Only Skilled Workers Will Make It In The Global Economy

WASHINGTON – We can argue that in America may be about half the work force is doing alright because it is positively connected to the fast-moving global economy. For them globalization is good. Most of them are "knowledge workers". They design the sophisticated technologies which power global or globally connected businesses, or at least are familiar with them and know how to work productively with them.

Some do well, many do not

If they are in high-tech, renewable energy, complex global logistics, medical science and diagnostics, digital design, supply chains creation, management and sustainability these American workers are probably doing alright.

However, most of the others –those who perform low value, repetitive tasks or who are engaged in manual labor – are or will soon be at the bottom of the skills pyramid. Unfortunately this means that their jobs are not and cannot become stepping stones to future employment in more challenging and more rewarding sectors. In many cases, the jobs that involve repetitive tasks will probably be outsourced, or will disappear altogether, as victims of the relentless automation wave.

Lack of skills, lack of opportunity

If you belong to the bottom half of the "old economy", your current position is bad and likely to get worse. If you do not have and cannot acquire the skills that give you dexterity with machines that work with numbers, (most likely because you had a poor education and therefore you do not know how to work with these systems), you have no career future. You are or will soon be pushed down into dead end manual labor jobs like janitor, landscape worker, bus boy, or nursing home attendant.

The unlucky former manufacturing workers who lost their jobs due to globalization and automation are equally in bad shape. If they cannot be retrained so that they could aspire to the more sophisticated positions in new high-tech manufacturing or services, in most cases they will end up in one of those dead end, low paying occupations.

Getting the jobs back

Of course, when then candidate Donald Trump came along in 2016 arguing that the only reasons these fine factory workers lost their jobs is the greed of their corporate employers seeking easy profits by exporting jobs overseas, along with unfair trade competition from China, Germany, South Korea, Japan, Mexico and everybody else, these displaced workers were eager to listen. And they were willing to believe that, indeed, all it takes to restore their old manufacturing jobs, (with all the perks and benefits), is a new President who really wants to help the little guy by turning things around in Washington.

Yes, they believed that a President can reverse the negative impact of globalization. Yes, he can force U.S. companies to stay at home and hire more American workers. Yes, he can re-negotiate unfair trade deals, so that the avalanche of cheap imports will stop, while American companies will find new markets abroad.

A nice dream

This is unfortunately only a nice dream. No, no President, however well-intentioned, can stop, let alone reverse, globalization. Yes, he can strong arm corporations in order to slow down or stop the outsourcing process. But this is no long term solution.

In the end, American companies will succeed only if they can be and stay competitive. Forcing them to keep expensive or money-losing operations in America, so that workers can collect a pay check, while their nimble foreign competitors conquer markets leads only to eventual economic decline.

The way out

So, what is the proper way of addressing this crisis brought about by the competition of cheap labor (mostly from Asia) and the relentless march of automation?

The only way is for the unskilled to become skilled.

Those who are not employable today because they lack the knowledge and the basic understanding of how the high-tech knowledge economy works need to get those skills. And fast. Those who do not, are left behind. For them there is no upward mobility, no career ladder.

The old adage that "hard work" is the key ingredient to success in America is no longer valid. Yes, diligence and discipline still matter. But only when accompanied by the sophisticated knowledge that allows mastery of complex systems.

How is France doing?

Well, if this is the rather gloomy picture for millions of Americans who may have missed the bus leading to the global economy, what about elsewhere? What about France, for instance?

France recently embarked in a an incredibly ambitious political experiment. The French voters ditched the established political parties, of the left and the right, and elected President the young and completely untested Emmanuel Macron. And the reason is that this investment banker turned politician, promised nothing less than economic renaissance.

While he phrased his campaign slogans differently, he promised the same end results promised by candidate and now President

Donald Trump: a complete bottom-up economic transformation.

Newly elected French President Emmanuel Macron claims that his policies will kick-start France into high gear. This rather old and unimaginative country will become a “Start-Up Nation”. As a result of fresh pro-growth policies, there will be a fresh crop of entrepreneurs and innovators.

Reform labor laws

Well, in principle this is possible. However, how do you make this happen? One good place to start is by reforming the antiquated French labor market. France is still prisoner of the old, pro-union leftist agenda which is all about the protection of workers rights. Nothing wrong with that, in principle.

The problem is however that by focusing on the protection of those who are employed, French labor laws make it much harder for employers to hire new workers. Indeed, when a new worker is hired, given all the protections he/she is entitled to, it becomes almost impossible or at least extremely costly to dismiss him/her when business is down.

In other words, by offering maximum protection to employed workers, French labor laws made sure that fewer workers would be hired, even in good times. In addition, the perks and benefits going by law to employees made French labor costs too high, this way making French companies less competitive in the global market place.

Bite the bullet

It seems that President Macron is willing to bite this bullet. His government wants to tackle labor laws reform.

But here is the political and psychological problem. Even if well designed and skillfully implemented, labor law reforms will threaten the job security of existing workers before they will be able to broaden the labor market, therefore offering new opportunities to those who cannot get into it today. Which is to say that there will be pain first (guaranteed), and (possible, hoped for) gains later.

Can Macron convince France?

Can President Macron convince the French people that he can manage this complicated process well? Can he convince workers who may lose their jobs now, on account of more flexible labor laws, that in the future, given greater overall flexibility, more appealing jobs will sprout across the nation, this way creating brighter prospects for millions of old and new workers? This is going to be a tough sale.

In the end, it is obvious that a brittle French jobs market will not help advance Macron's vision of France as a "Start-Up Nation". Economic renaissance is very appealing until voters realize that change may entail threats to their current security. I am a bit pessimistic about the depth of France's newly discovered enthusiasm for enterprise and innovation, once the French realize that this hoped for transformation is not pain free.

