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Solid Ground

Global outlook

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Global
Macro strategy

Previous reports on this theme

National capitalism

The move to divert domestic savings to shore up government finances has begun. It will require liquidation of assets to fund public debt. These assets are likely to be those of other states, including government debt. This will create intense financial economic and political friction. Just as Smoot-Hawley intensified the Great Depression, this "national capitalism" will worsen the current downturn. Uncertainty over which Eurozone nations will be able to ratify the fiscal compact of 9 December will amplify the impact. Europe is the epicentre, but China's move towards a balance-of-payments deficit creates similarly deflationary dynamics.

Repression first creates deflation

- Politicians can offer more than austerity, default, devaluation or hyperinflation.
- One simple solution will be highly popular: make banks and other savings institutions fund the state at interest rates below the rate of inflation.
- Bank shareholders and savers will bear the brunt of this financial repression.
- The move to repression will create a return of capital to home base, which will push yields higher elsewhere and intensify deflationary pressures.

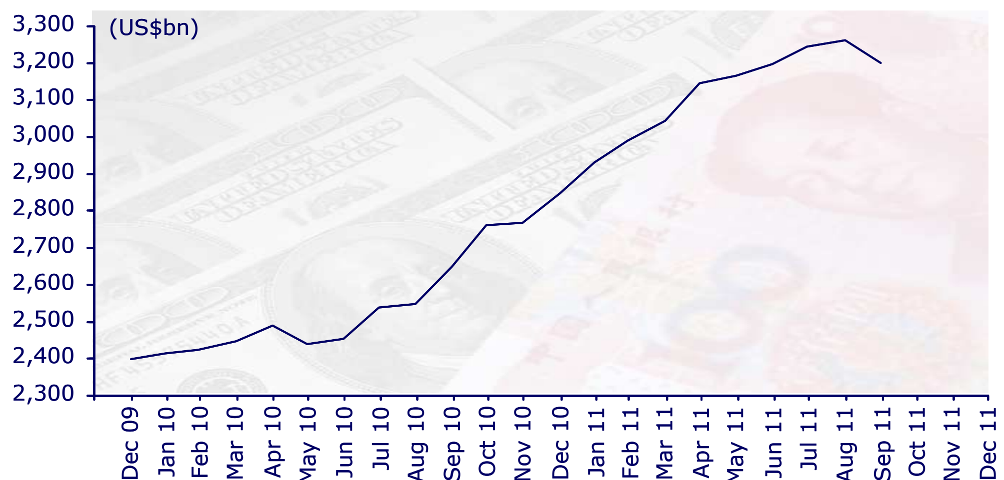
The political dissolution of the euro, 2012

- How aggressive financial repression needs to be will depend on whether Eurozone countries finally ratify the 9 December 'fiscal compact'.
- Although all 17 members have signed the deal, in 2012 many will fail to ratify it and we will see countries leave the Eurozone.
- Investors need to plan for a Eurozone breakup and take any bounce in markets associated with the signing of the deal as a selling opportunity.
- The deflation on the way to this breakup could take equities to a great bear-market bottom, and present an excellent buying opportunity sometime in 2012.

China's capital exports end

- China's BOP surplus is shrinking rapidly. If this continues, the People's Bank of China will buy fewer Treasuries and print fewer yuan.
- Such action would constrict growth and inflation in both jurisdictions.
- China's command-economy banks can be put to use to offset low growth in PBOC-created money, and an enforced deflation in China in 2012 need not follow.
- The rapid slowdown in foreign central bank purchases of Treasuries continues to threaten a further rapid private-sector deleveraging in the USA.

China's foreign-exchange reserves: An era nears its end



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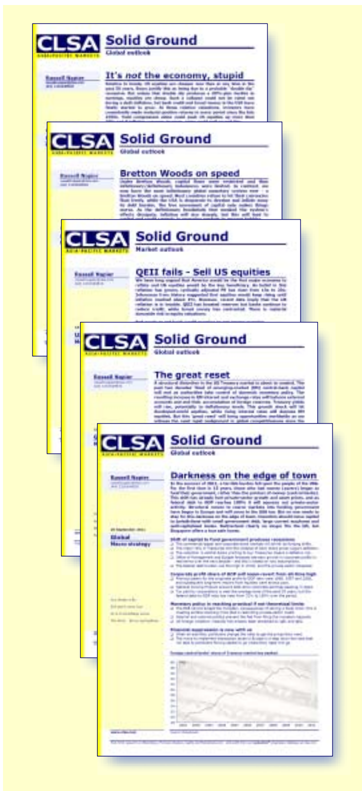

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About Russell Napier

Russell Napier is a consultant with CLSA, writing on issues affecting global equity markets. He worked as an investment manager at Baillie Gifford in Edinburgh, before moving to Foreign & Colonial Emerging Markets in London. In May 1995, Russell became Asian equity strategist at CLSA in Hong Kong. He was ranked No. 1 for Asian strategy in both the *Asiamoney* and Institutional Investor polls in 1997, 1998 and 1999. Since 1999 he has worked as a consultant for CLSA. Russell has developed and runs a course called A Practical History of Financial Markets. The course is aimed at fund managers and involves teachers with some 150 years of experience communicating the key lessons in financial history in just two days (www.sifeco.org). Russell's book *Anatomy of the Bear* was named investment read of the year for 2006 in the *FT*, and was republished in 2007 and 2009.

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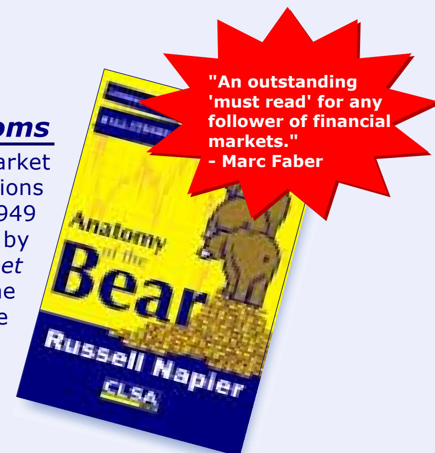
Anatomy of the Bear:

Lessons from Wall Street's Four Great Bottoms

Russell Napier's acclaimed book examines financial market history as a guide to the future. Looking at the four occasions when US equities were most undervalued - 1921, 1932, 1949 and 1982 - Napier set out to answer key questions by analysing every article that appeared in *The Wall Street Journal* either side of the market bottom. Through the 70,000 articles he examined, one begins to understand the features pointing to a great buying opportunity arising. Napier offers investors a field guide to making the best financial provisions for the future.



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National capitalism

Financial repression will force the sale of foreign assets, including sovereign debt

Solid Ground has long argued that the 2008 crisis would end with sovereign-debt crises and financial repression - the process of forcing or cajoling private-sector savings into funding public-sector debt. The sovereign debt crisis is now evident in Europe and financial repression has begun. Primarily under the guise of macro prudential regulation, governments are causing domestic financial institutions to buy more of their debt.

Where capital inflows have been monetised, withdrawal of foreign-currency credit directly impacts monetary policy

While individuals may seek to get their capital as far from government manipulation as possible, domestic savings institutions cannot be so flexible. In particular, banks, increasingly owned or directed by the state, will be forced to liquidate foreign assets to shore up domestic state finances. This creates obvious problems in Europe given the extent of cross-border lending. It will also reduce the availability of the foreign-currency credit that emerging markets have amassed since 2009, creating particular problems in jurisdictions which seek to keep their exchange rates stable. A capital exodus forced by financial repression elsewhere would offset current-account surpluses and potentially force a monetary contraction where exchange rates are defended by central banks. The recent weakness of Asian exchange rates suggests that such a repatriation of capital is already underway.

Macro prudential regulation can act as a *de facto* capital control

Like Smoot-Hawley restricted the free movement of goods across borders, this “national capitalism” restricts the free movement of capital. A country that pursues national capitalism while still accessing credit from other countries can lower the cost of funding its government and private sector. However, its banks will be acting to tighten credit in other countries. Thus macro prudential regulation used as a *de facto* capital control has similarities with the beggar-thy-neighbour consequences of Smoot-Hawley. Financial repression sets in train a process of further credit tightening, increased deflationary forces and worsening cross-border political tensions.

Deal signed on 9 December will divide Europe

The 9 December agreement in Brussels will impose budget deficit limits on countries, enforced by the European Commission. This is clearly a huge constitutional shift and diminution of sovereign powers. However, there can be no future within the Eurozone for those that do not accept the deal. Even if all members sign, 2012 will be dominated by wrangling over whether the people have a direct say on the issue, which will probably delay the ECB’s move to a more expansive policy and the introduction of Eurobonds. The longer this delay before ratification continues, the more likely national capitalism and deflation becomes. Compounding the negative impact of further delay is the likelihood that one or more members cannot sign, leading to financial chaos as markets begin to price a euro breakup.

China rapidly ceasing to be an exporter of capital to the world

Exacerbating national capitalism is the fact that China is no longer a great enforced exporter of capital. In September, China probably ran a balance-of-payments (BOP) deficit as capital outflows more than offset its current-account surplus and capital inflows. This suggests that the long era of an undervalued renminbi is ending. The current-account surplus is shrinking as wage growth outstrips productivity growth and, more importantly, private capital sees reasons to invest elsewhere. China will cease to be a mass exporter of capital to the world in general and the US Treasury in particular. While steady BOP deficits remain unlikely, the era of huge surpluses is over.

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PBOC selling Treasuries and buying renminbi means tighter liquidity

If the People's Bank of China (PBOC) starts selling Treasuries and buying back renminbi, deflationary risks will rise sharply. Before that happens we should expect a clampdown on capital outflow from China. This will bring some relief, but merely postpones the inevitable. Even then, China's defence of its exchange rate and contraction of bank reserves need not have the expected impact on bank balance sheets. Normally commercial banks would respond by contracting loan books and destroying money, but China's command-economy banking system does not have to do this. Thus the defence of the exchange rate need not produce deflationary monetary policy.

