

Global Markets Asia

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Economic Research

Global Market 2010- the facts

What is really going on?

February 2010

Commissioned

By



**BAKER TILLY
THAILAND**

Global Market 2010- the facts

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An Independent Report
Commissioned by



BAKER TILLY
THAILAND



MBMG
GROUP

Director

For business leaders in Thailand



Introduction

Baker Tilly Thailand is delighted to be introducing Global Market Asia's report entitled "Global Market 2010- the facts," an independent assessment of where the global markets are heading in 2010.

Since the 2008 crisis the markets have entered a period of extreme uncertainty and volatility. The media and the press continue to send out conflicting reports that change direction and position from day to day on isolated subjects that fail to address how the big picture is really unfolding. Global Markets Asia has therefore published an unbiased assessment of their view of the world markets in order to help both the public and professionals alike improve their understanding of the situation. Please note this report has been undertaken completely independently of **Baker Tilly Thailand** and does not necessarily reflect the views of **Baker Tilly Thailand**.

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Global Market 2010- the facts

Executive Summary

Unemployment dominates the global economy with official rates doubling since 2008 in most western jurisdictions. As a result demand has fallen in the west, which continues to adversely affect global trade. Emerging markets have shown themselves to be much more resilient to downturn as a result of better fiscal balances, higher foreign reserves and lower foreign currency credit exposure.

Asian economies have partially rebounded in 2009 driven by domestic demand. Government stimulus has been more effective as a result of Asia's stronger fiscal position at the outset of crisis. Despite positive signs, a continuing, sustained turnaround is not assured, given the main drivers of recovery from the 1997 crisis- a durable rebound in external demand from outside the region, and the opportunity to lower interest rates-will be lacking this time around.

In the main western economies the policy boost to recession is already starting to diminish and fundamental financial sector repair is progressing slowly i.e. policy forces that are driving the current rebound will gradually lose strength, and the real financial forces will remain weak.

In Europe regional imbalances that remained hidden during the boom period have been exposed by crisis and are increasingly causing instability within the common market. A prolonged period of job losses is expected to weigh on Europe beyond 2010 and the overall regional rebound is likely to be slow.

In the USA consumption will not revive until the diminution of employment losses coincides with firmer asset prices. The gradual pace of recovery points to a prolonged period of subdued inflation and vulnerability to deflation.

In Asia inflation risks are becoming more pressing. Some economies are seeing large asset price increases in response to low interest rates and easy credit, which could be exacerbated by strong capital inflows. China is already addressing this with policy measures designed to reign in such pressures.

For the world market there must be adjustment in the pattern of global demand in order to stand a chance of staging a sustainable recovery. Until this occurs there is a real risk that western recovery stalls and deflationary forces become entrenched. In the meantime bubble burst risks still linger. If the recovery were to stall and be followed by stagnation or very low growth, deficits and debt could balloon to difficult-to-sustain levels. If globalization goes into reverse it is likely that protectionism will escalate in some jurisdictions.

Completing financial sector repair in the west is critical for a return to growth and so far progress has been negligible. The key issue facing policymakers and central banks is when to tighten money supply, but given their track record, the markets are nervous. The tipping point will occur in mid 2010 when economies are exposed to reality again as the effects of stimulus fade. Given this uncertainty even the IMF now admits that "growth assumptions for 2010 seem optimistic".

Where are we now?

Unemployment continues to dominate the global economy

Faced with low demand, weak revenue, large excess capacity, and tight credit conditions, advanced economies are likely to continue laying off workers. In the United States, the official unemployment rate has doubled from its pre-crisis level to hover around a 26-year high of 10%. Official rates ignore the long term unemployed, which, if they were included, would drive the real unemployment rate above 20%.

The real unemployment rate in the USA is now over 20%!

In Europe the unemployment rate is also now approaching double digits. Countries that experienced seismic real-estate-related shocks, such as Ireland and Spain, have seen much larger increases in unemployment because of a sharp contraction in construction. The rate of increase in Europe reflects a regional labour policy of adjusting payrolls by lowering hours worked rather than the number of workers. The danger here is that a sluggish recovery will make further job cuts likely. In emerging Europe and CIS recovery is expected to be slower than in other emerging regions because cross-border capital flows will likely remain lower for some time.

As a result trade remains weak...

The downturn in trade experienced in 2009 seems to mainly reflect falling demand rather than the lack of trade finance that has been the focus of media and political comment. This is a pull-string (lack of demand) problem not a push one right now and trade demand has largely evaporated.

Emerging markets in better shape

Financial stress increased sharply during the final quarter of 2008 and subsided from historical highs in early 2009. Interestingly, the stress index show increased resilience across all emerging economies during the current crisis. By comparison, the collapse of Long-Term Capital Management in 1998, the dot-com crash in 2000, and the U.S. corporate crises (WorldCom, Enron, and Arthur Andersen defaults) in 2002 all created higher levels of stress in emerging economies than the current global financial crisis. What stands out is that financial stress rose much less, compared with past global episodes, and financial market resilience was observed in all emerging markets.

