GLOBAL
ECONOMY

3/18

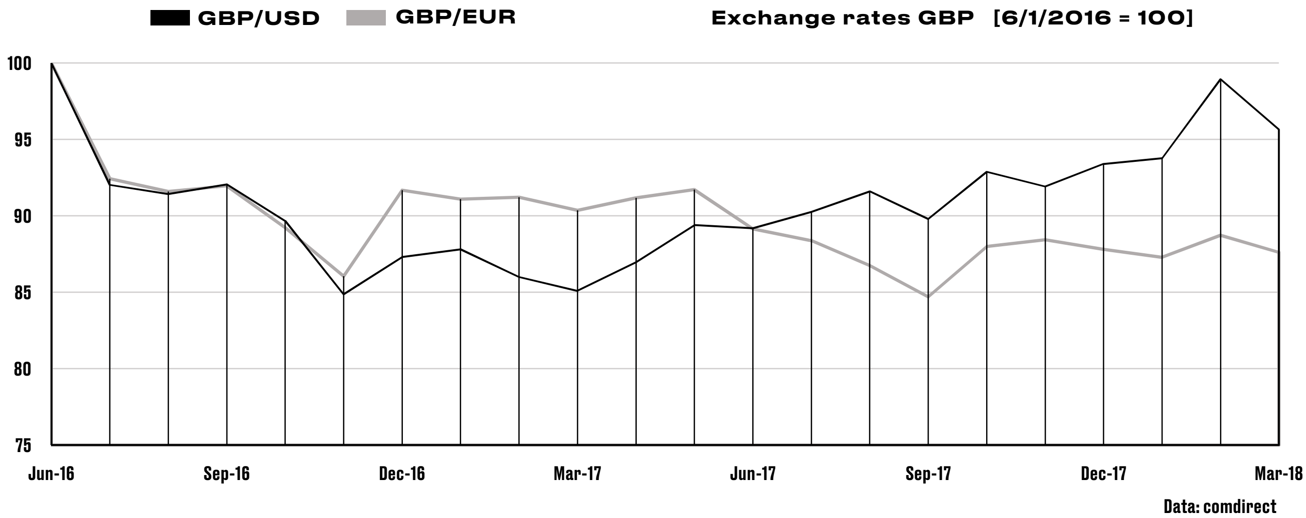
Fraud and rotten debt increasingly threaten India’s state banks

Returning volatility about to push Yen higher

J.S. Research

Cabinet in open infighting as EU rejects UK 'cherry-picking' approach

The Prime Minister's word is up for debate – that is how far Theresa May has come Remember her speech at Lancaster House last year, where she vowed to take Britain out of the Single Market and the customs union? Well, particularly the latter has become the central point of haggling between Remainers and Leavers in Cabinet, with the Chancellor of the Exchequer and the Home Office Secretary favouring to remain within the customs union (which is the new policy of Labour, too), while the Foreign Secretary and the Secretary of State for Trade are opposing it. Time and again the Cabinet has been failing to reach a shared position on the subject which is part and parcel to the UK's strategy in the second phase of the Brexit negotiations. The linchpin meeting of the Cabinet Brexit committee at Chequers has failed to bring a material change, while that tug-of-war is overshadowed by a more or less concealed jockeying of individual ministers to position themselves to succeed Theresa May. Yet the customs union is not the only bone of contention. Backbench Brexiteers, now officially led by the rising political star Jacob Rees-Mogg, are threatening open rebellion over the mooted standstill or "off-the-shelve" transition, where Britain would have to implement whatever new laws and regulations the EU might pass without having any say in it. In the eyes of the vociferous Brexiteers, that would leave Britain as a "vassal state" (Rees-Mogg). With regard to future trade relations, too, there is a mighty clash between those in favour of a "blank-sheet" approach where to start the UK's trade relations with the EU from scratch (favoured by the Brexiteers), and those advocating a status quo, opt-out approach where all existing agreements with the EU would be checked on an individual basis (favoured by the Remainers). The final shot came when some 60 backbench Brexiteers wrote a letter to the Prime Minister demanding a clean break from the EU and "full regulatory autonomy". Ironically, the letter pinpoints Theresa May exactly to her position presented in that very Lancaster House speech mentioned above. Just as we have been projecting since last year's election, the Conservatives are falling apart over this epochal struggle. At the risk of repeating ourselves, this makes a collapse of the government before the year is out very likely, some way or the other. Over in Brussels, the picture isn't any better. The British side has added