I doubt that Macron will have the ability to convince most of the country that a more fluid society with fewer protections is also a more flexible society that creates more opportunities. No doubt most French would like to see more competitive companies and more jobs created. But those who are employed now do not want to lose whatever job security they have.

The challenge

As noted above, even here in America, until not too long ago the quintessential "Start-Up Nation", in many sectors of our society and economy we are failing to live up to the old and time-tested "can do" spirit of flexibility and quick adaptation to new circumstances.

We failed to build the education, vocational training and retraining structures that would have allowed millions of workers to have a relatively smooth transition from old-fashioned, large scale manufacturing to a new, complex and more demanding knowledge economy.

Can an even more ossified France do a better job? Can a young, optimistic President Macron inject a new vigor into a declining economy?

Time will tell.

OPEC Defeated By US Shale Oil?

WASHINGTON – It seems that American shale oil producers, an assorted group of small and medium-sized firms which gained strength in the last decade and are now operating in many states, have become the swing producers in a position to influence global oil prices. How did that happen?

Cutting costs

U.S. shale oil production is relatively new. At the beginning of the "shale revolution" the cost of extracting oil from shale formations was quite high. But now they have come down significantly, mostly because of aggressive cost cutting measures adopted in response to OPEC imposed low prices. (More on this below). On account of this incredibly fast makeover, today a large number of the shale companies, especially those operating in West Texas, are profitable even with oil well below $ 50 per barrel.

Most interestingly, shale oil producers now have the ability to ramp production up and down with relative ease, this way adjusting to global market conditions, without causing major disruptions to their operations. They can increase output when prices are higher and cut back when prices are too low. Conventional oil producers do not have this option.

With crude around $ 50 per barrel, it is good news to have a substantial number of U.S. based oil producers supplying the domestic market, while making a profit even in this new era of low prices. This is a big plus for the American energy sector, and for all American consumers of energy products.

OPEC reactions

With good cause, OPEC saw the spectacular increase of U.S. production caused by the large scale exploitation of abundant shale oil reserves (an additional 4 million barrels a day in just a few years) as a threat to its market dominance.

Hence a very simple strategy aimed at eliminating the American shale oil threat. The plan was to deliberately over produce, this way causing a global glut and consequently falling oil prices. The bet was that a long stretch of low prices would kill the U.S. high cost shale newcomers who –according to all analysts– could not survive with oil below $ 60 per barrel.

After having eliminated the U.S. menace, OPEC would go back to business as usual, reaffirming its position as the oil cartel which alone has the power to dictate prices by manipulating supply.

The strategy failed

But it did not work out this way. Not by a long shot. And this is because the U.S. shale producers, surprising everybody, managed to quickly adopt major technological improvements which increased well productivity, while aggressively cutting other production costs, this way staying profitable even with oil below $ 50 per barrel.

All in all, the Saudi/OPEC plan failed. While several marginal U.S. shale producers could not make the adjustments fast enough and went bankrupt, most of the shale sector survived the OPEC imposed squeeze on profits.

The high cost of low prices

In the meantime, the extended period of low prices hurt OPEC producers very badly. They saw their precious oil based revenue dwindle rather dramatically. It soon became clear that most OPEC countries could not sustain an extended period of low prices.

Therefore, led by Saudi Arabia, the OPEC cartel, (this time working in concert with non OPEC Russia), tried to change strategy and jack up prices by cutting production, this way eliminating the oil glut they had created.

But this new approach is also failing. As oil prices go up on account of OPEC/Russia production cuts, the U.S. shale companies ramped up production, this way offsetting the OPEC/Russia cuts. As OPEC imposes cuts on its members, the U.S. shale sector produces more, while Saudi Arabia is denied the revenue gains that should have resulted from production cuts. So, the OPEC strategy aimed at eliminating the U.S. shale threat to its market dominance did not work.

Loss of precious revenue

That said, the sustained “attack” against US shale has been horribly expensive for the OPEC cartel members. Years of low prices hurt major Middle Eastern oil producers, (not to mention Nigeria and Venezuela, and non OPEC Russia, among others), in a significant way.

Most of these countries rely heavily on oil revenues to finance all or most public spending. Many of them had adopted national spending programs and budgets which assumed oil prices at $ 90, or $ 80 per barrel.

This means that all of them are facing fiscal problems or outright crises. Lacking oil revenue in the expected amounts, they have to cut spending and borrow more in international financial markets. But this is not an easy adjustment.

For example, in Saudi Arabia major spending cuts caused by declining oil revenue could lead to unprecedented political problems down the line. Almost the entire Saudi population depends one way or the other on direct or indirect government subsidies funded entirely via the oil revenue.

Reforms will take time

We know that the Saudi Monarchy is now openly committed to a major economic and fiscal transformation which will (hopefully) reduce and eventually eliminate all state subsidies, while promoting plans aimed at diversifying the economy. But, even in the best of circumstances, this is going to be a long journey. Cutting government largesse too much too soon could be politically dangerous.

Bottom line; U.S. shale wins; OPEC cartel and its new allies lose.

Can Brexit Be Reversed?

WASHINGTON – Looking at the reactions of sadness and disbelief in Britain to the results of the Brexit vote, I am beginning to feel that the end of this England/EU tragedy (farce?) has not been written, yet. (On this, see also Gideon Rachman's reflections in The Financial Times). By that I mean that a new London-Brussels compromise may be negotiated and struck that will allow Britain to stay in the EU, albeit with a few new qualifications regarding its membership.

What have we done?

I say this because the British are clearly not that happy about the outcome of their vote. Based on the widespread consternation now pervading the UK, (*"My God! What have we done?"*), my hunch is that many among those who voted Leave had no idea about they were doing, and of the dire consequences of a vote that would take Britain out of the EU.

Even worse, many truly believed all the lies told by the Leave leaders regarding all the British money earmarked for Brussels that from now on would stay in Great Britain, and about how wonderful everything would be, once the UK regained its "independence" from Brussels. Most of that talk was just brazen, totally irresponsible propaganda.

