Steering the parallel economy

Time for a hard look at the navigators?

By Colin Coverdale June edition 2012 Paper 20

Some commentators have talked up the economy based on recent mining sector activity. The actuality is the non-mining sector in which most of us live is facing tight times without too much light at the end of the tunnel.

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Whilst we appreciate that surpluses expand general capacity and illustrate a healthy economy, the evidence is pretty thin when it depends upon one sector and is not indicative of the domestic condition. Everyone respects the contribution the miners are making however they are investing hundreds of millions of dollars on specific mining infrastructure which is then counted into the overall expansion. The Reserve Bank is rightly cutting rates on the one hand and warning of a fall in house prices on the other (which is already happening). However proclaiming the glass is half full probably makes some of us feel better but such comments come at a time when the real scenario is continued tightening.

It's obvious purchasing power is shrinking as plainly indicated by the continuing business failures and profit warnings from the retailing, manufacturing, tourism, property and construction sectors. Exporting businesses are preoccupied with the effects of the high dollar, whilst importers are now dodging the rise and falls in our currency to avoid being caught with exchange losses. We are told spending is down and that *"People are cautious because of the uncertain environment"*' and why wouldn't they be? However the brutal truth runs deeper as the general population is feeling. The future for the Federal Government is plainly writ unless they undertake measures to help hold costs, cut red tape and aid business and especially small businesses. For some politicians it must be like the boy with his finger in the dyke i.e. to pull it out lets the hole grow bigger. The analogy is that many an MP faces losing their job and must be in despair of finding a solution.

Baby Boomer clout running out

Unfortunately there are other factors at work which *no* elected party will be able to fix easily. The 800lb Gorilla in the room is the combination of the GFC plus the passage of the Baby Boomers through western society. The concern about this particular combination is it could spark a deflationary period. Deflation occurs when prices fall in response to decreasing money flows. Competition for revenue; trying to maintain profitability plus the need to reduce stocks depresses the business sectors. Without real growth in the domestic economy the process can become systemic and hard to reverse. Prices which have been artificially inflated during the boom fall as businesses price downward and asset values fall through lack of buyers and restrictions on credit. The effects can be quite concerning when mortgage and loan repayments remain the same but asset values fall. As businesses continue to cut prices in the low return cycle the stresses force them to find the lowest cost levels and this eventually leads to laying off employees. To illustrate; the Qld State Premier has hinted that 20,000 public servants need to be cut over the next two years to stem the financial haemorrhaging he has just taken over.

We are in the middle of a world balancing act right now because China is slowing, our high dollar is presently reconfiguring the export industry and in addition we face a new carbon tax, mining royalty (MRRT), rising utility prices and slowing property markets. I can't help but think the government is hoping everything will somehow solve itself if they talk it up.

The Reserve Bank will be well aware of the threats and will try to stimulate the economy by dropping rates; however there is no guarantee that will work. The purpose of rate cuts is to free up money so it can flow into the economy. This sort of manipulation is well understood but no longer guaranteed under current world circumstances. It has failed to stimulate growth in the USA and the same lesson has been experienced by Japan where the economy remained flat through the 1990's despite very low interest rates.

"They say I'm constantly screwing up. I call it being consistent."

It can be hard to crank up a recovery when an overburdened economy becomes focussed on debt reduction, savings and discriminatory purchasing. Sending cheques in the mail as the USA and Australia have done (and is doing again) is not proof of stimulation either. Firstly it's only a temporary respite to the longer term problem and secondly it is used to lower debt and pay bills rather than generate new spending. Basically Australia cannot afford the amount of money required to do the real revival job just as the USA hasn't done either. They have resorted to printing more money under Quantities Easing policy which Bernanke is about to do again. These measures are temporary respites meant to fuel growth by increasing the money supply.
The lurking danger is that it may fan inflation which would simply complicate the whole situation. Nobody really wants that even though a low level of inflation around 3% to 4% is considered to be beneficial to growth in normal times. However, the world has changed since that scenario was applicable.

Those Boomers

I go back to my comment on the Baby Boomers because this is a phenomenon post WWII not faced by previous generations. It was the richest generation ever, fuelling a long period of growth despite the intervening ups and downs. The Boomer generation was born between about 1947 and 1965 so the youngest Boomers are 51/52 and the oldest are now 65/66. Four million Boomers were born in Australia between 1946 and 1961 and its common knowledge they are now retiring at a higher rate than there are available replacements. Generations X and Y will have to do the heavy lifting as immigration can only partially fill the gap about to be experienced by western nations over the next 10 years.

The Boomers were expected to retire with loads of money and continue to spend it in happy retirement. However they too have been caught up in the boom and have too much debt, too little cash and may live too long to sustain the lifestyle they expected to enjoy. Consequently they need to continue working plus we need them in the workforce. The result is that the expected effects of the Boomer Bubble are gradually deflating to a whimper. One effect is there may not be enough buyers for all the businesses being passed on by the retirees. Perhaps we are entering the 'age of amalgamations'.

