Dr Adrian Blundell-Wignall
Special Advisor to the Secretary-General
Organisation for Economic Co-operation and Development (OECD)

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

Adrian BLUNDELL-WIGNALL
Special Advisor to the Secretary-General
OECD Directorate for Financial and Enterprise Affairs
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 can't 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.
And in China—a Different Story

![Graph showing productivity and wage trends in China's All sectors.](image-url)
• 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)
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?
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?
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.
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
Emerging SOE
China SOE
China Non-SOE
Profit Margins and Leverage

![Graph showing profit margins and leverage for Advanced and China over the years from 2002 to 2016. The graph compares profit margins and leverage for SOE and Non-SOE entities.](image)
China Excess Capacity Issues
(July at an annual rate)

Source: World Steel Association, China Customs, OECD calculations.
• 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.
% of total China exports (average 1993-2016)
Belt and Road vs OECD in Trade

% of total China exports

- B&R countries
- OECD (Excl. OECD B&R countries)
- Other countries
China Debt Situation: Poor Country With Debt of the Rich Countries

![Graph showing GDP (%)]
China Shadow Banking Activity

**Entrusted Loans + Trust Loans + Undiscounted Bank Acceptances**

- **Trillion Yuan**
- **%GDP (RHS)**

**WEALTH MANAGEMENT PRODUCTS**

- **Trillion Yuan**
- **%GDP (RHS)**
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
• 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
- Rest of the world
- Asia exc. China & Japan
- Europe (excl. United Kingdom)
- Japan
- China
- United Kingdom

Corporate bonds
- Rest of the world
- Asia exc. China & Japan
- Europe (excl. United Kingdom)
- Japan
- China
- United Kingdom
Underwriting fees as a percentage of total proceeds, median values, 2000-2016

**Initial public offerings**
- United States
- Europe (excl. United Kingdom)
- Japan
- China

**Corporate bonds**
- United States
- Europe (excl. United Kingdom)
- Japan
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

Index (100=Jan 2014)

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

(100=Jan 2014)
Thank you

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www.oecd.org/finance/
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Dr Luci Ellis
Assistant Governor - Economic Reserve Bank of Australia

*The current global expansion*

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