CHINA FINANCIAL MARKETS

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Don’t get caught up in the January optimism

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Happy Dragon Year. This week’s entry is especially long to make up for the lack of postings over the holidays.

Good unemployment numbers in Germany and good manufacturing numbers in the US and China have fueled some January optimism, but I wouldn’t get too impressed just yet. The major global imbalances that set off the crisis are still unresolved – in fact it is easy to argue that in many cases they are worse than ever – and it is hard to see where we are likely to get sustained growth in demand. There are still too many things to worry about in 2012 and beyond.

But not everything we worry about is worth worrying about. One of the more absurd fears that still pops up every few months is the panic over the possibility that foreign central banks (i.e. the Chinese) might stop “lending” to the US government. If they ever decide to stop buying US Treasury bonds, the argument goes, US interest rates would soar and the US government would suddenly find itself unable to fund its fiscal deficit.

I apologize for repeating an argument I have made many times before in this newsletter, but aside from the fact that Chinese “lending” to the US government is not a discretionary decision that they can choose or not choose to do – it is the automatic consequence of a growth model that requires a trade surplus to absorb domestic overcapacity – the idea that the US government needs foreign funding is based on a very fundamental misunderstanding of the balance of payments. The US government does not need foreign buyers for its bonds. On the contrary, it is in Washington’s best interest that foreign central banks sharply reduce their purchases of USG bonds.

This issue came up again last weekend, when the *Financial Times* reported that foreign central bank purchases of US government bonds had declined sharply in December, but, surprisingly I guess, there had been with no noticeable impact on US interest rates:

> *Holdings of US Treasuries by foreign central banks have fallen by a record amount over the past four weeks according to the latest Federal Reserve data. The net $69bn drop in Treasury holdings registered at the Fed by foreign official institutions comes as benchmark yields ended 2011 near record low levels and when the US central bank is conducting Operation Twist, its $400bn programme to sell shorter-lived Treasury bonds and buy those with longer maturities.*
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> *The decline in foreign holdings of Treasuries in recent weeks has not resulted in higher yields and lower prices because other investors have sought the safety of US debt. "Given where the 10-year Treasury is ending the year, it's difficult to say the flows are a bearish move," said Ian Lyngen, strategist at CRT Capital.*

The *FT* claims that the reason US rates did not rise in the face of reduced foreign central bank purchases is because other private investors replaced them, but this kind of reasoning is based on a misconception. US interest rates have very little to do with foreign purchases of US government bonds.

Why? Because foreigners do not fund fiscal deficits. They fund current account deficits, and as an accounting requirement the size of the current account deficit is exactly equal to the net foreign funding. Capital account inflows must exactly match current account outflows.

The direction of causality can go either way. If investment in the US is so high, for example, that it is impossible for US savings to supply the full demand (as occurred during much of the 19th Century), then the US must import foreign capital to make up the shortfall. The difference between domestic US investment and domestic US savings, of course, is equal to the net amount of foreign savings imported into the US, and is also equal to the US current account deficit. In this case soaring US investment causes the US to have a current account deficit and leads foreigners to fund this excess investment.

Capital exports can drive the current account

But the direction of causality can also run the opposite way. Suppose foreign central banks have decided for domestic reasons (for example in order to generate domestic employment) to accumulate hoards of US government obligations and so run a trade surplus. This will cause a surge of net capital inflow into the US. In that case the US must run a current account deficit equal to the net inflow.

There are several ways this can happen. One way is for the surge in foreign capital inflows to cause a sharp rise in what otherwise would have been unnecessary or unfunded investment – the real estate bubbles in Spain and the US might be obvious examples of this. Another way is for foreign savings to displace domestic savings, perhaps by funding a credit-fueled consumption boom.

But whether for good reasons or bad reasons there is no escaping the fact that net capital imports into the US, whether pulled by domestic needs or pushed by foreign needs, must be accompanied by a rising US current account deficit – this is just arithmetic. So what happens if foreign central banks and other foreign investors pull back their purchases of US government bonds – won't interest rates rise and the economy collapse?

