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Global Economic Recovery – Inflating Volcanic Calderas

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Ashok Dhillon has 40 years of front-line business experience in Canada and International markets. He incorporated his first construction company in 1974, and since then has founded and led companies in construction and international power development.

Over the last 20 years Mr. Dhillon, has led and worked with top Canadian talent in the legal, engineering and accounting firms, such as Fasken Martineau, Russell & DuMullen, Stikeman Elliott; Hatch, Moneco Agra, New Brunswick Power, SNC Lavalin; and Ernst & Young, Arthur Anderson, and Grant Thornton. And in London, worked with Perkins Couie and Morgan Grenfell. Mr. Dhillon's companies have partnered and worked with Pan Canadian Oil & Gas, WestCoast Energy, TransCanada Pipelines, and international companies such as AES, Enron Power, Hyundai Heavy Industries.

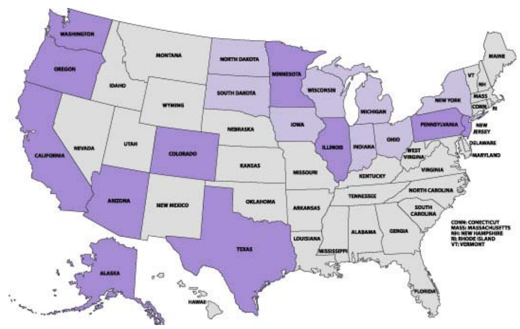
Mr. Dhillon has worked and negotiated with highest levels of Governments in Canada and India. He has pursued and won mandates to develop power plants in Canada, and foreign jurisdictions such as Hungary, Iran, Pakistan and India with uncompromising ethical standards. His extensive experience in securing 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".

Wall-E and the Plant

There are green shoots appearing in the scorched global economic landscape, but the periodic ongoing convulsions from the last financial meltdown, 5 years ago, are continuing to create seismic shifts in the geo-political-economic restructuring and realignment that is currently taking place. The Euro Zone is seemingly the most unstable tectonic plate right now, and the major tremors that continue to emanate from there can bring on another major setback to the global recovery. The United States, Japan and China also have the capacity to implode, due to the highly unstable mass of hot air, in terms of the massive stimulus being injected into the banking and financial system, that is having very limited impact on economic activity and job creation, but is inflating asset bubbles, particularly the stock and real estate markets, which are being touted as signs of economic recovery for these major economies. So, while the general consensus is that recovery seems to taking place, globally, our 'bird's-eye' view is showing a number of major economic calderas that are inflating, smoldering and do not look in the least stable.

Upon taking a quick inventory of the major economies or economic zones today, this is what we see:



The United States is probably the leader in the net recovery effort at this time, even though the GDP growth numbers are relatively anemic, compared to most Asian economies. The economic resurgence numbers are being boosted artificially by the massive financial stimulus, yet this is an economy whose underlying fundamental economic structure is sound, albeit currently compromised by massive growing debt and poisonous partisan politics. The fact is the economy is being pumped full of 'debt steroids' and is therefore on a forced growth track, thereby increasing the risks in all its asset classes.

Clay Bennett

But, increasingly the cheap internal energy resource bonanza gives the United States incredible long term advantage, as does its depreciating dollar. China, Japan and Europe have high energy costs and intractable structural internal problems that are going to take longer to right.

In spite of the built-in advantages, the risks of growing on steroids cannot be discounted or

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ignored. Firstly, there can be nasty side effects, such as artificially created asset bubbles leading to the accompanying sense of illusionary economic strength that masks the inherent risks still present. Secondly, the dangers of using steroids in the gym or in the economy are probably the same. Upon reducing or stopping the regular dosage, there is the immediate sense of loss of strength, accompanied by the inevitable loss of confidence, triggering the deflation of asset bubbles and the economy as a whole. As in the gym, sustainable national financial well being and economic strength are the result of and adherence to basic prudent principals of financial discipline, economic and policy innovation, meaningful gains in productivity and the advantage of the right trend in demographics. The United States is not yet on the path of exercising basic prudent principals and is definitely addicted to stimulus steroids for the time being, and is therefore inherently unstable.