Compared with past global crises emerging markets were much more resilient

Two factors moderated the stress response in emerging markets:

- 1) Improved macro conditions such as higher foreign reserves or fiscal balances
- 2) Lower foreign currency exposure among borrowers (a source of major stress during past crises.)

Especially Asia....

In 2008 domestic demand faltered leading to falling confidence, rising uncertainty, weakening labor markets, tightening financial conditions, and rising spare capacity. The manufacturing-oriented economies (Korea, Singapore, and Taiwan) had recorded peak declines in industrial production of about 25% Y-o-Y. Only China, Indonesia, and India escaped a severe recession, the result of large policy stimuli and, in the case of India, less dependence on exports.

Growth resumed in 2009, driven entirely by domestic demand. Growth dynamics appeared strongest, where domestic demand appears robust, particularly in China and India. In Japan, the turnaround is more gradual and still a work in progress. Other economies showed similar signs of stabilization, with rising industrial production in Hong Kong SAR, India, Korea, Philippines, Taiwan, and Thailand. The overall good health of banking sectors also limited the impact of the financial crisis.

The rebound in Asia can be linked to three factors:

- 1) Very aggressive (in some countries) expansionary fiscal and monetary policy.
- 2) Rebounding financial markets and capital inflows, which eased financing constraints for smaller export enterprises and improved consumer and business confidence.
- 3) A return to industrial growth following large inventory adjustments notably in Japan, Korea, and Taiwan.

Extensive fiscal and monetary support eased tensions in financial markets and helped soften the decline in domestic demand. Central banks provided ample liquidity (Japan) and lowered policy rates (India, Indonesia, Korea, Malaysia, Philippines, Taiwan, and Thailand). In China, a temporary relaxation of credit ceilings and low interest rates buoyed credit growth (private credit grew by 24 % during the first six months of 2009). Given its comparably robust fiscal position at the onset of the crisis, discretionary support in Asia has been stronger than in other regions. Most programs are aimed at bolstering consumption, especially for durables (Japan, Korea) and at upgrading infrastructure and re-tooling factories (China). The rebound in equity markets and the resumption of capital inflows in the context of a generalized decline in risk aversion is providing a further impetus. This upward shift was accompanied by renewed capital inflows into debt and equity markets. In tandem, most currencies have strengthened, and the spread for Asian corporate debt has narrowed which helped ease financing constraints on corporations and households.

Discretionary central support in Asia has been stronger than in other regions

Is the Asian rebound sustainable?

Despite these positive signs, a continuing, sustained turnaround is not assured. Weakening labor markets could drag on consumption, and significant excess capacity in industry will dampen investment demand. The lower interest rate stimulus is also no longer available in many jurisdictions. Furthermore, the main driver of past recoveries—a durable rebound in external demand from outside the region—will be lacking this time around. Exports from Asia remain about 30 % below 2008 peaks including key sectors such as electronics. However a sharp increase in domestic demand has boosted Chinese imports from the region, especially from Indonesia and Korea, and this has helped arrest the sharp contraction in the region's export sector. China and India will need to continue to lead the expansion in 2010.

The main driver of recovery will be lacking this time

The shadow of the western real estate spectre lingers

Consumers in economies such as the United States that have been hit hard by financial and real-estate shocks are now deleveraging. The inflow into equities in 2009 appears to suggest a sign of recovery, though this is more likely to be a speculative rebound in response to over-correction in 2008. Any signs of equity market correction in 2010 could lead to further

Real estate may not see a strong rebound for some time

exacerbated retreats from risk assets of all kinds. Real-estate-related activity, along with the related downward pressure on bank balance sheets that lies at the origin of the global downturn, may not see a strong rebound for some time. Subdued consumption in advanced economies will weigh on many emerging economies' exports, particularly once inventory rebuilding has run its course. Construction activity will stay weak for the foreseeable future. Jurisdictions where construction has been an important contributor to growth in recent years will be hardest hit.

In the short term, property prices have started to exhibit greater stability in some advanced economies, such as the United States and the United Kingdom, but these and many other markets face the risk of further price declines. A return to more buoyant housing conditions is unlikely as long as households face difficult job market prospects and foreclosures continue to mount. House prices continue to decline across a broad range of economies and an analysis of past house price cycles suggests that for most economies, there could still be significant corrections to come given the stronger-than average upturn in house prices that preceded the crash.

