

# “Lilies of the field, who toil not...”

*John Maynard Keynes*

## Services in the developed economies

December 2010

### **Colonial First State Global Asset Management**

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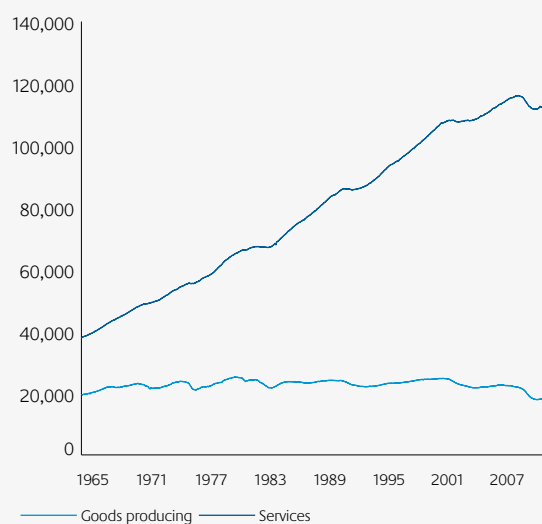
# Executive summary

In 1930, John Maynard Keynes predicted that the pursuit of economic growth would end by the year 2030. He argued that productivity growth would be enough to provide each person with a sufficient standard of living to mean just 15 hours of work a week would be required. Just 20 years from 2030, such an outcome seems unlikely, particularly at a time when many in developed economies are nearly entirely unproductive – unemployed. Yet, a dramatic change in the way the developed world lives and works has certainly occurred; for most physical toil is in the distant past.

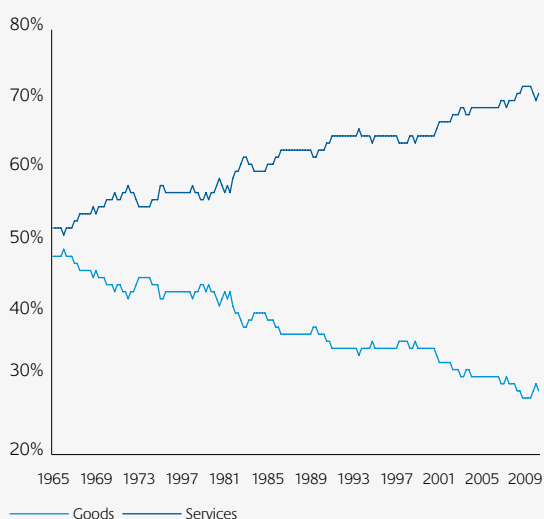
The movement away from physical toil is observed in the dramatic changes to the way people work. For millennia, humans have worked to produce a product. First, it was food and over time it became goods of increasingly greater value. But today, in the developed world, most working individuals provide a service; such as IT, financial services, health-care and in turn these people seek people to clean, cook or entertain. These services raise our living standards and allow us to be more productive with the time we have. Often we may use this time to make more money, but it's a deliberate choice rather than the forced circumstance of growing food, building shelter and keeping warm.

Household consumption as a share of GDP has risen to nearly 70% in the US economy from 63% in 1948. GDP growth means that household consumption in real dollars has risen by 8 times since 1948. While higher consumption is often scorned as being merely the excessive ownership of LCD TVs, it is really about improving the living standards of households, largely through the provision of services. The shift to services is observed in the two charts below. The first chart shows employment in goods production and service provision while the second shows the share of GDP each sector creates, both in the US.

**Chart 1: US employment by sector (total employment, ending October 2010)**



**Chart 2: US Goods and Services in GDP (share of total, ending June 2010)**



Source: Bloomberg.

In 1965 goods production employed 20 million people and produced just less than 50% of GDP. Today, it employs just less than 20 million people and contributes only 30% to GDP. The services industry has grown from 40 million people to employ over 110 million. This change has substantial benefits not least the greater level of specialisation that should enable both higher wages for providers and higher levels of utility for users. A manufactured, mass produced product is less able to increase the utility of an individual than a personalised service.

