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China channels 'Monkeybrains'

Too much debt got us into this mess, and too much debt will see us out of it. Socialize the risk of a new cycle of open-throttle lending and cling to the monetary system that assures a repeat crisis. Such, approximately, is the global policy-making consensus. Central bankers and finance ministers have achieved an uncommon meeting of the minds. The cure for what ails us is the hair of the dog that bit us, they prescribe, though not in exactly those words.

It's no small thing that China is especially enamored of the shot-and-a-beer-for-breakfast approach. Nothing about China is small or insignificant nowadays, since the Chinese economy is actually growing. It might, indeed, account for 74% of worldwide GDP growth in the three years to 2010, the International Monetary Fund estimates. Since 2005, China has generated 73% of the global growth in oil consumption and 77% of the global growth in coal consumption. By the looks of things, it accounts for a fair share of the growth in worldwide luxury-car consumption, too:

FRANKFURT (Dow Jones)—BMW AG said Monday that sales at its core BMW brand in China were up 46% on the year in June at 8,033 cars, fueled by strong demand for its X5 and X6 models.

Sales in China for both the BMW and the compact Mini brand rose 44% on the year at 8,506 cars, a company spokesman said.

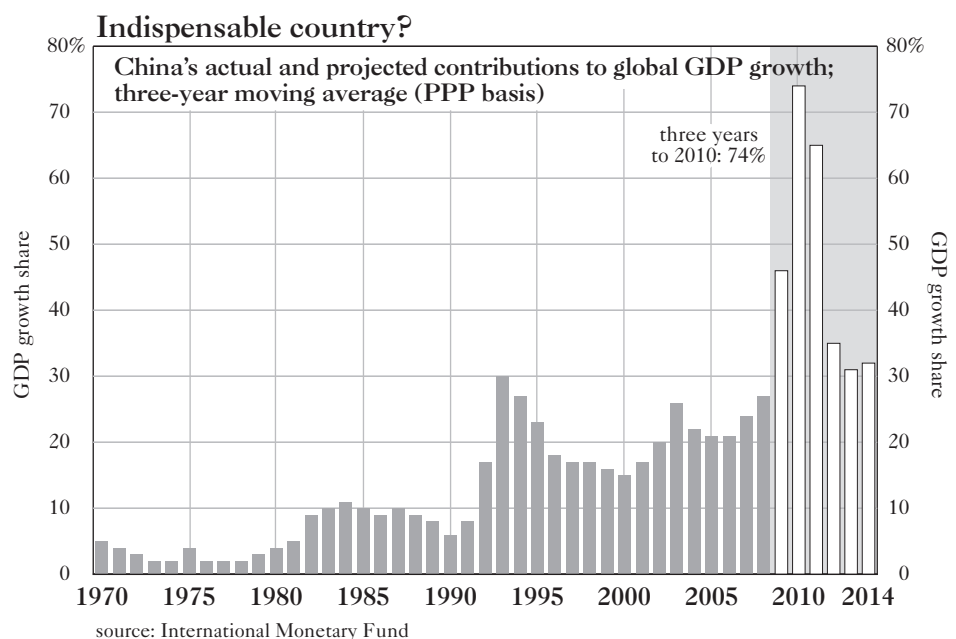
Now unfolding is a preview of the next, the future, credit collapse. Such

methods as China is employing—a borrowing binge centrally planned and directed—will eventually come to grief, as the readers of *Grant's* know full well. Indeed, in money matters, nearly everything seems to come to grief sooner or later. However, it is equally true that, before the grief, comes the laughter and levitation. Massive injections of money and credit are always unsound. But for stocks, commodities and credit, they are bullish before they are bearish. In the fad for “quantitative easing,” when might the laughter turn to tears? How to prepare for that inflection point? How to see it coming?

China is not alone in seeding bad loans right on top of the previous cycle's only partially harvested crop

of desperate debts. Loan guarantees, commercial paper purchases and other forms of financial artificial respiration by the governments of the G-20 nations sum to the equivalent of 32% of last year's combined G-20 gross domestic product, the IMF estimates. That is on top of average fiscal stimulus equivalent to 5.5% of GDP. So the United States, implementing fiscal and monetary stimulus worth nearly 30% of GDP (*Grant's*, April 3), is not far out of the interventionist mainstream. China is in a class by itself.

