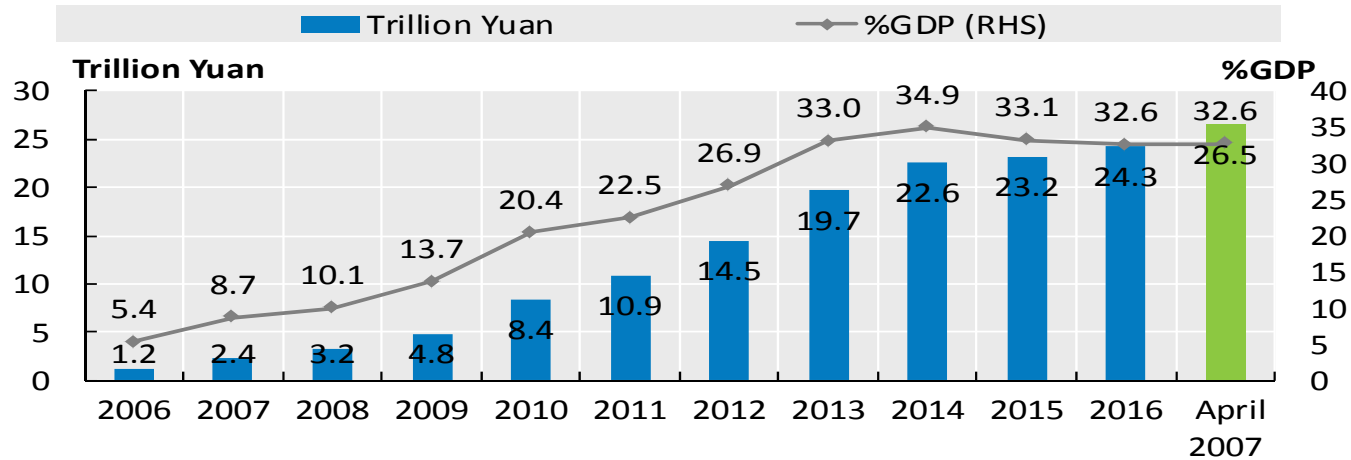
■ General government ■ Households and NPISHs ■ Non-financial corporations



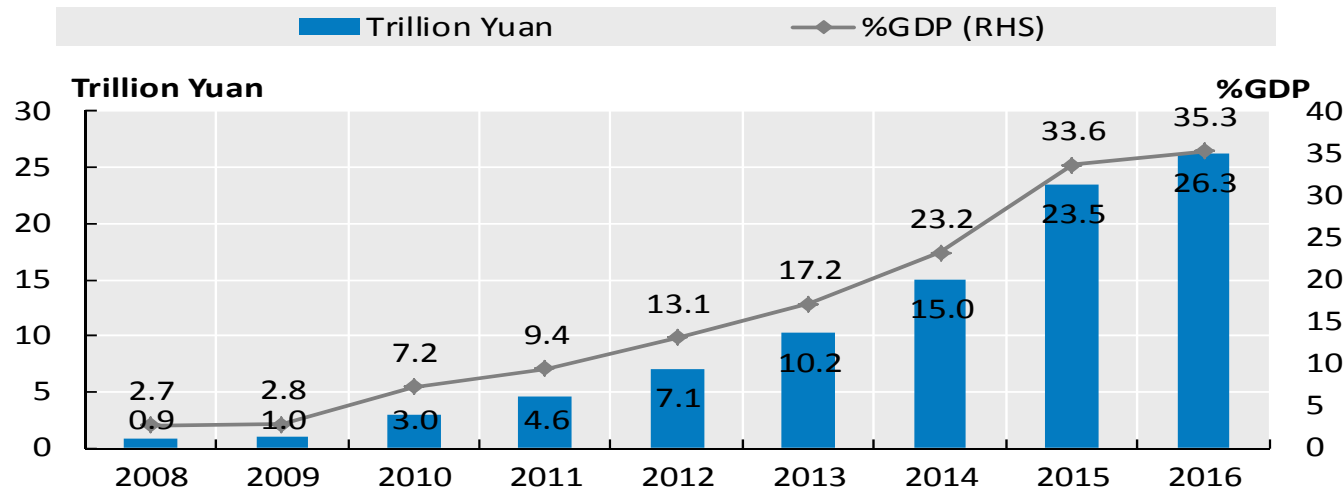


China Shadow Banking Activity

Entrusted Loans + Trust Loans + Undiscounted Bank Acceptances



WEALTH MANAGEMENT PRODUCTS





What role have companies played in the backlash against globalisation?

