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THE GOLDILOCKS RECOVERY: 'JUST RIGHT' IS JUST NOT RIGHT

The New Industrial Revolution spread a huge increase in high-quality, low-cost production capacity throughout the world. In many countries, this vastly expanded capacity produced goods well in excess of domestic needs, a phenomenon we labeled the "production hurricane." To keep the increased manufacturing capacity busy, countries moved aggressively to the export market.

In the early months of the World Trade Organization, numerous countries supported its free-trade concept, hoping it would help them further raise exports. But the production hurricane dramatically intensified export competition, lowering the cost of export goods. As one country's cheap exports became another country's cheap imports, thereby undercutting the importing country's own products, many began to have second thoughts. Now, political leaders hear screams from domestic manufacturers and workers to protect their own markets. Those countries are reverting to protectionist tactics, putting up new barriers to imports and foreign influences in their economies.

This shift back to protectionism is occurring at a time when politicians and economists were asserting that things were "just right" for the overall world economy. They noted publicly that a broad range of countries was about to embark on a prolonged period of economic growth with low inflation – a scenario one observer described as "the Goldilocks recovery goes global." This new protectionist wave could introduce an element of trade dissension and economic volatility into that idyllic scenario.

The Best of All Possible Economies

The latest buzz from the economic front suggests that we are entering a prolonged period of global growth with minimal inflation – an idyllic era free of time-honored perils. Looking at 1997, OECD projects that, for the first time since 1985, **all** of its 29 member countries will enjoy growth. One-upping that forecast, IMF expects that the developing countries and the transition economies of Russia and Eastern Europe will join in the fun. Peering deeper into its crystal ball, IMF projects that the next few years could see the most broadly based period of economic growth since much earlier this century. This growth would occur at a time when the average world inflation rate is poised to fall to its lowest level in almost 30 years. (*Economist*, 1/4/97)

Going beyond OECD and IMF's rather straightforward projections, Union Bank of Switzerland adds an element of luck to the forecast. The bank's recent in-depth analysis of the world economy declared: "The tranquillity of the 1990s is not due to sudden major shifts in...real economies. Instead, the world has had a lucky break [due to] a unique set of accidents." The accidents (the reunification of Germany at the wrong rate of exchange, the locking of exchange rates within the European Union, the bursting of Japan's real estate

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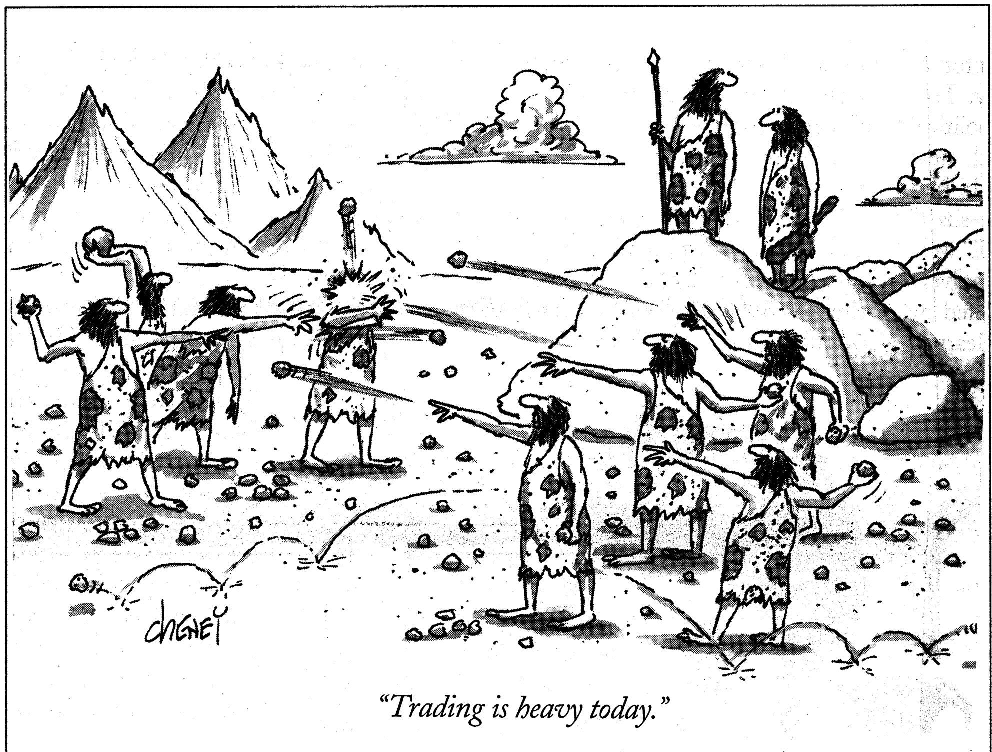
bubble) combined to minimize the volatility of the global business cycle. The study concluded that the current economic "exuberance" in many countries is not only rational but also likely to persist and spread to Western Europe and Japan. (*International Herald Tribune*, 4/21/97)