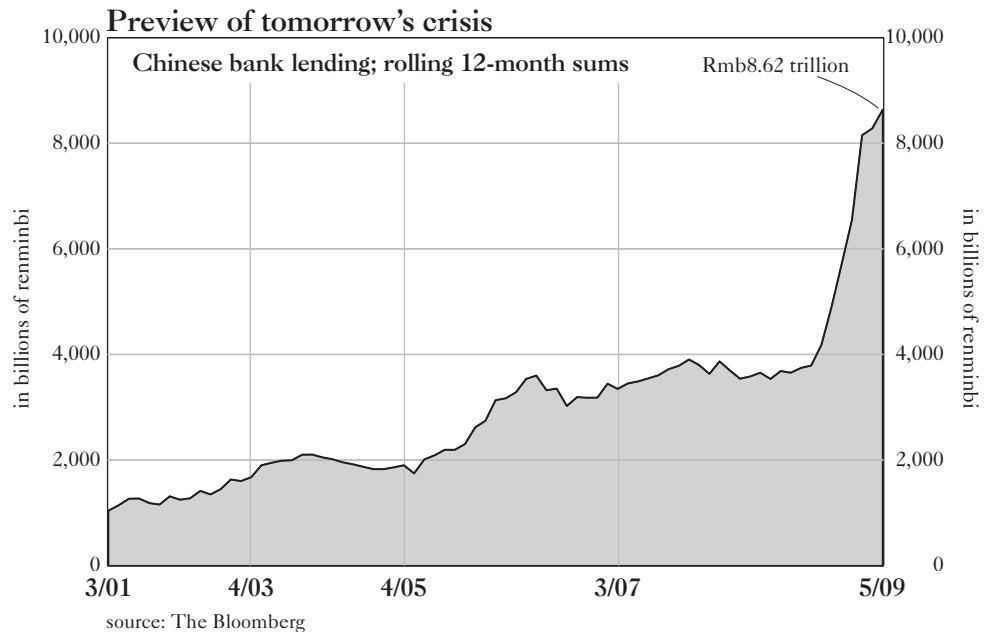
In the 1930s, Western intellectuals persuaded themselves that the Soviet economic model was depression-proof. Today, not a few investors marvel at the vigor of the modified commu-



nist economic model of the People's Republic. Credit may contract in the United States, but it expands—nay, explodes—in China. “If the rumored new lending figures for June are accurate (for more, see Michael Pettis’s blog at mpettis.com),” observes colleague Ian McCulley, “Chinese banks will have lent 7 trillion renminbi, or a little more than \$1 trillion, in the first half of 2009, compared to Rmb4.9 trillion in all of 2008, Rmb3.6 trillion in 2007 and Rmb3.2 trillion in 2006. New lending was exceptionally strong in the first three months of this year. It tapered off a bit in April and May but appears to have roared back in June.”

Complementary roars have issued from China’s manufacturing industries and world commodity pits. Last week, the People’s Republic purchasing managers’ survey registered 53.2, its fourth consecutive month over the 50% mark that indicates economy-wide growth. The Shanghai A-share market jumped by 65% in the first half, to a level that fixes its value at 31 times trailing net income, up from 12.8 times at the October lows. Chinese M-2 was 25.7% larger in May than it was a year before. Chinese officialdom is targeting 8% GDP growth this year, while the World Bank predicts 7.2%, of which, the organization says, six full percentage points owe their existence to government stimulus. As between the 8% government forecast and the 7.2% non-government forecast, our money is on the government. Not only do the cadres print the money, but they also calculate the GDP. So, falling in with the Communist Party, we, too, predict 8% growth for 2009—barring an early explosion in the Chinese banking system.

New directives to Fannie Mae and Freddie Mac to refinance certain mortgages at up to 125% of appraised home value reaffirm the U.S. government’s membership in the hair-of-the-dog bloc. But no credit-market intervention approaches the one being mounted in Beijing. For it, the world’s commodity producers say daily prayers of thanksgiving, and their gratitude would truly be incalculable if only they knew how long the Chinese could keep it going. Absent Chinese stockpiling, where would commodity prices be? Without a functioning Chinese banking system, where would the world economy be?