- Banks capturing regulators and pushing back on regulation— is Basel IV dead??
- Underwriting fees raising the cost of IPOs (hurting long-term investment)

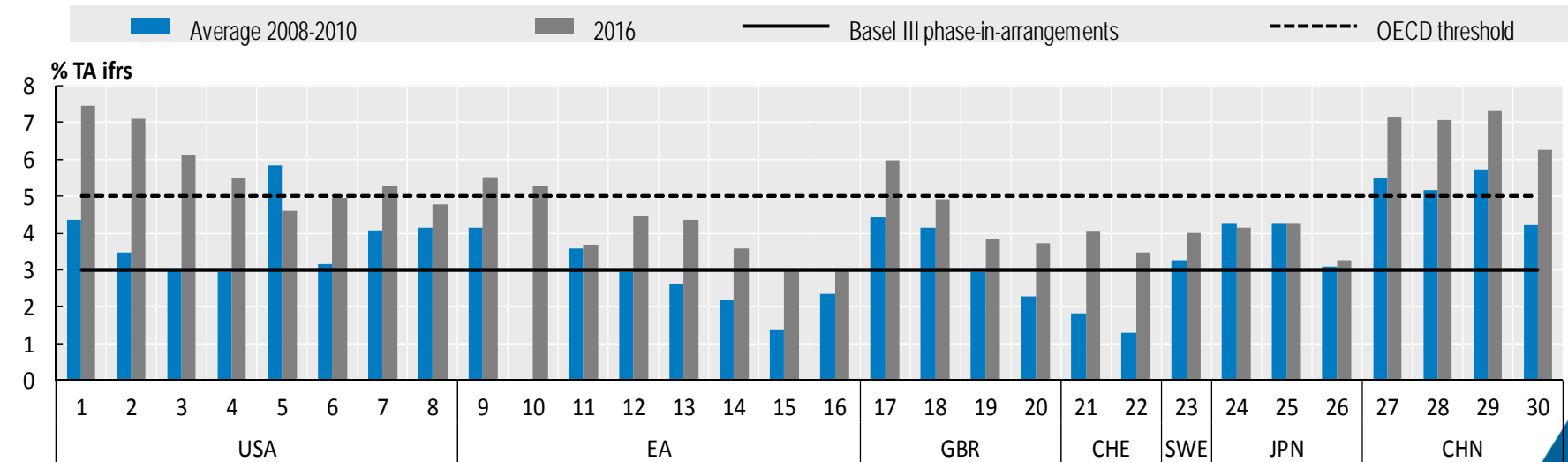
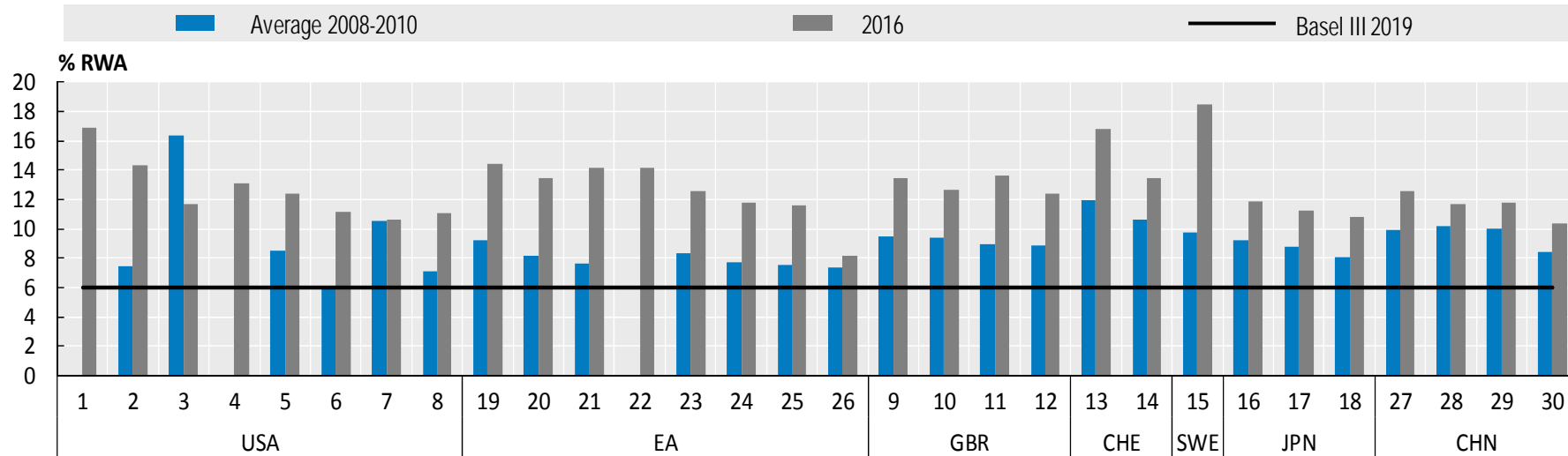
AND

