

Will East Asia Rule the World Economy? Economic and Financial Lessons from the 1970s

R Taggart Murphy

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In a recent article (<http://www.ft.com/cms/s/0/3a6dc5f8-5447-11de-a58d-00144feabdc0.html>) in the Financial Times, “Why a little knowledge of inflation can be dangerous” Russell Napier muses on the possible return of the circumstances of the 1970s – most particularly inflation. After a good, smart slap at academics and their infatuation with the efficient markets hypothesis for “making it even more likely that lessons from the pre-disinflationary era are not yet priced in,” Napier notes that “investors unburdened by dreams of efficiency and prepared to learn the lessons of history will have a decided advantage in the search for positive real returns.”

And what might those lessons be? That given what governments are doing today to pull us out of the current recession, another bout of 1970s-style inflation is probably on the horizon. That investors need “to look for investment vehicles that can be highly adaptive to this new

environment.” And that “investors need to hold more overseas assets” because, after all, “as investors discovered during the 1970s, a government in dire straits can depress returns on a very wide range of domestic assets.”

Here is where Napier becomes very interesting to readers of Asia Pacific Journal. For he goes on to write, “during (the 1970s), inflation in the west transferred unimaginable wealth to a very few in the Middle East. Our new inflationary wave will transfer wealth from the consumers of goods in the west to the producers of goods in the east.”

Napier doesn’t spell out what he means by the “east” but I think we can safely assume he is talking about China, Japan, and Korea. The conventional wisdom is that these three countries – particularly the latter two – are having a bad time of it; indeed Richard Katz has noted in a May 25 post at the SSJ Forum

(http://ssj.iss.u-tokyo.ac.jp/archives/2009/05/sj_5580_japans.html) that “The latest GDP figures show a recession of truly stunning proportions in Japan... that Japan is having, by far, the worst recession among the rich countries in the

OECD.” And even the blurb that starts off James Fallows’ widely noted piece in the April issue of the Atlantic

(<http://www.theatlantic.com/doc/200904/chinese-innovation>) on China’s ability to ride out the current difficulties concedes that today “the signs of depression are everywhere” in China. And if Napier meant to write only of China, he would have said “China” rather than “the east.”

So if Napier is right, what is in store? Let’s consider what happened back in the 1970s. Before 1973, oil producers were price takers. In that year, they wrested control of oil markets from their customers – primarily the Americans – and since then have largely been price setters. The Yom Kippur War of 1973 and the subsequent suspension of petroleum exports by Arab oil producers may have demonstrated to producers that they had the power to control oil markets. But the underlying motive for the muscle flexing by the OPEC cartel was surely the loss of real income following the end of the Bretton Woods system in 1971. That collapse of a system that had permitted the United States to export inflation to non-dollar economies saw the value of the dollar plummet as pent up inflationary pressures surged back into dollar instruments with a vengeance. The oil producers, and any entity being paid in dollars, suddenly found itself poorer. But the oil producers discovered they had the power to claw back the losses they were incurring from inflation, and they used it –not

just to recover those losses, but to enrich themselves.

Similarly, today the three East Asian economic powerhouses collectively possess much of the world’s productive capacity – just as OPEC had (and has) much of the world’s oil producing capacity. A generation of corporate outsourcing in the United States and elsewhere, combined with blinkered adherence to an ideology of free trade helped bring on one of the largest scale transfers of production capacity in history: from the West to Japan, China, and Korea. (I discuss the role that “free trade” has played in providing a cover for an assault on middle class incomes in countries such as the US and the UK here (<http://www.newleftreview.org/?page=article&view=2787>).) While much of that capacity – at least in China – may be owned by outsiders, even the Chinese are taking advantage of current economic circumstances to bring as much as they can under their control.

If and when the economies of the US and the UK revive, these countries will find themselves forced to place orders for everything from capital equipment to consumer goods from manufacturers in the Asian trio. It is conceivable that the world will return to the status quo ante, and the Asian producers will swallow whatever prices are set in competitive American, British and German markets. But if Napier is right, the Asian producers may wake up to the power that they have – particularly if the policies being

followed in Washington and London to stimulate economies result, as he suspects they will, in a return of inflation. Japan, China, and Korea may insist that they be compensated in some form for the weakened purchasing power of the currency in which they are being paid.

One way to do that would involve insisting that their Western customers pay for Asian goods in currencies they control. Indeed, Brad Setser has written a long thoughtful piece (<http://blogs.cfr.org/setser/2009/05/15/different-conceptions-of-chinas-role-in-the-global-financial-system/>) on how China may seek to shape the post recession global financial order; he notes “China’s evident discomfort with its dollar exposure.”

