



Crescat Capital

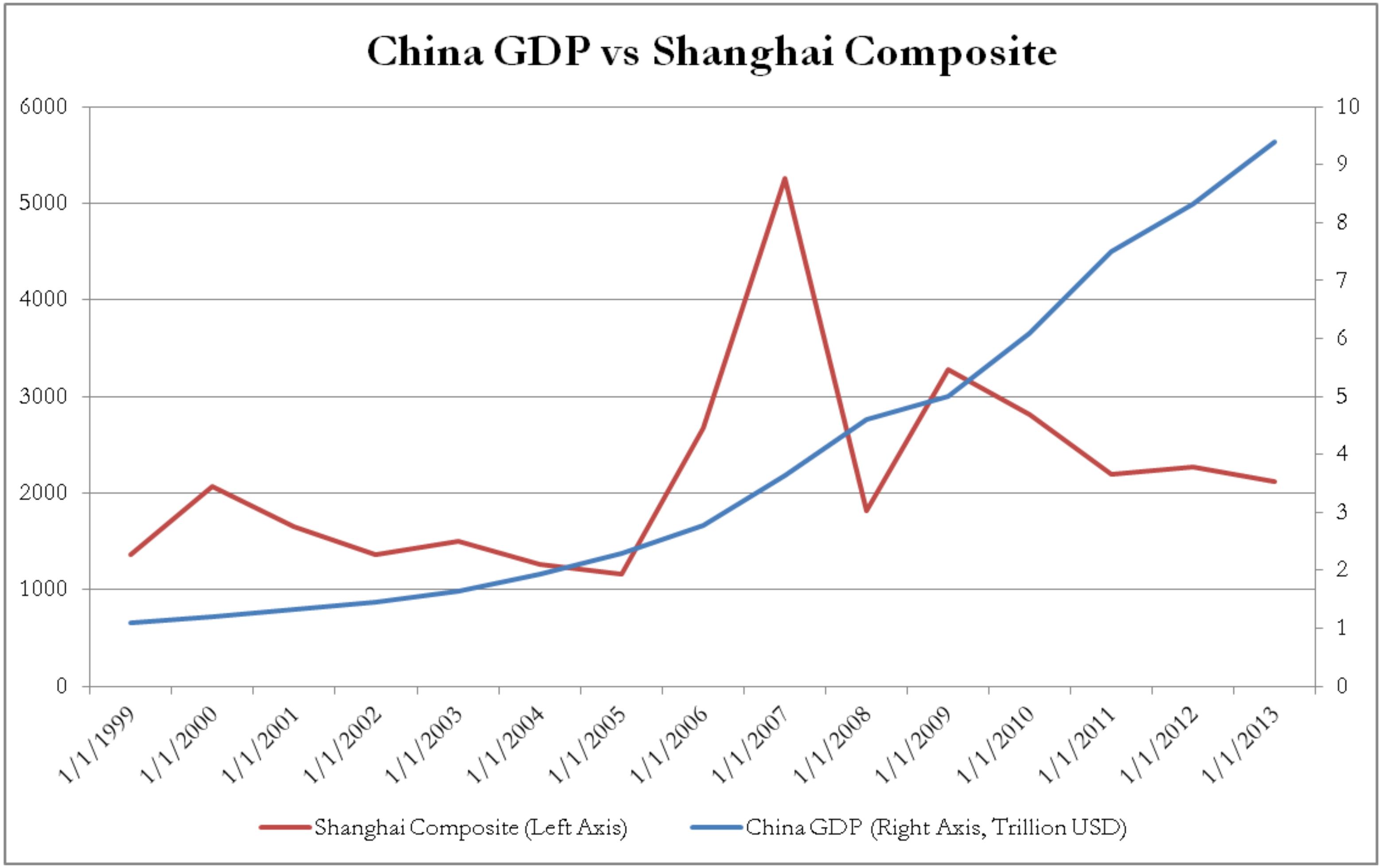
China Currency and Credit Bubble

March 27, 2014

There is an Imbalance in China

- Infrastructure overcapacity
- Real Estate Bubble
- Non Performing Loan Problem
- Shadow Banking Excess
- Unrealistic Growth Expectations
- Declining Foreign Direct Investment
- Increasing Capital Outflows
- Misconception that government policies guarantee continued high real GDP growth
- Global misconception that currency is undervalued

