Blind to the risks

China’s debt bubble is massive and includes both external dollar-denominated debt and internal local currency debt.

It includes everything from real estate loans and infrastructure bond issues to the Ponzi-like ‘wealth management products’ offered by banks and ‘shadow finance’ conducted by corrupt provincial officials.

This debt bubble is far bigger than what the US and the developed economies faced in 2007. A Fed rate increase now might be just what it takes to pop this bubble.

The problem is that Janet Yellen and other members of the Fed Board of Governors have not shown particular awareness of these dangers.

They are looking almost exclusively at the US economy, with very little concern shown for the rest of the world.

Many Western analysts treat China as if it were a normal developing economy, albeit much larger and more important than others. This is a mistake. China is far from normal. It is ruled centrally by the Communist Party of China.

Wall Street and Washington analysts tend to treat communism as an anachronism and say it is just a facade for what is rapidly becoming a more capitalist society. Nothing could be further from the truth.

Michael Auslin, writing in The Wall Street Journal on 29 January 2015, reported on an atmosphere of fear inside China with the ascension of its new ruler, Xi Jinping:

‘In just two years, Mr Xi has become the most powerful Chinese leader since at least Deng Xiaoping, and perhaps even since Mao Zedong. Some longtime experts talk about the possibility of something approaching one-man rule in Beijing, anathema since the excesses leading up to Mao’s death in 1976. Others argue that collective leadership is alive and well, but the party is indeed tightening its grip on Chinese society.’

China’s supporters point to its US$4 trillion reserve position, mostly denominated in US dollars and consisting largely of US Treasury securities. This is indeed a source of strength that China can use to bail out its banks and douse the flames of any credit crisis.

But will they? Consider the consequences…

Between a rock and a hard place

If China has to dump US Treasury securities to deal with a crisis caused by a US rate increase, that will drive US interest rates higher, making the crisis even worse.

Many crises over the past 25 years, including the sterling crisis of 1992, the Mexican peso crisis of 1994 and the Asian-Russia financial crisis of 1997–98, have taught that once confidence is lost and a run on a central bank starts, no amount of reserves are enough to stop it.

The Chinese Communists will not go down without a fight. They will use every financial weapon in their arsenal to stem the coming debt crisis in China. These weapons include capital controls, selective defaults, asset freezes and currency wars.

[Editor’s Note: Currency wars are one of the most important dynamics in the global financial system today. Jim wrote about this at length years ago in his first book, Currency Wars. But what Jim didn’t mention then is that, if you know what you’re doing, you can profit handsomely from them. Click here to discover the best strategy you can use to survive the currency wars unscathed.]

China has already eased monetary policy three times in the past six months through a combination of interest rate cuts and reductions in required bank reserves. The Shanghai Stock Exchange is in bubble territory in the expectation of more monetary ease ahead.

Truly, China is between a rock and a hard place. If China maintains a strong currency, this will help its dollar debtors pay their debt, but it will hurt exporters and possibly pop the Shanghai stock bubble.

If China cheapens its currency, this will help exports and asset prices, but it makes the US dollar debt harder to pay.

On balance, China will probably maintain a strong yuan because they want to keep the IMF happy at a time when the yuan may join the IMF's SDR basket as a global reserve currency. And it will put more stress on an overextended debt situation. This is a topic I will follow closely in my new investment advisory service, Jim Rickards' Strategic Intelligence.

As for Chinese stocks, the best advice is to keep away. They may go higher on more monetary easing…but a bubble is still a bubble.