

Thursday, February 25, 2010

## INDEX

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## SUMMARY

### **The end of an untenable growth model?**

A considerable proportion of growth over the past 25 years is due to a spiral of rising asset prices, more borrowing and more consuming. This has now come to an end, but it seems as if the authorities are not accepting it yet and want to breathe new life into the old growth model through artificial interventions.

The bounds of possibility are fast approaching, however. Public finances are rapidly deteriorating, China is about to tighten monetary policy to prevent overheating and, despite all the stimulation, there has been little or no recovery of the underlying economy.

Evidently, it is high time that a large proportion of old (consumptive) debts were repaid. This will mean extremely low growth for the coming years. The government will then have to keep a check on public finances; otherwise there is a risk of a new crisis.

### **Implications for the financial markets**

In our view, the financial markets are still discounting too rosy a picture for the future. We therefore expect asset prices (stock prices, company bonds and property) to remain under pressure for the coming quarters to years. We foresee EUR/USD weakening further in the coming quarters towards 1.20. A further fall towards parity would then not surprise us.

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## THE END OF AN UNTENABLE GROWTH MODEL?

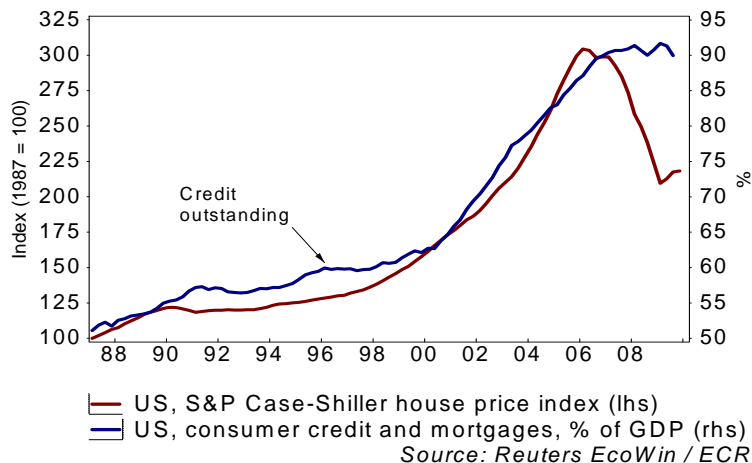
*The strong growth of the past 25 years was extraordinary in comparison with the previous century.*

“A rising tide lifts all boats” is a well-known saying, which implies that a growing economy benefits virtually everyone. After the recession in the early 1980s, the tide – the world economy – actually only rose, with just the odd sudden, but brief, fall (Asian Crisis in 1997, ICT crash in 2001). On balance, the world economy experienced historically high growth in that period of an average of 3.2%. Almost one and a half times as much as the average a hundred years before. Average growth between 2003 and 2009 was even 4.25%. This generated a psychology that assumed that the tide can only rise.

*It was supported by low inflation and credit-driven consumption growth.*

The question is how this can be possible, as a virtually uninterrupted growth period of 25 years goes against the economic theory books. Normally, there is a cycle where an economic decline filters all kinds of inefficiencies out of the system, creating a healthy foundation for a subsequent period of expansion. In earlier reports we already explained in detail what caused this exceptional situation. Due to a coincidence of a number of structural changes in the economy, inflation was constantly under downward pressure. This gave the central banks the opportunity to implement an easy monetary policy. This increasingly pushed up asset prices, against which consumers and companies started borrowing more and banks lending more to invest more but, primarily, to consume more. This created an economy in Europe and the US, in particular, which was driven by rising asset prices and more debts.

**Borrowing money to ride the tide of increasing house prices eventually proved unsustainable**

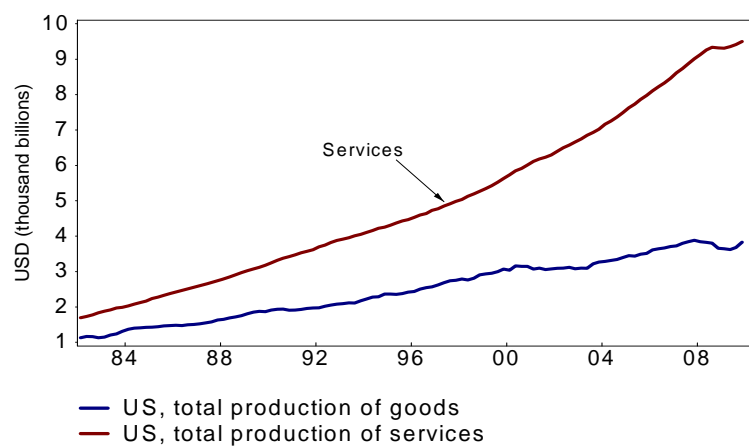


*This growth model has proved untenable, but the minority who warned of this were overwhelmed by the optimists.*

