Changing Dynamics of Globalization

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In the mid-1940s, the world's major economies found themselves in need of working cooperatively to rebuild war-torn economies in Europe and Asia, and reconvert America's mighty economic engine from its focus on war to the pursuit of national and global economic growth. Governments met to negotiate a new financial structure under the International Monetary Fund (IMF) and the World Bank, and a new international framework of trading rules under the General Agreement on Tariffs and Trade (GATT). This began a decades-long process of reducing controls on capital flows and impediments to worldwide liberalization of trade which continued from that time until now, 70 years later.

The world experienced "globalization". National economies became increasingly interconnected and interdependent in the transition to what has become a single global marketplace.

Trade as the Primary Engine of Economic Growth

International trade gathered momentum, and for 60 years grew at a rate approximately twice as fast as world production.

Many nations in the 1950s and 1960s found that their own domestic demand, in the form of consumption and investment, was not strong enough to drive positive economic growth. Wages were far too low, agriculture too mired in subsistence farming, investment in industry too scarce. However, the faster rate of growth of world trade offered a new pathway to economic growth by shifting domestic resources to produce exports into a faster growing world marketplace. Trade became an express train to the future as an alternative to the antiquated, slow-moving local train.

In the first phase of this post-1940s wave of globalization, US multinational companies expanded their direct investment in many countries, but with particular focus on the rebuilding of Europe. By the mid-1960s European companies and workers were complaining that US multinationals were taking over large segments of European industry, threatening the "Americanization" of Europe and undermining the security of European workers. By 1967 several European political leaders had urged President Lyndon Johnson to act to slow down the multinationals' efforts to devour European industry. In response, Johnson "leaked" to the press that he was considering the application of foreign direct investment (FDI) controls in response to European concerns. Several European leaders called the White House in panic, warning that turning off US direct investment to Europe would halt European growth. The idea of US controls on FDI was the dismissed by the White House spokesmen as a false rumor.

Quietly, during this same period, major US retailers began seeking to procure or produce textiles and apparel in the cheap labor economies around the world, beginning a process later described as "outsourcing". Reliant on cheap labor, Japan became a major exporter of textiles and apparel, and Hong Kong followed close behind. President John F. Kennedy came under intense political pressure to impose restrictions on US imports of Asian textiles and apparel. As bilateral agreements to restrict such trade came into effect, alternative suppliers were found among other Asian countries and from Latin America. One after another, the US imposed bilateral (and sometimes unilateral) trade restrictions on "cheap labor" nations. Domestic political pressure grew in the US to restrict imports throughout subsequent decades, and restrictions of one kind or another came to pass in such varied industries as steel, autos, TVs, machine tools, and ball bearings. By the time President Ronald Reagan came to power, his first term as president included several new trade restrictive arrangements with Japan, even though he personally believed in the importance of freer trade and freer global financial markets.

Another phase was adaptation to rising labor costs in some of the key exporting countries. In Japan, industry was reoriented from reliance on high labor-content, low value-added manufactured exports to lower labor-content, higher value-added products. Japan's exports moved up the technology ladder, to steel, shipbuilding, infrastructure products, and electronic consumer products like TVs. That process did generate some major trade frictions with the US, and continues to this day, but with fewer frictions in most recent years.

But another globalization process was also set in motion, as Japanese manufacturers learned to invest in production outside Japan, in many countries around the world, including the US, Japan's biggest market at that time. American pressure to restrict imports not surprisingly encouraged foreign companies to move production inside the US, and eventually develop their own networks of suppliers there among domestic ones. The same process was set in motion in Europe, as both US and Japanese companies opened new production facilities in many of the European Common Market economies.

Japan is now a major exporter of automotive and other transportation products such as railroads. It is a major exporter of capital goods intended to enhance power production or manufacturing capacity in other nations. It is at the forefront of development and sales of automated mechanisms like robotics and automated industrial fabrication.

South Korea and Taiwan, dependent on exports as their primary engine of economic growth, soon followed the path of structural transition that Japan took, shifting from high labor-content manufactures to lower labor-content, higher value-added products among advanced manufactured items such as autos and capital goods designed to boost the productive capacity of other nations.

Before the global financial crisis that erupted in late 2008, the vaunted Chinese export engine accounted for more than 40% of Chinese GDP growth. When Lehman Brothers collapsed, world trade collapsed. For the first time since the great recession of the 1930s, world trade remained in a prolonged contraction. China was abruptly confronted with a dramatic decline in world trade demand. Simultaneously, China experienced growing pressure for rising wages among its manufacturing industries.

During the collapse of world trade in 2008-09 China found urgent need to reconfigure its economy, and to seek greater growth from domestic consumption and the building of new structures, housing, and infrastructure. It was hard pressed to reconfigure exports from reliance on high labor-content to lower labor-content, much higher value-added manufactures. China too saw an opportunity to step up the building and selling of automotive products not only for its own market but also for sales abroad. China copied Japanese railroad technologies and began building a capability to sell and install major railroad infrastructure in other nations, aggressively seeking new markets in places like Africa and Latin America. China's technological capabilities advanced dramatically, enabling it to enter world markets for much higher value-added parts, components, sub-assemblies, and ultimately final products that enhance the capabilities of other national economies to increase productivity and economic growth.

