ANOTHER MARKETPLACE TAPERING TALE: THE CHINA STORY
 September 9, 2013

PRELUDE

Chuck Berry sings in "Too Much Monkey Business":
"Salesman talkin' to me- tryin' to run me up a creek.
Says you can buy it, go on try it- you can pay me next week, ahh!
Too much monkey business. Too much monkey business.
Too much monkey business for me to be involved in!"

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When, why, and to what extent will the Federal Reserve Board slow down its gargantuan debt purchasing scheme? Marketplace wizards and media sages fervently debate the timing, extent, and wisdom of any reduction in the Fed's massive United States Treasury and mortgage-backed securities (money printing) buying program. The Fed meets three more times this year: on 9/17-18, 10/29-30 (not long after the mid-October annual meetings of the International Monetary Fund/World Bank), and 12/17-18.

In any event, a modest Fed tapering of its extravagant securities purchases (currently $85 billion per month) will represent only a slight change in the central bank's long run policy of marketplace tampering. Beginning in late 2008/early 2009, the highly accommodative Fed has engaged in several ardent rounds of massive money printing (quantitative easing) and fervently embraced a yield repression policy (via keeping the Federal Funds rate near the ground floor). Isn't it great for many people (except some savers) that government and corporate and mortgage interest rates were pushed lower (at least until recently? Observers applaud the S+P 500's leap from its March 2009 bottom, the modest recovery in US housing prices, and the dip in US unemployment. Expressing sincere devotion to its interpretation of its legislative mandate, and kindly giving audiences forward guidance rhetoric, the widely-beloved Fed shows no sign of reversing the money printing program (liquidating its debt portfolio) or raising the Fed Funds rate anytime soon (despite the recent noteworthy increase in UST rates in recent months).

CHINA'S TAPERING: OPENING LINES

In the 1947 film "The Lady from Shanghai", Mrs. Bannister states: "You need more than luck in Shanghai." (Orson Welles, director)

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The China economic miracle of recent years has astounded global gurus. Economic policy makers and watchers inside and outside of China forecast its likely continuation. In the intertwined global economy, such sunny predictions about China also aim at boosting confidence regarding international economic growth prospects. Admittedly some Chinese indicators show display reasons for such optimism. And the Financial Times recently remarked "almost everyone agrees that there is little sign that the global economic crisis is about to have a Chinese third act to follow the US and eurozone, which starred in Acts One and Two." (7/24/13, p6).

Unfortunately, the so-called "real", "underlying", and "overall" China economic scene nevertheless is relatively opaque and challenging to understand. Telling any story about the nation's economy, whether bullish or bearish, requires caution, and audiences should listen to these viewpoints with some skepticism. Many Chinese statistical indicators arguably are difficult to assemble comprehensively as well as to interpret (whether by the Chinese government or outside experts). How accurate is official Chinese economic information? Political considerations perhaps influence the substance of some Chinese data reports.

Moreover, several other signs from or related to China suggest that China's real GDP growth has tapered faster than many believe. Besides, it may taper a fair amount beneath generally predicted levels of over 7.5 percent. Like the United States and many other nations since the emergence of the worldwide economic disaster, China embarked upon and sustained highly accommodative monetary campaigns and huge deficit spending adventures. Might GDP expansion diminish if these policies (and related credit creation and leverage) are slowed or reversed? Even though China's overall government debt as a percentage of GDP is less than that of the United States, much of Europe, and Japan, why should China entirely escape the debt challenges and related unpleasant consequences endured by these nations? In contrast to most conventional wisdom, China nowadays probably faces some significant systemic financial (economic) problems.

THE CHINESE SLOWDOWN: A TAPERING STORY

"Seek truth from facts." Mao Zedong and Deng Xiaoping

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The International Monetary Fund's recent Article IV Consultation (7/17/13, "China: Selected Economic Indicators", p4; "Staff Report", 6/27/13, Table 6, p40) chronicles fantastic Chinese growth. Real GDP reached 10.4 percent in 2010 (9.6pc in 2008, 9.2pc in 2009), edging down only slightly to 9.3pc in 2011. Dare one ask how much of this expansion derived from generous deficit spending and loose central bank money strategies? In 2012, it stood at a still-robust 7.8pc. IMF clairvoyants predict 2013 expansion at 7.8pc, with 2014's 7.7pc. In 2015, GDP will grow 7.6pc, with 2016 through 2018 at 7.5pc.

