Globalisation and Derivatives

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Abstract:

Privatisation went global. So did deregulation. Implicitly, both became part of the Washington Consensus; and the woolly concept of globalisation provided an umbrella for everything that those who wanted to exploit it thought they could get out of it. Ill-defined, globalisation has been neither benign nor risk-free either for those on whom it has been imposed or the "globalisers". The United States has embraced a concept and practices disastrous not only to its economy and society but also to its political and strategic position and its continuing role as a superpower.

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1. Introduction

"Globalisation" is a facile and ill-defined term encompassing a variety of national policies and worldwide events. In 1999, former Fed Chairman Volcker called "Globalization… the glib catch word of the day." For him as for many others, it represented a natural, indeed inexorable, progression towards a "borderless world" with the virtual demise of the sovereign nation state and a decline in economic and other independence of emerging economies, under the globalised leadership of the major developed economies of the United States, Europe and Japan. In a 1999 lecture, he said:

"Consider all these trends—in finance, in industry, in monetary affairs—together. What we see is emerging countries wishing to participate fully in the world economy. Under the pressure of crises, they have been willing to sacrifice previously strongly held views about economic sovereignty and policy autonomy. They do not do so lightly. They do so because they perceive the balance of economic advantage is on the side of integration, not on the side of isolation. And technology makes it increasingly difficult to compromise the issue."

For a mostly silent majority who embraced "globalisation," faith often substituting for analysis gave the necessary stimulus and direction to economic and other activity. A more vocal minority saw the notion as overstated and its benefits less benign. Rather they saw globalisation as of doubtful value, potentially dangerous and possibly oppressive. This prompted debate between those who, on the one hand, see attractions in supranational authorities or concepts that compete with nation states and, on the other, those who continue to regard nation states as the principal actors in global politics and economics. The latter see security issues as still paramount, with peaceful, global change still a distant prospect. Volcker found it "both surprising and encouraging that so few countries, and so few influential voices in the developing world, seek to reverse the integration process, or even to slow it down. Mr. Mahathir in Malaysia is the principal exception, and Malaysia has adopted a rather comprehensive set of exchange and capital controls."

2. Containerisation

To a large extent, globalisation owes its origins, not to grand philosophical concepts or ideologies, but to such practical ideas as Malcom McLean's containerisation of trade. His first containership, *Ideal-X,* entered service on 26 April 1956. He expanded his enterprise by serving the American forces in Vietnam from 1965 and then by realising that his containerships could exploit Japan's wide-open markets by returning that way, almost cost-free, from Vietnam to the West Coast of the United States.

The new technology was quickly and comprehensively embraced by Japan itself: "Japan was the world's fastest-growing economy during the 1960s: between 1960 and 1973 Japanese industrial output quadrupled. Already the second-largest source of U.S. imports, by the late 1960s Japan was quickly moving up the ladder from apparel and transistor radios to stereo systems, cars and industrial equipment. It took little imagination to envision the potential for container shipping." [1]

Containerization radically changed the content of world trade. Among other things, it re-structured manufacturing worldwide. United States manufacturing began to wither, not through "free-trade" notions and negotiations in GATT or WTO, but through a revolution in national and international transport technology.

The first Japanese containership, owned by Matson partner N.Y.K. Line, completed its maiden voyage to America in September 1968. Six weeks later, [Malcom McLean's] Sea-Land began six sailings a month from Yokohama to the West Coast, its ships laden with televisions and stereos produced by Japanese factories. Other Japanese carriers entered as well. The Japan-West Coast route, which had no commercial container service at all before September 1967, was suddenly crowded with ships needing to be filled. Seven different companies were competing for less than 7,000 tons of eastbound freight each month by

the end of 1968, and more were about to join. The lack of business proved to be only temporary. The cargo would soon come, in a flood. The huge increase in long-distance trade that came in the container's wake was foreseen by no one. When he studied the role of freight in the New York region in the late 1950s, Harvard economist Benjamin Chinitz predicted that containerization would favor metropolitan New York's industrial base by letting the region's factories ship to the South more cheaply than plants in New England or the Midwest. Apparel, the region's biggest manufacturing sector, would not be affected by changes in transport costs, because it was not 'transport-sensitive.'
… Chinitz… was hardly alone in failing to recognize the extent to which lower shipping costs would stimulate trade. Through the 1960s, study after study projected the growth of containerization by assuming that existing import and export trends would continue, with the cargo gradually being shifted into containers. The possibility that the container would permit a worldwide economic restructuring that would vastly increase the flow of trade was not taken seriously. …Yet in the end, the logic of shipping freight in containers was so compelling, the cost savings so enormous, that the container took the world by storm. Half a century after McLean's Ideal-X, the equivalent of 300 million 20-foot containers were making their way across the world's oceans each year, with 26% of them originating in China alone. Countless more were being shipped cross-border by truck or train. [1]

An American idea, the product of American imagination and enterprise, containerisation helped moderate the tyranny of distance; and whittled away the "natural" protection distance gave to American industry. Containerisation came at a time when American advocacy of free, non-discriminatory trade was at his height in the 1950s and 1960s but continued to flourish robustly when, after 1969, the advantages of higher efficiency and lower cost of international transport came to accrue not only to the United States but relatively much more to those countries displacing it as the world's great suppliers and traders. Initially, that was Japan. The advantages flowed on strongly to the Asian Tigers and, increasingly after the 1980s, to China and India. A great American idea joined perniciously with poorly conceived monetary and credit policies and ideologies of free markets and free trade, to intensify the threat of self-destruction to American industry – and, ultimately, American power.