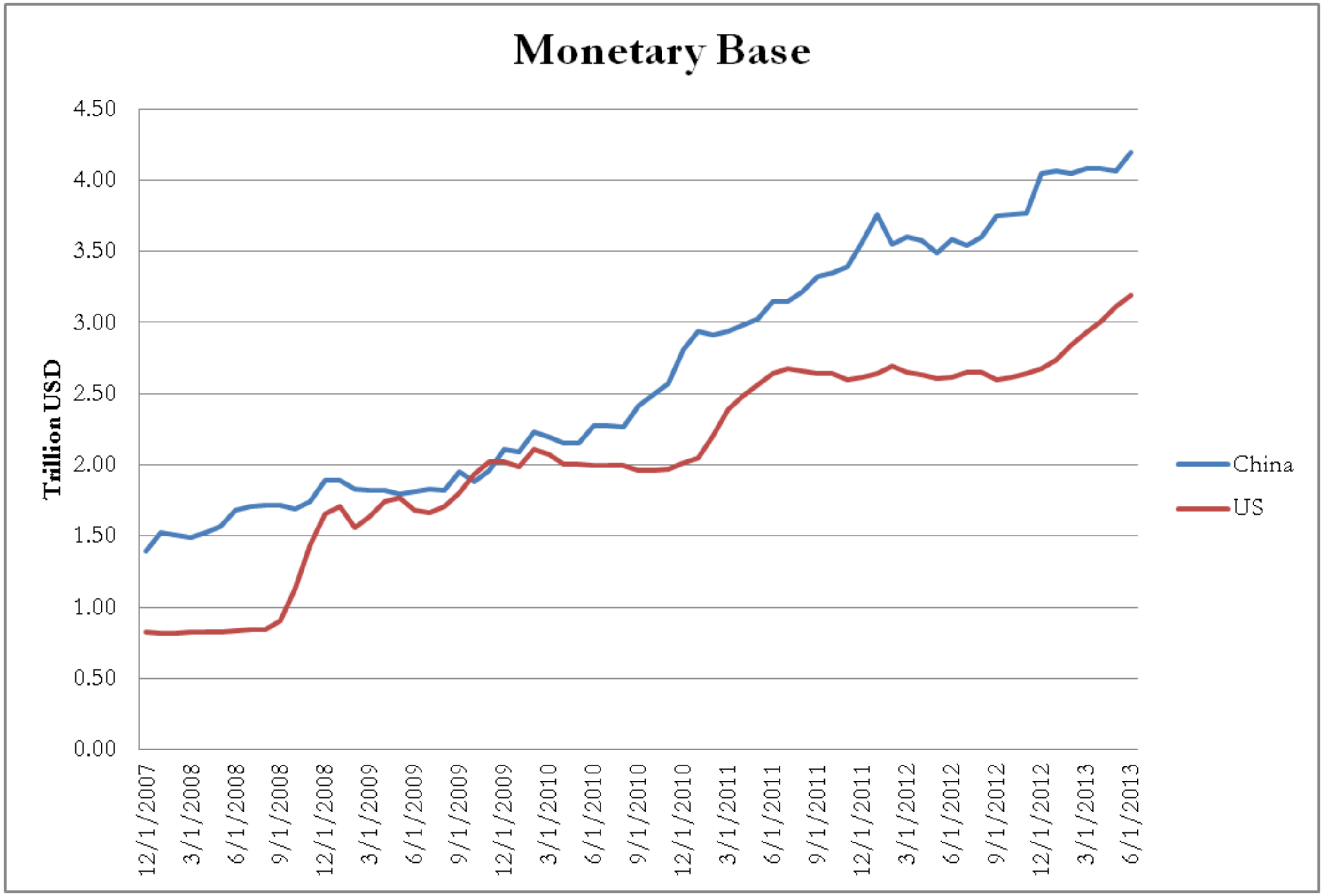
GDP vs Stock Indices



Source: Bloomberg, Federal Reserve Economic Data

If China's GDP growth has been so strong, why hasn't its stock market been performing?

