

BIENVILLE MACRO REVIEW

China's Dangerous Game - An Update

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CHINA'S DANGEROUS GAME - UPDATE

Summary

In *China's Dangerous Game* (February 2012), we highlighted China's domestic imbalances and their implications for a highly-interconnected global economy. In *China's Paradox* (October 2012), we reviewed the structural challenges inhibiting a necessary rebalancing of growth to a more sustainable model. Collectively, we suggested market participants may be underestimating the likelihood of a material slowdown in China's growth rate. With the recent collapse in export growth and the disruptions in the interbank market, China has now moved to the forefront of investors' minds.

- China's economy cannot be viewed in isolation. Its transition from export-oriented to investment-led growth combined with its size has affected the entire globe, resulting in trade deficits in the domestic world and a commodity boom in resource-rich countries. China's inevitable transition to more domestic demand represents a profound shift in the global economy
- Because the world as a whole is a closed system, China's enormous trade surpluses manifested as trade deficits in the West, most notably in the U.S. prior to the recent crisis. China's previous unwillingness to rebalance to a consumption-based model, reducing dependence on external demand, was in direct opposition to the need of the U.S. to shrink its external deficits
- Despite the ongoing debate over the wisdom and efficacy of unconventional policy in the U.S., QE created inflation in China and has arguably assisted the U.S. in reducing its trade deficit, a necessary condition for more balanced growth
- China's quasi-peg to the USD resulted a de facto currency bloc, linking two highly dissimilar countries (a slow growing, over-levered developed economy with a rapidly rising, low-income emerging market). To prevent a more rapid nominal appreciation of the currency over the past few years, the PBOC intervened by printing domestic currency. The result has been inflationary, driving up wages
- Since 2005, China's real effective exchange rate has appreciated by over 70%, representing a material loss in competitiveness. Export growth has since collapsed and other surveys are suggesting continued slowing. Aggressive monetary policy in Japan that has recently weakened the yen could aggravate the situation



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- Despite an exorbitant level of domestic savings, fixed asset investment—the leading driver of growth—has been funded with copious amounts of credit, facilitated in part by the interbank market. Recent stress will result in a credit tightening, likely slowing domestic contributions to growth further.
- Thus far in 2013, China has experienced 9.1 trillion yuan in new credit growth, which is above target. The increase in the money supply (M2) is also currently running above target. So although the PBOC has tools to alleviate some of the liquidity pressures in the interbank market, doing so may encourage lending far beyond these targets, exacerbating the issues the PBOC is now fighting
- Sources have suggested the desire of Chinese policymakers to engineer a form of ‘controlled chaos’ in 2013 in order to reign in previous excesses, reduce moral hazard and emphasize the quality of growth (i.e., ‘rebalancing’). Recent policy statements and various anecdotes seem to confirm this view
- Although commendable and necessary, this strategy is also dangerous. Engineering a ‘soft landing’ with an opaque and highly-leveraged banking system is prone to policy error. Recent history has demonstrated that policymakers are more successful at changing the direction of certain variables (i.e., credit growth) than controlling the magnitude of them
- Should export growth continue to slow, triggering an increase in unemployment, the authorities may be tempted to regain competitiveness through a weaker currency. This could be easily achieved by opening the capital account, allowing domestic Chinese capital to flow out of the country to areas where returns are higher. Leadership has already stated their intent to open the capital account



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As noted previously, China's economy is deeply imbalanced, relying on an extraordinary amount of fixed asset investment to sustain predetermined rates of growth...

Exports and Investment represent nearly 80% of growth...

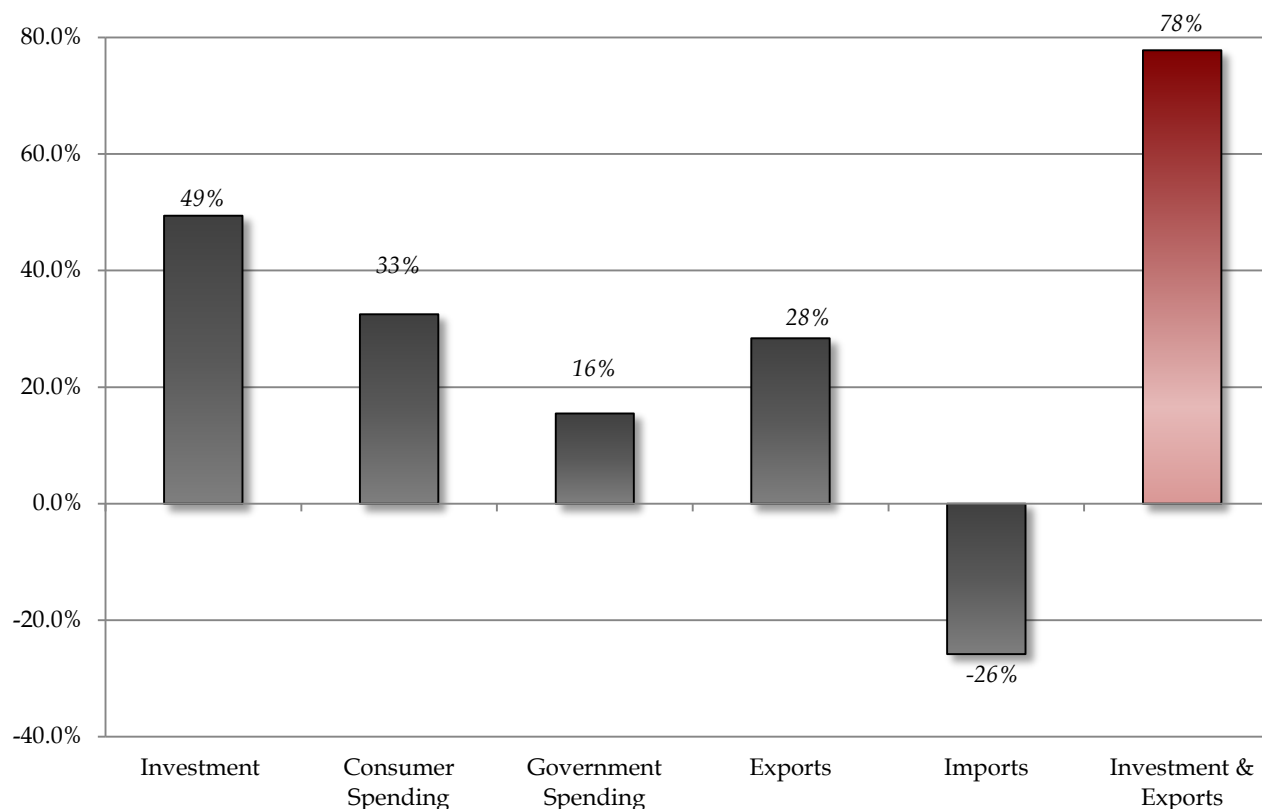
...as both slow, consumption cannot rise fast enough to prevent overall growth from decelerating

