**The Economy New Rules: Go Glocal**

Globalization used to be a one-way street led away from America. Now high energy prices, political risk and technological shifts are bringing opportunity back home. Welcome to the era of localnomics. By Rana Foroohar

If there’s a single company that illustrates the huge range of opportunities and challenges facing the U.S. economy today, it might be Caterpillar, the heavy-machinery giant based in Peoria, Ill. Like most firms, Cat took a hit following the financial crisis. But since then, it’s bounced back-and how. After a strong second quarter, the firm is on track for a second record-breaking year in a row and will likely sell $70 billion of its famous yellow earthmovers, tractors and mining equipment globally.
As products roll off the line at the recently expanded East Peoria factory, every one is marked with a flag that designates its final destination. There are a lot of Chinese, Indian and Australian flags. But there are plenty of American ones too, and their numbers are growing. “We put those flags on a few years back. I wanted our workers to understand that globalization isn’t necessarily about someone taking your job,” says Caterpillar CEO Doug Oberhelman. Indeed, Caterpillar thinks less about a single world market than many regional ones. The company is global, but where it can, it sources and produces locally, which is a natural hedge against everything from oil prices to currency risk to changing customer tastes. The bottom line: jobs and growth are split more or less equally between the U.S. and the rest of the world. It worked something like that from the mid-1980s to 2008, a period of unprecedented market calm that economists call the Great Moderation. Not so much anymore.

This isn’t how globalization was supposed to work. Until quite recently, it was seen as a one-way street. American companies, which led the charge four decades or so ago into growing global markets, were its ambassadors, and American workers, whose wages and upward mobility were flattened, were the victims. The core idea was that globalization, technological innovation and unfettered free trade would erase historical and geographic boundaries, making the world ever more economically interconnected and alike. (Foreign-affairs writer Tom Friedman famously encapsulated this notion with the title of his book “The World is Flat.”) In this vision, all nations would be on an even playing field, and the U.S. would come under more and more competitive pressure from eager upstart nations.

The thing is that the world was never as flat as we thought, and its getting bumpier. The flaws in the premise are coming into focus. Consider the following: when energy prices and and political risk go up, far-flung global supply chains make less economic sense. Low-wage workers in China look attractive-until robots operated by highly skilled laborers at home are able to do their jobs even more cheaply. Unfettered free trade seems great until the world’s fastest growing economies won’t play by the rules of the game.

Since the financial crisis, fragmentation rather than unity has become the norm. You can see it everywhere, from the euro-zone crisis to Communist Party infighting in China. In just the past few months, Argentines renationalized their biggest oil company, and several nations put capital controls on their currencies. Rich and poor regions from the E.U. to Japan and from China to Turkey are ramping up tariff increases, export restrictions and self-serving regulatory changes. World Trade Organization director general Pascal Lamy calls the rise in protectionism “alarming” and frets that we are headed back to the 1930s.

Given all the risks out there in the world, the 2% economy-in place of our historical 3% to 4% yearly growth-has become the new normal for the foreseeable future. So is it possible to survive or even thrive in the new normal?

The answer is yes, but only if you know where to look and how to pivot. A key truism in this new age of volatility is that”everything local will take clear priority,” says Peter Atwater, a financial researcher who studies social mood and the markets. That means much more focus on regional economic ecosystems and how to foster job creation at home instead of relying on global markets to raise all boats. In short, we need to be aware of the myths of globalization and how we can unleash untapped economic power close to home. Here are some of the new rules of localnomics.



**Rule No. 1 – Hometown Bankers Know Best**

During the Great Moderation, finance was the industry that ruled the world. It greased the wheels of globalization, spreading capital like pixie dust, and came to represent some 30% of total corporate profitability in the U.S., up from about 11% in 1975. Even after the financial crisis, banks represent a greater percentage of the economy than ever before. Slowly, but surely, that’s changing. The Dodd-Frank banking legislation, which is still under construction, may well be toughened in the wake of several new banking scandals. Regulators on both sides of the Atlantic are making a new push to rein in banks, and even the Fed may be considering ways to goose the mortgage market by forcing banks to lend.