While there has been a lot of pain in the U.S. economy since the 2008 crash that continues to be felt today, yet the signs of gain that are apparent currently are the result of massive monetary stimulus, bringing into question the reality of the recovery once the stimulus is gradually shutdown, as it must. The high flying stock markets in the U.S., boosted by the rocket fuel of easy and massive liquidity, are too detached from reality to offer any real assurance of economic recovery to anyone, let alone to the public at large, without whose real participation no economic recovery can be engineered and sustained. Unemployment and consumer debt levels continue to be high, and without the clear signs of overall economic strength and effectively functioning bipartisan government, confidence continues to be low. The resilience, innovation, productivity and general strength of the American economy will eventually prevail, but real sustainable economic recovery seems still some years away. Meanwhile near term dangers are rising from excessive liquidity, asset bubbles, and a devaluing reserve currency, forcing non-reserve direct inter-currency trade between competitor countries, further casting a long shadow on the confidence of other countries in the dollar. The American Government may not have an option but to try and inflate its way out of the massive debt problem, but other countries in turn are following suit, and are devaluing their currencies to stay competitive. The question is, if everyone tries to export their deflation, who is going to absorb it and the economic pain that comes with it? We still anticipate a serious correction in the soaring equity markets, and a retrenchment in the U.S. economy before truly sustainable recovery can take hold.

Canada is slowing and will continue to slow. The heavily resource weighted economy will continue to be negatively affected by the general global recession, the weakness of its largest trading partner the U.S., and the ongoing retrenchment of the major emerging markets like China and India. Apart from the slowdown in commodities, manufacturing will continue to be weak, as will agricultural product prices in an increasingly competitive and shrinking market, as each potential client country imports less and in turn tries to boost its own local production and exports.

The Canadian consumer is heavily indebted and facing a slowing economy. This means additional and growing problems. The wealth of most Canadians is primarily in their generally well paying jobs, their high priced real estate assets and to a lesser degree in their investments in the financial markets. The outlook for all three sources of wealth is currently weak, and negative in the near term. The financial market is being weighed down by the retrenchment in commodities, job outlook is weak with a slowing economy, and the real estate market is sliding downwards in a much anticipated soft landing, which could accelerate into a hard landing if interest rates were to rise

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unexpectedly or the economy were to suffer additional job losses.

Canada has one of the largest underdeveloped land masses as a country with one of the smallest populations, and yet it has some of the highest real estate prices in the World. In our view, this is not a sustainable equation and we expect a correction.

The recent weakening of the Canadian dollar bodes well for exporters, but the potential benefits are being negated by the targeted weakening of competitive currencies such as the U.S. Dollar, the Euro, the Russian Ruble, the Japanese Yen, the South Korean Won, the Indian Rupee, and now the Australian Dollar, as each country and zone looks to energetically boost its exports. The continued competition among exporting countries, through their committed efforts to devalue their currencies through aggressive expansionist monetary policies, and/or historically low interest rates, will pose ongoing challenges to Canada's GDP growth, and its long term export aspirations.

With North America thus locked in an overall slow growth trajectory, and facing competitive headwinds, the other international economic giants have a greater load to bear in their efforts to resuscitate themselves. Most of them are in no shape to carry any additional weight of a bogged down global economy while competing with the recently revitalized former export giants, the U.S. and Japan.

The Euro Zone is in truly terrible shape with most of its major economies firmly mired in an intractable recession. The overall unemployment rate of Euro Zone is reported to be 12%. This number masks the truly frightening real unemployment numbers of some of its key economies such as Greece, Spain, Italy, and Portugal which are in the neighborhood of 27% to 30%. In some parts of these economies the unemployment number among the youth, is at or above 50%, and in some parts of Greece, youth unemployment is estimated to be in the range of 60% - 75%.