There could still be significant house price corrections to come

Commercial real estate, which has lagged the residential sector, is now also going through a severe downturn. Current rent levels for office, retail, and industrial space are still, on average, almost 15 % above the historical norm. Increasing vacancy rates and decreasing rents will exert further pressure on commercial property prices. While resource exporting countries have found that property markets have been given a short-term respite by the rebound in the prices of certain commodities, the U.S. market more clearly illustrates the scale of the problem. In the United States, commercial real estate prices went through a boom of their own between 2005 and 2007, which has since turned into a bust, down around 40 % from their peak (this compares with a peak-to-trough decline of 27 % in the market bust of 1987-92). Distressed leveraged commercial real estate investors facing difficulties in refinancing the loans that are coming due combined with soaring delinquencies have the potential to create a second wave of financial distress in exposed financial institutions. Many commentators see property issues as a major likely potential cause of further difficulties within the financial sector.

The deleveraging process may take another 6 to 7 years to complete

A macro-study by the McKinsey Global Institute recently presented to economists at the 2010 Davos World Economic Forum blamed excessive debt within the public and private sectors, much of it secured by real estate, as the root cause of the 2008 Financial Crisis. The report concludes that the deleveraging process is likely to take six to seven years to complete.

Deleveraging in western markets has been extraordinarily slow to get started by comparison with former cycles. One of the main reasons for this may be the planting of underlying assets under many layers of structured securities during the boom period. As a consequence there seems to be either a general reluctance, inability, or lack of understanding and concern to tackle the issue, unravel the securities and recycle assets back into the market to create the foundation for a new growth cycle.

Where are we heading?

Recovery with policy support continued, but diminishing?

Monetary, fiscal, and financial policies have played a critical role in deflecting the adverse feedback loops between the financial and real sectors. However, in the main western economies the policy boost to growth is already starting to diminish and fundamental financial sector repair is progressing slowly **i.e. policy forces that are driving the current rebound will gradually lose strength, and the real financial forces will remain weak.** Inventory rebuilding will gradually lose its influence, with the focus increasingly turning to the rate at which consumption and investment start to rebuild.

Europe- higher unemployment?

Provided there are no major unforeseen shocks, advanced economies are projected to expand sluggishly through much of 2010, with output growth possibly rising later in the year. In Europe the pace of decline is continuing to moderate, with France and Germany recovering and the United Kingdom boldly claiming to have exited recession. The output decline across the region was driven by a combination of falling domestic demand-especially investment-and shrinking trade, with individual economies suffering to varying extents depending largely on their pre-crisis imbalances. Economies with moderate current account deficits or surpluses have generally seen smaller downturns. However, given its export-oriented economy, Germany was severely affected by the fall in external demand, although activity is now increasing from the recovery in global trade above the regional average. In comparison, the downturn in France was somewhat less pronounced, in part because of lower trade openness and a larger public sector.

With inflation rates low and credit markets severely disrupted, central banks in the advanced economies reduced interest rates aggressively and introduced some unconventional measures, including underwriting of assets by the Bank of England and purchases of covered bonds by the European Central Bank. Many advanced economies committed considerable budgetary resources to support the financial sector, mainly through guarantees. At the same time, countries with more limited policy room at the onset of the recession, such as Italy, and most of the emerging economies, were not in a position to introduce major stimulus. Moreover, most countries in emerging Europe have also been constrained by the outflow of foreign capital (or the risk thereof), with some forced to tighten their monetary stance and consolidate fiscal accounts. Emerging Europe has been hit particularly hard by the drop in capital inflows. This led to major contractions in the Baltic economies, Bulgaria, and Romania, although exchange rates acted as a shock absorber in economies with flexible regimes. Bosnia, Hungary, Latvia, Romania, and Serbia are currently receiving IMF balance of payments support, whereas Poland has access to the IMF Flexible Credit Line in order to safeguard market confidence.

Prolonged period of job losses expected to weigh on Europe beyond 2010

Improvements will be driven by policy support and improved confidence. However, a prolonged period of significant job losses is expected to weigh on activity in Europe beyond 2010. Contraction continues in much of emerging Europe and the overall regional rebound is likely to be slow. Financial market conditions in the region have improved, but the largely

bank-based financial system will take time to fully resume its intermediating role. Tight credit conditions will limit private investment, and rising unemployment will weigh on consumption, especially as public support is gradually withdrawn. Emerging Europe will need to adapt to much tighter external financing constraints and is especially vulnerable to further contractions in cross-border funding, and large cross-border exposures by Austria, Belgium and a number of other advanced economies remain a risk to banks in these countries.

Since the 2008 crisis Global Markets Asia have repeatedly brought attention to sovereign and institutional debt in the so called PIGS block as the Achilles Heel of the Eurozone. Countries who have benefited from cheaper sovereign debt as a result of joining the Eurozone, and have run up outsized deficits, are increasingly likely to be a potential source of instability to the whole European block. For now, and throughout 2010 it appears most likely that Germany and the major EU players will pursue a policy of supporting any ailing jurisdictions in order to maintain financial stability within the Eurozone, and avoid any erosion of solidarity within the Union. This must ultimately increase public debt though and further hinder recovery.

