

Monday, March 20, 2006

Perils of a New Globalization

Investors Insight Publishing

Introduction

Two week's ago in my Friday letter, Thoughts From the Frontline, I wrote about the Dubai ports situation, Smoot-Hawley, globalization and protectionism. Today we look at two commentaries by Stephen Roach, Chief Economist of Morgan Stanley. The first was from Monday, March 13 and the follow up was on Friday, March 17.

Roach explores the newest data on trade flows and weighs in with his view of protectionism. Back in the 1930s politicians were trying to protect manufacturing jobs, but now they are reacting to the loss of white-collar jobs brought on by the internet and globalization. The developed world fears a decrease in living standards and the developing world hopes to increase theirs, but protectionism may bring about the worst outcome for both and that is why this was picked for this week's Outside the Box.

- John Mauldin

Perils of a New Globalization

By: Stephen Roach
March 2006

On the surface, the global economy seems to be off to a great start in early 2006. The Great American Growth Machine has revved up again after a Katrina- and energy-related sputter in the final period of 2005. Japan is back, and even Europe is stirring. For China, India, and the rest of the developing world, vigor generally remains the name of the game. The global growth dynamic looks synchronous and increasingly powerful. With inflation remaining low, isn't this the best of all possible worlds?

Beneath the surface, the answer is a resounding "no." Contrary to widespread expectations, synchronous growth in an unbalanced world compounds the imbalances -- it doesn't resolve them. When imbalances reach the magnitude they are today, rebalancing actually requires an asynchronous global growth outcome. Excessive growth in the deficit country (the United States) needs to slow, while lagging growth in the surplus countries (especially Japan and Europe) needs to pick up. The latter seems to be happening, but the former is not. America's record \$68.5 billion trade deficit in January 2006 says it all: US imports and exports are now so far out of balance, that sustained

solid growth in the US economy can only beget larger and larger external deficits. This could well be a major -- yet largely unappreciated -- point of vulnerability for the global economy and world financial markets.

Consider first the arithmetic of the problem. In the United States, total imports of goods and services are now 59% larger than exports. With the US still running a small surplus on services of around \$5 billion per month -- probably not for much longer, I may add -- that cushion masks an even larger mismatch in the goods piece of the trade balance. In fact, America's imports of tradable goods are currently 89% larger than US exports of manufactured products. This astonishing mismatch between purchases of goods made abroad and overseas sales of American-made products is an important outgrowth of a huge surge in import penetration into the United States over the past 20 years. Goods imports rose to 37% of America's domestic purchases of goods in 4Q05 -- up dramatically from readings of 27% in 1995 and 20% in 1985.

High levels of import penetration pretty much pre-ordain the vicious circle of ever-expanding trade deficits for economies with vigorous growth in internal spending. Again, it's hard to argue with the math. Given the high import content of domestic demand, a given increment of consumption growth, for example, produces a much larger surge in imports than would have been the case in days past when import content was considerably lower. Moreover, the extreme imbalance that now exists between goods imports and exports makes it next to impossible for the US to export its way out of this problem. Exports would now have to expand at twice the growth rate of imports just to hold America's outsize trade deficit on goods constant!

Consider next the analytics of the problem. There are two distinctly different strains of thought that are used to explain America's gaping trade deficit -- the micro of competitiveness and the macro of saving. The former speaks to the rough and tumble battle in the arena of global trade and often involves politically contentious trade disputes between nations. Taken to its extreme, disputes over competitiveness can lead to trade frictions and even protectionism -- hardly a trivial concern these days in light of the outbreak of China-bashing now evident in Washington.

The other rationale follows from the classic saving-investment identity of orthodox macroeconomics -- that nations with shortages of domestic saving will attempt to import surplus saving from abroad in order to maintain investment and overall growth objectives. That means they must then run massive current account deficits in order to attain the foreign capital. Moreover, with the trade deficit accounting for fully 93% of the US current account deficit, this explanation also implies that the extraordinary imbalance between imports and exports is very much an outgrowth of an equally extraordinary shortfall in domestic saving. With America's net national saving rate having plunged into negative territory for the first time ever to the tune of -1.2% of national income in 3Q05, it is next to impossible to avoid large trade deficits. For the US, there is an important twist to the macro underpinnings of the trade deficit: Inasmuch as the surging wealth of American consumers biases the income-based personal saving rate sharply to the downside, the trade deficit is also an outgrowth of the asset-dependent character of the

US economy.

