The Overseas Intelligence Report

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For many months now, I have been writing about how unchecked migration into the industrialized nations was behind much of the unrest taking place in those countries. This week, I have discovered that many of the countries demanding our attention now have a new common thread running through the narrative. Recent unrest in France, though well covered by the international press, seems to lack an understanding of the real reason for the riots taking place in Paris. This same reason – to one degree or another – explains the discontentment on display in India, South Africa, Great Britain and Germany. It also was present at the OPEC + Russia meeting that took place last weekend.

The governments from all of these countries have discovered that their citizens are tired of the austerity imposed on them after the financial panic that took place back in 2008. They want fewer taxes and more government services. As you will see, most governments, faced with the prospect of lost elections and/or civil unrest, are doing their best to tamp down this growing demand for change. I offer up this observation before I turn to the details: eventually, governments that spend money they don't have to make their citizens happy, end up in a very bad spot. Obviously, some countries have more room to maneuver than others, but most are playing a dangerous game.

South Africa

The newly elected president of the country, Cyril Ramaphosa, received the best news possible last week, when the government announced that the country emerged from the recession that marred his first few months in office. Thanks to growth in manufacturing, finance and trade, the economy reported an annualized growth rate of 2.2% during the third quarter. There is little doubt that the number one reason for this abrupt turnaround in the economy was the enthusiasm that Ramaphosa instilled in his people. The removal of his thoroughly corrupt predecessor sparked hopes that the new President could end the graft and corruption that has plagued the country for the past few years.

His commitment to root out those responsible for this corruption was boosted in mid-November when Ramaphosa accepted the resignation of home affairs minister Malusi Gigaba. Mr. Gigaba, a rising star in the African National Congress party, resigned after a court found that he lied under oath about his role in a corrupt deal involving a luxury private airport. The government alleges that Mr. Gigaba stopped the project at the behest of the Gupta family; a powerful family business behind many of the corrupt practices that plagued the former president, Jacob Zuma.

Unfortunately, not all news from South Africa is good. The nation is in the midst of a string of scheduled blackouts – courtesy of Eskom, the national power company. The blackouts are expected to have a major impact on the nation's industrial production figures for the fourth quarter, increasing the likelihood that the recent good economic numbers will be short-lived.

While the immediate cause of the blackouts was blamed on breakdowns at "a number of generating units." The real reason for concern is that these breakdowns are expected to grow dramatically. The previous administration failed to fund an infrastructure program that could have kept the electrical grid in good shape, choosing instead to loot the coffers for personal gain.

Even if the new government can find the capital needed to fund a new spending program, there is no guarantee the government-run monopoly will spend it wisely and in a timely fashion.

Another red flag was raised when the National Assembly followed through on its promise to begin seizing farmland from white Afrikaners. In a 183-77 vote, the assembly amended the constitution and set a date of March 2019 for the introduction of a formal bill designed to take the land away from the white population without providing compensation.

The bottom line is this: While it is easy to understand the motivating factors behind this desire to expropriate land currently in the hands of white farmers, there are still reasons to criticize the move. Hiengiwe Mkhaliphi, a member of the Economic Freedom Party, reminded everyone of the anger motivating these takings when she declared during her speech before Congress, "Your time is up, white people."

Around the same time, Sisonke Msimang, an author born in South Africa, but who recently moved to Australia, wrote an article for the Financial Times in which she criticized those who say South Africa's move towards collectivist agriculture means the country must suffer the same fate as Zimbabwe. She laments the world's unease over land seizures, claiming their fears of a "white genocide" blind them to the great things South Africa can achieve by pursuing "African self-determination."

Left unsaid is that African self-determination is just another name for socialist and collectivists policies that have failed all societies (both black and white) that have tried them in the past.

South Africa's economy is greatly dependent on farming and mining, two areas the new President and his collectivists-minded government seem determined to nationalize. I fear for the long-term stability of Africa's most prosperous nation.

