Where Has Credit Gone Wrong?

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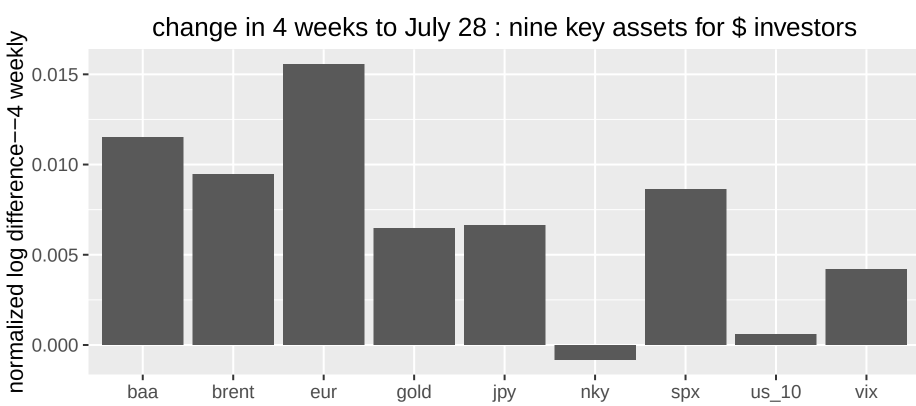
- **An Example: Saudi Arabia and Russia**
- **Starting Fed Portfolio Roll-Offs**
- **Time to Slow ECB Bond Buying**
- **China's 19th National Party Congress**

Financial asset prices continued their tear upwards. Gains were concentrated in higher corporate bond and in equities. Even the riskier assets that I think are at great risk held up–gold, bitcoins, and tech stocks.

Investments outside of the dollar block were up, too, particularly the euro. The move has become enough to suggest a drag on prospective earnings for European stocks.

Oil was up, reversing last month's loss but not yet suggesting a trend. I the following pages I discuss one place where glaring credit trouble is building if oil prices resume their slide.



Commodity prices were up as the global recovery gains traction. For oil, stronger global demand in emerging markets will mean a quicker drop in excess inventories. For copper, the coming of electric cars can boost demand.

Europe's systemic collapse keeps looking more remote. The Swiss franc, a perennial safe alternative, collapsed, as European populism fades in the face of solid employment gains. Britain's hasty lunge toward exit from the Eurozone is looking less advantageous, and may morph into something much less definite than predicted.

Emerging market equities were mostly up, in response to better growth prospects in a recovering global economy and the outlook for higher commodity prices.

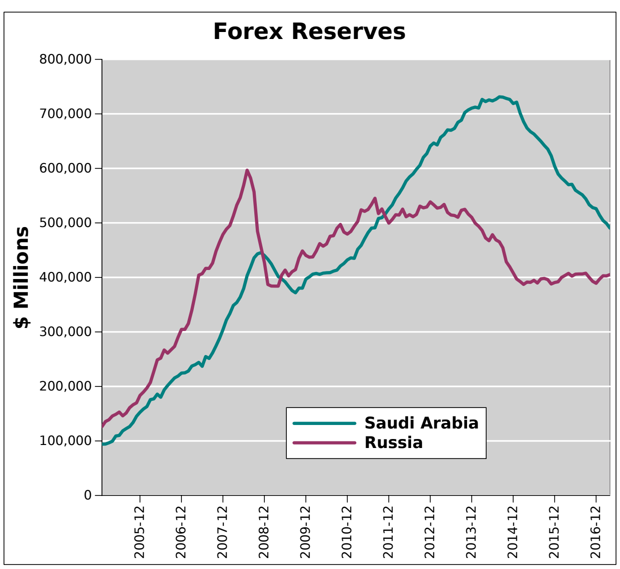
An Example: Saudi Arabia and Russia. Buoyant asset markets always paper over risk in ways that will only become painfully obvious later on. One such risk is to be found among oil exporters. Saudi Arabia started on its quest to drive down oil prices in 2014 with foreign exchange reserves at a record $730 billion. Prices certainly fell, as did Saudi exports and reserves, the latter by $240 billion in 32 months, a pace that cannot long continue. (See chart below.)

