Avalon Perspectives

2022 Part 2: Whither The Global Economy?

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2022-Part 2: Whither the global economy?

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In Part 1, Cyrus the Virus waxed eloquent on the pandemic, its origin, and the prognosis for the future. Dr Minto Freeman, the monetary economist, tried in vain to get his views heard but you will read about his thoughts significantly in Part 2 of the Report. In both Parts, things that are widely known, are not discussed even if important.

The story so far:* *The world is witnessing the end of the pandemic and start of an endemic Covid, when we will live with it like TB, Malaria, etc. We will witness periodic spikes which will hurt but hopefully, the world will not be frozen in fear despite whatever future damage emerging variants of Covid do.

Raj: Now let's discuss economic, social, political, and other predictions for 2022 while avoiding aspects that are well-known. Allow me to set the economic context. The world can expect a nominal GDP growth of 9.3 to 9.5% in 2022 but how does that help anyone unless we talk about a little detail called inflation? You cannot ignore it anymore. It has already come back to bite and will reduce the Real GDP Growth substantially. For instance, it is more than likely that global inflation in 2022 could be about 4.5 to 5%. So, the Real GDP growth may be only about 4.2 to 4.5% in 2022. That is not bad at all, going by long term averages, though is lower than the 5.7 to 5.8% expected in 2021. Many countries will move closer to the pre-pandemic growth trajectory, but many will be left behind.

Minto: The monetary policy adopted by the OECD will determine the inflation and thus the Real GDP growth in……

Cyrus (impatiently): The issue is not inflation but how you will deal with asset bubbles caused by the rising asset price inflation. Your monetary policy for saving the world from me, has created new monsters which can burst. If a bubble is allowed to burst suddenly, you will have global chaos. On the other hand, you could gradually reduce external policy pressure on the bubble to prevent it from bursting suddenly. However, that will slow down the economic recovery.

Raj: How real is the danger of the bubble burst?

Minto: Oh, that is very real. Look at Real Estate in China. See what unrestricted debt has done to Evergrande. That is why the US Fed and the Bank of England have signalled in advance by warning of 3 interest rate hikes before end 2022. So, less shocks. I know that you had predicted just that in your last year's paper though many economists, including I, had denied the possibility before H2 of 2023. With inflation raging high and asset prices shooting up, there is no option but to reduce liquidity and raise interest rates in a calibrated manner.

Raj: What calibration has China done to ease the supply chain-led inflation and stock market worries?

Minto: Nothing really except where it helps their manufacturers push out good to their ports. But they have applied curbs on big users of power, overnight. They systematically killed tech companies in online tutoring and took the mickey out of ecommerce giants whose proxy shares were listed outside China. There is some weird thinking behind all that. That has delayed supply-chain normalisation.

Cyrus: You free marketers in the West will never understand the virtues of solving economic and social problems before they hit you in the face. You conveniently blame the periodic bubbles and crashes as an inevitable part of capitalism. Freedom and regulation must go hand in hand. Social goals are supreme, they can't be decided by market forces. That is what China is doing.

Raj: Is a crash unavoidable, be it stock markets, real estate, gold, cryptos, credit, or whatever? What happens to the Dollar and countries that have a hoard of dollars? Any surprises in store?

Minto: Anything that soared irrationally 2021 will settle lower when the normalcy is restored but a big crash is unlikely. Crazy IPO valuations are not here to stay. The madness in many parts of the World, including India, will abate when equity is no more the only show in town. When interest rate rises are forewarned by the Regulators, as is now the case, the stock market discounts pricing in advance, and the attractiveness of debt improves. Many overvalued stocks will dip without bringing the whole market crashing down. Tech stocks have started correcting in the US as will some life sciences stocks soon. Some bears like Jim Rogers will scare you out of your pants about the 'biggest crash of our lifetime', but it is not imminent in 2022 if what Cyrus says about the pandemic is true. The stock markets in Argentina, Brazil and Pakistan are showing extreme weakness (MSCI Index is negative in the last week of 2021). They may struggle in 2022.

