

Decline And Fall:
The Dollar Faces An
Uncertain Future Page 26

Building Boom: The
Coming Infrastructure
Spending Surge Page 32

Credit Where It's Due:
Preparing For A Post-
Stimulus World Page 38

Survey: The World's Best Foreign Exchange Providers

GLOBAL FINANCE

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Looking Ahead

The Dawn Of
A New Decade

Page 18

2010
2011 2012 2013
2014 2015
2016
2017
2018 2019

38 Credit Where It's Due

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Credit Where It's Due

As governments around the world contemplate reeling in the financial lifelines that helped them prevent a global systemic meltdown, the prospects for credit growth in the coming decade are still unclear.

While a credit debacle, led by the US subprime meltdown, unleashed the global economic downturn in 2007, it appears a gradual increase in credit availability is contributing to a global recovery, albeit a painfully slow one. However, with much of the outcome the result of massive government interventions and stimulus efforts, analysts must now consider what the global credit markets will look like once government programs begin to wind down this year.

World governments, particularly in developed nations, responded to the financial crisis by slashing interest rates, injecting capital into their economies and boosting countercyclical spending. Such measures caused fiscal balances to deteriorate by some 3% of GDP last year in high-income countries and by an estimated 4.4% in developing markets. "The expansionary policies and financial sector interventions undertaken by governments and central banks over the past months should reduce the depth and length of the recession," says a World Bank report. "They also, however, will pose a challenge to economic management once the global economy begins to recover."

The World Bank also notes that governments in high-income countries have increased their stakes in the financial system to unprecedented levels, making an eventual return to private control of the banking system critical to reestablishing an efficient financial sector. It also suggests central banks will need to unwind their monetary supply expansion to curb inflation. "Reducing fiscal deficits to maintain debt sustainability will be an important political challenge," says the World Bank report.

Mark Esbeck, president of the International Network of M&A Partners (IMAP), a global organization of M&A advisers, says there is still a great deal of government influence in financial markets. "The outcome of such government interference or regulation is likely to constrain global credit and make it difficult for market participants to predict behaviors as the economies recover around the world," says Esbeck, noting it is more difficult to predict political reactions to changing economic circumstances. "The major issue is to address the 'too big to fail' dilemma that governments felt they were trapped into," he explains.

"Governments tend to be poor allocators of capital, and most economies will

work better to the extent the government stays out of lending decisions," adds Sam Katzman, chief investment officer at Constellation Wealth Advisors, a multi-family investment office in New York. "That is not to say that the intervention and special loan programs initiated by the central banks weren't useful. The problem is that once governments become involved, they feel it necessary to begin to impose their politics on the system," he says.

Some analysts say government stimulus packages could prove to be a double-edged sword. "Injecting massive monetary stimulus into the world economy is like taking huge doses of anabolic steroids into your body; expect urges to take risks that you would not normally take, and to have some body parts shrink, while others bulge," says Robert Smith, founder and managing director of Turan Corporation in Boston and author, along with Peter Zheutlin, of *Riches Among the Ruins: Adventures in the Dark Corners of the Global Economy*. He says shrinking body parts are a metaphor for the US dollar, while commodity prices, high-coupon currencies, debt and equity prices, and Chinese real estate represent the bulges.

"Investors, crazed by monetary steroids, are playing Russian roulette with a pistol loaded with duration and credit risk. Investors are crawling out farther and farther on the yield curve looking for higher yields; they are taking greater and greater credit risks just to get a few hundred basis points above the paltry yields of US treasuries," says Smith. He points to access to international bond markets by El Salvador, Angola, Nigeria and Vietnam, and the expected market return this year by Russia at just a few percentage points above US treasuries, as proof.

While developed nations are seeking record financing to support stimulus moves, the situation may not bode well for developing nations. "With developed world sovereigns borrowing up to \$12 trillion through the end of 2010, interest rates will eventually climb, making it much harder for emerging and frontier countries to borrow," notes Smith, adding developing countries could still pose interesting investment options for the future. "After the cloud of monetary stimulus is lifted, we will see that emerging economies, and even some frontier economies, could be excellent markets for mortgage and consumer credits," he says.

There are some potential pitfalls ahead. Ross Healy, chairman and CEO of Strategic Analysis Corporation in Canada, says the global credit market is being asked to support the US and other developed nations in their efforts to spark growth. "The greatest pitfall is that, in the end, the US deficit cannot be financed internationally and the US cannot stop running a huge deficit because to do so would be to abort what is passing for a recovery there," he says. "The US is in the same financial condition now as Japan arrived at back in 1996, and from which Japan has never recovered." According to Healy, Japanese government debt

has risen from 40% of GDP to 200% since 1996.

Steven Kolyer, capital markets partner at law firm Clifford Chance, says pitfalls will be in mature markets with "thin government financial wherewithal or low GNP but high levels of consumer debt." Kolyer nevertheless predicts opportunities will arise in certain undervalued emerging markets "where natural resources are abundant or where business growth in manufacturing and consumption is increasing to service new markets or better service existing markets."

The corporate sector credit outlook remains mixed. Kevin Gaynor, chief

capital formation—lending and equity investment—and not simply credit availability that will spark economic growth," he argues. "The developed world's household sector, which accounts for the lion's share of GDP, is characterized by a relative absence of creditworthy borrowers; hence, credit availability alone will not suffice to drive credit growth." He contends there must first be a deleveraging.

A report by State Street Global Advisors says 2010 will likely be the transition to whatever economic environment will prevail over the next decade. "With valuations in global credit and even equity markets no longer reflect-

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markets economist for global banking and markets at RBS, says there is currently a record corporate cash-flow surplus, as companies retire debt and equity at the fastest pace in 60 years. Those able to tap bond markets are refinancing at lower rates. "Whether the corporate sector in Western economies will come roaring back on capital expenditure, or whether they will continue to show restraint for another year or so, is an open question," says Gaynor. "It seems to us they will be very cautious about adding capacity, and so, while replacement capital expenditure and operating spend will no doubt increase somewhat, the demand for new credit is unlikely to be brisk."

Credit is not the only solution to the global downturn, according to Eiad Asbahi, CEO and managing partner at Prescience Investment Group. "It is

ing the risk of systemic failure, expected fundamentals should be the driver of financial markets' performance for the coming year," says the report. "Yet the massive amount of government support and stimulus dominating major global economies make the real state of underlying fundamentals difficult to discern."

The OECD raised its 2010 growth forecast for its 30 members to 1.9%, from an initial 0.7%, and predicts growth will be a higher 2.5% next year, following an estimated 3.5% contraction in 2009. However, the organization says it is time for economic growth, so far driven by government stimulus, to become self-sustaining. "It is now time to plan the exit strategy from the crisis policies," says Jorgen Elmeskov, head of the OECD's economics department, "even if its implementation will be progressive." ■