The truth as to what lies behind the US external deficit is undoubtedly a combination of the micro and the macro. But the bottom line is that these external imbalances are getting worse rather than better -- even in the face of an apparent resynchronization of the global growth dynamic. In my view, that reflects the dominance of the macro aspects of the problem. The income-based saving of America's asset economy is so low and the import penetration of its real economy is so high, that more growth in US aggregate demand simply begets ever-mounting trade and current-account deficits. This imposes enormous strains on the international financing mechanism to keep the game going. In 2005, the US needed about \$3 billion of foreign capital inflows each business day of the year -- up dramatically from the \$2 billion daily funding requirement just two years ago in 2003.

Such external dependency of any nation is simply without precedent in the annals of globalization and international finance. Moreover, it is the diametric opposite of the flows that drove the globalization of the late 19th and early 20th centuries, when surplus saving of rich European countries was used to fund the development of newly settled developing countries in the Americas and Asia/Pacific. Today, China -- still one of the poorest countries of the world in terms of per capita income -- has played an increasingly critical role in funding the US hegemon. The rules of engagement in foreign aid have been turned inside out -- rather than flowing from the rich to the poor as once was the case, capital is now moving from the poor to the rich. Nor does the saving-short US seem to have much appreciation for the precarious nature of this arrangement. Not only is China bashing on the rise, but Washington politicians are becoming increasingly heavy-handed in attempting to manage the external lifeline of capital inflows.

The Dubai port incident, unfortunately, is only the tip of a much bigger iceberg. There was also last year's high-profile rejection of a bid to buy Unocal by a Chinese oil company. Moreover, in recent weeks, Washington's increasingly xenophobic politicians have gone even further. A leading US senator floated the possibility of legislation preventing cross-border acquisitions of US companies by foreign state-owned entities. And during last week's negotiations over the debt ceiling bill -- with a lifting of the government's debt limit required only because a saving-short US has decided to up the ante on deficit spending -- there was actually an attempt made to restrict foreign ownership of US Treasuries. The good news, if you want to call it that, is that this latter attempt has since been watered down "only" to require a detailed accounting of the overseas holding of US government debt. But the irony of these politically motivated efforts to throw "sand in the gears" of America's external funding mechanism is especially striking: At precisely the moment when the US has pushed its external funding requirements into unprecedented territory, it is becoming more and more aggressive in dictating the terms of the requisite inflows.

Meanwhile, there's another very important shoe about to fall in the arena of global capital flows -- the likely shrinkage of current-account surpluses by the world's largest biggest savers. Japan, China, and even Germany are all making determined efforts to stimulate internal consumption in order to promote balanced and sustainable economic expansions. This will have the effect of drawing down their excess saving, reducing their trade and

current account surpluses, and leaving them with less external capital available to fund America's saving shortfall. Japan is leading the way in that regard; on the back of a marked pickup in domestic demand, its trade balance has gone from surplus to deficit for the first time in five years. China is also increasingly focused on transforming its export-led economy into a consumer-driven growth dynamic; that emphasis is very much in evidence at this year's National People's Congress currently in session in Beijing. These developments in both Japan and China are further examples of the pitfalls of a renewal of synchronous growth in an unbalanced world: Unless the deficit nation (the United States) starts saving again, a drawdown of saving elsewhere in the global economy will only complicate the world's current-account financing tensions.

To me, all this speaks of an increasingly treacherous endgame for the current state of tranquility in world financial markets -- especially the all-important expectational underpinnings of the dollar and longer-term US real interest rates. Investors are nearly unanimous these days in dismissing the mounting economic and political tensions of an unbalanced world -- arguing that it is in everyone's best interest to keep the game going. The retort of increasingly smug US fund managers is typically something along the lines of, "What else are the Chinese going to buy -- euros?"

At the same time, I worry about an even more treacherous aspect of the endgame. An earlier era of globalization was brought to a tragic end by two world wars in the first half of the 20th century. While history rarely repeats itself, the rhymes never cease to amaze me. The current wave of globalization is occurring against the backdrop of a very different mosaic of geopolitical risks than those which prevailed a century ago. Nation-specific rivalries have given way to threats coming from the amorphous terrorist ranks. Yet there is a worrisome common thread: In both cases, the integration of economies and capital markets clashed with the fragmentation of geopolitical order. Add in the current tensions associated with widening income disparities, real wage stagnation in developed countries, and the growing outbreak of trade frictions and protectionism, and today's world looks far from secure. The tripwires of globalization are now being set.

Economics and politics are on a dangerous collision course. As the forces of globalization strengthen, the drumbeat of protectionism is growing louder. Made in France, the European strain of protectionism reflects a newfound nationalism that strikes at the heart of pan-regional integration. Made in America and exacerbated by fear of the "China factor," a different strain of protectionism plays to the angst of middle-class US wage earners.

