
ECONOMIC AND POLITICAL FORECASTING

The structural change that genuinely changes everything
...but that we do not acknowledge yet

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Founder of Analyse. Debate. Act. Economics Ltd

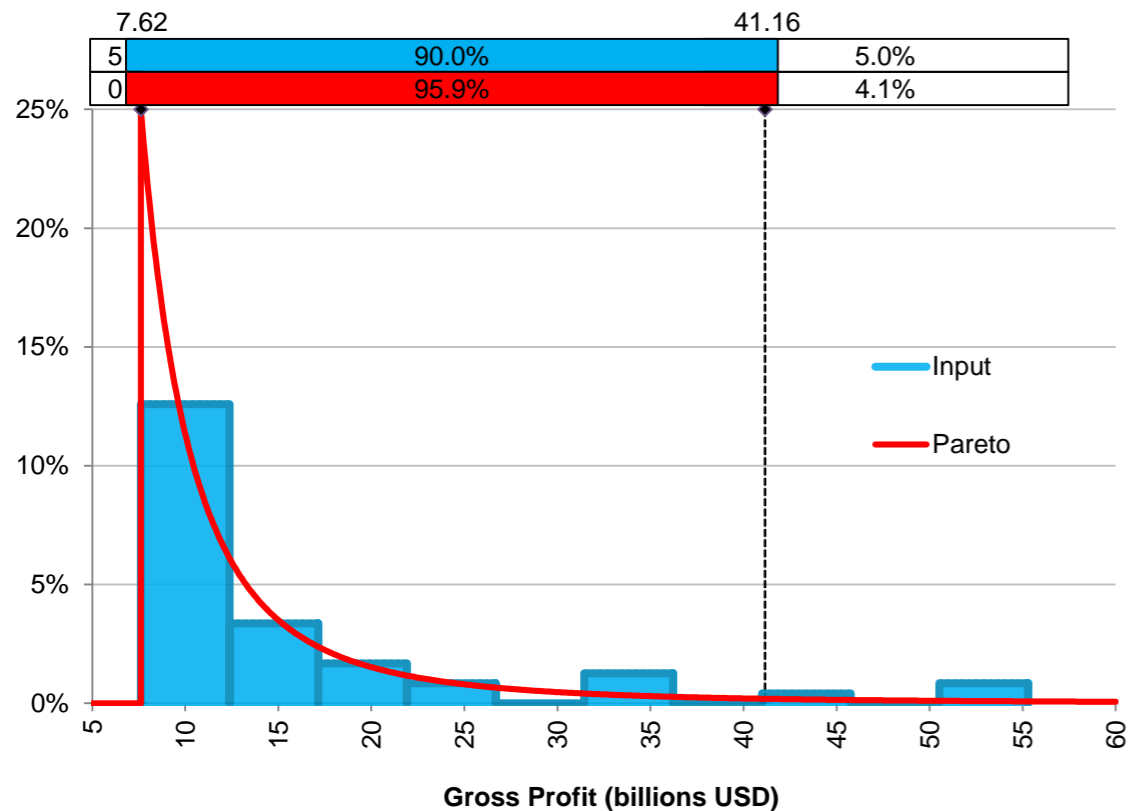
3rd September 2019

STRUCTURAL POLARISATION AND THE CURRENT BUSINESS CYCLE

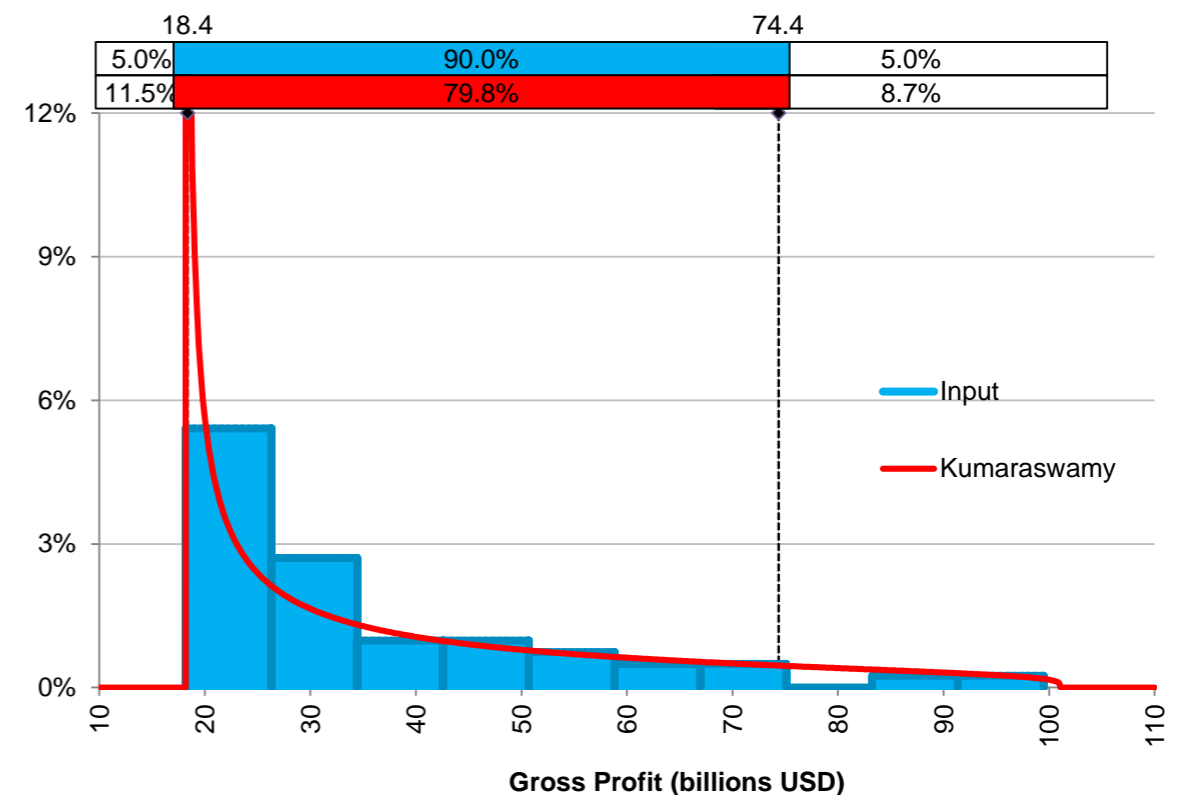
- In 2018, we published a report documenting how we had observed an increasing widening gap between the performance of large and ultra-large companies and the small/medium ones. Back then, we highlighted that this process, in our view, was fuelled by three big trends: persistently low interest rates; deep globalisation; and the data-IT technological leap.
- Each factor draws strength from the other two, and the three together make an increasing polarisation of balance sheets unstoppable, in our view, in the current macroeconomic and fiscal policy framework.
- Globalisation and the data-led technological leap make global reach easier than ever before, and persistently low interest rates make leverage easier, which ultimately means faster business strategic decisions and thus represents an immensely powerful competitive advantage.
- In 2018, we subsequently published a correlated report on inflation and why it was not as low as it appeared from the widely available consumer price inflation indices. Among the reasons we flagged then, we noted that the deepening of big data and artificial intelligence, make the pricing of items more complex in a way that it makes it more likely that national statistical offices are underestimating the actual pricing of goods and services.
- In this presentation, we build on those two intuitions, and we expand them with the hindsight of a further year of research and the confidence that the process of the polarisation of balance sheets in the business sector (or what we also called “growing inequality of corporate balance sheets”) is the critical phenomenon that is behind the business cycle downturn that started last year and, in our view, will be the factor behind the next global recession.
- We remain convinced that a global recession is highly unlikely soon, but we are very concerned that, when it hits, it will be worse than 2008 and the policy responses may be very different to what the markets have grown addicted to: monetary stimulus and mild fiscal support.

DISTRIBUTION OF THE TOP-50 COMPANIES GLOBALLY 2000-CURRENT

50-largest companies globally in 2000



50-largest companies globally in 2009



Notes: the charts show the distribution of the top-50 companies in terms of 12-month cumulative profits in USDbn, using Bloomberg data. The horizontal axis shows the size of the balance sheet, the vertical axis shows the relative frequency in the sample.

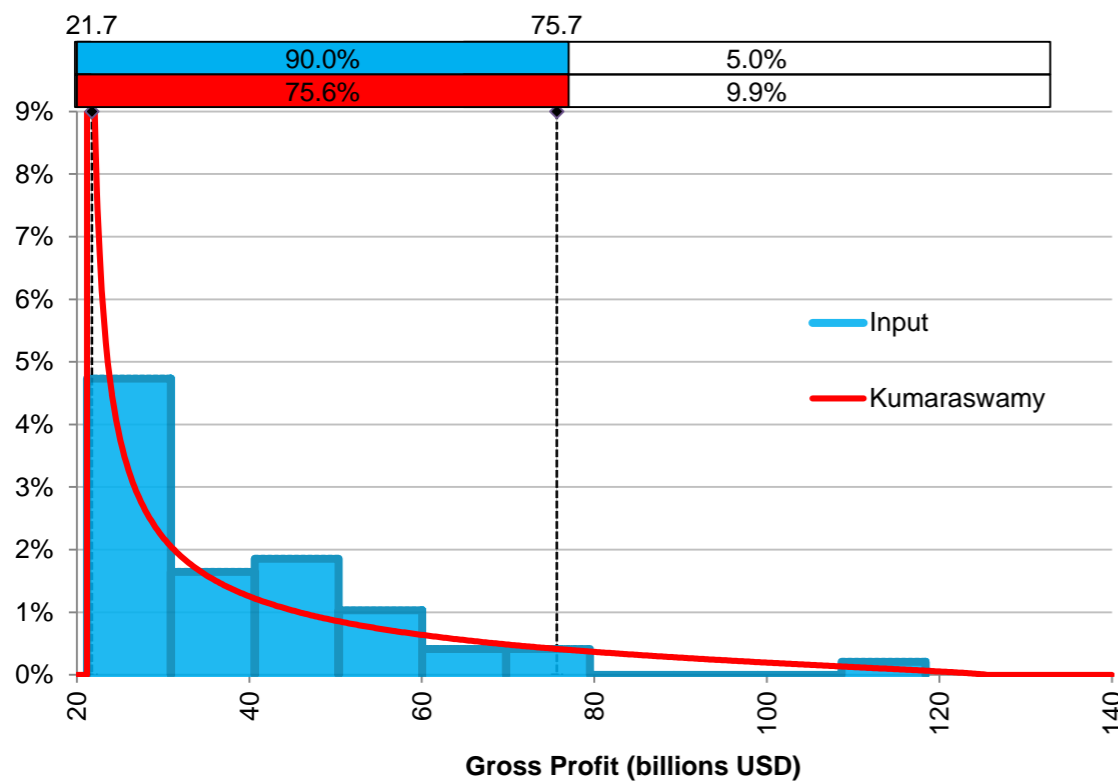
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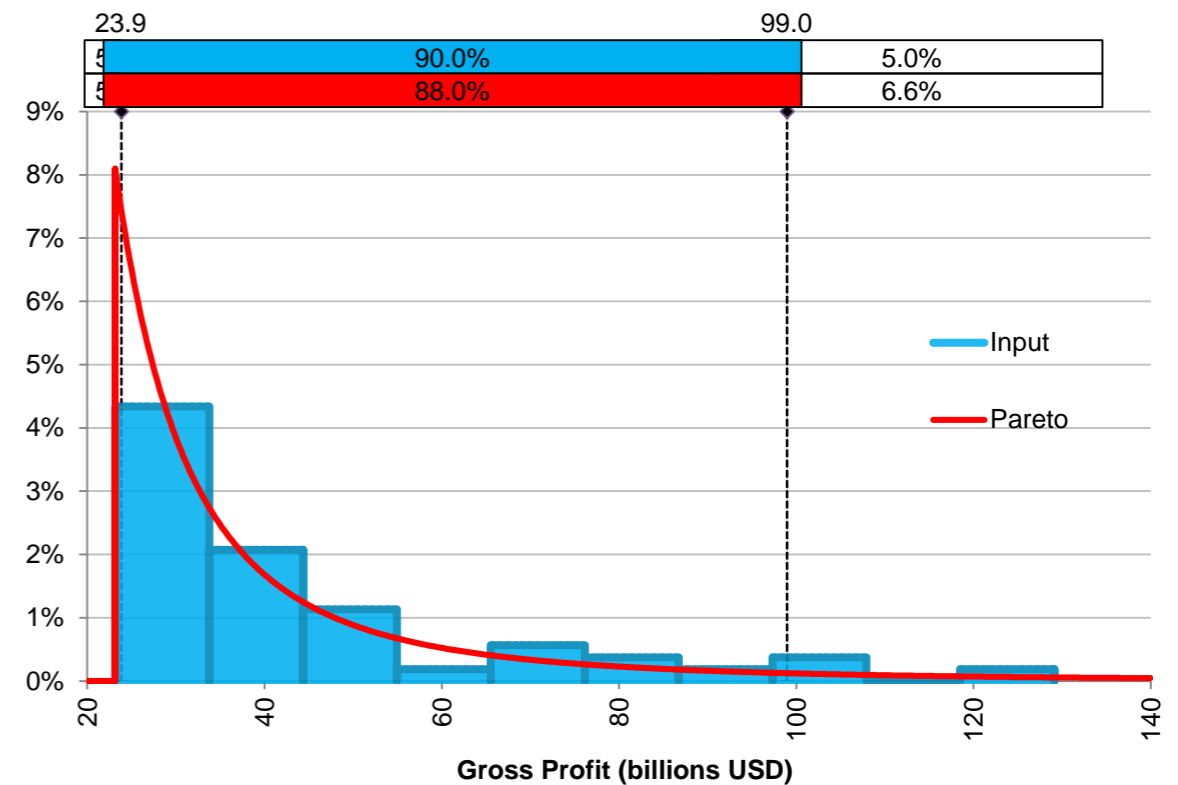
Source: Bloomberg, ADA Economics

DISTRIBUTION OF THE TOP-50 COMPANIES GLOBALLY 2000-CURRENT

50-largest companies globally in 2014



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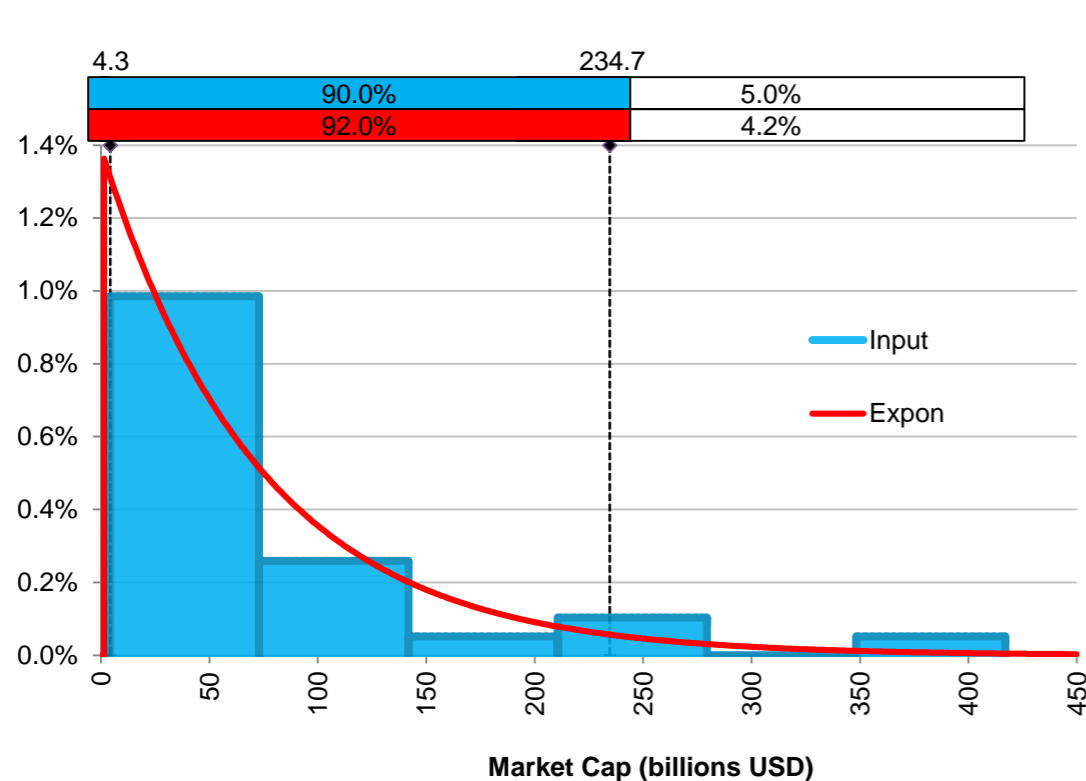
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FIRST: THE BASICS, WHY TODAY'S ECONOMY IS NOT LIKE 20+YRS AGO

