GLOBAL
ECONOMY

8/18

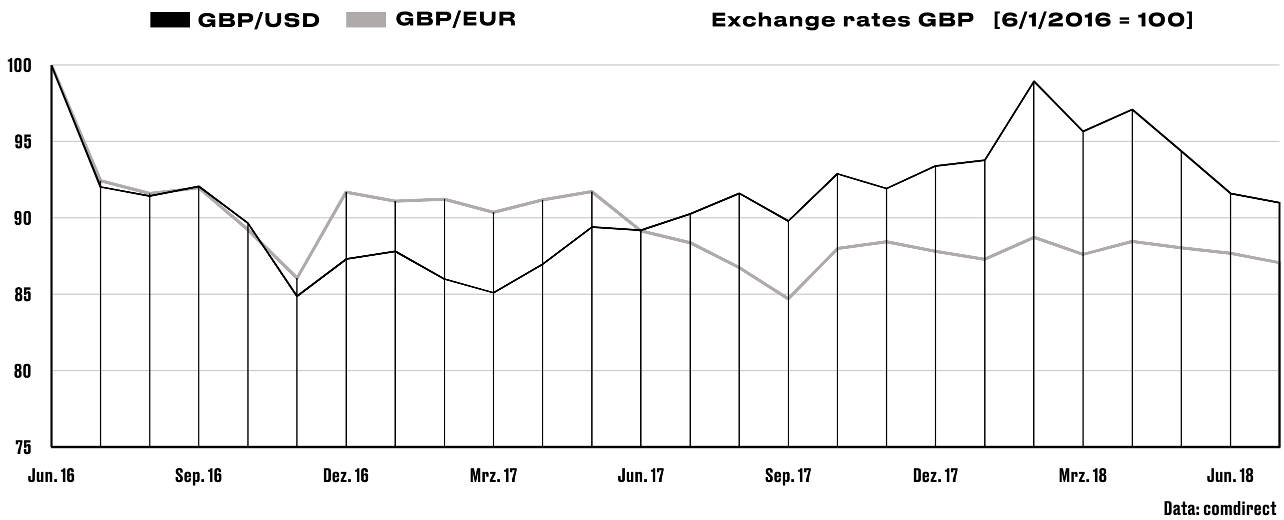
China's investment efficiency heralds end of growth by writ

Singapore-Dollar exposed to foreign exchange turmoil

J.S. Research

Brexiteers far from defeat as Britain is heading for no-deal Brexit

The last week of Parliament's sitting before the summer recess was telling in many ways – and, if anything, those illuminated as to why we have been sticking to our foreboding of a no deal-Brexit from the beginning of last year. How can that be, you might ask, when still so many commentators state the seemingly obvious, that there is a cross-party majority in the Commons in favour of a soft Brexit or even a Brexit in name only, where Britain would remain in virtually every tie-up with the European Union, the customs union and the Single Market included. Clamouring as they might, those commentators say, Brexiteers have lost their grip on Brexit and cannot, in any event, force the UK into a hard or even no deal-Brexit, for their sheer lack of votes in Parliament. The resignations of Boris Johnson and David Davis, the former Foreign and Brexit Secretary, respectively, are taken as proof that Brexiteers finally accepted they had lost to the business-minded likes of the Chancellor, Philip Hammond, and the Business Secretary, Greg Clark, whose preferences are embodied by the so-called Chequers agreement after the countryside residence of the Prime Minister. We cannot but believe this analysis to be mistaken, and gravely so. First, it ignores the merciless mechanics of party politics in Westminster only loosened in times of war so far. And second, it tends to take the compliance of the EU27 to rescue Britain from its self-inflicted brink of a no deal-Brexit as granted. The first point is essential to understand why, even though they might be in a minority on their own, the hard-line Brexiteers assembled in the European Research Group (ERG) within the Conservative Parliamentary Party have the numbers to threaten and push a minority-government into policies of their preference. In what might yet turn out to be the decisive moment when the chance of a Brexit deal was lost irrevocably, the Commons' vote on the bill regulating the UK's customs policy after Brexit delivered a prominent example for this power of Conservative Brexiteers. Fearing a defeat, the government gave in to all four amendments to its own bill the ERG had tabled. It did so fully well knowing that that, in turn, would incense the Europhiles among the Conservative benches – and it did. And yet, tactically the government called the right decision, since it won the vote on both the amendments and the bill, even though by the

