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Global Economy, 2014 – Looming Catastrophe Part 2

WRITTEN BY: ASHOK DHILLON

Ashok Dhillon has 40 years of front-line business experience in Canada and International markets. He has founded and led companies in construction and international power development.

Mr. Dhillon has worked and negotiated with highest levels of Governments in Canada and India. He has pursued and won mandates to develop power plants in Canada, and foreign jurisdictions such as Hungary, Iran, Pakistan and India with uncompromising ethical standards. His extensive experience in securing and negotiating multi-hundred million and billion dollar mandates in power project development, gives him in-depth knowledge and intuitive insights into macro and micro, national and international, geo-political and economic realities and trends.

Mr. Dhillon has been invited to speak on international business at various forums, including as an expert witness for the Standing Senate Committee, Government of Canada, on “The Rise of Russia, China and India”.

In Part I of this ‘Global Economic Report’ we emphasized the dangers of the mounting debt, against the still shrinking economic output of global economies.

The singular reliance on financial stimulus and monetary easing of global governments and their central banks, to engender global economic growth since the crash of 2008, is now dangerously stale and counterproductive. Old asset bubbles that had popped with the crash in 2008, with such tremendous pain and expense, have incredulously and stubbornly been re-inflated to dangerous levels over the last 5 years. The re-inflated asset markets have no solid foundation under them, as for the most part, the underlying economies are still weak and unable to support or justify the inflated asset prices.

Therefore we have been consistent in stating over the past year and a half that the ultra-stimulative policies being single-mindedly followed by the World’s central banks, without the proportionate effort by governments into correcting the serious structural changes required to restructure the ailing economies, has created another and perhaps bigger ‘easy money’ bubble in the World’s asset markets, the deflating of which will be catastrophic for the global economies.

We have always held that initial Q1, and perhaps Q2 (*financial and monetary stimulus/easing*) was required to prevent the total collapse of the global financial system in the aftermath of the 2008 crash. But subsequent to that, we did not see the merit to the floodgates of financial stimulus (*Q3, and similar versions of it, Worldwide*) being opened and left open, without any direct action being taken to fix the structural problems that are now inherent in the global economies. In fact, we saw the act of throwing more and more money at the problem becoming the problem itself, as it has become today, particularly in the United States, China and in Japan.

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We could not see how exacerbating the problem that had culminated in the previous crash (*due to the excessive overleveraging*) could possibly bring on a sustainable global economic recovery, without massive global productivity counterbalancing it. Well the balancing did not happen, as the governments, as is their wont, shied from the more difficult path of immediate and co-operative correcting of the structural problems, and chose instead to throw Trillions at an unstable and largely unsustainable economic growth model. They have not only failed collectively, but in our view, governments have fueled a much bigger problem now, that has the potential when it implodes, to threaten once again the entire global economic structure.

It is always a bit unnerving to anticipate and write about potential scenarios unfolding, and then a few days later find such anticipation as headline news.

In our Part I of this Report, we did ***not*** anticipate the Russian territorial invasion of Ukraine, but we did anticipate, *"There are far too many potential triggers in the struggling global economies and environment today that could provide the pin to prick the first bubble, and start the cascading phizzes and pops.*

*There are big asset bubbles and **potential political trouble**, brewing in China, Japan, India, the United States, **Europe, Russia,** Brazil, Argentina (South America in general), the Middle East, the United Kingdom, Australia, and some of the countries of South East Asia, like Thailand and Indonesia".*

Will the Russian induced geo-political crisis in Ukraine be the 'pin' to prick the global bubbles? It certainly has the potential, as some sort of political and economic sanctions (*at this time the only real option*) are imposed by the United States and Europe on Russia (*none of the economies are too robust at the moment*). After being out maneuvered by Putin on Syria, the United States (*Obama*) will not want to look weak and out maneuvered again on Ukraine. And in spite of Europe's reluctance to impose harsh economic sanctions, for fear of retaliation by the cut-off of energy imports from Russia (*natural gas and oil*), Europe will feel impelled to take some action to support the U.S. and Ukraine, and punish Russia. The escalation of political and economic push backs, by all sides, will affect the Russian, European and the global energy prices and thus the economies, and more importantly increase the distrust and toxicity of an already poisoned, conflict prone geo-political economic global environment that will contribute to the global economic weakening.

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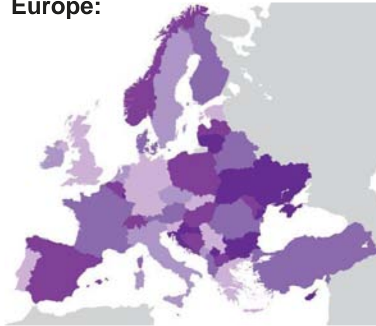
As the global economic structure is already under significant pressure from a number of percolating political and economic problems, it will not take a lot to start a cascade of small fractures that could turn into a global economic regression.

This is a good place to pick up where we left off in our Economic Report, Part 1.

In Part 1 of this Report we had covered the United States, China and Japan. In this report we will look at Europe, Russia, India, Australia and South America.

