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A peek at the future health and wealth of our global economy

A new McKinsey report looks at four scenarios for inflation, interest rates, and growth over the next decade. Three of the economic outcomes portend stagnation and stagflation—but one offers hope.

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Banking instability. High interest rates. Pervasive geopolitical upset. These and other headwinds are pressing powerfully against leaders' and organizations' attempts to be more productive and create more economic value. In this episode of *The McKinsey Podcast*, senior partner Sven Smit puts these trends in context. He shares findings from the McKinsey Global Institute's latest Future of Wealth research with podcast host and editorial director Roberta Fusaro. He offers four potential scenarios for inflation, interest rates, and growth to 2030 and considers their implications for the future health and wealth of the global economy.

Also in this episode, in an excerpt from our *Author Talks* series, we hear from Farah Stockman, who, in her book, *American Made: What Happens to People When Work Disappears* (Penguin Random House, October 2021), clarifies our understanding of the working class.

The McKinsey Podcast is cohosted by Roberta Fusaro and Lucia Rahilly. This transcript has been edited for clarity and length.

A difference between paper wealth and real wealth

Roberta Fusaro: Sven, thanks so much for joining us on the podcast today.

Sven Smit: It's great to be with you, Roberta.

Roberta Fusaro: We're talking about the health and wealth of our global economy. In our recent research on the Future of Wealth, we modeled the outlook for the global economy, specifically for inflation, interest rates, and growth over the next ten years. We looked at what that might mean for equity, real estate, and debt.

The research confirms that the global balance sheet grew faster than GDP. That's sort of the difference between real wealth and paper wealth, correct? What does it look like on the ground?

Sven Smit: You're totally right. For the first time, we conducted research adding up the entire world's full balance sheet: in the real world, that is represented by houses, real estate in general, the productive capital of businesses, etcetera. We also looked at debt and equities, which would represent the ownership of those assets.

If you look at the last 20 years of GDP growth, that could manifest in a material increase in real estate, more land, or more equipment in factories. Prices could go up, too.

Normally, these factors move in lockstep. But in the last 20 years, we saw the growth of $160 trillion in paper wealth—but that growth only came through prices. Obviously, this shows that assets are scarce; this is obvious in the housing market. Many people would like a nicer, bigger house, but there aren't enough available.

Now whether this paper wealth remains depends on whether these shortages continue. Housing could very well continue to be a store of value, but if the housing shortage doesn't continue and other factors come to play, then we could see paper wealth evaporate.

Roberta Fusaro: Besides this example with the housing market, are there other broader implications? Why do business leaders need to care about this mismatch or gap?

Sven Smit: Many people often just look at the profit-and-loss statement when looking at the aggregate economy. They actually don't look at the balance sheet, but the balance sheet has very profound implications.

You could have large mismatches between the debt that was used to finance assets and the value of what you purchased with that financing—for example, real estate, equipment, etcetera. The value of that equipment could go down, but the debt may need to be paid at higher interest rates. Looking at the world's future that way is very important because we are living in a time of higher interest rates and higher inflation.

So we want to pay attention to the balance sheet because that's where the stock value sits. The world's GDP sits at about $100 trillion, but the world's balance sheet is worth north of $500 trillion. So there's more stock than flow. Therefore, if the stock moves around 20 percent, that's equivalent to the same amount as the global GDP.

A small variation on the balance sheet would turn out to be a large variation in the real economy. That stock value is people's wealth, businesses' wealth, and influences their sense of whether they can continue to spend. In this sense, real estate can reflect people's wealth.

Global applications

Roberta Fusaro: Right. A lot of the analysis focuses on the United States—why is that? And are these findings applicable globally?

Sven Smit: The findings are absolutely applicable globally. We have analyzed many countries. That said, the United States in general has more data. It's also a large market and more uniform. We are continuously working to analyze the other markets at more depth, but the lessons of this report are totally applicable everywhere else.

Scenario One: A return to the past

Roberta Fusaro: Sven, you and the team reviewed the economic health and wealth in the United States and elsewhere through four scenarios. Three portend stagnation and stagflation. One projects what we call productivity acceleration. I want to take a closer look at each of the four.

The first that we talk about is a "return to a past era" scenario. What would that look like on the ground?

Sven Smit: Basically, that scenario mimics the era of the last 30 years: the global era of markets, of globalization, of low geopolitical instability, low interest rates, low inflation, etcetera. A continued shortage of assets would mean that as GDP grows, the gap between paper wealth and real wealth would get bigger. So basically, we would go back to what we were used to for the last ten, 20 years.

Roberta Fusaro: Right. So it would be more of the same.