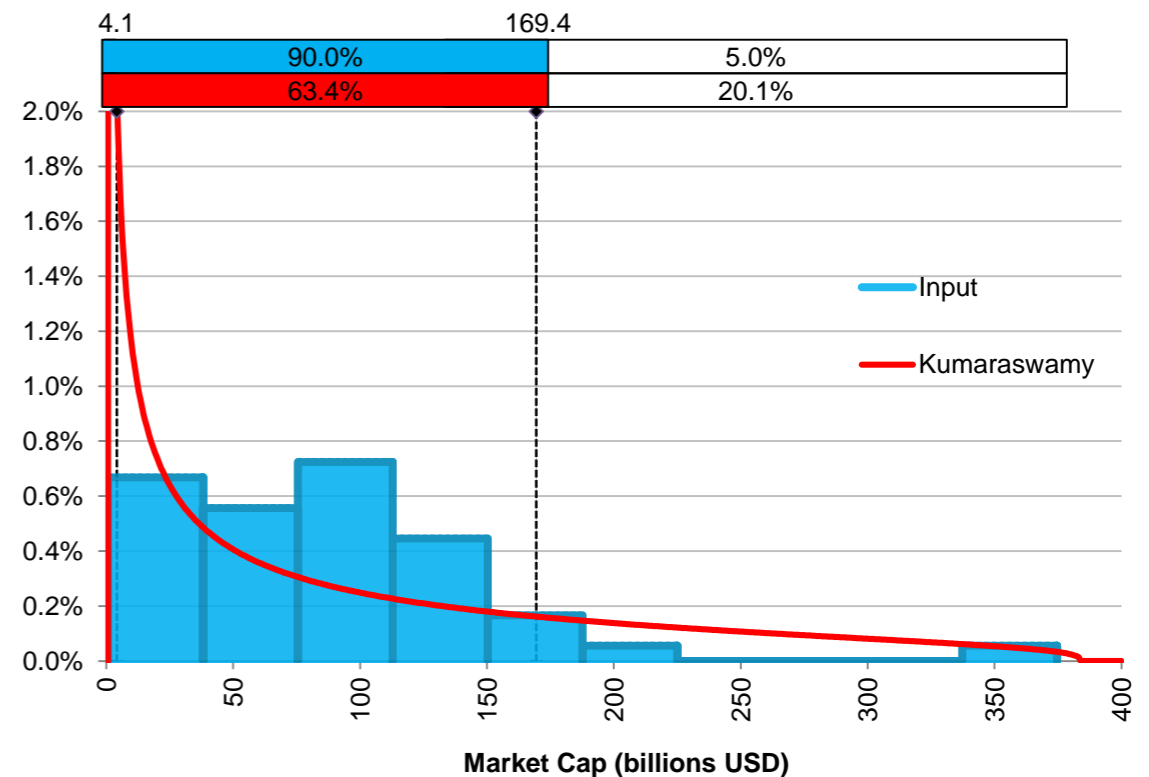
- The polarisation of business sector balance sheets has three critically important elements: the large companies in a country are getting bigger at a faster rate than the rest (size here should be interpreted as financial size, not in terms of employment); there are more and more of these “titans” as time goes by; and their size is now comparable in gross profit terms to the nominal GDP of a medium-sized country.
- That is: the distribution of companies based on their financial strength metrics (profits, revenues or market capitalisation) has a long right-hand side, which is getting longer compared with the left-hand side of the distribution, where micro/small and medium-sized companies cluster. Even among the large and the very large, we can see a tendency for the largest or biggest to get bigger still faster than the rest.
- The first legitimate question on this process is why should this be any different from the historical dynamic of the business sector, where large companies always existed.
- The answer is twofold: historically, only a few sectors could aspire to become enormously large relative to the bulk of the corporate sector: banking and utilities. These sectors benefit from particular network features and, thus, to curb their natural monopoly or oligopolistic strength, special regulation is in place pretty much everywhere globally. The second very important thing to remember is that, historically, these companies have been significantly limited by the geography of the country in which they reside: the European single market and lower barriers to trade have permitted banks and energy companies, for example, to expand their operations to other countries, but generally the home market remains the critically important one and they remain subject to extra regulation in most of the countries they operate in anyway.
- This is not what we are facing today: where the ease of reaching global demand and recognition allows companies in pretty much any sector to behave or aspire to behave like an oligopoly.
- Most sectors can see one or more companies aspiring to build a global oligopoly-like status, but we only regulate the traditional “network” sectors.

DISTRIBUTION OF THE TOP-50 COMPANIES GLOBALLY BY MARKET CAPITALISATION

50-largest companies globally in 2000



50-largest companies globally in 2009



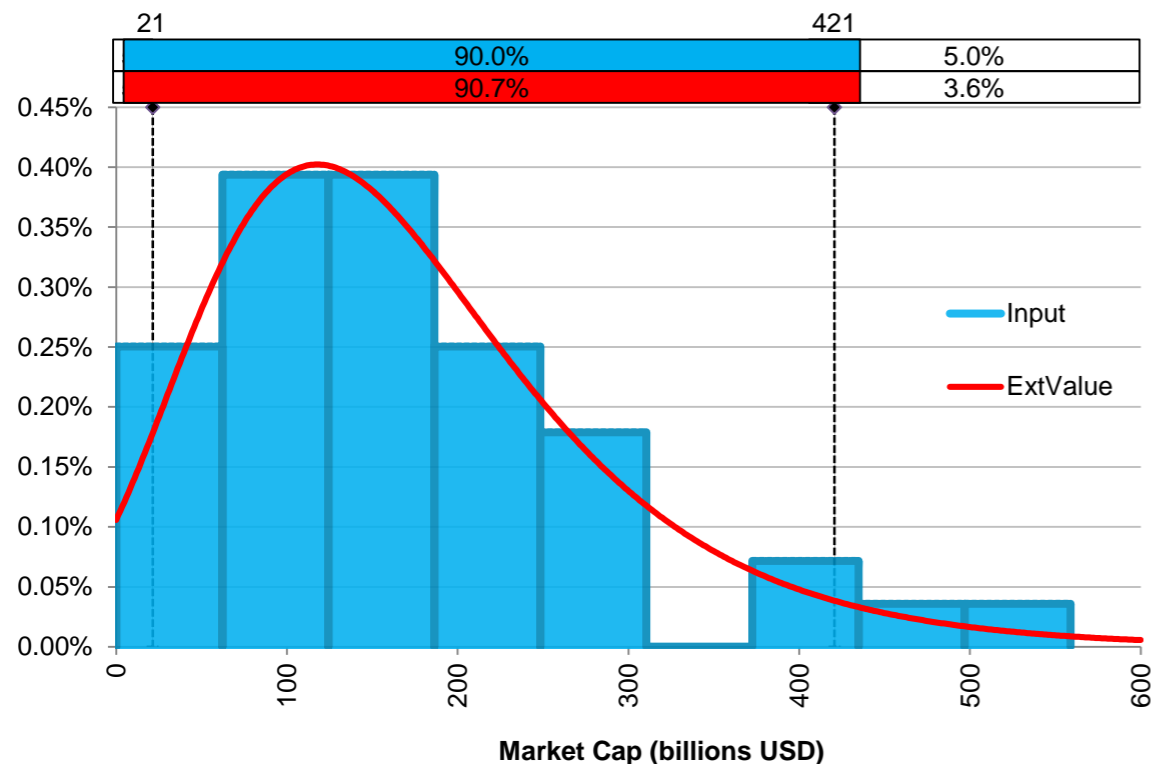
Notes: market capitalisation evolves differently from profits and revenues. It shows less of a tendency to move “right with a thin tail” but, nonetheless, do note the magnitude of the change in sheer size through the whole distribution. Considering how infinitely smaller the micro to medium-sized companies are anywhere globally and how much more slowly the balance sheets of micro to medium-sized companies develop relative to the titans, it should give a very good impression of how uneven the visibility is towards policy makers of the two far ends of the corporate distribution. The small and medium-sized are plainly too small and too many to be visible at the government level, especially compared with the sheer size and lobbying ability of the very large.

Not only that, consider that, while the concept of private pension schemes and private savings management is well established and represents a steady flow of liquidity to large companies, nothing comparable exists for the micro to small companies. *De facto*, this means that there are two very different “monetary policies” in place: the ultra loose for the large and super large, and the “neutral to tight” for the small to medium.

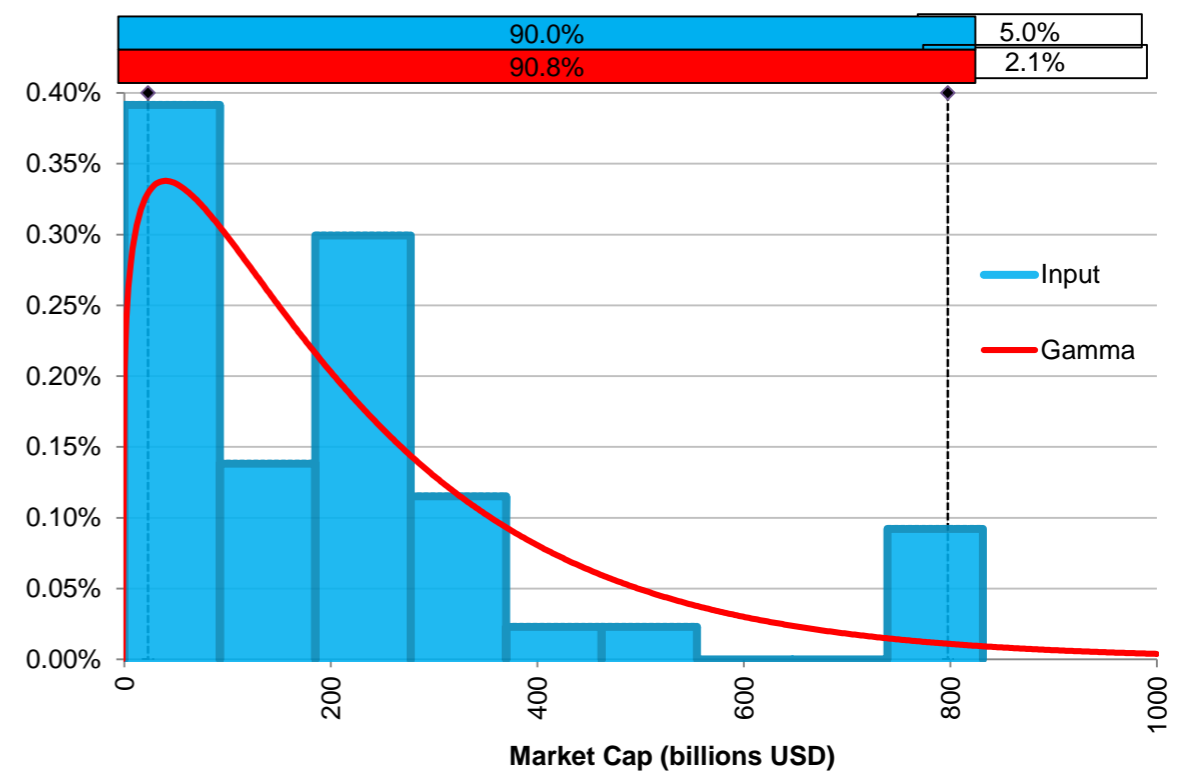
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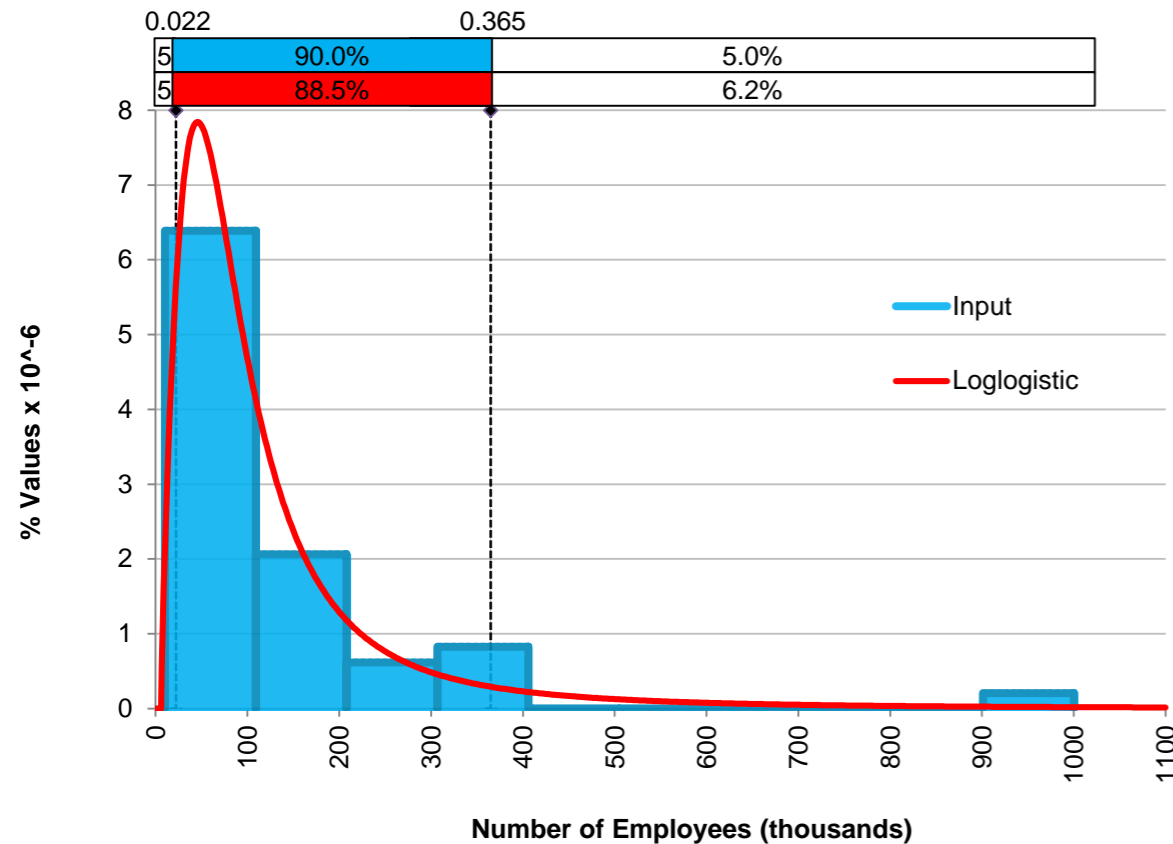
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SECONDLY: WHAT ARE THE IMPLICATIONS OF THIS PROCESS FOR GROWTH?

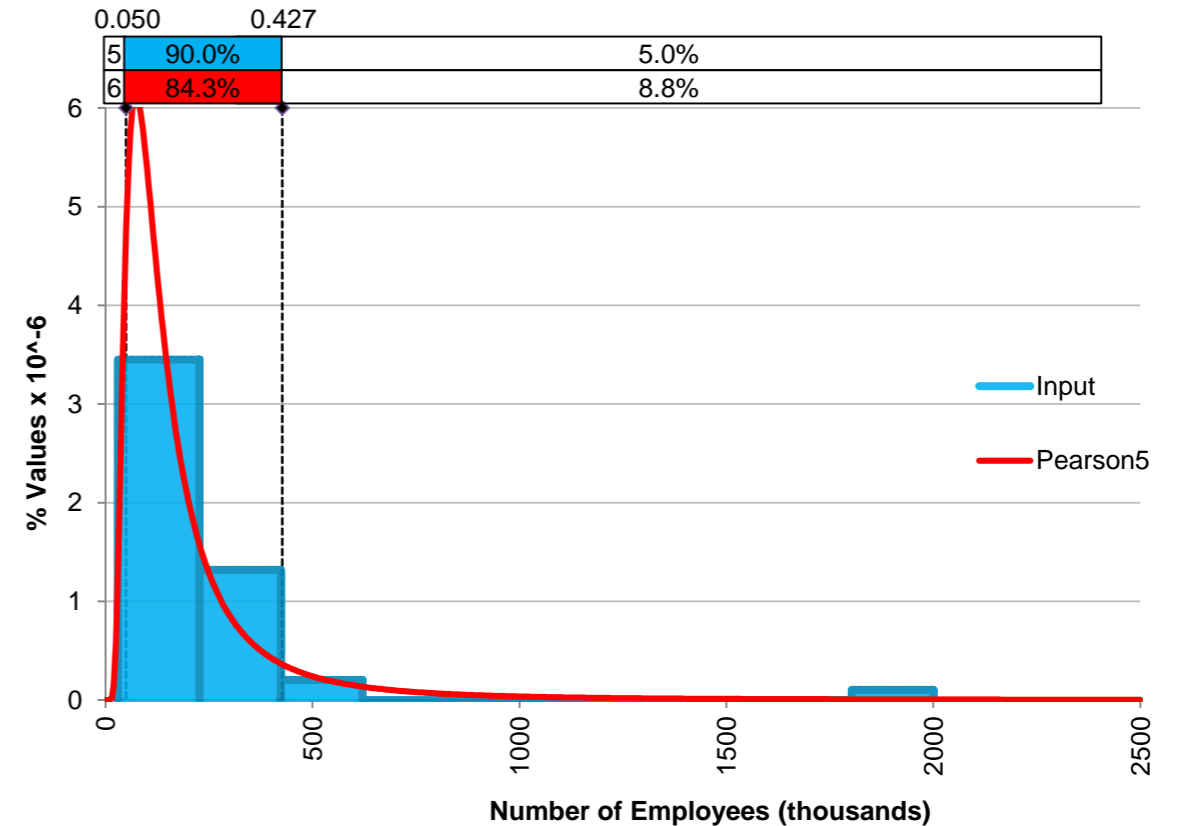
- In our view, the polarisation of business sector balance sheets has profound implications for economic growth and, in this phase, the impact is largely negative.
- First, the more this trend carries on, the more there is a crowding out of the market share of micro to medium-sized companies, which are responsible, on average, for half of the employment in any country. The more the smaller end of the balance sheet distribution spectrum is squeezed, the lower, on the margin, will be the benefit of robust real GDP growth on employment. Beware that we are talking about a less powerful connection between real GDP and employment, not that employment cannot get better.
- Crowding out of SMEs also implies less support for investment in the aggregate for that segment, which largely invests out of retained earnings and expected future demand.
- Secondly, polarisation implies an imbalance in the competitive equilibrium present in an economy. Beware that competition is a changing phenomenon, not a static one; however, broadly speaking, the deeper the polarisation, the less competitive the playing field in the business sector becomes; and, the more widespread this phenomenon is, the less likely it is that it will self-correct.
- Financial power is an important factor defining access and protection from and by the judicial system.
- Balance sheet size means visibility at the policy-making level: the bigger, the more visible; while, at the smaller end of the balance sheet distribution, government policies become increasingly less well-tailored because companies become too small, less visible and, thus, less well-understood in a timely manner.
- Financial size affects the speed at which a company can respond to a change in the business environment; in particular, how quickly it can adapt to the changes brought about by big data and artificial intelligence.

