China's Stock Market Collapse*

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The recent rout in the Chinese stock market – and the Chinese authorities' increasingly panicky responses to it that temporarily halted the decline – may not seem all that important to some observers. Indeed, there are analysts who have said that this is just the typical behaviour of a still immature stock market that is still "froth" in the wider scheme of things, and not so significant for real economic processes in China. After all, the Chinese economy is still much more state-controlled than most, the main banks are still state-owned and stock market capitalization relative to GDP is still small compared to most western countries, with less than 15 per cent of household savings invested in stocks. Most of all, there is the perception that a state sitting on around nearly $4 trillion in foreign exchange reserves should be rich enough to handle any such exigency without feeling the pain or letting others feel it.

But this relatively benign approach misses some crucial points about how the Chinese economy has changed over the past few years, as well as the dynamics of this meltdown and its impact in the wider Asian region. Since the Global Recession, which China weathered rather well, there have been changes in the orientation of the Chinese government and further moves towards financial liberalization, which were rather muted before then. And these resulted in big changes in borrowing patterns as well greater exposure to the still nascent stock market, in what have turned out to be clearly unsustainable rates.

Some of this has to do with real economic processes. The export-led strategy that had proved so successful over two decades received a big shock in 2008 and pointed to the need to generate more domestic sources of demand. But instead of focussing on stimulating consumption through rising wage shares of national income (which could eventually have threatened the export-driven model) the Chinese authorities chose to put their faith in even more accumulation to keep growth rates buoyant. So the "recovery package" that the Chinese government out in place in the wake of the Great Recession of 2008-09 was essentially one that encouraged more investment, in an economy in which investment rates already accounted for close to half of GDP. The stimulus measures encouraged provincial governments and public sector enterprises to borrow heavily and invest in infrastructure, in construction as well as in more productive capacities even though it was becoming evident that there had clearly been excessive capacity creation in the previous period. They also encouraged much more active interest in the real estate sector, which became the driver of China's growth in the recent period.

Much of this investment was on the basis of money borrowed from the public sector banks that had dominated the financial landscape in China. But as the real estate sector started showing signs of a major bubble, banks were restricted from putting much more money into such loans, and there were also caps on their deposit and lending rates. This encouraged the growth of a "shadow banking" sector that emerged as a form of regulatory arbitrage, as various trusts and non-bank financial institutions created "wealth management products" to offer higher returns to savers and provided financing for real estate and construction, fuelling the property boom. Surprisingly, the authorities turned a blind eye to such developments – and even implicitly encouraged them, allowing banks to lend money to such financial institutions and thereby get indirectly implicated in this process.

The result has been a dramatic explosion of debt in just a few years. Between 2007 and 2014, total debt in China (in absolute Renminbi terms) went up four times, and the debt-GDP ratio nearly doubled. At around 282 per cent of GDP, this makes debt in China relatively much larger than in, say, the United States. Corporate debt increased to reach 125 per cent of GDP; provincial governments are also highly leveraged for infrastructure investment; and debt held by households has gone up nearly threefold to a hefty 65 per cent of GDP. Fully half of the debt (much of it coming from the unregulated shadow banking institutions that were allowed to flourish) was oriented directly or indirectly towards the real estate market and housing finance, fuelling property bubbles in major Chinese cities that began to burst around a year ago.

We know what happens when the value of the underlying asset falls: this affects the capacity to repay, as the US housing market in 2006-08 vividly illustrated. The housing bubble began to subside from early 2014: total property sales fell by nearly 8 per cent in that year, and new land purchases by developers have fallen by nearly one-third in the first quarter of 2015 compared to the same period the previous year. The index of housing prices for 70 cities shows that average new home prices dropped nearly 10 percent by May 2015 compared to the beginning of 2014.

The subsiding of the froth in the housing market led to investor focus on the stock market, which then began to sizzle. The past year showed how irrational such markets can be, as stock market indices went up by more than one and a half times in around a year, reaching a peak in early June. For some stocks, the price-equity values crossed 200. This was clearly crazy and begged for a correction, which was bound to happen. But that correction was untidy in the extreme. Since12 June, stocks have plummeted, and on the worst day in early July they were trading on average at nearly 50 per cent lower than the peak. Worse still, at first various emergency measures of the government - from suspending trading in stocks of nearly 800 companies, through forcing brokers not to sell their shares, to indirectly buying shares on a mass scale through the China Securities Finance Corporation and sovereign wealth funds–did not work in stemming the downslide and may even have backfired by adding to the sense of panic.

Thereafter, there has been some stabilisation, although this is clearly artificially created and the market is likely to remain jittery for some time. In any case, the inflated stock prices have still not come down to what could otherwise be called reasonable levels given the crazy increases during the bubble phase, and so there may be more "correction" required. This has created a problem for the Chinese state, whose aura of economic omnipotence has taken a severe battering, because it is no longer clear how exactly they should best deal with this situation. Having talked up stock market, extolled it as a sign of China's growing economic strength and encouraged much greater participation in it by relatively small retail investors who are now suffering, they will find it difficult to allow it to decline any further, yet may be powerless to prevent it in the medium term.

This will have impact beyond the obvious problems for stockbrokers and some of China's rich. In the period of the boom - and particularly in its later stages – tens of millions of small retail investors were enticed to enter the market, sometimes betting their entire savings in the hope of making amazing gains. As is the case in most such cycles, they are the ones who will be most badly hit by the bust. The political fallout of their losses is likely to be unpleasant at the least, and potentially more dangerous.

More significantly, this asset deflation hitting both real estate and stocks comes in the context of an overall slowdown in GDP growth driven by poor export performance in the past year, which is already having negative multiplier effects across the economy. The Chinese government has cut interest rates four times since November and launched a slew of stimulus efforts to shore up economic growth. Few of them seem to have worked as intended, bringing to mind the desperate but unproductive efforts of Japan's government nearly three decades ago. Manufacturing activity - the mainstay of the economy - is falling and jobs are being shed in this sector.

This has already begun to infect other economies across the world. China's imports fell by 17 per cent in the first quarter of the year compared to the previous year - and analysts say this is just the beginning. The resulting pain is being felt by commodity producers and intermediate manufacturers from Brazil to Nigeria to Thailand. The worst impacts are in Asia where China had become the hub of an export-oriented production network catering mostly to the west. Many of these Asian economies are already into or about to begin their own asset deflation processes, as the highly leveraged property bubbles in those countries have started to collapse. Contagion will spread both through trade and through finance, with negative feedback loops widely in evidence.

With such an integrated world economy, such severe headwinds cannot go unnoticed in any region. And the febrile behaviour of finance is only likely to make things worse. So those who are looking only at Greece and the crazy behaviour of the European Union may well be looking in the wrong direction to identify the next big crisis as it comes.

But there is a bigger lesson in this, beyond that of concern for the immediate future. The lesson is that unregulated finance is not just a terrible master – it can also never be a servant (that is, under the control) of society and the real economy once it is unleashed. If an economy as strong and apparently state-directed as that of China can be so badly hit by these crazy moves in asset markets with only partial deregulation of financial activities, the clear dangers of such deregulation should then be apparent to everyone.

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