China's Bigger Economic Threat: real-estate bubble, roller-coaster stock market, shadow-banking sector

Sunday 24 June 2018, by BELLO Walden (Date first published: 23 June 2018).

Would the US be better off helping stabilize the Chinese economy, rather than gearing up for a trade war?

Contents

Conventional wisdom holds that China is on the ascent and the United States is in decline, that China's economy is roaring with raw energy and that Beijing's "Belt and Road" mega-project of infrastructure building in Central, South, and Southeast Asia is laying the basis for its global economic hegemony.

Some question whether Beijing's ambitions are sustainable. Inequality in China is approaching that in the United States, which portends rising domestic discontent, while China's grave environmental problems may pose inexorable limits to its economic expansion.

Perhaps the greatest immediate threat to China's rise to economic supremacy, however, is the same phenomenon that felled the US economy in 2008—financialization, the channeling of resources to the financial economy over the real economy. Indeed, there are three troubling signs that China is a prime candidate to be the site of the next financial crisis: overheating in its real-estate sector, a roller-coaster stock market, and a rapidly growing shadow-banking sector.

CHINA'S REAL-ESTATE BUBBLE

There is no doubt that China is already in the midst of a real-estate bubble. As in the United States during the subprime-mortgage bubble that culminated in the global financial crisis of 2007–09, the real-estate market has attracted too many wealthy and middle-class speculators, leading to a frenzy that has seen real-estate prices climb sharply.

Chinese real-estate prices soared in so-called Tier 1 cities like Beijing and Shanghai from 2015 to 2017, pushing worried authorities there to take measures to pop the bubble. Major cities, including Beijing, imposed various measures: They increased down-payment requirements, tightened mortgage restrictions, banned the resale of property for several years, and limited the number of homes that people can buy.

Perhaps the greatest threat to China's rise is the same phenomenon that felled the US economy in 2008.

However, Chinese authorities face a dilemma. On the one hand, workers complain that the bubble has placed owning and renting apartments beyond their reach, thus fueling social instability. On the other hand, a sharp drop in real-estate prices could bring down the rest of the Chinese economy and—given China's increasingly central role as a source of international demand—the rest of the global economy along with it. China's real-estate sector accounts for an estimated 15 percent of GDP and 20 percent of the national demand for loans. Thus, according to Chinese banking experts Andrew Sheng and Ng Chow Soon, any slowdown would "adversely affect construction-related industries along the entire supply chain, including steel, cement, and other building materials."

THE SHANGHAI CASINO

Financial repression—keeping the interest rates on deposits low to subsidize China's powerful alliance of export industries and governments in the coastal provinces—has been central in pushing investors into real-estate speculation. However, growing uncertainties in that sector have caused many middle-class investors to seek higher returns in the country's poorly regulated stock market. The unfortunate result: A good many Chinese have lost their fortunes as stock prices fluctuated wildly. As early as 2001, Wu Jinglian, widely regarded as one of the country's leading reform economists, characterized the corruption-ridden Shanghai and Shenzhen stock exchanges as "worse than a casino" in which investors would inevitably lose money over the long run.

At the peak of the Shanghai market, in June 2015, a Bloomberg analyst wrote that "No other stock market has grown as much in dollar terms over a 12-month period," noting that the previous year's gain was greater "than the $5 trillion size of Japan's entire stock market."

When the Shanghai index plunged 40 percent later that summer, Chinese investors were hit with huge losses—debt they still grapple with today. Many lost all their savings—a significant personal tragedy (and a looming national crisis) in a country with such a poorly developed social-security system.

Chinese stock markets (now the world's second-largest, according to The Balance, an online financial journal) stabilized in 2017, and seemed to have recovered the trust of investors when they were struck by contagion from the global sell-off of stocks in February 2018, posting one of their biggest losses since the 2015 collapse.

SHADOW BANKING COMES OUT OF THE SHADOWS

Another source of financial instability is the virtual monopoly on credit access held by export-oriented industries, state-owned enterprises, and the local governments of favored coastal regions. With the demand for credit from other sectors unmet by the official banking sector, the void has been rapidly filled by so-called shadow banks.