No, on the contrary, the economy will actually grow faster and, to the extent that interest rates are high because of default worries (as they are in Spain), interest rates might even decline. Why? Because if there is a reduction in net foreign capital inflows there must also be a reduction in the US current account deficit. This can happen in good ways or in bad ways. In Spain, for example, it will happen as a collapse in domestic demand and high levels of unemployment.

What is more plausible, in the case of the US, is that reduced capital inflows reduce the value of the dollar, causing exports to rise and imports to drop. If this happens in an orderly way, US unemployment will drop and US business profits will rise.

What will happen to US Treasury rates? They are likely to remain unaffected for two reasons. First, the decline in US unemployment will result in a decline in fiscal expenditures since the main reason for fiscal expansion is to reduce unemployment. Second the reduction in unemployment and the increase in business profits will increase tax revenues. Lower spending and higher revenues means less borrowing, and so fewer foreign purchases of US government bonds will be matched by fewer US government sales of bonds.

Remember that saying that the US needs more foreigners to buy US government bonds in order to keep interest rates low is exactly the same as saying the US needs a bigger current account deficit in order to keep interest rates low. This cannot be true.

Are foreigners (i.e. China) likely to buy fewer US government bonds in the next year or so? It depends on whether or not China continues to run a large current account surplus, and this is hard to predict since it is based more on political factors than economic ones. China's current account surplus has contracted quite dramatically in the past four years, not because of domestic rebalancing, of course, but because of forced foreign rebalancing, and there are many who think the trade balance may actually go into deficit next year.

Will the trade surplus drop?

But there is going to be a great deal of resistance within China to further contraction. Premier Wen is already warning about a tough first quarter. According to an article in the *South China Morning Post*:

> *Premier Wen Jiabao has warned that China's economy could face difficult times in the first quarter, but said the government was ready to "fine-tune" monetary policy. Wen said people should be confident the nation would surmount economic hurdles and usher in stable growth.*
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> *"We have a relatively cool market, which is the core of today's problems," he told local businessmen during a tour of Hunan province on Sunday and Monday. The premier said China had to deal with the twin pressures of an economic downturn and high prices, Xinhua reported. Dwindling external demand and rising costs for enterprises made the situation more complicated than after the 2008 global financial crisis, Wen said.*

Huo Jianguo, head of the Ministry of Commerce's research unit, was much more explicit. Last week he warned about the consequences of slow export growth.

> *China needs annual export growth of at least 15 per cent to ensure stable economic expansion as the rate of domestic investment cools, the head of the trade ministry's think-tank said in comments published yesterday. "We just can't tolerate the simultaneous fall in investment, consumption and exports," Huo Jianguo, head of the Ministry of Commerce's research unit, told the Shanghai Securities News. "A growth rate of 15 per cent [in exports] is basically a benchmark and any growth below that would start to affect employment."*
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> *Beijing has pledged to stabilise exports and boost imports next year to balance trade as part of efforts to bring equilibrium back to the economy and insulate it from the effects of deteriorating external demand. Many international economists believe China's growth has been fuelled by a reliance on investment spending, creating asset bubbles and overcapacity*

> *problems that pose more serious structural challenges than shifting external trade conditions. But Huo said concerns about falling exports were growing.*
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> *"In fact, the investment-driven model of 2009 has changed, exports are playing an incremental role in overall growth - so when export growth eases, people get nervous." Huo noted that at least 80 million jobs are related to exports - many of them held by migrant workers and therefore vital for social stability.*

We are seeing a lot more of these kinds of comments from policymakers in China, and clearly there is going to be pressure not to let a declining current account surplus act as a drag on growth when everything else is dragging too, even though weakening demand abroad should automatically reduce China's surplus and even push it into deficit. My guess is that by mid-year trade tensions are going to heat up further as surplus countries like China struggle to maintain their surpluses and deficit countries struggle to reduce their deficits.

