



THE ANXIOUS AGE OF REVALUATIONS: GOVERNMENTS, CURRENCIES AND THE SUCKING SOUND

The Golden Age of Earnings, a time when the cost of raw materials, labor and technology remained steady and low, has given way to the Anxious Age of Revaluations, a seeming upside-down version of the Golden Age. A principal cause behind the shift has been the reversal of fortunes for countries such as China, which during the Golden Age exported deflation but now are exporting inflation.

World governments are dealing with this new problem by taking more assertive actions to support their economies, including foregoing their affinity – during the Golden Age – for things like open markets and free-floating currencies. The price of exports is becoming an issue, which means that currency values are becoming an issue. Many countries are trying different tactics to restrain inflation without actually increasing interest rates. We anticipate governments taking additional actions to: push up the dollar's value (even as the U.S. government may want it to slide further); control prices and manage money supply; protect domestic markets and economies; accept market volatility; and employ competitive devaluations to sustain growth.

The Golden Age of Earnings

After his unsuccessful run for president in 1992, Ross Perot launched a personal campaign against the North American Free Trade Association (NAFTA), suggesting that Americans hear a “great sucking sound,” the sound of American jobs being pulled down to Mexico. He proved to be prescient, as *maquiladoras* sprouted along the Mexican border to build everything from televisions to air conditioners.

What Perot did not anticipate, however, was Mexico's own need to hear the “sucking sound,” as jobs soon left that country for China, where workers earned as little as 35 cents per hour, as opposed to the Mexican's \$2-plus per hour. Philips Electronics and Canon vacated their Mexican plants and headed to China as well as Thailand and Cambodia. Meanwhile, in China, the state-owned Chery Automobile Corporate started selling cars to the domestic market at prices roughly 10,000 yuan cheaper than General Motors and Volkswagen, both of which had spent money building

factories in China with the hope of dominating the Chinese market (see “China’s Mega Export: Deflation,” **IF 2333**, 12/4/02).

The New Industrial Revolution was playing itself out. We first discussed this concept in the 1980s, when industrial production became easily transferable and companies started moving factories and facilities anyplace in the world that lowered costs. The sucking sound that Perot eventually identified came from a lower-cost location pulling manufacturing (and then services) from more expensive locations (see “The New Industrial Revolution,” **IF 616**, 6/7/85 and “The Playing Out of the New Industrial Revolution, Part III: Turmoil Rules, Dude,” **IF 2107**, 3/31/00).

As a result of this migrating capacity, costs, including raw materials, energy, labor and technology, became endemically low. Everything producers needed to undercut global market prices was in place, and the last huge producing country in this quest for ever-lower costs was China. Brands shifted production from their countries’ of origin to China and Asia, and retailers worldwide bought discounted goods from Chinese producers. These brand companies and retailers were able to convert lowered costs into handsome margins. As a result of these realities, China had a new and substantial export: deflation.

This new level of internationalization accelerated the emergence of a globalized labor market that forced individual workers in the U.S. and elsewhere in the industrialized West to compete with workers in less industrialized countries such as China, India and Vietnam. As a result, wages in the U.S. stagnated, actually declining in real terms during the first years of this century. As U.S. companies tried to offset China’s low-cost advantage, they increasingly transferred benefits costs to employees. What replaced wage increases and enabled individuals to remain active consumers was the biggest run-up in overall consumer debt in U.S. history, jumping from \$7.4 trillion in 2000 to \$14.4 trillion in 2007. (*Newsweek*, 4/28/08)

In short, with labor costs declining, raw materials prices remaining stable and technology costs declining, global businesses enjoyed what can only be called the Golden Age of Earnings. Between 2000 and 2006, according to the U.S. Bureau of Economic Analysis, the

median income of American workers remained flat, while corporate profits doubled. In the final quarter of 2005, corporate profits claimed the largest share of U.S. gross domestic profit (GDP) in 37 years, reaching 11.6 percent. (*finfacts.com*, 4/3/06)