Whether the threat is perceived to be from the inside (Europe) or the outside (the United States), the responses of increasingly populist politicians are worrisome, to say the least. French Prime Minister Dominique de Villepin is seeking to protect "strategic" industries from foreign ownership. In the US, it's not just resistance to foreign takeovers, with bipartisan support building in the Senate to impose steep tariffs on China. All this harkens back to the demise of an earlier globalization that many date by the enactment of the infamous Smoot-Hawley Tariff Act of 1930 -- a political blunder that may well have been key in turning a US stock market crash and recession into worldwide depression.

Like the circumstances over 75 years ago, the current global trade dynamic has played an increasingly important role in boosting the world economy. Protectionism and the contraction in global trade it would trigger puts all that at risk.

Today's world, of course, is very different than it was back then. So, too, are the forces of globalization that are causing such a powerful political backlash. In the early part of the 20th century, the world was brought together by the cross-border exchange of manufactured products. In the early part of the 21st century, globalization has swept into a very different realm of commerce -- information flows, financial capital, and services.

A globalization that moves from the tangible aspects of tradable goods activity to the more intangible functions of the Knowledge Economy is not well understood. But the impacts of this shifting character of cross-border integration could well be more powerful today than they were in the past. Blue-collar workers in factories have long been on the front line in facing global pressures. White-collar workers in services-based enterprises have not. That was then. The rules of engagement on the battleground of globalization have changed. Like manufacturing, the services economy is now on the leading edge of feeling the stresses and strains of an increasingly competitive and open world economy.

This is an extraordinary development in the continuum of economic history. Economists have long dubbed services as "nontradables" -- underscoring the time-honored proposition that service providers had to be in close proximity with their customers to offer in-person delivery of expertise, advice, or assistance. In the Internet Age, that contract has been re-written. Now, with the click of a mouse, many once nontradable services can be offered from anywhere in the world. At work is the globalization of software programming, engineering, design, medicine, accounting, consulting, and a multitude of other professional services. The result is an IT-enabled globalization that throws long-sheltered knowledge workers into the global competitive arena for the first time ever.

As was the case in the early 1930s, the globalization of labor markets is at the heart of today's protectionist backlash. But the pressures are very different as they migrate from manufacturing to services. That's not to say blue-collar workers aren't feeling the heat in today's world. Unfortunately, there just aren't that many of them left. Factory sector workers currently account for only about 15% of total employment in the G-7 collection of major industrial countries (the US, Canada, Japan, France, Italy, Germany and the UK) -- about half the 29% share prevailing as recently as 1970. While there could well be more to come in the attrition of manufacturing employment -- the US portion is now close to 10% -- simple math tells us this aspect of the hollowing has just about run its course.

With the pendulum of global competition now swinging toward services, the resulting white-collar shock has added a new and very destabilizing element to the globalization debate. It has created a deepening sense of anxiety that afflicts workers who have long harbored the belief that they would not have to face pressures from low-wage offshore talent pools. The persistent stagnation of inflation-adjusted wages in the developed world

-- even in a high-productivity-growth US economy -- has shattered that sense of security. A powerful global labor arbitrage is at work -- triggering a wrenching compression of real wages in the rich, developed world, while, at the same, allowing pay rates to rise in the low-wage developing world.

Politicians have been quick to come to the defense of the new warriors of globalization. The numbers leave them with little choice. Unlike the sharply reduced ranks of manufacturing-based employment in the developed world, services are the dominant source of work, income generation, and political power. In the G-7 countries, services currently account for close to 75% of the total workforce -- literally five times the share of manufacturing. And yet that's where the current strain of globalization is playing out with greatest intensity -- and where it meets its greatest resistance from the politicians. Little wonder that services reforms have stalled in Europe, or that the Doha Round of global trade liberalization has been stymied by a highly contentious debate over services.

Significantly, the new globalization could be far more disruptive than the strain of the early 20th century. That's due importantly to the extraordinary speed of the transformation now at work. Courtesy of rapidly increasing e-based connectivity, together with ever-widening low-cost bandwidth, the global labor arbitrage is moving rapidly up the value chain. Five years ago, when the debate was first joined on white-collar offshoring, the focus was on relatively low-value-added data processing and call centers. Today, the whole gamut of higher-value-added professional services workers is feeling the heat. Unlike the relatively slow-moving globalization in tradable goods, IT-enabled globalization has moved at hyper-speed to the upper echelons of the occupational hierarchy in the white-collar services economy.

