The Bad “Lesson” of The EU Debt Crisis Is That There Will Always Be A Bailout

By Paolo von Schirach

July 31, 2013

WASHINGTON – The situation in Europe turned from really dramatic into just chronic. No more talk of a “Greece Exit”. There are no defaults on the horizon. Still, there has been no qualitative change. Therefore it would be highly deceptive to call this calmer state of affairs a real improvement. The reality is that Southern Europe cannot travel at the same speed of its better organized Northern counterparts relying on its own means. This means that Club Med will have to receive aid and/or special treatment for a long, long time. Who knows, may be in perpetuity.

Bailout does not affect the fundamentals

Mostly for political reasons, wealthier Northern Europe (read: Germany) decided that it was and still is in its own self-interest to bail out its Southern poor, and perennially disorganized, cousins. Better to pay now, then to face the headwinds and possible chaos that may result from a sovereign debt default.

Still, nobody believes at this juncture that the bailout money and/or the indirect fiscal support via ECB bond buying programs or easy credit to battered banks will cause a real qualitative transformation within the South. While economic conditions may improve somewhat, the fundamentals remain bad. For example, Sergio Marchionne, the CEO of FIAT, still the largest Italian industrial conglomerate, in a call with analysts indicated that “***Italy continues to have an impossible***

environment for industry”.

Now, consider this rosy assessment on the economic fundamentals within the third largest Eurozone economy, coming as it does from a pretty seasoned practitioner. How is a profoundly uncompetitive country that continues to have impossible conditions for industry (i.e. growth) going to produce the extra wealth that will allow it to get out of its impossibly high national debt? The simple answer is: “Never”. Italy will probably limp along, supported by ECB bond buying and some other half measures. It may not drown, but it will never become an energetic, competitive economy. In other words, thanks to extra help it will not go under, even though the best it can hope for is survival.

Everybody gets a rescue package

And here comes the real point. If you are a policy maker in Slovenia, Poland or Hungary, having noted that Germany decided that Greece and the others are indeed “too big to fail”, you will conclude that, if your country gets into serious trouble, it will be considered too big to fail, just like all the others. Help will come. You will not be allowed to go under. This “message” unfortunately has a perverse effect, because it diminishes the pressure on other mediocre economies to get busy in order to jump-start serious growth.

Michigan allowed Detroit to go under, a lesson for all other troubled municipalities

In a different, but somehow related, context the State of Michigan allowed battered Detroit to go under. Michigan decided that its own domestic “Greece” was not “too big to fail”. It did not bail it out. It forced it into bankruptcy. The just initiated bankruptcy process in turn allowed the rest of America to see and evaluate the compounded effects of unfavorable economics and bad public administration, combined with over generous pensions to public employees.

As a result, local administrators in Chicago, Oakland and other challenged cities now have a strong extra incentive to get their own house in order. If Detroit is not “too big to fail”, chances are that their own municipalities, all of them headed Detroit’s way, may also go under. Therefore some at least may conclude that it is time to get busy and make changes, (renegotiating unsustainable pension benefits would be a good start), before it is too late.

Rescue packages are a disincentive to implement reforms

In contrast, policy-makers in Europe get essentially the opposite message. ***“Your countries are perennial economic under achievers. Your public accounts are headed the wrong way. But not to worry. Just as they did with Greece, the wealthy Northern partners will bail you out”.*** If this is indeed the “lesson” of the catastrophic debt crisis that began back in 2009, then you can bet that with the exception of a more solid North most of Europe will lack the incentive to do better and therefore will continue to underperform.

Global Warming Is Real – Still, Do Not Force The Adoption Of Imperfect Renewable Energy, Put More Money into R&D

WASHINGTON – If we knew for sure that man-made global warming were accelerating at a dramatic pace, threatening an imminent global catastrophe and the very survival of the world, then the most desperate counter measures would be appropriate. But we are not there. We have a major problem that is progressively getting worse; but not a catastrophe. The environmentalists of course believe the opposite, and therefore believe that in order to save the earth it is appropriate to impose punitive taxes against carbon based energy, while at the same time forcing the immediate adoption of still imperfect renewable energy technologies.

