

# Wanted: Credible Centrist Political Leaders

**WASHINGTON** – Recently, a Democratic party elected leader of national renown argued in a public forum that in order to regain lost momentum and credibility with the American voters the Democrats have to redefine themselves as the party of economic growth and inclusiveness.

## **Common sense messages**

At a national event focused on the future of U.S. small businesses, a Republican national leader claimed that America's greatness rests on its foundations as an opportunity society in which people can advance because of a rules based system that recognizes and rewards merit.

John Hickenlooper, the Governor of Colorado, a successful state chief executive, stated that through collaboration between Republican and Democrats we can find workable compromises on the future of the US health care system, and other national priorities.

Well, what do I make of all this? Very simple. These statements made by credible centrists in both parties raise the hope that it may be possible, even in this incredibly poisoned political climate, to rally millions of Americans, hopefully a majority, around the basic ideas of an optimistic country in which policy-makers promote economic growth, while upward mobility is based on genuine merit; and nobody is excluded or kept from advancing because of social class, gender, race, or anything else. In fact, the opposite –equal opportunity for all- is embraced by all.

And this must include quality education, the best foundation of future success in life, available to everyone; while bridges are built across every divide, and doors are wide open

to all who are willing to make an effort.

### **It is an old idea**

This idea of America as a level playing field and fair rules used to be a shared vision embraced by most. Indeed, it was the belief that America offered genuine opportunity that attracted millions of immigrants who wanted to create in America a better life for themselves. It is about time to re-propose this vision in a manner that can be shared by today's Americans –Democrats and Republicans.

Indeed, who could object to public policies that promote economic growth, social advancement based on merit, while all citizens have genuine access to quality education, careers and consequently a good seat at the table?

### **Lost hope**

Of course, the last few years have told us an entirely different story. It is a story of lost hope, deep disappointment, and resentment. A story of popular distrust in the honesty and abilities of most elected leaders. A story of exaggerated promises not kept.

This has created an emotional anti-government rebellion on the right, (*"Washington is a rotten place"*), and the triumph of policy agendas on the left which advocate economic and social re-balancing achieved through redistribution by taking (ill-gotten gains) from the few ultra rich and giving to the rest of society. All this will be wisely designed and orchestrated by government, through taxation and subsidies.

### **Despondent America**

The outcome of all this is not pretty. The unexpected outcome of the November 2016 presidential elections is evidence of the widespread feeling of deep despair. Indeed, according to millions who voted for Donald Trump, "the system" failed

–period. Its failure is so deep that it is not worth salvaging. In fact, it should be dismantled. In fact, millions of Americans voted for Trump mostly because he is not a professional politician. Therefore he is untarnished by Washington's rot and well equipped to "*clean the stables*", "*drain the swamp*" and all by himself –with his power and superior intelligence– transform America.

Paradoxically, notwithstanding continuous economic growth and much lower unemployment since the end of the Great Recession in 2010, rightly or wrongly millions of Americans who used to be part of a self-confident middle class now are and feel poorer, left behind and alienated. At the same time, millions of young people feel hopeless facing a world of diminished opportunities, while laboring under the crushing weight of absurdly large student debts.

### **There is a way out**

That said, I sense that there is a way out of this. Difficult, yes; but not impossible. Yes, America needs house cleaning. It needs fresh faces not tainted by the old ways of doing business.

The unimaginative political elites still populating Washington, DC have survived by over promising everything to everybody, while pretending to pay for all the goodies they offered to various (of course deserving) constituencies, knowing full well that the only way to finance all this public largess (unaffordable entitlements) was and is to borrow more and more, this way getting the country deeper and deeper into debt.

Sadly, the Washington elites have no real economic growth strategy, while their policies aimed at buying votes through entitlements funded by public money and more and more borrowing are driving America towards the abyss of insolvency.

### **Credible people who will tell the truth**

Most Americans have common sense. However, they need credible new leaders who will tell the unvarnished truth about the dangers of systemic and growing fiscal imbalances, (i.e. we have to agree on a sensible plan to reform all major federal entitlement programs, by far our biggest fiscal problem), while pointing the only way to get out of this ditch: economic policies (think tax reform and smart deregulation affecting business activities) that will promote a more robust economic growth in a genuinely open and inclusive society. An inclusive society in which elected leaders are committed to destroying all artificial barriers to entry, while opening new avenues of opportunity to all.

(President Donald Trump, a new leader who is not carrying the baggage of the distrusted establishment politicians, could lead the way in shaping a new American political conversation. As his presidency is just getting started, it is impossible to say whether he will engage in this effort or not. We should all hope that he will. This would benefit the country and him).

### **Impossible?**

Well, in the end all this “back to basics” idea founded on the values of openness, fairness and merit sounds too lofty, in fact unrealistic. Yes, this is an appeal to an admittedly mythologized idea of an America *“where anything is possible as long as you work hard and play by the rules”* which (truth be told) never fully existed in the way many refer to it.

And then there is the huge problem of yanking benefits away from millions (deserving or undeserving, it does not matter) who got used to getting them. *“Come on...get real. Nobody gets elected by promising less, let alone by promising to cut existing benefits. And we in Washington just do not know how to deliver stronger economic growth. We only know how to distribute subsidies”*.

## **The way ahead**

And yet, if we do not want to see America follow Europe on the path leading to historic decline, it is imperative to make real progress on these two related fronts:

***1) restore fiscal sanity by reforming all the major entitlement programs***

***2) genuinely and forcefully promote economic growth and real opportunity for all***

The alternative is political chaos, the de-legitimization of our institutions, and rapid economic decline.

Some elected leaders of both parties know this. I just hope that their common sense message will be heard, understood and embraced.

---

## **Italy Still In Crisis, But Some Media Are In Denial**

**WASHINGTON** – Sometimes I wonder where is the boundary between self-deception and willful manipulation. Are some media in free countries deluding themselves or are they really trying to deceive you when painting a rosy pictures of what is in reality a dreadful situation?

