Tullett Prebon Research, a blog by Dr Tim Morgan

Is globalisation the culprit? The real story behind the slump

by Tim Morgan on November 1, 2012

Prompted by some of the research that I'm undertaking for a current project, I've been exploring the possibility that the ongoing economic slump is the direct result of globalisation. In essence, the thesis is that globalisation has distorted the normal relationship between production, consumption and debt beyond the point of sustainability. Put simply, the West is in irreversible trouble simply because it has consumed more just as it has produced less. Let's follow this through and see where it takes us.

A company in the US manufactures a television at a cost of $350, and sells it for $400, earning a margin of $50. The company then becomes able, courtesy of globalisation, to manufacture the same television in China for $50, boosting its margin from $50 to $350. The switch boosts the company's profitability, and creates a cash inflow that is banked by the company. At the same time, skilled jobs are lost in the US, and created in China.

Chinese workers, though still very poorly paid by western standards, have enjoyed a big increase in their earnings, and they choose to save part of this increase for a rainy day. Their employers, too, have swelling profits to bank. Cash piles are now expanding both in China and in the US.

Banks need to lend this money and, fortunately, they have ready takers amongst Americans who, having lost well-paid jobs and taken lower-paid employment instead, are increasingly dependent on debt to maintain their standards of living. Next, bankers, trying to create an even larger borrowing market beyond this group, create sub-prime. Interest rates fall, reflecting both surplus cash and a policy decision to boost consumer spending in pursuit of economic growth.

So far, so logical. But what has really happened here is that, in the US (and in the West generally), **production has diminished whereas consumption has increased**, making citizens ever more dependent on debt. Increasing your consumption whilst reducing your production is, by definition, unsustainable.

As other manufacturers get in on the globalisation act, the prices of televisions fall, from $400 to $300. Despite this, margins remain high. The declining prices of televisions (and other goods) cause policymakers to worry about deflation, and to act accordingly by cutting policy rates still further.

But the deflation fear is misplaced, because the expansion of activity in China (and in other emerging economies) boosts demand for raw materials. This has countervailing, inflationary effects, since surges in the costs of commodities more than outweigh declines in the prices of manufactured goods. The steady increase in credit-fuelled consumption in the West tips the balance in favour of inflation rather than deflation.

Unfortunately, this rise in inflation is masked by ever-more-misleading official data, such that real interest rates turn negative (which seems to have happened as long ago as 1997).

In the West, a small minority prospers, principally the CEOs of companies whose profits have surged, and bankers who gain from the expansion of the lending sector. On the other hand, the majority suffers, both because of declining wages and because of rising indebtedness.

The Western response to diminishing production is to expand service industries, but there must be significant doubt about how much real value is created by doing each others' washing. Meanwhile, the relationship between debt and incomes is getting out of control.

At this point, the merest whiff of suspicion about the impossibility of servicing (let alone repaying) the mountain of debt is all it takes to spook credit markets and, by reversing the surge in the prices of collateral assets, to expose gaping holes in banks' balance sheets.

The central banks are forced to step in to rescue the banking system – witness the explosion in the balance sheets of, for example, the Fed and the Bank of England – and no option remains but to resort to QE. The only difference between QE and printing money is the claimed intention of reversing it at some point in the future.

The next sequential stage – which probably lies in the very near future – is the realisation that the claimed reversibility of QE is nonsense. For example, do we *really* believe that the Bank of England can ever reverse £375bn of money creation?

And that, logically, is where the tragedy ends – in money-printing, hyperinflation and collapse.

Am I missing something? I certainly hope so……