Anxious Age of Revaluations

The sucking sound that Perot heard coming from Mexico has now become the sucking sound coming from China. During the few years that comprise the Golden Age, the Chinese sucking sound represented the pull of jobs from everywhere to China lowering costs for international companies. Now that sound represents not only the pull of jobs to China but also its usurpation of the world’s raw materials. This pull of oil, gas, iron ore, wheat and other commodities no longer triggers world deflation, as in the prior era, but inflation. To take one recent example, Chinese steelmakers just signed a deal with Rio Tinto to assure an ample supply of iron ore for the next year at a price that is 96.5 percent higher than **one year earlier**. The prior year’s contracts managed just a 9.5 percent increase. China is “Hoovering up” the iron ore and forcing up the price for everyone else. (*Financial Times*, 6/23/08)

Whereas China and its low-cost Asia neighbors once exported deflation, China and all producing countries—exporting everything from oil to

rice—are now exporting inflation. Consuming countries benefited from the deflationary spiral, and they are now suffering through the inflationary spiral. After several years of actual decreases, the price of China’s exports to the U.S. increased by 4.1 percent during the year ending April 2008, and as the yuan slowly increases in value against the dollar, inflation should increase even more. And China’s new status as an exporter of inflation is being abetted by a whole range of countries that produce and export natural resources, from food to energy. Meanwhile, China itself is importing inflation from other producing countries, with food prices surging in China by 22 percent in the past year, while non-food consumer prices increased just 1.8 percent. (*Economist*, 5/24/08)

At the same time in the U.S., the real estate bubble that conveniently replaced salary increases with inflated asset “wealth” during the Golden Age has now collapsed. The elimination of consumer access to further credit has added pressure to family budgets and is driving an invigorated call for pay increases – and workers are increasingly turning to unions to secure those increases. The real estate collapse has also triggered problems for major financial institutions and ended the high liquidity tide that kept corporate profits afloat during the Golden Age of Earnings.



The global economy is now experiencing a near complete reversal of that Golden Age. Raw materials, including energy and food, are no longer inexpensive. Labor costs in China, Europe, Asia and potentially the U.S. and Latin America are starting to increase, rapidly in some places. The cost of production technology is rising as well, tripped not only by energy and transportation costs but also by significant increases in the prices of steel and other construction materials.

The world seems upside-down compared to a few years ago. The routine reporting of increased profits and the resulting steadily increasing equities markets have been replaced by massive demonstrations against high food prices and increasingly hostile labor strikes. Confidence in the future, once a staple of Western economies, has given way to anxiety about today as well as tomorrow (see “Developed Countries Sing the Blues: Economic Stresses and Political Liabilities in Highly Industrialized Countries,” **IF 2911**, 5/30/08).

In this upside-down world, everything is being revalued, including the basic elements that helped form the Golden Age—raw materials, labor and technology. Those who supplied these items at lower costs during the Golden Age now claim that what they provided was undervalued, and when possible, they have responded with huge price increases. For instance, the 19 commodities on the Reuters/Jeffries CRB Index increased 29 percent in the first six months of this year. The UBS Bloomberg measure of 26 commodities increased 33 percent, to an all-time high. Prices on many commodities as diverse as coking coal and rice reached historic highs. Prices of goods and services that remained inexpensive during the Golden Age are tending upward in this new environment, and in many cases, moving upward with considerable force. (*Bloomberg*, 6/30/08)

Consumers are also revaluing things they once bought without question; thus, declining sales have hit once popular companies and products such as Starbucks, fine dining, travel, fitness centers, first-class tickets, clothing and sport utility vehicles (SUVs). New, lower values on large cars, especially SUVs, forced Chrysler to end its leasing program, the area of car sales most vulnerable to sudden declines in car values.

Markets are also more skeptical of the valuations attached to many of the corporations that enjoyed the Golden Era of Earnings, and if equities markets offer any

insight into the effects of that skepticism, new valuations are generally lower. As stable as the Golden Age was for some, the Anxious Age of Revaluations is destabilizing for most, and no end to this valuation volatility is in sight.