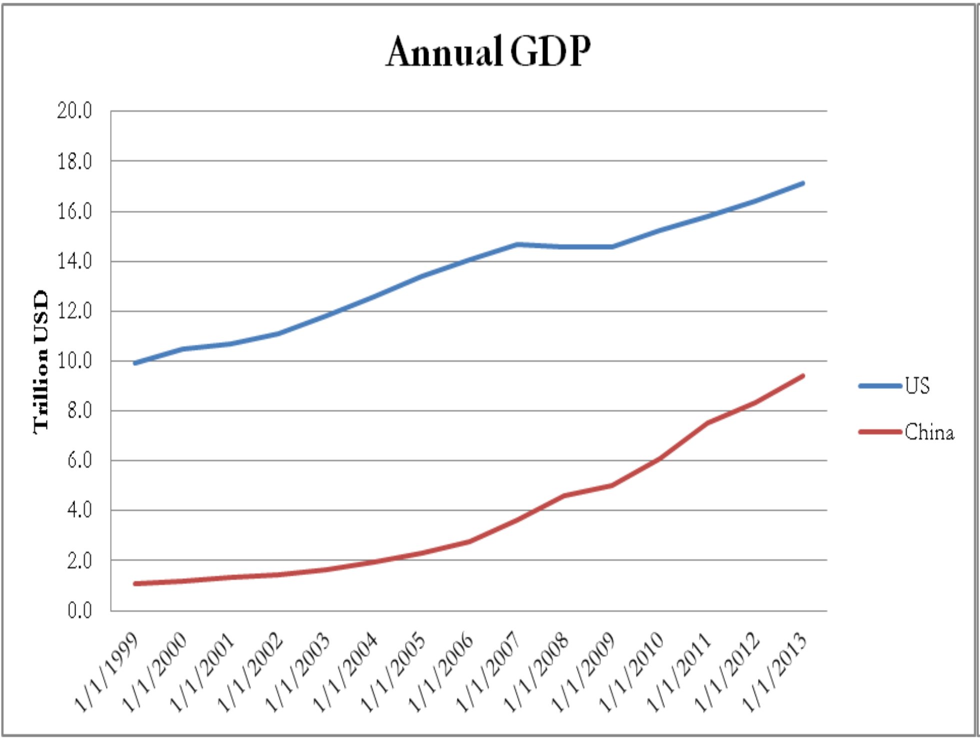
Quantitative Easing: Fed vs. PBOC

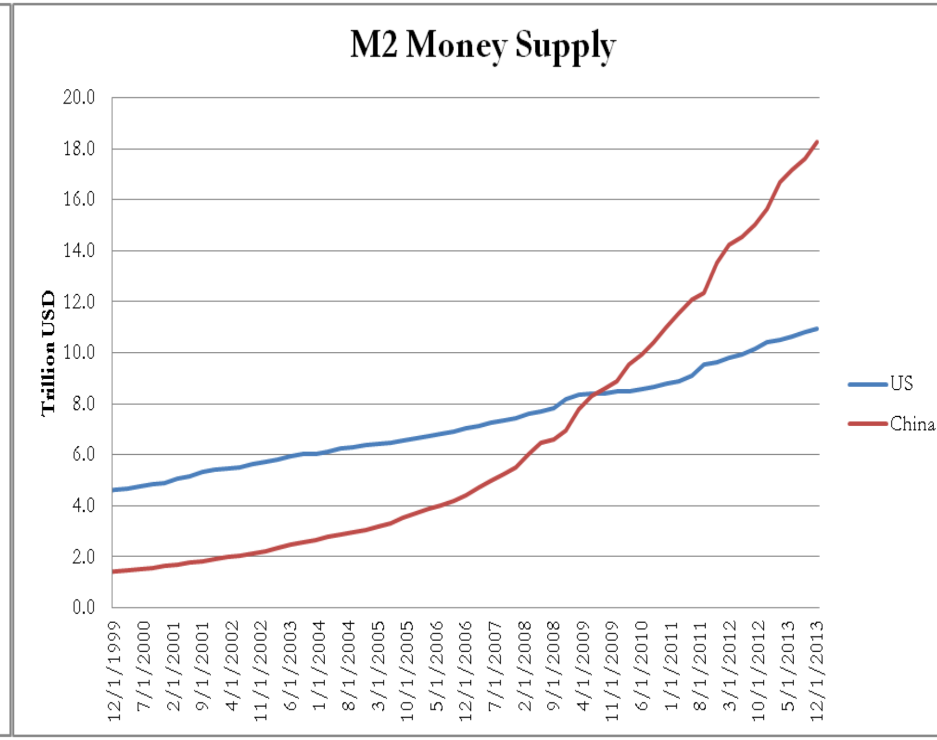


Source: Bloomberg

PBOC has printed even more money than the Federal Reserve

China Currency and Credit Bubble

