Inferential Focus

BRIEFING

IF 3403 February 11, 2013

THE BIG SHIFT PLAYS OUT:

A RESTRUCTURING ECONOMY AND ITS EFFECTS

CONTEXT & DYNAMICS

Moving toward *the fifth year of this recovery, significant shortcomings of the economy are starting to look less like a slow recovery than the effects of something larger and with greater staying power than any economic downturn, even if that downturn was reasonably called the Great Recession. The effects of what we have called the Big Shift are starting to become more problematic for developed countries, and the shrinking of wages and salaries that has resulted from that economic shift is causing systemic problems. What will happen if another cyclical downturn occurs before the economy returns to its pre-Great Recession level? For one thing, it would be a signal of the kind of economic restructuring that the Big Shift is forcing. With this in mind, is it possible that the recent run-up in the New York Stock Exchange is another round of irrational exuberance?*

OPPORTUNITIES

- *Products and services that make individuals with diminished financial capabilities feel secure.*
- *International companies that market to developing countries.*
- *Automation/robotics – the right balance of machines and humans.*
- *Products and services that meet a "good enough" standard among wage-challenged consumers.*
- *Healthcare efficiencies in the developed world; healthcare services in the developing world.*

RISKS

- *Depending too heavily on middle-class consumer spending.*
- *Debt availability based on an old model of wages and salaries.*
- *Retailers' share of the economy shrinks (digital and physical combined).*
- *Automation/Robotics – efficiency obsessions go too far.*
- *Inflationary pricing.*

INFERENTIAL FOCUS

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A Statistics Story

The economic crisis triggered by the failure of tricked-out financial instruments and dubious mortgage practices garnered the name the Great Recession for a reason. Not only did it generate numbers that made every other post-World War II recession pale by comparison, it seems to have accelerated a structural change in the economy that has been under way for years, if not decades. As the recovery moves toward its fifth year, what had been characterized as effects of the Great Recession are starting to look like effects of something much greater than a recession, something structural with long-term consequences?

> What had been characterized as effects of the Great Recession are starting to look like effects of something much greater.

◆ Since 2000, 70 percent of the country's college graduates have seen their after-inflation hourly wages decline.

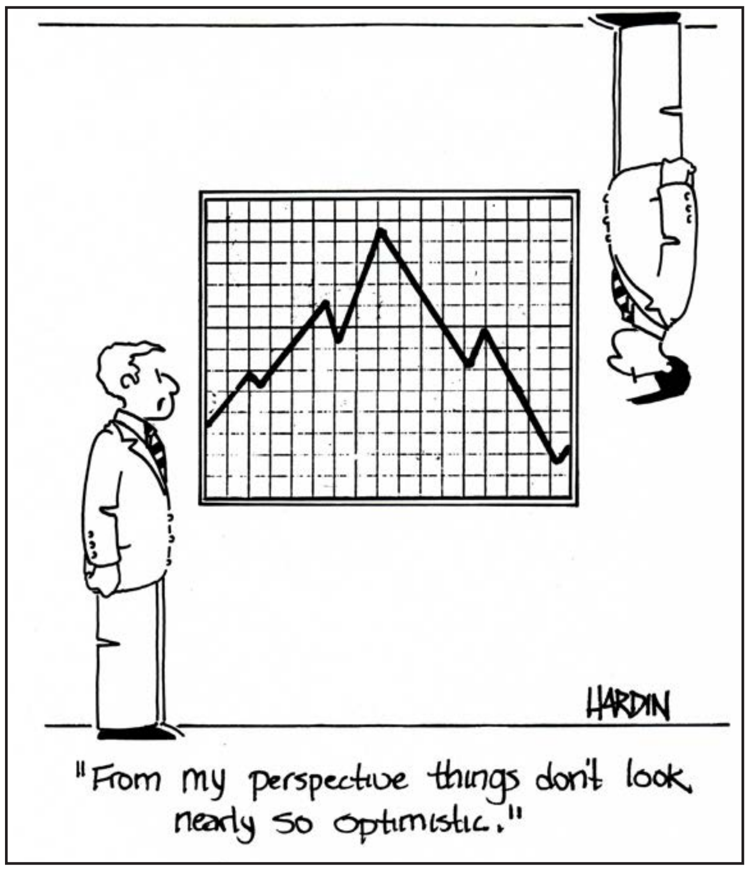
◆ One in four workers in the United States now earns less than $10 per hour, and a quarter of all jobs pays below the poverty level for a family of four. More than 146 million Americans have jobs but earn less than they need to pay monthly bills for food, clothing, housing, transportation, child care and healthcare.