As public cries for a safer financial grow louder, it’s quite likely that banks will eventually be broken up into smaller, more manageable pieces and forced to hold more capital, moving the industry from global laissez-faire business as usual and toward a more traditinoal banking model.

Already, in Europe, banking is balkanizing along national lines. There, the rollback of the decade-long, cross-border integration of banking may turn out to be a bad thing, because it underscores a lack of faith in the euro and will expose deeper rifts in the continental economy as a whole.

But in the U.S., the shifts in banking may be a happy event. Too-big-to-manage institutions may be reined in or even split up, allowing smaller entities to focus on what they do best, be it high-flying trading or local lending. (Being closer to the ground, such commercial banks will know their consumers better, which could mitigate risk and increase capital flows to small businesses.) As profit margins shrink, the fees banks charge may get higher. But banking may also become more the way it is in “It’s a Wonderful Life,” “which has certain advantages in terms of reconnecting people back to their local communities,” says Atwater.

**Rule No. 2 – Manufacturing Matters**

As finance fades into the backdrop, manufacturing takes center stage, and each hometown accomplishment brings crucial carryover effects for the surrounding economy.

It’s not being overly dramatic to say that the world is on the verge of a new industrial revolution as manufacturing regains its traditional role as a global growth driver. Manufacturing’s share of global output is 17.4%, the highest it’s been in over a decade. The growth has been driven not only by China but also by the U.S. (the second-biggest factory nation by output), which got a boost from the government’s Detroit bailouts. Indeed, if the U.S. manufacturing economy were a nation, it would be the ninth largest in the world.

Government support is certainly one of the reasons for the boom. Manufacturing is politically very important because it’s one of the few areas of the economy that is creating solid middle-income jobs. (See Rule No. 3. Export-oriented jobs pay 9% more on average.) The reason the latest U.S. jobs numbers aren’t worse than they are is that Detroit has been holding its own. A weaker dollar and more-competitive global wage rates have also helped U.S. manufacturing, as have two other key trends: the rise of emerging markets, which buy a growing chunk of American exports, and a homegrown energy boom in shale gas and oil, which is goosing other parts of the economy like commercial construction and agriculture. This underscores manufacturing’s important spillover effect for the rest of the economy. The Bureau of Economic Analysis calculates that every $1 on manufacturing GDP drives an incremental $1.42 of activity in the nonmanufacturing economy.

The fact was recently heralded by, of all people, Airbus CEO Fabrice Bregier in a July 2 announcement in Mobile, Ala., where the European aircraft hiant is opening a new plant, citing a more competitive labor and growth climate in the U.S. as compared with Europe. It was a bitter day for the French and the Germans. Manufacturing is a key souce of innovation, accounting for 70% of private-sector R & D and 90% of patents issued in the U.S. When a high-end manufacturing operation like Airbus sets up shop in a community, the benefits stay disproportionately within the local ecosystem. Spillover benefits decline by half when you go 700 miles beyond a manufacturing site, according to economist Wolfgang Keller.

So how to create more of these local hubs? Ensure access to a highly skilled labor force, connect educators to job creators, and help smaller businesses become suppliers to big firms. (See Rules 3 and 4.)

**Rule No. 3**

At the Caterpillar factory line in East Peoria, yet another important trend of the new normal is on display: labor bifurcation. Extremely cheap workers – robots – now do much of the tedious, physically demanding welding at the plant. Other work is done by high-end technicians, many of whom need computer skills to manipulate the robots. The number of human employees hasn’t actually decreased over the past few years as the firm has added robots, but their skill level has increased. Welding is no longer a job for someone with only a high school degree. It’s something that requires advanced in-house training or a community-college certification.

This situation is a microcosm of the global labor market. Even as Apple recently announced it would work with its supplier Foxconn to cut hours and boost pay for laborers in its Chinese factories, Foxconn itself has plans to deploy about 1 million new industrial robots in factories across the Middle Kingdom over the next three years. Chinese workers are getting more expensive, with pay rising about 17% a year, but their productivity isn’t increasing quite so fact.

That’s one reason the Boston Consulting Group estimates that within five years, as many as 3 million manufacturing jobs could come back to the U.S. But they won’t be old-style, cheap-labor jobs. They’ll be high-skill, high-demand positions.

