China Hard Landing

The problems in Europe lie in plain sight. It is likely that the ECB will eventually print money to monetize European sovereign debt, albeit at the eleventh hour, on the eve of some pan European bank threatening not to open for business one winter's morning. The debt problems in the US are also pretty evident. Every US Treasury is now a PIK. India's rupee has recently been sold down as public finances deteriorate. For real trouble one has to look at China.

The mild recovery in past couple of months in the US has come through exports of capital goods to the resource rich countries to its North and South who have in turn been feeding the building boom in China. This is at risk of coming to a quick end.

So far, with over 9% GDP growth and a slowdown in inflation, China seems to be heading for a soft landing. With official statistics hard to come by and methods of data collection and cleaning unclear, it is difficult to rely on hard numbers. Instead we turn to anecdotal evidence of a credit crunch in no small part engineered by the government itself.

The confluence of fiscal expansion through infrastructure investment, credit creation through off balance sheet vehicles akin to the SIV, as well as debt monetization in the West most notably the Fed, has created inflation in China. Headline numbers of just under 6% hide food price inflation numbers of nearly 12%, a price paid most by the poor and less by the rich. Asset price inflation further increases the rich poor divide as the cost of shelter has surged.

Inflation is a politically charged issue and so while the government fine tunes policy by reducing reserve requirements for selected commercial banks, a general easing is not viable.

As the government has restricted credit creation it has not only starved companies of access to mainstream credit, it has also created an informal and thus unpoliced shadow banking system of significant size. The SIV like LGFVs and trust companies which have been deployed in financing local government infrastructure projects number over 10,000 and are estimated to be over 2 trillion USD in size. Worryingly the senior liabilities are duration mismatched through short term retail products. Current estimates of bank exposure to the LGFVs exclude backstop facilities. Indeed information is sparse as to the existence and identity of a backstop lender. Ultimately of course it will be the central government.

Exports from China have slowed. In 2008 there was a sharp singular lurch in exports as trade finance was suddenly withdrawn as the international banking system went into temporary cardiac arrest. Exports subsequently resumed but by then a weakening USD and a higher savings rate in Western economies have capped China’s export growth.

A similar risk exists today. The slowdown in Europe and the tepid growth in the US, coupled with an increased savings rate must dampen demand for Chinese exports. However, this is a continuous and orderly process.

The European sovereign crisis is now impacting European banks’ ability to provide trade finance, an area where they typically dominate. A shortage of USD in the European banking system is leading European banks especially the French banks to cut down the size of their USD assets as funding in USD becomes more expensive. US banks are reported to be stepping in to this market but they remain similarly capital constrained. A credit crunch in trade finance is likely to take a heavy toll on an export driven economy like China and will be a drag on its foreign exchange reserves.

Most of all China needs to print good numbers in growth, inflation, employment and trade. Why? Because the financial strength of any country is highly dependent on the confidence that its creditors have in it. China’s debt to GDP ratio is hard to determine and various sources cite numbers from 17% to 160%. Opacity is the enemy of confidence.

The coming Chinese Lunar New Year will be especially important. Anecdotal evidence already points at unpaid wages and zombie companies. The residential rental markets have begun to show signs of weakness as foreign company reps have been repatriated amidst weak business growth. The Lunar New Year is when workers from the central regions return home from the industrial cities for their annual family reunion. The layoffs, if any, will occur then. Businesses will not want to bear repatriation charges, will not want irate ex employees picketing shop fronts and factories, and will count on laid-off employees not incurring travel expenses to the industrial cities to demonstrate or express their grievances.

In 2012 the National People’s Congress elects the next leader of the country so it can ill afford economic instability. While economic growth is important what is more important is inflation. And inflation in the rural areas is driven by food and agricultural products where inflation is running not at 5% but closer to 12%. Absent a credit fueled infrastructure binge, China may face low growth and high inflation (there is a word for that.) The politics of China are likely to push the government to be more vigilant on inflation than on growth.