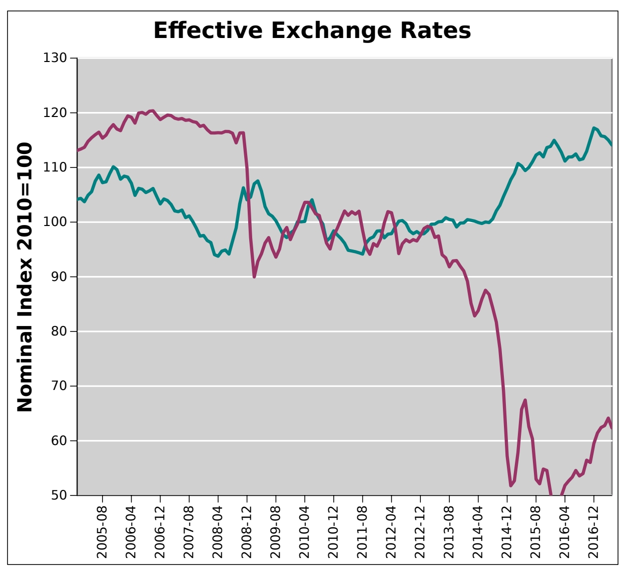
Adapting to the World. Saudi leaders made a key choice to finance the period of cheap oil, and not to adapt. By stark contrast, Russia, which produces almost the same amount of oil, has stabilized its reserves despite suffering the same drop in sales prices. Key to the difference is Russia's long-lost tie to a fixed exchange rate. When oil prices fall in Russia, the impact is felt in the currency, in import prices and in import levels. That difference is seen in Russia's 50

These two oil producers are quite different in other ways. One is the history of deeper financial linkages of Russia with the world compared with the absence of any need for external finance by Saudi Arabia. That leaves Saudi Arabia today with room to start borrowing to keep cushion the pace of any adjustment that may be needed. A big international bond was issued this year, more will follow and a slice of ARAMCO is to be sold to equity investors next year. That should buy some time.

Eventual Adjustment. But some adjustment will be needed in Saudi Arabia beyond financing. Like other ancien regimes, any nation organized on a medieval basis must be struggling for public acceptance. In this struggle its aristocratic rulers have long redirected any local opposition into foreign jihadist efforts. The other key policy to buy acquiescence to their rule has been a system of education and hiring by the government for locals who would never get a job otherwise in the global economy. To take the resulting hot-house economy forward, the government struggles to solutions. [1]

Ultimately the big vector of financial risk comes from the Saudi policy of fighting history as well as its political enemies via a fixed exchange rate. As the end begins to loom, this currency fixing will come under pressure. With a growing domestic financial system, the risk of capital flight will loom. Probably some mistake in security matters around the country's great struggle with Iran and the Shiite world, for example around Qatar, will be the immediate trigger for trouble.





[1] Council of Economic and Development Affairs (April 2016) *Saudi Vision 2030* Saudi Gazette, Riyadh. Retrieved from https://english.alarabiya.net/en/perspective/features/2016/04/26/Full-text-of-Saudi-Arabia-s-Vision-2030.html

Starting Fed Portfolio Roll-Offs. Inventory effects were more muted than I expected, and final demand was not particularly buoyant, giving us a quite muted GDP in the first half of 2017. Looking ahead, car sales are running far behind production: rising inventories and falling effective prices will eventually demand a production cut once managers get over their fear of provoking presidential complaints. But a long-delayed business investment recovery is also possible, once businesses decide not to wait for any longer for tax changes, which may never materialize from beleaguered this administration. On balance, we face a sustained but limited recovery for the balance of the year.

Meanwhile inflation seemed to dip, possibly because of the more immediate pass-through of lower oil prices into general prices than before. Or, possibly, because of the delayed impact of improved technology. Whatever the reason, the Fed seems set to respond by cutting its bond portfolio more than by raising interest rates. Yellen keeps coming back to their notion of a zero real "natural" rate, which at 1.5% inflation is very close to today's rates. But the Fed can still take steps to normalize its portfolio, allowing a small but rising value of bonds to roll off its balance sheet, probably to be announced in September.

Of course the question to which the Fed Board has no answer is: if a zero real rate is required to get the asset values that sustain adequate spending, what *path of rates* is actually going to get the best sustained level of asset values and growth over time? After a series of collapsed asset price bubbles, the problem of finding the lowest-risk path to a finance-led recovery is tough, maybe impossible. Facing the unknown, the Fed will proceed very gingerly, too gingerly for me.

In the next phase of global tightening, we expect to see Fed bond sales and ECB tapering down its buying program, to impact mostly longer-term rates. (Assuming the Bank of Japan does not get trapped into absorbing infinite amounts of bonds at its zero 10-year rate target.) US policy rate hikes, which more directly affect the dollar, may pause. That combination, will tend to weaken the dollar and increase our imported inflation risks amid rising longer-term rates.