Too much infrastructure

Before I go on to discuss debt, I wanted to make a quick reference to something sent to me by Charles Horner, a senior fellow at the Hudson Institute. I am glad to say that the overinvestment thesis is much more widely acknowledged today than it was even two or three years ago, but one myth, I think, is that most of the overinvestment excesses in China are concentrated in the real estate sector. I have always argued that it is infrastructure where the most amount of investment has been wasted.

Its impossible to prove one way or the other, but Horner sent me a paper in the *Oxford Review of Economic Policy*, by Oxford's Bent Flyvbjerg, with the rather alarming title "Survival of the unfittest: why the worst infrastructure gets built—and what we can do about it", which suggests why we need to be so worried about infrastructure spending in China – aide from the fact that the numbers are simply huge.

In the paper Flyvbjerg looks at infrastructure projects in a number of countries (not in China, though, because he needed decent data) and shows how the benefits of these projects are systematically overstated and the costs systematically understated. More important, he shows how these terrible results are simply the expected outcomes of the way infrastructure projects are typically designed and implemented.

It is not a very happy paper in general, but I am pretty sure that many people who read it probably had a thought similar to mine: if infrastructure spending can be so seriously mismanaged in relatively transparent systems with greater political accountability, what might happen in a country with a huge infrastructure boom stretching over decades, much less transparency, and very little political accountability? Isn't the potential for waste vast?

Who knows, but it seems that Beijing is increasingly worried about that possibility. Here is an article from this week's *Caijing*:

> *A golden but brief era for urban railway suppliers, builders and related companies across China appears to have ended in recent months. Local governments nationwide have slashed infrastructure spending since last summer, and the urban rail business has slowed to a crawl after several years of rapid growth.*
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> *…NDRC imposed extremely tight regulations on the approval process for subway construction before 2008, said Jin Yongxiang, general manager of Beijing's Dayue Consulting Firm, which advises subway projects. Jin said "the situation took a 180 degree turn" in April 2009, when the State Council reduced the minimum capital requirement for urban rail projects to 25 percent. At that time, a NDRC source told Caixin, credit was loose and bank loans were easy to obtain.*
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> *"In some cases, the NDRC gave a nod to an urban rail project even if a local government had yet to meet the minimum capital requirement," the source said. "With NDRC's approval for subway projects, banks were willing to lend and would not hold city governments to the capital requirement." In some cities, though, enthusiasm for the urban railway building went too far.*
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> *For example, rail lines were built where few people live on the outskirts of the Hunan Province city of Changsha, said Wang Chengli, an urban transit professor at the city's Central South University. Today, exit gates for some of the city's finished subway stations lead to farm fields. Wang said Changsha authorities installed far fewer kilometers of track in the city's center than in its suburbs. Each project was approved by the central government, he added.*
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> *Zhang says China learned important lessons from the fast-track subway program. For example, he now thinks subways should never have been built in "many cities." "The only cities that should have built subways are super-large ones such as Beijing, Shanghai, Tianjin, Shenzhen, Wuhan, Nanjing and Guangzhou," Zhang said. "Provincial capitals such as Shenyang and Taiyuan can handle their transit needs with a single, light-rail line." Subways can be uneconomical in smaller cities. Zhang*

said final costs for many projects were often much higher than a local government's estimate.

Little by little the claim repeated by so many China bulls – that you can never spend too much on infrastructure – is being eroded. It is possible, it turns out, to waste a lot of money even on infrastructure, and if debt-fueled investment is being wasted in China, as I have been arguing for over half a decade, then without doubt debt must be rising at an unsustainable pace. Last week *Bloomberg* had this article, which suggests that even the official numbers, which show debt soaring, may be understating the reality:

Debt accumulated by companies financing local governments such as Tianjin…is rising, a survey of Chinese-language bond prospectuses issued this year indicates. It also suggests the total owed by all such entities likely dwarfs the count by China's national auditor and figures disclosed by banks.   Bloomberg News tallied the debt disclosed by all 231 local government financing companies that sold bonds, notes or commercial paper through Dec. 10 this year. The total amounted to 3.96 trillion yuan ($622 billion), mostly in bank loans, more than the current size of the European bailout fund.