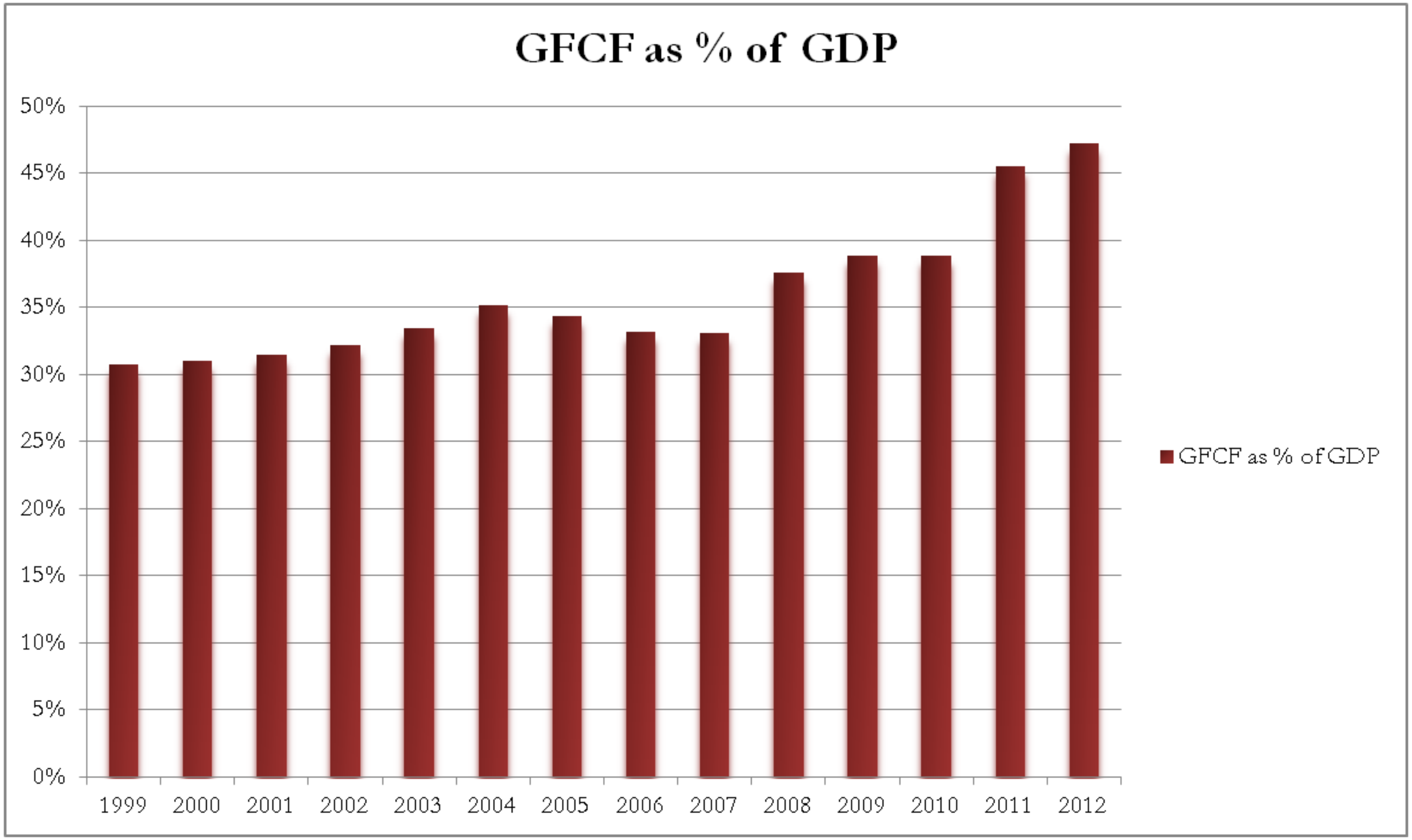




Source: Bloomberg , Federal Reserve Economic Data

China's Money Supply (M2) Exceeds the U.S. by 64% But its Economy (GDP) is 45% smaller (USD Equivalent)