Anxiety About Currencies

Currencies are not immune to the effects of the Anxious Age of Revaluations. In fact, they have moved to the forefront of many countries' responses to the new economic environment. Currencies, like so many commodities, corporations and products, are being revalued, sometimes with harsh effects. As a result, many governments are trying to stabilize their currencies in the face of these new market revaluations.

◆ The Mexican government placed controls on 150 basic foodstuffs, in effect holding the currency steady as it relates to those specific items. (*Financial Times*, 6/19/08)

◆ Twenty-nine countries, during the recent skyrocketing of food prices, sharply curtailed or halted altogether the export of foods they produced, essentially controlling the price at home by keeping ample supply at home. This action holds currencies stable by maintaining food prices stable or declining. (*New York Times*, 6/30/08)

◆ The Indian and Chinese governments substantially increased the mandatory reserves that banks must hold, thereby reducing the money supply floating around the economy and easing inflation pressures that eat away at a currency's value. (*Times of India*, 6/24/08)

◆ The Vietnamese government halted the import of gold because so many citizens were using the country's currency, the dong, to buy the inflation-mediating commodity. By doing so, the government sought to halt the currency's slide in international markets. (*Financial Times*, 6/24/08)

◆ China and the U.S. have issued extra government bonds to absorb excess cash sloshing around their economies. The U.S. Federal Reserve would like to put in place additional incentives for U.S. banks to place more of their cash reserves with the Fed, thereby enabling the government to remove more cash from the economy as a means to slow inflation without raising interest rates. (*BusinessWeek*, 6/2/08; *Financial Times*, 6/25/08)

◆ The government of South Korea sold one billion U.S. dollars and bought the won on open markets, sending its currency up 1.5 percent, all in an effort to combat inflation, which reached a seven-year high in June. Similarly, in May, Indonesia bought \$2.6 billion of its currency, the rupiah. (*Financial Times*, 6/25/08)



"The Europeans are taking advantage of the exchange rate."

Such actions reveal governments trying to affix some predictable and stable value to their currencies to avoid unwanted market swings in value. This list of actions does not include more traditional governmental efforts to control inflation and currency values through increased interest rates, an approach taken by countries such as China, Russia, Indonesia and Brazil. Moreover, countries whose currencies are pegged to the dollar, as do most Persian Gulf countries as well as China, including Hong Kong, must now reconsider that peg as a way to control inflation domestically. Specifically, the Saudi Arabian pegging of its riyal to the dollar has led to an inflation rate of more than 12 percent in that country simply because of the dollar's lower value on international markets and because the Saudis had to match America's lower interest rates – despite their healthy economy – just to sustain the peg. (*Economist*, 5/24/08; *Financial Times*, 6/18/08)

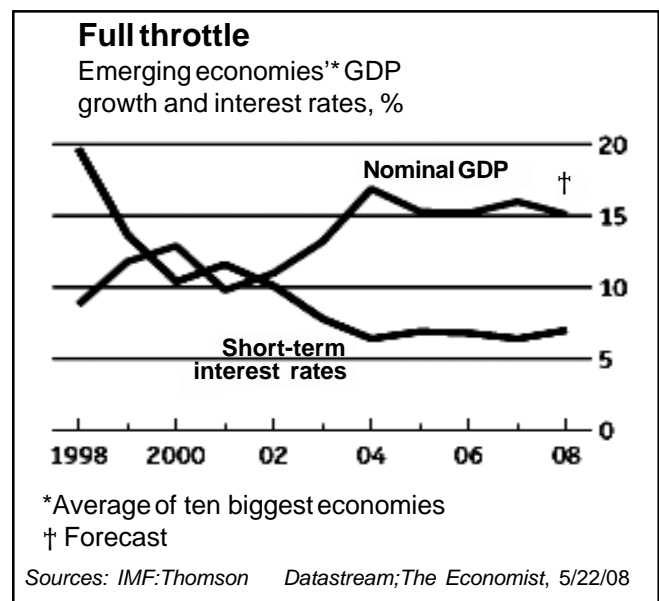
The Anxious Age of Revaluations will continue to create volatility, even unpredictability, in currency markets because accepted values for the economies that stand behind the currencies have yet to be established. Thus, currencies and economies face the same revaluation that is taking place among once “undervalued” or “overvalued” products, services, raw materials and the like. And in all those instances, markets are still juggling and weighing possible value resets.



