FROM THE FOUNDER

Could Globalization Crack Up?

Here's a prediction: Barack Obama and the Democratic Party could, after four years, be out of power for a generation. The economic challenges are that daunting. The same would have been true had Mitt Romney won the U.S. presidential election.

I'm not talking just about the U.S. fiscal cliff or America's "budgetary crystal meth habit," as financier Bill Gross recently described Washington's inability to contain today's exploding debt. Nor am I merely referring to Japan's heart-stopping potential fiscal nightmare or the eurozone's losing struggle with austerity policies. Nor to the economic aftereffects of Hurricane Sandy, coming at the worst possible time for the United States.

The risk stems from something more fundamental: The globalization model of the past thirty years is at risk of cracking up. And there appears to be no new model to replace it.

Since April, an ugly economic world has turned uglier. The annual growth rate of total global exports has collapsed. Exports were a crucial engine in powering the U.S. economy out of the worst of the recession in the second half of 2009 and remain important for growth. Many of the world's important economic powers are highly export-dependent for GDP growth.

Lately, even China and India, which were thought able to decouple from the weakness of the industrialized world, have fallen victim to the seizing up of global trade. The World Trade Organization has slashed its estimates for trade growth. The UN Conference on Trade and Development reports that economic growth is weakening worldwide. The International Monetary Fund paints an ugly picture of the world economy.

Meanwhile, the Doha Trade Round is on life support. The world is at the edge of a currency war with more than a dozen countries beyond China manipulating their currencies against the dollar for trade advantage, according to the Peterson Institute for International Economics. China is experiencing trade deficits and has slapped tariffs on American-made automobiles in response to U.S. duties on Chinese tires. Leto Research analyst Criton Zoakos argues that rapid Chinese wage inflation and new software-based cost-cutting manufacturing technologies in the United States are setting the stage potentially to make the globalization model "obsolete."

Financial liberalization, including the free flow of capital, is also under worldwide pressure. Banks are rapidly becoming more nationalistic. This trend is heightened by regulatory barriers implemented in the

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wake of the global financial crisis and the subsequent eurozone crisis. In many cases, it is now more difficult for investment capital to move across borders.

The eurozone is at the heart of this deglobalization trend. European banks have traditionally been the source of roughly 80 percent of trade financing in emerging markets. Now these severely undercapitalized banks are forced to bring that capital home, and it is not clear that U.S., Japanese, or Chinese banks are in a position to fill the gap. Capital scarcity combined with the need for banks to retain more capital is inhibiting global trade financing and threatens to ratchet the deglobalization trend into higher gear. To be sure, the U.S. economy, with trade only 13 percent as a percentage of GDP, can limp along under these conditions, but achieving the level of robust growth needed for full employment will be difficult. That's because the rise of geopolitical tensions resulting from globalization's weakening risks is increasing U.S. investor nervousness, contributing to a debilitating risk-averse financial environment.

It is difficult to underestimate the degree to which this flawed, sometimes frightening good we call globalization has been the proverbial goose that laid the golden eggs. As a result, the public has unrealistic expectations about how much the economy can deliver in a post-globalization world.

To be sure, globalization's benefits have been unequally distributed. Financial liberalization has also led to a frightening rollercoaster ride of financial terror and heartache.

Yet at the same time the globalization period that began in the late 1970s, slowly progressed in the 1980s, and soared to extraordinary heights after the 1989 fall of the Berlin Wall led to a doubling of the global free-market labor force—from 2.7 billion to 6 billion. In the United States alone, globalization led to forty million new jobs under both Republican and Democratic presidents. Gary Hufbauer of the Peterson Institute has pointed out that America has been "$1 trillion richer each year because of globalized trade."

During this period, the Dow Jones Industrial Average climbed from roughly 800 in 1979 to over 13,000 by the end of 2007 as the brunt of the financial crisis was hitting. To match that stock market success in percentage terms over the next three decades, the Dow would have to far exceed 175,000.

In 2003, the peak of the era of financial globalization, financial services accounted for an absurdly high percentage of the U.S. stock market's earnings—30 percent—and 40 percent of corporate U.S. profits. Our regulatory guardians of systemic risk were asleep and the bubble burst. Yet now we have the opposite scenario. American banks are overregulated, risk-averse, and unwilling to fuel much of an economic expansion.

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No one can yet say what will replace this void in U.S. gross domestic product left by the shrinking of financial services. Many think the United States, with its ample natural gas supplies and new fracking energy retrieval techniques, can become an energy exporter. Yet reaching consensus on energy policy won't be easy. Energy is a political battleground where the promise of energy independence has been elusive for decades. Dramatic game-changing breakthroughs in innovation are always possible, but are impossible to predict.

Despite its flaws, globalization has been a wealth-creating machine. That is why the world's governments spent $15 trillion and central banks increased their balance sheets by $5 trillion in response to the financial crisis, essentially to try to save that machine.

Yet the globalization model is at risk of cracking up anyway—and there's no replacement in sight. Instead of addressing this dangerous tectonic shift in world economic affairs, our policymakers—the so-called G-20 of the world's most economically important nations—have become an ineffective sideshow with periodic gatherings of little relevance. The house is on fire, the roof is at risk of collapse, and the G-20 is having tea and scones sitting serenely in the parlor. No wonder the winner of the U.S. presidential election could end up the loser.

—DAVID M. SMICK
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