Armchair Economics

Perspectives from an economic everyman

The Global Reset

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Are trade renegotiations going to turn into a real trade war? Maybe the recent Hong Kong events, combined with the slowing of China's economy, will push China to get a deal done. We shall see. Regardless, globalization presents large challenges today. Resolving them might require something more than signing a new trade agreement.

But if we break apart the current global supply chain, won't that lead to a spate of economic challenges, which could include war? Isn't that what happened after the Smoot-Hawley Tariff was enacted in 1930, starting a period of protectionism that created the Great Depression, maybe even tipped the scales towards World War II? Shouldn't we have learned our lesson? Tariffs and trade wars are not good!!!

All of this is true. Tariffs and trade wars are not good. But they happen. This wouldn't be the first time global trade broke down. Why does it happen?

Let's start with what should be an obvious lesson. Globalization is not a win-win for everyone. As noted in my last essay, *Newtonian Economics*, for every major policy action there is a reaction. And quite often, that reaction isn't seen for a few decades.

The most obvious big winners of modern globalization have been the countries with cheap labor, devoid of any focus on the environment and prone to lying and cheating. Globalization has transformed several of these countries from third world to emerging markets. As third world countries, they struggled to feed all their people. Now as emerging markets, many of their citizens enjoy the fruits of modern consumerism.

Another big winner has been the multi-national companies that provide consumer products and services. All manner of food, clothing, jewelry, electronics, household goods, travel, leisure and other consumer companies have benefited from the developing prosperity in emerging markets.

One other winner has been the large, developed-economy companies that make capital goods, basically all kinds of equipment and machinery. These companies were rewarded with a decline in labor costs, the ability to skirt environmental regulations and the early growth of emerging markets.

But then China stole everyone's intellectual property.

Now developed-market companies have Chinese state-supported competitors, and the Chinese government has been pushing its citizens and companies to buy products and services from domestic providers, its national champions. Life may have been peachy at the beginning of globalization for developed-economy goods and service providers, but now they face increasing competition from lower-cost producers that are state subsidized and state supported.

There was one other big winner in modern globalization. But let's save that story for later, as those lucky folks emerged as a result of globalization's big losers.

The losers in modern globalization have been the working class in developed nations like the United States and Europe.

At its core, globalization was an opportunity for developed-market companies to lower their labor costs. Factory labor in the United States and Europe lost out to the cheap labor of China and a handful of other emerging countries. Whole industries picked up and left for Asia. The replacement jobs for these developed-economy losers were in lower-pay and lower-benefits service and consumption industries.

The number of manufacturing jobs in the U.S. has dropped from close to 20 million in 1980 to just under 13 million today. The number of service industry jobs in the U.S. has grown from around 70 million in 1980 to almost 120 million today.

As globalization pushed developed-market labor into lower-paying jobs, many developed-market living costs were rising faster than wages. Getting to pay lower prices for clothing, electronics, some household furnishings and toys felt great—until people had to pay their rent, electricity, transportation, insurance, education and medical bills.

As globalization has played out, the growing economic despair of the developed-market working class has made them ever more resentful of immigration. "Why are we letting foreigners into our country and subsidizing their lifestyles with our money when it is foreigners who have destroyed our own lifestyles?"

They've also grown resentful of their governing class. "Why did they give away our prosperity? Why do they support foreigners over us? Why do they care more about politics than our own economy, our own legal citizens, our own country?"

The circumstances that led to these losers created the opportunity for globalization's other big winner.

As American manufacturers moved production overseas, service industries began to grow. Today, service is America's dominant economic engine. Service not only pays less than manufacturing does, it also has a lower economic multiplier. We can see this in the lower GDP growth that's plagued the United States for over a decade. To confront this consequent economic malaise, government turned to classical Keynesian and central bank stimulus.

John Maynard Keynes (1883-1946) was probably the most influential economist of the modern industrial era. In his 1936 book, *The General Theory of Employment, Interest and Money,* Keynes suggested that when economic slowdowns surface, countries should stimulate their economies through greater government spending. As the theory went, increased government spending beyond tax collections (i.e., deficit spending) would jumpstart economic growth. Consequent future tax collections would then pay down stimulus-created deficit.

But there was a flaw in Keynes' theory. Keynes assumed the government's extra spending would waterfall and be recycled within the domestic economy, reigniting growth. That's how it would have theoretically worked in 1936. But today, in economies that are dominated by service, not production, greater government deficit spending has netted less domestic stimulus. Making matters worse, today's technologies have created an unprecedented level of globalization.

In this digital world, a large amount of Keynesian stimulus "leaked out," providing less stimulus domestically and more stimulus for emerging market economies. As a result, America increased its trade deficit, debt and middle-class despair, while emerging-markets increased their trade surpluses, savings and prosperity.

To further combat malaise, central banks in the United States, Europe and Japan implemented accommodative monetary policy. Interest rates were slashed. The cost to borrow money collapsed, which allowed consumers to purchase more on credit. This, coupled with poor regulation, led to the United States housing crisis of the mid 2000s and the European banking crisis soon after. Effects of both still linger.

With interest rates almost at zero, central banks were then forced to start "printing money," known as quantitative easing. Sovereign debt and the balance sheets of central banks in the United States, Europe and Japan have since exploded.

This brings us to our final winner in modern globalization, the one that arose from the ashes of the working class' despair. That winner is the financial class.

The people who work with money have enjoyed a huge windfall. When the cost to borrow money declines, the value of a financial asset rises. When central banks add money into the system, the value of a financial asset rises. When government adds money into an economy via Keynesian stimulus, the value of a financial asset rises.

Since the early 1980s—when modern globalization started gaining momentum, debt began to grow, interest rates started to decline and when economy reached a disaster point (2008/09)—central banks have been adding money into the system. Consequently, financial investors have experienced a rising-tide-lifts-*their*-ships boost. Real estate, public securities and private securities investors have gotten very wealthy.

All this financial stimulus has led developed economies into a Keynesian trap, where more and more deficit spending and quantitative easing is needed to keep economy "growing." And the massive flow of capital into financial assets has given us "The Fed Put," an unimplied guarantee that if financial asset values are at risk, the Federal Reserve (our central bank) will add stimulus of some kind to ensure values don't fall too far. Financial asset values can't fall too far because they are leveraged, meaning the banks and investors holding that debt could face serious problems.

Welcome to the consequences of globalization, the Newtonian Economic Reaction to a policy change that started about forty years ago. The third world has been lifted up, while the first world has become fraught with social and economic challenge.

Today, the developed-markets working class have lost sight of the “American dream,” whether that’s the U.S. or the European version. All was fine until the number of losers grew large enough to form a political force. They elected Donald Trump president. They voted for Brexit. They continue to grow in ranks in Europe.

No matter the outcome of today’s trade renegotiations, it would be naïve to expect globalization’s losers to be quickly or easily appeased. Their prospects for prosperity are not returning anytime soon. A tipping point has been reached. A global reset has been put in motion.

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