No triumph

Well, what do you know, in the aftermath of this clear victory, the language of the Leave leaders all of a sudden has become very nuanced, almost timid. *"Well, there will be some financial gains, but not too many." "Yes, we shall regain control over immigration, but not total."*

In other words, no atmosphere of triumph. In fact it looks like: *"And now, what do we do? Getting out of the EU looks a lot more complicated than we thought"* .

Looking at all this, many voters are getting the feeling that by voting for Brexit they bought a dream of a "new independence" that would make everybody rich that has no basis in reality.

No more Great Britain?

Besides, the Leave front probably did not consider adequately the domestic political repercussions of the referendum outcome. With England in favor of leaving, while Scotland and Northern Ireland are strongly in favor of remaining, we have the elements of a major national dispute that may very well lead to the breakup of the United Kingdom. The possible end of Great Britain seems to be too much of a price to pay in the context of a vote that was supposed to assert British independence from Brussels.

Not a super majority

And, last but not least, while the 52% to 48% vote in favor is Brexit is clear, it is far from overwhelming. In other words, almost half the people in the UK voted to stay in the EU. And if you look at the actual number of votes cast, (only 72% of all voters participated in the referendum), in the end only 36% of the British citizens went for Brexit. A strong plurality, to be sure; but not a convincing majority.

Can this be undone?

Well, given all that, can something be done to reverse the outcome of this referendum? Something is indeed possible. It is not inconceivable that we can see in the coming weeks and months a fresh round of negotiations between London and Brussels aimed at reaching a new compromise that may satisfy a majority of British voters.

If we can assume a new arrangement whereby the UK gets a few more concessions from Brussels, especially on the number of EU immigrants it is willing to accept, it is entirely possible to have another referendum justified by the fact that the situation has changed, because now there is a new, more “favorable” UK-EU deal on the table.

If the victory for the Leave camp had been much more decisive, with a larger voter turnout, any idea of starting new negotiations leading to a new compromise and a new vote would be totally implausible. But the fact is that only 36% of the voters affirmed their wish to leave the EU. And it seems that now many of them regret that vote.

Compromise, anybody?

Can there be a face-saving compromise? Imagine a new, more favorable (for the UK) deal followed by another referendum. Great Britain decides to stay in the EU on the basis of a new arrangement with Brussels. The Brexit camp can still claim victory because better terms were obtained on account of their successful agitation. This second act may not be easy. But it is entirely possible.

I still believe that the EU is mostly a turbocharged Chamber of Commerce with vain glorious and ill-defined political unification aspirations. And I still believe that this vote in the UK highlights the lack of genuine buy-in in the “Idea of Europe” on the part of large segments of European public opinion. But tearing the whole thing down without any plan whatsoever for a post-EU Great Britain is not the best way to move forward.

The EU is not the source of all problems

Here is the thing. The UK and other EU members have deep problems. But most of them do not stem from Brussels. They are rooted in large and frankly non affordable social programs, lack of labor mobility, low levels of investments and productivity, and declining fertility rates.

The notion sold to a majority of the British public before this referendum that the country’s difficulties originate from its EU membership is false and totally misleading. True enough, Brussels does not help much. But, no, it is not the source of the widespread economic suffering affecting the UK and the rest of Europe. Therefore, getting out of Europe is no cure.

Italian Prime Minister Talking Nonsense

WASHINGTON – Yes, there is something to be said about optimistic political leaders who inspire their people to hang on and do the impossible, even when things do not look so good. Sometimes convincing leadership can perform miracles. Think of Winston Churchill during WWII, or Ronald Reagan in the 1980s.

The South comes back to life

Well, so what do we make of this statement by Italian Prime Minister Matteo Renzi during a recent visit to Naples? This is what Renzi said; *“If the South* [of Italy] *restarts, Italy will restart, this way becoming Europe’s locomotive”*. Think of that: Italy (11% unemployment, practically zero growth for a decade) transformed into Europe’s engine. And all this because of the South, (one of the most depressed regions within the EU), all of a sudden roaring into action. What do you know, in the blink of an eye Italy will be ahead of Germany!

Laughable

Is this sunny optimism or laughable stuff? Please pick the latter. The South of Italy has been and is a perennial tragedy of malinvestment, corruption, stupidity, apathy and desperation leading young people to emigrate. And please do not forget the almost complete dominance of organized crime, (Mafia, Camorra and N'drangheta), in practically all matters.

How The Economist sees it

If you want details, here is how The Economist put it a while ago:

"The south [of Italy]*grew more slowly than the north before the financial crisis. But the main source of the divergence has been the south's disastrous performance since then: its economy contracted almost twice as fast as the north's in 2008-13—by 13% compared with 7%. The Mezzogiorno—eight southern regions including the islands of Sardinia and Sicily—has suffered sustained economic contraction for the past seven years. Unicredit, Italy's biggest bank, expects it to continue. […]"*

"Of the 943,000 Italians who became unemployed between 2007 and 2014, 70% were southerners. Italy's aggregate workforce contracted by 4% over that time; the south's, by 10.7%. ***Employment in the south is lower than in any country in the European Union, at 40%;*** [bold added] *in the north, it is 64%. Female employment in southern Italy is just 33%, compared with 50% nationally; that makes Greece, at 43%, look good.* ***Unemployment last year was 21.7% in the south, compared with 13.6% nationally.*** [bold added]. *The share of northern and southern families living in absolute poverty grew from 3.3% and 5.8% respectively in 2007, to 5.8% and 12.6% in 2013."*

"Downward pressure on demand is exacerbated by the south's lower birth rate and emigration northward and abroad. The average southern woman has 1.4 children, down from 2.2 in 1980. In the north, fertility has actually increased, from 1.4 in 1980 to 1.5 now. Net migration from south to north between 2001 and 2013 was more than 700,000 people, 70% of whom were

aged between 15 and 34; more than a quarter were graduates. Marco Zigon of Getra, a Neapolitan manufacturer of electric transformers, says finding engineers in Naples, or ones willing to move there, is becoming ever harder. According to Istat, Italy's statistical body, over the next 50 years the south could lose 4.2m residents, a fifth of its population, to the north or abroad."