The shift to such an outcome has been an inevitable consequence of the Industrial Revolution. It is, also, a shift that is accelerating. At the heart of this acceleration has been an improved efficiency in the way the market, globally, operates. Markets for goods and services are becoming considerably more effective; promoting greater efficiency and, in turn, increasing economic activity.

Markets that are unconstrained allocate resources very effectively. The most efficient markets are those where the scale of information and mobility are such that the greatest number of agents can participate. As participation is constrained, market efficiency effectively falls. There are a number of important drivers of improved markets, but three important ones have been technology, greater scale and abundant capital – with China at the very heart.

Many people believe that the current model for the world economy is broken and in need of repair. For example, the existence of trade surpluses in one part of the world and deficits elsewhere is thought of as an ‘imbalance’ in need of rebalance. This essay argues that the opposite is the case and that many of the trends identified as symptoms of dysfunction in the world economy are actually signs of its strength. As a result, many policies being pursued by governments are inappropriate, working against the long run growth prospects for both the domestic economies of those governments and for the world economy.

This essay seeks to explain how the world got to this place, whether we want to be here (short answer: YES) and how can further growth and recovery be fostered in such a world. The essay argues that many of the trends identified as symptoms of a broken global economy are, actually, signs of its strength. These include global imbalances and, perhaps rising house prices. It suggests that part of the strength inherent to the global economy may be relatively bad for global capital markets. It concludes that, in many economies, policy is not so much anti-cyclical, but anti-structural and may foster a period of deflation, particularly in the US.

But above all, it argues that globalisation enables localisation, the delivery of goods and services locally. Rather than being a counter-attack against the malign forces of globalisation, localisation is bred by the very positive nature of globalisation. As globalisation better allocates resources, more is available to use locally, promoting employment and more sustainable living.

# How have we got to where we are?

## Technology has, since the wheel, been creating more efficient markets through enhanced mobility and information transfer.

### The role of technology

At the height of the post-Lehman's collapse despair John Steinbeck's classic novel of the Depression, *The Grapes of Wrath*, seemed to be essential reading. It seemed to be a guide book for the coming depression. Yet, on contemplation it was not the similarities, but the differences, that offered the most value, particularly the way technology could transform markets.

*The Grapes of Wrath* is the story of a family of Mid-Western share-croppers forced from their land in the Oklahoma Dustbowl. They travel cross-country to California, in a jalopy, to find work in the orange groves. It is a story of the past, serving to highlight the transformation in mobility and information availability that has occurred since 1930.

Capital mobility in an agrarian society is zero. The Indiana farms had been made redundant by over-farming and a poor climate. The share-croppers just couldn't lift up their (rented) capital and transfer it somewhere else where it may be more fruitful. Nor could the orchards of California be moved closer to the idle labour of the Mid-West. In an industrial economy capital does have greater mobility and so can be moved, expensively, to markets or cheaper labour as has been the case with Asia. This can act to smooth the process of structural change in an economy. In a service economy where businesses tend to use only limited fixed plant and equipment, this process can occur even faster. The capital can move to the labour.

Labour mobility has undergone a similar transformation. Rather than a long, cross-country, jalopy ride on unpaved roads, an unemployed share-cropper in Indiana could afford to board a Southwest Airlines flight. Even a cross-country car journey would be substantially cheaper and quicker.

On arrival in California, the share-croppers travel from orchard to orchard in search of work. It is an expensive, dangerous and time-consuming task. Today, the same itinerant labourer can search for work and accommodation on the internet, use a mobile phone to contact potential employers and an i-pad

to locate the orchard. In Kenya, for instance, Masai tribesmen use mobile phones to identify good grazing conditions and which markets have the highest selling prices. Again, technology, through information sharing, is helping to smooth economic activity and promote its growth.

Technology's role in creating more efficient markets has also driven the shift to a services economy, largely by making goods so much cheaper as a share of household income and encouraging specialisation. There are two particular ways this has occurred; more distant manufacturing and improved price discovery.

The change in transport technology has had a most marked impact on a country such as Australia that is relatively isolated and short of people. Rather than having to manufacture the majority of the goods it needs, at a high cost in capital and labour terms, Australia can import manufactured goods and free labour and capital for specialisation in higher value services.