Renminbi no longer grossly undervalued; this restricts Chinese monetary policy

A BOP deficit may not augur tight monetary policy and an economic collapse in China, but it will be a nasty surprise to those who consider Beijing to be unfettered in manufacturing its desired GDP growth rate. Investors have come to believe there is an inherently structural vendor-financing relationship between the USA and China. They will be shocked to learn that this is the result of a long cycle that began in 1994 when China devalued the renminbi. Since then the PBOC has been printing money. However, authorities that link their exchange rate to others lose a degree of monetary flexibility even when they operate behind a wall of capital controls. As those controls weaken and the exchange rate becomes less undervalued, their ability to run loose monetary policy can be significantly restricted.

Without the PBOC, US savers will have to fund the US government

The deterioration in China's BOP means the PBOC will become much less important as a funder of the US government. As *Solid Ground* argued in *The great reset* and *Darkness on the edge of town*, US savers will be forced to shoulder more of the burden. The shift of savings to fund the government is already squeezing credit availability to the US private sector, hampering growth and adding to the global forces of deflation.

National capitalism threatens tighter global liquidity and deflation

National capitalism threatens tighter global liquidity. Financial suppression's purpose is to force interest rates below inflation and permit governments to reduce their debt burdens. This is likely to be achieved in the long run, but in 2012 it is likely to deliver a painful deflationary shock similar to that of September 2008-March 2009. The combination of such a shock and a sovereign debt crisis is a nightmare for investors: government debt of highly indebted nations cannot be presumed to deliver positive nominal or real returns, as it would normally do when deflation calls. The only good news may be that a deflationary shock will finally end the artificial support of asset prices which central bankers have come to see as their duty. Until then, investors need to maintain their wealth in preparation to buy good things cheap. The only safe haven is cash, and *Solid Ground* continues to recommend Singapore dollars as the most secure currency.

Foreign central bank purchases of Treasuries have fallen sharply

Growth in Treasuries versus value of Treasuries held by foreign central banks

(US$bn)	Growth in total outstanding federal securities	Growth in value of foreign central bank holdings
2007	237	178
2008	1,224	663
2009	1,443	479
2010	1,584	441
3Q11	389	40

Source: Federal Reserve Flow of Fund Statistics

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Repression first creates deflation

Financial repression is a much easier solution than austerity, default or hyperinflation

Many countries are facing a financial future of austerity, default or hyperinflation. The paths to these outcomes are well known even to politicians, and they all carry major financial and huge political costs. Rare will be the politician who delivers any of these outcomes and then secures re-election. But one simple solution will be highly popular with most of the electorate: make banks and other savings institutions fund the state at interest rates below the rate of inflation. This allows any politician to run for re-election on the appealing slogan of: 'You don't pay; banks do'. Given this source of low-cost funding, many very nasty decisions on cutting spending and raising taxes can be avoided. The printing presses will still have to run to ensure inflation and not deflation, but hyperinflation will probably not be necessary to wipe out public-sector debt. Government finances will be more sustainable and there will be no need to default. And with banks providing financing at nominal interest rates below the rate of nominal GDP growth, governments can perhaps see economic growth returning them to solvency.

Savers are the casualties

Any solution to the sovereign-debt crisis will cause suffering, but repression creates the most politically palatable pain. Bank shareholders will feel the brunt, followed, as interest rates are kept below inflation, by savers. Thankfully for politicians, both groups are clearly an electoral minority. Since the longer-term price of inefficient capital allocation in a period of negative real interest rates is, like all long-term problems, something for the next politician to deal with, this approach represents the path of political least resistance and is already under way. Note that while banks are the obvious vehicle through which to prop up state finances, all domestic financial institutions can be similarly utilised.

As the repression speeds up, investors remain distracted by the risks of austerity, default and hyperinflation. For those who still doubt that financial repression is the future, let us first look at the present:

Financial repression has already begun

- Ireland has used funds from its National Pension Reserves to finance its banking system. Using Irish savers' money reduces the amount that the government of Ireland has to borrow.
- Ireland is also using the National Pension Reserves to 'support the exchequer's funding programme' - ie, to reduce the amount that the government must borrow to finance itself.
- The recent Italian budget raised the capital-gains tax, but not on gains on government debt. Thus, through the repression of relative tax rates, government debt is made more attractive to domestic savers.
- The French government will transfer €36bn from its pension reserve. A rapid reduction in the 40% allocation to equities is foreseen as the government will increase the fund's weighting to government bonds, apparently as part of a shift to asset liability modelling.
- The Hungarian government has threatened to cancel the state pension of any citizen who does not move their private-sector pension back under state control. Anyone who makes no election of any sort will automatically see their pension assets returned to state control. The government intends to use these transferred monies to buy government debt.
- Argentina seized control of private-sector pension funds in 2008 and then used the US$29bn pot to fund the government.

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QE reduces bond yields and eventually boosts inflation

- Central bankers are creating new bank reserves as payment for their purchases of government debt (quantitative easing). By increasing demand for government debt, they push yields lower. The manipulation of government bond yields to lower levels forces financial institutions to lend funds to the government at lower rates than they otherwise would. At some stage the creation of excess bank reserves could result in commercial-bank balance sheet expansion producing an increase in bank credit, money supply and inflation. A continuation of QE at this stage would force financial institutions to fund the government at ever more negative real rates of interest.
- The new BIS capital-adequacy framework contains proposed minimum liquidity levels for the global banking system. Banks will have to hold more 'unencumbered, high quality, liquid assets', which should be eligible for discounting at central banks. The new liquidity coverage ratio will result in banks holding larger inventories of government debt.

The UK's nationalised banks are funding the government

- The UK's partially nationalised banking system saw the value of its British-government debt holdings rise from £54bn in January 2010 to £102bn in September 2011. In the six months to April 2011, UK commercial banks bought 91% of the new issuance of British government debt.
- Portugal has transferred €5.6bn from bank pension-fund accounts to the national government. Transferring the asset, while ignoring the future liability, will assist the government in meeting its fiscal deficit targets.
- The Austrian central bank is restricting domestic commercial banks from lending funds to their subsidiaries in Central and Eastern Europe (CEE). The move came as government bond yields rose, as investors feared that Austrian commercial-bank losses in CEE might force a government bank bailout. The government hopes to keep its own bond yields down by restricting capital outflows from commercial banks.
- An article in *The Wall Street Journal* entitled 'European Nations Pressure Own Banks for Loans' described how banks were being cajoled into funding national governments. It quoted a senior Italian bank executive as saying, 'we know that if we reduce our exposure, we'll be killed by the Italian Treasury'. A Portuguese bank executive was reported as saying of Portuguese government debt: 'On one hand these are risky assets that should be dumped, but on the other hand, there is pressure to keep investing in them.' In the first nine months of the year, bank lending to the Spanish state increased by 14% while private-sector credit declined.

Buying national debt can create a dumping of non-national debt

The initial move to repression will create a return of capital to home base which will be deflationary in nature. As time progresses, banks and other financial institutions will increasingly become the receptacles for national sovereign debt. There are several implications for investors from the rolling financial repression catalogued above:

- Expect the acceleration of financial repression where bond yields are well above inflation. These jurisdictions are in a debt trap and repression is their most politically acceptable exit strategy. At this stage this relates to certain Eurozone countries, but as we have seen, the French and UK governments have taken some repressive steps even at current low financing costs. There could be a speculative gain to be had in buying such sovereign debt as financial repression ramps up and pushes interest rates to much lower levels.

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- Do not invest in the equity of banks or insurance companies that will be forced to invest in sovereign debt at negative real interest rates.
- Negative real interest rates, even at the long end of the yield curve, will be with us for a very long time. Any spikes in long real rates, as we are currently witnessing in Europe, will not endure for prolonged periods as they will be met by greater degrees of repression. Key yields would rise to very high levels on a Eurozone breakup (see Section 2), but extreme financial suppression would then be used to bring them down.
- For financial repression to work, it will entail restrictions on the free movement of capital.
- In the Eurozone, the most dangerous result of financial repression will be a decline in cross-border lending. Forcing or cajoling domestic savings institutions to provide local credit reduces their ability to provide credit offshore. Repression, aimed at inflating away debts, will most likely trigger short-term capital movements which are deflationary in nature.

In the modern financial system, repression first brings deflation

This last impact is now most important for the performance of global asset prices worldwide. As investors witnessed in September 2008-March 2009, deflation means a sharp decline in the price of equities. Such deflation is now likely, as a move to financial repression will have entirely different implications in today's global financial system than it had in the post-WWII era. Repression was successful then, when the stocks of international capital financing national financial systems were extremely limited and could not be removed rapidly from any country due to capital controls. Another crucial difference was that each country had its own central bank capable of creating inflation above artificially depressed nominal rates of interest.

This is not 1945 and repression can create a move of capital back to the home state

We now live in a very different world - nowhere more so than in the Eurozone. While the Euro countries may be a long way from fiscal union, the degree of cross-border lending shows that they are already in a financial union. Another key change is that Europe now permits the free movement of capital. Thus, not only are financial systems more interdependent, their relationships can change quickly. For most of the postwar period, when Europe was surrounded by capital controls, these were simply non-issues.

The complications on the nominal-interest side of the equation are large, but probably not as large as on the inflationary side. Eurozone members no longer have their own central banks. We now live in a world where financial repression could place upward pressure on non-national interest rates and where there is no national central bank to create the inflation needed to produce negative real rates. As we shall see, the current structure in Europe means that a unilateral move to repression by one nation could exacerbate a deflationary spiral within the group.

Bank lending to domestic sovereigns can expand without reducing cross-border lending . . .

