ON THE PERIPHERY (THE MONEY JUNGLE, PART FOUR)

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"The many ways of prophesying I charted…it was I that set mortals on the murky road of prophecy. Flaming signs I made visible which till then were only dim." Prometheus, in Aeschylus's tragedy "Prometheus Bound"

OPENING ACT

According to conventional rhetoric, nations such as Greece, Portugal, and Ireland and their terrible sovereign debt problems are out there on the periphery. In troubling times, such concepts of distance in interest rate, currency, equity, and commodity marketplace discussions occasionally offer comfort to nervous observers. What's relatively or supposedly unimportant nevertheless can become quite significant to a so-called or apparent center of things and allegedly core worldviews regarding it. This sometimes can happen rather fast.

Consider recent talk and behavior by leading nations and other illustrious players and analysts in regard to the European periphery. Not only Germany and France, but also the European Central Bank, the United States, Japan, China, the International Monetary Fund, and others now diligently monitor the fiscal and political situation in Greece. Also, scan the past few decades. Don't forget how crucial emerging marketplaces and developing nations have been to key territories such as the United States and other industrialized (advanced) countries.

Besides, even on a key economic stage, new actors and factors can strut into the limelight. Let's not overlook chronicles of the worldwide financial crisis that erupted in 2007 and accelerated in 2008. In the land of the biggest economic participant, the United States, think back to 2006 and early 2007. At that time, how many had placed American real estate and subprime lending (and leverage and other intertwined issues) on their radar screens as variables to worry about significantly?

Finally, substantial and increasing globalization and the intertwining of stock, debt, currency, and commodity territories warn marketplace players and soothsayers. We should be cautious in dismissing events, processes, and participants in some seemingly distant landscape as necessarily and inevitably insignificant to us.

GRECIAN FORMULAS

"I got the rockin' pneumonia,
I need a shot of rhythm and blues.
I caught the rollin' arthritis
Sittin' down at a rhythm review.
Roll over Beethoven they're rockin' in two by two." Chuck Berry, "Roll Over Beethoven"

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Although Greece is a rather small country in the European (and worldwide) financial arena, its unhealthy situation has spread fears of contagion elsewhere. Impatient financial doctors apparently have made some further progress in reducing Greece's sovereign debt and fiscal ills, even though they probably do not cure them. Buying time offers hope for further remedies-

whether in Greece, in other nations on the European periphery, or elsewhere around the world-right?

Anyway, the emerging deal for a "rollover" of Greek sovereign debt as part of a new rescue plan cheers many marketplace viewers. However, to complete and implement this evolving and somewhat misty arrangement, a great deal remains to be done within Greece (including more austerity measures) and by Eurozone finance ministers, the European Central Bank, and the International Monetary Fund. Let's keep in mind the role of private creditors in this affair. Their involvement should be "substantial" and "voluntary". In addition, the current fine print (Financial Times, 6/18-19/11, pp1, 3) hints the rollover only includes about E85billion falling due in the next three years. This sum represents only part of the E270bb of concern to some European finance ministers, and is only around twenty-five percent of the nearly E350bb in Greek sovereign debt outstanding.

Finally, during their national turmoil, many Greeks themselves have spirited their money out of their local banks. The NYTimes notes (6/19/11, pp6, 12) ECB data reveals that Greek banks lost four billion Euros in deposits in May 2011 and 2.4 billion in April. This disappearance is part of a "bank run" in which 60 billion Euros (a quarter of Greece's gross domestic product) has fled the country since the crisis commenced.

Greece's debt drama on the European periphery (and similar plays on other frontiers) highlights the acrobatic wordplay of marketplace performers. Debtors and creditors, as well as regulators and lawyers and even politicians, know the magic word "default" has ominous consequences. You can call a fiscal or other debt situation a disaster. Fine, you can label the mournful scene or event a debacle. You can swear it's dismal, depressing, disheartening, and deplorable. But no matter what, try not to call it (and the related fix involving it) a "default"! Words such as "rollover", "reprofiling", and "restructuring" are satisfactory, as long as they do not cause the dreadful term "default" to spring permanently into the dialogue.

AMERICAN THEATRICS

The theme song for the Muppets, "Fraggle Rock":
"Dance your cares away
Worry's for another day
Let the music play
Down at Fraggle Rock."

