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Chinese Economy Fall Down and its Effects on World Economy

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ABSTRACT

The Chinese stock market crashed during the period from June to August of 2015. Due to this crash on 24th August 2015 there was a loss of 8.49% in share index. This was called as Black Monday. On 25th August 2015 there were similar losses of over 7% causing some commentators to call it Black Tuesday. China has one of the largest markets of the world; its crash has affected the world market. The effect of the crash on the world market has been observed and analysed.

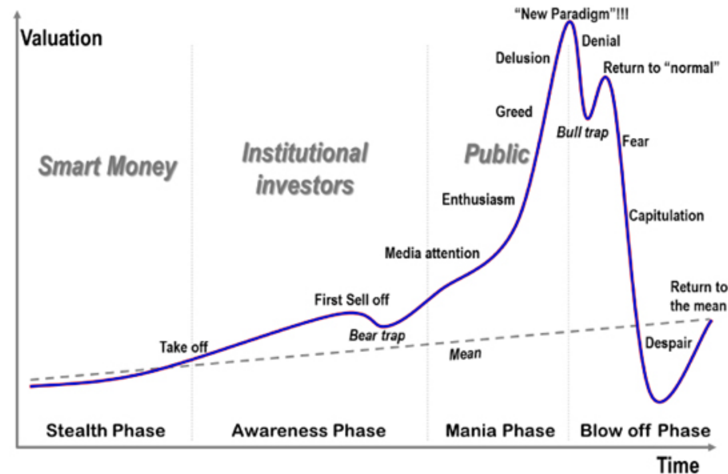
Keywords: Devaluation, Market fall, Chinese stock market.

1. INTRODUCTION

Chinese stock market is one of the largest stock markets in the world. The Chinese stock market crash began with the popping of the stock market bubble on 12 June 2015. A third of the value of A-Shares on the Shanghai Stock Exchange was lost within one month of the event. Major aftershocks occurred around 27th July and 24th August 2015. Values of Chinese Stock markets continued to drop despite of the efforts by the government to reduce the fall. On 24th August 2015, Shanghai index fell again by 8.49percent, marking the largest fall since 2007. As a result, billions of pounds were lost on international stock markets with some international commentators labelling the day Black Monday. There were similar losses of over 7% on 25 August 2015 causing some commentators to call it Black Tuesday.

Financial Bubble of an Economy

As you can see bubbles have 4 main phases:



Source: **hofstra.edu**

1. Stealth – Normally a new technology or some type of change that creates a new paradigm will make investors judge that a particular index, asset class, or stock is going to outperform the rest of the market. The savvy investors are fast to recognize the opportunity and invest in it. This is what we call the "smart money," which is cautiously invested. Prices start to gradually increase, however, the average retail investor or even most of the institutional investors cannot perceive the change and have not identify the opportunity yet.

2. Awareness – At this stage many institutional investors and some retail investors start to notice the uptrend in prices. These investors will want to participate in the price appreciation and will pour more money, which will result in even more inflation. At this stage, a few short-term sell-offs, each one starting at a higher level than the previous one, can occur. In the stock markets, this moment is called bear trap. We talked before about "smart money," These investors will take the mini-selloffs to increase their position and will start feeling more confident about the up move. Right at the end of this second phase the media will start airing the positive effects of the increase in prices. The effect will be "less smart money" or as its known "dumb money" entering the investment.

3. Mania – Now every investor knows about the "tremendous opportunity" that the particular investment is offering. People that never invested a dime, and that never had a trading or investment account, start pouring all their savings, and borrowings, into the investment. No one wants to miss in the "once in a lifetime opportunity." Stories of the humongous amounts being made by some investors, the number of new millionaires, and the unlikely successful investors cover the media in this stage. Greed mode is on. At the same time the "smart money" is gradually and silently getting out of the investment or they start heavily hedging it. Some of the most heavily invested market participants will make the assessment that there are new fundamentals that reign the investment and this will justify the future price appreciation. Now the bubble is really close to burst.

4. Blow-off – There will be always some type of trigger that will make all the market participants realize that the situation has changed. In reality the situation is the same, but the simple fact that the majority of the participants feel that the situation has changed is enough to start the sell.