This is where the snag is, however. An economy driven on the basis of credit-driven consumption growth gives a false impression of easy wealth creation. Easy, because an economy focused continually on facilitating the domestic asset price and credit boom has no foreign competition (and actually benefits from cheap imports – especially as employees can participate in the rapidly-growing industries related to the credit and asset markets and this keeps inflation and interest rates low). It gives a false sense of security, however, as consumption growth based on more credit is nothing other than bringing forward future growth. In other words, the tide may be rising rapidly, but you can be sure that it will fall just as rapidly in the future. Things would, naturally, be different if the borrowed money was used for investment with which (more) money can be earned in the future for fulfilling interest and repayment obligations. This has not been the case, however.

This growth system automatically grinds to a halt at some point. Back in 1979, the economist Kindleberger wrote a book describing 'the way to a financial crisis' based on a number of historical bubbles. The similarities between the bubbles described and the property and credit bubbles of this century are striking. In every case, more and more borrowed money was speculated on further price rises (in the last case on rising housing prices) without paying much attention to the underlying economic reality. This process stops as soon as insiders start selling and a bank or financial institution gets into difficulties.

**Asset and credit boom led to expansion of service sector**



Source: Reuters EcoWin / ECR

Perceptive economists and analysts could therefore have seen this crisis coming. Nevertheless, a lot of people complain that the crisis was so unexpected. This is equally easy to explain:

- There were, indeed, economists who warned at an early stage that the pace of borrowing and the rise in housing prices could not be maintained indefinitely, that the deficits on the US current account were causing dangerous imbalances and that credit spreads had shrunk substantially. But they were not taken very seriously. First of all, it was proved time after time that the situation could be maintained longer than these economists claimed. Secondly, doing anything about it would mean having to change a successful growth model. That was difficult to sell and will continue to be so in the future. It therefore seemed best to ignore it.
- Economists who warned of the dangers at an early state (in 1990, for example) were proved wrong year after year. There is then a great tendency to admit you were wrong and go along with the theories that give a positive twist to the imbalances that have been created.

*How the causes of the credit crisis are viewed and the sentiment of the markets will be essential in the coming years.*

In the coming quarters to years, how the authorities and financial markets view the more deeply underlying causes of this crisis is important. Governments and central bankers acting on the premise that the core of the crisis is too many consumptive debts will probably think of different solutions from those who feel that this crisis may be extraordinarily deep and long-lasting, but that the underlying growth model has not changed at all. The question is to what extent the financial markets will support the

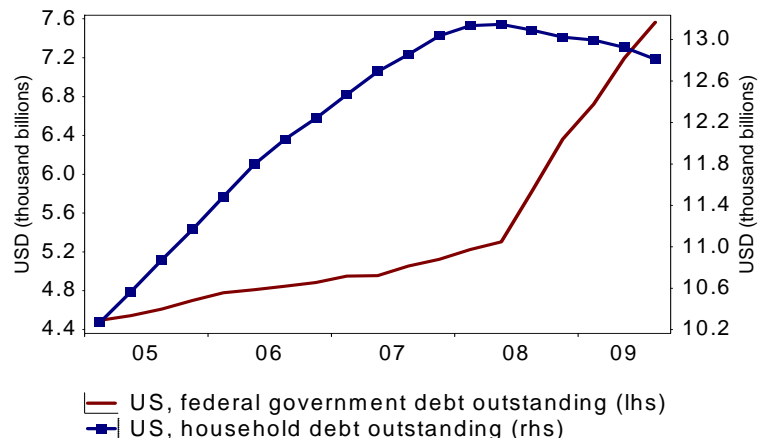
authorities. After all, as soon as the markets start protesting it will be far more difficult – and impossible in the long run - for governments to maintain their policy. More about this in the following chapters.