The debate breaks down over what needs to be done. The rich countries have opted for protectionism while the poor countries continue to bet on export-led growth. Meanwhile, a confluence of powerful new competitive forces -- the open architecture of IT-enabled connectivity, the push for efficiency solutions in the high-cost developed world, and the availability of an enormous reservoir of high-quality offshore knowledge workers -- drives the new strain of globalization ahead at breakneck speed. At the same time, the global labor arbitrage is forcing a realignment of relative wages in the world economy -- with the developed world fearing a "race to the bottom" while the developing world is hoping to ride the rising tide. The combination of IT-enabled services globalization and real wage stagnation in the rich developed world is too tempting for populist politicians to resist.

Unfortunately, there is no easy resolution of these political and economic tensions. In the end, the competitive profile of any knowledge worker reflects the interplay between skillsets and fully-loaded costs. A nation's stock of human capital is key in shaping the former, while the ever-declining price of IT-enabled connectivity puts an important new wrinkle into the cost calculus. Countries that sign up for globalization must meet both aspects of this challenge head-on. The hyper-speed by which this challenge is changing in the Internet Age adds a critical urgency to the politicization of globalization -- and to the protectionist pressures it has evoked.

The orthodox prescription is to counsel patience -- that the "win-win" of globalization eventually will raise living standards in the developing world while creating new markets to be tapped by industrial countries. Yet the hyper-speed of an IT-enabled globalization draws the rewards of that patience into serious question -- at least for the foreseeable future. In the end, politicians are always best at counting votes. With workers in services outnumbering those in manufacturing by a factor of five to one, the body politic in the industrial world has cast its ballot in favor of protectionism. Opportunistic politicians are taking the bait -- seemingly unconcerned about the tragic lessons of the 1930s. While today's globalization is very different than it was back then, the risks of making a big mistake on trade policy should not be minimized.

Conclusion

I hope you enjoyed this look at globalization and the challenges we face. You can read more of Stephen Roach's comments and the rest of the Morgan Stanley Global Economics Team at <http://www.morganstanley.com/GEFdata/digests/latest-digest.html>

Your against protectionism analyst,

John F. Mauldin
johnmauldin@investorsinsight.com

Disclaimer

John Mauldin is president of Millennium Wave Advisors, LLC, a registered investment advisor. All material presented herein is believed to be reliable but we cannot attest to its accuracy. Investment recommendations may change and readers are urged to check with their investment counselors before making any investment decisions.

Opinions expressed in these reports may change without prior notice. John Mauldin and/or the staffs at Millennium Wave Advisors, LLC and InvestorsInsight Publishing, Inc. ("InvestorsInsight") may or may not have investments in any funds cited above.

PAST RESULTS ARE NOT INDICATIVE OF FUTURE RESULTS. THERE IS RISK OF LOSS AS WELL AS THE OPPORTUNITY FOR GAIN WHEN INVESTING IN MANAGED FUNDS. WHEN CONSIDERING ALTERNATIVE INVESTMENTS, INCLUDING HEDGE FUNDS, YOU SHOULD CONSIDER VARIOUS RISKS INCLUDING THE FACT THAT SOME PRODUCTS: OFTEN ENGAGE IN LEVERAGING AND OTHER SPECULATIVE INVESTMENT PRACTICES THAT MAY INCREASE THE RISK OF INVESTMENT LOSS, CAN BE ILLIQUID, ARE NOT REQUIRED TO PROVIDE PERIODIC PRICING OR VALUATION

INFORMATION TO INVESTORS, MAY INVOLVE COMPLEX TAX STRUCTURES AND DELAYS IN DISTRIBUTING IMPORTANT TAX INFORMATION, ARE NOT SUBJECT TO THE SAME REGULATORY REQUIREMENTS AS MUTUAL FUNDS, OFTEN CHARGE HIGH FEES, AND IN MANY CASES THE UNDERLYING INVESTMENTS ARE NOT TRANSPARENT AND ARE KNOWN ONLY TO THE INVESTMENT MANAGER.

Communications from InvestorsInsight are intended solely for informational purposes. Statements made by various authors, advertisers, sponsors and other contributors do not necessarily reflect the opinions of InvestorsInsight, and should not be construed as an endorsement by InvestorsInsight, either expressed or implied. InvestorsInsight is not responsible for typographic errors or other inaccuracies in the content. We believe the information contained herein to be accurate and reliable. However, errors may occasionally occur. Therefore, all information and materials are provided "AS IS" without any warranty of any kind. Past results are not indicative of future results.

We encourage readers to review our complete [legal](#) and [privacy](#) statements.

InvestorsInsight Publishing, Inc. -- 14900 Landmark Blvd #350, Dallas, Texas 75254

© InvestorsInsight Publishing, Inc. 2005 ALL RIGHTS RESERVED

Perils of a New Globalization An article on Stephan Roach's exploration the newest data on trade flows and weighs in with his view of protectionism.