In some cases media outlets, financial advisers and/or even the financial authorities will try to comfort investors and make them believe that the uptrend is not over, that the sellout is just a bump on the road. Some people will believe it; this will make the fall come in phases, but really fast ones. The drop will be at a much faster rate than the one that made the investment vehicle go up. At this point the "smart money" will be calmly waiting for the rest of the investors to sell all their assets, for the leveraged asset owners to go bankrupt, and for the value of the investment undershoot the mean. In this moment, the "smart money" will be, again, buying while the average investor is still licking his wounds.

The Chinese Equity Bubble

This chart illustrates the daily prices of the Shanghai Stock Exchange Composite Index. This index includes the A-shares and B-Shares that trade at the Shanghai Stock Exchange.

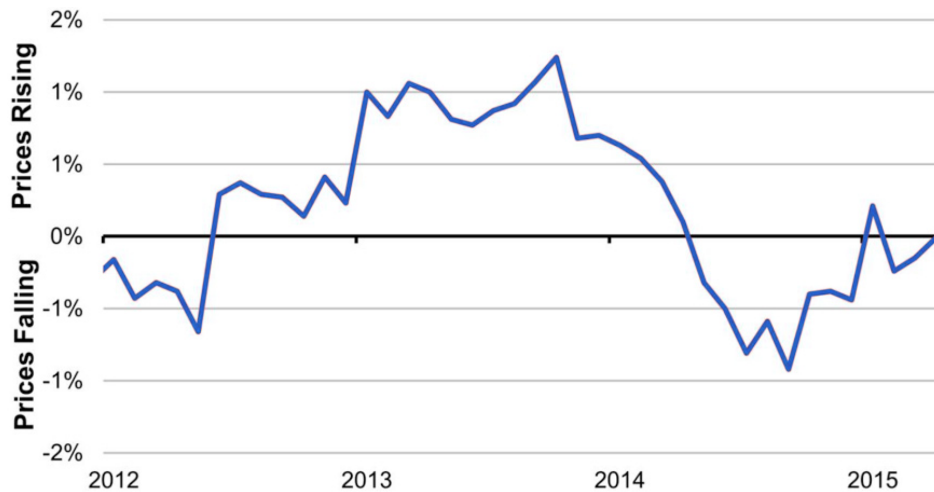
Source: **Yahoo finance**

Having the previous chart in mind, the anatomy of a bubble, and the phases and explanations, let's try to explain what has happened in the Chinese equity space.

From 2009 to 2012 China adopted an expansionary fiscal policy and a moderately easy monetary policy in order to stimulate the economy. The People's Bank of China plus the tandem Xi Jinping, China's paramount leader, and the Premier Li Keqiang came to the conclusion that this policy combination would improve the growth perspectives, which were quite damaged after the global financial crisis. This policy affected, among other dimensions, the property market. The following chart shows the price index for a 100 major cities in China.

The property value increased after the first years of expansionary policies, but as you can see in the chart, in 2014 property prices started to first, grow at a low pace and then decline. This was the moment when the equity markets started the rally that ended last 12th of June. In the moment that the property market started dropping, the Chinese people run out of choices over what to do with their money, which due to the expansive policies was more abundant than in recent past periods. It is key to remember that

they cannot transfer the money out of the country easily and that bank interest rates didn't cover inflation. The investors turn to the stock market, and since they can only invest, in most cases, in domestic shares, the Shanghai Stock Exchange was set to have the classic boom-burst cycle.



Source: **China Real Estate Index System/SouFun Holdings | THE WALL STREET JOURNAL**

