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2011

2011 : The icebergs are coming

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By Raj Nair

2011 will be the year when several European countries and some US States are adrift in a sea of debt with dangerous icebergs floating around. They are aware of the icebergs like the crew of the Titanic but are ignoring action, hoping still for illusory soft solutions. This will also be the year of fake recovery in some countries and real growth in many. Both Europe and the US enter 2011, strapped and bandaged but only the latter can look to a 'feel good' year ahead. Spice that with a bit of what Google and Social media could do to change the world; voila, 2011 could be very interesting for business!

2010 was the year of Band-Aid. As I had written last year, Band Aid can only do what Band Aid does - a little healing on the surface, which does not mean much when the wounds are deep. That the financial excesses of the first decade of the 21st century had shaken the foundations of several institutions, besides banks, is not in doubt.

The Long cycle alluded to by me two years ago to explain the Crisis of 2008-09, has still not lifted. Significantly, it was a 100 years ago, on May 31, 1911 that the hull of the Titanic was launched. According to the Austrian School of Business Cycles, which modern economists debunk but has predicted cycles pretty well for the past 100 years, the Great Depression was a consequence of the runaway central bank credit expansion of the 1920s. It was also the year when Ludwig Von Mises who predicted the Great Depression, wrote the seminal book, *Theory of Money and Credit.*

Over-supply of cheap money causes misallocation of resources in assets resulting in bubbles, which burst eventually with predictable but unpleasant consequences if not cooled down. There is a debt bubble in Europe and in the US right now, and no long term solutions seem acceptable to politicians. They want growth to happen in order to absorb the economic excesses of the past. Their wishes would, in all, probability, be granted in the US in 2011 but only by postponing the inevitable. Europe may not be so lucky. Spain, Portugal and Italy are nervously dodging icebergs.

It is significant that 1911 was when America was in its ascendancy. Those were the heady days when entrepreneurs ruled the roost with supreme optimism. Frank Woolworth was so successful that he broke ground in that year with intent to build the tallest building in the world for his company's office in NY. It did not matter that the Empire State Building towered over the Woolworth, because for most of the 20th century, his company almost defined discount retailing. In 1997, Woolworth closed the last of its stores and slipped into history. In the same year, on another continent, Deng Xiao-Peng passed away having seen the fruits of his radical change efforts. China was rising. The story of Woolworth is the story of several important companies in the West and there is more to come. Those that survive like the IBMs of the world have reinvented themselves more than once and are global Multi Nationals with a game plan to exploit opportunities to buy, make and sell as they unfold anywhere in the world. And in 2011, much of that action, will be in Asia.

In my predictions for 2010, the predominant theme was that the needle is perceptibly shifting towards the East and that more of it would come in 2010. The fact is that in 2010, the shift accelerated with USA and Europe together shedding an estimated 0.9 % share in the global GDP, whereas Asia's share rose by 0.6%. It was to some extent, hastened by the deep wounds in the Western economies caused by the machinations of greedy bankers and a significant section of the populace which was ignorant of risks that the products sold to them carried. But the fundamental reason for Asia's resurgence, especially that of China and India is a combination of higher domestic activity and increased competitiveness. These two countries themselves increased their share of world GDP by 0.5% in 2010 – a very significant jump for a one year period! The events of 2011 may further accelerate the shift.

What are the big themes for 2011?

The global economy

China will be centre stage for a number of good reasons, not just for GDP growth of between 9.7 to 9.9% in 2011. Besides being the banker for the West and the number one supplier of affordable goods, it is now asserting itself quite firmly on international issues. It will not be a pushover on matters like currency valuation although one may expect that it will revalue its currency in gradual steps in 2011. That may suit its focus on growing domestic consumption as the next growth engine in the 5 year Plan that will be revealed in March 2011. Exports to the West alone will not satisfy the economic growth desires of China. One would also expect that China would want to make imported goods cheaper for its citizens as it celebrates the 90^{th} year of the Chinese Communist Party. It is also concerned about its dependency on imported oil whose prices have firmed up. Historically, whenever China raised its interest rates, oil prices have dropped due to fear of slower economic growth. Already, automakers are worried by the restrictions being placed on new car registrations to curb traffic snarls in some cities. Since raising of interest rates will also help to keep the rising inflation in check (food inflation now a worrisome 11%), one should expect China to pull the interest rate trigger again in 2011.