Some will argue that in a world of financial repression, bank lending to the domestic sovereign can accelerate without causing a contraction in cross-border lending. This certainly could be the case. Banks are not like other institutions: they do not need money to lend money. It is thus possible that repression will lead to a boom in lending to domestic sovereigns as banks extend their balance sheets, creating deposits in the process. But it is not likely. Across Europe the commercial banks are being forced to raise more capital and shrink their balance sheets. While Bank of International Settlements (BIS) capital-adequacy definitions still ascribe low risk weightings to non-national

. . . but this is unlikely

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Euro sovereigns, the risks associated with lending to the private sector in Eurozone countries clearly remain high. As we have seen in Austria, restrictions on cross-border lending are a natural reaction for any state seeking to reduce its ultimate liability to bail out its banks and their depositors. Given these factors, it seems very unlikely that commercial banks can ramp up funding of domestic sovereigns without reducing cross-border lending.

Financial repression by one state restricts the credit flow to other states

Financial repression, acting as it does to restrict capital movement, is a breach of Article 63 of the Treaty on the Functioning of the European Union. However that treaty also recognises in Article 66 that governments can temporarily suspend the free movement of capital when there is a threat to the operation of European monetary union. Countries seeking to use domestic savings to manipulate the price of their sovereign debt could call upon Article 66, perhaps under the guise of macro prudential regulation. However, what would be the consequences if French bond yields rose sharply due to Italian banks dumping positions to buy Italian government debt?

The initial unilateral move would tend to push bond yields higher elsewhere in Europe. In the process it would generate tremendous political friction and exacerbate deflationary forces through rising interest rates. The scale of cross-border financial lending in the Eurozone is so large that any such attempt at financial repression would quickly produce these negative consequences for other states. Foreign banks have provided up to 30% of the funding for some governments (Finland) and as little as 11% for others (Ireland). For the 10 Eurozone nations for which data are available, on average overseas banks provide 20% of their public finance. This proportion rises sharply if we include financing from other overseas financial institutions such as insurance companies. Any move that forced these institutions to switch to financing the domestic sovereign would create major dislocation to European sovereign debt markets. There would be similar dislocations in the funding of the private sector.

Banks' cross-border lending of euros already declining

The BIS Quarterly Review shows that the value of cross-border bank loans in the Eurozone was US$6,598bn at the end of March 2011 and 69% of these loans were denominated in euros. Thus the initial move by any country to focus bank lending for domestic purposes, public or private, would result in a reduction in this US$4,549bn cross-border Euroloan business, which is already contracting and is 5.5% smaller than it was in December 2008. Even this minor decline in cross-border lending has played an important role in pushing up sovereign bond yields and commercial credit spreads, and unilateral financial repression would greatly accelerate this process and further tighten liquidity.

The BIS data make it clear that the vast majority of cross-border borrowing in Europe is sourced from European banks. Only Germany and France get less than 78% of their cross-border credit from non-European sources; most Eurozone countries source more than 90% of such loans from European institutions. Figure 1 shows Eurozone countries' total offshore borrowing, but this in effect means borrowing from other European countries.

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European cross-border finance is huge

Figure 1

Banks' cross-border loans to Eurozone countries

	Amount (€bn)	As % of GDP		Amount (€bn)	As % of GDP
Austria	80	30	Italy	421	29
Belgium	235	73	Luxembourg	504	12,600
Cyprus	47	293	Malta	21	420
Estonia	7	54	Netherlands	589	107
Finland	102	61	Portugal	123	77
France	998	54	Slovakia	11	18
Germany	893	38	Slovenia	17	30
Greece	78	35	Spain	406	41
Ireland	426	77			

Source: BIS

Data misleading for international loan-booking centres like Ireland

The table includes all cross-border bank loans to a particular country. It does not distinguish between the nationalities of the borrowers who borrow in that country. It thus tends to overstate the borrowings of countries such as Luxembourg, Malta and Ireland, where loan documentation is often signed by foreign entities for tax reasons. Even accounting for these distortions to some national data, the importance of cross-border bank lending is evident. Most countries in the Eurozone have borrowed sums larger than half their GDP from offshore banks. This of course relates only to bank loans. It does not include debt securities held by non-nationals, which is shown in Figure 2.

Bank loans mature slowly but securities can be dumped quickly

Figure 2

Internationally owned debt securities of Eurozone states

(€bn)	Securities (as at Jun 2011)	GDP	As % of GDP
Austria	282	271	104
Belgium	482	323	149
Cyprus	47	16	294
Estonia	7	13	54
Finland	123	180	68
France	1,707	1,927	89
Germany	2,222	2,471	90
Greece	343	229	150
Ireland	399	156	256
Italy	1,127	1,545	73
Luxembourg	83	41	202
Malta	21	5	420
Netherlands	1,120	585	191
Portugal	212	172	123
Slovakia	11	62	18
Slovenia	18	36	50
Spain	1,500	1,059	142

Source: BIS

Cross-border finance via debt security purchases is much more important than cross-border bank loans

Unlike the data for bank loans, the international debt security figures are based on the borrower's nationality, rather than on the country in which the loan is booked. This includes domestic sovereign debt held by non-nationals from anywhere in the world, not just the Eurozone. We thus have a much better idea of how much any given country has borrowed. A significant portion of these securities are held by offshore banks but are not included in the loan data in Figure 1. Thus, should banks be forced to buy their own national debt, they might sell their non-local debt securities to fund such purchases.

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Liquid debt securities are widely held across borders

Figure 2 shows that cross-border lending through investment in debt securities is even bigger than cross-border bank lending. When we combine the two data sets in Figure 3, the scale of the Eurozone's reliance on cross-border finance becomes apparent.

Offshore borrowing is larger than GDP in most Eurozone countries

Figure 3

International loans and debt securities for Eurozone states

(€bn)	Loans	Securities (as at Jun 2011)	GDP	As % of GDP
Austria	80	282	271	134
Belgium	235	482	323	222
Cyprus	47	47	16	588
Estonia	7	7	13	108
Finland	102	123	180	125
France	998	1,707	1,927	140
Germany	893	2,222	2,471	126
Greece	78	343	229	184
Ireland	426	399	156	529
Italy	421	1,127	1,545	100
Luxembourg	21	83	41	254
Malta	504	21	5	10,500
Netherlands	589	1,120	585	292
Portugal	123	212	172	195
Slovakia	11	11	62	35
Slovenia	17	18	36	97
Spain	406	1,500	1,059	180
Total	4,958	9,704		

Source: BIS

Most Eurozone countries' cross-border borrowings represent at least 100% of GDP

As already noted, the loan data includes borrowings by non-national corporations and distorts the borrowing for countries like Luxembourg and Ireland. However even taking these distortions into account, the only countries where foreign borrowings are less than 100% of GDP are Slovakia and Slovenia. The scale of cross-border financing shows how a move by one state to enforce reductions in foreign lending would have very material impacts on credit availability in other states. After WWII, one man's repression was not another's credit tightening; today everything is different.

All will suffer as suppression begins . . .

. . . but the longer-term losers could be the net borrowers from offshore

Figures 1-3 focus on cross-border credit, but of course all countries that borrow also lend abroad through either their domestic banking systems or the purchase of overseas debt securities. The contention above is that one nation's move to repression would push up yield spreads in other countries and exacerbate deflationary forces. In that scenario it does not matter which countries are net lenders or net borrowers. However, if repression spread to all countries then the greatest losers would be the net borrowers from abroad. While this may not be a near-term scenario, investors need to consider which countries' financial systems would be most impacted by across-the-board shifts towards domestic lending.

Figure 4 looks at the Eurozone banking systems' internal assets and liabilities by nationality of the ownership of those banks.

Prepared for: ThomsonReuters

Spain is the largest net borrower in the Eurozone

Figure 4

International positions by nationality of BIS reporting banks

(US$bn)	Assets	Liabilities	Net
Austria	445	323	122
Belgium	534	624	(90)
Finland	48	96	(48)
France	4,438	4,178	260
Germany	4,241	3,395	846
Greece	226	149	77
Ireland	497	382	115
Italy	995	1,029	(34)
Luxembourg	172	135	37
Netherlands	1,519	1,595	(76)
Portugal	198	211	(13)
Spain	840	1,072	(232)
Total			**964**

Source: BIS

Europe's most exposed net borrowers are Spain, Finland and Belgium

It must be stressed that the table shows all non-national assets and liabilities of Eurozone banking systems. Thus these are global assets and liabilities and not just those borrowed and lent within the Eurozone. Their global nature is evident as the net position sums to US$964bn, showing these banks as net lenders to the world. The table also clearly shows that the Spanish banking system is the most exposed to any withdrawal, forced or otherwise, of credit lines from outside Spain. Spanish banks are net borrowers of €174bn from abroad - a sum equivalent to almost 20% of GDP - while the Finnish and Belgian banks' net foreign liabilities also amount to around 20% of their respective GDP. They would therefore be the ultimate losers if financial repression became widespread.

Like Smoot-Hawley, any one country can benefit from national capitalism . . .

The interdependence in lending is similar to interdependence in trade, and financial repression could trigger the same kind of damaging deflationary forces as the USA's introduction of the Smoot-Hawley tariff act in 1930. A country can benefit greatly by denying its national market to foreign imports while continuing to export, but in the process it disrupts the export businesses of its trading partners. Similarly, if a country's banking system is forced to focus on domestic lending and restricts its lending activities in other jurisdictions, the government can continue to borrow from non-national sources while boosting its ability to borrow from its own banks. Credit spreads in this nation will tend to narrow, while spreads in the other countries will tend to widen.

. . . but one state's advantage comes at a cost to others

Simply put, if the Italian government forces domestic commercial banks to buy its debt, it could cause those banks to pull credit lines from elsewhere in Europe. This will push the cost of financing the Italian state onto other countries, which can accept this or perhaps strike back. Will they retaliate, as many countries did when the Smoot-Hawley act imposed import tariffs in 1930? The temptation to do whatever is necessary to reduce the high interest rates that spell austerity, deflation or default is likely to make such repression irresistible to politicians seeking re-election. A growing move to repression is increasingly probable and as the analysis above shows, is likely to produce a further deflationary shock in the European and perhaps global economy.