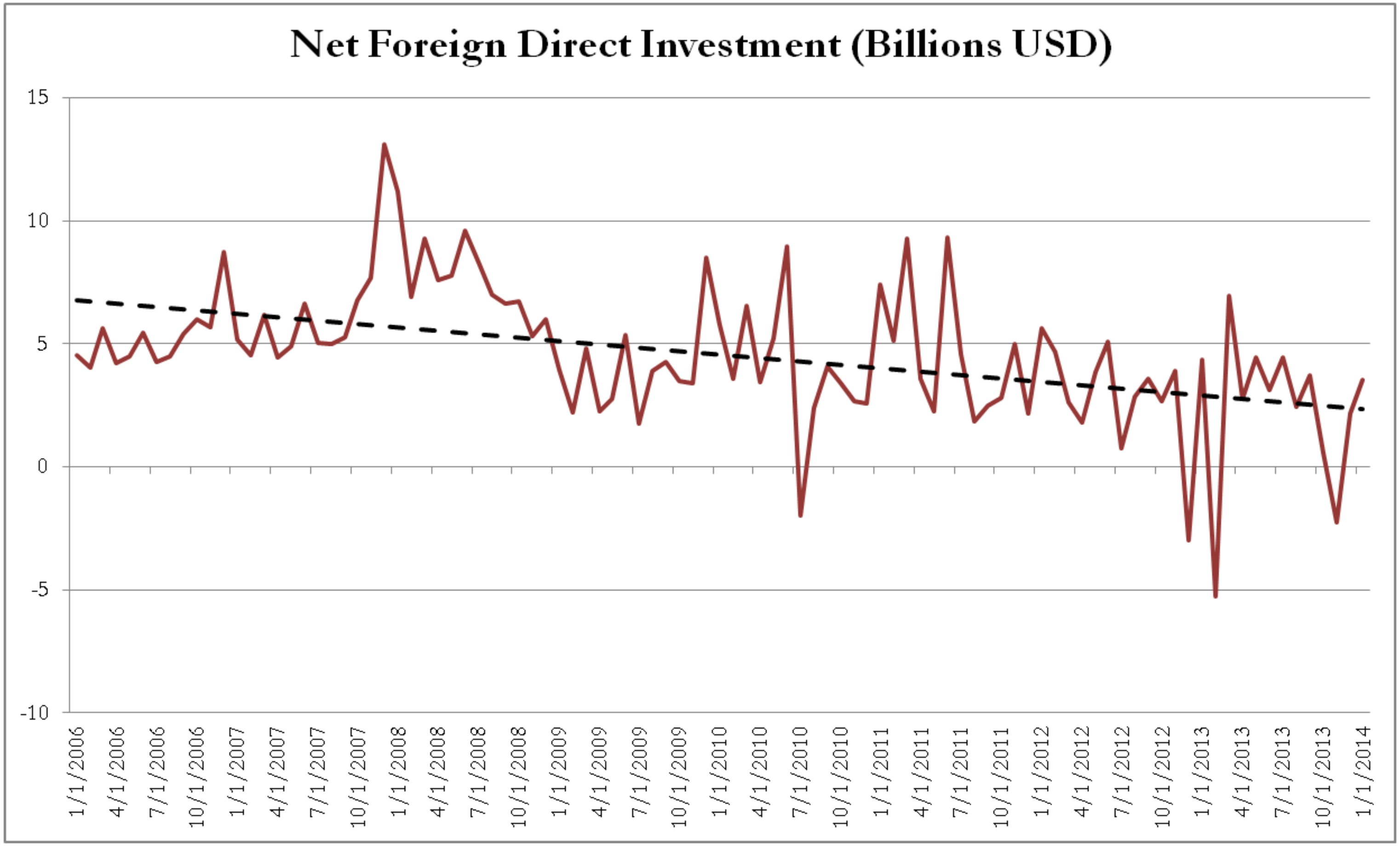
Gross Fixed Capital Formation vs. GDP



Source: IMF

Fixed capital spending has driven the largest portion of China's GDP growth, both of which are unsustainable