When one steps back from the blandishments the Euro leaders use to describe the economic problems faced by certain of their countries, and look at the current reality, the Euro Zone is experiencing a full-blown depression in some of its economies. The problems are deeply structural and require the kind of strong local and unified leadership that the Euro leaders are incapable of providing at this time. There is no institutional cohesiveness as in banking, which is required to push through unpleasant but necessary reforms that must be undertaken to correct the imbalances in the various economies. Nor is there political viability for those tough enough in the ruling parties that would have the nerve to propose meaningful structural change within the "problem" countries, or within the Euro Zone itself. All political leaders are already facing serious protests amongst their respective populations, which are demanding less painful solutions to problems that that have no painless solutions. The composition and structure of the European Union is itself in question and further crises amongst its major members could threaten its very viability. Europe still has the potential to derail the fragile global recovery.

China, the nation that has been punching above its real weight in global importance, has enough socio-economic structural troubles of its own to have the capacity to singlehandedly stabilize the rest of the globe. In fact it desperately needs to have Europe and North America recover to their former economic and consumption strength, to regain its own stability.

China's many problems are: the sagging export demand, the devaluing of the currencies of its major trading partners, particularly Japan (its largest trading partner), and of the U.S., South Korea, Europe, Russia, Australia, the rest of South and South-East Asia etc. As each of these countries push down their currency, they create additional challenges to China's efforts at export resurgence, which means rising factory over-capacity and potential job losses among its workforce. At the same time, devaluing external currencies boost China's internal inflation rate through the rising imports prices, particularly in energy and foods. China can ill afford either. Potential factory slowdown/shutdowns coupled with rising cost of living could spur destabilizing unrest amongst its restive population. China's strong currency is a heavy liability against Japan's dramatically falling Yen, adding to the challenge of maintaining its pre-eminence as the leading exporter. The Chinese Renminbi having been held artificially low for a long time has been allowed to rise modestly by the Chinese Government, which has been under consistent international pressure to allow the currency to appreciate. But now, China is under increasing pressure from its competitors, and eventually must succumb again to weakening its currency to stay competitive.

In spite of doing an admirable job of the constant economic/political tightrope walking, China's internal problems of economic structural imbalances are mounting and are in need of serious attention. While China's Government can and does move swiftly and resolutely to address most problems, the critical issues that are facing it today are more social and political in nature. By its political compunction to maintain a one party rule, China's government handicaps itself severely in moving on the social and political reforms that are seriously overdue.

As the presence of the communist party is pervasive in the economy, the recently appointed leaders face an impossible situation in trying to curtail the Party's influence, ownership and sense of entitlement, which is entrenched in the DNA at all levels of State and Central governance, without changing the structure of its political system or loosening its iron grip on the country, in any meaningful way.

China needs to diversify from its overbearing public sector (government owned) predominance in the economy, which through its notorious inefficiency, and preponderance towards pervasive corruption, is making effective economic performance increasingly costly and difficult. The endemic corruption and the terrible impersonal inefficiency of the system are fueling increasing dissatisfaction among the people, and that is a growing problem for the government. Yet in trying to maintain the essential status-quo in the one party ruling structure, the Government is effectively handicapped in bringing about the necessary change. In the coming years the Chinese Government is going to be increasingly preoccupied with managing the growing frustrations and expectations of a diverse, far flung, changing constituent base, at a time of mounting challenges in the international environment. Two of the methods that the Chinese government employs to keep public sentiment generally on its side is: 1) to periodically whip up nationalistic fervor by

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creating small international incidents with its traditional 'enemies': Japan, Taiwan, Vietnam and India and by reminding its population of old insults by former Western colonizers; 2) the second more recent strategy is to fan national pride by raising its profile and clout on the international stage through the demonstration of its economic and military prowess. In the early part of this year China rekindled its many 'international disputes' with its neighbours, particularly Japan, which led to an eruption of violent patriotic demonstrations against Japanese corporations and products. The Government followed that up with 'incidents' of territorial disputes with India, Vietnam, Philippines and Malaysia. These 'incidents' keep the focus of the people directed on international issues, rather than dwelling on internal problems. Lately, the new leader, Mr. Xi, is implementing the second part of the ongoing strategy, which is to showcase China's rising power and influence on the international stage to fan national pride, which galvanizes the people's attention on the accomplishments of the communist government, rather than its shortcomings, and the lack of an individual's rights.