France

Emmanuel Macron became the President of France 19 months ago by running a campaign that promised economic reforms at home, greater integration of the European economies and the advancement of global governance to address mass migration and global warming. His first efforts at bringing change to the French economy met with some success. He pushed for and achieved reforms that made it easier to create jobs in the country and he faced down a belligerent railway union that wanted to stop reforms designed to improve productivity and cut costs. As he celebrated his first year in office, Macron was enjoying his successes and his high favorability ratings.

Encouraged by these early successes, Macron turned his attention to the second and third action items on his list. He engaged German Chancellor Angela Merkel in discussions about how to move European integration forward by floating ideas about greater fiscal integration. While Merkel was open to the idea of exploring ways to merge European economies, she and many other northern EU states were not keen on pledging their assets to help bail out their less frugal neighbors to the south. Talk of a French-German alliance was quickly moved to the back burner.

Macron's other foray into international affairs - his effort to coax American President Donald Trump to remain in the Paris Climate Accord - failed as well. As one of the few European leaders who had expressed a willingness to work with President Trump, this failure proved especially embarrassing and produced a rift between the two leaders that remains to this day.

While the failure to "handle" Donald Trump damaged his ambitions to become a world leader, his dreams did not end until his efforts to use an expanded energy tax designed to ween the French off fossil fuels proved very unpopular at home. Macron's determination to ignore protests over this tax produced the growing unrest that eventually led to massive demonstrations around the country. Efforts to diffuse the situation only furthered the narrative that he was ignoring the concerns of ordinary French citizens. Soon thereafter, the demonstrations became violent. Promises to delay the tax quickly became a promise to end the tax, but by then it was too late. Radicals from both the far left and the far right have involved themselves in the protests and calls for an end to the tax have now become calls for Macron's resignation.

Desperate to save his presidency, Macron proposed a slew of new reforms designed to counter the notion he is only interested in helping the rich. He announced that the government would raise the country's minimum wage by €100 a month - without forcing employers to come up with the extra money and he exempted overtime pay from taxes through 2019. He also implored private businesses to pay workers an end-of-year bonus, which would also be exempted from taxes. Lastly, he pledged to cancel an increase in taxes on the French equivalent of Social Security payments for those pensions below €2,000 per month.

The bottom line is this: It is too early to know if these changes, combined with the President's public admission that he "hurt some of you with what I said," will end the protests. France has a long history of bringing down governments by marching in the streets and Macron has made it clear that, while he is chastened, he will not reverse course when it comes to his big policy objectives. He announced he will not reinstate the so-called wealth tax on those making the most money in the country and his pledge to eliminate the new energy tax is good only for 2019. He must also come to grips with the fact that those on the political fringes are now in charge of the mob. They care little about reforms. They want to bring down his government so they can have another crack at power. No amount of mea culpas by Macron will end their hostility. If violent demonstrations continue through the end of the year, Macron's government may be in trouble.

India

On paper, the Indian economy is doing very well. GDP growth has averaged around 7% for the past few years and inflation has remained below 4% for most of the last two years. The main stock market index – the SENSEX – is up 71% over the past five years and almost 300% since 2009. Like most currencies, the Indian Rupee has lost a little ground to the U.S. dollar this year, but it has rallied a bit over the past couple of months. Most encouraging for the country, the measure of government debt-to-GDP has remained flat for the past eight years, at around 69%.

Given these numbers, you would expect that the current ruling party would be enjoying high poll numbers and widespread support. You would be wrong. In recent state elections, Prime Minister Narendra Modi's Bharatiya Janata party (BJP) experienced stunning losses at the hands of the opposition Congress party. The Congress party once dominated India, thanks to the leadership of the Gandhi family. Today, the great-grandson of the legendary Mahatma Gandhi, Rahul Gandhi, is leading a revival thanks to support from unemployed Indian youth and nervous farmers. With a national election looming in 2019, there is now real doubt whether Mr. Modi and his party can garner the necessary votes to retain control of the government.

Rumors of the pending defeat help explain why the prime minister has been attacking the Reserve Bank of India and its governor, Urjit Patel. The RBI has maintained a hawkish approach to monetary policy this year, despite a recent slowdown in the annual rate of growth. The decline from an 8.2% annual rate to a 7.1% annual rate in the latest data prompted Mr. Modi to call on the central bank to provide new liquidity to the banking system in light of the slowing growth.