Prepared for: ThomsonReuters

The political dissolution of the euro, 2012

On 9 December, a deal will be presented for political union

The journey along the path of financial repression has begun. How aggressive this repression needs to be will depend upon how many Eurozone countries are prepared to ratify an agreement creating a new 'fiscal compact' for Europe. At this stage the only EU state that will not follow that path is the UK, which is not a member of the Eurozone. However, the agreement on 9 December now kickstarts a process of negotiation and then ratification that is likely to be both long and doomed to end in failure. As this new treaty will represent the biggest constitutional change for the Western European states since 1945, it will almost certainly be put to the vote in many countries. The uncertainty during this period as to how many eventual members of the Eurozone there will be is likely to lead to limited action by the ECB and continued reductions in credit by Europe's commercial banks..

Europe changed forever on 14 November 2011. That day, Germany's Chancellor Angela Merkel announced at the annual conference of her Christian Democratic Party:

> 'It is time for a breakthrough to a new Europe. The task of our generation is to complete economic and monetary union, and build political union in Europe, step by step . . . That does not mean less Europe, it means more Europe.'

Eurozone members asked to move from endorsing austerity to endorsing political union

Eurozone countries, struggling to enforce austerity, were confronted with an even more dramatic political challenge: signing away the rights of the sovereign state. France and Germany drafted changes to the European treaties, which were presented to the EU leaders at the meeting on 8 December. A line was drawn between those prepared to negotiate for a political union and those who were not. To stay in the Eurozone, members must accept budget deficit targets enforced by the European Commission, ceding a large part of their sovereignty to an unelected body. The scale of the permissible fiscal deficits has in effect been set by the Germans. With agreement in theory, the difficult bit now begins.

What elected government would cede its powers to an unelected body?

Under a fiscal or political union, the ECB would be free to buy sovereign debt, safe in the knowledge that these purchases will not lift the yoke of fiscal austerity from the governments, while the German authorities can agree to the issuance of Eurobonds in the knowledge that cheaper finance for European governments will not lift the yoke. For those prepared to let the European Commission determine their tax-and-spend policies, there is thus much monetary relief available. All they have to do is simply renege on a promise that only sovereign governments can make: "no taxation without representation". Despite the agreement in Brussels on 9 December, it is unlikely that all Eurozone members will be able to deliver on this major handover of sovereignty.

Financial markets will celebrate . . .

The need for financial repression would be much more limited if easier monetary policy and Eurobond finance were freely available. Both the bond and equity markets would probably benefit from a package which promises much easier monetary policy, albeit combined with fiscal austerity. Thus the key to calling the outlook for Europe, financial repression and national capitalism depends upon how the move towards political union progresses. If this deal really can be ratified by all the Eurozone members then a much more optimistic outcome for financial markets will ensue. If it cannot be signed or subsequently ratified, then a Eurozone breakup and financial crisis is probable.

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. . . but the deal will not be ratified

This analyst believes that although the politicians of all 17 Eurozone members have signed the deal, in 2012, through the electoral process, many will fail to ratify it and we will see countries leave the Eurozone. The probability of such a scenario will most likely prevent the delivery of easier ECB monetary policy and Eurobond issuance after the agreement is signed. Investors need to plan for a Eurozone breakup and take any bounce in markets associated with the signing of the deal as a selling opportunity.

Previous changes of this magnitude in the EU constitution have triggered referendums

The implementation of fiscal targets enforced by the European Commission is already clearly part of the deal and is a change much larger than that encompassed in the Treaty establishing a Constitution for Europe (TCE). This treaty was signed by the leaders of the then 25 members of the EU in October 2004. It was agreed to by the governments of both Eurozone and non-Eurozone countries, and this agreement was only possible with a limited step to more centralised power. However even this was sufficient to lead to referendums in Denmark, France, Ireland, the Netherlands, Luxembourg, Portugal and Spain. (Not all these referendums were held, as both France and the Netherlands voted against the treaty and it was clear that it could not be ratified.) It will be very difficult for any political system which had offered a referendum on the TCE not to offer a referendum on a deal that entails a much larger surrender of sovereign powers. While only Ireland is legally bound to hold a referendum, the TCE ratification process suggests that a further six countries would be bound by convention to offer referendums on this new agreement.

Such a surrender of sovereign rights is likely to provoke a strong domestic reaction

All politicians have to consider the domestic ramifications of their actions on the international stage, and a surrender of sovereign rights on such a grand scale is likely to provoke a strong domestic reaction. In the coalition-dominated politics of Europe, signing such a deal could be political suicide for some leaders. Even if staying in the euro promised the best economic outcome, it is not certain that the European electorate would choose this option, given the price. It may be a political reality that all leaders negotiate and sign such a deal but have to offer a referendum for ratification. In this way no politician would ultimately have to accept the damage to their political career from signing away significant sovereign rights. In 2012 the future for the Eurozone will most likely be decided at the ballot box. Given current opinion polls and past votes this is likely to lead to some countries failing to ratify the 9 December agreement. As it would be impossible for a Eurozone country to be unfettered by the centralised budget process, a vote against the agreement would be a vote to leave the Eurozone. The dislocation to the financial system from a Eurozone exit is likely to be extremely negative for economic growth and financial markets.

Referendums across Europe in 2012 will decide the fate of the Eurozone

A brief overview of the current political situation in the 17 countries suggests that referendums on the 9 December deal are likely, and past results suggest that some peoples will vote it down:

- **Austria**: The current coalition does not include either of Austria's far right anti-euro parties. However, both did well in the 2008 election, together taking 28% of the vote. The most recent opinion poll shows the leading anti-EU party tied with the largest political party at around 28%. The current coalition was formed on an understanding that any changes to the EU constitution would be put to the people in a referendum. While the Austrian Chancellor has argued that the 9 December deal is not a constitutional change, this seems like wishful thinking. It will be very difficult for the coalition to deny the Austrian electorate a referendum on the deal. If no such referendum is called, the next parliamentary election is not due until September 2013.

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Belgium likely to sign, but government could fall if France/Netherlands do not

- **Belgium**: On 1 December 2011, Belgium's political parties announced that after 536 days of negotiation, they were finally able to form its first government since the election of June 2010. The new government now has a week to decide whether to sign its sovereignty away to a Federal States of Europe. There is little doubt that the coalition of Walloons and Flemings would have to sign. However, if either the Netherlands or France decides not to sign the deal, Belgium would be in a dreadful political situation and its government could be very short lived.
- **Cyprus**: Given the country's close political, economic and defence ties with Greece, it will almost certainly follow the Greek decision on 9 December and thereafter.
- **Estonia**: The country joined the Eurozone in January 2011. It has a moderate centrist government which does not face re-election until 2015. With economic conditions in Estonia improving post austerity, the politicians are likely to sign the deal. A referendum is unlikely.
- **Finland**: The nationalist anti-EU party, the True Finns, is the largest opposition party in parliament and won 19% of the vote in the 2011 parliamentary elections. A presidential election will take place in January 2012 and the True Finns are likely to field a candidate on a pro-sovereignty, anti-EU ticket. Finland did have a referendum in 1994 on whether to join the European Union. Within hours of the agreement on 9 December the Finnish government indicated that it would be unable to contribute to the European Stability Mechanism if the need for unanimous voting ended. As a small nation, the Finns have most to lose from a centralisation of power in Brussels. The combination of a vocal nationalist minority party and an election in January 2012 could upset plans for Finland to ratify the agreement.

Issue of sovereignty will dominate the French presidential election

- **France**: In a television address on 27 October, President Sarkozy told the French people they would have to become 'more like Germans'. This would include working harder and retiring later. There was thus little doubt that Sarkozy would commit France to political union on 9 December. This major change to French sovereignty and the change to 'more German' working conditions are likely to be the major issues of the French presidential election in April. Opinion polls show the French Socialist Party candidate Francois Hollande leading with 35% of the vote, Sarkozy with 24% and Marine Le Pen of the anti-EU Front National in third place with 19%. The signing of the agreement may help Le Pen at Sarkozy's expense, but the most likely outcome in April is a win by Hollande. The French Socialist Party's fiscal promises would all be massively constrained by the 9 December deal. This might lead it to campaign on amending the deal, which would be destabilising for markets during the campaign. However, after the election it is highly likely that the socialists would back the deal. France offered a referendum on the October 2004 treaty on greater centralisation of European powers. There will be pressure to offer such a referendum again, given the greater degree of integration involved.

Germany's constitutional court will likely require a change to the constitution

- **Germany**: Chancellor Merkel's foot is on the accelerator for political union. She must thus be confident that she can bring her parliament and her people to endorse such a deal. The next general election is not due until September 2013 and it is not clear who Germans would vote for if they wished to back out of the deal. There can be no political union without Germany and the elite seem fully committed to it. The key stumbling block appears to be the German constitutional court. Its recent decisions indicate that it would not sanction further passing of powers to Brussels

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without an amendment of Germany's constitution. This can be done in parliament or it may be done via a referendum. Merkel is keen to avoid this and will continue to argue that the deal is not a constitutional change.

- **Greece**: There will be a parliamentary election in February 2012. The unelected prime minister will run on a fiscal austerity programme enforced by the European Commission. Like all of fringe Europe, Greece is between the rock of signing away its sovereign rights and the hard place of leaving the euro. However in an election, rather than a referendum, those opposed to the 9 December agreement will have to rely on a political party running on a policy of refusing to ratify the deal. Only time will tell whether the Greek electorate will get the chance to vote for anti-agreement politicians. We will know the complexion of the new government by 19 February.

A referendum is likely in Ireland . . .