### **Italy's public debt**

For instance, take the perennial tragedy of the Italian gigantic national debt coupled with a sorry-looking economy that, after almost 10 years in recession, is still below pre-crisis level; this way making it virtually impossible for

Italy to exit the negative spiral of high debt and almost zero growth.

Italy's public debt is not even close to Japan's world record (240% of GDP); but, at above 130% of GDP, it is among the worst cases. Coupled with a non performing economy, this massive debt is just like an enormous millstone around Italy's neck.

Right now, thanks to European Central Bank (ECB) policies that reduced interest rates to almost nothing, this gargantuan fiscal hole is still manageable. But debt service on such a large-scale is a huge liability for a country whose economy has been doing very poorly for almost a decade. (After years in the red, Italy's projected economic growth for 2015 is 0.9%).

### **It keeps growing**

Worse yet, this debt, albeit slowly, keeps growing. 2015 will be the worst year ever, with debt touching almost 133% of GDP. At some point, interest rates will go up again. When that happens the Italian economy, unless a miracle occurs, may be unable to generate the additional revenue to manage this level of debt, let alone begin retiring it.

### **Change of direction?**

Alright, you get the picture: a dreadful situation. That said, I was really intrigued when I saw this headline in La Repubblica a major Italian daily: *"Stability, Padoan: Debt Takes Opposite Course, It Goes Down, After 8 Years"*.

Well, the meaning of the headline is clear, and unmistakable. It says that according to Pier Carlo Padoan, Minister of the Economy and Finance in the Renzi government, there has been an inversion. Public debt is now actually going down. Think of that.

## **What happened?**

Now, this is news. What happened? Some dramatic spending reform that actually cut outlays? Something like dramatic public pensions reform? Or health care reform that cut cost in a serious way?

Well, none of this. In fact, the headline is false.

If you bother to read it, the article clearly states that Italy's public debt will actually go up –and not down– in 2015. It will grow to 132.85% of GDP –a historic record. However, according to a government forecast delivered by Minister Padoan, “the news” is that debt is projected to go down to 131.4% of GDP in 2016, and hopefully down to 127% in 2017.

## **Fake news**

So, here is the thing. Debt is still incredibly high. And it will go even higher this year. But the government projects that its wise policies will bring about...what? Well, a really modest reduction next year, and a slightly bigger one the following year. Of course this is only a forecast that may turn out to be wrong, as most forecast usually are.

## **Just a hope, smuggled as news**

So, there you go. The dramatic change of direction declared as fact in the headline does not exist. It is at a best a hope for a future decline –and a very modest decline at that– of what is and will remain a gigantic public debt.

Again, even assuming that this inversion would really take place next year and the year after, it is so small that it would change essentially nothing. Public debt decreasing –may be– from 133% to 127% of GDP, in a few years? And this is news?

## **Delusion and deception**

I repeat the opening question: is this optimistic headline another sad case of self-deception, or is it a conscious attempt to present to the readers a rosy picture, even without any real facts supporting it?

Given what I know about Italy, it is likely to be both. Sadly, even intelligent, educated people have lost contact with reality. They dream. Audiences will believe anything and politicians will say anything that they believe will work as a tranquilizer. *"Things are getting better". "We see the light at the end of the tunnel".*

### **In the swamp**

The reality is that Italy is still in the middle of the swamp, and there is no real policy remedy agreed upon, let alone seriously implemented, that will tackle the over spending caused by its bloated welfare state, foster innovation, investments, productivity, and ultimately jobs creation. Without these changes actually taking place, you can count on continuing high unemployment, (currently 12.4%), an anemic economy, high taxes, and a perennially over sized public debt.

---

## **Thanks To The Central Banks, The Equity Bubble Is Getting Bigger**

**WASHINGTON** – Imagine this. There are lots of chronically sick patients in the hospital. Many of them are deteriorating rapidly. The right therapies cannot be administered because of absurd delays caused by infighting within the Ministry of Health.



## **Give them morphine**

The physicians in charge of the hospital know what is needed to take care of the patients. But they have no resources. The only thing they have got is morphine, lots of it.

Well, since we cannot cure the patients, at least let's alleviate their severe pain. "Morphine for everybody!" orders the Director of the hospital. "But sir, this is no cure", argues a young doctor. "What do we do when the effect of morphine wears off?", he asks. "Well, we will give them some more. We have ample supply", replies the Director.

## **Quantitative Easing is morphine**

This may be a far-fetched analogy, but here it is. The patients are the sick economies in Europe, Japan, the US and now –in a major way– China. The Ministry of Health are the Governments incapable of tackling the structural issues of lack of productive investments, labor market rigidity and high public spending. The hospital Director are the Central Bankers. And the morphine is an ample supply is Quantitative Easing, (QE).

## **Central Bank left alone to manage the economies**

The Western economies are really sick. There is too much leverage, low productivity, too much private debt and out of control public spending. But Governments do essentially nothing about any of this. They are paralyzed by ideological disputes and bogus arguments about austerity and income redistribution. The only institutions that can do "something" are the Central Banks. They have no real "cure" for any of this. But they can provide temporary relief by keeping interest rates close to zero, (here is the morphine, in the form of QE), thereby giving everybody the illusion that the situation, while difficult, is manageable. The patients are still very sick. But (thanks to ample doses of QE-morphine) they feel no pain; and so they are led to believe that they

have been cured.

### **More QE, it is still party time!**

This is totally absurd. But this is exactly what is happening. The European Central Bank, after having launched its own QE a while ago, just declared that the Eurozone economies need some more monetary easing. The Central Bank in China just announced some more easy money measures, in a country, mind you, that accumulated a monstrous amount of debt (much of it bad debt) in just a few years.