It should also be noted that during this transition, Chinese exporters increasingly found they were competing directly with EU manufactured exports, most particularly with Germany's automotive and durable capital goods sectors. Thus, the recent weakening of the euro has become an added direct threat to the profoundly challenging Chinese transition, especially in competition for demand in the various emerging market economies around the world.

Similar structural transitions, to a greater or lesser degree, have also been underway recently in other Southeast Asian countries.

Dramatic World Trade Slowdown

However, at the time of the Lehman collapse and the ensuing collapse of world credit markets and world trade, a new pattern of economic "globalization" unfolded. First, the world experienced the

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longest, deepest contraction in world trade since the 1930s. Then, after a brief effort to regain its 2008 all-time peak, world trade was unable to regain the momentum of the last 50 years. Instead, world trade hesitatingly fell into a new pattern of weak and in some months negative growth, averaging no more than the rate of growth of world production.

In essence, world trade is no longer an express train available to weaker economies attempting to escape from weak domestic consumption by selling into faster growing foreign demand. This by itself poses a daunting challenge to governments that have populations grown accustomed to faster economic growth, including rising wages.

At least for the next several years world trade will probably grow far more slowly, at approximately the rate of growth of the world's more advanced economies.

But this slowdown of world trade growth poses yet another profound challenge. Most of the nations that turned to reliance on an export engine also resorted to increasing borrowings of capital from advanced economies which had been made extraordinarily cheap by UK, US, Japanese, and now European central banks' initiation of QE and zero interest policies (ZIRP). A huge flow of capital borrowed through short-term, near zero cost finance flowed to China and emerging market economies to fund the long-term restructuring of Asia.

Moreover, many Asians as well as foreign investors in Asia learned that securitization could be used to increase financial leverage, especially through nonbank financial intermediaries, often referred to these days as shadow banks. Importers of copper or iron ore in China learned that they could dump shiploads of ore portside, not for processing, but to be proffered as collateral for borrowing cash for investment in other activities. With few rules or laws and many regulators ready to "cooperate", the ratio of borrowings to underlying collateral in many commodities grew, and grew, and grew

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even more. Collateralization in China has grown to such a point no one really knows how heavily collateralized inventories of Chinese raw materials might be.

Not surprisingly, many world investors in iron and copper ore thought that Chinese demand was directly an indicator of Chinese economic growth, when much of the demand was not for industrial use but simply as a source of increasingly leveraged cheap capital. China discovered what London bankers have long exploited by means of rehypothecation of assets, borrowing and reborrowing up to four times the value of underlying assets to generate new cash for trading. However, the Chinese went further, often pledging the same assets to several different lenders, so that the multiple stages of rehypothecation may stretch far beyond four-to-one. This poses the horrific possibility that commodity-based collateralization could implode in the event of margin calls, forcing massive unwinding of commodity positions all at once with huge deflationary consequences for many world resources.

Now, in 2015, there is growing apprehension that the Asian region will not only suffer increased capital flight, but that the mountain of short-term borrowing will become more expensive to maintain, and the excessive leveraging embodied in commodity trading and shadow banking might implode.

The IMF and some central bankers around the world have intensified warnings of a possible massive reversal of capital flows out of Asia at a time when world trade had come to a standstill and global economic growth is slowing, leaving little means to service high and growing debt.

But while all of this reconfiguration of global manufacturing was taking place, another profound force of globalization was moving like a giant tsunami across world financial markets. Trading in stocks, bonds, commodities, currencies, and many other financial instruments became computerized, and through information technology became globalized. Trading was no longer limited by borders, and investors learned to trade among different asset classes worldwide. National regulatory rules were overwhelmed by globalized trading. Nowhere is this more visible than in global currency trading.

In 2015 the volume of world trading in currencies is more than $5 trillion per day. Decades ago currency trading was done through elaborate international banking mechanisms which cleared transactions daily but with banks taking significant fees for every transaction. Today, currency trading operates far faster, dominated by computerized, algorithmic trading operating in a few thousandths of a second per transaction. Such computerized trading is now popularly known as High Frequency Trading (HFT).

In 2015 world financial markets, especially currency markets, thus operate at an entirely different speed than anything dreamed about a decade before. Worldwide currency trading operates six days a week, 24 hours a day. HFT accounts for more than half of the total, and at various times of the day surges to about two-thirds of all currency transactions.

With HFT dominating, currency movements can easily take place faster and in far bigger swings than at any time in human history. We can already see growing examples of “flash crashes” in stocks and sovereign debt instruments like German Bunds, and it is evident that such events could easily occur in less liquid commodities. But abrupt, big currency movements are now also possible on a scale never envisaged by most currency traders just a few years ago.