Real estate is an asset class which is local, as is its bubble formation. It has global implications only when there are global financial assets built on it, as it was between 2005 and 2008 distorting the normal real estate demand and supply, leading to the Credit Crisis of 2008. Normally real estate is a poor yielding asset whose attraction is raised when interest rates drop substantially or when supply is constrained. Bubbles developed in China, S Korea, etc., heated up in North America, and hardly moved in some parts of India. It will cool down proportionately in 2022 given the imminent rise in interest rates. China, where a quarter of the personal assets of its citizens is parked in real estate, is likely to make heroic efforts to save its citizens from slaughter while letting real estate tycoons and their paper wealth slip down the tube. As for other assets, when uncertainties reduce and the global economy is picking up, I don't see why Gold should not decline in 2022, nor do I see an immediate reason for the Dollar to weaken despite the US having become the most indebted nation in the world. Not till China and Russia find a way to reduce the Dollar's role as a global Reserve Currency.

Cyrus: I have travelled across global markets, have seen humans attach value to assets that have no fundamental value. Diamonds and gold, get some attributed value as a safe haven when other assets fall. But stay away from Cryptos till some such value association evolves. It’s a pure speculative asset till then. They have lost a third of their value from the peak in November 2021.

I agree with Minto that increase in interest rates and decrease in Central bank sponsored liquidity if done in a calibrated and transparent manner will help to prevent a bubble burst by giving investors and speculators time to move out of vulnerable assets without panicking. Some countries like Turkey, will pay the price for lack of transparency.

Most investment assets will witness volatility with a little help from me and inept policy makers. Omicron is not the last mutation. I saw SPACS doing well in ASEAN in 2021. Will they be the flavour of 2022?

Raj: Let’s not go there. Regulators have virtually killed the growth of this controversial fund-raising model in the US and recently, in India too. It will evolve into a more sensible and transparent avatar but not in 2022.

Will there be a move to bring some equilibrium in global supply chains soon? Disruptions have played havoc with inflation in general and with freight rates.

Cyrus: I will take that because I am the one who has travelled all over the world in that past 2 years. I have seen that 20% of the world container ships are stuck in ports due to delays. Since this is not a structural increase in demand, the overall production of new containers is not being increased. Given that the total number of containers is finite, freight rates have shot through the roof. The rates from China to Dubai have risen 9-fold! Further, the demand for consumer goods seems to have shot through the roof during Covid for want of other entertainment, etc. Lifestyle has changed. At the same time, producing factories especially some small ones have shut shop, some channel members have closed, etc.

I see disruptions wherever I go. I also noticed that in many developed markets, the inventory held by retailers has dropped. In the US, the ratio of inventory to sales is likely 1.15:1 at end 2021 as against about 1.4:1 in normal times. This has created problems in the mix of inventory as well. Hence ordering discipline has gone haywire globally, says one of the Chinese suppliers whom I infected during the Delta wave. I see this supply chain problem persisting deep into the year before easing in Q4 2022. The world of buyers and suppliers want equilibrium to be reached soon; only the logistics folks want this situation to continue.

Minto: As economies normalise, the demand for services like entertainment, vacation travel, etc., will come back and reduce the overspend on consumer goods. That will reduce the load on supply chains. There are other challenges too. It will hurt poor countries who primarily supply commodities and raw materials even more. India is saved by the robust IT and ITES sector, besides the retail sector is coming back well.

The semi-conductor shortage cannot be solved quickly in 2022 but the supply situation for commodity chips will ease a bit in H2. The world is going digital more rapidly than before the pandemic. Over 160 sectors including ecommerce, automotive, mobile telephony, laptops and servers, medical devices, industry 4.0 and even normal digital transformation, etc. have raised the demand for semiconductors. No one anticipated this surge before the pandemic. In 2021, the demand growth for semiconductors was 4 times the estimate of 6.3% made Semi-conductor Industry Association in 2019. So, this problem will flow into

2023. TSMC which accounts for over 25% of the world's chip production (and 70+% of all sophisticated chips) has plans, besides normal expansion, to start production at new sites in Arizona (USA), Japan and Southern Taiwan with an outlay of $100 billion but stable output will be seen only in 2024. Do you know that the auto industry is glaring at a huge loss of sales in 2022 despite the growing vehicle demand? If you own a vehicle, look after it with TLC, the waiting time for new cars has already shot up in many countries.