Green tech not quite mature

The fact is, as Biorn Lomborg, Director of the Copenhagen Consensus Center, argues in a compelling FT piece *(Only cheaper "green" fuels will force changes in energy use,* July 30, 2013), that: A) while global warming is real and is a serious problem, we do not have an impending catastrophe; B) the early adoption of green technologies as they exist today would not do much to reverse global warming; C) this "solution" amounts to imposing an enormous cost on consumers forced to use electricity that is much more expensive, because it is produced by as yet immature renewable energy technologies.

To be clear, Lomborg does not dismiss global warming as a fantasy, nor does he believe that the pursuit of renewable energy is wasteful. He has no "pro-carbon" bias. His argument is against the early adoption of green technologies that, while promising, are still not cost-effective. His simple point is that when wind, solar or whatever else will be really cost competitive, they will replace carbon based energy sources, as a matter of course, without any subsidies, special taxes or other ad hoc policy mandates.

Better technologies always displace older ones

As he points out, we did not get the world to adopt personal computers by subsidizing rudimentary electronics and by taxing typewriters, so that people would be forced to buy ineffective, primitive personal computers. Indeed, we had to wait for a certain level of technological development to allow innovators to come up with viable PCs that people really wanted to buy. When they became available and proved to be reliable, then typewriters became immediately obsolete.

By the same token, as soon as renewable energy will become truly competitive, it will not take much for the market to abandon fossil fuels, no matter how plentiful. If state of the art solar panels can provide reliable cheaper electricity, then it is good-bye to coal, natural gas and whatever else we have been using. As history demonstrates, when technologies become obsolete, they are tossed away, without even a second thought.

Promote green tech by spending a lot more on R&D

In order to get faster to our coveted “green tech” future, Lomborg proposed to subsidize R&D, as opposed to forcing the early adoption of the still imperfect technologies we have today. Of course spending a lot more on R&D is no guarantee of success. But it will create more opportunities for innovators to come up with real qualitative changes that may indeed create a new energy technology environment.

If we can produce electricity through solar at a fraction of what it costs to do so by using natural gas, you can bet that, just as the new cost-effective solar panels are rolled out, the gas wells will be closed down in no time. But to force people to abandon gas today, and use still imperfect wind or solar is bad policy and bad economics. And it gets even worse if you need to convince reluctant taxpayers that they really have to swallow this –today–because we are cooking up the planet and soon enough there will be gigantic floods and other man-made catastrophes.

Global warming is a serious matter. But it is best addressed by producing something truly viable that will replace carbon based energy sources. Therefore let’s redouble our research efforts in “green tech”. Forcing the adoption of half backed technologies ahead of time translates into additional costs, political resistance and negligible improvements. All in all, a bad idea.

Is Methane Hydrate The New Energy Frontier?

By Paolo von Schirach

July 29, 2013

WASHINGTON – Until a few years ago, outside of a very small circle of US energy industry practitioners, nobody had ever heard of “shale gas”, “shale oil” or “hydraulic fracturing”, (now better known as “fracking”). And even smart analysts were unable to appreciate the impact of the economic transformation that the exploitation of shale gas was about to bring about. Indeed, as late as 2008, well-regarded energy experts were predicting sky-high natural gas prices in America and the need to import gas because of the rapid depletion of our dwindling reserves.

The revolution came

Well, just a few years later, it is all upside down. Yes, thanks to shale gas, America is now a leading world natural gas producer. As a result of this shale bonanza, America’s prices are about $ 3 to 4 per million btu, while in Japan the price for natural gas is about $ 16. This enormous differential created a major economic advantage for US energy intensive industries, making them more competitive world-wide.

Implications of shale gas not yet fully understood

However, even though the *"US Shale Revolution*" is unfolding, the extent of its value has not been fully understood. For instance, we are still far from embracing Liquefied or Compressed Natural Gas (LNG, CNG) as the obvious, cost-effective alternatives to expensive diesel fuel for heavy trucks. The economic advantages are obvious, but the policy incentives aimed at speeding up an economically advantageous transition to LNG/CNG are not there. In other words, change is not understood as early and as well as it should be.

Methane Hydrate: the new magic energy source?

