What Could Possibly Go Wrong?

The Wall Street Journal and BloombergView have just run articles on the shadow banking system in China. This has put me in a nostalgic mood.

About 35 years ago when I was living in Japan, I made a side trip to Hong Kong. I took the hydrofoil to Macau one afternoon and the same service back early the next morning. On the morning trip, I am sure that I saw many of the same faces that I saw the day before. They had been gambling all night and were now heading back, blurry eyed and hungover, to their desks in Hong Kong’s financial district.

My fellow travelers now sit atop the world’s second biggest economy and a steaming pile of debt. What could possibly go wrong?

The WSJ article is the more detailed one. It describes the market for wealth management products (“WMP,” which is ominously and accurately close to the acronym for weapons of mass destruction). These are products sold to Chinese “investors” – remember the boat back from Macao – by Chinese banks. The former are looking to circumvent the interest rate caps on deposits and other restrictions on investment. The latter are looking to circumvent the limitations on lending and balance sheet growth. Meanwhile, in the background, the Chinese government, which is supposedly trying to wean the Chinese economy off its debt-driven GDP manipulations, is paraphrasing St. Augustine: “Lord, make me financially prudent…but not yet!”

WMP issuance equaled $1.1 trillion in 2015, a nearly 75% jump on the prior year and equaling 40% of the total growth in credit. Almost one-third of the WMP were bought by credit institutions for inclusion in other WMP - WMP Squared! Many of the WMP also involve leverage, often from the issuing bank, to juice the return. Over three-quarters of the WMP mature within six months, which means that they will have to be rolled over in order to continue to finance their assets, which typically have much longer maturities. Speaking of assets, nobody really knows – or much cares – what is in the WMP, although there are loans to many loss-making sectors of the Chinese economy, which suffer from huge overcapacity and shrinking competitiveness, and a hefty participation in the booming Chinese bond market.

I said that no one much cares what is in the WMP. This is because, despite warning labels that the WMP are not guaranteed, many investors think that the issuing bank - and therefore ultimately the government - is on the hook for repayment. The fact that the biggest growth is coming from small- and medium-sized banks is indirect confirmation of this. I mean, it’s not like some salesman at a small bank with a monthly quota and a mortgage would be winking and nodding with Mr. and Mrs. Joe Lee or Tom Wong, would it? Nah, that kind of stuff never happens.

So we have a booming market in opaque, complicated financial instruments involving layers of risk, leverage and maturity mismatches. We have unsophisticated investors and issuers, both seeking to avoid government regulations and expecting to be bailed out in the worst case. We have cross-holdings and backdoor exposures to regular credit channels. We have all of this taking place in an environment of booming credit expansion, a deteriorating economy and financial repression.

I hate to repeat myself, but really...WHAT COULD POSSIBLY GO WRONG?

(As an aside, why doesn’t some enterprising ETF manager come up with a product that systematically shorts whatever it is the Chinese have been manically buying? This is one of the few sure things in the financial markets. It would have done gang busters with the Chinese stock market last year and the recent wild speculation on iron ore and rebar steel. Now, it could focus on bitcoins and Vancouver real estate, along with the WMP (or their sponsors). This would close the loop on the bilateral trade. We have had all the nice, cheap Chinese manufactured goods, for which we have
given them pretty pieces of green paper. Now, we take the pretty green paper back.)

*Is Smaller Government Smarter Government?*

I am becoming more and more convinced on the need for radical decentralization of government.

I have previously argued that decentralized government is better because it promotes competition in government services. I have recently read an article that provides a further argument. Smaller government provides a strong incentive for voters to educate themselves and monitor their elected officials.

The article is written by Ilya Somin and based on his book *Democracy and Political Ignorance: Why Smaller Government is Smarter*. Somin is a law professor at George Mason University, a rare university in America that is heavily influenced by libertarian thought.

The book starts from the “rational voter hypothesis” (RVH). The RVH argues that, when the probabilities of influencing voting outcomes and the personal impacts of political changes are taken into consideration, voters are merely being rational when they spend much less time learning about political issues than, say, choosing a new toaster. As everyone who has ever debated politics with the man in the street knows, voters are ignorant, but the RVH says that they have no motivation to be otherwise.

However, as the size of the relevant government entity shrinks, the probabilities change and so do the incentives to learn. This is true of voting in the ballot box and, even more importantly, of “foot voting” (that is, moving to an area of better government). As Somin puts it in the article:

For example, millions of poorly educated and sometimes illiterate African-Americans in the early 20th century Jim Crow South determined that conditions were relatively less oppressive in the North (and also in some parts of the South compared to others) and migrated accordingly. This, despite the fact that southern state governments deliberately tried to keep them ignorant by impeding the flow of information about opportunities in the North....

The informational advantages of foot voting over ballot box voting strengthen the case for limiting and decentralizing government. The more decentralized government is, the more issues can be decided through foot voting.

Of course, this argument can be taken further. As a general statement, the private market works by “foot voting” – whether I buy or not buy a product or service – rather than “ballot box voting.” There is an element of aggregation in both, but the private market has an incentive, as every businessman who has targeted a niche market knows, to optimize the tradeoff between scale and individual choice.[1] One of the general reasons to prefer private economic markets to public political markets is that the former motivate and use information far more effectively and selectively, and they do a far better job of catering to individual wants (much to the consternation of Bernie Sanders, whose statist mind is unable to understand why we should want 23 different types of deodorant).

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“A free lunch? You can’t afford a free lunch,” by Groucho Marx, a true genius
One of the major trends in technology, in particular, is towards disaggregation and greater individual choice. Cable TV stations and internet podcasts are perfect examples. The 3D printing revolution, which is fast approaching, will represent another huge leap in this direction.