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REMEMBERING THE FUTURE
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The Great Wall of Steroids: The New Silk Road and the Chinese Case

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Introduction

"Panics do not destroy capital; they merely reveal the extent to which it has been previously destroyed by its betrayal in hopelessly unproductive works." John Stuart Mills

In our June newsletter we announced that we will publish sometime in the fall our thoughts and findings on China. The time has come. In that June issue we showed how the current and leading indicators pointed to a Chinese slowdown. Since then, our commentaries (see the one posted on August 9) have pointed out that China might be the next stage/stop of the global crisis. However, before we proceed, let me publicly express my appreciation and gratitude to legendary hedge fund manager and investor Jim Chanos for his insights and notes he shared with me.

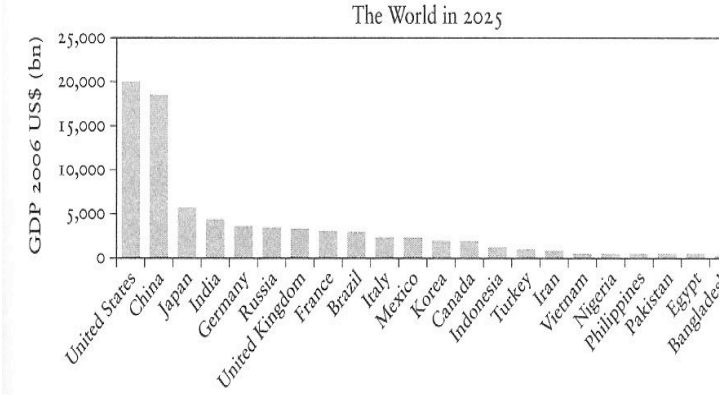
In our publications we have explained that the financial crisis that started in the summer of 2007 will evolve into three phases, namely: Financial/securities crisis; deleveraging/fiscal crisis; and currency/paper-money crisis. The epicenter of the first crisis was the US. The epicenter of the second was the EU. The epicenter of the third we estimate to be China. We should also state at this point that while we cannot predict an imminent collapse in China, we cannot exclude it either.

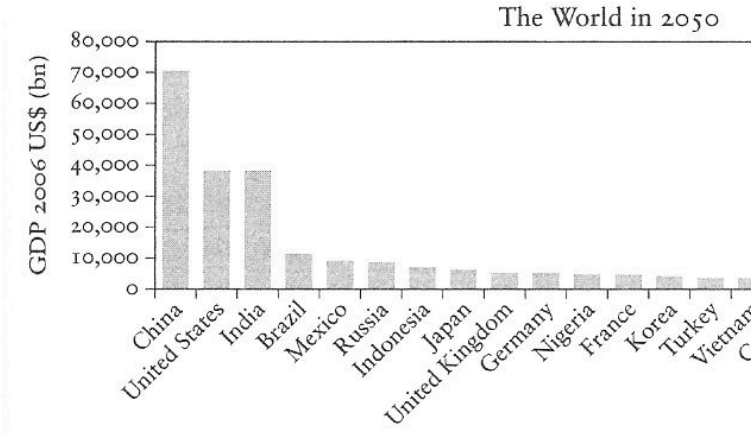
Our analysis is based on fundamental economic facts, geopolitical analysis, and historical understandings. We believe that the times are changing, and that China will be called upon to play a very significant leading role in the years to come. We would not be surprised (see figure 1 below) if China indeed is the leading economy within 10 years, and if the new international reserve currency to be unfolded over the course of the next 7-10 years is based to a large extent on the Chinese currency (RMB). However, we also believe that China is a huge bubble and a slush fund that needs catharsis before it starts playing its designated role in the future. The current issue discusses China's promising future, as well as its bubbles, and what they might mean for the global economy. If we are correct that China may collapse, then the recommendations are obvious: avoid Chinese exposure, load up on safe hard assets, and even short holdings of China.

From Dubai With Love: And Then, There Were More Bubbles

In our commentaries during the week of August 30th, we outlined some facts about the promising Chinese future. China is projected to become the #1 leader in geoeconomics. It is a well-reported fact that the trajectory of China is based on its track record of growth, investments, resources, acquisitions, strategic partnerships, savings, middle class formation, and demographics (among others). All those may position China in a place that it will become the #1 economic power around the world within the next twenty years, especially when we take into account that it uses hybrid measures of geoeconomics and geopolitics to dominate the seas and the trade crossroads of the 21st century. Last year China overtook Germany as the #3 economic power, and just last month overtook Japan as the #2.The following figure shows that trajectory.