The IMF declares that China's general government gross debt was 17.7 percent of GDP in 2009. It rose to 33.5pc in 2010, but fell to 26.1pc in 2012, with 2013 at 22.4pc. These modest levels surely look excellent! Recall the darker times of the global financial crisis. The general government balance (the deficit) was merely -3.1pc of GDP in 2009. The deficit slid to -1.3pc in 2011, with 2012's at -2.2pc. The guide predicts it will be -2.1pc in 2013 at -2.1pc, with a meager -1.8pc in 2014. Although the nation's current account surplus has tumbled dramatically from 2008's huge 9.3pc of GDP to 1.9pc in 2011 and 2.3pc in 2012, that is still a surplus. The expected 2013 current account surplus will reach 2.5pc, with 2014's 2.7pc.

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The IMF figures thus show only a modest diminution in China's real GDP growth for 2012 and thereafter relative to the splendid 2008-2011 span. However, players should gather and review some generally unheralded details in the IMF pages as well as other marketplace information. That analysis indicates that China's growth tapering may very well turn out to be significantly greater than the IMF and most others believe. Assorted stimulus measures by China's politicians and central bank (perhaps assisted by other international guardians in America, Europe, and elsewhere) may manage to postpone this greater tapering in China's growth to some extent. But such delay (or a temporary mitigation of that growth slowdown) probably will not eliminate a tapering greater than what the IMF and the majority of other economic sentinels expect.

Yet as in America (and keep Japan's recent chapter in its recovery quest in mind), China's easy money and deficit spending entangle with and thereby have supported much of China's spectacular economic growth. What happens when debt, credit, and leverage problems loom in China?

Anyway, despite the IMF's overall optimism regarding China's GDP growth, start by underlining the fine print of the "Staff Report" for this Article IV Consultation (6/27/13). "Since the global crisis, a mix of investment, credit, and fiscal stimulus has underpinned activity. The pattern of growth is not sustainable and is raising vulnerabilities. While China still has significant buffers to weather shocks, the margins of safety are diminishing." ("Key Issues", p3). There is a need to accelerate financial sector reforms and have "strengthened oversight, governance, and investor accountability". Also, see paragraph 10 at p10, which points to "a steady build-up of leverage that is eroding the strength of financial sector, local government, and corporate balance sheets." See Table 3 (p37), which notes ample growth in broad money (M2). Though its annual percentage change fell from 2009's 28.4 percent plateau (16.7pc in 2007), it still was a lofty 14.4pc in 2012 (Table 4's numbers vary from Table 3's and carry up to May 2013 but are similar to them). China's credit growth spiked from 16.1pc in 2007 to 31.7pc in 2009, and 2012's 15.0pc remains elevated. In addition, there is "excess capacity in many [economic] sectors" (paragraph 3, p6).

Suppose the Chinese economy is marching along very well and tapering only a little- or that growth will be cut only a bit in the future. Then why did the nation's government commence a "mini-stimulus" a few months ago, eliminating taxes on small businesses, cutting exporters' costs, and helping to construct railways (Financial Times, 7/25/13, p1). The headline notes that the mini-stimulus "highlights Chinese fears over economy".

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Recall the headline numbers noted above for 2012 for China's general government debt (26.1pc) and the general government deficit (-2.2pc). The debt situation implied by these estimates almost certainly presents a misleading perspective on the Chinese debt problem.

Buried within the Article IV Consultation "Staff Report" is an analysis of Chinese government debt that includes local government finance vehicles and off-budget funds. This more inclusive ("augmented") viewpoint surely offers a more realistic perspective than the headline figures. The IMF estimates that in 2012 the "augmented" government debt was 45 percent of GDP; the "augmented" fiscal deficit was about 10 percent of GDP (p12; and see Box 1, page 13). So "fiscal space is considerably more limited than headline data suggest. The large augmented fiscal deficits also raise questions about local governments' ability to continue financing the current level of spending and service their debts, which has implications for financial system asset quality and the potential need for central government support."

Table 5 (at p39) and Table 8 (p42) offer further evidence on the levels of China's augmented government debt and deficits (2012's numbers for "augmented government debt" slightly differ from those noted on p12). The 2012 augmented government debt is 46.2 percent of GDP, with the augmented fiscal deficit a very large -9.7pc of GDP (note the enormous 15.0pc augmented deficit in 2009; 2010's was 9.0pc, with 2011's -5.0pc). Augmented government debt in 2013 is 42.9pc of GDP, rising slightly to 45.4pc in 2016 before falling to 42.9pc in 2018. The augmented fiscal deficit slides to -7.2pc in 2013 and -6.7pc in 2014, declining further to -5.1pc in 2018.