Watching all this unfold, Wall Street correctly concluded that in this environment where everybody is injecting even more liquidity there is no way that the US Federal Reserve will go against this powerful current and raise interest rates in 2015. With US rates still near zero, it still makes sense to put money in equities, since everything else will give you no financial reward.

Investors got the message. "It is still party time!" And so, Wall Street shot up on Thursday. The Dow Jones added 300 points. There was further growth on Friday. Has this optimism about equities got anything to do with the real economy? Not really.

### **Perverse incentives**

This is yet another Fed-induced rally. (By indirectly signalling that it will not raise rates in 2015, the Fed gave the green light). Needless to say, this is madness. Equity prices in developed economies now are largely disconnected from the fundamentals.

Even worse, thanks to QE governments in highly indebted countries, from Europe to the US, are under no pressure to reform their public finances, because they can keep borrowing at very low interest, this way creating and sustaining the insane delusion that more and more debt is a good way to

finance chronic over spending.

### **Commodities took a dive**

In the meantime, though, emerging countries whose commodities fueled the crazy debt-driven Chinese construction investments binge are feeling the pain. As China could not sustain its own truly over sized madness, it stop buying stuff.

Therefore, commodity prices collapsed. As a result, Brazil, Australia, South Africa, Chile, Argentina, Zambia, and many others are suffering, in a major way. They built their budgets with the unwarranted assumption that commodity prices would stay in the stratosphere for ever. Now they have to go back to the drawing board.

In the meantime, their semi-impooverished people have no extra cash to buy new things, while their currencies are worth a lot less. This penury will further depress exports from industrial countries, this way further reinforcing the global downward spiral.

### **No incentives to engage in serious reforms**

So, here is the picture. The global economy is doing poorly, in large part because of minimal growth in the debt-burdened West where Governments still spend money on unaffordable entitlements instead of creating a business friendly environment that will encourage private investments in wealth-creating innovation.

Most emerging markets are in recession or close to it.

But at least in Europe, Japan, the US (and now China) the real extent of the problem is disguised. Developed countries enjoy a drug-induced financial markets buoyancy (QE is morphine) because the Central Banks keep pumping in liquidity, this way allowing the stock market bubbles to continue.

### **Another big bubble**

This is a gimmick. A dangerous gimmick. At some point it will have to stop. I am not sure when. But it cannot go on for ever. I do not even want to think about what will happen when this gigantic bubble will explode.

---

## Can We Find Decent People To Fix Our Democracies?

**WASHINGTON** – Democracy and free markets anyone? By this I mean opting for a real republican government with fair rules, transparency, honesty, and constructive debates. And office holders who really believe that their job is to further the public good, while allowing private citizens who play by clear and fair rules to engage in whatever activity they may be interested in.

### **What happened to liberal democracies?**

Does any of this still exist? The answer is a qualified yes. However, the real article is almost extinct. There are only approximations. Unfortunately, most self-described liberal democracies are only distant relatives of the original model.

In most Western countries, citizens mistakenly believe that it is perfectly alright to bend the political process and the state institutions so that they will provide for them, or at least subsidize them. This entitlement mind frame is a perversion of any honest notion of the state as guardian of the public good. And yet, the “welfare state” model is now the standard, with plenty of intellectuals willing to affirm its legitimacy and high moral standing.

### **Welfare and statism**

To make things worse, the welfare state goes hand in hand with a statist economic model. Many people do not believe that public institutions should limit themselves to the role of impartial arbiters and enforcers when economic rules are broken. No, the state should run things, (banks, utilities, airlines, railways, factories), or at a very least dictate via minute regulations how they should be run.

All this amounts to a state that got bigger, more expensive and more powerful, and in most cases more wasteful. As a consequence, some people in charge of powerful institutions that control huge assets or resources have enormous power. And this often unchecked power is an open invitation to corruption.

## **Corruption**

Corruption in turn has the effect of a chronic, debilitating disease. It is nasty parasite that eats up resources, while engendering cynicism and sometimes despair. Who will have the enthusiasm to think about starting a new business when they know that at each step of the way there will an intrusive bureaucracy run by voracious corrupt officials demanding bribes?

Well, this is the picture. In some instances, it gets to be too much. And people protest, loudly. (Witness what is going on right now in Brazil, with daily street protests and demands for the impeachment of President Dilma Rousseff).

Ironically, even semi-dictators complain about corruption. Vladimir Putin commented that there is way too much corruption in the recently annexed Crimea. Think of that. According to Putin, the once oppressed ethnic Russians of Crimea, instead of showing gratitude towards their Russian liberators, engage in all sorts of shady practices. The level of corruption in Crimea is now so bad that even Putin thinks it is way too much.

## **Here is the picture**

Well, without being too gloomy, here is the picture. Europe is slowly sinking under the weight of unsustainable public debt. Indeed, lacking enough revenue, this is the only way to finance all the benefits. Too much debt weighs on the economy. Too many regulations impede innovation, business formation, and therefore the creation of new employment. A bloated public sector fosters waste and corruption.

These days, confronted with economic stagnation, lack of opportunity and high unemployment, people are restless and unhappy. This being the case, they could opt for better political leaders.

But no, they do not do this. With few and limited exceptions, no way that any political force proposing to go back to the original free market, liberal democratic model could get vast popular support and succeed. *"Yes, reforms may be nice, but don't even think of touching my benefits"*.

## **Looking for a "Big Man"**

As real world solutions are excluded, the only alternative seems to be escapism. Yes, let's elect someone –A *Big Man*– who will make all this go away. Let's elect someone who will tell us that we are the innocent victims of a vicious cabal made out of corrupt politicians in bed with exploitative financiers. And then we have all the illegal immigrants who steal our jobs, not to mention unfair trading partners who cheat. Therefore, let's elect someone who will clean house, throw all the rascals in jail, and start fresh. *(Of course, the magic broom will steer clear of all my benefits and subsidies. And don't you dare raise my taxes)*.

