

Economic outlook for 2012

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The global situation:

Europe cannot survive in the long-term. It does not matter how many people desperately want it to, it defies the laws of economics. You cannot strap a bicycle to a car and keep driving; whether you will kill the cyclist or the attachments break, is irrelevant – it does not work. Most people in New Zealand are bemused at how the whole European integration project survives, or how it happened in the first place; it must be remembered that after World War Two most Europeans desperately sought integration as the best way of avoiding being invaded yet again; they were happy to sacrifice their nationhood for a certain peace. European integration is a giant industry; honest figures are impossible to unearth but four years ago the core of the EU alone employed over 55,000 staff, most of whom were some of the best paid bureaucrats on the planet! Now a hundred thousand pen-pushers are fighting potential redundancy with all their cunning and that is why there is so much resourcefulness, ingenuity and blind faith in every latest sticking-plaster arrangement that comes out of Brussels..

Why has the issue evolved the way it has? It has been progressed by a series of downward steps – a classic case of the situation forcing the decision:

1. An indebted country needs more money
2. Traditional sources will not oblige
3. A stop-gap is found, increasingly recycling the same money or printing more making the situation worse - but no longer imminent
4. The leaders have another summit and pledge a little of their own money and hope for enough from somewhere else – and yet more austerity
5. They announce a grand plan
6. Return to (1)

So why can the European leaders not sort the problem out?

1. They cannot pledge any more of their own money because it will reduce their own credit rating.
2. Their voters (or constitutional courts) will not allow it.
3. Too much austerity will strangle their economies.
4. They are incapable of effective tax collection.
5. No-one else wants to lend them any money – when the 1 trillion EFSF was announced in November, they went cap in hand to China, Norway, Qatar, Singapore etc. – all the sovereign wealth funds. Be honest, would you lend a country in Europe some money right now? Should your super scheme do it?

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Why are the commercial institutions who seem to control the issue so reluctant to drive home the final nail in the coffin? Firstly they are benefiting from the increased margins they can justify – and secondly they need time to extract themselves from the areas of potential fallout – as much time as they can. Graphs of exposure to European debt read like president Obama's popularity ratings, high on the left and going down over time with a fierce slope. So this debt is being held by less and less parties (and the IMF) as everyone (who is able to) ducks out of the house of cards, leaving the ECB lending to European banks who then lend to European governments who, if they were a mortgagee would be deemed unable to pay – no wonder the ratings agencies disapprove!

In other currency unions, mobility of resources balances out differences in productivity levels. In the US, jobs – and therefore people – move from state to state as a consequence of relative economic health. This option does not exist in Europe; Greeks and Danes do not, will not and (due to language) cannot up-sticks and relocate to act as a balancing factor. The focus on austerity, correct though it is, overlooks the fact that if you purge a country's cost base by axing spending you must replace that demand due to increased competitiveness. In this instance, that can only happen as the Euro slides and slides. If it slides and slides, who will want to hold it?

In a nutshell, it does not matter how much people want something to work, if it is impossible, it will not work, no matter how unthinkable the consequences. **So it will fail**, the only questions are how and when. There are sliding scales of how painful the split will be, how quick the process will be and how fragmented the end result is, and those are, it must be confessed, beyond the ability of this consultancy to predict with enough certainty to stake our name on it. We hope it is soon, so the consequent recovery can start as soon as possible – which is brutal but better.

What will happen?

There will be two 'shock waves' following the primary event – the first will be almost immediate and will see a seizure of finance for a few weeks, similar to 2008 but better controlled (by dint of being anticipated). This will not be as bad as it sounds because a lot of planning has gone into it already. The second will diminish global demand and be more like the falling of the tide than a tidal wave. The good news is that while Europe and European firms will be hampered by legal complications and austerity for some time, the resources they would have consumed will be eagerly consumed elsewhere (see below).

We talked last year about the world needing inflation. The IMF's Quarterly Publication, *Finance & Development*, talks about 'financial repression' which is when governments implement policies to channel to themselves funds that would otherwise go elsewhere. High reserve requirements, implicit caps in interest rates, directed lending by captive domestic audiences and a whole host of other unseen tools allow governments to drive down their debt by creating real world inflation and underpaying for sovereign debt. If governments make real interest rates negative (which they are) it is in effect a tax – subtle, effective and necessary but a tax nevertheless.

