

# We have entered the world of disaster economics

**Gillian Tett**

Are the bond markets going mad? It is a question that many investors might ask. For as anxiety has erupted in the eurozone, something striking has occurred with respect to US Treasuries and German Bunds. If you look at the credit derivatives market – the place where investors judge the risk of bond default – government bonds are getting riskier, not just in places such as Greece but in supposed havens such as Germany, too. Two years ago, for example, the credit default spread on a German Bund stood at 40 basis points – meaning that it cost €40,000 to insure €10m of bonds each year against default. Recently, though, the spread has been well above 100bp, and could rise again if Angela Merkel, the German chancellor, opts for more bailouts. US bonds have also become riskier, judging by credit default swap prices, as Congress remains gridlocked on fiscal policy. Normally this would imply that bond yields should also rise. After all, classic investment theory suggests that bond prices fall (and yields rise) with higher credit risk.

That is exactly what has happened with corporate bonds in recent years, not to mention with sovereigns such as Greece. But in Germany and the US government bond yields have recently hit multi-decade lows. Short-term to medium-term bonds are paying negative real returns. Why? One explanation is that the CDS market overstates default risk. Another – increasingly popular – idea is that bond investors are complacent about Germany and the US. A thoughtful new paper from Joshua Rosner, the investment analyst, predicts that German bond yields could soon rise as investors wake up to the costs of a eurozone bailout. The gap could also be blamed on deflation fears, a liquidity trap or government meddling (ie quantitative easing.)

But another intriguing idea that is creating a market buzz has been advanced by economists at Fulcrum Asset Management (including Gavyn Davies in an FT blog post.) This blames a psychological-generational shift among investors around the concept of “disaster”.

During most of the past few decades, Fulcrum argues, investors and economists did not discuss “disaster” much. Little wonder: if

you use the definition of “disaster” advanced by the economist Robert Barro – namely at least a 10 per cent decline in national gross domestic product per capita – there were 58 disasters in the 20th century. But crucially, only two of these occurred between 1950 and 2000; most modern investors built their careers in a world without disaster risk.

**The grab for safe assets may not be a short-term trend. The financial world may need to overhaul its investment frameworks**

But now the world has changed. And so investor behaviour has shifted too, Fulcrum says. For the key point to understand about investing is that assets have two functions: they can produce returns, but they also offer protection. When disaster risk is low, investors stress the former; when the risk rises, they focus on the latter.

However, the nature of this approach can vary across markets. In countries where government

default risk is deemed low, bonds are better than equities for “protection”; but in markets where default risk is higher, equities and bonds are correlated. Fulcrum thinks there is a clear statistical way to tell which country is in which camp: when the sovereign CDS spread jumps above 200bp, bond and equities move together. But when CDS spreads are below 200bp, government bonds retain their “safe” status, and yields and CDS prices are uncorrelated. Spain and Greece are in the first camp, and France is almost in that group too. But the US and Germany are in the second group. Hence bond yields can fall – even as default concerns rise in a moderate way.

This argument has shortcomings. It does not take account of how expected inflation or deflation affects bond prices. Nor does it recognise other asset classes. Frightened investors might choose to buy commodities or corporate bonds, instead of government bonds. And while a 200bp “tipping point” seems to work well in the eurozone, it is unclear how it applies to the US.

If this disaster theory has a grain of truth – as I suspect it does – there are at least three implications. First, it suggests that governments may

have overstated the degree to which quantitative easing, not fear, has reduced bond yields. Second, it implies that the investor grab for safe assets may not be a short-term phenomenon; “disaster risk” could influence asset prices for a long time. Third, there is a bigger point: the financial world may need to overhaul its investment frameworks.

When portfolio theory developed in the second half of the 20th century, financiers assumed that the world would always be fairly stable; but as Mr Barro’s work shows, this low-disaster period may have been an exception to the norm. The idea that investors always want to maximise returns in a rational way, not “insure” against Armageddon, may have been a function of an unusual time, not a timeless truth. Perhaps the world will return to that era; but do not bet on it soon. In a world of “disaster” economics, in other words, bond markets could remain “baffling” for a long time; unless, of course, an inflation or political shock creates an explosion of default fears in Germany (or the US) – and those bonds and credit derivatives markets finally come into line.