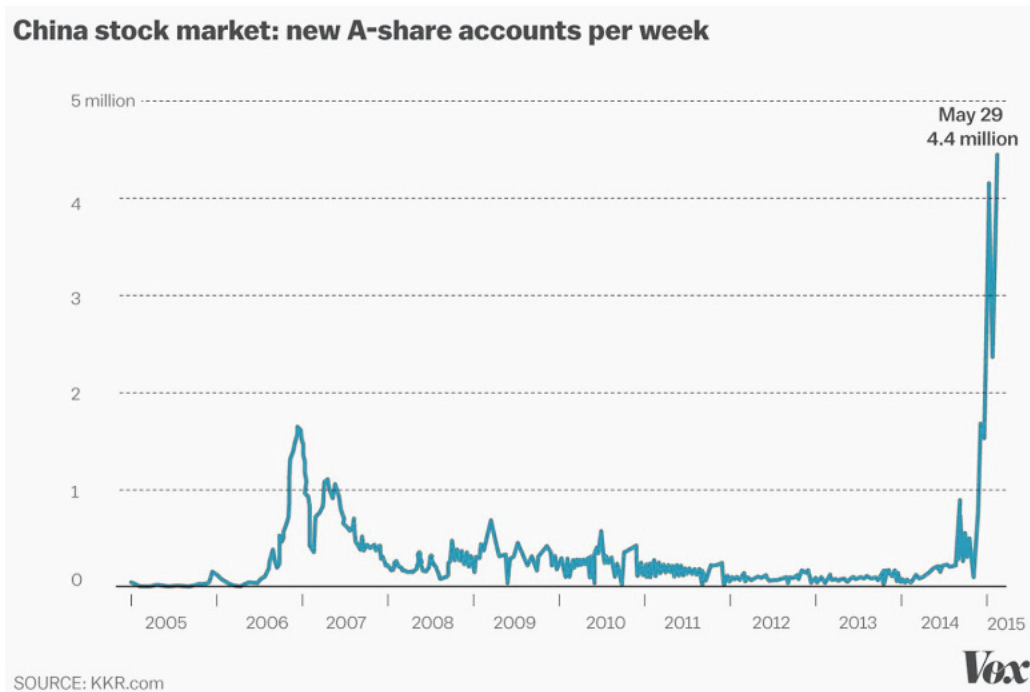
However, in the beginning of this bull-run the average investors did not participate. In the first half of 2014, no one wanted to know anything about the Chinese markets. For six years the Shanghai Stock exchange was experiencing and tremendously punishing bear market while other markets such as the U.S. were rewarding investors with Hefty wins. However, in April Goldman Sachs, Morgan Stanley, and JPMorgan all published institutional-research reports illustrating the opportunity in the Chinese market. Some of the biggest asset managers were already buying into the Chinese market. As you can see, it matches perfectly with the stealth phase of the bubble. Let's move to the awareness phase.

In the second half of 2014 and as specially in the last quarter of 2014 the buying of Chinese equities intensified. The Shanghai Stock Exchange went from 2100 to 3350. This means that it went up almost 60% in a period of 6 months. During December 2014 and last January, we saw the exchange doing exactly what an investment vehicle would do at the end of the phase of awareness, it experienced a series of sell-offs each of them at a higher point than the last one. If you remember this point is called the bear trap. It lasted until the beginning of February of this year. This was also the moment when the media really started covering the Chinese's market bull run. Some of the news could read:

- China's stocks roar back in 2014, trashing India – CNBC (December 2014)
- Mobius says China's Bull Market Is Just getting started – Bloomberg (December 2014)
- China's stock market is not in a bubble – CNBC (January 2015)
- Bull run in Chinese shares is just the "beginning" – BBC (January 2015)
- Charts: China stocks may form new long-term uptrend – CNBC (March 2015)