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Alongside federal deficit spending, the Federal Reserve's money printing festivities and its fierce devotion to keeping policy rates pinned to the floor have created some semblance of a recovery. So has the further weakening of the broad real trade-weighted dollar. Unfortunately, household net worth remains well below its pre-crisis peak. Consumer confidence is gloomy; consumer real income remains mediocre, unemployment is still elevated, and real estate prices are feeble. The middle class has been squeezed. What about those surviving on the margins? Measures such as participation in food stamp programs indicate that the ranks of America's poor have been growing despite the economic revival. Notwithstanding lofty US corporate profits, benchmark equity measures such as the S+P 500 have edged lower in recent weeks.

The furious quest to solve fiscal and other problems on the so-called European periphery is mirrored in fights underway on America's home front. Spotlights focus on America's recent

gigantic deficit spending. However, the distant future also sometimes has a way of elbowing into the present.

The awesome unpleasant long run fiscal issues (costs) facing the United States now scare not only economic sentinels such as the Federal Reserve. See Chairman Bernanke's speech at the "Annual Conference of the Committee for a Responsible Federal Budget" (Washington, DC; 6/14/11). Increasingly, debt dilemmas involving both the immediate present and the somewhat distant future gradually have drifted more and more into Washington's debates. Quarrels regarding the debt ceiling and the desirability (or necessity) of spending cuts and revenue enhancements are at center stage. These days, the President has a fiscal proposal. Republicans have deficit plans. Democrats likewise have schemes. Congressional groups hunt for common ground. Audiences in illuminated financial circles and prestigious think tanks are armed with ideas.

What will political star performers in America's budget burlesque actually do to solve the huge fiscal problem? The Greece "rollover" solution is partial and temporary. A similar outcome, likewise accompanied by enchanting rhetoric, is likely in America.

Most current American political discussions and proposals are long on ideology but relatively short on specifics that would add up to a genuine (several trillion dollar) solution. Republican and Democratic differences seem substantial. The right wing flaps, the left wing flutters. The 2012 election beckons. Assorted interest groups heatedly compete (whether noisily or quietly) for attention, benefits, entitlements, and fair shares. Given that America's indebtedness has not quite climbed to unthinkable (unfixable) levels yet, why not postpone substantial effort to decisively and definitively handle it?

Since Congress and the President are rushing to act in some fashion, what will they do? For the near term, and to buy time (even if it fails to win the future) these worthy leaders probably will paper over the massive fiscal problem by a blend of modest legislation and clever wordplay. To subdue fears and win applause, these nimble dancers will boost the debt ceiling sufficiently to get through most or all of the 2012 election season. Agile orators will trumpet their marvelous hundreds of billions (maybe even over a trillion) in cuts. However, many of the reductions will not be specific or unchangeable, and the vista over which they are added up probably will run 10 or 20 years. Thus the improvement in the fiscal situation likely will not be nearly as great as heralded.

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Recently a venerable country gentleman, Mr. Vernon C., offered his views on the current political scene to his friends at the Rusty Bones Diner. "Most of these big-time political movers and shakers are just like exotic dancers. Posturing is a big part of their show."

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America's fiscal mess is not confined to Washington. US states also face mountainous problems. If California were an independent nation, its economy would be about the eighth largest on earth. The state's Wild West Gold Rush belongs to a distant past, an era more than a century ago. Nowadays California has "inched closer to a repeat of its 2009 fiscal crisis, when America's most populous state issued IOUs to its creditors in lieu of cash"; the governor just vetoed a budget proposal seeking to close a nearly $10bb deficit. (Financial Times, 6/17/11, p6).

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Severely indebted nations like present-day Greece provide another relevant perspective to distant nations. All else equal, when debtors cannot easily repay their debts, and especially when they lack substantial national savings (resources), their interest rates generally rise.

Since the emergence of the worldwide economic crisis, the United States often has seen its government note and bond yields dive during periods of widespread "flight to quality" fears. But what would happen to US rates (and the US dollar) if concerns blossomed regarding America's easy ability to pay its creditors? And foreigners are a substantial share of America's creditors. How attractive are current low US government yields?

The European Central Bank a few days ago listed five intertwined risks to the financial stability of the European Union. Many of these surely are not restricted to that region. One of these is "the prospect of an unexpected and sudden, market-driven rise in long-term interest rates" ("Financial Stability Review", "Overview", June 2011, 6/15/11, p2).

PERIPHERAL VISION

The famed British military commander, the Duke of Wellington said: "I have been passing my life in guessing what I might meet with beyond the next hill, or round the next corner."