3. Closeness, Togetherness and Choice

There can be little argument against the notion of globalisation, in the sense that, in the last hundred and, more particularly, the last twenty years, people around the world have come closer physically and in ease of communication. The development of civilisation over past millennia has led us, not inevitably or without occasional setbacks, towards a world civilisation in which we can all, as one option, communicate and cooperate; or, as a less attractive option, debate destructively in a "road-rage" kind of irrationality and, ultimately perhaps, fight to the death and our mutual extinction. We can now communicate instantly with anyone else on earth. We can track events anywhere through television, radio or internet or through the traditional press which now has sources available with an immediacy never dreamed of before. We can travel by commercial jet from our home international airport to any other international airport in the world – now less than 20 hours away - in a single hop.

These are marvels that would have amazed and entranced earlier generations. But some negatives are terrifying. Attacks by our enemies or by terrorists can now be mounted more quickly than ever before; and intercontinental ballistic missiles can land warheads to devastate our patch of territory before we even know they're on the way. Immigrants can flood our territory legally or illegally – and perhaps bring diseases that will kill thousands, even millions. Whether through migration or normal commercial and tourist travel, those diseases will circle the earth anyway. The Black Death took decades to make its laborious way across thirteenth and fourteenth century Europe. Today, we travel so quickly and frequently as to contract a disease from someone halfway around the world as easily as from a next-door neighbour.

So, whether we like it or not, we are going to have globalisation – of some kind. Indeed, we have it already. Four hundred years ago, a dynamic Chinese society embarked on globalisation, making voyages from East Asian ports to the south and west as far as the Red Sea and Zanzibar. If they had persisted, they might have circled the globe, conducting their trade and promoting their civilisation with everyone everywhere and so have become like the Americans whose consensus - and McDonald's - spread around the world. But cautious policymaking bureaucrats in Peking decided that the enterprise should be halted, the adventurers should withdraw back into their own kingdom and the door be closed on "globalisation." The door was not closed for ever but its re-opening, for the Chinese, was postponed for some centuries. Now it is open again – and Chinese containers pile up in the United States, deep in central Europe, Africa and everywhere else where trade is done.

Are we now free – the United States and other globalisers – to withdraw as the Chinese once did or must we "globalise" incessantly? Can we withdraw into our own territories and live to ourselves? Can we decide that globalisation is too dangerous or too great a challenge and retire from the race, whether it might lead, on the one hand, to a miracle of fruitful cooperation or, on the other, to destructive, internecine conflict.

At almost any time in the past either option might have been at least partially open to us; but it is hard to imagine that it is still open to us – in any complete sense - now. We have some options as to the nature of the globalisation that we might advocate and support; but that is about all. Joseph Stiglitz wrote that, in Latin America, "the boom that the inflow of money had brought about was more than offset by the bust that followed." He went on to say that "The same could be said for each of the areas of globalisation. In the mid-nineties, [the Clinton administration] put forward a vision of the world in which trade liberalization would bring unprecedented prosperity to all, in both the developed and the less developed countries. By the end of the nineties, the treaties that we had hailed so proudly were seen as unbalanced, trade liberalization as a new way in which the rich and powerful could exploit the weak and the poor. Just as the market economy had not delivered what it promised to the countries of the former Soviet Union – it brought unprecedented poverty, not unprecedented prosperity – trade liberalization often did not deliver what it had promised. Export-led growth had been the hallmark of the most successful region in the world, East Asia, but the policies its nations had pursued were a far cry from the trade liberalization policies that had been pushed on Latin America. Latin American policies focused on opening up their markets to imports, rather than promoting exports, and too often jobs were destroyed rather than created." [2]

In some countries such as Zambia, globalisation caused whole industrial communities to disappear. Zambian businessman Parbhoo "once owned one of Livingstone's 40 factories in a flourishing textile industry. But output collapsed under East Asian competition, aided by president Chiluba's decision, egged on by the International Monetary Fund and World Bank, to slash protective tariffs rapidly in the early 1990s. So quick was the resulting implosion that most of the factory owners, disillusioned, left the country altogether. Of the 2,000 or so Indians formerly in Livingstone, about 150 are left. 'The rest went to the US or Canada,' Parbhoo says. 'Or they are running corner shops in London.' The theory of comparative advantage in trade, developed nearly two centuries ago by the English economist David Ricardo, holds that countries should trade freely and concentrate on what each is relatively good at. But in Livingstone the speed with which traditional industry collapsed led to much of the country's business class upping and leaving, taking with it the capital, experience and entrepreneurial drive that might have helped the country seize new opportunities." [3]

4. Derivatives

> "Long ago, Mark Twain said: 'A man who tries to carry a cat home by its tail will learn a lesson that cannot be learned in any other way.' If Twain were around now, he might try winding up a derivatives business. After a few days he would opt for cats."
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> - Warren Buffet, Annual Report to Shareholders, March 2006

The concept of globalisation and its practical application through the relatively free flow of capital in ever increasing volume opened the gates to ever more speculation and the creation of new or refinement of old financial devices. Derivatives became the rage. Existing derivatives trading could expand. New derivatives could be designed and used to give more security – as Greenspan was inclined to believe – or, as critics were inclined to note, more opportunities for high-risk speculation. The four basic categories of futures, forwards, options and swaps, often wrapped up in such a comprehensive term as "hedges," spawned a myriad of varieties and sub-groups.

