The China Bubble's Coming -- But Not the One You Think

Forget about a Shanghai stock bubble. The whole Chinese economy's getting ready to burst.

BY VITALIY KATSENELSON | JULY 23, 2009

Financial commentators are obsessively debating whether the recent rise in the Chinese stock market means there's a bubble -- and if so, when it's going to burst.

My take? Who cares! What happens to the broader Chinese economy is what we should really be watching. It will have a far-reaching impact on the rest of the world -- much more far-reaching than a decline in stocks.

Despite everything, the Chinese economy has shown incredible resilience recently. Although its biggest customers -- the United States and Europe -- are struggling (to say the least) and its exports are down more than 20 percent, China is still spitting out economic growth numbers as if there weren't a worry in the world. The most recent estimate put annual growth at nearly 8 percent.

Is the Chinese economy operating in a different economic reality? Will it continue to grow, no matter what the global economy is doing?

The answer to both questions is no. China's fortunes over the past decade are reminiscent of Lucent Technologies in the 1990s. Lucent sold computer equipment to dot-coms. At first, its growth was natural, the result of selling goods to traditional, cash-generating companies. After opportunities with cash-generating customers dried out, it moved to start-ups -- and its growth became slightly artificial. These dot-coms were able to buy Lucent's equipment only by raising money through private equity and equity markets, since their business models didn't factor in the necessity of cash-flow generation.

Funds to buy Lucent's equipment quickly dried up, and its growth should have decelerated or declined. Instead, Lucent offered its own financing to dot-coms by borrowing and lending money on the cheap to finance the purchase of its own equipment. This worked well enough, until it came time to pay back the loans.

The United States, of course, isn't a dot-com. But a great portion of its growth came from borrowing Chinese money to buy Chinese goods, which means that Chinese growth was dependent on that very same borrowing.

Now the United States and the rest of the world is retrenching, corporations are slashing their spending, and consumers are closing their pocket books. This means that the consumption of Chinese goods is on the decline. And this is where the dot-com analogy breaks down. Unlike Lucent, China has nuclear weapons. It can print money at will and can simply order its banks to lend. It is a communist command economy, after all. Lucent is now a $2 stock. China won't go down that easily.

The Chinese central bank has a significant advantage over the U.S. Federal Reserve. Chairman Ben Bernanke and his cohort may print a lot of money (and they did), but there's almost nothing they can do to speed the velocity of money. They simply cannot force banks to lend without nationalizing them (and only the government-sponsored enterprises have been nationalized). They also cannot force corporations and consumers to spend. Since China isn't a democracy, it doesn't suffer these problems.

China's communist government owns a large part of the money-creation and money-spending apparatus. Money supply therefore shot up 28.5 percent in June. Since it controls the banks, it can force them to lend, which it has also done.

Finally, China can force government-owned corporate entities to borrow and spend, and spend quickly itself. This isn't some slow-moving, touchy-feely democracy. If the Chinese government decides to build a highway, it simply draws a straight line on the map. Any obstacle -- like a hospital, a school, or a Politburo member's house -- can become a casualty of the greater good. (Okay -- maybe not the Politburo member's house).

Although China can't control consumer spending, the consumer is a comparatively small part of its economy. Plus, currency control diminishes the consumer's buying power. All of this makes the United States' TARP plans look like child's play. If China wants to stimulate the economy, it does so -- and fast. That's why the country is producing such robust economic numbers.

Why is China doing this? It doesn't have the kind of social safety net one sees in the developed world, so it needs to keep its economy going at any cost. Millions of people have migrated to its cities, and now they're hungry and unemployed. People without food or work tend to riot. To keep that from happening, the government is more than willing to artificially stimulate the economy, in the hopes of buying time until the global system stabilizes. It's literally forcing banks to lend -- which will create a huge pile of horrible loans on top of the ones they've originated over the last decade.

But don't confuse fast growth with sustainable growth. Much of China's growth over the past decade has come from lending to the United States. The country suffers from real overcapacity. And now growth comes from borrowing -- and hundreds of billion-dollar decisions made on the fly don't inspire a lot of confidence. For example, a nearly completed, 13-story building in Shanghai collapsed in June due to the poor quality of its construction.

This growth will result in a huge pile of bad debt -- as forced lending is bad lending. The list of negative consequences is very long, but the bottom line is simple: There is no miracle in the Chinese miracle growth, and China will pay a price. The only question is when and how much.

Another casualty of what's taking place in China is the U.S. interest rate. China sold goods to the United States and received dollars in exchange. If China were to follow the natural order of things, it would have converted those dollars to renminbi (that is, sell dollars and buy renminbi). The dollar would have declined and renminbi would have risen. But this would have made Chinese goods more expensive in dollars -- making Chinese products less price-competitive. China would have exported less, and its economy would have grown at a much slower rate.

But China chose a different route. Instead of exchanging dollars back into renminbi and thus driving the dollar down and the renminbi up -- the natural order of things -- China parked its money in the dollar by buying Treasurys. It artificially propped up the dollar. And now, China is sitting on 2.2 trillion of them.

Now, China needs to stimulate its economy. It's facing a very delicate situation indeed: It needs the money internally to finance its continued growth. However, if it were to sell dollar-denominated treasuries, several bad things would happen. Its currency would skyrocket -- meaning the loss of its competitive low-cost-producer edge. Or, U.S. interest rates would go up dramatically -- not good for its biggest customer, and therefore not good for China.

This is why China is desperately trying to figure out how to withdraw its funds from the dollar without driving it down -- not an easy feat.

And the U.S. government isn't helping: It's printing money and issuing Treasurys at a fast clip, and needs somebody to keep buying them. If China reduces or halts its buying, the United States may be looking at high interest rates, with or without inflation. (The latter scenario is most worrying.)

All in all, this spells trouble -- a big, big Chinese bubble. Identifying such bubbles is a lot easier than timing their collapse. But as we've recently learned, you can defy the laws of financial gravity for only so long. Put simply, mean reversion is a bitch. And the longer excesses persist, the harder the financial gravity will bring China's economy back to Earth.

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