

# **THE STATE OF THE GLOBAL ECONOMY**

## **INTRODUCTION TO THE BUSINESS AND FINANCIAL ENVIRONMENT SESSION (BFE 1): MBA**

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The session deals with some complex and interesting issues. Although you will not understand the details and the complexity of all the issues that I introduce, you will become familiar with the ideas and as you think about them you will find them becoming clearer and increasingly useful. They are fundamental to your entire programme. I provide these notes as an overview. You will also be given time in the session to develop the ideas in groups in preparing your assignment. Look on my website<sup>i</sup> for related articles and notes.

The session will begin with an overview of the global macro economy. Then discussion will move to microeconomic and social aspects. In the latter case the pivot of the discussion is the notion of competitive advantage, its foundations in competitive dynamics, marketing, segmentation, operations and strategy; generally in the discourse of governments, firms and business schools; the dynamism it introduces into capitalism and its disastrous effects too.

### **The global economy**

We begin the story by distinguishing

- a. the system state: where the economy is now
- b. the trajectory of the system over time,,: that is the series of system states from now into the future (and from the past to now).

### **The system state of the global economy**

The world is recovering from a global financial crisis the costs of which globally are somewhere between \$60 trillion and \$120<sup>ii</sup>. The emerging markets are recovering more quickly than the developed markets. But the recovery only took place at all because of huge bailouts by western banks of their distressed financial systems accompanied by a fiscal stimulus and easy monetary policy (quantitative easing) plus an enormous fiscal stimulus in China (the biggest the world has ever seen) amounting to 25% of Chinese GDP.

The costs of the recent financial crisis (the Great recession) arise as unemployment, lost output, default and income (and wealth) transfers to lucky members of the financial sector from the rest of the world.

Globally there is potential deficient demand (and the risk of deflation) and excess supply. Actual demand and supply has been kept high to avoid a Great Depression like the 1930's: instead of a Great Depression we have had a Great Recession (beginning in 2007).

Deficient demand results from the slow recovery of the USA, dirty floats of exchange rates in China and Russia because they want to keep their export prices competitive, and generally the need for the household, government and financial sectors in the west to deleverage. The most recent financial crisis occurred because of over leveraging especially in the financial sectors, leading to over leveraging in household sectors due to asset price bubbles (especially housing) and lately government deleveraging. the need for governments to deleverage in the USA and the UK primarily because of the costs of their bailouts of their financial sectors and in other countries (the PIIIGS especially) because of Ponzi<sup>iii</sup> government spending.

Excess supply in the world is also partly the result of bailouts and fiscal rescue packages which keep interest rates low and fiscal spending on investment in china and tax holidays and corporate bailouts (autos). Another reason for excess supply is the attempt by the BRICS<sup>iv</sup> to maintain export led growth by keeping their exchange rates undervalued (dirty floats). In the EU surplus countries especially Germany have undervalued currencies in real terms against other Euro countries; undervalued in real terms because unit labour costs in Germany are relatively low (high German labour productivity and relatively low money wages).

This leads us to another aspect of the need to deleverage; trade and current account surpluses in some countries and corresponding deficits in others.

China Russia and in the EU Germany have trade surpluses and the USA, the UK and Japan for example have corresponding deficits. Essentially the USA needs to save more and consume less: and China needs to save less and consume more. It should be clear that trade (and current account) surpluses and deficits must net out to zero. For the thirty years or more the world has relied on the US economy to boost world demand. Currently there is not country or region able to replace the USA in this respect. This problem is compounded by huge consumer and government debt in the US which restricts spending and the need for China to have export led growth to avoid social disruption. Pressure in the USA exists to cut government debt and government financial deficit at time when unemployment in the USA is rising and growth is slow.

So the world economy faces dilemmas. The solution to one set of problems makes other problems worse. To a lesser extent the same issues face the UK as face the USA but relatively the UK is a minor economy.

As a framework for describing the system states I will use the meta model. but it should be remembered that the system state refers to a stat at a moment in time. The meta model consists of the underlying dynamics at q moment in time; inner and outer dynamics (with respect to an organisation), layoffs, and orgrammar.

## Trajectory; the future

Trajectory describes the path of a system over time: the series of system states over time as the dynamics (plus payoffs and or grammar) change over time. So trajectory is in time and system states describe moments in time.

It is important to distinguish system states from equilibria or equilibrium. A system must be in some state or other, but it is rarely if ever in equilibrium: things are always changing. Perhaps we have periods of tranquillity and that is what we mean by equilibrium.

Trajectories over time may be gradual and continuous with little change in system states over short intervals over time: maybe change is sudden and dramatic. Normal curve thinking leads us to concentrate on averages and to believe that deviations from the average (large deviations) are unusual<sup>v</sup>. In fact, black swans, or extreme events occur much more frequently than normal curve thinking leads us to believe. For example there has been more than 100 financial crises in the world over the last 30 years and typically senior management is concerned with managing extreme, unexpected events, sudden crises. A recent prime minister<sup>vi</sup> of the UK was asked what he worried about most: "events dear boy" he replied. Many managers would sympathise with this reply I think.

Let us think about possible trajectories for the global economy: possible scenarios, is probably a better phrase since we can't know the future. Almost certainly the Eurozone as it is now, will break up. The size of the breakup depends on events and policies. If PIIIGS<sup>vii</sup> debt is rescheduled, and somehow underwritten; if the euro crisis does not spread to Spain, Italy and further (Greece, Ireland, Iceland many of the Baltic States and perhaps Portugal countries; if a blind eye is turned to bigger of these economies and the USA defaulting; in the latter case if the the dollar is allowed to depreciate; if the ECB allowed to take over the fiscal policy of the PIIIGS states, including perhaps Spain; if Saudi Arabia remains willing to act as a swing oil producer to prevent the price of oil rocketing; if financial institutions in the west are willing to accept more regulation; even than any government dares to propose at the moment; if states are willing to cooperate rather than compete; if corporates drop the search for competitive advantage; if governments drop the discourse of competitive advantage; if we all become less greedy; if the rich (countries and individuals) become less greedy; if there are not too many natural disasters, wars or terrorist strikes; if some of these ifs (I'm sure you can think of a few more ifs) don't happen, then things will be OK.

