

The 10 economic factors in the world outlook for 2011 – and the 3 dominos

*by Paul C Sandison**

Apart from geo-political risk-taking coming to a head around the 28th March, there are a number of negative headwinds building in the international economy, particularly in the United States and Europe. Despite bullish sentiment currently in ascendance in the stock markets, it is clear to many economists that the world is in for a turbulent time in 2011.

Of course, there is no one-to-one correlation between the economy and the stock market, and they tend to do their own thing for extended periods of time. However, this time around the magnitude of the approaching storm will not escape the stock market, in part because QE3, QE4 and QE5 are not likely to happen. Even if they do, the effect will be insufficient to maintain stock prices in the face of waves of indogenous and exogenous shocks to the US economy.

Additional QE shots will also be utterly useless to the economy when the macro-economic tectonic plates shift on a magna scale. In my analysis, the salient world economic and social developments coming in the next two years are going to happen due to the following tensions building to the point of explosion:

- 1 The sovereign debt crisis in Europe is putting great pressure on the EU financial system and is contributing to the difficulties in achieving growth in large parts of the EU. Although the EU ruling class is slowly beginning to conduct changes in the EU financial sector, it is taking far too long and it does not have the necessary political perspective and understanding to see that the structural imbalances in the eurozone are now moving to rip the eurozone apart.

Although EU institutions and their leaders are successively building what amounts to a federal system for loans to weak eurozone countries, it is more and more becoming evident that they have no real idea of the convulsions they are throwing the weaker eurozone countries into. The ECB and the European Reconstruction Bank are simply not intending to supply ailing nations with credit at reasonable rates, and the whole EU project is in great danger of failing altogether through mounting debt. There is an overhanging risk that the debt will cascade through emergency package after package until collapse and default of a debtor country is a fact, accompanied thereafter by huge social upheavals across the 16 eurozone nations and ultimately across the entire EU of 27 countries as well.

The object of the latest 750 bn euros support fund is to end the despicable scenes when the bond vigilantes, in cahoots with the rating agencies, pick off one weak EU economy at time and extract extortionate rates of interest, a fate hitherto experienced by Greece, Ireland and now Portugal. Once operational, this fund is intended to go a long way to eliminating the debt crisis in Europe altogether. Given the financial headwinds about to hit, this arrangement has not come a moment too soon. But will it be enough? The Stockholm professor, economic analyst, and author on economic growth, bubbles and crises, Stefan de Vylder, does not think so. He foresees the demise of the eurozone (see [link](#)).

China has lost confidence in the dithering US political and economic system, prone as the latter is to delays, lobbying, partisan interests and pork-barrel politics and has declared a willingness to assist Europe with support if necessary to achieve sovereign financial stability. The EU is an important export market for China and it is in the interest of China to assist the EU to weather its current sovereign debt crises.

On the face of it, the EU looks set to weather the approaching financial storm with much greater robustness than the US, even though the EU will, like most economies, be affected by any double dip in the US. But again, will the Chinese assistance be enough given the wide cracks fast developing in the EU? Furthermore, what will happen when China itself runs into

great problems, which it is heading towards at rapid speed? I will continue with China later under factor 9.

2 The US first-time unemployment rate is as high as ever, 9.8%, while the real number out of work is estimated to be over 17 million people. Without any significant growth in the US economy (i.e. at least 6% per annum) these numbers are going to remain high for many years, perhaps a decade or more.

3 Every 400 000 new people out of work in the US puts further downward pressure on the US housing market as they default on their mortgages a few months down the line. Unsold US residential housing inventory is now close to four million homes and the average time to a sale 24 months. The market has 25% further down to go.

4 US large banks are still under pressure because they are still carrying toxic assets on their books (or off them) and are unwilling to lend to businesses, making it difficult for them to expand. A number of the larger banks are also being sued by other companies, for example Bank of America by PIMCO for fraud in relation to the value of the sub-prime mortgage-backed securities sold to them three years ago. Regional banks are also under pressure and another 500 are estimated to hit the wall in 2011.