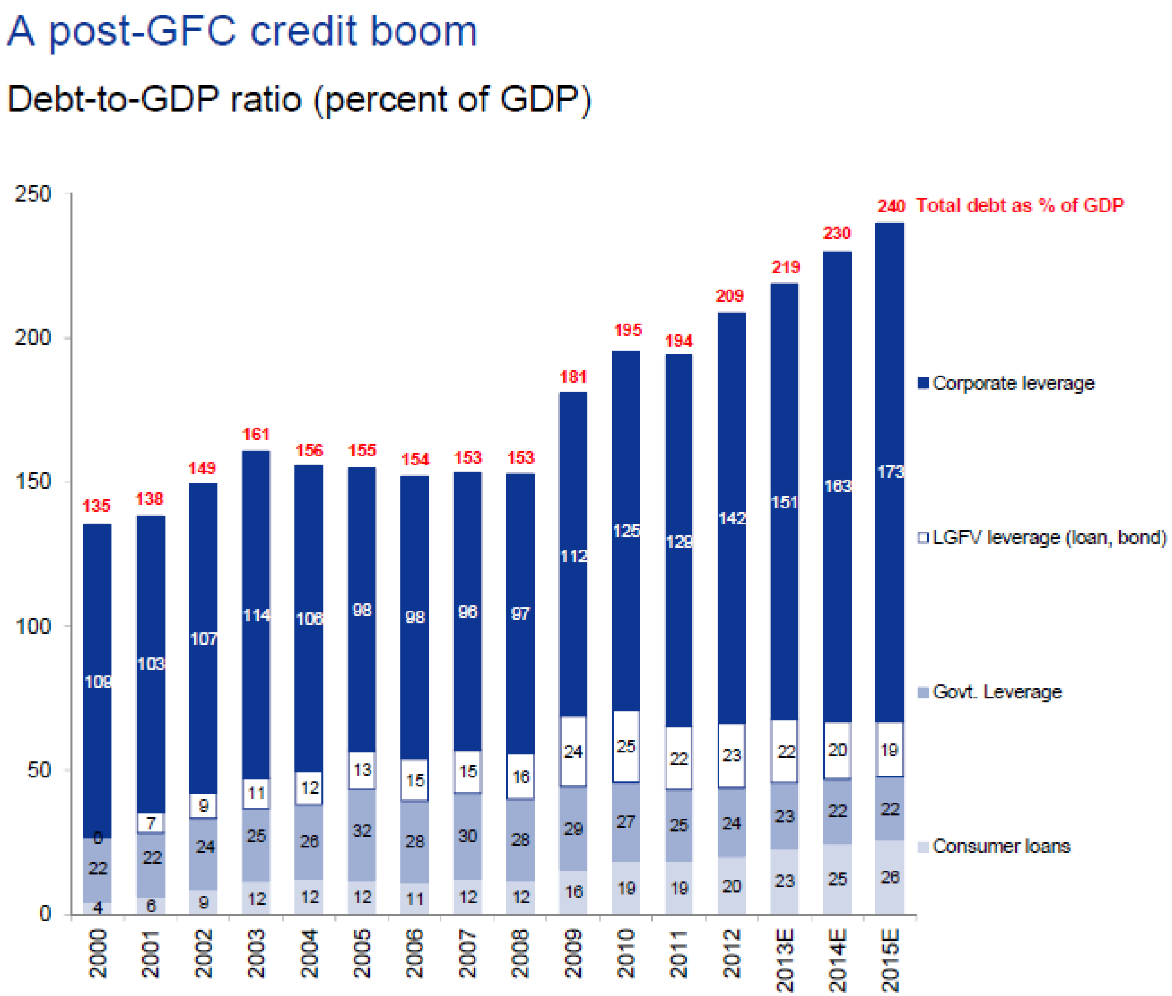
Declining Foreign Direct Investment in China



