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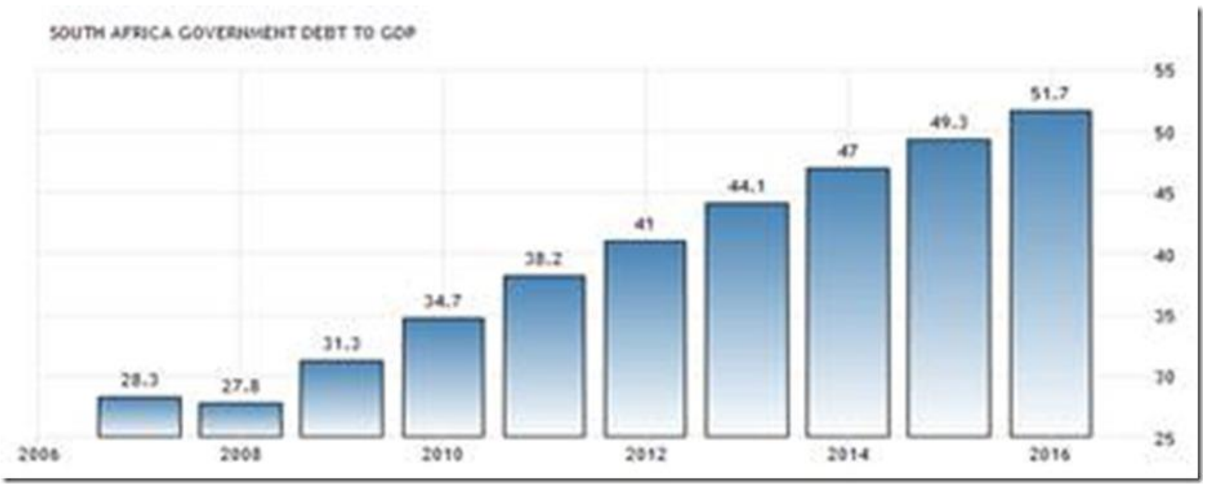
How to solve South Africa's financial crisis

By Richard Cluver

The major nations of the world are swimming in debt. They are in fact mortgaging the future earnings of their children to meet present costs. Taking South Africa as an example, the Government currently spends 60 percent of its tax income on the "Social Wage"; that is on social grants and health services and 40 percent on the public service wage bill.

For everything else it does, the South African Government has to resort to borrowing.....and every year the social wage rises at a faster rate than tax revenue which guarantees that our indebtedness will continue growing and already, as my graph shows, our Government debt amounts to 51 percent of Gross Domestic Product.



At the current rate it will reach 60 percent sometime in the year 2019. Above that level it becomes increasingly impossible because the interest alone on the debt is likely to be greater than government's tax revenue in an era of rising interest rates. And South Africa is one of the world's least-indebted governments!

Next I have listed the 16 governments with debt of over 100 percent of their Gross National Product.

Country	Public debt as % of GDP (CIA)[1]	Date	Total (Gross) government debt as % of GDP (IMF)
Japan	234.7	2016	237.918
Greece	181.6	2016	158.546
Jamaica	130.1	2016	146.591
Lebanon	132.5	2016	139.527
Italy	132.5	2016	126.978
Eritrea	119.8	2016	125.785
Portugal	126.2	2016	122.985
Ireland	77.9	2016	117.122
Grenada	110.0	2012	112.567
Cape Verde	116.8	2016	112.199
Singapore	110.5	2016	111.017
Bhutan	30.0	2016	107.511
Cyprus	104.6	2016	107.106
United States	73.8	2016	106.71
Belgium	106.7	2016	105.600
Barbados	108.9	2016	100.351

To understand what this means, a nation's Gross National Product is the sum of all the earnings of all of the people and all of the companies at work in that country. Thus, for example, if every citizen of Barbados and every business operating there sacrificed their entire income for a year they would nearly be able to pay off that debt. Similarly Japan, whose indebtedness is 237.918 percent of GDP, would need all of its citizens and all of its businesses to sacrifice their entire income for two and a third years just to settle their Government's debts.

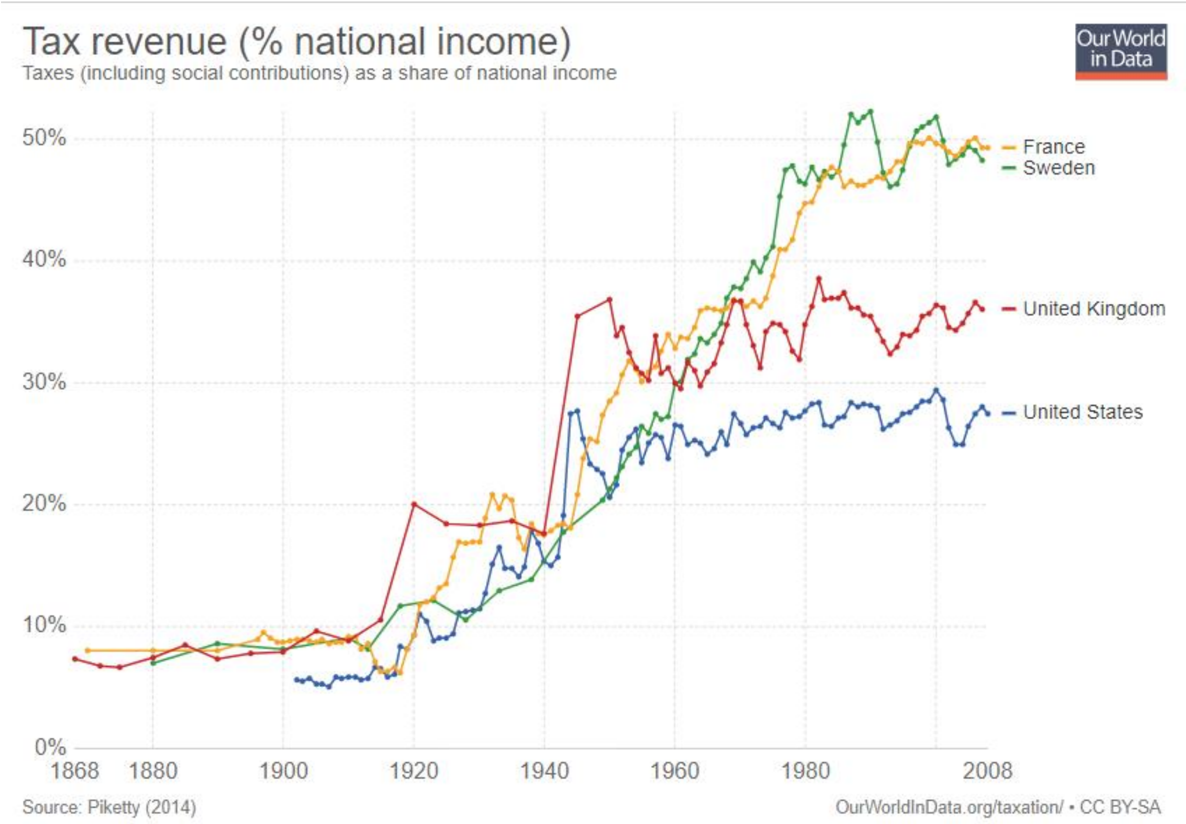
Well that is just not going to happen is it? Part of the problem is that there are a lot of people out there with their hands out and very few with enough to share. In South Africa 3.3 million people pay 99 percent of all the income taxes. Meanwhile, out of a total population of 55-million, 30 million are recipients of grants. And it is not particularly different elsewhere in the world.

There are really only 20 countries in the world which arguably can afford social grants and already most are buckling under the pressure. Almost all of their governments are operating in deficit, providing social services by borrowing in the sovereign debt market. That is why in the United States President Donald Trump was during 2017 trying to repeal "Obama Care" because he had recognised that US taxpayers could not afford the burden.

Meanwhile in Britain the Government had just announced that all people in their twenties must expect to work until the age of 70 because for them the state pension will be unable to cope with an ageing population and longer life spans.

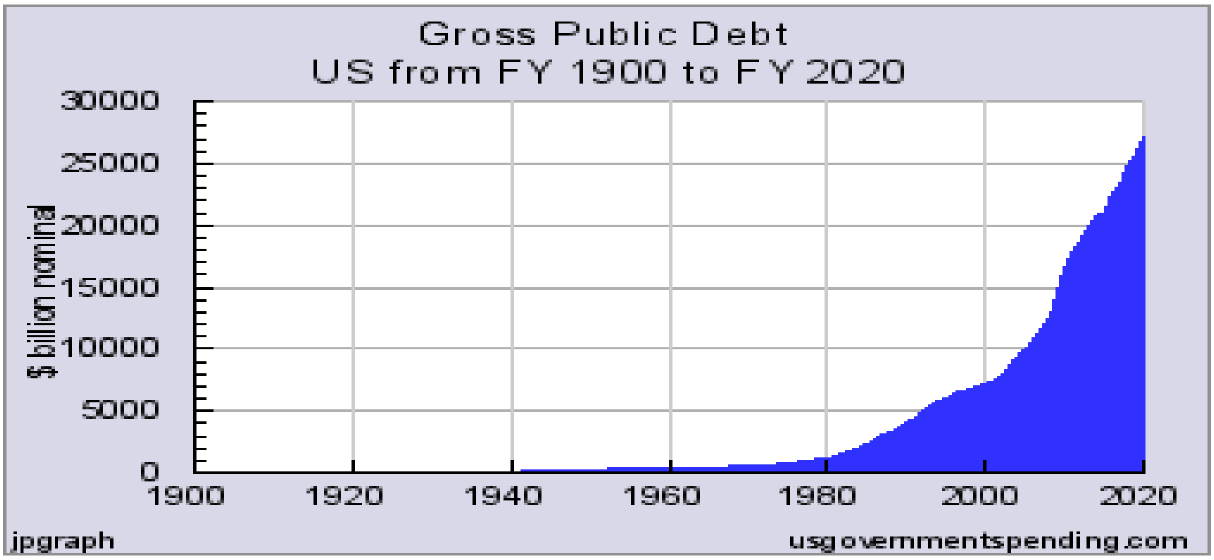
Democracy, as a concept which believes the state should guarantee that every citizen is equal and entitled to certain basic rights such as a roof over his head and an adequate supply of food, simply will not be able to sustain such numbers. As a concept it will have collapsed, long before our grandchildren retire. But what will replace it; dictatorships, and totalitarian states? Your guess is as good as mine but it is likely that the gated estates we now live in will have become walled-off skyscraper cities with private armies to protect those wealthy enough to afford to live within them.