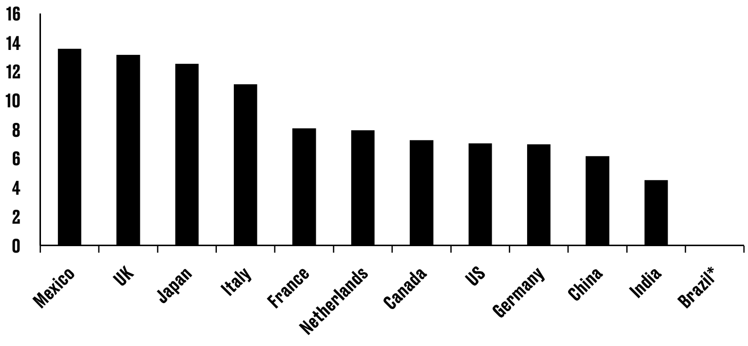


thinnest of margins. This simply means that, when crunch time is there, the Europhiles either lack the stomach or the numbers or both to defeat the government, and that the Brexiteers, by contrast, neither fear a downfall of the government nor lack the numbers to get their will – not least because more often than not, Labour Brexiteers have now voted with Tory ones than Europhiles on both sides of the House have been able to muster an alliance in favour of a soft Brexit. To surmount that double fault line between parties and Brexit factions, only a government of National Unity would help – i.e., a grand coalition. Jeremy Corbyn and the Labour top brass, however, are certainly not interested in propping up a Tory government which is, in their eyes, rife for disintegration. It may well be that this set-up of the Commons will lead into complete stalemate eventually – but to conclude from that a high likelihood that Brexit might be aborted completely is, in our view, wishful thinking. The reason for that judgement is the second point mentioned above: The assumed amicability of the EU27 should Britain out of a Westminster stalemate and yet another general election ask for an extension of the deadline running until 29 March 2019. For the EU27 to give its consent, all 27 member states have to agree to it. Not only is that rather unlikely, regarding, for example, France's determination not to let off the British from their self-created hook, even if that leads to economic costs for French businesses. It is also unlikely because such a process would, in any event, need weeks and weeks to be completed. Time, however, is in short supply from here, with the summer recess consuming another five precious weeks and Brexit negotiations nowhere near a timely agreement. The main reason why we do not expect at least that agreement to come about to potentially buy an extension of the deadline set by the infamous Art. 50 is – yep – the Irish border. After accepting those Brexiteer amendments to the customs bill mentioned above, which have made an exceptional treatment of Northern Ireland in terms of customs borders illegal, Theresa May positively challenged the EU to "evolve" its position on just that, i.e., the backstop agreed in last December. That explicitly stipulates for the no deal-scenario that Northern Ireland would remain both in the customs union and the Single Market to avoid a hard border in Ireland at any rate. In other words: By backtracking on its position with regards to the question of the Irish border as mandated in the already agreed backstop, the UK government has reduced its negotiation approach to a single, make-or-break issue. In the meantime, the EU has already refuted the Chequers customs proposal, approved by the Commons. Just recently, at least, Michel Barnier has signalled some leeway even in the most fiendish of quandaries, the issue if the Irish Border - ostensibly after the intervention of chancellor Merkel and other EU leaders. Hence, our base scenario remains a no deal-Brexit, yet the path towards it will probably change: We now expect an agreement between the UK and the EU, if only for a mighty fudge of all contentious issues to be settled in the coming negotiations on the future relationship until the end of 2020. That, however, will result in the most open of compromises standing virtually no chance in the House of Commons, which, in turn, will bring about the long projected general election. Time, then, will inevitably run out before any deal can be ratified until the end of March, 2019.