◆ Nearly half of working Americans with college degrees are overqualified for their jobs. For instance, 25 percent of retail sales clerks have college degrees.

◆ Half the 7.5 million jobs lost in the Great Recession paid mid-level salaries (*i.e.*, $38,000 to $68,000), but only 2 percent of the first 3.5 million jobs created since the recession ended paid in that range, and 79 percent were low-paying jobs. In the four recessions that preceded the Great Recession, the percent of jobs created that were mid-salary ranged from a low of 30 percent to a high of 46 percent.

(*The Week*, 2/8/13; *New York Times,* 1/13/13; *Wall Street Journal*, 1/8/13; *National*, 1/24/13)

The last item about the low percentage of new jobs paying mid-level salaries hints at a larger context for the economy. Certainly, the Great Recession deserved its moniker because of its severity, but even that deep a recession cannot explain the lackluster post-recession performance of the economy. And, indeed, it does not. A deeper look at a few more numbers can begin to uncover a larger story that takes into account a larger piece of history.



Structural Shifts Are Hard to Take

As the Dow Jones Industrial Averages rounded 14,000 (and then retreated), casual observers might have concluded that the economy was ready to take off. But in today's structurally shifting economy, the traditional assumption that the stock market is a bellwether might be anachronistic. In fact, 60 percent of the profits generated by S&P 500 companies comes from international manufacturing firms that account for only about 15 percent of U.S. employment. (*Time*, 1/28/13)

Several numbers suggest that while economic growth is taking place, fewer people are participating in that growth than in past recoveries. Such a condition does not bode well for an economy dependent on consumers for nearly 70 percent of its activity.

◆ In the years before 1975, aggregated wages as a percent of America's gross domestic product (GDP) hovered just above 50 percent. By 2001, the percent had slipped slightly to 49 percent, and since then, it has plummeted to 43.5 percent, the lowest percent on record. Overall wages, including benefits, as a percent of GDP have fallen to a 50-year low.

◆ Between 1973 and 2011, worker productivity increased by 80 percent, while real median compensation increased at one-eighth that pace.

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◆ In the recessions that followed World War II, post-recession recoveries took 6 months to return to the jobs level that existed prior to the recession. But then, the 1990 recovery took 15 months to return to the pre-recession jobs level; the 2001 recovery took 39 months; and the current recovery is 68 months old and still far from reaching the pre-recession jobs level.

◆ Between 2000 and 2011, the American economy expanded by 18 percent, but the median real income for working-age households (headed by someone under 65 years of age) actually declined 12.4 percent.

◆ In the 1990s, new businesses opened their doors with an average of 7.6 employees; today they open with 4.7 employees.

