If China hits the wall, U.S. may wobble

http://www.philly.com/philly/business/20150726_If_China_hits_the_wall__U_S__may_wobble.html#GgQk6dl6HTZrEFJw.99

Mark Zandi
Posted: Sunday, July 26, 2015

The U.S. economic expansion just celebrated its sixth birthday. There have been longer periods of consistent growth in our economic history, but not many.

This is especially impressive, given that the economy has brushed aside a long string of threats. In just the last year, there have been Russia's invasion of Ukraine, Ebola, ISIS' rampage through the Middle East, and Greece's near expulsion from the euro zone.

But our biggest challenge may be just ahead: Namely, the Chinese economic juggernaut hitting a wall.

This concern is crystallized by recent wild ups-and-downs in the Chinese stock market. Chinese stocks went skyward during the first half of the year, doubling in value. They have since suffered a dizzying decline, falling by about one-third at the worst of the sell-off a couple of weeks ago.

For perspective, it took three years for U.S. stock prices to double during the tech bubble of the late 1990s. And when that bubble burst, it took more than two years for the market to regain a third of its value.

The roller coaster in Chinese stocks won't have much direct impact on the Chinese economy or our own. Fewer than 10 percent of Chinese households own stocks, compared with closer to one-half here. Chinese companies don't rely on the stock market as a source of capital to expand operations the way high-flying companies do in the United States.

Yet, China's stock gyrations highlight the country's serious vulnerabilities. Most obvious, judging by the panicked reaction of Chinese authorities to the stock market decline, their hold on the country's increasingly complex economy is tenuous.

They pulled out all the stops to end the downdraft in stock prices. Cutting interest rates wasn't surprising, but they also halted trading in most stocks for a while, forced large investors to stop selling and even to buy more, curtailed the ability of short-sellers to bet against the market, and eased pressure on those who borrowed money to buy shares.

Chinese stocks have finally stabilized, but investors know this is only because of the government's extreme actions, not because of the growth prospects of Chinese companies. No one is going to invest in Chinese stocks on a bet that the government will continue to bail them out.

Chinese authorities also clearly can't bear the volatility endemic in modern financial markets. Many benefits come from our financial markets: They are incredibly efficient at taking what we save and turning those savings into productive investments.

Our financial system can go off the rails, sometimes way off, as it did in the financial crisis. Nonetheless, over the long run, it is a huge plus for our economy.

Perhaps most discomfiting is that Chinese households that did jump into the market borrowed with abandon to speculate in stocks. This is symptomatic of a broader recent borrowing frenzy by Chinese companies, banks, and local governments.

Very few countries in history have seen their debt load increase by as much in as short a period. Even our borrowing during the subprime mortgage bubble doesn't measure up.

Rampant borrowing like this never ends well. The near collapse of our financial system is testimony to that. Indeed, no country has ever larded up on as much debt as China and not suffered a debilitating financial crisis and economic downturn.

And a China blow-up that goes way beyond its stock market would be an overwhelming problem for the entire world. China is the second largest global economy after the U.S. But even more important, it accounts for far and away the most growth. One-third of global growth in the current expansion is due to China alone.

Chinese authorities acknowledge that their economy has issues, but they also argue that they can manage them. China has a $3.5 trillion pile of savings built up from years of trade surpluses it can use to patch any holes in the economic dikes.

Its financial system is also still largely walled off from the rest of the world. Financial crises in most countries happen when anxious global investors dump their stocks, bonds, and other holdings in that country and move their money to safer places such as the U.S. This can't happen to China.

These are reasonable arguments and they mean China likely will forestall a major downturn this year, or perhaps even for the next few years. However, Chinese leverage only continues to increase, its trade surpluses are much smaller, and the financial system is steadily opening to the rest of the world.

China's economy will eventually stumble. The hope is that it will happen only after our own economic expansion celebrates a lot more birthdays.

--

Mark Zandi is Chief Economist at Moody's Analytics in West Chester, where he directs economic research.