Figure 1: China's Economic Trajectory





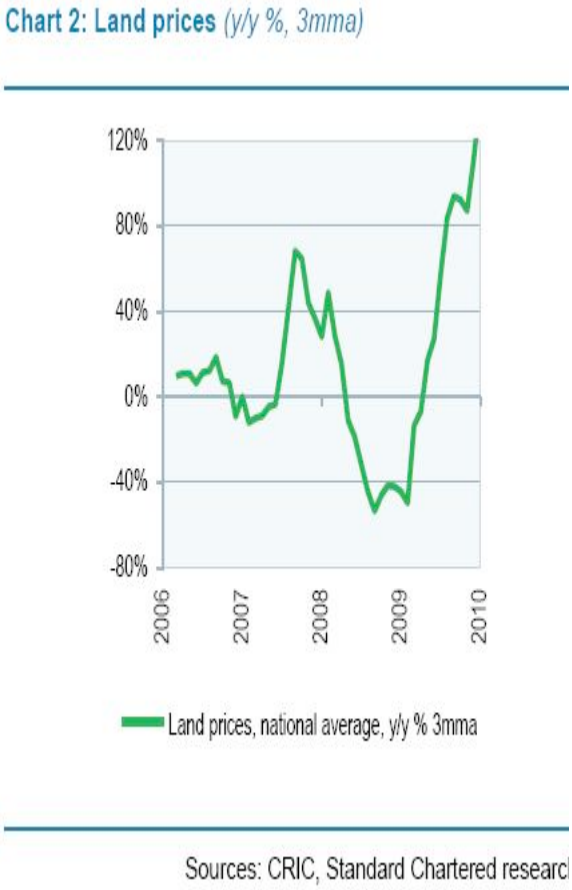
Source: Goldman Sachs Projections

As our commentaries outlined, the promising Chinese trajectory should be viewed in conjunction with the new development phase of the global economy where developing nations will be playing a much more important role. However, at this stage we ought to discuss the bubbles that exist in China, and what the implications are of a possible burst. Let us start then, with the familiar story – much fresher than the US real estate bubble – called Dubai.

Dubai collapsed last November. It was an accident waiting to happen. Dubai had no hard assets, but desired to be the metropolis and the crossroads of the Middle East. The oil assets are in Abu Dhabi, not in Dubai. Dubai was successful without any substance of assets to create a real estate market that epitomized a classic bubble with inflated properties. That property-frenzy and real estate inflation fed the credit bubble. This was a classic case where properties and projects' valuation become the collateral for credit extension. Dubai collapsed because that's what happens to bubbles, sooner or later. The Chinese real estate sector is another bubble. Here are some facts:

1. There is a huge glut of unoccupied real estate property that is unreal. The Chinese love real estate, but observers believe that the recent trends are quite abnormal. The Chinese government was to a large extent able to deflate the previous real estate bubble, but this time things are much more serious. The vacancy rate for both the residential and commercial sectors is at record levels. The banks have over-extended themselves with real estate loans for projects that remain vacant well after construction is completed, and at prices that are unreal, as the following figures show.

Figure 2: Land Prices and Vacant Projects



Source: Doug Katner, New York Times

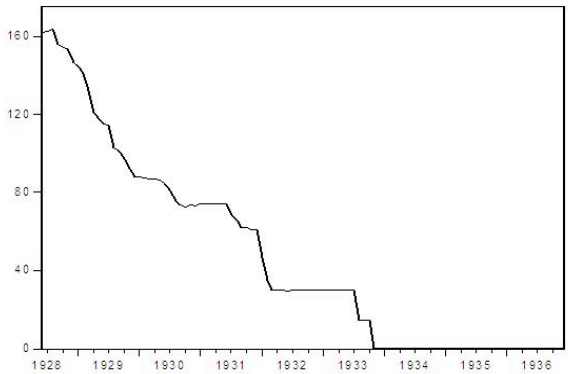
2. Unaffordable housing becomes the anchor of social discontent. The rising Chinese middle class cannot afford decent housing, and that enhances feelings of alienation, reduces morale and productivity, lowers disposable income and spending, while it endangers banks that have extended loans for real estate purposes. Without a doubt the Chinese stimulus (over 10% of their GDP) of 2009 contributed significantly to that bubble. Banks were encouraged to loan money overlooking issues of proper due diligence and banking prudence. Of course, the government lately is trying to deflate that excess lending by taking measures (higher reserves, higher taxes and fees if properties are resold within 5 years, higher down payments, etc.) that curtail credit and home purchases, but we believe that it may be too late. It may be too late because the over-extension of credit was too fast and too much. Credit rose by almost one third within a year. Complexes and even cities (such as Ordos in inner-Mongolia) were erected that now stand empty. The vacancy rate stands at over 30% (see related article in the Wall Street Journal on August 21, titled "China's Looming Real Estate Bubble").

3. The Chinese experience in the real estate market is guided by government actions. The real estate sector was privatized in the early 1990s. Thus, the Chinese owners and investors have never really experienced a market turmoil and collapse. Given that and the fact that there are no real estate taxes, while the transaction fees are minimal, the Chinese bought into this bubble because they felt that prices can only go up. At the same time their equity market is very volatile, while banks pay negative yields on savings when accounting for inflation. All of the above created a frenzy and contributed to the bubble. When the bubble bursts, it will be primarily banks, state-owned enterprises, and developers who will be hurt the most. There are reports of trillions of RMB loans that are non-performing, and hence the Chinese Banking Authorities directive to banks last month to perform stress tests with the assumption of as much as 60% bad loans.

