The Case *for* Pessimism

The coming new age of scarcity.

By William R. White

In 1940, John Maynard Keynes wrote an influential essay called "How to Pay for the War." In it, he outlined how the needs of war required that consumption be reduced or deferred if high inflation and growing inequality were to be avoided. Today, it seems little recognized that we are in an equally alarming situation. While the primary threat is not invasion by a foreign power, we have already begun a similar relentless transition from what Keynes referred to as an "age of plenty" to an "age of scarcity." The result seems likely to be continuing inflationary pressures and higher real interest rates over a much longer time period than most currently envisage.

Indeed, the potential problems arising from that transition might be even more severe and of broader scope than those feared by Keynes. Record high debt levels, both private and public, constrain future public policy options while rising inequality already threatens the democratic order in many countries. If unaddressed, climate change could threaten human advancement and even our existence. In short, like covid patients with pre-morbidities, the global economy is showing signs of systemic instability that could destabilize other related systems.

The last few decades, roughly dating from the end of the Cold War in 1989, could well be described as the "age of plenty," although not everyone got the benefits. A prominent supply-side feature was enhanced global political cooperation allied with market-based reforms almost everywhere. This led to a massive expansion in output, unprecedented growth in global value-added chains

William R. White is a former economic adviser at the Bank for International Settlements.

THE INTERNATIONAL ECONOMY
THE MAGAZINE OF INTERNATIONAL ECONOMIC POLICY
220 I Street, N.E., Suite 200
Washington, D.C. 20002
Phone: 202-861-0791
Fax: 202-861-0790
www.international-economy.com
editor@international-economy.com

(with China and Eastern Europe at their core), and a much sharper expansion of trade than GDP up until 2009 at least. The global workforce also increased significantly, as recently documented by Charles Goodhart and Manoj Pradhan (*The Great Demographic Reversal: Ageing Societies, Waning Inequality, and an Inflation Revival,* 2020). In emerging markets, a growing population and urbanization interacted with globalization to increase competition with workers in advanced countries. In advanced countries themselves, the work force also rose sharply due to favorable demographics and rising participation rates, especially for women. The fact that workers were increasingly in better health and better educated also helped boost output.

Of lesser but still significant importance, market-based reforms and global supply chains facilitated a growing focus by firms on efficiency, low-cost production, and shareholder value. As well, the supply of fossil-based energy and food rose relatively quickly in response to sharply rising demand, thus constraining potential price increases. Finally, there was a revolution in information technology. From its start in 1989, the World Wide Web became the internet and mobile phones spread everywhere. Driven by Moore's Law, processing became ever cheaper, and information storage transformed from analog to digital. Driven by all the above, online shopping and working from home became both possible and increasingly attractive alternatives to more conventional practices.

The global effect of all these supply-side forces was to raise average living standards, particularly in emerging markets. Billions were lifted out of poverty. However, they also pushed down the relative cost of labor to the benefit of profits, especially in the advanced countries. The implication of this was that median wages for workers in advanced economies failed to advance at the pace that an "age of plenty" might have implied.

Demand side developments also contributed to the "age of plenty." Investment was relatively weak in advanced countries as low labor costs, relative to the cost of capital, induced factor substitution. While central banks in advanced countries generally eased monetary policy in response to this disinflationary environment, consumption (and debt accumulation) generally responded more positively than did investment. Andrew Smithers has attributed a significant part of this to the "bonus culture" which led senior management to cut investment and borrow cheaply to raise cash for share buybacks which directly increased share prices and their bonuses. A more Austrian interpretation would be that current consumption financed by debt constrains future consumption, so there was no need to invest to meet a demand that was not likely to materialize. Finally, governments spent less on both "guns and butter" (military and social expenditures). The end of the cold war implied a peace dividend while, in many countries, a reform agenda based on market principles implied less spending for the purposes of income redistribution.

The world we are now heading into, the "age of scarcity," promises to be starkly different. Every one of the developments contributing to the secular "age of plenty" is now easing significantly or is going sharply into reverse.

