Time to ‘do a Larry’: Life, Miss Liberty and The Pursuit of Openness (01/10/19)

Economists like me see the world through the prism of models, fitted to statistical data and tested against market realities. Economic models provide uniquely powerful perspectives…

…But there are other ways of gaining understanding about an economy and its workers. This was brought home to me last month when I accompanied my wife on a trip different to any I had ever taken. We drove for two weeks on two-lane roads from Chicago to Portland across the Great Plains and Rocky Mountains.

Larry Summers: ‘I discovered the rest of America on my summer holiday’

(Your analyst has just returned from a week visiting clients in Toronto, New York and Boston discussing the 27 countries that, key objective measures suggest, have a 50/50 chance of a systemic banking crisis within three years (subscribers see When Debt Matters: Where to Expect Credit Crises in the Next Recession 3Q 2019). As four of those countries facing a systemic banking crisis are within the Eurozone, it was not a great surprise to see Sabine Lautenschläger resign from the ECB during the week. Given the scale of the likely financial crisis and given the arrival of France’s ex-Finance Minister to run the ECB, few Germans will want their fingerprints on the next ‘whatever it takes’ policy given the implications for German savers. There may not be a rush of volunteers to replace her, but no doubt a suitable academic can be found to endorse the destruction of German savings now necessary for the relief of debt elsewhere; an economic theoretician with a guaranteed defined benefit pension may be just the person for the job!

Whoever replaces Lautenschläger, it will be yet another agent appointed by agents to distort and assign the money of principals - personal responsibility really is so nineteenth century! As the great Charles Munger is wont to say, ‘show me incentives and I’ll show you outcomes’. With the prime incentive of the agents to create a single currency for nineteen differing European economies with grossly different levels of debt and savings, the outcomes are perverse for the price of money and, in the long term, also for the purchasing power of money. Rather amusingly to your analyst, investors seem to think that Italy should be the epicenter of any future Eurozone crisis, yet its private debt-to-GDP ratio has been reduced to the same level as Germany! Thus, when the credit crisis does come its locus will clearly come as a great surprise to most. Sacre bleu!

One always wishes that it was possible to issue a second version of any report following a roadshow, given the insights that flow from the full and frank exchange of views with the fund management community. As well as the insights from debate, one also gathers a good sense of the consensus opinion and thus where one’s own opinion is very out of line with consensus. So, apart from the discovery that investors are unaware that six of the world’s nine most highly geared countries are in the Eurozone, what other dangerous consensus opinions did your analyst encounter between cups of bad coffee and discussing the lovely weather with the visiting Haiti delegation to the UN in the lift at the Grand Hyatt?

The most interesting and consequential difference was that nine out of ten fund managers believe that President Trump will strike a trade deal with China as this is essential for him to win an election! Regular readers will know that The Solid Ground believes that the US has switched from a China engagement to a China containment policy. That changes everything in the world and could well do so for decades to come. That so many investors still believe that we are in just a trade war is somewhat shocking. It is, however, just another example of how people in finance assume economic outcomes are the number one thing incentivising the actions of others.

A business school education introduces the young and naïve to homo economicus at such a young and impressionable age that it can take a lifetime to discover that he is in fact fictional – ask Larry Summers (see I discovered the rest of America on my summer holiday, FT, 8th October 2018). The paramount
place money takes in the hierarchy of needs of a financial professional, given the nature of the day job, is not necessarily shared by others and recent elections have proven this, much to the shock of investors. [Investors seeking a de-introduction to *homo economicus* can come and join us for the *Practical History of Financial Market Course* in London on October 31st, [www.didaskoeducation.org](http://www.didaskoeducation.org).]

Yes, we do all need to ‘do a Larry’, perhaps even getting to the stage where those we meet can be called people or citizens rather than the ‘workers’ that Larry bumped into on his own road trip. The difference between a citizen and a worker, at least in a democracy, is that they all get one vote each - the same as Larry. In Larry’s economics they may be an ‘input’ but in democracy their role is very different. If Larry didn’t find *homo economicus* on his drive from coast to coast, he won’t find him at the ballot box either. We need to get out more because the odds are not nine out of ten that President Trump will do a trade deal if he wants to get elected. There is a much more powerful route to the White House for President Trump which involves no trade deal and which recognises something in the hierarchy of needs that ranks well above money - patriotism.