Volatility Is as Volatility Does

The ups and downs of currencies are not neutral in their effects on other economies and currencies. When a currency declines in value, its new value lowers the price of that country's exports on international markets, thereby negatively impacting competing exports from other countries. The weakened currency also decreases the international buying power of that country's consumers. Conversely, when a country increases its interest rates and encourages an upward movement to its currency, that new value of the country's currency increases prices on its exports, thereby helping other countries' exports in global markets. The strengthened currency also increases the international buying power of that country's consumers. For instance, if European economies continue to slow this year and the value of the euro declines, economies in Eastern Europe, which, in the instances of Poland, Hungary and the Czech Republic, sends more than 50 percent of its exports to Western Europe, will be negatively affected. (*Financial Times*, 6/18/08)

For that reason, many countries, like those noted in the bulleted items above, have made any number of tries at controlling inflation domestically while keeping the value of their currencies low in order to preserve the competitiveness of their exports. During the Golden Age of Earnings when China was exporting deflation, central banks in emerging economies were able to keep interest rates relatively low, especially when measured against their GDP.



Also, governments with emerging economies have managed to keep the growth of their broad money supply at roughly 20 percent over the past year, nearly triple that of developed countries, with Russia swelling money supply by 40 percent in the past year. Typically, such substantial increases in money supply would have triggered inflation, but with prices being held in check by China's exportation of deflation, countries could keep interest rates especially low and also flood their economies with money (liquidity) without risking inflation – the Golden Age, indeed. (*Economist*, 5/24/08)

Exporting countries do not want the permissive environment to end, and that desire (or perhaps a need for some countries) is likely to trigger the competitive use of currency values and trade regulations. How can exporting countries whose goods and services are being revalued downward by world markets – especially finished products in what we have called “sunset” industries – keep their growth going?

The short answer is: price, which in a global market eventually means – currencies. China, for instance, must now play the currency value game. With a currency pegged to the dollar, China's currency has not increased in value the way it would have without the peg. That has triggered negative responses from leaders in its foreign markets. For instance, in June the EU raised tariffs on some goods from China, including leather shoes, plastic bags and cathode-ray tube televisions, and the European Commission placed anti-dumping measures on Chinese citric acid and is investigating alleged dumping practices around steel production. (*Nikkei Weekly*, 6/23/08)

Beijing does not mind a slow increase in the value of the yuan because that makes its own foreign purchases of food, raw materials and energy less expensive, and it will help stimulate a domestic economy, something to lessen the economy's dependence on exports. Yet, it does not want to yield to Western political pressure and allow the currency to increase in value appreciably in the short term because that would make its exports too expensive, not a good thing when its major markets are entering an economic slowdown.

During the first six months of this year, the yuan increased in value against the dollar, rising from 7.3 yuan to the dollar to 6.9. That encouraged investors to buy into the yuan under the assumption that further adjustments would be coming. As a result, a massive infusion of

foreign “hot money” entered the market – \$52 billion in the first six months of this year, up 45.5 percent overall last year – exacerbating already increasing inflationary pressures. “Experts” think China should make one large jump in the yuan's value, thereby short-circuiting currency players. Yet, as mentioned, such a move would devastate the country's export-driven economy. China had a more abrupt answer to would-be currency speculators: pushing the value of the renminbi down 0.3 percent on July 28, the single largest one-day drop since Beijing allowed the currency to start strengthening in 2005. (*Business Week*, 7/28/08; *Financial Times*, 7/29/08)

The solution for China is increasingly becoming the answer for many countries: manipulate its currency and export prices to sustain growth and control inflation. That will require avoiding market forces when possible and using government control to generate desired economic results at home.

Governments still have some control over currency values, even though most are supposedly free to float on global markets. Trade is another area in which governments can still apply a measure of control, even though markets are allegedly open. As the Anxious Age of Revaluations moves along, the downward pressures that it adds to many economies will prod some governments to act:

Push up the dollar – Too many countries are hurt by the declining value of the dollar. Despite a weakening U.S. economy, those countries could well try to boost the dollar's value (and may already be doing so).