- **Ireland**: Under Irish constitutional law, a referendum is triggered by a change to the constitution. While it seems highly likely that politicians will pretend the 9 December agreement is not a constitutional change, it is very clear that it will be the largest change in Ireland's constitution since the establishment of the Republic. If both houses of parliament ratify the agreement then it is difficult to see how a referendum can be avoided. The Attorney General will have to decide whether a referendum is warranted. The Irish people will face the same dilemma as the Greeks but on a simple yes-or-no vote, rather than by electing a government to implement their desires. The Irish government has already suggested to its neighbours that a yes vote would be more likely if Ireland could be given some 'sweeteners' in the negotiating process. Ireland initially voted against the Lisbon Treaty, and opinions towards the EU have hardened during the austerity process.

. . . but may be averted in Italy

- **Italy**: With no general election due until 2013, any disagreement with Mario Monti's signing of the agreement would have to find its voice through coalition politics or on the streets. Should there be a significant reaction to the agreement, a more nationalistic Berlusconi could return and seek to build a coalition to prevent this major change to the Italian constitution. With no referendum offered on the 2004 treaty, there is precedent for the current technocratic government to refuse a referendum on this deal.
- **Luxembourg**: The politicians have little option but to follow the decisions of France and Germany. Luxembourg did have a referendum in 2005 to endorse the proposed Constitution of Europe and voted in favour by 56%. With more sovereignty due to be signed away on 9 December, there will be strong calls for another referendum.
- **Malta**: The next election is not due until 2013. Malta voted in a referendum to join the EU in 2003. Perhaps ironically, its most recent referendum (in May 2011) was on whether to legalise divorce: 52% voted in favour. There was no referendum on the constitutional changes signed by the government in October 2004 following Malta's accession to the EU in May of that year.

The Netherlands is also likely to offer a referendum

- **Netherlands**: A general election is not due until 2014. In the referendum on the 2004 treaty, the Dutch voted emphatically against. It will be very difficult to deny them a referendum on a deal that goes much further in surrendering sovereign rights, and it is far from certain that they would endorse the agreement. Note that the anti-EU party of Geert Wilders became the third-largest party in the lower house elections of June 2010, increasing its number of seats from 9 to 24. A referendum in the Netherlands is therefore likely.

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Portugal had a referendum on the 2004 treaty change

- **Portugal**: The current parliament was just elected in June 2011. The dominant Social Democrats are committed to the austerity programme and are very likely to sign the deal. The government offered the people a referendum on the October 2004 treaty and thus, given the scale of powers to be transferred to the European Commission, another is likely on the 9 December agreement. Having recently endorsed the Social Democrats, the Portuguese may well vote yes. While the element of political union is an added aspect since the June election, few voters can be unaware that their government is already following a mandate from external parties.

A general election due in Slovakia in March

- **Slovakia**: There will be a parliamentary election in March 2012, due to the previous government losing a no-confidence vote on its support for the European Financial Stability Fund. The current coalition has fallen on the issue of whether Slovakia should be providing funds to bail out richer countries in Europe. The politicians signed the 9 December pact due to its commitments to bind these rich countries to strict fiscal deficit targets with enforceability. It is unlikely that a treaty could be ratified prior to the March 2012 election. In 2010, enough signatures were collected to force a referendum on six largely unconnected issues. It is not clear that anti-EU sentiment would be strong enough to enforce a referendum on the deal, but for the above reasons one is likely to be offered anyway.
- **Slovenia**: The current Social Democratic Party-led coalition signed the agreement. There will be an election in October 2012, but the main political parties are all likely to support further integration with the EU. The country had a referendum in 2011 on various issues which were much less controversial than the 9 December deal. Offering a referendum on the deal is likely to be the easy way for politicians to proceed.
- **Spain**: A new centre-right government was elected in November 2011 and will come to power on 13 December. The caretaker government signed the deal - presumably in consultation with the new government. Nothing in the newly elected government's manifesto pledged a major split from the Eurozone. The people of Spain had a referendum on the October 2004 treaty and would thus expect a referendum on the new deal. Having already elected an austerity government, it is difficult to say how they will feel about the combination of austerity and restricted sovereignty.

Up to 11 Eurozone electorates may have their say on the deal

The above shows that there will be five important elections in the Eurozone in 2012: Finland, France, Greece, Slovakia and Slovenia. Using the ratification process for the 2004 treaty as a guide and current political commitments, we should also expect referendums on the deal in Austria, France, Ireland, Luxembourg, the Netherlands, Portugal and Spain. Even in Germany the constitutional court could insist on changing the constitution, which can be done either in parliament or by referendum. Some will doubt whether the politicians are prepared to submit the deal to the vagaries of a referendum: as we see above, Europeans have regularly voted against further shifts towards a Federal States of Europe. Indeed the German finance minister has suggested that the deal could be construed merely as an amendment to Protocol 14 and thus could be both signed and ratified by governments, bypassing national parliaments and any need for referendums. This, however, seems to be wishful thinking; parliaments and peoples will recognise the deal as the greatest constitutional change in Western Europe since the war. Any attempt to bypass ratification by parliament or referendum is likely to lead to major internal political friction. This very prospect may mean that most Eurozone countries will have to offer referendums on this change to their constitutions. In 2012 the future of the euro will be decided at the ballot box.

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The scale of support for those who ratify the deal must be spelled out

The economic consequences of ratifying this deal could not be in greater contrast to the consequences of not doing so. Of course the people must also be made aware of this stark economic choice if they are to ratify the deal. This might even involve the ECB spelling out just what yields the signing nations' bonds could "expect" to trade at with its support. Only time will tell if this stark economic choice will be sufficiently tempting for people to sign away a material portion of their sovereign rights. Throughout 2012, opinion polls will show us which way the wind is blowing - and despite dire economic consequences for those who do not ratify, it will be a very close-run thing.

Prolonged ratification will delay ECB liquidity creation and Eurobond issuance

There would thus be at least 12 ballots in 2012 where the electorate of Europe could vote against the deal. For market participants, the key issue is just how expansive can the ECB be and how large can Eurobond issues be prior to final ratification. It would seem very dangerous for the ECB to launch a major liquidity boost and associated accumulation of Eurozone sovereign debt before it was clear who would continue as a member. Similarly, it is unclear which countries would be able to benefit from borrowing at low Eurobond interest rates before they were clearly committed to the new political union. Even if the political elite somehow avoid offering referenda to their people, there will be ample opportunity for some voters to prevent their states from ratifying the agreement in the presidential and parliamentary elections next year. During this prolonged period of uncertainty, the ECB is likely to remain constrained, Eurobonds unissued and European commercial banks in contractionary mode, which will not be good for bond or equity markets.

This long period of continued and probably growing uncertainty will be bad for economic growth. The dysfunctional European banking system is likely to remain so throughout the period. There is little prospect of expanding bank credit as the banks remain committed to shrinking their balance sheets. As argued in Section 1, growing financial repression would initially force credit spreads higher in Europe, further dampening growth. The likelihood is that a European recession would intensify as the relief the markets expect from ECB action and Eurobond issuance is seen as an increasingly distant prospect.

A Eurozone exit by even one country would spell chaos in the European banking system

As time passes, markets will speculate on which nations are unlikely to ratify the agreement. The data in Section 1 indicate how intertwined the Eurozone's financial systems have become. A move to denominate even some of the current euro debt in a new, weaker currency would produce a very material hit to commercial bank capital across Europe. The scale of that disruption will depend upon the cross-border debt burden of any nation that elects not to pursue political union and leave the Eurozone. However even an exit by a country as small as Ireland or Greece would be likely to diminish the amount of bank capital in Europe and further postpone the next credit expansion and economic upswing.

. . . but any rally in markets should be shortlived

Markets might well be in a mood to celebrate the 9 December deal in expectation of easier ECB monetary policy and Eurobonds, and a rally in Eurozone equities and bonds is likely. This will be premature, and investors should sell into such a rally. Easy money and Eurobond issuance will have to wait until after the deal is ratified. The process will be noisy, poisonous and perhaps even bloody given the intensity of internal disagreement on how to proceed. Forecasting just how radical the political reaction will be is difficult, but the uncertainty surrounding it is good enough reason to avoid European bonds and equities.

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A vote for a Eurozone exit is likely in 2012

Next year will be full of uncertainty and there will be at least one and probably several failures to ratify. Further major hits to Eurozone bank capital on the departure of any member would further depress economic activity. The result of the euro's dissolution will ultimately be central banks operating monetary policies solely aimed at reflation, rather than the current policy of enforcing fiscal sovereignty. Investors should therefore wait out the political chaos until the nature of the dissolution is clear and the damage to the credit system is evident. Deflation risks will be high and equity valuations will be low. Into this despair will step a newly enfranchised ECB and some newly enfranchised national central banks. Their goal will be reflation and they are very likely to succeed. It is likely that European equities' cyclically adjusted PEs could be back to 1982 levels by the time we get to this stage. This will represent a great bottom and a wonderful buying opportunity.

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China's capital exports end

Chinese BOP deficits are deflationary

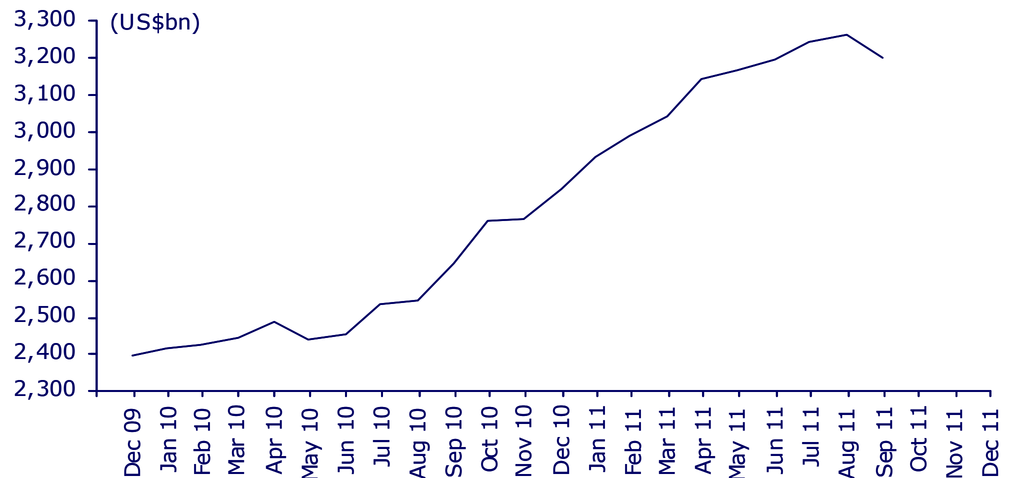
Following the major devaluation of the renminbi in 1994, China acted to keep its currency undervalued and in the process reported large balance-of-payments (BOP) surpluses. These resulted in a rapid accumulation of foreign exchange reserves and the creation of renminbi, which depressed US Treasury yields and boosted renminbi money supply. This inherently inflationary process was mitigated by the fact that for most of this period, China was also exporting goods at ever-lower prices. This period in history has now ended.