There are 6,576 of such entities across China, according to a June count by the National Audit Office, which put their total debt at 4.97 trillion yuan. That means the 231 borrowers studied by Bloomberg have alone amassed more than three-quarters of the overall debt.

The fact so few of the companies have accumulated that much debt suggests a bigger problem, says Fraser Howie, the Singapore-based managing director of CLSA Asia-Pacific Markets who has written two books on China's financial system. "You should be more worried than you think," he said of Bloomberg's findings. "Certainly more worried than the banks will tell you.

Why debt matters

There is more to the article.   For example Huang Jifa, in the investment banking division at ICBC, reportedly says that local government loans aren't a problem because the projects will generate returns, even if not immediately. "The money that Chinese local governments have borrowed is not like the money people borrowed in Europe or Greece," Huang said in a Nov. 24 interview. "The Chinese government's borrowed money is all invested. Many projects will have returns."

Maybe, but I am pretty skeptical. The problem of course is that it doesn't matter that many infrastructure projects in China have returns. I am sure many do (as did many projects in Greece, no doubt). What really matters is whether all the various projects in the aggregate are generating greater returns than the debt servicing cost, adjusting of course for all hidden and explicit subsidies. If not, then debt levels must be rising faster than the economy's ability to service the debt.

Here, by the way, is another interesting related article, from last week's *South China Morning Post*.

> *Auditors have uncovered 530 billion yuan (US$84.21 billion) worth of irregularities with local government debt, the National Audit Office said on Wednesday. An audit report, published on China's central government website, reveals some of the problems investment analysts had believed to lay beneath the 10.7 trillion mountain of debt that local governments had amassed by the end of last year.*
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> *The report, conducted for the last year budget year, found problems including 46.5 billion yuan worth of "irregular credit guarantees", 73.2 billion yuan worth of loans secured against irregular collateral, 35.1 billion yuan spent on stocks, houses and polluting plants and 132 billion yuan worth of expenditure not made by its approved deadline.*
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> *"A fifth problem is the fraudulent and underpayment of registered capital in financing vehicles, which amounted to 244.15 billion yuan," the report said. The local governments involved have been ordered to correct wrongdoings, but the clean-up work remains less than half done in some areas, the report shows.*

Xinhua later added an update to the story in which they focused on the amount of the irregularity that had been recouped:

> *Nearly half of the misused funds uncovered in the auditing of China's local government debts in 2010 has been recouped, authorities said on Wednesday. Of the 530.9 billion yuan (about 84.3 billion U.S. dollars) of misused funds uncovered for the year 2010, around 259.2 billion yuan had been recouped by Oct. 2011, the National Audit Office (NAO) said in a report on the year's auditing progress.*
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> *…Violations of the management of local debts involved illegal guarantees for local debts, misdirected funds to capital, property and energy-consuming markets, and the operation of fake investment*

> *companies, the report said, adding that the governments have been moving actively to correct the irregularities.*

This particular story is less important than the frequency with which we hear similar stories. Every credit bubble in history seems to have been accompanied by a surge in accounting "irregularities". Irving Fisher explained why in the 1930s, and Hyman Minsky also indirectly showed why this might happen. It is, I guess, a necessary accompaniment to out-of-control credit expansion.

I get many calls from investors and journalists on these debt-related topics, usually because they worry about the ability of specific borrowers and sectors to service the reported debt, and I always make the same response. The debt will be serviced. One way or the other it will be assumed by the central government through the banking system.

But this is not the important issue. The important issue is that it is clearly proving impossible to keep GDP growth levels high without explosive debt growth, and there are serious debt capacity limits to this kind of debt growth. I have no idea where the debt will next show up, or what the next debt panic will be (I suspect this year it will be SOE debt), but I have no doubt that there will be more of these debt panics. This is not an accident. It is intrinsic to the way the development model works.