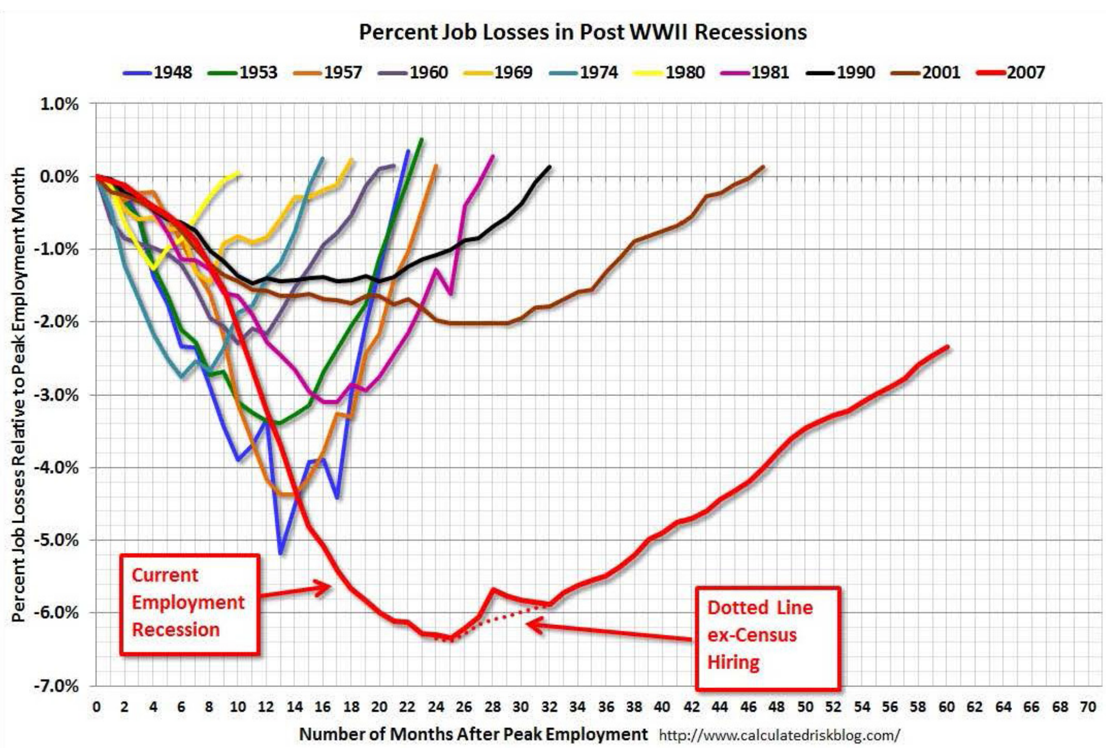
◆ New hires in the Detroit auto industry can expect to be paid $18 per hour, down from more than $28 per hour four years ago.

(*New York Times,* 11/14/12 and 1/13/13; *National*, 1/24/13; *Current History*, 1/13)

As several of these facts highlight, something started to shift in the 1970s and, despite temporary periods of economic hyperactivity (*i.e.*, the Internet and housing bubbles), that shift continues today. The 1973 oil embargo, imposed by OPEC, seemed to be the start of what we have called the Big Shift, a huge transfer of wealth from net consuming/importing countries to net producing/exporting countries (see "The Big Shift," Parts I & II, **IF 3224** and **3225**, 12/23/11 and 12/30/11).

That shift in wealth changed both the importing and exporting countries in substantial ways. Between 1980 and 2010, for instance, the percent of global GDP accounted for by trade increased from 30 to 56 percent, and the share of foreign direct investment quadrupled, making the flow of capital worldwide a much greater part of the economic growth for the 26 members of the Organization of Economic Co-operation and Development (OECD). With jobs leaving developed countries and more capital flowing easily across borders, those involved in capital markets fared much better in the Big Shift world than did those in developed economies depending on their labor for a living. (*Current History*, 1/13)

As just noted, the Big Shift moved many jobs from consuming countries to exporting countries and hollowed out labor-intensive manufacturing among consuming countries, encouraging importing countries to assume more and more debt (financed, in part,



by exporting countries) to pay for the products and services citizens wanted, even though the economy was undergoing changes that made it difficult to generate the kinds of growth necessary to support such debt.