Indeed, it seems very difficult, even for key market players, to fully appreciate the relevance and impact of epochal disruptive changes. ***That said, if we had so many problems in embracing fracking, how about appreciating the possible impact of the successful exploitation of abundant "methane hydrate"? Yes, this seems to be another, totally new, hydrocarbon frontier. We are talking about enormous quantities of methane gas trapped in frozen deposits located in permafrost areas and at the bottom of the sea, all over the world.***

At the moment the recovery technologies are still not advanced enough to make drilling for this enormous amount of energy economically viable. But remember that the same was said about fracking: "It is too expensive. It is too dangerous. It will never work".

Japan is leading

For the moment, the Japanese are ahead of the pack in testing technologies that will allow the recovery of methane hydrate from the sea floor. They are actually doing it, although only on an experimental basis. Of course, energy starved Japan would have a lot to gain from the development of its own energy sources. But North America also has enormous deposit of this new energy.

ConocoPhillips has been involved in an experiment aimed at extracting methane from a deposit in Alaska. The consensus is that for the time being the processes currently available are way too expensive, and therefore unable to compete with the exploitation of abundant shale gas.

Keep an eye on developments

But I would keep an eye on ongoing efforts pursued by Japan and others. Ingenuity and persistence gave us shale gas. It is not be excluded that soon enough we shall be talking about the "*Methane Hydrate Revolution*" that will transform Japan's –and possibly America's– energy future.

Walking Around The Beautiful Wesley Heights Neighborhood In Washington, DC; But The Streets Are Totally Deserted – Why Is That?

By Paolo von Schirach

July 28, 2013

WASHINGTON – I live in a lovely, green neighborhood in North West Washington DC called Wesley Heights. Plenty of trees, beautiful houses with large and lush gardens. A very short walk away there is an impressive National Park, right in the middle of the city. It is called Glover-Archbold Park. It is not huge; but large enough to give the feeling of pristine wilderness, especially in the Summer, when all the trees are fully green and the vegetation looks very thick. There are birds, deer and lots of squirrels.

Walking around

I like to walk around my neighborhood. The streets are usually quiet. Hardly any car traffic there. And it is quite pleasant to look at the beautiful houses and their gardens, while enjoying the shade of so many large trees. I find these leisurely walks very relaxing.

And yet, there is something truly puzzling in this beautiful scenery. In general I am the only person taking a walk, regardless of the time of day. Except for an occasional man or woman walking their dog, there is nobody else taking advantage of this lovely scenery. And I really mean nobody.

As I said, the neighborhood is quite beautiful, in many ways stately. The large houses, some of them real mansions, are usually old but very well-kept and in impeccable shape. They convey an aura of comfortable wealth and achievement. I imagine the owners to be part of the Washington professional elites. Law firm partners, surgeons, lobbyists, high-ranking government officials, who knows.

Nobody there

And yet, these people do not enjoy their neighborhood. Nobody walks around. For this elementary reason, nobody has the opportunity to meet other people in a simple casual way, exchange greetings, get to know one another. I find this odd. The area is really beautiful and quite safe. And yet those who live there live in their homes as if they were small fortresses. Beyond their daily commute to their office, rarely, if at all would they venture out for a casual walk.

Man as a Social Animal?

Well, this behavior plainly contradicts the ancient and usually correct assumption that *“Man is a Social Animal”,* naturally drawn to other human beings. Indeed in the Western world urban landscapes were designed to foster human interaction. Ancient Greek cities had the *Agora’,* the market square, as a place of commerce but also as a venue for social interactions. The Romans created the thermal baths as a place of relaxation. But going to the baths was also an opportunity to meet friends and exchange ideas. Likewise, as cities were reborn in Europe after the Middle Ages, a key feature was the town square that would also be the venue for markets and fairs. There you would find the main church and quite often the building that would house the city government. And the church bells would also double as public advisories. They would signal ceremonies and celebrations but also imminent danger. In either case, the people would flock to the town square. In other words, the Western World is full of evidence indicating that people used to spend a lot of time in the streets and in other purposely designed public places; places where they would meet friends, mingle and get to know one another.

So many missed opportunities

But this is not the case in my beautiful Wesley Heights neighborhood. Its inhabitants live confined in their own homes. If they venture out it will be by car to go to work or run errands elsewhere. Of course, there is nothing wrong in any of this. Except that this life style deprives those who live here of the opportunity to enrich and be enriched by others.

Imagine how many opportunities for personal or professional connections among smart, well-educated high achievers have been and will be missed. Simple encounters could lead to new friendships, partnerships, business ventures, alliances, even marriages.

