ARE WE HEADED FOR A FALL?

Addressing global economic turmoil requires fundamental shifts in strategy and action.

By Mark Morgan

Every day we're hit with another headline about the precarious global economy and growing political unrest, and it seems to keep getting worse. What does this mean for our companies, and how can management accountants provide influence and leadership during this time of crisis?

The global economy sits at the pinnacle of a super debt cycle that has been forming for 40 years by debt growing faster than the underlying economic foundation. Put simply, the world has made 40 years of investment with negative return, and we are perilously close to a meltdown.

Japan's long-term economic outlook is most vulnerable because of the time required to deal with the severity of the recent ecological and natural disasters and rebuild its industrial infrastructure. Reliance on imported materials for rebuilding coupled with a strong yen value hurts exports and has resulted in trade deficits there for the first time in 30 years.

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Resolving funding for the Eurozone debt is the world economy's most immediate crisis. Debt and reckless sovereign behavior have created huge budget gaps in countries unwilling to curb spending, threatening certain collapse if there's no dramatic change in fiscal discipline. The world continues to follow the daily developments to restore economic and political stability in Greece that are led by the determined effort of Germany's Chancellor Merkel to lay a lasting foundation for the Eurozone's overall recovery.

The scale of the U.S. economy and the federal government's consumption-based debt policy allows the printing of new money to delay a collapse, but it will require infrastructure growth to avoid experiencing the same level of severity currently in the Eurozone. The United States woke up to the magnitude of its own crisis in 2011 when it was forced to address the issue of raising the debt ceiling (printing more money) or face insolvency. The government avoided raising the debt ceiling by borrowing $214 billion from federal pension funds. But without fiscal reform and creation of a jobs-enabling infrastructure, this action just delays the inevitable crisis as this borrowing must be repaid with interest once the debt ceiling is raised.

These pieces paint a potentially ugly worldwide economic horizon. Management accountants must use analysis, modeling, and perspective to get realistic assumptions for currency exposure, inflation, and market growth into budgets and forecasts.

What Brought Us Here?

The debt-cycle nightmare can be traced to four underlying causes: elimination of the gold standard, impact of changes in demographics, loss of economic infrastructure, and hostage to oil.

The Gold Standard

For centuries, gold and silver had been the exchange vehicle for economic transactions between two countries. Intercontinental trade reached levels during the 19th Century that made exchanging precious metals impossible and led to the introduction of paper money.

For the exchange of paper money between countries to work, governments had to guarantee gold and silver reserves equal to the value of their outstanding paper. This led to the introduction of the gold standard in the late 1800s, which meant that governments could exchange paper for precious metals on demand. The gold standard was abandoned during World War I because of the cost to wage war. So much paper was printed that the gold standard couldn't be put back in place at the end of the war. Instead, a modified version required reserves to equal the value of at least 50% of the outstanding paper currency.

But the massive impact of the Great Depression followed closely by the cost of World War II knocked out the gold standard again. After WWII, the Bretton Woods system, which was established in 1944 and became operational in 1945, modified the gold standard by tying the exchange value for all currencies to a set price of gold and requiring member countries to maintain sufficient reserves to convert their currency held by foreign governments. Since the U.S. held most of the world's gold, the

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dollar became the de facto world trade currency.

Next, the cost to fund the Vietnam War and social programs of the 1960s created huge funding pressures and hyperinflation within the U.S. economy. The currency coverage of the U.S. gold reserves in 1970 fell from 50% to under 25%. Other countries lost confidence in the ability of the U.S. government to cut spending and control inflation, and in 1971 the Nixon administration made an overnight unilateral decision to end convertibility of U.S. dollars to gold.

One by one, countries withdrew from the Bretton Woods system, and by March 1976 the world's major currencies were free floating. In other words, the currency exchange rates based on the value of gold were no longer the principal means of administering monetary policy, leaving governments free to print money.

Demographic Changes and Loss of Infrastructure

The maturing of the Baby Boomers has been well documented, but its impact on the global economic model hasn't. The post-WWII population explosion leading to the Baby Boomer generation was a global event. All major countries experienced significant population growth coupled with significant economic globalization that was a result of transportation and technology advances coming out of the war.

Postwar rebuilding and new manufacturing infrastructures were a perfect match for the consumption appetite of the growing population of the 1950s and 1960s. But the infrastructure and economic gains weren't sustained in the 1970s and later because governments didn't react proactively when demographics shifted, and fewer people began paying into the social system as increasing numbers were taking money out.

Japan's economy was the first to feel the combined impacts of shifting demographics and decreased economic growth when housing values collapsed and a new Gross Domestic Product (GDP) was created. Japan reacted by building a manufacturing infrastructure that helped it create high-quality goods at comparatively low costs, and it has been an exporting nation for the last 30 years.