Hence the appeal of Beppe Grillo and his 5 Stelle movement in Italy, the National Front in France, Podemos in Spain, and Syriza in Greece. And, most recently, the British Labor Party choose as new leader Jeremy Corbyn, an old (age 66),

unreconstructed Socialist whose ridiculous ideas have the fresh fragrance of the 1950s.

### **Bad news from America**

But what about America, the reliable bastion of democratic capitalism? Bad news from that front. Right now, in what is supposed to be a serious exercise aimed at selecting candidates for President, the leading contenders on the left and on the right are people who in ordinary circumstances would be dismissed as laughable populists.

### **Bernie Sanders and Donald Trump**

But no, they are not dismissed. They are in fact adored. On the left, Vermont Senator Bernie Sanders is an eccentric museum piece, a socialist who talks with passion about income redistribution. On the right, businessman Donald Trump argues passionately that he is really smart, while everybody else is stupid; and this is his main qualification for becoming President.

All this is disheartening. Confronted with this detachment from reality and consequent lowering of the level of policy debates, many commentators argue that this is a "healthy rebellion" against an ossified political system dominated by worn-out elites made out of professional politicians.

*"You see, the people got fed up with the establishment, and so now they vent their frustrations by supporting populists who make outlandish claims. Perfectly understandable, no?"*

### **Venting frustration is not smart**

***No, not at all! While we can understand that frustrated people may engage in foolish behavior, this does not make foolish behavior smart. It is in fact stupid and destructive. If we accepted this logic, then we should accept as "normal" the fact that some unemployed workers become thieves, while others***

***become alcoholics or drug addicts.***

Indeed, let's agree that *"the system is inefficient and corrupt"*. Let's assume that this is true. Well, then let's try to find more honest and more competent people to run it.

Electing Jeremy Corbyn in the UK, or Bernie Sanders or Donald Trump here in the US will solve nothing.

**We no longer understand what this is all about**

***But then, why are socialists, populists and demagogues so in fashion, these days? Why the appeal of politicians who loudly promise easy fixes? Very simple: because many members of our societies have lost the meaning of the fundamental values that make republican government possible.***

A republican government is supposed to manage the sectors that individuals cannot take care of on their own, while allowing people to freely live their lives. Government should take care of the truly needy; but it is not a philanthropy tasked with delivering plenty of goods at no cost. Government has costs that need to be financed through fair taxation; but it is not a mechanism for redistributing wealth.

Government should be about the protection of individual rights, within clear and transparent rules. Government should allow all law-abiding private citizens to engage in wealth-producing activities. In other words, I can do my own thing, but this pursuit positively excludes taking advantage of others.

**We got ourselves in this mess**

***Sadly, we forgot all this. And so we are caught between our deep dissatisfaction with our sorry-looking, stagnating democracies and our inability to see that we got here precisely because we lost our understanding of what the state is, and what it should do.***



---

# Beyond The Debt Crisis, What Will Happen in Greece?

**WASHINGTON** – Suppose that recalcitrant Greece and its not so well disposed creditors (the EU, the ECB, and the IMF) finally come up with a last minute compromise that avoids bankruptcy and the exit from the Euro. Then what?

## **Just a temporary fix?**

If such a compromise is just a temporary political fix, (this is what I suspect it will be), the proverbial bandage to stop the bleeding, then you can bet that in a few months this open wound will be once again infected, and therefore in need of some other fix.

As onlookers pray for a “solution” based on some kind of bargain, they fail to acknowledge how Greece got into this horrendous crisis. This unprecedented fiscal and economic debacle did not come all of a sudden, due to bad luck.

## **The root causes**

It came about at the end of 2009 because of the cumulative impact of extraordinarily bad policies in a non competitive economy, carried out year after year by rapacious and incompetent ruling elites. As The Economist put it (*My big fat Greek divorce*, June 20, 2015) the crisis is the result of structural impediments to growth: “[...] rampant clientelism, hopeless public administration, comically bad regulations, a

*lethargic and unreliable justice system, nationalised assets and oligopolies, and inflexible markets for goods and services and labor*". And I would add to this long (and frankly frightening) list *endemic corruption and lack of innovative enterprises* that can create a competitive edge in any economic sector.

### **Kill the virus**

The point of all this is that, until the Greeks abandon the flawed beliefs and values that support their failed economic and administrative "eco-system", the root causes of this never ending mess will continue to work as an endemic ideological virus.

Greece found itself in a deep hole because of this ideological virus. Indeed, while it had every opportunity to do so, in the 1980s and 1990s Greece failed to become a modern, efficient, and competitive industrial democracy, with free market incentives, clear rules for all, a reliable justice system and accountability for elected officials.

### **Embrace modernity and sound values**

These are the preconditions for success and some degree of prosperity. Economic success does not have much to do with built-in advantages such as abundant natural resources, oil or gas.

It has to do with embracing values that support a transparent democracy, and pro-growth policies. These values shape the attitude of the citizens about what is necessary to promote growth (education, infrastructure, access to credit, and more), and the governments that can competently run the commonwealth.

There is absolutely nothing that prevents the Greek people from adopting new beliefs that will help them to get rid of the pre-capitalistic, dysfunctional economic

system dominated by rent-seeking protected oligarchies and corrupt public administrators.

Indeed, there is no objective limit that prevents Greece from becoming a Taiwan in the Mediterranean. It is all about doing away with a culture and value system inimical to growth and prosperity, while sincerely adopting a strong belief in enterprise, responsibility and transparency.

### **A fantasy?**

I recognize that this looks like a fantasy. Such a radical cultural and psychological transformation may never happen, simply because it is too complicated to engineer it. This is true.

However, only a mad man would believe that the culture and value system that led Greece to this hellish predicament of financial ruin and economic decline are working really well.