Lest there be any doubt about that, consider the following graph:



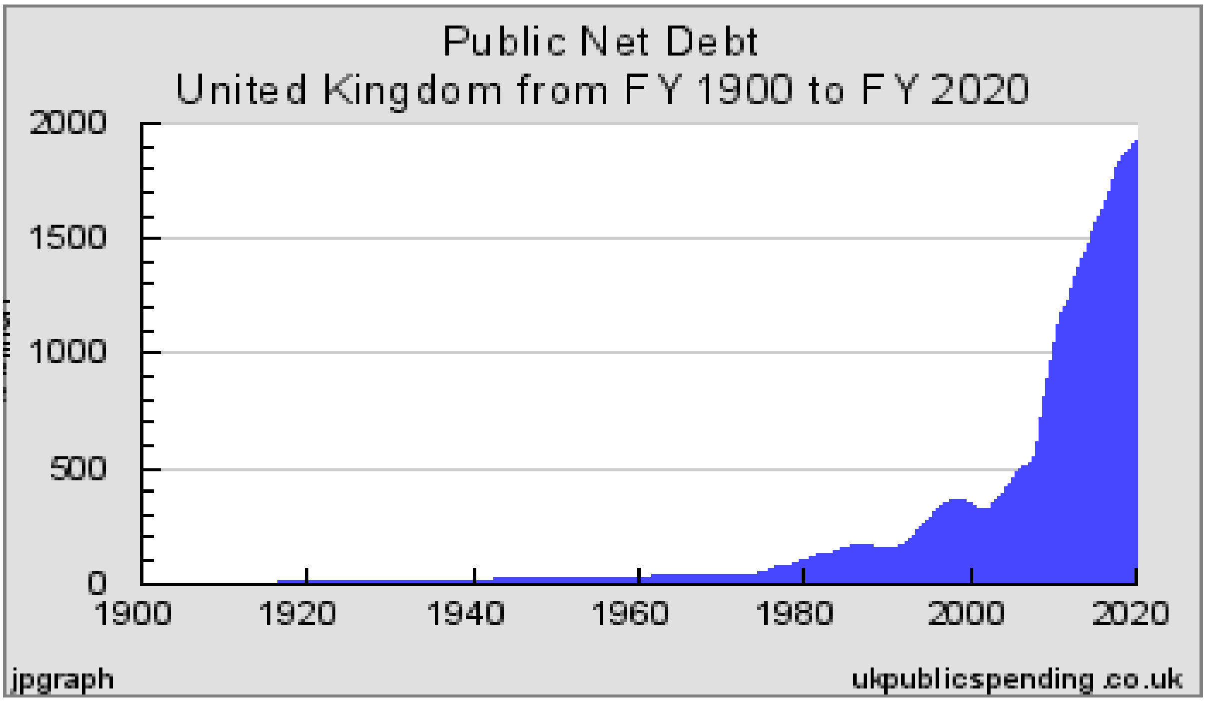
Year after year Governments of the world have steadily increased the taxes, levies and duties they have gathered from their people to the extent that most studies show that it is impossible to collect more. The graph vividly illustrates how, over the past two centuries, governments the world over have squeezed their citizenry with ever-higher tax demands to the extent that the point of taxpayer exhaustion was reached sometime in the 1980s when the graph traces flatten out at approximately the 40 percent level in Britain, 60 percent in France and Sweden and 30 percent in the USA.

Thereafter they had to resort to borrowing as my next graph illustrates.



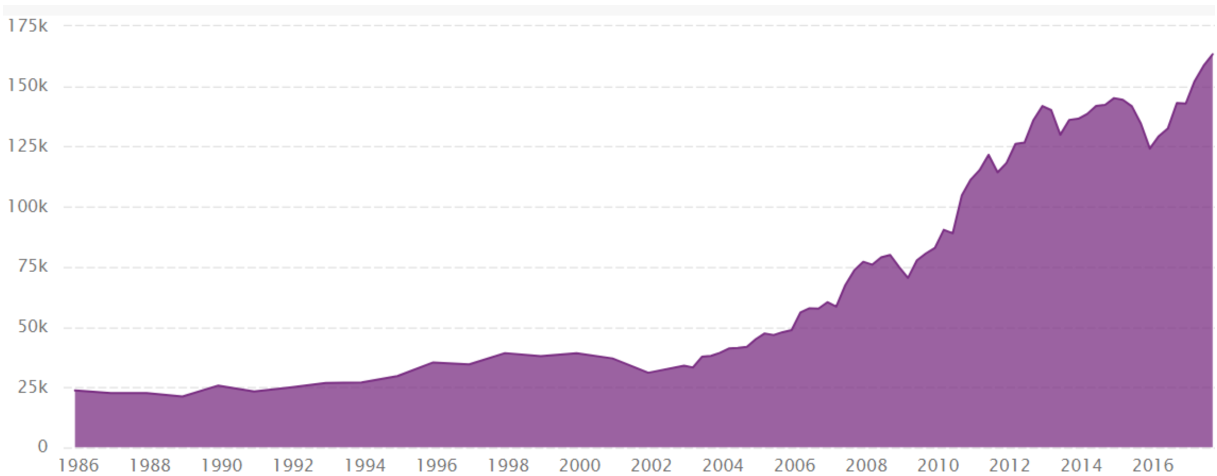
Here I depict how US government debt soared from 1980 onwards once taxpayer exhaustion had occurred when the taxes collected there reached just less that 30 percent of national income.

In my next graph I offer you the case of Britain where you will see exactly the same pattern with the national debt running at comparatively benign levels for three quarters of the last century and then exploding upwards from 1980 onwards.

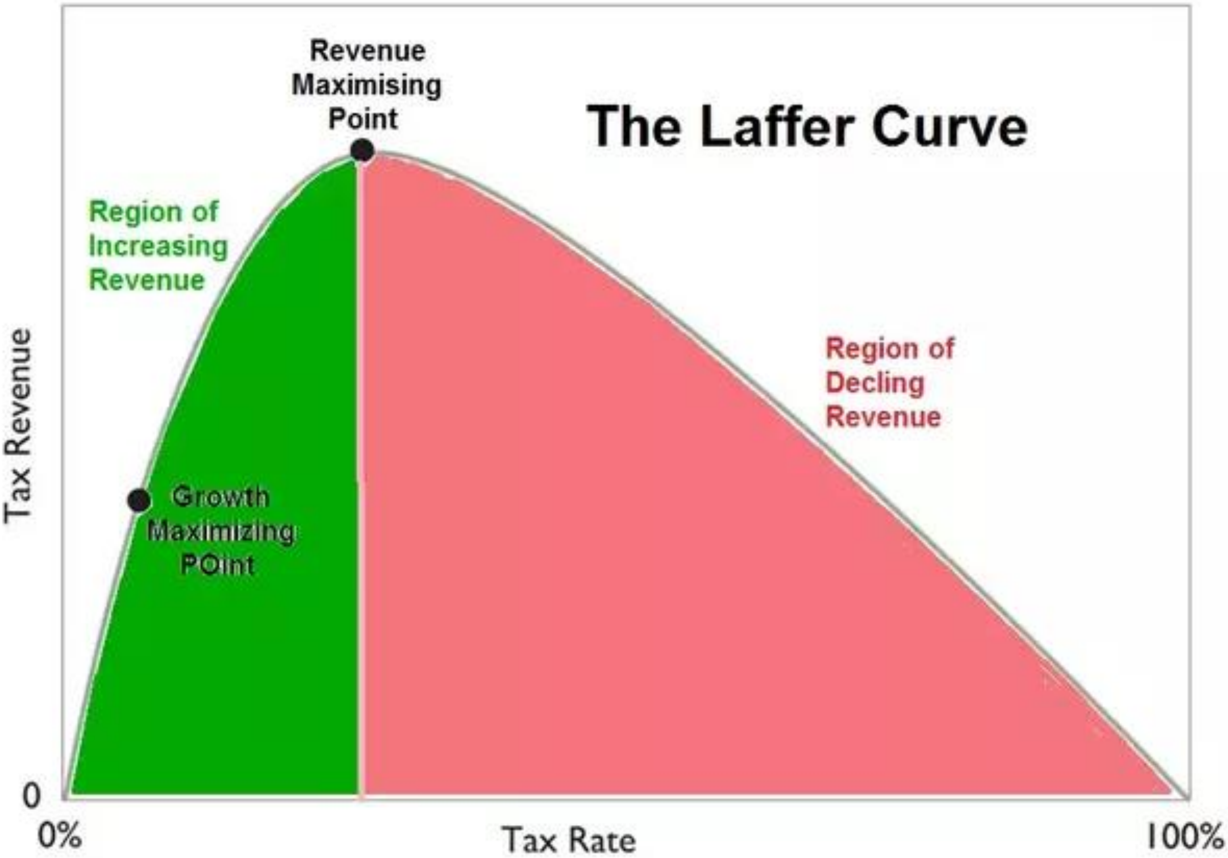


The graphs offer frightening examples of this phenomenon, and it is no different wherever you look throughout the world. The fact is that governments have never learned the lessons of good household budgeting; of living within their means.

And South Africa has been no different. My next graph illustrates how our foreign debt has grown seven-fold since the 1980s.



To understand the concept of tax payer exhaustion I need to turn to the work of economist Arthur Laffer which suggests that as tax rates increase from low levels the revenues collected will increase until at some point further tax rate increases will actually lead to lower tax revenues as the disincentive effects of higher taxes begin to dominate.



While Laffer's primary objective was to illustrate the relationship between taxes and production (i.e. that taxing any economic activity results in less of that economic activity and resultantly lower tax revenues), the Laffer curve also illustrates that higher tax rates result in a greater incentive for tax avoidance and evasion which could also cause tax revenues to fall.

Tax systems do not operate in a vacuum. They are impacted by the social, economic, and political environment in which they operate. Where taxpayers perceive a government to be corrupt, inefficient and wasteful, not delivering benefits to taxpayers or the broader citizenry or a country is in tough economic times, this will result in the Laffer curve shifting downwards and to the left.

The evidence emanating from South Africa's 2018 Budget suggests South Africa was a relatively late comer to this phenomenon but it has now maximised the tax revenues that it can extract from its citizens and has possibly even gone past that point and is now on the downward slope of the curve. That is why there was a R51-billion shortfall in the budget.

So how did we get there? Tax revenue doubled in the ten years to 2018, according to data from the South African Revenue Service (SARS). According to SARS's head of revenue and research, Randall Carolissen, personal income tax had been the biggest contributor since the 2008-09 financial crisis.

Revenue increased from R572.8bn in 2007-08 to R1.144-trillion in 2016-17, up R571.3bn. In this period, the total revenue collected was R8.13-trillion while revenue from personal income tax increased from 29.6% in 2007-08 to 37.2% in 2016-17.

In the 2017 medium-term budget policy statement, then Finance Minister Malusi Gigaba estimated the tax revenue deficit to be R50.8bn in 2017-18; that is the

highest deficit since the 2009 recession. The budget deficit was also projected to widen from 3.1% to 4.3% of GDP.

So it is crunch time for South Africa. The latest tax increases, if the widely accepted Laffer studies are correct, will NOT produce the required revenue and we have exhausted our borrowing capacity.

Like governments all over the world, South Africa has to face up to the fact that in future it will have to live within its budget. But does it intend doing so? Ominously, Parliament has just passed the first reading of a new law allowing the government to expropriate without compensation any property of its citizens.

Furthermore, the Institute of Race Relations has warned that because the "property clause" is so often discussed in relation to land reform and the agricultural sector it is often mistakenly assumed that a move on property rights will be limited to farming and agricultural landholdings.

Furthermore, such actions by governments have not been limited to South Africa. Not long ago the island government of Cyprus targeted the bank accounts of its citizens and the government of Canada passed enabling legislation allowing it to do the same.

Where might it end? Unable to tax their people further and having exhausted their borrowing capacity, is the world beginning to enter a new phase in which governments arbitrarily confiscate the assets of their citizens in order to continue pursuing policies which do not necessarily accord with the best interests of everyone?

Is there an alternative to all this?

Might I humbly suggest that South Africa could be a role model for the world in charting a way out of this seeming economic impasse. It would involve nations, in the first instance, committing themselves constitutionally to living within their budgets.

In my career as a financial journalist I have shown over and over again that people who can commit to saving a tenth of their income and investing the proceeds wisely can guarantee themselves freedom from financial worries in the short-term and comparative wealth in their retirement. Furthermore, while I cannot claim the credit for it, I was a confidant of the then City Treasurer of Durban, Ossie Gorven in the 1980s when that municipality used this process to turn itself into a debt-free city. In this latter instance the City Council entered into a compact with its ratepayers that an initial additional levy upon their rates would result in a reduction of further rates increases and subsequently to real reductions. Durban, in those years, became an example of how municipalities could emancipate themselves.