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(NB this is an unstated reason why the Europeans want to stamp on the City of London – it acts as a competitor and obstacle to the financial repression they have exercised for decades)

America might rally behind Mitt Romney and elect a man who can sort out its problems, but the chance of his wheels coming off at some point are still significant. The American political system is broken as irreparably as the European financial system; the process of 'Gerrymandering' has created an electoral system where the vast majority of electorates are a certain victory for one side or the other. Therefore the main intent of the candidate is to win as much of their party's support, rather than moving to the centre. American politics is so polarised now that the lowest number of Bills ever have some element of cross-party support, by a considerable margin. In order to be sure of winning the Republican nomination, a candidate must have the kind of line on guns, abortion, gay marriage that makes them unlikely to be open-minded about other matters. This polarisation leads to fanaticism – neither side listens to the other and sees dissent amongst its own as heresy; most Republican voters have such a blanket opposition to raising taxes they will not permit it even as part of a package to close loopholes – even though their tax code is now 3.2 million pages!

The American economy will gradually improve this year but the rise in their currency (due to the demise of the Euro) will hamper their manufacturers just when things start to look better – so whilst it won't be doom and gloom, the US economy is not poised to be the engine of global growth. One step forward, one step backward..

Luckily, given the above, there is the rest of the world and even though China and Russia might be faltering, India continues to march onwards along with Sub-Saharan Africa which is showing record levels of growth (despite Zimbabwe and South Africa). This is the year – nay the decade – of the G20 country and expect the likes of Turkey, Indonesia, South Korea, Brazil and Thailand* to power ahead and drag with them many of their neighbours. Europe's lack of demand will help these countries more than it will hinder them and the rise of their own domestic consumer will be a regional boost and drive global demand for raw materials. There is not the space or need to go into developing economies in too much detail, but there are a good number of larger countries who are doing well through efficiency, enthusiasm, and innovation.

** Not actually a G20 country but similar to the other examples and one of several economies that are almost big enough to warrant inclusion – while opinions differ slightly, there are roughly 32 larger economies in the world and in the above we are referring to that group less China, Russia, Europe and America.*

And here in New Zealand:

European suppliers

This advice is taken from the Outlook last year, when we had the courage to say:

If you deal in the Euro you simply cannot afford not to plan for its collapse. Consider the potential and likely impacts on your supply chain (or customer base) in the event of:

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1. *Price uncertainty*
2. *Currency collapse (would your suppliers run out of their raw materials)*
3. *Interrupted supply*
4. *Strike action*
5. *Inability to conduct financial transactions*

To that we would now add a year later, avoid entering into contracts in the Euro if it can be avoided, or ensure that some provision is made for an alternative currency.

Cashflow.

The BMC did worry that January 2012 would be as painful as January 2009 for some businesses, but it has proved smoother than that. We hope to see things loosen off slightly during the year (see domestic demand below) and would hope that our banks (who are to a degree insulated from the European shock-wave) will have the courage and decency to leave matters as unaffected as possible. A tall order, some might say.

Christchurch

There are two questions to be answered about the fate of the garden city: Will it ever stop – and will the much-vaunted construction bubble ever come? The BMC is pessimistic about the end of 'aftershocks' (see below) and is concerned that safety and insurance concerns could see the rebuild take place in dribs and drabs, especially if further after-shocks continue to change the perception of where is and is not safe to build. This is a situation where there is no right answer and the government will be all too aware that its handling of this matter could well define their next election campaign. We suspect that it will not be until the tail end of 2012 that the industries who will supply this re-build will enjoy a decent amount of uplift; it will take longer than everyone imagines, not for the first contract, but for the certainty of further ones.

Farming

Take comfort that the lousy weather this holiday has improved household balance sheets (by reducing spending) and added a couple of billion dollars to our balance of payments. Fonterra was on track to add 10% to last years supply (March year) and anyone who has a garden will know that the two days of rain, two days of sun cycle which has lasted since early Dec is amazing for growing – especially grass. As the G20 (32) countries mentioned above continue to bloom, expect New Zealand's primary produce to find new markets in ever more growing regional economies. This is good for us and will ensure that farming pumps a large injection into the economy this year.