Source: Bloomberg

Foreign investors are losing confidence in the Chinese economy

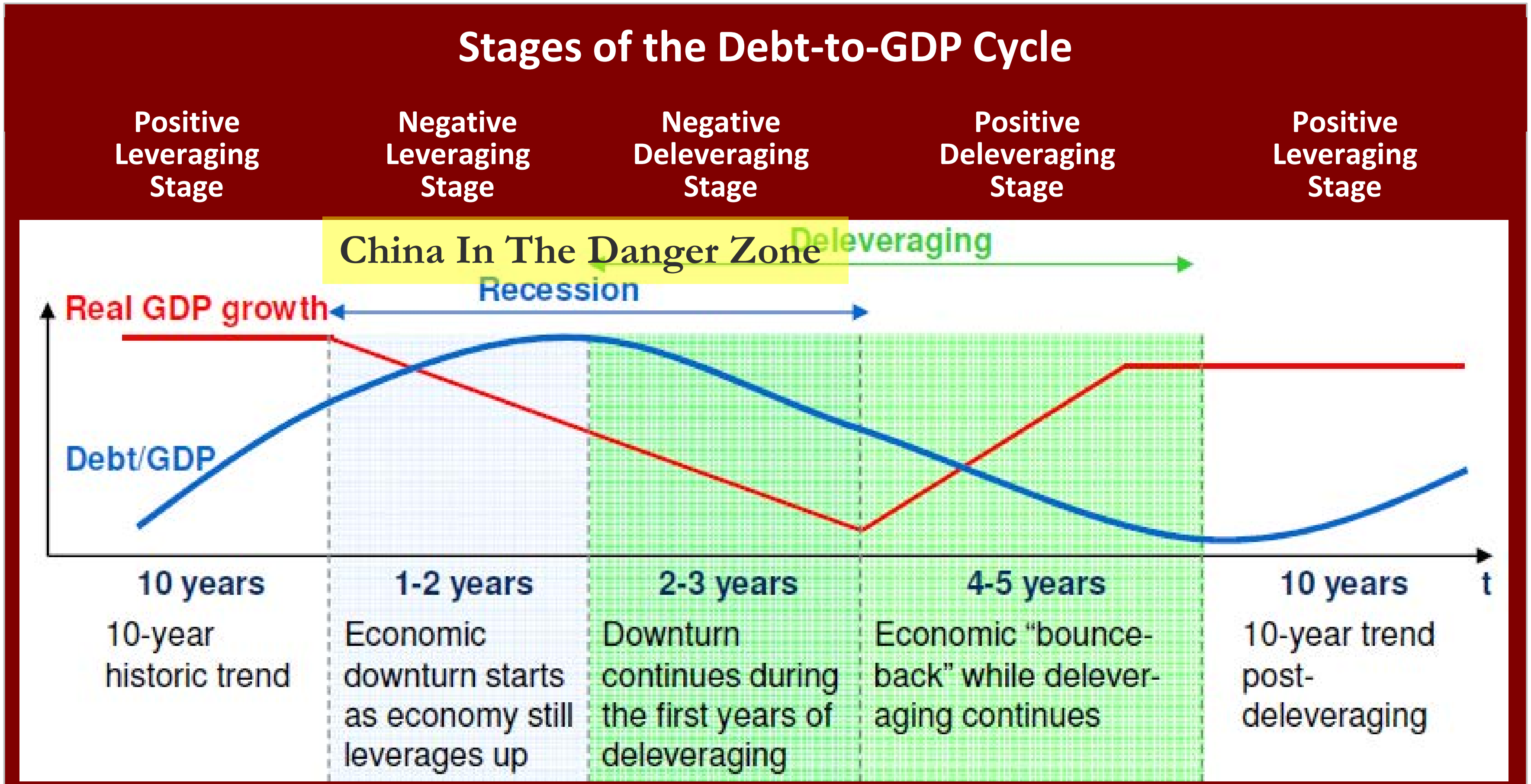
China Credit Bubble



Source: PBOC, Gao Hua Securities, GS Global Investment Research.

China's debt has been growing even faster than its GDP

Debt to GDP Leveraging & Deleveraging



Source: McKinsey Global Institute

Scenario 1 – Banking Crisis

Trigger: China tries to sustain its long-term growth by reining in its credit bubble:

- China tapers its money printing
- Raises interest rates

Problem:

Credit tightening triggers: debt defaults, real estate crash, deflation, China cannot achieve its nominal or real GDP growth targets

Scenario 2– Currency Crisis

Trigger: China continues to bail out its financial institutions to prevent defaults, bank runs, and social/political unrest

Problem:
Money printing creates inflation; ongoing moral hazard; capital flight; makes Yuan vulnerable to a currency raid as China cannot defend its peg and its credit markets at the same time; China cannot achieve its real GDP growth targets; nominal GDP grows but due to massive inflation and currency devaluation