There is, furthermore, no reason why governments could not emulate this example. It would involve, as I have said, an initial compact with the taxpayers of this country in the form of a constitutional guarantee that Government would never spend more than 90 percent of its income and would employ the balance to, in the first instance, redeem its debts and later to both reduce taxes and build up an investment portfolio towards a hoped for eventual day when South Africa might become a tax-free country.

But how to live within their means? Well, noting that South Africa currently expects to pay at least R180-billion each year to service its debt, getting rid of that would amply enable us to live within our means as a country.

But how to get rid of it? I have suggested in a letter to President Cyril Ramaphosa that if the Government were to mount an effective publicity campaign beginning with the constitutional compact I have already outlined, our citizenry could be persuaded to come to the party to buy a new form of government bond featuring a tax-free interest coupon.

In the hands of a high-income earner a tax-free bond would be worth 38 percent which implies that whereas the government currently has to pay a yield average of 8.15 percent on its sovereign debt, a yield of anything north of 5 percent could be very attractive to South Africans and this could in turn help to dramatically reduce the government's debt servicing costs.

Furthermore, such a bond should be very attractive to pension and insurance funds if the tax-free element could trickle down to their recipients to enhance their tax-free income levels. Thus, for example, a pensioner over the age of 75 can currently receive an annual income of R135 300 and pay absolutely no tax at all. Assume he or his pension fund is allowed to invest a million Rands in such a tax-free bond providing a five percent tax-free yield which could trickle down to give him an additional R50 000 a year, thus increasing his monthly tax-free income of R11 275 by R4 166.70 for every R1-million so invested.

It will not be too difficult in such circumstances for the Government to initially replace, its foreign borrowings and, ultimately all its local borrowings by this means, thus opening up an era of economic certainty in which low and steadily diminishing tax rates could lead to massive foreign investment in local manufacture which could go a very long way towards both increasing our tax base and eliminating unemployment which could in turn lead to a drastic reduction of the State's poverty relief costs.

Obviously these things could not be done in isolation for such an industrialisation programme would imply the need for drastic improvements to our education system in order to create a suitable supply of skilled workers while greater flexibility in our labour laws would be an imperative to attract foreign industrialists. But that is beyond the scope of this discussion.

Getting rich from Politics

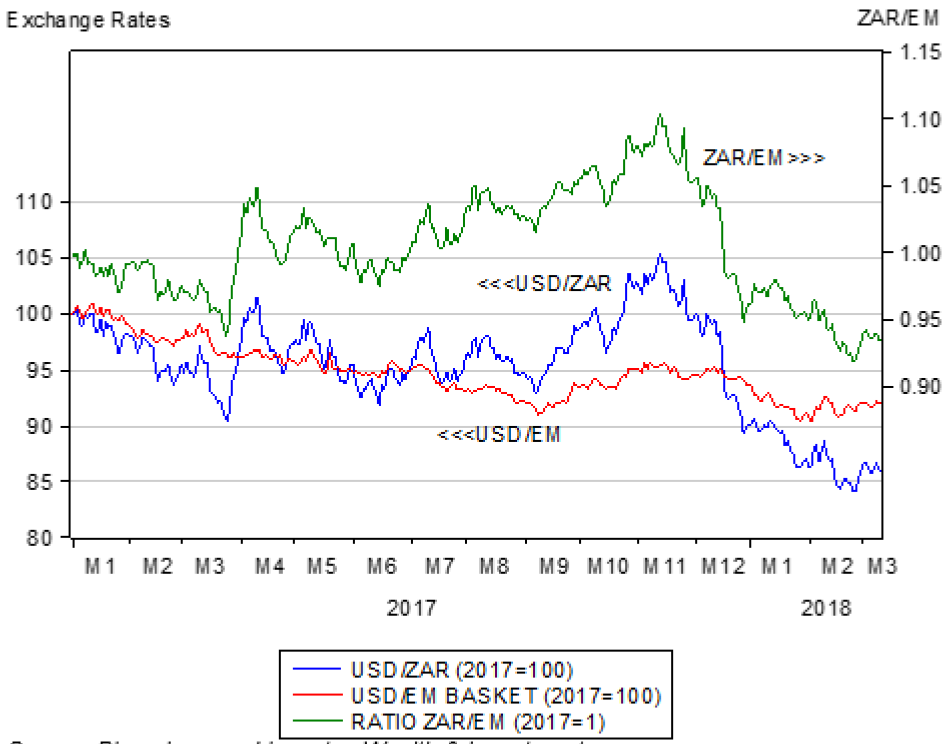
by Brian Kantor

It is possible to get very rich from politics in an honest and old-fashioned way. Recent SA political and economic events prove so.

Had you predicted that Cyril Ramaphosa would win the ANC election in December and ascend to the presidency of SA, and bought the rand and the shares and bonds that benefit from a strong rand, you would have done very well. And you'd have done even better if you had sold those securities (including the US dollar or euro) that weaken when the rand responds to good news about SA.

The USD/ZAR reached a recent low of R14.46 on 15 November. It is now R11.77, an improvement of about 20%. The rand has also gained 24% against the JPMorgan Index of emerging market exchange rates (FXJPEMCS), since then indicating it was South African-specific surprises rather than global forces that has driven the rand recently.

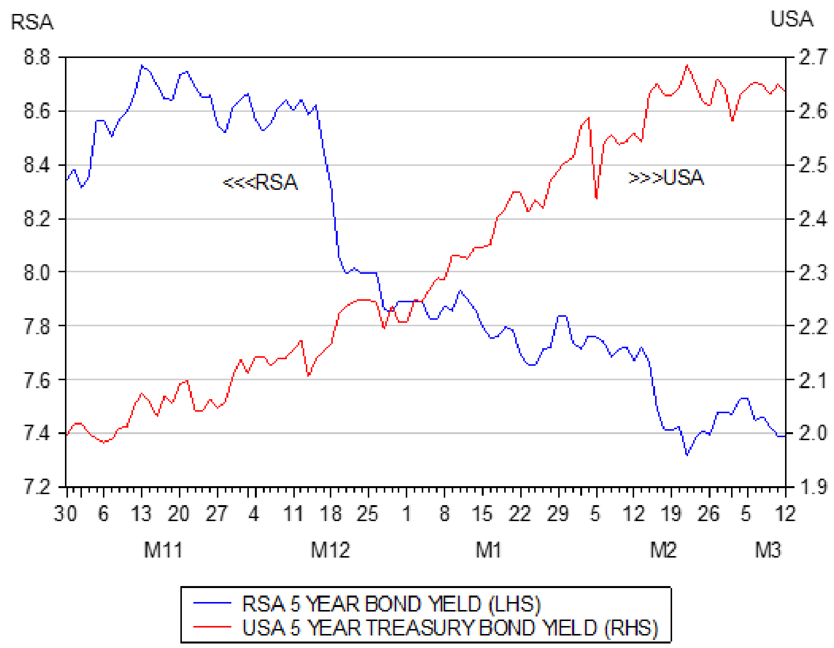
Figure 1: The rand vs the US dollar and an emerging market currency basket (2017=100 or 1)



Source: Bloomberg and Investec Wealth & Investment

The cost to the taxpayer of issuing rand-denominated debt has fallen significantly. The yield on five year RSA bonds has fallen from 8.69% on15 November to 7.38% on 12 March that is by 1.31% or equivalent to a 16% decline in the cost of issuing new government debt of this duration. This even as US interest rates were moving in the opposite direction.

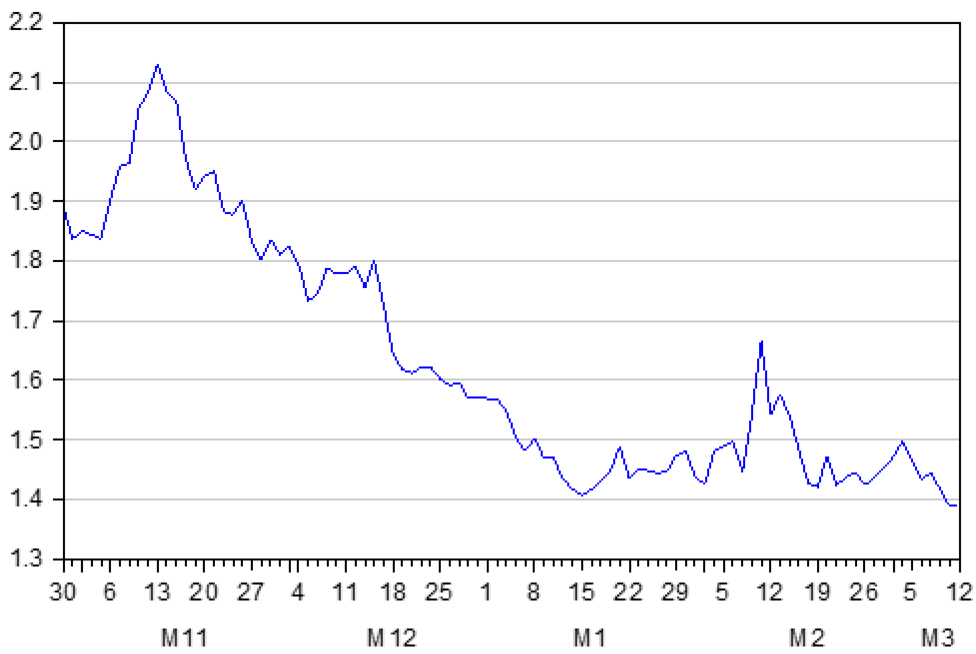
Figure 2: Bond yields in SA and the US (five year), November 2017 to 12 March 2018



Source: Bloomberg and Investec Wealth & Investment

The extra yield SA has to offer investors in US Treasury bonds for five year money (the sovereign risk premium) has fallen from 206 to 139 basis points. Over the same period, enough to bring SA debt well within investment grade quality. A one per cent per annum saving on interest, given the volume of government debt to be serviced and rolled over, is worth about R6bn to the SA taxpayer (hopefully) or the recipient of extra government spending (alas more realistically).