Household consumption in China is low because household incomes are low. Shifting this distribution requires both political will and time

The purpose of investment is to provide the productive capacity and infrastructure for exports and consumption

Investment needs to slow to approximately 35%, a decline of 15% of GDP

Composition of China's GDP (2011)



Source: IMF; Lombard Street Research; Bienville Capital Management

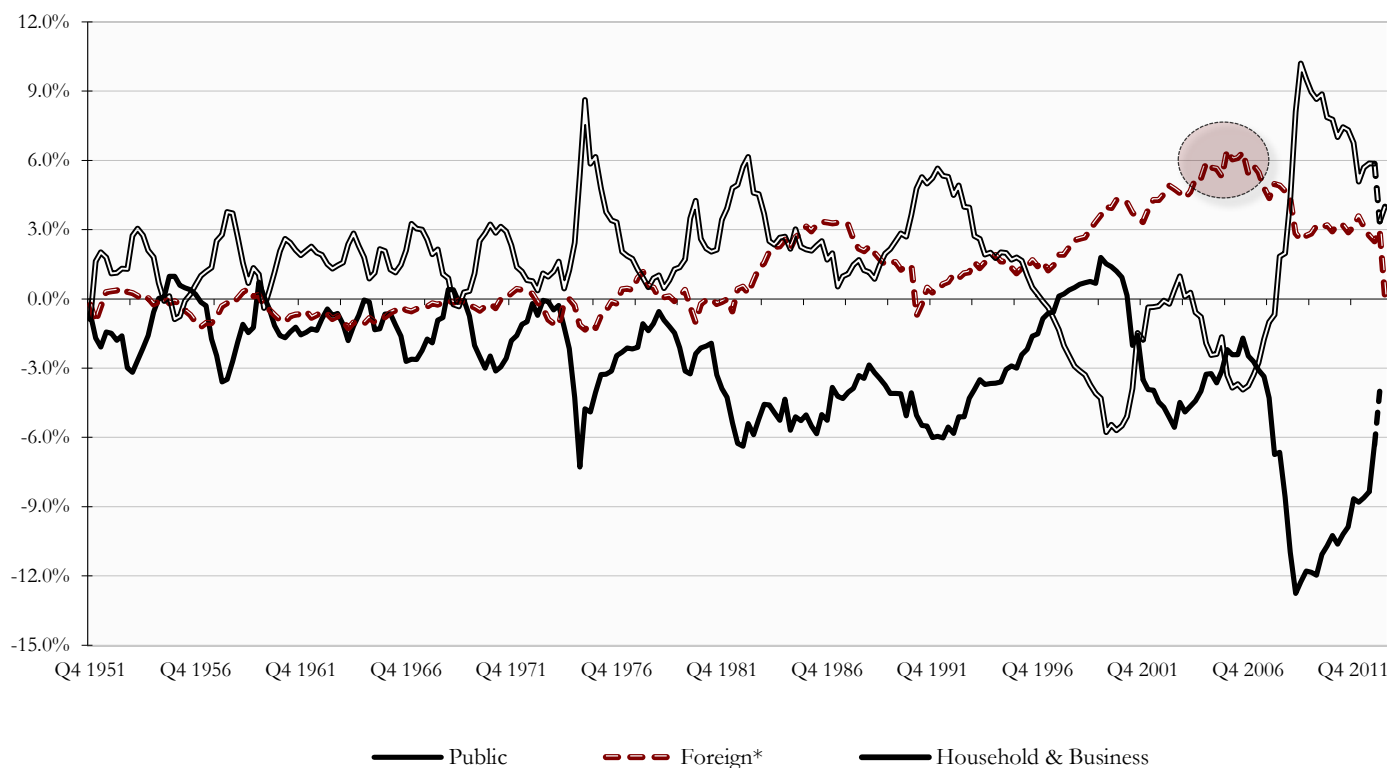


**Any financial indicators or benchmarks shown are for illustrative and/or comparative purposes only. Certain information has been provided by and/or is based on third party sources and, although believed to be reliable, such information has not been independently verified and its accuracy, timeliness or completeness cannot be guaranteed.*

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China's imbalanced growth – previously heavily reliant on exports and trade surpluses – manifested as trade deficits in the U.S. The U.S.'s current account deficit peaked at 6% of GDP, an alarming level...

U.S. Flow of Funds by Sector
(as % of GDP)



Source: IMF

By looking at the flows among sectors of the U.S. economy, theoretically, the U.S. should have tightened fiscal policy and devalued its currency against China (and other surplus countries)

But because of China's quasi-peg to the USD, the U.S. couldn't devalue. However, QE provided virtually the same effect



CHINA'S DANGEROUS GAME - UPDATE

In Q1 2007, the current account deficit of the U.S. was at an alarming level, nearly 6.0% of GDP...