[gillian.tett@ft.com](mailto:gillian.tett@ft.com)

# A slowdown is good for China and good for the world

**Michael Pettis**

China’s official growth rate has fallen sharply; its real growth rate may be substantially lower; the country is tipping into deflation; and Premier Wen Jiabao has warned, yet again, that the economy is under serious pressure. China seems to be heading towards a hard landing and Beijing, many Chinese and foreign experts warn, must cut interest rates drastically and expand credit, so saving itself and the world from disaster.

They are wrong. What is happening in China may be just what it and the world need. After many failed attempts, over the past six months we may have been seeing the beginning of China’s urgently needed rebalancing, in which it will correct over-reliance on investment in favour of more consumption.

The process will not be easy. Debt levels have risen so quickly that unless many years of over-investment are quickly reversed, China will face serious problems, maybe even a crisis – but the sooner China starts rebalancing, the less painful it will be. With China’s consumption share of gross domestic product at barely more than half the global average, however, and with the highest investment rate in the world, rebalancing will require effort.

The key to raising the consumption share of growth is to get household income to rise from its unprecedentedly low share of GDP. This requires China to increase wages, revalue the renminbi and, most importantly, reduce the enormous tax that households implicitly pay to borrowers in the form of artificially low interest rates. But these measures will slow

**Rather than demanding that Beijing reverse the process, we should be relieved China is finally solving its problems**

growth. The implicit “financial repression” tax, especially, is both the major cause of China’s economic imbalance and the source of its spectacular growth. Forcing up the real interest rate is the most important step Beijing can take to redress the domestic imbalances and to reduce wasteful spending. And this seems to be happening. Beijing has reduced interest rates twice this year and reluctant policy makers are under intense pressure to reduce them further, but with inflation falling much more quickly than interest rates, the real return for household depositors has soared in recent months, as has the real cost of borrowing. China is repairing one of its worst distortions.

This cannot help but reduce investment growth, and so China’s GDP growth rate must fall sharply. China bulls, late to understand the unhealthy implications of the distortions that generated so much growth, have finally recognised how urgent rebalancing is, but they still fail to understand that this cannot happen at high growth rates. China’s investment growth rate must fall for many years before the household income share of GDP is high enough for consumption to replace investment as the engine of growth.

As China rebalances we would expect slowing growth and rapidly rising real interest rates, which is exactly what we are seeing. Rather than panicking and demanding that Beijing reverse the process, we should be relieved that China is finally solving its problems. But won’t slower growth create social dislocation in China and economic dislocation around the world? No, not if it is managed well. Remember that Chinese rebalancing requires household to income grow faster than GDP for many years, and if Chinese growth slows even to 3 per cent, as I expect it will, but household income continues growing at 5-6 per cent, this is far from being socially disruptive.

What the rest of the world needs from China is not faster growth but more demand. Rebalancing will provide that, although the trade surplus will probably rise before it begins to decline. This will result in falling prices for hard commodities, and so will hurt countries such as Australia and Brazil, but rising Chinese demand and lower commodity prices are good for global growth overall.

It is too early to say whether or not China has really begun its great rebalancing. Among other things, this would mean the rapid growth in state sector wealth – which mainly benefits China’s political elite – must slow sharply. It is likely that the elite will resist this ferociously. We should expect tremendous pressure to reverse the process. Commodity exporters and China’s economic elite may not like it, but this is a good sign for nearly everyone else.

*The writer is a political commentator and a two-time candidate for the Republican nomination for president*

*The writer is a finance professor at Peking University and a senior associate at the Carnegie Endowment*

# Assad’s regime is finished – do not mourn its passing



**David Gardner**

When a dictatorship cannot regain control over a country in revolt for 18 months despite repeated offensives, when it cannot police the countryside away from the main roads, cannot secure the capital or its main trading hub, cannot even protect its innermost citadels and has to pull troops from its borders to protect its palaces, it is finished. This is the case with the dictatorship of Bashar al-Assad, who is still trying to kill his way out of the crisis, even as poorly armed rebels swarm through Syria’s cities and his supporters melt away. He is finished.

Last week’s insurgent bombing of his security cabinet in Damascus was devastating. He lost at least four of his top enforcers, including his brother-in-law, Assef Shawkat, the brains behind the Assad clan and reportedly also his cousin, intelligence chief Hafez Makhoul, brother of Rami Makhoul, the financier of the enterprise.

