Edition No. 5

Renationalising the world?

bergsicht

CHAPTER 1

A timely cold shower

Until a couple of weeks ago, even the most hardened of sceptics would have found themselves swimming against a tide of rose-tinted representations and optimistic interpretations of current political and economic events. Emboldened by sporadic green shoots of recovery in economic growth and the reassuring, double-digit annual returns achieved by leading share indices (the SMI was up 20.2%, the DAX 25.5%, the Dow Jones Industrial 26.5% and the S&P 500 29.6% in 2013), most forecasters were anticipating cloudless skies for the 2014 investment year. Of twenty Wall Street analysts making financial forecasts at the beginning of the year, no more than two had predicted a negative annual performance for the S&P 500 in 2014.

But things have already turned out a little differently – in January, at least. Sparked by a few wobbles in currencies, bonds and equities in several key emerging markets such as Brazil and Turkey, the ructions we have witnessed in global stock and currency trading in recent days and weeks have proved a timely reminder of the risks of blithe insouciance when it comes to managing investments. By the same token, anticipating the next financial crisis round every corner and making Cassandra-like predictions of the imminent collapse of the global economic system is a far cry from best practice. So how can investors maintain a healthy level of common sense – or, more precisely, cultivate appropriate risk awareness? By bearing in mind that contractions of a greater or lesser magnitude are entirely normal after long periods of expansion and by acknowledging the inherent limitations of forecasts.

To this extent, the markets' reminder that risk is never far away (despite appearances to the contrary) could not have come at a better time than January 2014. For this is the month in which clients and banks typically sit down to discuss asset management plans and, were it not for January's short sharp shock, some investors might have been tempted to set overly ambitious risk parameters that would have come back to haunt them very painfully indeed in the event of a genuine contraction – a contingency of which there is currently little sign, it must be said.

This kind of shock could of course come to pass in 2014, though. Let us be under no illusions: for the most part, the performance, if we can call it that, of stock markets last year rests neither on robust economic expansion nor ebulliently confident investment activity in the industrial sector, nor yet any increase in corporate margins and profits. Stock valuations leave little headroom for the future, unless significantly more dynamic economic growth materialises. Instead, investors benefited partly from the calm that settled over the financial system as bypasses and ongoing liquidity transfusions from the central banks temporarily managed to hold off the worst shocks to the system, and partly from the base effect of the preceding contractions. Not long ago, equity investors were bemoaning zero ten-year returns – 2013 managed to fix that particular "defect".

Any such light on the horizon should, however, always be viewed against the backdrop of the truly *extraordinary* role assumed by the central banks in quelling the financial crisis: not only have they famously cut interest rates to rock-bottom levels, they have also used "quantitative easing" to inject the system with unprecedented liquidity, bloated their own balance sheets to previously unparalleled dimensions (incorporating debt securities of questionable quality by the short ton in the process), got involved in the nuts and bolts of banking and played an active role in the part-nationalisation of the entire banking sector. Or – as in the case of the European Central Bank (ECB) – promised to do all these things and more besides, which for a central bank is tantamount to actually doing them. Such intervention may have been necessary to save the system, but we still haven't reached the end of these manoeuvres by a long chalk. We think the real challenge – finding a way out of these extraordinary circumstances and back towards normality – is yet to come. Normality would spell higher interest rates.

This is also the reason why even the slightest hint that normalisation might be in the offing has elicited such a nervous reaction on trading floors – exciting tremors in the neuralgic, newly industrialised countries that have then spilled over into the established markets. When Fed chairman Bernanke mentioned "tapering" (i.e. reining in special monetary measures), a cold chill ran through the financial community, and much the same thing happens whenever economic data are published that are slightly "too positive" – as though this were something fundamentally undesirable.

All this places us on the horns of a bizarre *dilemma*: from a valuation perspective, the equity markets ought really to be craving more vigorous growth, and yet any such growth would be devastating, as monetary normalisation would necessarily follow hot on its heels. While exercising all due theoretical caution when coining terms, we are nonetheless inclined to describe the effects of the extraordinary monetary policy pursued by the central banks – and thus the heights scaled by the equity indices – as "asset inflation"; labouring under no illusions and fully aware of the risks involved, we have positioned our equity holdings accordingly.