During the financial crisis, while the public sector borrowed to provide temporary demand, QE served an underappreciated role: it inflated China...

The money printed via QE flowed 'downhill' to the undervalued portion of the quasi-currency bloc to China, inflating wages and unit labor costs. Since, the U.S. has moved back towards trade balance

The national accounting identity ensures that all financial flows in an economy sum to zero. Therefore, one sector's financial balance cannot be analyzed in isolation as its effects will be felt elsewhere...

- When the U.S. public sector is in deficit, as it has been, annual flows to finance the deficit must come from the private sector and/or the foreign account (i.e., the inverse of the current account)
- Leading up to the crisis, the private sector over-levered. Following the crisis, the government sector levered, or borrowed, in order to provide demand for the economy, while the private sector reduced demand in order to repair balance sheets
- To eventually achieve a more sustainable balance, both the public sector and private sector needed to de-lever. However, they could not do so simultaneously unless the foreign account moved towards balance, meaning the current account improved
- This dynamic strongly suggested a negative outcome for China and other surplus countries, including many emerging markets reliant on external demand (refusing to adjust their economies post-financial crisis)

U.S. Sector Financial Balances	Public	+	Private	+	Foreign Account	=	0.0%
Q1 2007 Balances	-2.5%	+	-3.3%	+	5.8%	=	0.0%
Q2 2009 Balances	-12.8%	+	10.2%	+	2.6%	=	0.0%
Current	-6.3%	+	3.4%	+	3.0%	=	0.0%
Sustainable	-4.0%	+	4.0%	+	0.0%	=	0.0%

Source: IMF

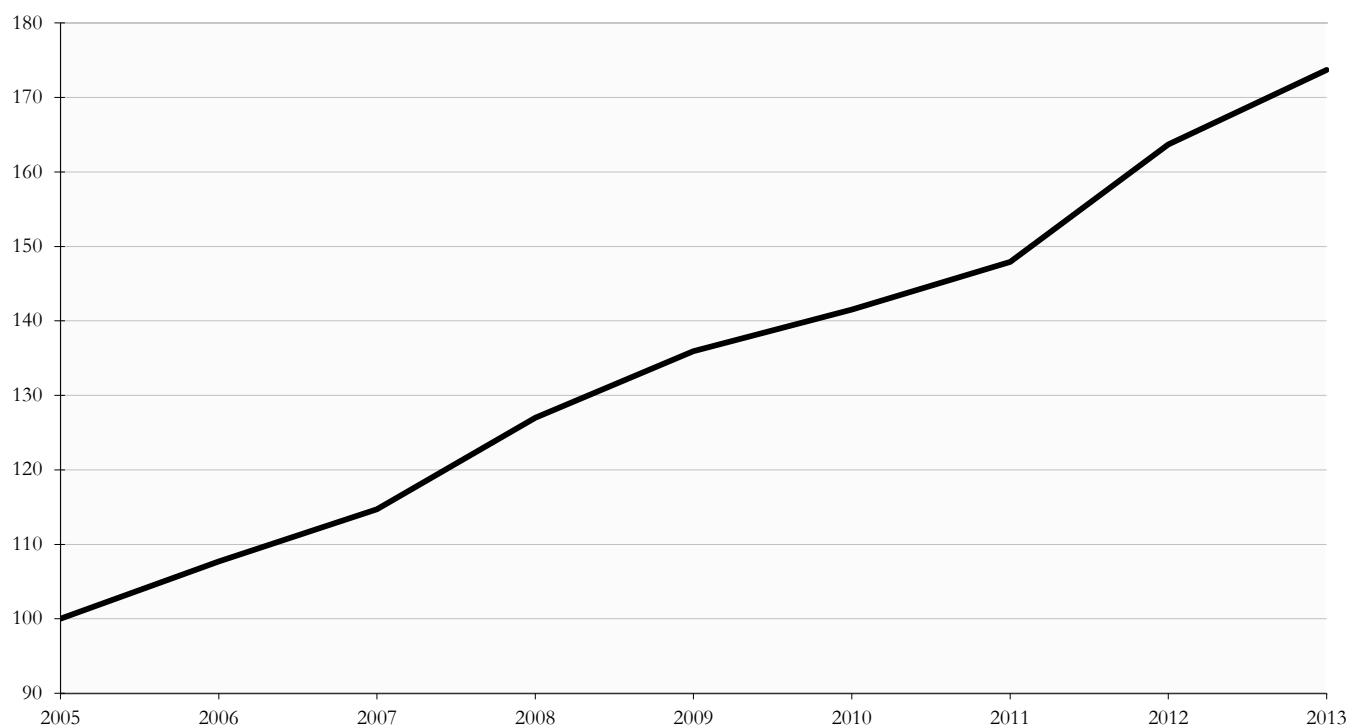


CHINA'S DANGEROUS GAME - UPDATE

In dollar terms, Chinese unit labor costs have been rising by 11% annualized since 2005

China's real exchange rate, which accounts for the nominal appreciation of the currency and the relative change in unit labor costs, has risen by over 70% since 2005 – the starting point of the crawling peg – representing a considerable loss of competitiveness...