Raj: The trade war between China and the US has hurt global trade. Will military conflicts like China- Taiwan, Russia-Ukraine, Israel- Palestine or ISI- Rest of the World put pressure on Supply Chains in 2022?

Cyrus: Not significantly. I have seen leaders of most countries from close quarters. China plays the Taiwan card partly to right a historical hurt and partly because it would love to get all the entrepreneurial talent and technology in Taiwan. If the CCP rattles Taiwan's cage from time to time, it can keep its domestic constituencies happy. An invasion will bring the US and Allied Forces into play. The CCP cannot risk having too many Chinese body bags.

In Ukraine, Putin and his Generals want to ensure that there are non-NATO buffer States around Russia. The huge military build-up is just a negotiating strategy to make the West agree to not admit Ukraine into NATO, and to also impress the military staff on whom Putin depends. Inside the Kremlin, they are not serious about invasion, because they will immediately lose their bargaining chips. Since the Pentagon understands it, the White House has been rejecting Putin's offers. Their troops are welcome to stay on the border, the winter will be tough on them, and it will be expensive to maintain supply lines. The US wants something else. More on that later.

Raj: So, no real danger on those two fronts. What about the Middle East? Will the Saudis compromise and isolate Hamas and Iran?

Cyrus: The Israeli lobby had brilliantly got the US in 2021 to forge an alliance between them, the UAE, USA, and India. Those ties are set to improve in 2022. Qatar is also tacitly in the grouping while staying out. The thawing of relations between the Israelis and the Saudis is evident from what I am seeing in the King's Palace. MbS is still looking for a straw to hold onto before he can formally swim into that camp. That can happen if Hamas can be brought into the Saudi orbit. Once that happens, it will be easier to negotiate peace between Palestinians and Israelis. India and UAE can also be used to negotiate with the Palestinians, but Iran will block all attempts to rope Hamas in. If Russia agrees not to supply arms to Iran but is allowed to sell to India by the US, it can weaken Iran without Russia not losing much. That may be the Ukraine deal. But Iran will need to be taken out or mollified and Russia needs to be under pressure, for which oil prices will have to fall to $ 60. The stumbling block is MbS who wants a price of $ 70+.

The low-key indirect talks between Iran and US, on restoring the Nuclear Deal started last week and is expected to continue in the early weeks of the new year. The Iranian side is taking a tough stance, insisting on first removing the economic embargo reimposed by Trump. OPEC's worry is that Iran will add 2.1 million barrels a day to the market in addition to the 0.7 million barrels per day that already find their way out of Iran at present. US and Israel are worried about giving Iran that additional economic clout.

If my Omicron version scares the day lights of the World for long enough (unlikely, though, for long), oil prices could drop. By March, Expo 2020 will be over in Dubai. If oil prices decline by then, UAE could mount pressure on MbS to let them produce more oil. A possibility of oil falling to the low $ 60s, exists only if politics meets economics.

Minto: Whenever energy costs exceed 5% the global GDP, oil prices correct. That will keep a cap of $ 75 per barrel and could push it down. But I will not speculate since oil prices are very fickle.

Raj: 2021 was the year of IPOs. What about 2022?

Minto: Yes, IPOs raised USD 450 billion globally in 2021, a 60% jump over the previous year, and there are analysts who expect a repeat in 2022.

Cyrus: May be, but debt issues will take some share of it once interest rates rise.

Raj: Let me add an Indian perspective. IPOs raised USD 17.5 billion in India this year through about 65 IPOs. If you think it's a rare frenzy, spare a thought for the line-up in 2022 when probably USD 26 billion is hoped to be raised. The elephant in the room is LIC which alone may raise USD 10 billion. Others include NSE, Ola Electric and other stars. But these lessons of the last couple of months will sober the valuations. That leads me to the Indian Government's policies and the Budget on February 1. With LIC and other disinvestments on the cards, we can expect a capital market and investor friendly Budget. The Government desperately needs funds to be able to spend on social welfare to set up the ruling party for victory at the hustings in 2024. Since the following two Budgets will be soft, they will raise taxes affecting the Middle and Upper classes in the 2022 Budget in ways, which only unimaginative number-crunching minions can, but which our bureaucrats are prone to endorse without learning from the myriads of complications and contradictions that fly in the face of the policy guidelines for ease of doing business, etc. that will be announced by the Prime Minister. They will just give it a glossy look.