Realising that not everyone votes for their financial self-interest is important in assessing how President Trump may take another route back to the White House that may not include a deal with China. As a Republican burnishing his strong support for the military, he may instead believe that finding a serious enemy from which to defend America may be a better way to secure re-election. Mike Pence has already made it very clear in his famous speech at The Hudson Institute in October last year (see *The Solid Ground Newsletter, Desolation Row: Which Side Are You On? 9th October 2018*) that the Chinese Communist Party (CCP) would fulfil all the necessary criteria to be such an enemy.

Pence’s follow-up speech on China, slated for June 4th 2019, allegedly goes even further in labelling the CCP as a threat to America and more generally global democracy. While that speech was pulled because of its incendiary nature, Reuters reported on September 6th that the speech will now be delivered ‘in the fall’ at the Wilson Center think-tank in Washington DC. The fact that that speech is now ready for launch suggests strongly to your author that it might well be Plan B for the President’s run for the White House. Plan B is to label the CCP as the dangerous enemy of our time, and to position the President as the strong pro-military leader who can protect the people from the threat.

It would be difficult for any Democratic candidate to be more staunch than President Trump on that issue and even more difficult for a Democrat to argue that the CCP is a benign force in the world to be engaged rather than contained. With the Democrats, particularly Elizabeth Warren, now fully on board with defending US economic interests from China, the President will have to move the election battlefield to another sphere of China relations - defence. Throughout history there has been a tried and tested route to power through the ballot box by identifying an enemy and offering to protect a people from that enemy. Thus the prospect of a trade deal between the US and China is not a nine in ten shot. Probably, more importantly, the consequences for financial markets from a Plan B approach to re-election are not just that there is no trade deal, but that the penny finally drops that we are in a Cold War.

I was sitting in the sunshine on Park Lane last Friday admiring Mies van der Rohe’s Seagram Building when I got a notification from Bloomberg to let me know that ‘White House Weighs Limits on U.S. Portfolio Flows into China’. It would be difficult to imagine a clearer signal of a move to a containment policy. Apparently not, however, as this is still just seen as another attempt to gain leverage on a trade deal, at least based upon the follow-up flurry of emails from investors! Well, perhaps, but when one considers there is now a capital, trade, intellectual property and military escalation against the CCP, one does wonder if this may be part of something bigger than a drive to sell more soya beans.

This news on possible restrictions on the free movement of capital to China will come to be seen as a crucial turning point in the history of this century. It will be seen as a turning point of a magnitude commensurate with the free movement of capital across borders that ultimately defined what globalisation is, rather than the free movement of goods. For professional investors in particular, prosperity has sprung not just from the innovation and creativity that thrives in a capitalist system, but also the ability of capital to move freely and thus arbitrage both labour and government. Since the GFC
The Solid Ground has argued that this era is coming to an end and for many people, primarily those living in emerging markets that have now imposed capital controls, it has already come to an end.

Our financialised world is a product of the lifting of capital controls that began in the late 1970s. The role of the financial sector will be greatly diminished as we go back towards more government control over capital flows. As The Solid Ground has argued many times before, investors do need to fear this imposed impact of the deliquification of assets, given that the world’s 119,000 open-ended mutual funds contain USD46.7trn of financial assets of which USD19.9trn is in equities. The world has changed since 1980 when there were just 564 mutual funds with total assets of just USD135bn! Financial assets are now held in structures that provide daily liquidity - until they don’t. The end of the free movement of capital will be the biggest deliquification event we have seen at least since 1914, and that event bankrupted the European banking system. It may come with a bang or it may come with a whimper but it will come. It has started.

In the shorter term investors need to consider how the CCP reacts to this potential restriction on capital flows into China. Whatever the financial markets may think, the CCP will now be in little doubt that a China containment policy has been launched as capital flows are politicised. Clearly they can hope that containment is a policy unique to this US President and, if they wait long enough, whether that be one year or five years, then both the President and the policy will go away.

This appears to have been their key approach to the problem so far, but the risks of such an approach have already risen markedly with the launch of Elizabeth Warren’s ‘Plan for Economic Patriotism’. However, be sure that there will be voices in China arguing that the CCP needs to take action now to prepare for containment and that hoping it goes away is too passive a response. The announcement on Friday of the possible move to restrict US capital flows into China can prompt retaliations on the capital account just as trade restrictions triggered retaliations on the trade account. Investors in Hong Kong should be particularly worried as to what those retaliations may mean.