China Real Effective Exchange Rate
(in USD)



Source: OECD; Lombard Street Research



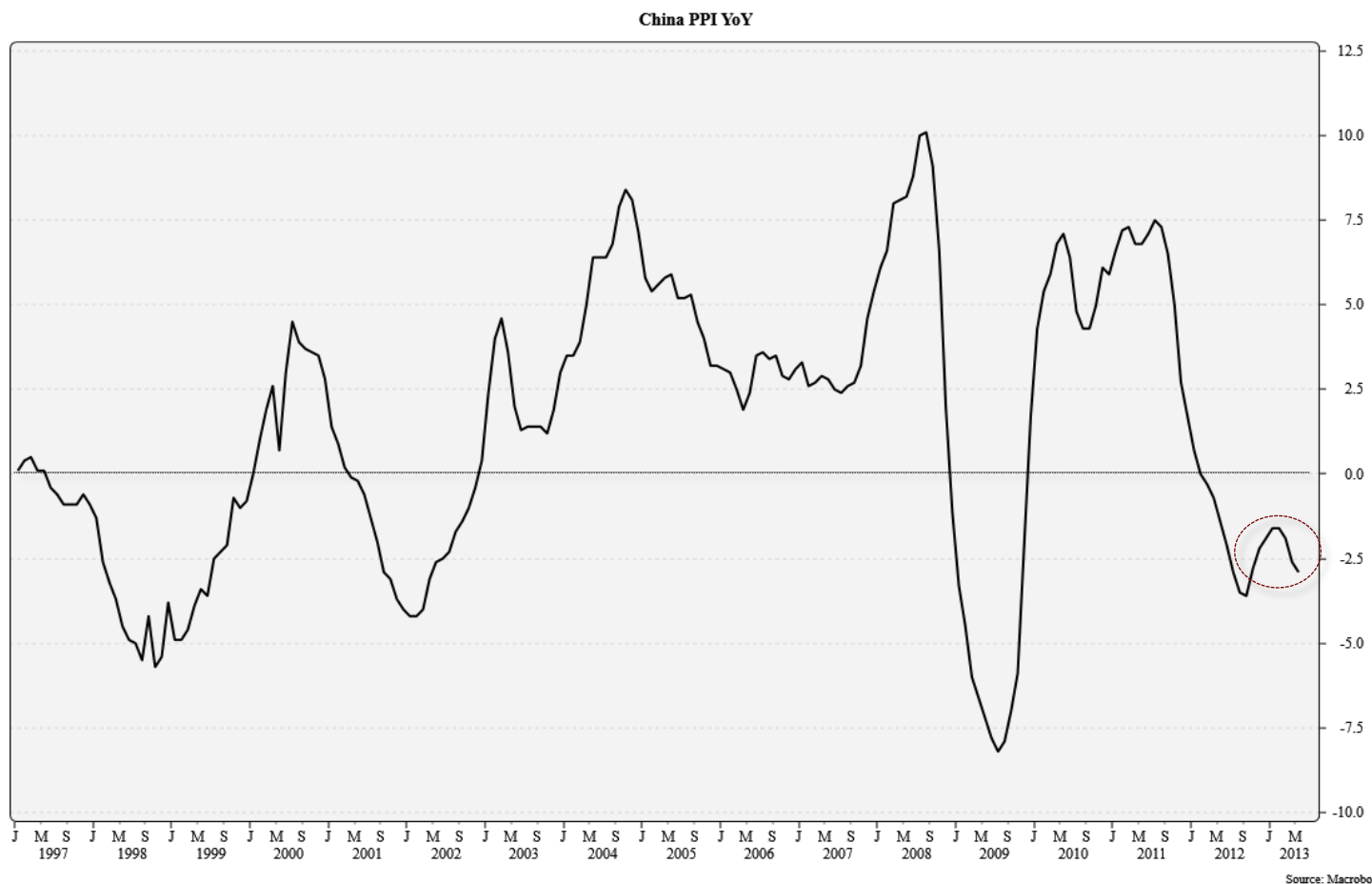
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China may be further pressured by its recent loss of competitiveness versus Japan...



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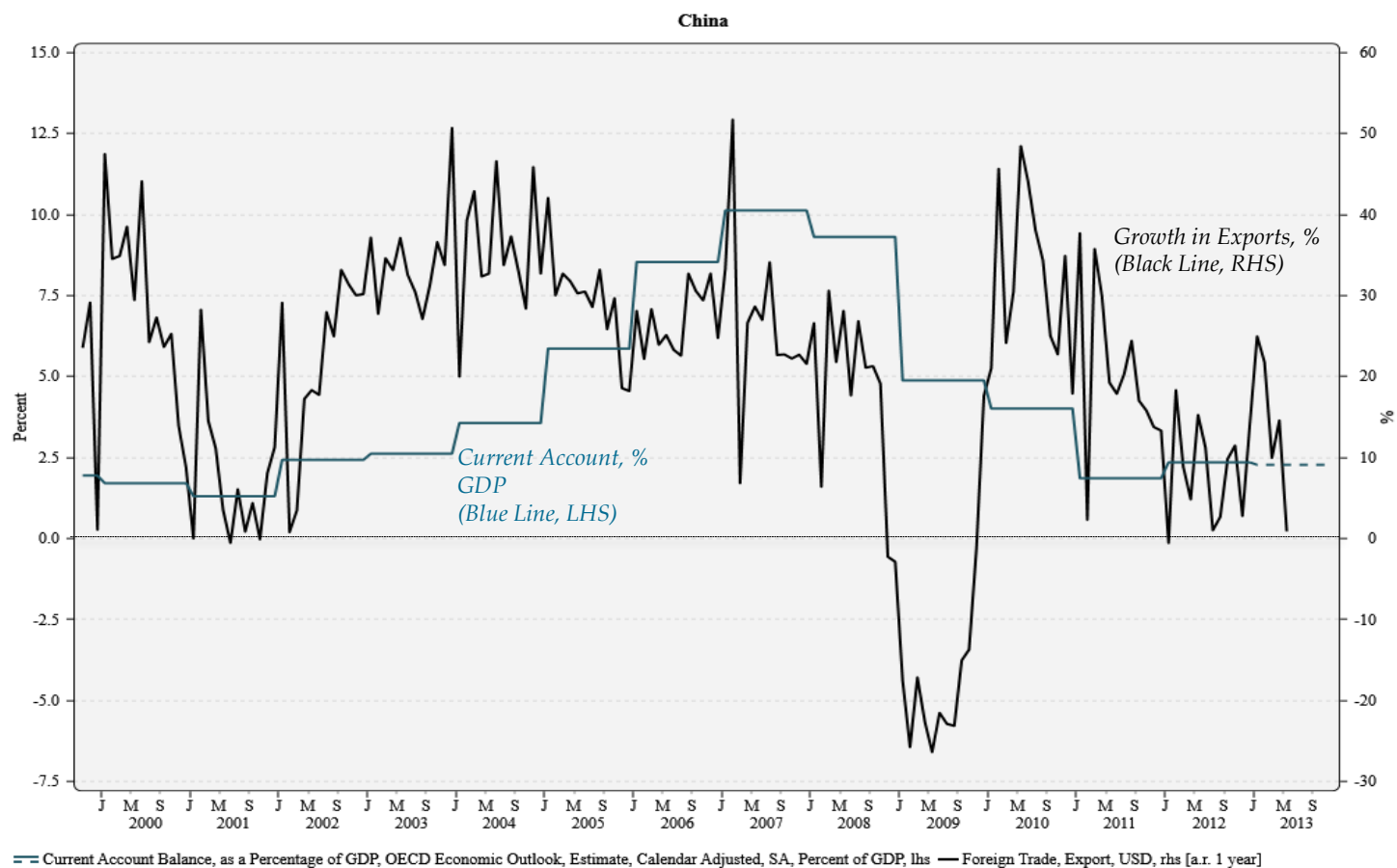
As China has lost competitiveness, producer prices have continued to deflate. With wages rising and the PPI in deflation, profits are under intense pressure, reducing the incentive to invest...