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In marketplaces, people select and assess phenomena in a variety of ways and reach diverse conclusions. In marketplaces, as in war and in everyday life, no one likes to be blindsided. Although some problems are reduced or disappear, others on the outskirts can march right onto our field.

These days, some wonder about inflation and its permanence, whether in emerging or developed nations. To what extent has the leveraging that preceded the outbreak of the worldwide economic crisis been reduced? Has much of the private indebtedness and related risks merely been shifted from consumers and many businesses to governments? Some are watching for renewed problems from the residential and commercial real estate sector, particularly that of the US. Have banks marked-to-market almost all of their real estate loans? What will be the lending- and thus the economic growth consequences- of the Basel committee banking rules (including surcharges)?

To what extent will American corporate profitability remain high, particularly if consumer spending does not pick up after the Federal Reserve's quantitative easing spree ends this month? Has a fevered scramble for adequate return (search for yield) by "investors" and other participants created allegedly excessive enthusiasm for certain "assets"? Are commodity prices likely to resume their rally if the world economy and its population continue to grow?

Think of the Middle East. What happens in Egypt and other nations if economic prosperity does not match rising political hopes? The Israel/Palestine logjam continues, as does the Iranian nuclear issue. Suppose significant unrest arises in Saudi Arabia's oil producing districts.

What about Japanese growth and its huge government debt, especially in the aftermath of its March 2011 earthquake? Tepco's (Tokyo Electric Power) compensation and nuclear decommissioning costs associated with the earthquake cannot be funded by the company alone. So says a special adviser to the Japanese Cabinet (Financial Times, 6/15/11, p18). What happens to Japanese interest rates? Yet Japan's pool of domestic savings available to finance its national

debts appears greater than does that of America. What if Japan, in order to rebuild its economy, buys fewer American Treasury notes and bonds?

A list of concerns and their interrelations can go on and on. In any event, a given marketplace visionary cannot be clairvoyant about everything.

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In marketplaces as elsewhere, raising the issue of the periphery suggests the merit of addressing what we take for granted and why. What is peripheral or marginal can become central (and vice versa), and so our faith in something or someone likewise can change or diminish. Or, our doubts can evolve or transform into belief. Let's take a quick look at China and raise a couple of questions. After all, faith in the China growth story and its future near-inevitability remains widespread and deep. The IMF's 6/17/11 "World Economic Outlook Update" (Table 1, p2) forecasts China's 2011 real growth at 9.6 percent, with that for 2012 at 9.5pc, unchanged from its April projections.

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First, in the current globalized economy, China depends on America and Europe (and elsewhere) for quite a bit of its growth. If the US or Europe slow down significantly, what does this mean for China? China is not some distant, isolated island. China didn't accumulate its mammoth foreign reserves (including US Treasury securities, for example) by selling to its own citizens.

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In today's interdependent world, if China's problems are sufficiently large, their consequences can reach well beyond China's borders.

The World Bank's "China Quarterly Update" of April 2011, like the June 2011 IMF forecast, generally is optimistic about China's growth prospects and overall economic situation. However, buried within the World Bank overview is a concern that should attract more attention (p12). "The property market is a particular source of risk…In the medium term, the widespread use of property as investment vehicle and the role of local government add to the risks. Property construction is an important part of the economy….Thus shocks to the property sector that would slow down construction significantly could have a large impact on the economy and balance sheets, taking into account bank exposure to construction and other sectors dependent on the real estate market. Moreover, a property downturn could affect the finances of local governments, which do a lot of the infrastructure investment and are important clients of the banking system."

This potential danger also is hinted at in the IMF's just-released "Global Financial Stability Report Market Update" (6/17/11, p3). "Market concerns about property prices center on China. In order to slow inflation, the central bank has tightened financial policies and hiked policy rates." How much should we worry? The GFSR Update continues: "Should such measures result in an unexpectedly sharp slowdown, the impact on property prices may be even higher. This is in part due to a recent history of strong investment in real estate, including by local authorities as part of the stimulus measures undertaken in response to the global crisis".

The World Bank and IMF (at least in these reports) do not quantify the risks from this property/local government/banking sector. However, they probably are not trivial.