Precisely because there is a deep crisis, this should be the time to look at other, far more successful models. Will the Greeks finally embrace a value system that can support and sustain modernity? They could, even though the record so far, (and that includes selecting Alexis Tsipras as Prime Minister), unfortunately suggests the opposite.

---

## **China Is Slowing Down – Old Model Not Working Anymore**

WASHINGTON – We all know that the Chinese economy is slowing down. But we do not know all the facts. The picture may be

much darker than what we can get from official statistics. It would seem that recent growth has been financed by large debts. Much of this debt will not be paid back because the money went to pay for ill-conceived projects. Local governments created large liabilities in order to finance development projects for which there is no market.

### **The Chinese economy is losing altitude**

In order to shed some more light on these issues I reproduce here excerpts from a longer article that appeared in the English language version of Caixin, a Chinese publication, (*Will Slow and Steady Win China's Economy Race?* By Yu Hairong, Xing Yun, Wu Hongyuran, Zhang Yuzhe and Wang Liwei, March 18, 2015).

*"The government said the gross domestic product growth rate sank to a six-year low 6.8 percent in January and February. Figures for those months came in far short of the average 7.7 percent forecast by economists from 14 financial institutions previously surveyed by Caixin. Fixed-asset investment growth and lending growth slowed as well during the period."*

*"Early-year GDP growth also came in below the 7 percent target for 2015 set by the government, as spelled out in an annual report on the government's work delivered by Premier Li Keqiang on March 5 to the opening session of the National People's Congress."*

*"Officials have acknowledged this year's slow start in the context of what Li and others have called the "new normal" for China's economy. GDP growth for "the first quarter will be below 7 percent," said Zhu Baoliang, director of the economic forecast department of the State Information Center (SIC), a government research agency. The government is pressing forward with transformational economic reforms, but pressure to modify the official approach to these long-term changes has been building as slowing growth affects banks, the overall business*

*climate and local government finances.”*

*“Pressure is building as the real economy turns downward,” said Xu Gao, chief economist at Everbright Securities. Zhu said how quickly the government is able to strike a balance between the slowdown and economic stability will largely depend on the ability of policymakers to maneuver and adjust fiscal policies.”*

*“Only in recent months has the Chinese business sector started to feel the full impact of a reform-related campaign to reduce the economy’s heavy reliance on what used to be ever-higher levels of fresh investment.”*

*“One sign of this impact is reflected in industrial value-added output, a measure of industrial production, which increased 6.8 percent during the January-February period compared to 8.6 percent for the same period last year. Nationwide, fixed-asset investment growth also slowed, increasing just 13.9 percent, down 1.8 percentage points compared to the first two months of 2014. A macro-economic analyst at Haitong Securities, Jiang Chao, predicted industrial value-added growth would fall to 6.5 percent in March. Other recent indicators of a changing business climate since the beginning of the year include reports of declining consumption of coal by power plants and slipping prices for manufactured steel.”*

*“A Shandong Province city official overseeing local business investment who asked not to be named said that many small and medium-sized companies decided to suspend or delay investment projects earlier this year. These companies, which contribute significantly to local economies, have had tight capital chains.”*

*“Banks, which finance four-fifths of the country’s economic growth, are lending more cautiously. Credit is still available, but more thought is going into credit-issuing*

decisions. "The most important questions revolve around finding assets with good prices and controllable risks," said the president of a commercial bank who asked not to be named. Risk control has become increasingly important in light of increasing numbers of bad loans. The China Banking Regulatory Commission (CBRC) said that as of December 31, the nation's commercial banks were saddled with 842.6 billion yuan worth of non-performing loans. That amount was up 42 percent from the beginning of 2014."

"Bad loan ratios are higher in some regions than in others. Government data show that for banks in the coastal provinces of Zhejiang and Shandong and in the interior provinces of Sichuan and Henan the average bad loan ratios are around 2 percent. The figures for banks in Shanxi Province and the Inner Mongolia region, both in the north, are about 5 percent. A manager at China Merchant's Bank said that its Sichuan branches are seeing an increasing number of bad loans. He blames the rise on the area's private lending network, heavy investment climate and the government's anti-corruption campaign. Yu Xuejun, chairman of the Supervisory Board for Key State-Owned Financial Institutions at the CBRC, said that bad loan rates are rising at a faster pace than in the past, "regardless of the region and bank."

"Moreover, loans to businesses in the commodities sector have been drying up due to risks tied to slumping prices for a variety of basic commodities, said a source at a joint-stock bank."

"Local governments are also facing credit pressure. Since last year, several governments, including those in Shanxi, Heilongjiang and Liaoning provinces, have reported declining revenues due to sluggish business for coal and steel companies crucial to their economies. Liaoning's government reported a 4.6 percent decline in 2014 revenue from the previous year. A bond market source said that the Inner Mongolia government's financial position is quickly deteriorating due to declining

coal prices. In February, the local government in Yijinhuoluo Qi, near the city of Ordos, had to borrow 20 million yuan from the central government to pay employees working on government-backed projects.”

**“A nationwide review of government debt ordered by the Ministry of Finance found that as of January 5 local governments had a combined 40 trillion yuan in liabilities. But that figure may be low because in late January the ministry found some data was falsified by local governments. [Bold added] A revised report was expected to be released in March. Local government platforms that borrowed money for infrastructure and other projects are a particular concern. In the eyes of a Shanghai bank executive who asked not to be named, the “local financing platforms’ default risks are much greater than imagined.” One reason, he said, is that “many governments repackaged old projects into new ones in order to obtain bank loans.”**

“The Ministry of Finance also set a quota of 1 trillion yuan in debt that local governments are allowed to convert from expensive loans into low-interest rate municipal bonds. The move was designed to help the governments finance new projects.”