Europe:



At this time to say that Europe is healing economically, is certainly to be in the 'glass is half full' camp.

We agree that some of the economic markers are fractionally better, such as the overall GDP and the PMI numbers, after years of being in the negative territory finally breaking out to the positive side, albeit marginally. But the many weaknesses of the Euro Zone, and the risks it is still facing, are so overwhelming that it puts us solidly into the - 'glass is half empty' camp. The recent Ukraine/Russia crisis has just added to those risks, and will underscore one of Europe's weaknesses if the crisis escalates, its dependence on Russia for energy.

The European Economic Union, the 'Euro-Area' is made up of 18 different countries (*economies*) that are significantly different from each other. Apart from the obvious language and cultural differences, their socio-economic characteristics are distinctly different, thereby ***not*** producing homogeneous results in their economic activities. Since the crash of 2008, Germany and the Northern European economies have led the Euro-Area in relative economic stability and growth, while the 'Southern' economies particularly Greece, Italy, Spain, Portugal and Cyprus have flirted with economic collapse. And, though these economies are a bit more stable now, due to the Euro Area member government's determination to stay together, most of them are still struggling to gain financial and economic traction and stability.

In spite of their differences, because these economies are now bound together with one currency, the macro-economic guidance of these economies must be common to all, making for an enormously difficult and unwieldy structure to stabilize and direct. Greater integration of their financial, economic and political institutions will need to take place (*greater financial and economic integration is being contemplated and worked on, particularly in banking*) before a more efficient macro-economy will emerge, and an effective steering mechanism can be designed to guide the disparate 18 economies more effectively.

In the meantime, while the Northern European economies show stability and growth, the Southern European economies continue to struggle under high unemployment, anemic growth momentum, deleveraging and threat of deflation.

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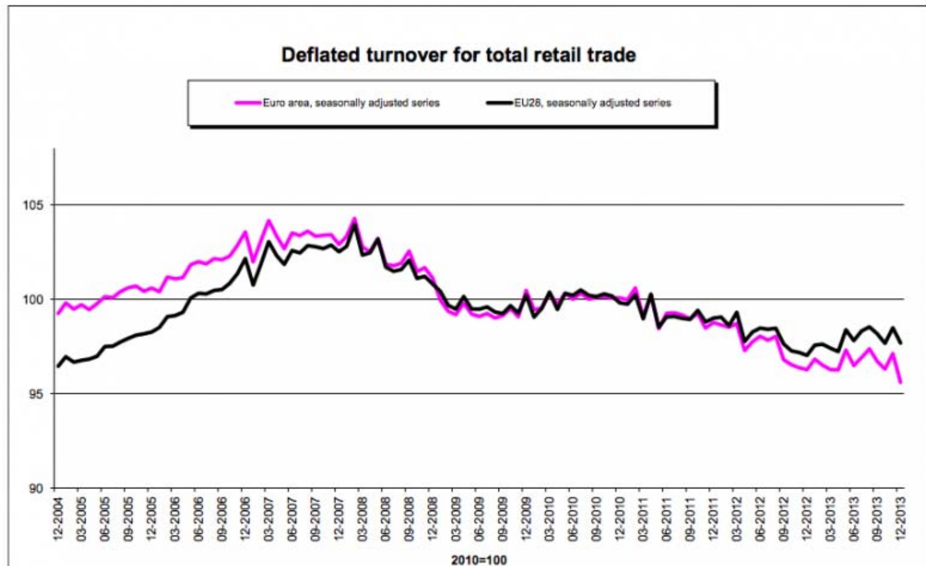
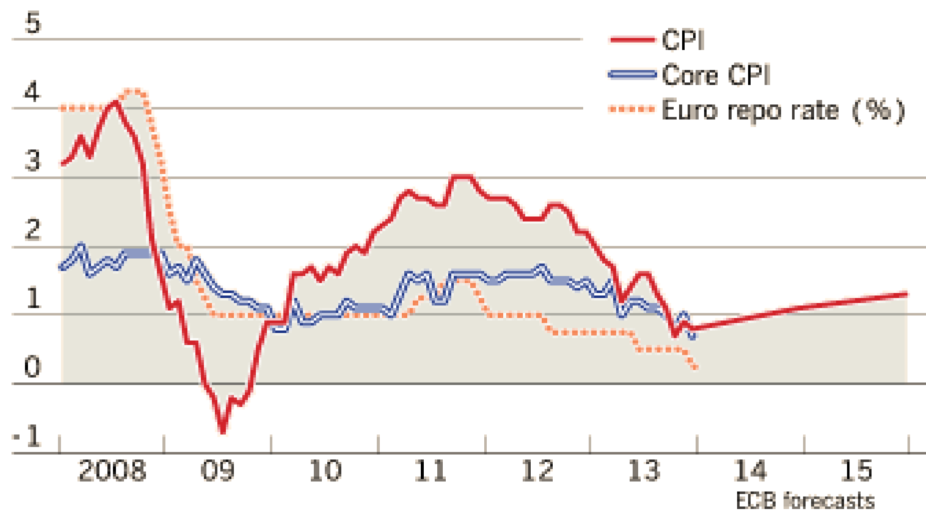
Deflation is still a strong possibility, and it would not take much of a political, financial or an economic shock, to push the Euro Area back into a full blown recession.