As was inevitable, rising inflation in China, especially in wages, has led to reduced competitiveness and declining surpluses. Perhaps more importantly, this is occurring as China's capital account has become significantly more porous. China reported a BOP deficit in September. If this continues, the Peoples Bank of Bank (PBOC) will be a seller of Treasuries, pushing yields higher, and a buyer of renminbi, thus shrinking or at least constraining Chinese domestic money-supply growth. This is a dynamic which would constrict growth and inflation in both jurisdictions and in extremis produce deflation. So how likely are such deficits and do they augur deflation? Can China use its command-economy banking system to once again defeat deflationary dynamics?

Chinese reserves declined from May to September 2011

Figure 5

China's foreign-exchange reserves



Source: Datastream

It is inevitable that the yuan becomes overvalued and the PBOC sells Treasuries

It is inevitable that China will run a BOP deficit. As *Solid Ground* has discussed many times before, it is not possible to hold an exchange rate at undervaluation forever. The monetisation of balance-of-payments surpluses produces excess money-supply growth, high inflation and declining competitiveness. Although this is obvious, it conflicts with how investors think it works. The oft-repeated mantra that there is a "vendor financing" arrangement in which China finances the USA to buy Chinese products assumes a structural rather than cyclical phenomenon. When the renminbi is overvalued, China will pull its finance from the USA as a result of a purely cyclical adjustment. Investors relying on some structural vendor-financing arrangement will be mightily surprised when an overvalued yuan results in the PBOC dumping Treasuries. Is such a shock now imminent?

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A BOP deficit can occur even with a current account surplus due to material capital outflows

China does not need a current-account deficit to move to a BOP deficit. It is possible that capital outflows could more than offset the current-account surplus and any capital inflow. Historically it would have been virtually impossible for this to occur, as China's capital controls permitted major capital inflows in the form of foreign direct investment, but severely restricted capital outflows. As everyone knows, private-sector capital still found ways to exit the country - initially through transfer pricing of exports, but other exit strategies developed. Over time the Chinese capital account has become increasingly porous, and the opening of offshore renminbi markets and the growth of the gambling business in Macau have created other capital-export opportunities. The evidence is that capital outflows are indeed increasing, creating the risk that China will run a BOP deficit long before it runs a current-account deficit.

Small rise in forex reserves in 4Q suggest a shrinking BOP surplus

The acceleration in China's capital outflow is evident if one looks at how its official figures for the current account stack up with the changes in its foreign-exchange reserves. The most recent State Administration of Foreign Exchange (SAFE) data show a current-account surplus of US$59bn and a capital account surplus of US$98bn in 2Q11. This should produce a US$143bn rise in reserves and the quarterly data show a rise of US$153bn, with accumulating interest and exchange-rate movements accounting for the difference. Although we do not have BOP data for 3Q, the rise in foreign-exchange reserves has been reported and shows an increase of just US$4bn. The static nature of China's foreign-exchange reserves in 3Q partly reflects the decline in the euro exchange rate relative to the dollar. While most of China's reserves are invested in Treasury securities, a material minority is invested in euro-denominated sovereign debt. If we assume that a third of China's reserves are denominated in euros, then the 7% slump in the value of the euro relative to the US dollar reduced the dollar value of Chinese foreign reserves by US$74bn during 3Q. Without this we could have expected a rise in reserves nearer to US$78bn, still half the rate of reserve accumulation posted in 2Q. So even accounting for exchange rate movements, it is likely that there was a major decline in China's BOP surplus in 3Q.

Figure 8, which shows the rise in China's foreign-exchange reserves in each quarter, unadjusted for exchange rate movements, puts the scale of the change in context.

China's foreign reserve growth slowed markedly in 3Q11

Figure 6

Quarterly rise in China's foreign exchange reserves

	(US$bn)
3Q10	194
4Q10	199
1Q11	198
2Q11	152
3Q11	4

Source: Datastream

Deterioration in capital account the most likely explanation for the decline in BOP surplus

It would be difficult to explain the likely rapid decline in China's BOP surplus in 3Q on a rapid change in the current-account surplus. The current account can change rapidly, but this does not happen often and is usually associated with a high-profile event that dramatically alters trade flows, such as the credit crunch of late 2008. It is much more likely that any rapid and major deterioration in the BOP is associated with a change in the capital account. There are two probable causes of such a change: a decline in offshore borrowing by Chinese corporations and an acceleration in capital outflows from the Chinese private sector.

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Most private-sector capital outflows are illegal and thus secretive

Capital outflow from the Chinese private sector is a taboo subject. As most such outflow is illegal, it is not surprising that most mainland Chinese exporting capital try not to advertise their transactions. What information there is comes anecdotally. Conversations with private bankers in Hong Kong and Singapore indicate accelerating capital inflows. Recent articles both on Bloomberg and in *The Wall Street Journal* have also focused on the diversification of Chinese savings. While the focus of such diversification is on property and associated with foreign education for children and passports, it clearly encompasses other asset purchases. Apart from the direct impact on the BOP surplus, this outflow raises another important issue for investors in China: why has it accelerated?

As the capital account becomes more porous, a shift in the stock of Chinese savings is virtually inevitable

The most obvious reason for the accelerating outflow is simply that it has become easier to get capital out of the country. In a nation of rapidly growing wealth and limited savings opportunities, just such an outflow should be expected as the chance to diversify increases. This dynamic has been the reason why *Solid Ground* has argued for many years that the renminbi would decline markedly if it was internationalised. In that scenario there would be a sudden shift in the stock of previously captive savings, which would very likely swamp the flows of current-account surplus and capital inflow.

We are not witnessing such a dramatic event. The capital account has become more porous without becoming too porous. However, as long as the capital account continues to slowly open, more and more of China's savings will seek to exit. This could produce regular BOP deficits even while China remains competitive in international trade. The decline in the BOP surplus in 3Q indicates that the capital account is now porous enough for China to face BOP deficits even with its current account surplus. The shift of savings to offshore assets is unlikely to be completed in just a few quarters; it is likely to be a feature driving China's external balances for many years to come.

Accelerating Chinese capital outflow may tell foreign investors much about relative asset prices

Accelerating private capital outflows from emerging markets have historically been an indictor of caution for foreigners seeking to invest in such jurisdictions. Locals in Latin America and Brazil in particular have exited their own assets and own currencies when foreign appetite has been at its highest. It is usually the locals, selling local assets, who end up on the right side of this trade. In Asia, capital outflows surged during the so-called "Asian economic miracle" in the years leading up to the crash of 1997. This surge in capital outflow does not necessarily mean that locals are better at forecasting crises: it just means that they realise how far their local currency will go in foreign markets. While foreigners are judging the relative attractiveness of an exchange rate based upon the current-account conditions, local savers are eyeing the relative cost of foreign assets.

There is just one exchange rate, and it can simultaneously be competitive for goods prices and uncompetitive for asset prices. Competitiveness in goods is well recognised as a change in relative production prices between trading partners. Competitiveness in assets works in a similar fashion, but not usually at the same time. Thus it is that Chinese savers can view the relative value of property in the USA very favourably compared to Shanghai, even while China remains a source of cheap exports. In a jurisdiction where real rates of interest are rarely positive, savers' returns are predicated on capital gains. When domestic capital gains seem hard to come by, as property prices fall or returns on export businesses decline, then the allure of foreign assets is likely to rise. In China, such diversification has had legal limitations but today it

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seems the rapidly growing number of wealthy Chinese have found ways to do this arbitrage. Foreign investors in China should be wary of putting more capital into Chinese assets when there is growing evidence that Chinese savers see greater value in foreign assets.

Bingeing on foreign-currency debt is a recurring theme in emerging markets

Veterans of emerging-market investment will be all too familiar with the role of foreign-currency debt in turning apparent BOP strength into weakness. The tendency for emerging-market authorities to depress their exchange rates has produced a seeming arbitrage opportunity for domestic companies, where they borrow foreign currency (invariably US dollars) and sell it for local currencies to finance domestic investment opportunities. Borrowers expect their undervalued currencies to rise relative to the dollar, and the trade is particularly attractive if the cost of borrowing dollars is below the cost of borrowing the local currency. Credit may simply be more easily available in dollars if local authorities are trying to restrict the availability of credit domestically.

The sale of borrowed dollars for local currency represents a capital inflow. It adds to any BOP surplus and forces the central bank to print money and buy foreign securities to prevent an unwanted rise in the exchange rate. For various reasons, usually associated with taxation, such flows can be dressed up as direct investment. Analysts see strong direct-investment inflows, while what is really happening is a buildup in foreign-currency debt causing an acceleration in the printing of money. There is evidence to suggest that just such a distortion has been happening in China. The constriction in global credit conditions is now likely to unwind this distortion.

China's capital inflows probably driven by Chinese entities' foreign-currency borrowing

The BIS Quarterly Review provides the most accurate insight into foreign-currency borrowing. It comprises data from reporting banks as well as data on debt securities. These show a sharp rise in China's US-dollar borrowing since the beginning of the global credit crunch.