Indeed, 63% of U.S. jobs will require postsecondary  training by 2018. The U.S. economy will create more than 14 million new jobs over the next 10 years, but only for workers with at least a community-college degree. These jobs – for people like dental hygienists, electricians and entry-level software engineers – would allow millions of people to move from living on the edge to being middle class. The problem is that a low percentage of college students in the U.S. – 30% at four-year colleges and 1 in 4 at two-year colleges – finish their degrees.

Some of that is about money, but it also reflects a relative lack of effort in the U.S. to connect educators with companies, particularly compared with what’s being done in growth machines like Germany. The result is a mismatch between degrees and jobs that some economists, like Harvard’s Rosabeth Moss Kanter, believe is responsible for as much as a third of the increase in unemployment since the Great Recession.

Tech – oriented community colleges with links to industry are an obvious solution, and the Obama Administration’s latest budget proposes $8 billion to fund such institutions. But political gridlock has stalled the proposal. So businesses like Caterpillar and Siemens are taking matters into their own hands, setting up programs with local community colleges. (Cities, take note: these programs can be job magnets. Caterpillar set up an engineering design center in South Dakota because of a strong community-college system there.) High-tech service companies like Microsoft, Cisco and IBM are starting six-year combined high school and community-college programs designed to churn out qualified midlevel employees. One such program, P-Tech, a public-private partnership led by IBM, has been adopted by Mayor Michael Bloomberg of New York City and Mayor Rahm Emanuel of Chicago as part of an effort to boost employment and growth. Expect private companies to take an even greater role in education while local leaders become economic actors.

**Rule No. 4**

One of the most amazing things about globalization is that for all the press it gets, it’s not nearly as broad-based as you would think. European business-school professor Pankaj Ghemawat’s recent book “World 3.0″ lays out in detail how the world never really all that flat to begin with. His numbers, which tweak some official tallies to account for what he believes are various errors in calculation, are compelling: by his estimates, exports account for only 20% of the world economy, cross-border foreign direct investment is only 9% of all investment, only 15% of venture-capital money is deployed outside home borders, less than 2% of all phone calls are international, less than a quarter of Internet traffic is routed across a national border and 90% of the world’s people will never leave the country in which they were born. “The challenge isn’t too much globalization,” says Ghemawat. “It’s too little.”

But that’s a hard sell politically at a time when the dark side of globalization – namely, growing inequality within nations – has resulted in a strong sense that an elite group of people and companies are flying safely above all the troubles in the global economy while the majority of those on the ground suffer. This was brought front and center earlier this year when an Apple executive being interviewed by the New York Times about why the iPhone is mostly made outside the U.S. was quoted as saying,”We [Apple] don’t have an obligation to solve America’s problems.”

The statement implied that not only should Apple put jobs wherever it was cheapest to do so globally (which is still mainly in Asia) but that this was a relatively seamless process. But the company’s recent labor problems with its supplier Foxconn in China prove that doing business globally is hardly simple. And companies with complex global supply chains have not only labor issues to contend with but also natural disasters (remember how last year’s tsunami and earthquakes in Japan disrupted auto-supply chains and sank industry growth for several quarters), high energy costs that make shipping more expensive and risks of corruption (as in the case of Walmart’s scandal in Mexico). The laissez-faire attitude toward globalization that prevailed during the Great Moderation seems decidedly naive today. “For much of the last 15 years, it seemed like the attitude was that anytime you could find a lower cost anywhere in the global supply chain, you did it, with no thought of the difficulties or risks that things could go wrong,” says Gene Sperling, head of the National Economic Council. “More U.S. companies are rethinking that calculation, and that holds open the promise of more location and insourcing here.”

UPS, which moves 2% to 3% of global GDP annually, says it views supply-chain disruption as the No. 1 risk facing multinational businesses today. Mitch Free, who runs MFG.com, one of the world’s largest online marketplaces for the manufacturing industry, says he’s seeing a big trend toward regional and local insourcing not only because of risk mitigation but because consumer demand for all things to be newer, faster, better is shortening the life cycle for products (as little as six weeks from production to market in many cases). The trend toward hyperlocal product customization to suit individual customer needs in everything from jeans to ditch diggers also favors just-in-time, local supply chains. “The dynamic is not so much that American firms are bringing jobs back to the U.S. from abroad as it is that companies everywhere are bringing jobs and operations closer to where their customers are,” says Free. “it’s all about regionalization and localization rather than globalization.”