CHAPTER 2

From buzzword to concept

"Asset inflation" is an expression we have studiously avoided in the past, partly because it has no foundation in economic theory, and partly because we did not wish to prematurely abandon our quest for the fundamental drivers of higher equity valuations for the sake of an empty buzzword. Also, we make no bones about the fact that we struggle with the notion that anything might be "too expensive" or "too cheap", "too high" or "too low", as such assertions presuppose that the markets are inefficient – or that there is someone or some entity that knows better than the markets. Under normal circumstances, this has always seemed an immodest position, to be adopted only with the utmost caution. Given the blatant distortions currently being wrought by the central banks' massive interventions, however, such reservations may be set aside without compunction for now.

But let us return to the theoretical principles. Consistent asset price inflation, caused by the kind of extreme and longstanding monetary policy stance of countries like Japan – which, incidentally, was later adopted in the USA and has also been practised in Europe since 2012 – is now acknowledged as an economic fact of life. Papers published by the economist Prof. Gunther Schnabl, who has been teaching at Leipzig University since 2006, have demonstrated just how great the incentives to speculate may be when monetary policy is *misused* as a *stabilising instrument* on financial markets. Such misuse stems from a major asymmetry between upside und downside: speculators make a profit on one side while shouldering far too little risk, which in turn is socialised via monetary policy. He goes on to describe the "ineffectiveness trap" into which the central banks fall when interest rates are close to zero and emphasises the risks of blurring the functions of state, central bank, financial sector and business, before highlighting the diminishing marginal efficiency of investments and the faltering growth associated with this kind of monetary policy. The most cogent overview of Schnabl's approach is to be found in an article on p. 8 of the NZZ (22.8.2012).

We shall take this analytical reasoning a step further in this *bergsicht* and explore possible ways of escaping this ineffectiveness trap. To anticipate our conclusions: these avenues are structural in nature and will involve either a root-and-branch clean-up of the current issues combined with a deregulation and loosening of political and regulatory constraints, or a pronounced lurch towards mercantilist and nationalist practices.

As Japan has been ploughing the furrow of ineffective monetary policy the longest and, under the banner of "Abenomics" (named after Shinzo Abe, the incumbent prime minister), recently seems to have been slipping into precisely the kind of nationalist trajectory described above, we shall devote one section of our commentary to this unique island republic in the North Pacific.

CHAPTER 3

Celebrated – ostracised

Japan is a good starting point not only because it has an extremely long track record of unsuccessful monetary stimulus, but also because it has such a clearly defined, insular geography and may be taken as a kind of prototype for characteristics observed in other countries (or groups of countries). This said, there are a number of specific conditions and circumstances whose roots are to be found in the particular mentality and history of Japan and its inhabitants. While making no claim to be Japanologists, we would like to bring up a few of these here where they contribute to an understanding of the wider situation.

The most recent phase of Japan's economic history is generally assumed to have started with the "Plaza Accord" of 1985, which marked a turning point in the *unparalleled success story* enjoyed by Japanese industry since World War II. It is well known that Japanese management and working practices closely matched the requirements of late-industrial economies for the production of high-quality goods such as cars, TV sets, machinery and equipment, ships and railways. The (never really clearly defined) term *keiretsu* echoed round the world, evincing a shudder in competitors on other continents. The *keiretsu* phenomenon involved the alliance of Japanese companies at a strategic level and the fusing of political and economic objectives. On an operational level, *keiretsu* typically involved arranging the workforce into cohorts, sharing responsibility for quality and efficiency and instilling a pronounced enthusiasm for both product and company amongst employees. Many of the organisational arrangements that are now standard in modern factories in Western industrialised nations have their roots in Japanese prototypes from the 1980s. From an economic perspective, the *keiretsu* phenomenon certainly has something distinctly cartelising about it, with all the short-term advantages and long-term disadvantages that this entails.