Similarly, recently, the internet has emerged as the provider of perfect price discovery, meaning households pay less for goods and services. Indeed the internet has transformed retailing by lowering its capital intensity. As an example, Wal-Mart was long considered a Leviathan in US retailing; an unchallengeable monopoly provider of goods. But last year it lost market share to Amazon, the on-line retailer. Rather than requiring a considerable physical presence, Amazon relied on the internet and a distribution network to undercut its larger rival. This year Wal-Mart responded by offering free freight on all online purchases.

These technological changes have created a world of increasingly cheap goods that, in turn, form the foundation of a service economy. At the heart of this explanation is an income and substitution effect. Cheap goods enable households to purchase both more goods but also increase their purchasing power in other areas. Disposable income, income excluding food, clothing, energy, has increased. In the developed world, the rising disposable income will be spent on services delivered in the domestic, rather than global, economy.

# China is the accelerant in the process – providing scale and capital

China has been the accelerant in this process. It is making markets much more efficient and should make the developed world richer. It is using capital aggressively to create scale with the effect of further lowering the cost of manufactured goods. It is also prepared to finance developed world consumption and investment; by purchasing foreign government debt. In effect, China is doing for the developed world, what the developed world could never do for itself.

## The role of competition

China is encouraging, in many areas, the most aggressively competitive markets the world has seen, with the benefits enjoyed across the global economy.

Part of the Chinese story is the Asian story. The emergence of Asia as a manufacturing hub has contributed substantially to the creation of more competitive global markets. China and the rest of Asia have pushed out the production possibility frontier, increasing the opportunity for scale benefits and lowering the price of manufactured goods. That these markets are competitive, either inter-nationally (between Korea and Japan for instance) or internally (China and Taiwan) only enhances the positive impact on prices.

But there is also a specifically Chinese aspect to this story. China promotes competitive markets. To be true, there are areas with restrictions; energy and water, finance, media and telecommunications. But broadly, and particularly where the end user is a Chinese household, China promotes hyper-competitive markets. In this way, China is effectively upsetting the capitalist paradigm.

Capitalism and the market mechanism are far from synonymous. The market can (given the right conditions) provide an optimal allocation of resources, both labour and capital. Capitalism represents something different; it represents the favouring of capital in the allocation process for various reasons including insufficient scale, political expediency and sometimes outright social good. But, the price of capitalism is a lower welfare outcome for households relative to firms.

This lower welfare outcome is manifest in higher prices for households.

The most obvious is to think about the Chinese attitude to copyright. The lack of respect for copying is well understood and often, in the developed world, seen as a deliberate strategy to transfer jobs from the developed world to China. But there may be a broader driver of this behaviour – the ability to raise living standards.

The Chinese don't discriminate in the attitude to copying; it can be Chinese companies copying foreign products, foreign companies asking Chinese companies to reproduce a competitor's product or Chinese companies copying products from other Chinese companies.

My favourite example is in toilet paper. The [picture below] shows two brands of paper, one, the market leader, is Vinda, and the second, Yinda, is nothing more than a direct copy. In effect, this is akin to having a roll of Kleenex paper next to Pleenex. This picture was taken in a large supermarket chain, not in a back street market place.



China is not prepared to protect the brand of one of its own manufacturers because protecting brands raises the cost of living and acts as a barrier to the country's primary aim, raising living standards. Brand protection creates a producer surplus, the ability for a firm to charge a higher price for a good than would otherwise be the case in a perfectly competitive market. This surplus is effectively a cost paid by the consumer and so raises living costs. By removing the producer surplus, higher living standards can be achieved.

This competition has a broader impact. Competition in China, through export markets, impacts the entire world bringing lower producer surpluses to global markets.

### **The abundance of capital**

China creates so much capital, it does not know what to do with it all. This is to the benefit of the world. Domestically, abundant capital creates scale in industries benefits the global economy by lowering prices. Internationally, the abundant capital is funding both investment and, perhaps unfortunately, consumption elsewhere in the world.