The RBI will raise interest rates in 2022, in sync with global trends. Banks in India are flush with funds but nowhere to lend. Housing, retail, and mid-corporate loans will increase but let's wait for the Budget announcement.

Raj: Too much dependence on China for global demand and economic growth. Any way out of this on the cards? Your views, Cyrus, since you originally hail from China, and you are active there right now.

Minto: This is better answered by an economist than by a virus. The world is addicted to China for affordable goods, for investment and now for many interesting digital services. The US had a two-way trade of $559 billion with China of which $303 bn was the adverse balance of trade. While the rest of the world ought to be delighted if that trade deficit is taken away and distributed amongst them, the reality is that they could probably not be able to afford to take that business at the Chinese prices. The US consumer will not be prepared to pay extra to save the world from China. Imagine, just 40 years ago they were not addicted to Chinese goods! A theoretical solution would be to raise import duties on Chinese goods. The EU could selectively do that, but it will be difficult to get a consensus. The US is wary since data shows that 90% of the additional cost of higher import tariffs were borne by US importers, and not shared 50:50 by the Chinese exporter lowering prices a bit and the importer picking up half the tab. The Chinese were guided by their government whereas the US thought it shouldn't, in a free market.

As for broken, indebted countries around the world, when Uncle Sam, the EU, and the IMF were looking the other way, China was like a White Knight coming with technology, expertise, workers, and funding to build badly needed infrastructure for them. It is popularly argued that the recipients will have to sell their soul to the Chinese Government in the process. What soul? In most cases, their souls had departed a while ago because of the inequity of the 'generous' world. America once generously carried China on its shoulders because of foresight blinded by the potential lucre. Now China is cunningly sitting on America's head.

There could have been a monetary policy solution to this but ……

Raj: Sorry. I conclude from all this is that dependency on China will continue for a while, China will do what China always does but there will be no conquest of Taiwan in 2022 and Ukraine is safe for now. The ME will slide towards peace with Israel, etc. Looks good for the global economy. But will there be no new wars to keep the military industrial complexes in the US and Russia alive? Will any of that impact energy prices?

Minto: The conspiratorial link between war and the military industrial complex will ensure that Iran will be on the boil, Afghanistan will not fade, and new theatres are opened in South America and probably in Africa. The Saudis will be advised by the US to quietly buy sophisticated multi-purpose equipment to defend their huge new cities, with the money saved by not having to fund Arab wars against Israel. None of these will likely impact energy prices, except temporarily, because oil trade routes may continue unhindered. Spurts in economic growth are likely to impact energy prices more than these skirmishes. A strong dollar may also cool oil prices, as could, the activation of the Russia- Germany gas pipeline, if it happens. In an ideal world, the US would like oil to be below $ 60 to make the Russian economy shaky.

Raj: Any political leadership predictions for 2022?

Cyrus: Xi will be raised to a higher exalted position when he completes 10 years as the Supremo in November despite lack of transparency while the Democrats could lose the House of Representatives due to America's transparency. Macron is likely to win the election since he handled the economy reasonably well during Covid whilst Boris Johnson's fate is a toss-up because he made a mess.

Me: None of that will change the course of the global economy. With this background, are now all set to discuss the brass tacks. Minto, what is your estimate of growth for major economies in 2022? I know that it will be slower than those in 2021 because the catch-up growth phase is almost over

Minto: Before, I state mine, let's look at Morgan Stanley's expectations and a Consensus estimate obtained by them. See Table 1. They are in the ballpark. My estimates which are shown alongside, are only slightly different in some cases. I would rather go a bit deeper to explain the situation going forward.