Add African immigrants to the mix

And let us not dwell on the dislocation and additional problems created by the tens of thousands of poor African immigrants who land in the South of Italy every year. They cause huge frictions, while straining modest resources. And, by the way, youth unemployment in the South reaches 60% in some regions.

OK, now we have some context within which to place Renzi's optimistic comments. Think of it for a moment: *"If the South restarts"*. This is total and utter nonsense.

Stupid statements

Given the bleak picture presented above, talking about such a *"restart"* as if it were achievable, and practically around the corner, is a bit like saying *"In a little while, when Afghanistan will be a modern industrial economy"….;* or *"Next year, after Venezuela's economy will be back on track""…;* or *"in 2017, after all of Africa will have electricity and clean water"…* For any of these highly desirable scenarios to materialize, every sane observer knows that we are talking generations, even assuming good policies and strong perseverance over decades.

Yes, it would be nice if overnight, magically…*"Pufff"*…the South of Italy became a modern Region, this way energizing the rest of the country, leading Italy to unimaginable new heights.

This is not going to happen

But no, this is not going to happen. The South is trapped in its culture of short termism, thievery, corruption, organized crime, and unbelievable levels of maladministration. The notion that one or two initiatives, and a sprinkle of investments will trigger a systemic transformation of this perennial economic swamp is not just naive, it is frankly stupid.

I am not sure why the Italian Prime Minister said this. But I find it remarkable that nobody called him on this. Nobody pointed out how preposterous all this is. No media comments. No requests for clarifications as to how this magic "restart" will materialize itself.

The Dream Of A Modern Saudi Arabia

WASHINGTON – Bloomberg Businessweek placed Saudi Arabia's Deputy Crown Prince Mohammed bin Salman on its cover (April 25 – May 1) underneath a caption that says he is *"preparing Saudi Arabia for the end of oil"*. The lengthy cover story is all about this energetic young Prince who –all alone– is determined to spearhead a series of bold initiatives and reforms aimed at re-engineering a country whose vast richness come from gigantic oil revenues, and not the skills of its citizens. Of course, being the son of the King helps a bit in what is still a top-down, absolute monarchy.

Plan to diversify the economy

The long article explains how the Deputy Crown Prince plans to diversify the economy. He wants to start selling shares of Saudi Aramco, probably the single largest oil company in the world. He would then invest the proceeds in a number of global companies. After this diversification, in the future Saudi Arabia's economic fortunes will be less tied to the ups and downs of oil prices.

No more subsidies

At a different level, the Prince wants to cut back the vast web of subsidies provided by the Royal Family to almost every Saudi citizens. But this may be a bit tricky. It is an open secret that direct or indirect payments to millions of people are the means through which the Saudi government keeps a lid on Saudi society. In a region marred by unrest and civil wars, not much anti-government unrest in Saudi Arabia, since almost every citizen gets a regular check from the government.

Problem: no real middle class

Well, so far so good. Except for one thing. Even assuming that all these reforms will work, at best Saudi Arabia can become more efficient. But it simply cannot become a modern society the way we understand it. For the very simply reason that Saudi Arabia does not have basic political freedoms and a modern middle class that can act as the engine of self-sustaining growth.

Here is the simple truth. Except for vast amounts of easy to extract and therefore highly profitable oil, Saudi Arabia does not have a real economy. Saudi Arabia does not have a sizable educated middle class with a fair number of entrepreneurs engaged in profitable, innovative businesses.

Monarchy controls oil

Saudi Arabia is an oil Kingdom (second largest crude reserves in the world) essentially "owned" by a mostly parasitical elite. This elite, (the extended Royal Family), controls all the oil wealth. The same leadership distributes some of the oil revenue proceeds to the rest of the country, in many cases via bogus government jobs that produce no value. It is fair to say that most Saudis do not do any real work. In the Kingdom real labor is provided by foreign workers.

No modern middle class

Now, given this picture, I submit that unless these fundamentals are drastically transformed it is essentially impossible to re-engineer the Saudi society. Capitalistic economies succeed mostly because of the existence of basic political freedoms and because of a solid, entrepreneurial middle class. By that I mean large numbers of reasonably well-educated, driven individuals who engage in money-making enterprises. Their activities are supported by bankers, lawyers, accountants, marketers, public relations professionals and what not.

In other words, modern competitive economies do not exist without a vibrant middle class that can produce at least some capable entrepreneurs. These entrepreneurs understand the value of innovation. They understand competition within a rules based system fairly managed by an independent judiciary that can act as a reliable referee in case of disputes.

Oil is the only productive sector

Well, guess what, none of this exists in Saudi Arabia. And I sincerely doubt that any of this can be created –essentially out of nothing– by an energetic Crown Prince eager to modernize a rent based economy in which, with the exceptions of the few skilled people who are in charge of the highly profitable energy sector, nobody has done anything even remotely approaching real, productive work for decades.

Rules based democracy

You want modernity? Well, then you need a rules based democracy in which people really understand and agree upon the proper balance between private and public, in which all players agree that the private sector is the driver of economic growth, while all economic actors appreciate the need to have and follow clear rules. You also need a government that is efficient, open, transparent, and fully accountable. Finally, you need basic freedoms, including laws that guarantee freedom of expression, and therefore truly free media.

Tinkering is possible; but no transformation

I see none of this in Saudi Arabia. Despite formidable constraints, I can see that some tinkering is definitely possible within the existing environment. If his reforms work, Prince Mohammed may be able to make the existing system less wasteful, less corrupt, and less dependent on the price of oil. And this is a good thing.