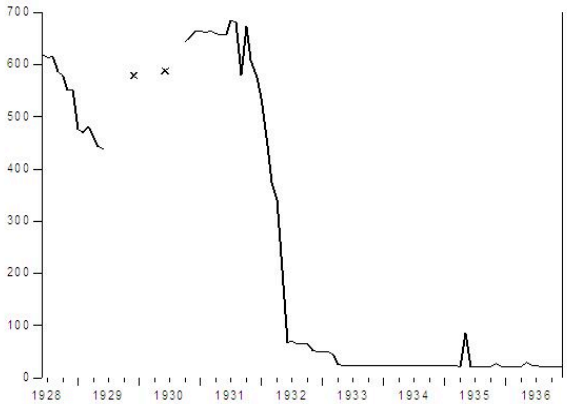
4. The over-extension of credit that took place in the West where assets were inflated and paper "assets" went to the stratosphere, is now taking place in China, - in a country where the institutions and the experience are lacking to address the bursting of bubbles. If the global imbalances were one of the significant factors for the recent financial collapse, then the misallocation of capital that has taken place in China, will also be one of the most significant factors that will result in a chaotic unwinding that has the potential of being the mother of all crises. Some analysts state that such a burst will not hurt China that much, due to its accumulated foreign reserves. On the contrary, we claim that because of such huge reserves a misallocation of capital has taken place – feeding a bond bubble in the US too – that has mispriced assets and risks. Historically too, countries that had excessive foreign reserves as a fraction of their GDP, such as the US in the 1920s and Japan in the 1980s, went through a major crisis (and let's not forget that Japan still is not doing that great). In those crises, we also need to remember the supplemental facts that contributed to the collapse, namely: cheap currency, trade surpluses, credit expansion, and huge inflows of foreign investments. Sound familiar? Certainly China does not exhibit any of those characteristics! Moreover, let us recall the French situation of the late 1920s. France at that time was holding almost half of the global foreign sterling reserves (the sterling was the international reserve currency at that time). The French situation resembles that of China today. The French were afraid of a sterling collapse, and thus they started shifting the reserves into the US dollar (see figure 4 below). The problem was that the

dollar was not that stable either, and thus for the French central bank (a private institution) to avoid bankruptcy they started unloading their dollar reserves by converting the reserves into gold. This of course contributed to the global money supply crash as well as to the deflationary pressures. The question then is: Is China in the French trap? The historical facts point that they are pretty close. The Chinese foreign reserves may prove to be not exactly the harbor that some analysts portray it to be, but rather the focus of a perfect storm that is gathering and is gaining speed and momentum. At some point the French tried to reverse their doing since their massive sales were hurting their balance sheet; however, it was soon understood that the momentum was against them. They were bailed out by the government, but the fact remains the same: Excessive foreign reserves represent a double sword and can become sources of instability and collapse.

Figure 3: France's Central Bank Unloading of the Sterling and the Loading up of USD

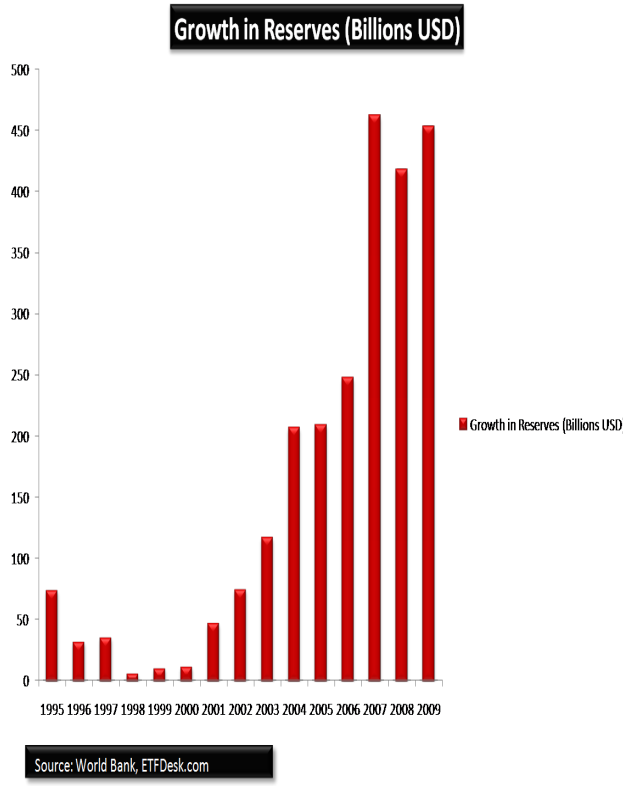


Source: Bank of France Archives



Our position thus is that the Chinese foreign reserves represent another bubble whose burst could have catastrophic consequences not only for China (by way of a significant drop in their asset holdings) but also for the US (bond market and dollar collapse) and the global economy. The following figure shows the extent of that bubble.