One real source for optimism (I will speak about this) is informationism, a cliché perhaps in one way, but not in all. The information revolution will certainly have as big an effect on the world as the print revolution did in Europe in the sixteenth century. just as the effects of the

print revolution, were at the time, unpredictable, so we cannot know the impact of the information revolution on trajectories in the future. One effect may be to hasten new economy thinking, recognising interdependence: both in terms of feedback and domino effects (which we are seeing now) and in terms of responsibilities of one organisation, one country, or region or individual to another.

Why should this happen? I don't know; it is a possibility. But one aspect of informationalism<sup>viii</sup> is that it is becoming clear that machines can perform many of the tasks we took to be exclusively human better than humans can. So questions may arise as to what humans are really about, including perhaps aspects that we call soul, or care, or humanity.

### **Interdependence: some case examples**

Interdependence is a theme underlying much of the session. It can take a system state form; that is synergies the idea that a system as a whole can be more than the sum of its parts. It can also take a dynamic or trajectory form; that is feedbacks from one entity to another over time.

Interdependence in the global economy is discussed under a number of headings; (in politics) blowbacks, domino effects, (in sociology) network effects, (in physics) percolation, (in immunology) viruses, (in biology) complexity catastrophe, (in economics, business and finance, all of the above and) externalities, synergies, the too big to fail problem and the Great Recession that began in 2007 and is still with us.

A problem that we find time and time again in telecoms and also in large organizations as varied as pharmaceuticals, beer and automobiles is that globalisation and informationalism have shortened product cycles and changed the nature of competition and the structure of costs. To compete, innovating firms have to incur high sunk costs (R&D, promotion, marketing, systems, structures, training, networks) which have to be paid back out of future revenues. But product cycles have got shorter meaning that there is less time to do so. Furthermore information travels fast and innovations can easily be copied: and firms who copy can do so at lower costs, undercutting the innovators. One of the features of the new economy is that the ratio of fixed (or sunk) costs to variable costs has risen, meaning that marginal costs are often very low and pricing at variable costs plus contribution leads to the commodification of many products and services. The same problems, in a slightly different form, occur in medium and small businesses. Perfectly good businesses small, medium and global, find themselves underperforming.

The second example of interdependence is the Great Recession that began in the mortgage markets of the USA and Europe with the failure of Lehman Brothers and bankruptcy of 6 of the major finance companies in the USA Northern Rock and most of the big banks in the UK. Many were too big to fail: so governments had to bail them out by nationalisation or guaranteeing their toxic assets. The crisis spread throughout Europe. It affected (with a few exceptions) the entire world, through loss of output, unemployment and insecurity, resulting in a cost to the world of somewhere between \$60 and \$120 trillion. As result of bailouts and the size of Banks relative to the size of the economies in which they were owned, national governments, first Iceland, followed by Greece, Ireland, Portugal and perhaps Spain had to seek bailouts which in threaten the existence of the Eurozone. <sup>ix</sup>So the problem of bank insolvency has led to the insolvency of nations. Spanish debt for example is held by international banks, who have securitized it (Ponzi finance) and passed it on through CDS and CDO's to other institutions who have .....and so on.<sup>x</sup>

The third example relating to interdependence are natural catastrophes (earthquakes and tsunamis), man-made catastrophes (Deepwater, Chernobyl, wars, global warming) and terrorism. These things are often (not always) independent with respect to causation. But, in their impact globally they are interdependent: they require, as do the first two examples, the same policy responses, new (creative) ways of thinking and co-operation rather than just seeking competitive advantage by nations or by firms.

## NOTES

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<sup>i</sup> See [robindcmatthews.com](http://robindcmatthews.com)

<sup>ii</sup> Bank of England estimates. Note that trillion is a galactic number.

<sup>iii</sup> Ponzi was known as an swindler in the past. Ponzi financing consists of creating apparent wealth founded on assets of spurious or doubtful value. Ponzi financing a well established practice of the banks which is countenanced by governments. People in the finance sector call Ponzi financing financial innovation.

<sup>iv</sup> Brazil, Russia, India, China, South Africa (BRICS)

<sup>v</sup> A habit in normal curve (Gaussian) thinking is to use the immediate past to estimate averages. So when the economy is on an upswing, there is a tendency to think that the upswing will continue forever.

<sup>vi</sup> Portugal, Iceland, Ireland, Italy, Greece, Spain (PIIGS).

<sup>vii</sup> Mr Harold Macmillan.

<sup>viii</sup> I include the revolution in biotechnology.

<sup>ix</sup> See <http://robindcmatthews.com> and/or <http://www.tcib.org.uk/about.html> and/or <http://gsf.inesnet.ru> for fuller versions of this note and also the Financial Tower of Babel in Russian and English.

<sup>x</sup> CDO collateralized debt obligations are debts which are securitized on other debts which have been packaged (into tranches) which are in turn repackaged and so on. CDS, credit default swaps are effectively insurance taken out by the buyer of the CDO which will come into effect if the CDO falls in value below some specified level. Banks become so highly leveraged, because it profits them to do so. When confidence falls, the value of these financial innovations collapses and governments step in to bail out the banks concerned. All this is called financial innovation.