Washington and Beijing – Rome and Byzantium?

1. The right time for cooling off

This year, both spring and autumn started on time. Spring on 13 March, when, against all expectations, financial market players snapped out of their three-year bout of pessimism and suddenly accomplished an optimistic revision of everything that had previously been regarded negatively. Not even the then threatening danger of war in the Middle East could spoil the mood, nor the quarrelling between the global powers and those that still wanted to be regarded as such, about the legitimacy of war against the dictator of Iraq, Saddam Hussein. Au contraire: a hundred times better than all the strategic experts put together, the financial markets anticipated the relatively unproblematic course of the war in an impressive fashion. And stock exchange prices went on climbing happily, and continually, higher, despite the fact that there was anything but a clear improvement in many basic conditions – the rapid and unproblematic course of the first phase of the Iraq campaign gave way to a second phase of long-drawn-out occupation of this enormous and ultimately hardly controllable country, with greater losses and less glory; the macroeconomic data gave rise to ever greater doubts about the likelihood of a rapid cyclical recovery in the global economy. Growth forecasts had to be revised downwards accordingly.

The fact that stock markets around the world continued to be bullish can only be attributed to the phenomenon of greater certainty. The survival, and indeed future success of any company, in the technology sector for instance, that had survived the last three years of dramatic downturn, and had even perhaps begun to show signs of renewed vitality, seemed more probable than it had in the preceding months and years. The conclusion of a clear-out phase benefits those that survive it. This is surely the reason that it was the “fallen angels” whose prices were the first to rise, while reliable, high-quality companies, whose survival had never been in doubt, at first fell into disfavour.

As mentioned, autumn also arrived on time – just at the moment when the first signs of greed and excess had reappeared in the markets. A good six weeks ago, we drew attention to the absurdly high P/E ratios that had already been reached again in the technology sector. A P/E of thirty, forty or more implies future profit growth of 100, 200 or more percent within a few years, and such may well be doubted, regardless of a demonstrable ability to survive. However, the current rougher weather on the financial markets was triggered, not by players’ insights regarding the questionability of excessive expectations, but by a political/macroeconomic event that may well indicate turbulence ahead. The G7 Conference in Dubai on the weekend of the equinox generated such indications. And since then, the US dollar has lost considerable ground against both the Euro and the yen, and volatility on the currency markets has risen by no less than 30 percent. Since 23 September the stock exchanges have allowed themselves at least a break. And the bond markets, which had previously been badly battered by the positive expectations on the stock exchanges, have seen interest rates corrected downwards again.

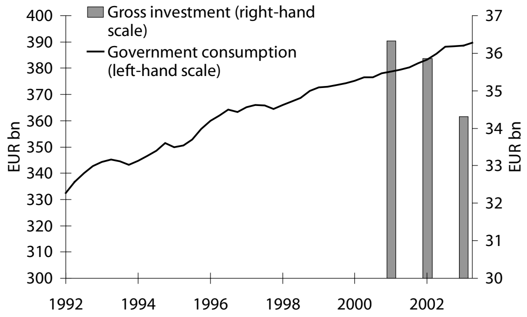
This autumnal cooling off comes at the right time for the more prudent experts, for the burgeoning euphoria on the stock markets gives rise to the unpleasant notion of a divergence between market movements and what can be derived objectively from the macro and microeconomic situation. Will growth in the USA or Europe (!) achieve, in two or three quarters, the vitality needed to justify the higher prices? And will the P&L and balance sheet situation of the companies be so robust that it will soon again be possible to speak confidently of a “fair” valuation by the markets? Reasonable doubt remains. And beyond this, it is increasingly difficult to dismiss the suspicion that the whole bull market since 13 March might have been due to cartel-like machinations on the part of the investment banks. They have, after all, been condemned to a condition of bonus-less underemployment for the past three years, and are undoubtedly capable of both clandestine deals and panicky, herd-like behaviour. For when, over and over again, we are confronted with so-called research material that at the beginning of the year recommended selling, and during the rally suddenly recommended buying the stock of one and the same company, without anything much fundamental about the company having changed – except the rise in the share price – then the alarm bells may well ring for sceptics. Then we would have returned to a time when capital investments of whatever quality were good enough for investors, and when, in an unparalleled sellers market, investment banking was nothing other than a gigantic, commission-driven selling machine for goods of increasingly inferior quality.