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Export growth, representing 30% to total demand in China, has stalled. The current account surplus has declined from over 10% of GDP to around 2.5%...

Given the strong correlation between China's export orders and its current account surplus, it is possible that China may soon run a current account deficit



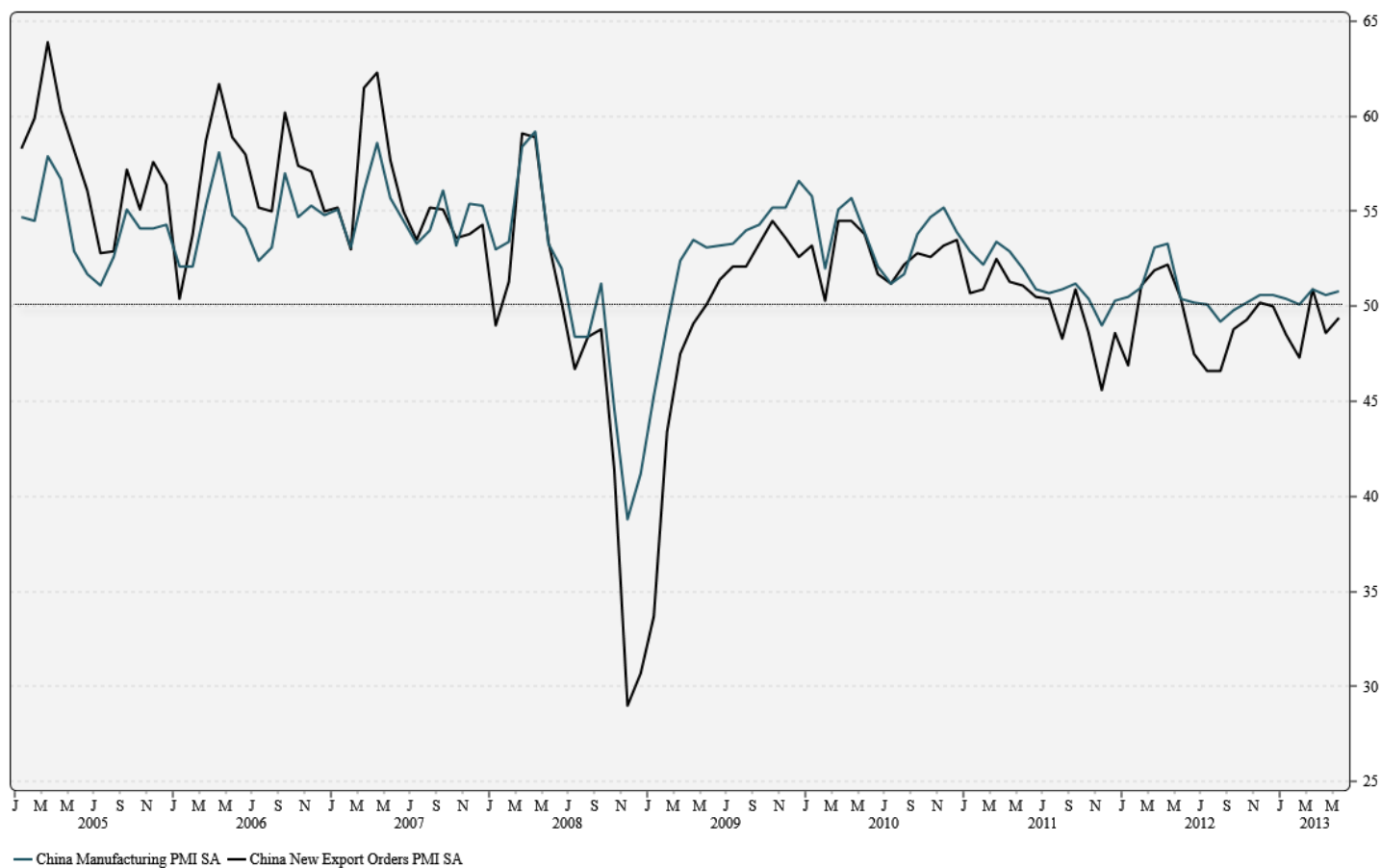
Source: Macrobond



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Additionally, the Chinese Purchasing Manager Index (PMI) surveys have been at or near contraction since 2011. In June, the export component fell to 44...