- Two hundred and forty cross-border cartels were detected and fined between 1990 and 2015, affecting USD 7.5 trillion in sales.
- Irresponsible business conduct – but abuse of human rights and the environment + corruption are rife in EMEs. Supply chain management by Western companies amiss.
- Rent-seeking behaviour through bribery and corruption is estimated by the World Bank to be 2% to 3% of world GDP pa (equivalent to the size of the French economy).





Competition in Bank Regulation: Core Tier 1 risk-weighted capital ratio vs. Basel III leverage ratio for G-SIBs 2008-2016





Underwriting: tacit collusion on fees push up the cost of IPOs

- While SOEs benefit from subsidised funding, private companies need equity finance for corporate governance to operate via market-based principal-agent incentives.
- Yet tacit collusion in underwriting appears to raise costs excessively for IPOs, undermining the incentive to use the equity market.
- Total fees collected from 10 IPOs worth USD 100 million each correspond to the entire IPO float of another USD 100 M company.

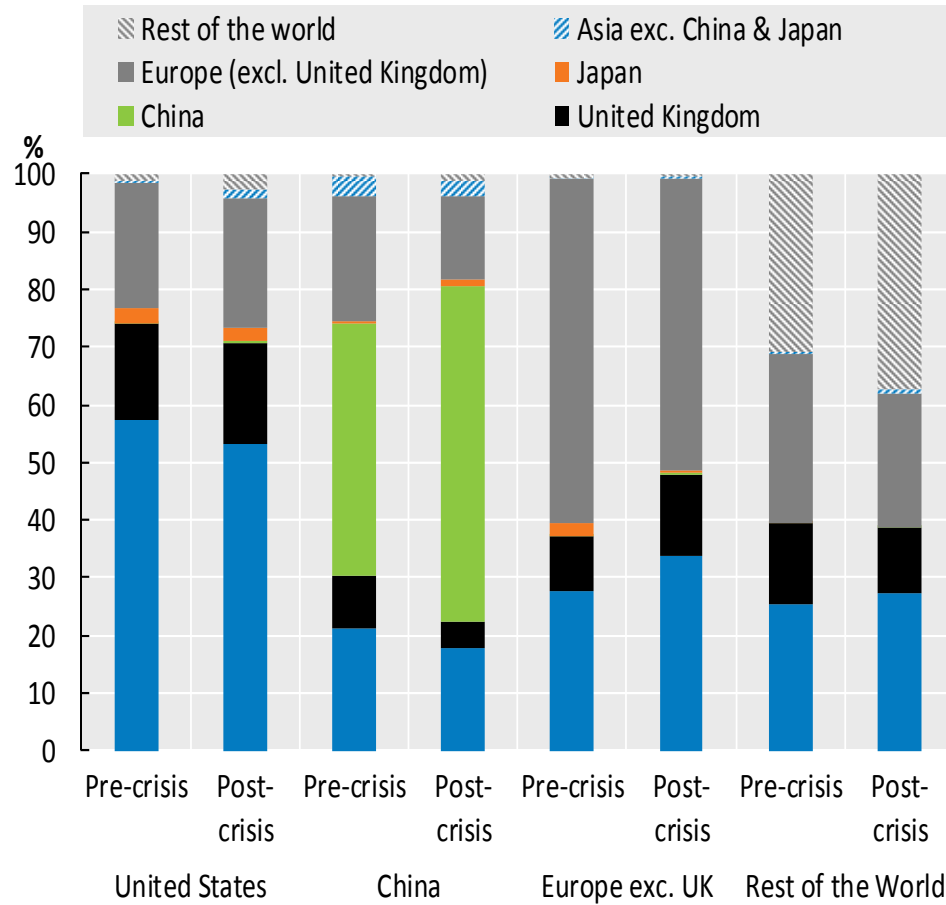




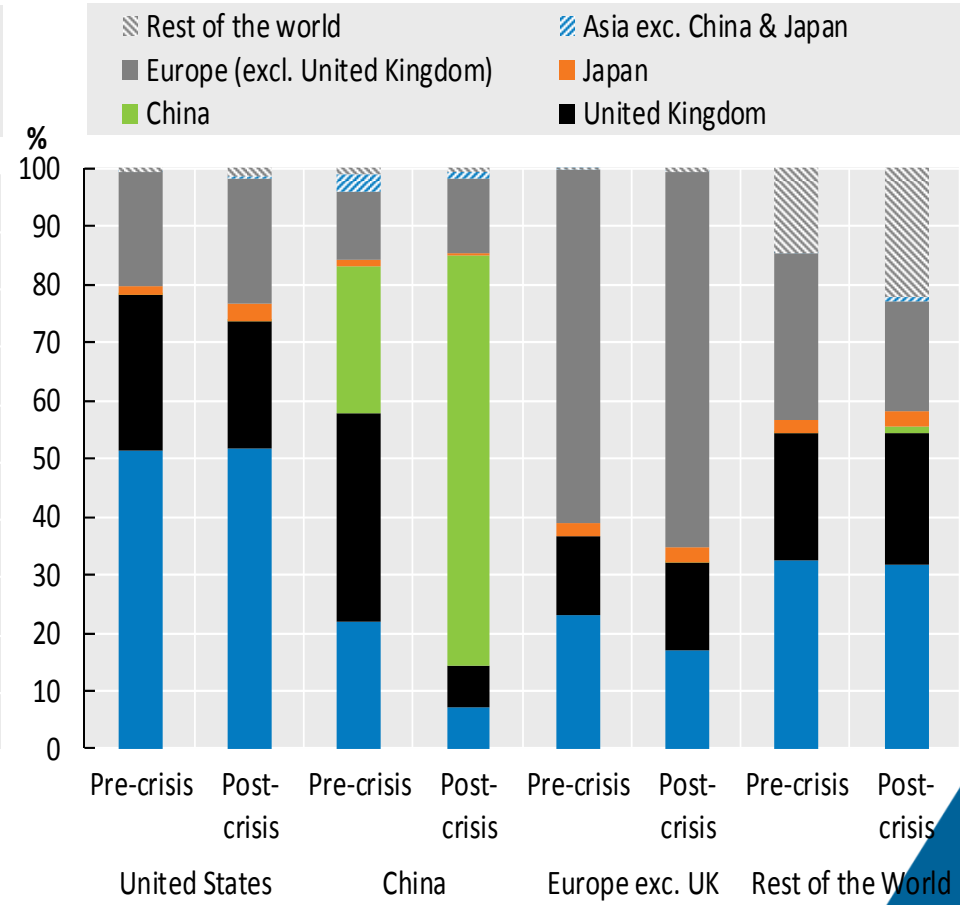
Market share of investment banks in underwriting