Sceptics disinclined to conspiracy theory will of course reject this attempt to explain the rally since spring 2003, and account for it through a combination of various factors: record low interest rates and thus low opportunity costs for share holdings, overcorrection in the previous downturn, lessening pressure to sell, lower volatility, and so on. Nevertheless: the cooling-off period at the end of September has come at the right time.

2. Global imbalances?

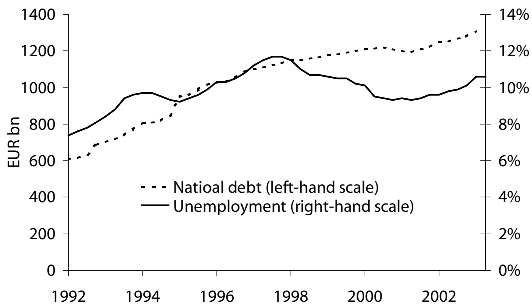
The finance ministers of the seven most important industrial nations in the world focused in Dubai on issues of economic growth and the increasingly clear and growing disparity between individual economic regions. The data has indeed been very remarkable for some time now. Europe is suffering from sustained and comprehensive weak growth. Comprehensive, in that virtually all sectors, except perhaps the public sector, have been affected by this weakness. Europe is ailing in investment, private consumption and house building; in the core countries, state investment in infrastructure is also declining. Europe, and in this regard Germany in particular (see figure below), is also suffering from sustained high unemployment, of structural nature. Repeated attempts to overcome this problem by means of employment programmes that are ultimately always fiscally oriented have fizzled out; their only effect has been an unbroken trend towards greater government consumption.

Focused on redistribution



Source: Statistisches Bundesamt Deutschland, Bloomberg; own presentation

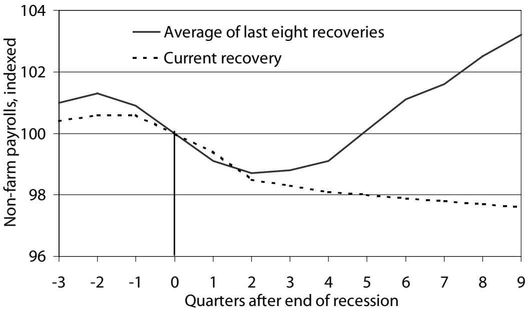
Unemployment: vain fiscal efforts



Source: Bloomberg; own presentation

The US economy is growing significantly faster than Europe's, but growth is unbalanced, limited to private consumption and private house building; defence expenditure has also been growing in an apparently fairly unrestricted fashion over the past year. Private investment, that unmistakable sign of growing hope and confidence, remains low. During the crisis of the last three years, American companies have made massive redundancies, or ceased operations altogether. The economic recovery since autumn 2001 has so far created virtually no new jobs, so that it is now not only being referred to as a "jobless recovery", but as a "job-loss recovery". And – how else could it be at present – the phenomenon is increasingly being made into an election theme. Those who, like us, do not regard the economic developments of the last few years as a cyclical crisis, and thus have never expected a cyclical upswing, are anything but surprised by this absence of job creation. Where there is no investment, no new jobs are created. And it is obviously not possible to beat people into investing: the phenomenon has little to do with politics in general, or any failure in American economic policy in particular. It is the unavoidable consequence of the unavoidable investment boom of the 1990s.

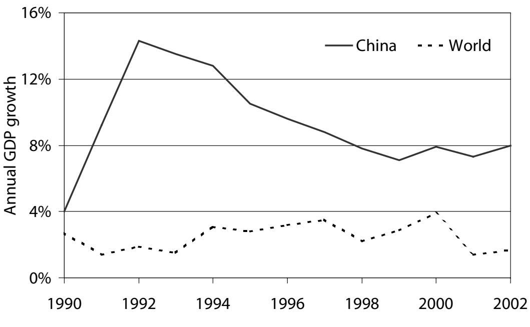
Recovery with no new jobs?



Source: Bureau of Labor Statistics; own presentation

There is at the moment only one genuine growth locomotive in the world, and this is hissing and steaming and smoking away in Southeast Asia, China, the surrounding Pacific states and India. But here too, and particularly in China, the individual parameters are fairly remarkable. In China, investment, industrial production and construction are all booming. This growth is largely explicable in terms of the low base it started from. Until recently, the Chinese themselves consumed little; at 40 percent their savings rate is extremely high. But the latest figures indicate a sharp rise in domestic demand. It is wrong to think of China's balance of trade as being unbalanced: the export of goods to the USA and to a lesser extent the rest of the world is largely compensated by the import of investment goods from the western industrial countries and of semi-finished products from the surrounding "tiger" states.