The overall PMI data has been poor, with a continued decline in manufacturing activity and weak export order numbers



Source: Macrobond

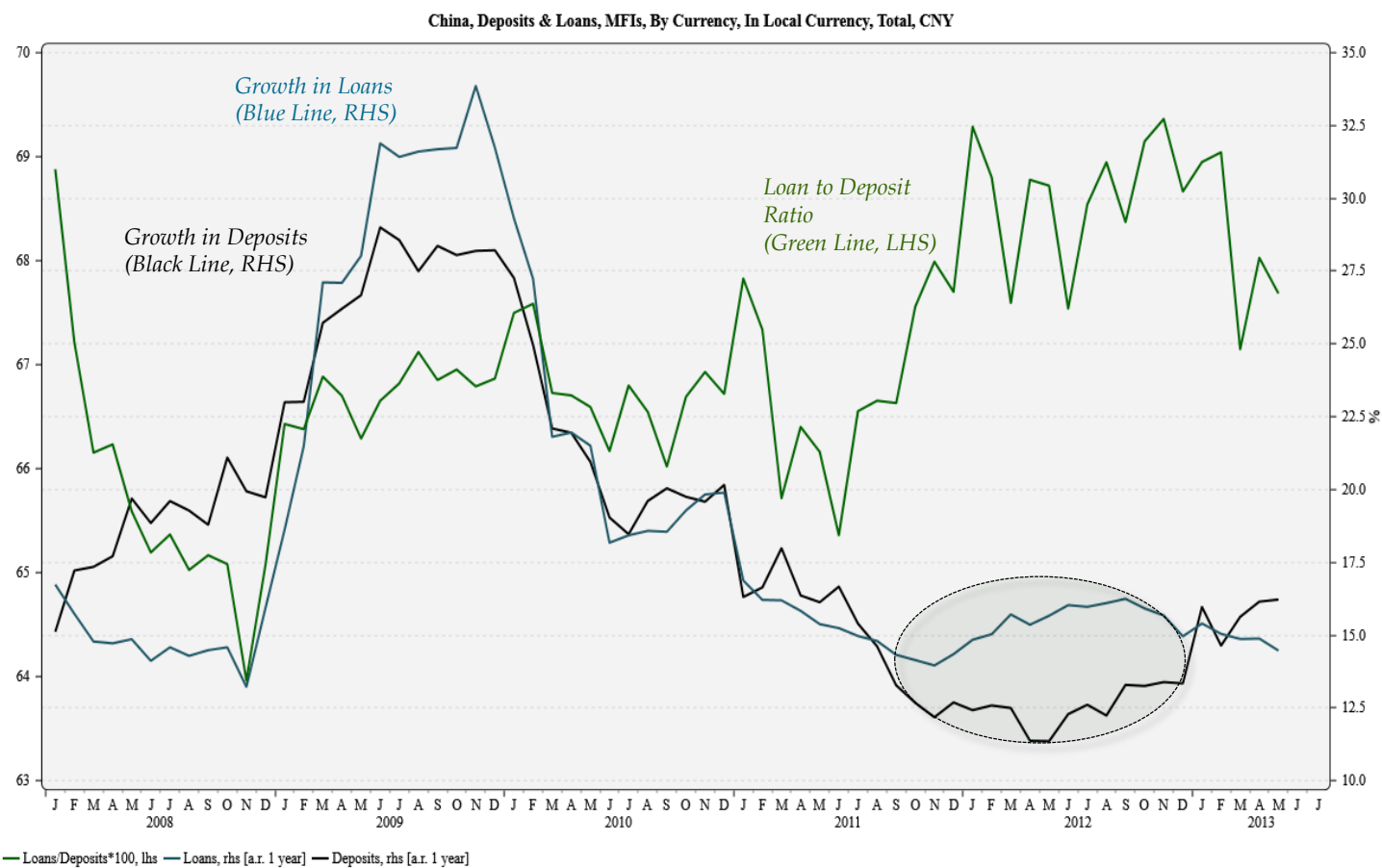


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For several years, strong lending growth exceeded deposit growth. Although lending drove investment and therefore overall GDP, it also left the banking system tight on liquidity...

The Chinese banks are mostly deposit financed, and grew loans faster than their funding sources (i.e., deposits) for several years...

The banks face a 70% loan-to-deposit ratio cap, which was reached in 2012, forcing them to eventually slow loan growth



Source: Macrobond



CHINA'S DANGEROUS GAME - UPDATE

SHIBOR rates reflect the cost of banks' borrowing from other banks...