A superb primer on the risks of China’s go-for-broke lending drive was published by Fitch Ratings on May 20. Is it not passing strange, the agency asks, that Chinese lending is accelerating even as Chinese corporate profits are shrinking? “Ordinarily, falling corporate earnings are met with tightened lending, but in China, precisely the reverse is evident. . . .” You would expect—and Fitch does anticipate—that the borrowers of these trillions of renminbi are not so profitable as they were in the boom, and some will therefore struggle to service their debts.

Reading Fitch on China, we think of the author Mark Singer on Oklahoma. In China, Fitch explains, credit losses don’t surface promptly on account of “pervasive rolling over and maturity extension of loans when they fall due. This not only leads to undercapturing of NPLs and delayed credit costs, but also, by extension, inflated capital. Consequently, in the short to medium run, Chinese banks’ performance may continue to hold up well as rapid loan growth drives up the denominator of NPL ratios and boosts profits via high volumes, but the medium-term risk of a deterioration in corporate portfolios is rising.”

Neither did credit losses surface right away at the Penn Square Bank, Singer related in his 1985 tour de force, “Funny Money.” Penn Square originated oil-patch loans at its headquarters in an Oklahoma City shop-

ping center during the boom of the late 1970s and early 1980s. Interests in these credits it syndicated far and wide. An alert loan buyer might have taken a cautionary hint from Penn Square’s super-fast growth and evident undercapitalization, if not from the nickname of its chief energy-lending officer—they called him “Monkeybrains.” But the Continental Illinois National Bank & Trust Co., of Chicago, one of Penn Square’s top loan participants, seemingly suspected nothing until the Oklahoma bank failed in 1982. When Continental Illinois itself became insolvent in 1984—pulled down, in part, by its Penn Square participations—a new chapter in the socialization of credit risk was opened. To save the Federal Deposit Insurance Fund, the government nationalized Continental, then the nation’s seventh-largest bank, with assets of \$41 billion. Pure and simple, it was too big to fail. Indeed, Comptroller of the Currency C. Todd Conover subsequently hinted, the 11 largest banks in the country were systemically irreplaceable. And so was born the too-big-to-fail doctrine. Whether or not it was an American invention, the policy today belongs to the world. China, in particular, has taken the idea and run with it.

Examining, first, the track of Chinese bank lending and, second, the trend in Chinese nonperforming loans, the seasoned reader will remember not only Monkeybrains but also Drexel

Burnham Lambert. In the mid-to-late 1980s, the American junk-bond market combined breakneck growth with muted default rates. The secret, fully revealed during the subsequent bear market, was that the default rates were a direct product of the issuance rates. Borrowers didn't default because of—to adapt the Fitch formulation to that earlier time—the “pervasive rolling over and maturity extension of bonds as they fell due.” Drexel failed when the junk market did.

The idea that the government will finally pick up the pieces may or may not drive the typical mid-size American bank to risk-taking from which it would otherwise shrink. In China, however, there appears to be no doubt. “Prior to the global crisis,” according to Fitch, “domestic [Chinese] credit conditions had been fairly tight; strict loan quotas had been put in place at the start of 2008 amid concerns about inflation, and [corporations] and banks were increasingly employing off-balance-sheet transactions to complete deals. However, since the rollout of the stimulus package [last November], the climate has dramatically changed. Projects that had been sidelined when quotas were tight have been put into action with the assumption that if problems arise, Beijing will likely step in with assistance.”

If problems arise? As Fitch itself implies, the only question is when: Non-performing loans at foreign banks in China, “which are generally believed to have stricter risk management and oversight and are less willing to roll over delinquent loans,” are already on the rise. Chinese loan officers work to a quota. They take their direction from their branch managers, who report to the senior management, which answers to the board of directors—and the directors hang on the words of the People's Bank.

The trouble these days is that too many motivated loan officers are chasing too few creditworthy borrowers. Net interest margins at Chinese banks are tightening on account of the recession and the governmentally sponsored drive to lend their way to prosperity. So loan officers push all the harder. “For example,” as Fitch explains, “a branch manager is given an annual profit target of Rmb35 million. If the average loan margin is 3.5%, he needs to lend Rmb1 billion to meet this goal. However, if the av-