Perhaps the most engaging current view of the world economy came from the January World Economic Forum in Davos, Switzerland. The overall message from the experts at the forum was that, with no big military conflicts on the horizon, the world economy should continue to grow at a healthy pace, avoiding disruptive shocks to international financial markets. In short, everything is "just right" for worldwide growth without inflation. We use that "just right" phrase advisedly: One panelist summarized the balanced state of the world business cycle as "the Goldilocks recovery goes global." (*Financial Times*, 1/31/97)

However, while this "Goldilocks" view of the global economy grows in popularity, we have noticed a significant shift that could contribute a decidedly sour taste to Goldie's world economic porridge: an intensifying battle for export markets and a resurgence of protectionist tactics.



"Trading is heavy today."

Conditions 'Just Right' For a Hurricane

The New Industrial Revolution, which posited that someone else can always make something faster, cheaper or better, led to an explosion in production capacity worldwide – new plants all capable of manufacturing high-quality, extremely competitive goods. The explosion began as manufacturers seeking to produce cheaper goods left high-wage, developed countries to build modern plants in low-wage, lesser-developed countries. To maximize profits, they tried to export as much of the lower-cost production as possible back to the high-wage countries. The new plants prospered, their host countries developed economically and, in time, wages in those countries rose. Manufacturers then moved on to a new tier of low-wage countries and repeated the process, exporting their new plant output to both the original high-wage countries and the developing countries they had just left. The repetition of this process created what we now call the production "hurricane" – a vicious swirl of export goods seeking markets. In many countries, production capacity far exceeds the domestic markets' ability to absorb goods manufactured, and those nations strive constantly to maximize exports – a struggle that is growing in intensity.

In many nations, the response to the hurricane has been paradoxical. More and more countries try to restrict imports (irritating trade partners) even as they increase exports (intensifying the hurricane). In more industrialized countries, items made abroad in lower-wage venues easily displace higher-priced, domestically manufactured goods, causing local producers and their workers to scream for protection. Political leaders hear those screams, and even as they pay lip service to the free-trade goals of the World Trade Organization (WTO), they also rebuild import barriers as a form of "hurricane insurance" – although continuing aggressive export policies that add to the

hurricane's force. These same political leaders originally envisioned the WTO as the instrument to bring order to this chaos. In Goldilocks' "just right" economies, the WTO might have worked. Right now, it is not working. Many countries are forgetting their WTO commitments and again adopting protectionist tactics that not only undermine free trade but threaten the foundations of the "Goldilocks recovery." Their actions send a strong message that, in Goldilocks' frame of reference, "just right" is just not right, and the idyllic economic forecast may be headed into turbulence.

The Production Hurricane

The basic energy source for the production hurricane is manufacturing capacity in excess of domestic needs. At the eye of the hurricane are manufacturers still increasing capacity even in the face of this surplus, further whipping up the swirl of goods looking for a market. Signs of the production hurricane are visible in many countries and many industries. For instance:

✦ China has built too many chemical fiber and cotton spinning plants. The resultant oversupply of raw materials has quickly turned into overcapacity in garment production. According to the State Statistical Bureau, China now has twice as much capacity as it needs to satisfy domestic demand, and a billion textile products (*e.g.*, shirts) lie unsold in warehouses. Chinese automakers and their foreign partners, despite sluggish sales and current surplus capacity, continue to add plant capacity at whopping rates. According to Auto Resources Asia, an industry consultant, capacity will reach 3.3 million autos by the year 2000, even though foreseeable demand is unlikely to exceed 2.25 million vehicles. Toshiba is building a new color-TV factory in China despite the fact that last year Beijing deemed domestic production capacity excessive. Foreign and domestic motorcycle and bicycle manufacturers have overexpanded their Chinese production, causing inventories to swell. Even Chinese beer production runs an estimated 15 million metric tons ahead of demand. But Chinese firms, anxious to secure jobs for all their employees, are very reluctant to cut back on production. (*Nikkei Weekly*, 10/7/96, 10/28/96 and 4/14/97; *USA Today*, 12/16/96; *South China Morning Post*, 1/4/97)

