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The Australian Economy- down the gum tree?

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“Leading indicators show Australia has not only avoided recession, but is leading the world recovery” thus says an Australian bank-sponsored economic index, applauded loudly by the Reserve Bank and enthusiastically cheered on by the sound of pre-electoral self-congratulatory back-slapping from Government!

Yet on the same November day on the other side of the world a leading French bank tells clients how to prepare for “global collapse” In a report entitled “Worst case debt scenario,” the banks assets team said state rescue packages over the last year have merely transferred private liabilities onto sagging sovereign shoulders creating a fresh set of problems that may plunge the global economy into a catastrophic double dip in 2010. “As yet nobody can say with any certainty whether we have in fact escaped the prospect of a global economic collapse.” Governments have already shot their fiscal bolts, public debt is at an all time historical high and aging western populations will make it harder to erode debt through growth. “High public debt looks unsustainable in the long run. We have almost reached a point of no return.” The current crisis displays “compelling similarities” with Japan during its lost decade with a big difference: Japan stayed afloat by exporting into a robust global economy and by letting the yen fall. It is just not feasible for half the world to follow this same strategy simultaneously!

How can it be that two respected institutions on other sides of the world can have such divergent views? Whilst one is predicting global equities to return to March 2009 lows, for property prices to tumble and for oil to fall back to \$50 in 2010, the other claims that strong government spending and the economic impetus of China has already brought Australia out of the recessionary woods! Perhaps they are both right, at least partly, but to get to the bottom of this maybe we need to take a step back and look at the crisis from everyone’s perspective.

Starting with the world situation, the 2008 crisis has exposed a fundamental structural flaw: a global market, under the control of individual national governments and regulators. Economic problems are being exacerbated by different jurisdictions now scrambling over one another to save their own individual economy in the wake of the crash, oblivious as to whether they are working against each other. This recession is not a once in decade downturn. This recession has occurred at the end of a 30-year long period of gradually reducing interest rates which have served to continuously lower the cost of credit and thereby boost productivity and drive up wealth. Now we are at the end of the road; interest rates are close to zero and cannot drop any further in order to stimulate markets. Governments worldwide are flailing about hopelessly in their efforts within their own jurisdictions, with neither recognition nor capacity to grasp that what we have just experienced may be the beginning of a major global shift that may ultimately end up fundamentally challenging and transforming the western democratic economic model that has boomed since the fall of the Berlin Wall.

In both the US and the EU, production is down, and unemployment continues to rise. Public spending, already at an unprecedented level before the crisis, looks set to double in some jurisdictions, which is likely to have a negative impact upon taxation for the next generation and will continue to adversely pressure currencies. When people or corporations are concerned about money they choose to delay purchases and borrowing, hold cash, distrust others and cautiously wait for new information to glean direction and motivation. Western banks started 2009 effectively paralyzed, unable to lend money. By the middle of the year when things had improved they discovered that market appetite for borrowing had diminished. By the final quarter of the year banks were aggressively stockpiling cash and capital reserves in anticipation of worse things to come. All these actions are rational acts of self-preservation that not only give a disturbingly negative view of the future, but ultimately worsen an already bad situation.

In the US President Obama may have thought that the only good thing about this crisis was that it was not his fault. Rather than be disconcerted by the huge size of the predicament, the pragmatist would see it as an opportunity to blame someone else for everything, whilst the scale of the problem affords a good reason to continue this approach for a number of years. Obama is therefore not under any great pressure to act quickly which is why he may have already missed a marvellous opportunity to craft significant change that would have fixed systemic problems. For now, additional regulation may hamper recovery of the financial markets, whilst a laissez faire approach may well be economically beneficial in the short term even though it is blatantly wrong and is likely to cause further long term damage. The ultimate losers in this game will likely be US society’s poorest and weakest at the foot of the food-chain- those for whom President Obama was elected as their

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champion. If the financial crisis ends up robbing him of the budget necessary to deliver social reforms promised at the time of his election, there is a real risk that those that put him into power may ultimately turn against him. Another political U turn in the 2012 presidential election would then only create additional confusion, foster uncertainty and further derail economic recovery.

The only good economic news in the world since 2008 has emanated from those Far Eastern economies that have weathered this storm much better than their western trading partners. They have achieved this by adopting a savings mentality in response to their harsh experiences of the 1997 Asian Crisis and have stockpiled currency reserves and restricted domestic credit. In 2009 China has embarked upon an aggressive fiscal stimulus and domestic credit expansion programme which has enabled its economy to grow and has boosted production and exports within other Asian jurisdictions and Africa. As a result of its stimulus programme China has not only managed to largely avoid recession but has become the main global engine for growth in the past year. Using retail sales during this period as an example, in the US sales have crashed whilst retail sales in China have doubled!

