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# More global imbalances ahead

The world has not fully recovered from the 2008 recession, and risks a prolonged stagnation from the euro crisis. But companies and shareholders are better prepared for a banking crisis than in 2008.

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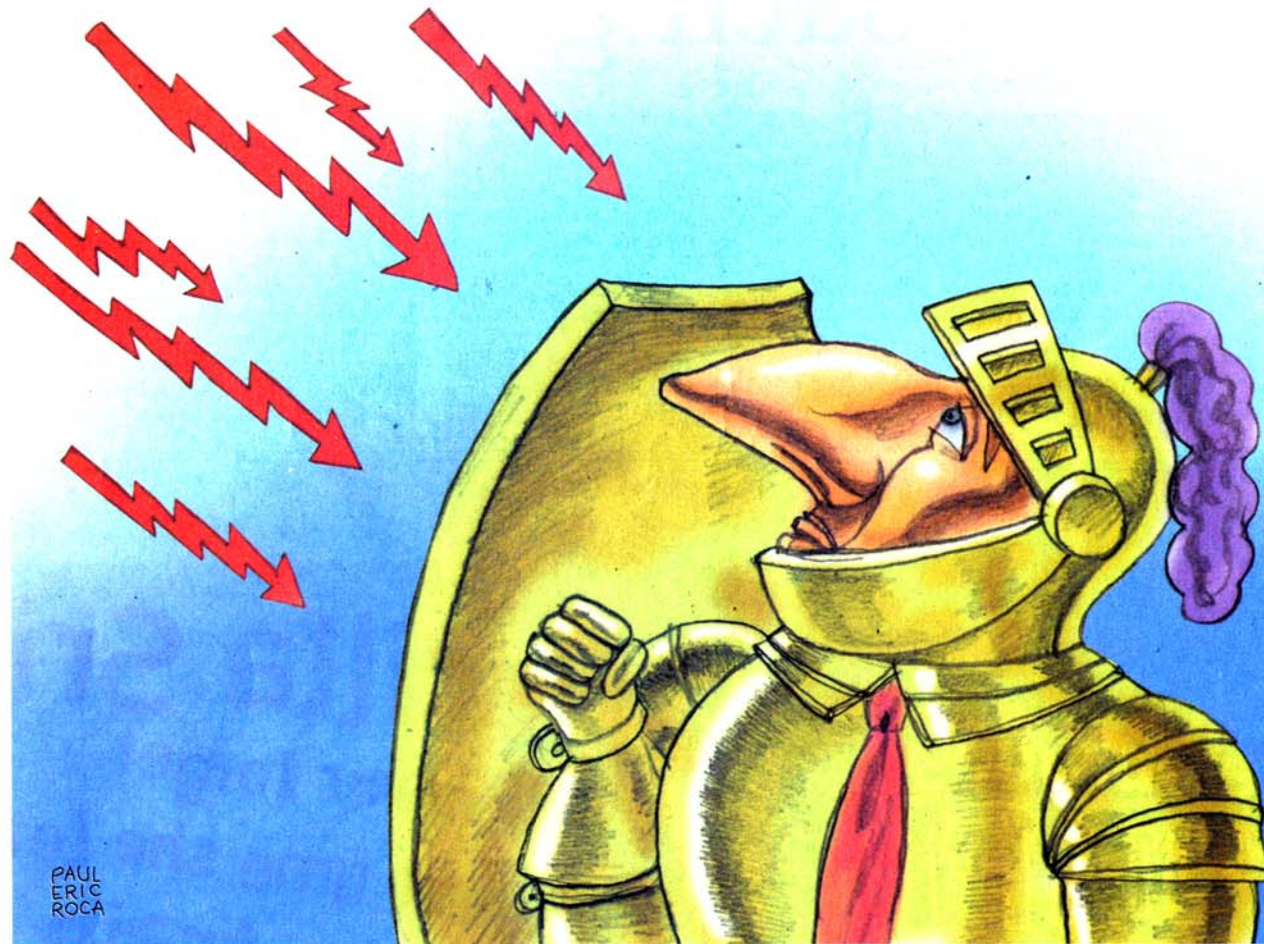
For The Straits Times




LAST summer, I discussed a possible double-dip recessionary scenario during an interview conducted by leading Chinese financial website hexun.com, often dubbed the CNBC of China.