China's growth: from volcanic to sustained



Source: World Bank; own presentation

Hence the topic for Dubai: can development like this simply continue? Will the result not be that Europe, and increasingly also the USA, will lose still more production-related jobs, which will give rise to greater hopelessness, and indeed despair with regard to Europe's expensive social institutions, while China develops more and more into a global producer, not merely of the cheapest, mass-produced goods, but increasingly of high-quality goods. Is China indeed fighting some kind of clandestine economic war against the West, by selling its cheaply produced goods in order one day to use the billions of dollars they have acquired to blackmail the ever more indebted Americans?

Or to put it a different way: is it acceptable that irresistible developments will result in Europe becoming a sort of low-growth global old people's home, the USA turning into a region of narcissistic, credit-based consumption, and Southeast Asia being the only part of the world where people still work? The question will not have been put so plainly or provocatively in Dubai, the more so as there were politicians at work here, with their well-known aversion to, and inability for long-term strategic thinking. Their short-term problem was restricted to the threateningly large and ever-increasing US trade deficit, for which a scapegoat was quickly found, in the shape of the undervalued Chinese currency. Already in the run-up to the Dubai conference, vigorous lobbying was in progress. The pressure on the Renminbi reached its first peak with the visit to Peking of the US Treasury Secretary, Snow, at the beginning of September. The argument goes like this: until a few years ago, China was a pretty hopelessly poor developing country, with an utterly hopeless state economy and a very unproductive agricultural sector. In the last few years, however, it has been able to achieve such major improvements in productivity that the current differential to the productivity of developed countries necessitates an upwards revaluation. By tying the Renminbi to the US dollar, China keeps its currency artificially low: the central bank buys up all dollars accrued for payments, as confirmed by the accumulated currency reserves. This policy enables China to keep wage rates artificially low and thus gain an unfair advantage in the global marketplace. In order to give the necessary force to the argument, draft legislation was presented in the US Senate to increase import duties on Chinese goods by 27.5 percent, should the Chinese fail to comply with the "wish" for an upwards revaluation.

Furthermore, it is also argued, China will sooner or later run into a serious problem with inflation, as, among other reasons, the non-neutralised flood of dollars is expanding the money supply far too strongly. Upwards revaluation of the currency would have a generally cooling effect, which must surely be welcome, both now and in the future.

Thus the fairly crude argument in the run-up to Dubai. It goes in the direction of blaming China for the weak, unbalanced or non-existent growth in other parts of the world: "China is growing at the West's expense", "China is destroying our jobs" is how the headlines then run. And thus, the world has already worked its way to the brink of another, much more serious crisis: that of revived protectionism.

3. A few corrections to the picture

It is a good plan to relativize, or indeed question this argument, characterised as it is by short-term (US election-related) interests. First: when China joined the World Trade Organization (WTO) in 2001, everyone was clear about the risk of taking into the group of free trade-oriented countries an economy that had only just started on the process of growing out of communism. The idea was that this would enable a more rapid transition to a market economy, assisted by growth impulses. There was also clarity as to the fact that reducing constraints on trade is one thing, and that a free capital market is quite another thing. China has, though, nothing worthy of the name of a banking system. Similarly to the situation in Japan, the existing banks sit on piles of probably worthless assets, and are thus in need of restructuring. The individual Chinese sees little or no possibility of choice between the various providers, and must place his or her enormous savings with an extremely inefficient institution. Much is obviously being done, but still more remains in disarray. The result is that for the time being China must abstain from opening its capital market, and thus from the free convertibility of its currency. Any other course of action would result in a massive flight by Chinese into foreign currencies. Those who therefore believe that the free float of the Renminbi would automatically cause it to appreciate might be in for a serious surprise. The valuation of a currency depends only in part on external forces – it is not possible simply to exclude the internal forces from the calculation! For these reasons, there is much in favour of a careful and cautious approach, entirely without time pressure (for example from an American election).