While the RBI considers itself independent, that independence is not guaranteed. Faced with the prospect of an overt government takeover of the central bank, Mr. Patel abruptly resigned as head of the bank on December 10. The next day, Shaktikanta Das was named as his replacement. Mr. Das is a career bureaucrat who has served in the finance ministry and was most recently the country's economic affairs secretary. He was the face of the Modi government's scheme to eliminate higher-value bank notes in 2016; undertaken to curb the shadow economy and crack down on rampant counterfeiting. He is widely seen as a supporter of the Prime Minister's plan to boost lending in both the state-regulated banking industry and the non-bank lenders known as the shadow banking sector.

The bottom line is this: The Indian markets have mostly remained calm during this shocking period of transition. Perhaps this is because investors are skeptical that Prime Minister Modi can affect changes to monetary policy on a scale large enough to change the country's current economic path. The state-regulated banking system is so laden with bad loans they are having a hard time raising the capital needed to make new ones. This is why the shadow banking system has become so important. Shadow bank loans grew by 20% this year after a 15% increase in 2017. Standard bank credit grew by just 7% this year, which was down slightly from 2017. Shadow banks currently fund one-third of the loans used for home ownership.

Given the importance of housing to India, it is easy to see why Mr. Modi is desperate to get the central bank to support his plans to improve the liquidity of the banking system.

Even if this plan succeeds, the recent election results suggest it might be too late for Mr. Modi to secure easy reelection next year. That said, the Congress party still needs to repeat its strong showing on the national stage, then they must convince a vast array of other opposition parties to agree to work together to form a coalition government.

We will need to wait and see whether Mr. Modi's gamble to boost growth by introducing less secure loans into the banking system will be enough to secure an election victory next year.

Brexit

Faced with certain defeat in Parliament, Prime Minister Theresa May canceled the vote on her Brexit proposal and climbed aboard an airplane to fly off to the European continent. There, she hoped to find a sympathetic ear and a new willingness on the part of the EU to make compromises with her government in an effort to save the Brexit treaty.

Based on comments made by EU officials before she alighted for Germany, she is not likely to get the answer she wants. The EU continues to insist that the divorce terms include an agreement to keep the border between Ireland and Northern Ireland open - even if that means splitting Northern Ireland off from the rest of the United Kingdom. Since Theresa May's grip on power is predicated on keeping her Northern Ireland coalition partners happy, this is nonstarter for her.

Speculation is swirling about what comes next. Assuming she will return home empty handed, some are calling for a second referendum, to put before the people the question of whether it is best to abandon Brexit and return to the EU as if none of this happened. As is her want, the PM seems to be suggesting that she will call for more delays should the EU refuse to compromise.

The bottom line is this: The dumpster fire that Brexit has become is starting to produce real economic harm on the UK economy. Faced with the prospect of losing access to European markets, many financial companies based in London are making plans to open new offices on the continent. Given the central role financial firms play in London's prosperity, such an exodus could consign the UK to a non-entity in the world of high finance.

With stakes this high, Britain needs a leader capable of making bold moves. Alas, Theresa May has more than proven that she does not have that in her. While there are some in her party who aspire to the role, none has enough support of the rank and file to win the job. As for the opposition party, Labor and its leader Jeremy Corbyn have little interest in leading Great Britain back to its glory days as a world leader. They seem determined to oppose any deal that keeps the Tories in power, regardless of the consequences to the British economy. They believe they can win the new elections, once Theresa May loses a vote of no confidence.

The late breaking news that members of her party have successfully called for a vote of no confidence does not really change what comes next. Given the political realities, the UK is left with nothing but ugly choices. Right now, the least ugly choice would be to reverse course and choose to remain a full member of the European Union; something the European Court of Justice has just declared a valid option. May's attempts at postponing the vote until next year is calculated to limit Parliament's choices to just two: stay or go home with nothing. Given that a majority of Parliament has always opposed Brexit, I suspect they would very much like the chance to stay, as long as they can cover their backsides by claiming they had no choice.

— David C. Jennett

We will publish our next letter on December 24, 2018

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