The illusory wealth effect

How today's Chinese economy came to be

by Jack Rodman

As September approached, no one was feeling good about the economy. Stock markets across the globe had experienced double-digit declines, wiping out any gains for 2015. This time, the pundits can blame both the US Federal Reserve — which seemed likely to increase short-term interest rates, ending almost seven years of quantitative easing that expanded its balance sheet by more than US$3 trillion — and China, whose economy has slowed significantly amidst a basketful of bubbles, in pursuit of an illusory wealth effect designed to wean the world's second-largest economy off its investment- and export-driven model to a consumer-driven economy.

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A review of my past writings reveals the recipe for events unfolding in China today, which, in turn, are contributing to the current global market chaos. What impact is China likely to have on the global economy and financial markets, and what tools does China have at its disposal to ease the pain or, economically speaking, orchestrate a soft landing?

The Chinese miracle

Let's examine the factors that led to the "China miracle": Double-digit economic growth driven by massive amounts of credit; cheap and plentiful labour willing to work hard for a generation to contribute to its country's success on the world stage; and cheap land upon which to build factories, housing and cities.

This led to two decades of double-digit GDP growth. During that time, China not only leapt onto the world stage, it catapulted itself into the No 2 spot, with the aim of overtaking the United States by 2030.

The foundation for this growth, however, was cast in the three ingredients of every financial crisis witnessed during the past 40 years: too much credit, too much investment into real estate, and a weak regulatory environment allowing the excesses of credit-investment real estate to unhinge the economy. These elements were present in the US savings and loan crisis that occurred principally during the 1980s, the bursting of Japan's economic bubble in 1989, the Asian financial crisis in 1997, the global financial crisis in 2008 and the "basket of bubbles" crippling the Chinese economy in summer 2015.

Over the years, I have written about China's myths and realities, presented comparative analyses of the Japan bubble and China's economy, and criticised other analysts who believed, "Yes, that is all true but, this time, China is different". I was fond of citing ignored issues with all fundamental approaches to financial analysis — discounted cashflow and the concept of the time value of money (ie, present value analysis), supply and demand, the utility of diminishing returns from investment in fixed assets to stimulate growth, and rapid growth in debt to GDP (from near zero to nearly 300 percent in two decades).

I cited, too, corruption at all levels of the Chinese economy, a lax or even collusive regulatory regime, and the government's attempt to ban transparency and free access to market data by rating agencies and analysts. These attempts were coupled with harsh retribution to reporters and analysts (including this author and, most recently, the International Monetary Fund) when individuals or organisations dared to challenge the status quo and the perception of a wealth effect — both used to maintain social harmony.

Real estate's role

The first Chinese wealth effect was to give people shelter by transferring squalid, 27-square-metre, communist-style, post-war houses to their tenants, who were working in state-owned-enterprise (SOE) factories and government offices throughout China. This gave the poorly-paid workers a down payment on their wealth effect and rewarded them for their hard work and trust in the party system. Many workers still live in these shoddy units, but many others were sold to allow their owners to move to larger, more modern units.

Shanghai Stock Exchange building

Real estate soon became a crucial part of the foundation of the Chinese economy, which seemed to benefit everyone: banks, local governments, brokerage services, developers, general contractors and commodity dealers, furniture sellers, etc. This contributed to a multiplier effect as real estate and construction grew to account for as much as 25 percent of GDP. Mortgage and real estate loans grew to as much as 60 percent to 70 percent of all new loans in the banking system. Attendant with this phenomenon was a view real estate could only increase in value.

When housing became unaffordable to young people and families — the value of house prices to median-area incomes was often 20 to 40 times — and the banking system's exposure to real estate was more than 40 percent to 50 percent of every loan on the books, the China Banking Regulatory Commission took steps to deflate the value of real estate through a variety of measures and restrictions. This slowed demand for real estate and curtailed the rise in real estate prices without causing the real estate bubble to burst. What remained were dozens of now infamous ghost cities, as many as 60 million vacant apartment units, and previously-empty office buildings now occupied by SOEs or owned by Chinese life insurance companies.

Shadow banking emerges

The bloom was off the rose for real estate as a way of creating the desired wealth effect. To reduce banks' overweight exposure to real estate loans, the loans had to be transferred off-balance sheet without causing a mark-to-market write-down (ie, triggering a loss). In addition, trusts and wealth-management products were set up to give the wealthiest bank customers a chance to build equity in high-yielding investments offering returns from 30 percent to 150 percent of capital investment. These trust and WMPs were backed by dodgy real estate and corporate loans.