DISTRIBUTION OF THE TOP-50 COMPANIES GLOBALLY AND HOW THEIR EMPLOYMENT HAS CHANGED

50-largest companies globally in 2000



50-largest companies globally in 2009

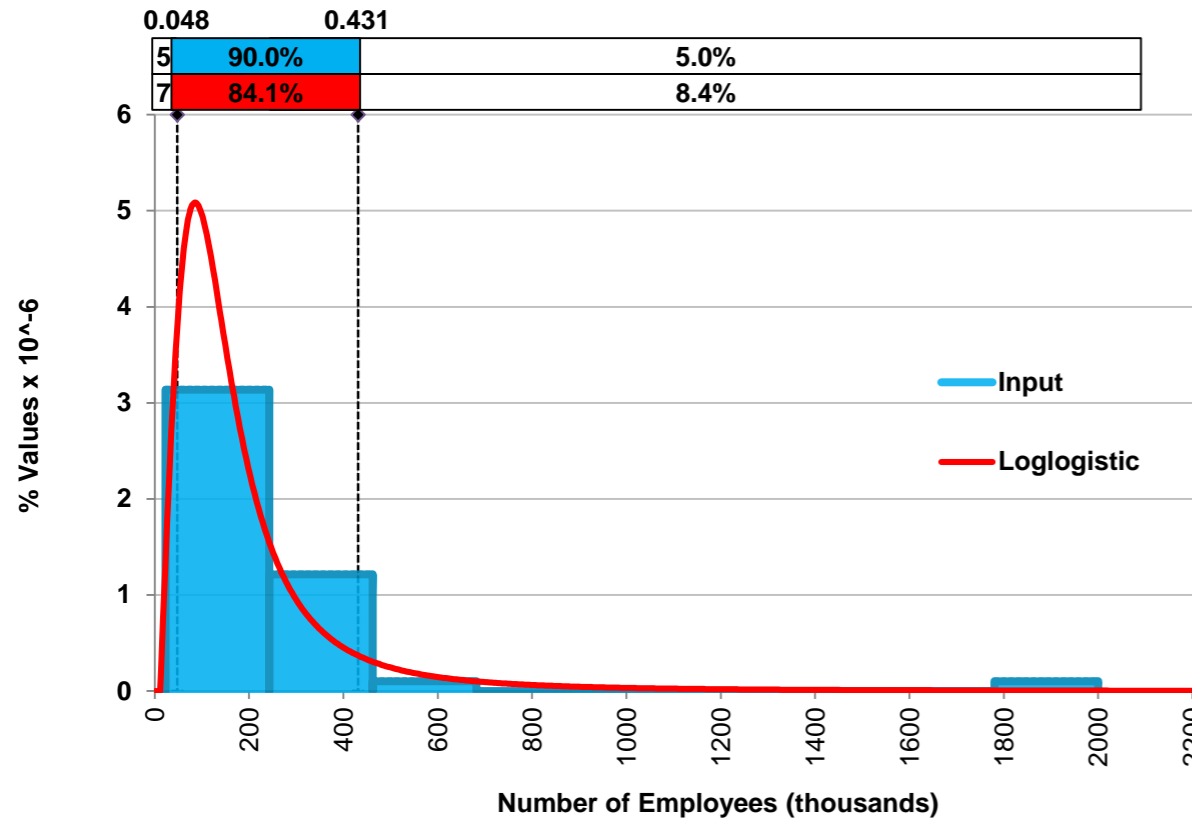


Notes: these charts plot the employment numbers reported by the companies we selected as the top-50 globally, and aim to show how the distribution evolves over time. First, employment does not have the same tendency to skew to the right, like profits/revenues or market capitalisation exhibit. Secondly, if we were to show the aggregate employment of these companies, it would be seen that, while, in terms of financial size, the aggregate is going from being equivalent to a medium-sized emerging market in 2000, it has now mushroomed to the aggregate size of a G7 country, but with a total employment pot half of what a country would show. Initially, we thought this was tentative evidence that this process would lead to less employment. However, after a year of careful consideration, we now believe that is not true: first, because the total employment impact of multinationals is underreported in their financial statements; and second, because it goes against what we observe in the aggregate employment data. The impact on employment is more subtle: it supports income inequality and it favours a compression of total compensation for the mid- and low-skilled labour force, but it does not depress the total number of jobs.

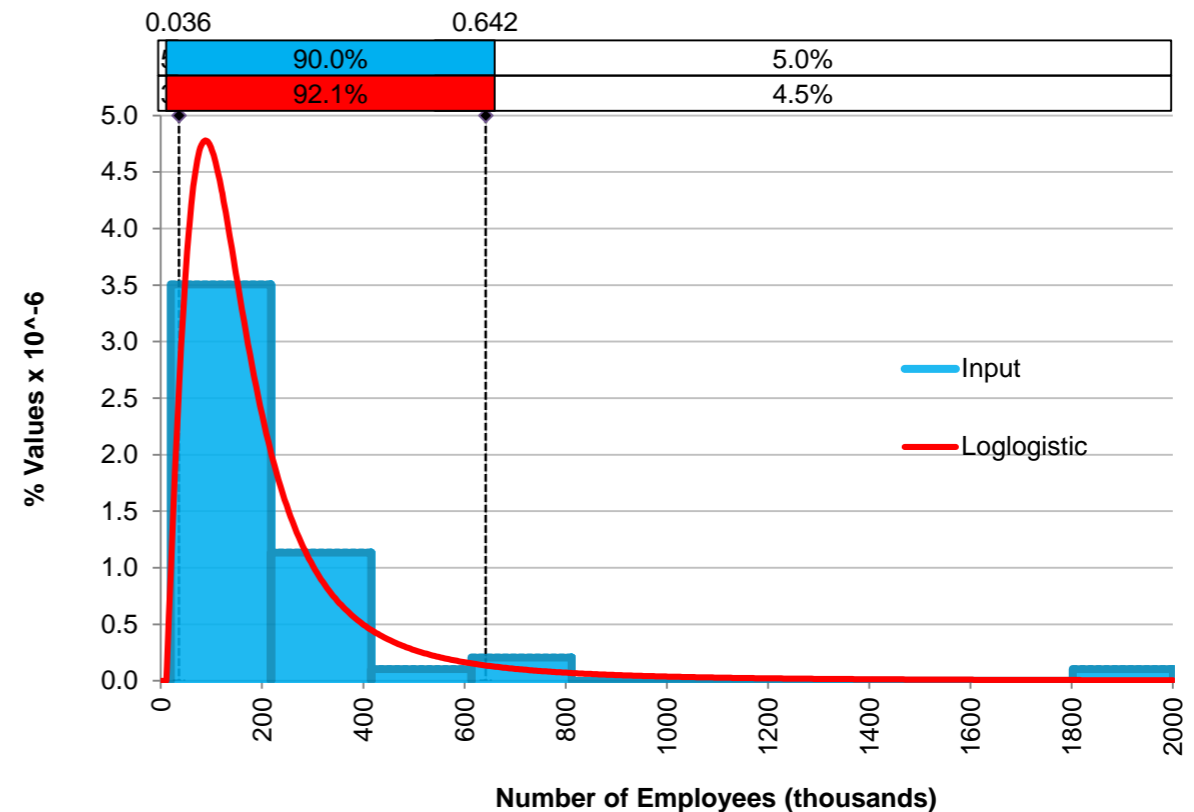
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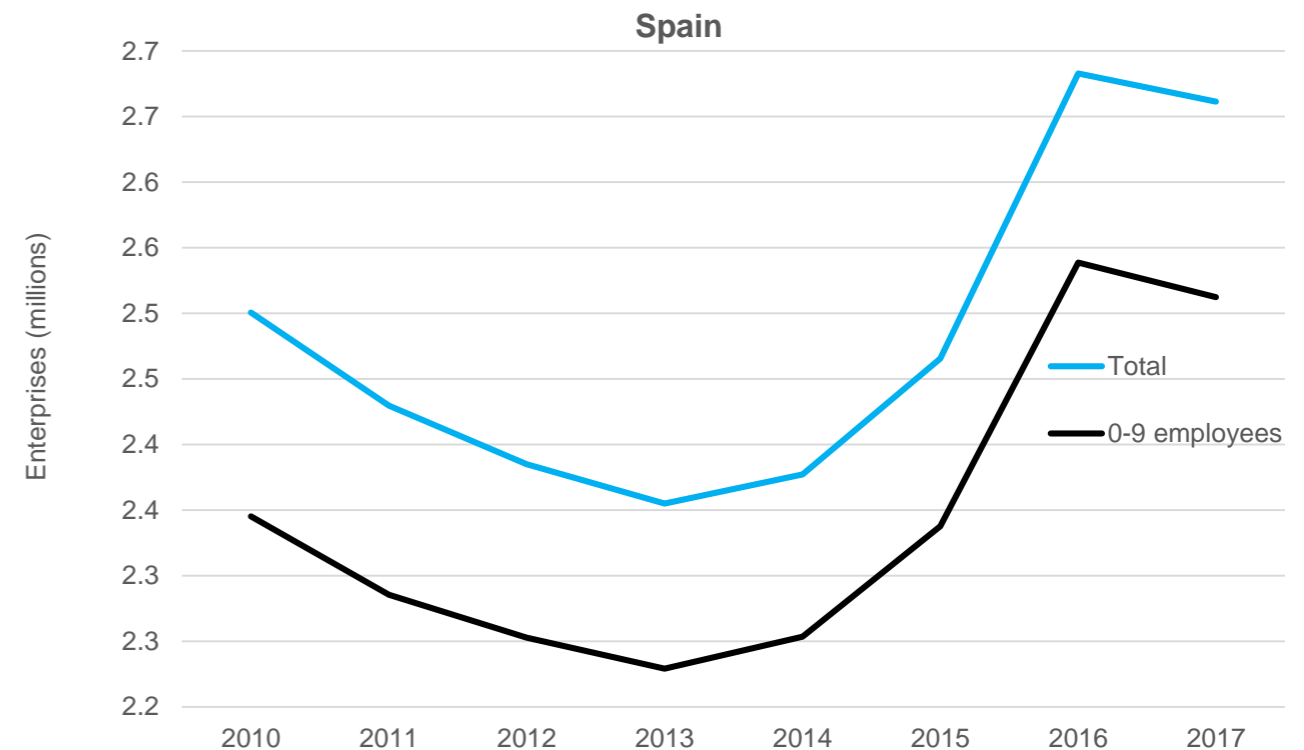
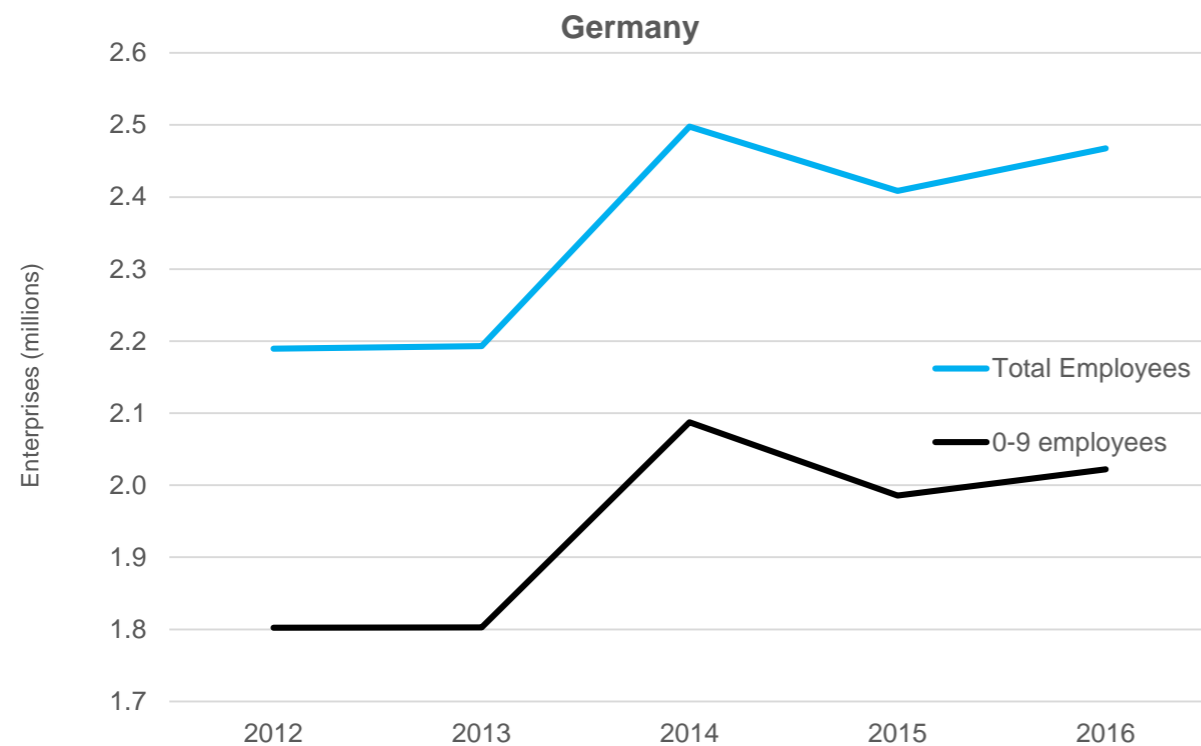
Source: Bloomberg, ADA Economics

SECONDLY: WHAT ARE THE IMPLICATIONS OF THIS PROCESS FOR GROWTH?

- Ultimately, financial power dictates a company's ability to survive and how long other companies can survive as well. In fact, the more the SMEs are squeezed, the harder it becomes for new companies to break through.
- Any country, to sustain a healthy degree of employment, social prosperity and, thus, a robust real potential growth rate, needs: 1) a high birth rate of new companies; 2) a decent survival rate of new companies; and 3) a reasonably dynamic process that allows the occasional small company to grow in size and eventually become dominant.
- Only 1) does not guarantee stable potential growth – it can simply be an indication of changing labour market dynamics, but not one of a healthy business environment.
- Only 1) and 2) are not a sufficient shield against the changes that are brought about by polarisation at the global level. You can have a country of plentiful and skilled entrepreneurs but, if they do not reach a sufficiently large scale, they risk becoming easy prey for external players, which will not safeguard potential GDP growth, in turn.
- Ultimately, what we are saying is that the polarisation of balance sheets eventually brings down the real potential growth of an economy.
- This process is not immediate because, in our view, there needs to be a certain critical threshold of “imbalance” to “backfire”, so to speak. Think, for example, about a small open economy at the beginning of a large wave of foreign direct investment. In that phase, usually there is a phase of polarisation because the incoming companies tend to be much stronger in terms of financial strength than the domestic companies. However, this process also brings knowhow and better integration with global supply chains and a widening of the aggregate production ability of the country, so it is largely beneficial.
- However, this is only one side of the story. The negative side is what is becoming clearer, especially in the past 10 years and particularly in Western Europe. The fact that it hurts Europe more today does not mean that other countries are immune. It only means that it will take longer to reach them.

THE EVOLUTION OF THE NUMBER OF COMPANIES IN THE BIG EU COUNTRIES

The aggregate number of enterprises across sector (business economy) measured by Eurostat, showing the total and only the 0-9 employees category



Notes: data on the demographics of the business sector and, in particular, the balance sheets of the micro to medium-sized companies are very limited and patchy. So, we need to make do with what we have.

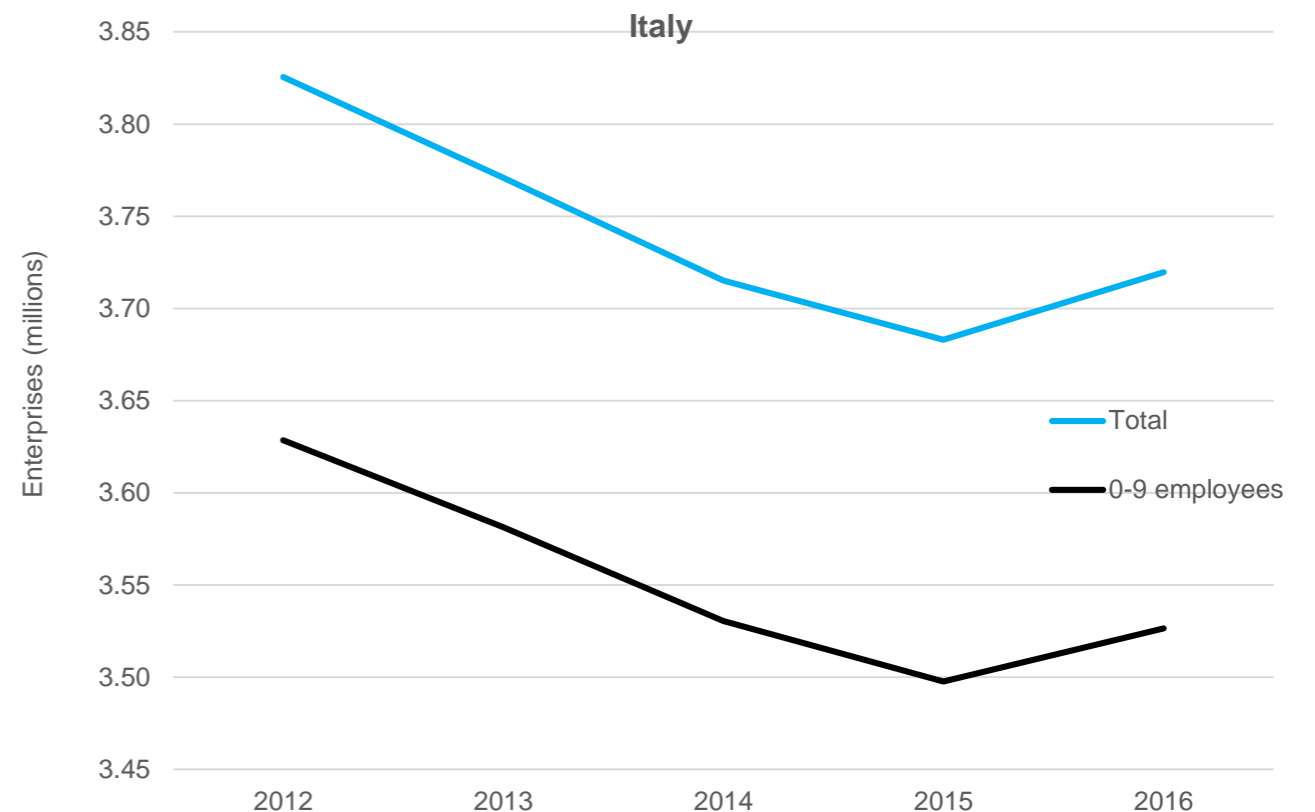
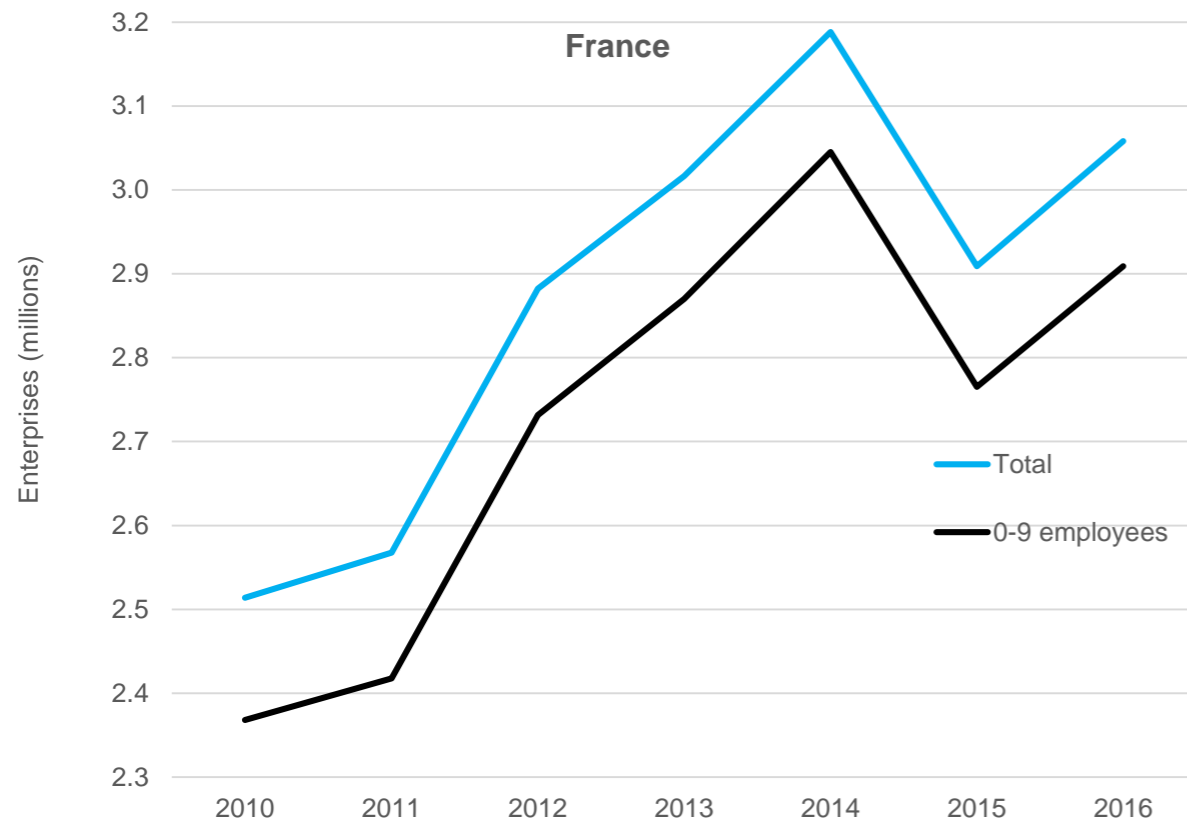
We used Eurostat data to simplify the cross-country comparison. Alas, the time series is not long, but it shows some evolution nonetheless, so it is a decent starting point.

