



# Market Perspectives

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## The Return of “Beggar-Thy-Neighbor”

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After a tempestuous few weeks in the markets, investors finally saw skies clear enough to embrace a little more risk. As a result, last week the S&P 500 and the Dow Jones Industrial Average each climbed nearly 4 percentage points; the FTSE 100 and NIKKEI 225 each rose nearly 2 percent; and the beaten-down euro found relative strength, gaining 1.6 percent against the dollar. With the risk trade myopically “on” again, at least for a week, the yield on 10-year U.S. Treasuries climbed nearly 3 percent.

None of this movement was especially surprising. Two weeks ago we discussed the impending “bounce with volatility.” Last week we reiterated the concept of the markets finding support and enjoying short-run recovery (despite the fact fundamental problems in the global economy have not changed).

But as I reflect on the events of last week, the real story is not momentarily clearer skies and cheer for the equity markets. The most important development in my mind came from a little powwow in Busan, South Korea – a place where the signals were not so auspicious for the global financial markets.

## The Significance of the G-20 Meeting

Last week, finance ministers and central banking governors from the Group of Twenty (G-20) nations met to discuss the problems in Europe and how to best bolster global economic recovery. What was disconcerting about this most recent summit was the popularity of a certain path of policies – it seems everyone wants to enact budget reform while simultaneously expanding economically. What’s wrong with that? Well, the way most G-20 economies plan to

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expand is through export growth, a strategy that looks to harness foreign demand for good and services rather than relying on domestic consumption. However, if overall world GDP growth is anemic or stagnant, the only way to achieve export-led growth is at the expense of someone else. In economics, this is often referred to as “beggar-thy-neighbor” policy, and it is a page straight out of the Great Depression’s text book.

## Beggar-Thy-Neighbor In Practice

In its most simplistic form, “beggar-thy-neighbor” describes any economic policy that seeks benefits for one country at the direct expense of another. In practice, it generally pertains to the process of competitive devaluation whereby a country depreciates its currency in the hope of increasing exports. Beggar-thy-neighbor adds nothing to global output in aggregate; instead, it attempts to reshuffle output from one nation to another, often times with dangerous consequences for long-term global trade. Beggar-thy-neighbor is the siphoning of global export market share, or the strategy of achieving gain by increasing the size of one piece of pie rather than increasing the overall size of the pie.

Beggar-thy-neighbor policies start with currency devaluation. If left unchecked it can lead down a dangerous road to protectionism, which in turn leads to the breakdown of global trade and a world where everyone is significantly worse off. Appropriately named, the economic term was originally borrowed from a card game called “Beggar-My-Neighbour,” a predecessor to the card game “War.” The rules entail taking cards from one pile to put into another. The game only ends when one player has stolen all the cards from the other. The last time beggar-thy-neighbor policies were enacted on a global scale it ended in what we euphemistically call “The Great Depression.”

## Everyone Wants To Export Their Way Out

How does this frightening economic concept pertain to the recent G-20 meeting? Following the last financial crisis, governments around the world opted to try to increase aggregate demand through a policy of government spending. This path of government-stimulated economic growth was obviously not a sustainable one. Now, as these nations face financial crisis as a result of fiscal policy, the G-20 leaders are searching for a new answer.

The popular response seems to be domestic belt tightening while looking to exports to offset the negative effects of austerity. The problem is, the exports of all the countries in the world cannot simultaneously grow without corresponding increases in domestic aggregate demand – something not likely to happen given every major government is looking to reduce the size of domestic deficits.

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### ECONOMICS ASIDE: BEGGAR THY NEIGHBOR

*Beggar-Thy-Neighbor is an expression in economics describing a set of policies that seek to benefit one country at the direct expense of others. In particular, beggar-thy-neighbor policies typically pertain to an international trade policy of competitive devaluation and increased protective barriers instituted at the expense of trading partners.*

*According to Wikipedia, the term was originally devised to characterize policies trying to cure domestic depression and unemployment by shifting effective demand away from imports onto domestically produced goods. This was generally achieved through tariffs and quotas or by competitive devaluation.*

*Beggar-thy-neighbor policies in the United States during the 1930s are generally attributed major factors leading to the Great Depression. In 1930, the Hawley–Smoot Tariff Act, raised U.S. tariffs on over 20,000 imported goods to record levels. Hawley-Smoot caused other countries to follow suit, resulting in a massive decrease in international trade and domestic production in the United States.*

*The name “Beggar-Thy-Neighbor” is attributed to an old-fashioned card game called “Beggar-My-Neighbor” that is similar in nature to the modern day card game “War.”*

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Take the European Union, for example. At the G-20 meeting, the European Central Bank said it is in favor of immediate fiscal consolidation – meaning European Union member countries will enact austerity measures accompanied by tax increases in order to shrink budget deficits. This sounds like a responsible plan, but in practice there are several problems. As we've discussed in recent weeks, higher unemployment rates and lower domestic demand are not only the hallmarks of austerity programs but also the enemies of GDP. One of the few ways to grow GDP during periods of fiscal consolidation is to sell more domestic production to the world, otherwise known as exporting your way out of trouble.