The crowd of companies and corporations dealing in some form of derivative grew to become a huge, largely unregulated and, in some respects, undisciplined mob. The opportunities for large and almost instantaneous gains from derivatives trading expanded and inspired more enterprises to enter the trade and deal, around the world, twenty-four hours a day. Not all were cowboy traders but the cowboys tended to give character to the derivatives environment more perhaps than the respectable institutions that joined in the daily hurly-burly alongside them.

Some, including those in regulatory positions, saw more benefit than danger in derivatives: "Alan Greenspan, long-time Chairman of the Federal Reserve, noted in 2003 that 'The benefits…have far exceeded their costs.' He also said that the 'growing array of derivatives and the related application of more sophisticated methods for measuring and managing risks had been key factors underlying the remarkable resilience of the banking system.'" [4] However, others were more aware that derivatives "indirectly or by virtue of their structure (e.g., options), almost invariably employ some element of leverage (i.e., 'other people's money')." [4] This was likely "a spur to their increased usage among amateur and professional investors (and speculators) alike, especially in recent years." [4]

Participants are of many kinds and of various degrees of experience and responsibility: "Adding further fuel to the fire has been the liberalization and globalization of financial markets. Because of competitive pressures and the ease with which capital flows between firms, markets and countries, activities that used to be limited to large firms in highly regulated sectors (e.g., banks) are being taken on board by all and sundry. Often in locations where standards are low or oversight is lax. Hedge funds, insurers, corporate treasuries, the finance arms of industrial companies, and other non-traditional players are increasingly involved in the derivatives market. For the most part, they have less stringent capital requirements and less of a history managing complicated financial risks and broad credit exposure through several cycles of economic activity than banks do. In sum, there are more inexperienced players taking part, more firms with diverse -- and occasionally inadequate -- capabilities linked to each other, and a maze of overlapping and often competing jurisdictions. This suggests that a simple solution, or even a consensus, will be almost impossible to find if and when the worst-case scenario does come to pass. Scarier still, it is likely the disease that typically goes hand-in-hand with disasters of the money kind will be transmitted around the world at light speed because of modern technology and advanced communications networks. The far-reaching epidemic that people don't usually like to discuss in mixed company, let alone acknowledge, when the worst unexpectedly happens: panic and contagion. Throughout history, they have been a recurring feature of convulsing markets and dramatic financial crises. When people are calm and otherwise thinking clearly, they tend, more often than not, to act rationally. However, when problems arise and even the most sophisticated players become terrified of losing their jobs or their shirts, or they are overwhelmed by the sheer scale of potential risks they are confronted with, they frequently experience a primal fight-or-flight response. Or even temporary paralysis -- like the proverbial deer in the headlights." [4]

In his report to shareholders in March 2006, Warren Buffet wrote, "We lost $104 million pre-tax last year in our continuing attempt to exit Gen Re's derivative operation. Our aggregate losses since we began this endeavour total $404 million." However, there was an even scarier contingency*:* "Gen Re was a relatively minor operator in the derivatives field. It has had the good fortune to unwind its supposedly liquid positions in a benign market, all the while free of financial or other pressures that might have forced it to conduct the liquidation in a less-than-efficient manner...It could be a different story for others in the future. Imagine, if you will, one or more firms (troubles often spread) with positions that are many multiples of ours attempting to liquidate in chaotic markets and under extreme, and well-publicized, pressures..."

Though large, Buffet’s company is a minor player in the huge derivatives field. Most derivative positions – that is, how the bets will come out – are imaginary. Both sides to a transaction enter a win in their accounts. Everyone values the derivatives in their accounts to give the most glowing picture. If all these positions are brought together as aggregates, what do they mean for the United States economy as a whole? One analyst says that “As real wealth leaves the country at roughly $1 trillion per year and debt service to foreigners continues to mount, the net profitability of corporate America has depended ever more on a web of lies and accounting fraud. The Fed has taken as much volatility out of the market as was necessary to keep the Ponzi schemes from unravelling to date, but the question remains as to how long this can go on. Eventually America will wake up to realize that its wealth is gone (transferred into the hands of wealthy foreigners and corporate executives). All that remains of many of America's great financial corporations is just a glittering shell, as real assets have been rotting away at the core.”

This shell might be shattered if one major or high-profile player collapses. In March 2006, markets were worried that General Motors, already burdened with huge losses, was now sliding even closer to the brink of bankruptcy, through its finance arm, GMAC. Huge, hidden losses at GMAC of some $2 billion through “accounting errors” associated with its immersion of $200 billion in credit derivatives sent tremors through the financial markets. This was at a time when global investors were already jittery about the modest crash of the Icelandic krona, with repercussions for assets in countries as far apart as Hungary, Turkey and New Zealand. Especially with simultaneous credit-tightening in the United States, Europe and Japan, something of a repeat of the 1998 LTCM crisis that, according to the Fed at the time, put the whole global financial system at risk, was feared. President Geithner of the New York Fed was reported to be demanding that the International Swaps and Derivatives Association (ISDA) clean up its act before - not after - any credit crunch. He said the "most conspicuous" problems were in the $12,400 billion market for credit derivatives, which have doubled in size every year for the last decade.

