

Interview with Dr. Paul Sheard, Senior Fellow at Harvard Kennedy School's Mossavar-Rahmani Center for Business and Government

The Pandemic Will Transform the Global Economy & International Relations

By Japan SPOTLIGHT

At this moment, in May 2020, it is difficult to predict the future of the global economy after the coronavirus. Whether the first wave of the pandemic will fade away soon is not quite certain. If a second and third wave come, how seriously they would affect the world are also questions that nobody can answer. How soon we can develop a medicine for treatment and vaccines to deal with the virus is another question that needs to be answered before we can have an objective outlook for the global economy.

But even at this current chaotic stage it is important to look ahead and consider what will most likely happen and how we can prepare for it. In particular, we need to understand properly what has happened and try to be analytical in thinking about a future strategy to cope with the crisis.

Dr. Paul Sheard, a well-known economist and former board member of the Research Institute of Economy, Trade and Industry (RIETI), gives us his analysis of the current situation and his views on the future in the following interview.

(Interviewed on May 5, 2020; some data updated)

Macroeconomic Prospects for the Global Economy

JS: Regarding the recently published IMF Outlook, we are curious about your view of its base-case scenario.

Sheard: I think it looks quite optimistic. I don't think any forecaster at the moment has a lot of confidence about their forecasts. So much is potentially changing and so much could happen. The situation is not getting any better, so most people look at their forecasts a week, two weeks, a month ago and they are looking optimistic. The IMF forecasts were prepared about a month ago for the Spring Meetings. The IMF is a big organization and when they put together a forecast there is quite a lag in preparing all the information. A 3% fall this year and a bounce-back next year looks quite optimistic, and I think it is optimistic on two counts.

One, the fall in global growth this year will probably be bigger than 3%; it depends on how far the economy falls and then how long it stays in a depressed state. All the indications are that, even if economies are opened up, they will take some time to get back to anywhere near pre-Covid levels. For next year, the IMF has a bounce-back of about 5.8%, which seems optimistic as well. That would leave the global economy at the end of 2021 about 2.6% above its



Dr. Paul Sheard

2019 level, the pre-Covid level. So what the IMF forecast is saying, taken together, is that the net effect of the coronavirus and the recovery over a two-year period is going to be a net positive, almost 3% global growth. That looks terribly optimistic, given what we know is happening to economic activity now. I don't think anybody can have confidence in particular numbers; we don't have all the April data or the second-quarter GDP data because it hasn't finished yet, but the most compelling piece of data at the moment is the US initial claims data. We now have 11 weeks of data since the shutdown began. The job losses in that period – or the cumulative initial claims – total almost 43 million people, and have been running between 2 million and 6 million per week.

The numbers are unprecedentedly bad. The unemployment rate went from 3.5% in February to 14.7% in April. We have never seen such an incredible spike in unemployment in the United States; it is unprecedented. In the Global Financial Crisis and Great Recession the unemployment rate in the US went from 6.1% in August 2008, just before the "Lehman Shock", to a peak of 10.0% in October 2009. That was the worst recession in the US since the Great Depression. The unemployment rate went up by 3.9 percentage points and it took 14 months for it to hit a peak. Compare that with this current situation where the unemployment rate spiked to nearly

15% in just two months. But it is much worse than that. The labor force has declined by 3.8% of its February level and the administration has said that the Paycheck Protection Program helped more than 50 million workers. Add up all the numbers and a rough calculation suggests that the real underlying unemployment rate could be as high as 40%.

That just gives you an indication. Japan is suffering, Europe is suffering, the US is suffering, China is suffering. Pretty much the major part of the global economy is experiencing that kind of negative shock to aggregate demand. Against that backdrop, these IMF numbers look very optimistic.

JS: What will be the key points in looking at the future economy? All countries are now engaged in some stimulative macro policy and that might be a key point in thinking about how economic growth will come back. The second factor might be financial stability, in particular in Latin American countries, for example.