### **The glitter is gone**

So, here is the picture. China’s GDP is growing less than official forecasts had predicted. Industrial production is down. In all this, many local governments need to be bailed out because of bad economic development decisions that led to “malinvestment” and high debt. That financial hole may be a lot bigger than early figures had indicated.

What do we make of all this?

A safe conclusion is that China’s golden moment is over, because much of it was fake. GDP growth was spurred by a construction boom that turned out to be a bubble, because

there is no real demand for all this debt-financed development. In the meantime, the country created an absurd level of over capacity in all the industrial sectors that support construction and infrastructure development. Many local governments got into big debt to finance big projects that have no economic rationale.

### **Beijing will pay all the bad debts**

As bad as this looks, China is not Greece. We can rest assured that Beijing can manage all this. The Chinese state has gigantic cash reserves that can and will cover all the existing bad debt. But this is a small consolation.

The bad news is that the current scenario indicates the end of an era. The old economic development strategy does not work anymore. A new model that will see a shift from capital investments to more consumer spending has been talked about, but is not operational.

The best I can think of is that, absent huge economic gains stemming from truly innovative sectors, China will go down to average emerging market growth rates of 4 to 5% a year. This is China's "new normal". And it does not look that great.

---

## **Greece Once Again Threatens Europe's Financial Stability**

**WASHINGTON** – Greece is again in the news, and for bad reasons. Early elections (to be held on January 25) had to be called



by Prime Minister Antonis Samaras. This is what is prescribed by the Greek Constitution when Parliament fails to elect a new President of the Republic. Early elections have raised the prospect on a new anti-austerity political majority headed by the leftist party Syriza.

### **Renegotiation?**

Syriza, led by Alexis Tsipras, is ahead in the polls, even though it is not clear how it would fashion a coalition in order to have a majority in Parliament. Still, assuming that Syriza prevails, then it is almost inevitable that Tsipras will reopen the complicated financial arrangements (with spending cuts, huge new credits and debt reduction in the mix) reached with the European Central Bank, the European Union and the International Monetary Fund that have allowed Greece to avoid bankruptcy.

Simply stated, Syriza believes that the draconian spending restriction imposed by this package are too strict. The Greek people are suffering too much. Therefore a new leftist majority would want to reopen the deal, in order to give Greece a bit more breathing room.

### **Where is the money?**

On the face of it, this whole idea is preposterous. Greece got into serious trouble because of its fiscal irresponsibility mixed with thievery and corruption. Until 2009 It kept on borrowing, while willfully falsifying its real deficit and debt numbers. The country has an uncompetitive economy. Its employment numbers were inflated by the number of people in totally unproductive but somewhat remunerative public jobs. Adding more public spending and/or employment without changing the economic fundamentals would amount to a temporary alleviation. It is clear that this "let's spend some more policy" is no economic growth strategy.

Still, be that as it may, could a winning leftist majority

pull this off? Well, it seems that the Greeks have bargaining power. And this power rests on the financial damage that would be caused to the rest of Europe by a Greek default and/or messy exit from the Euro.

### **If Greece goes...**

In other words, here is the threat: *"If we go down, we bring you down with us. So, be careful."* Indeed, the consensus in Europe is that a Greek financial debacle would cause intolerable pain in France, Germany and elsewhere. Too many EU financial institutions have invested in Greek deals and Greek debt. The losses would be painful. This being the case, a new anti-austerity Greek government may have enough leverage to get what it wants –a lessening of the austerity constraints–without paying any price.

### **Weak Eurozone**

Well, who knows how things will turn out in the end. But one thing is clear. This is a never-ending bad story. Beyond Greece, the fact is that the Eurozone is inherently weak. If a third tier, semi-bankrupt economy can threaten the stability of the entire currency union, something is wrong.

And what is wrong is that the Euro is a common currency that imposes all sorts of constraints on inherently weak countries that have no basic agreement among them on fiscal and economic strategies aimed at achieving real growth.

### **A union of the poor**

The Euro is a poorly designed monetary alliance that links mediocre and semi-destitute countries. The semi-destitute (Greece, Spain, Italy and Portugal) are supposed to follow a low spending and smaller government diet. But the fact is that beyond lavish public spending that creates fake employment, and therefore fake income, these countries have almost nothing.

## **No credible growth strategy**

There is no credible, self-propelled economic growth strategy in Greece or Italy. It would take a major revolution to radically transform labor markets, to create incentives for new businesses and to concentrate resources in R&D, so that competitive new products could be successfully launched.

None of this is on the horizon. Admittedly, the austerity policies imposed by Europe are no picnic. They mean lower standards of living, without a real prospect of any real improvement. But the leftist populist idea whereby there is, of course, a free lunch is no better.

## **Who will pay?**

Let's assume that Syriza wins the January 25 elections and Greece wins its political battle with Brussels and Frankfurt. So the new Prime Minister Tspiras will manage to obtain a reduction of the austerity measures previously imposed. Fine. And then what? Who is going to pay for the added cash doled out by the Government to make the people feel better? There is no money. This policy shift could only be financed by issuing more debt. Yes, this means adding new debt to the old. Is this a strategy? Sadly this is the best that one can find.

## **A strong currency assumes strong countries**

Leaving Greece aside, the sad truth is that a currency union by itself cannot magically create wealth. It can be a good instrument to create synergies among economically interdependent countries already tied by a variety of economic and commercial agreements. But the implicit assumption is that these countries are doing well. If these countries are doing poorly, or very poorly, a currency union is no substitute for better economic growth strategies.

Until Europe will remain the prisoner of disastrous statist

policies centered on inefficient public sectors, the Europeans will never get out of this mess. The ECB clever manoeuvres are not –and cannot be– a substitute for policies that generate real wealth.

---

## Japan Headed Towards Disaster?

**WASHINGTON** – Unfortunately for Japan, smashing political victories do not translate into good economic performance. Prime Minister Shinzo Abe held a snap election and won handsomely, even though the turnout was small. Despite another recession caused by a collapse of consumer spending, it would appear that the voters have confidence in his strategy to revive the Japanese economy.