That helped shift priorities in many consuming countries from industrial production to creative financial engineering, ultimately with severe economic consequences. It also piled cash in the foreign-exchange coffers of producing countries, resulting in an increased number of sovereign wealth funds, which recently have been deploying their capital to purchase devalued assets in the very importing countries that spent that capital buying goods from the exporting countries (see "Making a Move: Cash-Rich Countries Exploit Their Advantage," **IF 3004**, 3/4/09).

But that is all history. Now the effects of the Big Shift are hitting home in more pronounced ways, and business and political leaders seem to be at a loss as to what to do. In Only the Paranoid Survive, a look at the structural changes undertaken at Intel in response to significant changes in the marketplace, Intel's former chief executive Andrew Grove writes that "when a strategic inflection point [his term for a significant change] sweeps through the industry, the more successful a participant was in the old industry structure, the more threatened it is by change and the more reluctant it is to adapt to it." In the post-World War II environment, the U.S. was that "successful" participant, enjoying status as a superpower with the world's largest economy and a reputation for being the greatest innovator, with the most forward-looking thought leaders, and a considerable force for democracy. It will be hard for leaders to recognize and adjust to an economy that might not be able to generate the kinds of growth needed to support such a post-war giant.

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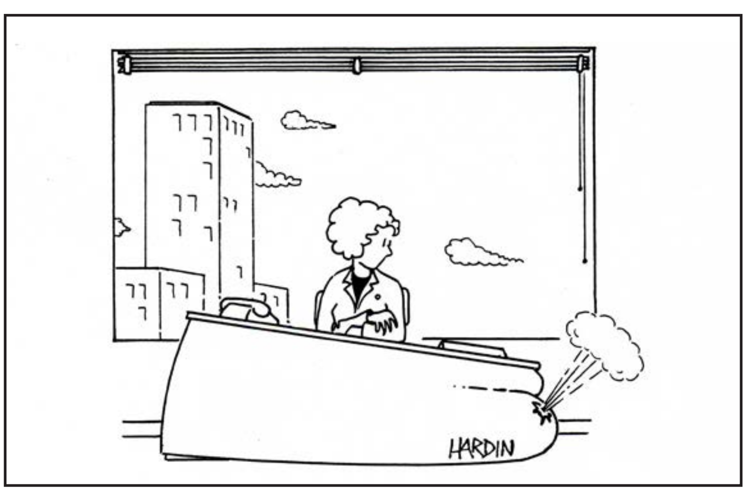


Where Does This Lead?

The causes of the salary dislocations that are putting a drag on the U.S. economy are many and diverse. Globalization has put a downward pressure on wages, as the global economy – in a very short period of time – added billions of workers to the global labor pool. Just the collapse of the Soviet Union resulted in what one observer called "the great doubling" of the international workforce, putting 1.5 billion new workers into world labor markets. (*Current History*, 1/13)

Another cause of the employee-wage imbalance has been technology, which continues to displace workers, creating a situation where more and more job seekers compete for fewer and fewer jobs. For instance, of the 2 million jobs lost since the Great Recession in finance, human resources, information technology and procurement – essentially back-office jobs – more than half were displaced by technology (others were outsourced or simply eliminated). In addition to direct job displacement, new technologies also carry a bias toward higher-skilled jobs, thereby widening the gap between salaries for those who can ride the wave of technology and those challenged (or displaced) by technology's capabilities. A study by the OECD concluded that over the past 25 years, technological change has been responsible for one-third of the income gap between the top 10-percentile-earners and the bottom-10-percentile earners. (*National,* 1/24/13; *Current History,* 1/13)

One additional cause of the worker wage and salary declines is corporate priorities. The top 50 employers of low-wage workers, for example, have been paying top executives, on average, $9.4 million per year, and since 2006, those same companies have distributed $175 billion in dividends to shareholders. To take one specific example, the average Wal-Mart worker receives $8.81 an hour, and one-third work too few hours to receive benefits. Last year, the company earned $16 billion. In the 1950s and until the Big Shift started to affect financial thinking, a majority of corporate profit growth went to employees' compensations (*i.e.*, salaries, benefits). The shift in corporate priorities from employees to shareholders has put downward pressure on salaries in many companies. (*The Week*, 2/8/13; *San Francisco Chronicle*, 2/10/13)