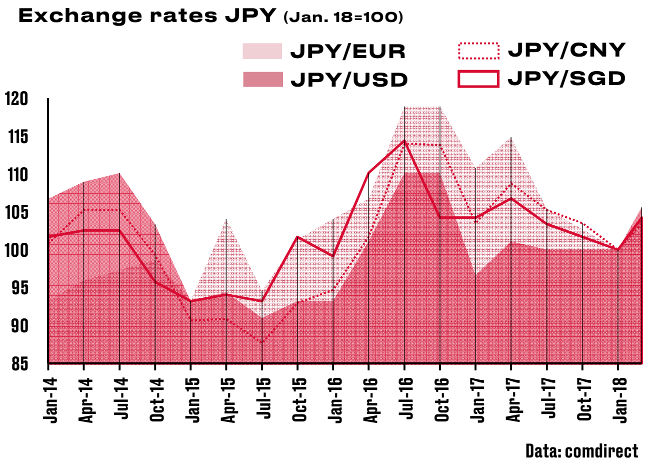
further tension to the talks by "exploring" options to avoid automatic, mandatory implementation of new EU rules during transition by obtaining the right to "vet" those first. The reaction of EU officials was unequivocal that this was but a waste of time; the EU's chief negotiator, Michel Barnier, reiterated this point later, demonstratively backed up by Germany and France. Nevertheless, No. 10 seems intent on bringing up the point during this round of talks in Brussels, if only to placate the Brexiteers in Westminster. It is increasingly hard to see how an agreement on the presumed done deal of transition shall be reached in time until the end of this month.

Indian state banks increasingly threatened by fraud and rotten debt

It is a problem about three years old now and has indeed featured already in this report (see issue 11-12/16); yet instead of improving, it appears to become ever more threatening: India's rotten commercial debt. In a mixture of profligate funds dispersion by the mostly state-owned banks in order to support the investment agenda of Narendra Modi, the Prime Minister, without much regard for credit quality, and positively fraudulent behaviour on the part of borrowers, the stranglehold of what is euphemistically termed as "non-performing assets" has been tightening from year to year. The most recent, prominent case of the Punjab National Bank falling prey to fraudsters at the jeweller chain Nirav Modi is only the tip of the iceberg: According to the Reserve Bank of India (RBI), some \$10bn of credit have been obtained in a fraudulent way – mind, that is the figure for the state banking system only, and valid for just 15 out of 22 banks into the addition with the others' numbers either unknown or undisclosed. The total of rotten commercial credit in the Indian economy amounts to roughly \$120bn, out of \$413bn – a whopping 30 per cent (as of March 31, 2017, the latest available statistic by the RBI). Small wonder, then, that credit growth has been a meagre 5.8% of late. This latter statistic shows the deleterious effects of bad debts weighing on the Indian economy: The level has become so high as to choke the supply of new credit, again regardless of its quality. Foreign banks, too, have been affected by the mess, with some institutions facing write-offs in excess well of 20 per cent, further restricting access to liquidity for business domestic and foreign alike. Yet so far, the government has been shirking wholesale reform, instead buying time with trickles of recapitalisation for the state banks. Yet if the current development continues, lending will grind to a virtual halt eventually, with dire consequences for an economy very much dependent of bank financing. As long as this issue is not solved, we expect the Indian economy to continue its comparatively subdued growth in the recent past, even if the fourth quarter of last year might have brought some (fleeting) improvement. It does not help that against this backdrop, India has reinstated tariffs against a range of industrial and agricultural products just last month. Apart from its other detrimental effects, protectionism will have a negative impact on export/import financing as the corollary of trade in goods and services, and thus dry up access of Indian banks to foreign liquidity further, just when they are in particular need of it.

Yen's status as safe haven will see it appreciating with volatility returning

It is one of apparently most counterintuitive currency developments this year: the appreciation of the Japanese Yen. Since the beginning of February, it has been steadily rising against not only the US-Dollar (which could be waved off with reference to the weakness of the greenback), but against the Euro, the Chinese Renminbi, and the Singapore Dollar, too (see chart). All that has been happening against the backdrop of the all but certain reappointment of Haruhiko Kuroda as the outspoken dovish governor of the Bank of Japan (BoJ) and an increasingly uncomfortable Japanese government carefully sounding off first statements of concern about the unwelcome strength of Nippon's currency. So what's going on here? In spite of Mr Kuroda's staying at the helm of the BoJ, some traders and analysts credit the Yen's strength to expectations of monetary 'normalisation' about to be also taking place in Japan sooner or later, with the central bank's policy as dovish as conceivable and thus prone to change tack in a particularly pronounced manner. We don't concur. True, Euro bulls for example got ahead of themselves, too, in expecting the ECB to tighten its policy sooner than originally anticipated – yet only to be disappointed at the end of February when ECB rate setters with, first and foremost, Mario