Although consumers no longer could buy real estate that would appreciate 20 percent to 30 percent a year, they now could invest in a WMP and earn interest of 15 percent to 20 percent every four to six months. The amount of capital ultimately flowing into these products — soon dubbed the "shadow banking" system — totalled approximately 18 trillion yuan (US$2.8 trillion) by mid-2013, when the government stopped reporting on the industry. The bubble had moved from real estate to WMPs and other trust products that were coming due, and the primary borrowers (developers) had no means of repayment in a declining real estate market. An occasional default here and there brought in the Chinese banks' asset management companies, which bought up defaulting WMPs and trust products to avoid losses to investors who believed they were buying bank (ie, government) insured products.

Building stock market investment

With the fate of the shadow banking system still hanging in the balance, Chinese officials needed another product to make people feel the wealth effect — and their global egos were smarting because they owned the worst-performing stock markets (Shanghai and Shenzhen) post–global financial crisis. China has always wanted Shanghai (and not Hong Kong) to become a global financial centre so, beginning in late 2012, Shanghai created a special financial zone, built

a new stock exchange, and constructed a "financial bridge" to allow investors in the mainland and Hong Kong to invest in each other's shares. Investors had steered clear of the stock market, which peaked in 2007 when the Shanghai Stock Exchange Composite Index approached 7000 and then declined to 1500 to 2000. It lingered there for many years while the Japanese, Korean, Singaporean, US, Indian and Latin American markets soared in a post–global financial crisis recovery.

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To accomplish this in as short a time as possible, the government allowed Chinese brokerage and securities firms (many of which went bust and had to be bailed out by the AMCs back in 2006–2008) to reconstitute themselves and unleash pent-up demand for stock market speculation. This was facilitated by extending credit via the banks to the securities and brokerage firms, which in turn offered investors 95 cents on the dollar for every nickel they invested in stocks. Margin-account debt ballooned, and a new bubble entered the basket. The market's meteoric rise caught the world off guard, and Chinese regulators were faced with as many as 20 million new brokerage accounts opening each month by the most vulnerable members of society, people who had not earned a high-school diploma.

As in past excesses, when the bubble became obvious and a crash could provoke social unrest, the government took action by reducing margin accounts in June 2015, which resulted in a more than 7 percent, one-day market decline, piercing the Chinese perception that stocks could "only go up" and, if they were to go down, the government would intervene to protect investors (which they have endeavoured to do from that day forth).

More-savvy investors chose to cash out and take their gains or losses. Those who stayed in risked future market gyrations, which came to be in less than 60 days, when China unexpectedly devalued the yuan and threw global markets into the worst chaos since the failure of Lehman Bros and the ensuing calamity.

Prognosis for the foreseeable future

Given how the markets work, US investors had to endure the Greek debt crisis. Although Greece has a miniscule impact on global GDP compared with China, the uncertainty and turmoil caused global markets to writhe like a yo-yo. It was not until Germany acquiesced and Mario Draghi, president of the European Central Bank, agreed to give the Greeks the elixir of quantitative easing that markets calmed down. The fact the United States has been imbibing this brew for the past six to seven years should not be lost on US readers' own wealth effects. When China devalued its currency this past August, global markets were thrown into chaos once again.

The problems are "too big to fail and too big to fix". China's traditional quick fix is to stimulate the economy, but with debt at 300 percent of GDP — and all industries operating below capacity and inventories at all-time highs — the traditional stimulus cocktail is unlikely to have the desired effect.

China recently dipped into its US$4 trillion of foreign exchange reserves to prop up the stock market, as well as shore up the banking system by injecting more capital and lowering reserve rate requirements to free up liquidity. Still, it is too little, too late. And recent easing of housing restrictions has failed to revitalise the real estate markets. Chinese exports are dependent on global demand, which has continued to slow. Dependent economies, such as Brazil and Australia, are feeling the pain from overbuilding infrastructure to support the export of commodities to China.

The Chinese consumer is not feeling wealthy, nor is the rest of the world. In general, China's real estate market is declining, the stock market is a bust, and WMPs are not nearly as attractive. Personal savings rates are still high; consumer prices have not declined and so have failed to entice a change in spending habits, which were always based on a lingering distrust of the government to provide a social safety net, primarily in the form of social security and healthcare to an ageing population.

The "next generation" is not marrying and starting families because it cannot afford housing, which is a precursor in China to family formations. The one-child policy has not provided enough of a working-age population to support an ageing demographic. As such, the desired shift to a consumer-driven economy is going to require a generational change based on many factors over time and not quick-fix efforts.

So, buckle your seat belts and hold on to your hats. I expect it will be a wild ride as China struggles to bring about the so-called "new normal" economy. ❖

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