Figure 3: The RSA sovereign risk spread – RSA five year CDS spread (RSA US dollar bond yields less US Treasury bond yields) November 2017 to March 2018)



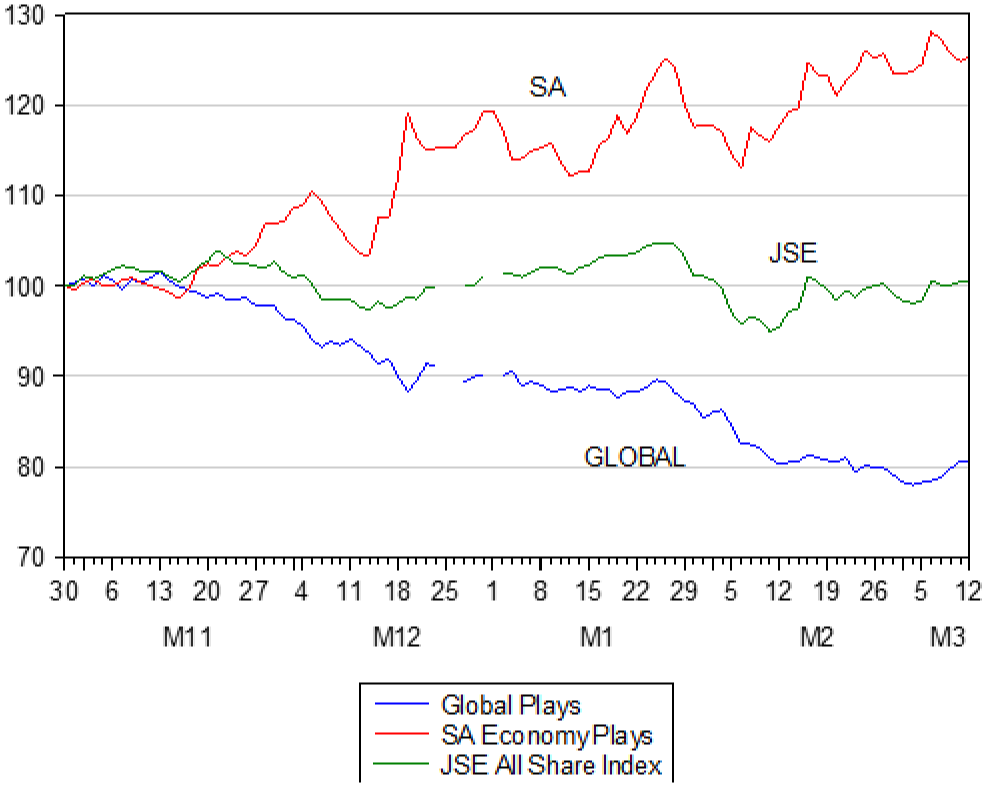
Source: Bloomberg and Investec Wealth & Investment

A stronger rand means less inflation and encourages households (who do more than 60% of all spending in SA) to spend more on the goods and services to be supplied to them by SA business. And the more profitable firms in turn will then hire more workers and equipment to service their growing custom. And less inflation may bring a lower repo rate and mortgage payments to further encourage spending. Enough extra spending to at last spark a recovery in the economy that has been growing much too slowly for far too long.

These implications of the stronger rand has therefore been dramatically registered in the share market. Companies with revenues and earnings generated in SA, banks and retailers for example, have become more valuable. While companies listed on the JSE, whose main line of business is generated offshore, have lost value. An equally weighted group of 14 large offshore plays has lost about 20% of its rand value since mid-November (see figures 4 and 5 below).

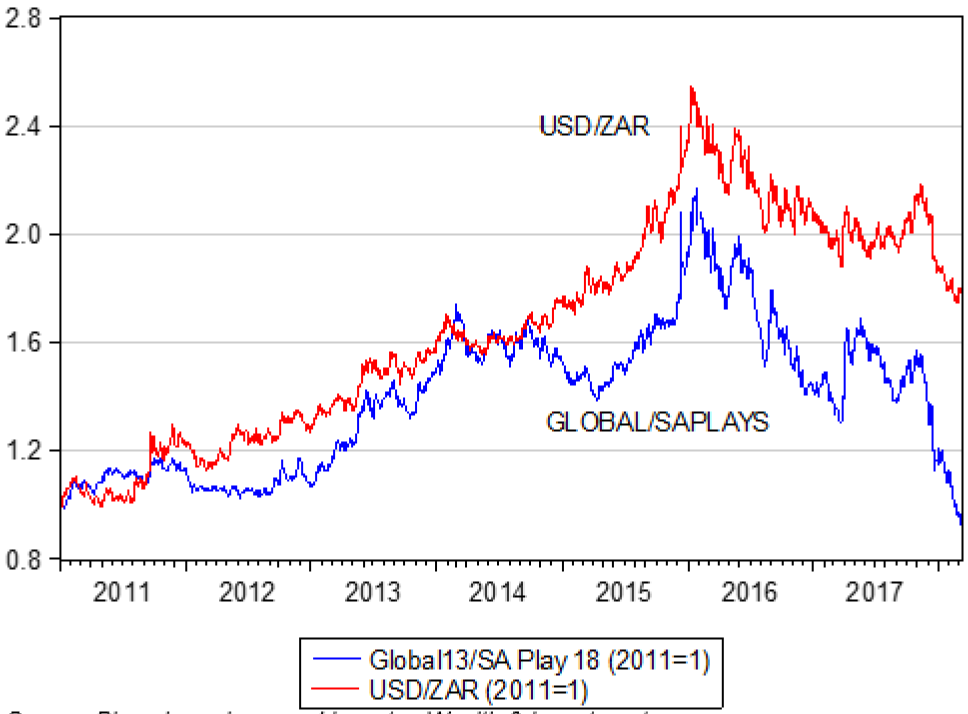
By contrast the rand value of a group of 18 equally weighted large SA economy plays on the JSE has increased by about 25% over the same short period. Buying SA and selling the world on a Ramaphosa victory would have been very value adding. Simply buying the JSE – with its mix of global and SA plays would – as an exchange traded fund would do, would have been to miss the value adding bus. It is in surprising turbulent times like this that active managers earn their fees.

Figure 4: JSE-listed companies – SA economy plays vs global plays and the JSE All Share Index (November 2017=100)



Source: Bloomberg, Iress and Investec Wealth & Investment

Figure 5: A comparison of two ratios – the USD/ZAR and the ratio of global to SA plays (2011=1)



Source: Bloomberg, Iress and Investec Wealth & Investment

The government led by Ramaphosa could provide much more of the good stuff for the SA economy by delivering on the promise of better government. Better still for the economy and its growth would be less government. Officials should intervene less in the economy – and show more respect for business and market forces as the critical drivers of the economy. Government should tax business income at lower rates and avoid subsidising other businesses that survive only with government aid.

Less intrusive government and consequently lower compliance costs would allow small businesses to compete with large businesses. And, more important, to free up the market for workers that leaves so many unemployed.

Government should also show a genuine willingness to sell off rather than add capital to the companies it owns: firms that survive to protect their employees from the performance indicators that private owners would demand of them – and reward accordingly.

The cabinet should recognise that its current set of economic policies of high spending and tax – ever more intervening government – has been a primary cause of the debilitating slow growth realised in recent years. A mix of all of the above policy recommendations would deliver economic growth and votes. A still weak economy could lose the ANC the next election in 2019.

Why American Workers Aren't Getting A Raise: An Economic Detective Story

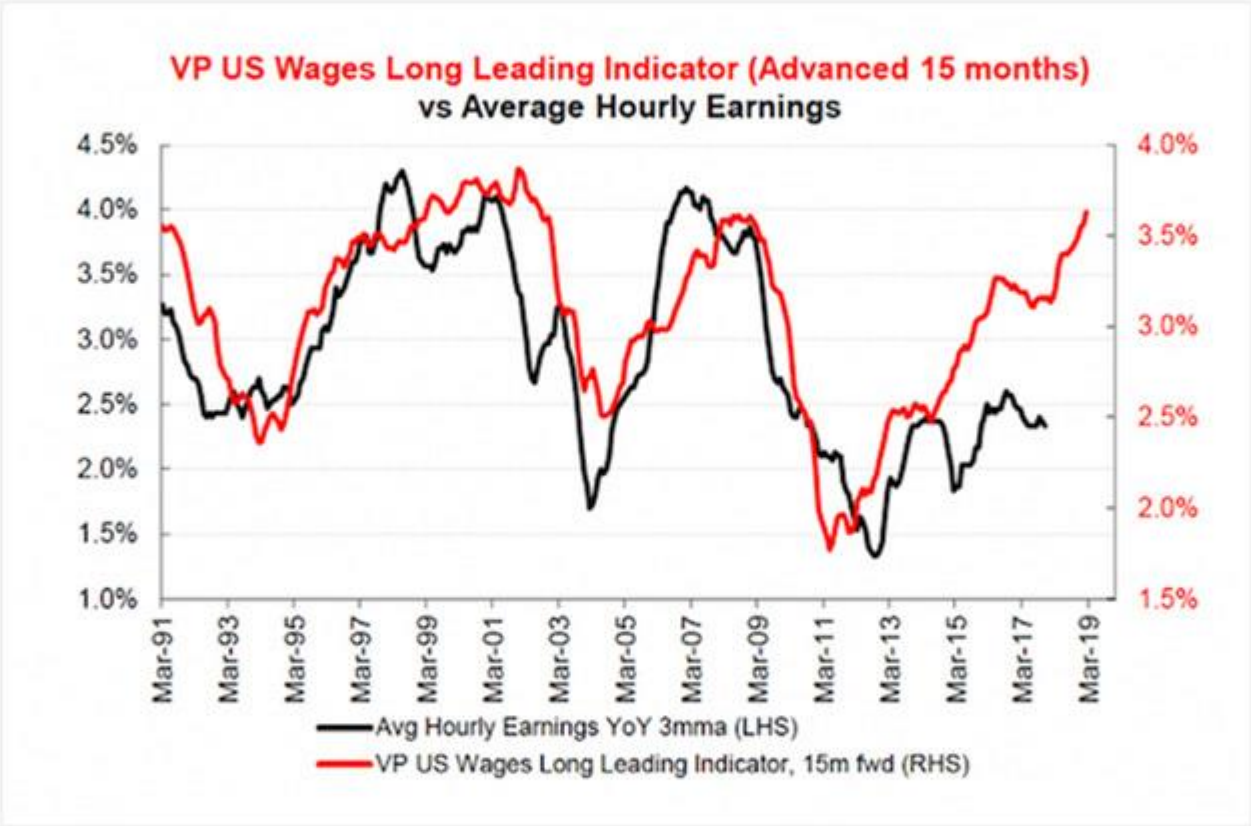
By Jonathan Tepper

For the past few months, I've been trying to solve an economic puzzle: why are wages growing so slowly despite a growing economy and a booming stock market?

Workers are productive and helping the economy grow, yet unlike previous economic expansions, we are hardly seeing big increases in wages. Instead, companies are sitting on their cash or giving it back to their shareholders through dividends and share buybacks.

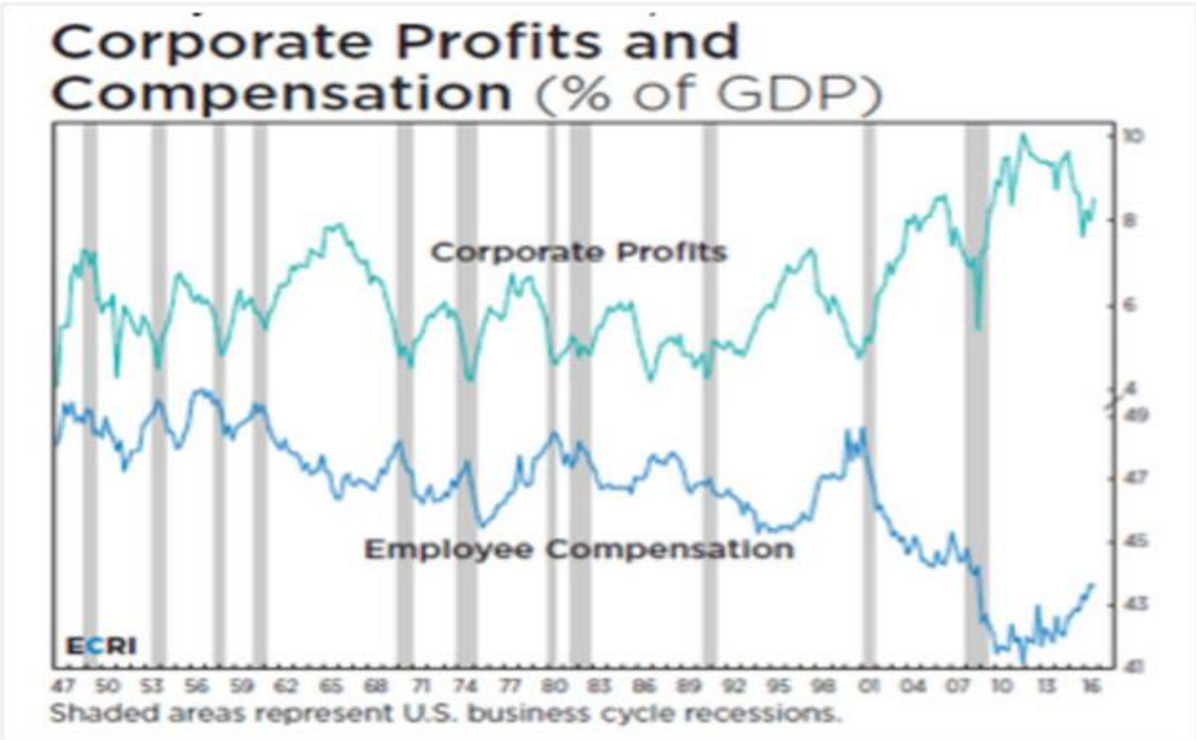
The answer of why wages are not growing mattered a lot to me. A few years ago, some friends and I started Variant Perception a company that predicts the ups and downs of the economy using leading indicators. Before growth or inflation turn up and down, there are generally clues that tell you what is coming. For example, building permits provide a good warning sign that growth will turn up or down. When the US stopped building as many houses in 2005-06, it predicted the recession of 2007-08.