## **AUTHORITIES' OSTRICH POLICY**

*Since the bubbles have burst, the debt mountain should now be reduced, but the authorities still seem to believe in the growth model.*

In our view, the bursting of the property and credit bubbles rang the death knell for the old growth model. After all, it means that over the coming years the tide will tend to fall, as old consumptive debts have to be repaid. In other words, the economy now has the tendency to reduce the debt mountain, with asset prices remaining under downward pressure for the time being. Moreover, after roughly 25 years of uninterrupted growth, it was high time all the excesses and inefficiencies were filtered out of the system. More important, however, is how the authorities view this. At the moment, the authorities are acting as if this crisis has done nothing to change the growth model. They are attempting to prevent the total debt mountain from shrinking and support the financial markets as far as possible, by means of monetary easing and inflating public debt.

**Deleveraging has started in the private sector, but is compensated for by the public sector**



Source: Reuters Ecowin / ECR

A logical reaction, in principle; over the past few decades it was continually proven that monetary and/or fiscal easing could stimulate the economy and asset prices to such an extent that a self-perpetuating spiral is created. The economy therefore seemed 'controllable', with central banks holding a tight rein.

*The massive fiscal and monetary stimulation appear to be reaching their limits, though.*

Despite the historically unprecedented fiscal and monetary stimulation, the success of this policy has been limited so far, however.

- In Europe, fears are growing that as soon as measures for stimulating car sales and keeping superfluous employees in their jobs come to an end, car sales will plunge and unemployment will rapidly rise.
- Economists are concerned for the British economy as soon as cuts have to be introduced after the elections in the middle of the year.

- In the US, there are increasing calls for implementing a following round of fiscal stimulation, as employment and lending are not increasing, despite large-scale stimulation. Moreover, concerns are growing as to how far the Fed will tighten monetary policy. Raising the discount rate last week prompted increasing fears of possible further tightening of policy.
- In Japan, finally, the Bank of Japan is under increasing pressure to implement further quantitative easing to fight deflation.

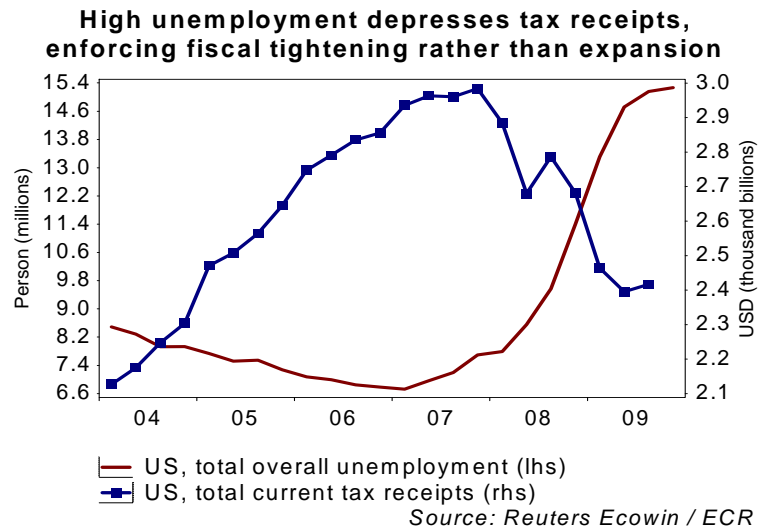
Nevertheless, most governments are assuming in their growth estimations that growth will pick up in the coming years. That expectation must be based on the hope that a self-perpetuating spiral will be created of rising employment, lending and consumption. According to the economists, the factors currently boosting growth, stock increase (or less stock reduction) and fiscal stimulation will all come to an end either this year or early next year. What's more, new, large-scale fiscal stimulation aimed at breathing new life into the economy is becoming increasingly difficult now that the financial markets are starting to protest against the serious deterioration of public finances and premiums on credit default swaps and long-term interest rates have risen on balance.