China is just one economy where surplus capital is being created. There is, globally, an abundant supply of capital, relative to demand, which is often described as 'global imbalances' or a 'savings glut'. The proposed solution to abundant supply is to control supply through price and quantity controls. The solution, to me, seems to be to raise the demand for capital. While the market sees capital imbalances as artificial constructs, I view them as structural in nature. As a result, deficit economies need to respond positively, rather than negatively, to what the global market for capital has created. These imbalances must be seen as an opportunity for comparative advantage.

Global imbalances are much more determined by demographics and socio-economic factors than currency levels. As such, for governments to influence the size of these imbalances requires governments to change the nature of decisions that individual firms and households need to make. In other words governments must change prices or demographics.

Imbalances refer to national level differences in the propensity to save or invest; in Australia we run a deficit – as a nation, we borrow rather than save. The US, UK and ex-Asia emerging markets generally behave in the same way. On the other side, Germany, Japan and China are the largest net savers.

Two factors drive the demand for savings; the retirement horizon and income volatility.

The ageing of the global economy seems to be a shared problem but in reality for some economies it is worse than for others. Germany and Japan are top of the list. The median age in Japan and Germany is 45, but in the US and Australia it's 37 and in the UK it's 40. Retirement is a materially more pressing issue for a German than for an American and as such they must save more of their income.

Obviously, income volatility for many people in developed economies has risen dramatically in the last two years with unemployment rates at multi-decade highs. But compare that volatility to the Chinese and it's in the shade. Chinese above the age of 40 have firsthand experience of the famine and deprivation caused by the Cultural Revolution – you want serious downside protection when there's no dole queue.

These are the drivers of 'imbalances' and trying to fight them is futile. As we've seen in Japan, people facing retirement will buy a security yielding 1.2%. If I'm a rational Australian I should take the other side of the trade and borrow at these rates. Imbalances are evidence of households in the US and Australia acting rationally. In a global economy, with global prices, why would a median aged Australian have a higher propensity to save than a median aged Japanese?

Economists can tend to focus on fixing the conditions that create an excess supply of capital. But, rather than halt the supply of capital, the best solution for increasing global productivity would seem to be to improve the demand for capital (there are things that demand capital other than No Income, No Job mortgages). This is something China has done. The trick has been to acknowledge that the cost of capital, because of supply, has fallen and so to accept a lower return on invested capital. This is the corollary of copying. By copying Chinese firms are accepting a lower return on capital. They accept, by default, a lower return than the first-mover and they benefit consumers by creating a more competitive market.

Two companies, Xinhua the state owned media organisation and Alibaba.com the business to business website, for instance, have decided to launch a new Chinese search engine to go into competition with Baidu, the dominant Chinese search engine. The first mover advantage has passed but the potential returns are sufficient to encourage competition.

This is behaviour we are unlikely to see from Western companies. Vodafone recently announced its plans to sell its Chinese business. Vodafone, upon sale, will have doubled its money in a period of approximately eight years. For a company with ambitious growth plans, exiting

# China is the accelerant in the process – providing scale and capital

continued

a, supposedly, high growth emerging market would seem strange. There are two reasons for Vodafone's exit; first, it thinks it can get better returns elsewhere and second, it understands that improving returns in China requires spending a substantially larger amount of capital.

So who's right? In the short term Vodafone. Vodafone should be able to allocate capital elsewhere, for higher returns, relatively easily while the Chinese competitors chasing Baidu face a high-risk strategy that could end in disaster. But in the medium-term I think Vodafone is vulnerable. Without the protection of scale, Vodafone is more likely to fall prey to the strategic advantages of scale that Chinese companies are achieving.

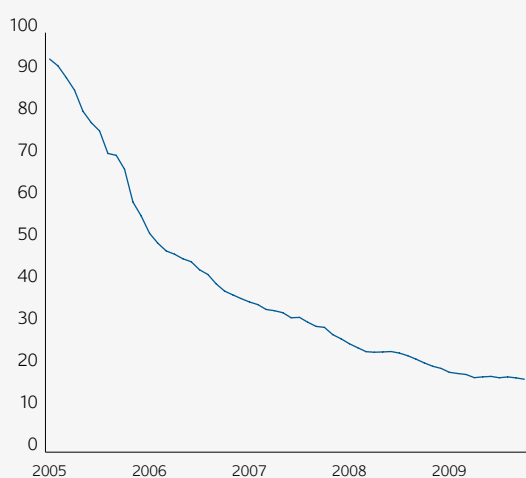
Telecommunications hardware is a good example of this. In 2009, a Canadian hardware manufacturer went out of business at the hands of Chinese competition. The company could not cope with the aggressive competition of two Chinese giants; Huawei and ZTE who had emerged, seemingly, from nowhere. They achieved a scale where they could effectively compete at prices around 50% lower than those of Nortel. The scale provided by China had created the base for these companies to be immediately hyper-competitive on a global scale.