Our leading indicator for wages normally provides a 15 month advanced warning of changes in wages. It is pretty good and all the ingredients are the same ones that have accurately worked for decades, yet the relationship has broken down. It was annoying me: why are wages not following growth? I should know the answer to why this is happening. I should have all the tools, yet something appeared broken in the economy.



All the signs that should lead to higher wages are present. Today, employers are saying that it is hard to find workers and many small businesses say they expect to raise wages, initial unemployment claims are extremely low. This should be an economy that is good for workers to get higher wages, yet wages stink.

After a lot of research, I think the answers are clear. Companies are keeping more of the economic pie



The flipside of low wages is that companies have taken a record part of the economic pie. Corporate profits as percentage of Gross Domestic Profit (GDP) are near record highs and labour's share of GDP is near record lows. You can see from the following chart that the chart looks like a giant alligator jaws. The divergence started in the early 1980s when the regular rise and fall of corporate profits and workers' compensation broke down.

The trend in corporate profits is a mystery to economists and investment strategists. Jeremy Grantham, a well-known investor, has pointed out, "Profits are the most mean-reverting series in finance. If margins don't revert something has gone wrong with capitalism." Employee compensation as a percentage of GDP has been falling for years (Source: Economic Cycle Research Institute)

Something has indeed gone very wrong with capitalism. In a competitive market, if a company is making a lot of money, other companies will get excited by the prospects of high profits and will enter the industry and compete. Eventually margins decline as more competitors fight each other. That is how dynamic, capitalist economies should be. Something is profoundly broken with capitalism if corporate profit margins do not revert to the historical mean.

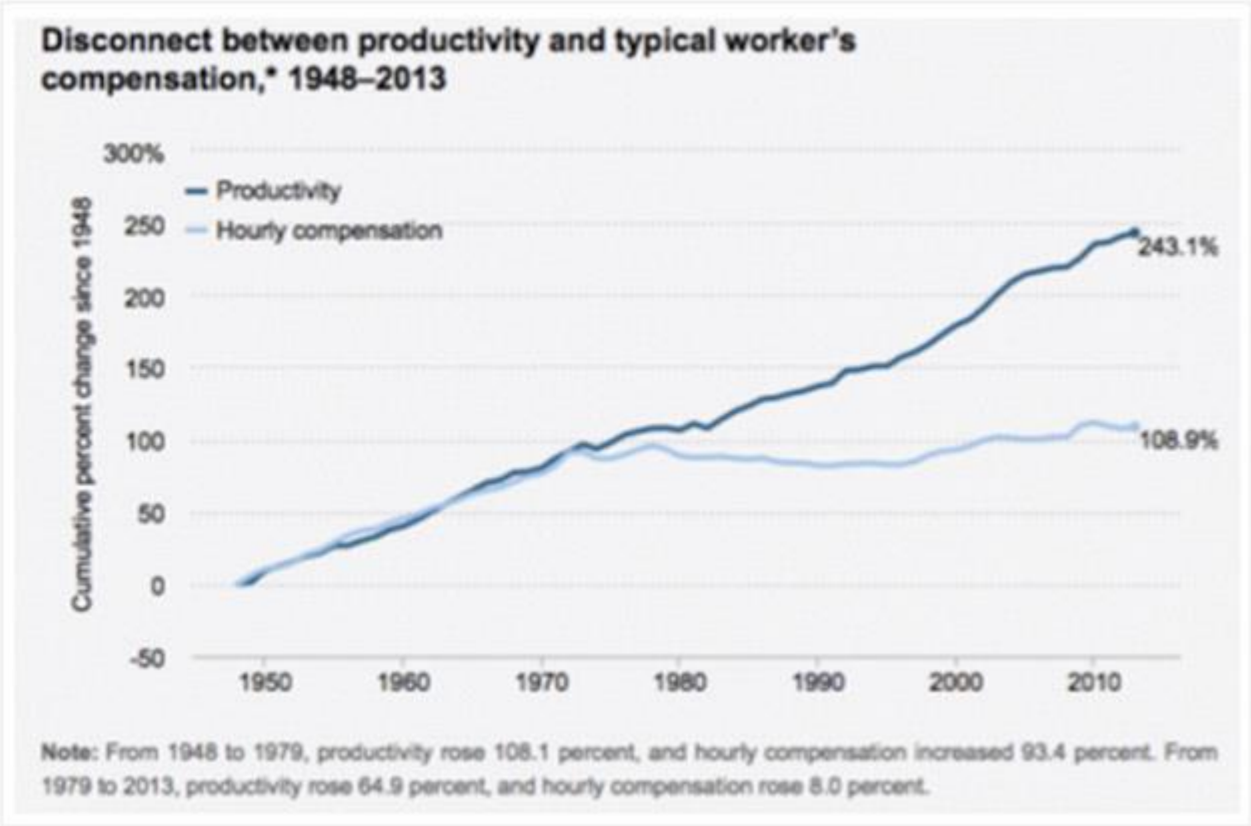
Rising industrial concentration is a powerful reason why profits don't mean revert and a powerful explanation for the imbalance between corporations and workers. Workers in many industries have fewer choices of employer, and when industries are monopolists or oligopolists, they have significant market power versus their employees.

The role of high industrial concentration on inequality is now becoming clear from dozens recent academic studies. Work by *The Economist* found that over the fifteen-year period from 1997 to 2012 two-thirds of American industries were more concentrated in the hands of a few firms.(i) In 2015, Jonathan Baker and Steven Salop found that "market power contributes to the development and perpetuation of inequality."

One of the most comprehensive overviews available of increasing industrial concentration shows that we have seen a collapse in the number of publicly listed companies and a shift in power towards big companies. Gustavo Grullon, Yelena Larkin, and Roni Michaely have documented how despite a much larger economy, we have seen the number of listed firms fall by half, and many industries now have only a few big players. There is a strong and direct correlation between how few players there are in an industry and how high corporate profits are.

Workers are productive but are not getting paid for it

Given the gaping disparity in pay between the average worker and CEOs, you might imagine managers were superstars and the average worker was bad at his job. But that is hardly the case. While many executives go on the front cover of *Fortune* or *Forbes* and get all the credit for their company stock, worker productivity has been steadily rising for decades. Unfortunately, earnings have not kept up with productivity increases. Workers are producing more goods with less labour, and companies are making higher profits, but the benefits are not being shared with workers. Notice that productivity growth has been rising in a straight line since the 1950s, but starting in 1980 hourly compensation has not risen much. The money from that gap doesn't vanish into thin air, and it has to show up somewhere.



Disconnect between productivity and typical worker's compensation (Source: Economic Policy Institute)

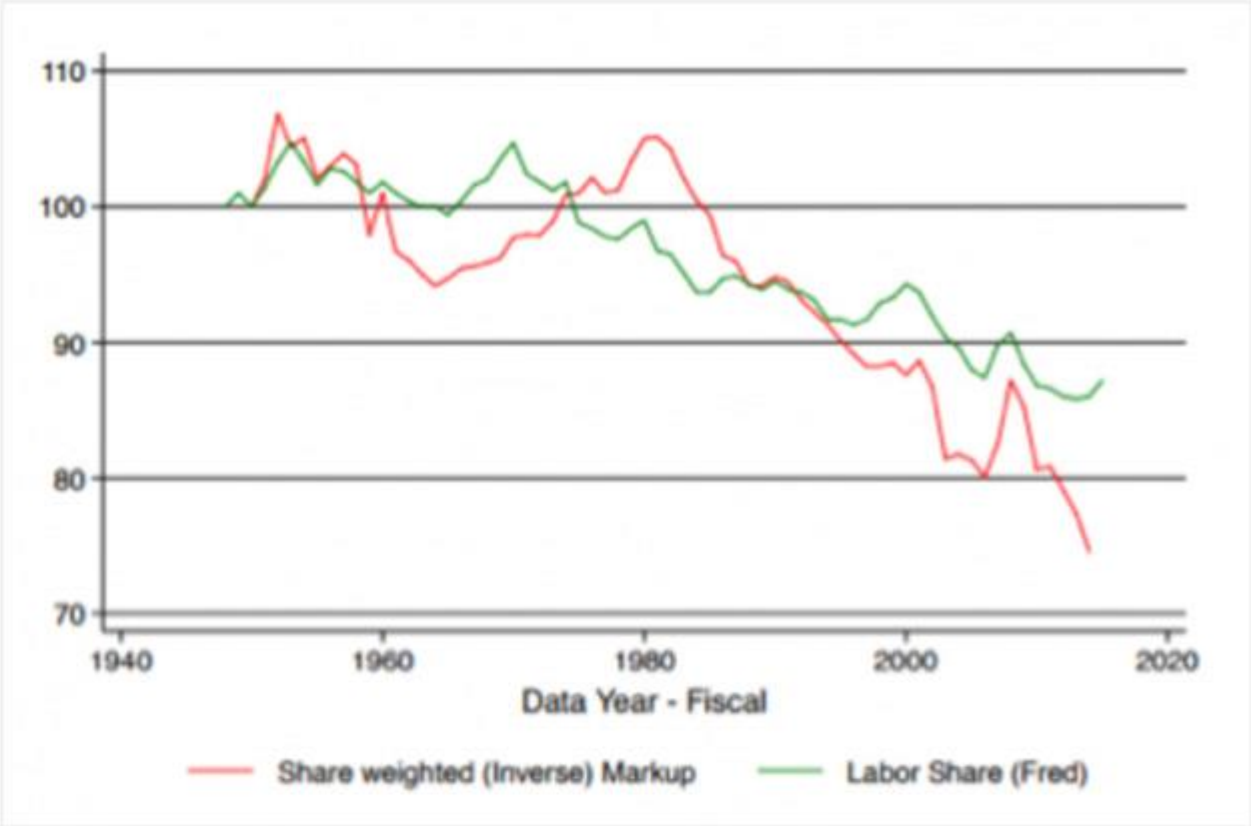
Some economists have argued that the gap between wages and productivity is an illusion. They argue that much of the gap can be explained by year-end bonuses, which are not included in hourly pay, by healthcare costs, which doesn't show up in a paycheck but the worker benefits from, and by stock options, which also doesn't show up in a paycheck. However, we can discount these explanations. Healthcare, bonuses and options are a real expense to companies, and if companies were getting hit with these costs instead of wages, it would show up in corporate profit margins. Today, corporate profit margins would not be at record highs. If the divergence between wages and productivity is real, the difference should clearly show up in corporate profits, and it does.