Signs of the old growth model of rising asset prices and consumptive debts recovering are also unfortunately, on closer consideration, looking less hopeful. Stock prices may have risen considerably, due to an easy monetary policy and better profits than expected, but a large proportion of the extra profit is due to drastic cost-cutting, while turnovers have remained constant due to fiscal stimulation. This situation is finite. Furthermore, the US housing market – the source of the crisis in the view of many analysts – also appears to be picking up. There is nothing strange about that; after all housing prices have fallen by an average of 30% from their top and a correction is therefore to be expected. More and more analysts are warning of a further fall, though. Due to the drop in housing prices, an estimated quarter of homeowners have a mortgage debt that is higher than the value of their home, so the temptation to hand the house and the mortgage back to the bank is great. More and more households with sufficient financial resources to comply with their mortgage obligations are also doing the same. Furthermore, there are signs that banks are keeping repossessed homes off the market, waiting for better prices. This means a greater supply in the future, especially as the interest rate percentage for many adjustable rate mortgages will be adjusted upwards over the coming 18 months, putting more households into financial difficulties.

*Growth expectations are positive. Public debt, company profit development, unemployment and the property markets are concerning, though.*

Falling property prices – commercial property is also under pressure in the US and Europe – and high and/or mounting unemployment mean lower tax revenue. Existing social security and healthcare systems that, in recent decades, had increasingly been based on high growth expectations and rising tax revenue are putting public finances further and further into the red. This increases the need for cuts, while the economy actually needs new fiscal stimulation to breath new life into the old growth model.

In our opinion, this makes it increasingly clear that the old growth model no longer works and the tide now has the strong tendency to fall. OECD estimations confirm this. The private sector is saving a lot. In Japan, more than 10% of income. In the US that figure is 7.3% and in the EMU 6.7%. Without the authorities countering this, it could lead to a deflationary spiral, with falling asset prices, less lending, falling consumption, mounting unemployment, etc. The authorities have been attempting to reverse this process, so far without much success, and turn it into a self-perpetuating inflationary spiral. All they have managed to achieve so far is to push the deflationary spiral into the background, but at what cost?



## NEW CRISIS THREATENS

A new crisis would stem from the sector where there is the greatest increase in debts. At least, this is the lesson we can learn from this crisis. The rapid rise in mortgage and consumptive debts, combined with the high leverage in the banking sector heralded this crisis. The search for places where debts are now mounting the most rapidly leads to:

- the governments, particularly in Europe, Japan and the US
- the Chinese banks

**Public finances have deteriorated rapidly everywhere.**

Preventing a deflationary spiral has cost an awful lot of money. Public finances that were still reasonably healthy before the crisis (those of Great Britain and Spain, for example) have swiftly deteriorated. Public finances that were already in a poor state before the crisis are now in an even worse state (Greece and Japan, for example). As a result, almost every Western country has a public debt of between 70% and 120% of the economy and has large deficits, which will only cause debts to mount even higher for the time being. The risk is that bond markets could aggravate the situation at any time by demanding higher interest rates on Treasuries. The interest payable item then soars, so debts mount even higher and an uncontrollable spiral is quickly generated. Many economists are therefore setting the 'risk limit' at a debt of 90% of the economy. As long as a country is below that limit it is relatively safe.

**The ageing population makes these developments even more worrying.**

Without measures, it is only a question of years before the US and most countries in Europe have an excess debt of more than 90% of the economy. Certainly if you add the future obligations that are currently being excluded from the equation. There are therefore calculations that the total value of future expenditure on pensions and healthcare will amount to many hundreds of percent of the current size of the economy (in the US, for example, an estimated more than 400%). These obligations could, of course, be spread out over many years, but on the other hand Europe's working population will shrink, due of the ageing of the population in general. This is already happening in Japan, but will happen in the US much later or not at all. The burden of the ageing population and higher debts will therefore have to be borne by

an ever-smaller group. The need to economise is therefore increasing. Most countries have, incidentally, already indicated that they will start doing so at the end of this year or in 2011.

**Fiscal tightening probably offers insufficient solutions.**

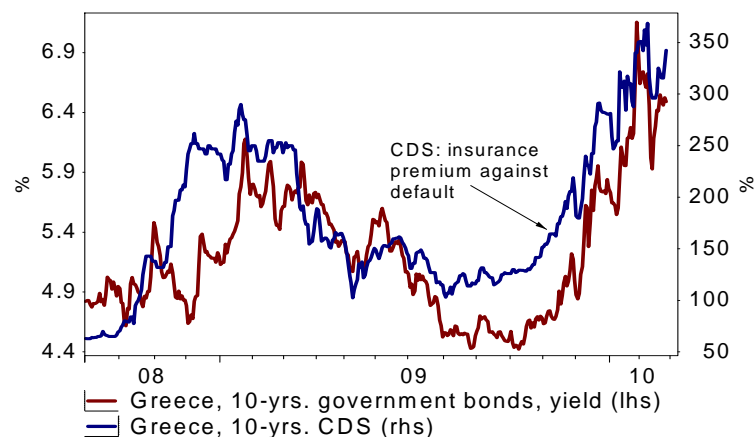
The question is whether fiscal tightening will improve the situation. First of all, a large proportion of tax revenue is linked to asset prices. There is a strong chance that fiscal tightening will force the deflationary spiral to the fore again, making asset prices fall and unemployment mount once more. Government revenue therefore falls and expenditure on social security rises further. Secondly, governments have issued a lot of guarantees to financial institutions to get the credit markets going again. With falling asset prices, bank losses will also mount and guarantees will be increasingly invoked.