But he cannot create a brand new country and a new Saudi society. And without these two prerequisites in place, there will be no modern country.

Too Many Bad Loans In India

WASHINGTON – India recently decided to change its methodology for calculating GDP and the rate of growth. And, presto, GDP now is a lot bigger, and growing much faster. Except that most analysts do not believe the numbers. No, the 7.5% rate of growth is more likely 5%.

Cooking the numbers

This is no mere detail. It is hard to take seriously a country that cooks up its numbers to make them look better. India's government better fix this, and fast. A major developing economy, a country of more than 1.3 billion, cannot risk becoming a laughing stock by producing data that most of the world believes is fake.

Fake statistics in Argentina

Indeed, Mauricio Macri, recently elected President of Argentina, immediately replaced all the top management at INDEC, the national statistics agency. The simple reason is that the agency had lost all credibility. Under the previous populist government, it published what the political leadership wanted. In order to re-establish credibility, accountability and transparency, as a minimum Argentina needs a truly professional, non-political statistics agency that will publish real data.

And so does India.

Bad loans

In India there are also other problems. There are just too many bad loans on the books of state controlled banks. More credit is extended to borrowers already in default. As a result, the percentage of Non Performing Loans, NPLs, jumped from 6% in 2011 to 14% in September 2015. According to the FT, this is *"the worst level in Asia".*

As the NPLs issue is out in the open, the markets are punishing banks stocks. But the government is reacting too slowly. Various analysts openly argue that Finance Minister Arun Jaitley should act swiftly. This situation damages India's financial sector, and more broadly it shows its corrupt politics.

Crony capitalism

It is obvious that all these NPLs are mostly about crony capitalism. Well connected Indian tycoons do not go bankrupt. No, first they get all the loans they want. And when their businesses go south, their bad debts are rolled over, and in fact augmented with the justification that a more robust capitalization of failed enterprises will finally heal them. But this never works.

NPLs in China

Look, this is happening everywhere in Asia. In China, virtually defunct State Owned Enterprises, SOEs, now explicitly called "Zombies", keep getting fresh capital from friendly state owned banks. How big is China's financial hole caused by NPLs? We do not know. But probably bigger than we think.

Rigged game

Thank God, in India there is a bit more transparency. Investors know more or less the extent of the NPLs problem. All the more reason to attend to it. State banks should not be in the business of funding well connected people who are lousy business leaders.

Difficult to get foreign investors to take the country seriously, if the Indian economy is perceived to be an insiders' game designed to fit the needs of corrupt elites.

Maersk Warning About Global

Slow Down – Recession In the US?

WASHINGTON – Maersk, (based in Denmark) is the largest shipping conglomerate in the world. Their business is to transport every day tens of thousands of containers from exporters to importers around the world. The company just announced losses for 2015. Just a temporary setback? Well, apparently not. Maersk ascribes this setback to shrinking global trade volumes. Their profits are way down because a much weaker world economy generates much less shipping of goods.

The worst since 2008

Maersk's CEO is quoted by the WSJ saying that the conglomerate is facing a "massive deterioration", adding that this is the worst they have seen since the onset of the Great Recession of 2008. Got that? We are back to a 2008-like scenario. I suggest that this is really bad.

And Maersk believes that this weak trade flows trend will continue in 2016. We should pay close attention to what Maersk managers say. Global shipping volumes are a very good proxy for world economic health. 95% of all manufactured goods are transported via containers that get to destination thanks to global shipping companies like Maersk.

Less activity in ports world-wide

Maersk is not alone in predicting bad times. DP World, a very large Dubai based port facilities management company, with operations in 70 terminals in practically every continent, chimed in, indicating that their business (handling the containers moved by Maersk and other shipping companies) is down, significantly. And the IMF confirms this pessimism about a global economy that run out of steam. They have lowered their forecasts for both growth and international trade flows.

So, here we go. The big companies that handle global trade are hurting. Their business is down because the world economy is slowing down, at a rapid pace. They are worried.

Weak economies

And why is that? Because the day of reckoning is finally getting close. The jig is up. For several years we have lived in a fools' paradise created by easy money created by central banks that caused asset price inflation in developed countries, and too much easy credit in emerging markets. Underlying economic conditions all over were rather weak, but everything looked good because of the artificial froth created by monetary easing. `

Central banks to the rescue

Until recently, when stock market worldwide showed signs of weakness, investors simply waited for central banks in the US, the EU, UK, and Japan to come to the rescue. And they were never disappointed. Trying to boost sagging economies, central bankers would launch, or relaunch, monetary easing, and zero per cent interest.

They would ladle quantitative easing, or QE. If it wasn't enough, they would ladle some more. When that did not do the trick, they went further. Some of them (Japan's Central Bank just joined the group) stopped paying interest to commercial banks parking their funds with them.

More of everything

And when even that proved to be insufficient, some of them started charging interest on deposits as a way to force banks to lend more in order to induce more growth. (Even Janet Yellen, the Chairwoman of the US Fed, just declared during a congressional testimony that negative interest rates could be looked at here in the US as a policy option, in some scenarios).

All these gimmicks produced some results. But nothing stellar. With all this gigantic monetary stimulus, the US has been growing at a modest 2%. Europe, at roughly 1%, has done much worse. Still, notwithstanding meager results, the international financial community seemed to be comfortable.

As long as the central banks seemed to be in control, busy doing one thing or another to prop up markets and keep stock markets reasonably buoyant, (regardless of the weak underlying economic fundamentals), it all looked promising.

Artificial valuations

Except that everybody, unless totally insane, must have known that nothing was right. Here is the thing. The extravagantly long season of monetary easing did not do much to grow the economies. But zero interest rates pushed cash from savings into stocks, therefore artificially boosting stock prices.