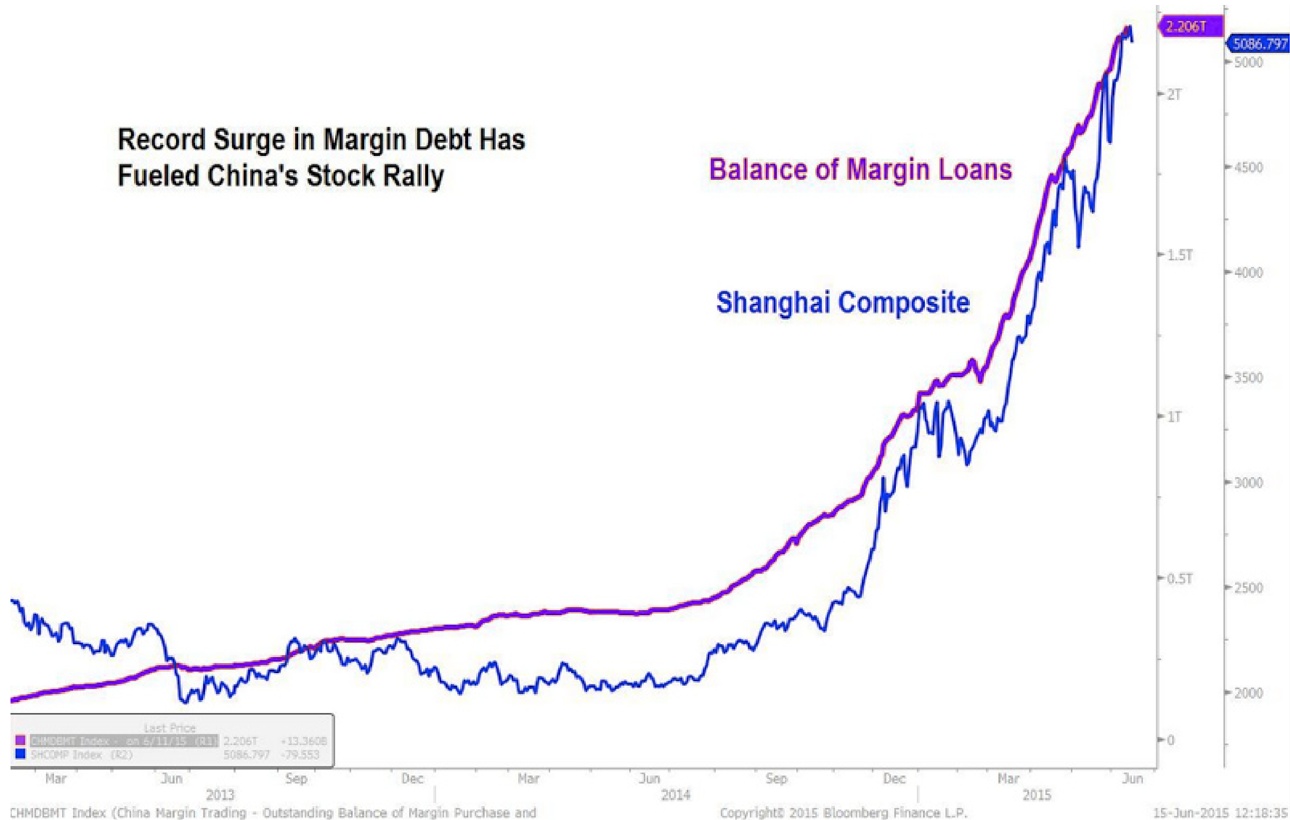
In these articles, the media was already forecasting the Chinese equities at the levels of 2007 in 12-24 months. Fits quite well the timeline of the bubble. On to the mania stage.

The Mania stage is the one that Chinese people have been experiencing for the last months. Since January and until the 12th of June, the Shanghai Stock Exchange went from 3350 to 5166, or 54% up. However, from June last year to June this year the index surged almost 150%. This boom has come as millions of citizens have been picking up trading. The volume of shares traded from January to May of 2015 was equal to that one traded in the whole 2014. More than 30 million new trading accounts were opened in the first 5 months of 2015, a number 3 times bigger than the total number of accounts opened in 2014 (data from China Securities Depository and Clearing Corp).



A survey from 2014 showed that two-thirds of Chinese investors didn't have a high school diploma. People were quitting their jobs to trade, and even farmers were giving up tending their fields in order to trade Chinese equities. Right before the 12th of June, brokers were opening 4 million trading accounts a week to meet the never-ending demand by retail investors. Margin accounts were prohibited until a few years ago, however since the government lifted the prohibition the lending has gone through the roof. It is quite surprising how the amount of margin lending (brokers lend money to their clients so they can buy stocks) went from basically nothing to a record high for any equity market in history, and only in a few year. This chart shows how the boom has been matched by a steep increase in margin lending.

As retail investors went all-in, the "smart money" started to get out. Before 2014, major shareholders of A-shares companies sold in average RMB100 billion worth of shares per year. However, in 2014 the amount was almost doubled, and in the period from January to May of 2015, the net sales from major shareholders reached the astonishing number of RMB360 billion. So, "dumb money" has been buying the shares from the "smart money." This fits perfectly the stages of enthusiasm, greed and delusion that form the Mania phase. News talking about the number of new millionaires and billionaires, as well as how easy it has been to make money in Chinese markets, have been common these past months:



Source: **Bloomberg**

- China, 100 new billionaires in less than a month: the miracle of the new Stock Exchange – Asia news (June 2015)
- Meet China's New 'Investor' Class: "It's A Lot Easier To Make Money From Stocks Than Farmwork – Zero hedge (June 2015)

As you can see, the mania stage experienced in China shares the characteristics of the one in the model of a bubble presented at the beginning of the post. Before moving on we need to add that this mania stage has been fueled also by the Chinese government that used the media to advice the citizens to buy stocks and participate in the bull market. Finally let's see how the blow-off is going.