India will not be far behind in growth despite several factors that will conspire to prevent the economy from hitting its true potential. Those include corruption, political impasse delaying the essential reforms, high oil prices, rising inflation and interest rates, terrorism from across the border, strengthening Rupee impacting exports, though marginally, etc. Despite all that one expects a real GDP growth of 8.2 to 8.6 % in Financial Year 2011-12. A real estate bubble has built up in major cities which the Government is concerned about. There could be selective attempts to limit capital access to speculative investments in real estate and also some interest rate play soon, in order to cool this sector. It will take a major stock market correction (most experts expect only technical corrections) and curtailing of housing finance to burst the real estate bubble. FDI and Portfolio inflows are likely to increase substantially due to the limited options within emerging markets. Manufacturing is expected to show healthy growth as also the services sector. Strengthening of the Rupee against the Dollar and the Euro will put some pressure on Indian exporters who already face the challenge of the slow growth in the West. India will need to find the political will and business gumption to make inroads into the Chinese domestic market in 2011, in order to secure a long term position in that attractive market.

Brazil, the shining star of Latin America in 2010 with a GDP growth of 7.6%, is expected to slow down to as low as 4.5 % growth despite positive economic health indicators including a projected net trade surplus. This is because of slower private consumption which will result from the termination of various benefits that were given to keep the growth high in the past 2 years and tighter consumer credit.

The Russian economy’s return to high growth will no doubt be aided by firm oil prices in the coming year. Analysts expect a GDP growth of the order of 4.3 % in 2011 which is higher than the 3.7% expected this year.

All in all, emerging markets are expected to provide a big boost to the global recovery in 2011. The West does not have strong legs to grow without cortisone provided by their Governments.

The US economy will grow largely thanks to the US Government’s all out bid to create a ‘feel good’ effect of wealth increase through quantitative easing. After the electoral setback, it is likely that the Government will borrow from the future to fund the present. The looming threat in 2011 comes from some important states which are close to bankruptcy.

Theoretically, they are supposed to balance their books but these States are not in a position to do so. They will be forced to borrow further or cut back on their expenses, many of which are long term commitments made to citizens. Likewise, there could be withdrawal of financial support to some cities, which could put papers issued by Municipalities look pretty suspect at best or like defaulting duds at worst. Some pain is on the way, and some will be postponed. The present mood indicates that the Administration would do its best to take the GDP growth to over 3 % propped by all the sops that it takes. The proclivity to increase money supply at low interest rates to rev up the economy remains the biggest challenge for the US. Oil price rise, curbs on spending by States, continued high unemployment, food inflation, etc. and the end of Quantitative Easing II by mid 2011 could conspire to pull GDP growth to below 3% in the US.

Europe is complicated for various economic, political and social reasons and these will continue to obscure the real solution. Pain in Spain, freeze in Greece, fear in Italy, problems in Portugal and Ireland, etc. will get more pronounced in 2011 as facts get exposed. Spain for instance is a huge problem given the size of its economy and the extent of exposure of banks to real estate whose values are still dipping. Economically prudent members led by Germany are not in an indulgent mood in regard to the PIIGS. They demand austerity much against the popular wishes of the people in the PIIGS which could result in further divergence of views amongst decision makers if the next round of elections in the weaker countries, throw up leaders who are less inclined to follow EU-imposed guidelines. That could threaten the very basis for a common currency. Hence 2011 will be a defining year for the Euro. Given the uncertainties that abound, the US $ may regain the safe haven status which could strengthen it vis a vis the Euro despite USA's own share of economic challenges. If the Euro weakens against the Dollar and oil prices rise, it will further impact the EU economies. In the last surge in oil prices in 2008, the impact on the Euro zone was muted by strengthening of the Euro against the Dollar. Consumer confidence in the Euro zone which was irrationally rising for a few months has finally declined in December. Ireland's woes or the problems faced by Portugal, Spain, Greece, etc. will not disappear. Bond spreads for the peripheral countries will increase, notwithstanding China's support for Portugal's bonds. Germany will remain EU's shining star and will strongly influence Euro zone policies.