pre-crisis vs. post-crisis, 2016

Initial public offerings



Corporate bonds

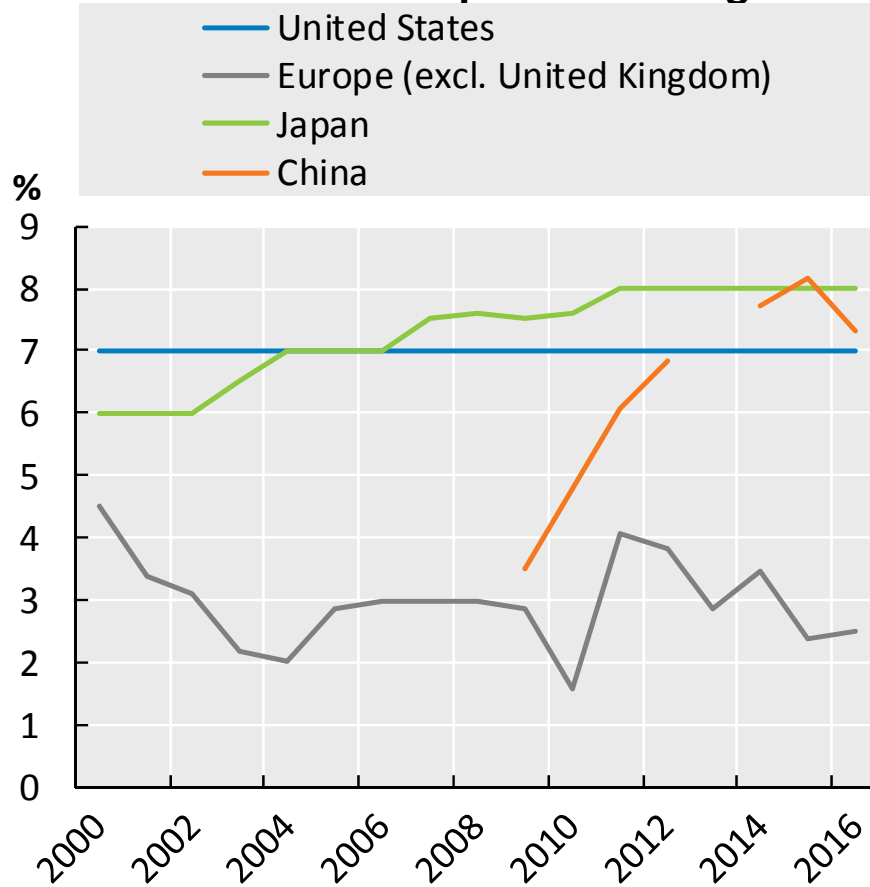




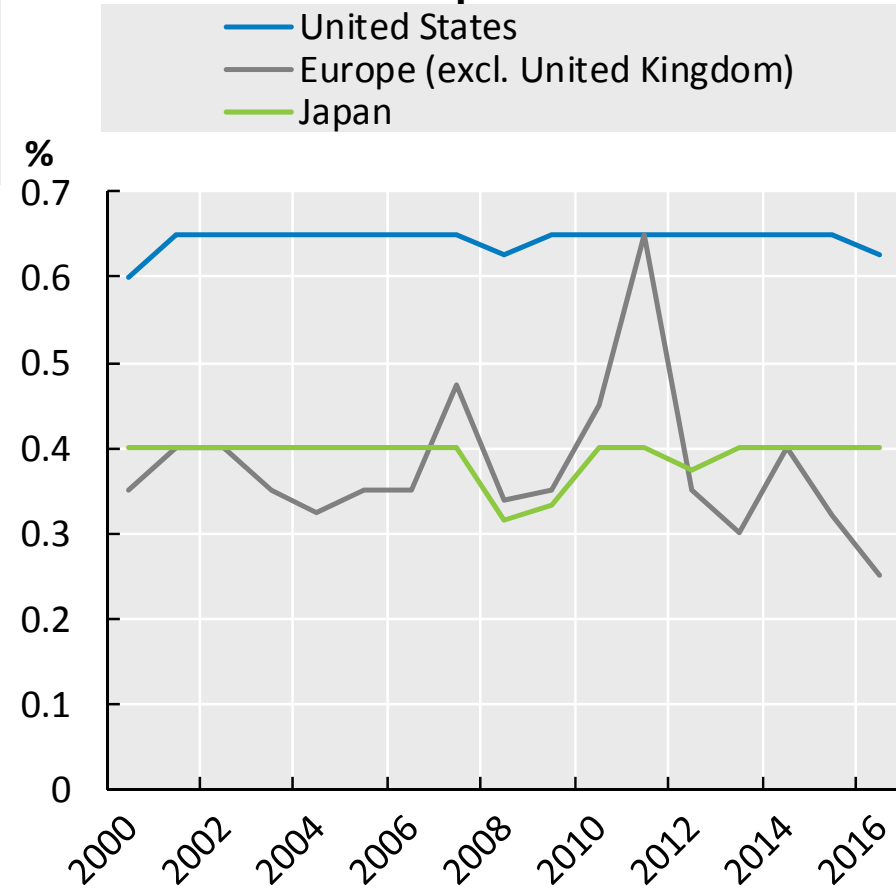
Underwriting fees

as a percentage of total proceeds, median values, 2000-2016

Initial public offerings



Corporate bonds





Brexit issues—a need for cooperation

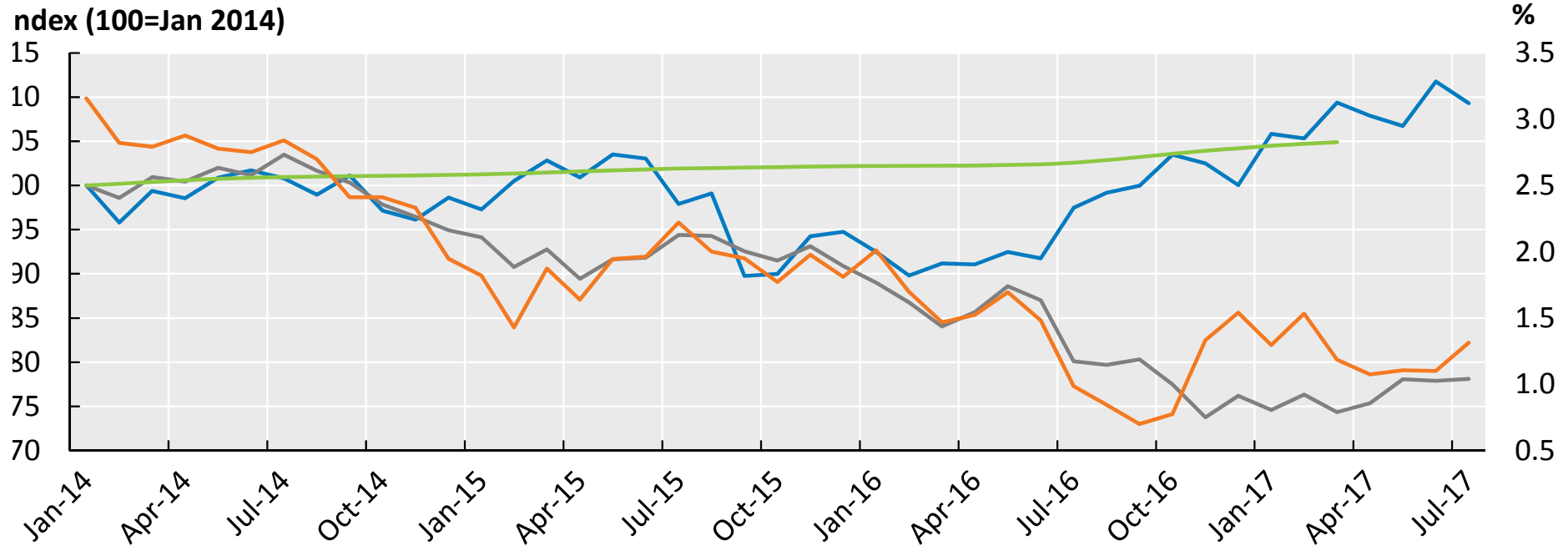
- The City of London is an agglomeration that serves the global financial system from which economies of scale and scope (internal to the location) are derived.
- Open trade in financial services is critical to finance in global markets not just for costs—example, catastrophe insurance coverage.
- Commitments under the OECD Codes of Liberalisation provide room for a pragmatic approach to the United Kingdom's exit from the European Union.