Freddie Mac and Fannie Mae form a clear example in this respect. Both organisations have been taken over by the US government. The government has already announced that it will not set further limits on money flows to the two organisations. In the meantime, however, 80% of all American mortgages are in the hands of or guaranteed by these or similar government organisations. Falling housing prices and an increasing number of foreclosures will therefore lead directly to higher budget deficits.

**Many economists therefore fear that exploding budget deficits will form the foundation of a new crisis.**

Many economists are therefore warning of a crisis due to public finances getting out of hand. The question is when. Many investors and analysts have already burned their fingers in recent decades when speculating on sharply rising Japanese interest rates due to major budget deficits and public debt. This could give the impression that at first sight public finances that have got out of hand can be maintained without the bond markets protesting. This is starting to look dangerously like the dominant view in the years preceding the bursting of the asset price and credit bubbles. From that point of view, the problems in Greece are a wake-up call for us and a sign that the bond markets will protest earlier than many economists now believe.

**Markets reacted swiftly to Greek problems, enforcing an end to ever worsening public finances**

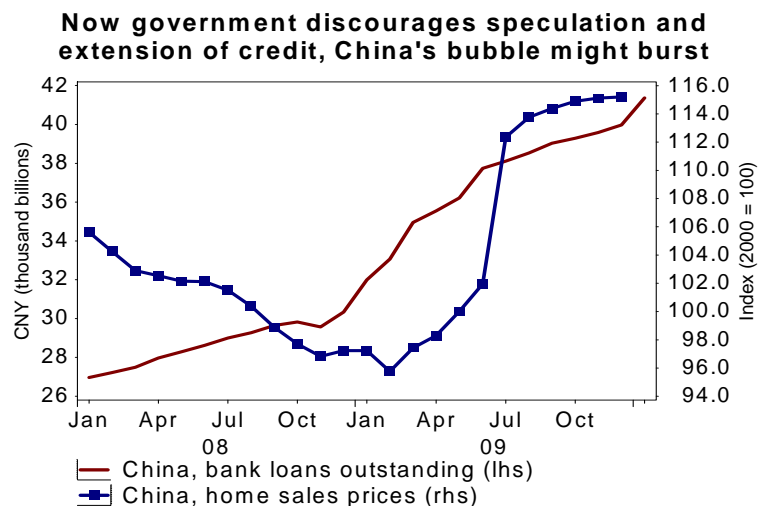


Source: Reuters Ecwin / ECR

## IS CHINA'S GROWTH SUCCESS A BUBBLE?

*The Chinese economy is showing many signs of bubble-forming*

Economists and analysts cannot agree as to whether the Chinese economy is a bubble. It does show the characteristics of bubble-forming. One-year interest rates in China have been at 5.31% since December 2008. With growth over the past year at 8.7%, this is a tremendous incentive to borrow and invest. Which is what has been happening on a large scale. Banks have extended roughly USD 1,400 billion in new loans – some 30% of the economy. The yuan is also pegged to the dollar, to stimulate export. A large proportion of these loans has been used for infrastructure and, in particular, property investment and speculation. Consequentially, the vacancy rate for commercial property in cities such as Beijing is mounting swiftly and land prices in cities have risen by tens and often hundreds of percent. Now that the government wants to limit credit growth and property speculation and the number of transactions in the property market is falling, it seems only a question of time before the bubble bursts and Chinese banks find themselves in grave difficulties due to an explosion of bad debts. Intuitively, bubble-forming in China would be logical. It stands to reason that, in a country that has managed to grow by around 10% annually in recent years, imbalances will be created that (can) lead to bubble-forming.