The problem, then, is not that there will be defaults. The problem is that the only alternative to default is to service the debt, and this is what will cause the real damage to the economy. If the economic benefits generated by the investment are less than the correctly-valued debt-servicing costs, as they almost certainly are, the difference has to be made up in the form of a transfer of resources from some sector of the economy.

As we saw in the last debt crisis, a decade ago, debt-servicing costs are only manageable in China thanks to financial repression – i.e. extremely low lending rates funded by even lower deposit rates -- which implies a huge transfer, equal to several percentage points of GDP annually, from household savers to corporate and government borrowers. Households, in other words, typically clean up banking messes.

Only consume!

The problem with this solution is in what it implies about future growth in demand. If investment is being wasted, it must be reduced or it will create a debt crisis eventually. If the external environment is tough, the demand impact of a sharp drop in investment cannot be made up for by a surge in the trade surplus – in fact the trade surplus may actually contribute negative demand. So where will the demand come from needed to pull the Chinese economy? The only possibility is a surge in domestic consumption.

Can consumption possibly surge? No, not if the household sector is going to be forced to clean up the banking mess again. This is the same problem that caused household consumption to drop after the last banking crisis from a very low 46% of GDP in 2000 to an astonishing 34% in 2010.

In that light, it was interesting to see this article in Wednesday's *South China Morning Post*:

> *The Chinese government is planning new policies to boost domestic consumption, especially of vehicles and appliances, in a bid to offset the effects of sagging export demand, the* China Daily *reported on Wednesday, quoting a government official. With tax rebates on vehicles and domestic appliances either having expired or due to expire, the government is working on new measures, said Huang Hai, former assistant minister of commerce and a member of the economic and trade policy consulting committee linked to the Ministry of Commerce.*
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> *These may include subsidies for families living in affordable housing that buy electrical appliances and for consumers planning to change cars, the paper said. The newspaper also quoted a Ministry of Commerce spokesman as saying that the ministry was considering new programmes to expand consumption, with details to be announced next week.*
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> *Huang also said over 10 government agencies, including the Ministry of Commerce, the National Development and Reform Commission (NDRC) and the Ministry of Finance, are expected to co-operate and propose concrete plans to boost consumption at a meeting slated for April.*

"If at first you don't succeed, try, try again," WC Fields advised but, he added, "then quit. There's no point in being a damn fool about it." I don't think this new attempt to boost consumption has any chance of succeeding, any more than similar polices did in 2009 and 2010.

Sure, consumption of automobiles and white goods surged back then, just as you would have expected given the subsidies, and they will surge again no doubt, but since those subsidies were ultimately paid for by the household sector, the policies did not translate into an overall surge in consumption because there was no net increase in household wealth. In fact during both of those years consumption continued to decline sharply as a share of GDP.

The *Financial Times* version of this story makes a classic mistake:

> *China has ample room to stimulate consumption. Household spending accounted for half of gross domestic product two decades ago but dwindled to just 33.8 per cent of GDP in 2010, a record low for a major economy in peacetime. China is probably now at a turning point in that consumption is beginning to become a bigger force in the economy, but this will be a "longer-term process", said Zhu Haibin, an economist with JPMorgan.*

For years China bulls have been arguing that because the Chinese save so extraordinarily much money, there is plenty of room to stimulate consumption – just get them to save a little less. The problem with this reasoning is that consumption is not low because Chinese households save a lot (they save in line with other Asian countries as a share of their income, and less than some). It is low because household income is such a low share of GDP.

It isn't about household savings

The only way to boost household consumption is either to redistribute income from the low-consuming rich to the high consuming poor, or, better yet, to redistribute wealth from the state to households. Both of these have serious political implications that have to be resolved and are unlikely even to be addressed with consumption subsidies. After five years of this argument, during which time consumption has plummeted relative to total savings, you would think they would start to abandon the idea that all we need to do to get consumption to surge is to reduce household savings a little.