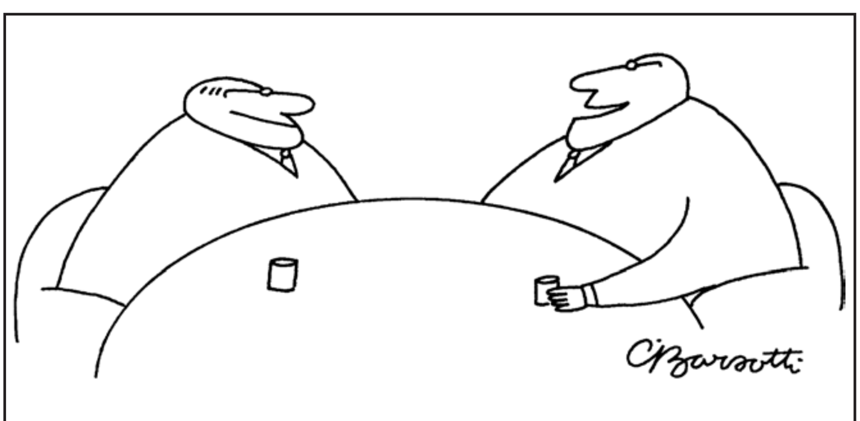
Whatever the causes – and there are many – the effects of the salary dislocations brought on by the Big Shift realities have yet to play out. Already, some very strange conditions are spreading across the economy. Consider the current Gini coefficient measurement. The Gini coefficient is a metric to quantify the distribution of wealth in an economy, with zero signifying a society in which every citizen has exactly the same income and the number one signifying a society in which all income goes to a lone individual. In other words, the closer the number is to one, the less distributed income is in the economy, and the closer it gets to zero, the more equitable the income distribution is. With such a tightly bound metric of zero to one, subtle moves in the figure can have large effects.

◆ Between 1979 and 2007, the Gini coefficient for the U.S. went from 0.48 to 0.59.

◆ The overall Gini coefficient figure for all of Europe is 0.33, for Asia, 0.34; for sub-Saharan Africa, 0.44; for Latin America, 0.49; and for the Arab Middle East, 0.39.

◆ Between 1998 and 2009, Russia's Gini coefficient moved from 0.50 to 0.35.

◆ In 1976, when Mao died, China's Gini coefficient hovered around 0.30. Between 1985 and 2007, the figure moved from 0.25 to 0.40, and more recently, to 0.50. (*Current History*, 9/12, 10/12, 12/12 and 1/13)



"The key is for the wannabes to think they have a chance in hell to be."

Sensing the risks of a rising disparity in income, Beijing recently ordered a 17 percent increase in minimum wages for urban workers and mandated an additional 10 percent increase annually until 2015. To focus on both ends of the wage gap, Beijing is capping salaries of top executives at all state-owned enterprises and mandating that future salary increases for these top earners increase more slowly than those of the average worker. The country is also working to complete a national healthcare program and a national pension plan. (*Caixin*, 2/6/13; *Current History*, 1/13)

Beijing's central-plan reaction stands in contrast to an anecdotal example of Pamela Waldron, an employee of a KFC restaurant in New York City. She has worked at the store for 8 years and is earning $7.75 per hour and has not had a raise since 2007. (*New York Times,* 1/13/13; *USA Today*, 1/29/13)

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Stagnant and sliding salaries in an economy heavily dependent on consumer spending are very likely to have a long-term effect on that economy. During the early years of this shift, the U.S. economy managed pretty well because of "imported deflation" – that is, it could import cheaper and cheaper products because manufacturers were able to move from low-cost producer to lower-cost producer, and, therefore, the prices of imported goods rarely went up and often went down. Also, since the Great Recession, the U.S. government has sustained social programs that have kept money flowing into the hands of those whose salaries were declining (unlike, say, several European countries that have drastically cut services lately and are experiencing widespread upheavals).