BREXIT: So Far So Good

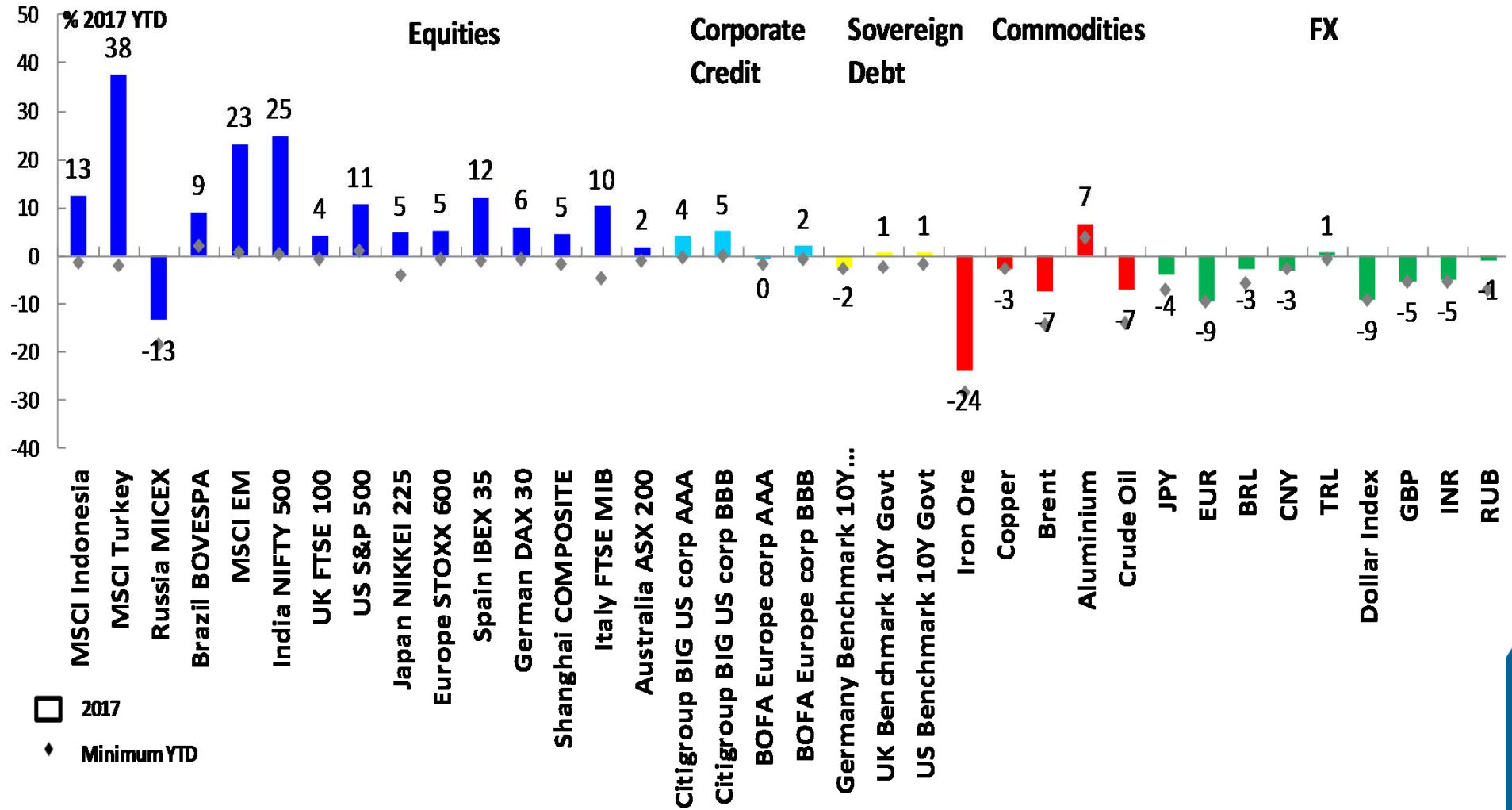
— FTSE 100 — FX (USD to GBP) — UK OECD composite indicator — UK 10Y interest rate (% , RHS)