The Plaza Accord saw the G5 states (USA, UK, West Germany, France and Japan) coordinating massive intervention on the currency markets with the aim of shoring up the value of the Deutschmark and the JPY against the USD. As the inflationary policy pursued at the beginning of the 1980s came to an end, the USD was experiencing strong upward pressure as a result of higher interest rates and the American government had come under political pressure from domestic exporters. The USA's trade deficit climbed to USD 150 billion (a high figure for the time), or approximately 3% of gross domestic product (GDP). Although the new currency policy enabled by Plaza did not significantly reduce the import/export imbalance with the Land of the Rising Sun (not least as Japanese business had leeway for substantial price reductions), capital nonetheless flowed into the Japanese currency area – capital seeking investment opportunities that would have a field day in Japanese equities and real estate. The Bank of Japan simultaneously opened the taps of the money supply and the country switched to an expansionary fiscal policy after the Louvre Accord of 1987. Between 1985 and the end of 1989, the Nikkei index rose by no less than 235% while Japanese banks, which were in close cahoots with the booming domestic real estate market, built up the most robust balance sheets of any financial institution round the world. Rather than investing in their own businesses, industrial companies began speculating on real estate in a big way.

By 1990, this "bubble economy" had vanished; the Nikkei lost two-thirds of its value almost overnight following a dramatic collapse in real estate prices and a veritable exodus from Japanese equities. We may presume that the implosion of the speculative bubble coincided with changes in the real economy – many analysts have pointed to macroeconomic conditions such as (for the time) record-breaking interest rates in the USA and Europe – but we are more inclined towards a structural interpretation of events. The triumphant advent of the PC – and subsequently, of the internet – was rapidly undermining the advantages of late-industrial Japanese production methods, with individual creativity usurping the place of group achievements and the transparency engendered by modern communications technology sidelining the obscure structures of *keiretsu*. The fall of the Iron Curtain gave Europe considerably more clout in the global economy and knocked Japan from pole position in growth and importance. Moreover, a great economic *nonpareil* was emerging just next door that to this day has succeeded in attracting capital and the world's attention in equal measure: the phenomenal rise of China to the status of a world economic power. Japan was kicked to the kerb.

CHAPTER 4

Stability rules

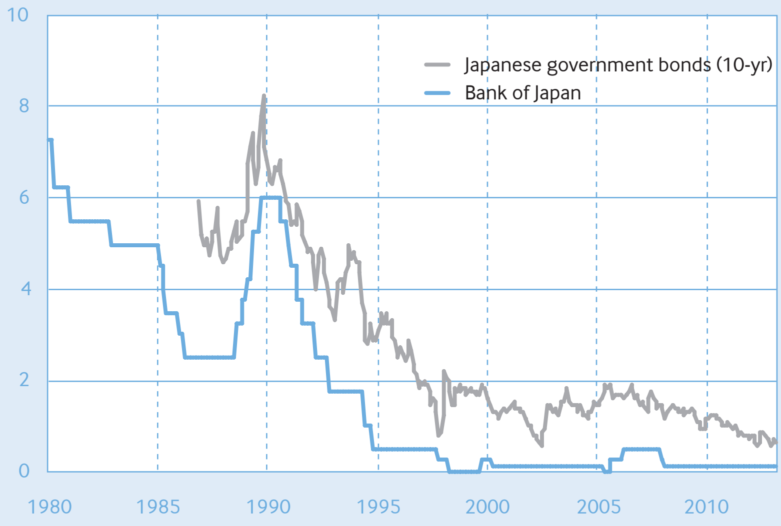
In the intervening period, Japan has been dogged by economic anaemia and has operated a policy of monetary and fiscal stimulus since the early 1990s, with a view to combating deflation. The Bank of Japan's policy rate has not exceeded 0.5% for almost 20 years now and yields on the country's 10-year government bonds have moved beyond the 2% mark only very briefly and inconsequentially; they currently stand at 0.6%. Over the same period, four attempts have been made to devalue the currency, most recently at the end of 2012 as part of the Abenomics strategy mentioned above, of which more later. Consumer price inflation has been fluctuating within a range of between +2% and –2% since 1991.

The Bank of Japan began expanding its balance sheet massively from 1998 and now has reserves of JPY 232 trillion, some 30% of GDP (cf. USA and UK: barely 20%; eurozone: around 25%). Its holdings are composed of 79% government bonds and are thus highly self-referential by international standards.