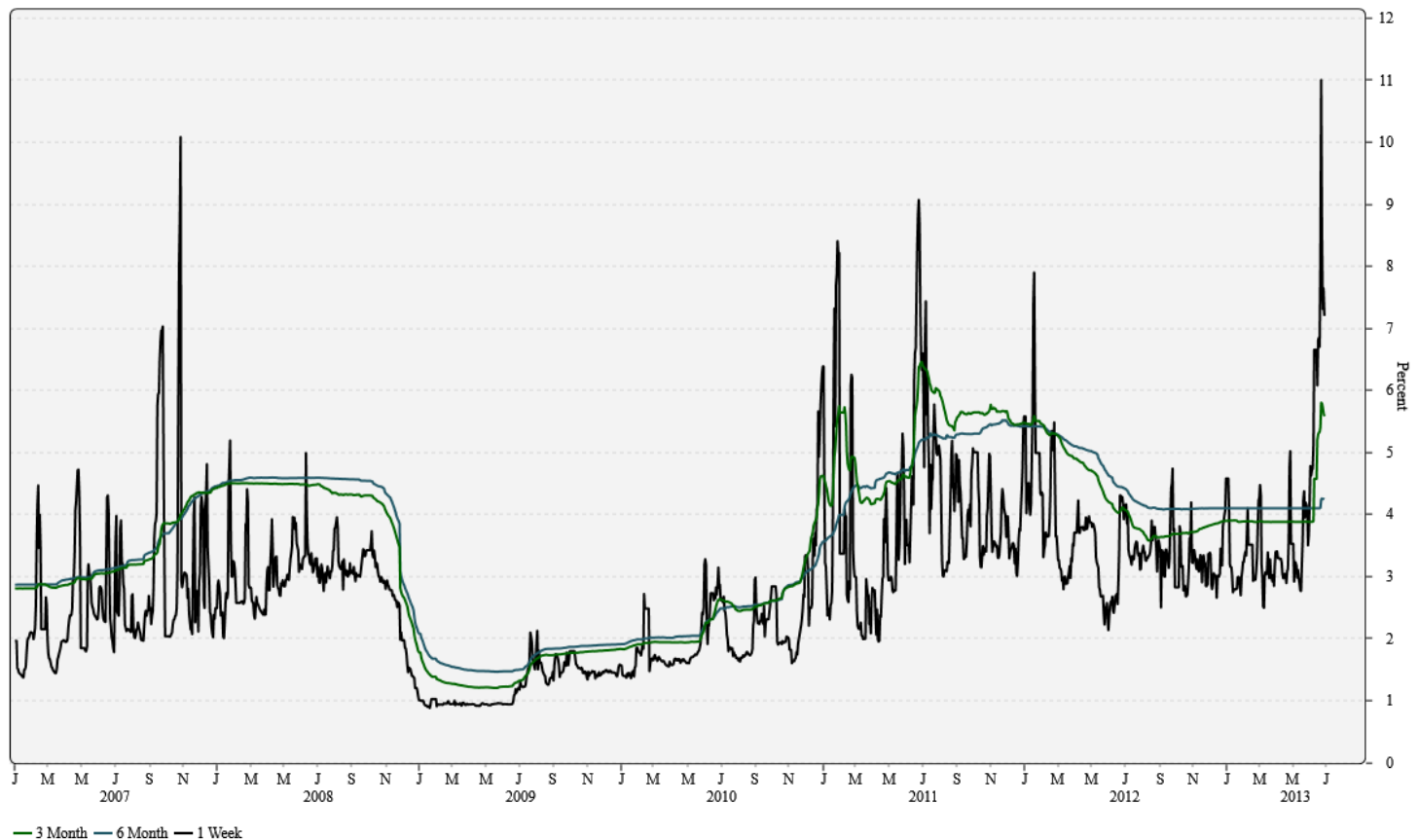
The default of a loan by Everbright, along with the PBOC's decision not to intervene, caused this spike

Because nonperforming loans are often rolled over, the interbank market is a better measure of stress within China's banking system than stated NPLs

Since 2008, interbank assets have risen from 9 trillion yuan to 31 trillion yuan

Recently, SHIBOR interbank rates spiked to their highest levels in several years, indicating severe liquidity stress in China's banking system. In contrast to previous episodes of stress, the recent spike was met with silence from the PBOC. It is now clear that the PBOC intends to discipline banks for poor lending decisions...

China, Interbank Rates, SHIBOR, Fixing



Source: Macrobond



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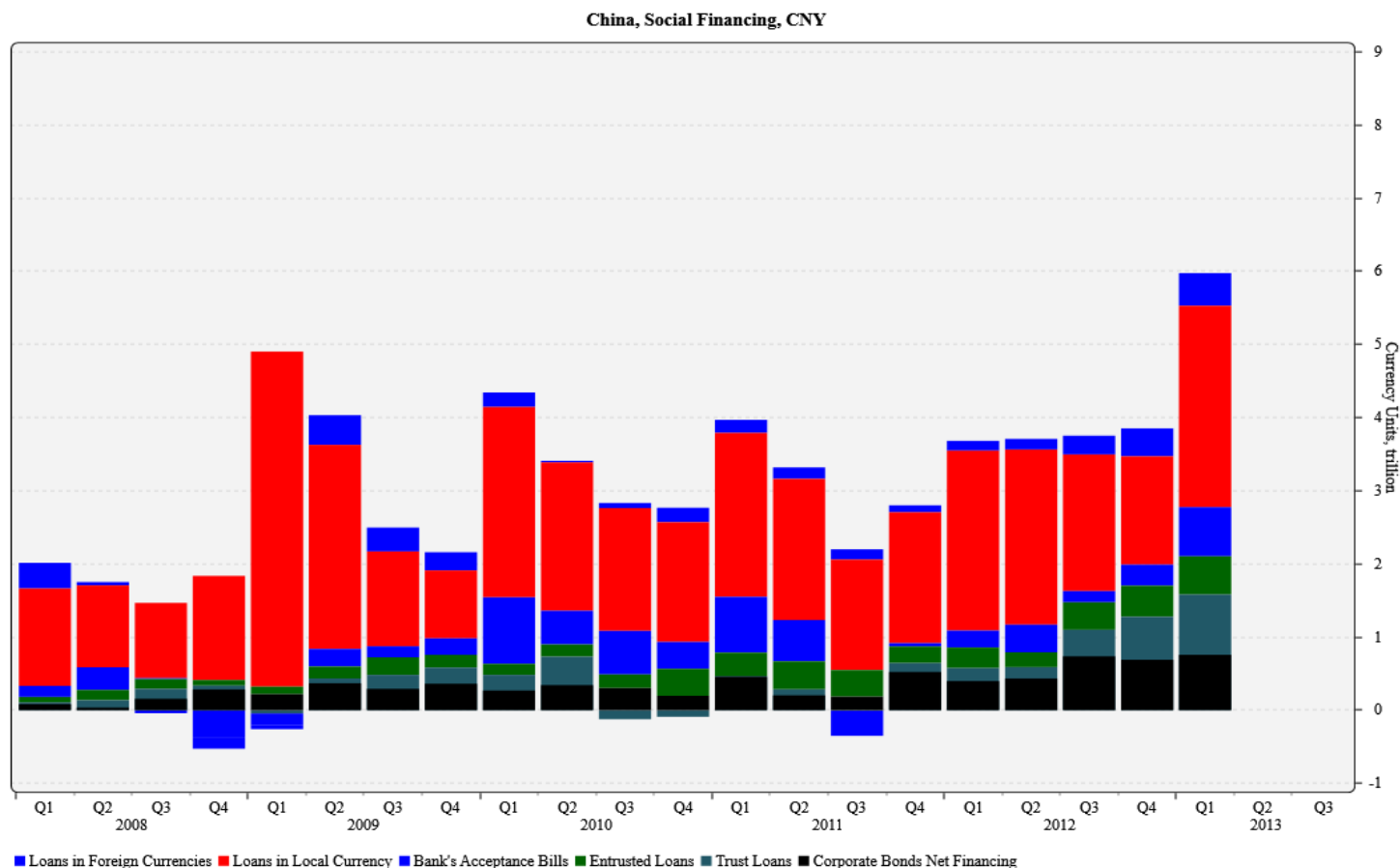
Increasingly, the growth in credit is coming not from bank loans, but from 'shadow' sources such as trusts products and banker's acceptances, where underlying collateral is questionable...