When we add in the possibility of a continued decline in house prices throughout China, we may start to feel some kind of wealth effect dragging consumption growth down even further as a share of GDP, although I am not sure I am too worried about that. The housing boom seems to have mainly benefitted speculators, and I don't think that it translated into a significant increase in consumption when housing pieces were on their way up. In that case it shouldn't matter too much on the way down either, although it is better to wait and see what happens.

Nonetheless on Tuesday *Xinhua* has this to say about housing prices:

> *Sales of both new and existing homes in Beijing plummeted in 2011 as a result of the government's efforts to cool down the runaway property market. New home sales in Beijing dropped 18.4 percent to 90,605 units*

in 2011 from a year ago, the Beijing News reported Monday, citing data from the city's housing regulator.

In terms of square footage, sales slumped 22.4 percent to 9.56 million square meters last year, falling below 10 million square meters for the first time in six years, the paper said. Existing property transactions also plunged. Sales in 2011 shrank 38.2 percent to 121,512 units, hitting a three-year low. Monthly sales of existing homes have stayed below 10,000 units since April, the paper said.

Increased down-payment requirements and mortgage rates, as well as limits on home purchases, led to the declines, the paper said, citing Zhang Dawei, a chief analyst with Centaline Property. Consumers will likely expect further price drops in 2012, as the government has reiterated that it will maintain the policies, Zhang said. Property prices in Beijing are likely to fall 10 percent to 20 percent over the next six to 12 months, he said.

On a related note, on Tuesday, Li Yan, a young musician I know, called me up to ask me for some advice. His parents, who come from and still live in a small town in Hebei province, wanted to buy him an apartment in Beijing, where he lives and works, because they were sure that in a few years the same apartment would cost an awful lot more. He wanted to know from me whether it made sense to do so. He had heard prices are coming down rapidly and asked me whether he should tell his parents to wait. Yes, I told him, wait.

I mention this story because Li Yan is a 21-year-old kid who has just started to become famous among Chinese youth for his wild antics and wilder music, and I suspect he thinks about and discusses finance and real estate as often as I think about and discuss life on Venus. Yet even he has heard that real estate prices are dropping. Two years ago, of course, no one in China had any doubt that real estate prices can only go up.

Enter the vulture

Salivating at the prospect of all this bad debt, it seems, are a number of funds that specialize in debt restructuring. According to an article in Thursday's *Financial Times*:

The vultures are flying east. From Kohlberg Kravis Roberts, which recently announced plans to set up shop in Hong Kong, to Apollo Management and US financier Wilbur Ross – China, it seems, is on the forefront of many distressed debt investors' mind. You can't blame them. With China's economic growth tailing off, the view is that companies which have

> *overleveraged themselves during the boom years are going to start to drop.*
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> *But feasting on the carrion is likely to be easier said than done. "Being a distressed debt investor in China is not as straightforward as in Europe or the US simply because China does not have a clear rule of law," Robert Partridge, Ernst & Young's head of transaction advisory services told beyondbrics. "Traditionally, distressed debt investing is all about legal certainty and being able to take control of companies and their assets through the courts."*
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> *In theory, the introduction of a new bankruptcy law in 2007 should go some way to allowing overseas lenders to use the courts to recover their debts in China. The Enterprise Bankruptcy Law (EBL) significantly broadened the role of creditors by providing, among other things, a mechanism for them to wind up distressed companies and reorganise them as well as force shareholders into loan-for-equity swaps. But in practice – a lack of experienced judges and administrators, and weak enforcement, mean this is not a process that debt holders, particularly foreign ones, can count on to enforce their rights over the assets.*

I agree with Partridge that things are much more complicated here in China than abroad, and certainly the wave of funds that came in to take advantage of the last big batch of distressed debt, a decade ago, were, it seems to me, fairly disappointed. Still, I wonder if this time things might not go a little better for them. For one thing we are starting to see NPLs rise even though there are many ways to keep from recognizing them:

