Europe? Don't Forget About the US and China

Much has been made in recent months concerning the issues faced in Europe. To be sure, the problems of Europe, both core and periphery, are very real. The economic fundamentals are frightening and obvious: sky-high unemployment, declining growth, capital flight, and declining wages have all become the norm in countries like Greece, Spain, and Italy. The political and social consequences may prove to be equally devastating, with protests becoming more frequent and severe as well as elections ousting many of the individuals who have been at the centre of the drama since it began. Volatility and uncertainty have increased notably in the last few weeks and many are predicting its continuation.

The premise of a scary outcome in Europe aside, there are a few greater issues which are receiving much less attention and, closer to home, will likely prove to have a greater impact. The United States seems poised for an extremely dramatic 2012 with a number of key items on the near-time horizon. Notably, the so-called "Fiscal Cliff", which represents a perfect economic storm involving the expiration of the Bush tax cuts, the end of a payroll tax cut, and the automatic spending cuts which are due to come into effect at the beginning of the year.

In isolation, these items could likely be dealt with by the White House and Congress in relatively short order; at the very least, the bandage solution can be applied for the near term. However, last summer's stalemate between a partisan Congress illustrated the precise difficulties that can impact the country. Take the enormous issues and complexities associated with the "Fiscal Cliff" and toss in a presidential election and you have a recipe for a tumultuous ride.

This, of course, says nothing about the debt ceiling debate that will also likely return to the forefront as the US government gets closer and closer to the upper limit. Most of us will recall the debacle that occurred last summer, with both parties in Congress arguing back and forth as well as the failure of the Joint Select Committee on Deficit Reduction, better known as the "Supercommittee". Most of us will also recall that this led to the historic downgrade of America's credit rating, no meaningful resolution, and the setup for a future showdown. Clearly, this is not in the best interest of the United States and its people, but it is hard to envision a scenario where such a polarized Congress can come to a unified and effective consensus in the midst of a Presidential election.

Perhaps more alarming is the prospect of a pronounced slowdown or even a hard landing in China. That slowdown is already occurring, with various downward revisions of growth estimates coming from a number of different analysts in both the public and private organizations of the world. Many forecasts put the estimate for Chinese GDP, which the Chinese have targeted at 7.5% annual growth, substantially below this target and slowing further.

The Chinese property market has also received its share of criticism, which the word "bubble" used frequently to describe the situation. Many commentators are accusing China of using property and infrastructure development to prop up GDP figures, a sentiment which may very well be close to the truth. Regardless of how the figures are derived, many point to the unaffordable levels of real estate now abounding in China, a country which, despite its meteoric rise, still has tens of millions of citizens in grinding poverty and average annual incomes of just a few thousand dollars.

The most frightening part, perhaps, is that all of these issues across the globe are interconnected to a large extent. Issues in Europe will quickly impact the demand for Chinese exports which will in turn impact US economic interests which will impact European economic interest, ad infinitum. This was quite clearly seen during the credit crisis of 2008 when global credit froze solid; the relationships between financial institutions around the world were revealed to be extremely connected and correlated.

Due to this interconnectedness, much has been made of European efforts to “ring fence” or isolate their banks from the issues in Europe’s periphery, but it is fairly obvious to even a casual observer why this is a difficult, if not impossible, task. Even if you could insulate a banking system from a Greek default or exit from the Eurozone, it says nothing of a Spanish, Irish, or Italian default on top of that. And even if banks can be isolated from sovereign defaults, it would be impossible to sidestep global, macroeconomic issues like declining growth or political upheaval in the United States and China.

Eventually, push must come to shove. The stimulus spending and bailout packages for corporations and sovereign nations have taken an enormous toll on the balance sheets of a wide variety of organizations over the last few years. Without at least moderate growth over the coming months and couple of years, debt servicing will become an even more paramount issue than it is right now.

Ultimately, the world currently has a great deal of debt and not much growth to service and reduce that debt. Greece is a prime example: given the incredibly large bailouts the nation has received, what is the expected payback period on such a staggering amount of debt? It is hard to imagine a situation where Greece even returns to a situation with growing GDP, let alone repayment of such debt.   And with fresh elections in Greece in June, we could just be a few short weeks away from the final act in the Greek tragedy.

Without a doubt, the issues in Europe are incredibly dangerous, but they must not be viewed as a strictly European problem, nor is this the only major economic power facing a difficult road ahead. China and the United States have their own obstacles to overcome, and while it is likely that the can could be kicked down the road, many observers recognize that we are starting to run out of road.