FINANCIAL PREPAREDNESS

"One of life's most painful moments comes when we must admit that we didn't do our homework, that we are not prepared." ~ Merlin Olsen

Issue #36
October 15, 2021

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China's Great Wall of Debt

I wanted to learn more about China—especially its precarious financial system—so I recently read China's Great Wall of Debt: Shadow Banks, Ghost Cities, Massive Loans, and the End of the Chinese Miracle by Dinny McMahon. It's a fascinating and well-written book. McMahon is fluent in Mandarin and worked in China as a journalist covering the Chinese economy and financial system for the *Wall Street Journal* and the Dow Jones News Service, so he knows a lot about the subject.

China has long been a land of extremes, everything from extreme isolationism, the Great Wall, an enormous population, the Great Leap Forward, the Cultural Revolution, the One Child policy, the Great Firewall, huge industrial overcapacity, and a massive position in U.S. Treasuries. The Chinese don't do anything halfway, and with the recent collapse of Evergrande Group (the second largest property developer in China, and the most valuable real estate company in the world in 2018), the likely imminent collapse of their financial system will be one of their biggest catastrophes yet, and will almost certainly precipitate the largest global financial/economic collapse in human history.

China's economy is no longer centrally planned as it was (disastrously) under Mao, but it's controlled (at least in theory) by the Chinese Communist Party (CCP), and about a quarter of the companies (especially larger ones in key/strategic industries) are owned by the state (including local governments). The central government in Beijing sets high level policy and issues directives (including unfunded mandates), but local governments have a surprising amount of autonomy, and pretty much do whatever they want and whatever they think they can get away with, which is almost everything.

Beijing's imperatives are (in this order) social stability (no demonstrations, unrest or dissent), economic growth, and revenue. It wants social stability because although CCP members currently enjoy the good life (China's inequality is one of the highest in the world), they know that they could easily end up like Romania's Nicolae Ceaușescu. It wants growth to become the largest economy in the world, and because that's the only thing that would keep everything from collapsing. And it wants local governments to generate revenue (not necessarily from taxes) in order to pay for everything.

Local officials are evaluated based on how well they achieve these objectives, which creates perverse incentives. For example, a local state-owned firm that perpetually loses money may be kept alive by the local government because it still generates tax revenue and provides jobs, even if it's inefficient and the product it makes is obsolete and/or no longer needed (industrial overcapacity is a huge problem in China). Local officials also have an incentive to protect local firms from competitors in other parts of China. Crucially, the career track for local government officials is an "up or out" system, so they can borrow massive amounts of money and squander it on idiotic projects like new cities, but they'll be long gone by the time it all goes to Hell. Beijing's obsession with hitting a (very ambitious) growth rate of 6.5% ensures that all economic statistics at every level of government are fraudulent.

The CCP (and to some extent, the Chinese people) want the benefits of capitalism (economic growth and prosperity) without capital, profits, risk or losses. The basic problems are a lack of clear property rights, the rule of man (instead of the rule of law), central planning, pervasive corruption and fraud, perverse incentives, excessive debt, a lack of investment options, an opaque and complex financial system, and extreme moral hazard (the expectation that the government will bail out everyone in the end).

The government often ignores its own laws, and pretty much does whatever local officials want. Laws are often worded vaguely enough that they can be broadly interpreted. Local courts usually side with the local government, or locals in general. It's like the Wild West of state capitalism—anything goes. Corruption is rampant despite Beijing's periodic anti-corruption campaigns that ensnare hundreds of thousands of officials and CCP members.

Almost all of the banks (especially the largest ones) are state owned, and are regularly pressured or compelled to bail out state-owned firms. "Interest rates don't work in China as they work elsewhere....interest rates are kept low as a subsidy for state firms....because state firms don't face the same pressure to repay loans as private companies in market economies do, higher rates don't dampen their appetite for credit...the government rations credit by telling banks just how much they're allowed to lend. However, at the end of 2009, it wasn't so easy just to turn off the taps. Many of the projects begun during the stimulus year...had only just started and needed to borrow more if they were ever to be finished, and banks were under pressure from local governments and state firms to keep lending." Since 2008, "the amount of new money that China has created...has dwarfed [the U.S., Europe and Japan] *combined*. Between 2007 and 2015, China was responsible for 63% of all new money created globally."

This massive debasement of people's savings has prompted them to move to the shadow banking system (trusts, wealth management products and peer-to-peer or P2P lending), which usually invests in real estate. McMahon writes, "At the end of 2014, the amount of credit that had been generated by the shadow banking system was about 40% the size of China's GDP. By mid-2016, that had doubled, to about 80%. It's almost inconceivable that any economy could productively deploy such a massive increase in debt in such a short period of time."