Sven Smit: Yes.

Roberta Fusaro: Sort of the do-nothing scenario.

Sven Smit: Yes, though I should clarify: we are not in "more of the same" right now—this would be more of a return to the past 20 years.

Scenario Two: High inflation and interest rates

Roberta Fusaro: OK. And how does that compare with the next scenario, the "higher-for-longer" scenario? Tell us more about that.

Sven Smit: That would involve persistently high inflation and interest rates, where growth slows. This would resemble the '70s oil shock in the US economy and Europe. Back then, essentially for two decades, inflation was at around 5 percent and interest rates were north of 5 percent.

In that scenario, you have a risk of equities going down, of debt being stressed, a lot of restructuring going on, an emerging market debt crisis, and so on. Basically, the balance sheet wouldn't be funded by a consistent level of growth, while at the same time inflationary and interest rate pressures would affect the price of capital.

Roberta Fusaro: For some of our younger listeners who don't remember the 1970s oil shocks, what did that actually look like on the ground?

Sven Smit: Well, I was a boy, seven years old. And I was roller-skating on the highways of my country because all parents were not allowed to drive on Sundays, to conserve oil. It was the oil shortage, not so much the real estate shortage, that drove the prices up into inflationary territory.

Other factors, like the Cold War, also contributed. I will say, I had a blissful youth and didn't notice much of it. But at that time, house prices went down in some markets by 20 percent and others by 40 percent,

> **‘This future scenario is based on the expectation that in the future of work, 50 percent of tasks can be automated with available technology.’**
>
> –Sven Smit

and equities went down over longer periods by 20 percent and 40 percent, which is very consistent with what's modeled here. For some reason, as a kid, you could have a good life. But my parents were basically shielding me from the worst of it.

Scenario Three: Crisis

Roberta Fusaro: Right. I remember long lines at the gas pumps.

The third scenario is seemingly the worst-case scenario, right? "The balance sheet reset." What would the economy look like under that scenario?

Sven Smit: That'd be what happened to Japan in the real estate crisis. That involved a much wider gap in paper wealth in Japan than we currently have in the world. This scenario would predict that the balance sheet would have to be adjusted relatively quickly, which would mean fast drops in asset prices for real estate, property-planted equipment, etcetera. Equities would, in turn, be affected by that because they'll reprice to growth. It'd be drawn out: deleveraging and a sharp contraction of asset prices.

Roberta Fusaro: How did businesses experience that in Japan? What happened?

Sven Smit: It felt like a crisis. There was restructuring, readjusting costs, and resetting the balance sheets, taking the bubbles out. That puts pressure on the labor market, meaning there may be no wage increases. And I would say the first round of that is pretty tough. Of course, in any crisis, after the first round of adjustments, there's a way back up, but you come from quite a deep point. And people felt that in their ordinary lives.

Scenario Four: More with less

Roberta Fusaro: Right. So productivity acceleration seems to be by far the most desirable outcome. What is the most simple and straightforward definition of productivity acceleration?

Sven Smit: With productivity, we basically measure GDP per capita: how much we can get done as individuals, in terms of output per hour, output per year. This has usually grown by 1 or 2 percent per year. So basically, in this scenario, for the same amount of hours worked, we could see 1 or 2 percent *more* output.

This has happened because of technological advances and digitization. But in the past, it was more based on energy consumption, tools, and education. This future scenario is based on the expectation that in the future of work, 50 percent of tasks can be automated with available technology. This would enable us to double output with the same number of people because of the gains in productivity. It would take maybe 20 years to do so, and that would support a lot of growth. Based on the resulting output, that growth would be *real* growth—not inflationary growth.

That would, in turn, suppress inflation, which would, in turn, suppress interest rates. That increased output would feel like prosperity. And in a way, all the predicaments that we have now would be ameliorated, like the threat of inflation eroding our wealth as we age, or the inflationary effects of energy transitions, or needing to diversify supply chains, or even having to spend more on defense in uncertain times. Those issues would be resolved if we could get more done with less time, or if we could get double the amount done in the same time. In this way, productivity will have to be the solution.

The interesting part is that the technology for the productivity exists; the question is whether we will have the human transformation speed to get it done.

Roberta Fusaro: The report says that accelerating productivity is elusive in advanced economies. Why is that so?

Sven Smit: Basically, productivity growth has decelerated for the past decades in the Western world, while of course developing market growth was partially driven by increased productivity in China, Africa, India, Latin America, and so on.

We have had a deceleration. This has been studied a million times, and I don't think there is a good answer as to why. Different ideas have been discussed. One is whether we actually measure output in the right way when we measure prices and the stuff we own. Are we, for example, really reflecting the fact that, through technology, we can do so much more? Did we account for the technology acceleration in the right way? That's one question.