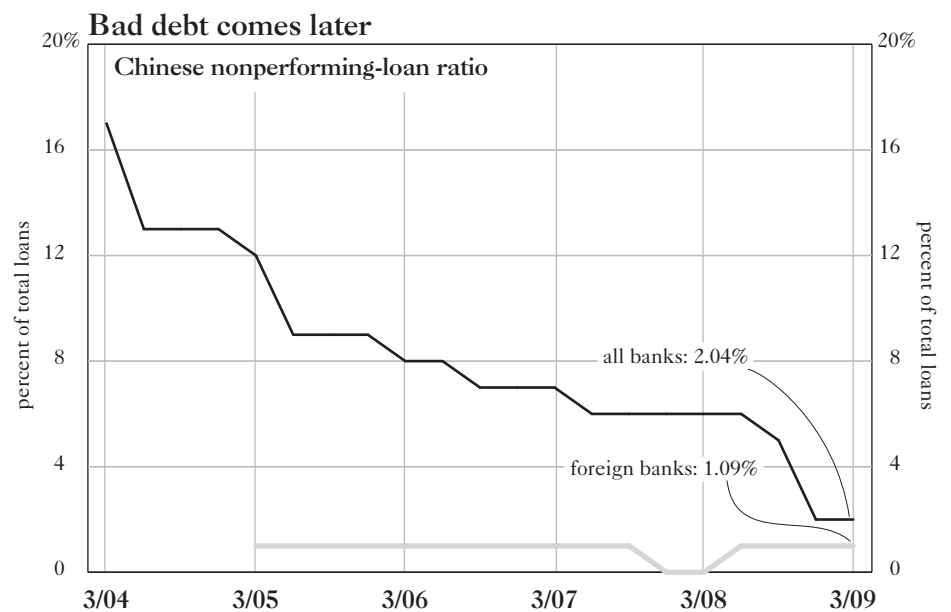
erage margin declines to 2%, he now needs Rmb1.75 billion to meet the same objective. This is not the first time Chinese banks have faced a margin squeeze, but in the past the ability to raise credit volume was limited by quotas [i.e., central-bank-imposed quotas to restrict lending to combat inflation]. Now, in a quota-less environment, that restraint is gone.”

China has its Sheila Bair as well as its Ben Bernanke, and the safety-and-soundness bureaucracy in March urged banks to set aside in reserve 150% of the par value of their bad debts, up from 120%. But the directive seems more in the way of a suggestion than a ukase. Certainly, the stock market does not believe that the evil end to the new credit boom is yet in sight. In Hong Kong, the big three Chinese banks—Industrial & Commercial Bank of China, Bank of China and China Construction Bank—trade at price-to-book multiples of 2.5, 1.7 and 2.5, respectively.

We are as bearish on the multiples as we are on the stated book values. On the other hand, the stock market is as sanguine about Chinese bank stocks as economists are complacent about Chinese inflation. The late Milton Friedman handed us not so much a postulate as a divine law when he said that “[i]nflation is always and everywhere a monetary phenomenon.” But a new generation of central bankers and economists is having its doubts. “Some worry that the rapid growth

of money and credit will lead to inflation,” the Beijing office of the World Bank advises in its June Quarterly Update. “However, with a lot of [spare] capacity in China and world-wide putting downward pressure on raw material prices unlikely to soar soon, substantial generalized price pressures seem unlikely any time soon.” An asterisk at the end of that sentence leads the reader to a footnote in which the World Bank economists finish the argument: “The relationship between monetary aggregates and inflation is complex. That is why central banks in mature market economies have largely abandoned using money as a guiding variable for inflation projections, giving priority to output gaps.”

So the economists give intellectual cover to the money printing. For the “mature market economies,” we advise a return to the basics, starting with the very definitional threshold of the problem. Inflation is not “too much money chasing too few goods,” but too much money, period. What the fatal, redundant increment of cash chooses to pursue varies from cycle to cycle. In pursuit, however, it never fails to distort something. Lately, the money has been chasing investment assets rather than goods and services. In Shanghai, it is chasing A-shares. Globally, this year, it has pushed up, or contributed to the pushing, of the prices of lead, copper and nickel by 75%, 71% and 50%, respectively. Who knows? Maybe the central banks have



source: The Bloomberg

prevented some prices from falling further than they otherwise would have done. Central bankers, however, to generalize across the profession, refuse even to imagine the problem in these terms. They are content rather to assert that, owing to the prodigious gap between output and potential output in recession-wracked economies, their actions have instigated no inflation but have forestalled deflation. Self-congratulations ringing in their ears, they are prepared to crank the presses even faster when duty next calls. What's the harm in it? they seem to ask.