The Chinese property/local government/banking sector probably is very opaque, at least to many. To what extent should one have substantial faith in that Chinese sector? In this context, remember and compare the US real estate situation prior to its disaster (and its consequences). Yet how

many economic guardians and marketplace participants waved caution flags and became devout doubters regarding real estate? Recall particularly America's subprime domain, but not only that realm. In the American context, don't forget various complex structures, shadowy off-balance sheet vehicles, notable leverage, questionable credit standards, uneven regulatory scrutiny, and so on.

Standard & Poor's (in June 2011) and Moody's (in April 2011) downgraded their outlooks on the Chinese property development sector. They speak of worsening credit conditions (rising rates, reduced bank lending, and tighter regulation), address the likelihood of falls in transaction volumes, and warn that developers may have to cut prices to maintain sales. There's been some talk of potential price wars. (Financial Times, 6/16/11, p2).

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So how big is China's local government indebtedness in general? Probably substantial. And probably not all of it is well collateralized. What is the extent of nonperforming loans, whether tied to the property marketplace or elsewhere? Maybe banks will have to be refinanced and recapitalized again? How much of the local government borrowing has been collateralized? Perhaps there is between $308-463 billion of uncollateralized, cash flow-less government debt sitting on bank balance sheets. See Financial Times stories (ft.com/alphaville, 6/7/11; 6/8/11 print edition, p23).

The Economist has a story from about a year ago related to these issues: "Chinese local-government debt Shell game" (3/11/10). It cites research by Professor Victor Shih of Northwestern University. He believes the outstanding debt of local governments extending guarantees on loans taken out by their special financing entities is about 11.4 trillion yuan (about $1.7 trillion). There also are commitments for a "further 12.7 trillion yuan, much of it tied to infrastructure projects designed to stimulate the economy."

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"Base Metal Chart Analysis" (4/19/11, p7) includes a chart on and comments regarding the China stock marketplace (Shanghai Stock Exchange Composite). "Though Chinese equities need not necessarily track the overall Chinese economy, failure to approach the October 2007 top [over 6120], or even surpass the August 2009 high [about 3480; 11/11/10 high about 3190, 4/18/11 high about 3065], warns that China's economy may be less robust than many believe." And: "Ask: to what extent has Chinese economic strength in recent years derived from money printing/easy credit? Probably a fair amount."

Currently, China's stocks are attacking near term support of about 2665 (1/21/11 low). For those who compare economic growth stories, note the double top in India's stock arena (the Sensex) just over 21000 (1/10/08 around 21200, 11/5/10 just over 21000). And let's note in passing three current news headlines on India. "India struggles to cap wage inflation amid skills shortage (Financial Times, 5/13/11, p4) and "Pressure As Growth Lags in India" (NYTimes, 6/15/11, pB1). "India business warns central bank on rates" (Financial Times, 6/16/11, p2). The story says business leaders do not want them lifted "to combat the highest inflation of any leading emerging market."

The US stock marketplace benchmark in recent weeks has slipped close to its 4/26/10 high around 1220.

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The China growth story has a couple of other topics worth mentioning. Analysts can muse as to how significant they are.

China's central bank reported that between the mid-1990s through 2008, corrupt Chinese officials smuggled about $124 billion out of China. (Financial Times, 6/17/11, p1). Apparently the central bank has offered no comment regarding any such money smuggling totals for the post-2008 period. The FT article, and presumably this central bank report as well, did not address the issue of the amount of money generated via corruption still remaining within China.

Several Chinese firms listed on foreign stock exchanges have been accused of "fraud, accounting discrepancies or other corporate governance failings." (Financial Times, 6/17/11, p23). In America, shares of at least 20 Chinese companies have been suspended or removed from New York stock exchanges in the past year after auditor resignations or accounting problems. The FT article also speaks of "China's weak and corrupt court system" as a risk for foreign investors in regard to the complex stock and bond frameworks of these Chinese firms. The structures (often using empty shell companies) are designed to circumvent China's strict capital control rules and thereby acquire funds from international capital marketplaces.

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China's huge foreign exchange reserves (and its ongoing trade surpluses) probably will enable it to surmount any difficulties (even rather severe ones) that may emerge within its property/local government/banking sector or elsewhere. Yet suppose it reduces the net amount of US Treasuries it buys (or decides to sell some of them), whether to help cover losses somewhere within China, or to keep its overall economy strong (and to thereby minimize social unrest).

CURTAINS

Some may declare that financial events and issues allegedly in the great distance surely cannot sneak up and advance too close to us. Besides, won't alert financial firefighters certainly devise ways to solve or contain the problem before it spreads like wildfire and we're burned badly?