Sheard: The first point to recognize about this event is that its impact on the economy is unprecedented. Worse than the Great Depression in terms of the hit to aggregate demand in some ways is that it is driven by a virus, a biological phenomenon. What is hitting the economy is the response of governments to that virus, which is to shut down much of the economy.

This is a totally different paradigm from anything seen before. Central banks and governments have pulled out all the stops. They have come out all guns blazing. They are acting as if they all believe in Modern Monetary Theory (MMT). Central banks are doing enormous liquidity operations and governments are transferring huge amounts of income to corporations and households, with the result that budget deficits will go through the roof.

If you look at this from a traditional perspective, it looks like an incredible macroeconomic stimulus. But it is not really a stimulus. Central banks and governments are not really trying to do with those measures what they normally try to do in a recession or a depression – which is to try to restore aggregate demand as quickly as possible. With the one hand they are shutting the economy down, and with the other hand they are easing monetary and fiscal policy, but they are not trying to get people to come out of their houses and go to restaurants or sports events or to go on holidays – or to go shopping in Ginza. They are not trying to do that, therefore this is a very different type of policy response. I think they are trying to do two things.

One is to minimize the second-round effects; a certain amount of reduction in aggregate demand is necessary, but they don't want that to go into a downward spiral, a tailspin that drags everything down. So they are trying to keep the fall in aggregate demand to the

absolute minimum. It is still a big fall but they are trying to cushion it.

The second thing is to keep the economy almost in suspended animation – that is, to provide a kind of lifeline to the economy to keep it intact, so that as it starts to open up it is ready to go again. This is a true exogenous shock to the economy, and if the virus goes away, in theory there is no reason why economic activity shouldn't go back to roughly what was happening before, so policymakers are trying to keep the economy intact. So that is the liquidity support, the income support. In the US you have the Paycheck Protection Program. The macro policies are very important but everything is going to be driven by what happens to this virus.

To the second point, I would not focus so much on financial stability in emerging economies because at the moment the biggest shock is to the US and Europe, in terms of the impact on economic activity of the virus. About 48% of deaths have been in Europe, and about 28% in the US. Only 1.2% of reported deaths have been in China, and Japan just 0.2% as of today. Financial stability is a concern, but it is really more of a concern about developed markets in terms of the global economy and that is why central banks and treasuries are taking such dramatic action.

Besides the pandemic, the next big question mark, if the virus does subside and through the second and third quarters it goes away, will concern how quickly does consumer spending and corporate investment come back. There are two possibilities. On the one hand you would think there would be a lot of pent-up demand for holidays and concerts and shopping and so on. I think that is a strong argument, but on the other hand, to what extent will consumer behavior have been changed by all of this? To what extent has business behavior changed? It may be that for a while consumers will be quite cautious, and also the opposite of pent-up demand or a kind of variation on pent-up demand is that maybe some people will have gotten used to a more modest way of living. People may have spent two months or more living largely in a virtual online world and there may be some change in mindset about this ostentatious consumer-oriented society. This is a once-in-a-century or maybe longer shock to the global economy and global society and just to the way the world operates. There will be all kinds of ramifications from this that will play out over time. Some of them may not manifest for five to 10 years, and at this point in time we can only hypothesize what they might be, but when people are looking back at the way in which the world has developed, it will become clear that the genesis of that event or change can be traced back to this moment in time, simply because it is such an unprecedented and unusual event that will have ramifications that may be quite deep. For example, there has been a trend in the Western world over the last 20 years or so towards people living in crowded urban areas. More and more people have been coming into and living in densely-populated city centers. Will that trend be

reversed? Will people return to rural and suburban areas?

The estimate for the number of people who died from influenza in the US this season is 24,000-62,000. The number of Covid-19-related deaths is already well above the upper end of that estimated range. The worldwide number for Covid-19 deaths is about 380,000 at the moment. Globally, the flu usually kills up to half a million or 600,000 people. The mortality rate for Covid-19 – I don't know exactly what the technical term is – but people estimate it to be in the 0.1-2% range. But it is not 10% or 20% or 50%. So one question I think people will have is, is this a once-in-a-century event? We have had Ebola, H1N1, SARS, MERS in the last 20 years – is this going to become the new normal? Are we going to get this kind of pandemic next year or in five years time? That is really important to the way consumers, businesses, governments, everybody reacts to this. Is it just a once-in-a-century earthquake or are we living in the Japanese archipelago where you expect earthquakes at any time? The answer has implications for the way all these entities behave.