How do these augmented Chinese debt and deficit levels compare with statistics of other key nations? The IMF's "Fiscal Monitor" (April 2013, Table 2) gives general government gross debt for advanced economies from 2012 through 2014 at about 110 percent, well above China's augmented figures. Overall fiscal balances in advanced economies show deficits of -9.0pc in 2009, -7.8pc in 2010, -6.6pc in 2011, -5.9pc in 2012, with -4.7pc in 2013 and -3.8pc in 2014 ("Fiscal Monitor", Table 1). The US's Article IV Consultation indicates America's general government (this includes US state and local governments) debt at 106.4pc of GDP in 2012, rising to about 109.8pc in 2014; its general government budget deficit is -8.5pc in 2012, with 2013's 109.2pc and 2014's -5.4pc (7/9/13, p13).

Although China's augmented general government debt level is much less severe than that of advanced nations, but its rapid uptrend is worrisome. Besides, are even these Chinese overall debt numbers conservative (accurate) for the present and realistic for the future? The future modest augmented government debt seems based on optimism regarding the China growth story of 7.5pc real GDP or so. Significantly, the relatively recent past as well as future Chinese augmented deficit spending totals generally are substantially higher those of advanced nations.

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Suppose the overall Chinese government debt situation- and even the central/federal government debt level by itself in particular- seems relatively good. However, this does not show the whole picture. Local governments and the banking and corporate sectors- and therefore China as a whole- still confront severe difficulties. Ask if China's local government debt situation and some banks will require bailouts. How surprising will such rescue efforts be? Recall the fading of the glorious Goldilocks Era, and compare China's current landscape with the United States housing and banking system problems during the worldwide economic crisis. Also, keep in mind the enduring sovereign debt crisis springing from the European "periphery".

Special financing vehicles enable China's local governments to borrow; these local governments also own businesses which borrow from state-owned banks. China's National Audit Office finally will conduct a "broad audit of debt incurred by government agencies", focusing on local government debt. Western economists estimate that total local government debt is two to three trillion dollars and rising (NYTimes, 7/29/13, pB3). Nominal Chinese 2013 is forecast at just under $9.5 trillion (the IMF "Staff Report" at Table 5, p39, gives nominal GDP of 57,732 billion renminbi; convert this to dollars at 6.1 renminbi per dollar). As a percentage of nominal GDP, the midpoint of the estimated government debt is 26.3 percent of GDP, a rather large percentage. How much of this debt is nonperforming? How many assets are underwater on a mark-to-market basis?

The Financial Times (7/29/13, p2) speaks of an audit of "all levels of debt". This article cites again an earlier FT article (4/17/13, p1). In an interview, a senior Chinese auditor commented that local government debt was "'out of control'" and "could spark a bigger financial crisis than the US housing market crash" The April FT article speaks of local government debt between Rmb10-20 trillion ($1.6 to $3.2 trillion), or 20 to 40 percent the size of the Chinese economy.

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In regard to China's debt and credit challenges, scan several other current headlines. For example, "Beijing turns to market fix on bad loans" (Financial Times, 8/16/13. p11). The article hints of problems with bad debt at state-owned banks, referring back to the ancient history of the country's 1998 bank non-performing loan solution. See also the FT at p13 that day: "Flood of bad debts to test China's system"; this notes the estimate by the Fitch rating agency (after its analysis of the shadow banking sector) of total debt at more than 200 percent of GDP (up from 125 percent in 2008). Official Chinese statistics show nonperforming loans rose in 2Q13 for a seventh straight quarter to Rm540 billion (at about 6.1 renminbi per US dollar, that is about $89 billion). Goldman Sachs estimates the country's total debt as a percentage of GDP at 219pc. Both Fitch and Goldman think its growth rate has been rapid in the past five years (Financial Times, 8/18/13. p19).

Nonperforming loans at large state-owned banks reached about thirty percent in the late 1990s (Financial Times, 8/18/13, p19) or alternatively twenty pc (FT again, 8/29/13, p19). Another rating agency, Standard+Poor's, warned of deterioration in the creditworthiness of Chinese state-owned and corporate companies over the next 12 months (Financial Times, 8/20/13, p19).