The second one is whether humans are catching up to the technology? For instance, everybody predicted that automatic teller machines would replace tellers at the bank. And yes, it is true, we don't really have tellers at the bank anymore, but we do have advisers at the bank; the number of people working at a bank is roughly still the same.

Basically, when something goes down, something else comes up. And the new thing might be less productive than the old one. So you gain productivity on one side, but that is compensated by the addition of something less productive. That said, I believe that productivity acceleration is possible in the future because of how digital we are now and how we can now automate.

Technology will bring the biggest gains

Roberta Fusaro: In this report and in other McKinsey research, McKinsey's taking a hard look at productivity under times of uncertainty. So where should productivity come from now? Or where is it coming from now?

Sven Smit: I think the biggest gain is technology related, and it's all forms of automation. Some algorithm does it; some tool does it. It can be a robot, it can be a scanner, etcetera. But automation should be one of the bigger things that will happen. Of course, there's always education and other improvements in human capital, which is people getting more productive; the better the skill of people, the better they can connect to their productivity.

But there's a third factor that's underestimated. It's the ability of organizations to change at pace, which is actually almost independent from skilling and technology. It's how fast are you adopting? In many companies, you first pilot in one corner, then you scale in one use case, and then the next, and then the next. And as a result, you're taking two, three years to get started. What if everybody on every new onboarding wave starts at scale at the same time? I think there's lots of inertia that we need to break through.

There might also be some regulatory obstacles to quickly transforming to high productivity. We will have to crack this problem. We are in a new era, and we need to behave like it is a new era on all fronts. It includes geopolitics, it includes this productivity acceleration, it includes the issues of the balance sheet that previously weren't there: many, many new issues. And if we set our minds to solve those, we will accelerate. But we should not operate like the '70s where we took 14 years to figure out our answers.

Roberta Fusaro: Right. You've mentioned regulation. What role can policy makers play in accelerating productivity?

Sven Smit: Labor market reforms will help here. Policies that encourage reskilling would also help. I also think capital to create automation will be made available because of the many benefits.

Financial institutions must stay alert

Roberta Fusaro: Given the dynamics that we've highlighted around paper versus real wealth, real outcomes, what's the play for financial companies, for banks? How will they need to change in this environment?

Sven Smit: I think the biggest change is to not assume the future's the same as the past. You actually have to understand whether your company, your bank, your insurance company can sustain these scenarios, can actually thrive in these scenarios, and how you can detect—early enough—which one you're in and whether you're navigating it the right way.

This probably will include having to change your business models in certain places to address risks and to return balance in the right places. That's why we find it so important to talk about the balance sheet.

Because the swing of the balance sheet is so big. And your question about financial institutions is very on point because as financial intermediators, they cover the entire balance sheet. So this stuff will go through them in a big way.

Roberta Fusaro: What about investors? Should they be looking at their decisions differently as well?

Sven Smit: Yes. They have been modeling earnings per share and all that kind of stuff, but different companies will now be exposed differently to the global balance sheet. Some will be OK in all four scenarios, maybe with more or less growth.

Some will suffer big hits or benefits to their balance sheet, but the balance sheet will swing. Not all companies have the same balance sheet structure. But if you have balance sheet events in the economy, you want to know whether you're investing against the world's balance sheet or with the world balance sheet.

Roberta Fusaro: Are we suggesting that executives look at all four of these scenarios? Or do we have a perspective on how likely one scenario is to emerge over another?

Sven Smit: I think they should look at all four and then also other factors. Inside macroeconomic scenarios, there will be lots of events, a certain regulation, a certain war, a certain this, a certain that. In every country, there could be a regulation. In every country, a competitor could do something. In every place, something else could happen. Your customers can be affected by all these events as well.

Roberta Fusaro: Is this the CEO's job? Who is involved with looking at these scenarios and making decisions?

Sven Smit: Yes. This rests on the CEO, the board, the top management team. This is not a side job. People are changing their supply chains, they're changing their business models. They've changed their investment stance. They changed their debt structures. These things are just too big to presume you can solve this at the microcell level.

Roberta Fusaro: Right. That leads me to the broader question. We all want to accelerate productivity. That seems to be the best scenario, right? But how can companies prepare for the less favorable ones?

Sven Smit: One thing that is consistent in our paper is to look at your balance sheet: where are the assets? How are they financed? What are the implications of high interest rates, lower equity returns?