Technically, the state owns all land, though after Deng Xiaoping's reforms, land can be leased from the state for long periods. But that doesn't stop local governments from seizing land and selling it to property developers. McMahon writes, "...land expropriations have been an absolute boon for local governments. From 2009 to 2015...China's governments collected 22 trillion yuan just from selling land....land sales in China account for roughly a third of all [government] revenue....The People's Republic has never shied away from taking the people's land. Millions of its citizens have been moved to make way for gargantuan infrastructure projects." This widespread use of eminent domain creates a bitter underclass that is ripe for revolution, especially when the disparity in wealth is so extreme.

McMahon writes, "Land has allowed the construction of projects that would have been impossible if the financial burden had fallen upon the Chinese taxpayers. But it's a privilege that has been abused by local governments that treat land finance as though it's free money. They've built whatever they wanted...without reference to any underlying need, and without financial consequence. And even worse, they've become addicted to it. In 2014 alone, local governments raised 31 times more money from land sales than they did in 2001." And when they run out of land to sell, they level hills or make more on the coast.

"...the scale and cost involved [with construction] are completely out of proportion to the likely scale of migration [from rural areas]....in 2013, plans for new cities and new districts were sufficient to house about 3.4 billion people, *more than twice* China's total population....the pace of internal migration has been slowing since mid-2010. Yet local governments' enthusiasm for construction hasn't cooled at all."

In recent years, "made in China" has become synonymous with toxic, shoddy products, and for good reason. In the construction industry, the emphasis is on speed, not quality. Construction companies routinely cut corners, and as a result, buildings in China have an expected life of about 20 years, half of those in Europe. Buildings are almost like a placeholder—what really has value is the land.

McMahon writes that "developing property has become a license to print money." In the decade between 2003 and 2013, property in China's biggest, most affluent cities appreciated by 13.1% per year, compared with 10.5% for second-tier cities and 7.9% for third-tier cities. By comparison, “U.S. housing prices grew 7.1% on average annually in the four years prior to the market's peak in 2006....In Beijing, people pay more than 20 times their annual income for a home, compared with 2.5 times in the U.S....Land prices in China increased fivefold between 2004 and 2015.”

“By 2010, so many state firms had become involved in developing real estate that the central government issued an edict telling them to divest their property arms and to focus more on their core businesses. The directive was roundly ignored. The money from real estate was too easy. Housing prices only ever went up...it always paid to keep building.”

Investors who own apartments almost never rent them out, because they don't really trust migrant workers to take care of them, and they think the large capital gain they expect to receive when they sell would dwarf any rental income.

“Housing construction is essential to buoying dozens of industries that are already mired in overcapacity, like steel, cement and glass....construction provides employment for 16% of the urban population. And with banks making about 30% of their loans to the property sector, the health of the financial system requires buoyant property prices.”

“What makes the land market a bubble is that prices are no longer determined by the supply of land relative to the demand for housing. Rather, they're set by the supply of money relative to the demand for somewhere to invest it. [Does that sound familiar?] Developers have borrowed a massive amount of money in recent years, and many of them are already showing signs of financial distress. But what keeps them afloat—and allows them to pay higher prices for land—is their ability to continue borrowing, particularly from shadow-banking sources....The risk is that when people...start losing faith in property,” property prices will fall, interest rates will rise, lending will stop, developers will default, and distress will spread throughout the financial system.

One of the hallmarks of an imminent financial bubble and/or a debt crisis is the rapid accumulation of debt. McMahon writes, “...in the 1990s, [Beijing] banned local governments from borrowing money. Yet local governments have been getting around that rule for almost 20 years by setting up companies [called local government financing vehicles, or LGFVs] that borrow on their behalf....LGFVs really took off in 2008, when Beijing turned a blind eye in the interest of stimulating the economy.”

“...there are more than 10,000 LGFVs across the country, owned by provinces, cities, prefectures and counties. Many are incredibly opaque and massively indebted. In 2015...Beijing overturned the moratorium on local governments' directly borrowing, allowing some to sell bonds [but] imposing hard caps on how much local authorities could borrow, both directly and indirectly. But by mid-2017, it was clear that local government had continued to balloon, as local authorities came up with new ways to evade the caps and avoid Beijing's oversight.”

“Even worse, China's cities and towns have amassed a mountain of debt in near-record time. At the end of 2008, China's local governments owed about 5.6 trillion yuan. Eight years later, the amount had tripled to 16.2 trillion, or $2.5 trillion. True, that's less than the $3.1 trillion of debt that U.S. states and local governments are responsible for, but the U.S. economy is almost 50% larger than China's, and American governments have spent 200 years building up to that level. Many of China's local governments simply don't have the resources to repay what they've borrowed."