Secondly: those who claim that China produces "at the expense" of the classic industrial nations overlook the extent to which the international division of labour is already practised. The world functions in a far less compartmentalised fashion than nationally oriented politicians can readily imagine. Analysis of the flows of trade to and from China reveals a highly complex situation. The amount of exchange within the Southeast Asian economic region is far greater than normally assumed. South Korea already exports more goods to China than it does to the USA. Conversely, China is currently building a harbour on the Yangshan Islands near Shanghai, whose main purpose will be to serve export activity in the Pacific region. The idea that China's trade with the USA is a one-way street is also wrong. It is true of goods such as textiles – we have recently been able to read that Levi Strauss is giving up its last manufacturing plant in the USA, which will be further grist to the protectionist mill. But it is simply not true of higher-value products. The Stanford economist Lau estimates the Chinese share of value-added on articles exported from China at a maximum of 30 percent, and for articles that go to the USA at not more than 20 percent. China is thus more like an enormous assembly line for components manufactured elsewhere. Accordingly, the argument for the appreciation of the Chinese currency can be relativized to the extent that the resulting higher Chinese production costs would influence only a small part of the USA's negative balance of trade.

Thirdly: cheap goods of ever higher quality from China are not just a bad thing: Western consumers benefit. Without the flow of goods from China, Wal-Mart, Gap, and now Levi Strauss, as well as the many providers of consumer goods this side of the Atlantic, could simply close down. A policy of over-rapid and rigorous appreciation of the Renminbi would damage the consumer side of the US economy in particular. Stephen Roach, head economist at Morgan Stanley, calculates the probable damage from the proposed protective duty at some USD 4 billion for the Wal-Mart chain alone.

None of this means that an adjustment of the Chinese currency is not unavoidable in the longer term. Au contraire: free trade must inevitably result in freer, and ultimately entirely free, movement of capital. Then the Chinese will be able to enjoy their newly created prosperity and use their stronger currency to purchase Western goods, to go on holiday in Honolulu and Mallorca, and to avail themselves of the services of Western banks, management consultants and lawyers. But change like this cannot happen overnight. For en route, what is ultimately still a socialist system will have ceased to exist as such. In the longer term, there can be no free trade without a free capital market, and neither of these without freedom and minimal civil rights.

4. Productivity and distribution of labour

The idea that cheap, higher quality goods from elsewhere are the devil's work has long been part of the protectionists' repertoire. And we quickly enough catch people – even ourselves, sometimes – falling into the trap of protectionist arguments. The trap has two levels. The first level is the false perception of the significance of productivity. "Economic output per hour of work" is one of the possible definitions, and thus far, everything seems clear enough. But this is already where the errors begin. For what constitutes "economic output", and what not, is decided not by some economic planning authority, but simply by the market alone, as it controls price by means of demand. "Economic output" once consisted of coal, candles, steam engines, horseshoes, flour sacks and similar. Today, it is mobile phones, DVDs, visits to beauty clinics or Disneyland and the like. The market knows no guidelines for more or less sensible products or services, and any considerations on productivity and productivity growth must be similarly unprejudiced. The cost-efficient sewing of blue cloth together into jeans is neither more nor less valuable than a high-priced operation on the drooping eyelids of an overweight American.

The dynamics of social and economic life invariably result in differing "economic outputs" being differently valued. Yesterday it was coal and candles; today it's mobiles and DVDs; tomorrow it'll be something else. Much of the emotion could be taken out of the discussion on the global division of labour if our understanding could be freed from the coal and candles of the past. Over and over again, we encounter the notion that production only takes place when some physical article is created. This would certainly not include the operated eyelids, not even to mention the psychological counselling by telephone for the overweight American. Wrong. Production occurs when a price is paid for a particular output. When we consider shifts in production between different areas of the world, we are well advised to keep in mind the economic axiom of the indifference of individual preference.

The second level of the misperception trap lies in believing that increased productivity in one area must inevitably cause economic damage, because the lower productivity elsewhere will result in competitive disadvantage and ultimately the discontinuation of production. This argument was used against the building of railways, on the grounds that they threatened to displace the slower coaches, and against electricity, because it would cause the collapse of candle and matchstick production. In the early 1970s, it was used against the computer, because it would cause much repetitive work to disappear, and today it is used against China's achievement of higher productivity. Why this fear of higher productivity? Because the dying out of what is obsolete is tangible and can be measured, by the loss of jobs for example, and because the increase in prosperity that derives from the reduced need for labour and capital becomes apparent only later and very indirectly. Higher productivity, more output per hour, lower costs per output: this releases capacity for other, new, higher-value possibilities.