PIGS block- a major source of instability to the European Union

GMA Insight Europe 2010: Since 2008 GMA has been warning that downturn may lead to the emergence of either a two-tier or slimmed down Eurozone. In 2010 unsustainable public debt versus bail-out will be the overriding battle and will severely test Eurozone solidarity. Any threats of local nationalism destabilizing the EU will be contained as long as the ECB continues to bail-out the weaker members. For how long can this be sustained though before there is a break-up? Expect to see a game of political poker develop between the big guns and the basket cases!

Russia- devaluation working?

Russia is reeling from the unraveling of an oil-boom-related surge in capital inflows, which culminated in the devaluation of the ruble in January 2009. The earlier focus on exchange rate stability had encouraged substantial foreign-currency borrowing by banks and corporations and contributed to unsustainably high rates of credit growth. The drop in commodity prices and a sudden reversal of capital flows led to a fall in fixed investment and shattered the nexus of high growth in investment, productivity, and real wages. As a result, GDP plummeted by almost 10 percent in the first half of 2009 relative to the same period a year earlier. Recent data indicate however that the contraction has begun to moderate and the pressures on the capital account and the exchange rate have eased.

GMA Insight Russia 2010: Waiting for real demand (not just speculative movement) for oil to rebound in order to mount a sustainable recovery. Could be a long wait.

USA- an impossible balancing act?

In the United States, consumption will not revive until the gradual diminution of employment losses coincides with firmer asset prices. The gradual pace of recovery points to a prolonged period of subdued inflation and vulnerability to mild deflation. Inflation will remain contained within specific assets while the increased monetary base continues to fail to equate to increased money circulation and is likely to continue to do so. On the demand side, although the personal saving rate has already climbed to about 5 percent, it still has a way to go to rebuild household balance sheets. The creation of the much greater monetary base by central banks and politicians is however a financial weapon of massive destruction to rival

Politicians and central bankers both have track records of doing the wrong thing at precisely the wrong time

the much feared derivative markets. In fact the monetary base worries us even more because this weapon is in the hands of politicians and central bankers. It's not always easy to tell the two apart and worryingly both have track records of doing exactly the wrong thing at the wrong time, especially when, as now, they may feel the need to resort to a broad range of complex tools that they've never used before! (On a more flippant note, what do you get when you combine the word "politician" with the word "banker?" Answer with due respect to the UK TV series "Only Fools and Horses," a "Plonker!") The release of this most toxic of assets into the real economy will determine the extent to which deflation dominates or inflation occurs. Higher inflation at this stage would of course be a double whammy as central banks may respond by tightening monetary policy more than expected. Additional inflation risks persist from the risk that potential output may have slowed more than appreciated, just as during the late 1970s, following a prolonged slowdown in activity that policymakers mistook as cyclical rather than structural. Underlying inflation pressure would then be higher than apparent in current inflation data.

GMA Insight USA 2010: Continuing economic contraction. The need for additional stimulus versus burgeoning public debt and interest rates is the overriding political issue. US government is now too big which will make it extremely difficult to achieve consensus and make the right calls. Between the politicians and the Fed they will almost certainly get it wrong. In order to move forwards again the US must now recognize that their core theory that markets self-adjust is now an anachronistic myth. Additional regulation of a flawed system will make things worse. The 2010 situation is extremely fragile, with high vulnerability to shocks, and potential for double dip.

Australia- all the eggs in one basket?

According to one measure of GDP output Australia was the only westernized major economy to avoid recession during 2009. It achieved this by changing its traditional trading ties and focusing on Asia. In 2009 China became Australia's largest individual trading partner which has created export resilience to that has helped minimize economic downturn in 2009. Other indicators to the Australian economy are similar to depressed western markets. Government borrowing has virtually doubled in the past 12 months. Unemployment may have declined gradually over the past few months but is still substantially above pre-crisis levels. Consumer spending is contracting and private sector credit is contracting. Even with this the Australian household has the greatest average debt worldwide and substantially above the US consumer, which suggests that further deleveraging may need to occur.

Other than the export order book Australian indicators follow the western pattern

Australia was the first jurisdiction in the world to take its foot off the monetary stimulus accelerator and increase interest rates in 2009, which suggests that the Government feels confident that the risk of further growth contraction has passed. Clearly the capital markets are nervous of this policy given the abrupt correction that occurred in early 2010 when the Reserve Bank passed on the opportunity to further hike rates upwards. Government response to this correction was unsatisfactory. Whilst the Australian order book is strong it is largely dependent upon China where there must be significant doubt about its ability to sustain past growth levels.

GMA Insight Australia 2010: This is an election year in Australia and clearly the incumbent government is vested in avoiding bad news prior to the polls. There is a real risk that shortly after the elections the markets lose confidence and fall in line with major western economies.

Asia- risk of inflation?