✦ To escape some of the world's highest wages and shortest working hours, German firms have been furiously establishing new manufacturing capacity abroad, duplicating existing capacity at home – capacity that can remain in play if German workers will accept lower wages and longer hours. Bundesbank figures showed that German investment abroad nearly doubled in 1995, to $32 billion, and rose an additional 40 percent last year. A recent survey found that 28 percent of Germany's 6,000 leading companies planned to create new production capacity abroad over the next three years. Luxury car maker Mercedes-Benz plans to increase its foreign production from 5 percent to 25 percent of sales in the next few years. In recent months, German chancellor Helmut Kohl has made trips to Latin America and the Philippines, promoting further German investment there. (*Journal of Commerce*, 9/16/96 and 10/31/96; *International Herald Tribune*, 4/8/97 and 4/10/97)

✦ Major Japanese and South Korean semiconductor makers were too optimistic in their most recent capacity expansions for 64-megabit memory chips. An 80 percent drop in the price of predecessor 16-megabit chips caused many chip makers to convert existing plants to 64-megabit chip production, making many of the new plants unnecessary. In the face of this overcapacity, Singapore is charging ahead with a $30-billion plan to build 25 new chip plants within the next decade. Drawn by generous Singapore government incentives, many of the Japanese and South Korean chip makers who overbuilt this past year have signed up as participants. (*Business Week*, 9/16/96; *Nikkei Weekly*, 3/31/97)

✦ South Korea's Daewoo has become the largest investor in Uzbekistan – close to $1 billion in nine projects. By the year 2000, one of the Daewoo projects hopes to produce about 160,000 cars and minivans a year. At another project, Daewoo workers assemble televisions, video recorders and audio systems. A third project builds telephone switching stations; a fourth, cellular telephones. The capacities of all these projects are well in excess of Uzbekistan's needs. According to Hee Choo Chung, Daewoo's managing director in Uzbekistan, "All our industries here are mainly targeted for export." (*RussiaReview*, 11/18/96)

With that brief statement, Mr. Hee neatly summarized the response of most countries to the production hurricane: export.

The Need to Export

Keeping new factories humming when domestic markets cannot absorb their output means one thing: export at any cost. The production hurricane has resulted in a broad range of countries trying to push as many goods as possible into export markets. For example:

✦ Malaysia has become the world's fastest-growing exporter this decade, showing an 18 percent annual export growth rate measured in U.S. dollars. (*Journal of Commerce*, 4/15/97)

✦ Japan, after a several-year period of coerced export restraint, is exploiting a weak yen to crank up its export engine. Tokyo's trade surplus with the U.S. has widened for five consecutive months, and export growth accounted for nearly half of Japan's economic expansion in the past two quarters. (*Asian Wall Street Journal*, 3/17/97)

✦ The German export machine has risen a notch in response to a fall in the value of the deutsche mark. German exports in the final quarter of last year exceeded the same period of 1995 by 8.9 percent. Most forecasters expect exports to rise between 6 and 7.5 percent in 1997. A German Economic Institute East European specialist forecasts that exports to Central and Eastern Europe will surge 18 to 20 percent this year. (*Journal of Commerce*, 2/24/97; *Economist*, 4/5/97)

✦ Canada's merchandise exports rose 7.7 percent in the first two months of this year, compared with the same period a year ago. This follows a record total $267 billion in exports in 1996, the fifth consecutive year of increases. Canadian exports of goods and services now account for nearly 40 percent of GDP. (*Financial Post*, 4/26/97)

✦ In 1996, Mexico became the largest foreign textile supplier to the U.S., moving up from the eighth-largest in 1993, the year NAFTA took effect. Textile shipments to the U.S. in 1996 jumped 41 percent from 1995 levels. (*Journal of Commerce*, 4/7/97)

✦ Russia has increased its export efforts, hustling arms around the Persian Gulf – long a stronghold of U.S. defense contractors. Low prices and increasingly sophisticated Western-style marketing methods have paid dividends for Russian arms dealers. Kuwait recently bought Russian infantry fighting vehicles, and the United Arab Emirates are considering a Russian proposal for an air-defense system. (*International Herald Tribune*, 4/5/97)

The U.S. also has stimulated exports, easing its restrictions on sales of advanced weapons to Latin America. As a first break in an outright U.S. ban on high-technology sales to Latin America, the Clinton administration will allow Lockheed Martin Corp. to submit a technical bid for sales of F-16 fighter planes to Chile. Military analysts have said the sale of F-16s could change the balance of air power in South America. Some in the State Department and the National Security Council fear it will stimulate a regional arms race...but quite possibly additional export sales – and that might be the overriding consideration.