Companies have more market power

The economists Jan De Loecker of Princteon University and Jan Eeckhout of the University College London found that average markups, have surged since the early1980s. The average markup was 18% in 1980, but by 2014 it was nearly 70%. Higher markups suggest an increase in what economists refer to as "market power," which is the result of more highly concentrated industries.

A markup may sound like a very technical term, but you see it in everyday life. The best example is in luxury goods, where the right logo on a handbag will make the leather sell for a lot more than it costs to make. Part of what you're paying for is status and association.

De Loecker and Eechkhout noted that The rise in markups explains lower wages almost perfectly. They also found that "the rise in markups naturally gives rise to a decrease in the labour share, a decrease in the capital share, a decrease in low skilled wages, a decrease in labour market participation, and decrease in job flows."



The Evolution of Average Markups (1960-2014)
(Source: Jan De Loecker, Jan Eeckhout)

Market power has been rising in many industries. Americans have the illusion of choice, but in industry after industry, a few players dominate the entire market:

Two corporations control 90% of the beer Americans drink.

When it comes to high-speed internet access, almost all markets are local monopolies; over 75 percent of households have no choice with only one provider.

Four airlines completely dominate airline traffic, often enjoying local monopolies or duopolies in their regional hubs. Five banks control about half of the nation’s banking assets.

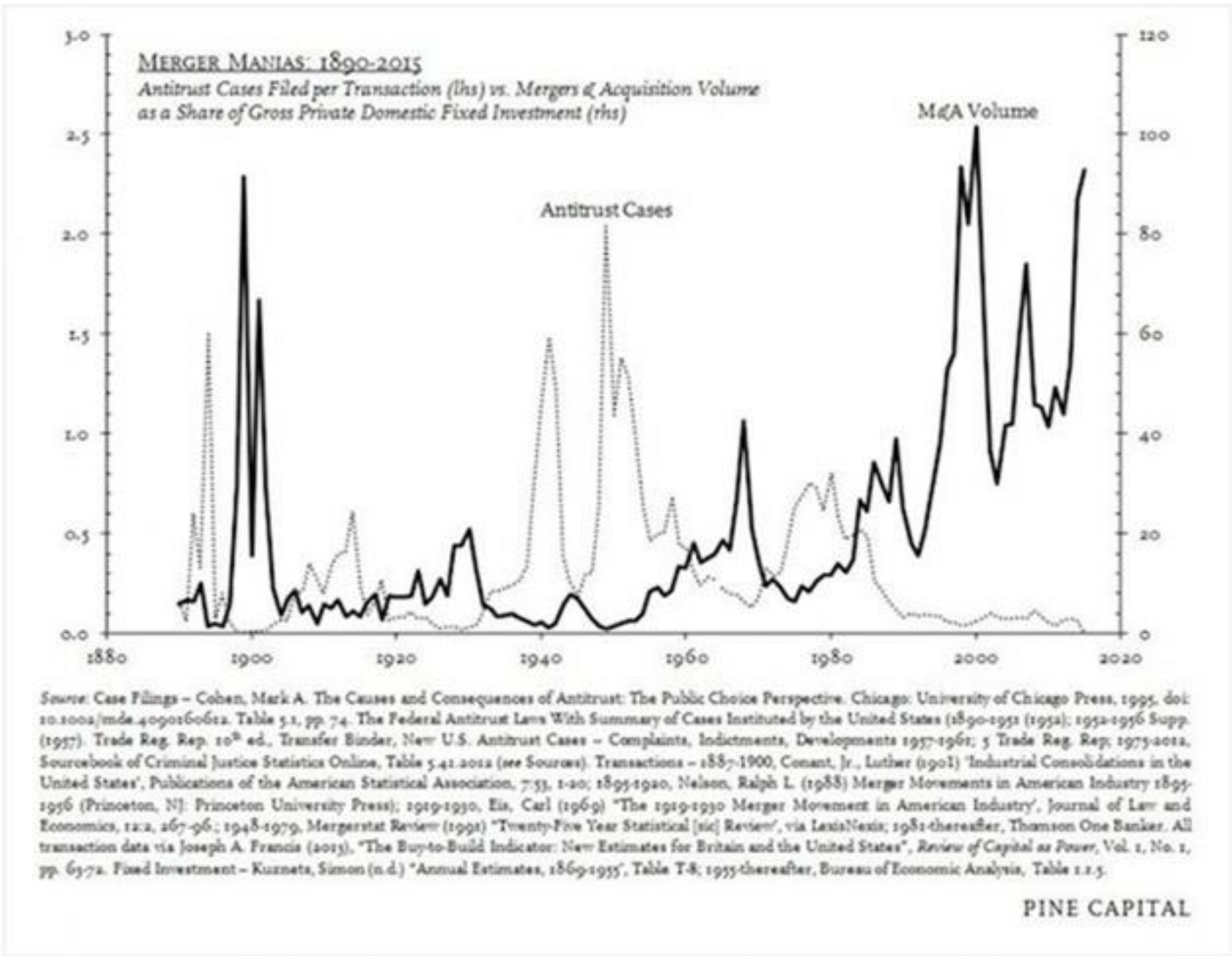
Many states have health insurance markets where the top two insurers have 80-90% market share. For example, in Alabama one company has 84% market share and in Hawaii one has 65% market share.

Four players control the entire US beef market.

After two mergers this year, three companies will control 70 percent of the world’s pesticide market and 80 percent of the US corn-seed market.

The list of industries with dominant players is endless.

After a wave of mergers, there is simply less competition.



Merger Manias 1890-2015: Merger Waves Are More Frequent and Bigger (Source: Pine Capital)

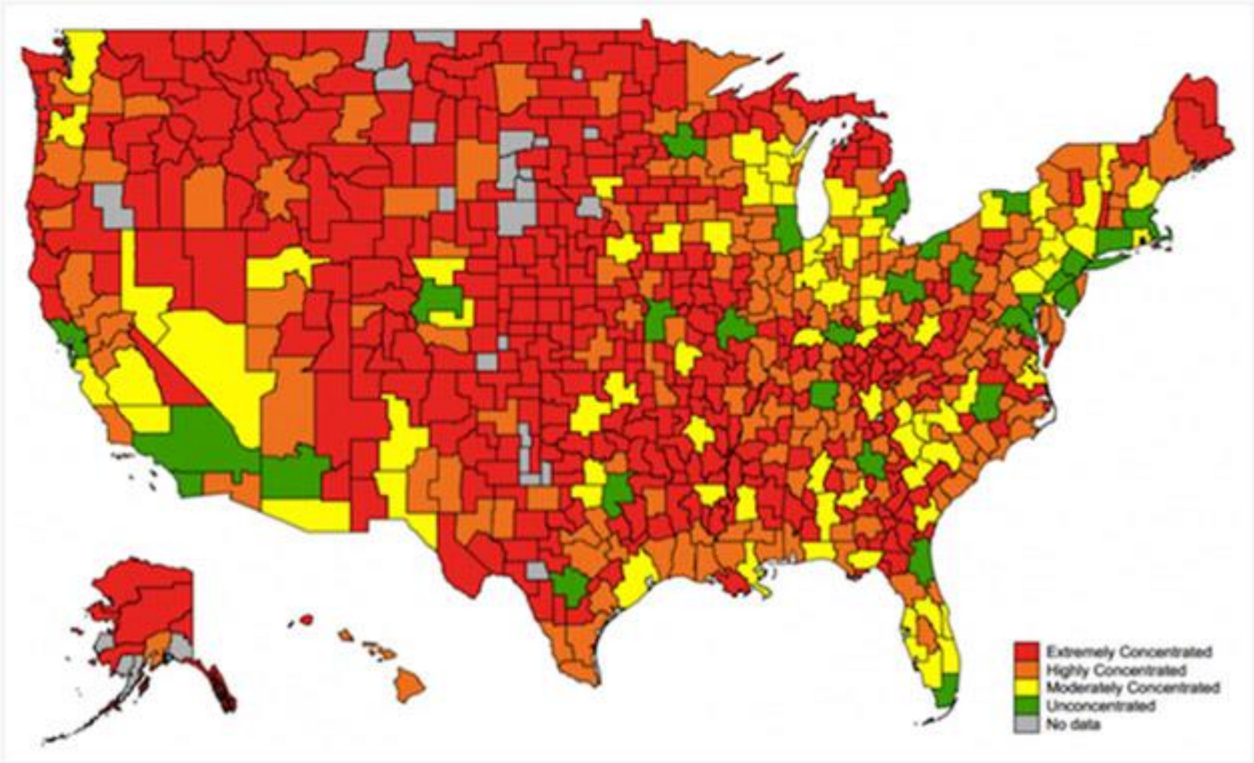
Over half of all public firms have disappeared over the last twenty years. We've seen a collapse of publicly listed companies. Astonishingly, according to a study by Credit Suisse, "between 1996 and 2016, the number of publicly-listed stocks in the U.S. fell by roughly 50%Š —Š from more than 7,300 to fewer than 3,600Š —Š while rising by about 50% in other developed nations." It is not lower growth or the global Financial Crisis that caused fewer IPOs. This is distinctly an American phenomenon.

The decline in listed companies has been so spectacular that the number is lower than it was in the early 1970s, when the real GDP in the US was just one third of what it is today. America's economy grows ever year, but the number of listed companies shrinks. On this trend, by 2070 we will only have one company per industry.

Many workers are dealing with a monopsonist In a monopoly, there is only one seller, while in a monopsony, there is only one buyer. The extreme example of a monopsony is a coal town in West Virginia, where the only buyer of labour is the coal company

Large parts of America are dominated by monopsonies. In a comprehensive study, Marshall Steinbaum, Ioana Marinescu, and Jose Azar looked across all industries and commuting zones in the US to measure how concentrated employers were. They found that most labour markets are very concentrated and that it has a strong negative impact on posted wages for job openings. They showed that going from a very competitive to a highly concentrated job market is associated with a 15-25% decline in wages.

The study shows that labour monopsony is not only pervasive across the US, but is especially so in non-metropolitan areas. This makes intuitive sense – smaller towns mean fewer employment options.



Areas with fewer employers have lower wages
(Source: Roosevelt Institute)

In a monopsony, workers have little choice in where they work and have little negotiating power for wages with employers. In a healthy economy, many firms would be competing equally for workers and would be incentivized to entice new hires with higher wages, better benefit packages, and few restrictions on their next career moves. But monopsonies make it easier for firms to depress worker wages. The classic example of this is a coal-mining town, where the coal plant is the only employer and only purchaser of labour. Today, in many smaller towns, WalMart is the new coal plant – and is the only retail company hiring.