Export

This is the decade of the G20 countries (and a few more who almost make that list) – New Zealand exporters (and their suppliers) should be looking at Mexico, Turkey, Indonesia, Canada, Australia, South Africa (with caution), Brazil etc. etc. Imagination is the key to success in externally focussed businesses; many export statistics will look completely different by 2020!

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Wise non-exporters will position themselves in the value chain of productive, export industries as areas of natural growth, and away from fickle internal consumer-driven demand, where possible.

Internal demand

There are some indicators that internal demand is now rising, albeit only in some sectors – and many of those sectors (such as some aspects of residential construction work) have structural constraints or can access unused resources in neighbouring sectors, meaning that over-heating is unlikely. Retail demand will continue to stay muted; household balance sheets may be partially restored but underlying consumer confidence is literally less reckless than it was five years ago, and as a result consumption habits have changed.

The BMC hopes that the positive effects of Christchurch and farming will lead to a strong performance from the third quarter onwards; that investment in plant and people will lead to a higher velocity of money and ambitious budgets for the year ending March 2013. Unless the fall of the Euro happens by then (or its fall is more a gentle lowering to the ground, which we consider unlikely) then internal demand will be a gentle upwards slope, with Business Confidence returning after the first quarter uninterrupted by bad news.

In summary, there is growing internal demand (albeit with considerable sensitivity to negative events) – expect slow growth in the first two quarters then much stronger from July onwards. When Europe goes, expect it to halve the growth for that quarter and take a quarter off the growth for the subsequent quarter.

Further seismic activity

As a client remarked cheekily to The BMC recently, *if it was your wife/husband/mother-in-law who was grumbling away like the seismic activity is around Christchurch (and other parts of the country), you would think the worst was still to come*. While The BMC does not offer geological forecasts as such, we consider the chances of further activity substantial (in some form) and urge all businesses to:

1. Revisit their risk management
2. Consider their crisis management
3. Revisit their insurances critically

Currency

With so many things in the melting pot, it is a hard task to forecast a major currency for 2012 let alone ours with no control over its own destiny! Good primary produce and Christchurch insurance funds will prop the currency up; demand for raw materials (when Christchurch rebuild starts) and global currency shocks will all push the dollar down. The BMC's advice would be to take cover on anything beyond the immediate as most of the currency swings this year will be prompted by events beyond the ability of our clients to foresee accurately.

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What you should do

Risk management

Every business should undergo a rigorous annual Risk Management Plan which examines not just the things everyone expects but starts by establishing the key Processes and Resources and then considers what might happen. This should produce a list of actions to eliminate, minimise or mitigate risk which the business can choose to accept or defer based on a cost-benefit analysis. This Operational Risk (the risk that something which worked yesterday will not function today) is considered separately from Strategic Risk – the subtle change in markets, value chains or other parts of the economic environment which affect the future health of the business.

Crisis management

The first few hours can save – or doom – a business. The BMC defines this as follows:

A Crisis is defined as an issue which has consequences beyond its direct ones (especially as a result of human, reputational or capacity damage). It is usually major or catastrophic in consequence, time-critical and the eventual outcome can be considerably affected by actions taken immediately.

For some businesses - those whose staff (or customers) could be endangered by product failure, time needs to be spent planning for the immediate consequences.

Sales planning

Sales has been aptly described as 'The transfer of enthusiasm from the seller to the buyer' and now is an excellent time to dust off the list of lost clients, missed opportunities and 'what-ifs' and take an acquisitive, imaginative approach to the year. Plan sales campaigns, plan to revisit prospects you have not succeeded with and plan for an element of change in your current customers. Identify what is new or uplifting about your business and what it offers and make it a mission to transfer enthusiasm for that to everyone in your market place. 2012 is the year for being positive and your sales plan should reflect that.

Consider impact of regional powers having greater influence on markets

As more countries thrust their way onto the global trading stage, expect opportunities (and competition) – and alternatives (especially to European suppliers). Consider all the components of your value chain and look at the emerging economies to see what might be done (Indonesia is not that far away).

Market overview – adjacent opportunities

In conjunction with the above, look at the fringes of your markets – the related products, similar customers, congruent processes – and try to identify options for growth – or collaboration - for 2012 – and then pursue them.

There are lots of reasons to be optimistic – demand will return and despite a couple of shocks 2012 will be a strong year. Be positive and be imaginative!