These products face even shakier funding than the banks, as they have to access it on the market

Thus far in 2013, China has experienced 9.1 trillion in new credit growth, above target

The increase in the money supply (M2) is also currently running above target. So, although the PBOC has tools to alleviate some of the liquidity pressures, doing so may encourage lending far beyond these targets, exacerbating the issues the PBOC is now fighting

Overall credit growth, or Total Social Financing, has been strong, with an enormous push in the first quarter. Nonetheless, overall economic growth has slowed, an ominous sign suggesting China has exhausted its ability to grow via credit-driven investment...



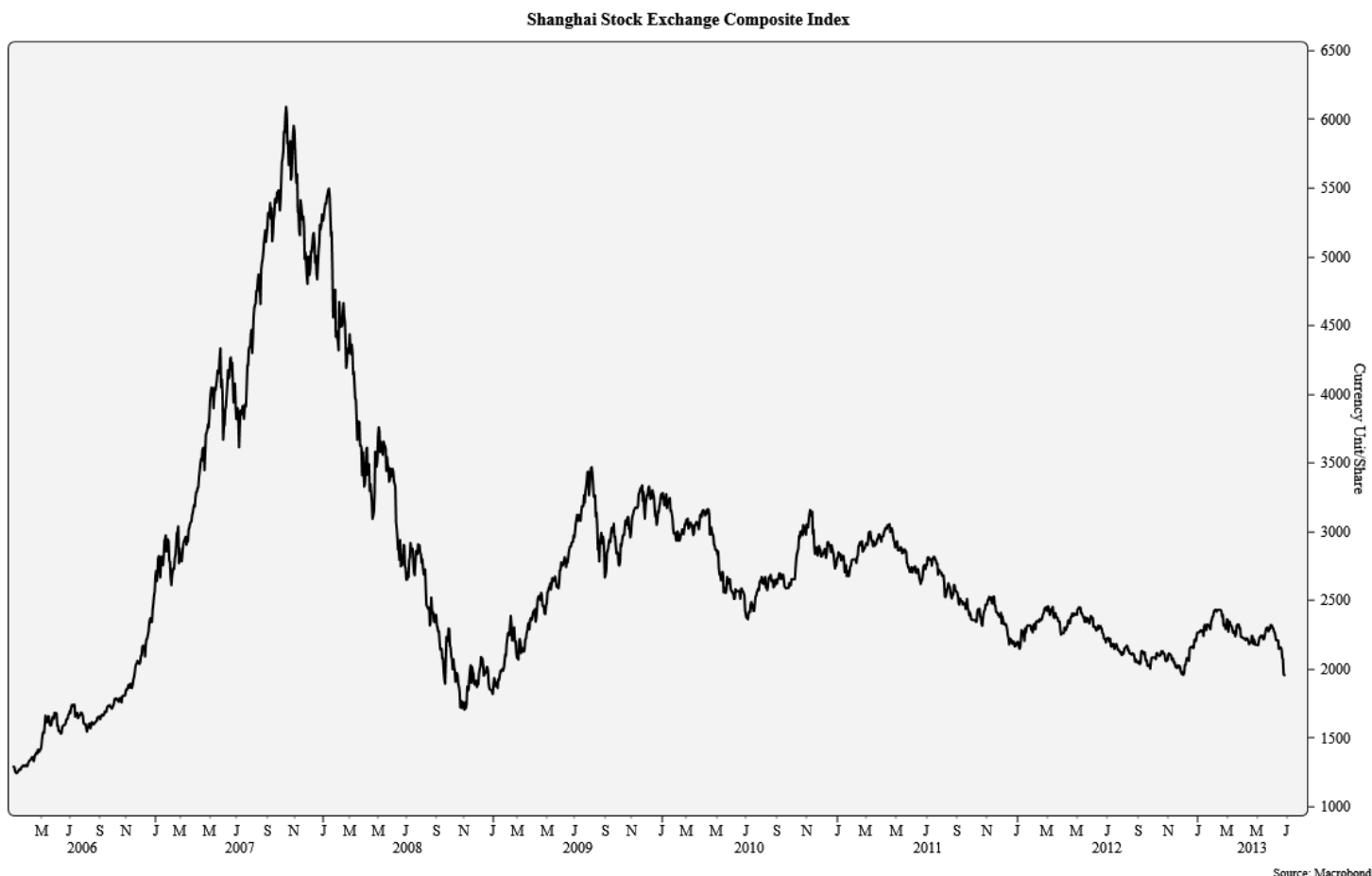
Source: Macrobond



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Despite the credit boom, the stock market had continued to perform poorly, declining in 2012 and again in 2013...

The local Shanghai market is an excellent barometer of excess liquidity in the system, and its poor performance reflects the slowing growth and tighter liquidity of the Chinese economy



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