Table 1. Real GDP Forecasts (Y on Y %)

GDP (%Y)	Minto 2022 E	Other 2022E		2023E	
	Minto	MS	Consensus	MS	Consensus
Global	**4.4**	4.7	4.3	3.8	3.6
G10	**4.0**	4.4	4.0	2.9	2.2
U.S.	**4.2**	4.6	4.0	3.7	2.4
Euro Area	**4.4**	4.6	4.3	2.5	2.1
Japan	**2.6**	2.9	2.6	1.6	1.3
UK	**5.0**	4.6	5.0	1.6	2.0
EM*	**4.7**	4.9	4.6	4.5	4.7
China	**5.4**	5.5	5.0	4.8	5.4
India	**6.5-7.5**	7.5	6.8	7.3	7.2
Brazil	**1.5**	0.5	1.0	1.8	2.0
Russia	**2.7**	2.7	2.5	2.5	2.1

Source: Minto Freeman, Bloomberg, Haver Analytics, IMF, Morgan Stanley Research (MS) forecasts. Note: Aggregates are PPP-weighted. Brazil consensus number taken from BCB market expectations survey. China consensus reflects a subset of peers.

The biggest lesson from the Pandemic is that aggressive Monetary Policy saved the world as much as hospital care, oxygen and vaccines did. It was not Keynesian economics. The rich countries had a more robust and deep financial system which gave them the flexibility to create oodles of liquidity and they did so quickly. They lowered interest rates to almost zero to take away the risk of borrowing, and created huge liquidity to make it possible for banks to lend, borrowers to invest in business, for consumers to fund their daily spend, etc. In the US, we launched schemes by the sack-full, with an Alphabet soup of 15 schemes with names like PDCF, MMLF, SRO, FIMA, ISL, etc. to ensure that the pandemic induced lock down does not kill the US economy and we even helped some other Central Banks for borrow temporarily against their US Securities, so that they, in turn, could fund their own Banks. They proved once again that monetary policy can determine GDP growth. Developing countries, including India, with much shallower financial markets, weaker banking systems and greater supply-side constraints, obviously could not do as much. They paid a price with poor to tepid economic performance over the two years. Every country tried to infuse liquidity, and many, have seen undesirable asset price bubbles develop.

The real GDP will be in 2022 will depend upon how each country manages to control inflation which would offset the nominal growth and more importantly, how they manage bubbles. Not every country is willing to share their long-term Central Bank plan to restore normalcy of liquidity and interest rates. It will be easy for New Zealand, the UK and Sweden but Central Banks in Russia, Japan, Australia, and Switzerland are not known for much transparency. Erdogan in Turkey has an additional problem that he does not understand and does not let experts take decisions. I expect Australia and Switzerland to grow by about 4%, Russia about 2.7% and Japan to do about 2.6%. However, China has slowed down, their Belt n Road project has taken a beating of late, their drive for more FDI wrapped up in diplomacy is evident, but Xi has made his intent to take control over the internet giants clear, under the guise of his 'common prosperity' goal. He knows how Western MNCs wag the tail of sovereign Western nations, when it comes to economic policies, regulations, etc. Xi will not use soft gloves while dealing with big business.

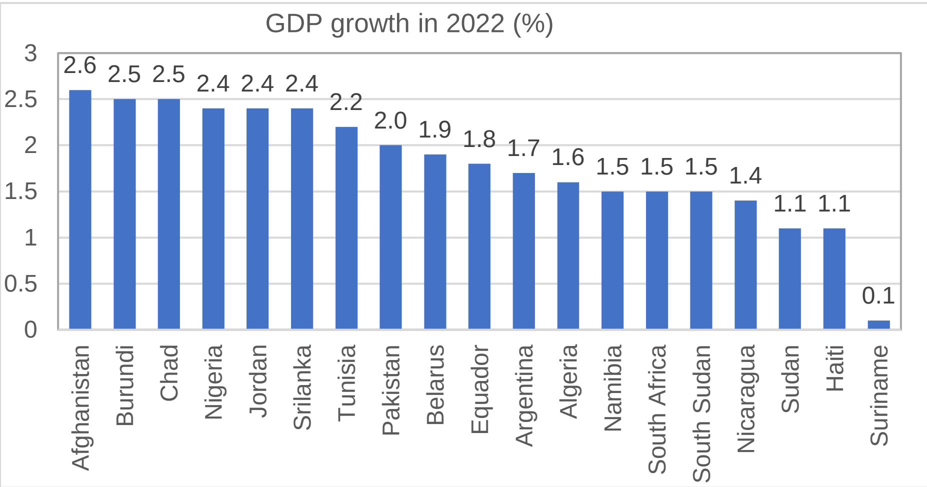
I have given a range of 6.5 to 7.5% for India else you will jump at me. There is a need for more private investment to breach the upper limit. It is actually a good time to place plant and machinery orders at highly discounted prices for capital intensive projects because demand will cross the pre-pandemic levels in 2022 in many sectors.