Time to Slow ECB Bond Buying. Restarting Europe's broad continental-scale manufacturing operations has boosted shipments and activity. The impact is particularly notable in peripheral Eastern European GDP and bouncing real estate markets. Over time, the gains in manufacturing seem to include strong capital goods exports to emerging markets, including China. Additionally, Macron's election in France promises a new approach to market economics and has led to a surge in local retail and manufacturing activity. Across Europe, unemployment keeps falling, putting workers back to work instead of supporting them at public expense. Across the region, public finances are improving surprisingly.

All problems become more manageable in an European-style recovery enabled by improved public finances. That means it is time to make some progress on non-performing loans, most of all in Greece and Cyprus, but also in Italy. At least in Italy progress will be helped by the way low funding costs from the ECB have encouraged an outbreak of competition in lending and easier conditions, as reported in the most recent ECB bank lending survey. Partly as a result, Italy seems to have gotten away with measures to stabilize depositors contrary to the spirit of EU law. Amidst the credit renaissance in Europe, even the Greeks remarkably seem to be able to sell new bonds.

Another unresolved problem in Europe is the very strong link among core country inflation rates. These are a direct result of the deepening trade links, and the law of one price that follows. But a recovery is also the time for productivity and labor market changes in Southern Europe, in line with the euro-price level, a project that is barely begun but on which a healthy long-term expansion depends.

Reacting to the recovery without inflation as in the US, the ECB is preparing to back off from its big bond buying effort. If the US is also shifting to bond run-offs and less rate hikes, a stronger euro is going to reduce import prices and further hinder the ECB from raising rates. So the only question that remains is the pace at which the ECB chooses to taper down its bond buying. Again, ECB President Draghi talked of starting to wind down the pace of new buying at the ECB's September or October meetings.

China's 19th National Party Congress. Growth in China has been a little stronger than I thought, hardly pausing from its robust rebound pace in 1Q. The gains are based on some export recovery, continued home construction, and the conclusion of a car assembly correction. Meanwhile, state supported investment in high-speed rail is reaching a limit as more remote and less travelled routes are built. Still, the first half clearly brought a surge in sales, and in business profits, mainly in mining where prices have moved up, and in the new tech services sector.

Policy remains dominated by factions struggling to appoint allies in the upcoming party congress, a once in five-year event. Absolute priority will be given to holding off any sudden shocks between now and year-end to support President Xi's search for control. But this enforcede stability is threatened with economic and military risks, mostly coming from the Trump White House, where China's steel exports and absence of decisive action to stop North Korean missile tests are sore points.

Partly as a means of showing his care with the economy, Xi is personally invoved with controlling the high and rising leverage of Chinese borrowers. He refers to study groups that have wrestled with the paradox that finance is needed to channel China's high savings into productive investment, but that excessive finance ends up wasting those savings. Some part of the excess credit growth of recent years went to new home buying with credit, part to finance local governments that do not have the taxes to meet their obligations, part to finance zombie companies in heavy industry, and lastly part also went to finance a recent wave of offshore investments. The last category got a sharp rebuke as four big companies were singled out for "illogical" offshore investment, and their state bank credit very publically cut off. Meanwhile, state owned companies have been directed to use debt to equity swaps to reduce leverage.

Investors have been cautious of the consequences of China's administered deleveraging cycle. As the immediate pressures of last month have abated and overnight rates come down, and as the PBOC takes its foot off the brakes, these administered measures are still present. One place the stress shows is in an underlying reserve loss in June (after allowing for appreciation in China's euro reserves.) Another is some sudden moves in the tech-oriented ChiNext index. Further equity volatility is expected as increasing amounts of locked-up equity becomes available for trading in the next few weeks. This is a system waiting for volatility to emerge again after the party congress.

As this rally continues, the risk of a correction continues to rise. The only question is: where is the weak point in a model of the future that includes borderline deflation, capped policy rates, and a re-marking upward of all asset prices?

One spot that is particularly vulnerable here is the idea that bond yields are kept down regardless of the coming drop in central bank buying. Another is the idea that certain vastly wealthy oil producers remain risk-free. Lastly, we have plenty of political risk of failure by an amateurish US administration to deliver the profits and growth it promised.

Amid those risks, I can see a steepening global curve as part of the process of step-wise normalization of markets, up to the point where it causes a modest equity correction. A trigger for the steepening move, besides central bank adjustments, could come once the US debt ceiling is lifted and normal US long term debt issuance resumes.