Prospects for Macro Policies

JS: All countries are now engaged in stimulative macro policies, which could cause some concern about inflation. What do you think about such concern?

Sheard: I don't think it is warranted at all. We had the same debate back in 2008-2010 about quantitative easing. The reason we are getting the monetary and fiscal stimulus is, of course, because aggregate demand is collapsing and unemployment is shooting up. That is really a deflationary environment. If these policies are successful they will stop deflation from happening or keep it short-lived. Throughout the whole developed world since the financial crisis, inflation has been missing. Japan was just coming out of deflation after 20 years. I don't see inflation as a risk at all at the moment; inflation happens, as you know, when there is too much money chasing too few goods. When the economy is pushing against its speed limit, it is at full employment and there is too much demand, too much purchasing power and it is starting to force prices up.

But there is a second thing that you need, and that is the central banks and governments not reacting to the threat of inflation. To get inflation you need inflationary pressures and then central banks in particular not sufficiently fighting those inflationary pressures. At the moment, central banks are fighting the threat of deflation and high unemployment. If at some point the central banks start to see inflation coming back, there are two things to note. One is, that will be associated with a return to normal – the demand will be coming back and hitting the supply constraints of the economy. Secondly, central banks know how to deal with inflation. It is much more

difficult to deal with deflation. So for all those reasons I am not worried about that. In the future, central banks and governments will have to change their policy settings. I mentioned MMT before. I think there will be a lot of interesting implications for macroeconomic policies and frameworks, but I don't worry about inflation.

JS: As you know, Japan already has a tremendous amount of fiscal debt. This debt will obviously increase more drastically, and in light of this how can Japan be better prepared for an aging society?

Sheard: It is a complicated issue. There is a lot of misunderstanding about budget deficits and government debt. Japan runs a current account surplus and is the biggest net creditor to the rest of the world. So the budget deficit is a deficit of the government sector. The private sector in Japan has a big net surplus of savings over investment. This big net surplus more than offsets the government deficit and leaves over a surplus of net savings that Japan can provide to the rest of the world, which is the current account surplus.

In terms of the aging issue, future generations will inherit the JGBs, which are a debt of the government but an asset for the people who hold them. In terms of the financial liability for Japan, those two things largely cancel out because most JGBs are held by Japanese. There is no real net burden from the debt. What is going to determine how prosperous Japan as an aging society will be is not how much government debt it has, but how productive the society is. To what extent will Japan be relying on foreign workers and immigrants? Productivity and technological innovation will be important. Also, changes in social behavior. Japanese are pretty healthy, and living longer lives means they can work longer too. That is really what is going to determine how prosperous Japan will be as an aging society. It will be the real economy, the real capital stock, the intellectual capital stock and the amount of social capital, not pieces of paper called JGBs.

International Relations

JS: Moving to the international economy and governance, some people are saying that Chinese influence will increase after this pandemic. China is much less affected by it than the US or G7 countries. How do you view Chinese influence after the pandemic?

Sheard: The big picture of the global political economy is that, with the rise of China, what we have been seeing playing out over the last 5-10 years is a major turning point in the global order, and specifically the end of Pax Americana, the end of the Bretton-Woods

system – a turning point for the liberal international order. The election of Donald Trump really drove this point home, that the US is no longer willing and able to play the role of the dominant global “benign” hegemon underwriting the global order – the global policeman underwriting security in Japan and the Korean Peninsula, in Europe through NATO, and in Australia too. It is no longer prepared to underwrite the global international order by opening its markets and being the consumer of first and last resort. They are just another big country, albeit a superpower. That is really the message from President Trump – we, the US, can no longer perform the role that we have hitherto performed, and which the rest of the world expected us to perform.