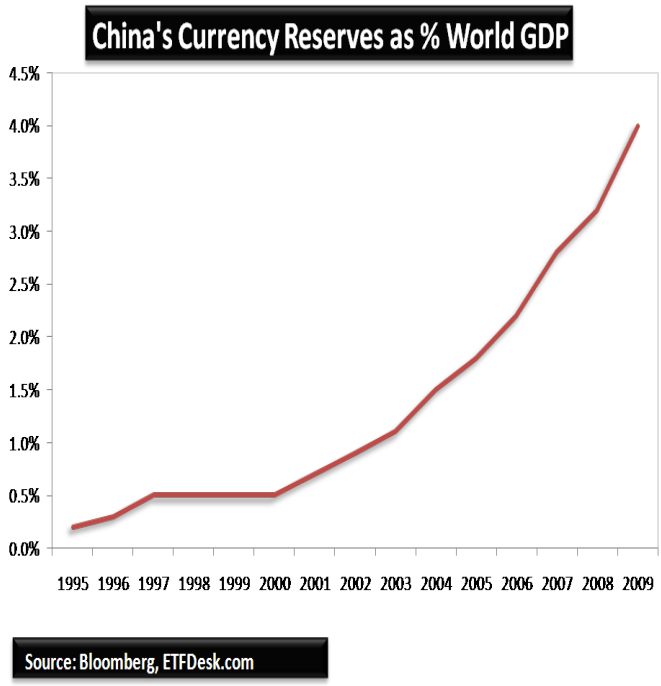
Figure 4: Chinese Foreign Reserves



Those reserves now exceed $2.4 trillion which is an amount larger than Italy's GDP. Moreover, with the rate at which they are growing ($400 billion/year) is like adding the whole GDP of Norway into the Chinese reserves! The situation is unsustainable, especially when we take into account that those reserves could be pledged as collateral for credit extension. Those reserves become a money printing machine that contributes to overheating, misallocation of capital, and bubbles in other sectors such as the real estate, infrastructure and/or financial paper "assets".

The following figure shows the Chinese reserves as a fraction of global GDP. As it can be seen from the figure below – and the numbers have increased in the last 8 months – the Chinese reserves exceed 4% of global GDP. In the 1920s the US reserves were almost 5% of the global GDP, as were Japan's reserves in the late 1980s. We all know what happened in the 1930s and what has happened to Japan in the last two decades (where the Nikkei index has lost more than 60% of its value, and has not recovered yet).

Figure 5: Chinese Foreign Reserves as a Percentage of Global GDP



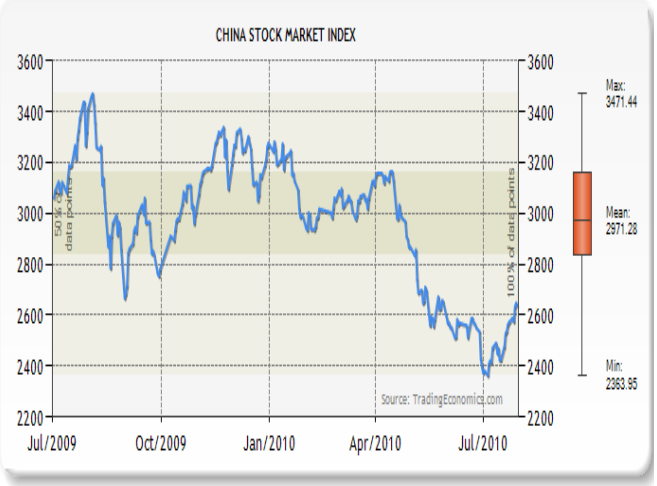
Thus, the situation is not only unsustainable but also dangerous. It is unsustainable because it subsidizes capital expenditures, misprices capital and other resources, artificially reduces risk exposure, misallocates investment spending, while enhancing growth via technical means, in lieu of substantive real natural measures and practices. The hoarding of reserves may attract foreign investments, which when sterilized via local currency purchases, increases the local money supply and thus create bubbles. Even if the central authorities try to buy back the extra cash, they issue bonds thus creating asset bases for creation of credit, and thus the bubbles are created or enhanced even more.

China recently reported that car sales may exceed 15 million units this year which will place her even ahead of the U.S. However, the increase in durable sales last year as well as this year has been achieved through subsidies and artificial measures. The Chinese consumers do not spend, and thus the bubbles in subsidies cannot sustain a live organism called economy. Chinese consumer spending has been dropping despite the impressive growth rates. Specifically, it was at 46% of GDP in 2000, it dropped to 41% in 2003, dropped more to 38% in 2006 and is now officially at 36%. This portrays an economy that is on steroids rather than natural food. It is unsustainable and contributes to the financial dangers explained earlier. The combination of the two could prove to be disastrous for the world economy if China collapses. If China were to collapse within the next 18-24 months, then its export engine will die down and the Asian model (global to some extent since Germany and others have been using it) of export-led growth will soon be dead.

The way out of the conundrum would be for the average Chinese consumers to experience a substantial increase in their disposal incomes. That could happen with higher wages, privatization of state-owned enterprises, establishment of safety nets (so the workers would not need to hoard so much money for precautionary purposes), and a significant revaluation of the RMB. Needless to say that such measures will also address - to some extent - the global imbalances issues.

It is our opinion that the market is preparing for the cathartic medicine and pre-discounts it as the following figure shows.

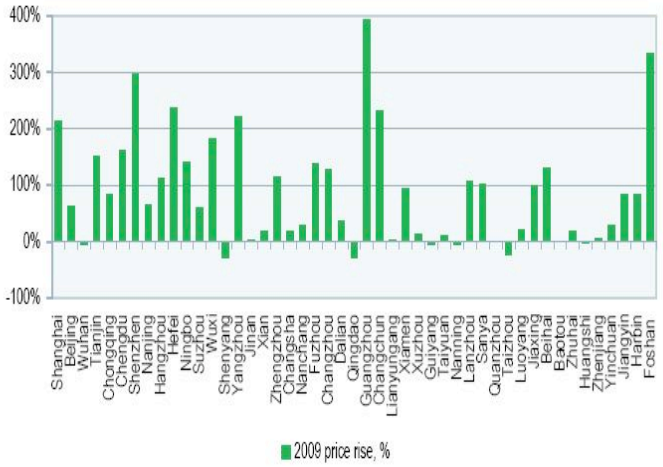
Figure 6: The Shanghai Stock Index



The more than 17% drop in the Chinese stock market since last summer, may be the prelude to the coming catharsis.