The credit-derivatives concept dates only from about 1997 with the launch of a financial product called Bistro (Broad Index Secured Trust Offering). It caught on and spread like wildfire to the $12.4 trillion market today. In a world already gorged on massive credit, Bistro and imitations allowed banks to expand loans, sell the risk of default and so leave their reserves ready for more loans whose risk again could be sold on. Just how much new expansion of credit the new derivatives have created, we do not know, but $12 trillion must have allowed a lot.

A worrying feature is that we do not know where the risk of these loans – almost certainly based on reduced borrower quality – has now settled. With further innovations already on the drawing board – derivatives of derivatives and "derivatives cubed" - one observer says that "the whole credit derivatives world has exploded at such a dizzy pace that nobody is exactly sure where the loan risk has gone. Have all the investors who have bought credit derivatives contracts checked the fine print to see what losses they could sustain? Does anybody understand the chain reaction that might be triggered by such losses? Could the world's trading system cope? And what would happen to those hedge funds that have been jumping into the credit derivatives world?" [5]

A further twist is that JPMorgan has been a pathfinder in the credit derivatives business; Bistro was their brainchild. JPMorgan Chase is one of the two United States clearing banks. Recently contingency plans were agreed if one or other or both banks should default. "Securities dealers need a contingency plan in the event one of the clearing banks is forced to exit the markets," commented Micah S. Green, President and CEO of the Bond Market Association. "Establishing New Bank is a prudent market-based initiative aimed at mitigating any potential problems caused by the sudden involuntary exit of one of the banks." No current evidence suggests that either of the clearing banks will be unable to fulfil its role in an emergency; but the pace and size of the financial evolution in recent years suggest that we can never be entirely certain where the risks lie, how large the potential liabilities are and what impact, in almost every direction of the financial compass, a collapse of some credit feature will have.

5. Commodities

While there has been this intense trading in derivatives and the creation of a staggering variety of pieces of financial paper, there has not necessarily been any equivalent expansion of real investment even, for example, in exploration for and exploitation of raw-material commodities. BHP merged with Billiton in 2005 not to expand exploration or immediate production but, "By building on our pasts and combining the assets of each company with the very best of our skills and people, we have created a company that is ideally placed to lead the resources industry into the future." The merger did not in itself create any new real, fixed-capital investment. Incentives for such investment came only as commodity markets emerged, in 2005, from the long slump in commodity prices since the 1980s. Now a booming demand for a wide range of commodities came from the newly industrializing countries, especially China and, more recently, India. This demand will not reach its peak probably for some years ahead; but now two countries with a combined population of more than 2 billion are developing – and industrializing - rapidly. They are being joined by some other countries, especially the Latin-American giant Brazil, with a population of 186 million.

The escalating industrialization of these countries has already pushed commodity prices to new record heights. The bell-wether commodity of copper reached a record price above $4,000 a ton in the latter part of 2005 and continued to rise well above $7,000 in 2006. This will provoke more active exploration; but, unless production of copper and a wide range of other commodities can be increased in the foreseeable future, prices are likely to rocket still higher and to be maintained at high levels for a long period. In the past, a period of low commodity prices which has depressed exploration and exploitation has been followed by a long period of rising prices which have stimulated exploration and production. In the period ahead, the further emergence of India, China and Brazil into the forefront of industrializing countries will provide robust reinforcement to this cyclical trend. A powerful injection of real investment will be needed rather than the merger-and-acquisitions type of ownership investment that has marked the commodity sector in the last twenty years. The signs are that this is beginning, just as one example, at the great multi-mineral Olympic Dam site in South Australia.

6. Globalization Spurs American Self-Destruction

One neglected feature of globalization is its impact on United States industry – and the industry of those countries that have adopted the American "model." The literature pays attention to damage done by globalization in the ***developing*** countries and to the impoverishment of their people. However, worthwhile attention is seldom paid to the ways in which the American model destroys American industry and the key role that globalization has played and continues to play in that self-destruction.

At the beginning of 2006, the well-informed Daily Reckoning told us that "We've yet to see a new factory built, or much real capital spending in the United States. Instead, the capital is being spent in Asia." [6] Here is one of the main keys to the problems of the American economy. The capital spending, creating new industrial giants, is being done in Asia. That's not new. It's been going on for years now, with no sign that this particularly striking expression of globalization is going to stop any time soon.

Another deeply worrying aspect of the American investment profile is that there is not only a lack of will to build factories or install new capital equipment but, when companies do “invest” in the United States, they do so mainly to enhance shareholder value. The obsession with shareholder value – based on the notion that wealth is created through rising asset prices – has become characteristic of the present American culture. To create business profits through mergers, acquisitions and cost-cutting is another great fallacy - and folly - that continues to damage the American economy. Corporate America’s profit performance has gone almost persistently from bad to worse since the early 1980s, a slide due not despite the new strategies but because of them.