The Changing Attitude Toward Free Trade

In the early months of the WTO, at least some degree of enthusiasm for free world trade prevailed. Most countries more or less put up with the global export push, challenging only the most aggressive exporters and typically using the WTO dispute format. But the competition for export business has grown even more intense, pushing prices down painfully and constricting the monetary volume of trade. World merchandise trade rose by 4 percent in 1996 to reach $5.1 trillion, but that represented a

substantial slowdown from the previous year's growth of 19.5 percent. (*Journal of Commerce*, 4/10/97)

This combination of increased competition for export markets and constricting trade volume has quickly reflected itself in the way countries look at free trade. As we first noted in "The World Trade Organization's Failing Aim?" (**IF 1716**, 6/12/96), enthusiasm for and commitment to free world trade have severely waned. In many countries, export growth has become paramount, relegating free trade everywhere to a lesser status. Moreover, political leaders are facing growing pressure from domestic manufacturers and workers to protect domestic markets and jobs. In response to this pressure, they are reverting to a pair of more restrictive courses of action reminiscent of pre-WTO days: keep foreign goods out; keep foreign influence out.

Most overt in this regard is South Korea. Seoul's current-account deficit tripled in 1996 to a record $23.7 billion – the second-largest in the world after the U.S. Central bank officials blamed the drop on the plunging prices of key export products – 61 percent for semiconductors, 15 percent for chemicals, 8 percent for steel products. These items accounted for nearly 40 percent of total South Korean exports. To redress the imbalance, Korean consumer groups in mid-1996 launched a "frugality campaign" urging consumers to spend less on luxury items. Since foreign goods are almost always more expensive than South Korean products, the campaign clearly targeted imports.

Though technically not a sponsor of the campaign, the Seoul government nonetheless unofficially orchestrated it. Some top government officials have even remarked on the "patriotic duty" of avoiding imports. European exporters have charged that Korean tax and customs officials are harassing them with excessive testing and labeling procedures, inordinate delays in customs clearance and repeated tax audits. They further note that Seoul has unjustly increased a number of import duties. Two foreign tobacco companies have charged that Korea's state-run tobacco company threatened to stop delivering Korean cigarettes to small retailers that sell foreign brands. In Pusan, South Korea's second-largest city, tobacco importers lost half their retailers and 30 percent of their business during the final third of 1996. After the National Tax Administration requested customer lists from automobile-leasing companies, sales of imported autos fell 45 percent. Tax authorities have even warned Korean golfers that two overseas golfing trips within a year will win them special scrutiny. (*Financial Times*, 2/10/97; *Asian Wall Street Journal*, 3/10/97; *Journal of Commerce*, 3/12/97 and 4/21/97)

"You'll have to excuse my wife. She's a bit of a control freak."

The South Korean frugality campaign against imports assumes a cynical coloration when paired with the recent Seoul announcement to **eliminate** the 8 percent tariff on semiconductors by 1999. Since the country imported more than $10 billion worth of semiconductors in 1996, the tariffs will mean a substantial drop in government revenue at a bad time. But the tariff elimination will qualify South Korea to join the newly formed Semiconductor Industry Council (Can you spell "cartel"?), a body created last year by the U.S. Semiconductor Industry Association and the Electronics Industries Association of Japan to "find common ground...[on] competitive issues facing the capital-intensive semiconductor industry." As a result, Seoul's free-

trade offer to eliminate import tariffs will simply help it join a group to control prices and allow it to export more easily. (*Journal of Commerce*, 4/3/97)

India, a darling of foreign investors in recent years, at first glance appears to be pursuing a more balanced, pro-WTO course of action. New Delhi recently announced a new five-year trade policy aimed at spurring exports by revamping promotion programs and simplifying paperwork and procedures. At the same time, the government also shifted more than 500 restricted import items to less restrictive categories. But India has started to display a strong protective side as well. In 1995, New Delhi slowed the privatization program it had begun in 1991, which was open to foreign investors. In April of this year, the country completely reversed itself and ordered foreign airlines to **withdraw** their investments from Indian domestic carriers within six months. Around 20 private airlines were launched in India after the government opened up the industry to the private sector in 1992. Aviation Minister C.M. Ibrahim stated that continued foreign investment in private Indian companies would lead to the destruction of India Airlines, the state-run domestic carrier, which faces chronic labor unrest and financial losses. (*International Herald Tribune*, 4/5/97; *Journal of Commerce*, 4/1/97 and 4/23/97)