> *Bad loans spiked at Shanghai Pudong Development Bank, signalling what some analysts say may be the start of a credit-deterioration cycle among mainland banks. While the non-performing-loan (NPL) ratio - or bad loans as a share of total loans - dropped 7 basis points to 0.44 per cent, the value of the Shanghai-based bank's outstanding bad loans rose 13.2 per cent in the fourth quarter to 5.86 billion yuan (HK$7.19 billion), according to mainland news outlet* Caixin*.*

It is amazing to me that NPLs can rise by 13.2%, but total loans rise so quickly that the NPL ratio actually declines. This can't be healthy for the bank's balance sheet.

A more important reason why the distressed business might de better this time around is that in the last debt crisis the bad debt was essentially resolved via financial repression (and not by the creation of AMCs, as so many people will still tell you). If you keep rolling debt over at negative real rates, no matter how bankrupt you were initially, eventually after enough time you will regain solvency. This is how the myth was created – and still widely believed – that China was able simply to "grow out" of the bad debt, and will do so again.

This time however I really doubt that the debt crisis can again be resolved by financial repression, since household wealth is already far too small a share of GDP, and expected GDP growth prospects much lower than in the past. Remember that if GDP growth slows sharply, the only way households can continue permitting that their share of GDP declines, as it has for the last thirty years, is if household income growth drops to zero or even goes negative.

Slower growth and an already-low share of GDP will mean that it will be politically very difficult to force households to clean up the mess another time. Add to this the problem of illiquidity in the banking sector, which is going the become an increasing problem over the next few years as borrowers have trouble repaying loans and will require more-or-less permanent ever-greening, and I think there will be much greater appetite for a real liquidation of bad debt.

Supporting SMEs

So maybe this time around the business of distressed debt might actually be profitable, although I think that in order to succeed the funds are first going to have to educate policymakers about the benefits to China of debt resolution. The main reason to restructure bad debt, remember, is not to help the banks, but rather to eliminate financial distress costs, which can be considerable, from the economy.

I am not sure policymakers have any idea why this might be the case, and until they do they will see the whole thing as a zero-sum game. Any profit for the likes of KKR, they will think, is by definition a loss for China. Once they understand that debt restructuring and liquidation is actually very positive for the economy, however, distressed debt might become an interesting business, although the lack of a predictable and enforceable legal framework is always going to be a big problem in China.

Beijing is clearly worried about rising difficulties at SMEs, fueled in part by crippling debt costs in the informal banking market. The MoF announced on Saturday a new measure aimed at helping them. According to an article in *Xinhua*:

> *The country's Ministry of Finance (MOF) announced Saturday that the nation's government departments will allocate at least 30 percent of their purchasing quota to small and medium-sized enterprises (SMEs) from the start of 2012. Meanwhile, 60 percent of the allocated quota will be*

reserved for small and micro-sized businesses, according to a new guideline jointly issued by the MOF and the Ministry of Industry and Information Technology, a statement on the MOF website said.

The guideline urges relevant units to step up making plans to buy from SMEs in 2012. It also forbids any institution or any individual from impeding or restricting SMEs' access to the government purchasing market, the statement said. Furthermore, in regards to projects that are not especially oriented to SMEs, the government purchaser or purchasing agency should first implement a 6-10 percent cut in product prices as reported by SMEs, and use the reduced pricing for bidding in order to give them advantages.

This is a little like one of those Rube Goldberg machines. Direct subsidies and access to capital at low or even negative real rates give inefficient SOEs huge advantages over more efficient SMEs. The balance is then partially restored by administrative measures that create a complex SME quota and a formula for adjusting SME prices downward.

This is a system just asking to be abused or dishonestly administered. There has to be a more efficient way. Raising interest rates to a reasonable level and eliminating the implied credit guarantee SOEs enjoy would, of course do the trick, but we can't do that because it would create enormous financial distress if SOEs were actually required to create sufficient economic value to pay real interest. So we hire a bunch of Rube Goldbergs.