Of itself, the bombing is not a game-changer; the Assads still command far superior firepower. But its emblematic power is irresistible. On top of the stream of defections and desertions from the Syrian army, the regime now has to contend with informers who have infiltrated its inner sanctum. Until the July 18 attack, the Assads had managed to instil terror of retribution inside the castle walls. Now it is they and their entourage who are running scared.

This was not just a deadly blow to

the security establishment. It struck the Assad clan network, the mix of security state and gangster enterprise that makes up this regime. Family, clan, predatory business interests and the security praetorians are all enmeshed.

Maher al-Assad, the president’s volatile younger brother, commands the army’s only two reliable strike forces, the Fourth Armoured Division and the Republican Guard – made up, like the security services, mainly of the Alawite minority to which the Assads belong, a heterodox branch of Shia Islam in a country that is three-quarters Sunni. But even the shabbih, mostly Alawite militia built around smuggling gangs that have been carrying out sectarian cleansing in the Alawite heartlands in the north-west, are often led by the president’s cousins and relatives, such as Nameer al-Assad in Latakia.

The supply of Assads is not inexhaustible, and some at least of their followers must be wondering where they are taking them. This month’s defection of Manaf Tlas, a Republican Guard general, stripped away the regime’s last Sunni veneer. The Assads’ decision to unsheathe the sectarian knife, to corral Syria’s minorities into its camp, has destroyed the fiction that it is the vital antidote to Sunni extremism. As minority Kurds, Christians and Druze start drifting towards the opposition, this is now a straight fight between the Alawites and the Sunnis – and their foreign backers.

Iran and Russia have stood with the regime, but they cannot fight its battles. In the Sunni camp, Saudi Arabia, Qatar and Turkey have stepped up aid, with the US in the background. Rebel forces have gained momentum since late spring and have crystallised into provincial commands. How much fighting there is to come depends on the cohesion



of a shrinking regime. Loyalist forces have over-run two districts of the capital after 10 days of fighting but meanwhile Aleppo, the commercial capital, has erupted. The Assads cannot be everywhere at once.

When they do fall, there is natural concern about what will replace them – especially since the Wahhabi Saudis and Qataris are directing their support towards the Islamist Muslim Brotherhood. Yet despite the regime’s slaughter of (mostly Sunni) civilians, and a few attested rebel atrocities, there have been no mass reprisals against the minorities. This suggests discipline and deliberation by opposition forces on the ground: the regional military councils and the local co-ordinating committees of activists driving the civic uprising. As in Libya, an international alliance against the Assads may have something to work with.

Turkey’s role could be important, especially if it can moderate Gulf influence on the Muslim Brotherhood and prevent Syria from being sucked further into the regional contest between Sunni and Shia. Russia may be useful in identifying elements of the present Syrian state that could serve as interlocutors on its future. An ultimatum from the Free Syrian Army, the rebel military umbrella,

giving officers and officials until the end of this month to defect, may hasten that process.

It is natural to worry about what will replace the Assads, but not in a way that encourages them to fight on. Their 42-year tyranny was a known quantity in a dangerously volatile region. For nearly four decades not a shot was fired across the Golan Heights, seized by Israel from Syria in the 1967 Arab-Israeli war and secured against Syrian counter-attack in the 1973 war.

But this should not blind us to how the Assads are brutalising their people now, or make us forget what they did in Lebanon and Iraq before. They played divide-and-rule with and within Lebanon’s mosaic of sects during three decades of occupation. They provided the main pipeline into Iraq for Sunni jihadists to wage attrition against US occupying forces and to slaughter Shia civilians. Posturing as the “beating heart of Arabism” and the fulcrum of an axis of resistance to Israel and western designs in the region, the Assads’ Syria was always willing to fight to the last Palestinian or Lebanese. The job now is to hasten its end, not to mourn its passing.

[david.gardner@ft.com](mailto:david.gardner@ft.com)

**It is natural to worry about what will replace the regime, a known quantity in a volatile region**

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# America needs no more neo-imperial nonsense

**Pat Buchanan**

Triumphant in the first Gulf war, George H.W. Bush, in October 1991, went before the UN to declare that the US’s goal was now to build a “New World Order”.