The strongest recovery has been felt by advanced economies in Asia. For a number of emerging economies inflation risks already are becoming more pressing. Inflation pressures have not eased as much as in the advanced economies, except in some emerging Asian and European economies. At the same time, output gaps are smaller and rebounds have been stronger in a number of these economies. Also, higher commodity prices tend to spill over faster into generalized wage pressures. Adding to these concerns, some economies are already seeing large asset price increases in response to low interest rates and easy credit, and such pressures could be exacerbated by strong capital inflows attracted by their dynamic performance. China is already addressing this with policy measures designed to reign in such pressures. Here in Thailand Dr. Kobsak Pootrakool of the Bank of Thailand's monetary policy unit recently told an audience at the FCCT that the bank's primary pre-occupation is now focused on preventing inflation and hot money flows.

GMA Insight Asia 2010: Another muted year with mounting pressure to find alternatives to western export dependency. Overall it is still in much better condition than western markets. It may likely present a potential currency safe haven within an extremely volatile global foreign exchange market.

China- reversing the global market?

A number of commentators in 2009 stated that the greatest risk facing the global economy was China having decoupled from the USA in terms of trade but not its currency. In 2010 the critically needed revaluation or floating of the Yuan looks increasingly unlikely to occur. This has benefits both for China and the world at large. However, not only would China lose huge sums of money through its huge US dollar holdings but more importantly would be seen to lose face by pandering to American calls for revaluation. China is focused exclusively upon itself in the long term and has little or no regard for any other nation. It is already reducing its holdings of US dollars in anticipation of a future move away from the greenback, and has been building up stocks of commodities and raw materials as a better reserve option. In 2010 it appears to becoming more risk averse to western assets and is restricting US investments to sovereigns or sovereign backed investments. China has already broken all the world records for sustained positive growth. This cannot continue indefinitely, and the foremost question is for how long can this be maintained until a correction occurs? On the positive side, given it is not a capital democracy any downturn in China should be a managed one, which should mitigate any major shocks to the system.

China now appears to be escalating protectionism by further increasing restrictions and further limiting capital flows for foreign entities and investors, a process that looks likely to spiral in the future. Financial pragmatism will overrule political sensitivity and successful foreign businesses in China should brace themselves.

GMA Insight China 2010: The global market has been built on the idea of open multilateral trade and the free flow of the US dollar. China has now exposed its alternative battle strategy focusing on bilateral trade exclusive of the US dollar where possible. This will push globalization into reverse, but will speed up the pace of China's increasing influence upon world trade and capital flows. China's motivation is based on political ambition, not profits which is not good for capitalism. This is a long-term play that will stretch far beyond the current year. For 2010, note that China has been taken lessons from the US spin machine, so take everything they say this year with a pinch of salt!

Beyond 2010: How Will the Global Economy Rebalance?

The major challenge facing the global market is the need for larger economies to deleverage by boosting net exports as many countries have done successfully in the past. The problem now is that it is not feasible to undertake this when a major part of the world economy all needs to do the same thing at the same time. The only alternative is to rebalance trade and consumer flows and the global pattern of demand. On the supply side, financial firms will need to be restructured and markets repaired to deliver adequate credit for sustainable increases in investment and productivity, and labor will need to be redeployed across sectors.

There MUST be adjustment in the pattern of global demand in order to sustain a strong recovery

On the demand side, rebalancing hinges on switching from public to private demand and from domestically to externally driven growth in the many economies that experienced asset price busts. By implication, economies that previously relied on export led growth will need to switch from externally to domestically driven growth. To complement efforts to repair the supply side of economies, there must also be adjustments in the pattern of global demand in order to sustain a strong recovery. Specifically, many economies that have followed export-led growth strategies and have run current account surpluses will need to rely more on domestic demand-notably emerging economies in Asia and elsewhere and Germany and Japan. This will help offset subdued domestic demand in economies that have typically run current account deficits and have experienced asset price (stock or housing) busts, including the United States, the United Kingdom, parts of the Euro area, and many emerging European economies. In these jurisdictions, private consumption and investment are unlikely to pick up the slack that will be left by diminishing fiscal stimulus, given that household incomes and corporate profits will be subdued and balance sheet repair will be under way for some time, implying higher saving rates. Hence, these economies' imports will be sluggish.

Risks to Sustainable Asian Growth

The risks to the Asian growth outlook are gradually becoming more balanced. The pickup in activity is so far being supported by many factors that could turn out to be temporary:

- Rebounding capital markets,
- Inventory adjustment, and
- Expansionary fiscal/monetary policy.

These forces may not be able to bring about a self-sustaining recovery if activity does not strengthen in other regions although Chinese policy stimulus could support recoveries in other parts of Asia.