"Since 2009, the China Banking Regulatory Commission has been in a constant game of whack-a-mole with the banks. No sooner does it clamp down on one aspect of shadow banking than the banks come up with another way to get around the various quotas and other restrictions aimed at controlling credit growth. Shadow banking has weakened Beijing's control of the economy by allowing banks to lend far in excess of what regulators deem prudent. The banks have deliberately designed shadow banking to be as opaque as possible, because they have no interest in Beijing's being able to work out just how much new credit they've created.

"For those companies which don't have collateral, banks have been willing to accept third-party guarantees--if the borrower can't repay the loan, then some other company promises to repay in its stead....Sometimes local government-owned state firms guarantee local private companies....And sometimes unrelated private companies guarantee each other....rather than protecting the banks, guarantees are spreading financial distress, turning what would otherwise have been isolated defaults into localized crises as the complex networks of interlocking mutual guarantees fall like dominoes. So far, such crises have remained local, but the potential for guarantee networks to spread contagion more widely lurks as an ever-present threat."

"...the safety net the financial system has constructed for itself relies heavily on the government's standing by two implicit guarantees: that it will continue to ensure fast economic growth, and that housing prices will remain buoyant. As long as housing prices are rising, financial institutions can continue lending, with the knowledge that their collateral is gold plated....[and] as long as growth remains strong, there's little need for collateral or third-party guarantees."

McMahon describes the explosion of the shadow banking industry despite slowing growth: "There has also been an explosion in the number of fringe financial companies—the sort that can be set up with few regulatory hurdles—in recent years. At the end of 2015, China had more than 7,100 leasing companies, 2,600 more than the year before and an eleven-fold increase from when the economy first started slowing, in 2012. There were 4,500 P2P platforms at the end of 2016, up from only 200 when the economy started slowing four years earlier. Meanwhile, the outstanding volume of wealth-management products increased by 56% in 2015 and by about 20% in 2016. 'Today everyone is playing in finance—state firms, private firms, everyone'."

As always, new skyscrapers are the final warning sign. "Throughout history, construction of the tallest skyscraper in the world has been synonymous with the imminent onset of economic crises, an association that goes back to 1873....[but] the construction of multiple skyscrapers all at once is an even better predictor. At the time of this writing [the book was published in 2018], China was building 25 skyscrapers taller than the Empire State Building. And of the 100 tallest buildings under construction anywhere in the world, 55 were in China. China is in the midst of an epic, nationwide skyscraper-construction boom....[However,] slower growth is starting to expose a multitude of sins....Slower growth exposes the waste, mismanagement, hubris, and fraud that remained hidden during the good times."

For years, China's top officials and economists have been well aware of the potential this has to cause a financial crisis. One of China's most influential economists wrote, "If the land markets cool, land prices drop and the volume of land sales fall...it will likely produce financial crises." Another Chinese economist and former top official said, "Local government debt is our subprime. Banks give loans to local governments that don't meet lending standards, the local governments then have trouble repaying the debt, and the banks...end up with bad loans." In 2015, a top budget official wrote, "Debt repayment pressure on some local government debt is massive, and is a hidden danger. If we let debt risks continue to accumulate, they will be bound to transmit to the financial world, triggering systemic financial risk." And in 2017, "Xi Jinping said that local government borrowing was one of the financial system's two great vulnerabilities (the other was the debt at state-owned firms)."

Interestingly, most Chinese investors expect to get bailed out by the government if they lose money on an investment. This expectation is due to a bailout culture in China in which state firms and local governments routinely get bailed out by state banks or the central government. And everyone knows how desperate the CCP and central government are to prevent demonstrations and discontent. "Protests over failed investments in China are increasingly common....you regularly see small groups of people outside city halls or the offices of local financial regulators, waving banners demanding the return of money earned from their 'blood and sweat'."

McMahon concludes, "...even if property prices fall, everyone assumes that Beijing will ultimately step in to bail out the financial system if need be. [***This is the mother of all moral hazards.***] However, the massive volume of bank lending, compounded by the complexity and size of shadow banking, increasingly casts that assumption into doubt. Beijing's ability to not only maintain fast growth and support housing prices but also to manage a successful system-wide bailout is looking increasingly fragile—much like the financial system itself."

When the Internet came along, I concluded that the CCP would never be able to survive it. Thanks in part to its Great Firewall, it has managed to survive thus far. But if there's a black swan that almost no one sees coming, it's the death of the CCP due to the collapse of China's financial system and economy.

What You Should Be Doing Now

1. With supply chains under stress and Americans quitting jobs at record rates, continue to accumulate food with a long shelf life.

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Generally, I don't have time to answer questions about your specific situation, but if you have a general question that I think other readers also have, let me know and I will provide an answer in a future issue.

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Before starting a new diet or exercise regimen, you should consult with a doctor, nutritionist, dietician, or personal trainer.