China : Investment Opportunity or Impending Disaster

We do not believe that China is a “bubble” ready to burst and take down large parts of the world’s financial system. Neither do we believe that China represents a compelling investment opportunity. Ironically, both of these beliefs are grounded in the same set of circumstances; essentially that China has a “surplus” of savings. China is the world’s biggest creditor, as evidenced by its $4 trillion stockpile of international reserves. It internally finances all it own capital needs and then some, as its long standing current account surpluses would suggest, and China’s relatively closed financial system does not allow relatively large amounts of portfolio capital flows. In other words, China does not rely on foreign capital and is not vulnerable to capital flight. Overall debt to GDP is moderate and, at the central government level, it is very low. Whereas debt in the private sector has been growing very rapidly over the past few years, most of this debt is still in the form of bank loans at state controlled banks. In the event of a credit crisis, the central government has the tools and capacity to control it by absorbing bad debts, recapitalizing banks, and avoiding the worst of credit crunch induced asset price and GDP declines that accompany credit contractions in market oriented economies with free cross border capital flows. In summary, China is an excellent credit risk with currently low systematic vulnerabilities in the financial system. We will address why we use the word “currently” later.

Notwithstanding claims of impending financial disaster, everyone knows China is an excellent credit and consequently, its hard currency debt, as well as the debt of almost all large Chinese issuers trades at extremely tight credit spreads. It is worth noting that the Chinese government issues relatively little hard currency debt, the vast majority of issuance is in Remimbi. Corporate hard currency debt is more prevalent and approximately 60% of this is issued by state owned enterprises. These issues generally trade as if they were state guaranteed even though there is no explicit support. The lion’s share of non state owned enterprise debt is issued by property development concerns and, to a lesser extent, mining and natural resource companies. As one would expect, this latter group of companies offers wider credit spreads. In some cases, significantly wider. However, all of these issuers benefit from the tendency of Chinese corporations and high net worth individuals to invest their considerable hard currency assets in the bonds of Chinese issuers. Brokers commonly estimate that 60-70% of all Chinese issuance is owned by Chinese investors. Not only does this tend to make spreads tight, it also hinders short sellers. Many naïve short sellers have initiated short China positions only to discover that bonds never widen, only tighten, and that the borrow on the bonds is precarious. When this occasionally is not the case, it is only because the Chinese investor base knows something about the issuer that is not publicly known and not widely disseminated outside of China.

This description of hard currency Chinese bonds suggests a market with very low returns and occasional higher yielding opportunities that one should approach with extreme caution. In other words, when compared with other markets, Chinese bonds offer relatively little return for the risk being taken. The main reason for this is China’s enormous savings rate. China’s savings rate is close to 50%, the highest in the world. When China’s economy was relatively small, the total amount of savings did not make much of an impact on the world economy and could be productively employed in developing China’s woefully underdeveloped industrial base. Twenty-five years later this industrial base is highly developed, particularly for exports, and China is now the world’s second largest economy. A 50% savings rate for the world’s second largest economy is a lot of savings. These savings are having a hard time finding a home, in other words borrowers. If this argument makes sense for the relative of Chinese bonds in hard currency, we think the argument is even more powerful when applied to local currency.

As previously discussed, China does not permit the free flow of capital. The original intent of this system was to channel China’s savings to industrial development in China and insulate the system from the ebb and flow of international investor sentiment. The system has largely accomplished its objectives. Now however, there is a tremendous amount of savings chasing a limited array of investment opportunities. Furthermore, the system was intended to favor borrowers, ie industrial development, over savers, and state control, ie lending by state banks, over non state controlled public markets. While the latter markets are slowly developing, the former is predominant. In addition, there is something in between which we will discuss later.

In any event, we view the Chinese local currency market’s structure as similar to the hard currency market. There are government obligations and obligations of entities believed to enjoy government support such as bonds of state owned enterprises and bank deposits. These obligations offer relatively low rates of return. Investment options that offer higher rates of return should be treated with extreme caution. Chinese accounting transparency is low; the numbers do not tell the full story. Corporate governance is poor; insiders, particularly politically connected ones, can do what they want. Additionally, these first two points equally apply to the Chinese legal system which creditors ultimately rely upon to protect their interests. The legal system is opaque and decisions are politically directed. When we consider that there is a large pool of “captive” Chinese savings desperately seeking higher returns, it is reasonable to assume that returns may not be commensurate with the risk.