The rise of Japanese *sovereign debt* has followed a still more striking trajectory: according to the IMF, it now amounts to some 240% of GDP (compared to Greece's almost 170%, Italy's 120% and the USA's 100%). Japan anticipated, as it were, what was later to overtake the USA and the eurozone. And the upshot of all these stimulus efforts? Output growth that has never limped much beyond the 2% mark in 20 years and an economy that has stumbled from one recession to the next, taking a particular hit in 2008/9.

The *failure* of Japanese economic and monetary policy over the last 25 years has been *spectacular*. In our opinion, three questions arise in this context. First, how can such an approach be maintained over such a

20 years of ultra-low interest rates in Japan



Source: Bloomberg.

the Japanese currency: i.e. the (probably correct) assumption that the Japanese government could at any time write off its sovereign debt with a haircut, much like the one Europe imposed on the Cypriots, only more brutal by far.

The relative appeal of the Japanese currency – rooted, as we have said, in the anticipation of a mega-expropriation – is only a part of the irony, however; there is a further, weightier consideration. The Japanese public are no fools. They are no less aware that their net financial position is being eroded, and we believe that this anticipatory wealth effect in the mind of the consum-

long period without the system imploding? Second, is Abenomics merely a continuation of "business as usual" or does it go beyond this – and, if so, in which direction? Thirdly, and setting aside any Japan-specific aspects for the moment, what can this Sisyphean experience teach Western industrialised nations about monetary and fiscal policy? How great is the danger that the "hysteresis" trap (the ineffectiveness of monetary policy as defined by Prof. Schnabl) will snap shut on us too? We shall address each of these questions in turn.

To our mind, one key fact explains the persistent stability of Japan's political, social and economic systems in the face of distinctly unfavourable conditions: the country is uniquely insular. There is thus an almost complete absence of foreign debt on the country's balance sheet; its giant public debt is "owned" almost exclusively by Japanese savers. Zombie banks that have been in a state of financial ruin for more than 20 years may nonetheless continue to vegetate, protected by the state and the central bank and shielded from external competition. There is no meaningful direct investment into Japan and immigration from beyond the island's borders is minimal, with the result that external corrective forces (with the exception of the JPY exchange rate) are entirely in abeyance. Where there is no foreign capital, none can take flight; where no foreign creditors have to be won over or appeased, there is no need for any objective assessment of creditworthiness; where no foreigners (are allowed to) work, there is no danger they will suddenly up sticks and head for the airports.

The irony is that it is precisely these self-referential "qualities" that lead the currency markets to rate the JPY as a "safe haven", subjecting the yen to a seemingly endless – and much reviled – cycle of *appreciation pressure*. There is presumably an anticipatory effect lurking behind this apparently illogical reverence for

er explains the ineffectiveness of cheap money as described by Schnabl; the creeping sense that you are actually poorer than you might appear on paper is hardly likely to lift anyone's spirits, is it?

What's more, the demographic situation is anything but dynamic. Japan gave up on reproduction long ago and its society is ageing inexorably. The older cohorts of the population should be allowed to break open their piggy banks and consume, rather than having to earmark their assets – whether implicitly or explicitly – for financing the indebted machinery of state. At this point, unremitting *financial repression* through ultra-low interest rates and monetary policy under hysteresis is unmasked not merely as irony, but as naked *cynicism*.