### **Abenomics is not working**

And yet there is very little evidence that he is succeeding. He has helped exports somewhat by forcing a currency devaluation. But his consumption tax caused people to stop spending thereby freezing the economy.

Now he has suspended any further consumption tax hike, while his government just launched yet another stimulus package worth about US \$ 29 billion, in the hope that this would spark some kind of new miracle.

However, based on past performance, it is unlikely that the economy will respond, while Japan's truly colossal national debt, now at 240% of GDP, keeps growing.

The Bank of Japan is bent on forcing a currency devaluation in order to boost exports, while it buys all the new government bonds. How long can this go on?

### **Negative savings rate**

In the meantime, the traditionally thrifty Japanese people have stopped saving. For the first time since 1955 the savings rate has gone negative, and it now stands at -1.3%.

In all this, the currency devaluation means higher cost for all imports. Of course, right now Japan is benefiting from lower oil costs, just like all other energy consumer countries. But a lower yen also means that everything else costs more. Real wages in Japan are not growing. And this means less disposable income and lower standards of living.

If this were not enough, please note that even with artificially depressed interest rates debt service now absorbs a staggering 40% of all government revenue. As debt keeps growing, interest on the national debt soon enough will swallow almost all revenue.

If you want to add another touch of gloom, Japan is experiencing population decline. This means a shrinking working population that soon enough will have to support a growing number of elderly retirees.

### **Japan is in decline**

So, here is the picture. Notwithstanding its coveted position as the number 3 economy in the world, (after the US and China), Japan has a declining population, and a stagnating economy with little prospect of new growth. The average Japanese has stopped saving. In the meantime, in just a few years the state has piled up a gigantic mountain of debt that weighs heavily on everything else.

### **Will more debt cure the country?**

And what does Prime Minister Abe do to improve all this? He creates more debt, in the shape of the just announced US \$ 29 billion stimulus package. Shinzo Abe may be a clever politician who knows how to win elections. However, with the active complicity of the Bank of Japan, he is doing his very best to steer Japan towards ruin, maybe even bankruptcy.

How much more debt can this anemic Japan withstand before the system cracks? I am afraid we shall find out fairly soon.

---

## The Economy Grows Modestly, While Wall Street Is At An All Time High

**WASHINGTON** – When it comes to US higher and higher stock prices I am struck by something truly odd, in fact frightening. There is an obvious disconnect between all time Wall Street highs and relatively weak economic data.

### **Mediocre economy**

The US economy is doing OK, but not especially well. After the weakest recovery in recent history, America is growing at 2% a year, may be a little better. However, unemployment around 6% is still too high. Labor participation is at historic lows. Real incomes have not grown for decades. A new generation of college graduates is coming into the labor market saddled with the heavy burden of gigantic student loans. These huge financial obligations prevent even the lucky ones who find decent jobs to spend, buy homes, etc. All in all, I would not

call this a booming economy.

### **Forget about the BRICS**

Add to this not particularly inspiring US picture the obvious fact that the global economy is doing poorly. Remember the BRICS? Not even one of them has met expectations. Brazil was all about its short-lived commodities export boom. Now it is in poor shape. Forget about Russia and sorry-looking South Africa. India, now under new management, may hold some promise. China's economic miracle story is over. The spectacular 30 year export-led model has run its course. At this time China is desperately trying to meet inflated growth targets by pumping more cash into a so-so economy already suffering of a serious case of "too much bad debt", coupled with massive overcapacity in some key sectors, like steel.

### **Europe and Japan are in decline**

In all this, Europe and Japan are in seriously bad shape. Simply stated, these are old, in fact exhausted societies with way too much public debt, negative birth rates, too many old people, negligible investments, bloated public sectors, and huge entitlement programs no longer supported by a large active work force paying into the system.

These old countries, mostly run by mediocre political leaders, simply cannot keep up any more. Italy has zero growth, an unemployment rate of 12%, with youth unemployment in the South up to 60%, and a national debt now equal to 130% of GDP. Japan is once again in a recession, while its national debt is 230% of GDP. None of this is fixable.

Now, let's point out the obvious. These are America's main trading partners. How can it be that the US economy is doing so-so, the rest of the world, including those who buy our goods and services, is in mediocre to bad shape and the US stock market is booming? It used to be that stock prices reflected basic fundamentals. Well, not any more.

## Stock valuations driven by Central Bankers

These days stock prices have little to do with the real economy. They are determined by the presumed positive impact of supposedly benign monetary policies implemented by Central Bankers. And what kind of magic are they doing? Well, the Central Bankers throw more and more invented money into the system while purchasing assets in order to ignite growth.

The evidence is that this does not increase the volume of productive investments; but it pushes up the valuation of stocks. Indeed, since real interest rates are kept below zero by the monetary authorities, where else will you put your money? Therefore, all the smart people buy more stocks, counting on Fed or ECB policies to push valuations higher and higher, no matter what the fundamentals may be. Japan's economy is not growing, but its stock market valuations doubled. Have we gone totally mad? The answer is "Yes".

### David Stockman's analysis

Here is how David Stockman sees it. Writing in his own [www.davidstockmancontracorner.com](http://www.davidstockmancontracorner.com) he says:

*"The global financial system has come unglued. Everywhere the real world evidence points to cooling growth, faltering investment, slowing trade, vast excess industrial capacity, peak private debt, public fiscal exhaustion, currency wars, intensified politico-military conflict and an unprecedented disconnect between debt-saturated real economies and irrationally exuberant financial markets.*

*Yet overnight two central banks promised what amounts to more **monetary heroin** [bold added] and, presto, the S&P 500 index jerked up to 2070. That is, the robo-traders inflated the PE multiple for S&P's basket of US-based global companies to a nose bleed 20X their reported LTM earnings.*

*And those earnings surely embody a high water mark in a world*



where Japan is going down for the count, China's house of cards is truly collapsing, Europe is plunging into a triple dip and Wall Street's spurious claim that 3% "escape velocity" has finally arrived in the US is soon to be discredited for the 5th year running. So it goes without saying that if "price discovery" actually existed in the Wall Street casino, the capitalization rate on these blatantly engineered earnings (i.e. inflated EPS owing to massive buybacks) would be decidedly less exuberant.

