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From The President:
History Lesson

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Highland Capital Management's co-founder and President James Dondero describes how many of the causes of the Asian financial crisis of the late '90s are present to an even greater extent in China

Shakespeare didn't have the financial markets in mind when he wrote that "what's past is prologue," but the words still ring true – especially when it comes to the bubble waiting to burst in China. Many of the underlying causes of the Asian currency and debt crisis of the late 1990s in countries like Thailand and South Korea – one of the worst sovereign financial disasters in history – have resurfaced to a greater extent in China. Among these are money supply growth outpacing GDP and reserves, aggressive lending, excessive infrastructure and real estate investment, and significant "hot money" inflows. In many ways, these excesses are more glaring than those behind the 2007 subprime market collapse - and the consequences are likely to be harsher.

Conventional wisdom holds that China's currency is undervalued because of large foreign exchange reserves, a trade surplus, high savings rates and overall economic strength. In reality, the key factor is China's ever-expanding money supply (M2), which has increased, on average, almost 22 percent a year between 2002 and 2010 and nearly 26 percent annually during the last two years. By contrast, U.S. M2 rose only 6 percent and 3 percent, respectively. These figures reveal that recent consumer price inflation in China of 5.4 percent (vs. 1.2 percent in the U.S.) cannot be attributed to the dollar peg or implicit adoption of U.S. monetary policy. In the aggregate, China's M2 is 20 percent larger than the U.S., but its GDP is 61 percent smaller.

China's foreign currency reserves, at $3 trillion, are low relative to M2 - another warning sign. According to official statistics, China's reserves as a percentage of M2 were only 26 percent at the end of 2010 (the actual percentage may be substantially lower). By comparison, the reserve ratio in Thailand was approximately 30 percent when speculators began betting against its currency in 1997. Reserve liquidity is equally important. Countries like the U.S. and Japan publish transparent statements outlining their foreign reserve holdings, allowing observers to evaluate the reserve liquidity. It should be no surprise that China is far more opaque, obscuring the composition, encumbrances, and availability of reserves.

The Chinese banking system is inflating its bubble. Despite their perceived strength, Chinese banks have relaxed lending standards during the last several years, and the government is struggling to control the unintended consequences. China's four largest banks, all supported by the central government, have financed massive capital investments, often undertaken by state-owned or state-associated firms.

This cozy relationship among state, bank, and enterprise mirrors South Korea in the early to mid-1990s, when the government pushed banks, financed by short-term foreign debt, to make ill-advised domestic currency loans to big conglomerates for long-term projects. This scheme led to the won falling 52 percent in the 1997-98 crisis. China is even less transparent than South Korea.

According to official figures, China's non-performing loan ratio is only 1.1 percent. However, even Chinese regulators have begun to question the health of many infrastructure loans initially guaranteed by local and provincial governments (the guarantees have since been revoked). Specifically, they deemed only 27 percent of funded projects generated enough cash flow to repay their debt, while 23 percent were high-risk and the remaining 50 percent likely needing some restructuring. Additionally, a shadow banking system has developed, with banks securitizing loans through off-balance sheet trusts. This further obscures the total amount of debt in the system – and the risk.

Compounding the problem is excessive infrastructure investment, which now equals about 50 percent of GDP. These projects, often funded as described above, have been undertaken with little consideration of their long-term return potential. Remember Economics 101: Successful economic growth relies on minimizing inputs while maximizing output. Historically, maximizing inputs with little regard to ROI generally has ended disastrously, and there's no reason to believe the Chinese model will fare any better, especially when fixed-asset investment accounts for 80 percent to 90 percent of overall GDP growth.

The bursting of China's real estate and infrastructure bubble would be felt globally. China currently consumes 88 percent of the world's iron ore production, 53 percent of tin, and 40 percent of its zinc and copper. In most cases, metal prices are elevated to roughly three times the cost of production. Should Chinese demand falter, metal prices could plummet worldwide.

Decreased demand could also result from a right-sizing of China's housing market, now at levels that dwarf the U.S. housing bubble's peak. Supply has clearly outpaced China's current housing needs; for example, "ghost towns" like Ordos were built for 1 million, but remain virtually deserted. An estimated 65 million urban homes have not used power for six months and are presumed vacant. Housing prices won't help clear this supply. Speculation has driven median home values relative to per capita income to four times the level in the U.S. at the peak of its own housing bubble.

More speculation comes from the $1.5 trillion to $2.5 trillion of "hot money" that has flowed into China recently to chase high deposit rates and anticipated currency appreciation. As seen in the past Asian crisis and more recently in Iceland and Ireland, these deposit flows will flee on any significant trade or currency weakness (Q1 2011 saw China's first trade deficit in seven years) or unexpected dollar strength. When "hot money" rushes for the exits, China's ability or inclination to defend its currency will be severely tested.

Predicting when a financial bubble will burst is difficult, and China is no different. That it will burst now seems inevitable, and when it does, it will happen with unprecedented speed and scale. To paraphrase legendary market analyst Robert Farrell, excess in one direction leads to opposite excess in the other direction, and exponentially rising markets do not correct by going sideways.

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