Draghi among them mostly reiterated their dovish stance for the time being, buttressed by abating inflation. And while as a matter of fact inflation is indeed rising in Nippon, it has not yet triggered the slightest change of tone by Mr Kuroda and his colleagues. In our view, that is simply because the Bank of Japan finally has got what it wanted all along: a reflationary environment with persistently high energy prices (see last issue of this report) and first tentative signs of price increases on Nippon's high streets, such as at popular food outlets. Rather than changing the minds of Japanese rate setters on presumably having reached their goal, monetary policy has just entered the comfort zone where it had been wanting to be ever since embarking on its enormous bond buying spree. From our perspective, thus, there is a zero chance that Mr Kuroda will switch to a normalisation of monetary policy this year already, as indeed he indicated at the beginning of this month when talking of Q2 in 2019 as the earliest date of exiting quantitative easing. In this, Japan's central bank displays many parallels to its Swedish counterpart, where investors likewise had expected the Riksbank way too early to drop its ultra-loose policy, only to be caught on the wrong foot in February, too (see issue 12/17 of this report). If at all, rate expectations hence are only the floor under the Yen. Yet decisive is the ubiquitous return of volatility to the world's markets, just as we had been projecting time and again in this report and in section 'Economic Ticker' on our website. After a downright soporific calm in the past year particularly, it has sprung back into life violently at the beginning of last month when US markets tumbled for fear of inflation and rising yields, taking down the world's equity markets with them. And just as reliably, the Yen has again emerged as the safe haven currency of choice. It is a recurring feature of the global economy that in times of financial distress, investors take flight into Nippon's currency. Now, volatility's violent jolting will prove to be not a mere flash in the pan; rather, its current levels are around its long-time average and will be upheld through the rest of the year. If political and/or macroeconomic risks such as a breakdown of the Brexit negotiations, a Eurosceptic government taking office in Italy, or a more pronounced downswing of the Chinese economy than anticipated come to happen, volatility will spike again and remain at yet more elevated levels. In these circumstances, the Yen's appreciating further might only be fended off by outright interventions of the Japanese government and the Bank of Japan, yet even then with limited effect for no intervention will be powerful enough to balance the hundreds of billions washing up at Japan's coast when fear rips through the markets. It is only against the US-Dollar that we expect a somewhat limited potential, simply because investors have oversold the buck heavily, underrating the Fed's determination to raise rates, and last but not least, the greenback's own status as a safe haven when the going gets tough.

Statistical Bulletin

FDI growth (y/y, nom., USD)

India (Dec.): +40 % → FDI growth in India jumped on a yearly basis in December. Compared with its long-run average, however, FDI levels merely showed a correction of their recent and just as volatile drop.

Brazil (Jan.): -44% → In Brazil, the statistic displayed just about the same swing, yet with the opposite sign, underlining that the economic recovery of the leading Latin American economy remains elusive for now.

Manufacturing PMI (Feb.)

Malaysia: 49.90 ↓ The manufacturing PMI in Malaysia dropped below the neutral level of 50, ranking the country among the very few with a PMI reading for the sector below that threshold.

Denmark: 69.38 ↑ Denmark provided the exact opposite picture, with the PMI booming to a positively prodigious level.

GDP growth (Q4/17, q/q, real)

Austria: +0.9% ↑ GDP growth in Austria continued to be robust towards the end of last year, confirming the country's status as one of the outperformers of the Euro Area.

Denmark: +1.0% → Again, Denmark showed economic strength in this regard, too. The Scandinavian country has thus been following its larger neighbour Sweden closely.

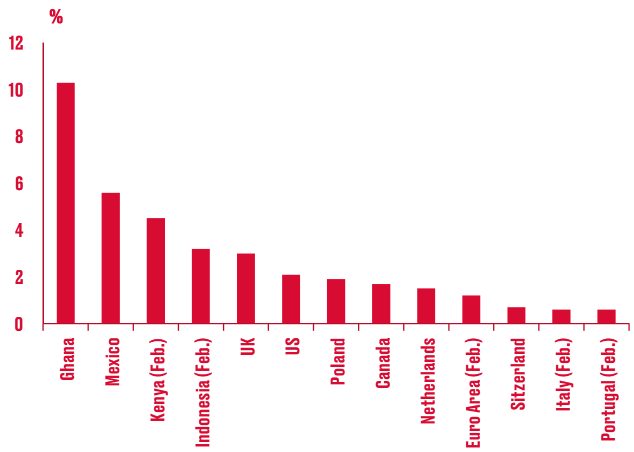
Consumer spending (Q4/17, y/y)

Canada (real): +3.5% → Consumer spending in Canada stuck to its robust levels, if levelling off for now.

Spain: +4.1% ↑ Spanish consumers, however, showed virtual ignorance of the Catalan secession crisis and continued to spend their money with full hands.

Inflation (March)

Inflation remains one of the blights on Ghana's economic success, although it has been tamed relatively already. Mexico's rate, too, is very high by international comparison, while Portugal might surprise most people by ranking at the very bottom.



Data: Trading Economics, bloomberg, comdirect, own calculations

Design concept: Firm | www.f-i-r-m.de

Published by J.S. Research KG
represented by Jakob Steffen,
owner & managing director
Dohlenweg 10,
D-42115 Wuppertal, Germany