Global Trade & Industrial Slowdown

In this context of global slowdown in trade, it should be expected that we shall experience a global slowdown in industrial production. As we look over industrial expectations in many countries it is becoming evident that new orders are weakening in many geographic locations. World shipping is slowing with transportation indices showing continuing declines in recent months. Capital spending plans are weakening everywhere, except perhaps in China where such plans are hastily being reconfigured in an attempt to put capital spending where it can be more productive. In the US, orders are weakening and companies are scaling back capital spending, often preferring share buybacks rather than spending on additional capacity.

This story of the evolution of globalization in the last 70 years does point to challenges for Japan that it has not faced before. Under “Abenomics”, Japan’s currency has moved dramatically from about ¥80 to the US dollar to more than ¥122. This particular level is especially sensitive because ¥122 is the breaking point of the trading range of the last 30 years. Computer programs are now being redesigned to consider the yen in an entirely new possible trading range, in a new context of slow global economic growth, currency volatility, and transaction speeds of a few thousandths of a second in markets operating 24 hours a day, six days a week.

When viewed in this global financial market framework, the valuation of the yen relative to other currencies can be seen as vital to most of Japan's Asian neighbors, including China. The key Asian economies are competing with one another in the same range of industrial exports, focused on higher value-added, lower labor-content exports of goods which enhance the productivity of other economies in transportation and industrial production. If the yen falls much more, South Korea would have to follow. China might wait until its renminbi is accepted into the IMF's Special Drawing Rights basket of currencies, but not long after that. China's remaining export thrust would be severely damaged if the yen were to fall significantly. (If the euro were to fall much more, China's trading sectors would also be under existential threat.)

In the US, there is much political controversy over the potential of further yen weakening, primarily driven by American automotive-related businesses and unions. This issue is increasingly being brought up in Congress as an instrument aimed at derailing international trade talks on the Trans-Pacific Partnership (TPP) trade agreement. A further yen decline will also heat up currency battles within Congress, driven by a variety of interest groups with specific constituency interests (for example, Southern States where Japanese and other foreign automotive companies have production facilities vs. Northern States which are home to the American "Big Three").

G7 Economic Summit 2015

The G7 Summit leaders met in early June 2015. They were all apprehensive the world had not yet fully escaped from the global financial crisis, and was instead in danger of slipping back into recession and financial market upheavals. They were also distracted by the impasse between Greece and the euro zone, and a potential Greek exit from Europe as we know it. The G7 could not reach any conclusions, but it was agreed by the European members that a US Fed rate hike later this year would not only be premature, given the weak status of the US economy, but could spark a global financial market meltdown across bonds, equities, commodities, and most worrisome, derivatives. Two days later the IMF's Christine Lagarde publicly warned the Fed of risks to the world associated with premature US interest rate action which might cause turmoil as Asia exits from short-term US dollar funding.

Fears of deflation in Europe and Asia have temporarily subsided, but with extreme swings possible in currencies and bond trading increasingly possible, a sprawling wave of deflation could occur without significant warnings. Deflation could also be spread across the world rapidly if several Asian currencies follow the yen further down relative to the dollar.

Thus, the breakout of the yen from its 30-year support level is a major event in terms of its potential effects on global markets. If the yen were to begin falling dramatically from its 30-year support level now, or in the coming months, South Korea would most likely have to allow its won to fall to remain competitive. Even more seriously, China would be unable to give up its ongoing changing export capabilities and rely solely on domestic consumption to drive growth. Chinese authorities would have to relax their grip on the yuan and let it fall dramatically, even though this would risk an even higher level of capital flight from China than has been taking place during the last several years.

China is already experiencing a dramatic economic slowdown. Official Chinese economic growth data are notoriously generated by central planning agencies which are expected to report growth consistent with recent official pronouncements of about 7.0% annualized real rate of growth. However, it is gradually becoming evident that China's real rate of growth is now far lower. Many micro indicators like electricity usage suggest near stagnation in key economic sectors.

Japan's Place Beside US, Europe & China in Single Global Marketplace

Globalization has become deeper and more pervasive in influence on every economy in the world. It has brought increased trade, more complex global logistical systems, greater exchange of technologies, and faster advances in innovation. It has also brought faster financial activities, enabling much greater swings in volatile markets at much higher speeds than ever before considered possible.

Globalization has also made the central bank management of economies much more difficult, as the policies of each central bank interact with all other currencies and financial markets. It is no longer possible for a central bank to manage nationally without considering the consequences of its actions internationally.

What is troubling in 2015 is that most governments, led by politicians, are focused on their own domestic challenges. When the global financial crisis erupted in 2008, the world's leaders agreed in the G20 to work cooperatively to address and resolve the crisis. Seven years later, each government seems to be moving autonomously, in separate directions, driven primarily by domestic politics and the complaints of citizens throughout the world that the world economy has lost momentum.

Historians will eventually address a question none can answer yet: was the global financial crisis already behind us, as President Barack Obama has suggested, or are we still in the same crisis, each nation thinking nationally while the world marketplace operates globally?

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