But none of this will ever take place, simply because nobody takes a walk. What a pity.

Green Shoots In Europe? Not Until It Will Create Innovative Economies

By Paolo von Schirach

July 27, 2013

WASHINGTON – The international business and financial media are desperately trying to tell us that the worst is over for Europe. Every tiny morsel of semi-good news is magnified in order to support the idea that we have real green shoots; and so all will be well, very soon –really. (*Look: Spain's unemployment is down from 27% to just 26%. Hey, the UK economy grew by 0.6%. Great news!)*

Good news from Europe?

Good news? Really? Look, Northern Europe may be doing alright, at least by international standards. But the South is another story. The combination of high social costs, inefficient and costly public services, lack of innovation, and corruption are at the root o a chronic crisis that may at best morph into semi-perpetual stagnation, assuming continuing support coming from Brussels and the European Central Bank. .

Of course there is no law dictating that "it has to be this way" in Italy or Spain. Post industrial knowledge economies are all about the production and optimization of intellectual capital and its coveted fruits: world-class innovative technologies. Assuming a decent level of education and the creation of a reasonably large cadre of smart people who can think and innovate, almost anything is possible. Look at Taiwan. Look at Bangalore in India. Look at state of the art Scandinavian corporations.

A pro-business eco-system

But while in theory all this is very straightforward, in practice the creation of a well-balanced "***eco-system***" that will spawn innovation is devilishly complicated. It is complicated because it rests on the creation of a good balance among intangible yet crucial factors. Yes, we need good education systems that will train young minds. But, while absolutely essential, this is not nearly enough.

We also need a society that will create real and easy to understand material incentives so that would-be innovators will apply their knowledge and enthusiasm to economically viable pursuits. And this implies the correct alignment of a host of extremely relevant factors. We need clear rules of the game (good laws), and credible enforcement mechanisms. Contracts need to be honored, Intellectual property needs to be adequately protected. Failures should not be the kiss of death for any would-be entrepreneur. Economic activities should be supported by modern infrastructure and decent public services. Capital markets should be well-regulated in order to ensure transparency. Likewise, commercial credit as well as venture capital should be available; and finally taxes should be fair, not punitive.

In other words we need a pro-growth environment that will make people believe that it is definitely worthwhile to make an effort trying something new, because there will be real rewards in case of success, while failure will not for ever disqualify an entrepreneur who tried and did not succeed.

It is not easy

All this sounds pretty self-evident; and yet it is extremely difficult to implement, because doing it right depends on a deep understanding of how to modulate and organize so many different moving parts in a harmonious way. For example, if we go back to the old Soviet Union, there is no doubt that the Communist system did produce a large number of first class scientists and engineers. That system created state of the art military hardware, (tanks, fighter jets and submarines), nuclear armed intercontinental ballistic missiles and satellites. That gigantic effort required the sustained production and harnessing of human talent and physical resources. The Soviets did that.

But they managed that process at an extremely high cost and in a very wasteful, top down, fashion. Indeed, lacking the same levels of inordinately high state spending devoted to one single goal, since the collapse of the Soviet Union the new post-communist Russia has been unable to create really modern, world competitive, high-tech champions. And yet it has its share of very smart people. The problem in Russia (as elsewhere) is that on top of smart people you also need a credible, self-sustaining, business friendly eco-system.

Southern Europe still believes in statist fallacies

Spain, Italy and Greece are not Russia; but they also lack a pro-innovation eco-system. They are plagued by a populist and fundamentally anti-business political culture that assumes, among other silly beliefs, that the state drives economic development. Wrong idea. The state is usually a mediocre to bad steward of public resources (that these indebted countries do not have to begin with).

If Europe’s real come back hinges on some new and clever public policy that will drive a turn around, we can search all we want for green shoots. While we may find some, they will never be enough.

In America Racial Prejudice Is Real. But It Is Largely Based On The Hard Facts of Black Criminality

By Paolo von Schirach

July 26, 2013

WASHINGTON – America’ self-appointed “civil rights leaders” point out that young Trayvon Martin was followed and then killed by George Zimmerman only because he was a Black teen-ager. In other words, he became “*a suspect*“, not because of his behavior, but just because of his race. And this very fact, argue the leaders, provides damning evidence of enduring racism in America. Blacks do not have a chance in this racist country, because there is an unwarranted assumption that they are all dangerous criminals.

