Globalisation makes the world go round

Gerard Lyons

In My View

HAVE you ever taken part in a debate where one side loses all the arguments but through sheer weight of numbers wins the vote? If you lived in Britain during the 1980s the answer would be yes.

The economic debate then went through many turns: an international monetarist model favouring a strong pound; then domestic monetary aggregates; followed by sterling's shadowing of the Deutchmark, then not shadowing the mark; and finally an unsuccessful and costly attempt to stay linked to the mark in the exchange rate mechanism.

Two recessions with an uncontrollable boom in between. In the past two years there has been an about-turn, and policy has become more pragmatic. Yet the people who blundered on these policies and lost the argument at each turn won the debate. Why?

Globalisation and the loss of economic sovereignty is probably the main explanation. It is now difficult for governments anywhere to act in isolation. Consequently, opposition parties as well as governments are adopting policies that appeal to international investors and the financial community. And this tends to be a very conservative policy. This is particularly the case in Britain, as international investors are needed to help service the budget and trade deficits. This has lessened the room for manoeuvre.

Yet the British economy is also benefiting from globalisation. The deregulation of the labour market is making Britain an attractive location for foreign direct investment. Although some of these jobs are low-skilled and low-paid, it is better than being unemployed, and as more investment arrives higher skilled jobs will be created, as we are already seeing in some areas. The recovery in world trade during the last year also boosted our economic performance, raising exports and business confidence.

According to the financial markets, this recovery in the UK and overseas is no different from previous ones. Strong growth is expected to continue, triggering rising inflation and higher official interest rates.

Yet most businessmen, workers or the unemployed would not be so confident about growth prospects. In Britain, for instance, people and firms have benefited from lower interest rates which have allowed debts to fall and balance sheets to improve. Although savings are at a high level, uncertainty about the future, plus the prospect of higher taxes and interest rates over the next year mean there is no 'feel good' factor. Thus companies will think twice before they invest.

The international environment is still tough and there are strong disinflationary pressures. Tighter policy is set to slow the US and UK economies from their recent above trend growth, thereby reducing inflation worries. And competitive pressures will dampen the pace of recovery elsewhere. This points to steady, not buoyant, world growth, with low inflation.

But financial markets and central bankers will need to be convinced that inflation is not a problem, particularly as commodity prices have risen sharply and surveys show that companies would like to raise prices. But it is hardly surprising that firms want to raise prices. The key issue is whether they can. But even in countries like the US and UK, which are well into recovery, any attempt to raise either producer or retail prices has not been successful. Large price increases one month have had to be reversed the next. Overall the inflation news has tended to be good.

There is strong price resistance from consumers to higher prices. Firms are under pressure to keep prices down if they want to maintain market share. There is also strong international pressure to downsize and keep costs under control. These pressures are particularly acute in Japan and, to a lesser extent Germany. Japanese companies are 'hollowing out', shifting production to low cost centres elsewhere in Asia, while German companies are moving production to elsewhere in Europe. But all countries are affected.

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Last year, hourly compensation in the UK manufacturing sector was $12.82, considerably less than Germany's $25.56, Japan's $19.20 and even France's $16.31. No wonder investors are attracted here. However, costs in the Far East are considerably less, at $5.37 in Korea and $5.23 in Taiwan. Even though South-east Asia accounts for a relatively small proportion of world demand, that region's production of high quality, low-cost goods is prompting significant pressure on international companies to keep costs under control. And with western European countries, including Britain, continuing to seek inward investment from Asia this is adding to pressure for costs to be kept low.

Labour market developments reinforce this trend. Wage growth is sluggish in most countries and many of the jobs being created are either part-time or low-paid.

The policy environment is reinforcing this disinflationary trend, particularly in Europe, where policy makers are still working towards achieving the Maastricht convergence criteria. One should not underestimate the political momentum towards a single currency but it is also important to realise that the economic environment is becoming more favourable for a resurrection of the ERM by the beginning of 1996. Already a number of currencies are trading in their old ERM bands. And the two preconditions for a return to these narrow bands will soon be in place: the need for low, stable interest rates; and economies improving, albeit gradually, in synchronisation. Even allowing for this I still have my doubts about the likelihood of a single currency, but it will certainly have some bearing on UK policy-making.

Throughout Europe inflation has long been replaced by unemployment as the major problem. Even though the unemployment rate is likely to have peaked this year in Europe it will still remain high. Yet policy stances do not reflect this changing economic environment. Monetary policies remain tight and there is little room for fiscal manoeuvre.

There are three ways to reduce high budget deficits: stronger growth; government action through tax hikes or spending cuts; a dose of surprise inflation. Even though governments throughout Europe are either cutting spending or raising taxes, deficits are likely to remain high. Thus markets will worry about the inflationary implications of high budgets. And these medium-term worries will reinforce the caution of central banks to keep monetary policy tight.

And, judging from their Inflation Report, the Bank of England certainly remains cautious. Once again the Bank has revised down its medium-term inflation forecast, expecting underlying inflation to be within the bottom half of the Government's 1-4 per cent target range in two years' time. This is a very favourable outlook, which hardly justifies higher rates. Despite this, the Bank believes the inflation risks are on the upside, particularly if the economy continues to grow too strongly. Hence the Bank is already preparing the ground for a further tightening. Base rates will probably rise towards 7 per cent by the middle of next year, slowing activity. This would then create an environment for the Chancellor to unveil possible sizable tax cuts next November.

But this policy shift could create problems for the Achilles heel of the British economy — the trade deficit. A tighter fiscal and looser monetary stance is needed for the trade picture to improve. Not the other way round.

The healthy export performance this year reflects not just the improvement in world trade but the lagged effects of sterling's sizable devaluation. Next year export growth may not be so healthy. Additionally, higher surpluses for oil and invisibles have diverted attention from the stubbornly high level of the non-oil trade deficit. This shows there is still an underlying trade problem. If demand gathers momentum import penetration would rise, triggering a deterioration in the trade deficit.

Despite its current good health the British economy is still suffering from some deep-rooted problems, linked to the low rate of previous saving and investment. With the international environment limiting the room for policy manoeuvre this suggests we should learn from our Far Eastern friends and implement longer-term policy aims. As they have shown, investment holds the key: investment in education, infrastructure and industry.

Dr Gerard Lyons is chief economist and executive director of DKB International, the subsidiary of Japan's Dai-ichi Kangyo Bank.

William Keegan is on holiday.