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Hypo Venture Capital Headlines: Warning of global stall may come too late to avoid crash by [Hypo Venture](#)

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Hypo Venture Capital Headlines: Warning of global stall may come too late to avoid crash

Unresolved debt leaves frustratingly slow growth as the best likely outcome, writes Satyajit Das.

In 2008, panicked governments and central banks injected huge amounts of money into their economies, in the form of government spending, tax concessions, ultra-low interest rates and “non-conventional” monetary strategies “code for printing money.

The actions prevented the Great Depression 2.0 temporarily, converting it into a deep recession. The US economy shrank by 8.9 per cent in 2008.

As individuals and companies reduced debt as banks cut off the supply of credit, governments increased their borrowing, propping up demand to keep the game going for a little longer. Governments gambled on a return to growth, solving all the problems.

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That bet has failed and high levels of government debt in some developed nations have become the central problem. Greece is Patient Zero in the global sovereign crisis, highlighting deep problems in public finances of developed nations.

While the deep economic contraction was a factor, much of the build-up in government debt had taken place before the crisis as a result of spending financed by increased borrowing.

Instead of treating the situation as a solvency problem and reducing the debt to sustainable levels, stronger countries within the European Union banded together to lend the distressed countries the money they needed.

Within about 12 months, Greece, Ireland and Portugal needed bailouts totalling almost €400 billion (\$554 billion). Many European banks, exposed to these borrowers, also lost access to commercial funding, becoming reliant on European Central Bank loans. Having to guarantee the weaker countries inevitably increased the liabilities of the stronger ones, weakening them.

Despite frantic attempts by policy makers, Greece, Ireland and Portugal will probably need debt restructuring. Spain and Italy are now firmly in the sights of markets.

The bailout strategy cannot continue without affecting the creditworthiness of France and Germany. In the absence of a continuing bailout, the European banking system is vulnerable and will need capital from governments “catch-22.

The sovereign debt problem is global. The US, Japan and others also owe more than they can repay.

At best, governments will cut spending or raise taxes to stabilise government debt as public sector solvency becomes the priority.

Reduction in government spending will slow growth, making the task of regaining control of

government finances more difficult. This may require deeper cuts in governments' spending and ever-higher taxes, mirroring the developed world in low growth for a protracted period.

At worst, some governments overwhelmed by their debts will default, causing a major disruption in financial markets, perhaps setting off a deep global recession.

Underlying economic activity has remained weak. Having shrunk by more than 12 per cent in 2008 and 2009, US output has yet to return to its 2007 peak. On a per-person, inflation-adjusted basis, output stands at virtually the same level as in the second quarter of 2005 – in effect America has stood still for six years. The same is true of many countries.

Given consumption is 60 to 70 per cent of individual developed economies, unemployment, underemployment and lack of income growth will reduce overall growth.

In the four years since the recession began, the US civilian working-age population has grown about 3 per cent but the economy has 5 per cent fewer jobs – 6.8 million jobs. The real unemployment rate – people without work, people involuntarily working part-time, people not looking for work because there is none to be found – is about 15-20 per cent in the US.

Even those Americans in work are generally working less and, adjusted for inflation, personal income is down 4 per cent, not counting payments from the government such as unemployment benefits.

The same is true in Europe, where the average official unemployment is above 10 per cent. In many countries such as Greece, Ireland, Portugal and Spain, unemployment is about 20 per cent and youth unemployment about 40-50 per cent, as the economies have shrunk 10-20 per cent. Understandably, consumer spending is weak.

Key sectors for employing workers, such as housing, are frozen. In the US, housing starts are running about 400,000 to 600,000 units annually, well below the level of the 1960s, down a staggering 70 per cent-plus from the peak and 50 per cent-plus from more normal levels.

With home prices down 35 per cent from the peak and predicted to fall further, Americans do not have a wealth buffer in housing equity to fall back on. Low interest rates and indifferent returns from investments mean the ability of retirees to consume is also low. The same is true of many developed economies.

After a sharp decline in economic activity in 2008, some emerging big economies – China, India, Brazil and Russia – recovered through massive domestic investment, aggressive expansion of domestic credit and, in some cases, strong commodity prices. They benefited from the stimulus packages of developed nations, which helped fuel exports. Money fleeing the developed world, looking for higher returns and elusive growth, provided cheap and easy capital. That cycle is coming to an end.