Unwarranted racial bias?

Of course, there is some truth in this. Whatever may have occurred in that tragic Zimmerman-Martin encounter, it is true that many Whites are afraid of Blacks, many times for no reason other than the fact that they (automatically?)associate criminal intent with the person's race. Still, while all blanket generalizations based on race or color are wrong, is White fear of Blacks totally unwarranted?

If we could have an honest debate, then we should acknowledge that many Whites fear Blacks because Blacks commit far too many crimes. And this has been the case for decades. Sure enough, one can argue that criminal behavior in some instances is the result of ignorance, poverty, lack of education and so on. Still, the average White person, having a general idea that far too many Blacks do indeed engage in criminal behavior, (whatever the reasons), may have grounds to fear that the next Black person he encounters may be dangerous.

Unfair assumptions

Any such blanket assumption is of course terribly unfair to a very large number of perfectly normal, law-abiding Black citizens. However, it is also unfair to conclude that such fears about Blacks are motivated only by racial bias. No, they are motivated by tons of crime statistics. When people know that Blacks commit many more crimes than other racial groups, then it is easy to jump to (unfair) conclusions, and assume that the next Black person I meet may also be a dangerous person.

Justice system discrimination

The same civil rights leaders argue that the extremely large number of Blacks prosecuted and then incarcerated is itself the outcome of racial bias. In other words, too many Blacks are in jail because there is extra zeal in pursuing Black offenders, as opposed to White offenders, precisely because they are Black. Therefore, the notion that a disproportionate number of Blacks engage in criminal behavior is a misperception due to horribly biased, selective law enforcement. If the criminal justice system were truly impartial and color blind, the skewed Black crime statistics would disappear.

This is an interesting theory; but I am not aware of any hard empirical evidence supporting it. Sociologists of all stripes routinely review and study US crime statistic, related data and trends all the time. The US justice system has plenty of anti-discriminatory laws on the books. There are plenty of organizations that would work pro-bono to sue law enforcement authorities in any instance of possible race-based discrimination. Are Black civil rights leaders saying that the clear evidence of ongoing criminal justice system discrimination is not taken into account because it is routinely suppressed?

Black crime is at the root of all this

So, here we are. Yes, there is White prejudice about the presumed criminal intent of Black people, no doubt about it. And most certainly in many cases, (possibly even in the Trayvon Martin case), it leads to White people jumping to the wrong conclusions regarding the intentions of Blacks. But it is also true that in most cases this bias is not based on racism. This bias is based on hard facts of crimes committed by Blacks.

If Black civil rights leaders were really honest about all this, they would tell their communities that there is a real problem within them. Sure, some criminal behavior may be due to poverty, ignorance, hopelessness and marginalization; but not most of it.

The consequences of the teen pregnancy explosion

Many studies point out that children of young, uneducated and often poor single mothers are much more likely to grow up in poverty and then engage in criminal behavior as young adults. Well, while teen pregnancy is a growing phenomenon nation wide, an astounding 73% of Black kids are children of single mothers, most of them uneducated and poor. Is the high incidence of teen pregnancy within Black communities, itself the precursor of a higher crime rate, the result of racism?

Politicians Who Sinned Can Come Back, Provided Humiliating Public Contrition And Pleas For Forgiveness

By Paolo von Schirach

July 25, 2013

WASHINGTON – America lost whatever yardstick it had for evaluating the character of people seeking public office. Once upon a time, private conduct was off-limits. Now, nothing is off-limits, and at the same time there is an absurd demand for spotless "perfection" whereby a speeding ticket in someone's record may invite speculation as to his/her recklessness and therefore reliability as an elected leader.

Spectacular failures

But then we have spectacular personal conduct failures, usually involving sex and extramarital affairs, (New York Governor Elliot Spitzer, Congressman Anthony Weiner, South Carolina Governor Mark Sanford, former CIA Director David Petraeus), followed however by an established ritual of pathetic and frankly ridiculous levels of public contrition, a brief period of atonement and –presto– the former sinner is back, as good as new, ready to devote his life to his true calling: “*serving the people*“.