5 Over 40 US states are bankrupt and will have a combined deficit of \$200bn in 2011. How is the US going to deal with this? If more money is printed then the national debt will increase.

6 There is now an ever greater probability of widespread US municipal bond defaults from 2011 on. The Republicans will have the majority in Congress from the 1st January 2011. They will appear to be responsible when nurses, doctors, teachers, firefighters, refuse collectors and other municipal workers are laid off and find that the Republican Congress had voted for cuts in public services and pensions. When cities and states fail, the people will demand solutions of Congress, and therefore of the majority party in control of Congress. Both sides will have great difficulty in achieving a majority in Congress in 2012.

Due to the dire straits a large percentage of the US population will soon be in, I believe that re-instating the tax rates for the top 2% richest in the US that George W Bush had cut, will become an inevitable policy of choice, even for Republicans! The econometrics are simple. Raising taxes for the common citizen would reduce spending power across 98% of the population and would thereby depress aggregate demand. However, even laymen know that raising taxes for the top 2% rich will not affect aggregate demand. The rich may stop buying the odd airplane, yacht and fancy apparel from foreign places, and stop buying shares and homes abroad, but they will not stop buying food and clothes at home. I believe the Republican Party will have to bite the bullet and take some very difficult decisions which are diametrically opposite to some of their populist slogans.

7 It is becoming questionable whether the Federal Reserve Bank will be allowed to conduct any more quantitative easing. The US population is horrified at the accumulated debt of well over \$13 trillion (over 100% of GPD). The debt is actually four times \$ 13 trillion if you include all the unfunded liabilities. They have voted for Republican congressmen who are avowedly determined to try and reduce the government deficit through reducing government spending. The Republicans will have a majority in Congress from the year end but not in the Senate. The Senate and the President could block any proposal coming from Congress.

Nevertheless, severe economic realities of unemployment, rising crime, death and social decay will force both Congress and the Senate and the President to achieve legislation which really deals with the economic problems or face the wrath of the electorate in 2012. In addition, Republican Senator Ron Paul will be chair of the finance committee and is bound to push for more cuts in the deficit, which means cuts in government spending. Obama and the Democratic party may be pushed to a fiscal policy that is more restrictive than before. However, in achieving cuts in deficit spending, federal austerity will drive down demand and

will exacerbate low turnover and low profits and low GDP growth. The Democrat voters will not be happy bunnies. Both parties will thus have to take difficult and distasteful decisions and yet still incur the wrath of their supporters.

8 The Baltic Exchange Dry Index (BDI) is currently at a major low, which indicates a significant drop in trade, particularly between China and the rest of the world. The BDI is a leading indicator, so expect trade volume and therefore the GDPs of many countries to drop in the months and quarters that are dead ahead in 2011.

9 We have increasing news of current and future monetary policy measures by the Chinese government, in particular the Chinese central bank, the Peoples Bank of China (PBOC), in their desperate attempts to try and cool off the overheated Chinese economy. The latest interest rate hike a few days ago was by 25 basis points to 5.81%.

China is experiencing a major housing bubble due to a turbo-driven two year expansion effort that has been conducted far too fast and far too uni-directional. Unfortunately, instead of acting to open up the service sector at the same time and growing the internal economy more slowly, China now has a one-sided internal economy. Particularly in the inland areas the new internal economy has largely consisted of building and infrastructure of completed cities that are now standing empty. The owners are speculators waiting for a continued rise in home prices. A classic bubble.

Since the fall in exports in 2008, construction now accounts for 60% of the Chinese GDP and the Chinese economy is massively overheating. In Q1 of 2010 alone, the increase of medium to long-term loans was 1,3 trillion renminbi for infrastructure and real estate, 70% of the total, while the increase for manufacturing was less than 300 bn renminbi, i.e. less than 12.5% of the total (World Bank, 2010).