Indeed, Caterpillar nurtures a network of about 2,000 local suppliers in the Illinois area alone, many of whom make a good living designing and producing customized goods for the firm – items destined for particular U.S. markts or specialized needs. Where things can be sourced locally, they are, in every Caterpillar territory internationally. “It allows us to better understand the needs of the local market and adjust the product quickly,” says Oberhelman,”but it’s also a natural currency and energy-cost hedge.”

Companies are also starting to realize that localnomics can help support their revenue growth. Suppliers can also buy things from their customers, and customers can be suppliers too. IBM, which sells a lot of its products and services to small and midsize firms, recently founded an online network to source more of its business needs from such companies in the U.S. Sixteen other companies, including Caterpillar, Dell and AMD, are taking part. Since the project, called Supplier Connection, went live in March, the companies have booked tens of millions of dollars in new business from small firms. This has an exponential growth effect. A recent study by the Center for an Urban Future found that most small businesses that became suppliers to multinationals saw their employment go up, on average, 164% within two years. For the large firms, it’s just smart business: many of the small and medium-size enterprises they fuel will undoubtedly become customers at some point.

**Rule No. 5 Local Leaders Must Step Up**

Localnomics has great potential. But how much can governments do to nurture local economics? And how much should they do?

Economists on both sides of the political spectrum have begun to argue that we need to rethink laissez-faire trade policies when we are up against state-run capitalistic systems like China, which openly gives preference to homegrown firms and limits foreign capital even as it exports massive amounts of cheap goods. Groups like the Council on Foreign Relations and the Information Technology and Innovation Foundation agree that the U.S. needs to get more aggressive about pursuing trade violations and punishing violators. Some economists call for sanctions or temporary tariffs.

There’s even a push in some quarters for the U.S. to shed its Alan Greenspan-era taboo on economic planning. “Manufacturing is thriving in China, Germany, Sweden and Singapore only because their governments set up specific vocational institutes to prepare workers for new industries,” wrote Kishore Mahbubani, head of the Lee Kuan Yew School of Public Policy in Singapore, in a “Financial Times” op-ed. “China has rapidly overtaken the U.S. in green technology because of a coordinated national response, not because Chinese businesses alone invested in green technology.”

In the U.S., industrial policy remains a third-rail notion. (See what happens if you mention Solyndra.) And developing policies to supprt localnomics is tricky, as many factors that support it – currency, oil prices and even labor rates – can change quickly. In just the past couple of months, manufacturing in the U.S. has begun to soften a bit as Europe and emerging markets slow down.

There is a risk of pitting state against state and city against city in a battle for short-term gains that can easily become a race to the bottom. Caterpillar decided to put a new factory in Texas because of, according to a spokesman,”port access, proximity to supply base and a more positive business climate.” A good chunk of that last factor has to do with superlow tax rates and nonunion labor. But states that try to outdo one another on tax cuts may eventually undermine infrastructure and services needed to fuel longer-term growth. And localnomics doesn’t mean the pressure on labor ends. Caterpillar creates lots of jobs, but even as profits and revenue rise, the company is seeking worker concessions and is embroiled in union skirmishes.

Yet many economists continue to believe that localnomics is America’s best hope for a real recovery. The McKinsey Global Institute recently published research noting that a large portion of the difference in economic growth between the U.S. and Europe is due to America’s more vibrant cities and regional centers of growth, rather than just a few large capitals that generate most of the nation’s wealth.

So count on cities to become more aggressive about protecting their economic future. Witness how Californian communities like San Bernardino and Stockton, driven to bankruptcy by mass foreclosures and frustrated by bank’s reluctance to renegotiate mortgages, have announced plans to seize loans on underwater homes and forcibly restructure them. Or how Ohio and Tennessee are making sizable commitments to attract high-tech research institutions. Or how Seattle and Philadelphia are cementing niches in the global clean-tech arena. All these initiatives represent a bracing response to gridlocked politics as usual in Washington. And they also add up to local-centric approaches that may someday take us beyond the slow growth of a 2% economy.