The Shanghai Stock Exchange has lost 25% since it peaked a month ago. I fail to recognize what the exact trigger for the sellout was, and I don't agree with those that say that it is due to the slowdown in the economic growth. I don't see how that perspective has change in the past month to result in this. At the moment Chinese investors are panicking, they are fearful and they try to find who is to blame for their losses in the past month. Some of them believe that foreigners are attacking their markets, but others, an increasing number, are starting to blame the government for their losses. This is because they feel that the government pushes them to invest with all the cheer-leading that it did, and still does. China has decided to take a few measurements in order to support the stock market and cut the sellout.

1. The government has lent RMB260 billion in order to buy "blue chip" stocks.
2. New RMB250 billion stimuli in order to foster growth in the Chinese economy.

3. The People's Bank of China cut rates to record lows resulting in a lower Yuan.
4. Speed up of government spending.
5. IPOs have been stopped.
6. Over 50% of the companies in the Chinese market have stopped trading.
7. Those considered big shareholders have a restriction that prohibits them to sell any stock in the next 6 months.
8. The variety of assets that can be posted as collateral has increased.

Reason for Chinese Economy Collapse

The market collapse is easy to explain. With only rare exceptions (like the 'flash crash' of 2010), collapses are always easy to explain, because they all have the same explanation.

Enough people wanted to take some of their money out of the market that prices began falling, which convinced more people to take money out. This imbalance continued, prices falling all the while, until there were more people who thought there was more money to be made getting in than getting out.

What needs explaining, with any bubble, is not why it deflated, but why it was inflated in the first place.

In most markets, this is a hard question to answer, with vague references to overconfidence and animal spirits being invoked. In China, there is a simpler explanation: the government did it, and everyone saw them do it. Indeed, government assurances in 2015 that the boom was just beginning served as an implicit guarantee of the market's safety for unsophisticated investors.

Over the last generation, China has become 'post-socialist'. The single-party state and its key institutions remain intact, even as the ideological stances associated with Communism (including, most dramatically, opposition to the market) have faded away. This has shifted the government's source of legitimacy from ideology to economic growth. A growing market is a potent symbol of that transformation.

And the government needs all those kinds of symbols it can get right now. Economic growth is slowing (still more than double U.S. growth, but slow for China), income inequality is now even worse than in the U.S., and the previous 'anyone can become wealthy' investment vehicle, real estate, is cooling.

Given all this, a market open to individual investors allowed the government to associate the general rising value of the Shanghai Composite plus the occasional, spectacular IPO with the idea that ordinary citizens could profit from the equities boom (a sentiment very like that in the U.S. in the late 1990s.) If Ma and Pa Shuihu could buy and sell stocks, Beijing could argue that the rapid minting of billionaires would lead to generalized prosperity for the masses, at least if the masses opened a brokerage account.

They accomplished this two ways. The first was regulatory adjustment, where it became easier and cheaper to buy stocks. They lowered trading costs. They lowered interest rates. They allowed people to borrow money more easily, even letting them use existing stocks as collateral. They allowed people to open more than one brokerage account, in order to maximize their chances of getting IPO stock.

The second way they helped inflate the market was using government media -- CCTV, Xinhua -- to talk up the market, which had the dual effect of publicizing it and advertising its (implicitly government-backed) safety. This brought in not just individual investors, but unsophisticated ones: 80% of new investors in 2015 had a high school degree or less, including 2/3 who didn't finish high school.

The bubble popping is a scary thing for Beijing, because it leads ordinary people to question their competence and control. But the government's reaction to the bubble popping is much scarier for China as a whole.

In recent moves to shore up the falling market, Beijing has pushed their pension funds to invest in the market. They've cut interest rates and trading costs. They have forbidden any institution that holds more than 5% of a single company's stock from selling it until this fall. They have threatened to jail short sellers. They've even announced that farmers can now use their land as collateral

The short-term effect of the bubble was that that a lot of people who thought they were rich aren't, and few people who invested late actually lost money. All that is minor, though, compared to the threat of what may happen now that other national institutions have been pressed into service re-inflating the market.

As a reaction to the bubble bursting, the government has weakened the regulations that keep the real economy from being swept up into the market economy. Bubbles come and go; the real damage they can do is in forcing people to sell underlying assets -- houses and farms especially -- to deal with the resulting debt, and the government has now made that outcome considerably likelier next time.

