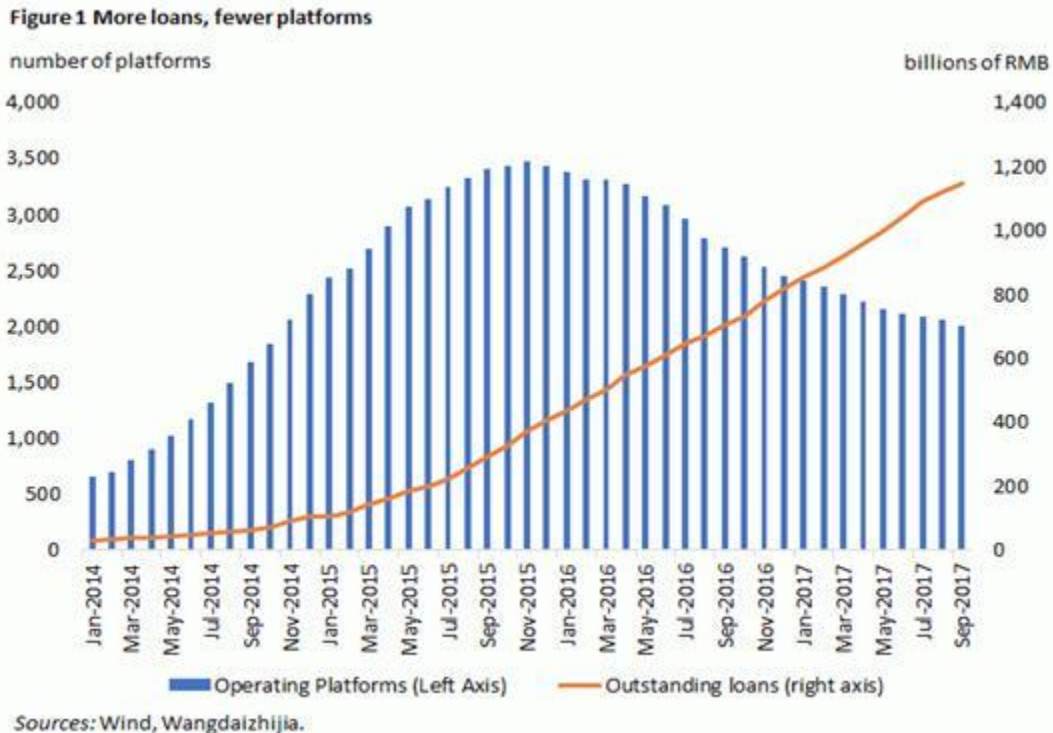


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China: cowboy capitalists versus “Communists”

China’s Shadow Banking Explosion



To paraphrase an old saying, “Trying to understand China is a lot of fun . . . but we wouldn’t want to live there.” China always has fit the “mystery wrapped in an enigma” label, always worth pondering; but since Communism was dropped in all but name beginning in the 1990’s (“There are more people who believe in Marxism in Berkeley, California, than in Beijing,” said one long-time China expert recently) it has been vital for us investors to pay close attention to the nature of things in China. Its economic role in the world is so important that we must follow China closely, mystery or not.

The Peterson Institute of International Economics is always one of the best stops to make, when we turn our gaze back to China. It has a habit of digging calmly beneath surface appearances and headlines, before coming to its conclusions. Last week it tackled one of the many corners of China’s economy which are labeled “ticking time bombs” by the media and many investment experts: P2P lending (“peer-to-peer”), which in China as well as the rest of the modern world means the seeming explosion in banking activities which don’t bother with banks themselves—or their massive government oversight—but use the internet, instead, to transfer money between lenders or investors, and borrowers. (Of course the hottest example of this is the Bitcoin or digital currency explosion going on as we speak . . . which is defining “hot” in the “surface of the Sun” range, rather than merely “frying pan.” We’ll take a look at that another time.)