Risks to a Sustainable Western Recovery

Downside risks to growth remain a concern. The main short-term risk is that the recovery stalls and deflationary forces become entrenched. This could be triggered by a number of adverse developments. Premature exit from accommodative monetary and fiscal policies, possibly driven by rising concerns about government intervention and unconventional action by central banks, seems to be a significant risk because the policy-induced rebound could be mistaken for the beginning of strong recovery. Also, there could be resistance to extending policy support long enough to allow private demand to make a sustained recovery. Progress in repairing financial balance sheets could be undercut by rising unemployment, greater-than-expected increases in delinquencies on residential mortgages and commercial real estate, and

The main risk is recovery stalling and deflation becomes entrenched

more corporate bankruptcies. With banks only weakly capitalized, this could lead to even tighter financial condition.

More generally, many shocks that otherwise could be absorbed - for example, a virulent epidemic or geopolitical tensions that remove excess capacity in the oil sector-may have a significant destabilizing impact, with the global economy and financial system in such a vulnerable state.

Ironically, bubble burst risk also remain - the rally in stock markets in 2009 could even be seen in the context of a bear market bubble and just as the crisis in confidence was underestimated during the downward spiral, the overconfidence of the markets in 2009 may have

**Bubble burst risk
still remains!**

also been underestimated and any need to sell falling stocks into thinly-traded markets during the rebound may precipitate disastrous weakness in equity markets and knock-on effects in the real economy.

There are also other specific short-term risks to the recovery. Much of the recent rebound in oil prices was related to cutbacks in production by the members of the Organization of Petroleum Exporting Countries, which were designed to stabilize prices in response to slumping demand. One key concern in the market is that higher oil prices could hinder economic recovery. In fact, oil prices have more than doubled from their trough last year, and further upside risks remain.

Extending the horizon to the medium term, there are two important risks to sustained recovery, which mainly affect the advanced economies. On the financial front, continued public skepticism toward what is perceived as bailouts for those responsible for the crisis could undercut public support for financial restructuring, thereby prolonging the crisis. The result would be an even more sluggish recovery or, possibly, a long-lasting credit crunch and the equivalent of a "lost decade" for growth.

On the macroeconomic policy front, the greatest risk revolves around deteriorating fiscal positions. The large increase in public debt and contingent liabilities incurred to provide stimulus to the economy and stabilize financial systems has already raised concerns in financial markets, as suggested by higher credit default swap (CDS) spreads on sovereign debt (although these are of limited reliability as an indicator), larger sovereign spreads for some advanced economies and talk of ratings downgrades. If the recovery were to stall and be followed by a prolonged period of stagnation or very low growth, deficits and debt could balloon to difficult-to-sustain levels. Such a development could seriously unsettle global bond markets. Presumably, concerns would surface first in vulnerable advanced and emerging economies, notably those with large financial sectors relative to the size of their economies or with low revenue bases and high public debt. This could then trigger another retrenchment in capital flows, which could drag down a number of other advanced and emerging economies. There could then be another crisis of confidence, currencies could adjust abruptly, and demand could slump, possibly raising fears about fiscal sustainability in even the larger advanced economies. Investors could react to these fears by taking flight into government or corporate bonds issued in economies with low public debt, including potentially some emerging economies, or by purchasing large amounts of precious metals. In either case, the world economy would go through profound turmoil and a long period of low activity.

**Government debt
could balloon to
difficult to sustain
levels**

Two further risks bear watching. First, whereas oil prices present some short-term risks, they present greater medium- to long-term risks to global growth. In particular, as current excess capacity is absorbed, prices could rise abruptly to very high levels just as they did during the previous upswing. This risk is amplified by cutbacks in investment in new capacity during the present downturn and continued uncertainties about oil investment regimes in some countries that have deferred investment in new fields. Second, although generally solid international collaboration for the most part initially contained pressure for trade and financial protectionism, this pressure seems to be strengthening as unemployment and social problems

Protectionism & barriers to trade may be erected in some economies

mount. Barriers to trade and financial flows might then be erected in some economies, triggering retaliatory moves by others. Financial markets could react quickly and vigorously, anticipating future losses in profits and productivity, leading to another downward spiral in activity.

Can Governments Maintain Confidence?

We are also concerned that should deficits increase and the process of restoring the health of the financial systems in the major advanced economies is even slower than in current baseline forecasts, a loss of productivity and confidence will result. Economic policy missteps could exacerbate this deterioration, including protectionist measures that distort incentives and reduce output. In such a scenario, emerging Asia would make very limited progress in rebalancing demand toward domestic sources, with private consumption failing to increase by as much as projected. In regions such as Japan and the United States, sluggish growth would be exacerbated *by* the fact that monetary policy remains constrained *by* the zero bound on nominal interest rates (you can't really cut nominal rates below zero!), implying rising pressure on real interest rates due to price disinflation. Under this scenario, world GDP growth would be lower from 2010, global current account rebalancing would become more elusive (current accounts would move toward larger surpluses in emerging Asia while deteriorating further in the United States, the UK and Europe).