Citing JPMorgan, the Financial Times reports that money owed by Chinese companies rose from 90 percent of GDP in 2007 to 124pc recently. When will this taper off? The IMF estimates the average debt-to-equity ratio of Chinese companies grew to almost 110 percent (the graph is about 105pc) in 2012, "making China's corporate sector more highly leveraged than those of all other big emerging markets." What will ensue from any substantial reduction of such leverage? The government is trying to contain the risks by telling banks to stop lending to sectors with excess capacity, attempting to reduce shadow banking (by trust companies and others), and reducing the issuance of bankers' acceptances. "With the steady stream of bailouts, what is nominally classified as corporate debt very quickly becomes government debt." (Financial Times, 8/28/13, pp1-2).

"Easy Credit Dries Up, Choking Growth in China", shouts the NYTimes (8/16/13, pp A1, 3) in reference to informal lending. Large state-owned banks lending at low regulated rates (not much above the inflation rate) "overwhelmingly" go to large state-owned businesses, government officials, and politically connected individuals. These fortunate recipients "then relend the money at much higher interest rates to small and medium-size businesses in the private sector that need the money to grow." In 2013, in one province discussed by the article, interest rates for small and medium businesses spiked from 25 to 40 percent a year to as much as 125 percent a year. Many defaults ensued in recent weeks. These debts are difficult to enforce in court.

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The consequences for China of its arguably excessive debt and leverage appear in "overbuilding and too high" real estate (especially housing) prices and substantial environmental damage. The NYTimes mentions a plan to tax home sellers on profits as well as making it harder for people to purchase a second home (3/5/13, pB1). While China's economic development has been "remarkable", the resulting environmental deterioration has been "notable" (IMF Article IV Consultation "Staff Report", Box 3, p19). Does economic growth need to slow (partly via some tapering of debt, credit, and leverage growth) to make housing more affordable and to preserve the Chinese (and global) environment?

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China's embrace of debt and credit in recent years is a widespread cultural phenomenon. "Chinese opt to get the good life on credit" (Financial Times, 8/29/13, pp1, 3). Did Americans ever follow this path? Chinese household debt as a share of disposable income ascended from the mid-20 percent level in 2003 (and 30pc in 2008) to over fifty percent at end 2012. It thus is starting to catch up with personal debt levels in America and Europe over 100pc of income. As a percent of GDP, China's household debt climbed from around 15pc to just over 30pc (estimates from the article's graphic).

A survey by Peking University of Chinese incomes manifests a large gap between top earners and those at the bottom. Households in the top five percent earned 23pc of China's total household income (NYTimes, 7/20/13, pA9). To what extent do the big earners benefit from an ability to borrow cheaply relative to the less affluent? Might more than a few Chinese politicians capture easy credit deals like those offered to some of the well-to-do?

Rampant credit and debt creation alongside lax political and regulatory supervision can result in significant corruption. Over two years ago, China's central bank reported that corrupt officials smuggled $124 billion out of the country between the mid-1990s and 2008 (Financial Times, 6/17/11, p1). Is China finally cracking down on economic wrongdoers? "China minister sacked as corruption probe widens" (Financial Times, 9/4/13, p2). Is this crackdown an effort to placate citizens upset not only about corruption, but also about slowing or declining earnings and weakening economic growth prospects?

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The IMF declares the renminbi is "moderately undervalued" against a broad basket of currencies, probably between five and ten percent (Article IV Consultation "Staff Report", 6/27/13, p1, pp27-28). If the renminbi strengthens, this will tend to reduce Chinese growth to some extent.

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If things were going wonderfully within the Chinese economic (and political) system, why would the nation's leaders underscore territorial quarrels with other nations? Recall the recent squabbles with Japan over tiny islands (Daioyu) controlled by Japan. Note the quarrel with India over the disputed India-China border. Keep the South China Sea issue in mind as well. China probably is not only concerned about land and related mineral rights. Some hostility to the opposing nations is probably not the only explanation. China would not be the first nation with domestic issues seeking to deflect attention from them that elects to highlight external problems.

Also, underline China's high-profile effort to promote its values relative to Western ideals. If all was well with China in its political (and economic) arenas, why heatedly attack alternative viewpoints? A Communist Party leadership paper (Document No. 9) criticized Western ideas of constitutional democracy and promotion of universal values of human rights and media independence (NYTimes 8/20/13, pp A1, 3).