By manipulating share prices upward through grossly overpriced mergers and acquisitions, managers have satisfied their shareholders and themselves. That has become – not unnaturally - the supreme goal of America’s new equity culture. Unfortunately, however, the spectacular enhancement of market valuations entails a variety of macroeconomic effects – on profits, business fixed investment, debt levels, balance sheets, interest expenses, corporate net worth, the current-account deficit. On balance, those effects seriously damage the whole national economy. In anything but a short-term and superficial sense, it is corporate self-mutilation. Much more importantly, it diminishes or destroys the solid base of the United States economy – as well as the political, strategic and every other base on which the standing, authority and power of the United States rests.

These harmful effects go back to the 1980s. By long tradition, America has been a high-consumption economy with relatively low rates of savings and investment. The declared primary aim of the much-heralded supply-side Reaganomics was to remedy this structural deficiency; but the policies failed on virtually all counts. Instead of growing, national savings and net capital investment plunged to unprecedented lows. As the advocates of supply-side economics had promised, the economy was, indeed, restructured, but – and here’s the rub - in a manner exactly contrary to their declared intention. In 1989, personal consumption accounted for 65.5% of GDP, as against 62% in 1979. At the same time, the share of gross fixed-capital investment in the non-financial sector shrank from 12.9% to 11.1% of GDP. National saving fell to 2% of GDP, compared with an average of almost 8% in the 1970s. The balance-of-payments current account sank into substantial deficit: from a near balance and perhaps even a small surplus in 1981, to a deficit equal to 3.5% of GDP in 1987.

What propelled the economy during these years was not booming corporate fixed-capital investment on the economy's supply side, but rapidly increasing debt of consumers and the federal government on the demand side. We repeat: consumers and the government provided the economy's dynamism not from the loudly heralded supply side but from the demand side. In other words, just as in the 1970s, though by a different route, policies succeeded not in reducing inflationary or stagflationary pressures but rather in intensifying them.

As well as consumers and the federal government, corporations also stepped up their borrowing, for the first time not for new fixed-capital investment, but mostly for mergers, acquisitions, stock repurchases and leveraged buyouts. As corporate debt soared while new fixed-capital investment lagged, the corporate sector's real net worth went into steep decline. As the 1980s ended, finance capitalism of a new kind – a casino-like capitalism based on an increasingly wide variety of speculative devices – was well on the way. To make money – quickly – rather than to enhance the real economy – rather more slowly – was now and became increasingly, in the 'nineties and the new millennium, the order of the day.

Of the Clinton Administration's policies of globalization, Joseph Stiglitz wrote that "we were focusing on helping the United States – even if it made the poor poorer, as it did so often. We were more concerned about the ability of Western countries to take resources out of Africa than about contributing to the long-term well-being of Africa." [7] Perhaps that judged fairly the selfishness and greed of many Americans who did deliberately and consistently act in that way. Another commentator spoke appreciatively of the strength of the American economy during the past twenty-three years, "during which there have been but two relatively shallow recessions" which "speaks eloquently of the resilience that comes with the globalization of trade and capital flows". [8]

In reality, however, globalization was less a prop for American prosperity and growth – less a prop that conferred resilience when markets turned down - than part of the means by which the United States inadvertently set itself on the road to self-destruction in the last part of the twentieth century and continues along that road six years into the twenty-first.

Under the guise of globalisation – and the free flow of the freest of private enterprise around the world – the United States, through its government and its corporations, has, in effect, succeeded in diminishing the productive power of the American economy that, in its finest hours, was its greatest strength; but that is not all. It is difficult to attach relative values to various parts of the outcomes of American follies of the past thirty years. However, as well as diminishing American fixed-capital investment and gutting a large part of American industry, the United States also succeeded in building up, at a pace and on a scale that has never been seen before, the productive capacity of other economies, some of which would inevitably be its rivals. This rivalry would express itself initially in economic and financial forms; but that would not be where it would end. From economic and financial power, there flows – as the Americans know better than anyone – political and strategic power. Richer and stronger rivals will issue ever more formidable challenges. In the end, they might take the master's place – America's place - at the top table and sit in the master's seat.

7. The Rake's Progress of American Corporations

As a percentage of GDP, American economic growth after 1980 appeared to be good; but its pattern and structure were badly imbalanced. The following decade of the 1990s divides into two strikingly different parts. For the consensus economists, the years until 1996 were the less satisfactory period, with economic growth below par, while the years afterwards were the vivid, booming "new-paradigm" years. However, the patient's real condition was not quite in keeping with that diagnosis.

Healthy economic growth shows primarily in high rates of real capital formation and profit growth. By these two measures, the United States economy performed best in the first half of the 1990s and miserably in the 1980s and, surprisingly, also in the late 1990s. It was in the first half of the 1990s that, in reality, net capital formation and profits were at their best for more than two decades. After their poor growth in the 1980s, both suddenly took off in steep upward curves.

A crucial question is whether the situation in 2006 resembles the favorable period of the first half of the 1990s or compares more convincingly with the 1980s and the second half of the 1990s. Regrettably, there are highly significant differences between the situation in the earlier 1990s and the situation today. Those differences relate to interest, depreciation charges and business saving and the way in which these factors have impacted on net business investment and, finally, the trade deficit. These factors have added to the cumulative cost of previous monetary policies and globalisation.

Let us look at each of the factors in turn.