Monetary policy may be constrained by zero % interest rates

Another policy danger is that of leaving stimulus measures in place too long, which carries the risk of distorting incentives and damaging public balance sheets. The timing and sequence of action will vary across countries, depending on the momentum of their recoveries, policy room, and progress toward financial sector repair, but coordination will be necessary to avoid adverse cross-border spillovers.

History suggests that both premature and/or delayed exits can be costly

History suggests that both premature and/or delayed exits can be costly (and that timing is generally beyond what can be expected from politicians (fiscal retrenchment and the Federal Reserve's doubling of reserve requirements during 1936-37 have been blamed for helping to undercut a nascent recovery; premature tax hikes in 1997 probably contributed to pushing Japan into recession; after the bursting of the dot-com bubble the slow withdrawal of monetary accommodation may have fostered the subsequent house price bubble).

Coordination within and across countries is important, because for example, the premature withdrawal of liquidity support measures or retail deposit guarantees could delay the unwinding of government guarantees for bank bond issues, which rank among the most distorted types of public intervention.

Timing of Monetary Tightening

The key issues facing monetary policymakers are when to tighten and how to unwind large balance sheets. The pace at which the buildup in central bank balance sheets should be unwound depends on progress in normalizing market conditions and the types of interventions in place. Continued central bank support will likely be needed through at least 2010 in many economies, and it could take much longer to unwind the buildup in illiquid assets on some central bank balance sheets, in fact the Fed has stated its aim to hold certain assets to maturity in the 2030s! This is a major obstacle (as will the need to continue supporting vulnerable housing markets) in the return of whatever might be regarded as normalization in Residential Mortgaged Backed Securities (RMBS) markets.

The key issue facing monetary policymakers is WHEN to tighten!

Supported by appropriate pricing, short-term liquidity operations will unwind naturally as market conditions improve while assets purchased outright can be resold into markets, starting with government securities and moving toward other securities should their markets normalize. However, getting the timing right is important, because resale of non-government securities too soon could undermine the gradual process of stabilizing distressed markets. In the meantime, central banks can absorb reserves as needed to tighten monetary conditions by engaging in reverse repurchase operations, offering interest-bearing term deposits to banks, or issuing their own paper. Less attractive options include raising reserve requirement or having treasuries sell government paper and deposit the proceeds in central banks. In any case, it would be useful for national treasuries and central banks to develop arrangements to

Can Central Banks function skillfully enough within competitive commercial markets?

protect central bank balance sheets from the risks associated with holding securities for extended periods, as has been done in some countries, such as the United Kingdom. Such arrangements help mitigate concerns that central banks might delay tightening out of concern for the impact of higher interest rates on the value of the assets on their balance sheets.

Regarding the timing of monetary policy tightening, the large increase in government debt is likely to put upward pressure on long-term interest rates as the recovery is sustained, crowding out private investment and some emerging economy sovereign issues. This will have dampening effects on growth, but there may also be other potentially negative effects if debt levels rise so high as to cause flight from traditional safe assets such as U.S. government debt. This will depend on growth prospects, investor preferences, interest rates, and the room available to cut spending or raise taxes to repay future debt. Once again this raises the spectre of political considerations and interference. Some countries, such as Italy and Japan, have sustained very high debt levels for a while already. Fortunately, neither of them featured among the advanced economies whose financial systems were badly hit by the crisis, thus they have avoided additional major contingent liabilities. Nonetheless, Italy suffered a major increase in risk premiums on its debt for a period during this crisis whereas Japan has been protected by its unique circumstances. Looking forward, pressures on spending and debt in advanced economies will mount. Western governments demonstrated a clear myopia in spotting adverse market events in the build up to the 2008 crisis and need to remember that markets always have a tendency to suddenly and dramatically catch up with slowly increasing vulnerabilities.

Markets have a tendency to suddenly and dramatically catch up with slowly increasing vulnerabilities

Financial Sector Recovery

Completing financial sector repair and reforming prudential frameworks are indispensable for a return to sustained growth over the medium term. In many countries, policy actions have been insufficient to return banking systems to a position from which they can sustain the recovery with solid credit growth, and remedying this shortfall must be given priority. In addition, attention must be paid to managing the exit from public support for financial operations and to reforming prudential frameworks to ensure stronger risk management.

Completing financial sector repair is indispensable for a return to growth

Restructuring financial firms' activities is the key for normal lending to resume. This will require balance sheet cleansing, recapitalization, and new business plans that are consistent with new funding models and new prudential frameworks. So far, there has been hardly any progress in removing impaired assets from bank balance sheets. The main challenge now is ongoing deterioration of asset quality, and so public policies and financial institutions have to become more forward looking and preemptive. Official stress tests, provided they are really objective, can be important instruments through which the condition of banks can be diagnosed and comprehensive recapitalization programs put in place. On this front, progress across countries has been uneven.