The flipside to that is the rise of China. China is obviously the other superpower in the world. In nominal GDP terms, the US accounts for 25% of global GDP, China is about 16%, Japan is next with about 6%. In terms of purchasing power parity (PPP), however, China is 20%, the US is 15%, and Japan is about 4%, behind India. A fundamental shift has taken place, but there is a real complication there. We may move in the next two decades into a situation where clearly the biggest and most powerful single country in the world – China – has a very different political system, a different ideological system and worldview. There is a real need for the world to come to terms with this geopolitical and geoeconomic shift. The US and China need to reach some kind of agreement but also the rest of the world needs to step up and start to understand that the rules of the global game have changed. Countries like Japan, Australia, the United Kingdom, as well as the European Union, have to decide what strategy they are going to take in that world and what role they can play in bringing about a new form of global governance.

The external environment that China will face particularly from the US and increasingly from Europe, and probably Japan and Australia too, is that the world is becoming increasingly skeptical of China’s management of information, such as the virus infections in China. When it comes to trade, you could argue that it did not matter too much if China had a different political, ideological and legal system. But now, there will be a move from the rest of the world to hold China much more accountable. What do you do when you have a dominant hegemonic country with a large population and huge economy, and their management of information is perhaps causing problems for the rest of the world? China is going to face a lot of headwinds in its relationships with the rest of the world. This is coming on top of the trade war with the US, where the issue at stake was the Section 301 US actions against China; essentially the US has said that China’s intellectual property (IP) practices are unacceptable and have to change. Japanese companies experienced this IP issue firsthand when they transferred production facilities to China in the 1970s-1990s. Now we have further dissatisfaction or some kind of resentment building against China, particularly in the Western world. China may emerge relatively unscathed compared to other

economies, but it will face a tougher global environment.

JS: To our knowledge, China’s concern at this moment seems to be about the supply chain in Asian countries and how it might be seriously damaged by the pandemic. It seems to be trying to strengthen relations with other Asian countries to sustain its supply chain. How do you view the impact of the pandemic upon supply chains, and more globally, what do you think would be the total impact on Asian economies?

Sheard: These supply chains are very articulated, multi-country, multi-stage of production, and have been a real motif of the economy in Asia. These sophisticated supply chains have taken on the form they have basically as a result of profit maximization decisions in the market economy. There may be some policy variables at work, but by and large companies look around and say, where do we want to source our inputs, where do we want to build our iPhones and semiconductors? So as a starting point, supply chains essentially represent the cumulative decentralized decisions of the actors in the market economy.

Those supply chains are going to change partly as a result of the same process. Each part of a supply chain involves two or more parties. Virtually all companies will be looking at their supply chains and reconsidering whether they are the right ones or not. This could be negative for China because it will be seen as a less attractive outsourcing destination. Not just because of rising labor costs, but because of some of the issues we mentioned before – if you outsource to China you might get caught in the crosshairs of the US-China economic and political wars. There has been a lot of talk in this country about the over-dependence of the US on China as the public and media are discovering that a lot of medicines and pharmaceuticals and personal protective equipment (PPE) are being made in China. So there has been a backlash already in the public debate.

Also, 5G and Huawei – how does all of this play into that? Presumably it will have a big impact. On May 1, President Trump declared a national emergency with response to the national power grid in the US. It is not that uncommon for a national emergency to be declared about specific issues, but it gives the government certain powers, including the ability to override the market economy. This executive order cited concerns that adversaries could potentially attack the power grid, and also cited concerns about the security and the integrity of the power grid. Part of this national emergency executive order mandates that equipment in the national power grid infrastructure cannot be supplied by adversaries of the US. The equipment in the grid at the moment that has been supplied by adversaries in the past will have to be switched out. China was not

specifically mentioned, but is probably the biggest target here. So that gives you an example of the kind of blowback China is likely to see from the US, and maybe Europe and Australia as well, to some of these supply chains.