These charts show that, regardless of the country – whether a new “growth tiger”, such as Spain, or a structured one like France or Germany, or even the UK before and after Brexit – they all depend strongly on micro companies: those that have UP TO NINE employees.

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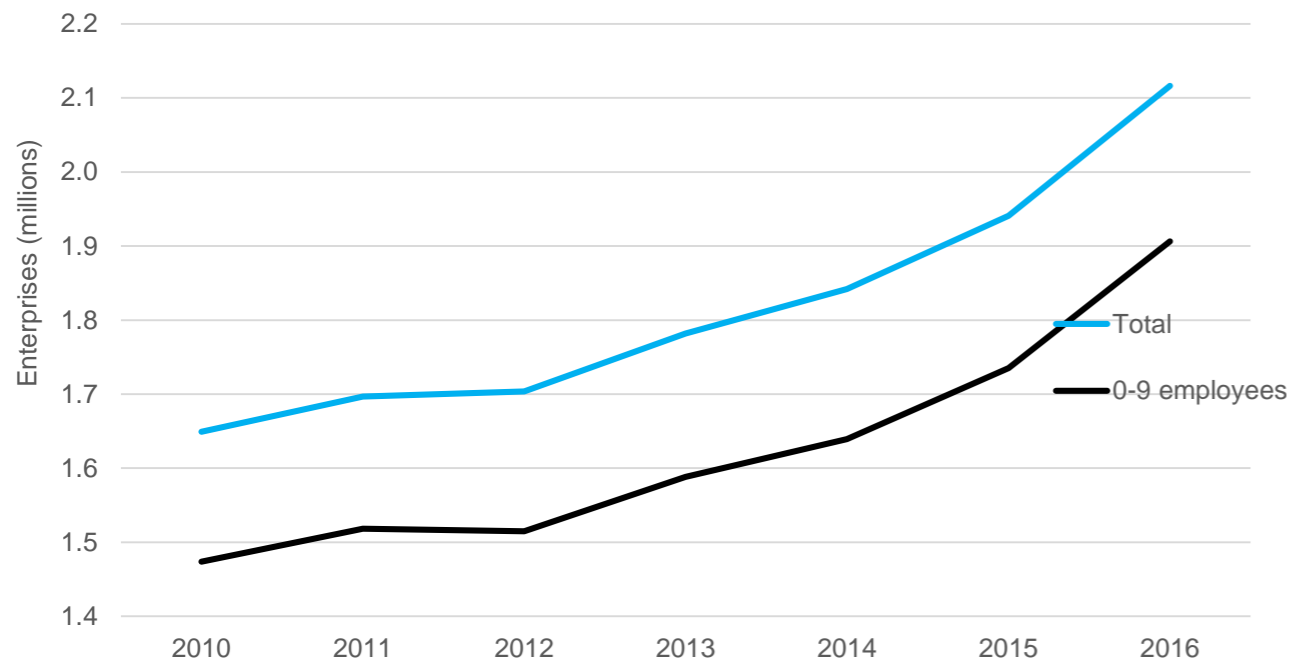
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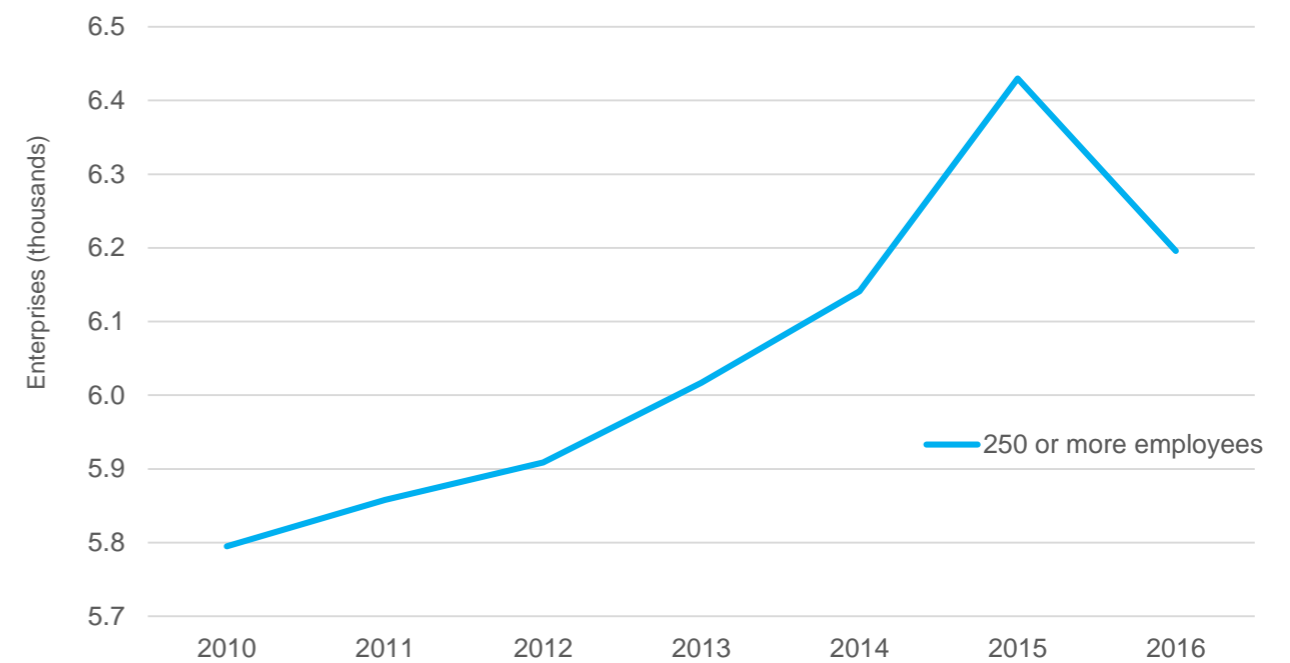
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THE EVOLUTION OF THE NUMBER OF COMPANIES IN THE UK

Number of enterprises per employment category for the total business economy



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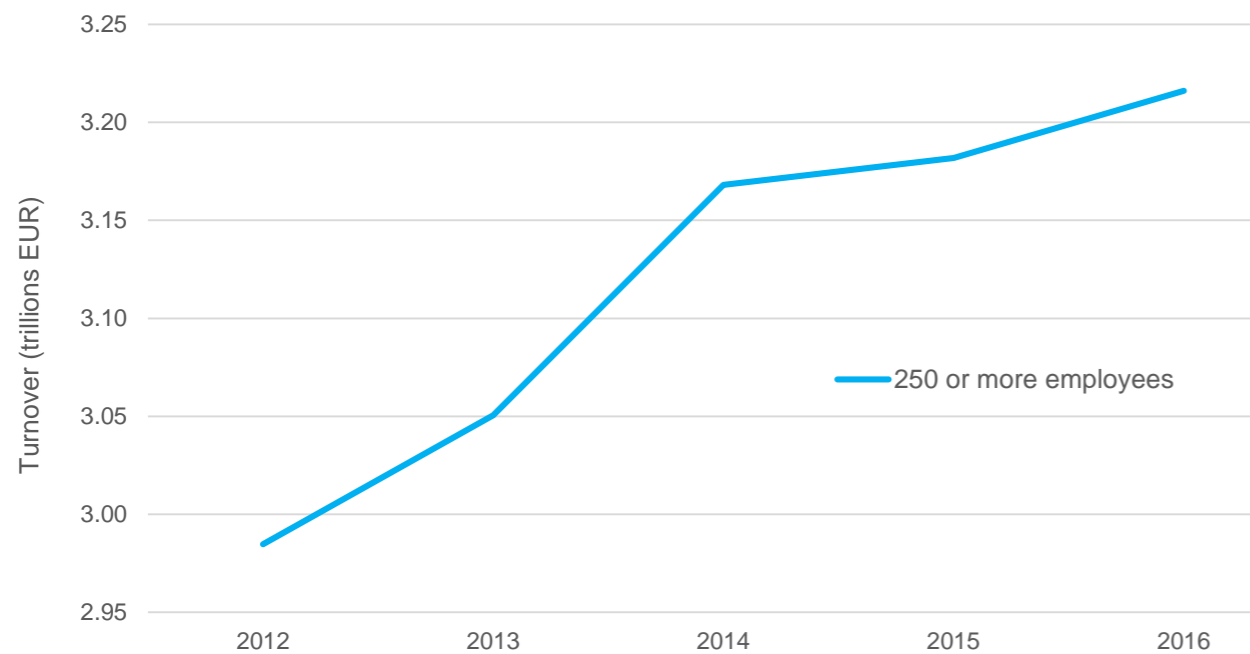
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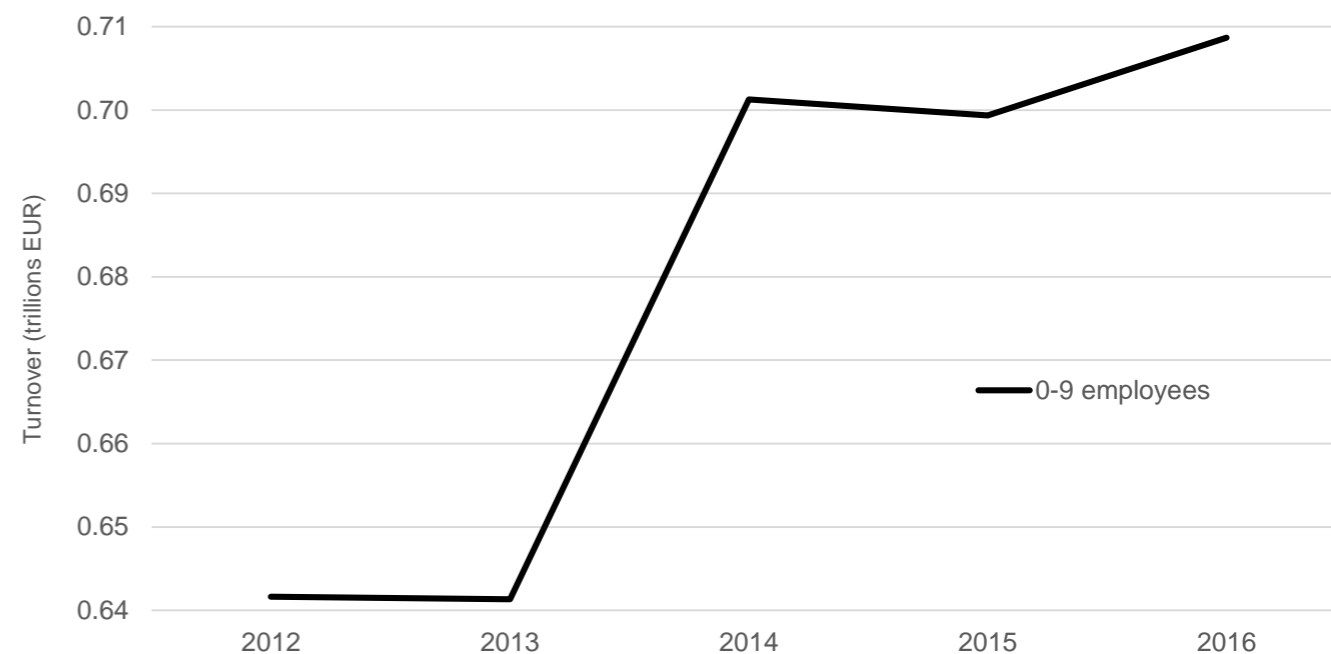
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AGGREGATE TURNOVER BY EMPLOYMENT SIZE CLASS: GERMANY

Turnover of enterprises in each category for the total business economy



Turnover of enterprises in each category for the total business economy

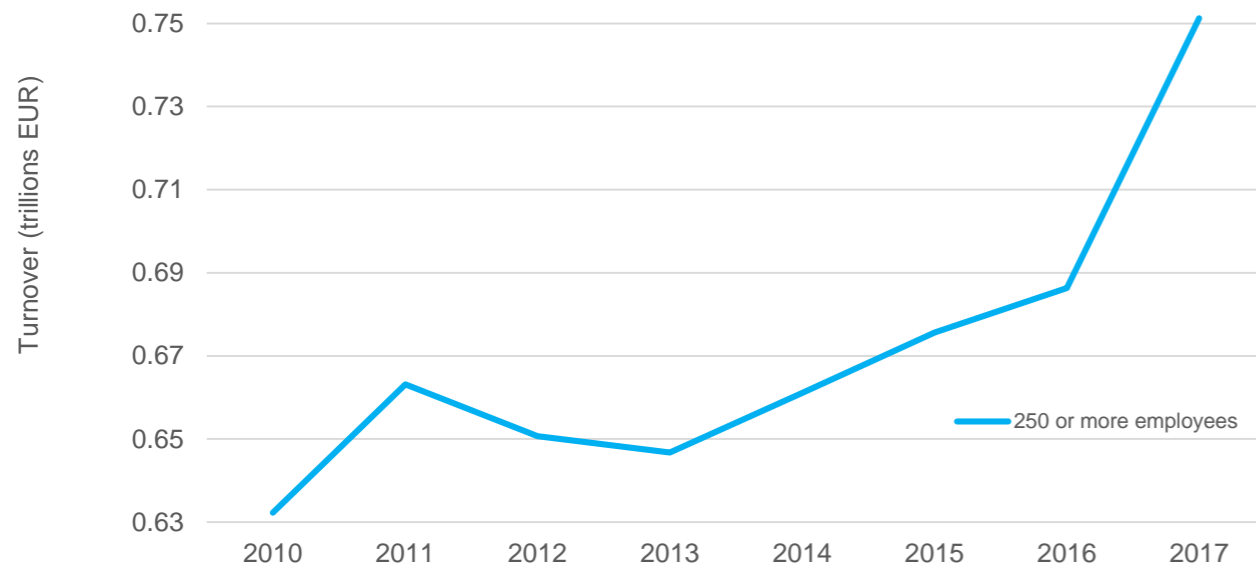


Notes: this shows the aggregate turnover by employment size class for the large and micro companies. The aim is to show the differences among the big EU countries over the past few years.