To summarize

1. Law of regression to mean-statistical anomalies (in this case, unprecedented gdp growth) are bound to eventually correct themselves eventually.
2. Demographics. The demographic dividend of China's one child policy (lots of working age people with few dependents) has already paid off, and is starting to even out (and may in fact harm them in the coming years as the number of working age people may not be enough to support all the retirees)
3. 'Catching up' with the developed economies. When there was such a massive gdp/capita difference between China and the developed economies, China could attract business from developed economies by performing low-value manufacturing at substantially reduced wages. Now that the wage gap is much smaller, China is transitioning to services, higher value manufacturing and domestic consumption. It seems to be doing this reasonably well, but the "low-hanging fruit" is gone.
4. Somewhat related to points (1) and (3), as the economy grows, a significant absolute growth translates into a lower percentage growth.

In 2014, GDP/capita grew 6.9% vs. 13.7% in 1984. Yet in absolute (PPP) terms it grew $839 in 2014 and only $78 in 1984**.**

The Devaluation of the Yuan

The Chinese government devaluing their currency **Yuan** by around 4% against the Dollar sent shivers across the world market.

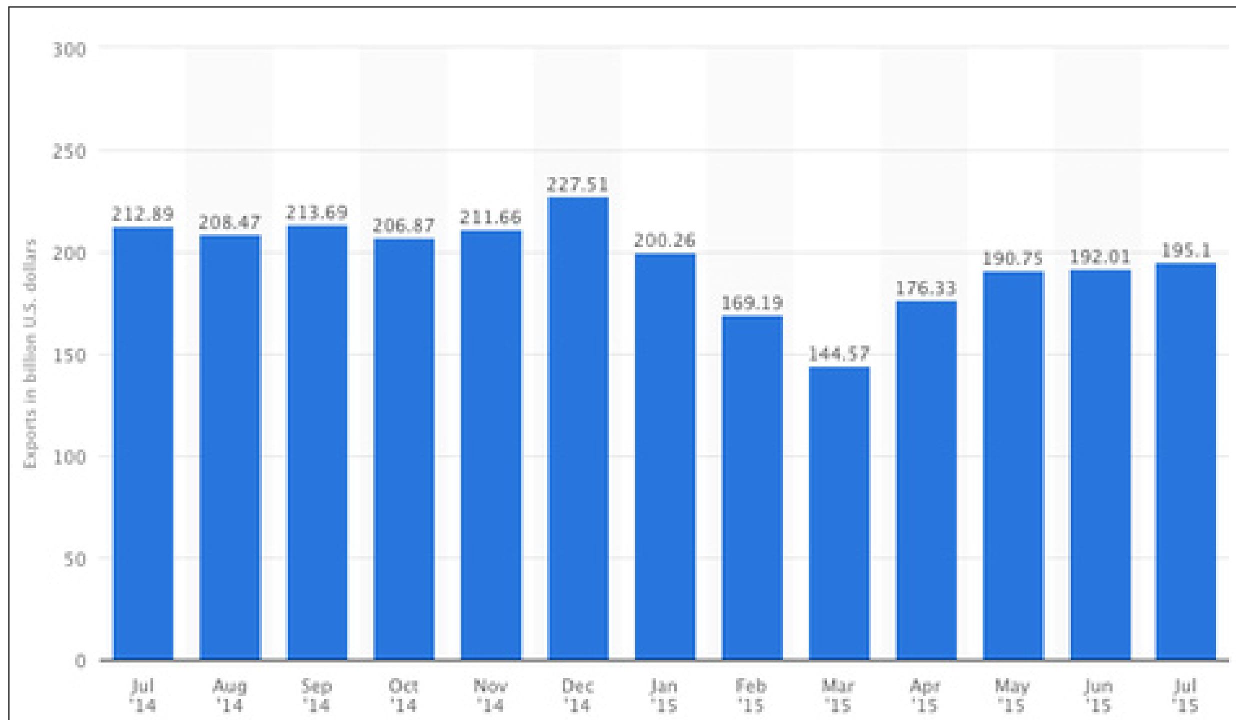
What does the Chinese Currency Devaluation Mean?

This means earlier if as a US citizen 1$ could get you 5¥, now 1$ may get you 8¥ thereby allowing you to buy more products. You can think of currency devaluation as a kind of a sale. Businesses in China that sell goods and services to customers in foreign countries have them priced in China's own currency, the Yuan. So if the Yuan becomes less valuable relative to the dollar/any foreign currency, Chinese products suddenly become cheaper and more attractive in US/any foreign country.