In fact, by cutting off interest rates at the knees, central banks punish thrift. Prolonging the lives of businesses that deserve to go out of business, they thwart the designs of the entrepreneurs who would, if they could, build something better. There's no end of mischief in quantitative easing. On the other hand, it's an ill monetary wind that blows no portfolio any good. Beijing has been lifting prices in resource markets. "The round of oil-field auctions in Baghdad last week," McCulley points out, "is a sign of things to come, as China National Petroleum Co. was part of a winning BP-led bid, while most other Western majors walked away complaining of unfair terms. (China National has a separate deal to develop other Iraqi fields.) Sinopec is buying Addax Petroleum, with reserves in West Africa and Iraq, in an \$8.8 billion deal, and, according to *The Wall Street Journal*, is paying \$16 per barrel of proven and probable reserves, more than triple the valuation of other deals in the region." Western companies may answer to their shareholders, but as an energy consultant put it to the *Financial Times* last week, "The Chinese companies are answering to politicians who have an aggressive strategy of resource capture."

The properly skeptical observer is in a quandary. China holds perhaps \$1.5 trillion of low-yielding Treasuries and U.S. agency securities. You'd expect it to be edging out of two-year

notes and Fannies and Freddie's into resource investments, even if it had no doubts about the dollar. But it does have doubts, which it has taken to expressing in deeds as well as in words. On Monday, a Shanghai municipal government finance official called a press conference to announce the decision of three local companies to begin settling import and export contracts in renminbi rather than dollars. From offstage, a Singapore currency analyst declared, according to Bloomberg, "This is a first step on the long road towards that target of making the [renminbi] a global reserve currency. That's probably going to take five years or more."

It could be a long, hard road if China's Monkeybrains banking system follows the Penn Square-type trajectory, as we expect it will. Besides, Bloomberg News, in the very same dispatch, relates that the dollar's share of official vault space climbed to 65%, or \$2.6 trillion, up 100 basis points on an admittedly incomplete sample set, in the first three months of the year. And it quotes He Yafei, China's deputy foreign minister, speaking in Rome on Sunday: "The dollar will maintain its role for 'many years to come.'"

So saying, He came to the root of the problem. The dollar's "role" in the world—its exalted status as a reserve currency—is what has facilitated the piling up of debts on one side of the Pacific and U.S. Treasury assets on the other. It is the dollar's role that has allowed the United States to consume much more than it produces and to finance the difference in the currency that it alone may lawfully print. China ships merchandise to us; we ship dollars to China. These dollars wind up at the doorstep of the People's Bank, which creates the renminbi with which to absorb them. And what does the bank do with its greenbacks? Why, it invests them in the securities of the U.S. government. Note, please, that the dollars might as well have never left home. Note also that their transit insti-

gates credit creation in China, some of which, though not all, may be neutralized, or "sterilized," by the People's Bank. Under a proper gold standard, creditor countries gain reserves while debtor countries lose them. Built into that system is a balancing mechanism. New under the paper-money arrangements of recent decades is a kind of intrinsic imbalance. The major debtor country loses no reserves even as the debtor countries gain them.

Our Great Recession has restored a small measure of balance to the international financial traffic. U.S. imports have fallen further than U.S. exports, thus reducing the U.S. current-account deficit for the first quarter to \$101.5 billion vs. the year-ago reading of \$179 billion. The second-quarter shortfall was the smallest in absolute terms since the fourth quarter of 2001, and the smallest as a percentage of GDP—2.9%—since the first quarter of 1999. Yet, still, China accumulates dollar bills. "Despite a year-over-year drop in exports of 26.4%," McCulley notes, "and the American consumer's newfound taste for thrift, China has posted an \$89 billion cumulative trade surplus through May, which is actually ahead of last year's record-setting pace."

A good-size portion of the Treasuries and agencies that America's creditor nations accumulate is held for safekeeping at the Federal Reserve Bank of New York. We track these custody holdings on pages six and seven of *Grant's*; the Fed discloses them every Thursday. Strange to relate, they have grown, not shrunk, in the past three months, at an annual rate of 27%.

All in all, the world is reverting to pre-crisis form. Central banks are monetizing dollars, subsidizing credit and socializing risks, and the People's Bank is outdoing all others in this direction. Certain it is that these unprecedented monetary maneuvers will come to a sorry and dramatic end. What we are struggling to divine is the timeline. Watch this space.