Even with this backdrop, it is possible to make a case for Chinese local investment by international investors. Real rates, even on safer assets, are higher than in many developed markets, the currency could reasonably be expected to appreciate over time, and diversification is a hard thing to find in this financially interconnected world. One could do worse than investing in the world’s second largest economy and arguably the world’s best credit. However, we would still advise against the higher yielding riskier segments of the market. As is the case with all higher yielding assets, investors might collect higher returns for some period of time but this attracts an ever greater number of investors and sets the stage for big losses. If one were to insist on investing in this segment we would recommend a locally based investment advisor with strong political connections.

Having stated our position on current risks and opportunities in China, it is worthwhile to discuss our outlook for the future and why we qualified systematic risk in China as “currently” low. Our view that systematic risk is increasing is based on the fact that the non state controlled public market portion of credit markets is growing as a share of the total credit supply. While many people view this change as favorable, and ultimately it maybe, less state control clearly increases the short term risk of credit induced panics. More worrying however is not the development of public markets but the something in between sector which we mentioned previously. Banks and trust companies have offered a plethora of products which offer yield starved savers higher returns and keep assets off their balance sheets. These products are technically not guaranteed by the sponsors, investors bear the risk, yet these are not public market credit products. The savers do not do their own due diligence and the private sector does not allocate capital. Due diligence and loan decisions still are made according to the political and murky processes of bank lending, just with less state control and oversight. This is the fastest growing component of credit. All forms of non-conventional bank lending have been dubbed the “shadow banking” sector. Five years ago shadow banking represented 13% of total credit, now it is 23%. This share of total credit is likely to continue to grow given that conventional credit is growing at 13% annually and the components of shadow banking are growing between 30-40% per year. As strange as the wording might sound, one can easily imagine a run on the bank in the non-bank shadow banking system.

While the size and importance of the shadow banking sector grows, the Chinese attitude towards the sector seems to fluctuate between from grudging tolerance and outright hostility. It is important to remember that shadow banking has its origins in attempts by Chinese citizens to circumvent central government directives. The Chinese people have a centuries old tradition of trying to avoid control by the central government but unlike the west, where a certain degree of private sector autonomy is considered desirable, this is not the case in China. Furthermore, many Chinese view the West’s shadow banking system as being one of the root causes for the 2008 financial crisis. When problems finally surface in China’s shadow banking system, as they eventually will, we believe the central government’s reaction is most likely to be similar to that of Federal Reserve’s response to Lehman’s difficulties. They will view a default and investor losses as necessary to impose market discipline and reign in the system. We expect that they will be shocked by the market reaction, just as the Federal Reserve was. If this scenario unfolds Chinese officials will have to take uncharacteristically swift decisive actions to avoid a severe credit contraction.

Although we think that China’s government still retains enough control to avoid a severe disruption of credit markets, our current sanguine view of the situation rests more on the belief that the Chinese government will not tighten credit enough to provoke a crisis. We believe that almost all modern credit crises start with government efforts to reign in credit growth. This occurs through some combination of interest rate rises and/or tighter restrictions on lending. Notwithstanding recent government rhetoric of a crackdown on shadow banking and runaway credit growth, we do not believe the government will tighten credit in a meaningful way. Growth is lower than the government has hoped for and inflation has dropped dramatically from 6% to in 2012 to 2% now. The government doesn’t want either of these figures to drop much more. Every time they seriously try to restrict credit both statistics weaken. When these statistics weaken, Chinese officials loosen credit again. There doesn’t seem to be the political will for a serious crackdown on credit. On the other hand, the longer shadow banking grows at such high rates, the more painful the contraction will be when it comes.

At this point one might ask why credit is growing so rapidly and why the authorities can’t just slow down this dangerous rate of credit growth. It all circles back to the fact that Chinese save nearly fifty percent of their income. As Keynes explained in the Paradox of Thrift, for an individual to save is a virtue but for the whole of society to save is both impossible and dangerous. Every dollar of savings must find a borrower that puts these savings to work. If not, aggregate demand is reduced and ultimately reduces GDP and aggregate savings so that savings is equal to investment. If a society insists on saving fifty percent of its income these savings must be invested or GDP will drop. In the early stages of China’s development, productive uses for this capital were relatively easy to find and this investment led to rapid growth in GDP. Despite rapid credit growth, debt ratios did not increase because GDP was growing just as rapidly, both real and nominal GDP. Since China essentially adopted the Japanese model of export led growth, investment focused on exports and also led to large and growing current account surpluses. These current account surpluses in turn served as a safety valve to channel some of China’s domestic savings into international investment. At the same time China’s desire to fix the level of its own currency in the face of massive current account surpluses led to rapid domestic money supply growth and relatively high levels of inflation. Highish inflation coupled with strong real growth rates allowed China’s overall debt to GDP ratios to remain relatively low in the face of tremendous credit growth. From China’s perspective it was something of a virtuous cycle. However, all cycles eventually come to an end.