Consequently, the U.S. has yet to face some of the negative consequences that the Big Shift is triggering.

The current recovery in the U.S. is 68 months old, and it is still not close to returning job levels to pre-recession numbers, and, moreover, through 2011, salaries in the recovery actually declined – what if a cyclical downturn happens before the pre-recession numbers are reached? It would signal that the economy has downshifted in its capabilities, a reality that would be in line with the effects of the Big Shift.

" Ms. Green, send in someone to curb my optimism. "

What Does This Mean?

Even though the economies of developed countries have yet to complete the adjustments necessary to align with the new realities created by the Big Shift, several implications are already apparent: focusing on jobs is insufficient; developed economies are entering a spiraling economic irony; the make-up of the U.S. economy is shifting: and women will continue to be the leading indicator of change.

◆ Focusing on creating jobs as a sole solution to the lingering heavy burdens of the Great Recession misses the long-term effects of the Big Shift. Stagnant and declining across-the-board compensation is a long-term threat to economic viability. China has tackled that problem head-on, yet Beijing's first actions could help but might not be sufficient. Meanwhile, talk in the U.S. of increasing the minimum wage, which could lift families from the bottom, will not alleviate the scope and extent of the strains caused by stunted wages, a condition that has been nearly four decades in the making.

◆ Imported deflation has kept consumer prices in line with the reality of sliding wages – international production and expanded automation have enabled manufacturers to produce their wares at cheaper and cheaper prices, and, when these goods are imported into an economy with stagnating wages, the lower prices have helped keep consumer spending alive (especially with new consumer-debt capabilities). Now, wages are rising in the countries that have, heretofore, been producing less expensive goods, leaving automation as the means to sustain lower prices (and China's Foxconn has announced it will deploy 1 million robots across its manufacturing facilities). But automation is also one of the reasons that developed economies, especially the U.S., are not creating jobs fast enough to keep up with population growth and to make up for the losses from the Great Recession. In fact, automation, technology and robotics are actually accelerating job displacement. And so, the situation comes down to what might be called a spiraling economic irony: The very thing that is reducing employment is now needed to keep prices low for those who still have jobs but are being paid less and less. What effects will this spiral create?

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◆ The U.S. economy has depended on consumer spending to generate roughly 70 percent of the economy. As the effects of the Big Shift start taking hold, that percentage will be decreasing.

◆ Women employees in the U.S. and elsewhere have been paid (and continue to be paid) less than their male counterparts for doing the same work – a recent look across 30 industrialized countries found the disparity in salaries between men and women to range from 7 percent to 30 percent, but a disparity occurred everywhere. Yet working women have still needed to keep up with men in office attire, to maintain the same kinds of work schedules and to continue to manage household expenses. That is to say, women have done more with less. We have called women "the leading indicator" of the changes society is undergoing, and that is true here, as well. As the economy structurally scales back from the post-war averages, women will increasingly be seen as the leading indicator of how to cope with the new realities. (*Governing,* 2/13)

The conditions brought on by the Big Shift do not portend a no-growth economy or necessarily indicate an imminent economic downturn. Nor do they suggest that the run-up in the Dow Jones Averages is "irrational exuberance." What they do express is a context of change that suggests growth will be harder to generate and will likely remain below historical levels in the developed world until such time as the drivers of the Big Shift (transfers of wealth into concentrated pools among exporting countries and various kinds of institutions) and the effects of The Big Shift in the U.S. and the developed world (salary stagnation and job shortages) are adjusted. Such a revision of the currently restructuring economy will require a strategic perspective and action at a very high level.