The two Charts below show that across the board demand is weak and prices under pressure. The deflationary pressures are still strong and reflecting the overall weakness of the Euro Area and the external global markets.





As a whole, Europe is still facing frightening unemployment realities. As per the following Chart, officially unemployment is stated at 12.2%, while youth unemployment ranges from to 25% to 30% in certain economies. But in certain pockets of some countries like Spain and Greece, youth unemployment is at 50% to 55%, and still trending up. Such punishing numbers underscore the difficulties facing Europe and its populations, and its precarious retreat from the brink of disintegration

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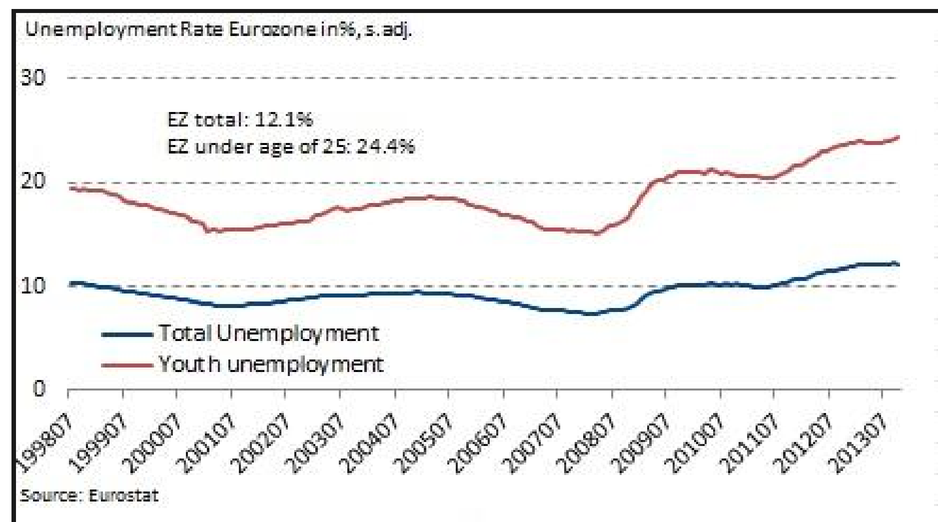
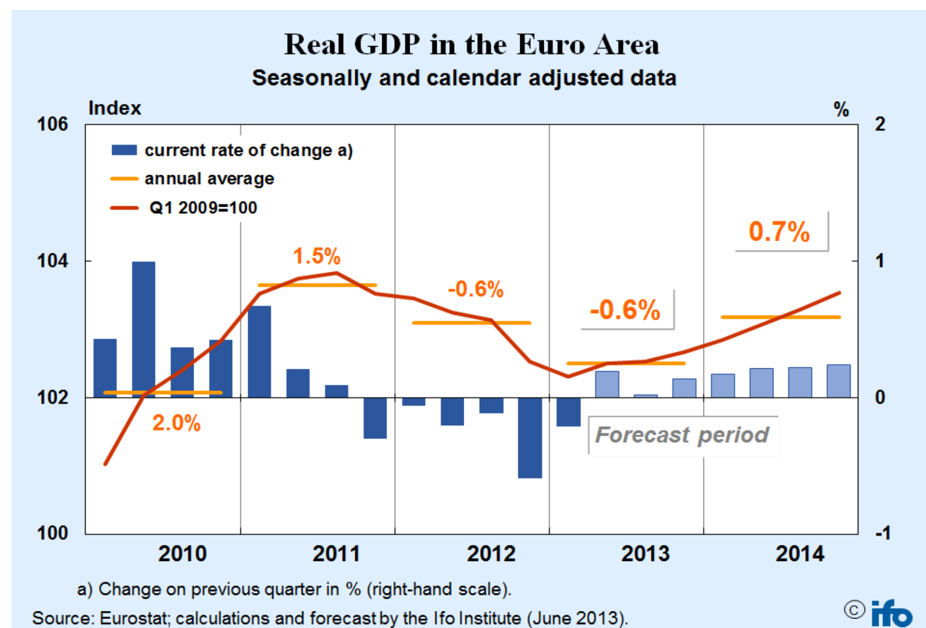
last year. The climb back may be arduous but possible, except for the scepter of looming external shocks such as an expected crash in the financial markets in the U.S., or the collapse in the real estate and banking bubbles of China, or the collapse of 'Abenomics' in Japan, or a number of other potential economic or political triggers.

Additionally, to add to the threats facing Europe and the global economies now, we have the crisis in Ukraine. This rather grim overall picture belies the 'glass is half full' optimism being projected and accepted today.