But if the world follows the pattern set in the 1970s, after toying with alternatives to the dollar as the world’s settlements and reserve currency, producers will settle again on the American currency -- at the price of much higher returns to themselves. Several petroleum exporters gave serious thought back in 1974 to billing their customers in currencies other than the dollar. For a variety of reasons – principal among them, the lack of a credible alternative currency and the US security umbrella provided to Saudi Arabia, the shah’s Iran, and the Gulf emirates – the major oil exporters went back to using dollars. And not just as the currency in which to bill their customers. They provided crucial support to the reconstitution of the global financial order by

putting the dollars they earned on deposit in London. From there, the world’s major banks on-lent those dollars to countries that suddenly needed to borrow money to pay their huge oil import bills.

What is important here: the oil exporters were not content simply to charge a whole lot more for what they were selling. They also reconfigured global finance in their favor. They got rich returns on their dollar deposits in London – by the mid 1970s, interest rates were running well over the inflation rate. When their customers in the non-oil developing countries found themselves unable to pay back what they had borrowed, it was banks in the United States and Europe that took the hit (Japanese banks also participated in the debt workouts, but the MOF had “guided” Japanese banks into considerable reduction in their exposure to developing world debt before the crisis of the early 1980s). And the oil producers put their money on deposit in London beyond the reach of the US authorities. The explosive growth of the Eurodollar markets – dollar markets unregulated by the US – dates to the 1970s.

Again, this whole episode is pregnant with suggestive parallels. The US military is a key variable in the power equations of Northeast as well as West Asia; an end to the dollar’s role as the global currency would render prohibitive to the US taxpayer the cost of projecting military force in this part of the world and supporting the

global structure of US military bases. A real alternative to the dollar does exist today in the form of the Euro, but it seems unlikely that the Asian trio will cede control of global money to a Frankfurt over which they have far less leverage than they do Washington. Other credible alternatives – some form of internationalized yen or yuan – would force China and Japan to engage in explicit bargaining. The logic of the situation suggests that it will be politically easier for both countries to permit the Federal Reserve to continue to issue what effectively would remain the world's money rather than for either Tokyo or Beijing to cede what would amount to monetary leadership to the other. (see discussion here (http://www.japanfocus.org/-R_T-Murphy/2913))

But this does not mean that the Asian trio – China in particular – will not seek to reconfigure global finance in its favor in much the same way the OPEC nations did a generation ago.

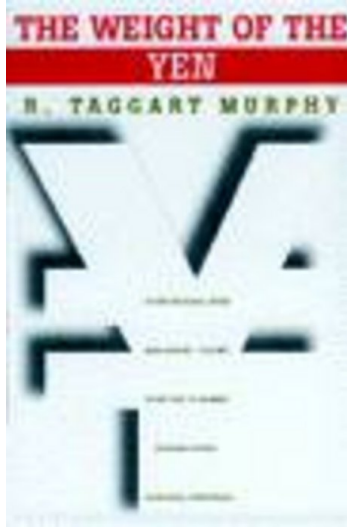
There is a limit to how far the parallels extend. Iran excepted, the oil exporters were thinly populated countries that literally could not spend all the money pouring into their coffers after the 1973 price hikes took effect. Japan faces a looming fiscal and demographic crunch while much of China's huge population still desperately needs all that money can buy. The oil exporters owe their wealth to an accident of geology and it would disappear overnight if a

new energy source could be commercialized in sufficient quantities at the right price. The Japanese, Chinese, and Koreans have worked very hard for what they have and all boast sophisticated, highly integrated economies that involve far more than pulling something out of the ground and selling it at many multiples of what it cost to extract it. Northeast Asia may, like the Middle East, be a dangerous and volatile region but in very different ways.

Nonetheless, Napier is onto something when he points out that just as the trauma of the 1970s saw a permanent transfer of wealth to the Middle East, today's economic upheavals could well result in another reconfiguration of global finance and global wealth that will see "the east" emerge with its power and clout greatly enhanced, whatever current difficulties may afflict these countries.

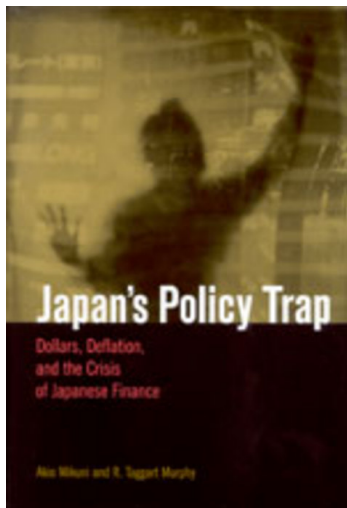
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