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What's the bottom line? China apparently has generated a fair amount of its economic growth from easy money and massive deficit spending (credit, debt, and leverage). It consequently faces a significant challenge of maintaining its high GDP growth rates while tapering accommodative monetary and fiscal deficit policies. In addition, China confronts a modest yet apparently growing systemic problem (risk) tied into these accommodative monetary and fiscal programs and the related lending, leverage, and bad debt issues. Perhaps Chinese control over its economy (especially given that economy's close connection with the global one) is much less than many claim. Looking forward, Chinese growth probably will taper more than most believe. In any event, one should not have blind faith in the continuation (repetition) of the recent extraordinary Chinese growth story.

TAPERING IN MARKETPLACES: CHINESE STOCKS AND BASE METALS

Confucius says in "The Analects": "He who gives no thought to difficulties in the future is sure to be beset by worries much closer at hand." (Book XV, paragraph 12)

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The Chinese stock marketplace of course does not represent China's overall economic (GDP) growth. However, the long bear trend of the Shanghai Composite Index indicates that observers should regard the apparent Chinese GDP growth miracle and its continuation with some caution.

After being assisted via Chinese government spending and monetary easing during the dark times of the worldwide economic disaster, the Shanghai Composite peaked on 8/4/09 at 3478 (far beneath 10/16/07's major top at 6124). Since August 2009, the Shanghai Composite has tapered, slumping lower and lower relative to prior tops. Recall the minor highs of 3187 on 11/11/10 and 3067 on 4/18/11. Despite its rally from 6/25/13's 1850 depth (see the S+P 500 low on 6/24/13 at 1560), the Shanghai Composite nowadays also still lurks beneath the interim tops at 2478 (2/27/12) and 2445 (2/18/13).

In regard to Chinese growth implications suggested from the Shanghai Composite equities, compare Hong Kong's Hang Seng Index. Indeed the Hang Seng has ascended from its 6/25/13 low at 19,426. However, recall the highs of 11/8/10 at 24,988, 4/8/11's 24,469 (note the timing of the Shanghai Composite's top), and 2/4/13's 23,944.

Chinese demand is a crucial factor for base metal playgrounds. Many believe that to some extent Chinese economic growth is reflected in part by trends in base metals prices. Yet base metals prices have slumped in recent years.

Note the decline in the London Metal Exchange's LMEX Index (which includes several base metals such as copper). The LMEX established a pinnacle from 2/14/11 4478 to 4/8/11 at 4469 (compare the timing of the Shanghai Composite and Hang Seng tops). Recall the lower peak at 3820 on 2/9/12 (see the Shanghai Composite's February 2012 high), as well as those at 3609 (9/14/12) and 3614 on 2/4/13 (Shanghai Composite high 2/18/13). The LMEX is around 3100 now.

Remember the declines in iron ore (delivered to Qingdao, China) from highs on 2/17/11 at $191.7 per metric ton and 2/20/13 at $160.8. Steel prices around $180 per metric ton (LME three month rolling forwards) are far underneath the summits of $620 (3/29/10) and $610 (7/26/10)

<u>TAPERING CHINESE DEMAND FOR US TREASURIES</u>

Tapering growth in China may reduce China's demand for United States Treasury debt securities. Of course UST yield and currency cross rate levels and trends matter, as does the size of China's current account surplus, US federal financing requirements (deficit levels), international political factors, and other variables.

See the US Treasury International Capital (TIC) report on major foreign holders of US Treasury securities (8/15/13 release; statistics through June 2013). Chinese demand for UST seems to have slowed. Mainland China's high was in May 2013 at $1.30 trillion down slightly from $1.28tr in June 2013. Its UST holdings have not climbed much over the past year. The June 2013 level is only about $130 billion over June 2012's $1.15tr (compare December 2012's $1.22tr). This hints, though by no means definitively, at a slowing of Chinese economic growth. Less demand for UST may reflect a smaller Chinese current account surplus which may indicate slower Chinese exports and thus a slower Chinese economy.

In any event, the recent sharp increase in US government yields probably is not only due to fears of tapering by the Federal Reserve. See "The US Treasury Two Year: Noteworthy Moves"

(8/19/13) and “Some US Money Flows: Riding the Waves” (8/8/13) for analysis of foreign net buying (selling) of UST and related topics.

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