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China:

Stock market crash shows madness of the market

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The Chinese stock market plunge over the past three weeks confirms that no matter how much the champions of capitalism pretend that it generates riches for the many, it remains an anarchic system responsible for the ruination of millions.

On 12 June, shares peaked – having grown by 150 percent over the previous 12 months. Share prices have now dropped by 30 percent as panic has set in.

As the market falls, it is taking with it the life savings of many tens of millions of Chinese workers and middle class who constitute 80 percent of the investors. These investors, most of whom have borrowed money using the value of the shares as collateral (a practice known as margin lending), are now selling into a market which is falling by the day.

In some cases they are selling out of fear that the price will drop further. More often, they are forced into selling because margin lenders insist they cover their losses.

And these are the lucky ones.

With nearly three-quarters of the share market frozen by share trading suspension and the activation of loss limits (trading halted when the price of the share drops by more than 10 percent in a day), many other investors are forced to sit on the sidelines.

The human cost of the bust is tremendous: impoverishment and loss of dignity for many, resulting in anguish and suicides as the victims confront their bankrupted futures.

Cruel trick

Chinese investors have been subjected to a cruel trick.

The government has pushed workers and middle class citizens to speculate on the stock market. There is no social security in China. Health care, once free, is now expensive. Housing, once provided by the government and state-owned enterprises, is now in the hands of the real estate and property development industry. Education costs are rising rapidly. Pensions are low.

Chinese workers therefore have sacrificed spending on everyday goods and services to build up their savings – equivalent to about 30 percent of GDP – just to avoid immiseration. They have put off having some good things in their lives to ensure that they can pay hospital bills and escape destitution when old.

Banks do not pay much interest on deposits, so people search out other methods to boost their savings. For several years, real estate boomed and investments there provided a return. Now the property market is flat and the money has switched out of real estate and into the stock market.

Investors were encouraged by the Chinese government and the media to buy into stocks. They were told that shares were a sure-fire way to riches.

President Xi Jinping's program since taking office in 2013 has been to advance Chinese capitalism by doing two things: more tightly integrate Chinese financial markets into global markets and boost consumer spending.

In relation to the first, the government has allowed Western investors to buy shares in Chinese companies via the Hong Kong stock exchange.

In relation to consumer spending, the government has encouraged people to buy shares in the hope that burgeoning share portfolios in the hands of the middle class and better paid workers would encourage them to go out and spend – to make up for the fall in demand for Chinese exports in world markets and to rebalance domestic demand away from investment. The government also saw a booming stock market as a way to allow indebted state owned enterprises to trade expensive loans for equity financing.

The central bank, the People's Bank of China, did plenty of things to pump up the bubble to persuade millions of people to put their money into shares. It cut interest rates and it lowered reserve requirements for banks, allowing them to loan more. It gave banks access to cheap funds. And in mid-April, in a final flourish, it allowed individuals to open up to 20 share trading accounts, producing an explosion of trading activity and borrowing.

Margin lending skyrocketed, increasing six fold in just 12 months. None of this activity was matched by growth in the productive economy which, indeed, was growing at its slowest rate for many years.

The government also lent its credibility to the whole exercise by linking the share market to the strength of the Chinese leadership of president Xi. Who would bet against the might of the Chinese Communist Party whose hand reaches into every corner of the Chinese economy?

Fall out

And now it has come unstuck. Attempts by the government to stem the collapse in the share market have so far come to nothing. Every single measure seems only to convince investors that the government has lost control and worse is yet to come. Indeed, these measures, reckless as they are, almost guarantee that worse is to come.

The crash will exacerbate problems in the productive economy. It is likely that the overnight destruction of immense household wealth will crimp consumption and thereby further depress Chinese growth.

There is concern also that the collapse of the stock exchange will have knock-on effects on the banks, as shares used as collateral for bank loans are liquidated. The property market, already well off the boil, will be hard hit by problems in the banks.

The Chinese government still has a range of fiscal and monetary tools at its disposal to limit the impact of the stock market bust on the broader economy. But when combined with other intractable problems, such as vast local government debts and chronic excess capacity across the manufacturing and property industries, the headwinds are growing.

With China now the world's second largest economy and the biggest market for dozens of countries, volatility in the Chinese economy matters like never before.

Commodity markets were already well off their peaks before this crisis. They are now in further retreat both because Chinese investors are selling off any assets they can to generate cash to meet their margin calls, and because slower Chinese growth will reduce demand for resources and energy.

Iron ore prices have fallen back to less than $45 a tonne. Copper, nickel, aluminium and zinc prices also have declined, hitting the prospects for Australia and other commodity exporters.

Journalistic coverage in the financial papers is notable for its lack of care for the millions of those now facing a bleak future. Markets rise, markets fall. But it's all in a day's work.

Contrast coverage of China with that of Greece. The fall in shares has wiped out $3.4 trillion from the value of the Chinese stock exchange – not much short of the total value of German GDP – and coverage in the media is restricted to the financial pages. Greek debt repayments are equivalent to US$354 billion, 10 percent of the Chinese wipe out.

The disaster in Chinese markets has its own characteristics. But it augurs ill for the West. If the specifics differ, the same broad government-driven program of asset inflation – driving up the price of paper assets in an attempt to stimulate the real economy – has been used in North America, Europe and Japan since the global financial crisis.

In the West, it's called "quantitative easing" and has been responsible for record low interest rates, stock market growth and the creation of fortunes for financial institutions and wealthy investors. Little in the way of productive investment has followed.

In the West, too, the stripping of social welfare and the enforced reliance on superannuation in place of state pensions has meant that the fortunes of hundreds of millions of workers are now tied to the gyrations of stock markets. The harrowed faces of Chinese people currently witnessing the devastation of their futures may be our futures too.

The crash will have political consequences in China. The share market bubble was a conscious plan by president Xi to rebalance the economy. With this bust, Xi's credibility among rival party leaders will have been damaged, raising the potential for factional battles within the ruling class.

But outside the ruling class, there will be resentment among millions of desperate people who have lost their savings. They will be looking angrily at the government, which assured them just weeks ago that the stock market was a one-way bet. They will also be aware that many of the big investors bailed out of the market some weeks before the bust.

Even if this anger is not expressed in street demonstrations (and these should not be ruled out), the sense common among many Chinese that the ruling elite cares not one jot for them will only grow.

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Red Flag