So European Union member nations plan to grow exports, good for them. The only problem is Barack Obama already promised to double U.S. exports over the next five years. And British Chancellor George Osborne said at the G-20 that he wants to see British exports to China “quite substantially increase.” Japan also plans to grow its exports with major producers like Toshiba and Nissan publicly predicting triple-digit increases in foreign sales. Then, of course, there's China, which just announced its May exports increased 50 percent year-over-year.

All this begs the question: if everyone is exporting, who is importing? If everyone is selling, who is buying? To lend my paraphrase to U.S. Treasury Secretary Timothy Geithner's message to the G-20, “I hope you all don't think the U.S. consumer is footing the bill for this.” The real answer, of course, is prices will determine which lucky nation gets to do the selling. The fastest way to affect prices is through currency manipulation.

## The Race To Devalue

Basic economics says when everyone wants to export, the winner will be the country that offers the lowest price. Beggar-thy-neighbor policy says the fastest way to have the best price is to devalue your currency. Recognition of this principle is readily apparent among G-20 member nations. French Prime Minister Francois Fillon went on record June 4 saying the euro's decline below 1.20 was “good news” because European exports would become more attractive. Similarly, Japan's new prime minister Naoto Kan was cited by Bloomberg last week as saying he favors a weaker yen. China has for years been accused of intentionally keeping its currency substantially undervalued in order to help its exporters.

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### ECONOMICS ASIDE: PURCHASING POWER PARITY

*How do you know when a currency is under- or overvalued? In economics, the main litmus test is a concept called purchasing power parity (PPP).*

*Purchasing power parity is the idea that exchange rates should balance the price of an identical basket of goods across all countries. When the same basket of goods is more expensive in a foreign country than in the United States, for example, PPP says the foreign currency is overvalued compared to the dollar.*

*So what does this mean for the euro, in particular? As of June 11, 2010, the euro stood at 1.21 U.S. dollars. Here is where three leading measures of PPP think the euro should be valued:*

*Bloomberg Financial ~ 1.12*

*The Economists' famous “Big Mac Index” ~ 1.08*

*Organisation for Economic Co-operation and Development (OECD) ~ 1.17*

*By any measure, the euro at 1.21 is overvalued compared to purchasing power parity. As I have said for some time, extended periods of devaluation await. The euro will need to remain substantially below purchasing power parity (which I believe is around 1.10, the average of the Bloomberg and Big Mac indices) in order to help struggling European economies get back on their feet.*

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Hopefully, by now you can start to see how beggar-thy-neighbor works. Everyone wants to export their way out of trouble, but in order to do so they need to devalue their currency and take “market share” from others. The currency devaluation spiral leads to political pressure to protect domestic production through tariffs and other barriers to trade. This sequence of events played out in the 1930s with the Hawley- Smoot Tariff Act, the largest rise in tariffs and trade barriers modern history. Protectionist trade policy is greatly attributed to setting off a global trade war that led to the Great Depression.

## What Does This Mean In The Near Term?

Don't get me wrong, I am not predicting trade wars leading to the next Great Depression, at least not yet. There is no reason to believe any of this will affect the trajectory of the U.S. economy in 2010, which I believe remains on track for 4% growth. The summer will likely continue to enjoy the feel-good fruits of recovery (which is now technically expansion). Finally, we can all sleep at night knowing we have a Central Bank that is absolutely, positively committed to flooding the world dollars (that's right the world, not just our country, think about the swap lines recently opened to the European Central Bank). Rest assured, our Central Bank will do everything in its power to keep output on track here in the U.S.

Across the pond, however, it does appear European leaders think they can export their way out of the current crisis. In the near term, the decline in the euro will continue to support this idea. But once the euro gets down to somewhere around 0.85 (yes, 0.85), we'll start to have real issues with China, Japan, and the United States as export competitors. There will be mounting pressure at that point to either increase the value of the euro or the United States will take its part in competitive devaluation.

The reality is, there are a lot of steps along the way between here and there and at each point there are opportunities. The summer will likely bring a reprieve from the heightened sense of global concern evident when the markets were falling 8% per month as they did in May. If history is any judge, large declines in May have been followed by rallies in June and July. So in the near term, everything looks alright. Nevertheless, the recent G-20 controversy reminds me there are real dangers lurking out there for the global economy, especially if European policy makers do not wisely chart their course of recovery.

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### WHAT IS THE G-20 AND WHAT DO THEY DO?

*The Group of Twenty (G-20) is a forum for finance ministers and central bank governors from 19 countries and the European Union. The G-20 was established in 1999, in the wake of the 1997 Asian Financial Crisis, to bring together major advanced and emerging economies to stabilize the global financial market. Since its inception, the G-20 has held annual Finance Ministers and Central Bank Governors' Meetings and discussed measures to promote the financial stability of the world and to achieve a sustainable economic growth and development.*

*Collectively, G-20 member countries represent around 90 percent of global gross national product, 80 percent of world trade (including EU intra-trade) and two-thirds of the world's population.*

*In 2010, the G-20 has eight scheduled meetings, the most recent of which was the Meeting of Finance Ministers and Central Bank Governors, June 3-5, in Busan, Korea. The next meeting will be the first of two annual Summit Meetings and will be held June 26-27 in Toronto, Canada..*

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