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It’s a MAD, MAD, World (and It’s Working!)

During the Cold War, a “M.A.D.” policy developed between the U.S. and U.S.S.R. M.A.D stood for Mutually Assured Destruction. The basic premise of this policy was a tit-for-tat approach to nuclear warfare: “If you launch a nuclear missile, we will respond with a launch of our own. No one wins and everyone loses.”

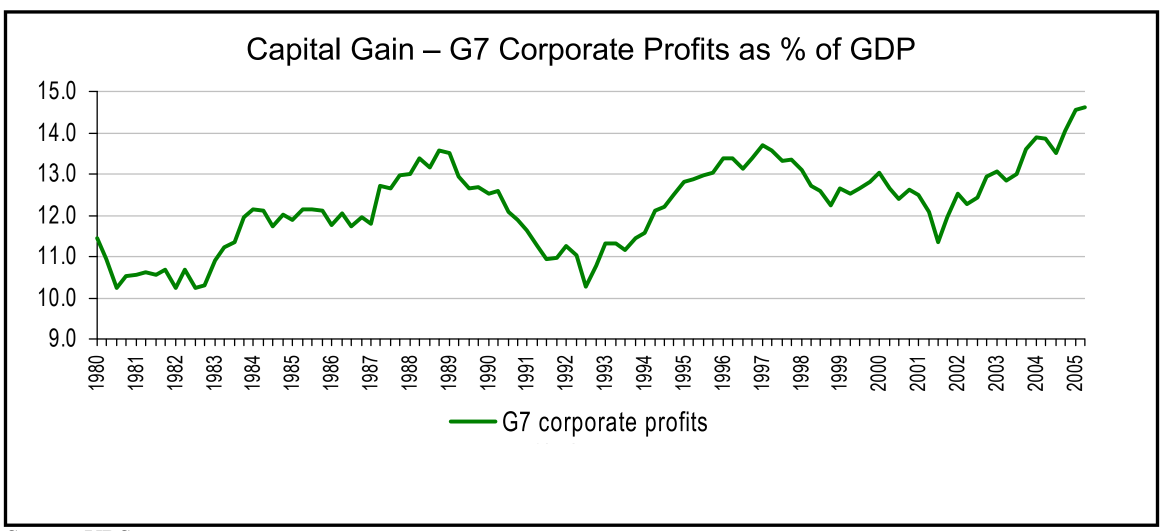
Today, it can be said that the U.S. and China have a similar policy in place, except that it is a de facto economic one. The U.S. buys China’s goods and China buys our Treasury Bonds. If one party stops playing its role, the other will also cease to play its role as well, and economic growth will come to a standstill. The dollar will decline in value, interest rates will rise and a recession, or worse, could be in the cards for the U.S. and the world at large. For China’s government, the outlook would be particularly catastrophic, as the resulting rise in unemployment would lead to widespread dissatisfaction with the current regime.

Consider this perspective of the “M.A.D.” economic policy between the U.S. and China. In 1946, the U.S. passed a law entitled the Full Employment Act of 1946. This was enacted because our leaders at the time were looking over their shoulders at the 1930’s, with its bread lines and unemployment numbers. After the end of WWII, there were concerns that the U.S. could find itself back in a similar predicament, and no politician wanted that outcome on his résumé. So, Congress enacted the Full Employment Act. This law had three objectives. Our government and related institutions, the Fed and the U.S. Treasury, were (1) to pursue growth of national output at a rate consistent with (2) full employment and (3) stable prices. For the most part, we achieved two out of three goals. Over the ensuing 20 years, growth was solid and employment rose as a result of a huge pent-up demand for consumer goods and services following the war. This growth in national output and employment was also fueled by the large saving pools that existed at the consumer level. But, while this law was successful in stimulating real economic growth, inflation went through the roof. Reflecting this inflation, interest rates rose dramatically from just over 2% to 14% in the near forty-year period between 1945 and the early 1980s. However, because the Full Employment Act was really about employment at any cost, it is fair to say that the law’s primary underlying intention was fulfilled, even though not all of its stated objectives were met.