It is worth, from time to time, taking a look into the literature of the nineteenth and early twentieth centuries. Victor Hugo, Gerhart Hauptmann or Charles Dickens: they all have one thing in common. They describe the unbelievable poverty at the time present in large areas of Europe. This was the age of coaches, coal and candles. It was also an age of deprivation and hunger, excessive working hours and child labour. Improved productivity, and this alone, has freed our society from the scourge of such poverty. (Those wishing to look more closely at this are recommended "Was für ein Leben, Schweizer Alltag vom 15. bis 18. Jahrhundert" by Albert Hauser, Zurich 1987. The pre-industrial period in Switzerland was characterised by dramatic deprivation and the necessity of emigration.)

Improvements in productivity are not possible without shifts in production. The economy, or better, individual businesses generally become more productive, not because they want to, but because they have to: a competitor appears, local or not, who can for some reason produce more efficiently: that is, more cheaply. So either one adapts and invests, or, sooner or later, one goes under. For the same reason, there will always be changes in the distribution of labour. Whereas it once made sense to manufacture textiles in the Zürcher Oberland, in the face of competition from China, a time comes when this no longer makes sense, and only the design and sales operations can be conducted from Switzerland on reasonable terms. Later, it suddenly becomes apparent that for a particular, high-value article domestic production again becomes an option. If "high-value" relates to time-to-market, for example, then the long distances to and from the Far East and the problems of intercontinental communication may become too troublesome, too costly and too inefficient.

The distribution of labour is an extremely dynamic process. We claimed above that China was in principle a vast assembly line for semi-finished products that were manufactured elsewhere. This may not be the case much longer. Swiss exporters are communicating very clearly that enormous efforts are under way in China to achieve more comprehensive production. Among other things, this would mean that the Western engineering industry would come under pressure, and that one might be well advised to anticipate these developments by means of direct investment in China.

Productivity improvements always have a material and a locational component. The locational component, the dying out of entire production capacities in larger or smaller regions, will always arouse bitter opposition. And it will always remain an opportunity for the exercise of political influence. The retention of existing structures will always be a political goal, because the structures are concrete, whereas the increased prosperity deriving from productivity improvements and the international distribution of labour can always only be of visionary nature. So, when a vast area of the world embarks on an economic leap forward, the opposition should come as no surprise. Ironically, but logically enough, this opposition comes from those countries that are committed to free trade, and that also operate an international organisation for this purpose.

5. No imbalance at all?

Above, we sketched in a rather crude fashion the global distribution of labour that is partly already in place, and partly under way: Europe as an old people's home, the USA as a temple to consumption, and the Far East as a highly efficient workshop. But this is really rather too crude, for it takes no account of the highly complex, multi-dimensional interlocking of an already very largely globalized economy. Europe is not only old, but also fairly innovative, and possesses extremely successful, internationally active companies investing very dynamically in the Far East and particularly in China. The Americans too are not only narcissistic consumers, but also have a higher education system that generates the most inventions worldwide. And the USA operates a capital market without which investment activity globally would simply collapse. And it does something else: it provides security at global level.

This provision of security represents the key to the understanding of the current economic order. It is of course difficult at the moment, especially in Europe, to discuss the subject of global security at all neutrally. Firstly, taking leave of what may once perhaps have been justifiable great-power attitudes is obviously a problem. It is however a fact that without the Americans, nothing whatsoever can function at the operational level. Secondly, Europe still maintains the illusion that multilateralism works, and has the greatest difficulty in comprehending the Bush administration's arbitrary and independent action in the Iraq conflict. Thirdly, and related, there is a feeling that the state of effective paralysis in the area of security policy is morally superior.

Nevertheless, and – in view of the many mistakes made by the Americans in their first imperial raid – with much understanding for the European position, security, on the oceans of the world, in international airspace and on the ground, from the next, and ever more dangerous, terrorist attack rests practically exclusively in American hands. History will probably show that the Americans stumbled more nolens than volens into their monopoly position with regard to security, for a democracy is signally unsuited for the implementation of imperial strategies. It was 11 September 2001, intended by its perpetrators as a blow against alleged American imperialism, that, ironically, provoked the stumble into exactly this monopoly position: the realisation, indeed the almost religiously inspired conviction that it is the responsibility of the American nation to ensure the security of the world. In order to demonstrate, with complete clarity, to the world as whole that this could be done, it was necessary to provide a couple of suitable examples as quickly as possible: first Afghanistan, and then Iraq. Both were militarily weak opponents, probably targeted by the Americans mainly on this account, and not because of their objective threat to global security. Otherwise, North Korea and Iran might have seemed more appropriate. In making this demonstration of power, it was important to provide evidence of the capacity to take independent action, by repudiating the international bodies, especially the UN, and by letting attempts at obstruction by former great powers peter out harmlessly.