One more issue to mention on supply chains. Globalization is a process which follows a relentless economic logic. Economists for many years have been pushing free trade, open markets, open financial markets. And of course we have IT as well which is globalizing the world. A highly globalized world which rests on the unleashing of market forces and the profit motive is wonderful from the perspective of raising people's welfare and economic efficiency. But it doesn't have built into it any redundancy, because firms are constantly looking for ways to cut costs and optimize supply chains. The market forces are relentlessly pushing you in one direction where you have a highly efficient system, but one that is actually quite fragile and not robust. So when the dust settles, there will have to be a reevaluation and governments will be rethinking some of these things and perhaps there is a case for some redundancy to be built into the system, even if that comes at the cost of some inefficiency.

Globalization Versus De-globalization

JS: Turning to the issue of de-globalization, this could happen in two contexts. First, this social distancing policy could encourage production domestically rather than overseas, perhaps using 3-D printing. Secondly, a rise in nationalism. The Trump administration, for example, might be fuelled by nationalism. Are you concerned by this potential de-globalization?

Sheard: I think that the pendulum was already starting to swing back against globalization. A bit earlier, the pendulum had swung right to the limit. Partly it was ideological, it was economists winning the arguments. It was partly facilitated by technology, computerization, and partly fuelled by experience – countries like Japan or the East Asian “Tigers” that opened up to the rest of the world and became trading nations were the ones successful at lifting living standards. China as well, coming into the WTO and for several years people said what a wonderful thing this was for tens of millions of Chinese people to be lifted out of poverty. The pendulum is swinging back, but you can't put the globalization genie back into the bottle. The market economy tends to push in the direction of globalization because capital seeks out higher returns and information technology facilitates it.

Governments have been pushing back a bit as domestic political pressures bubble up, and this pandemic will keep the pendulum swinging back. The pandemic is now shutting down air travel. People

have been given a reminder that we are living in a Westphalian system of nation states, where a core sovereign right and obligation is to ensure that borders have integrity.

The interesting issue about this whole event is that governments have suddenly done some very heavy-handed things – the shutdown, travel restrictions, contact tracing. So suddenly we have had this little experience – even people who live in Western democracies like Japan or the UK or Australia – where suddenly the government's intrusion into the economy and people's lives has been very dramatic and autocratic. So, the policy response that this event has underscored in some sense is the need for the role of the government, the nation state, to be there to protect its people. I think that is just something that is going to have to sink in and seep through the system for a while. Take the EU for example, with its key principle of free movement of people or the overlapping Schengen Area, a collection of 26 countries that have scrapped border controls between them. It is one thing to have free movement of people, but nation states remain and the external borders of the EU are still owned by member states, so there are a lot of mismatches in the system.

I think that the other thing with globalization is that there has been this populist backlash against it. The more globalization you have, and particularly with instant connectivity and access to information anywhere in the world, the more benefits it creates, but also it may create insecurities in people's psyche, whereby the more globalized the world they live in, the more they want to have something that they feel they belong to – something that is theirs. Japanese may live in a very globalized world but you still have your Japanese culture and calendar, and having that and preserving that gives you the best of both worlds. With this backlash against globalization, people are not opposed to it *per se* but they want to have balance, they don't want to feel that everything is being diluted into one amorphous globalized world.

The second aspect is that part of the backlash is because there are winners and losers from globalization. The losers are by and large blue collar workers, less educated workers, less skilled workers. They may have gained as consumers but they have lost as workers and maybe as citizens. I think that what happened with the financial crisis in particular was a loss of confidence. The constituencies left behind by globalization lost confidence in the social contract and in the elites. They may have been used to viewing the elites as experts who knew what they were doing and were acting on behalf of general society. But I think that, with the financial crisis and the rise of China and the hollowing out of industrial America, more and more people have started to believe that the elites are in it for themselves and don't care about other people or worse still even look down on them. So it is a real political backlash, and this is part of Brexit too. How this plays out after the pandemic is yet to be seen, but potentially it could have major effects because, who are the people who are really

suffering in this case? When unemployment goes to 20-30% it is the most marginalized people. The stock market is down by only about 8% in the US and is doing much better relative to what the economy is doing. I think that the kind of policy response we have seen – notably policies such as the Paycheck Protection Program – shows that politicians are aware of this problem and are bending over backwards to minimize the damage, but in the coming years in the political realm there could be a serious backlash against the elites and experts. Inequality may be exacerbated and that may reach some kind of political boiling point.