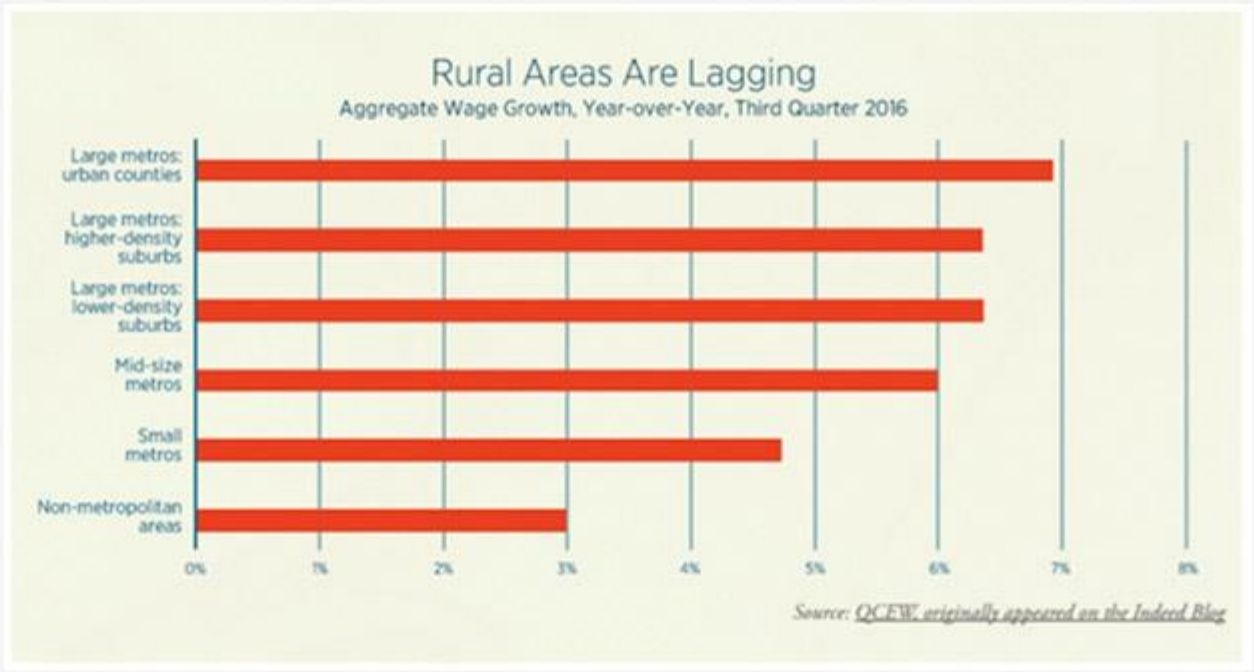
Many firms are able to suppress the bargaining power of labour by making labour markets less competitive. Economists Jason Furman and Alan Krueger argue that firms in concentrated industries are able to suppress wages through collusion and non-compete agreements that cover 20% of American workers.

Many workers live in a rural area with less choice of jobs

Today, the story of America is largely the story of two economies – rural and urban. It was not always this way. The antitrust movement of the 1940s not only targeted giant firms, but was also an attempt to weaken regional centres that had amassed too much power. This largely worked and, by the mid 1970's, there was a fairly uniform American standard of living – being middle class in the Mideast was pretty much the same as middle class in New England. However, in the 1980s, many of the policies that helped ensure this balance between regions was neglected or reversed.

A great divide formed between rural and metropolitan areas in the US. In 1980, if you lived in Washington D.C., your per-capita income was 29 percent above the average American; in 2013 you would be 68 percent above. In New York City, the income was 80 percent above the national average in 1980 and skyrocketed to 172 percent above by 2013. Power and money began concentrating in urban centres across the country as a rural ‘brain drain’ occurred.

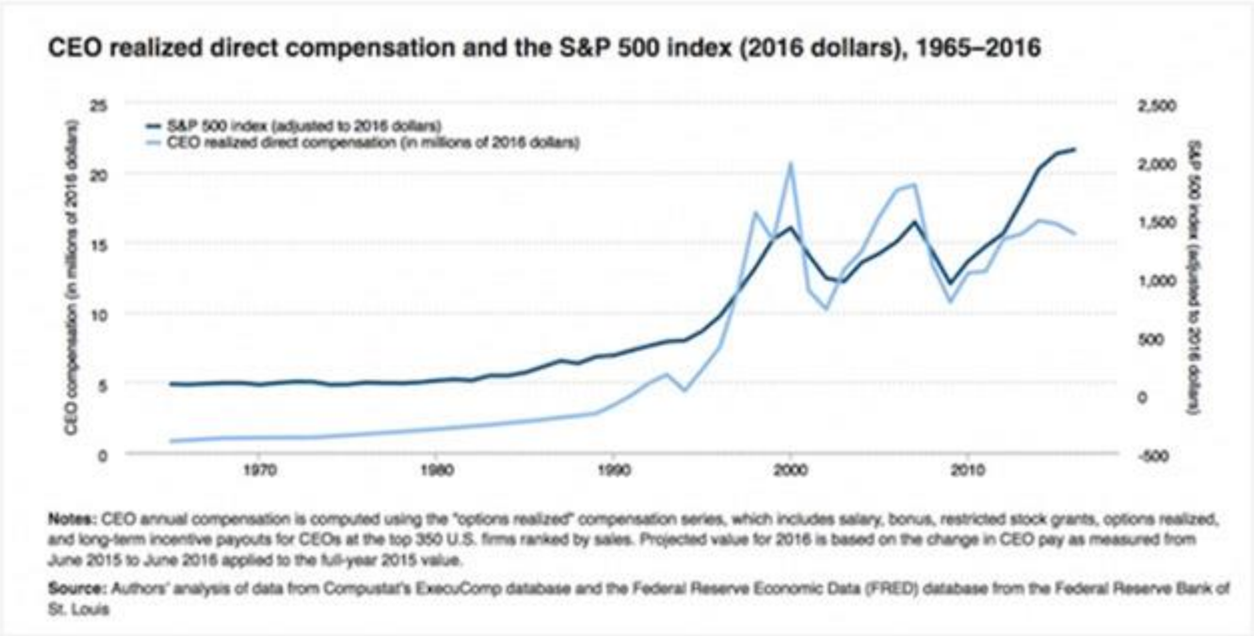
Major cities attract diverse talent and many corporations, which must bid competitively for workers. Workers living in these cities make significantly more money than workers elsewhere. There is power in numbers, and nurses who have 5 metropolitan hospitals to choose from will make more money than those who work in a town with only one hospital.



Rural Areas Are Lagging
(Source: Bloomberg, Shift: The Commission on Work, Workers, and Technology)

CEOs are getting paid a lot more than workers

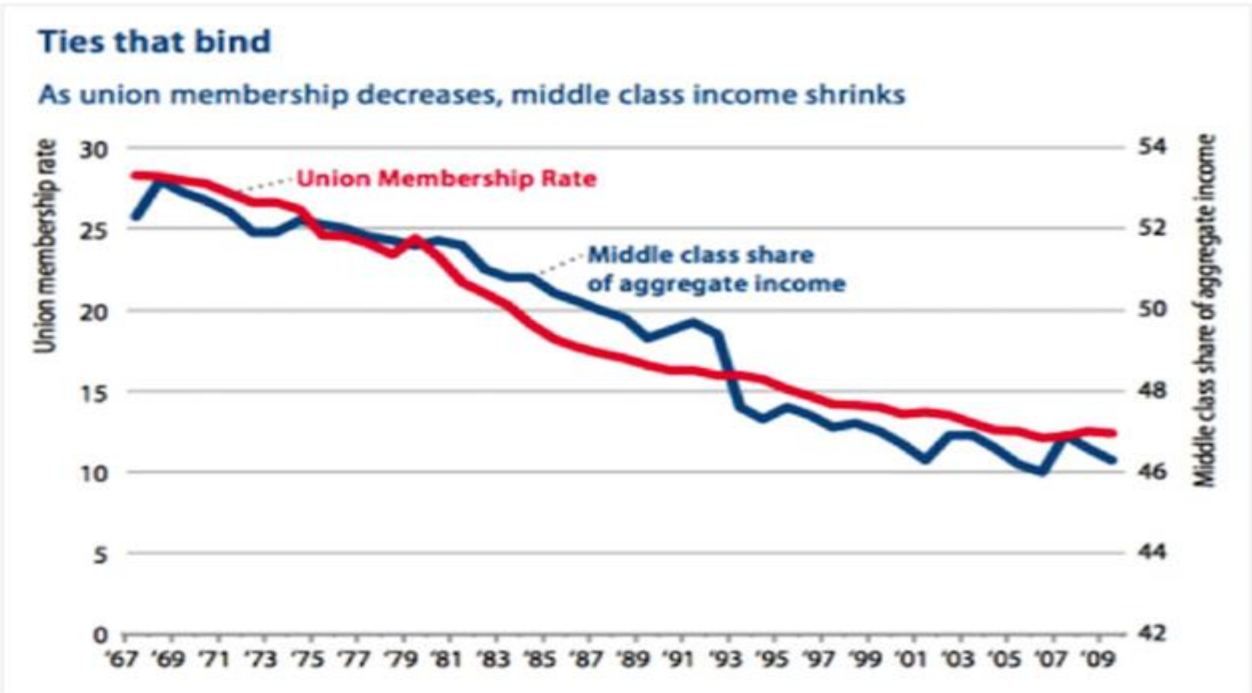
In the US CEO pay has exploded. From 1978 to 2013, CEO compensation adjusted for inflation increased 937%. By contrast, the average worker’s income grew by a pathetic 10% over the same period. To put the change in perspective, the CEO-to-worker pay ratio was 33-to-1 in 1978 and grew to 276-to-1 in 2015.(viii) The US is a big outlier in terms of how vastly overpaid the top corporate officers are vs the average worker. For CEOs in the UK, the ratio is 22; in France, it’s 15; and in Germany it’s 12.(ix) US CEOs are vastly overpaid no matter how you look at it.



Rising CEO-to-Worker Compensation Ratio (Source: Economic Policy Institute)

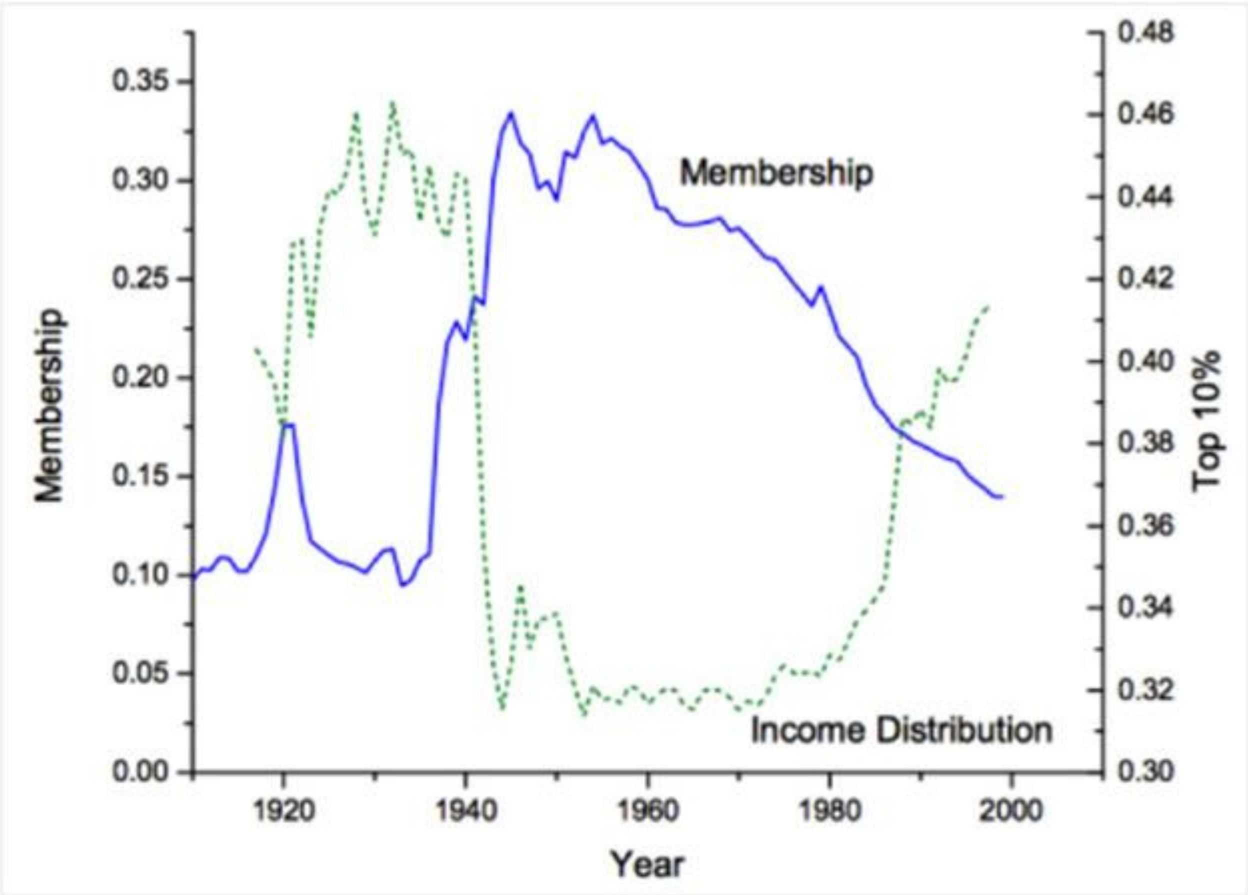
There is no countervailing force to high CEO and low worker pay

Unions maintained an important part in American working life for decades, but then declined again. In 1983, about 1 in 5 Americans were part of a union; today, only 6.4% of private sector workers in America are unionized and less than 11% of total workers.(x) This represents a considerable decline in the ability of workers to organize. Unions, though controversial, provided a needed forum for workers to band together and advocate for their collective rights.