*Others see less risk in the rapid rise in productivity, incomes and consumption.*

On the other hand, high growth, rapidly increasing investments and a strong development of credit growth are natural when a country is developing. China has a population of 1.3 billion, of which by no means all are sharing in the economic growth. The provinces of West China, in particular, are still behind the East Coast. Moreover, labour productivity, incomes and consumption are rising rapidly. From that point of view, investment has to increase quickly to facilitate fast growth.

*We feel there is a strong chance of a considerable correction this year.*

The truth probably lies somewhere in the middle. China is therefore not experiencing the kind of bubble-forming that took place in the US and Europe in recent years and in the late 1980s in Japan. It is, however, becoming increasingly clear that the active government intervention and the high growth objective at all costs have led to major imbalances, which could be followed at any time by a correction. With weak growth in the West (the major customer for the Asian export industry), monetary tightening in China and increasing pressure to revalue the yuan, we feel there is a strong chance of

a considerable correction this year. Stock prices are already giving warning signals; for the past few months already the Chinese stock market has been performing less well than American stock indices.

## WHERE CAN WE EXPECT RESCUE TO COME FROM?

*Once company stocks have been built up and fiscal stimulation finishes, another economic boost is needed.*

None of the developments described above make the situation any rosier. As soon as company stocks have been built up again and governments are forced to tighten rather than ease fiscal policy, the majority of the counterforces that have been pushing the deflationary spiral into the background so far will be eliminated. Central banks can make up part of this by increasing quantitative easing. The most this will achieve is to indirectly stimulate the economy by keeping interest rates down. Direct stimulation will have to come from elsewhere to fill the gap the governments will leave.

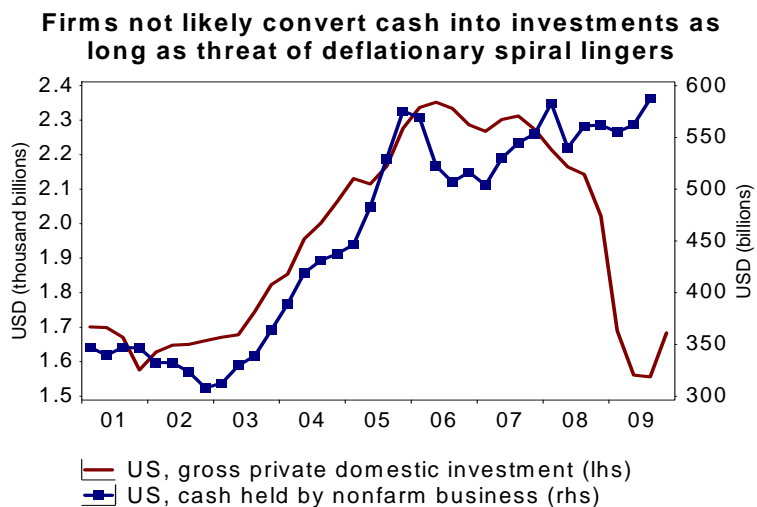
*Export appears to offer insufficient opportunities.*

More export is one way. But the next question is where to? Germany and Japan are benefiting from rising exports to China, but if the economy there does decline, as we expect, then this will cease. And the US, the biggest end user of products and services before the crisis, also wants to export more to boost its own economy. This applies equally to Great Britain, while the EMU doesn't appear to be capable of importing any more.

*The question is whether a growth spiral can be created in time, through investments.*

A second way is to hope that a self-perpetuating spiral is created before the government tightens fiscal policy. This, however, will need an improvement in employment and lending, which there is no chance of at the moment. It could still happen, though. Some economists point out that investment can act as a boost. After all, investments in the US have dropped sharply in relation to the economy since 2006. At the same time, cash positions have improved considerably, due to better profits than expected. From this point of view, therefore, there is plenty of room for investments financed with own funds in the coming quarters. Employment could then pick up, as well as consumption, profits and so forth. Banks will then automatically have more confidence in lending.

Once major obstacle, however, is that companies will not be very inclined to expand as long as it is clear that without fiscal stimulation there is a threat of a deflationary spiral, in which asset prices will fall and consumption will tend to shrink. Moreover, higher cash positions can also be used to increase dividends (which will probably be the preferred option for investors).