This cannot go on for ever.

Therefore, investors paying high prices for inflated assets must know that these high valuations were and are artificial. What happens when the central banks cannot provide any more monetary easing?

Governments have done nothing

It is true that central banks intervened so heavily mostly because governments did practically nothing. Sadly, in most western countries there has been no serious attempt to launch new pro-market, pro-growth, pro-investments policies. And it is obvious that, without a business friendly policy environment, there will be fewer investments, less innovation, less enterprise, fewer new companies, and fewer new jobs. And this means no growth, or lackluster growth.

But policy-makers, paralyzed by their ideological blinders that privilege spending on social issues as opposed of investments in future growth, sat on their hands.

It is true that central bankers, at least in the US and in the EU, pleaded with governments. They wanted action, real reforms that would free up resources, favor enterprise and therefore new growth. They did say that they could not manage the economies all on their own. But nobody listened, and almost nothing happened.

No reforms in the US

In the US nothing has been done about reforming entitlement spending (Social Security, Medicare and Medicaid) and a horrendously complicated, burdensome federal tax system that discourages business creation. On the contrary, instead of reducing regulations, the US government keeps adding more, this way suffocating enterprises with unnecessary mandates.

In Europe, if anything, it is even worse. In Japan, Prime Minister Shinzo Abe back in December 2010 announced "Abenomics" a major reform plan consisting of "three arrows": fiscal stimulus, monetary easing and structural reforms. Well, thanks to a subservient Bank of Japan, he got the monetary easing. But the rest –especially the structural reforms– did not happen. Abe simply could not deliver. Japan continues to stagnate.

Central banks keep easing

So, confronted with systemically weak economies, and no help from policy-makers, the central banks tried to provide more oxygen via monetary stimulus. And it worked; but only a little. However, in so doing, the central banks created unprecedented asset price distortions and misdirected the allocation of capital. Trying to buy some time, they created a gigantic mess.

Nervous investors

And now investors are very uneasy. They are on the lookout for any signs that may indicate the imminent collapse of this house of cards. They know that China, the most astonishing example of fake growth almost entirely financed (since the 2008 Great Recession) by unprecedented levels of new debt, is doing poorly. How poorly? Well, we do not know, because we cannot trust Chinese economic statistics. But global investors know that something really bad is brewing there. There is massive industrial over capacity, and no new demand. There is capital flight. For how long can the Chinese Government keep so many virtually bankrupt companies open? Not for ever.

And the same investors know and fear the cascading effects of the China retreat, some of them already unfolding, (and captured by Maersk’s warning on world trade flows deterioration). Indeed, South Korea, Thailand, Japan, Indonesia, Australia and others are closely tied to the Chinese economy. Many of their companies are part of China’s supply chains. So, as China goes down, they follow. This means a broader contraction.

Commodities down

And then you have all the commodities producing countries, also hurt badly by China’s slow down. This would be bad enough as it is. But it is made a lot worse by the fact that the rapid growth of many sectors (not just commodities) in emerging markets was debt-financed. Now that business is down, and profits have disappeared, where is the money to pay back the loans? These companies are going down, while their fall causes losses in the financial sector. This means more negative ripple effects.

So, here is the picture. Stock markets are over valued. Commodities producing countries are in bad shape because of lack of demand from China and over supply. There is too much bad debt.

Too much debt

Now, is this another September 2008 in the making? Who knows really. It is clear that no major economy is in high gear. On top of that, at least some highly indebted companies will be unable to make it. There are nasty rumors of troubled European banks with too many non performing loans on their books. Now they are abandoned by investors who fear the worst.

In China, at least for now, the losses are disguised through heavy-handed interventions by the state. But what about elsewhere? In the US, for instance, many of the companies that participated in the now defunct shale oil boom borrowed heavily to finance their operations. Because of the oil price collapse, now many of them will go under. This already hurt producers, contractors, suppliers and vendors, not to mention tens of thousands of high paying jobs lost. And you have to add the banks that financed the energy boom to the list. More broadly, the global financial system is exposed to a lot of non recoverable loans in emerging markets.

Bad news

So, there you have it. The global economic slow down is here to stay, according to Maersk and others. I would trust them. It is their core business to properly understand trends in trade flows.

Commodities prices are not going to rebound. Mining multinationals from Glencore to BHP Billiton to Vale are in bad shape. China got a massive indigestion and stopped buying. Brazil is in a recession. Russia is doing poorly because of low oil prices. Europe is fragile. And there is a lot of bad debt in distressed emerging countries.

US cannot insulate itself

It is true that in this rather gloomy context the US is not doing so badly. We have some growth, (a bit more than 2%), and unemployment is way down, (4.9%). The point is that the US is not strong enough to be able to insulate itself from these global currents. While the American economy is less dependent on foreign trade, many large US companies are tied to world markets. (Think about Caterpillar, or General Electric). If they suffer because of lost foreign sales, there will be ripple effects. At some point America as a whole will also feel the pain.

And if this happens while investors lose confidence in the Fed's ability to keep propping up markets with some more tricks, then all bets are off. At that point expect a mad rush for the exit.

Right now a US recession seems a very distant possibility. But may be it is a lot closer than we think.

Major Economic Reforms In Saudi Arabia?

WASHINGTON – What is going in Saudi Arabia? Probably too much. We have now an odd stew of engineered low oil prices that created huge economic and fiscal constraints, in Saudi Arabia and in other oil-producing countries, mixed with a new "Master Plan" for the country that includes extremely ambitious reforms unlikely to succeed.

Low oil prices

Let’s look at oil prices. We know that the Saudis have willfully caused the global oil prices collapse that began in 2014, and continues today, by refusing to cut their massive output (in excess of 10 million barrels a day) when crude prices became soft on account of the extra supply created (in a very short time) by US shale oil producers.

