

The Chinese Black Swan

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Party rulers in China are trapped in a position that chess players deeply fear — zugzwang — where any move made puts you at disadvantage. In China, the cost of both action and inaction is potential economic collapse.

China is slowly starting to face the consequences of its actions — loans grew over 30% a year over the last few years — and inflation is rising fast. Inflation in developed countries is unpleasant, but it is tolerable. For a developing country — and China, despite its size, is still a developing country — it can be catastrophic. In developed countries, we spend two or three times less on food as a percentage of our income as people do in developing countries. Therefore, though food inflation is unpleasant, we have a much greater tolerance (margin of safety) for it. While food inflation the US can mean fewer trips to restaurants or no summer vacation, food inflation in China leads to hunger.



The Chinese government is desperately trying to put the brakes on the economy. It is shutting off lending to land developers and has raised bank reserve requirements five times this year. However, its success on the inflation front will likely lead to a slowdown of the economy and high unemployment. Ironically, those were the issues party planners tried to cure when they stimulated the hell out of the economy over the last few years.

China bulls are arguing that the almighty Chinese government will be able to soft-land the economy. Unlikely, I'd say. Forced lending was at the core of Chinese economic growth. Simply put, there is too much debt to go bad. According to [Ernst and Young](#), one third of the \$700 billion in loans taken out by local governments may face repayment problems. The People Bank of China estimates that Chinese banks' exposure to local government loans is 14 trillion yuan (or \$2.2 trillion), according to the June 17 South China Morning Post. Once lending is cut off, property prices will stop appreciating (and likely collapse — that is what usually happens in a Ponzi scheme). Also, the overcapacity in the industrial sector and commercial real estate will come to the surface. And suddenly everyone will discover that the venerable emperor has no clothes.

I often hear the argument that China will not have a real estate crisis of US proportions because home and condo owners have to put 30-40% down when they buy. So where do people get the money to buy a house that costs, on average, 8 times their annual income (a figure several times higher than in the US)? Some of it comes from savings, and some comes from borrowing from relatives.

Let's pause for a second. In the 1990s, the Chinese banking system basically collapsed. To revive it, the Chinese government took bad loans from banks' balance sheets and put them into off-balance-sheet vehicles (Enron would be proud of that financial ingenuity). Banks started to func-



tion as though nothing had happened. To finance the off-balance-sheet assets, the government set deposit interest rates at very low levels: 1% or so. In a country with a very high savings rate and 5% inflation, this resulted in a 4% annual loss of purchasing power.

Chinese consumers were punished severely over the last 10 years for the banking crisis of the late '90s. And they'll be punished even more soon. Keeping money in the bank didn't make that much sense, and investment alternatives were limited. However, they could invest in an asset that supposedly never declines in price – a house or condo. So they did. As China slams the brakes on the economy and as housing prices fall, the banks will lose plenty of money. But more importantly, it is the people who bought tremendously overpriced houses, and their relatives who lent them money, who will lose. The wealth and hard work of more than one generation will be lost, and this kind of pain leads to political unrest. That is the Chinese Black Swan!

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