The Chinese government's practice of limiting family size has also led to an imbalance of workers to support an aging population, but China has also been planning an economic response. It recently unveiled its 12th five-year economic development plan that features 7% annual economic growth, $640 billion investment in renewable energy, construction of six million homes, and expanding rural development.

The U.S. and Europe haven't demonstrated a planned response to their demographic evolution. Since the 1980s, both economies have benefited from the influx of imports from the Asian markets in the form of increased spending power as the lower-cost goods led to a higher standard of living, but this was without building true economic growth.

Economic growth is derived from a jobs infrastructure that creates value beyond the cost of investment. But Europe and the U.S. have experienced a permanent loss of unskilled jobs, primarily as a result of competition from the Asian suppliers. The U.S. also has lost significant numbers of skilled R&D and manufacturing jobs that have transferred to tax-haven countries. Since 1990, hundreds of thousands of skilled jobs in the software, pharmaceutical, and chemical industries have been permanently moved offshore to countries that provide significant tax relief for corporate activity located within their borders. The primary tax havens include Switzerland, Singapore, and Ireland. Earnings (cash) from profits on intercompany sales are maintained offshore since the U.S. tax rates are highly punitive if the income is brought onshore.

The U.S. and European economies have maintained their false sense of prosperity by printing money to support domestic consumption (mortgages and domestic goods) instead of creating new infrastructure that would increase the GDP. The result is a progressive decline in value-producing infrastructure that's resulting in a shift to a service-focused economy to support consumption habits for goods produced offshore.

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Hostage to Oil

Oil consumption seems to have been with us forever, but it's actually a condition we've experienced for about 50 years. Though oil was first harvested commercially in the 1880s, coal was the major source of energy prior to 1960. Yet half the oil consumption in the history of the world has taken place in the last 40 years because of increased demand driven by transportation, heating, consumables, and global shifts in the distribution of goods. This means the supply of oil that's easy and cost effective to harvest is depleted. Coupled with devalued currencies and the impact on cost from political unrest in the Middle East, oil has become permanently expensive.

Much has been written about the untapped sources lying under the U.S. and Canada, but consider these factors: Together, the U.S. and Canada sit on the largest oil supply in the world. The massive U.S. deposits of shale oil are technically kerogen, a precursor to refined petroleum. The Canadian fields contain heavy oil deposits that must be extracted from sand. In both cases, significant investment is required before long-term benefits can be realized. Will the governments or oil companies be willing to make the required debt investment to develop domestic production?

New investment would equal new jobs, advances in technology, and reduced dependence on foreign oil. The U.S. consumes about 19 million barrels of oil per day, so domestic exploration and development would significantly reduce its dependence and put money back into the domestic economy. Private equity investment is likely to be seen in the next decade.

High oil and energy costs have an inflationary impact. Companies that pass impacts to consumers to protect margins see consumption slide; maintaining current pricing for goods or services leads to margin deterioration. Diligent end-to-end review of the supply chain is required to minimize the impact of transportation and energy costs. Management accountants should do such analysis and challenge sourcing strategies to optimize regional market margins and sourcing costs.

Solving the Problems

What can be done to solve the underlying problems? Here's what must happen:

Prevent a European Banking Meltdown

Finalizing the financial disciplines to plug the gaping budget gaps in the crisis countries like Greece and Portugal—while structuring an agreement for how debt will be carried throughout the Eurozone and European banking community—is the most immediate global economic issue. Fiscal reform guidelines have been reached with the Greek government, and debt funding will proceed. This will become the footprint for Portugal and, if necessary, Spain. The new Italian government has managed to implement corrective fiscal disciplines. Any default would trigger progressive repercussions that would quickly spread to large banks in Germany and France, then move to Belgium and the U.K., and then

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hit the U.S. like the bank collapse tsunami of 2008.

New bond sales of €800 billion are required to fund maturing debt in the Eurozone over the next two years. The Eurozone's overall sovereignty will be threatened again as the new debt of each country matures. German Chancellor Angela Merkel is proving to be the iron lady of the early 21st Century by demanding fiscal reform in the Eurozone, resisting pressure for Germany to hold a disproportionate share of the high-risk debt of the smaller countries, and leading the crusade required for the European Central Bank (ECB) and International Monetary Fund (IMF) to share the risk through loans, guarantees, and relief. The key for the Eurozone is keeping Germany and France financially healthy while preventing an overload on the European banking system. At the end of the day, the European banking system can teeter but must not topple.

Reduce Debt and Rebuild Infrastructure in the U.S.

The U.S. debt and lack of clear long-term corrective strategy finds this country in a crisis situation where debt equals GDP. Demographics are inescapable. The U.S. has a jobs base that's insufficient to support the cost of government spending, including military, pensions, and medical benefits.

The total debt for all sectors is 350% of the U.S. GDP. It will require a minimum of 15 years of debt reduction to bring the ratio under 200%, which is considered a healthy ratio for debt to growth. The U.S. debt sits at a staggering $14 trillion supporting a budget deficit of $1.3 trillion, partly because of a trade deficit with China of $275 billion.