The scale of Chinese capital with the recognition that returns on capital, necessarily, must be lower does two things. First, it improves, substantially, developed and developing world economies. Technology and capital contribute to dramatic improvements in the productivity of economies. Productivity enhancements raise activity levels, employment, incomes and so standards of living. But second, it continues to lower the returns that capital can earn and this is where China turns the world on its head. Capital is no longer valuable and, increasingly, this becomes self-evident in the returns that capital can achieve.

## Illustrating the new world – Why we want to be here...

The example of a TV demonstrates the impact of competition on price. The price of a 42-inch LCD TV has fallen from US\$4,000 to US\$800 in the course of five years. This decline, demonstrated in the chart below, points to the rising purchasing power of households in the last five years. The rise of China's manufacturing base and the strength of competition have contributed to a substantial rise in the ability of households to raise living standards as the cost of goods falls.

Chart 3: US LCD TV price (price per inch, monthly)



Source: Bloomberg.

But competition is fundamentally bad for capital.

This is the other part of the TV story; the TV manufacturing market. Quite obviously, the declining price of TVs is a function of innovation and good investment decisions. Importantly, however, the benefit of these innovations and investment decisions are quickly flowing to consumers not the firms themselves. A company innovates, not to earn a protected excess return on historic innovation, but to stay in business. This highlights the difficulty of achieving a sustainable excess return on capital when scale is such an issue.

A company, in this area, that has achieved a sustainable excess return on capital is Apple. The American technology company's iPhone has achieved a sustainable advantage through continuous innovation. By evolving through four models it has managed to stay ahead of the competition and earn an excess return that is not competed away. iPhones are not being dramatically discounted and no competitor has established a meaningful challenge. But the story is not as simple as Apple earning all the excess returns.

At the heart of Apple's success, and so returns, are design individuals not capital. Individuals can leave or demand higher wages. Individuals detract from the returns capital can earn. It certainly was not always thus. Through the industrial revolution the demand for labour was limited to a small set of potential employers; labour was a price taker. Today, in a world of labour mobility and intellectual property, labour is increasingly valuable and it is capital that pays the price. This means rising wages but lower returns on capital.

This is the new world.

At its core a services-based economy is associated with greater levels of welfare through a more effective economy. This improvement is manifest in higher life expectancy, due to a combination of a lesser requirement for physical labour and greater wealth that can be allocated to healthcare. It is also seen in greater levels of universal education with benefits for both the individual and society. Services promote enhanced co-operation and communication with the impact of greater social integration.

# Illustrating the new world – Why we want to be here...

continued

A services based economy should also be more efficient in smoothing economic activity because it improves the decision making of firms and individuals.

Services employment better rewards individuals for talent and effort. In a manufacturing business it is difficult to differentiate yourself. Tasks, generally, are too similar to easily stand out. Indeed, this inability to differentiate oneself from the crowd created an environment in which unions became increasingly necessary to act as a collective bargaining agent. In a services business it is easier to differentiate performance through value to clients and bargain individually. The rewards for innovation that flow to labour are much higher because they are so valuable. These higher wages support higher levels of economic activity with a continued positive cycle for activity.

The business cycle can be less pronounced.

Firms are able to make better resourcing and production decisions in a services business. Consider the financial crisis. From late 2008, the global manufacturing industry sank much further than should have been the case based on absolute demand levels. The great de-stocking by businesses, both wholesale and retail, led to dramatic declines in manufacturing production and employment with negative consequences for the wider economy. This may, in part, be explained by concentrated decision making. Despite, just in time manufacturing, stocking decisions are made by relatively few people. With strong group-think, inventory was wound down too far, too fast, and the economy suffered.