(i) Interest Charges

A very obvious difference between the two periods can be seen in the trend of corporate interest expenses. In the early 1990s, corporate earnings profited greatly from a steep decline in the burden of their interest charges as rates went down. In 1996, interest expenses of $108 billion compared with before-tax profits of $460 billion. That was a huge improvement compared with 1990, when interest expenses of $156 billion had compared with before-tax profits of $329 billion. From that, we go to the situation more recently when, in 2002, annual interest charges of about $193 billion compared with before-tax profits of about $320 billion.

A decline in interest rates has typically boosted profits in all previous cyclical recoveries. In the 2001 recession and recovery, the Fed slashed its rate to unprecedented post-war lows. However, interest expenses stayed high because, unlike the experience in all previous post-World-War-Two recoveries, corporations were unable to convert debt into equity through the stock market. American stock markets remained so overvalued that even the dramatic monetary easing of the Fed failed to push them to still higher levels. “Stocks are overvalued by every historical measure,” Agora Financial declared in a “Survival Report” of March 2006. Consequently, debt levels for the corporate sector as a whole remained at all-time highs relative to the size of the economy, thus maintaining interest outlays at exorbitantly high levels.

Depreciation charges were an even greater burden on corporate outlays, largely because corporate investment in the United States has shifted strongly toward short-lived, high-tech investment in, for example, computers. Consequently, a rapidly growing proportion of gross investment represents replacement of existing stock, that is, depreciation charges whose sharp acceleration in recent years has inevitably eaten away more quickly at net profits. The difference between the early and the late 1990s was striking. During the first half of the 1990s, the rise in the non-residential sector’s depreciation charges averaged $27.4 billion a year. Between 1996 and 2001, it averaged $55.4 billion a year. Since then, it has been running at an annual rate between $60 and 70 billion.

The exceptional increases in interest and depreciation expenses have meant that funds available for business saving and thus for re-investment in American enterprises have been savagely reduced. The reduction of business savings has entailed a drastic reduction in net business investment.

(ii) Business Dis-saving

Cash available to businesses for investment comes from undistributed profits minus depreciation charges. Due to the massive shift in corporate investment toward short-lived investment, capital consumption and depreciation charges almost quintupled between 1980 and 2002 from $231 billion to more than $1,000 billion. By contrast, the other cash-flow component, undistributed profits, representing business saving, fell sharply. After averaging 2.9% of GDP from 1950 to 1979, they declined in the 1980s to 1.8%. They fell even further after 1997, hitting a record low in 2002. Undistributed profits have now plunged deeply into negative territory – for the first time since the Great Depression. A major reason is, again, obsession with short-term shareholder value; so that corporations keep paying ever-higher dividends out of ever-lower earnings. Until about 1997, corporations paid rising dividends from more sharply rising profits, leaving increased undistributed profits. Since then, the situation has reversed so fundamentally that undistributed profits are and likely to remain negative.

In 1997, non-financial corporations paid $218.1 billion in dividends from $337.7 billion in after-tax profits. In 2002, they paid dividends of $285.8 billion out of sharply lower profits of $197.0 billion. In other words, they financed a substantial and growing part of their dividends by drawing on their cash reserves or borrowing. In past, more normal times, the distribution was about half and half – half after-tax profits went to dividends, half were undistributed. That reflected underlying profit trends. Now, we have the exact opposite. Dividend payments have been rising to an all-time high as a share of national income, while profits, by the same measure, have fallen to an all-time low. Excessive and what would once have been regarded as highly imprudent dividend payments are now used to prop up overvalued stock prices. The flip side is that balance sheets are not repaired but plundered ever more by corporate managers. In more rational times – when the whole corporate world was not joining in the fashionable financial folly - it would have been regarded as a policy of corporate cowboys, con-men or people reduced to the absolute depths of financial desperation.

The macroeconomic effects of these trends – the impact on the American economy as a whole and on the place of the United States in the world power system – are important. Growth of investment in tangible assets – factories, commercial buildings, machinery – is paramount in creating national wealth and corporate profits. With the focus on the non-residential and non-financial sector, high-investment economies have historically also been high-profit economies. High profits stimulate high investment and nurture its persistence. From the macroeconomic perspective, high investment spending creates high profits, high profit expectations induce continuing high rates of capital investment and high investment spending makes for their self-fulfillment. This virtuous cycle nourishes growth, employment, income and wealth.

However, a widely held view, particularly in America, is that business profits have their main source in consumer spending as by far the biggest GDP component. This is one of the greatest fallacies in assessing the American economy because total consumer incomes, being the main source of the consumer's spending – wages, interest, rent, etc. – derive from economic activity; that is, they derive essentially from business spending. By buying goods and services, the consumer recycles business expenses. However, to the extent that he saves part of his current income, his recycling falls short of the expenses that businesses have incurred in their activity. To make a profit ultimately, supplementary business revenue is needed in excess of consumer saving. Here is the crucial role of fixed-capital investment.

Traditionally and characteristically, the largest and most important profit source of the business sector is its own spending on net fixed-capital investment. This spending is so important because, from a macro perspective, it adds to immediate business revenue without immediate business expense. Firms capitalize their investment spending in their balance sheets, incurring no expense until depreciation charges begin a year later. On the other hand, the manufacturer who produces and sells the capital goods registers this in its full amount as immediate revenue. This illustrates the close causal relationship between business net fixed investment and profit creation.