Seeking to ease a growing trade deficit that approached $3 billion for the first quarter of 1997, Brazil recently turned to import restrictions. At the end of March, the country's central bank published "temporary" restrictions on import financing. One new rule requires importers to pay cash – even though they possess longer-term letters of credit – when their shipment arrives at customs facilities. The rule is intended to discourage Brazilian retail chains and supermarkets from importing consumer goods. (*Journal of Commerce*, 4/1/97)

France is another country developing a protectionist streak. In Paris, job preservation has become a giant political issue. The French government has been trying since last year to privatize the giant Thomson SA. The public, as well as many in government, insist that the buyer of Thomson be French, feeling that would maximize the opportunity to preserve domestic jobs.

A first agreement to sell the company fell through because part of the sale involved the purchase of Thomson Multimedia, an unprofitable television manufacturing division, by South Korea's Daewoo Electronics. The public opposed the sale intensely, the independent Privatization Commission objected to it, and with no other buyer for Thomson Multimedia, Prime Minister Alain Juppé abandoned his hopes of a package deal covering all of Thomson. Juppé opted instead to privatize the sought-after Thomson-CSF, the country's leading defense electronics manufacturer. But when a British suitor, General Electric Co. (GEC), tried to enter the bidding, the French Finance Ministry said that it would be contrary to "essential interests of national security" to allow Thomson to fall into foreign hands and disallowed GEC's candidacy.

Even though France supports the European Union's plan to integrate defense industries and even though French officials have described Thomson's privatization as a step toward forging a European defense-electronics giant capable of competing with Raytheon and Hughes, Paris refuses to let Thomson pass from French hands in pursuit of that goal. To make sure no one missed their protectionist signal, less than a week later the French government scuttled a merger between Framatome, a state-controlled maker of nuclear reactors, and GEC Alsthom, a joint venture of GEC and Alcatel Alsthom SA, by insisting that GEC hold less than 50 percent in the new company. (*International Herald Tribune*, 4/5/97, 4/7/97 and 4/8/97)

"What good is power if you don't use it?"

Finally, as part of Indonesia's "national car program" to create a domestic auto manufacturing industry, Jakarta has given an Indonesian–South Korean joint venture with ties to President Suharto's family permission to import auto components exempt from the high tariffs and luxury taxes foreign competitors must pay. In response, the European Union, the U.S. and Japan all recently filed complaints with the WTO. Indonesia's response was not exactly in the spirit of free trade. On April 22, Indonesia's minister of trade and industry, Tunky Ariwibowo, announced that the government will provide "whatever assistance is necessary" to complete the national car program prior to an expected 1999 World Trade Organization ruling on the issue. (*Journal of Commerce*, 4/21/97 and 4/24/97)

The examples above suggest that the world has reached an inflection point in regard to free trade. To sum up, the New Industrial Revolution led to a huge expansion of high-quality, low-cost production capacity throughout the world. With capacity well in excess of domestic needs, many countries embarked on determined export efforts to maximize utilization of surplus plants. They aligned themselves with the WTO's goals to promote worldwide free trade during that organization's early months. But competition for export sales has escalated and export prices have dropped, increasingly displacing domestically produced goods from home markets.

Now, the WTO goals seem too costly, and many countries are retreating from them. WTO-inspired loosening actions on trade are giving way to a new wave of protectionist moves, as political leaders in many nations respond to cries from the public and domestic businesses to reduce foreign influence in business, insulate local markets from imports and preserve jobs. These leaders are willing to risk foreign sanctions and challenge within the WTO to address what they consider a more pressing domestic problem. Yet even as they start to rebuild protectionist walls, these same nations continue their efforts to maximize exports. In their effort to have it both ways, they are jeopardizing the world economy's newfound stability. If this new protectionist wave continues to build, our latest "just right" world of Goldilocks could dissolve into trade dissension and economic volatility. The next Davos forum might have to acknowledge that the economy was just not right after all, and some participant will have to make the sad announcement: "Goldilocks has left the building."