With Saudi Arabia opposed to production cuts, the OPEC cartel had no choice. They had to endure the consequences of dramatically lower prices until Riyadh will change its mind. So far, it has not.

What is the end game?

Why is Saudi Arabia doing this? Who knows really. I believe that this is an anti-Iranian move, and by extension, a move also directed against Shia dominated Iraq.

We know that for a while at least Saudi Arabia can afford to lose billions of dollars, the result of the lower prices it has imposed, because it can count on a significant financial cushion, in the neighborhood of $ 628 billion.

A huge price

Still, it is clear that the Kingdom is already paying a huge price. The Saudi state depends almost entirely on its vast oil revenue to finance all public expenditures. Dramatically lower revenue means huge public deficits. Last year the shortfall was almost $ 100 billion. Again, the Saudis can afford to do this, at least for a few more years. But, at some point, their reserves will be gone. And then what?

Major reforms announced

But this is not the only major development underway in Saudi Arabia. No, there is plenty more going on. Just as the Royal Family running the state is adjusting its policies to the lean years it has created, it came out with a new plan aimed at transforming the country. And this is no exaggeration.

The plan has been developed under the guidance of Prince Mohammed bin-Salman, the 30-year-old son of King Salman and now deputy Crown Prince. The young Prince (who is also Minister of Defense) is in charge of the Council of Economic and Development Affairs. The Council is a new institution established in January 2015, and placed in charge of planning future economic policies.

Privatizations, and a lot more

Here are the highlights. There will be large-scale privatizations, including health care services. There will be a deliberate effort to move Saudi citizens away from cushy state jobs *and into a soon to be created private sector* (I am not making this up) that will not rely on the established oil economy. (Currently, two-thirds of all Saudi workers are employed by the state). There will be an end to fuel subsidies and other freebies.

In other words, the plan is to make Saudi Arabia into a modern, vibrant, innovation-driven, private sector-led economy, no longer dependent on its enormous hydrocarbon resources.

Slim chances of success

In principle, this is not at all a bad idea. In practice, it all depends on the time line and the quality of both the plans and the execution. Let’s say this plainly. Usually these Grand Reform Plans do not work. And they do not work because the objectives are unrealistic, because people resist change, because sleek blueprints drawn by highly paid consultants fail to take fully into account the drag created by entrenched cultural habits and traditional mind sets. And in most cases all participants under estimate how long it takes for anything of substance to be implemented, and become eventually self-sustaining.

Abenomics failed

Look, Prime Minister Shinzo Abe has essentially failed in his noble attempt to revitalize Japan. He called it “Abenomics”. And there was a lot of suggestive imagery built to support it. Abe talked about arrows in his quiver and how they would reach their targets. But it simply did not work.

And yet Japan is a highly advanced industrial democracy, with many world class companies, a modern state, and lots of highly educated people. Nonetheless, Abe’s Grand Plan, did not work. There is too much inertia, there are too many political, institutional and cultural obstacles. The Japanese people are unable to get out of their complacent, (and in the end self-destructive), mind set.

Now, if modern Japan cannot quickly embrace and own a vision of vibrant change, what makes Prince Mohammed think that sleepy Saudi Arabia, a country in which most people do nothing, (large numbers of foreign workers have been hired to perform most tasks), while oil money subsidizes the entire economy and society, will do much better?

In Europe, welfare reforms almost impossible

Welfare and subsidies create dependence. Of course, in theory it is possible to wean people away from dependence on public largesse. But it is extremely difficult. Look everywhere.

In Europe all entitlement programs are essentially untouchable. Greece had to get all the way to the edge of the abyss before any political leader would accept the notion that the government had to reduce unaffordable social programs.

In other words, it took complete financial ruin before real reforms (this means cuts) could be contemplated. And even under those extreme circumstances reforms were fiercely resisted by most citizens.

Better results in Saudi Arabia?

Given these examples, one needs a truly heroic level of optimism to believe that Saudi Arabia will eagerly embrace change and quickly transform itself into some kind of Big Singapore in the Middle East.

This is a country that lives under a heavy blanket of religious conservatism. It is an absolute monarchy in which basic human rights are unknown. Women are second class citizens. It is a nation where, beyond oil and refining oil products, there is essentially no other industry. And this is the soil where the leaders want to plant the seeds of innovation and modernity? Good luck to them.

May be in 20 years

Look, assuming a perfectly modulated plan and a 20 to 30 years time horizon, some real changes may be possible. But the impression here is that Prince Mohammed is in a hurry. The perception is that we wants everybody to get busy, right now. *"Give me a private sector-led, non-oil economy, today".*

So, here is the thing. It is good to have bold dreams of modernization. But in the case of Saudi Arabia, this new reform plan looks a lot like lunacy.

Emerging Markets Crisis Dragging Down The Global Economy

WASHINGTON – Will emerging markets in crisis drag down the global economy? Probably not. But they have added and will continue to add to the negatives.

Enormous debt

Consider this. According to the WSJ, *“foreign banks have lent $ 3.6 trillion to companies in emerging markets, and foreign investors hold, on average, 25% of local debt in developing economies”.*

Now, a lot of these credits were used to finance added production capacity in key commodities producing industries. But we know what happened. China, after its fantastic, multi-year buying spree simply stopped buying. China cannot absorb more.

And therefore commodities collapsed, dragging down all the investors, and those banks that financed them.

Ripple effects

That said, it is important to note that this negative trend is not confined to the companies operating in the sectors directly hit. It also affected other unrelated sectors that were hoping to ride the wave of economic growth fueled by the extra revenue created by sky-high commodities prices.

For instance, the WSJ points out that *“Indonesian telecom PT Trikomsel Oke Tbk. nearly doubled its debt from 2012 to 2015, as it rushed to open hundreds of retail stores across the country. But the firm’s revenue collapsed after growth in South-east Asia’s largest economy fell to six-year lows” .* Now the company cannot pay back its bonds, “and already defaulted on $ 460 million of its debt”, according to the same WSJ story.

