

Circular Reasoning and China

By Clark Winter

Most investors, including many experts, will tell you without hesitation that the recent global equity meltdown began in China, where nervous investors were spooked by the idea that the Chinese government would institute a capital gains tax on the stock exchange's soaring profits. Because everyone decided to take their profits at the same time, the reasoning goes, there was an avalanche of sellers in advance of a government decree, and hardly any buyers. Investors in other nations, witnessing the selloff, placed their own sell orders, against their own local fears—a slowing US economy, too many Polish plumbers in Europe, skittish real estate markets, upcoming French elections that were going to expose the raw emotions of the immigration question again, or the fact that tax season is coming and markets traditionally pull back as investors sell to pay their impending bills and then buy once the revenueurs have been satisfied.

If the theory has any validity, then it ought to stand up to a number of tests. First, the Chinese equity markets have gone into freefall several times in the past decade. Since China's stock markets opened more than a decade and a half ago, scandals, the government's own ownership of many of the listed companies and a poor history of regulation have caused both wild price

none of the past downdrafts had any impact on the global markets.

Second, contagion is usually caused by interconnectivity. Whether it is the international carry trade that arbitrages the interest rates of one nation against those of another, or international investors growing fearful of a nation's investment or trade policies, when one investment sharply diminishes in value, then others connected to it are often lumped together and sold out as well, irrespective of their singular merits. But there was little interconnectivity with China. The Chinese make it extremely difficult for foreign investors to take direct part in their markets, and their currency is not subject to normal market forces because it is so rigidly controlled by the government.

Indeed, the only argument that China's stock market woes were somehow infectious are that collectively, and because of mass communications, we all sort of worry about the same things, even if we worry about different things. What I mean is that if fear is in the air, we are all investment creatures and we all smell it. But even that idea doesn't really hold out much possibility of being right. On the day that China was falling, the markets that suffered the least were those closest to and most nearly tied to China's economy – Malaysia, Japan and Hong Kong. Malaysia finished, in fact, in

positive territory at the end of the first day's fall.

While we might never be able to answer the question of whether China's fall was the first domino in a worldwide correction, we might want to reflect on what might happen next. To do that, you need to know what China will do with its \$1 trillion in foreign exchange reserves, almost all of which is actually in US Treasuries or American mortgage-backed securities. In the previous column I wrote, I noted that if there were a correction of any sort, then nations with large reserves were going to feel a lot of pressure from citizens who wanted those reserves used for their own rescue, and not the salvation of Americans who show little propensity to save (that's where all those dollars come from), and instead live off the savings of others. The Chinese people want more money to be spent on the nation's inadequate education system (translation: people want more opportunity) and on better health care (translation: people want longer lives so they can enjoy the fruits of their labors), and on an improved environment (translation: if Bangkok can enjoy clean air after less than a decade of effort, why not Beijing?) not on keeping US mortgage and credit card rates low

enough that Americans can continue to spend. The Chinese people are telling their government, in effect, that they are now a large enough market so that they don't need to tightly hold onto so many dollars, and that perhaps the time has come to either get a better return on investment than US Treasuries, or to recycle some of the cash for better lives for China. Either way, it could mean more dollars flowing into the global liquidity system, and that could mean another downward push on the value of US equities.

But it could also mean just the opposite. China is not the only nation that is about to come under pressure for more social spending, and how emerging nations handle the calls for a better life for their citizens will determine in which direction the global economy heads over the next year. If that spending results in more goods purchase—MRI machines, vaccines and pharmaceuticals, more textbooks and computers for classrooms, more infrastructure—then the result is an upsurge in international trade. And an expanding global economy. If it is spent on fattening entitlement regimes and featherbedding bureaucracies, the results may not be pretty. ■