Raj: That's not good but are there other big concerns?

Minto: There is a structural problem indicated by the narrow gap in GDP growth between Developed Nations (4.0%) and Emerging Markets (4.7%) in 2022. It's not been so low for decades. It looks more serious if you take China out; EM growth will fall to 4.2%. The pandemic has hurt badly. A structural solution is required. Even the BRIC story is damaged, not only is the expected growth of BRICs only 5.1% but it does not even look like a logical grouping anymore with Russia and Brazil almost in another orbit with 2.7 and 1.5% expected GDP growth respectively.

You had rightly predicted that the rich will get richer, and poor will get poorer in your paper for 2021. The picture looks dismal for poor countries in 2022. See Table 2 below.

Table 2: Projected GDP growth for poor and developing countries



These countries need at least 4% growth in the short term to survive and 6% for the next 5 years to grow out of the mess they are in. Covid and other local issues have flattened them in the recent past. There could be riots, social turmoil, coups, and even huge migrations from those countries to developed nations which will have to choose between illegal migration and economic aid. Without international aid they will become a bleeding sore for the better off nations.

Raj: Finally, since technology has impacted the economy heavily in the past decade, a quick look at technology is warranted. Several new technologies are waiting to take off. My readers know about most of them. Since there is space only to discuss one, how about Metaverse? It's going to be fantastic but when it is fully fledged.

Cyrus: I ran into Zuckerberg, Satya Nadela, Tim Cook and Sundar Pichai whilst they were waiting for a Congressional hearing. What I heard from them was all bull… Far from reality.

Raj: But that's what Metaverse is supposed to mean- a Universe outside the real one. It will be quite a while before it gets created to a degree of 'fullness' but in the meanwhile, even the early building blocks will do wonders for us. If poets are licenced to imagine the impossible, and painters are lauded for progressing from calendar and classical art to impressionism, surrealism, cubism, and abstract, why don't you want to be transported by technology into a metaverse which can open many potentially useful solutions?

It can change ecommerce, social media, education, art, tourism, entertainment, manufacturing, industry 4.0, quality control, maintenance, etc. Further, its development will be less like the evolution of the computer or automobiles, and more like how the digital camera started as an inferior quality, low pixel camera to one that soon delivered high quality images that killed film cameras. We will see the confluence of the principles of classical physics, quantum mechanics, and reality through advancements in AR and VR tech devices, better chips, 5 and 6 G internet penetration, sophisticated software including block chain, holo-transportation, etc. You will be able to send your avatar to a meeting with real people in another city, quickly switch to the OT where your wife is delivering a baby and when that is done, switch to a physical meeting with your team. In 2022, you will be able to do some parts of it using devices which are available currently or awaiting launch but three years from now the experience will be good and by 2030 it will be excellent. You can already attend meetings with Avatars using FB's Horizon Workrooms using Oculus VR devices. Microsoft's 365 Connected Spaces allows companies to connect and engage with their retail outlets or warehouse or factories during an office meeting far away. Gaming is where many of the revolutionary work will happen first. There are many companies in the fray, not just Facebook and Microsoft. Example: Unity Technologies, Nvidia, Epic Games, Matterport, Fastly, Roblox, DraftKings, etc. So, the play has started, and some applications will hit the market in 2022. Can businesses afford to wait endlessly for the perfect moment or jump into the fray now as users and as beta sites for testing and codeveloping applications? The winners will not wait nor will leading research-based technology universities.

Minto (overwhelmed): This calls for rethinking by economists. I am not ready yet.

Cyrus (worried): Is there room for RNA/DNA viruses in your Metaverse?

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