Three years ago Jim Chanos created a sensation by laying out the case that China’s growth was essentially a bubble. The main thrust of his theses was that China was spending 45% of its GDP on investment. Such a situation is unprecedented in modern history and naturally represents a bubble. We believed he was wrong at the time and way too early. In addition we have to admit that we were quite annoyed at how bears and media kept referring to Ghost Cities when the only example anyone could cite was Urdu in western China. Other examples were simply developments on the outskirts of cities that generally became populated over the course of 18 to 24 months. GaveKal’s Dragonomics did a very good piece on this. That being said, Chanos was right in that the law of diminishing returns makes such levels of investment harder and harder to maintain without creating a bubble of unproductive investment and bad debt. Although the day of disaster is not yet here, since 2012 China has been moving in this direction.

In the aftermath of the 2008 financial crisis demand for Chinese exports declined dramatically. This led to a reduction in China’s current account surplus from 6% of GDP to approximately 2% currently. As previously discussed, current account surpluses effectively export local savings to the rest of the world. If Chinese savings which previously had been used by the rest of the world were not used within China GDP would have declined. That is why China’s government undertook massive investment projects and encouraged others to take on debt to do so. These measures successfully avoided a recession. However, over the past few years the government 2012 the government has become increasingly concerned about credit growth. The primary reason for this concern is that unlike prior to the crisis, debt to GDP levels for the economy have been rising dramatically. The reasons for this are fairly straight forward. First, since the current account surplus has shrunk a greater share of domestic savings must be used internally to avoid a contraction in GDP. Therefore, the rate of credit growth has accelerated. Second, this decline in exports along with a naturally declining rate of return on increasing amounts of domestic investment has reduced the rate of real growth. Finally, this slower growth rate coupled with a smaller current account surplus that needs to be sterilized in China’s managed currency regime has led to lower inflation. Chinese credit is growing faster while GDP is growing more slowly. This trend has accelerated since 2012 when the government started to abandon its official stimulus program. Although central government debt to GDP levels have been relatively stable over the past few years, since 2012 private sector borrowing has exploded going from 120% of GDP to nearly 200%. Clearly this can not go on indefinitely. Whereas there is an argument that a sovereign’s capacity to issue debt in its own currency is unlimited, there is definitely a limit for the private sector.

The Chinese government understands that this situation cannot continue. That is why they are trying to reign in credit growth. What’s troubling though is that they don’t clearly seem to understand that clamping down on credit growth alone is not only insufficient but counterproductive. In a society that insists on saving half of its income reigning in credit growth alone leads to recession, deflation, and ultimately depression. Ironically these conditions cause people to save more and make matters worse. Absent an increase in the current account surplus, which effectively exports this surplus savings problem to the rest of the world, the only solution is to save less and consume more. However, this requires a complete reorientation of the economy. As Michael ? explains in his book with the somewhat sensational title “the impending collapse in China”, shifting from an export led economy to a domestic consumption led economy will be painful. If China’s leadership is not willing to take this short term pain, credit growth will turn into a bubble that will explode in a very painful way.

The implications of this situation for the rest of the world are unclear. Since China has followed the Japanese model, the Japanese experience may be relevant. Japan also went through a rapid export focused industrialization process which was funded by a high domestic savings rate. They also experienced high growth rates and large current account surpluses over many years. However, declining rates of return on marginal investment coupled with the need to invest an immense pool of savings from what suddenly was a major economy led to rapidly increasing debt to GDP levels, asset price increases, and ultimately the lost decade. Even the demographic challenges of Japan and China two decades later are similar. What we saw in Japan was that a credit induced contraction in a big surplus savings nation can be moderately disruptive to the world economy as it reduces its external investment and pulls the marginal bid away from certain assets such as trophy real estate. In this case, China’s relatively closed financial system means that they are not as big a player in as many financial markets as Japan was. More importantly, since both Japan and China’s biggest impact has been on supply, their relative importance to worldwide aggregate demand is smaller than the relative sizes of their economies. Consequently Japan could go through its lost decade with relatively little impact on worldwide aggregate demand. We suspect this would also be the case with China. A Chinese contraction would perhaps have a severe impact on many commodity prices and certain luxury goods such as furs and champagne but the overall impact would be limited. That being said, commodity producers have been disproportionately large issuers of debt over the past decade and the world economy is more fragile than it was during Japan’s lost decade. Although we believe the most recent round of China bears are still too early, we nevertheless believe that China will represent a fault line for the next round of credit related seismic activity.