China's over-investment in infrastructure produced short-term growth but many of the projects are not economically viable and will drag down future growth.

Many are funded by borrowing that cannot be repaid, creating bad debts within the banking system. This will require diversion of funds to bail out troubled institutions. The tepid growth in the US and Europe, its two largest trading partners, will slow Chinese exports.

China's foreign-exchange reserves, invested in US and European government bonds and denominated in dollars and euros, are increasingly worthless, as they cannot be sold and, if held, will be paid back in sharply devalued currency with lower purchasing power.

Printing money, as the US has done, devalues the US dollar and creates additional pressure on China. Strong capital flows overwhelm smaller markets, creating destabilising asset-price bubbles.

Commodities traded in dollars increase in price, creating inflation. Domestic inflation forces higher interest rates, slowing down the economy. The high proportion of spending on food and energy in emerging countries means a higher proportion of income is needed for essentials, reducing disposable income and increasing wage pressures.

These factors choke off growth. While improving US competitiveness and reducing its outstanding debt, a policy of devaluation of the US dollar may trigger trade and currency wars.

There are already accusations of protectionism, currency manipulation and unfair competition. Many emerging markets have already implemented capital controls.

These will be strengthened and supplemented by other measures such as trade sanctions. The Swiss National Bank recently announced moves to stop the flow of money into Swiss francs seeking a safe haven, crimping growth and Swiss exporters's ability to compete.

Currency intervention may trigger tit-for-tat retaliation, reminiscent of the trade wars of the 1930s, and will retard global growth.

While government finances are in reasonable shape and the banking system remains stable, Australia is not immune from the problems outside its borders.

A slowing global economy and, with it, a slowing Chinese economy, will reduce demand for Australian exports. Despite stellar prices for and high volumes of exports, Australia still runs a current account deficit of more than 2 per cent of gross domestic product, which must be financed.

Disruptions in money markets will affect the cost of funds for Australian banks and businesses as well as reducing the amount of funding available.

The government and Reserve Bank point to the pipeline of resource projects that will power the Australian economy. These ventures are contingent on demand for the product and availability of finance, both of which are fragile.

The high exchange rate, reducing competitiveness, and a narrowly based economy highly dependent on consumption, property and financial services, will limit economic flexibility if the global economy deteriorates.

The recent volatility in financial markets is rooted in the realisation future growth will be low and in the lack of credible policy options.

Government support for the economy is restricted because of excessive debt levels and the reluctance of investors to finance indebted sovereigns.

Interest rates in most developed countries are low or zero, restricting the ability to stimulate the economy by cutting borrowing cost.

Unconventional monetary strategies – namely printing money or quantitative easing – have been tried with limited success. Further doses, while eagerly anticipated by market participants, may not be very effective.

The inability of both Europe and America to deal with their debt problems reflects both political paralysis and the absence of clear and effective solutions as well as disagreement between politicians and technocrats about the right policies.

The most likely outcome is a protracted period of low, slow growth, analogous to Japan's Ushinawareta Junen – the lost decade or two. The best case is a slow decline in living standards and wealth as the excesses of the past are paid for.

The risk of instability is very high. A more violent correction and a breakdown in markets, as in 2008 or worse, are possible. Frequent bouts of panic and volatility as the global economy deleverages "reduces debt" are likely. Problems created gradually over more than the past three decades can be corrected only slowly and painfully.

Powered flight requires air to flow smoothly over the wing at a certain speed. Erratic or slow airflow can cause a plane to stall.

Most modern aircraft are fitted with a "stick shaker" a mechanical device that rapidly and noisily vibrates the control yoke or "stick" of an aircraft to warn the pilot of an imminent stall. The eerie sound of the stick shaker can sometime be heard on cockpit voice recordings of doomed flights just before they crash.

The global economy, too, needs airflow "smooth, steady and strong growth. Unfortunately, the global economy's stick shaker is vibrating violently. It remains to be seen whether the economic pilots can regain control and land the flight safely or whether it ends in a crash.

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