Fake apologies

My take is that the human weaknesses revealed by these scandals are real, even though it is hard to say how much they tell us about Mr. X fitness for public office. But what worries me are the fake, ritualized public confessions, the “must have” stoic spouse at the side of the sinner during a packed press conference in which she publicly and solemnly states that she has forgiven him, this way allowing (in fact inviting) the whole country to follow suit.

There is nothing sincere in any of this. The contrition is fake, the apology is fake and so is the public support (that later on becomes the imprimatur of political viability) provided by a complicit spouse. As a result, the whole thing has the authenticity of TV Wrestling Matches. It becomes silly entertainment. The professional politicians know this. They play the script provided by their PR people and are confident that, as long as they go through the motions showing “genuine” contrition, all will be well and they will be forgiven.

I do not know what to say about all this insincerity. Again, it would be foolish to think that once upon a time all elected officials were virtuous. We just did not know much about their private affairs, and so their public persona appeared much better than it was.

Absurdly high moral standards, or no standard?

But now we want to know “***everything***“, as if everything really mattered. Still, in the end nothing really matters, because when someone gets caught in the act a good show of public contrition with a mandatory plea for forgiveness washes everything away.

And so as a society we seem to waver between absurdly high moral standards and no standards at all.

Financial Analyst Meredith Whitney Points Out That After The Detroit Bankruptcy Pensions Are Fair Game

By Paolo von Schirach

July 24, 2013

WASHINGTON – Meredith Whitney saw it coming. Back in 2010 she warned about the shaky finances of US municipalities. Her dire forecasts of financial ruin did not come true, but now we have Detroit's mega bankruptcy that (sort of) vindicates her predictions. Still, going forward there is more than just bankruptcies, as she writes in an insightful op-ed piece in the FT, (*Detroit may start a wave of municipal bankruptcies,* July 24, 2013).

At issue: generous pensions

Indeed, Meredith points out that the Detroit meltdown is a watershed, because this is the first time in which the interests of taxpayers/citizens are placed on an equal footing as those of retirees and bondholders. In other words, going forward, any attempt to rebalance municipal finances will have to include a renegotiation of pensions benefits foolishly offered in what appeared to be better times to municipal workers.

Indeed Detroit got into this mess largely because of the impossibility to finance its outstanding pension obligations, themselves the legacy of lousy politics. Very briefly, in Detroit and elsewhere municipal administrators bought and still buy the political support of public employees through generous retirement packages. This is relatively easy to do because when the retirement benefits are due the elected officials who agreed to them are long gone.

Cut services, raise taxes in order to pay pensions

Still, as these over generous packages are widespread practice, now more and more US municipalities face huge obligations, without the money to pay for them. As Meredith explains, until now the political pressure has been to do whatever is necessary to pay pensions and bondholders, meanwhile cutting public services ands rasing taxes as a way to stay afloat. However, this is a raw deal for taxpayers and all citizens: lousy services and higher taxes, while retirees still do OK because they keep getting their benefits.

While Detroit is clearly an extreme case, its unhappy citizens went through the same dreadful path: horrible and declining services, (they do not even replace bulbs for street lights anymore), and progressively higher taxes. It is obvious that nobody wants to live in a city that offers less and less, while it taxes residents more. Those who can leave, this way causing the tax base to shrink even more. A truly perverse outcome of a bad policy.

Pensions no longer taboo

So, what has changed after Detroit? What has changed, Meredith argues, is that from now on retirement packages and bondholders interest will no longer be untouchable. And this is not just about extreme cases like Detroit, but about the myriad of municipalities across America that are slowly headed that way.

Indeed, more and more cities cut services and raise taxes in order to pay pensions and bondholders. And it is clear that at the root of this slow moving crisis we usually find over generous and in fact unaffordable retirement packages negotiated by myopic (or cynical) elected officials essentially to buy political support.

While each situation will be different, the Detroit bankruptcy has broken the “pensions protection taboo”. Yes, retirees who felt reassured that, no matter what, their pensions would always be untouchable now will realize that they may have to lose something as a result of any effort aimed at straightening battered municipal finances. Of course, amending or voiding legally binding deals will be extremely complicated; and any such attempt will invite fierce litigation.

Retirees and bondholders will have to share the pain

Still, Detroit’s bankruptcy sets an important precedent. The interests and welfare of municipal tax payers should count at least as much as those of retirees and bondholders. Besides, it is obvious that lower taxes and improved services will make cities more attractive.