Spanish surprise

Turning abroad, there is additional reason to doubt that the global imbalances have at least partly corrected. It seems to me that nothing in Europe is improving except sentiment, and this won't last long, especially as Angel Merkel's solution to every European problem seems to be to try to embed more rules about restrictions on budget deficits into more European constitutions.

Not only is this irrelevant to the problem at hand, but she should know that in a pinch it is always possible anyway to run up huge contingent liabilities without violating formal budget restrictions. China, after all, has a fiscal surplus, and yet it would be foolish to assume from this that the government's liabilities must be minimal and declining.

Merkel is apparently a member of the school of thought that believes that financial crises are caused mainly by bureaucratic sloppiness. Clean up the rulebook and everything will be fine. Meanwhile austerity is not leading, as many expected, to better debt ratios. Here is an article from last week's *Financial Times* about the Spanish budget deficit:

> *Spain's centre-right government has warned that this year's budget deficit is likely to reach 8 per cent of gross domestic product, much higher than expected and a full 2 percentage points, or €20bn, above the target agreed with the European Union.*
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> *Soraya Sáenz de Santamaría, deputy prime minister for the Popular party government that took office a week ago, announced immediate cuts of €8.9bn in annual public spending and tax rises worth €6bn after a cabinet meeting on Friday. "It's a big [deficit] overshoot," she said. "We are in an extraordinary and unforeseen situation. But the government will not have the slightest hesitation in confronting it."*
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> *The PP government of Mariano Rajoy, prime minister, had been expected to raise the 2011 deficit estimate from 6 per cent of GDP and blame the former Socialist administration of José Luis Rodríguez Zapatero. But the scale of the revision was larger than predicted, even by pessimistic economists, who thought it would be to 7 per cent or less, and is likely to worry investors. It will also make it harder for Spain to meet its 2012 deficit target of 4.4 per cent.*

When you read contemporary newspaper reports written during earlier sovereign financial crises, one of the things you notice is all the articles that month after month and year after year revise fiscal deficit and debt estimates upward and revise GDP growth estimates downward. This is not an accident, and it is not even caused by dishonest governments trying to boost confidence. It is one of the almost automatic consequences of the financial distress process.

When a country is experiencing a financial crisis there is a tendency to underestimate – perhaps because it is poorly understood –the consequence of financial distress behavior on debt and the underlying economy. I have discussed this several times in previous newsletters, and the main point is that once debt levels are perceived to be too high there is a very automatic process by which all the major actors in the economy change their behavior in ways that increase financial fragility, reduce growth, and force up fiscal deficits.

This means that almost all our projections, even when we think we are being conservative, are likely to be excessively optimistic because we are not taking into account the automatic change in behavior. For the next few years in Europe we should expect constantly to be surprised when data turns out to be worse than projected. Spain will regularly surprise us with higher deficits than expected, as will Italy, Greece, Portugal, and several other countries. This is part of the dynamics of any sovereign financial crisis.

Also part of the dynamics is rising nationalism and increasing radicalized politics. Actions last week by Hungarian Prime Minister Victor Orban should remind us of this problem, if reminding is necessary. According to an article in the *Financial Times*:

> *This week saw the introduction of Mr. Orban's new constitution. Suffused with ethnic nationalism, it reeks of an ambition for one-party rule. It promises repression of personal freedoms within Hungary and, through an extension of citizenship to Hungarian minorities elsewhere, threatens instability in ethnically-diverse neighbours.*
>
> *The constitution has to be seen alongside a slew of new basic laws and the gerrymandering of the electoral system. Together, they bestow inordinate power on the ruling Fidesz party. The prime minister can claim to have won the 2010 election fairly. Now he is deploying a two-thirds majority in parliament to deny opponents the same possibility.*

This isn't the first case of deteriorating politics and a reduced commitment to democracy, and it won't be the last.

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