A sustained economic recovery by the United States requires, as an imperative, a powerful rebound in net fixed-capital investment and profits. However, with depreciation charges at their unusually high level, it needs still higher gross investment to yield any increase in net investment. In 2001, it took the abnormally high sum of about four and a half dollars of gross fixed investment to yield just one dollar of net addition to the capital stock.

(iii) The Trade Balance

Having identified some of the unfavorable developments in interest and depreciation charges that directly affect profits, we must now concede that there are still other major impediments to economic growth. They are in the balance sheets, they are in the stock market and they are also in the economy's gross imbalances. That last brings us to one of the largest impediments, one that has been with the United States – and some other countries - for the best part of a quarter of a century and that, especially in the last ten years, has tended to grow to ever more gigantic proportions. It is an impediment to which American policymakers and economists have tended to be curiously blind. They have been blind to its causes and, for the most part, confused about its implications. This monster impeding United States growth, employment, investment and most other factors crucial to the health of the American economy is the huge trade deficit – the yawning gap between the production and consumption of goods and services in and by the United States economy. Here we come back to confront squarely and unequivocally issues involved in globalisation.

Especially for the Americans, globalisation has tended to mean that individuals and corporations are free to go ahead and make their fixed-capital investment overseas, make their profits overseas and, in large part, recycle them overseas and import as much as they can, at the lowest possible prices, to feed the voracious American consumer. In total inadvertence on the part of most Americans, the practices deriving from these freedoms have constituted a recipe for economic self-destruction – and, in the wider view, for national political and strategic suicide by the United States.

Again, we note the curious complacency with which the chronic and growing trade deficit has been regarded. Many analysts and observers have seen it as proof of the strength of the American economy and the intellectual and commercial brilliance of those who manage American policies. Some see it as a distinguishing mark of uniquely successful American "imperialism" of the late twentieth and early twenty-first century. In short, what might characteristically have been regarded as a pernicious economic imbalance by most policymakers and economists in the past is now treated by many distinguished observers as an irrefutable confirmation of American power.

In fact, we suggest that the trade deficit reflects an excess of domestic spending over domestic production. Its cause, its size and its persistence are all tied up with the notion of globalization whose free flow of international funds has permitted shifts in the impact of consumer-price inflation – through the capacity of imports to mop up the excess of domestic spending over domestic production – and has allowed the untrammeled substitution of fixed-capital investment by "ownership" investment on a global scale. Without globalization, the process of economic and financial – and political and strategic - change would have been much slower and some decisive rectification of imbalances of a variety of kinds would have had to be undertaken much earlier. The delay in making that rectification probably means that we will need much more drastic and painful measures to correct imbalances when the time finally and inevitably comes to correct them.

In the United States, the trade deficit specifically reflects unprecedented over-consumption and under-saving, causing pervasive, deleterious effects on the economy, among them the strangulation of manufacturing. The trade deficit has been a major contributor to poor profit and income outcomes for American corporations and American workers. It is worth noting that the fluctuations in the United States trade deficit since the early 1980s coincide with fluctuations in corporate profit performance. While the trade deficit is not the only influence on profits, it is certainly a major influence. During the 1980s, the profits record of American corporations was very poor until 1986. Then profits took off – mainly in manufacturing - coinciding with a sudden, robust improvement in the American trade balance. An unusually steep rise in profits followed until 1997. Assuredly not by accident, these were also the best years for the American trade balance which improved until 1993 and deteriorated only moderately in the following years. The dramatic turn for the worse both for profits and the trade balance started in precise coincidence after 1997. As the trade deficit exploded, profits imploded.

The close connection between the two derives from the gap that the trade deficit creates between United States business revenues and expenses. Clearly, the greatest part of the money that the consumer spends on the soaring import surplus comes from the business sector's wage bill. Instead of recycling it through purchases of domestic goods to domestic producers, he diverts it to foreign producers, boosting their revenues and profits. It is globalization's revenge on the rapacity of American globalisers.

Profits and incomes are created by spending. Consequently, a diversion of domestic spending to foreign producers – in early 2006 – to the tune of around $800 billion a year, must necessarily exert a heavy drag on incomes and profits in the deficit country. (The United States is not unique in this effect. A country like Australia has experienced fundamentally the same outcomes – from globalization and associated doctrines - in the last twenty to thirty years.) To sustain domestic incomes and spending, more and more domestic credit and debt creation is needed. Obviously, this is a policy for which, sooner or later, there must come a day of reckoning.

Ominously, the deficit has been establishing ever-new records in the first half dozen years of the new millennium, even though American domestic demand growth has slowed sharply. After hitting an annualized record $546 billion in the fourth quarter of 2002, the deficit moved, during 2005, to an annualized rate of $640 billion and then to an annualized rate at the end of the year of around $800 billion. The deficit has surged from 5.2% of GDP at the end of 2002, to about 6% in the middle of 2005 and more than 7% in the early months of 2006.

Given the persistence of the consumer borrowing-and-spending spree, nothing else could reasonably have been expected. The latest monthly deficits have been getting close to $70 billion. Year-on-year goods imports have risen about 12% contrasted with an equivalent rise of about 5% in goods exports. Even this customary comparison of growth rates is misleading because they relate to substantially different export and import values. The 12% rise in imports is on annualized goods imports of $1300 billion in early 2002; the 5% rise in exports is on goods exports of only about $700 billion at that time.