Taking action to defend yourself from containment involves circling the wagons, both militarily and also financially. Getting the wagons into that formation is never easy, particularly where it involves other states who may or may not wish to side with China in any new Cold War. However, there is one state, more accurately a Special Administrative Region, that is easily put amongst the circled wagons and that is Hong Kong. While the media will focus on whether we are to see a higher level of People’s Liberation Army involvement within Hong Kong, investors should focus on China’s plans for Hong Kong’s USD432bn of foreign exchange reserves.

By simply forcing a re-pegging of the HK dollar to the RMB, China would trigger a USD432bn liquidation of primarily US Treasury securities and the purchase of the same value of RMB denominated Chinese government debt. That would send a powerful message to the US as to how China might seek the capital flow it so desperately needs if it is to both accelerate its growth and maintain a stable exchange rate. It is also a prudent move by a CCP worried that sequestration of its US dollar assets by the US administration is an increasingly live possibility, now that containment extends to capital flows. Re-pegging the HK dollar to the RMB, almost certainly through a currency board system, would trigger massive capital outflow from Hong Kong, much tighter monetary policy, and asset price deflation. Whether the CCP would permit the free flow of capital out of Hong Kong in such a situation, only time will tell but the fear of capital controls will rise, in itself exacerbating the problem. The long-term prognosis for Hong Kong from this move is as dire as the short-term prognosis, and may be even worse.

The Solid Ground has long argued that China will abandon its exchange rate management regime and adapt an entirely independent monetary policy, something that has always been inevitable given that China is now the world’s second largest economy. Any move by the White House to restrict US capital inflow to China just brings the decision to float the RMB, to implement an independent monetary policy, even closer. Why on earth would China continue to link its exchange rate largely to the US in an age of containment? With the likely restrictions on capital flows and the Pence speech due in the next few weeks, can China wait any longer before moving to circle its monetary and financial wagons in linking the HK dollar to the RMB and then floating the RMB? From reading past research subscribers will know...
the gross deflationary consequences of such a move and also, from the new quarterly report, which 27 countries will likely see a systemic banking crisis when it happens.

I left for North America puzzled as to why almost everyone thinks that President Trump will strike a trade deal with China. However, that puzzlement has lifted somewhat during the week as I increasingly realised that the opinion on the likelihood of a trade deal is being reinforced by every major bank that issues investment research. Given these institutions’ investments in China, and their hope for business from China, one should not expect a full and frank assessment of the outlook for US/China relations from that quarter. Companies and executives expressing too frank a view on the appropriate relationship between the PRC and Hong Kong have already paid a heavy price for voicing such opinions.

It would be difficult for any major bank issuing research to voice an opinion that does not foresee continued peace and harmony between the US and China. As the actual deterioration in relations continues, as it has done between the PRC and the people of Hong Kong, it will become even more difficult for investment bank research to honestly assess the economic and financial outlook for China in particular. That, of course, is just another reason why it is time for fund managers to consider the sources of their research and to seek independent advice in a world where so much of that advice is tainted by such commercial conflict of interest. Investment research is already priced as a loss leader for other services and now it can be further compromised by the efforts of the large banks to maintain good relationships with the PRC. Capital is being politicised and it is thus not just in terms of capital flows that the age of openness is ending.

While in NYC on Friday your analyst had cause to visit Trump Tower between meetings. In the basement of the building is a shop selling all the Trump merchandise that anyone, or anyone’s friends and relatives, could possibly wish for. I was there, however, not because I was in need of an imitation gold bar Trump savings bank but to buy, just in case of emergency, a stand-by bottle opener - one can never have too many. I was lucky enough to find one and even luckier to find one that was entirely politically neutral as it did not carry the President’s moniker. It was a bottle-opener appended to a model of the Statue of Liberty. In recognition of the momentous news on Friday, I did ask the sales associate in the Trump store not to remove the sales sticker affixed to the rear of Miss Liberty. On that sticker it says Made in China. To state the blindingly obvious, liberty is not made in the PRC and soon neither will Liberty.
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