One may regard this approach as a failure, or condemn it as immoral. However, the fact remains that the Americans have a monopoly position on security issues, and we will, for better or worse, have to come to terms with it for the foreseeable future. Security at sea, security in the air, greater security on the ground: in economic terms, these are public goods, which can typically be "consumed" without being used up, and for whose "use" it is difficult to charge a price. The problem then normally arises of the financing of such public goods, together with the related problem of inadequate production. Specifically: when the USA ensures that China and Japan can obtain oil from the Middle East safely and unproblematically, then what is happening is the consumption of the public good "security" by the Chinese and Japanese. For both countries, a secure oil supply is a key factor in further economic development. If the USA ensures that Pakistan behaves relatively reasonably towards India, then India is profiting from the public good "security" in the region. And when the show of force in Iraq makes it clear to all other regimes in the Middle East that something similar could happen to them, and they therefore behave in a more or less civilised fashion in the future, then this greater security is being "consumed" by the world as a whole, including, nota bene, Europe.

International security is a public good, and when it is produced by a monopolist it can be charged for. Japan, China and to a lesser extent India and many other up-and-coming economies pay their share by holding dollars in their currency reserves, accepting that by doing so they are treating a probably depreciating currency as an asset. They buy the treasury bills, notes and bonds needed by the Americans to finance their budget, and thus preserve the Americans from the need to finance themselves, which could only be done by more saving. Do these countries' central banks do this voluntarily? Certainly not. But the US dollar is and, given the political situation will remain for the foreseeable future, the only currency that ensures convertibility in most conceivable situations.

This closes the circle, and also relativizes the significance of America's double deficit. The USA *must* allow itself to be compensated in some way for its production of security. Here, incidentally, a new form of security-related distribution of labour is emerging. The Europeans and the relevant international organisations are being allocated the role of the clean-up crew – though the Americans are keen to retain their supremacy in this phase too. Unilateralism when striking; multilateralism for the clearing up – this is the USA's imperial leadership approach. And it will also undoubtedly define the role of Nato and any future European security unit.

6. Consequences for investment strategy

A couple of immediate and short-term consequences can be drawn from the world economic order thus sketched out. The dollar circulation pattern described above provides the Americans with considerable incentive neither to reduce the budget deficit, nor to seriously reduce public consumption in favour of higher savings. Accordingly the US dollar will probably tend to be weak rather than strong, the more so as a policy of dollar depreciation holds no risk for the USA of importing inflation. As long as oil is paid for in dollars, there will be no problems of this sort.

But nor, of course, should the risks of this circulation pattern be neglected. For one thing, the high level of public and private debt in the USA has resulted in the build-up of a substantial interest-rate risk. Rising interest rates would have devastating consequences in a rapid fall in the solvency of highly indebted individuals and organisations, as well as considerable impact on the valuation of assets. The second risk is of a material nature. Security policy is only a valuable public good as long as it is – grosso modo, naturally – successful. A serious failure, such as the repeatedly threatened detonation of a “dirty bomb” by terrorists on the American continent might shake confidence in the Americans’ ability to help achieve more sustained international security to its very foundations. The inevitable consequence of such an event would be a global flight into another convertible medium, such as gold.

In the longer term, entirely different questions arise. Is it intelligent to carry one’s money exclusively to Rome, to the imperial switching centre? Does the monopolistic character that we have described for security issues also apply for economic issues? Absolutely not. Labour will increasingly be distributed around the world. China will attempt to produce higher-value goods, and turn increasingly to consumption. Production will also return to our regions, if we have done our structural homework. Component manufacture and assembly will be intermingled, so that ultimately it will hardly be possible to determine where an article really comes from. In other words, added value will be generated all around the world. Accordingly, any investment strategy must be globally orientated, but with great care being given to the selection of the specific investment vehicles. For however highly developed production may be in some areas of the Far East, the constitutional structures are often equally archaic. But impeccably functioning constitutional mechanisms are the basic precondition for the dispatch of money to anywhere in the world, whether as a loan or to purchase shares in property. In this connection interested readers will find in the “Market Overview” some specific proposals for achieving an appropriate Far East exposure in globally diversified portfolios.

A final word. If the USA is the new Rome, then one ought also to bear Byzantium in mind. Byzantium survived for a thousand years longer than Rome. There is something almost irresistible about the idea that China might become the next Byzantium. And for that, one would need to be prepared in good time.

KH, 6.10.2003