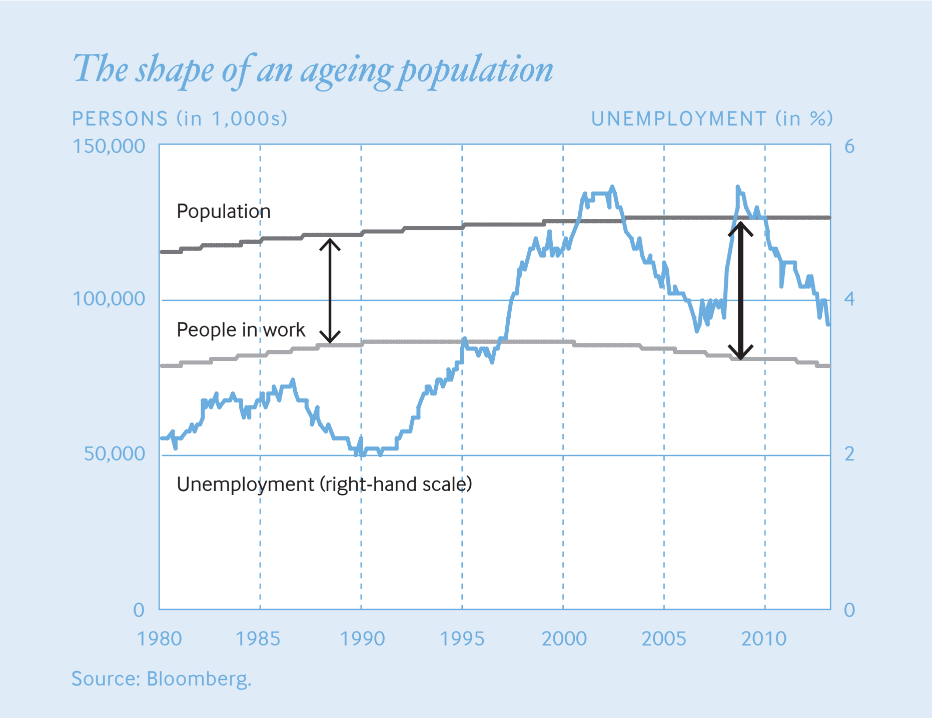
To any outsider, the most astonishing thing about this constellation is the social and political acceptance it has encountered for a quarter of a century. We have no wish to stray onto potentially treacherous ethnological territory at this juncture, but the equanimity with which Japan, for the sake of stability, puts up with a ruling class that obfuscates everywhere and succeeds nowhere, is unparalleled. This island nation, that throughout its history has borne the slings and arrows of storms, earthquakes, tsunamis and wars, holds its ground and endures with stoic calm a state of affairs that anywhere else would be accounted protracted economic and political *hara-kiri*.

CHAPTER 5

Rising sun?

Or have things indeed changed under Prime Minister Shinzo Abe? And if so, how? This is our second question.

Let us refresh our memories with a few facts.



Shinzo Abe has represented the LDP (which has held power almost uninterruptedly since World War II) once already as Japan's prime minister, in 2006/7; his relatively short incumbency as the youngest premier in Japan's recent history culminated in an ignominious electoral defeat that swept the opposition to power. Abe, who hails from a respected political family, returned his party to the helm in December 2012 with a promise to breathe new life into the Japanese economy. Despite Fukushima (2011), Abe is a proponent of nuclear power and has militated for the reactivation of decommissioned power stations, albeit so far without success.

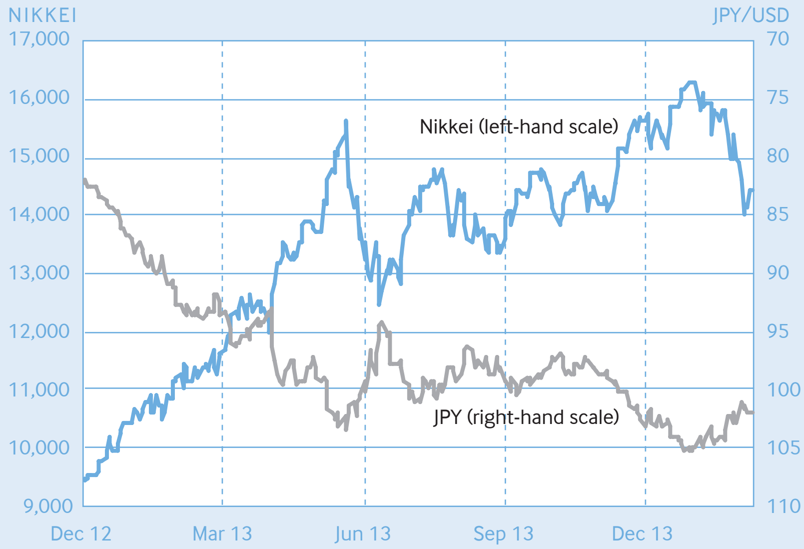
Shinzo Abe's reflation programme comprises three "arrows": another round of massive *monetary stimulus*, an additional *fiscal programme*, and far-reaching *structural reform*. The latter is further divided into three sub-categories: first, Japan's industrial capacity is to be revamped, with regeneration to be achieved through a host of measures in innovation, research and development, on the labour market, and in IT, etc; the SME sector is also to be "renewed". Second, the worldwide competitiveness of the Japanese economy is to be improved and market power recouped through strategic partnerships and a globally oriented national recruitment policy. Third, Japan is to focus explicitly on creating new markets around the world, notably in preventive healthcare (particularly for the older generation), clean energy, secure market infrastructure and decentralised centres of excellence.