*Many years of low growth is the best we can hope for.*

We therefore stick to our opinion that the coming years will not be easy. Not for the economy and therefore not for asset prices, either. The best the authorities will be able to achieve, in our view, is to prevent the tide from falling too quickly. It is probably (and hopefully) possible to create a situation of many years of persistently low growth where future innovation and production power will be used to repay old debts. We feel more optimistic in this respect for the US than for Europe or Japan (also see our recent reports). In our opinion, rate and price trends in the financial markets do not yet correspond with this outlook.

*Suggestions for an inflation policy are overlooking the power of the bond markets.*

#### Finally

There have been increasing signs in recent weeks that an inflation policy is the most obvious solution, especially for countries where the mountain of debts (domestic or foreign) has risen the highest. In theory, inflation has the following advantages. Debts remain constant while wages and profits rise, so debts start weighing less heavily. This is also the reason why the authorities are desperate to prevent deflation at all costs. The central bank's monetary policy could also become more effective. With interest rates currently close to 0%, for example, there is no room to reduce interest rates further. If inflation rises while interest rates are kept constant, however, then real interest rates fall and the economy is further stimulated.

This reasoning is entirely correct, but in our view one important point is being overlooked: the reaction of the bond markets. As soon as bond markets get wind of an inflation policy, long-term interest rates will rise. This has a negative effect on asset prices and the (re)financing of investments and old debts becomes substantially more expensive. Ultimately, therefore, an inflation policy will do more harm than good. So we have serious doubts that this will be a realistic solution.

What we see as a far more feasible solution is to oblige the government, banks and, for example, major investors such as pension funds to invest part of their capital in Treasuries, to keep long-term interest rates artificially low and facilitate the repayment of old debts. This measure was regularly implemented until deregulation in the 1980s.

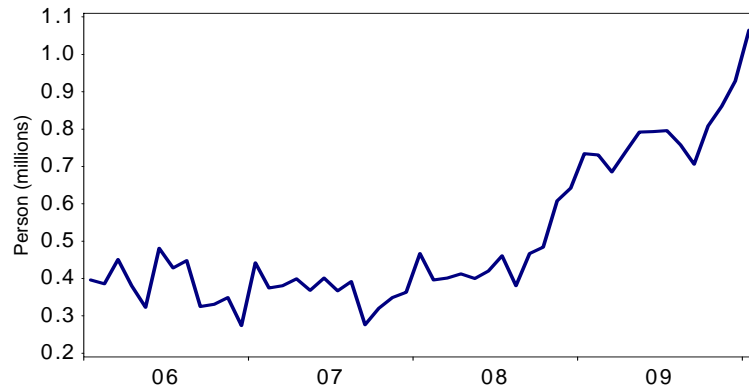
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## IMPLICATIONS FOR THE FINANCIAL MARKETS

*The chance of a self-perpetuating growth spiral is slight.*

In our view, policymakers and the financial markets are still assuming too rosy a picture for the future. There are great hopes of a self-perpetuating spiral – as was usual after monetary and fiscal stimulation in the past 25 years - being generated in time to compensate for the negative effect of fiscal tightening. We feel the chance is slight and even if a self-perpetuating spiral is generated then the question is whether rising interest rates will throw a spanner in the works; after all inflation expectations will then increase rapidly. With the fast deteriorating outlook for public finances and the lack of recovery in lending and job growth, the markets are slowly but surely beginning to doubt whether such a spiral will be generated in time. What's more, monetary tightening in China is causing increasing concerns.

**More jobs do not mean lower unemployment as discouraged workers will enter labour market**



— US, people not applying for jobs, though available

Source: Reuters Ecwin / ECR

*A deflationary spiral is a real danger, which will be accompanied by negative economic develops and a weaker euro.*