The GDP (*the economic growth rate*) has finally moved into positive territory (*the Chart below*) and is estimated to be at approximately 0.7% in early 2014. As we said earlier, there are improvements in some of the statistical numbers but the Euro Area is far from recovered and overall barely managing above zero growth rates. And this frail 'recovery' is the result of extraordinary and combined efforts of all 18 governments, their Central Banks, the Euro Group (*like a master steering committee*) and the powerful European Central Bank, that has committed to "whatever it takes".



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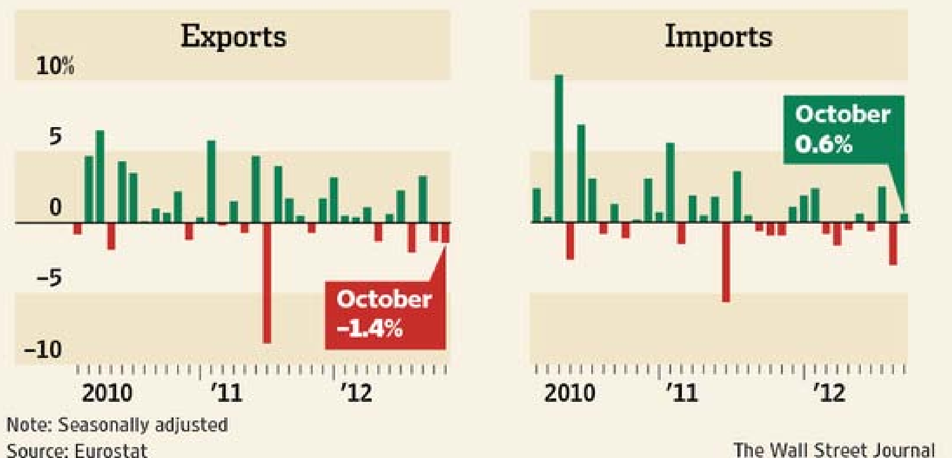
Looking at the previous Chart we must Keep in mind that the European Commission and the IMF had to consistently ***re-adjust downwards,*** their optimistic forecasts of the last couple of years, we feel, in light of the risks still inherent in its own 18 economies, and the considerable risks posed by the overleveraged global economies, especially America, China and Japan, the gains in the Euro Area at this time are too precarious to be relied on, and the positive trend too prone to reversals.

While GDP and PMI numbers are marginally positive, exports are weak and demand lack luster. The stronger trending currency the 'Euro' is having an adverse impact as exports decline due to the higher cost to external buyers, and imports climb only marginally as their costs go down for the Europeans. But Europe is facing weak internal markets, and except for the U.S. perhaps, a weakening external global demand with China, India, Russia and South America still slowing materially.



Conversely, the extended and persistent weakness of Europe, in our view, not about to change materially any time soon, will continue to have a negative economic impact on all those economies (*particularly China*) that were profiting by exporting goods and services to one of the World's biggest and most developed markets, the Euro Area. But now Europe has become the case-study of a complicated political and economic experiment that still needs a lot of work, compromise and greater integration to make it even moderately and sustainably workable. In the meantime, its economic weakness will continue to negatively affect the emerging and export dependent economies.

It is as we had said in our earlier Reports; the global economy is locked in a downward spiral of falling demand, internal and external, that just Quantitative Easing will not be able to arrest, regardless of the QEs size and duration. There has to be material realignment in the makeup of major economies as external demand languishes, as most developed countries continue to struggle with anemic 'recovery', and the large emerging economies try to cope with overcapacity due to the lack of robust demand from developed countries, and the resultant declining growth rates.

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India:

The largest Democracy in the World and the second largest consumer market after China has faltered. Unfortunately India has a penchant for neutralizing its own strengths and consistently magnifying its many weaknesses.

India has a far better internal consumption market than China. In fact, its economy is solidly and reliably supported by its internal market, comprising of its population of over 1.2 Billion. India's internal consumption makes up approximately 60% of its GDP, versus 35% of China's. And this huge internal market has protected India many a times from severe external economic shocks.

Additionally, India has possibly the best demographics of any country in the World, as almost half of its massive population of over 1.2 Billion people (*projected to pass China's 1.3 Billion*) is less than 25 years of age. This compares favourably to most large developed or emerging economies that are facing deteriorating demographics.

Additionally, as a legacy of the British, India has the advantage of having hundreds of years of head start, over countries like Japan, South Korea, China, Russia, Latin and South America, and others, in the knowledge and use of the English language, which is the accepted Universal and business language of the World. Also as a legacy of the British Raj, India has a small (*compared to the total of the private and public educational system*) but excellent number of mostly private 'English-Medium' schools, colleges and universities that produce well educated graduates (*in basic education*) who are able to communicate and integrate with relative ease with the global community. Yet, India squanders these strengths, and does not cultivate them with any real sense of focused nationalistic development, through targeted policies, due to the inexorable rise of politics of division since Independence.