We cannot expect any real moderation of this situation – unless there is a fundamental change in American policies or some sensational development in the world economy. Otherwise, the trade deficit is destined to swell further, if only because the mathematics of the imbalances have become so daunting. Imports of goods and services are now about 1.5 times larger than exports. This means that exports have to grow 1.5 times faster than imports just to keep the deficit from widening further. When we look at the deficit in these terms, we can only conclude that, like so many other features of the American economy, the trade deficit has – under the influence of the invisible hand, deregulation, the “free” market and globalisation – ballooned out of control. However, if only to confirm that United States policymakers and economists – feckless as they may be - are no different in quality and understanding from their counterparts elsewhere, we stress again that, especially in some other Anglo-Saxon countries, the trade deficit is, if in the hands of anyone, only in the hands of the gods. The New Zealand trade deficit, for example, in relation to GDP is even more spectacular than that of the United States.

In a very real sense, China has derived huge benefits in terms of economic development from the markets it has been allowed to exploit in the United States. At any time before 1980, she could never have imagined in any optimistic fantasy enjoying such a miracle of favourable policies from the biggest and richest consumer market the world has ever known. However, the miracle has persisted now for more than a quarter century not because of anything that China has done – except for Deng's new course proclaimed in 1979 – but because of self-destructive policies adopted by the United States.

8. Conclusions

Our conclusion must be that globalization has been costly for the United States, though it may have brought short-term gains for Corporate America. The lifts in shareholder value have enhanced rewards to corporate chiefs who now receive more than 10% of corporate revenues as contrasted with less than 5% twenty years ago. However, American middle and lower income earners have suffered severely in the new economic and financial environment that globalisation has played such a significant part in creating. "As Americans," Robert Kuttner wrote, "we have [in the past] benefited from a social compact of protections enacted by our democratically elected representatives – minimum wage laws, safety and health laws, social insurance, consumer safeguards, the right of workers to unionize and so on. When we trade with nations that have no such protections, we run the risk of importing the absence of a social compact along with the products. That doesn't mean we should seal up our borders, but it does mean we should look harder at the terms of engagement. Shouldn't we insist on certain social minimums in nations that want to trade freely with us? Should we allow the exploitation of foreign labor to lead to the battering down of wages and standards at home? Business insists that trading nations respect its property rights. What about human rights and social rights?" [9]

Globalization has globalized the opportunities for American corporations and individuals to enrich themselves by extending their short-term shareholder-value culture and their casino-finance activities beyond the United States to the whole world economy. Globalization has allowed funds to be moved easily and quickly to take instant advantage of opportunities offering in Asia, Africa, Latin America or elsewhere. There is no need to endure the patient wait for funds carefully invested in fixed-capital to yield their rewards many months or years down the track – and even then have those rewards ignored by analysts and markets. Analysts and markets have become more interested in speculative – and spectacular - enterprises yielding quick profits on a relatively grand scale. How long would it take for an investment in a traditional factory to make the sort of profit that George Soros is reputed to have made on his gamble on the British currency in the early 1990s? How long would it then take for that profit to be reflected in shareholder value on the stock markets?

Globalization has meant that opportunities for making gains of billions of dollars increased almost every year, in a variety of markets. Soros warned that “Extending the market mechanism to all domains has the potential of destroying society”; but there was never much chance that he would have made his own gains, so quickly, in more traditional enterprise. Nor was there any chance that the legions of other global speculators would be ready to neglect new opportunities to make such profits in the future. “The potential of destroying society” is there but that will not destroy the “market mechanism” so long as the potential for profits – large and quick – is there too.

In the end, however, we will be compelled to evaluate globalisation by what it delivers in political, social, economic and, ultimately, strategic terms. If, as it seems, it has indeed contributed to the destruction of the American economy – and the American society - as well as to intensifying poverty and distress in the third world, then its essential features need to be re-examined to determine their positive and negative outcomes and their realistic prospects for the future. Globalisation should not continue to be embraced because it is imagined to offer some sort of “pie-in-the-sky.” Nor should it be a sort of secular faith that may or may not deliver the rewards of a cooperative, prosperous, thriving humanity, living in peace with itself that, in recent years, so many of us have blissfully, but naively imagined it to promise.

In conclusion, globalisation could, conceptually, be a useful means of promoting peaceful change – in the developed and developing world – but we need a more precise definition and a clearer understanding of the ways in which national economies and the world economy should operate so as to avoid globalisation’s economic, financial and social pitfalls. Rather than a globalisation based on greed and error, our goal should be to embark on the more enlightened and productive paths that, in vague ways, some of the more discerning but cautious protagonists of globalisation have envisaged. By working together in practical ways, we might thus realise a vision of peaceful change, conquest of poverty and disease, and carefully protective exploitation of the planet we all share. The last should be in ways to secure rather than ravage what we may reasonably hope for ourselves and our children in the future.

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3 “Dipak and the Goliaths”, Alan Beattie, FT Magazine, 10/11 December 2005, p. 22

4 Michael Panzner, “The Coming Disaster in the Derivatives Market,” 12 November 2005

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6 “The Daily Reckoning”, London, 5 January 2006.

7 “The Roaring Nineties”, op. cit., p. 237.

8 “With Rosy Predictions, Pundits Missing 2006's Warning Signs” by Steven Pearlstein, January 4, 2006, p. D01

9 “The Dubai debacle: How free is trade?” IHT, 15 March 2006, p.7.