Scenario 3 – Twin Crises

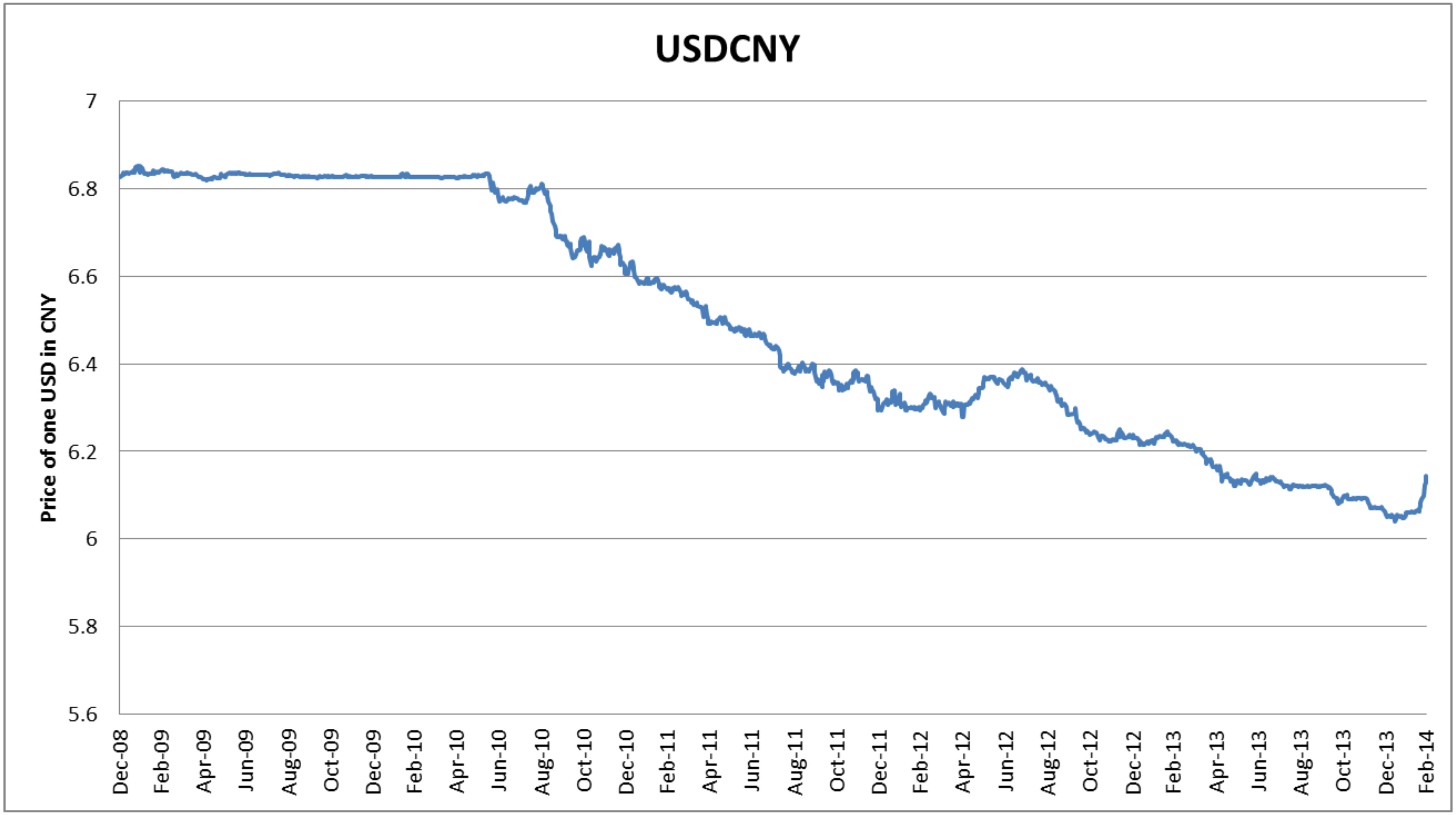
Banking Crisis and **Currency Crisis** feed off of each other:

- Self reinforcing
- Ongoing bailouts of domestic credit markets create downward pressure on currency
- Currency devaluation creates inflation; closes off access to global credit markets; creates economic and banking crisis

Warning Signs

- PBOC attempts to tighten credit have been leading to severe liquidity squeezes (Shibor interest rate dislocations) loan defaults which have only led to more necessary PBOC cash injections
- China flows into physical gold at the individual level are draining cash from banks
- Global Capital Flows – Foreign Direct Investment in China has been declining, Emerging Market Fund Flows into China declining, Chinese flows of capital out of country increasing

Recent Pressure in Chinese Yuan (CNY/USD) Counter to Appreciation Trend



Source: Bloomberg

China Yuan Money Richly Valued Relative to U.S.

ECONOMIC DATA	CHINA	U.S.
Money Supply (M2)	$18 Trillion (USD)	$11 Trillion
Gross Domestic Product (GDP)	$9.3 Trillion (USD)	$17 Trillion
M2/GDP Ratio	1.94	.65
Money Velocity (GDP/M2)	0.51	1.54
Exchange Rate	6.21 CNY/USD	.161 USD/CNY
Exchange Rate at GDP/M2 Parity	18 CNY/USD	.056 USD/CNY

Source: PBOC, Federal Reserve

190% potential Yuan devaluation under M2/GDP parity

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Definition of a Currency Crisis

"A speculative attack on the foreign exchange value of a currency, resulting in a sharp depreciation or forcing the authorities to sell foreign exchange reserves and raise domestic interest rates to defend the currency"

Source: Glick and Hutchinson 2011

Disclosures

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