5. As we mentioned earlier, Chinese prices for land have skyrocketed. In some cities and industrial sections of the country land prices have doubled in just one year, while in other cities prices have increased as much as 400%, as the following chart shows. The beneficiaries are local authorities which own the land that is sold.

Chart 7: Land prices appreciated across China in 2009 (%)

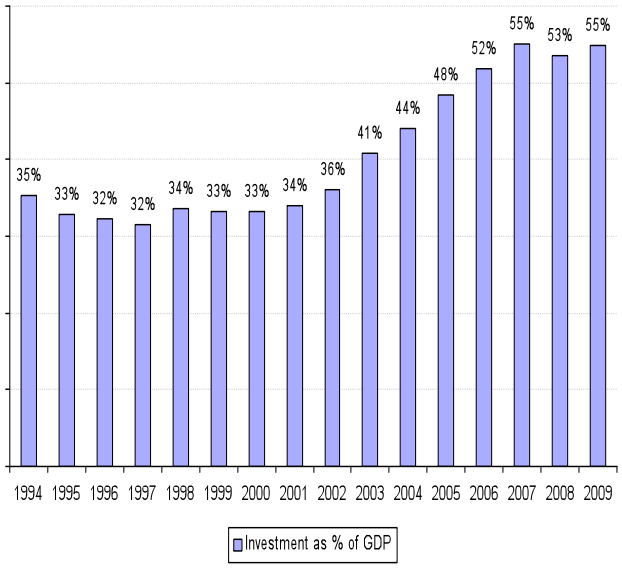


Sources: CRIC, Standard Chartered Research

The problem with this unnatural and speculative growth is that when it is linked to other unnatural trends and bubbles, such as the credit extension, the accumulation of foreign reserves, the irrational investment spending on projects that cannot pay off, the foreign capital inflows, and the under-consumption patterns due to depressed wages and safety nets, then you have a case where it is not just an asset class that endangers the country, but the totality of the asset classes – except the ones that are considered hard assets - that are in jeopardy. The danger of course is even bigger when that country is an "anchor" for cheap imports, bond sales, deficit and debt refinancing, cost containment, and low inflation, among others. The shaking that a Chinese collapse may produce could bring tsunamis throughout the world.

6. As the following figure shows, the growth of the fixed capital investments in China as a fraction of the GDP, have surpassed every imagination. While such fixed investment spending keeps people employed and stimulates economic growth, it could prove to be a traumatic experience if such spending is contributing to overcapacity, and/or is financed by credit without the proper evaluations (e.g. without having a genuine positive net present value, a realistic rate of return that exceeds the cost of funds, or a discounted cash flow that meets investment returns benchmarks).

Figure 8: Fixed Capital Investments as a Percentage of GDP



Source: China National Bureau of Statistics

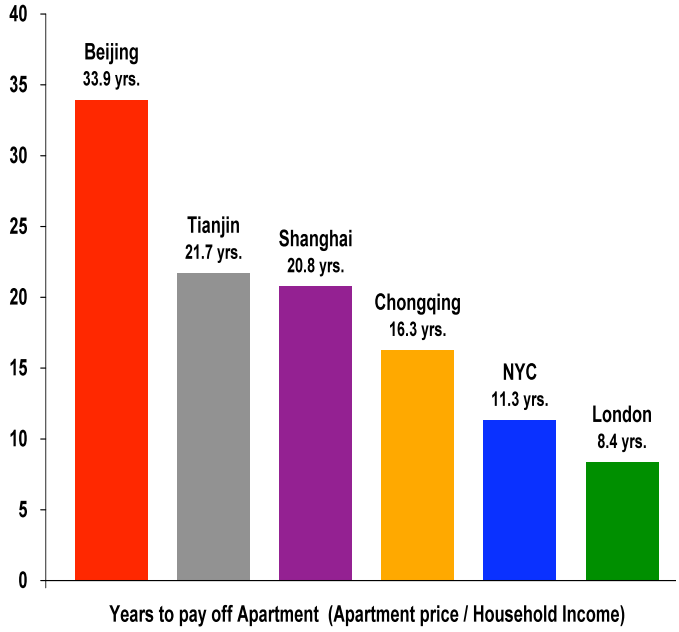
We are afraid that we have seen this movie before. The high figures above attract foreign capital, which in collaboration with sterilized and unsterilized credit operations expand the money supply, drive asset prices higher, fuel a boom via credit and subsidies (the slush funds) and eventually become the epicenter of a crisis where investors (domestic and foreign) are burned.

The excesses that have been created in several sectors in the Chinese economy – fueled by credit creation, financial instruments known as CWMPs as explained below, and investment spending – has become a feeding loop mechanism that artificially sustains growth, and does not translate into higher spending of the locally produced goods, as we explained earlier. The result is that a potential quake could be even more intensive if and when it comes because the growth that the country is experiencing is based on the expansion of inputs rather than on productivity growth rate (where each unit of output is produced at lower costs). The diminishing returns of the inputs' expansion come back and haunt those who relied on them.