The reality of debt

Put the gradual lessening of the working population together with the effects of the GFC and what do we have – the reality of the worlds financial mess and the complex task of repairing it. In my last paper I spelled out the out-of-balance National debts of leading European nations but I did not detail the domestic debt within those countries. The domestic debt burdens are at the heart of the problem, for example:

- The world's largest economy (USA) has domestic debt levels of US$55trn which is 3.5 times that of their total GDP (US$16trn). Government debt is an additional 100% of total GDP.
- Little old Australia has domestic debt of A$2trn+ which is 1.5 times our total GDP (A$1.35trn). Government debt is expected to reach $300bn or approx. 30%+ of total GDP before 2013. Whilst that may look better by comparison the effect on our economy can be just as hard because we are so much smaller.

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The Federal Reserve

The Reserve Bank has virtually been rendered powerless by the big 4 Banks in Australia dancing to their own tunes. Whilst the Big 4

compete for deposits and tell us that their cost of borrowing is rising and justify their high profits as safeguards against 'things going wrong in Europe', we are left to deal with the results. It would appear the game they play is to have already jacked up their rates in readiness for cuts.
I am waiting for the day when they fully prove their claim that overseas borrowing costs are so high that they cannot pass on full rate cuts at home. We all understand the 'deposits in – lending out' game but cannot quite fathom how borrowing internationally at high rates in order to lend nationally at relatively low rates makes record profits in a downturn for several years running. The profiteering on credit card rates, fees and other charges they have dreamed up are a disgrace in the present financial circumstances. I think they think we are all very stupid!

One good thing about the Reserve cutting rates is that it may deter investment in the A$ and help lower the exchange rate. However it's unlikely to be cut again this time round as the Reserve will want to wait and see. That would come as a blessing to exporters and manufacturers who need larger falls yet to go under parity. The closures and loss of export related businesses was entirely predictable and will continue as long as rates do not fall. It's a fact of economic life that a high $A is of no use to an export economy trying to compete at international level.

Overseas

We certainly can't sustain further debt being passed into the economy and any government that doesn't act will remain in trouble; especially one that tries to teach the G20 how 'to do it the Australian way'. Certainly Greece would be committing suicide to break away from the EU and I have maintained that the structure is too critical to Europe to allow it to fall apart. It may have looked like a good escape route if Greece had wished to run away from its debt but the result of declaring bankruptcy would have been ruinous for years. The other 'out' is for the European Central Bank to refuel the banking system so banks can further write down their social debt levels. This would help refuel growth at street level where it is badly needed. Basically it would be a better use of money than protecting EU debt and using more debt to service existing debt. I have no doubts that steps will be taken to soften the austerity measures in order to keep the EU together even if it means postponing doomsday.

The erratic situation is already slowing world trade and that's where the 'China Syndrome' comes in – if their export customers are broke then China slows too (which is happening). It's the ripple effect that eventually reaches us and dents the mining boom however subtly or otherwise. China is aware of the competition arising against Australia from India, Russia and Brazil and that there are other suppliers they could turn to. That suggest that prices will fall and then level out rather than continue to rise or be dynamic.

Business is doing it hard

The uneasy business mood in Australia is easy to read when you count the number of business closures, downsizings and profit warnings. These are hurtful events that damage owners, suppliers, employees and their families. The earlier collapses from the likes of Klein's, Clive Peters, Borders Books, Angus & Robinson, Storm Financial, Raptis and Crazy Clarks were signals of more to come. There followed the likes of WOW group, CMI the auto parts supplier, the Retravision chain supplier and the Hastie property group. We have had profit warnings from notables such as JB Hi-Fi, Boral, Transfield, Stockland and Leighton. All of these (and others) point to the structural change that is and will continue to take place.

ASIC indicators show that over a 6 month period to June 2012 some 5,000 businesses went into administration and up to March this year we have had the highest failure rates since 1999. Marginal businesses have either already fallen over or are on the edge of doing so. This can be observed by the number of empty shops and premises up for lease. So what are the likely effects *'going forward'* as someone we all know frequently says?

1. 2012/2013 will continue to be flat years probably going through to 2014/2015 as Boomer spending starts to decline.
2. We will experience rising unemployment as employers cut costs and especially as long as the $A remains at 100c plus.
3. The EU will have to band together and coordinate ways to bail itself out by easing the repayment demands and acting cooperatively. Austerity will have to be better managed to restart employment and avoid continued political unrest.