Restructuring financial firms' activities is the key for normal lending to resume

Western governments have shown a clear misunderstanding of how financial institutions and the credit markets function demonstrated by the failure of bank bail-outs to increase lending. In 2010 western governments are proposing the introduction of levies on financial institutions such as Tobin taxes, or in the US either a global transaction tax or a tax on bank liabilities. Political will for such an initiative has increased to a stage where allowances for such tax revenues have been incorporated within the 2011 US budget. Outside government there is no support for these measures, and the general view amongst financial analysts and commentators is that such a move will further damage an already weakened banking sector and will hamper and delay a return to growth in western markets.

GMA Insight Banking Sector 2010: GMA has been extremely critical of western governments approach to cleaning up the banking sector since the 2008 crisis. After the last major crash during the late 1980s western jurisdictions chose to auction off bad loans to third parties as soon as possible. As an example the USA sold USD 194 billion of distressed debt in order to kick-start a new market cycle. This was the template used in Asia after 1997 that helped enable the markets return to growth quickly. History has proven that until distressed debt is liquidated and recycled not only will banks be discouraged from lending again, but uncertainty and fear of further price erosion holds the entire market back.

This time western governments have chosen to hold and managed distressed debt rather than pursue the proven recycling solution. This is likely to be a drag on market recovery and the financial sector for a number of years to come and will likely prove to be a more costly option. This approach is similar to that adopted by Japan in the 1990s which was a direct contributor to its lost decade of creeping recession.

Government's current ill-considered approach to new additional regulations such as Basel 3, executive compensation and additional taxation for the banking sector, together create a depressing future outlook for the western banking sector as a whole.

Future Growth Rates

Turning to growth rates, these are likely to remain low, <2%, for a considerable time. Analysis of previous financial crises suggests that many are followed by large, permanent output losses relative to pre-crisis trends, because impaired financial systems take time to heal, slowing investment and innovation (Japan being the classic case in point). High cyclical unemployment may raise structural unemployment especially in regions with greater rigidity.

The IMF admits that “growth assumptions seem optimistic”. More adjustment will likely be needed to ensure long-term fiscal sustainability, particularly on the revenue side. One critical example is healthcare reform. Richer nations such as the United States will spend relatively more on health care, but the significant inefficiencies in the U.S. health care system, as evidenced by the fact that similar healthcare is achieved at different costs across different states, may lead to expansion beyond available budgets, especially under the additional burden of new legislation.

Even without such additional burdens, caution is warranted about the continuing influence of rapid credit growth in many countries. Credit pricing and overleveraging is still the core malignant problem and this situation is likely to prevail as long as interest rates remain close to zero. In the mature markets critical deleveraging still has a long way to go, whilst in the emerging markets maintaining high credit growth runs the risk of creating incentives for over investment, unsustainable asset price inflation, and a worsening of credit quality in the banking system similar to that experienced in 2008 in the west.

Since the new Millennium there has been a huge increase in the number of western government employees and contractors. Unlike the private sector, where there has been substantial retrenchment since the 2008 crisis, government numbers have actually gone the other way and continue to swell. The democratic capitalist model works best with strong regulations and small government, but the current recession has exposed the fundamental structural administrative weakness facing the west. That is big government that has been shown up by its creation of ineffective regulations and an inability to manage its own economy.

Western governments, politicians and central bankers have demonstrated a particular talent for mismanaging monetary policy and nothing in their present actions suggests that they have or will learn anything from past mistakes. Their core strategy remains to cloud the real issues with extensive lashings of confidence building media hype and spin that they hope the markets will swallow and boost their own ratings. For the sake of everyone let's hope they can pull off another confidence trick of this type when their economies are directly exposed to reality again as the effects of stimulus fade in mid 2010.

(The substance of this report was based on research from a number of sources primarily the IMF's **World Economic Outlook October 2009.**)

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John Sheehan followed financial crisis around the world for a decade with former US investment bank Lehman Brothers, specializing in distressed debt acquisition & loan servicing, corporate restructuring, real estate investment & lending and structured finance.

He worked in Asia Pacific after the 1997 crisis until 2005 and thereafter in Europe and Latin America gaining global experience through transactions in Thailand, Malaysia, Singapore, Indonesia, the Philippines, Hong Kong, Taiwan, Korea, India, Australia, Brazil, Columbia, Portugal, Spain, Germany, Poland, the Czech Republic, Greece, Turkey and Israel.

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

A wide range of presentations have been made to both government and private sectors throughout the region. These draw upon John's global experience and provide an insider's view of the demise of Lehman, the resultant credit meltdown and subsequent global economic downturn. John's objective is to isolate the most relevant core issues and help the audience appreciate what is really going on behind a wall of media hype and political spin.

John's articles have been extensively published throughout the Asian press in 2009. His views on the underlying trends in the global economy in 2010 have recently drawn widespread attention from international media and television.

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