In a service business there are no inventory decisions to be made. There is demand or there is not demand. While businesses can seek to lower costs, employment decisions are only made in direct response to actual, not expected, demand.

This awareness of real-time demand enables services employees to also make better decisions, because they, too, better understand demand dynamics. In Australia, particularly, the strong weight to services employment helped smooth the economic cycle as individuals made informed decisions to spend, rather than save, and to take advantage of record low interest rates and government stimulus.

Finally, a service based economy becomes more centred on household consumption rather than business investment. There are a couple of reasons for this. First, service delivery is much less capital dependent at a corporate level. Services are delivered from offices, at homes or online. The need for plant and equipment is small, often just a desk, telephone, computer and perhaps a car. Second, as demand for corporate capital investment falls, consumption must rise in its share; largely through increased use of services. This is the great irony of globalisation; accepting the trends of globalisation means accepting greater localisation. Localisation is not so much a social counter-attack against globalisation but a necessary adaptation to globalisation's trends.

# The risks in this environment

The creation of huge supplies of capital by China and other economies has, undoubtedly, helped create the conditions that led to the credit crisis. In the absence of higher, perceived, risk-adjusted returns, surplus economies funded investment in US residential and commercial property, and infrastructure with debt structures that were very vulnerable to, relatively, small changes in interest rates. The lack of demand for more productive investment played an important role in the creation of the housing bubble. The demand for capital must rise rather than constraining the supply of capital.

Certainly, the crisis, in part, has played an important role in raising the demand for capital. The crisis in the US and Europe is very similar to the crises that have wrecked emerging markets in the past. Economies such as Indonesia and Thailand, in 1997, saw destructive bursting of asset price bubbles in the wake of strong inward capital flows. The divergence, this time, has been in the wake of the crisis. Rather than capital flows reversing, capital has continued to flow into the United States, keeping interest rates low and providing the capital to strengthen balance sheets. Rather than the long and slow grind usually associated with balance sheet recoveries the US has been able to quickly move on.

But beyond the current situation, the developed world needs to establish frameworks to improve demand for capital. Part of the problem with lots of capital, ill-directed, is the emergence of asset bubbles. The current surplus position and the consequent low interest rates certainly risks further, destructive bubble bursting in coming years.

As explained above, corporates do not have as intense demand for capital as was once the case. Increasingly, business success is driven by labour rather than fixed capital. The requirement for fixed plant and equipment is falling. As an example, Facebook, the social networking website, now has a \$33 billion valuation but very low fixed capital. The value is in the network of people rather than in the fixed capital; the value is solely in the good idea.

In the absence of corporate demand for capital, households have tended to fall into the breach. This, too, makes a lot of sense in a service economy. Housing, or shelter, is an essential service and as purchasing power increases, it makes sense to spend more on accommodation both in absolute and relative terms. Furthermore, low interest rates lower debt servicing costs, enabling households to spend even more on housing and so increasing their vulnerability. Upward pressure on housing prices is also driven by the incentive for housing close to places of work, particularly in the absence of good transport infrastructure. While households should use debt, to smooth consumption over time, it should be constrained to avoid excessive indebtedness.

This leaves the borrower of last resort as the government. Governments, in deficit economies, need to be prepared to borrow more. There are a number of reasons for this. First, government borrowing should help to crowd out some of the excessive borrowing for housing by households as a result of higher interest rates. Second, government is in a position, through capital investment, to use surplus capital most efficiently in a service based economy.

Investment in infrastructure is essential to improving the efficiency of a service-based economy and soaking up excess capital. A locally based, service economy requires more infrastructure. It needs better transport infrastructure to speed people and goods to customers. It needs more efficient energy and water infrastructure

# The risks in this environment

continued

to lower living costs. It needs the social infrastructure of education and health to improve living standards and the contributions individuals make to society and the economy.

As infrastructure will retain strong elements of a public good, even if a user pay model is the most efficient means of servicing the debt required, governments must take the lead on planning and funding this investment. In the absence of large corporations pressing for

infrastructure upgrades, government must be more keenly aware of the infrastructure pressures in the economy and be able to respond to them quickly. Government must find ways to identify the most pressing need.