4. The US$ dollar will regain/maintain central currency status as the US gradually recovers from its recession. The US started its recovery almost two years ahead of the EU and will experience a recovery ahead of Europe.
5. China is slowing as its export activity weakens. However, it will continue to *regulate* the rate of its internal growth to provide politically ‘good’ GDP figures. It will keep its Yuan at least partially tied to the US$ (if not fully) in order to retain the value differential for export purposes
6. The winners in Australia will be the businesses with sufficient cash to pay their bills and remain active in their markets. As could be expected, the suppliers of essentials will win through better than most.
7. Retailers will continue to commoditise their markets by discounting prices and *right sizing* (downwards) to match the ‘new normal’ levels of demand. Partly due to being well and truly over-shopped and overly competitive.
8. It’s a good time for takeovers, mergers and buy-outs for those with the funds. Amalgamations and takeovers will become more numerous as the opportunities are seized by the stronger players.
9. The internet will rapidly become more competitive resulting in the withdrawal of some businesses relying solely on the Net. Internet companies will turn to more competitive use of traditional media to gain attention and boost revenues.
10. Both Federal and State Governments will be forced into restructuring spending in order to cut costs. Fringe expenditures will go by the wayside and the big spending areas will again be put under the magnifying glass.
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Retailing

A last word on retailing about what some commentators are currently saying:

- ***Retail is being hard hit by Internet purchasing*** *as sales on the net leave them behind. Internet retailing is rising at twice the rate of bricks & mortar stores...*
  The fact is Internet sales have risen at double high street sales only as a percentage on a small base. The quoted comparisons were that Internet sales rose at 5% v. high street sales at less than 2% in a given quarter. Consider that retailing on the net in Australia has just crept up to 5% of total retail sales, meaning that 95% are still made in the bricks and mortar stores. Which percentage category would you prefer to be in when it comes to counting the money? Internet sales have a long, long way to go before becoming the first choice channel. All retailing is not automatically aligned with selling on the net.

- ***The chains are becoming an anachronism*** *by their very nature as Omni/multi-channel marketing takes over.*
  The fact is Omni/multi-channel marketing has been around for years and retailers have adapted as the channels have arisen. Manufacturers, wholesalers and distributors adapted to selling direct to consumers long ago in order to stay ahead of their production outputs. They chose to ‘doublecross’ their retailing allies by utilising all the available channels and the technological age has simply produced additional conduits. It won’t be long before the RAID chip (radio identification tag) transforms the check-out process to make it even easier to buy goods via smart phones or Credit Cards. Omni channel marketing (to use the new buzz word) is neither a new phenomenon nor a particularly good way to market as it

breeds discounting which further assists the commoditising of markets. As more retailers turn to the Internet they build up the number of consumer choices; then will follow increased price discounting as the competition heats too (and it's already started).

- ***Traditional retailers are too slow to change*** *to the contemporary demands of today's consumers.*
  The fact is it's the structural changes in society that are beating them. Like other developed countries we have become over-shopped to the point of absurdity. In any large mall you'll find the same franchises, supermarkets, liquor outlets, fashion brands, fast food outlets, coffee chains etc.
  The major brands are everywhere and in a booming economy they could all exist. In tightening markets it's another story as the overcapacity becomes exposed. When the flow of cash decreases and consumers are forced to discriminate, the marginal (weaker) businesses fall over. For the big chains this means killing off the non-profitable stores and resizing to match decreased demand. The gradual passage of the Boomers through society is a compounding factor but an irreversible change to mainstream business.

- ***Consumers are holding back*** *from purchasing due to concerns about the economic situation.*
  Well you'd have to ask why they wouldn't but again it's more than that. Consumers are preoccupied with debt reduction and getting their own house in order. Rising costs are eating into incomes to the extent that many have to reorient their priorities and number one is reducing debt and number two saving to build superannuation. These are the real challenges which are now discernible in most family's outgoings.

History repeats

A little tale on past retailing.........everything goes round that can go round. In 2001 near Bond Street tube station in London there was an experimental shop which displayed only one item of each of their well-priced kitchenware products. You could examine the products and order via the net or pay and place a written order. They guaranteed a 3 day delivery to anywhere in the UK – great idea? A year later the business had folded through lack of sales. Now 11 years later the same idea is emerging with some companies selling on the net displaying their goods in small bricks & mortar stores to generate sales. It will be interesting to see if it works now.

In 1999 a US company called ShopCo put 400 vans on the road delivering orders across the States for traditional companies as well as internet retailers. Another good idea!? They collapsed having 'burnt' $350m trying to make it work across mainland USA. I see similar attempts being made today and at least one I know of has already failed. It's a flawed business model because whilst the mass order delivery philosophy works the large capital inputs required to execute the service is based on returns from small orders which cannot provide adequate margin.

It's also noticeable how tight times breed active multi-level marketing organisations (MLM) which are spawned by suppliers turning to low cost channels to capture share of wallet.

Footnote

Business is a serious game and the consequences of failure are widespread. Not having an understanding of what is happening can cause owners to make the wrong moves. I advise my readers to look hard at offers of *silver bullet* remedies because inevitably they don't work. Change the business strategy if necessary but never forget that customers are the only things that count or there is no business.....so treat them well.

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