Reasons China May have Done This:

(i) **Slowest growth rate in the last 5 years:** The Chinese economy recorded the 7% growth rate in the 2nd quarter. (The slowest in the last five years)

(ii) **Slow-down seen in the Chinese exports:**



Devaluation would reduce the prices of Chinese products in the world market. Just as sales help a store sell more products, Currency devaluation would help countries boost their exports.

(iii) **China's movement towards a floating exchange rate:** Most developed countries, including the US, allow the market supply and demand to determine the dollar value. That is not the case with China. Until 2005, the government kept its currency pegged to the dollar, with the central bank buying or selling currency as necessary to ensure that 1$ was worth around 8.2 ¥. Since 2005, the currency has been pegged to a basket of currencies, and the exchange rate has changed over time **but China still actively manages the currency's value on a day-to-day basis.**

(iv) **Enhance Yuan's and improve China's standing:** China desires to have Yuan included in IMF's so-called Special Drawing Right's basket so that it gets an enhanced stature and be treated as an elite currency along the likes of the dollar, the euro and the yen. The I.M.F. last week deferred that particular seal of approval, deciding not to include it.

(v) **Currency Manipulation at work:** Many also accuse China of trying to gain an unfair trade advantage over America though "currency manipulation" – just as the US is negotiating the important Trans-Pacific Partnership trade agreement with a number of China's rivals, including Japan.

Impact on the World Economy

- **Harm businesses in other countries:** A cheap yuan gives Chinese exporters an advantage in world markets, which can harm businesses in other countries.
- **Currency Wars:** Since it will make Chinese exports more competitive and exports from other countries uncompetitive. This would lead to other countries also devalue their currency leading to a currency war.
- **Deflationary tendencies:** Some countries which have not devalued may experience deflationary tendencies in turn slowing down economic growth in the country and in turn the world. Countries importing goods from China would be a victim of this direct deflationary effect.

To summarize, if Beijing allows the Yuan to decline further in coming months, it could increase trade tensions, or even a "currency war", in which the world's biggies face off in a beggar-thy-neighbor battle to seize the largest possible share of global consumer demand.

Beggar thy neighbor - an international trading policy that got its name from making a beggar out of your neighbor by utilizing currency devaluations and protective barriers to alleviate a nation's economic difficulties at the expense of other countries. While the policy may help repair an economic hardship in the nation but it will harm the country's trading partners.

The problem with China devaluation is not the devaluation per se, but what this devaluation entails. China is starting to run out of bullets to encourage the growth of an economy that its starting to slowdown at quite a high pace. This is why they are force to take a measurement that, in theory boosts growth.

Why do currency wars exist?

Let's use this point to get some macroeconomics concepts clear. We all know what GDP is, but how do we get to that number? There are three ways:

Production Approach – The GDP is calculated as the gross value of all domestic output for all the economic activities minus the intermediate consumption which are the cost of materials, products, and services used in the production of final goods or services.

Income Approach – Known by another name, GDI, the GDP given by the income approach should match the one given by the Production Approach. In this second way we need to add the following 4 factors.

Retributions to business' workers

Corporate Profits

Investment income

Unincorporated businesses' income

To these 4 factors we need to add the indirect taxes minus subsidies, and depreciation.

Expenditure Approach – This is the approach that we are going to use to explain why currency devaluation is a tool to improve GDP growth, at least in theory. In this third approach we add all the uses of goods and services that are final by adding all the final expenditures in the economy. In this approach GDP is known as Y and it is the sum of consumption (C), Investment (I), government spending (G), and net exports à Exports – Imports (X-M)

$$Y = C + I + G + (X - M)$$

In an economy where consumption and investment are stagnant and low, and where the government doesn't have the ability to inject more money, the easiest and fastest way to affect the GDP growth would be to modify the net exports number. Exchange rates have the answer! If the country that is experiencing the above-mentioned situation exports a significant amount of goods and services it could devalue its currency in order to improve its GDP. This devaluation would have an almost immediate effect in the GDP growth rate since the domestic products would be way more attractive in foreign countries and the foreign products would be less attractive in the domestic region.

Devaluation is a tool that shows desperation and that can provoke major unrest in the EM as we are seeing.

