



Allentown

*Well we're living here in Allentown
And they're closing all the factories down
Out in Bethlehem they're killing time
Filling out forms
Standing in line
And we're living here in Allentown*

– Billy Joel, 1982

We're all Allentowners now. Granted, 90% of the workforce is still reporting for work on time, but our standard of living, our confidence in the future – we're standing in line in Allentown. Lost in the policy debate surrounding the elections and the subsequent demonization of the Federal Reserve's Quantitative Easing ("QE2") policies has been any recognition of why we no longer live on Ronald Reagan's shining hill or how we might possibly reclaim higher ground. There are two fundamental explanations:

- 1) The global economy is suffering from a lack of aggregate demand. In simple English that means that consumers are not buying enough things and that companies are not hiring enough people because of it. Growth slows down, especially in developed as opposed to developing countries, and the steel mills of Allentown, USA and Sheffield, England close down.

This shortfall of global demand is a nearly impossible concept to grasp

amongst politicians and their citizenry. Don't people always want to buy more things and isn't demand theoretically insatiable? They do, and it is. Yet economic growth is a delicate dance between production and finance and when a nation's or a family's credit card gets maxed out, then demand/spending slows measurably. We are witnessing these commonsensical repercussions across the entire continent of Europe today and to a lesser extent in the United States.

Developing nations and their consumers want to buy things too. And while their economies are growing fast, their overall size is not yet sufficient to pull along the economies of Europe, Japan and the U.S. Their financial systems are still maturing and reminiscent of a spindly-legged baby giraffe, having lots of upward potential, but still striving for balance after a series of missteps, the most recent of which was the trio of the 1997–98 Asian

crisis, the 1998 Russian default and the 2001 Argentine default. And so their policies are oriented towards export to debt-laden developed nations instead of internal consumption, leaving a gaping hole in global aggregate demand. China is a locomotive to be sure, but it cannot pull the global economy uphill on the basis of mercantilistic exports alone. It needs to develop many more of its own shopping malls and that will take years, if not decades.

- 2) With insufficient demand, nations compete furiously for their share of the diminishing global growth pie. All look to borrow growth from somewhere else. Nearly a half century ago, the undisputed champion of global growth was the United States – it held all the cards: an unscathed post-WWII industrial base, an acknowledged Bretton Woods reserve currency and an educated workforce able to out-innovate any and all competitors. No wonder our policies encouraged open markets and free trade policies that would only feed the United States hegemon. At some point in the 1970s to 1980s, however, the rest of the world began to catch up. Japan produced better cars than Detroit, the Iron Curtain fell, and the rise of China was soon to rock American/developed economies out of their presumption that the world was their export oyster. Billy Joel's Allentown was transformed from an iron and coke/chromium steel behemoth into

an unemployment center, filling out forms – standing in line.

And so the United States and its developed economy counterparts face an unfamiliar crisis of unrecognized dimensions and potentially endless proportions. Politicians and respective electorates focus on taxes or healthcare when the ultimate demon is a lack of global demand and the international competitiveness to thrive. The solution for more jobs is seen as a simple quick step of extending the Bush tax cuts or incenting small businesses to hire additional workers, or in the case of Euroland, shoring up government balance sheets with emergency funding. It is not. These policies only temporarily bolster consumption while failing to address the fundamental problem of developed economies: Job growth is moving inexorably to developing economies because they are more competitive. Free trade and open competition, like a stretched rubber band, have snapped the U.S. and many of its Euroland counterparts in the face. By many estimates, Chinese labor works for 10% or less than its American counterparts. In addition, and importantly, it is able to innovate as quickly or replicate what we do. Jobs, in other words, can never come back to the level or the prosperity reminiscent of 1960s' Allentown, Pennsylvania until the playing field is leveled.

This phrase of a “level playing field” opens up endless possibilities. If, in fact, the solution to how we can reclaim the vision of Ronald Reagan's “shining

hill” and the Allentown of decades past is to “level the playing field,” there are obviously a number of ways to do it. The constructive way is to stop making paper and start making things. Replace subprimes, and yes, Treasury bonds with American cars, steel, iPads, airplanes, corn – whatever the world wants that we can make better and/or cheaper. Learn how to compete again. Investments in infrastructure and 21st century education and research, as opposed to 20th century education are mandatory, as is a withdrawal from resource-draining foreign wars. It will be a tough way back, but it can be done with sacrifice and appropriate public policies that encourage innovation, education and national reconstruction, as opposed to Wall Street finance and Main Street consumption.

The second route to the level playing field involves political and financial chicanery: trade and immigration barriers, currency devaluation and military domination of foreign oil-producing nations. It is by far the less preferable route, but unfortunately the one that is easier and, therefore, most politically feasible. Politicians do not get elected on the basis of “sacrifice.” They get elected by pointing to foreign demons, be they in the Middle East or in Asia. The Chinese yuan is a far easier target than the American workers earning ten times their Chinese counterparts and producing an inferior product to boot. Politicians also get elected by promising to keep taxes low, even for the rich, with the argument that small business owners cannot afford the increase. The real beneficiaries however,

are the mega-millionaires of Wall Street and Newport Beach. And yes, policy-makers at the Fed write trillions of dollars’ worth of checks under the guise of quantitative easing, a policy which takes Charles Ponzi one step further by purchasing the government’s own paper in a last gasp effort to support asset prices.

Faced with these two decidedly different routes to “level the playing field” it seems obvious that the United States is opting for “Easy Street” as opposed to “Buckle Down Road.” Granted, “The Ben Bernank” as a YouTube cartoon rather hilariously labeled him, has for several months importuned Congress and the Executive Branch to institute substantive reforms, while he attempts to keep the patient alive via non-conventional monetary policy. But very few others are willing to extract their heads from the sand. The President’s debt commission with its insistence on low personal and corporate income tax rates and a mere 15 cent increase in the gasoline tax was one example. The Republicans’ reluctance to advance detailed ideas for budget balancing is another. And the Democrats’ two-year focus on the biggest entitlement program since Social Security – healthcare – as opposed to fundamental reforms to counter our lack of global competitiveness – is perhaps the most grievous example of lost opportunity. Unlike the United Kingdom, where Prime Minister Cameron has championed fiscal conservatism, or even Euroland, which is being forced in the direction of Angela Merkel’s Germanic work ethic, the United States seems to acknowledge no bounds

to what it can spend to bolster consumption or how much it can print to support its asset markets. We will more than likely continue to “level the playing field” via currency devaluation and an increasing emphasis on trade barriers and immigration, as opposed to constructive policies to make this country more competitive in the global marketplace.

If so, investors should recognize that an emphasis on currency depreciation and trade restrictions are counter to their own interests. Not only would their dollar-denominated investments lose purchasing power over time from a global perspective, but they would do so also via a policy of near 0% interest rates, which are confiscatory in real terms when accompanied by positive and eventually accelerating inflation. In addition, although corporate profits are in many cases broadly diversified across national borders, there should be little doubt that the objective of tariffs and trade barriers is to advantage domestic labor as opposed to domestic capital; profits, therefore will ultimately not benefit.

Unless developed economies learn to compete the old-fashioned way – by making more goods and making them better – the smart money will continue to move offshore to Asia, Brazil and other developing economies, both in asset and in currency space. The United States in short, needs to make things not paper, but that is not likely unless we see a policy revolution in Washington DC. In the meantime, our unemployed will continue to fill out forms and stand in line. We’re living here in Allentown.

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