China has ramped up its offshore borrowing

Figure 7

External loans of BIS reporting banks to China

(US$bn)	Dec 08	Dec 29	Dec 10	1Q11
Loans	114	124	251	326

Source: BIS Quarterly Review

Figure 7 shows that since the end of 2008, when the global credit crunch began, the value of China's borrowings from foreign banks increased by 190% to US$212bn. While a rise in the dollar value of foreign debt can be caused by exchange-rate movements, it is difficult to see how any currency could rise rapidly enough against the dollar to account for this increase. To the extent that these foreign borrowings are transformed into purchases of renminbi, they represent a capital inflow. The squeeze on dollar borrowing access for European banks may now bring any such capital inflows to an end.

Foreign banks have seen major increases in their exposures to China

The loan data in Figure 7 do not encapsulate all the credit flowing to China from foreign banks. Banks extend credit in other ways, most notably by the purchase of debt securities. The BIS Quarterly Review also provides data for total international claims on China from reporting banks, and this had risen to US$458bn by the end of March 2011. The same data show additional credit of US$136bn provided in local-currency loans in China by foreign banks. The growth in credit from foreign banks has been striking.

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Total foreign claims have risen by US$330bn in just two years

Figure 8

Total foreign claims of BIS reporting banks on China

(US$bn)	March 2009	March 2011
Total foreign claims	264	594
International	188	458
Local	75	135

Source: BIS Quarterly Review

Exchange-rate movements should not have played a major role in increasing China's indebtedness

It has to be stressed that exchange-rate movements can result in an increase in the value of any country's foreign loans in dollar terms. However the bulk of such loans are made in US dollars and thus are unaffected by foreign-currency adjustments. The only denomination of lending likely to have seen its dollar value rising sharply since 2009 would be the Swiss franc. Thus perhaps partially through exchange-rate impacts but more likely through a surge in new borrowing, China's indebtedness to foreign banks has soared.

Almost 80% of China's loans from foreign banks roll over within a year

Of the US$458bn in international claims on China, fully 78% matures within one year. Chinese banks are by far the largest borrowers and account for 50% of the US$594bn in total foreign claims, posting growth of 149% in the value of foreign credit from March 2009 to March 2011. There is no full accounting for which banking systems are most exposed to China and the per-country data accounts for significantly less than the US$594bn in total foreign claims. Only 24 countries provide details of their banks' total claims on China, accounting for US$425bn (72% of the total). Hong Kong and Singapore are notable by their absence from this list, and while we cannot know which countries supply the remaining 28%, it seems likely that Hong Kong and perhaps also Singapore have significant exposures. Of the US$425bn in foreign claims which we can account for by bank nationality, the countries with the biggest exposure are the UK (26%), Europe (26%), the USA (19%) and Japan (12%). China, and its banks in particular, have become very reliant upon borrowing from UK and European banks in the past few years.

Chinese banks likely to have borrowed dollars to lend to Chinese entities

It is clear that the bulk of China's borrowing from offshore banks is by its banking system, with maturities of less than one year. As these banks are increasingly international, it is possible that they then lend these dollars to non-Chinese customers in the international marketplace. To the extent that this is happening it obviously represents duration and credit risks for Chinese banks but does not impact China's BOP. As China does not provide locational banking statistics to the BIS, it is not possible to assess to what extent the US$297bn that foreign banks have in claims on Chinese banks represents lending to domestic Chinese entities. However given the nature of the Chinese banking system and its still fledgling international network, it seems likely that the bulk of this financing has been used to provide loans to Chinese customers.

Best guess is that European banks have indirectly financed a major portion of capital inflows

We cannot tell whether the banks made their loans in dollars or renminbi, nor whether the ultimate borrower used the proceeds for renminbi investment. It has to be stressed that none of the proceeds of these borrowings have necessarily been sold to buy renminbi or finance renminbi investment. It is possible that the loans were used to purchase foreign assets, or plant machinery and equipment for import to China. We simply cannot tell how much if any of these borrowings resulted in additional purchases of renminbi, thus creating bigger BOP surpluses and forcing the PBOC to print more currency. However, the scale of the sums involved raises a strong suspicion that many Chinese banks and businesses have been borrowing short-term in foreign currency to finance activities in renminbi. This would represent a capital inflow that boosted the China's BOP surplus and reserve accumulation

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over the past few years. When this borrowing and lending ends, China's capital inflows will decline and the likelihood of a BOP deficit will increase. The move by European banks to restrict their dollar credit growth could thus push China to ever-smaller surpluses. It is a bizarre world where European bank lending to Chinese borrowers boosts purchases of Treasuries and forces the PBOC to create renminbi. However, that is the world we live in, and reversing the trade will negatively impact Chinese liquidity and US Treasury yields.

Shrinkage in the BOP limits China's monetary flexibility

The decline in China's BOP surplus is driven by a decline in the current-account surplus combined with an accelerating capital outflow. With European banks likely to be restricting their foreign-currency lending to China, it is likely that a decline in capital inflows may now also play a role in reducing the BOP surplus. September's BOP deficit may have been an aberration, but it is a clear warning to investors that the era when China was an exporter to the world is coming to an end. The inevitable reduction in competitiveness associated with rising wages, combined with an ever-increasing porosity of the capital account, mean that the PBOC will be buying fewer Treasuries and printing fewer renminbi. The exchange-rate policy has forced this major creator of global liquidity to depress US interest rates and flush renminbi liquidity through the system. It has been an inherently inflationary dynamic which is now coming to and end and it increases the prospects that a deflationary global episode is now likely.

China has unique policy responses via its state-owned banking system

Investors have great faith in the policy flexibility of the Chinese authorities, blessed with the twin evils of a command-economy banking system and capital controls. These two enemies to the efficient allocation of capital are seen as China's two key strengths by investors, who should know better. While it is true that these impediments to a free market do allow the Chinese authorities to pull economic rabbits from the hat, few seem to question the vitality of such rabbits. The crucial change is that a declining BOP significantly reduces China's ability to meet investors' expectation that it will always hit its growth targets. The flexibility to hit these targets is high when the exchange rate is undervalued as it delivers strong export growth and also forces the creation of large amounts of renminbi. However growth targets are somewhat more difficult to achieve if the exchange-rate policy results in a BOP nearing deficit and forces the PBOC to buy back its currency at a time when exports are weakening.

In the period of undervaluation, China fought against the inflationary impacts of the ensuing rapid growth in its monetary base with sterilisation and rapidly rising reserve ratios for commercial banks. If the BOP surplus continues to decline and reserve creation slows, one should expect no sterilisation and rapid declines in reserve ratios. There is thus flexibility to offset some of the slowdown in reserve growth associated with smaller BOP surpluses. Within the framework of a command-economy banking system, the link between central bank and commercial bank action is tenuous anyway. The system can sever any direct links between its balance sheet and the size of its reserves. Thus, although a shrinking BOP surplus reduces China's policy flexibility, it does not necessarily force it into a deflationary contraction to rebuild competitiveness.

Any restriction in PBOC flexibility of concern to foreign investors betting on reflation

Although the contraction in the BOP surplus restricts PBOC policy flexibility, the authorities still have significant flexibility to offset the deflationary dynamic that normally follows from exchange-rate overvaluation in fixed exchange-rate regimes. On top of this flexibility, they can also clamp down on the illegal capital outflow that is diminishing the BOP surplus and their ability to create renminbi.

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Another option would be to simply abolish the exchange target when it begins to report any BOP deficits. The PBOC would be entirely free to pursue an easier monetary policy and the renminbi would likely decline on the international exchanges. Such a move would result in renewed competitiveness, a deflation impetus for the world and an international political outcry.

Most investors are likely to be surprised by lower BOP surpluses

Thus China still has unique tools to continue to manage (or distort, depending upon one's opinion) levels of economic growth. However, most investors are still likely to be surprised when they see the first real restriction on PBOC monetary policy come home to roost through sharply lower BOP surpluses. Thus this move most likely does not augur deflation for China but will be a shock for those who are betting on the likelihood that China will meet its growth targets. The time has come when Beijing will struggle to deliver.

Focus on China's structural issues will be bad for asset prices

As is normal in times of cyclical strife, there will probably then be more focus on China's structural issues. With perhaps the worst system for capital allocation in the world, competing with Russia and Cuba though clearly behind North Korea, there will be much to focus on. For years investors traded off their concerns on the quality of capital allocation for the surety of high and dependable growth. One linchpin of that growth will soon be gone and, as investors are wont to do, the cyclical slowdown will be construed as a revelation of a structural mess. This will be bad for foreign confidence in China and for Chinese asset prices.

Latest data show no increase in foreign central bank holdings of US securities since May

While most of this section has focused on the increasing risks of a growth undershoot in China, the main deflationary risk from this adjustment is in the USA. As *Solid Ground* - 'The great reset' argued in June 2011, the decline in the percentage of Treasuries owned by foreigners has potential deflationary implications for the USA. The report argued that the need for US savers to fund the government, in the absence of buying from foreign central banks, will squeeze out funding for the private sector. The decline in the size of the commercial-paper and corporate-bond markets since then suggests that this process may be underway. New York Federal Reserve data indicate that foreign central bank purchases of Treasuries have slowed dramatically, and that the value of marketable securities held in trust for foreign central banks was unchanged between 4 May and 30 November of this year. This does not mean that such purchases have definitely stopped, as in recent years a significant portion of foreign central bank accumulation of Treasuries has not been through the Federal Reserve. However, it is a measure of accumulation that has risen steadily in recent years along with the total accumulation of Treasuries by foreign central banks, and the stagnation seen this year suggests that there has been at least a major slowdown in this accumulation. In a world where China's BOP shifted to lower levels or moved to deficit, we might even see total holdings of US marketable securities by foreign central banks decline. This would be a very different world and would put extreme pressure on private-sector savers to fund the state.

