Aviator Update – October 2021
Lindsey Lawrance

AVIATOR CAPITAL

Bailouts and Bitcoins

I'm a little surprised by the level of feedback received from last month's comments. I'm also pleased that none of it was at all disparaging – I didn't think there was anything too controversial in there. It resulted in some interesting discussions and today I want to explore some aspects in greater detail… probably venturing into some more controversial territory.

To briefly recap, last month we were exploring the situation in China with respect to Evergrande – the big property developer teetering on the brink of bankruptcy. We discussed how this saga is the predictable outcome of the economic policies pursued by the Chinese Communist Party over the last 30 years and how it poses a major challenge for their leadership to deal with.

As noted, it's evident that Evergrande (and, to an extent, the wider property development industry) will see some sort of "saving". However, whilst the Chinese government has the ability to bail everything out, they won't want to. This is because, at a point where debt is well-known to be getting a major problem, simply bailing everyone out sends a very bad message – a message of "hey, go crazy, be reckless, accumulate as much debt as you can… because if things go bad, we will be here to bail you out".

I made the comment that "…the Chinese government has the know-how and financial means (credibility) to make this whole Evergrande situation go away. They can bail out everyone."

I was asked what this means – what does it mean for them to have the "financial means" and "credibility".

This is a really interesting topic – a topic that I can practically guarantee will forever periodically raise its head somewhere around the world – perhaps even one day in Australia. These events are usually accompanied by major financial markets turmoil – which, on some level, should be welcomed for the opportunities they present. Therefore, as investors, its valuable that we have an understanding of all this ahead of time in order to best capitalise on the opportunities.

Credit and Trust:

A key to understanding how the modern economy works is appreciating the role credit plays within it. And in order to appreciate this, you first need to appreciate the role "trust" plays in credit.

In fact, the word “credit”, when traced back to its French and Latin roots basically means “trust”.

Many businesses of all shapes and sizes provide their customers with goods and services every day on the proviso that customer will pay them later. Even the simplest of daily transactions such as having a meal at a restaurant can be used as an example.

Typically, when you sit down for a meal at a restaurant, the restauranteur doesn’t ask you for $100 deposit before serving you. They serve you whatever you order on the understanding that you will settle the bill at the end of the meal. They trust their customers to do that.

Many of us will pay the bill with a credit card. What are we essentially doing when we do this? We’re borrowing money from the bank to settle the bill. Our bank fronts us the money, trusting that we will pay it back (or, let’s be real, they hope we only pay a small portion of it back so that they can charge us an exorbitant interest rate on the balance owing).

Layer upon layer of transactions all built on trust. That’s the economy.

To digress slightly for a moment, an important feature of a “good”, productive economy is a set of laws and processes enabling an individual or organisation to enforce their claim on someone who breaks that trust. This type of “social infrastructure” provided by the government is what empowers individuals to participate in the economy, creating true “wealth” for the nation.

Of course, business runs on credit and trust and its usually the case that the larger the business, the greater the reliance on credit. Looking at Evergrande, here are some of the major liabilities:

There’s the employees and contractors - construction workers of all types that show up to work assuming they will get paid when they submit their invoices.

There’re customers that have bought off the plan - handed over money (often 100% of the purchase price) for a new apartment.

Bondholders of varying shapes and sizes have lent the company money – larger institutional investors down to mums and dads via “wealth management products”.

Banks will have provided loans of varying shapes and sizes.

Cash flow management is obviously very important for any entity – individuals, households, businesses small and large as well as governments. Of course, there’s nothing wrong with using credit within your cash flow management systems. However, one of the problems

China faces at this juncture is a large number of large business that are excessively reliant on increasing levels of debt.

Even when an entity doesn't rely on an ability to increase their debt, an ability to take on new debt is generally taken for granted. Companies normally need to "roll over" credit facilities fairly frequently – replacing a maturing facility with something new.

"Two Ways. Gradually, then suddenly"

This line from Ernest Hemmingway's novel, The Sun Also Rises, epitomises the way in which businesses go bankrupt.

Most of the time businesses have little trouble accessing the financing that they need – rolling debt facilities as needed. But if that key attribute of "trust" is broken… well… that's when the proverbial poop hits the fan.

This is essentially where Evergrande is at. After years and years of accumulating more and more debt, suddenly, stakeholders fear the company might not be able to honour its debts as-and-when they fall due. To a company reliant on accessing debt to survive, an inability to access new funding is fatal. All those business transactions built on trust come screeching to a halt – why would you supply goods or services to the business on the proviso that they pay you later? Why would you sign up to buy a new apartment if there's doubt as to whether it will be completed? Why would you lend the company more money if they might not pay it back?

The Bailout

The Bailout. A phrase that became a staple in financial circles during the Global Financial Crisis and subsequent European Debt Crisis. It has its origins in the maritime world – "bailing-out" a sinking ship with a bucket.

Transcribed into the finance world, a bailout is essentially the saving of a sinking company (or in the case of Europe, a sinking country!)

It its purest, simplest form, a bailout could simply be giving a company a whole heap of money – enough to settle the debts it has trouble repaying. But realistically a bailout program needs to me much more nuanced than simply settling debts for someone else.

It is helpful to think of the financial system as being similar to the plumbing system in your house. Or perhaps a large building. Keeping water (money) flowing to all parts of the building (economy) where it's needed is important. Continuing the analogy, the system also needs to be able to process the "waste" (bad debts) that is a natural part of the system.

Banks – the beating heart

Sitting at the centre of the financial web are the facilitators of the payments system – we usually call them banks. Maintaining trust in the banking system is paramount – both internally and externally.

Of course, individuals need to be able to trust the banking system. In the simplest sense, if they don't you have a good old-fashioned bank run where everyone seeks to get their deposits out of the bank as quickly as they can.