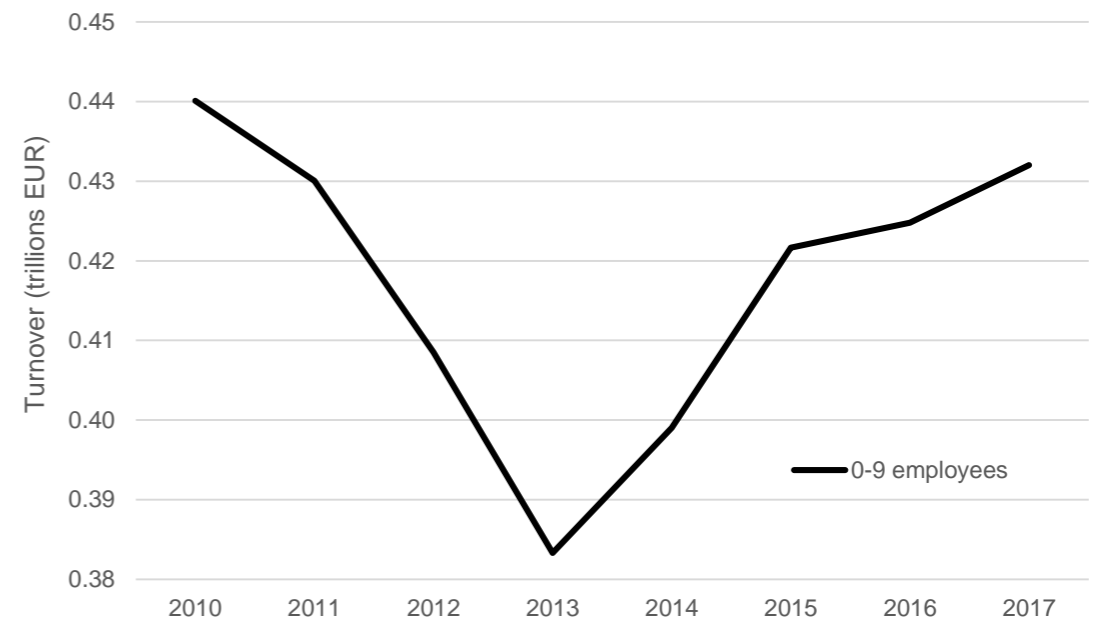
Source: Eurostat, ADA Economics

AGGREGATE TURNOVER BY EMPLOYMENT SIZE CLASS: SPAIN

Turnover of enterprises in each category for the total business economy



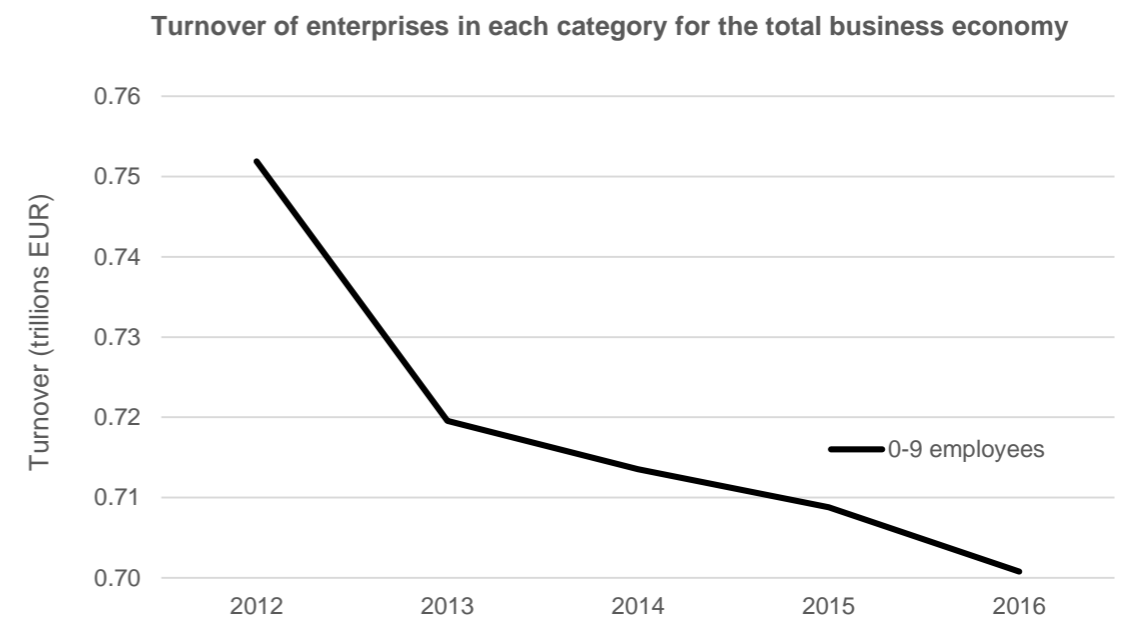
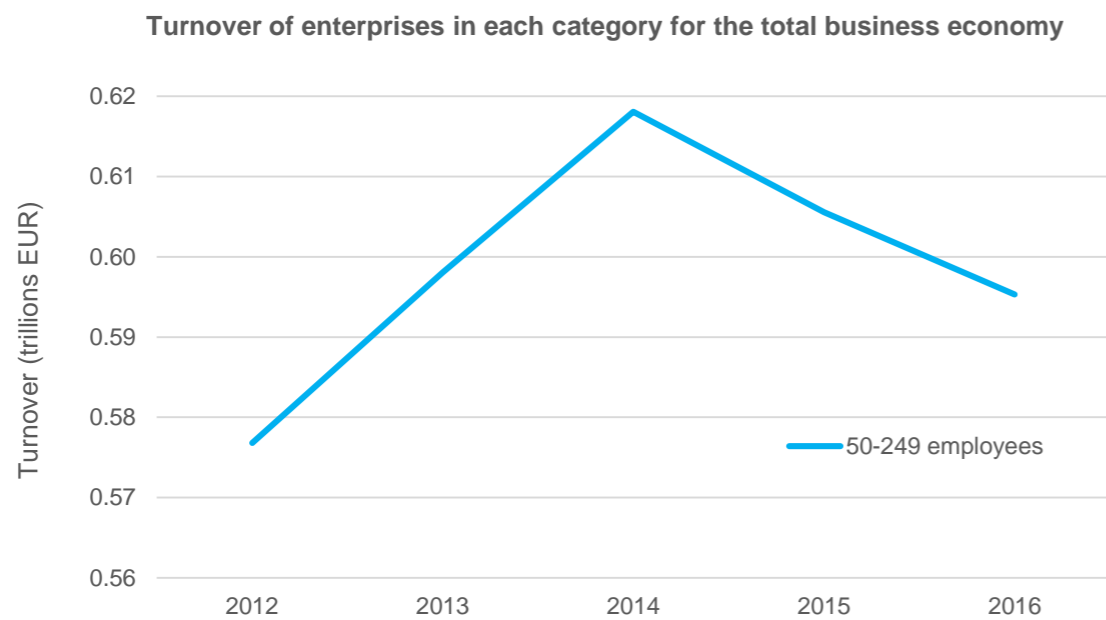
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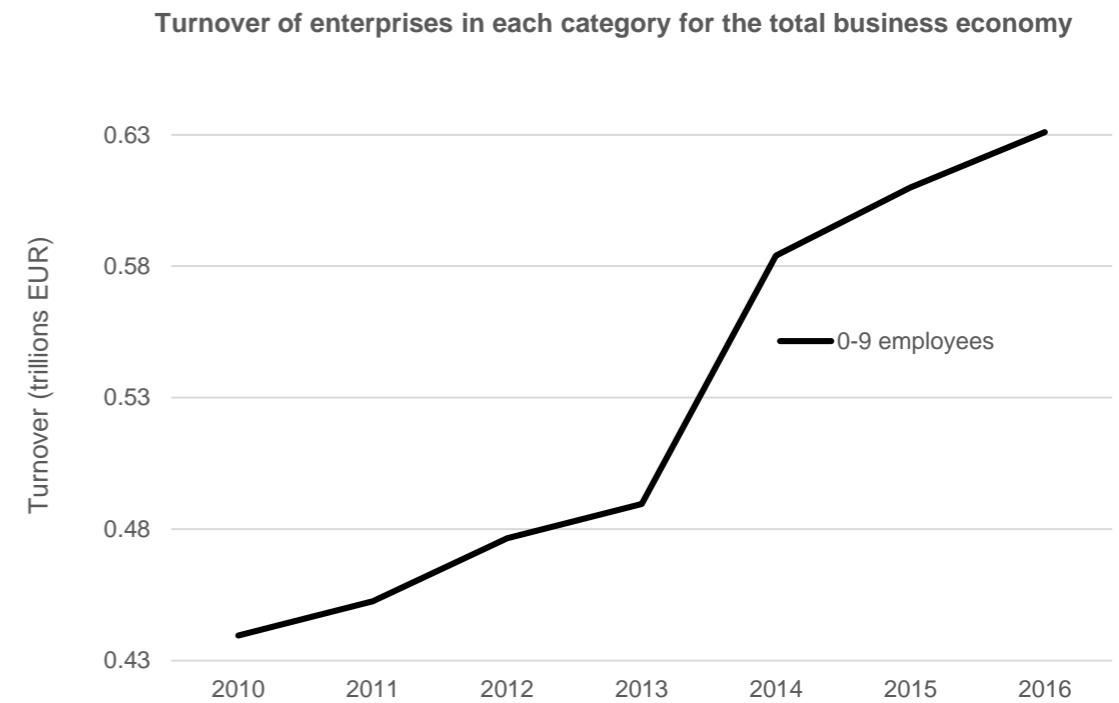
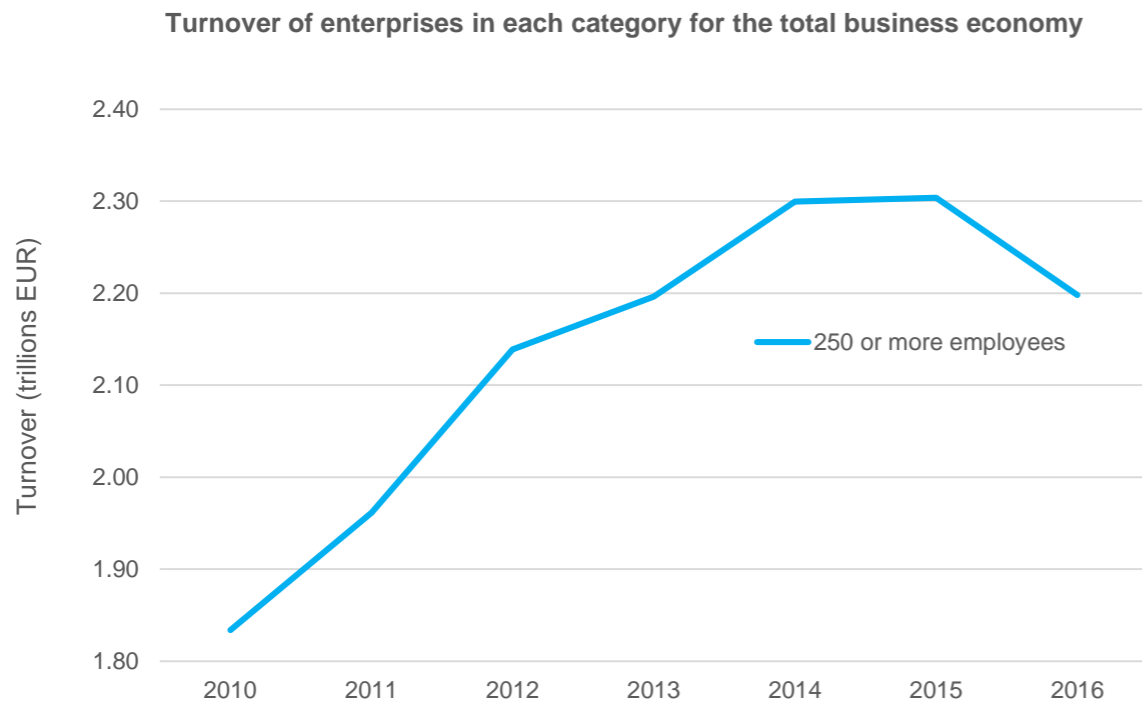
AGGREGATE TURNOVER BY EMPLOYMENT SIZE CLASS: ITALY



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Source: Eurostat, ADA Economics

AGGREGATE TURNOVER BY EMPLOYMENT SIZE CLASS: UNITED KINGDOM



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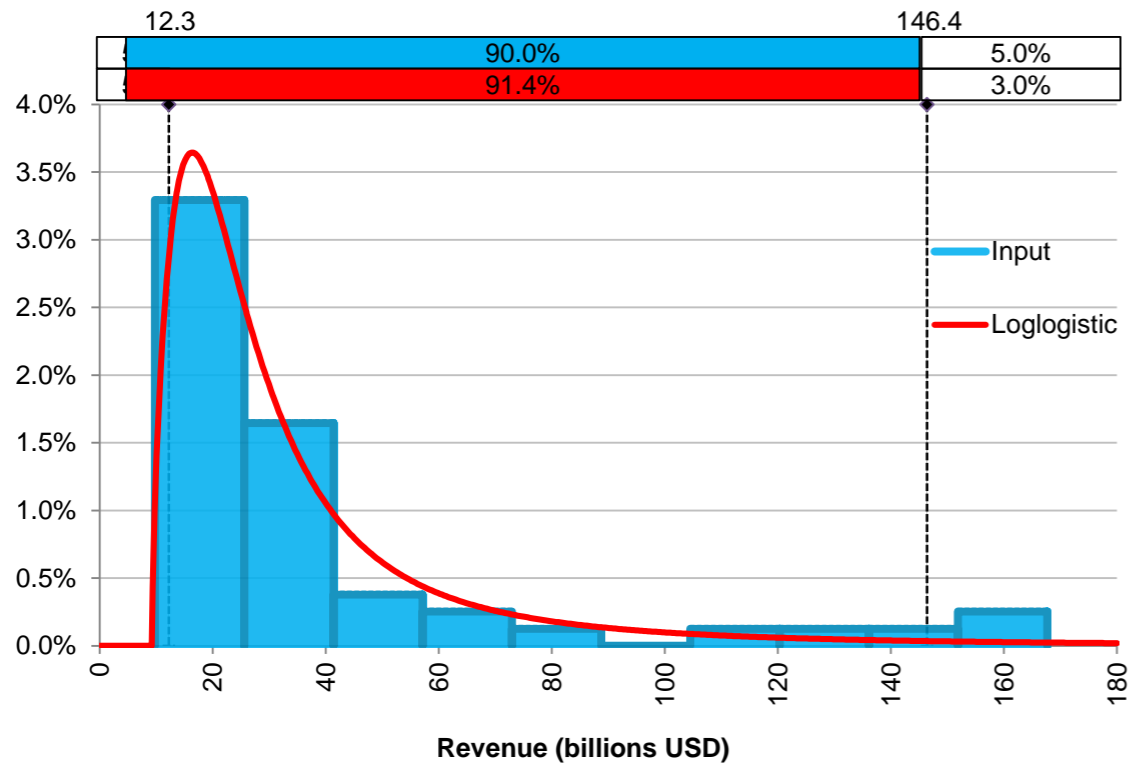
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THIRDLY: WHAT ABOUT INFLATION?

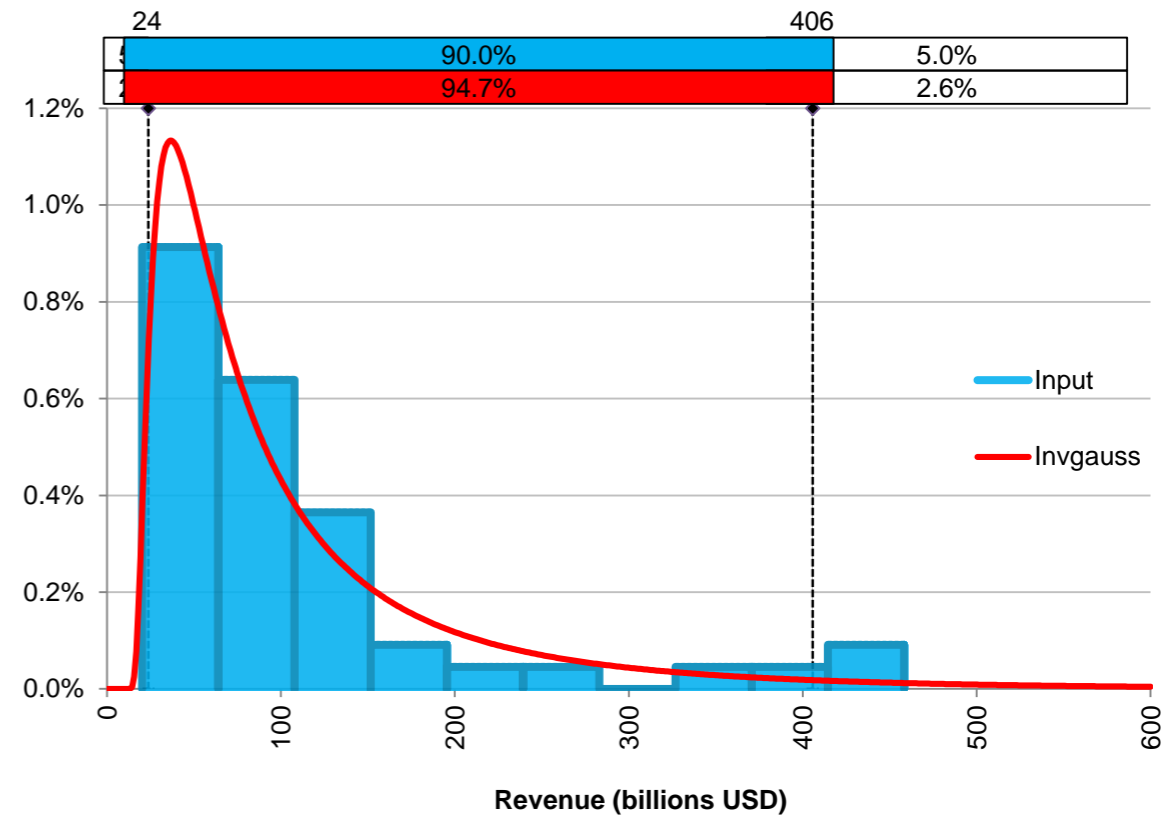
- In our view, the polarisation of business sector balance sheets is changing the nature of inflation as well.
- First, as the revenue pot of the “ultra large” companies grows, it means that their direct influence on the pricing of items has grown and, thus, there is almost a direct link between company strategy and the inflation rate of a country.
- Secondly, as more companies with market influence become more and more skilled at pricing strategies using big data and artificial intelligence, the seasonality of inflation changes. It used to be the case that there were two important periods in the year that were dictated by, *de facto*, regulated or standardised pricing practices: think about the sales months (depending on the country, usually in December/January and around July); or, on the contrary, the months when tariffs tended to rise (for utilities, for example, it was not uncommon to rise in January or in March-April). With big data, sales become less dominant, because short-term offers become more common.
- During times when customer demand becomes soft, pricing can be immediately cut to stimulate consumption – the size of the adjustment can be fine tuned to the shape of the demand curve, instead of following a more broad-based approach that were used in the sales season of -20/-50/-70% discounts, for example.
- On the upside, creating a more complex pricing structure (think about a product that needs two or more services to function properly: electricity usually has a per usage tariff and a rental access tariff; accommodation online increasingly has a main charge and a cleaning fee; airlines have a seat price, but also a check-in cost, for example) allows companies to lift the total price in a more deceptive way for the user and for the national statistical surveys, which need to be able to gather standardised items.