The problem of competitive devaluation is that no country will benefit from the devaluation since at the end all the currencies remain at a similar level after all the devaluations have taken place. This could result in countries using protectionist measures, such as tariffs or subsidies, in order to promote domestic consumption and exports. This results in a drop in international trade and a loss of output for the entire economy.

WHAT NOW?

The Chinese government has delayed too long in getting its own government officials to adjust to a more realistic and sustainable growth rate of 5-6%, down from the original 7 - 8% which China has had over the past 30 years. When the party realized that it would have to adjust to a slower growth rate, instead of explaining how to do this and why it should be done, it looked for higher growth numbers from the stock market, even though these numbers were unsustainable. Since 2014, it has been urging Chinese citizens to

invest in the stock market, and has been urging Chinese companies already listed overseas to move their company listings to Shanghai and Shenzhen.

The result of all this is that the Chinese government is creating another unsustainable bubble, which is creating a bigger mess when the bubble pops. That is what is happening now as the Shanghai and Shenzhen markets turn south, beginning in June 2015.

It introduces a new blanket security law which includes "sensitive" news coverage on the economy this could have been avoided if President Xi and the rest of the government said that the Chinese economy needs to go through a period of restructuring and slower growth, and that this would be necessary because the whole global economy is changing. When this restructuring is completed, then China would be favorably positioned for new growth.

This crisis is all about the management and mismanagement of people's expectations. The party got so addicted to the idea of 7 - 8% annual growth that it would literally do ANYTHING to maintain those numbers even though those numbers were clearly unsustainable, and would result in the creation of new bubbles, which is exactly what the Shanghai and Shenzhen stock markets have become. The party tied its own legitimacy too tightly to 7 - 8% growth and is now paying the price.

The main thing it's doing "right" is that it is moving away from the policy of: "GDP growth targets first, all else second".

The governors of the developed provinces have all been told by Xi that meeting targets on pollution reduction and other "quality of life" metrics outweigh the GDP target.

This is a major step forward for the country as a whole. The obsession with GDP targets led directly to the over-construction and excess steel and cement production. Basically governors would abuse these easy tricks to inflate their provincial GDP figures. Now, they can focus on things that actually matter to people's lives.

The main "doing it wrong" thing is in regards to the "internationalization" of the financial markets.

After the stock market crash of last week and this week, it's fairly clear that the PBOC is not equipped to deal with foreign capital in Chinese markets to the extent they believed they were. Both the CNY exchange rate and the major indices have shown dramatic fluctuations in the past years that have done a lot of damage to the real economy's smooth operation.

The financial industry's state purpose is to facilitate the capital needs of the real economy, it is not to make money gambling off of fluctuations in the real economy. And from the last few years it seems China is losing grasp of this concept...

2. CONCLUSION

Globalization means that economies are more connected now than ever before. China has the world's second largest economy after the US, and is the world's single largest manufacturer, especially of consumer goods.

This means that commodity export economies such as Brazil, Indonesia, Russia and Australia which are heavily dependent on China buying their raw materials are absolutely getting destroyed now.

China is dependent on the US and Europe for buying most of China's manufactured goods, but demand for Chinese goods has been soft. China is stuck with WAY too much manufacturing capacity which it really should not have built in the first place.

This extra manufacturing capacity is now debt which eventually needs to be repaid. In order to pay off debt, you need to sell product, but there is no sign that this will happen in a timely fashion so that this debt can be serviced.

No one country will benefit economically, given the overwhelming intertwining relationships between China and other countries in the world.

In the long run, my opinion is that China, and everyone else will be for the better. The reason being that the hard actions been taken by Chinato enact is absolutely necessary to reform and restructure an economy that is:

1. Impossible to sustain the high rate of growth.
2. Achieved on the wasteful and inefficient utilization of capital in redundant fixed assets such as housing and infrastructures, a bubble that's inevitable to burst.
3. Dominated by badly crony run state owned enterprises that hog the vast majority of capital, providing subpar returns on the captive capital, and meanwhile starving capital needed for private enterprises, which are much better run and really the bulwark of economic and wealth generators for China in the long run.
4. The recent market correction should prove once and for all, and has indeed proven to the CCP that market forces is the best efficient all locator of resources, and will eventually rout interventionist policies, to the huge impairment of state treasury.

The path to a truly reformed governance of the country, both to the political and economic structures cannot be executed in isolation, or it will fail with certainty.

The CCP has to be resolute in its reform efforts, as there is really no other alternative to effect a happy ending. And a happy ending is good for all - in the long run.

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