THE NATIONAL INVESTOR

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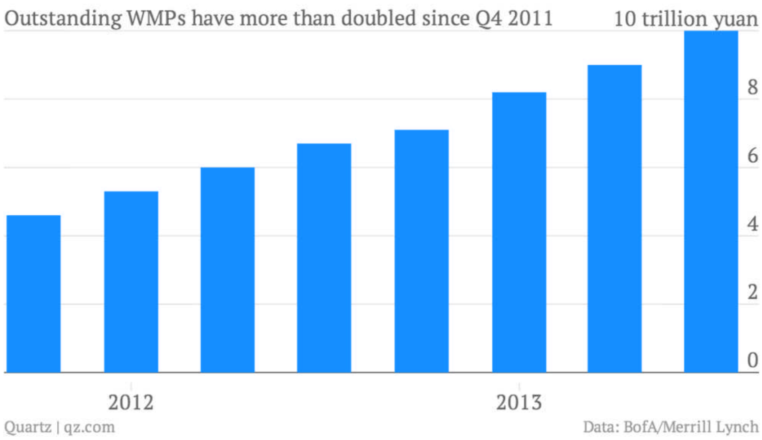
March 25, 2014 “For where your treasure is, there will your heart be also.”—Matthew 6:21 **Vol. No. 19 - 6**

(The below is an excerpt from the 2nd regular issue of *The National Investor* for March, 2014.)

ITEM: China tries to manage a "controlled explosion"

The recent past has given us the sharpest decline in the value of the Chinese yuan in 20 years. Economic growth is slowing, if not contracting. Non-performing loans have increased and, recently, some parties have been allowed to default on obligations. "Fire sales" of assets have been increasing. In an attempt to counter all this, Chinese officials are talking of *new* stimulus measures they may be rolling out to, in part, add even more to the nation's housing stock, commercial property and infrastructure (never mind that much of what they already have built in recent years remains unused/uninhabited.)

Add this all together and you have what David Pilling, *Financial Times* Asia Editor, recently described as a fairly deliberate and necessary "controlled explosion." China's leadership knows it needs to take some of the steam out of what has been a runaway credit-creation binge, especially on the part of its shadow banking system. That, in turn, has been inflated due to demand from the country's various wealth management products, or WMP's. They are part retail product for the wealthier Chinese, part hedge fund, and part shadow bank themselves. Much in the same way that similar funds here in the U.S. to a great extent created and then fed the runaway mortgage/housing boom here, these WMP's have driven the increasingly risky bubbles in China.



Already, though, allowing just a couple entities to go belly up has others scrambling to get liquid, or otherwise at least a bit less leveraged and vulnerable. As Ambrose Evans-Pritchard reported a few days ago in London's *Telegraph*, there have been reports of "fire sales" of property by Chinese investors; one example had prices in Hong Kong being slashed by 20% almost overnight to bring about quick sales. Now--on top of the solar company that defaulted a couple weeks ago--there has been the report of a real estate-related entity going bust: the collapse of Zhejiang Xingrun, with $570m of outstanding debts.

Pilling's analogy of China trying to manage a "controlled explosion" is quite apt. No doubt most of you have seen videos in the past of controlled demolitions of buildings. If the engineers and explosive experts know what they are doing, the building they *want* to destroy comes down without affecting any buildings nearby. Sure, there's a mess to clean up; but not such a big one as would happen if other buildings are damaged by the falling debris.

China clearly knows it must rein in the shadow banks and WMP's, and has started to do so. It also knows that allowing some of the more reckless of these "buildings" to fall must be orchestrated in such a way as to limit the damage. To that end, the government is making noise anew about *more* new stimulus and spending on infrastructure and residential property. With the weakening of the yuan, this will theoretically cushion the blows and reduce the chances that finally letting some air out of *existing* bubbles will spread to a broader, full-blown credit crisis/debt implosion.

I have pointed out many times--and should do so again here--that China *does* have one big advantage in its favor that could make all this work out without triggering a financial disaster. Unlike in the U.S. and most everywhere else, where the central banks are chiefly in charge and the governments are pretty much owned by and respond to *them*, it's the opposite in China. There, the People's Bank of China is an arm of the government, *and instructed by it.* So among other things, it really is easier for Chinese officials in their "command economy" to manage things, including when it comes to this latest attempt at the so-called "controlled explosion."

None the less, as I have also said, this doesn't mean that China is immune to the simple laws of mathematics. This remains a risky proposition which, properly, has recalibrated expectations over Chinese-driven global growth. And, Chinese leaders' belated good intentions aside, it keeps ever before us the possibility that any one of these "weak links" could end up breaking the whole *global* leveraged chain of burdensome, unsustainable debt.