The chart above happens to look like a Bitcoin price chart, rocketing from nothing toward a million dollars or so, and merely catching its breath at its recent record of \$5,000 and other such nickel-and-dime price tags. It’s not Bitcoin, but the 3-year explosion in peer-to-peer loans in China: zero in early 2014; \$173 billion today. That’s the orange line. The blue bars are the number of internet platforms offering P2P loans and deposits. We can think of those platforms as the “banks” which 4.5 million P2P-playing Chinese are using, instead of all the traditional brick-and-mortar dinosaurs. These banks-in-the-ether exploded from 500 to 3500, then plunged to 2100 lately—because China’s regulators began imposing rules for them, and because a good many of them were, naturally, scams and Ponzi schemes which soon vanished with their depositors’ money.

Here are the really interesting points about this story.

- China's entrepreneurs were lightning-fast in capitalizing on the P2P opportunity. Those entrepreneurs included everything from outright crooks to real businesspeople trying to create something of lasting value.
- China's investors were also lightning-fast to jump on the bandwagon, drawn by "lending" rates of 15% to 500%. (That top end being the loan-shark, break-your-legs rate, which kicked in when a borrower defaulted, along with genuine loan-shark leg-breakers to actually collect the defaulted loans.)
- China's government regulators were slow to see the problem; slow to react; and ineffective with their first actions. Yes, they were normal banking regulators. But they did not give up, and it's pretty clear that their strategy will eventually control the risk of P2P lending . . . long before it gets big enough to really threaten China's economy and financial system.

The story is especially interesting because, in fact, it is also typical of so much going on within China's remarkable economic story. China's political leaders would like the world to believe they are guiding and directing a powerful economic elephant, so to speak, walking steadily forward toward ever-greater internal wealth and international power. But it's not an elephant—it's always been more like a bucking bronco, ridden gleefully by a billion would-be cowboy capitalists, pretty much ignoring the ringmaster until he pulls out his six-gun and shoots one of them, now and then. Then they calm down, temporarily and just barely. Although they spout Marxist-Leninist nonsense, both they and all the cowboys know they don't mean it. They all know the real message, since the 1990's, from China's political dictators has been: "Everyone, try to get rich—and good luck to you! But stay out of politics—if you know what's good for you."

Returning to the chart up there, Outlook's wild guess would be that 50% or more of those 2,100 remaining "P2P Lending Platforms" are, in fact, Ponzi schemes to some degree: that is, they lose money at the actual "banking" business, but keep paying their old depositors with new money brought in by new depositors—and with any extra "new money," they make more loans to defaulting borrowers, so they can pretend those borrowers aren't defaulting . . . for a while longer. (And people say banking is boring!) And Outlook's next wild guess would be that something uncomfortably similar also describes China's banking system itself—though certainly more in the "evergreen" loan practices, than the Ponzi schemes. This is as "open" a secret as there is, in today's global economy—hence the considerable number of expert alarmists who've been predicting China's financial collapse for several years.

Outlook thinks this risk deserves constant hard-eyed scrutiny . . . but it does not deserve our acceptance and belief. As Japan proved in the 1990's, when its banks were similarly riddled with bad loans, the only way to wreck a banking and financial system is for the government to allow a panic and run. A perfectly solvent system can be wrecked that way as easily as a perfectly insolvent system—as the U.S. came close to proving, in the Calamity year of 2008 after Lehman Brothers was allowed to fail. It seems rather clear to Outlook that China's regulators and top political leaders are perfectly aware of this fact of banking life, and not at all inclined to "free up" China's financial system enough to give speculators and short-sellers the foothold they might use to get a run rolling.

Meanwhile, China's vast crowd of aspiring cowboy capitalists is pouring a great deal of energy into the economy—which is exactly why it has grown so remarkably these past decades. That economy has at least its share of big risks and problems—often created by meddling politicians—but the incoming energy looks quite likely to keep outgrowing the problems.

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