The improvement in infrastructure can also play an important role in lowering living costs and enhancing the supply of affordable housing within range of work places taking pressure off households to bid up prices.

# The current context

This relatively Panglossian view of the global economy stands in stark contrast to the current reality for all but a handful of developed world economies. Unemployment remains at cyclical highs in the US and Europe and in Japan it is approaching historically high levels. The service economy does not seem to be working.

This under-performance, in the context of the above however, is explicable. The failure of the service economy to work is a failure of policy. Policy-makers have not evolved their view of the world to a point such that policy matches economic structure. Primarily, low interest rates and a weak currency are bad economic policy in a service economy.

The best possible policy decision, for the US, to be made in the wake of the Lehman crisis was competitive appreciation. Good policy should raise the relative wealth of a nation, even in the short-term. Such a policy would remain rooted in conventional theory but recognise the evolved structure of the US economy.

Historically, low interest rates and a weak currency have promoted a recovery. The theory is simple. A recession creates a lot of excess capacity, more than the domestic economy can handle. Low interest rates and, particularly, a weak currency spur the international competitiveness of an economy and meaning excess capacity is soaked up externally, allowing the economy to grow. But this only works when the level of global comparative advantage is relatively low and the excess capacity is internationally competitive.

This is not the case in the US today and the global economy broadly. The level of comparative advantage globally is enormous; economies rarely do things today that can't be done more efficiently somewhere else. This is the benefit of globalisation. A falling currency is insufficient compensation for the scale of comparative advantage. Furthermore, the excess capacity in the US is not internationally competitive. Job losses have been in many of the services industries where customers are domestic rather than international and the excess capital is in housing; entirely a non-traded good.

For this policy to work, the US economy would need to undergo a significant, and backward, structural change. This structural change would require the return of manufacturing capital to the US and re-skilling of the labour force. This would take time and, probably, require

substantial structural unemployment in the meantime as service demand falls. Yet this is what policy-makers want to pursue.

Many commentators suggest the risk to QE2 and a weak dollar is a period of high inflation expectations based on the steep rises in commodity prices since Ben Bernanke's speech at Jackson Hole in August 2010 that signalled a shift towards further monetary easing. This, however, ignores the structural change. The intervening period will be deflationary, suggesting the US risks the lost decades experienced by the Japanese in the last twenty years.

A falling US dollar effectively fights against globalisation because it halts localisation and works against the benefits of global imbalances. It is an anti-structural policy that can have only the smallest of short-term cyclical impacts. Falling purchasing power requires households to squeeze other parts of their budget; this will be locally provided services. As the costs of imported goods rise, household demand for services ranging from house painting, to dry cleaning, to entertainment must fall. The response of these providers must be to either deploy less people (unemployment) or lower costs (lower wages and so further declines in purchasing power). Given services represent 70% of the economy these deflationary trends will swamp the impact of rising import prices. This is a deflationary spiral.

Such an environment of low to negative nominal growth and a weakening currency would also encourage US companies, with strong balance sheets, to invest offshore rather than in their own economy. This is a further weakness of the policy.

The alternative to de-valuing the currency through asset purchases, a direct, even if unintended, consequence, is to help it appreciate. By raising interest rates, the US dollar would strengthen globally, raising the purchasing power of US households and spurring a broader and more sustainable recovery. Most importantly, it capitalises on an American's comparative advantage; providing labour to the biggest consumer market in

the world. There is a reason why economies have for centuries exported labour to the United States and why obtaining a Green Card is so important. There is no more profitable market in which to provide a service. No-one, living in China or other parts of Asia, can effectively compete with someone living in America when it comes to providing a service to Americans (the Indian business process out-sourcing industry employs just 2 million people servicing the entire English-speaking developed world). They can't paint homes, undertake a physical examination, sell a home, fix a car or write an effective, culturally aware, advertising campaign.

There are a number of drivers for this positive outcome from an appreciating currency.