Digital Technology's Impact on the Economy

JS: Looking beyond the pandemic, IT seems to be our only hope for making a positive change to business behavior and consumer behavior while also contributing to economic growth. As in the Osaka G20 meeting last year, we will need some rules for the flow of information, and especially for information technology. How might we achieve this?

Sheard: One effect of this pandemic has been to give a boost to the online economy. I suspect that many people who were dragging their heels in moving online have been forced to adopt technologies permanently, so it has been a positive demand shock to the IT sector. Will it raise global growth potential? I am reluctant to say yes, because we have already had several decades of spectacular information technology developments. Among economists there is the concept of the “productivity puzzle”. It is a little similar now – although we have had this information revolution going on for some time now, we have had only modest productivity growth, particularly since the financial crisis. There is a whole debate about whether productivity is being mis-measured, since it is measured with respect to GDP, so if GDP is being mis-measured then so is productivity.

I am not sure that I would draw a direct line from IT to improving growth potential for the global economy. Imagine if we froze the existing stock of human knowledge and technology in place today. There is a frontier of technological knowledge which the US, Japan and parts of China are operating at. Imagine if we did not have any more technological innovation – how much growth could you still get in the global economy? There is still Africa, South America, the Middle East, parts of Southeast Asia, India, even many people in China – hundreds of millions of people who are not operating in an economic system that has fully incorporated all of the existing technology and knowledge in the world. We could get tremendous increases in potential growth in much of the world just by figuring out the economic institutions and political institutions capable of moving everyone to the technological frontier. This is just a caution

that IT is not necessarily the productivity savior and may exacerbate some inequalities also.

What seems to be going on in the world is the creation of a new virtual economy. New business models are increasingly going online to create a whole new virtual economy. One metric I like to look at is the market cap of major companies like Amazon, which is now \$1.23 trillion, while Apple is \$1.40 trillion and Microsoft \$1.39 trillion. If you add up the market cap of the “Big 5” tech companies, it comes to \$5.6 trillion dollars. A lot of these companies only came into existence in the last 15-25 years, so I would give that as an example of this creative destruction that is happening. What it means is that a lot of the existing capital stock in the world is made redundant because of this virtual economy that is being constructed. In other words, when you get this IT revolution, in the IT part of the economy you get tremendous productivity improvement, but when you measure it at the level of the whole economy which includes a capital stock which is being depreciated by rapid technological innovation, it dilutes that effect dramatically.

In terms of global IT governance, Europe has launched the General Data Protection Regulation, and different countries are trying different approaches on this. Harking back to the question on global governance and US-China relations, there will be an increasing need to have some kind of global rules of the road. There is a Chinese Internet. There is a Chinese information sphere which takes place in the Chinese language mainly, and Japan has one as well. How that whole system interacts and will be governed is a big issue. A very specific issue is what trust we can have in information. How do we ensure in the global economy that there is high integrity of data and that everyone is operating on the same global platform of information?

I mentioned the Pax Americana turning point, which has implications for the WTO, IMF, Bretton Woods, NATO, etc. However, on top of that, we also need new global institutions to deal with the Internet and information and data, etc. Maybe this is a good chance to get a new prototype where the US, China and other countries come to the table and have a proper kind of discussion. We need something like the landmark 1944 Bretton Woods Conference again at this point in time where we can deliberate on and devise a new set of institutions, but in today's 24-hour news cycle and everyone connected to the Internet, how do you get key players to come together for uninterrupted discussion? We need to think of some way to give policymakers the space to go offline almost and really work through some of these issues and come up with some solutions, insulated from the constant glare of the media and having to be responsive in real time to their own electorates and political pressures. **JS**

Written with the cooperation of Joel Challender who is a translator, interpreter, researcher and writer specializing in Japanese disaster preparedness.