Additionally for China the low hanging fruit days of runaway economic growth through capital investment in endless infrastructure development, cheap factory labour, and artificially held lower currency, are basically over. The 'capital investment in infrastructure' route to GDP growth, is creating a dangerously lopsided economy that is building an ever increasing risk of non-performing loans in the banking and non-banking sector. And, China's hot real estate continues to inflate in spite of consistent efforts by the Government to cool it. The Government is quite aware of the dangerous imbalances in its economy and has said as much, but it is still handicapped in making quick, effective and permanent changes.

In the international arena competition is rising dramatically in international trade, low cost labour availability, and lower competing currency rates. So in our opinion, China's growth rate is likely to falter further until it can adjust to the new global economic realities of lower exports, the need for greater internal consumption, far less capital investment into infrastructure growth, and more investment into true social and political reform. All of these changes could take China quite a few years to successfully implement.

Japan's new and profoundly aggressive expansionist monetary policy is a new and unexpected threat to China's dominance in international trade. It's too early to tell whether Prime Minister Shinzo Abe's desperate economic experiment is going to be successful in breaking Japan out of its decade's long deflationary trap, or backfire and further damage an economy fighting deteriorating fundamentals in demographic trends and international competitiveness. Whether it is successful or not, this most recent and stunning stimulus action, in both audacity and scope, has dramatically lifted the stock market (*which had a recent sharp correction*) while equally dramatically devalued the Yen, to the consternation and detriment to all exporting and competing countries, particularly China, South Korea, Taiwan and the United States.

Our assessment is the same - we don't believe that Japan's structural problems, which are significantly aging and declining population base, increasingly competitive international global trade, and declining productivity amongst the younger generation, are going to be rectified with massive amounts of money being thrown at the problems. Japan may just end up destroying its savings.

Over the past few years, apart from the impact of the global recession, India has faltered primarily due to recurring, pervasive corruption scandals of a scale that have emasculated the

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coalition government led by the Congress Party. But the corruption scandals have been surfacing at State levels too, which combined with the scandals at the Centre, have derailed effective governance for a number of years, taking a toll on India's economy at a time when leadership was needed the most, to effectively battle the external negative economic influences.

The scale and pervasiveness of the corruption has shaken the notorious apathy of the Indian public, which has traditionally participated in and accepted corruption as a daily part of their life in India. When the public won't change their ways, the democratically elected governments officials can't change, themselves being from the public. On top of the gridlock in governance, the Indian Government launched a number of high profile court cases against major foreign companies to recapture taxes that it felt were owed for transactions that were completed in the past. That action of reaching back many years after a transaction has been completed has shaken the confidence of foreign investors resulting in a reduction in foreign direct investment. Foreign and local capital investment is hesitant and discouraged by the endless policy gridlock, and flip-flops of governments at both the State and Central levels.

India's current problems are many, entrenched and systemic, but the underlying economic and social structure is sound and has fundamental strength. India cannot match China's discipline and efficiency that comes from absolute control through an autocratic heavy handed one party governing system, that puts its own and the country's interest far ahead of its people's rights, but India has the institutional infrastructure that does not require restructuring, as China's does. India is a raucous, inefficient, volatile, undisciplined democracy, operating in and evolving from an essentially feudal hierarchal society, whose governing bodies are abysmally ineffective, yet its political system empowers its people to exercise their rights to a large degree. Hence India does not face the possibility of a future cataclysmic political change as China does. India's development is patchy, beset with relapses, much slower but perhaps steadier in the coming years. India will continue to wallow in poor and compromised governance in the coming years as there seems to be the absence of strong untainted leadership in the major political parties at this time. The coming election promises to result in another dysfunctional coalition of multi-regional parties led by a weak and emasculated national party. Nevertheless India will continue to post moderate growth in the 4% to 6% range going forward. As the popular Indian saying goes, "India functions in spite of its governments".