At that time, Singapore was reporting record GDP growth. I was an oddity to even talk about any double-dip recession. But I was convinced back then, as I am now, that the global economy had not resolved the underlying structural issues leading to the financial crisis of 2008. Governments simply deferred dealing with the problems by converting private indebtedness into public indebtedness, and then hoped for the best.

Given recent developments, a prolonged economic stagnation in the West with specific "distress hot spots" may be just as likely as an outright global double-dip recession.

Ironically, stagnation may turn out to be a more problematic outcome, because it provides a convenient excuse for elected governments to sweep the underlying structural problems under the carpet.

The October 2011 US jobs report showed an increase in non-farm payroll by 80,000, which was still below what would be required to keep up with natural population growth in the United States.

The bigger concern lies in a slightly controversial statistic published by the US Bureau of Labour Statistics called U6, sometimes called the "real" unemployment rate. U6 is a broader measure that includes discouraged workers and partially employed ones, and it went from 16.2 per cent in August 2011 to 16.5 per cent in September 2011 and back to 16.2 per cent in October 2011. More importantly, the annual averages of U6 (reported quarterly) have been staying stubbornly above 16 per cent since 2009, compared to its 2008 average of 10.5 per cent.

The point is this: Partial unemployment cannot be ignored in this case, because many Americans have taken one year or more to find jobs relevant to their skills in this deep downturn. Curiously enough, some economists have been quick to comment on double-dip fears without referencing the trends on U6.

The real debate should be whether the global economy has truly emerged from the great recession of 2008 in the first place, and what would be its potential damage from a series of potentially messy disorderly sovereign defaults in Europe.

First, it is clear that euro zone banks holding troubled sovereign bonds will be among the immediate casualties in the event of a sovereign default in Europe.

Beyond this, how might a banking crisis translate into challenges for the real economy? This is where the issue becomes intriguing. The short answer is that the impact of a banking crisis may be less on the real economy than in 2008.

## Back to 2008?

FOR sure, when banks fail, bank employees who lose their jobs will suffer. Bank shareholders who lose their equity values, and debt holders who face a possible default, will also suffer an impact – though things may not turn out as badly as 2008, as shareholders and debt holders have all adapted.

In a typical bankruptcy scenario, cash deposits are considered the general obligations of a failed bank; in theory, large depositors can only recover certain cents on the dollar.

Since the financial crisis of 2008, depositors have begun parking cash under multiple financial institutions below the limits guaranteed by depositor insurance schemes. Anyone who needs to store a large amount of cash will buy government securities and hold them in escrow accounts beyond the reach of bankruptcy administrators. In short, it is less likely for a bank failure today to translate into massive disappearance of depositor wealth.

Banks are also responsible for the financing of goods and trades in the real economy. As one example, truck manufacturers were hit particularly hard by the financial crisis of 2008. Demand for new trucks disappeared quickly as prospective customers scrapped plans for capital expenditure, or customers simply could not get the expected financing to take deliveries. All of a sudden, truck manufacturers were burdened with unsellable inventories, but still had to pay for parts already assembled and overhead costs.

However, companies have quickly adapted since the previous financial crisis. The Wall Street Journal reported that, in preparation for a possible downturn, truck makers Scania and Volvo have already reduced their debts and, in particular, exposure to short-term funding.

Even hedge funds, which primarily rely on banks for financing, are increasingly doing business with multiple prime brokers to minimise possible disruptions from bank failures.

The financial crisis of 2008 was a shock to the real economy because some banks that were not expected to fail would have done so without government bail-outs, and agents in the real economy were ill prepared to adapt.

In contrast, the current mess in the euro zone is so well broadcast that the immediate impact on the functioning of the real economy is expected to be more muted.

No doubt there will be long-term effects: In Europe, banks are typically nationalised rather than allowed to fail.