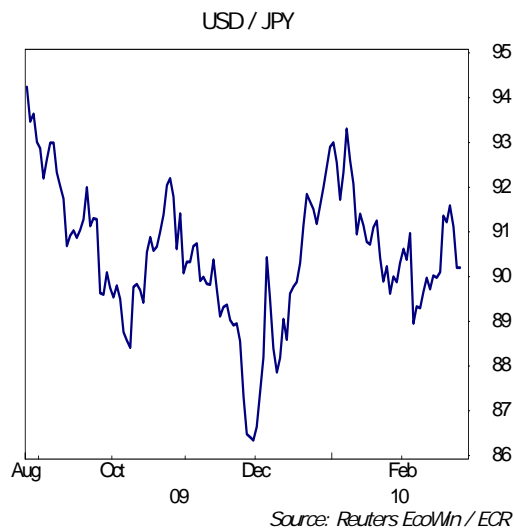
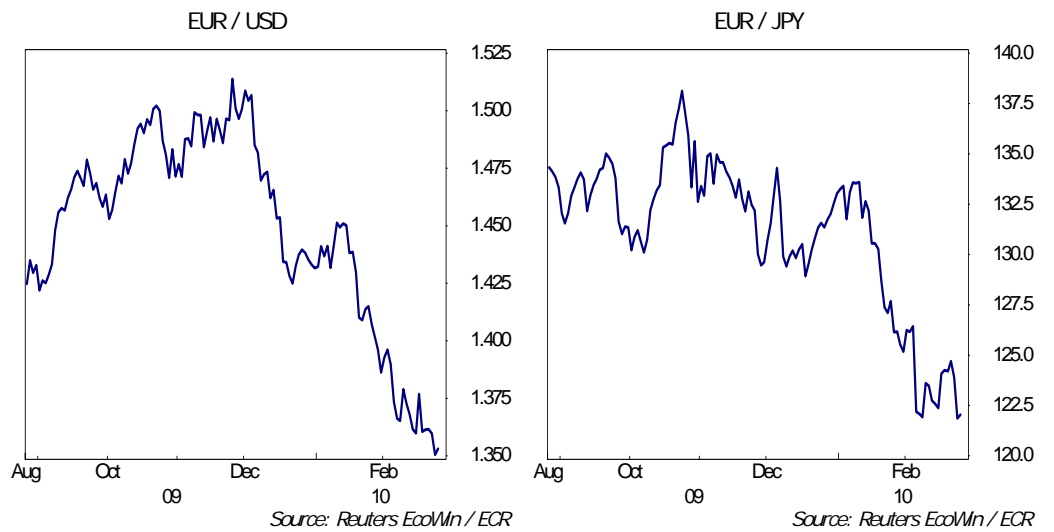
For the longer term (the coming quarters to years), we see these concerns increasing and the deflationary spiral that is now being kept in the background coming to the fore again. This is absolutely negative for stock, commodity and housing prices. We therefore envisage the bank's problems growing again. In other words, we expect investors to opt for safety rather than risk. In addition to lower stock prices and wider credit spreads, this means the reversal of carry trades and the repayment of old debts. As, relatively, most loans are in dollars, this means a higher demand for the currency. Moreover, the growth expectations for the US are better – or less negative – than those for Europe and Japan. We therefore envisage EUR/USD weakening substantially. Towards 1.20 in any event and probably lower (in time, parity would not surprise us).

*In the longer term, we expect yields on 10-year US Treasuries to rise to 4.5% - 5.0%*

The picture for long-term interest rates is less clear. On one hand, US and German Treasuries still enjoy a safe haven status, so long-term interest rates should fall in the event of growing uncertainty. On the other hand, that safe haven status is coming under increasing pressure, due to rapidly deteriorating public finances. On balance, we therefore envisage upward pressure on long-term interest rates in the coming quarters. We do not expect yields on 10-year US Treasuries to rise any higher than 4.5% - 5.0%, as the government and central bank will then do everything possible to suppress interest rates again. The threat of this, alone, will be sufficient to prevent any further rise in interest rates, in our view. For the coming quarters, at least. Incidentally, we do foresee interest rates for company bonds and bank loans then rising further.

*In the short term, we don't expect the markets to reaction particularly negatively, due to easy monetary policy.*

For the short term, we are slightly more optimistic where rates and prices are concerned. With increasing uncertainty and low inflation, monetary policy will remain easy for the time being in Europe and the US. As long as the economy shows no signs of increasing weakness, this is positive for asset prices. We therefore expect the fall in the first weeks to months to be gradual, at least, but asset prices will probably move sideways on balance. We expect the same thing for EUR/USD, in principle. After probably falling further initially towards 1.31 – 1.30, we expect the rate to rise again to around 1.40 before continuing its fall towards 1.20. Partly because technical analysis points this way (the euro is oversold and investor sentiment towards the euro if highly negative, which are good indications of a counter-reaction) and partly because aid to the Greek government, for example, and the fact that the ECB's growth expectations are better than expected could boost the euro.



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