Despite potential short term strengthening of the Dollar, there is no mistaking the fact that the longer term direction is downwards for the Dollar. The year is likely to also witness the start of the decline of the influence of the Dollar in International trade. The first stone has already been thrown at it by the Chinese and the Russians recently when they entered into a private deal to conduct business with each other without using the Dollar. The currency tension between the US and China is likely to continue in 2011 although foreign exchange experts feel that the Renmimbi will strengthen against the US $. The Indian Rupee too is expected to strengthen against the Dollar due to the relative performance of the economies and the interest rate differential. This will offset India's export competitiveness caused by productivity improvement. In some sense, the Indian economy is more vulnerable to Oil price increases than almost any other factor. That makes a discussion on 'peak oil' relevant.

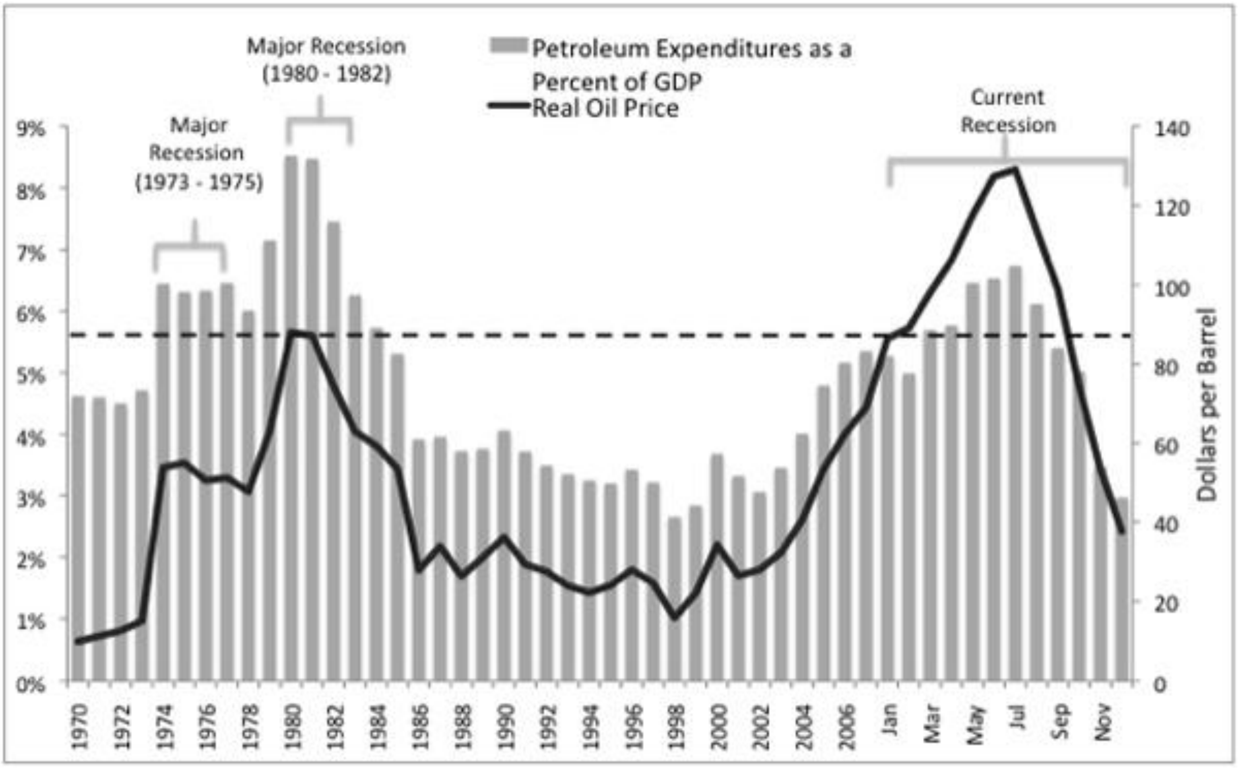
Whither Oil prices?

There is a lot of concern about Peak Oil and where the oil prices are headed from the current levels and how it will impact the global economy. Even if the EU grows marginally, the US at between 2.75 and 3.3 %, there will be an upward pressure on oil prices because emerging markets will collectively grow at around 6% at a time, when oil production is not rising significantly and spare oil production capacity is diminishing.

Oil is already close to $90 per barrel. Will we finally see speculators' driving it to $200, as was expected by Goldman Sachs in 2008? Unlikely.

There is a view that when the spend on oil/ petroleum resources crosses 5.5% of the GDP, growth becomes unsustainable and will result in demand depletion for oil and drop in prices (See Table below). Will 'peak oil' not change that equation?