Latterly, the Chinese government has several times raised reserve ratio requirements (RRR) for mortgages, but local banks and politicians are caught in an upward spiral of local demands to continue to provide employment and keep consumption up, and have circumvented these requirements in different ways to force yet more lending for new projects. RRR has failed to curb the expansion. The bubble is unsustainable and the end is near.

The Chinese Government will now have to raise Central Bank interest rates to cool off the housing bubble. Raising interest rates is a very blunt and dangerous weapon. Normally, cooling runaway housing construction or the mortgage lending business should be achieved through other means which do not affect those sectors of the economy that are not overheating. In the present case that has been tried and it failed. The need drastically to intervene and stabilise the Chinese economy is urgent.

Interest rate adjustment is a tricky animal. Achieving a soft landing for the economy, particularly in the present case, should not be expected. If one raises interest rates in baby steps then little happens for months and years, all while the overheating continues and makes the problem far worse. Finally an unknown tipping point is triggered and an extra large crash is a fact.

Larger hikes cannot be effected overnight either, because 4 to 6 weeks between interest rate decisions is necessary. It takes this long to ascertain whether the desired effect has been achieved before deciding on a further hike or not, and by how much the rate should be adjusted the second time. Notwithstanding this constraint, a country that is overheating needs to act sooner rather than later. The greater the bubble in credit, the greater the implosion in credit after the bubble is popped.

The inevitable interest rate hikes in China will have three drastic effects:

Firstly, the housing construction sector will crash and mortgage lending will crash. Secondly, the interest rate rises will affect the entire economy. Think the US from April 2007 on. Thirdly,

the interest rate hikes will result in an increasingly appreciating renminbi vis a vis the dollar. American customers will face higher costs for essential white, mechanical, electronic and other goods from China. Chinese goods will be more expensive to the US customer and imports from China will drop. Large swathes of Chinese export factories, already struggling with non-existent margins in cut-throat competition with other Asian economies, will go out of business. The great China growth machine will slow, as in Q3 and Q4 2008. This time deflation will be a distinct possibility, for the expansionary credit weapon will have been depleted.

10 Oil speculation is rearing its ugly head again. Despite there being no remarkable increase in US factory demand for energy, the price spike presently building is due to the same factors in 2008 - market disequilibrium between supply and demand providing an ideal ground for speculation. The prevailing view on the stock market during the Q4 of 2010 was that global growth will spike again soon and the world will run out of oil again. This view is making the markets nervous that the available oil will be insufficient to service a growing world economy. The apprehension is driving prices up. In theory inventory is up, but the oil speculators are again hoarding oil in tankers floating lifelessly in harbours and fjords around the world, thus withholding the oil from the market and driving up prices further. The owners have everything to win by waiting for a better price in the months to come.

An oil price top of \$147 by the end of May is in sight. As in 2008 an oil price above \$100 a barrel and rising will start adding great costs to production and service sectors around the globe. Once again, companies will fold and the stock market will dip. The rising oil price is a sure sign that a switch into a double dip is right ahead.

The question for investors is: exactly when the markets will finally get the message? There could be the classic rise until mid-May, and then the usual implosion in the scary month of October. Or the real downward spike could uncharacteristically come much earlier. How? The usual smaller dip in January and February could just keep on going down. The last bizarre alternative is that the stock market fails to read the writing on the economy wall, and the stock market keeps on going. For a while. As the great liberal economist Lord Keynes said, "The market can stay irrational longer than you can remain solvent".

Now, dear reader. You choose. There are 3 dominos standing in a little circle, each facing the other two. They are China, the US, and the EU. Which is going to fall first?

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* Paul Sandison, 63, is a social critic of contemporary society. Although born in South Africa, he has lived in Europe for nearly 40 years. His forebears include an ancient ancestor to King Niall of Ireland, and Charlemagne. Paul is currently promoting American and European arrangements of contemporary Irish music. His hobbies are reading, development economics and jogging.