In some respects, China’s decision to tie its currency to the U.S. dollar in 1995 and its accession to WTO membership in December of 2001 placed the country in a position similar to the U.S. in 1946. Much like the motivation behind the Full Employment Act, China's decision to peg its currency and join the WTO was all about employment. China's demographics are changing rapidly, and this will have an enormous impact on the country's employment profile. For instance, 200 million people are in the process of moving from the country to the cities, and this migration is transforming the make-up of China's urban workforce. In addition, China's state owned enterprises (SOEs) are entities that "employ" people but add little value to the country's GDP. In the end, China must find ways to employ its growing urban labor pool in real jobs that translate into real growth, and it will gladly run the risk of inflation and excess investment through foreign capital deployment. In the middle of the 20th century, unemployment was the U.S.'s social nightmare, and now, at the start of the 21st century, it is China's.

If we take a larger view of the international economy, we can see that today's economic "M.A.D" policy is also at work for countries other than the U.S. and China. Richard Freeman, an economist at Harvard, refers to China's impact on the world economy as a "positive supply-side shock." In fact, the entry of all four BRIC countries (Brazil, Russia, India and China) into the world economy has more than doubled the world's labor force, with China accounting for half of that increase.

These new entrants have brought little capital with them. Hence, we have twice the amount of workers with the same amount of available capital. With the addition of the BRIC countries to the international labor force, the ratio of capital to labor has fallen by 50%, probably the largest change in history. It is this ratio that determines the relative returns to labor and capital, and also helps to explain the recent trends in wages and profits. Real wage growth and wages as a percentage of national income have been weak in the developed countries, but profits and returns on capital have been very high, as a result of capital's relative scarcity. In fact, corporate profits in the G7 countries are at 25-year highs, showing a fifty percent increase over 1980. (See chart below) Taken together, the changing international relationship between labor and capital has increased the potential growth for countries throughout the world, has helped hold down inflation, and has caused huge changes in the relative prices of capital, goods, and assets.



Source: UBS

In short, China's emergence into the world economy has made labor relatively abundant and capital relatively scarce. Because China's economy needs to grow in tandem with its rapidly expanding labor pool, the trends outlined above should continue for some time. Specifically, China's increasingly prominent role on the world stage should continue to impact the prices and availability of natural resources, particularly oil. For example, China's rate of oil consumption is one-fifteenth that of America. This is partly due to the fact that, whereas there is one car for every two Americans, there is only one car for every 70 Chinese. If we consider the huge gap between China's current oil consumption and its future oil needs, it is not surprising that China has already accounted for over one third of the increase in global oil demand since 2000. Needless to say, China's demand for oil shows no sign of abating.

At the same time, as pointed out by The Economist, China's ability to produce goods more cheaply has pushed down the prices of many goods around the world. In America, for example, the average prices of shoes and clothing have fallen by 10% in the past decade, a drop of 35% in real terms. So, in many ways, the current M.A.D policy between the U.S. and China has done what the U.S. was unable to do in 1946 – spur national growth, increase employment, and keep inflation under control at the same time.

Therefore, the de facto economic policy between the U.S. and China is working. Both nations need one another. China needs employment opportunities, which the U.S. fulfills by an ongoing demand for Chinese goods, and the U.S. needs financing to manage its trade and fiscal deficits, which China fulfills by investing in U.S. Treasury bonds. This policy may not be stable in the long run, but it appears to be a functioning paradigm that will stay in place for the foreseeable future.

The larger lesson that can be learned from our discussion of this new "M.A.D." policy is that globalization is a good thing, and has been rewarding for both citizens and investors throughout the world. The Law of Comparative Advantage, in which every nation specializes in making what it makes well and then trades those goods for other goods and services it desires, is the "unseen hand" that allows everyone to prosper. Over the next ten years, the most important function of our international economy will be to refine the trading paradigm between the developing countries, that offer labor and low wages, and the developed countries, that possess capital and technology. The current "M.A.D." policy is helping to realize the benefits of this system, and the world's inhabitants will be better off because of it.

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