As strange as this may sound to myopic local leaders, people and businesses will be inclined to relocate where there is higher quality of life with affordable costs.

China’s Government Keeps Afloat Money Losing

Corporations With Easy Credit

By Paolo von Schirach

July 23, 2013

WASHINGTON – Imagine for a moment that penniless Detroit had not been forced into bankruptcy. Imagine that, as Detroit finances were getting worse, a year or two ago the Federal Government had decided to step in with a combination of "economic development grants", tax holidays and long term loans at well below market rates. Well, today there would be no headlines about bankruptcy. Detroit would still be doing poorly, with little chance of a real turn around. But we would not be reading about the largest municipal debacle in US history.

Cheap credit hides losses

Let's shift scenarios. Imagine large Chinese state-owned corporations, (SOEs), that are doing poorly because their profit margins are shrinking as their export markets in the USA and Europe are no longer generating demand. The SOEs, if they behaved like normal Western corporations, would fire workers, close down factories, downsize, try to innovate and survive. If, despite their best efforts, they could not cope, they would have to declare bankruptcy.

This may be the case in America, a country in which you can succeed beyond imagination; but where you also have the "right to fail". But in China different rules apply. We have to keep in mind that Chinese SOEs are at the same time economic and social entities. They make things; but they also provide employment, hence a measure of social stability, a most precious asset for the Communist Party in power, and willing to do whatever it takes to stay in power.

Therefore, if a Chinese SOE is in trouble, it will go to a state-owned bank and it will have no problem getting easy credit. With this fresh cash in hand it will keep factories opened and workers employed, even though the business prospects look lousy. Well, but what if its products are no longer competitive? Very simple, the SOEs will sell below cost. But how can this be? How can banks keep pouring good money into uncompetitive, money losing companies?

Subsidies are normal

No problem, really. China’s Government can and will do this. Remember that SOEs are only accountable to political authorities and not to private shareholders. While they are economic entities, most of all they are part of the larger political apparatus. They are arms of the state. And the state-owned banks, for the time being, have all the cash the SOEs may need to stay alive.

Indeed, over a period of 30 years, a period in which most Chinese corporations –public and private– won foreign markets on the basis of their extremely low prices, (due to unglamorous cheap labor), vast cash reserves were accumulated. This huge cushion can now be used to subsidise inefficient producers. In the meantime, China’s GDP numbers will keep going up; even though some of the production counted does not amount to new wealth.

More and more construction

Likewise, in order to keep people employed, China continues to invest in construction and infrastructure, even though, because of massive over investment, now there are diminishing returns. This economic growth policy based on large scale over investment makes no economic sense. True, but once again in China efficient capital allocation is secondary. The top priority is to keep people employed, while at the same time impressing the world with still exceptionally high GDP growth figures.

Well, I do not want to give the impression that China is all fake. But there are more and more signs that a lot of its economy is indeed fake.

Cheap labor advantage, a thing of the past

Cheap labor was an exceptional advantage that China exploited to the fullest extent for 30 years. But it is now evaporating. China's labor is getting more expensive, while many US factories are reducing the relevance of labor costs (hence China's low price advantage) through increasing automation, while American producers now benefit from exceptionally low energy costs, thanks to cheap electricity generated by abundant domestic shale gas.

In the meantime, the Chinese Government, while allowing private enterprises to grow and flourish, kept alive inefficient SOEs that add little value, while in some cases they only consume resources, because they lose money.

The end of the Chinese miracle

As I said, China has huge cash reserves. So it can afford to subsidise even large economic inefficiencies for the sake of social and political stability. But this means less real growth and weaker foundations for future prosperity. To keep things in perspective, China is not about to fall into any abyss. There is no catastrophe ahead.

But there will be a real slow down. For the time being, through fake statistics and window dressing, the Chinese leadership can hide the truth. But not for much longer.

Detroit’s Bankruptcy Is About Unaffordable Pension Obligations

By Paolo von Schirach

July 22, 2013

WASHINGTON – The convenient narrative about the Detroit bankruptcy is that the city is the main (and quite innocent) victim of the auto sector crisis. As GM and Chrysler went under, Detroit was sunk by the gigantic downdraft created by this epic collapse. Convenient story. Except that it is mostly untrue. In fact, the auto sector (however diminished) is back, while Detroit got worse. Of course Detroit was going to feel the negative impact of the auto sector crisis. But the real truth is that Detroit is the victim of the ill effects of racial and social conflicts coupled with decades of poor administration.

