

# Table of Contents

From globalization to localization . . . . . 1



# From globalization to localization

By Stephen Roach

Morgan Stanley's Chief Economist creeps ever closer to acknowledging the implicit content of his 'bear market' line. In fact this time he even includes a graphic purporting to map the quantitative 'battle between labor and capital', before disingenuously diverting the question into spurious terms like 'globalization and localization' and even more oddly imagining the 'labor' side of the 'battle' as something fought by 'pro-labor' politicians like Prodi, Zapatero et al. Notably absent are battle sites like Bangladeshi textiles, Chilean copper mines, etc., where elected representatives have nothing to add.

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From Globalization to Localization

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Stephen Roach

**What's new:** Globalization hasn't exactly lived up to its "win-win" billing. While the developing world has benefited from the first win, in the rich countries the spoils of the second win have gone mainly to the owners of capital. This has sparked a political backlash that could favor a "localization" — driven by the self-interest of individual nations.

**Conclusions:** There is a striking asymmetry to globalization's macro impacts: (1) With China leading the way, living standards have improved dramatically in the developing world; benefits have been shared both by workers and by the owners of capital. (2) Benefits in the developed world have been skewed away from labor; for the "G7-plus" group of industrial economies, the labor share of national income fell to a record low of 53.7% in mid-2006 while the profits share soared to a record high of 15.6%. (3) The pro-capital bias of globalization's impacts on the rich countries could sow the seeds of a pro-labor political backlash in the US, France, Germany, Spain, Italy, Japan, and Australia.

**Market implications:** Macro impacts of such a pro-labor agenda: Wages could go up and corporate profits could come under pressure. There could also be heightened regulatory scrutiny — especially with respect to perceptions of excess returns in financial markets (i.e., hedge funds and private equity) and inequities of rewards at the upper end of the income distribution (i.e., tax cuts for the wealthy and executive compensation).

**Risks:** Localization taken to its extreme could also spawn protectionism — giving rise to accelerating inflation, higher interest rates, greater volatility in financial markets, and a potentially vicious unwinding of an over-extended credit cycle. Localization could prove equally challenging for the beneficiaries of globalization's first win — new companies in the developing world and the employment growth they generate.

On one level, there seems to be no stopping the powerful forces of globalization. Not only has the world just completed four years of the strongest global growth since the early 1970s, but in 2006, cross-border trade as a share of world GDP pierced the 30% threshold for the first time ever - almost three times the portion prevailing during the last global boom over 30 years ago. What a great testament to the stunning successes of globalization!

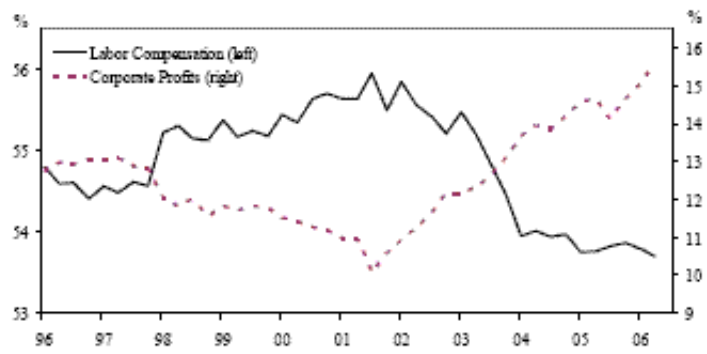
On another level, however, there are increasingly disquieting signs. That's because of a striking asymmetry in the benefits of globalization. While living standards have improved in many segments of the developing world, a new set of pressures is bearing down on the rich countries of the developed world. Most notably, an extraordinary squeeze on labor incomes has occurred in the industrial world - an outcome that challenges the fundamental premises of the "win-win" models of globalization. Ricardian comparative advantage tells us that the first win goes to low-wage workers in developing economies who enter the global economy - initially through their involvement in export production and eventually as a new class of consumers. The second win is presumed to benefit the rich nations of the developed world - where consumers can expand their standard of living by buying low-cost, high-quality goods from poor countries and where workers can ultimately gain from being involved in the production of more sophisticated products exported to increasingly prosperous developing economies.