Once you take that in, then you can look at your business model to figure out the better profitability situation and look at the flows. But the scenarios, these things are not continuous. We will shift from one to the other probably in a relatively swift moment. It could be one year from now, it could be four years from now. But we will be in one of these places.

Since the balance sheet is so big, a shift from one to the other scenario will very quickly bite the balance sheet and take large events through your profit-and-loss statement. So I would spend more time on the balance sheet, in addition of course to all the work on the business model and the profit-and-loss statement. It's crucial in these times.

The market will accommodate long-term vision

Roberta Fusaro: What about long-term-ism versus short-term-ism. Looking at the four scenarios requires taking this long-term view, and I know sometimes it can be hard for executives to get into that mindset.

Do you have a perspective on why it's so hard, and why people do need to start to take this long-term view?

Sven Smit: I might surprise you, but I actually don't believe this short-term/long-term issue is a big issue.

Roberta Fusaro: Interesting.

Sven Smit: It might be at some individuals' level, but we've had companies that had zero profits that had very high value for a long time. So it's not that the market can't see a unique future against a very different future of today. We've seen companies make very large investments against a quarter and be successful and be valued.

So it's not the market that's the problem. I actually think the market might be less short term. Elements of the market are short term, but the market can credit long-term bets and has done so in the past.

Having talked to many, many leaders around the world, there's way more long-term thinking right now because it's more needed. So I already see it being internalized, but it's new, and the topics are complex. And that is where people are still struggling.

Roberta Fusaro: Yes, and thank you for making that distinction between short-term/long-term-ism versus market view of long term. That's really helpful. Sven, what surprised you most about the research?

Sven Smit: At the beginning of this research, we thought big financial institutions would have the most interest in the results of the global balance sheet. Indeed, they had a very serious interest in it.

But now that we've created concrete scenarios that show the balance sheet could trigger scenarios in which equities are not going to go up, that's a very serious message for everybody who's participating in the economy, in the market, because the balance sheet swings can bite you and accelerate you in surprising ways.

Roberta Fusaro: Let me just say, for someone whose head is not immersed in all the details of the global balance sheet, this has been really educational. I appreciate you taking the time.

Sven Smit: Thank you, Roberta. This is not an easy topic, but it's fundamental.

Lucia Rahilly: Moving from macro to microeconomics, let's hear from Farah Stockman, author of *American Made: What Happens to People When Work Disappears*, about our changing perceptions of the working class.

Farah Stockman: We talk a lot about the White working class. The working class is not White. It is very diverse. It's a disservice to working-class people not to truly see that.

For blue-collar people, the civil rights and women's rights movements had so much to do with jobs. Literally, they boiled down, in many cases, to one thing, which is: are you allowed to operate a machine on the factory floor? The labor movement has made those jobs middle-class jobs. So what was the civil rights movement but the fight for those jobs?

Of course, within 15 years after the Civil Rights Act passed, factories started moving away. First to the American South where there are no labor unions, and then overseas. So we'll never know what racial disparities would look like today if those factories had remained.

I think in some educated quarters, there's a way that we talk about the working class and laid-off factory workers as if they're just a bunch of privileged, whiny White men who need to get over it. We don't look at the fact that in the '70s, many of them were forced to share their jobs with Black people and with women, and they didn't want to do it. But they did it. Guess who didn't

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–Farah Stockman

share their jobs? The corporate boards that today look an awful lot like they did back in the ’60s.

So in a lot of ways, race is used as a way to dismiss these economic grievances of a whole class of people. The conversation that we have in educated circles about White privilege is really important, but oftentimes it pretends that the laid-off White factory worker has the same amount of privilege as the White CEO.

I looked at how many women are working in manufacturing. It’s something like three million American women who work in manufacturing–far more than work as lawyers. Yet their needs are almost invisible. But if you were to go to them and talk about women’s issues and what they would be looking for, they’re looking for childcare. They’re looking for the ability to have a baby and take paid leave.

A lot of the women’s issues that I read about: how do we negotiate salaries like a man? A woman in a factory doesn’t have to negotiate salaries like a man. They don’t negotiate their salaries—the union has salaries that everybody who is this machine operator with this [many] years of seniority has got to get this. We don’t understand their lives very well. That’s one of the reasons it’s so hard to communicate about their needs and about what we can do for them.

The most shocking thing I learned through this process is that only a third of American adults have a four-year college degree. Almost every decision of significance is made by people with advanced degrees. And yet we are a tiny slice of the country. We have the power to make these decisions, and yet our economic reality is vastly different than the people who have to live with our decisions. The disconnect, culturally, geographically became so clear.

We have to rebuild our ties to working people. If we want to represent them and keep making these decisions and running the country, we have to make globalization work for them.

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