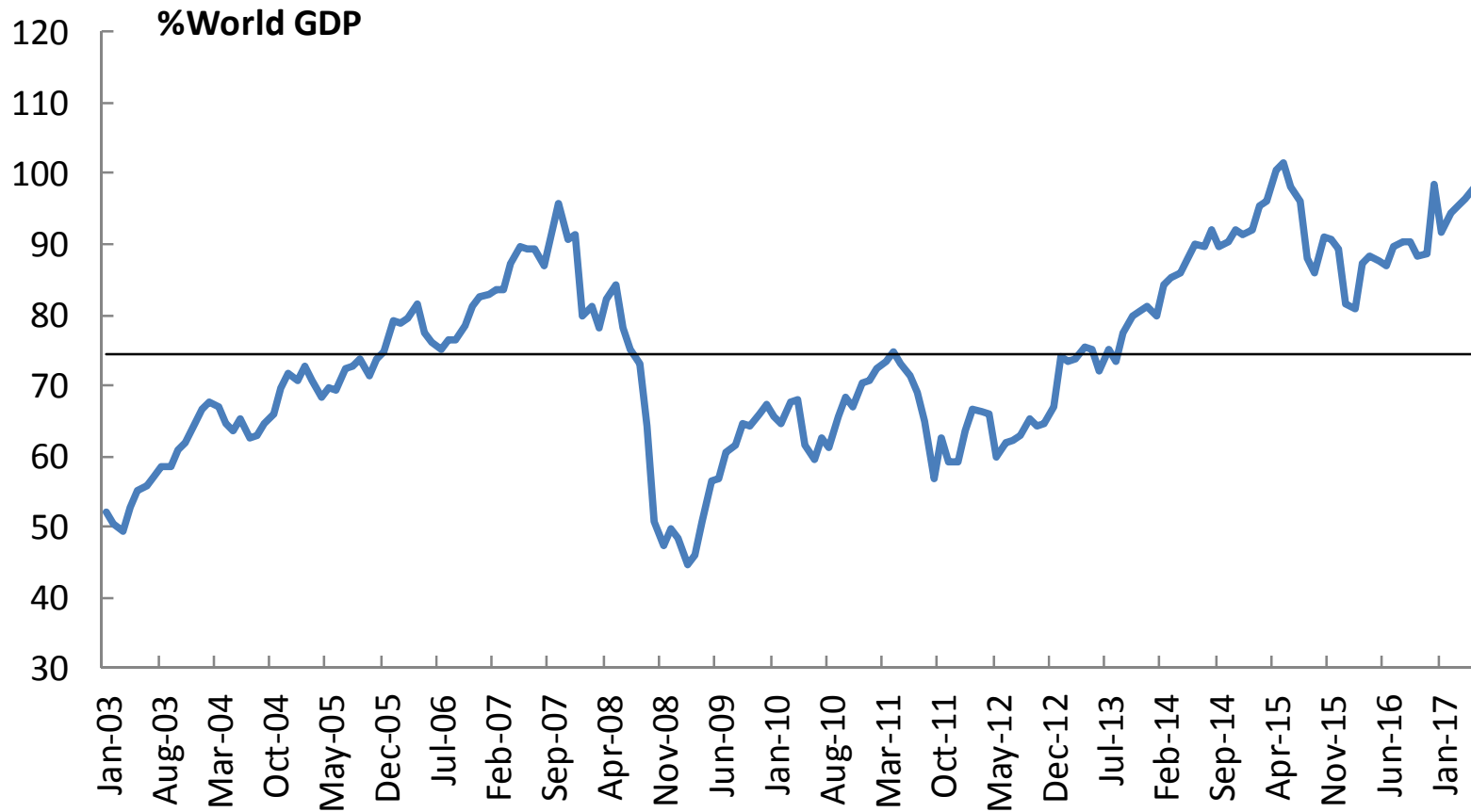
Markets This Year

last up-date July, 26th 2017





World Equity Market Valuation





Thank you

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Dr Luci Ellis
Assistant Governor - Economic
Reserve Bank of Australia

The current global expansion

Wednesday 20 September

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