It is a great theory — but it's not working as advertised. The first win is hard to dispute. China has led the way, with more than a quadrupling of its per capita GDP since the early 1990s. Other developing countries have lagged the Chinese experience but have still made considerable progress in boosting living standards. India's standard of living, for example, has more than doubled during the past 15 years. Moreover, according to IMF statistics, per capita GDP in Eastern and Central Europe is likely to have expanded at a 3.6% average annual rate in the decade ending 2007 - a dramatic acceleration from the 0.3% pace of the prior 10-year period. In the Middle East, a 2.7% trend in the growth of per capita output in the decade ending 2007 would be nearly double the 1.5% pace of the previous 10 years. Developing Asia stands out from the rest of the pack, with a 6.2% average annual increase in per capita GDP estimated over the 1998 to 2007 period - little changed from the vigorous 6.3% trend over the 1988-97 interval. Moreover, the first win hasn't just gone to labor. Four years of extraordinary returns for emerging market stocks and bonds underscore impressive returns to capital, as well.

The problem lies with the second win — the supposed benefits accruing to the rich countries of the developed world. And that's where the going has gotten especially tough. In recent years, the benefits of the second win have accrued primarily to the owners of capital at the expense of the providers of labor. At work is a powerful asymmetry in the impacts of globalization and global competition on the world's major industrial economies — namely, record highs in the returns accruing to capital and record lows in the rewards going to labor (see accompanying figure). The global labor arbitrage has put unrelenting pressure on employment and real wages in the high-cost developed world — resulting in a compression of the labor income share down to a record low of 53.7% of industrial world national income in mid-2006. With labor costs easily accounting for the largest portion of business expenses, this has proved to be a veritable bonanza for the return to capital — pushing the profits share of national income in the major countries of the industrial world to historical highs of 15.6% in 2Q06.

Exhibit 1

## The Battle Between Capital and Labor (Shares of National Income: G7+Economies)



\* G7+ includes the US, Japan, EMU, UK, and Canada.  
Source: National sources, Morgan Stanley Research

This asymmetry in the second win is not without very important consequences. In days of yore — when labor and its organized unions actually had bargaining power — the current squeeze on labor income in the developed world would have undoubtedly resulted in some form of a “worker backlash.” In today’s increasingly globalized world, however, workers have no such power. But their elected political representatives most certainly do. And there can be no mistaking the important shift that has recently occurred in the political alignment of the industrial world — with the majority shifting from the pro-capital right to the pro-labor left. Not only is that the case in the United States, but such a tendency is also evident in Germany, France, Italy, Spain, Japan, and possibly even Australia.

The political response in the US bears special mention. Most importantly, it has not arisen out of thin air — there are important macro-analytic reasons behind this backlash. Unlike Europe and Japan, where relatively stagnant real wages have matched up quite closely with weak or declining productivity, in the US, real compensation has been going nowhere in a rising productivity climate. Over the five-year, 2001–05 period, real compensation per hour in the nonfarm business sector expanded at just a 1.4% average annual rate — less than half the 3.1% pace of trend productivity over this same period. While macro teaches us that, over time, workers are rewarded in accordance with their marginal product, that most assuredly has not been the case during America’s newfound productivity renaissance. Moreover, recent research has pointed up the inequity of the so-called productivity dividend that has accrued to US workers. According to Ian Dew-Becker and Robert Gordon of Northwestern University, only the top 10% of the US income distribution have experienced growth in labor income equal to or above aggregate productivity growth since 1997 (see “Where Did the Productivity Growth Go,” Brookings Papers on Economic Activity, 2005).