Banks also need to trust each other and the banking system. In their role as operators of the payments system, banks constantly have massive payables and receivables amongst each other. In normal times, these all get settled seamlessly through the interbank market.

But if the banks think that one of them might be so stressed that it might not be able to find the cash flow needed to make the payments it needs; the whole system comes crashing down. This, simplistically, is what happened when Lehman Brothers collapsed.

To paraphrase colourful '80's businessman Alan Bond; "if I owe the bank $100,000, that's my problem… if I owe the bank $100 million, that's the bank's problem!"

Bad debts are part of banking but so too is prudent management of loan portfolios. Chinese banks are surely being carefully scrutinised with respect to their asset holdings – by themselves, by the other banks and by their regulators.

The Evergrande Bailout

China needs to keep its financial plumbing infrastructure flowing – that's the biggest risk. Again, that doesn't necessarily mean just settling all of Evergrande's debts for them.

The Chinese were allowed to watch America and Europe deal with the terrible messes left behind during and after the GFC and, from various research notes released from their reserve bank, they learnt a lot.

What Chinese authorities are inevitably doing at the moment is carefully tracing the liabilities that exist as well as monitoring liquidity. Based on the US and European experiences, they might find they need to do things such as:

Taking an equity stake in Evergrande – providing a capital injection to keep it afloat via buying a big chunk of the business (taking it over)

They might buy Evergrande debts from holders such as banks (a play from the US "Troubled Asset Relief Program")

The probably will need to extend some sort of loan guarantees to banks in order to provide them with the confidence to continue to extend credit to other businesses similar to Evergrande.

They might need to take projects off Evergrande and finance other developers to finish them, ensuring individuals get the apartments they pre-purchased.

The central bank might need to provide greater funding support to banks in order to ensure liquidity in the interbank market.

Perhaps they need to reiterate bank deposit guarantees in order to maintain public trust in the banking system.

These are just some of the possibilities.

Know-how and credibility:

In order to successfully undertake a bailout, the Chinese government must have both the know-how and credibility.

Know-how is easy enough to grasp – it's about understanding how their financial system works and how to keep the plumbing working. Again, based on various papers released by their central bank, I believe they possess the know-how to maintain order.

"Credibility" is a little more abstract. What I'm referring to with this is the actual financial means to "save the day". Does China have the financial means to bail out Evergrande (and the next Evergrande)?

In this regard, remember that a government cannot "create wealth" – it merely redistributes.

To begin with, let's use Australia's recent bailout of covid-affected workers as an example.

Via the jobkeeper programs, the government paid workers to do nothing. How can the government pay people to do nothing? Surely there's some financial ramifications of this.

They key to the answer is the size of the bailout relative to the size of the economy.

With a decent, productive, relatively diversified economy, the Aussie government was able to credibly enact the jobkeeper measures without any real impacts. Enough of the economy was still chugging along – producing valuable goods and services – and relative to the value of the goods and services being produced, the bailout was small.

How did the US manage to successfully bail out significant parts of their economy during the GFC? How did Europe save Greece, Portugal, Spain and Ireland? For the same reason – their economies were large and productive enough to "fund" the costs of the bailouts.

Why can't Venezuela bail out its troubled economy? Why couldn't the new Taliban government provide credible loan guarantees to the Afghanistan banks in order to spur lending and economic development? Because there's basically no economy to harness. They can try, but the market will see straight through their words and say in response "you can't credibly back that up!"

Despite being very unbalanced and having a growth model that it wholly unsustainable, the Chinese government has plenty of "economy" to harness – they can credibly redistribute economic resources towards Evergrande. Although huge, the numbers involved in the Evergrande mess are not so huge such that the required bailout measures wouldn't be "credible".

However, as we discussed last time, whilst China will likely make it through this Evergrande mess okay, it's just one of what will be many more "problems" resulting from their investment-driven economic model that's past its "best-before date".

Crypto – the answer?

I know I shouldn't kick this hornet's nest, but it is directly related to this Evergrande mess on a number of levels.

A couple of months ago China made headlines when it moved to declare cryptocurrencies illegal and banned all transactions. This makes sense for a couple of reasons…

Recall that a key feature of China's economic model is financial repression along with a closed capital account. It is very difficult for Chinese citizens to get money out of China and the Chinese government want to keep it that way. Crypto obviously poses a major threat to this, unless it's their crypto that they can control.

There's plenty of chatter about whether other nations will soon follow in China's footsteps banning crypto. I'd argue that other nations simply care a lot less than China.

Most nations have an open capital account – we can move funds around the world quite freely. Go on, try it – move all your assets somewhere else. Move all your money into Bitcoin…

Capital flight from China would be a real issue for the Chinese leadership and the risks have just increased with a "stalling" of the property bubble. Capital flight simply doesn't pose any real risk to a nation like Australia.

I’m sorry Bitcoin fans, but Bitcoin isn’t the future of money. It’s important to understand that a “hard money” regime embedded in many crypto fans’ world view represents a massive step backwards.

Look, the system isn’t perfect at present. I have repeatedly expressed my objections towards the “activist” policies of many central banks, particularly the US Federal Reserve and their pursuit of silly policies that have done little but induce reckless “risk-on” behaviour, helping sow the seeds for the next meltdown. But “the system” does work.

The bailout measures China needs to be pondering at the moment? They are only possible under a financial system that allows financial resources to be harnessed and “money supply” to grow and contract as needed. Without these features, authorities could do little, thus ensuring a complete breakdown in trust and collapse in the economy.

Sorry Bitcoin fans, this is not a better, more “free market” outcome. It’s just not.

Anyhow, for now we will watch with interest what the Chinese leaders do. There’s some real implications for Australia although there’s plenty of time to explore those later – these issues will be with us for a while.