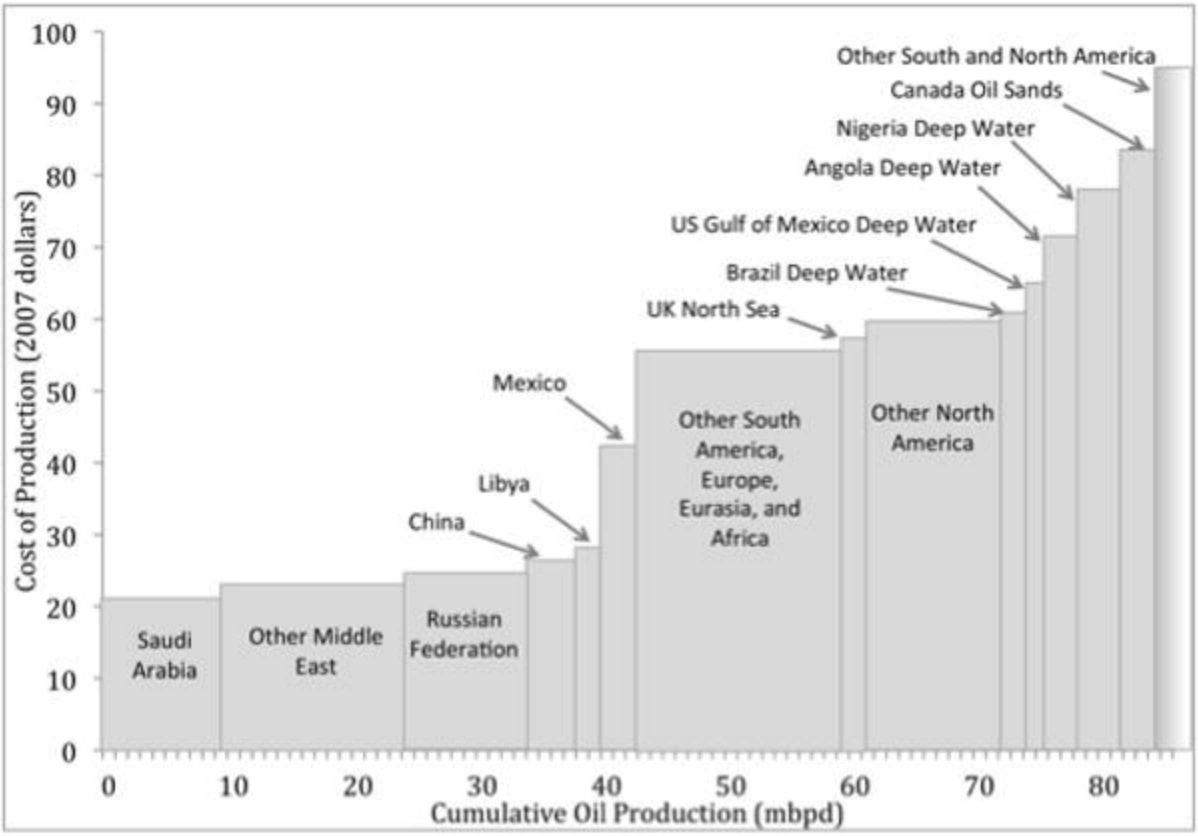
Table: Petroleum expenditures as a percent of GDP



Source: David Murphy, Oil Drum

Peak Conventional Oil has already happened in 2006 at around 70 billion barrels per day (International Energy Agency) but Peak Oil which includes unconventional sources of oil like oil shale, Natural Gas Liquids etc. may happen anywhere between 2018 and 2035. That will call for non conventional Oil to become profitable to produce from now on. One estimate puts the cost at $80 per barrel, about 4 times the cost of producing oil from the Gwahar fields in Saudi Arabia.

Figure. Estimates of the cost of production for oil production from various locations.



Source:Data from Cera

This means that the days of cheap oil are almost over barring speculative peaks and troughs. The spare oil capacity is expected to decline from about 5 bbpd in 2011 to around 3 bbpd in 2012 and drop further beyond that. Easy money conditions could encourage Hedge Funds to speculate in oil as they did in 2007-2008, to keep an upward pressure on prices. The offsetting elements to consider are:

- Natural Gas, if it continues to get priced at 25% of the price per BTU of crude oil, has the potential to substitute the stationary uses of oil, which accounts for 45% of the demand for oil. Currently there is no shortage of Natural gas.
- Ratio of oil expenditure to GDP will be pretty close to the limit beyond which economic slumps get triggered.
- The susceptibility of the EU economies could curb runaway oil price hike.