These issues were not lost in the recent mid-term elections in the US. Aside from the obvious referendum on Iraq, exit polls suggest that the squeeze on labor income and its distributional ramifications were uppermost in the minds of American voters. And, now, a Democratic Congress is about to find itself center stage in the battle between capital and labor. The old Congress was quite transparent as to where it is headed in this regard — having introduced, by our count, 27 separate pieces of legislation since early 2005 that would impose some type of punitive actions on trade with China. The new Congress could go further — not just on the trade frictions front but also in embracing additional elements of a pro-labor agenda. In fact, newly elected Democratic leaders already have promised immediate passage of the first increase in the minimum wage in ten years. In my view, these are just the early warning signs of a US Congress that is likely to be far more sympathetic to the plight of labor than it was in the past.

Nor is America alone in tilting to the pro-labor left. In France, the ascendancy of Ségolène Royal offers a modern-day mix of pro-labor politics with a protectionist bias. Italy's Prodi is also pro-labor, and in Spain, Zapatero is certainly more sympathetic to the plight of labor than Aznar was. In Germany, Merkel has tilted increasingly toward labor after she nearly lost the election running on a pro-market reform agenda. The new Abe government in Japan has teamed up with the center right in support of the "second chance society" — attempting to make certain that the victims in the rough and tumble arena of global competition are given the opportunity to come back. And in Australia, Kevin Rudd, the newly anointed opposition leader, seems set to center his platform on the struggle of the average worker.

This pro-labor political tilt is as much an outgrowth of the hyper-speed of IT-enabled globalization as it is traceable to the competitive pressures bearing down on workers in both manufacturing and services. With a sense of economic insecurity moving rapidly up the occupational hierarchy — from software programmers and engineers to medical and legal professionals — a palpable sense of shock is spreading rapidly into the knowledge-worker occupations that have long been shielded from economic adversity. This has resulted in a serious loss of confidence in the second "win" of globalization — in effect, shattering the illusion that trade liberalization would be the rising tide that lifts all boats. In response, the pendulum has swung from the theoretical promises of globalization to the self-interest of individual countries — in essence, a "localization."

I fully realize it is heresy to challenge the greatest mega-trend of our lifetime. So let me state categorically that I am not heralding the demise of globalization. What I suspect is that a partial backtracking is probably now at hand, as a leftward tilt of the body politic in the industrial world voices a strong protest over the extraordinary disparity that has opened up between the returns to capital and the rewards of labor. The extent of any backtracking is a verdict that lies in the hands of the politicians — specifically, how far they are willing to go in legislating an effort to narrow this disparity. History does not treat the record of such political intervention all that well. Unfortunately, that doesn't mean politicians will resist the temptations to try.

An era of localization will undoubtedly have some very different characteristics from those of the recent past. The most obvious — wages could go up and corporate profits could come under pressure. But it also seems reasonable to expect pro-labor politicians to direct regulatory scrutiny at excess returns on capital — focusing, in particular, on the perceptions of excess returns in financial markets (i.e., hedge funds and private equity) as well as on the inequities of rewards at the upper end of the income distribution (i.e., tax cuts for wealthy citizens and the excesses of executive compensation). Moreover, localization taken to its extreme could also spell heightened risks of protectionism — especially if the global economy slows and unemployment starts to rise in 2007, as we anticipate. Under those circumstances, localization could ultimately give rise to accelerating inflation, higher interest rates, greater volatility in financial markets, and a potentially vicious unwinding of an over-extended credit cycle. And, of course, the protectionist ramifications of localization could prove equally challenging for the beneficiaries of globalization's first win — dynamic new companies in the developing world and the employment growth they generate.

Don't confuse prognosis with advocacy. Many of these potential developments, especially a drift toward protectionism, are without any redeeming merit, in my view. But this is what happens when trends go to extremes. In freemarket systems, the pendulum of economic power then invariably swings the other way. An era of localization will undoubtedly have more frictions than the unfettered strain of capitalism and globalization that has been so dominant over the past decade. The big question, in my view, pertains mainly to degree — how far the pendulum swings from globalization to localization. The answer rests with the body politic. The repercussions lie in economics and financial markets.