What has been achieved so far, and what not? We can tick off monetary stimulus and the fiscal programme – both sets of measures are in full swing and the monetary policy side in particular has also already borne fruit. The Bank of Japan incrementally reduced the value of the JPY by 24% against the USD over the course of 2013. One consequence of this was to galvanise the Japanese export industry, enabling large domestic players with a global footprint such as Honda, Toyota and Bridgestone to increase their profits significantly last year. This was achieved through higher turnover (thanks to the depreciated currency) but also through the currency effect arising from profit-taking among foreign subsidiaries operating in dollar markets, among others. The renewed focus on activist monetary policy also fired the imagination of the global investment community, making the Japanese equity market one of the most attractive in the world in 2013. The chart below shows just how closely the performance of the Japanese stock exchange correlates with the devaluation of the JPY. There are Rorschach tests that are less symmetrical …

This close correlation between monetary policy and the state of the equity market tells us all we need to know about the markets' verdict on arrows 2 and 3 of Shinzo Abe's programme: they are perceived to have had little effect; or, to put it more judiciously, their effect can hardly be measured. The results of the fiscal programmes are the same as others the world over: jobs are indeed created, and the forced renewal of infrastructure will generate potential that may very well be effective even over the long term – but large amounts of valuable capital will also trickle away into the mire of bureaucracy, low-priority to pointless projects will be funded and the national debt will once again rise in leaps and bounds.

Arrow 3 – structural reform – is a source of some *impatience* and *disappointment*. Laying even a finger on what has organically grown and bedded into place is clearly fraught with difficulty in Japan, and authoritative reports from expert sources suggest that nothing tangible has been achieved in this area. Furthermore, in our view, Abenomics' third arrow wilfully *excludes* several *areas of decisive importance* – decisive in the sense that they represent elements that would be essential to revitalising Japan's economy and society. These are: allowing immigration, cleaning up the banking system (including both permitting and encouraging the activities of foreign institutions) and opening up the Japanese market to foreign direct investment. We mentioned *hara-kiri* above. While we have no desire to misuse the term, we concede that structural reform of this kind – while essential from an economic perspective – would be political suicide.

Our take on Abenomics thus comes out somewhere between sceptical and negative. There is really nothing new about arrows 1 and 2; they boil down, *Japan's stock market: purely currency-driven*



Source: Bloomberg. Note: the right axis is shown inverted; a falling curve thus indicates a depreciation of JPY.

grosso modo, to the monetary and fiscal policy that has been a fixture in Japan since the beginning of the 1990s – although these measures are now being interpreted and applied far more aggressively. A closer analysis of Japanese businesses suggests that last year's stock market boom was all hat and very little cattle, as it were. While the car manufacturers (which are important, of course) are certainly far better off, stocks such as Canon, Komatsu, Kyocera, the Mitsubishi conglomerate or Sony have little to show for themselves either in terms of revenues or profits.

Our overriding fear is that Shinzo Abe, too, will get bogged down in hysteresis – trapped in ineffective monetary and fiscal intervention; if this happens, there is a risk that, instead of finally getting to grips with real structural reform, he will veer off in a completely different and rather less appealing direction. The first signs of this are already apparent. We have mentioned Japan's aggressive monetary policy. Quite how prepared the global currency system is for the departure of a key player, and how it might react, is difficult to foresee at present.