Rejecting this as Wilsonian utopianism, my 1992 presidential campaign called for an end to US military intervention where no vital interest was imperilled, for federal action to secure our southern border and for a halt to the outsourcing of US manufacturing jobs.

We advocated a Hamiltonian policy to support industry and a Jeffersonian foreign policy of peaceful commerce with all nations but entangling alliances with none. And we were denounced as isolationists and protectionists.

We lost. But Mr Bush lost too, when Ross Perot, running on the same theme – putting America first – stripped away a third of the coalition Richard Nixon and Ronald Reagan put together, leaving Mr Bush with an incumbent’s smallest share of the vote since William Howard Taft.

Mr Bush’s foreign policy record

could not save him. The US was looking inward in 1992, as it does today. As Mitt Romney burnishes his foreign policy credentials this week, he should keep this lesson in mind.

Having learnt from his father’s defeat, George W. Bush offered a “more humble” policy. But after September 11, he had a Damascene conversion, went nation-building in Afghanistan and Iraq, and declared the US’s goal was “to end tyranny in our world”. Americans responded by relieving the Republican party of both houses of Congress in 2006 and the presidency in 2008.

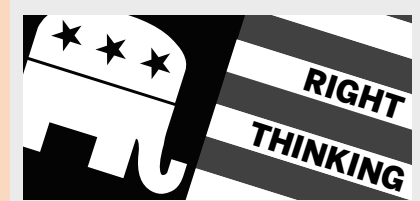
We cannot afford any more neo-imperial nonsense. With trillion-dollar deficits, a soaring national debt, and 10,000 baby boomers reaching eligibility for Social Security and Medicare every day, the US is beginning to break under the strain of its commitments.

What doth it profit a man if he gain the whole world but suffer the loss of his soul? A biblical hubris took hold of our republic. By pushing Nato into Russia’s front yard, planting bases in central Asia, dispatching democracy crusaders to subvert regimes in Ukraine, Belarus

and Georgia, we undid the good work of Reagan and drove Moscow back into alliance with Beijing.

US influence in the Middle East is at a nadir. Our alliances with Turkey and Saudi Arabia are frayed. Pakistan bristles. Israel impatiently dismisses our pathetic pleas for it to stop building settlements. And as the Muslim Brotherhood rose when Hosni Mubarak fell in Cairo, so it looks likely to rise again when Bashar al-Assad falls in Damascus.

America needs a new foreign policy rooted in today’s reality, not in yesterday’s cold war or in tomorrow’s dream of global democracy. For as Turkey’s Recep Tayyip Erdogan reminds us, in his



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region democracy is a bus you get off when it reaches your stop.

We must roll up the empire and put America first again. We should swiftly complete Barack Obama’s work, end the war in Afghanistan and close US bases in central Asia. We should tell Ukraine and Georgia that Nato membership is closed. No US interest there justifies risking a clash with Russia. Let us tell Vladimir Putin that if he stays out of our yard, we will stay out of his.

Half a century ago, Dwight Eisenhower told John F. Kennedy to start pulling troops out of Europe, or else the continent would end up permanently dependent on the US. Was Ike not right? Europeans should take full responsibility for their own defence. The near debacle in Libya, where Britain and France might have been fought to exhaustion by Muammer Gaddafi had not the US intervened, exposed the atrophied state of Nato’s European members.

South Korea has a population twice that of North Korea and an economy 40 times as large. What are US soldiers still doing in the demilitarised zone? The frontier that will determine the fate of the

US is not the 38th parallel, but the 2,000-mile border with Mexico.

Elsewhere in Asia, it is Russia’s land that China covets but India’s that China holds. Vietnam and the Philippines are defying Beijing’s claims to the Spratly Islands. Japan is showing a resolve to hold the Senkaku Islands. Let the neighbours do the containment.

In the Islamic world, Victor Hugo’s dictum applies: stronger than all the armies of earth is the power of an idea whose time has come. Islamic fundamentalism and ethno-nationalism, the two forces tearing countries apart from central Africa to south Asia, are not problems that can be solved by Seal Team Six.

Let us cease our interventions and call a halt to our endless hectoring. How other nations rule themselves is not really the US’s business. If there is nation-building to be done, let it begin here. The watchword of the Romney campaign and presidency should be enlightened nationalism. Time, again, to put America first.

*The writer is a political commentator and a two-time candidate for the Republican nomination for president*