Control prices and manage money supply – Managing currency values without altering interest rates will continue to be critical to countries combating imported inflation.

Protect domestic markets and economies – While “protectionism” is a pejorative term to hardened free marketers, it is a political necessity for more and more world leaders. In defense of economic growth, governments have started to apply whatever tools they need to alter market dynamics in their favor, including tariffs, taxes and quotas.

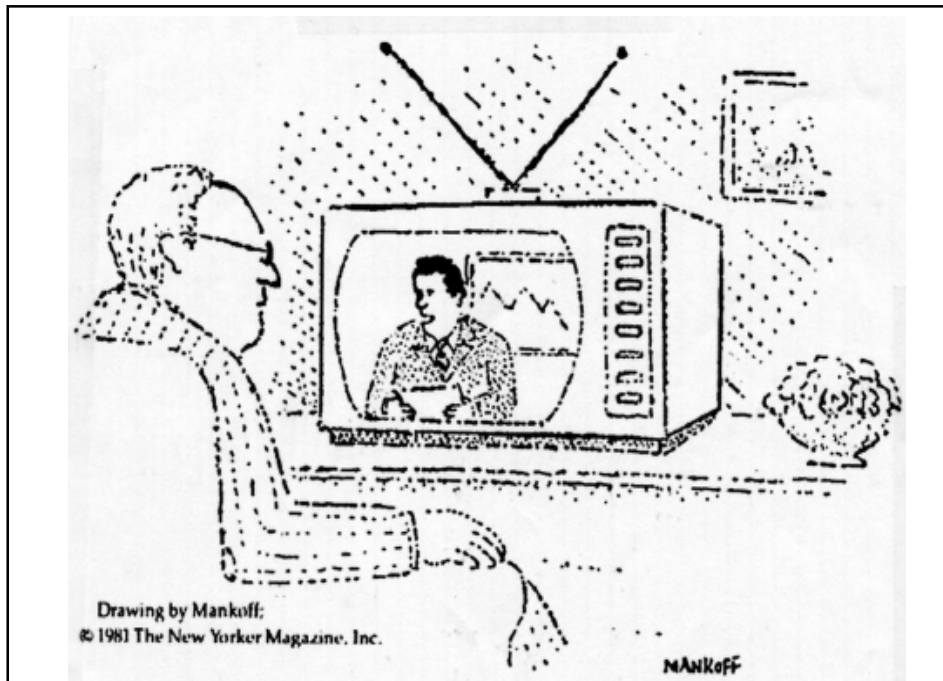
Expect volatility in import prices – We have discussed how state-owned enterprises are taking hold of pricing in commodities they control, and they may be entering an era of “market combat,”

as they seek to control and manage prices while standard market forces move with business cycles. As a result, we could see substantial swings in prices – as we already have this past year.

Employ competitive devaluations to sustain growth – With China and other countries exporting inflation, it seems contradictory to suggest that currency manipulations, especially pushing values downward, would be likely. But exporting countries will soon need to stimulate their economies and will want to keep their product prices low. The U.S. could well lead this competition when it starts.

Perot's sucking sound of jobs being pulled down to Mexico shifted to a sucking sound emanating

from jobs being pulled into China. Then the sound came from China sucking up raw materials and natural resources worldwide, and in the instances of China and India with their huge populations, the effect on prices has been both quick and substantial. The shifting application of Perot's famous descriptor paralleled a transition from China (and other low-cost countries) exporting deflation to China (and other commodity-hungry countries) exporting inflation. In response to the latest economic condition, countries have become more aggressive in protecting their economic interests. As a result, the new sucking sound comes from governments vacuuming up (and dumping) open-market concepts on currencies, pricing and trade.



“On Wall Street today, news of lower interest rates sent the stock market up, but then the expectation that these rates would be inflationary sent the market down, until the realization that lower rates might stimulate the sluggish economy pushed the market up, before it ultimately went down on fears that an overheated economy would lead to a reimposition of higher interest rates.”