Falling Union Membership and Lower Middle Class Share of Income (Source: *The Atlantic)*

Inequality is inversely related to union membership. If you plot the percentage of national income going to the top 10%, as you can see it is almost the perfect mirror image. When union membership is low, a higher percentage of income goes to the top 10%. This may help, in part, to explain recent trends in income inequality.



Union Membership vs Income Distribution to Top 10% (Source: *The Atlantic,* Emin M. Dinlersoz and Jeremy Greenwood) (xi)

Managers collectively represent thousands if not millions of shareholders. Union leaders may likewise represent thousands if not millions of workers. The strength of unions, however, does not come merely from concentrating forces but from the real threat of strikes. There is an extremely high correlation historically between the index of the number of strikes in the US with the wage growth of workers. Today, strikes are extremely rare, and this in part explains why wages are so low.

The Middle of an Era

By George Friedman

If you take a snapshot of the world every 20 years or so, the reality of how the world works and what matters will have shifted dramatically compared with the previous snapshot.

On the other hand, at any point in time there is a general belief that the world as it is at this moment will remain in place for a long time. It is not just the public but also experts and those who govern who tend to fail to see how transitory the present reality is. As a result – and this is what makes it important – as the geopolitical system shifts, there is a tendency to see the shifts as transitory, a temporary disruption caused by unfortunate events, until they are well entrenched, and so we tend to align ourselves with the shift far too late.

In 1900, Europe was peaceful and prosperous, and it dominated the world. It was assumed that this was a permanent reality. By 1920, Europe had torn itself apart, impoverished itself, in a bloody war. It was assumed that Germany, having been defeated, was finished. By 1940, Germany had re-emerged and was astride Europe. It was assumed that the German tide could not be resisted. By 1960, Germany was an occupied and divided country. It was assumed that war between the strongest of the occupiers, the United States and the Soviet Union, was inevitable. By 1980, there had been a war, but in Vietnam rather than Europe, and the United States had been defeated. The U.S. was now aligned with China against the Soviet Union. It was assumed that the Soviets were a permanent and dangerous enemy to both countries. By 2000, the Soviet Union no longer existed. It was assumed that the key interest of all countries was economic growth, and that traditional conflict among nations had become a marginal matter.

Twenty years is an arbitrary time period, but historically it's about the length of a human generation. The world changes radically in each generation, but the dates can vary. The last era began in 1991 and ended in 2008. Yet even now there are many who are waiting for the world of 1991 to return. More important, only now is the full power of what started in 2008 being felt.

Life After the Cold War

Consider how the world changed in 1991. The Soviet Union collapsed, and it was assumed that the rump state, Russia, was no longer a significant factor in how the world worked. Europe signed the Maastricht Treaty, which was seriously and reasonably believed to be the preface for the creation of a United States of Europe. The United States led a vast coalition of nations against Iraq's occupation of Kuwait, defeating Iraq with few dissenting voices. China had adopted capitalism and begun its historic economic surge; it seemed an unstoppable train headed toward liberal democracy. Japan, the previous economic miracle that would never end, was in the midst of its transformative economic crisis. With the Cold War over, the U.S. was the only global power, and the world was reshaping itself in the American image.

The world was filled with the promise that the horrors and dangers of the 20th century were behind us. And for a time, that appeared to be the case. The first sign that the world was not quite as it seemed came in 2001, when operatives of al-Qaida attacked the United States, and the United States struck out at the Islamic world.

That era hung on for a few more years, until two events a few weeks apart finally broke it. On Aug. 8, 2008, Russia and Georgia went to war, putting to rest the idea that Russia had fallen into permanent, shabby irrelevance, or that conventional warfare was obsolete. Then on Sept. 15, 2008, Lehman Brothers collapsed, wrecking the illusion that the global economy could only go up. In the span of just over five weeks, the core assumptions of the era began to change.

Russia was no longer a superpower, but it was certainly still a regional power. It still had a sphere of influence beyond its borders, and it would protect its interests by force. The empire the czars had created would not go quietly into that good night.

The core weakness of the European Union was revealed: It was not a nation-state but merely a treaty joined into by sovereign states whose leaders were elected by their citizens and whose loyalty was to their voters, not to Brussels. The EU was a perfectly designed instrument for economic success, but it could not cope with economic dysfunction because economic pain did not distribute itself neatly over the bloc's vast geography. Each member state increasingly pursued its own interests and frequently found the EU a hindrance rather than a help. 2008 was the high point of Europe.

China found in 2008 that an economy built on exports was not in its hands but in the hands of its customers. The economic stagnation that followed transformed China from a powerful engine pouring goods out to eager customers to a nation scrambling to put out financial fires, fantasizing about endless roads and artificial intelligence, all while turning into a dictatorship that would likely define it for the next era. Japan, rather than descend into disaster, used its social solidarity to weather its crisis by accepting the idea that a declining population and stable growth lead to higher per capita income.

And the United States discovered that being astride the world was a prescription for stumbling and falling. The war against jihadism would not end; the Russians would not accept their place in the world order; the Chinese would be less an economic problem than a potential military one; and the Europeans would be self-absorbed and provincial, as would be expected from their position. The United States realized that it was not ready, institutionally or psychologically, to manage the power it had acquired, and it could not delegate.

The world in 2008, some 17 years after the last era had begun, did not resemble what most people expected. For a long time – for some even today – there was the expectation that the post-Cold War world (as good a name as there is for what began in 1991) was the norm, and but for someone's bungling we would still be there and certainly would return to it. But eras come and go, and the world of 2008 will be in place well into the 2020s.

After 10 years, its outline is already clear. It is a time of economic dysfunction, defined by slow growth and unequal distribution of wealth, leading to domestic political tension and deep international friction. Countries will be focused on their own problems, and those problems will create trouble abroad. It is a world that is best described as parochial, tense and angry. There are worse things that it can be. But much depends on how rapidly the United States matures into its role as the single-most powerful country in the world. Likely the emergence of the U.S. from its internal rages will be the major feature of the next era.

Twenty years means nothing in history, but it means everything in our lives, so our tendency to convince ourselves of the permanence of the present era is understandable. But history didn't end in 1991, and it didn't end in 2008. For better or worse, this too shall pass.

Cranking up trade issue volume

By John Wyn-Evans

Although "America First" was a key mantra of Donald Trump's campaign, it's taken him over a year in office to really crank up the volume on trade issues, and this represents a major reversal to his more market-friendly interventions in 2017, especially when combined with the changing composition of his key White House advisors.

Unhelpfully, this all boiled up during a week that included a meeting of the Federal Reserve Open Market Committee at which members took a slightly more hawkish turn, and also when the reaction to Facebook's unauthorised release of data put downward pressure on the whole Technology sector. If there is one consolation, it is that equity markets, although weak, did not display the extremes of volatility witnessed at the start of February.

Why are trade wars back on the political agenda? Once again it is the rise of populist forces that are the prime motivation. As we have discussed in the past, not least when considering the outcomes of elections and referendums, there is a substantial minority of the electorate –

certainly big enough to constitute a meaningful swing vote – that feels it has not benefitted from the relentless march of globalisation over the last few decades. Manufacturing jobs, in particular, have been relocated to lower cost countries primarily located in emerging economies, and whole industries and communities have been "hollowed out".

The situation has been exacerbated by the use of unconventional monetary policy since the financial crisis, which has increased wealth gaps by boosting the value of financial assets, which tend to be owned by a wealthier minority. Protectionist policy, taken at face value, is directed at an attempt to level the playing field in favour of domestic production.

So far, so simple. But there is more than a suspicion that Trump's motives are self-serving. He is under intense pressure from Robert Mueller's investigation into Russian influence on the outcome of the 2016 election, while also facing the bad publicity surrounding an alleged affair with a star from the adult entertainment industry; mid-term elections are on the horizon in November, with the Republicans facing the threat of losing their majority in the House of Representatives.

What better way to shift the narrative and rally the voters than by sticking it to the Chinese? And it's fairly clear that China is the main focus of his policy, because the EU, Mexico, Canada, Australia, Argentina, Brazil and South Korea were all granted exemptions from the tariffs on steel and aluminium.

Of course, China is not guilt-free in all of this. It has championed mercantilist policy in the past by allowing its currency to be weak and investing hugely in excess industrial capacity, but it has been reining back such behavior more recently. Of perhaps greater concern is the alleged theft of intellectual property. China has recognised for a while that being the world's bargain basement is not a sustainable path to greater wealth, so has been working on raising the value-added content of its exports.

Although it's very difficult to prove these things, one can see that it's tempting to take a short cut by using someone else's ideas rather than taking the time and expense to develop your own. One need only type "Range Rover Evoque Chinese copy" into an internet search bar to see a striking example of this (alleged) behaviour. And that's the clever thing about Donald Trump – he probably does have just enough evidence to make his actions seem justifiable, so it's hard to see him backing down.

However, Trump has decided to take on a formidable opponent, which probably has greater tolerance to sustain hostilities – and the fact that President Xi is not beholden to the whims of voters is a plus for him. China's exports to the US account for about 4% of Chinese GDP and the trade surplus in goods and services is around 3%. China is growing at a real 6.5% per annum, so has some cushion even if it exports nothing to the US.

China is already undertaking massive investment in its "New Silk Road" initiative to broaden trade ties across Eurasia, South-East Asia, and the subcontinents of Asia and Africa, and so has no shortage of new trade opportunities. It also boasts the fastest-growing consumer economy (in terms of money spent), which remains massively alluring for overseas companies who want to do business there. American corporations can already see this crock of gold fading, and are lobbying the president to tread more carefully. Interestingly, the Chinese themselves have been relatively measured in their responses so far.

In reality, a resolution of this spat will probably require that all parties involved "save face" and that Trump, in particular, can project a certain image at home. However, it is also incumbent upon politicians in much of the western world to recognise what is driving the populist agenda and to address issues such as inequality – and this will involve making unpopular decisions, which politicians never like because it reduces the chances of being re-elected. From an investment perspective, greater trade friction reduces overall global growth and tends to create more inflationary pressures, owing to the tariffs imposed and less choice for consumers. It also reduces innovation as domestic companies are shielded from international competition. That is quite the opposite of what we have experienced for much of the last half-century, a period that has been generally kind to investors. It is important that the rest of the world is not sucked into Trump's drama.

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