China's investment efficiency points to further trouble

A decreasing marginal product is not only a law of great significance in economics, but a matter of fact in virtually every industry particularly in manufacturing. By increasing levels of energy and other input factors, you will get an ever decreasing extra production – on the basis of a given technology, of course. That is why technological progress is of so paramount importance: Without it, the law of decreasing marginal product would have been exacting ridiculous levels of input just to augment a given level of macroeconomic output long since. Hence, on a macroeconomic level, the law holds as much as on the microeconomic one. A seemingly simple, yet insightful yardstick of efficiency of a whole economy's investment is the so-called incremental capital output ratio (ICOR), measuring a country's share of gross fixed capital formation in its total GDP as a multiple of the country's real GDP growth. Take India, for example: Its share of gross investments in total GDP is about 32 per cent; with real GDP growth at some 7 per cent, an ICOR of roughly 4.5 results. That is a fairly typical level for emerging economies with a still relatively low capital stock and thus relatively high levels of marginal product of investment, which, in turn, more often than not yields high real GDP growth. Advanced economies, by comparison, typically boast double-digit ICORs, simply because with regards to their relatively sizeable stocks of capital accumulated already, their marginal product of investment is meagre. Hang on a minute, you might say, what about that technological progress mentioned above? Well, that is exactly the great productivity debate of our day: After the enormous productivity boom of information technology and the internet, why is productivity growth so weak? The very same holds true for the marginal efficiency of investment, of course: Emerging countries with their huge potentials for improvement on the current technological basis still boast high levels of investment efficiency, whereas industrial economies right now need ever more investment to exact the same contribution to real GDP growth, which is why they have to have high levels of consumption compared to investment as drivers of real GDP growth. The ICOR, hence, is a very helpful tool to identify economies with relative inefficient compositions of macroeconomic demand. Take Mexico as another example: Though an emerging market without doubt, it sports an ICOR which much more resembles that of advanced economies. That is primarily because its real GDP growth is so weak, but

Incremental capital output ratio (ICOR, 2017)



*Brazil: negative growth, data: trading economics

also because its GDP share of gross investment is comparatively high at the expense of consumption. The UK and Italy are other such cases in point where industrialised economies, too, boast too weak a GDP growth rate relative to their shares of fixed investment levels. Now what about the elephant in the room, China? The country used to have an ICOR of around four, just like India mentioned above, and just what one would expect to find in an economy still very much undeveloped in its vast hinterland to the west of the industrialised coast region. But not so: Slowly but continuously, China's investment efficiency has been decreasing, simply for its sheer scale. The country still holds the absolute record among the G20 in the share of investment in GDP: A full 45 per cent of the Middle Kingdom's GDP is constituted by investment – so much for China's often erroneously touted re-pivoting towards consumption. Real GDP growth, alas, is falling, and it has been falling for years. Thus, ICOR has been creeping up and above six, and by all likelihood will remain climbing as the country undergoes a major financial re-engineering at the hands of the government, reducing real GDP growth in the process while simultaneously trying to prop it up by constructing yet more white elephants. Fine, but isn't that mere descriptive statistics? What's the matter if China's ICOR is deteriorating? The matter is this: There comes the day the government will no longer be able to prop up real growth rates by commissioning yet more investment, apart from the latter's increasingly unsustainable debt-driven financing for the same reason of a decreasing marginal product of investment. Thus, the ICOR is just another warning light of a likely hard landing of China's economy, flashing a very deep shade of amber right now.

Sing-Dollar no safe haven this time around

Just like the city state itself, the Singapore dollar often is a relative haven of stability in volatile East and Southeast Asia. In this regard only the Yen constitutes a competitor, though it, too, is prone to relatively higher volatility than the Singapore Dollar the longer the observed timeframe becomes. One might argue that this relative stability simply is the result of the Sing dollar's exchange rate being managed by the Monetary Authority of Singapore (MAS), yet that does not invalidate the stability itself: Firstly, management by the MAS will not stop any time soon because it is the authority's monetary policy instrument of choice. And secondly, being a major financial centre and creditor of the region, the city state's currency always is in demand when debtors rush to obtain it in order to meet their obligations in times of financial stress. This year to date, the Sing dollar has mildly appreciated against Euro, while it has lost some value against both the Yen and the US dollar. Its most remarkable development of late, however, has been that against the Chinese Renminbi, soaring over the past two months as the Chinese currency has been coming under pressure. This inevitably bears implications for monetary policy. Mirroring the global retrenchment of quantitative easing, first and foremost by the US Federal Reserve, the MAS has started a very gentle tightening on its own. Monetary policy in the Lion City, as stated above, is not being implemented by setting interest rates, but, rather unusually, by managing the exchange rate of the currency – undoubtedly the more effective instrument for a tiny city state with uninhibited external capital flows. For the first time in six years, this April the MAS increased the slope of its managed trade band within which it allows the Singapore dollar to settle. Since then, however, the threat of an all-out trade war between the United States and Singapore's most important trade partner, China, has escalated faster than most had been anticipating, while the Middle Kingdom's economy has been slowing down anyway. Indeed, this backdrop is the reason why in spite of Singaporean businesses keeping their good spirits for the time being, our economic indicator for the city state, the SiNGES has been being lacklustre all over the recent months (see our website). And outside of a sudden and complete truce between the US and China, it appears that trade conditions have overrun monetary policy, calling for anything but tightening. That said, the MAS is assisted by both the US dollar and the Yen about to stand strong, even though for different reasons. While the Fed keeps raising rates and the greenback gets strengthened by protectionism (in the short run, at least), the Bank of Japan has just tweaked its policy so as to gain greater flexibility in its yield curve management, in effect allowing for a stronger Yen than before. It is only against the Euro, plagued by political risk emanating from Italy and a potentially chaotic Brexit that the Sing dollar might be appreciating in the near future. If the MAS simply leaves its policy unchanged, it might thus effect less of a tightening it envisaged originally, yet only to the advantage of Singapore's economy about to be battered by trade frictions and lower export demand. In a worse scenario, it might even be forced to retract April's decision to raise the trading band before the year is out. Hence, rather than playing to its usual script of relative strength in times of trouble, expect the Singapore dollar to weaken in the months ahead, with its returning to the lows of 2015 and 2016 against the US dollar and the Yen, respectively, not too outlandish a scenario.