Australia has significantly increased its trading ties with Asia since the 1997 Asian crisis, which has enabled it to benefit from growth within Asia and create additional domestic employment. In the past decade exports from Australia to the Americas have increased by 39%, by 73% to the EU, and to a staggering 182% to East Asia. 75% of all Australian exports now go to East Asia with 75% of the East Asian total going to China, Japan and South Korea. China has replaced Japan as Australia's largest individual trading partner in 2009 and the Chinese market is now its main driver of exports. This export resilience has been a major contributor to Australia's wealth in 2009 and has been a crucial factor in avoiding recession, albeit at the risk of putting all ones eggs in one basket. The Australian government believes its markets will be back to their historic growth trend in 2010 as a result of which they have been one of the first jurisdictions in the world to take their foot off the monetary stimulus accelerator and increase interest rates. The Reserve Bank stated when implementing this that "the risk of serious economic contraction in Australia had now passed" and the authorities clearly feel confident in the global market and the risk of growth contraction in their domestic market as stimulus fades.

Other indicators of economic health in Australia do not look so promising though and are generally in line with depressed western markets. Unemployment has risen by 45% within 18 months and has now surpassed the 1999 peak. Consumer spending is dropping and private sector credit is contracting. Conversely government borrowing has virtually doubled in the past 12 months. These negative indicators tend to cast a shadow over Government's decision to lower fiscal stimulus so early, and in this regard Australian policy is contrary to other western governments who are using their unemployment rate as a benchmark for phasing out economic stimulus.

One of the major challenges facing the world in the new IT age is managing globalization. Individual jurisdictions are no longer in control of their own economic destiny, which creates a much more complicated situation than politicians and governments are used to dealing with, and is major contributing factor to the severity of the current downturn. This external control issue impacts Australia more than most of the large western nations given the relatively small size of its economy and its dependence on foreign flows as a net capital importer to its capital markets.

Whilst the Chinese economy has held up very well throughout the downturn there must be some doubt as to the continuing sustainability of its own domestic stimulus package. Given that the US consumer spends two times China and India's combined GDP each year, the alarming condition of the depressed US economy must ultimately damage China's production unless there is a sudden and unlikely return to growth in the USA. As an indication, world trade as measured by the Baltic Dry Index has increased this year, but is still less than half of its peak in 2008 and is more in line with 2002 levels.

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The greatest threat to wealth in the global market now appears to be China decoupling from the US economy, but not its currency. China increasingly appears to be caught between a rock and a hard place. If it doesn't float and revalue its currency it will almost certainly create a domestic inflationary bubble of catastrophic proportions when it bursts. On the other hand, if it does float its currency upwards against the dollar, the value of its US Government securities holdings will plummet and damage its reserves. Meanwhile China continues to stockpile commodities and export its excess capacity to depressed western markets in the shape of underpriced manufactured goods which is exerting deflationary pressures and prolonging recession. China and the US seem increasingly at odds with one another over this issue and the longer this imbalance remains the greater the risk of globalization going into reverse and the fuelling of protectionism.

Whilst all this is playing out the global market will be characterized by economic uncertainty and extreme currency volatility. Individual government responses to the crisis so far have typically seen the adoption of expensive quick fixes, and prayers for an early return to growth. If the global market does not resurrect quickly there is no plan B nor budget for a long drawn out recession. Politicians worldwide must get their heads up out of their own jurisdictions and realize that what is going on outside their boundaries impacts both their investment and trading partners and their own futures. Until governments get to grips with this, the global economy will continue to wobble and national capital markets are reduced to a lottery. Nobody really knows what will happen next and the message for 2010 seems to be to expect the unexpected!

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He worked in Asia Pacific after the 1997 crisis until 2005 and thereafter in Europe and Latin America gaining global experience through transactions in twenty different jurisdictions.

Disenchanted with the approach adopted by Lehman, John left the firm in August 2008, one month before they declared bankruptcy. He returned to South East Asia and established Global Markets Asia in order to provide local businesses and institutions with a clearer understanding of what is occurring in the global market and how this may impact them.

From 2009 a number of presentations and articles have been published that draw upon John's wide global experience and an insider's view of the demise of Lehman, the resultant credit meltdown and global economic downturn.

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