If financial markets perceive that certain European countries can ill afford their share of the bill from saving these banks, the potential consequence will be an economic contagion, much alike the 1997 Asian financial crisis.

In 1997, Japan was the only Asian economic power, but few Asian countries would ask Tokyo for serious financial help due to the burdens of history. It was only left to the International Monetary Fund (IMF) to bail out South Korea and Thailand.

Indonesia did not suffer the worst meltdown until almost a year later, and IMF austerity measures led to widespread street violence. Asian central banks quickly learnt their hard lessons and began building up massive reserves. Looking where South Korea is today economically, it is hard to deny that strong medicine that doesn't kill can be a blessing.

As one can infer from the sagas on the European bail-out package, the euro zone has an unwieldy political process for policymaking. At this pace, it may take years to sort out its banking problems.

## Impact outside Europe

THE economic impact outside the euro zone will be the slowdown of global aggregate demands. Such an assessment was shared by Ms Christine Lagarde, managing director of the IMF, in a speech at Moscow's State University of the Ministry of Finance on Monday: "The economy in general is in a dangerous and uncertain phase – there is clearly a darkening outlook and adverse risks."

A euro zone in trouble may hasten the recovery of the US economy, in that those American companies that survive the painful initial slowdown are probably in better shape than their European counterparts to respond to the eventual recovery of global demands.

Asia will continue its export currency policy in addition to stimulating internal demands. China may need to deploy another policy stimulus to support its banks – this time perhaps by using non-fiscal tools such as lowering the required reserve ratios (RRR) of its banks. Still, that will build up asset inflation pressure.

Most Asian governments will be under intense public pressure against offering more than symbolic gestures to assist their former colonial masters in Europe. Ironically, that may end up protecting Asian economies from the crisis in Europe, freeing them to drive the global recovery.

Net result: We can expect to see a significantly weakened European economy. The US will face another slowdown. Under mounting public pressure, elected US officials will finally pay attention to addressing the underlying structural issues via painful reforms. With Chinese 2011/Q3 GDP growth coming in at a still impressive 9.1 per cent, Asia is likely to be the first region to bounce back from the initial slowdown.

All in all, we expect more global imbalances ahead, until some of the underlying fundamental structural issues are resolved.

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## What's next

THE prolonged stagnation sparked by the spread of the euro zone banking crisis will see some geopolitical shifts in the region. Here are some possible consequences:

- Fearing that its oil and natural gas exports to Western Europe may be adversely impacted, Russia will put more emphasis on reaching the natural resource markets in Asia by approving joint ventures such as new pipelines and LNG terminals. Russia, China and other major emerging economies would jointly demand a bigger say in the International Monetary Fund in exchange for channelling support to Europe via the multilateral organisation.
- European countries will look east for business opportunities, as witnessed by Hong Kong's recent hosting of the world's biggest wine auction this year. This trend will be facilitated by China's planning of high-speed rail links to reach Europe, Russia and South-East Asia using "standard gauge", and the rail network is eventually expected to reach the Middle East and North Africa.
- The new Chinese rail link and pipeline projects will become the modern Silk Road, supporting a digitally-driven economy where expertise and resources flow eastward while manufactured goods flow westward. European governments will actively seek access to Asian markets, but the benefits in terms of local job creation may not be immediately obvious to the general European population. The resulting anger and resentment may boil over into nationalistic and protectionist sentiments.
- The US cannot win a currency war against its Chinese bankers as long as it needs China's support to roll over its debts; instead, the real US currency war will be fought against Europe, with both competing to sell cheaper and superior products and services to Asia.
- Impressive Chinese military projects such as the "Underground Great Wall" and the launching of China's first aircraft carrier will be closely aligned to achieving its economic objectives. China will project its military power not just to its immediate vicinity in the East China and South China Seas, but also to the traditional "Spice Routes" to the Middle East and Africa via Indian Ocean. Russia and China will strengthen its historical alliance to marginalise Japan's influence in the Pacific and to reduce the United States' military presence in Asia.

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