The shadow-banking sector is perhaps best defined as a network of financial intermediaries whose activities and products are outside the formal, government-regulated banking system. Many of the shadow-banking system's transactions are not reflected on the regular balance sheets of the country's financial institutions. But when a liquidity crisis takes place, the fiction of an independent investment vehicle is ripped apart by creditors who factor these off-balance-sheet transactions into their financial assessments of the mother institution.

Rather than a military face-off, the United States might be better advised to prepare for threats posed by China's economic weakness.

The shadow-banking system in China is not yet as sophisticated as its counterparts on Wall Street and in London, but it is getting there. Ballpark estimates of the trades carried out in China's shadow-banking sector range from $10 trillion to more than $18 trillion.

In 2013, according to one of the more authoritative studies, the scale of shadow-banking risk assets—i.e., assets marked by great volatility, like stocks and real estate—came to 53 percent of China's GDP. That might appear small when compared with the global average of about 120 percent of GDP, but the reality is that many of these shadow-banking creditors have raised their capital by borrowing from the formal banking sector. These loans are either registered on the books or "hidden" in special off-balance-sheet vehicles. Should a shadow-banking crisis ensue, it is estimated that up to half of the nonperforming loans of the shadow-banking sector could be "transferred" to the formal banking sector, thus undermining it as well. In addition, the shadow-banking sector is heavily invested in real-estate trusts. Thus, a sharp drop in property valuations would immediately have a negative impact on the shadow-banking sector—creditors would be left running after bankrupt developers or holding massively depreciated real estate as collateral.

Is China, in fact, still distant from a Lehman Brothers–style crisis? Interestingly, Sheng and Ng point out that while "China's shadow banking problem is still manageable…time is of the essence and a comprehensive policy package is urgently needed to preempt any escalation of shadow banking NPLs [nonperforming loans], which could have contagion effects." Beijing is now cracking down on the shadow banks, but these are elusive entities.

Finance is the Achilles' heel of the Chinese economy. The negative synergy between an overheating real-estate sector, a volatile stock market, and an uncontrolled shadow-banking system could well be the cause of the next big crisis to hit the global economy, rivaling the severity of the Asian financial crisis of 1997–98 and the global financial implosion of 2008–09.

INSTEAD OF WAR...

Rather than gearing up for a military face-off in the South China Sea or engaging in a trade war with Beijing (which no one will win), the United States and its allies might be better advised to prepare for the threat that China's economic weakness poses to the US economy and, indeed, the world's.

Global financial reform—a task urgently needed (but never undertaken) after the 2008 financial crisis—is one area where cooperation would immeasurably benefit China, the United States, and the rest of the planet. The loss of $5.2 trillion during this February's global financial meltdown has highlighted the necessity of putting stronger restrictions on the global movement of speculative capital before it spawns a bigger crisis in the real economy. The regulation of dangerous real-estate-backed securities and derivatives—the same types of instruments that triggered the 2008 financial crisis, and which are now making their appearance in Asian markets—should be a top priority.

When it comes to trade, there are far better strategies than a trade war to deal with Beijing. It is true that the export of jobs to China by US corporations, supported by free-trade and globalization enthusiasts in government, has been a major cause of the deindustrialization of significant parts of the United States, but the solutions lie in building bridges, not walls. First, we need formal or informal trade agreements to limit select industrial exports to the United States, much like the Reagan-era arrangements with Japan to limit automobile exports bought time for the US car industry to retool and recover. Second, we need an industrial policy, drawing from the current playbook of

Germany and China, in which an activist state channels private and public investment and promotes job creation in cutting-edge industries, such as renewable-energy-based infrastructure and transportation.

None of this is as simple—or as foolish—as a military face-off near the Chinese coast. Too often, for America's national-security managers, the US military is a hammer, and every problem looks like a nail. But as US officials begin to address the rise of Chinese power, they would do far better to understand the stake that the United States and the rest of the world now have in a healthy Chinese economy, and worry more about avoiding its economic implosion than about planning for a military explosion.

Walden Bello

P.S.

* THE NATION. JUNE 23, 2018 6:00 AM:
https://www.thenation.com/article/chinas-bigger-economic-threat/

Editor's note: This piece has been updated to correct a copy error that previously omitted the last paragraph. It has now been restored.

* Walden Bello is the international adjunct professor in sociology at the State University of New York at Binghamton and the author of 21 books, including the soon-to-be-published The Fall of China: Preventing the Next Crash.