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The great reset - An update

***The great reset* foresaw a squeeze on private-sector funding in the USA**

In June, *The great reset* forecast that foreign central bank funding for the US government would wane and that as a result US savers would have to make up the difference. The likely result of this shift of savings would be a squeezing out of private-sector credit and an economic slowdown. With the publication of the Flow of Funds statistics for 3Q11 on 8 December we can now see how the great reset is progressing.

The statistics show that while total Federal debt increased by US$389bn in 3Q, foreign central bank Treasuries holdings increased by just US$40bn. This is in marked contrast to the very high percentages of Treasury issuance these institutions bought during the past decade.

Figure 9 shows the growth of credit market instruments issued by the federal government and the growth in the value of these securities held by foreign central banks.

Foreign central bank purchases of Treasuries fell sharply in 3Q

Figure 9

Growth in Treasuries versus value of Treasuries held by foreign central banks

(US$bn)	Growth in total outstanding federal securities	Growth in value of foreign central bank holdings
2007	237	178
2008	1,224	663
2009	1,443	479
2010	1,584	441
3Q11	389	40

Source: Federal Reserve Flow of Fund Statistics

In 3Q11 only 10% of Treasury issuance went to foreign central banks

The table shows that foreign central banks financed 75% of the growth in US federal debt in 2007. This declined to 53% in 2009, 33% in 2009 and 28% in 2010. In 3Q11, they financed just 10% of the increase. New York Federal Reserve data for 4Q suggest that this slowdown was continuing as of 30 November.

Foreign private savings funded 26% of increase in Treasury funding in 3Q

Private savings funded the remaining US$349bn increase in federal debt in 3Q, with the foreign private sector contributing US$101bn and US savers providing the rest. US households increased their holdings by US$88bn, life and insurance companies by US$41bn and mutual funds US$47bn. Thus, while US savers did step up to fund the government in 3Q, they received significant assistance from foreigners.

Yet even with this help, the US private sector's funding of the government resulted in a US$69bn contraction in private-sector credit, continuing a long decline which began post the Lehman Brothers bankruptcy.

Decline in private-sector credit in the USA continued in 3Q

Figure 10

QoQ decline in US credit market instruments outstanding ex-Treasuries

	(US$bn)
1Q10	840
2Q10	360
3Q10	115
4Q10	54
1Q11	61
2Q11	146
3Q11	69

Source: Federal Reserve Flow of Funds Statistics

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Financial-sector funding most squeezed

Figure 10 shows a US$215bn contraction in private-sector credit in the past two quarters. This is the largest six-month contraction since 2Q-3Q10. The squeezing out of the private sector thus continues.

A breakdown of this contraction shows that it is falling heaviest on the financial sector. The three major sources of private-sector funding are the commercial paper market, the corporate bond market and bank loans. The corporate bond market increased in value by just US$15bn in 3Q, as a US$62bn contraction in financial institutions' debt outstanding offset a US$73bn increase in the value of nonfinancial bonds. As in previous quarters, the asset-backed securities sector bore the brunt, with the value of its bonds outstanding declining by US$53bn. Thus the data show a squeeze on the financial sector but an increase in credit available to the nonfinancial sector. On a net basis the corporate bond market was virtually unchanged in the quarter and neither added to nor subtracted from outstanding private-sector credit.

Commercial paper market contracted, largely due to reduced funding to foreign banks

The commercial paper market contracted by US$78bn in 3Q. As with the corporate bond market there is a contrast between the trends in the financial and nonfinancial sectors, with nonfinancial commercial paper actually increasing by US$18bn. We also have a breakdown for foreign issuers. This shows a US$65bn decline in total commercial paper by foreign issuers, almost all of which was driven by a decline in the financial sector. So most of the US$78bn contraction in commercial paper was due to a decline in funding to foreign corporations, particularly banks.

Arrival of foreign savings, pulling of foreign US-dollar credit mitigated impact of credit squeeze

Combining the commercial paper and corporate bond markets, we see a US$63bn contraction in private-sector credit, which is falling particularly heavily on the financial sector and on foreign banks in particular. So while the lack of foreign central bank buying of Treasuries produced a contraction in the availability of private credit, the arrival of US$101bn in foreign savings into the Treasury market mitigated this contraction. The contraction in credit which has resulted has fallen particularly heavily on foreigners funding in the US corporate bond and commercial paper markets. The US non-financial sector has been able to increase its funding in the commercial paper and corporate bond markets. The expansion of credit to this sector may explain why GDP growth did not falter during 3Q.

- The banking system has been the key provider of private-sector credit

The contraction in the disintermediated credit markets in 3Q is in contrast to the expansion of credit in the US banking system. Total loans and leases in bank credit increased by US$117bn in the quarter. With commercial and industrial loans growing particularly strongly, credit is getting to the small and medium enterprises that hire people, which is very positive for the US economy. This increase in bank credit represents an annualised growth rate of 6.6% and is in great contrast to the contraction we have seen in bank loans and leases since October 2008. The ability of the commercial banks to grow credit at this pace is a particular surprise to this analyst. With bank share prices collapsing over the year, credit spreads rising and bank paper issuance declining, the most likely consequence would have been a contraction in lending. However, through the slump in bank share and bond prices in 2Q and 3Q, the US banking system managed to increase the size of its balance sheet. It remains unlikely that this dichotomy will continue, and the most likely prospect is for the banks to rein in lending, given their funding difficulties. Although it is early days, there are signs that banks have stopped growing loans and leases, which peaked at US$6,914bn on 2 November but had declined to US$6,909bn by 23 November.

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The great reset has fallen predominantly on foreign borrowers of dollars

Thus we can say that the decline in foreign central bank buying of Treasuries forecast in *The great reset* has happened. It produced a contraction in private-sector credit in the USA, but the scale of this contraction was mitigated by the foreign private sector buying US$101bn of Treasuries. The contraction in private sector borrowing through the commercial paper and corporate bond market fell primarily on foreign corporations and financial institutions. Meanwhile, the US nonfinancial private sector managed to increase its credit during the quarter, partly in the commercial paper and corporate bond markets, but primarily by borrowing in the banking system. The ability of this sector to buck the contraction in private-sector credit explains why the economy continues to grow. However, a continuation of this trend is unlikely. Should foreign savers stop buying Treasuries, it will be more difficult for US savers to fund both the government and the private-sector. In particular, it seems unlikely that US commercial banks can continue to extend credit, given the distressed trading levels of their bonds and equities.

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Conclusion

In a world of cross-border lending, financial repression leads to deflation first

Governments are struggling to find funding. This report argues that a move to financial repression to fund the state in Europe is already underway. With banks restrained in expanding balance sheets to buy this extra debt, they will be forced to reduce credit exposures to other states. Thus the initial move to repression tends to force interest rates higher outside the nation state and increase the forces of deflation. This negative outlook would only be negated if banks decided to go on a lending binge and financed the national sovereign by a major balance-sheet expansion. This would negate the need to pull funding from elsewhere and the balance sheet expansion would boost money supply. With bank capital strained and new regulations forcing higher capital adequacy and liquidity ratios, this more inflationary adaptation to fund the state seems unlikely.

In addition to Europe, there are many states that will struggle to fund themselves as the baby boom generation retires. Financial repression will increasingly be seen as more palatable than austerity, default or hyperinflation, which are the other options for a bankrupt state.

When China's BOP surpluses end, its money won't be in Kansas anymore

The deflationary forces from Europe's financial repression will be exacerbated by the deflationary impact of shrinking Chinese BOP surpluses. Any BOP deficit from China will force the PBOC to sell Treasuries and buy back renminbi. In forcing US Treasury yields higher and constricting money supply growth in China, a BOP deficit tightens global monetary policy. Deficits are not guaranteed, but the days of large surpluses, excessive renminbi printing and mass depression of Treasury yields are over.

The euro will not have 17 members by the end of 2012

In 2012 the peoples of the Eurozone will have to either cede their sovereignty to the Federal States of Europe or leave the euro. It seems likely that some of the 17 Eurozone states will opt for independence. While we await the results of referendums on this issue, the ECB is likely to keep its "big bazooka" of monetary easing in the armoury and Europe's commercial banks are likely to continue to shrink their balance sheets. This is bad for economic activity in Europe, but not as bad as the messy creation of a new euro with less than 17 members, which is were we are headed. The hit to commercial banks' balance sheets as old euro members default through nonpayment or payment in weak currencies should signal the low for European equity markets.

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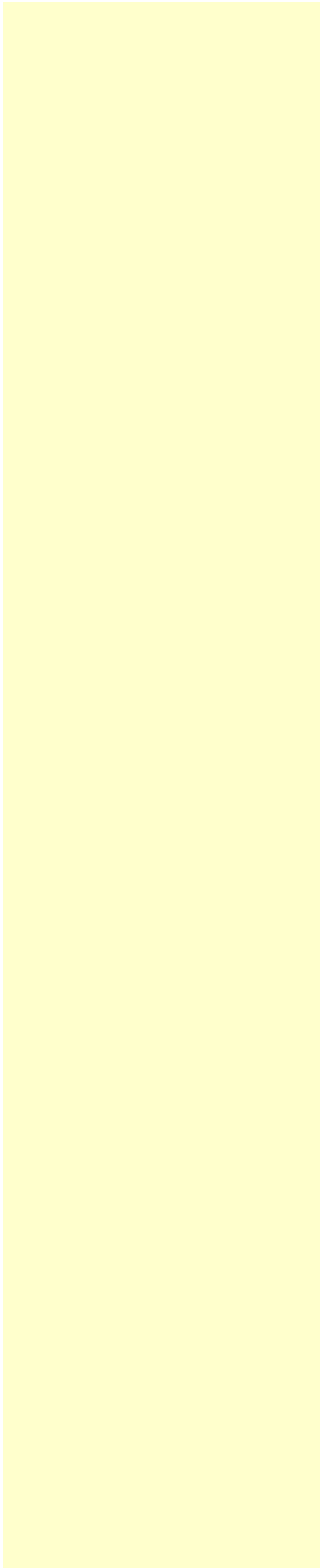

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