DISTRIBUTION OF TOP-50 COMPANIES GLOBALLY RANKED BY REVENUE

50-largest companies globally in 2000



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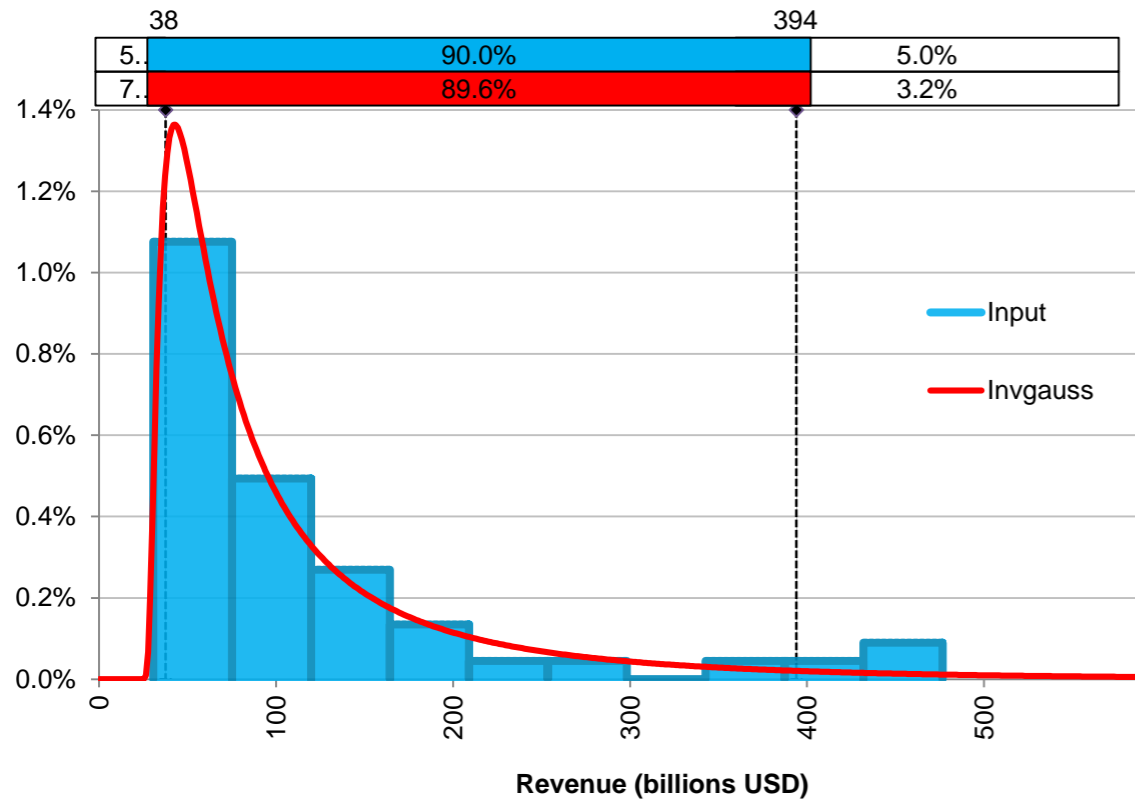
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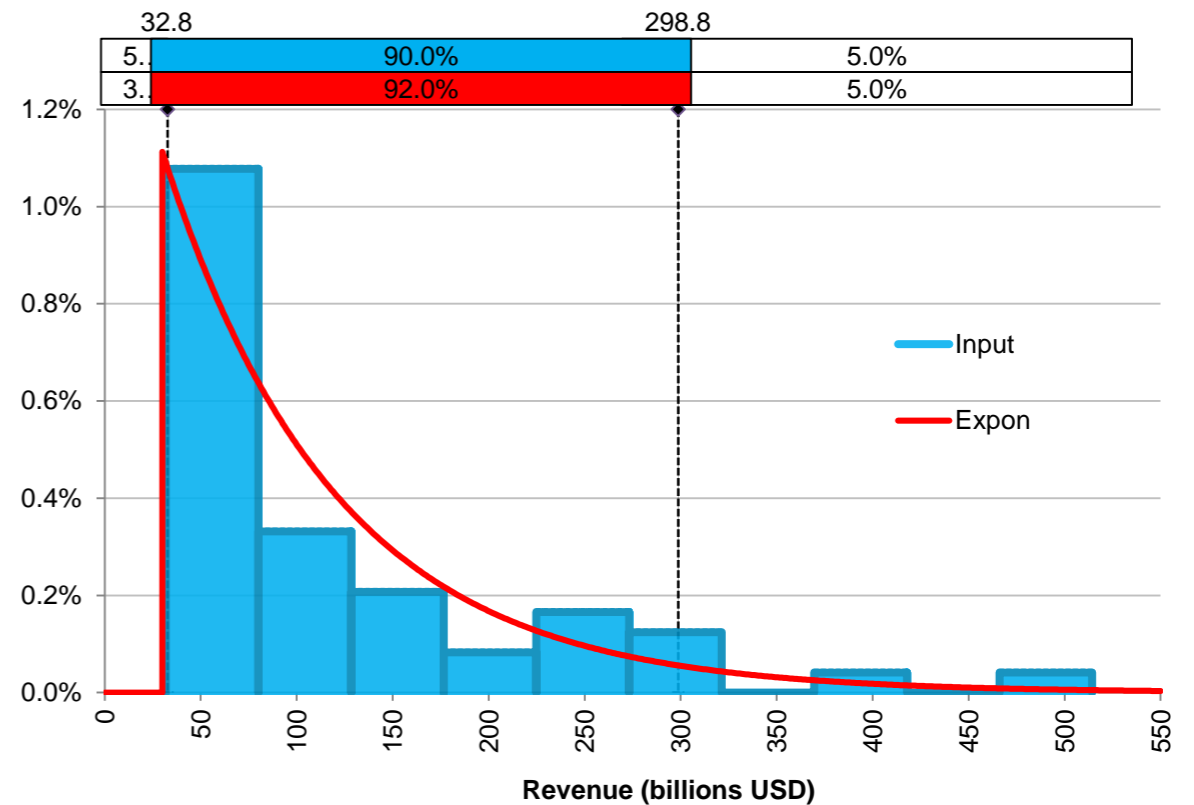
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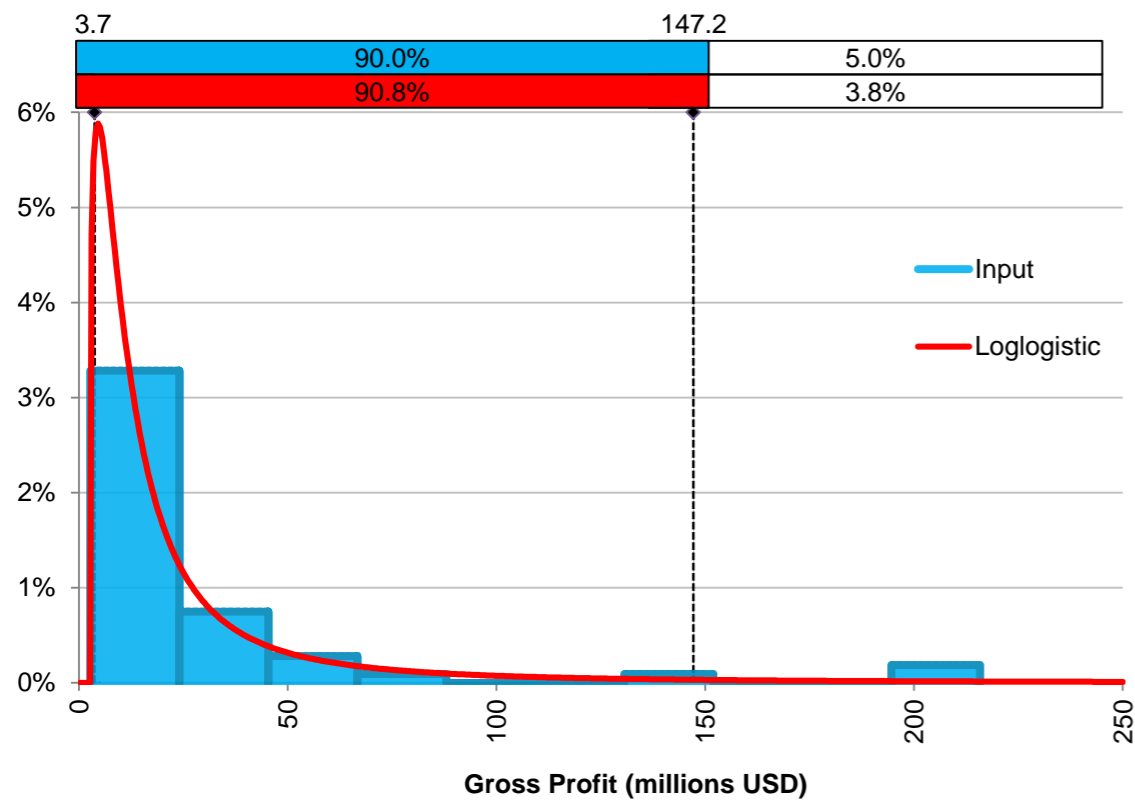
Source: Bloomberg, ADA Economics

THE DOMESTIC AND THE GLOBAL ANGLE – BOTH EQUALLY IMPORTANT

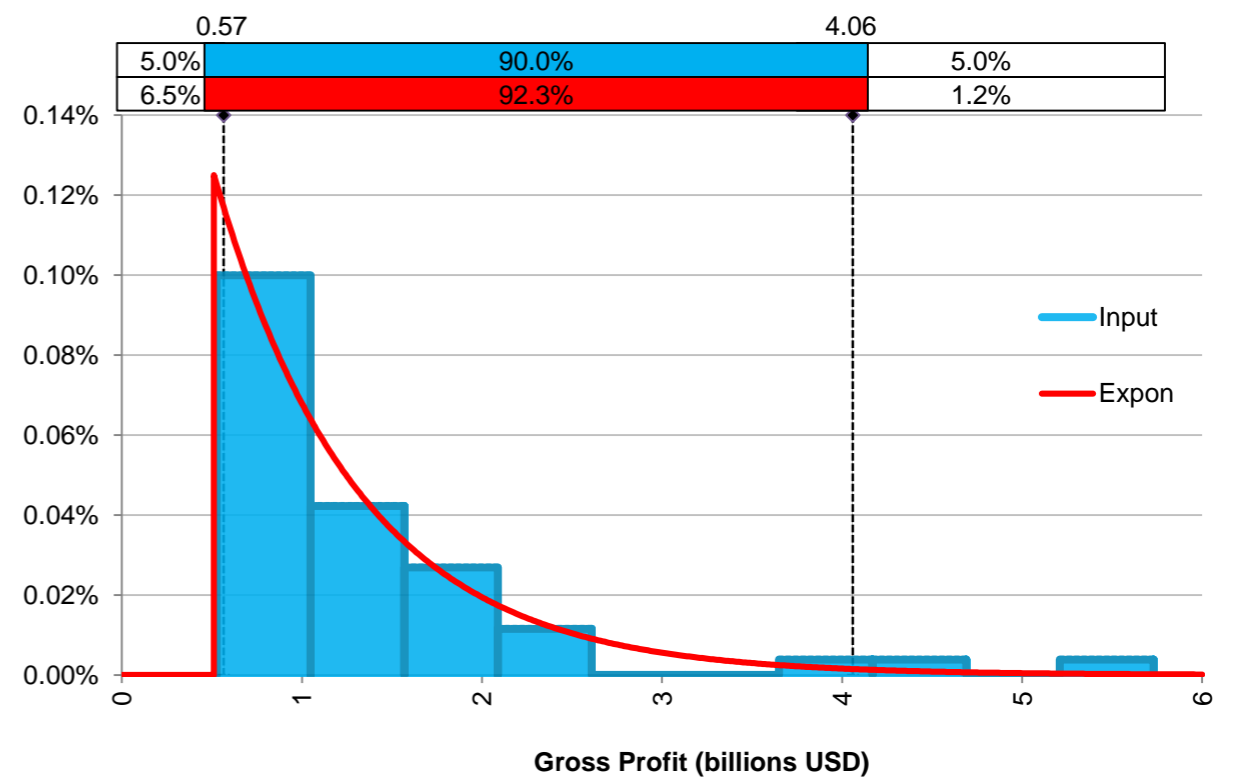
- Competition is at the heart of economic growth – a thriving competitive environment domestically generates economic prosperity and a strong competitive footing globally allows countries to attract financial and human capital.
- Polarisation of balance sheets is a phenomenon that needs to be considered at the country level and at the global level.
 - A widening divide within the domestic borders, but where the largest companies there are still very small in global terms makes for a bad mix: it could depress economic growth domestically and limits pricing power at the global level, leaving the country more susceptible to negative terms of trade shocks.
 - A widening divide within the domestic border, but where the largest companies at home are among the largest ones globally as well creates a serious conflict of interest at the policy-making level: on the one hand, there is an interest in supporting the giants to keep their global size and increase it (preferably), despite the fact that the smaller companies domestically (and the voters attached to those companies) are not well-supported. This is when the political landscape becomes more complex – variations of this phenomenon are visible in France, Germany and Italy right now.
- Ultimately, this phenomenon calls for a profound rethinking of the three pillars of policy making in modern societies: monetary policy (as a result of its impact on inflation and potential GDP growth); industrial policy (if you want to avoid cutting your potential growth to zero and keeping it there for decades); and competition policy (which needs to go in tandem with the industrial strategy).
- It should be evident now why this economic phenomenon, in our view, is at the heart of Europe's problems most acutely: Europe has one strategy for monetary policy, industrial policy and competition policy, which fits no sovereign state well. The political ramifications of polarisation accentuate the complexity of governance and reform. So, either all three levels of policy strategy are re-thought, or the European Union as we know it is coming to an end.

