Fixing fixed-investment incentives

By Jim O'Neill
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Back in February, I noted that the global economy at the end of 2016 was in a stronger cyclical position than most people had expected, given the political upheavals of the previous 12 months. That upward momentum carried through to the first quarter of 2017. According to the latest "nowcast"-type indicators, world GDP growth is exceeding 4% – perhaps the strongest performance seen since before the 2008 financial crisis.

Still, some observers – and not just chronic pessimists – have countered that the evidence remains anecdotal, and that it is impossible to predict how long the current economic moment will last. Indeed, there have been other periods in the long post-2008 recovery when growth returned, only to peter out quickly and become sluggish again.

To bolster long-term economic growth, business investment will have to increase. Unfortunately, this is easier said than done. In Western economies in particular, non-residential fixed investment is precisely the factor that was missing in previous, short-lived cycles of acceleration.

No one can say for sure why non-residential business investment has failed to recover in recent years. But I suspect that the slightly pessimistic conventional wisdom on this question is wrong.

The conventional argument asserts that wary CEOs have come to see long-term risks as "just not worth it." The many uncertainties they face include concerns about excessive regulation, burdensome corporate taxation, high debt levels, erratic policymaking, the political backlash against globalization, and doubts that consumer spending outside (or even within) the United States will last.

A less pessimistic view holds that, after 2008, it became inevitable that the global economy would unhitch itself from the US consumer engine and adjust to the rise of emerging consumer economies, not least China. When that happens, we can all live happily ever after.

I tend to side with this less pessimistic crowd. As I pointed out in March, China's economy did surprisingly well in the first quarter of 2017, and that seems to be the case in the second quarter as well. In fact, China's latest monthly data show signs of economic acceleration, especially in consumption. And it was evident in the first-quarter data that Chinese consumers are becoming an increasingly important driver of economic growth.

When confronted with the numbers, pessimists respond by insisting that China's recent strong economic performance is only temporary – a product of yet more unsustainable stimulus. And even if growth does last, they argue, the Chinese authorities will not allow Western businesses – or even Chinese businesses, according to ultra-pessimists – to benefit from it. But whether or not the pessimists turn out to be right about China, it is odd that business investment remains tepid even during times when the engine of global growth is located elsewhere, such as in the US or Europe (Germany in particular).

During my time as the head of the British government's Review on Antimicrobial Resistance, I had to develop a better understanding of the pharmaceutical industry, and I learned that there is something to be said for microeconomic forces – and for basic common sense.

Consider the future, which always has been uncertain and always will be. And yet the biggest economic busts have happened when businesses were not uncertain enough – when they were sure that the future would be rosy. An overabundance of certainty might explain the 2000-2001 dot-com bubble, and many others.

But if, thanks to the increased availability of so much information (including different viewpoints and opinions), we now *know* that the future is always uncertain, the behavior of Western businesses (and many in the emerging world) is eminently logical, especially given the current workings of the financial system. Why would business leaders invest in an uncertain world, rather than paying dividends to demanding (but generally risk-averse) investors, or buying back some of their companies' own shares (thereby improving the price/earnings ratio and, better yet, increasing their own remuneration)?

At the end of the day, the CEOs and the most aggressive investors are all happy with this approach. Unfortunately, the same cannot be said for the company's employees, past and present, who reap no benefits in their paychecks or pensions (which are actually being eroded by the low yields on government bonds across Western countries).

It is past time for our elected governments to change the rules of the game. For starters, that means updating the tax code to make debt issuance far less attractive, especially when the proceeds are being used to buy back shares. At a minimum, it should be harder to buy back shares than to issue true dividend payments. That way, at least all shareholders, not just senior-executive insiders, will benefit.

Furthermore, those same executives should not be remunerated on the basis of short-term price-to-equity targets. More investors should be demanding that the incentives change to reflect true measures of long-term performance.

To its credit, the Norwegian Sovereign Wealth Fund recently spoke out in favor of such changes. Other large institutional investors and policymakers should follow suit, to give the corporate world a nudge. If we change the incentives, we just might finally see business investment make a comeback.

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