In the environment of divisive politics, all assets left behind by the long departed English, or those representative of a modern society, including, computers, certain technologies, higher education for girls, the English language, western wear etc. are used by some of the politicians as symbols of past foreign domination, to stir up community or national sentiment. The children of these same politicians are, in the mean time, studying in expensive schools within India, or ***abroad,*** and availing themselves of all advantages, while their parents passionately denounce foreign influences within India. The hypocrisy of such politicians is hidden from most of their constituents, as the constituents are mostly rural and largely unaware, or choose to ignore the double standards being indulged in by the politicians. Such hypocrisies are common to the global political realm as dysfunctional and corrupt politicians point to 'foreign' influences to deflect the scrutiny otherwise directed at them. But in India, because of the sheer size of its political diversity and population, and its overall underdevelopment, such practices can bring on populist but highly damaging policies that set India and its development back by years, if not by lost decades.

Additionally, India's entrenched culture of pervasive corruption has increasingly swung its vast ethnic, religious and caste diversity towards divisive politics, making it fertile ground for generally ignorant, petty and incompetent politicians, to sow seeds of suspicion and division. By doing so, they appeal to their own particular

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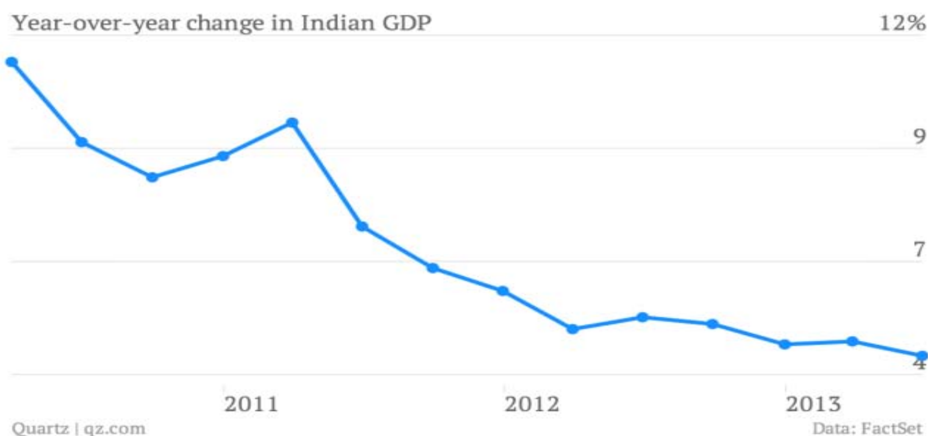
communities for votes, in their bid to rise to power and position, which once attained is mostly unaccountable to the people.

To be fair to India, it's not exclusive in its political class being corrupt enough to use whatever means available to it, to attain and retain political power. Such a political reality is all too distressingly common to most countries, but in India the sheer scale of the extraordinary challenges facing it, makes divisive politics and corruption a lethal brew that incapacitates the country, and/or moves it backwards. The developing India could have been the stalwart of stability in the past economically shaky years for the global economy, but it instead sank under the burden of endemic corruption, regional politics and indifferent governance under the incumbent ruling Congress Party led coalition, and is today limping along at less than 5% growth rate (*most recent estimates, 4.7%*). We had predicted such a decline back in documentation dated 2009 "…*India's internal growth will continue to be strong and in line with our expectations which were a more modest 5-6%, than the Government's 9-10%...*"

The apologists for India would point to a GDP rate of 4.7% and compare it favourably with the anemic growth rates of the developed economies, but the developed economies are already developed, and light years ahead in providing for their citizens, and therefore do not have to contend with the hundreds of millions of the abjectly poor, numbering well over half a billion (*but then who's counting*). The unfortunate part of all this is that even in the current difficult global economic environment, India, due to its strong internal demand in public consumption, and its vast infrastructure needs, could have grown in the range of 6%, sustainably.

From a near 9.5% growth rate in 2010, India's economy has slowed to approximately 4.7% at the end of 2013. Additionally, 2014 is an election year for the Central Government. Therefore, for most of this year India will be preoccupied with elections and its aftermath (*all the horse trading required to form a ruling coalition, as a majority government does not seem likely*) and most important policy decisions and their implementation, will be essentially on hold, so we do not anticipate any significant improvement in growth rates, in 2014. But, of all the major economies in the World, India has perhaps some of the best fundamentals for solid sustainable growth (*5% to 7%*) for the next couple of decades, if this impending election brings about a government that actually governs competently and impartially (*a tall order indeed*).



Raghuram Rajan, a former Chief Economist at the IMF and a Professor of Finance at the Booth School of Business, Chicago, internationally renowned and acclaimed as a celebrity in economic circles, was appointed as the new Governor of the Reserve