Statistical Bulletin

Industrial production (June, y/y)

Japan: -1.2% ↓ Industrial production in Japan seems to belie the country's recently bright GDP numbers: Growth stood at a full 0.5% q/q in the three months to June. Manufacturing and construction, however, have been the weak spot, with the Yen staying stubbornly strong and new orders oscillating wildly in the first half of the year.
Netherlands: -0.2% ↓ Industrial output in the Netherlands fell ever so slightly. Yet that worryingly appears to confirm a downward trend established over the recent past, perfectly in line with the much debated slowdown of Eurozone manufacturing down from its heights of last year.

Retail sales (June, y/y)

Czech Republic: +2% ↓ Retail sales in the Czech Republic saw their growth dented markedly, albeit to levels still strong. Czech consumers' confidence lost a bit of their recent froth, so that for the time being, there does not seem to be a new trend established, confirmed by still rising consumer credit.
US: +6.6% ↑ Americans seem not to be disconcerted by anything right now. The economy is booming, employment bouncing, and house prices are rising – consumers' purses, thus, are on a loose string.

Imports (June, y/y)

France: +7.3% (EUR) ↑ Imports into France took a mighty lift in June to a new all-time high, confirming the country's lately supercharged economic activity.
Turkey: -3.8% (USD) ↓ In yet another sign of brewing economic trouble, Turkey's imports have been weakening over the past months.

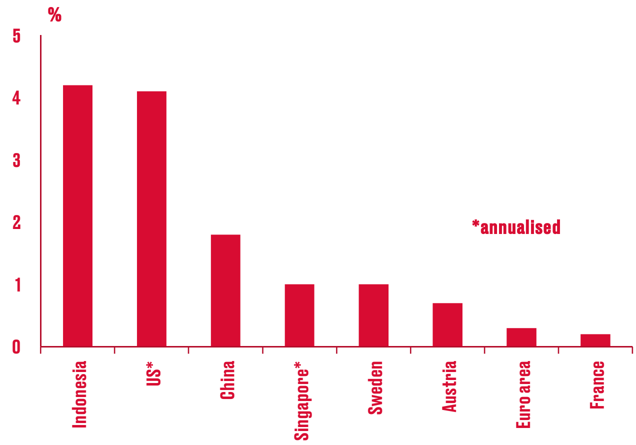
Terms of trade (June, pts.)

Australia: 87.70 → Australia's terms of trade are a victim of China's economic slowdown, due to the overwhelming importance of the former's mining exports. A currently weak Aussie-Dollar mirrors that conspicuously.
Mexico: 47.55 ↓ Mexico's ratio of export and import prices deteriorated further, with the country first in line to take a hit from Donald Trump's tariff policies.

GDP growth (Q2/18, q/q)

Economic growth was all but frothy in Indonesia, though the country's growth rate is prone to excessive swings. China remains decent for the time being, yet the slowdown becomes ever more visible. Sweden keeps its status as the star among industrialised Europe, yet followed closely by a very sturdy Austrian economy.

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**