First, on a global basis, incomes rise. This is especially important for the poor because it is the poor whose spending is most concentrated on imported goods such as clothing and footwear plus commodities such as food and energy. As relative incomes rise, spending on imported goods fall as a share of all consumption, and spending on domestic services can be undertaken. This will boost employment due to the labour intensive nature of services.

Second, higher interest rates aid the recovery in household balance sheets. This occurs for two reasons. Higher interest rates, the stronger currency and the improved outlook will allow households to gain comfort with their balance sheets faster. The value of paper gains to households are of limited value in the wake of the housing recession. By better rewarding households for savings (higher interest rates), the threshold at which balance sheets reach comfort levels falls. While asset price falls on higher interest rates may have a short-term negative impact, the medium term outlook for asset prices, on improved demand conditions, is more positive. Housing demand will rise because employed people will spur household formation; in turn this will raise prices. Equities, too, will rise on the back of an improved demand outlook. Lastly, higher interest rates will remove the likelihood of damaging asset bubbles re-emerging.

Finally, an improved domestic demand outlook probably has more of a positive impact on domestic manufacturers than a weak currency. Demand for US manufactured goods, such as airplane engines, is relatively price inelastic and much of the demand will come from a strong domestic economy, anyway.

A strong currency should, therefore, boost demand. Also, input prices, such as commodities, will fall in price.

This policy strategy would seem unorthodox but is in fact rooted in orthodoxy. That it seems unorthodox may be due to the way the economy is traditionally viewed and the mistaken perceptions of participants. An important driver of this is the equity market. Each day market participants view equity markets as a proxy for activity in the wider economy. But, in reality, they represent only a small part of the wider economy. For instance, while 30% of the US economy produces goods, 70% of the S&P 500 can be classified as a goods producer. The S&P 500 also fails to take account of smaller businesses that remain the largest employers of labour. It ignores the ability of this great mass of enterprises to promote growth in the economy. It's also the case that the perspective of many people in America is that China has become the more powerful economy. This misunderstands the wealth gap between an average American (per capita income 2009 US\$46,000, 11th in the world) and an average Chinese (per capita income 2009 US\$6,700, 130th in the world) in purchasing power parity terms. Why does policy seem to want to pick a fight with an economy, per capita terms, one seventh of the US?

While, rightly, policy should not necessarily be formulated to optimise another economy's growth, the negative impact on China could have substantial global implications. First, QE is making monetary policy more difficult. Chinese authorities are now struggling to control inflation caused by rising global prices with potential negative social outcomes. A failure to control inflation also risks asset bubbles that will have consequences for developed world markets. Second, it is blasting an expensive hole in the global supply chain, forcing accelerated structural change. As Chinese production becomes too expensive it must re-locate elsewhere in Asia or the developing world, but this process takes time. In the meantime, consumers in the developed world will face either lower production or higher costs as factories re-locate to more profitable regions. In addition, the structural change brought on China will, actually, induce fiercer competition with the developed world's manufacturing base as its production becomes even more advanced.

# Conclusion

A remarkable structural change has occurred in the global economy. Never before have so many resources, both physical and labour, been applied to improving global living standards so efficiently. Yet, the global economy is in danger of allowing the gains to wash away under the weight of bad policy.

The world has changed because markets work and they work best when more technology, competition and resources are made available to them. China has been at the forefront of a new wave in the improved market efficiency. Its size and embrace of competition have had a substantial impact on the living standards of not only the Chinese but the entire global economy.

But policy, both monetary and also trade, is seeking to stymie this change. Policy, particularly in the US, is fighting against structural change meaning any cyclical benefits will remain short-lived and, in the medium-term, are likely to be damaging. The biggest problem seems to be that policy-makers remain focused on the cycle, as if the cycle is nothing more than a continuous sine curve, always evenly up and down. But the focus on cycle means the gradual but significant structural change is ignored.

Perhaps, Australia is lucky. Perhaps, the obvious nature of the China boom has raised the eyes of Australian policy-makers to the structural story. But the Reserve Bank of Australia's policy response to structural change is promoting a strong short-term environment as well most evident in the strong labour market.

It seems to me, that if policy makers elsewhere saw that globalisation promotes localisation, the outcome for economies and households would be so much more positive and we may all become like *lilies of the field, who toil not...*

## Further information

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