On the supply side, global political cooperation has been replaced with fears of geopolitical confrontation and outright protectionism. National security, especially in the United States and China, has risen much higher on the ladder of priorities and no one can tell at this point how economically costly it will prove to be. While advanced economies will suffer, the International Monetary Fund and World Bank have expressed concerns that emerging markets might suffer even more as foreign direct investment retreats into "friendly countries only." The effective global work force is also declining due to demographic trends, falling participation rates, and skills mismatches arising from educational preferences. Observing increasing longevity and the rising incidence of dementia, Goodhart and Pradhan remind us that more workers will be required to care for the elderly, leaving still fewer workers for other needs.

While the primary threat is not invasion by a foreign power, we have already begun a similar relentless transition from what Keynes referred to as an "age of plenty" to an "age of scarcity."

The efficiency of global production will also suffer in the future from attempts to build resilience into production systems. This need was clearly demonstrated by the supply shortages that emerged during the covid pandemic. Growing concern for stakeholder as opposed to shareholder value will also raise production costs. Energy supply will be severely constrained in the future by concerns about climate change. Investment in new sources of fossil-based energy has been limited by fears of their being "stranded."

Continued on page 57

Continued from page 41

Investment in renewable energy has been rising rapidly, but projected supply still falls well short of future demands. Moreover, an acceleration of such investment is being held back by planning problems (grid expansion and connection), rising costs of inputs (especially labor and metals), and a worrying new trend towards resource nationalism.

Concerns about food supply center around the interaction of a still-growing global population and the impact of climate change on available land and the resiliency of current food staples like rice and wheat. With respect to information technology, the McKinsey Global Institute has recently suggested that the benefits of digitalization and connectivity are reaching a "saturation" point. Since there is a continuing debate in academic circles about the future of productivity growth, and given the promise of artificial intelligence, it would likely be prudent to conclude only that "time will tell."

The last few decades could well be described as the "age of plenty," although not everyone got the benefits.

Supply will also be constrained in the future by four "heritage" problems: namely, underinvestment, malinvestment, hysteresis, and concentration. Underinvestment refers to the recent low rate of investment already noted above, especially investment in fossil fuels and in prospecting for metals. Malinvestment, a word used by economist Friedrich Hayek, refers to investment in endeavors that will most likely never make a profit. Cheap financing over recent decades has led to an explosion of such firms, with negative implications for both productivity growth and financial stability. Hysteresis effects refers to recent research that documents how all economic downturns have "scarring effects" that leave the level of potential output permanently reduced. The covid pandemic has clearly left such scars, and any future downturn (say due to financial instability) will do the same. Finally, production and distribution systems have become ever more concentrated, increasing the scope for anticompetitive price increases.

Demand side developments will also contribute to the emerging "age of scarcity." Looking forward, each negative supply shock noted above implies a high prospective rate of social return on some future investment. Increasing national security provides the justification for the investment required to support decoupling/de-risking. Higher labor costs should provide a strong incentive to invest in automation and the capital stock. Building redundancy and modularity into global supply chains to increase their resiliency will also demand a higher level of investment. As for climate change, adaptation to this implies new investments to repair damage done by weather events and new investments to minimize the cost of future damage caused by such events. Mitigation or reduction of temperature change requires a whole new energy system based on electrification and renewables. Indeed, the International Energy Agency recently estimated the annual costs of achieving net-zero by 2050 to be $4 trillion, about 6 percent of global GDP in 2023. This is far above current spending levels.

Finally, government spending on both guns and butter also seems likely to rise. In light of recent geopolitical developments, military spending is already rising sharply almost everywhere. Increasing political polarization and civil disorder have also underlined the importance of reducing income inequality as well as inequality of opportunity. It is being more widely recognized that "trickle down" has not worked and that those left behind are increasingly questioning core democratic principles.

While slower growth will be a global phenomenon, the International Monetary Fund and World Bank fear that emerging markets will be hardest hit.