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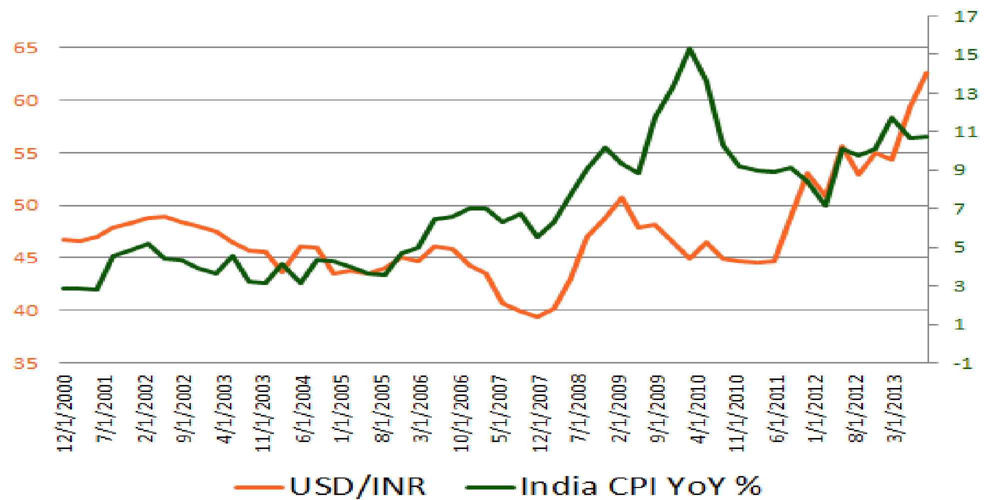
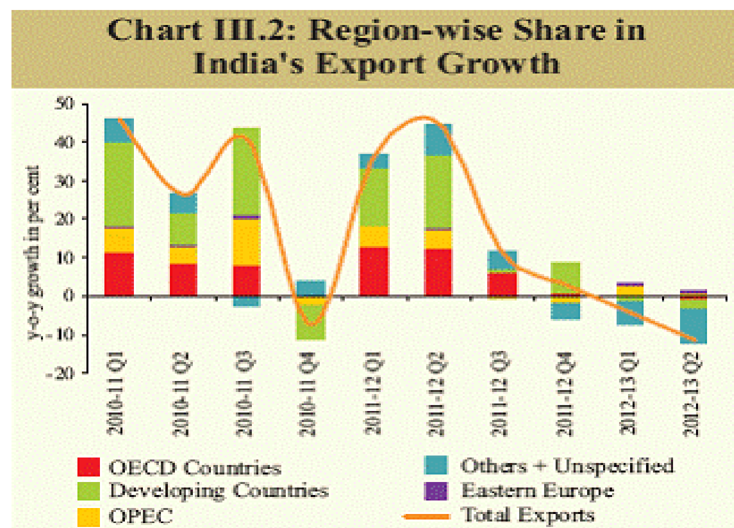
Bank of India (*India's Central Bank*), in September 2013. He moved quickly to stabilize the Indian Rupee, which had been practically in freefall against the U.S. dollar, since about the middle of 2011, further exacerbating the troublesome resurgence of high inflation by the middle of 2012. With the Rupee stabilized somewhat, Raghuram Rajan has targeted bringing down India's inflation rate. Rajan's appointment as the RBI Governor and his quick subsequent actions have earned him the confidence and approval of Indian and foreign investors.

Inflation over the past decade has made holding the Rupee an unattractive option for global investors, but the central bank under Raghuram Rajan is finally moving to change that.



India's incredibly poor internal governance of the last few years, coupled with the ongoing weakness in external demand has crushed India's exports resulting in a problematically high (*almost 5%*) current account deficit that had in turn crushed the Rupee. Under the new RBI Governor, India is moving towards correcting its most glaring problems, he quickly raised interest rates to fight inflation and stabilize the Rupee, and if India gets a workable government after this election (*in April/May 2014*) India could become a rare, relatively stable economy, in the coming global financial economic turmoil.



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Australia:

The investment fuelled explosion in China's infrastructure construction, and the rise of its extraordinary manufacturing capacity over the past two decades proved to be a boon for resource based economies like Australia, Canada, Brazil, Africa and others. Australia particularly, in the past decade, knowingly and firmly hitched its star to China's rising, resource devouring wagon. And while China grew and consumed raw materials at a hereto unprecedented rate, Australia did very well. Recently as China's sizzling growth rate has cooled, so has Australia's. In the Chart below, the Australian Bureau of Statistics has estimated 2014 GDP rate at 2.8%. In our view, that estimate is optimistic and real growth will probably come in about 2.5% or lower, as China's economy cools further, and drags the Australian economy down with it.

Overall, Australia's near term prospects do not look good. Its GDP is declining steadily over the past 6 quarters and will continue to do so, in our view. While the other Asian economies (*other than China*) continue to post decent growth numbers relative to the developed economies, the global commodity demand will continue to slide due to China's falling demand for raw materials and energy.

In the following Charts, Australia's internal consumption is projected to decline, which will be in line with its slowing economy, along with substantial drops in business and mining investment and capacity utilization. Australia's housing sector has been a bright spot with robust increases in prices, but now with the near and medium term economic prospects dimming, housing prices will be negatively impacted. With the commodity markets looking grim, Australia is facing some serious headwinds.