In every corner of the world, symbolic actions are occasionally taken whose emblematic significance might well seem blown out of all proportion to cosmopolitan contemporaries, but which are nonetheless capable of treading on toes and opening old wounds. Amongst these would certainly figure the visits paid by Japanese prime ministers to the *Yasukuni shrine* in Chiyoda, a suburb of Tokyo. The memorial is dedicated to the Japanese and enemy (!) fallen of the various wars since 1869, but despite such veneration, the shrine is considered a nationalist symbol. Senior Japanese politicians' visits to the memorial seem almost an essential rite of passage for domestic consumption, but their effect further afield, i.e. in the former colonies of China and Korea, is devastating; the dilemma has been defused in the past with skilful Japanese semantics in that trips have been designated "unofficial". Unlike his predecessors, Shinzo Abe did not choose the day of Japanese capitulation after World War II (15 August) for his visit, but his appearance on the anniversary of the day he took office could not have been more official and thus more provocative; all this was compounded by the fact that the visit coincided with a phase of heightened tension with the People's Republic of China following Beijing's demand that flight plans be submitted for aircraft entering the air defence identification zone over the East China Sea.

The Economist has concluded that Abenomics is really neither an economic policy nor a recovery plan, but rather a strategy to reinforce national security, and our concerns tend in the same direction (18.5.2013). There are indeed other, less symbolic but no less substantive, hints of the *nationalist and conservative impulses* to the solution sought by Shinzo Abe, and to our mind, these include the efforts to reinstate nuclear power. Japan is currently highly reliant on petroleum and natural gas imports, with expensive consequences during a policy of currency devaluation, but there is more to his efforts than that; there is the notion of insular autarchy. Arrow 3 will not be a programme to deregulate and open up Japan, but rather a hodge-podge of mercantilist, state-sponsored capitalist/*keiretsu* and militarist set pieces – the continuation of failed monetary and fiscal policies "by other means". A USD 240 billion increase in defence spending is planned for the next five years, earmarked for hardware that includes stealth bombers, warships and amphibious vehicles.

This is fraught with hazards. The *part of the world* in which all this is happening is *a priori* dangerous and in a state of upheaval to boot. The new Chinese government has unambiguously hegemonic ambitions and Japan finds itself on the strategic fault line between the USA and China. South Korea, hardly known for taking a shy or retiring approach, is bearing the brunt of Japan's devaluation policy. China and Korea both have old scores to settle with Japan. Far be it for us to conjure up the spectre of armed conflict here, though; wars are always unpredictable and ultimately to the detriment of all concerned – *sub specie aeternitatis*, they are clearly "irrational". Political elites and oligarchies often see this rather differently, however, and it is difficult to contend that the general populace in such countries have much say in the matter. It doesn't even have to come to open conflict; a rearmament spiral is all it would take for globalisation to be stopped in its tracks and – as so often throughout history – a country would once again wake to find it had frittered away precious resources for ultimately unproductive ends.

CHAPTER 6

Japan, an object lesson?

Twenty-five years of anaemic growth and little prospect of an end to economic inertia: reason enough for other parts of the world to stop and think what might be done better, or differently – and what should be avoided at all costs. This takes us neatly to the third question. Can any lessons be drawn from the example of Japan? The answer is: yes and no (or rather – no and yes).

No, because Japan, as we have just outlined, is indeed a very special case. Virtually all Western industrialised nations – as well as the vast majority of the emerging, newly industrialised countries – have far more open architectures. This renders them periodically more vulnerable to abrupt change (e.g. in capital flows) but at the same time also obliges them to adapt their structures in order to court international acceptance. Relentless competitive pressure, however inconvenient it may be in specific cases, has a galvanising effect and is ultimately the only tried-and-tested force to keep politicians in check. For all the reservations we harbour about reform efforts in southern Europe, for example, there would not have been a sovereign debt crisis in Europe without such pressure from the financial markets and things might have muddled along for a lot longer. International openness inevitably involves a certain degree of international dependence and susceptibility to outside influence. The question is whether any corrective provided by the market can really still assert itself in light of the ECB's assurances of unlimited stabilisation efforts. We have our doubts.

We might thus also answer the question in the affirmative, as the hysteresis problem is too real and present to be brushed aside lightly. There is no evidence that the monetary policy "success story" has achieved anything beyond merely stabilising the financial system in either the *USA* or *Europe*; *growth* is *too low*. Having said this, debt levels in many countries are so high that any genuine growth – and ensuing interest rate rises – would present politicians with a nightmare scenario; the situation we face does indeed have all the hallmarks of a catch-22.