DISTRIBUTION OF THE TOP-50 CHINESE COMPANIES 2000 TO PRESENT

50-largest Chinese companies in 2000



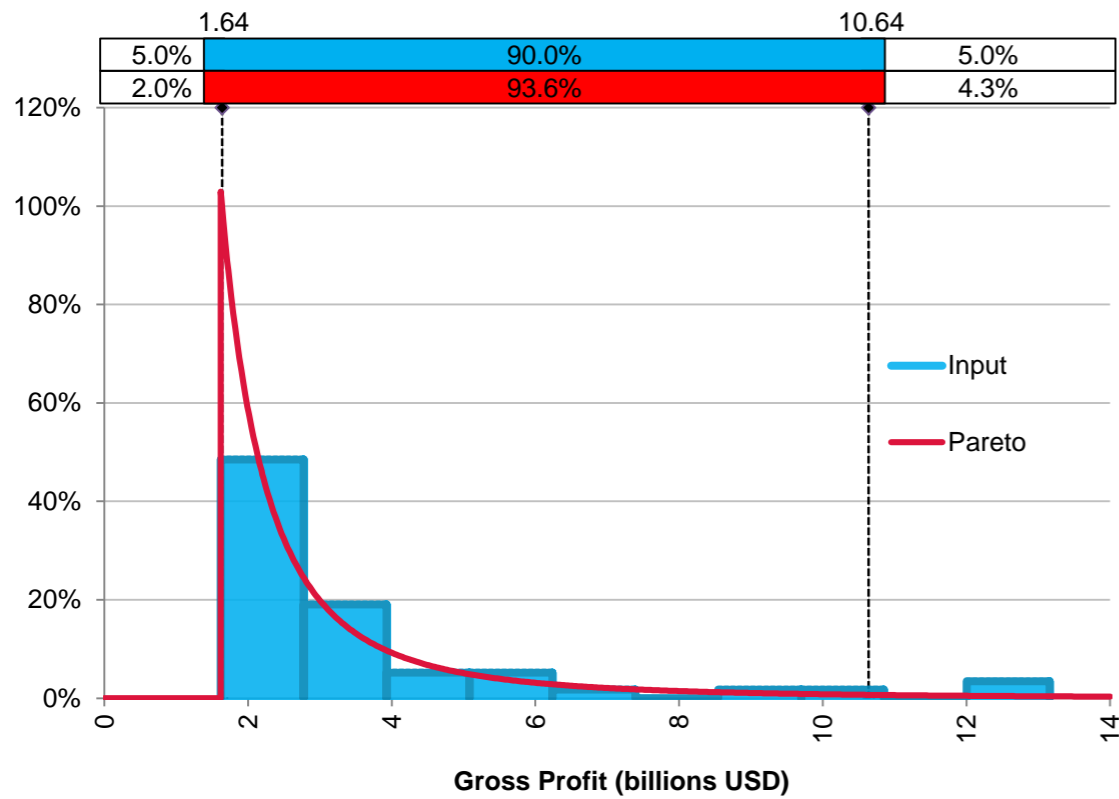
50-largest Chinese companies in 2009



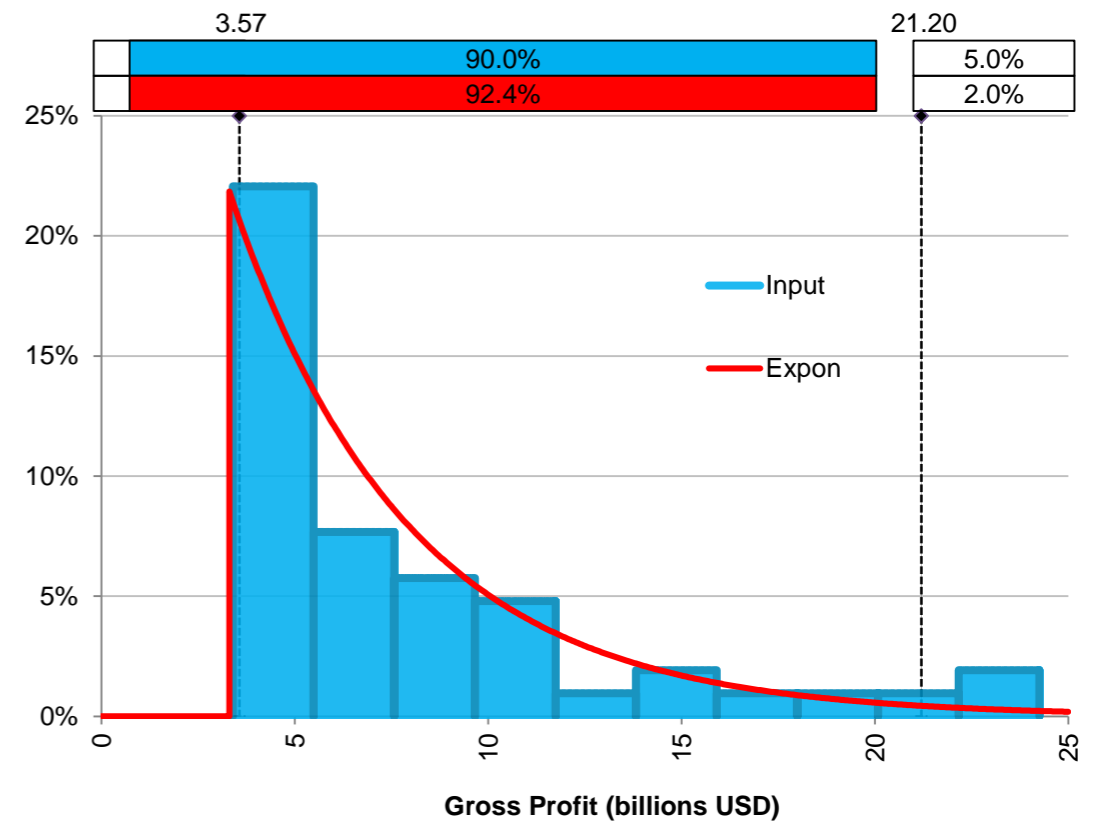
Source: Bloomberg, ADA Economics

DISTRIBUTION OF THE TOP-50 CHINESE COMPANIES 2000 TO PRESENT

50-largest Chinese companies in 2014



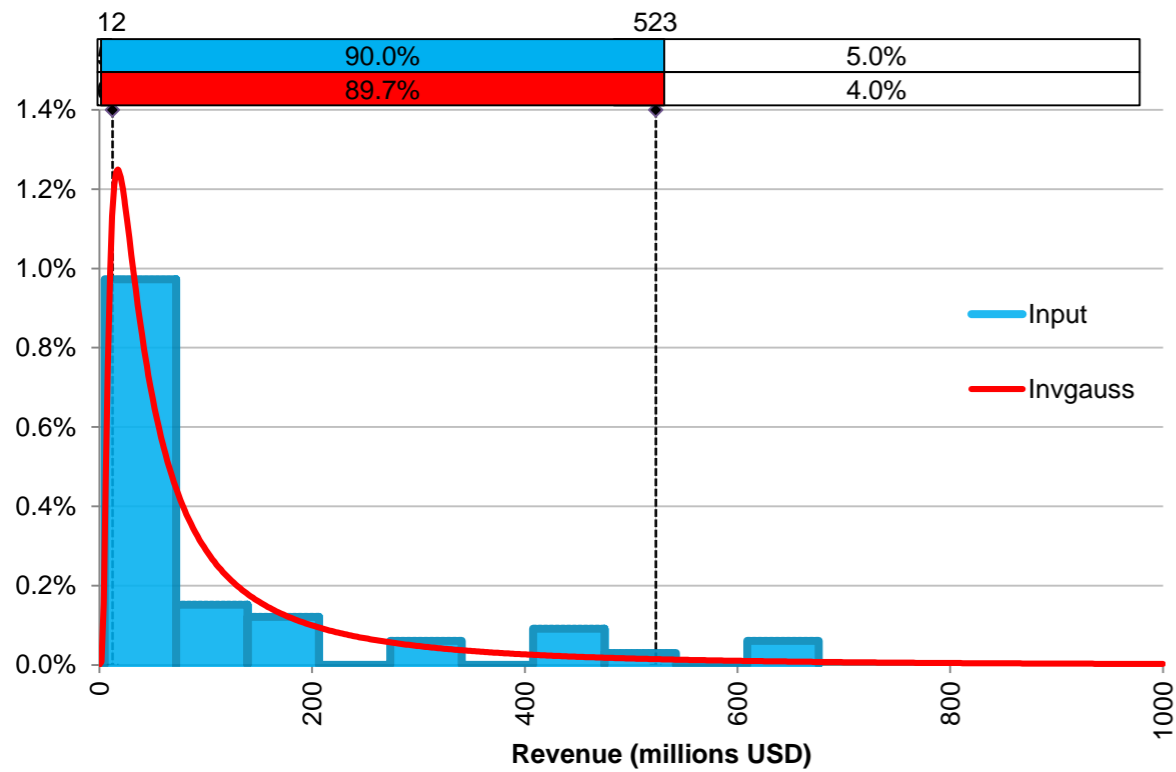
50-largest Chinese companies in 2019



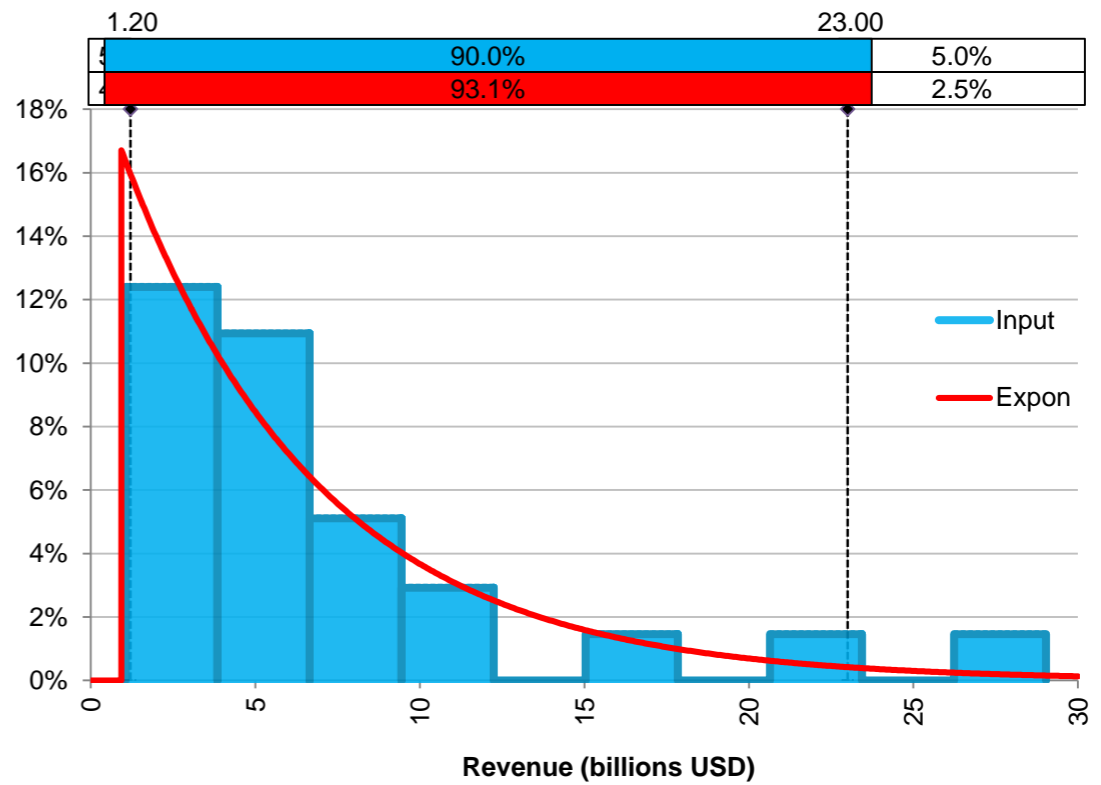
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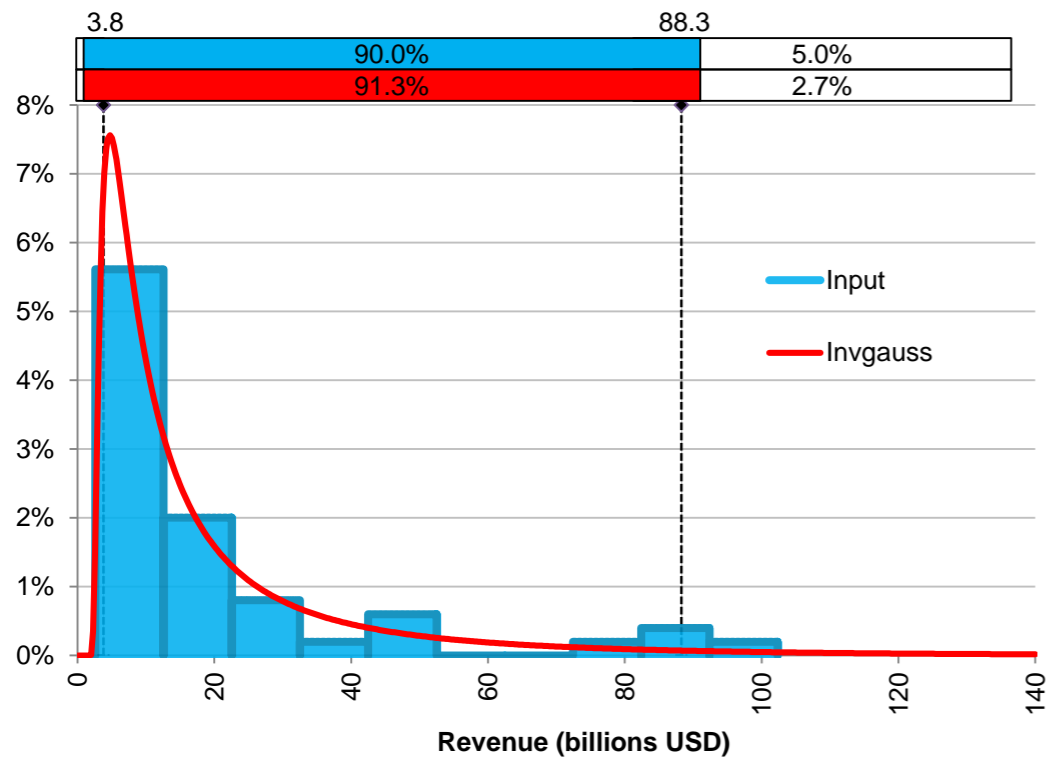
50-largest Chinese companies in 2009



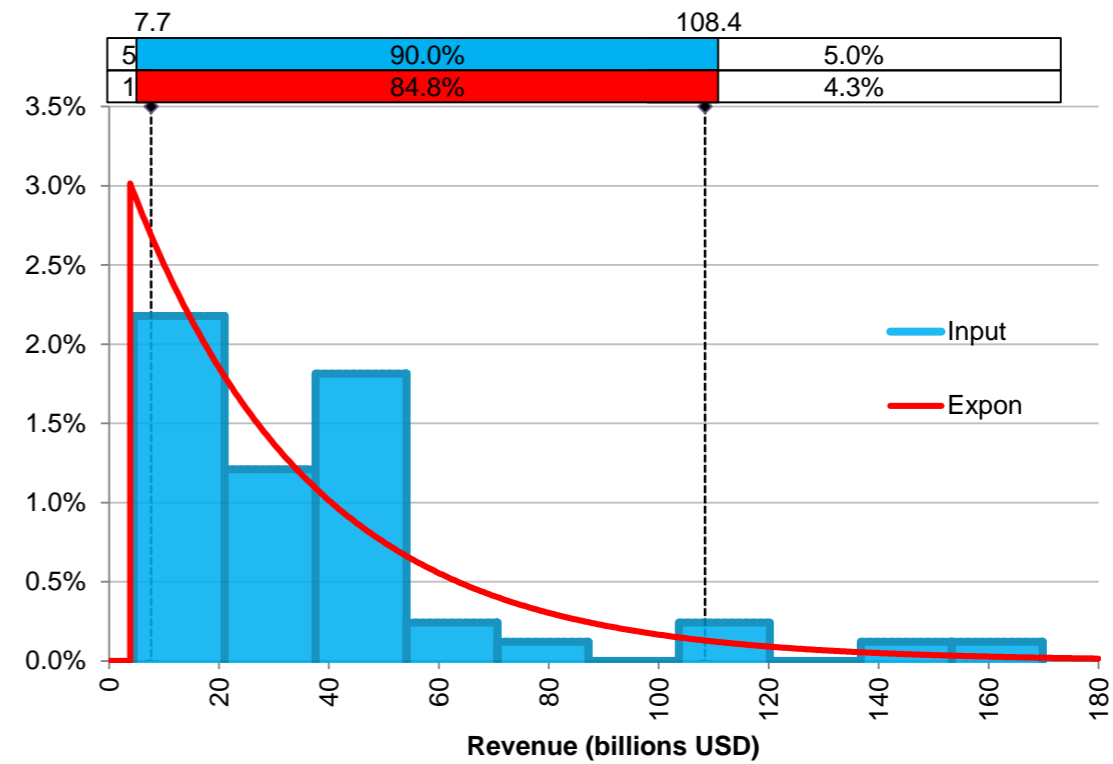
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DISTRIBUTION OF THE TOP-50 CHINESE COMPANIES 2000 TO PRESENT

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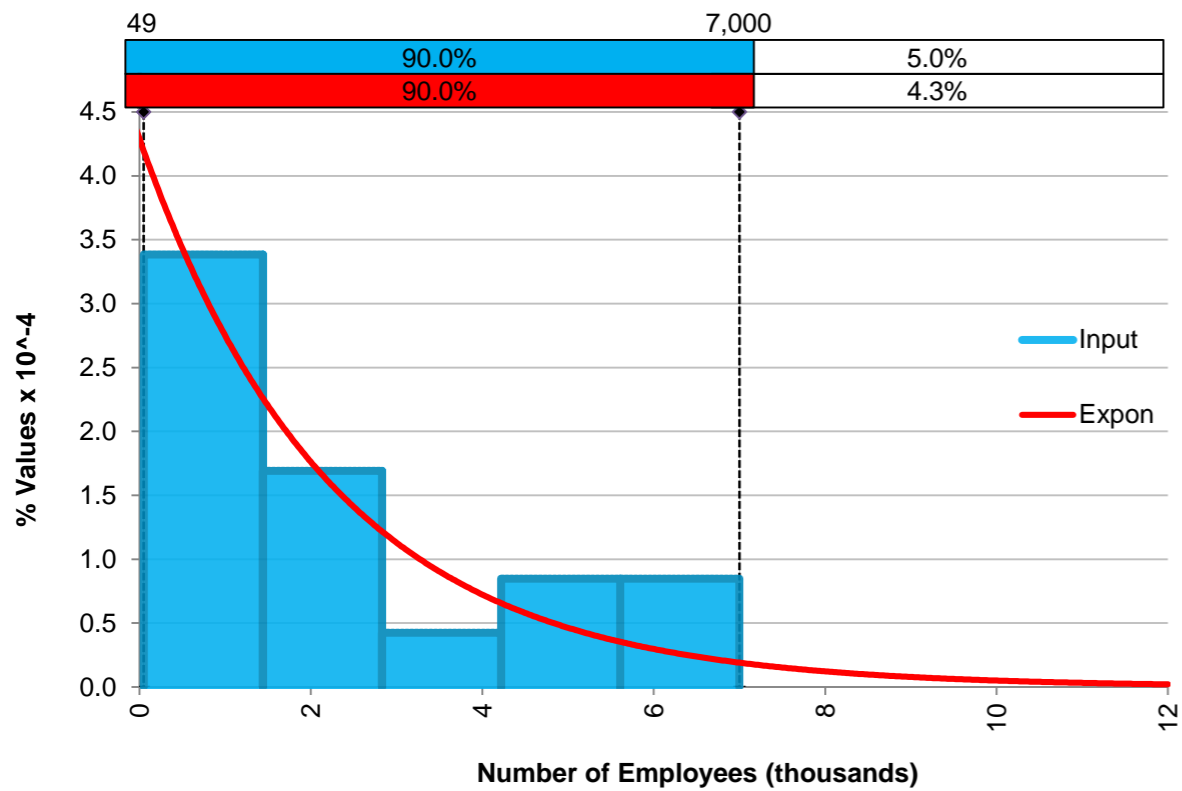
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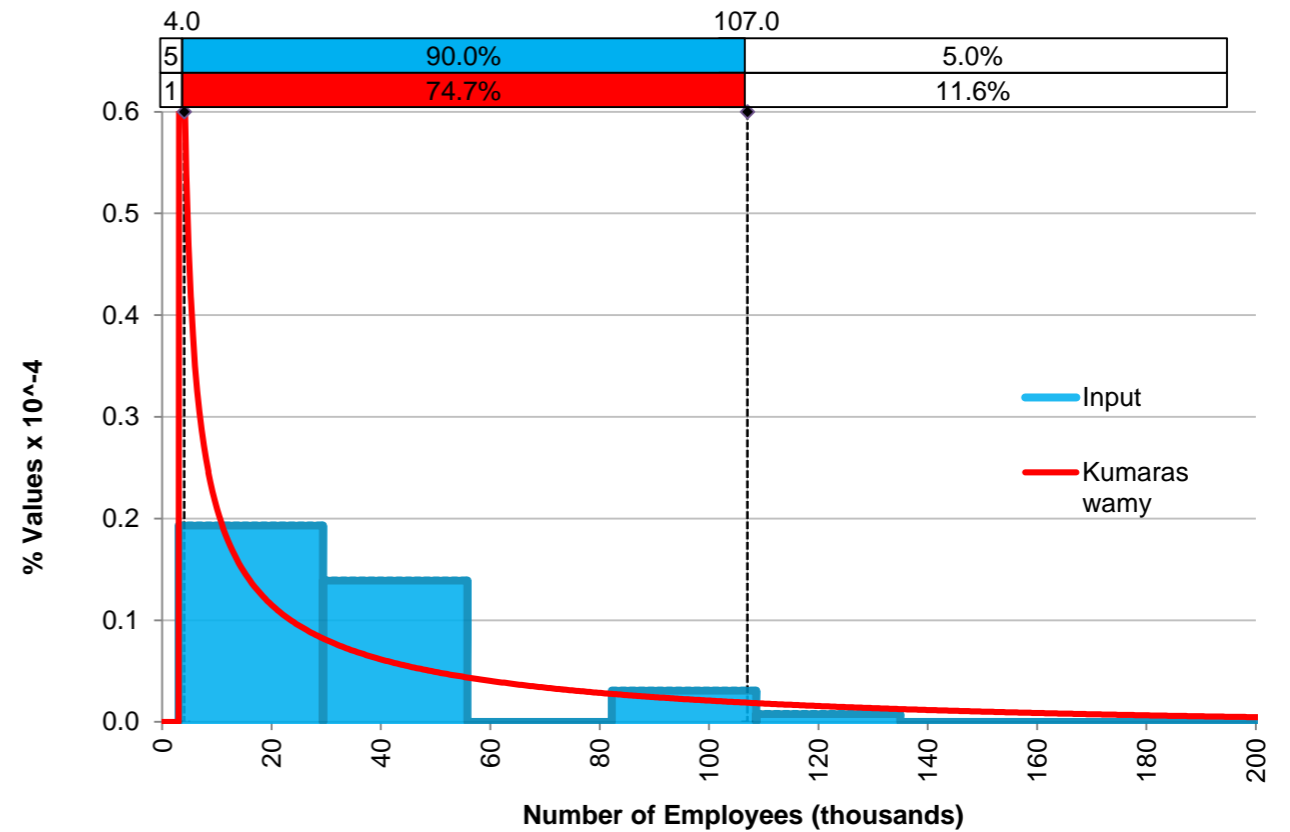
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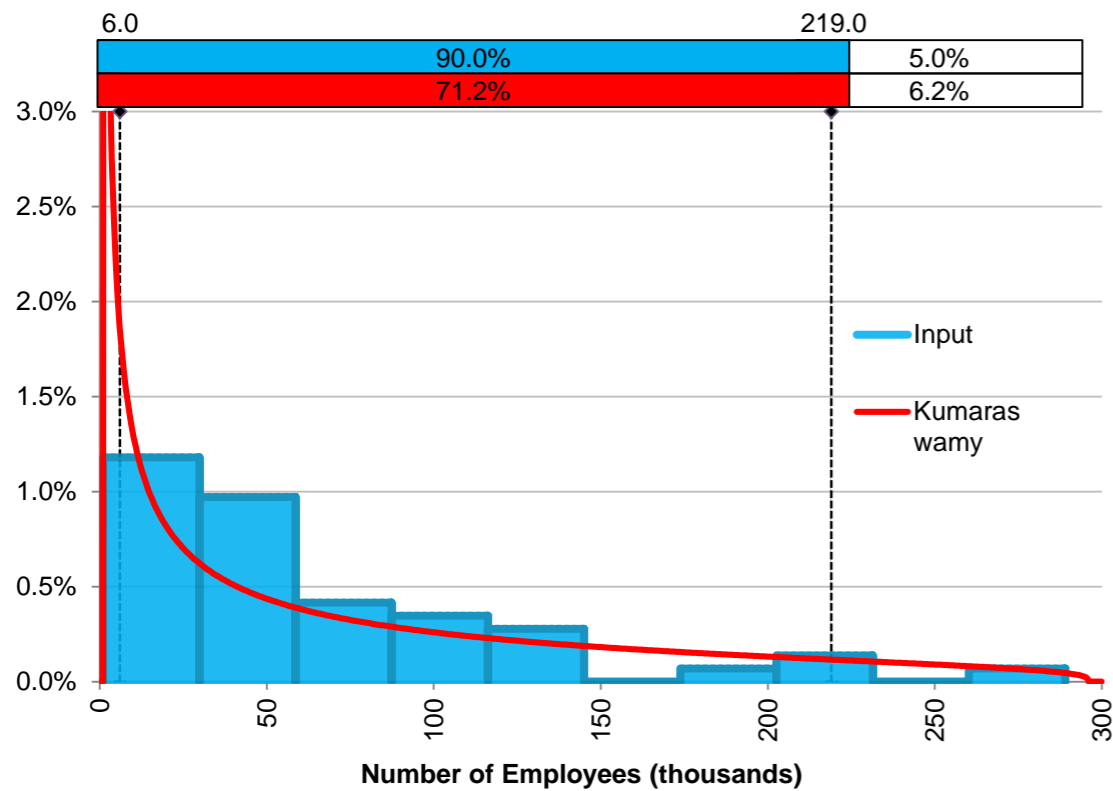
50-largest Chinese companies in 2009