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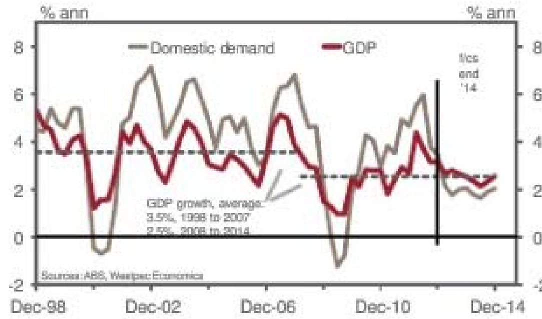
Australian economic conditions



Hours worked contract

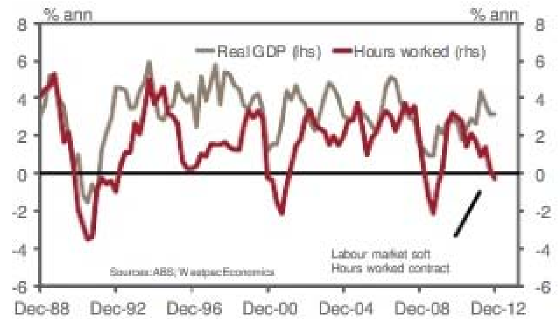


Chart 3.

Australian growth mix

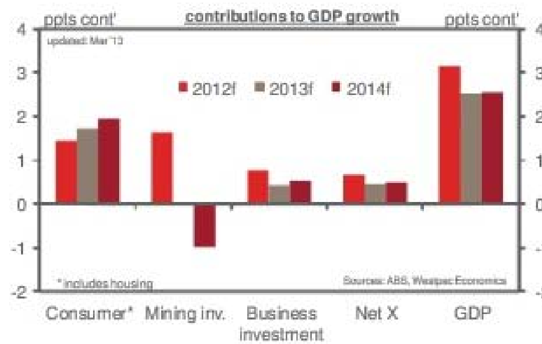


Chart 4.

Housing & mining investment, share of GDP

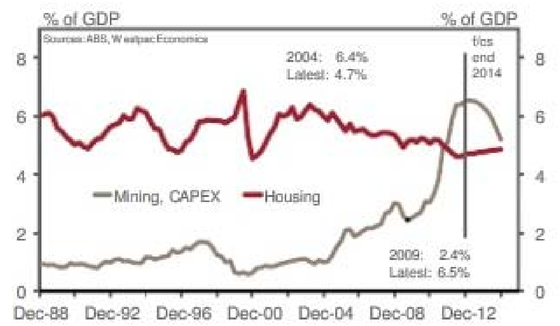


Chart 5.

Household savings rate

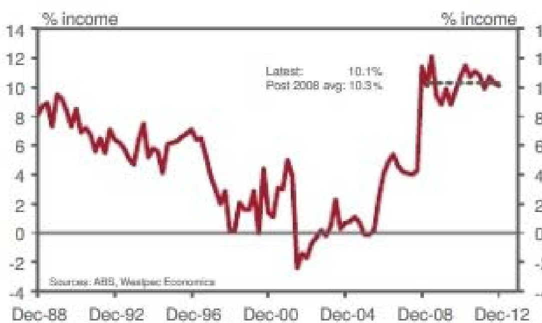
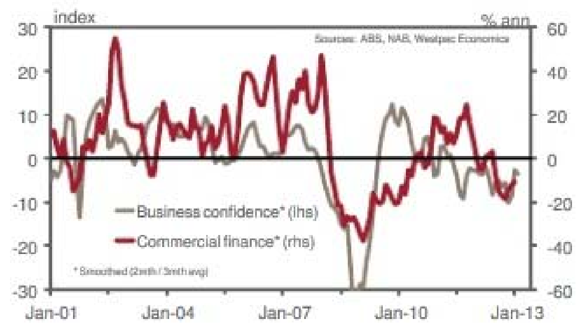


Chart 6.

Business confidence & commercial finance



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Central & South America:

Latin and South American countries/economies have always been volatile. Their penchant for revolutions, Dictatorships, tendencies towards nationalism and socialism and resultant nationalization of foreign owned assets, crime and drug cartels, along with (*at times*) out of control inflation and currency collapses, made that entire region unique and economically dangerous.

In the past decade and a half, after the seeming global triumph of Western capitalism over communism, Latin and South America had swung towards the right with even avowed leftist leaders such as Brazil's former President Lula taking a more productive centrist economic policy stand, with verifiable positive results. But with the widening gulf between the rich and the poor, and after the 2008 crash when *Western capitalism's excesses led to a near global financial system crash and the loss of credibility in developing countries*, the politics of the region have swung again to the left, along with the return of traditional and potentially violent political volatility and instability. The current scenario in most Latin and South American economies reflects the return, to a degree, of the above summation of the region's ills.

Over the past couple of years some of the region's major centrist and right of centre economies that had been doing very well, like Mexico, Brazil, Chile, Peru and Columbia have now declined somewhat in their prospects, amid the economic weakness in the region and the overall weakness in the global economies.

Overall exports are down due to the weaker global and China demand, which is particularly reflected in demand for commodities being seriously muted. The soft commodity markets are significantly impacting mining operations and mining related investments. This lack of incoming foreign direct investment has some of the currencies under significant pressure, which in turn is fueling inflation.