The 1967 Detroit riots

Detroit’s problems started after the gigantic 1967 riots, among the worst in US history. Sparked by police action that seemed unwarranted, Detroit’s Blacks went on a rampage that lasted five long days. There was so much violence that Governor George W. Romney (Mitt Romney’s father) called the National Guard and President Johnson sent in the US Army. A curfew was ordered. At the end, there were 43 dead, 1189 injured, 7, 200 arrests and 2,000 building destroyed.

Seeing all that destruction, Whites felt unsafe and started leaving the city, this way causing a progressive shrinking of its tax base. How did the municipality cope? Poorly. Over many years, the city administration, caught between a shrinking revenue base and mounting pension obligations, quite foolishly decided not to renegotiate pensions, going instead for more tax hikes in order make ends meet.

Making it worse

Well, not surprisingly, higher taxes going to pay for outstanding pension obligations, as opposed to funding new city projects, encouraged even more people to leave the city, therefore making the lack of revenue problem worse, year after year. Short of cash, Detroit did what other cities did and do: it issued bonds. Investors believed that those high interest bonds would be "safe", because it seemed unthinkable to anybody that one of America's largest cities, even though in bad shape, would be allowed to go belly up.

High pension costs, no money to pay for them

And this is Detroit's story: Too many costly obligations towards large number of retirees, high taxes but not enough revenue, (after having lost most of the tax base due to tax hikes), and growing debt issued for the sole purpose of paying for pensions.

The only way to rebalance the fiscal outlook would have been a combination of renegotiated (meaning lower) pension benefits and measures aimed at encouraging economic growth and thus a larger and healthier revenue base. But the city did neither. The pension agreements stayed, while taxed remained too high to encourage new business. And so, year after year, things got a bit worse.

Bankruptcy

And now, here we are: bankruptcy. This is of course a tragedy for all those who trusted the word of city administrators. And this includes retirees who will see cuts in benefits and bond holders who will not see their money back.

That said, as painful as this is, it is welcome news that Detroit is not *"too big to fail*". Detroit failed because it had unwisely created massive obligations, (due to the political deals between public services unions and public officials), that it could not meet. Its attempts to raise more revenue while city services were deteriorating made matters worse. It lost its tax base, while it created an army of (now) angry bondholders.

Other cities headed the same way

The cautionary tale in all this is that Detroit is only the tip of the iceberg. Many other large US municipalities, (like Chicago), are headed exactly in the same direction: too many unfunded liabilities to retirees. Trying to make up the difference through a combination of higher taxes and more borrowing is both suicidal and not enough, as Detroit's story demonstrated. Tax payers will vote with their feet. They will simply move somewhere else in order ta avoid paying higher taxes.

Just like Greece

Ultimately, Detroit's problems are not that different from Greece's problems: too much spending on over generous social programs, without a growing economy that will generate the necessary revenue. While this bankruptcy is a mess, it is a good thing that Detroit is not "too big to fail". Numbers should mean something, and when something is unsustainable it is wise to put an end to it. In the case of Greece, for the moment numbers do not count. Greece's future is about political calculations on the part of its EU partners willing to keep the bail out going, despite all. Indeed, notwithstanding its stubborn inability to embrace serious reforms, Greece's EU partners decided to support this virtually bankrupt country. This would be the equivalent of Detroit, whatever its financial outlook, seeking and getting more credit.

US Federal Government has the same problem

Long term the US Federal Government faces a similar scenario. Even though the short term fiscal picture, thanks to the impact of the dreaded "sequester" has improved somewhat, long term America is faced with growing debt. And why? Yes, you guessed it, it is mostly about social spending obligations (mostly health care to seniors) completely out of line with Federal revenue. For the time being, the world is eager to lend money to Uncle Sam, trusting America's creditworthiness. But what if global credit markets stop believing that America will pay back? As a minimum they will demand higher interest rates, this way making the fiscal outlook a lot worse.

Of course, Detroit is much, much smaller than the entire United States. And yet, until recently all creditors were comforted by the notion that such a large city would never go into bankruptcy.