Well, this means that there are huge ripple effects, not limited to Indonesia. Indeed, Japan’s Softbank Group, an investor in PT Trikomsel, is now taking losses on account of this failed growth strategy.

Widespread damage

And this is not an isolated case. The outlook is equally grim for Brazil, South Africa and Australia. So, here we go: bad debt, financial losses, bankruptcies, lower revenue, growing unemployment. Is this mix deadly? Probably not. But it is bad both for the countries affected and for the world.

Emerging countries now account for a larger percentage of the global economy. Much was said about how a new, self-confident middle class capable and willing to spend on more cars, and more consumer goods would help boost the global economy. Well, this will have to wait. These countries are in serious trouble. Amid crises and depreciated currencies, the new middle class is a lot poorer, these days.

So, what does this mean for the global economy? It means another wet blanket on growth. The commodities producing countries and their lenders are in trouble because of lack of demand. This means that they will buy less from the West. Lack of demand in China and elsewhere means lower growth in Brazil. A poorer Brazil will buy less from Europe or America.

China drags down all its foreign suppliers

By itself this would be bad, but not catastrophic. But here is the thing. China financed its gigantic investment spree with astronomic levels of new debt. This debt will never be recovered, simply because the investment-driven bubble burst.

So, what does this mean? Well, China sits on enormous cash reserves, so it can weather the storm. Still, this capital will be used to plug holes rather than fund productive investments. As China slows down, its under performing economy drags down all the Asian countries that have become an integral part of China-centered supply chains. Think South Korea, Taiwan, Thailand, and also Japan. Their exports to China are down.

Is America insulated from all this?

Where does this leave America? Much has been said about the fact that the US economy is not so dependent on exports. Many US firms trade domestically, say between Connecticut and Colorado. Not many depend on exports. And US banks are not exposed to Chinese debt.

Still, as the whole world slows down, rather fast, can the US be the only island of growth and prosperity? I doubt it.

“The Economist” Mocking China

WASHINGTON – It is no surprise that The Economist‘s cover this week is about China. The Shanghai Stock Market is almost in free fall, notwithstanding highly publicized state interventions (unthinkable in real market economies) to stabilize share prices. And we know about the zigzagging yuan, China’s currency, in the midst of what appears to be policy confusion at the Central Bank.

“Everything’s under control”

But what is interesting is that The Economist chose mockery, as opposed to a serious, even dramatic title, to depict the situation. The cover shows a drawing of a dragon with a totally terrified expression racing downhill (to nowhere), while a disheveled President Xi is struggling to stay in the saddle. The title says: *“Everything’s under control”.*

This is important. The Economist‘s editors could have chosen a different cover to introduce a story of serious economic troubles in the world’s second largest economy. For instance: a picture of a stern looking President Xi, with a title saying something like: *“China in peril?”.*

Satire, not reverence

But no, they chose mockery instead to portray a deteriorating economic situation. Well, this may not be the most irreverent satire. But it is satire nonetheless.

And I think that this needs to be noted, because of the sharp contrast with the almost reverential tone of most China coverage that used to be the norm until recently.

In awe of China’s leaders

Indeed, until not too long ago, most western media were almost in awe of China. After all, this was the country that had done the impossible: 30 years of uninterrupted growth. Imagine that: 10% a year added to GDP, year after year. No other country had done that.

The Chinese technocrats in charge of economic policies were depicted as all-knowing, super smart technocrats, armed with refined long-range strategies that we mere mortals could not even begin to comprehend, and the super human gift of infallibility.

Show the cracks

Well, now there seem to be huge cracks in the splendid Chinese economic edifice. The meteoric rise is over. In fact, more and more western business media openly say that most likely the real rate of growth in China is much lower than the still more than respectable 7% (if it were true) officially declared by Beijing.

Publish the bad news

There seems to be less reluctance to publish “the bad stuff” that at least indirectly contradicts official rosy numbers. For example: in 2015 there have been 2,774 unauthorized strikes in China. This is up from 1,379 in 2014, according to The Economist. These strikes (all of them illegal) are a sign of growing restlessness, possibly of major troubles brewing. And, by the way, the authoritative Caixin survey of the manufacturing sector just recorded the 26th consecutive month of decline.

Clueless leaders

Let's be clear. Nobody is suggesting that China is about to fall apart. But it is suggested, in fact declared, that China's heroic days are over. It is also argued more or less openly that the Chinese leaders are sometimes clueless, especially when it comes to managing financial and monetary affairs. As The Economist put it in the same issue:*"The past six months have been hard on the reputation of China's economic managers. Their attempts to bring troublesome stock markets to heel border on slapstick".* **"Slapstick?"** Yes, this is comedy, not tragedy. Hilarious levels of gross incompetence.

And, finally it is taken for granted that the Chinese publish inflated growth statistics that nobody believes anymore.

Now it is alright to mock

Well, I think that when it becomes alright to make fun of completely humorless leaders who want to be taken very seriously all the time, then we enter a different dimension.

The cartoon message is that these stern looking people who want to appear in serene control of everything in truth do not know what they are doing, while they deliberately lie about the extent of their problems. Sure *"Everything's under control"* –they tell us– while the scared dragon races downhill, towards nothing.

Meaning: *"Sorry guys, we do not buy the old super-performing China story anymore".*

This hurts

I believe that this scared dragon cartoon on the cover of one of the most influential news magazines in the world hurts more than any title that would criticize the merit of specific economic choices.

This cover story does not say that China is pursuing wrong-headed policies. This funny cartoon says that this a bunch of clueless amateurs, clearly out of their depth.

I am sure that to be dismissed with a laugh hurts a lot more than to be criticized.

The China Myth is officially dead; and Thank God for that!