A slower growth rate of aggregate potential, along with much stronger demand for investment during the "age of scarcity," would seem a recipe for higher inflation and higher interest rates, both nominal and real. Not surprisingly, this would be just the opposite of the conditions that prevailed during the "age of plenty."

While slower growth will be a global phenomenon, the International Monetary Fund and World Bank fear that emerging markets will be hardest hit. Government deficits will also likely trend higher everywhere. This will be due to higher infrastructure investment (related to climate change in particular), military spending, and higher debt service due to higher interest rates. More welcome is the likelihood that higher wages should support workers' incomes and should mitigate inequality, thus reducing the need for extra government spending on redistribution. Finally, in an "age of scarcity," a significant increase in bankruptcies might be expected.

How should public policy react to these evolving and difficult circumstances? At least four possibilities suggest themselves, each with its own shortcomings.

First, governments could decide not to make the investments and guns and butter expenditures described above as being socially desirable. This would mitigate the short-run problems of inflation and rising government deficits. However, longer-run problems associated with national security and climate change would remain unaddressed with potentially disastrous outcomes.

Second, governments could increase their expenditures as suggested, let the deficits and borrowing rise, and rely on tighter monetary policy to return to current inflation targets. Current difficulties in doing this, in the aftermath of the covid pandemic and the invasion of Ukraine, imply this task will become even more difficult in the "age of scarcity"; repeated and overlapping supply side shocks would seem highly likely to encourage a wage-price spiral. Relying on higher interest rates could also lead to financial instability. Current ratios of private sector debt to revenues are very high and there are many other indicators of potential stress in the financial system. As well, higher rates could also generate perceptions of government debt unsustainability, leading to still higher rates in turn—the Truss effect. Current ratios of public sector debt to GDP are very high for peacetime and, in many countries, quantitative easing has made debt service much more responsive to higher short-term interest rates. In a worst-case scenario, instability in one sector could lead to instability in the other—often referred to in Europe as the "Banking-Sovereign nexus."

Third, governments could act as above (increased spending financed by more borrowing) but try to limit the feedback effects on interest rates and debt service through administrative procedures and capital controls. So called "financial repression," in which inflation is allowed to rise but interest rates are held down, was used successfully to reduce debt overhang after World War ll. The first problem is that this strategy might not work in the modern financial world whose complexity and openness invites evasion, in which case we are back to the dangers of the second case above. The second problem, even supposing repression can be made to work, is that the debt overhang problem is resolved at the expense of creditors (including pension funds) and to the advantage of debtors (including leveraged private equity firms). Given current concerns about inequality, this forced redistribution of wealth would seem likely to have dangerous political repercussions.

Ordinary citizens must accept that, in an "age of scarcity," their only choice is between "half a loaf or no loaf at all."

Fourth, governments could respond to the coming challenges in the spirit (if not the letter) of Keynes' "How to Pay for the War." The need for tighter money would be reduced by broader supply side reforms to increase economic potential. This latter objective might also be served by tax reform favoring investment over consumption. Increased fiscal expenditures, associated with climate change and other high priorities, would be paid for by efforts to improve efficiency in government and higher taxes/lower tax expenditures designed to fall specifically on consumption by the wealthy. Importantly, this should be complemented by pension reform and other regulatory proposals to increase saving rates overall. Finally, procedures for facilitating insolvencies and timely restructuring would be improved to ensure they happened in an orderly rather than a disorderly way.

This last approach might be the best way to confront looming challenges, but it too has its shortcomings. Politicians must lead the way even if it hurts their chances of reelection. Vested interests must cease to resist reforms that are in the public interest. Ordinary citizens must accept that, in an "age of scarcity," their only choice is between "half a loaf or no loaf at all." These requirements are difficult and unlikely to be met in practice, implying that one of the other three possibilities will be chosen as offering an easier path going forward. Sadly, each one of these alternative paths is likely to prove much more dangerous than is currently anticipated. ◆