7. We should now link the capital investment spending to the credit extension that has been fueling the growth and is feeding the bubbles. In 2009 banks loaned more than 5.2 trillion RBMs for infrastructure and industrial spending. The growth in credit by the largest five Chinese banks relative to the previous year was more than 50%. Even by Chinese

growth standards such credit extension is unjustifiable. Moreover, such credit stimulus represented close to 15% of Chinese GDP, which by itself is dangerous when it happens within a few short months. To that we should also add the fiscal stimulus, which was almost another 15% of GDP (the US stimulus in contrast was about 5.5% of GDP). The problem with both the credit and fiscal stimuli was that local officials started spending money for the sake of spending it i.e. without any proper analysis and evaluation of the projects involved, while state-owned enterprises and banks did exactly the same thing. All these spending measures contributed to the misallocation of resources, waste, bubbles, and diversion of funds into the real estate sector, as well as into export-oriented subsidies which in turn exacerbated the buildup of imbalances. As experts also testify, the whole process has been changing Chinese attitudes, culture, and mentality shaping new values and priorities. From a historical and sociological standpoint these kinds of changes could prove to be very damaging to the psyche and soul of a nation. According to C.B. Richard Ellis' findings, office rents fell in Shanghai and Beijing by over 20% in 2009. Moreover, according to the same survey there are currently over 2.6 billion square meters (close to 30 billion square feet) of non-residential real estate projects under construction in major Chinese cities, financed through the steroids explained earlier, and which may result into the Great Wall of Foreclosures in the years ahead.
The next figure shows that Chinese residential real estate is unaffordable and sows the seeds for discontent and corruption.

Figure 9: Affordability of Housing



Source: National Bureau of Statistics (China), U.S. Census Bureau, Office for National Statistics (UK)

When it takes 3 times more to pay off an apartment in Beijing than it takes to pay off an apartment in NY, we know we are dealing with an unhealthy market that is destined to burst. A burst of such a bubble will prohibit the development of a true middle class in China that could have sustained its growth internally, could also destroy the generational savings that the Chinese people have built up over a long period, could inflict significant damages to construction material prices, will force sales of Chinese holdings (here come some dreadful consequences for US bonds as well as some geopolitical considerations as to who will control and buy the assets that the Chinese will be forced to sell), and could become the tipping point of a demographic and social turmoil that could upset geopolitical balances for many years to come.

Fixed Investment Spending, Overcapacity, Credit Extension, and Systemic Risks

Edward Chancellor in his book Devil Take the Hindmost, as well as in other of his writings, George Cooper in The Origin of Financial Crises, and Hyman Minsky in Stabilizing an Unstable Economy, outline some basic signals of a bubble.

Let's review them and add a couple of our own:

1. Excessive investment spending and capital misallocation. The 2009 IMF World Economic Outlook Report states that countries with high investment share of GDP, experience the steepest and most prolonged downturns.
2. Excessive credit growth, low yields, and money supply growth rate that is out of touch with fundamental economic growth rates.
3. Asset prices increase at a rate significantly higher than the one justified by long-term growth and productivity measures.
4. The debt level as a percentage of GDP (both public and private debts) and the debt service burden as a fraction of the income required to service the debt, also increase substantially.
5. A pervasive climate and psyche that this time the growth story is different, due to new technological inventions, promising demographics, tremendous profit prospects, and a newly found ability of the authorities for smooth landing. Moreover, the attitude is that if something goes wrong, big daddy (a.k.a. government, central banks, or the Greenspan put) will bail out the speculative maniacs (especially if they are too big to fail). At the same time, corruption increases, books are cooked, and a party-spirit glorifies the unsustainable and the unjustifiable.
6. Underwriting standards are violated that allow the funding of projects that cannot pay off their dues.
7. New financial instruments are being invented that are sliced and sold as investments and which in turn are being used as collateral for further extension of credit. At the same time there is a lack of proper monitoring by the regulatory authorities.

Do we see any of the above in the case of China? Actually, the question should have been: Is anything from the above list missing from the Chinese picture?

The China story is another story about promising growth due to demographics and low production costs. At the same time, the Chinese buildup of foreign reserves has given China an aura of invincibility. Despite the global financial crisis, China seems to keep growing at impressive rates. However, its economy has become lopsided. Its growth followed the classic export-led model. At the same time it effectively kept its currency cheap while subsidizing its exporting industries. The threat of protectionism will be clear in a double dip.