A number of decidedly left leaning countries, particularly Venezuela, Ecuador, Nicaragua, are facing increasing political turmoil with the resultant economic woes. These countries will add to the general volatility of the region and coupled with the global economic weakness, we do not see a rebound in the fortunes of these economies. The general consensus is that the Latin and South American economies, collectively will post approximately 3% growth in 2014, with the stronger economies (*politically stable and right of centre or centrist*) being around 4% and the weaker countries (*politically and economically left of centre, and volatile*) will grow at about 2% and less.

This economic region, Latin & South America including the Caribbean, is made up of 28 economies and approximately 600 million people. It is incredibly diverse and rich in natural and cultural resources, and could be an economic power house. But, historically and to a degree to the present, it has always been plagued with poor governance, corruption, exploitation, division, and at times extreme political and financial upheavals. Over the last decade or so, as noted above, the region tilted towards democracy: politically, and to the right of centre: economically, but that trend seems to have reversed, dramatically in some countries, and moderately in others. Our sense is that the region is going to underperform, and could see greater economic regression in 2014.

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Conclusion:

The most significant economic trend in the coming months that will have a discernible impact on the global economy is going to be the slowing Chinese economy. China has reached that tipping point where it either cuts back on its debt supported expansion, and slows its growth rate, or it keeps inflating its debt and credit bubble to keep growth going at 7.5% and above, and has a catastrophic implosion. There are no other choices. The days of controlled sustained high economic growth are over, and the Chinese government realizes it, in our opinion.

Lately, in letting a relatively small private sector company, Chaori Solar Energy, go into default for its US$14M payment due on its international bonds, the Chinese government, in our view, was setting the stage for the World to get used to the idea of Chinese companies defaulting. Up to this point, in the over two decades of breakneck economic growth, no public or private company was allowed to default. But now there is an overwhelming overhang of bad debt casting its long shadow on the Chinese economy, and we anticipate a lot more defaults in the coming months and years. We believe the permitted default was a signal sent by China's government to the World, of the coming bad news, as most everything possible is carefully assessed and orchestrated in China, before it is disclosed to the World.

China's government is between the proverbial rock and a hard place. Global demand across the board is muted and will continue to be so. This leaves China with a huge overcapacity problem. Its internal market is woefully underdeveloped and cannot possibly absorb the overcapacity. In the past 5 years, since the implosion of global demand post 2008 crash, China's government filled the gap by expanding its credit and debt market to an astronomical level, in the official (*State controlled*) and unofficial banking (*shadow banking*) and financial sector. That debt made possible the greatest construction boom the World has ever known, which continued to drive high growth rates post 2008, as the West and the rest of the World languished. And the World was wowed by Chinese economic prowess (*reminds us of the World's fawning admiration for Japan Management techniques in the early '90s, when everyone was studying the undefeatable Japanese model*).

But the extraordinary building boom grew an equally large debt and real estate bubble that now threatens China's economic and political stability. If China does not meaningfully curtail its credit binge, it risks an uncontrolled debt implosion. If it does tighten its credit meaningfully, its growth rate will contract materially and for a long time, with all the resultant nasty side effects, such as dangerous economic and political instability.

The Chinese government is in a tough spot and therefore will, in our view, ramp up nationalistic sentiments, by pointing to external and internal threats, e.g. the Uighurs from the North West Province of Xinjiang, and South China Sea problems with Japan, Malaysia etc. And it will try and implement its 'Reform' agenda highlighted in its Third Plenum, but there it will have less success, as too many of China's rich and powerful (*most of China's ruling elite at the Central, Regional and Local level*) will actively oppose and sabotage that effort.

Along with China, the United State's financial markets pose a similar major threat to the global economies, as they have soared detached from reality, like China's construction boom, on ridiculous amounts of easy money from the Federal Reserve (*the Fed*). Like China's government, the Fed has no choice but to cut back or risk an

asset bubble implosion bigger than the 2008 crash. The Fed has started to “taper” back the bond purchases (*money output*) but is still stoking asset bubbles by keeping the printing presses going and interest rates artificially low (*near zero*).

The financial markets have experienced an unprecedented bull run based solely on easy money from the Fed. As is often said in the markets now ‘the Fed has underwritten every risk and hit every bid’.

But reality has a nasty habit of intruding on irrational exuberance, be it in China or in the United States, or anywhere else for that matter. And according to our analysis, both markets and economies are dangerously overinflated with debt, with no real rational economic underpinnings. In a global economic environment, with little to no possibility of real growth for a number of years to come, as highlighted and discussed in this Report, Parts 1 & 2, both markets and economies of China and America pose a real threat to global economic stability in the near term.

If things end badly, as we reasonably expect them to, in spite of the current efforts of the global governments and the central banks, then it could be an economic catastrophe, resulting in a decade of global stagnation and strife. While we are not optimistic about it, we hope this impending and looming catastrophe, in the making over the past 5 years can somehow be averted.

We advise our readers, to be mindful and use extreme caution in moving forward in all your economic planning.