The question of what arrow 3 (structural policy) might look like in real life is thus one of interest to the Western industrialised nations as well, albeit to a lesser extent. Unfortunately, the temptation to combat ineffective monetary and fiscal policy with mercantilist means is real. Not that Western politicians regularly visit shrines, but there are nevertheless clear signs of an increasing appetite for the pursuit of national interests, and – no less significantly – of an acceptance of this approach in public discourse. For instance, the Germans responded to the news that the American NSA's secret service activities also extend to industrial espionage with remarkable indifference. Why else, if not for mercantilist reasons, would intelligence-gathering be taking place among competitors in so-called friendly nations?

National interests also seem to be making their presence felt in respect of corporate tax collection. An OECD position paper has suggested that in future, corporate income tax liability should be set according to the location in which a company's "economic substance" (i.e. value) is created. To achieve this, international concerns would have to surrender detailed information about their activities within and between individual countries, including particulars of employees, wage costs, interest calculations, handling of and payment for intellectual property, centralised services, etc. We suspect this can only end badly – in the first place, for the companies that will have to bear the cost of providing such data, and secondly, for the authorities, who will be expected to understand such corporate structures. Thirdly, this draws up potential battle lines between countries and economic blocs. And fourthly, it will mean that firms will have to give serious thought to "deglobalisation" if they do not wish to founder between the Scylla and Charybdis of competing tax regimes. Can it be stopped? Highly unlikely – it is in tune with a prevailing *zeitgeist* that holds the state sector sacrosanct and accounts private interests a sideshow. There is talk of "repatriation of corporate profits" and this fine phrase is even dressed up with the imprimatur of tax ethics, but in essence, it amounts to nothing more than the mercantilist ambition of maximising benefit for the national fiscus.

Again, we have no desire to be overly pessimistic, but anticipating which way the wind is blowing gives one more time to prepare for potential developments. What form might these "potential developments" take? We believe politicians will seek to escape the monetary and fiscal policy trap not through a nudge towards deregulation and structural reform of the kind currently being attempted by Japan's Prime Minister Abe but rather via political activism and the prosecution of national interests. Such "national" interests have *de facto* always been synonymous with the vested interests of certain stakeholders in the economy and in society, which is what makes their elevation to a general political roadmap so appealing for those who stand to benefit. From a politico-economic perspective, however, market liberalisation and deregulation will fall by the wayside.

CHAPTER 7

More thought required

What does this mean for investors, the capital providers in an economy? Two consequences spring to mind. For a start, the golden age of *globalisation* and *convergence* of economic methods may well be *over* for now. Mistakes are bound to be made whenever political activism is on the menu. In place of *détente*, the potential for conflict is currently being ratcheted up, so caution is counselled. The Chinese claim to hegemony will alter the global economic system, as will the danger that the West – specifically the eurozone – fails to free itself from its self-imposed hysteresis trap or indeed (following what seems to be Japan's lead) attempts to break free by continuing such a policy "by other means". The USA will continue to assert the trifecta of its political, military and economic might in an even more forthright manner. There is likely to be some backsliding in adherence to WTO standards. Free trade agreements will continue to be negotiated, and possibly even signed, but their deeper import will be negligible.

Capital is fundamentally highly liquid, flowing more freely than mercury, and it wastes no time in locating the optimal combination of risk and return. Crucial though diversification is, we think it is worth taking a closer look at the opportunities and risks of specific capital deployments – much as we have done with Japan in this edition of *bergsicht*. Global economic developments will be neither uniform nor ubiquitous, and it is important to take these differences into account.

Furthermore, if there is any truth to the hypothesis of decreasing global convergence, *businesses* will have to come to terms with formidable *strategic challenges*, e.g. deciding on locations, evaluating regulatory conditions, assessing political risks. Mistakes will be made. Some companies will adapt to circumstances better than others. A colossus firmly entrenched in a hegemonic power may imagine it has the upper hand, but a high price will be exacted by the system for its exalted position – and a smaller, more agile competitor is thus not entirely without prospects. Those wishing to target investments rather than merely sticking to an index basket should take a long, hard look at the management committees of the companies in question.

And lastly, is a less convergent world a less joyful prospect? If nationalism degenerates into open warfare, then certainly. But if it adds to life's rich tapestry, not necessarily. When it comes down to it, not everything in this world needs to be American.

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