Hence a consensus view is that we should be looking at oil in the range of $ 90 to $ 102 (average around $93) per barrel in 2011 subject to the dollar not falling in value due to lax monetary policy.

Potential economic risks:

It will be calming to note that CDS which singed the world in 2008 and triggered the Global Economic collapse, and which continued to remain high in absolute terms in 2009, has indeed shown signs of decline from $57 trillion to $30 trillion over the 2 years ending June 30, 2010. The semi-annual BIS survey 2010 suggests that the overall outstanding position for all types of OTC derivatives fell 4% to $583 trillion in June 2010 reversing the 2% increase in the second half of 2009. Inflation remains one of the biggest issues for the world in 2011. Oil, commodities, food, will challenge Governments as they struggle to manage their monetary policies, etc.

Europe's debt crisis may go beyond the PIIGS to engulf countries like Belgium whose public debt is now close to its GDP. Eastern Europe is sitting on thin ice. While the IMF feels that there is not much to fear, a default anywhere could trigger a chain of events given the interdependencies between nations in the EU.

Uncertain conditions in the ME will continue to prevail. The West will do what it takes to keep the region from boiling over with an eye on oil prices. Pakistan and Afghanistan will remain a bug bear for the whole world in 2011 as terrorism exported from this region will challenge efforts to find peace. India will be particularly susceptible as Pakistan's economy continues to struggle, with mounting tension between the weak and corrupt government and power hungry military.

Global Manufacturing investments will rise

Investments in manufacturing are expected to rise significantly across the world. That augurs well for the capital goods sector the world over. This investment will be more pronounced in Asia. The investments will come not only from domestic companies but also from the Fortune 1000 many of which are sitting on cash. Sub-sector analysis is outside the scope of this paper but it could be deduced that raw materials and consumables manufacturers have a good year ahead. This could put additional pressure on commodity prices.

Google, social media and the business world

Why talk about Google in the 2011 economic predictions?

How can one ignore the impact of an organisation which serves 45 billion adverts a year, has 2 million corporations as users for its gmail service, whose search capability is used by more than half the business decision makers in the world and their subordinates, whose maps are used extensively to find one's way anywhere in the world, whose Android system for smart phones is threatening to make life difficult for Apple, etc? It is the equivalent of China in the business world. Its impact on the economics of business is so powerful that Scott Cleland, President of Precurser LLC is imploring the U.S. Department of Justice's Antitrust Division and the European Commission's Competition Directorate to sue Google and break it up based on some research that his company has done. Be that as it may, Google impacts revenue, productivity and prospects of businesses big and small, all over the world. Google enables and in some cases disables online marketing.

Noteworthy amongst the numerous things that Google may do to business in 2011, is the serious entry into Social Media through acquisitions. It launched Hotspot because of its failed attempt to acquire Yelp, the online company that has a vast number of local businesses writing about themselves, numerous customers posting reviews, and others searching for reviews. Google wants take its involvement in Social Media to another level of scope and scale to fight Face Book. Their past attempts did not end in glory. By 2012 (if Google gets the social aspects of their act right this time), a number of B2C and some B2B businesses will want to be on Google Hotspot to have their claims vetted by online customers in order to grow their business.

Will advertising get disintermediated? Yes, to an extent.

This will be one of Google's tentacles to reach into the Social Media world, but one should expect some announcements about a big initiative from Google before mid 2011. This year will be the tipping point for the use of Social Media in business. The high level of consumer and employee activity on Social Media will push several companies into deploying Social Media in marketing, procurement, R&D, Market research, PR, HR, etc. even in India. Google Editions will help people buy books from online retailers and store them on Google servers. The confluence of smart phones, tablet devices and social media in 2011 will herald a new era of digital enablement of business that will change the way business is conducted.

Corporate enterprises everywhere in the world should resolve to not get left behind, and this is true even in emerging economies like India. Like some economies in Europe will need to dodge icebergs of debt in 2011 so as to not end up like the Titanic, many businesses will face icebergs of internal resistance and ignorance in the digital age. But as Henry Kissinger once said,***" The task of the leader is to get his people from where they are to where they have not been".***

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