

The Continental Economics Institute Currency Review

2012 - World Economic Outlook

The year 2011 will be remembered as the year of the European sovereign crisis. This crisis is not yet over. On the contrary: The risk for 2012 is that the European crisis will spread across the globe. The stagnation in Europe and the United States will continue. Along with Japan the major world economies are in crisis. Step by step this crisis is also affecting emerging markets.

Economic Growth

The economic crisis shows up as a sovereign debt crisis. Yet the source of the current economic misery is the crisis in the housing market of the United States. The debt crisis is the consequence because the outbreak of the financial market crisis in 2008 has led to exorbitant spending by governments at the same time when the revenue from taxes fell because of the recession.

The effects of the global crisis are most disastrous in the periphery of the eurozone. Greece is experiencing a deep recession and is unable to pay its debt without help from the International Monetary Fund and the bailout fund created by the European Union. The conditions posed upon Greece require a sharp cut in public spending. This way the financial crisis produces also a social crisis.

A debt impairment of the larger European countries would exceed the capacity of financial aid from the IMF and the European Union and cause extreme turbulence in the global economy with the consequence of a deep recession in the global economy.

The negative expectations hinder economic activity not only in countries in crisis. The prospects for a rapid recovery of the global economy remain negative.

At the end of the year 2011 there were some indications that perhaps the U.S. economy could be on the road to recovery. But there is lack of a solid foundation for sustainable economic growth in the United States. The U.S. economy still suffers from deep distortions of its capital structure and the burden of public and private debt in the U.S. is worse than in Europe.

International trade

The need to put an end to the international trade imbalances as they show up in the figures of the current account balance of payments in many countries hampers the prospects for international trade. A large part of economic growth in China depends on the external sector. In order to maintain a surplus in foreign trade requires deficits in other regions. In the past it was mainly the United States that absorbed the Chinese surplus. Because of the stagnation in the United States and Europe, China is faced with the challenge of finding other destinations beyond the advanced countries.

The urgency of reducing public debt requires compensating the weakness of domestic demand with exports. Thus, new conflicts in international trade are programmed.

Among the first manifestations of the more confrontational environment in the arena of international trade were the complaints about a "currency war" launched by Brazil. The concern that some euro zone countries could abandon the common currency adds to haunt international trade.

Inflation

Despite extremely expansive monetary policies implemented in the United States, Europe and Japan in an effort to contain the global financial crisis, inflation is still relatively mild. The U.S. central bank continues to practice a monetary policy that

combines interest rates almost at zero percent with quantitative easing and activity monetizing U.S. public debt. When the European sovereign debt crisis began to affect countries such as Spain and Italy, the European Central Bank has also initiated a program to monetize the debt by purchasing government securities of countries that experienced a high rate of interest in the process of refinancing their debt. Thus the global liquidity remains high and this increases the risk of inflationary consequences in a dimension that could become very difficult to control in the future.

From now on the anti-inflationary forces will operate with less impact. The factors which helped to contain inflation in the past decades such as strong productivity gains that came with an avalanche of new technologies, the intensity of global competition and the supply of cheap labor especially in China and Eastern Europe, are losing steam.

With the shift in favor of monetary policies to fight the recession together with the weakening of technological progress and the use of the supply of cheap labor close to its limit, global inflation will be on the rise.

Markets

The auctions of debentures of Germany and Italy in November 2011 showed that not only the small countries of the periphery are in danger. It is likely that this trend will continue during 2012 and lead to a climate of anxiety with higher interest rates in the United States, Japan along with the countries in Europe. This scenario could become even more problematic when the credit contraction is accompanied by rising inflation. This type of environment will not allow a major rise of the prices of financial assets. Selectivity will be increasingly important. The market is in the process of becoming highly heterogeneous producing an almost irrational coexistence of extremely overvalued assets alongside highly undervalued asset.

The current crisis shows up as a public debt crisis, but the deeper cause lies in the monetary system of today. The monetary system of fiat money allows an indebtedness of the economy beyond its capacity in the long run. A monetary system without anchor contains the tendency to produce one bubble after the other.

For decades, financial markets have had the feature that when one bubble was imploding, another bubble was already in the process of inflating. As of now it appears that we are near the end of this roller coaster. While in the past the motto of success was to go with the masses and follow the herd, now the same motto is a recipe for disaster. While in the past it was a good bet to expect subsidies and bailouts from the government when things should go wrong, one will wait in vain in the future. While in the past government bonds were the safest bet, such an investment has become high risk now.

Currencies

It is remarkable that the euro exchange rate has remained relatively stable despite the almost hysterical pronouncements of an imminent demise of the European monetary union. This bodes well for a new phase of strength of the euro once a more rational assessment of the situation will set in. With rising interest rates in the major economic areas, the attractiveness of emerging economies will fall and with it their respective currencies. This holds particularly for those emerging economies that have experienced strong overvaluations of their currencies in terms of purchasing power parity. Among the major currencies, the US dollar is about to suffer from the over-easing of the US

central bank. There is also a high probability that the British pound will decline because of the isolation of Britain in the European Union.

Conclusion

Almost all governments are technically bankrupt. This is the big difference that marks the new period. The role of the public sector is beyond its zenith. A radical change of policy and of society and consequently of the financial markets is on its way. The next battle of this revolutionary process has already begun. This battle takes place in the arena of money about the establishment of a monetary system that would operate without state intervention.

Antony Mueller, CEI, December 2011