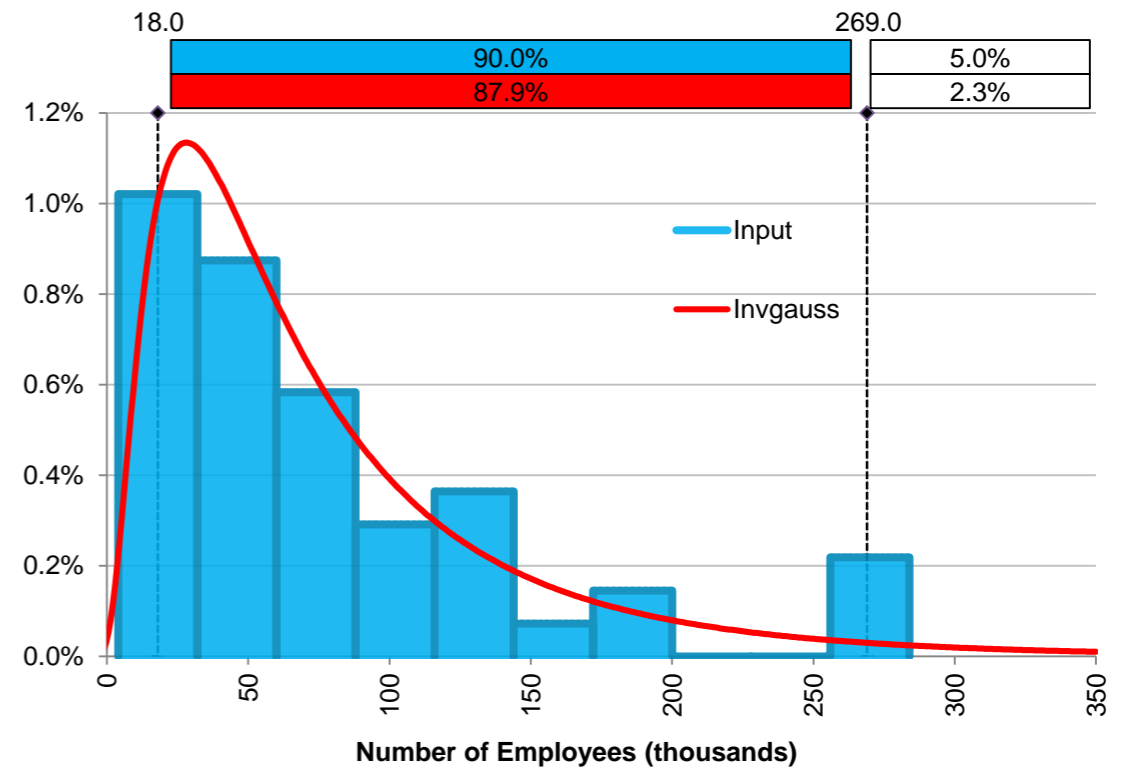
Source: Bloomberg, ADA Economics

DISTRIBUTION OF THE TOP-50 CHINESE COMPANIES 2000 TO PRESENT

50-largest Chinese companies in 2014



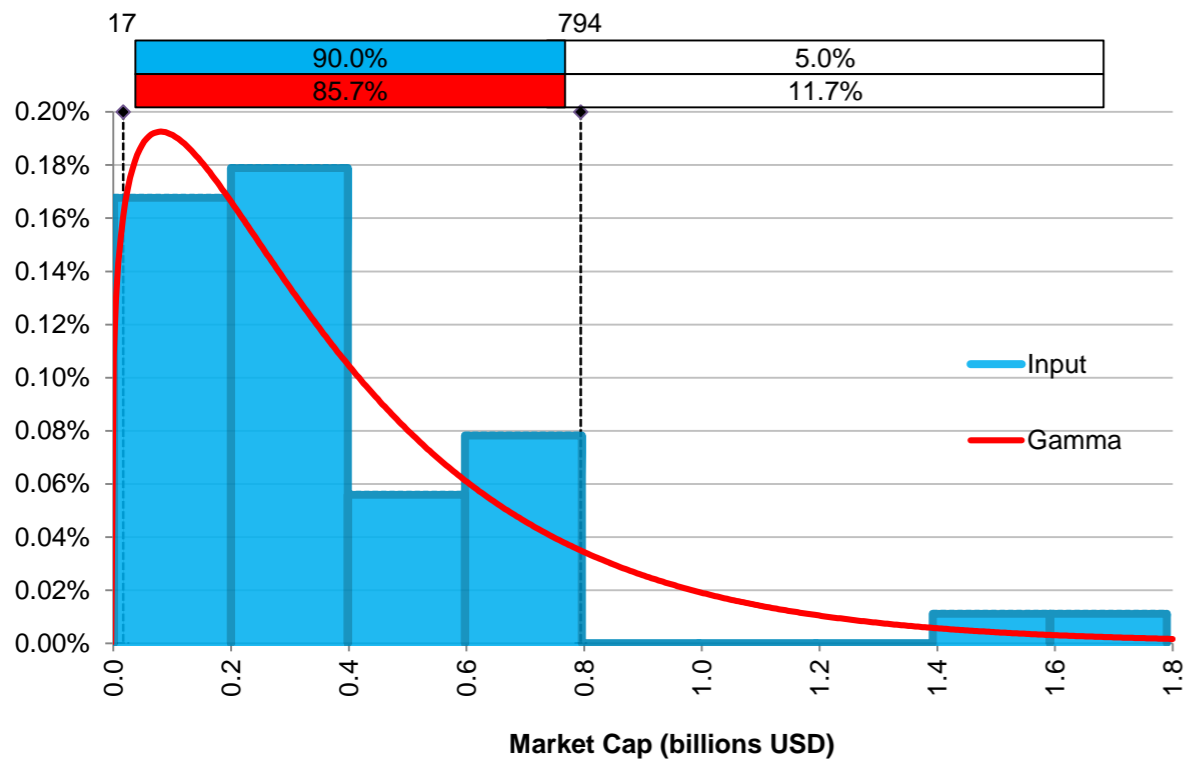
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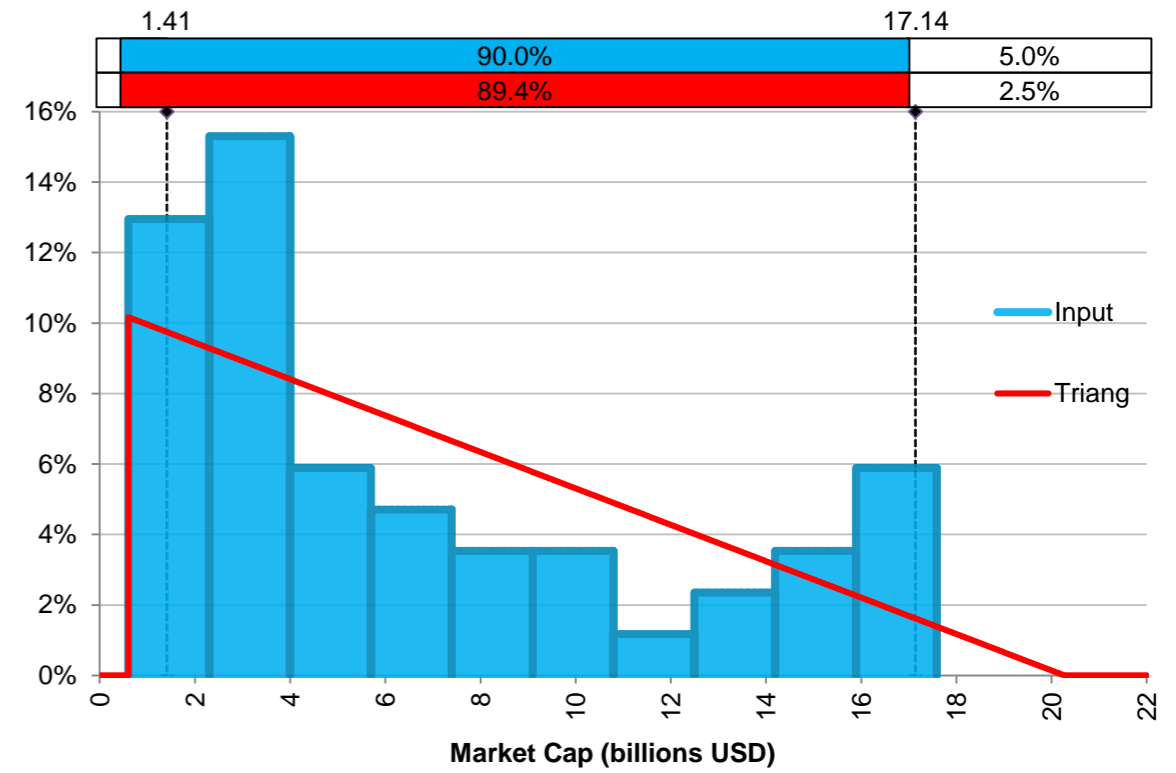
Source: Bloomberg, ADA Economics

DISTRIBUTION OF THE TOP-50 CHINESE COMPANIES 2000 TO PRESENT

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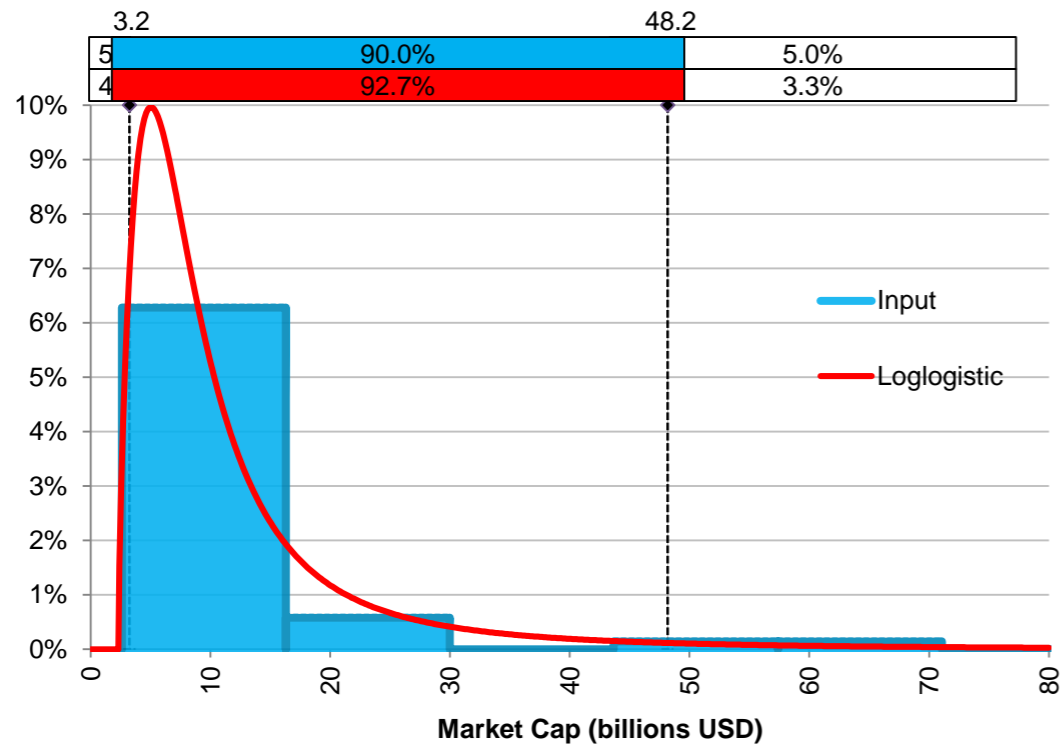
50-largest Chinese companies in 2009



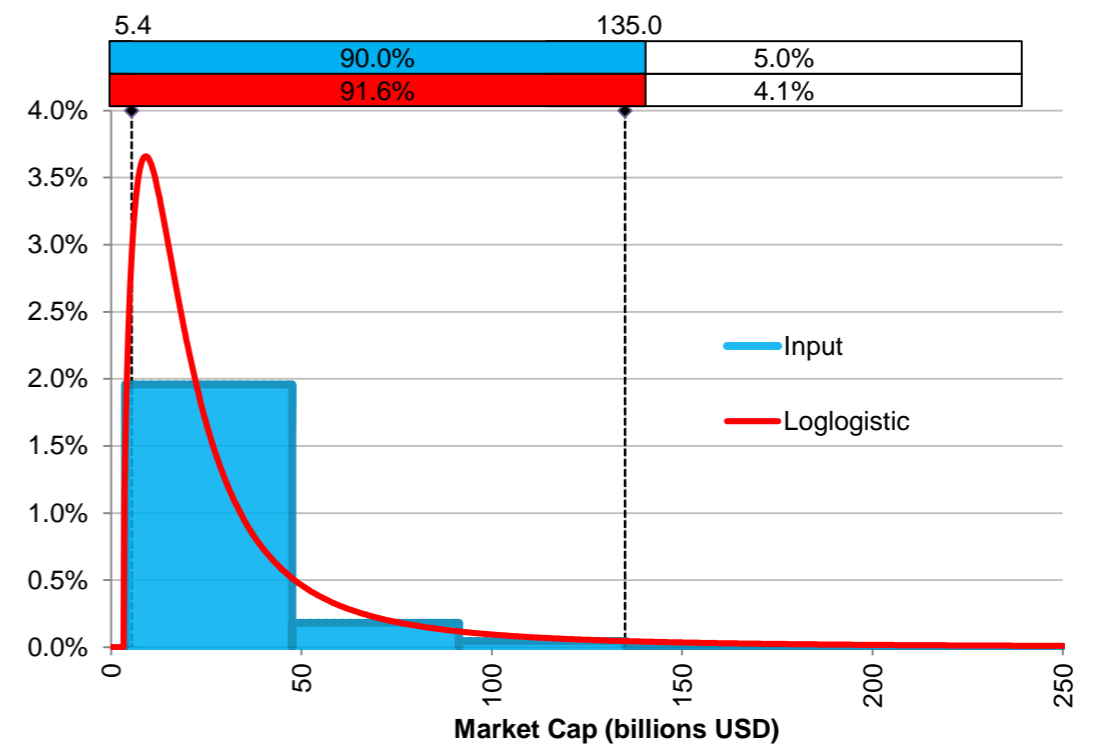
Source: Bloomberg, ADA Economics

DISTRIBUTION OF THE TOP-50 CHINESE COMPANIES 2000 TO PRESENT

50-largest Chinese companies in 2014



50-largest Chinese companies in 2019



Source: Bloomberg, ADA Economics

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