In our view the above mentioned countries and economic zones are the most important to setting the direction of the global economic trends. All are struggling with an altered reality because their relative position in the supply and demand of goods and services in the global geo-political economic structure has changed drastically since the 2008 financial crisis. The previous economic structure in which most of these countries were operating and thriving in, are no longer viable. Most governments are aware of this new reality, but are handicapped in their ability to effectively deal with it. The changes required in their economies are dramatic and painful to implement. These required structural changes, to be implemented amid the financial deprivation accompanying them, are in most countries hampered by the backlash of an incensed public that sees themselves as the victims of corrupt governments and ultra greedy large financial players that not only brought about the financial collapse, but profited from it at the expense of

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the average citizen, who is now being asked to bear the pain and pay the price.

As all these countries struggle to adjust to the new realities, major and at times very painful adjustments need to undertaken in internal economic policy, followed by the realignment of economic output geared towards possibly new directions and new markets, before any real and sustainable global economic recovery can take hold without the fear of additional crashes. Collectively, we are not there yet.

For the remainder of the year the global economy is going to continue to struggle to solidify the small gains that are becoming visible in some countries, the most important of those being the United States and China. Europe has a daunting task ahead of itself to just preserve its existing structure, let alone make any meaningful gains economically. While some of its major economies will continue to teeter on the edge of the precipice, threatening to take the global nascent recovery down with them if they topple over, the governments of the individual countries will continue to face increasing public angst and frustration as the near depression like conditions persist over the coming year.

Asia will continue to post the most robust growth rates in the World in the coming years, but those growth rates are going to be tempered in the near term by the lack of pre 2008 crash consumption levels in the Western developed economies. In the meantime the Asian export giants are going to realign their sights on developing new markets for their wares, be it boosting internal consumption or opening new markets such as Africa, the Caribbean, Latin and South America, as per China's current focus. We have not focused on Latin and South America as we feel that while these countries represent a growing and important part of the global economy, yet their current economic status will not dramatically affect the global economy at this time. In a similar manner we have chosen not to include Russia in this report. The development of internal markets and the new geographic markets will take many years to match or exceed the previous critical mass of the Western markets in dollar volume, but it must be done as the Western countries must curtail imports from Asia and boost exports to the region to revitalize their own recovery.

These fundamental shifts of economic tectonic plates are in the very initial stages of realignment, making for a volatile and dangerous period ahead. Adding to the dangers are the inflating asset bubbles in the U.S., China and now Japan.

To us they resemble inflating volcanic calderas, which have the risk of blowing up with devastating effect to the global economy if the Central Banks do not time the release of the building pressure perfectly. If they ease the stimulus too early, the questionable economic recovery to-date will quickly deflate, and if they keep inflating for a bit too long then some asset bubble somewhere is bound to blow up, triggering another possible downward spiral and setting back any hopes of economic recovery many more years, and afflicting far greater pain than was felt in the last crash. Plus it will shatter the faith in the stimulus methodology to generate economic recovery (which is already being questioned), and will leave governments and central banks helpless in face of the resulting devastating global deflation. If nothing that drastic happens, in our view, it will still take years for the 'New World Order' to take shape, and for countries to find new workable models to grow in and thereby become the drivers of next cycle of global economic prosperity.

To our readers, we advise to proceed with extra caution in this volatile, unstable geo-political economic environment. Expect possibly severe corrections in stock, bonds and real estate markets over the remainder of the year, softening of the energy and financial sectors, and further volatility and uncertainty in the global geo-political economic landscape. For those with greater tolerance for risk the United States, China, India and select countries in Africa are the best long term bets at this time.