First and foremost, the federal government needs to define economic policy and programs for jobs creation. Since 1980, 40% of the income growth in the U.S. has been realized by the top 1% of the population. The 99% can't maintain their standard of living during the next 15 years without a change to the U.S. model of capitalism to create jobs that generate exportable goods while imposing tariffs on imported goods to level the playing field for U.S. goods.

Without action by the U.S. government to reduce debt and recreate jobs onshore, the U.S. could lose its status as the largest world economy, based on GDP, and China could become the dominant world economy in a few years. In fact, in a recent Gallup Economy poll, most Americans interviewed said they believe China is the leading economic power today and the U.S. second. Regarding trade agreements, targeting only a 10% reduction in imports from trade nations like China would essentially solve unemployment and the trade deficit by making goods produced domestically by consumption nations more price competitive and attractive for export. The yuan is significantly undervalued against the dollar, which provides China with a built-in export subsidy. Imposing tariffs would raise the price of imports and eventually force China to realign its currency and close the gap between the cost of its exports and domestic production within all countries consuming its goods.

On a macro level, policy change is needed to create incentives to build infrastructure and sustainable jobs. American banks have a massive amount of capital accumulated but not invested. More than $2.2 trillion sits in banks uncommitted to loans. In theory, $2 trillion held in cash reserves should be able to support $20 trillion in loans. Since the 2008 collapse, bankers lack confidence that the U.S. economy will be able to support loans to leverage growth. Tapping the growth potential of this capital would be a critical step that would lead the world out of recession.

Next, U.S. corporations are holding $2 trillion offshore in tax-haven countries because the U.S. is the only country that imposes taxes on corporate earnings generated overseas. Sound policy is required that will enable regular onshore flow and incentives for reinvestment in infrastructure, particularly to recreate a base of skilled and unskilled jobs in the industries that have moved offshore. Without incentives, this cash and jobs will stay offshore and fund investment elsewhere in the world.

How Management Accountants Can React

The debt restructuring plans to solve the Eurozone crisis is a two-year solution. The U.S. has pledged low interest rates for the same window of time. Companies must take immediate action to prepare for revisiting this crisis in two years. While the financial crisis is global and the underlying problems exist at a macro level, management accountants can bring impactful leadership at the micro level within their companies. The following actions should be considered in building operating strategies and influencing decisions over the next two years:

◆ Have an effective strategy to hedge against currency volatility. As the euro grows stronger with resolution of the debt crisis and the yen continues to run strong, there will be potential for large valuation swings to distort revenue and impact costs that multinational companies should mitigate with an effective hedging strategy.

◆ Restructure debt to take advantage of low interest rates that will continue for the next two years.

◆ Review Asian-based sourcing to ensure that supply and quality for components and finished goods are sustainable while Japan rebuilds its capabilities. The automotive segment is still rebuilding and reconfiguring its Asian-based supply network. Explore shifting to Korea- and China-based suppliers in response to any supply disruption from Japan.

◆ Prepare for inflation to heat up in Europe, which will result in slowed market growth, as well as in the BRIC countries (Brazil, Russia, China, and India) as cost to expand scale becomes more expensive and complex. Companies are finding that significant resource investment is required to expand their business to reach the rural areas of these countries, where significant growth potential still exists. This has led to significant headcount reductions in the corporate and functional cost areas of stagnant markets in order to shift resources and fund growth in the geographies where business is growing.

◆ Revisit the capacity and capability requirements of your global supply chain network to optimize working capital creation and cash flow. Revise regional sourcing strategies to optimize capacity utilization, cost efficiency, and delivery options.

◆ Take advantage of low interest rates and depressed asset values to make strategic investments that reduce complexity and distance within the supply chain for North America. Idle capacity in the U.S. can be purchased at fractional cost with attractive interest rates, and states offering tax incentives for job creation potentially make it economically feasible to relocate portions or the entire sourcing network for North America back onshore.

◆ Prepare for dramatic change in government reimbursement for products in the U.S. as well as increased price pressure from government tender programs in Europe and Latin America. Government competitive-bidding campaigns globally will continue to significantly reduce margins in segments where multiple suppliers occupy the market space. Diversify your product portfolio to reduce exposure if reimbursement reductions could hit your major products.

◆ Increase focus on business development as the slowdown in market growth and increased portfolio threats will create merger activity and segment compression.

◆ Increase competitive analysis and benchmark best-in-class performance to influence portfolio priorities, market investment, and spending strategies.

◆ Improve internal financial reporting, modeling, and key performance indicators (KPIs) to increase transparency and agility in decision making.

Management accountants must be the voice for proactive strategy and planning through relevant, fact-based analysis with perspective that helps define tactical priorities in the global markets, enables margin delivery, and improves free cash flow. Sorting the complexities into rational perspective for focus and action is a prime opportunity for our function to deliver leadership and create value. **SF**

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