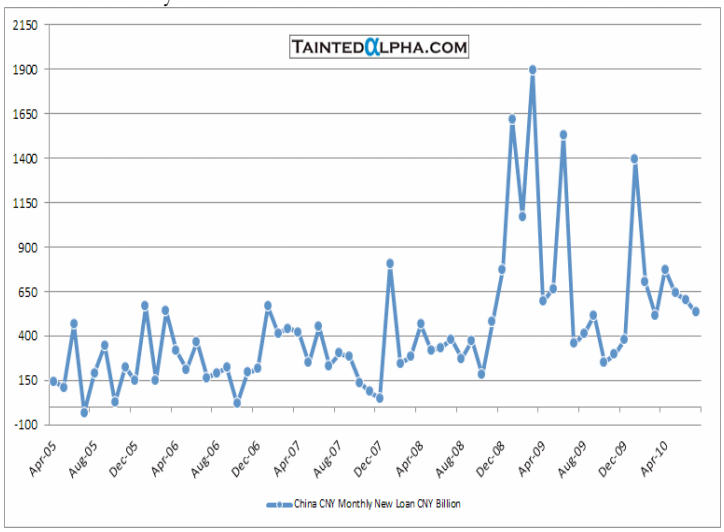
The main issue however, will be the buildup of excess capacity. The outcome (GDP growth) has become the target for authorities in China. Thus, reminiscent to the cases of US corporations in the 1990s – such as MCI, Enron, etc. - the officials are tempted to create slush fund operations, dress up and sugar-coat reality. Thus while the growth appears "real" it hides overcapacity and useless investments that cannot pay off the debt by which they were financed with. When investment decisions are made in order to meet the growth target, and especially if they are financed within a framework of moral hazard, then artificial and non-substantive economic outcomes are achieved that inflate bubbles – such as real estate and infrastructure projects – which eventually burst and burn those who have depended on them.

Moreover, when those involved in the undertaking of the projects are state-owned enterprises (SOEs), and those who financed them are state-owned banks, then you have the lethal cocktail we mentioned before where preferential treatment and favors are exchanged for the sake of the target while ignoring standardized underwriting procedures. This kind of investment procurement is dangerous not only for China, but also for those who depend on China (such as those in Africa, S. America, and Asia who through recent trade agreements envision growth and prosperity).

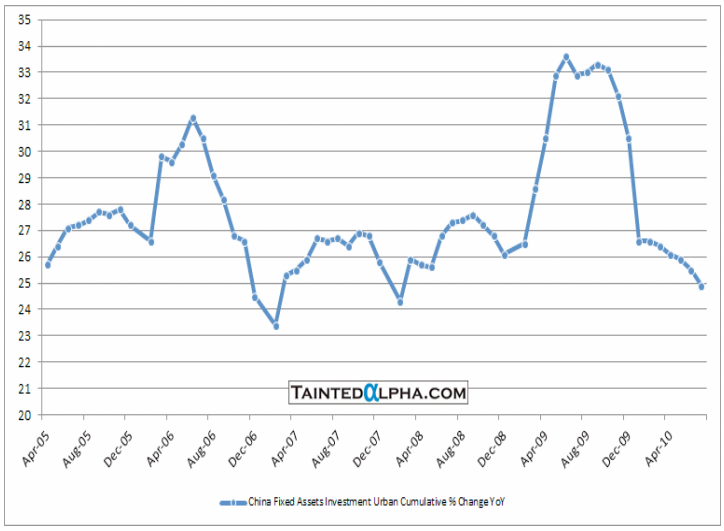
The exponential growth rate of fixed asset investments (FAI) in China especially over the last few years (see next figure) raises the question of how well the money was spent and it also questions the quality of those investments. In 2009, FAI contributed 90% of Chinese growth. Moreover, more than 55% of the stimuli (fiscal and monetary) were spent on infrastructure projects extending overcapacity and fueling a bubble.

Figure 10: Credit Extension/New Loans, and Fixed Asset Investment (FAI) in China

Part I: Monthly New Loans & Credit Extension



Part II: Annual Growth in FAI



Given the existing levels of Chinese overcapacity (e.g. many small airports run at half capacity) and the powerless Chinese consumers, one obviously has to question the wisdom of building even greater capacity when there are doubts of its need, but also if the financing can be paid back.

A report by the European Chamber late last year, identified overcapacity in the following sectors: iron, steel, cement, shipbuilding, flat glass, wind power, and poly-crystalline silicon. In the cement industry, capital investments rose by over 65% in 2009 despite the overcapacity. This is a classic case of low total factor productivity, and diminishing returns. If the loans go bad, then the inability to recoup the costs will fall on the government which will either have to come up with a scheme or will be forced to unload assets.

We could echo Professor Minxin Pei's comments in his book China's Trapped Transition: The Limits of Developmental Autocracy, where he writes that endemic corruption in China "steadily increases a country's systemic risks. As a result, its financial system is fragile, its environment degraded and vulnerable, its law enforcement establishment tainted and ineffective, its infrastructure insecure, its public health service unresponsive, and its regulatory system creaky."