In truth, nothing has changed about the precarious state of the world since yesterday. Except.... except the Great Bloviator at the ECB [President Mario Draghi] made another fatuous and undeliverable promise-- this time that he would do whatever he "must to raise inflation and inflation expectations as fast as possible"; and, at nearly the same hour, the desperate comrades in Beijing administered another sharp poke in the eye to China's savers by lowering the deposit rate to by 25 bps to 2.75%.

Let's see. Can it possibly be true that European growth is faltering because it does not have enough inflation? Or that China's fantastic borrowing and building boom is cooling rapidly because the People Bank of China (PBOC) has been too stingy?

The answer is not on your life, of course. So why would stocks soar based on two overnight announcements that can not possibly alleviate Europe's slide into recession or the collapse of China's out-of-control investment and construction bubble?"

### **This boom is unsustainable**

Well, there is no valid economic reason for these incredibly high stock valuations, except for the crazy belief held by most investors that Central Bankers have magic wealth creation powers.

As long as the monetary authorities of the US, Europe, Japan and now China can keep their magician tricks going, (buying assets while keeping interest rates at zero), everybody in America will continue to believe that the stratospheric Wall Street valuations are justified.

I do not know when, but there will be a point when the Central Bankers will run out of tricks, and therefore this whole Wall Street boom will unravel, because it is based on nothing real.

---

## Italy Is Slowly Sinking – Years Of Recession Or Zero Growth – Unemployment At 12.6%

**WASHINGTON** – Mario Draghi, the President of the European Central Bank (ECB) deserves praise for his ability to save the Euro, despite major liquidity crises and recessions affecting many weak Eurozone members, (Greece, Italy, Spain and Portugal). Largely thanks to Draghi's excellent stewardship, the Euro is a solid currency; and nobody is concerned about any forthcoming catastrophic event.

### **Monetary policy cannot create growth**

That said, the overall picture of slow growth or zero growth economies within the Eurozone and the broader European Union demonstrates that even a well conceived monetary policy cannot produce growth. It can support growth, it can facilitate

it; but it cannot *create* it.

### **France is in real trouble**

The battered (if not devastated) economies of Southern Europe are not going to collapse. But there is very little indication of a rebound.

France, (the number two economy within the Eurozone, after Germany), is in trouble. Essentially no growth, high unemployment, while major political opposition makes it difficult to cut public spending. Extremely unpopular President Francois Hollande, (his favorable ratings are now at 17%), a Socialist, has once again reshuffled his cabinet in order to recreate some hope. But the country's mood is pessimistic.

### **Italy even worse**

In Italy, (third largest economy within the Eurozone), it is a lot worse. Freshly minted Prime Minister Matteo Renzi, who became the country's chief executive with zero experience at the national level, (he used to be the Mayor of Florence, a second tier city), came in with bold ideas for economic renewal. But, so far, no results.

Italy languishes in the swamps of zero growth, or worse. Flat or declining GDP in 2012, 2013 and now 2014. At the same time, the official unemployment rate is still at 12.6%, while youth unemployment is at 40%, (60% in the poorer south of the country).

(By comparison, do consider that in the US most economists and policy-makers argue that America's 6% unemployment rate is unacceptably high).

The Italian leftist newspaper La Repubblica, (instinctively a supporter of this government), writes that the Italian economy is in "*extreme darkness*".

## **Dark outlook**

And just to cheer everybody up, here is how Giorgio Napolitano, head of the Confindustria, the most important voice of Italy's corporate leaders, assesses Italy's situation and prospects. At a recent public event in Rimini he said that :

***"The economic situation is dramatic. We need a project for this country. Once and for all we have to think about what we want to be, what we want to become...We have to relaunch our corporations, because without [profit-making] corporations, there is no way forward, at the economic or social level...For 20 years Italy has been living above its means. Wealth has been wasted. This way we are lowering our standard of living. Our GDP keeps going down. And even in 2014, unless we have a miracle, we shall have more negative data, just as in 2012 and 2013..."***

Please note that Napolitano says that Italy needs "a project". Implicitly this means that he does not have much confidence in the only "project" now on the table: the reform agenda announced by Prime Minister Matteo Renzi.

And do consider that Renzi came into office as a really bold innovator: a no-nonsense young leader, unafraid to chart a new course. In short, Italy's best hope.

Well, what should Italy do to get out of this path leading to a slow but steady decline? Here is my list.

***-Drastically reduce the burden of a bloated public administration***

***-End endemic corruption***

***-Fight and defeat organized crime***

***-Reform labor markets in order to create flexibility***

***-Reform the pensions system***

***–Reduce the oppressive tax burden that discourages investments***

***–Invest in modern infrastructure***

***–Dramatically increase targeted R&D investments***

***–Create a competitive higher education system***

***–Stop illegal immigration***

The list is so long and so large that I doubt that much can be done by this or any other Prime Minister.

## **Old Continent**

Mario Draghi is an excellent ECB President. But, sadly, without the support of a drastic cultural shift, even good monetary policies are not enough to transform his native Italy, (and the other weak economies at Europe's periphery).

As for the rest of the European Union, except for a more globally competitive North, the EU as a whole does not inspire any enthusiasm.

The Old Continent is indeed just that: "Old". Old ideas, old values, old leadership, old societies yield structurally inefficient economies.