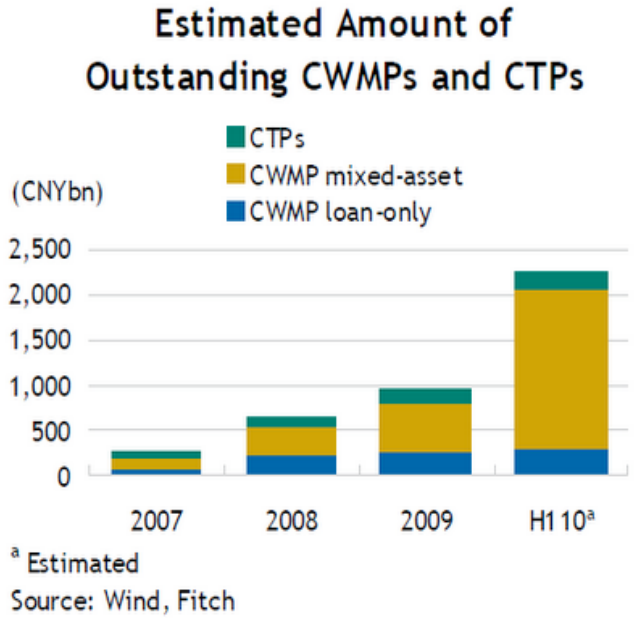
The enormous size of the non-performing loans in China is such that they could unravel the whole state-directed growth exercise. We in the West experienced the Ponzi scheme where "assets" were authenticated as worthy of higher prices, then hypothecated and re-hypothecated again and again for the purpose of credit extension, leverage financing and a good party at the expense of those who eventually will pay the bill. We are afraid that China is in the same boat. The Chinese scheme as exposed by Fitch's report on Chinese banks is as follows: The government dictates growth rates. The local officials do whatever it takes to achieve the targets. However, local governments are prohibited from guaranteeing loans. Thus, they set up SPVs (special purpose vehicles) whose capital is provided by the local governments. The SPVs borrow from banks (a great majority of them state-owned), who unload the loans to investors via new financial instruments (CWMPs), and the spending spree starts. It is estimated that half of last year's loans were given to SPVs, where the underlying projects have little if any cash flow! The assumption of course is that the growth of the economy can justify the loans and the spending, despite the fact that the people cannot spend since they lack the income. Alternatively, the local governments can pay off the loans with land sales proceeds. The problem is, as we have shown, that land prices are outlandish. Thus, if the real estate market crashes, local government revenue will tank too, and here you go in terms of a the new phase in the financial crisis, this time made in China!

Fitch writes in their report: "*Fitch ratings cautions that lending has not slowed nearly as much as official data suggests, due to the increasing amount of credit being shifted off of Chinese banks' balance sheets via informal securitization (ie the re-packaging of loans into investment products for sale to investors)." Fitch believes the vast majority of these transactions are not publicly disclosed by Chinese banks and few if any, traces of the loans remain in financial statements. The growing popularity of this activity is increasingly distorting credit growth figures at an institutional and system level, resulting in pervasive understatement of credit growth and credit exposure. Consequently, Chinese banks' loan loss reserves and capital are more exposed to credit losses than current data suggests.*"

Fitch also reports that the informal securitization rates are rising and are concentrated in few banks, as the following figure shows. Among the five biggest Chinese banks, this informal securitization increased by more than 50% between the first half of 2009 and the first half of 2010. The growth targets, the need to make room on banks' balance sheets for new loans and the hunger for greater yields and returns created this dangerous

environment of credit explosion based on questionable assets and thus the inability to payback debts, while it incentivized managers to promote questionable instruments.

Figure 11: The Increase in Credit-Backed Wealth Management Products (CWMPs)



The problems were exacerbated when we take into account that the original borrowers are not known to those who buy the securities of the CWMPs. It could be a municipal authority that was told to build a mall that nobody visits, or a single corporation that owns assets in the shipbuilding industry that suffers from excess capacity. Even worse, there is no Michael Milken in China to create a secondary market for those CWMPs. Thus the liquidity concerns, especially given the fact that when the tremors start, banks will have no other party to rely on for assistance since they originated the loans, created the CWMPs, marketed and distributed them, while at the same time managed the loans and became the custodians.

To us it seems that the Chinese credit tower has been becoming structurally unstable. To that we should add three additional risks that are mispriced in the credit picture. First, the quality and over-valuation of the underlying assets that support the credit expansion; second, the liquidity that is necessary to protect the credit system from a systemic tremor; and third, the loopholes and innovations of Chinese trust companies in avoiding the regulatory rules, and thus setting in motion the undermining of the structural foundations of the credit tower.

The instability of the structure has also to do with that fact that banks buy and sell each other's products as well as with the upcoming maturities of financial instruments. Regulations that prohibit the securitization and the off-balance sheet activities raise doubt about the ability of investors to recover their capital since banks cannot raise the capital via securitization of trusts companies' loans that the bank used to pre-sell to investors to pay back old investors. The situation becomes even more complex if the banks need to be bring back the original loans onto their balance sheets. In that case the loan/deposit ratios will deteriorate as will the banks' capital ratios.

Some Wall Street gurus are telling us that the securitization market is small in China. Guess again. Swap agreements are thriving in China, where loans are repackaged and sold to investors, institutions and other entities, sometimes in the form of a swap, especially just before the financial reports are due. In that case the transactions are off-balance sheet (Lehman Brothers anyone?) allowing banks to stay within the lending directives and regulations. In 2006 Ernst & Young estimated close to one trillion USD of non-performing loans in China. Anyone want to guess what the amount is today in an economy close to 5 trillion USD?

Conclusion

The analysis above points to a conclusion that is disheartening, but possibly inevitable. China has all the characteristics of an unsustainable bubble that will burst. The consequences of that fall will be worldwide. It may force us to rethink geopolitics and geoeconomics. It may reveal that the emperor is naked. It may crash currencies and debt markets. It may lead us to a true Great Recession. It may point to some defensive and pre-cautionary measures as well as to some offensive measures from those who could gain from possible Chinese turmoil. From a global perspective our question is: Cui bono (who benefits) from the possible collapse?

DUM SPIRO SPERO!