THE STORY OF TWO ECONOMIC LOCOMOTIVES.
One running out of steam the other about to explode.

The two dominant economies on this planet are the USA and China. The USA dominates financially with $84 trillion in household wealth compared to China's $32 trillion (excluding the state sector in China which accounts for another 50%). On the other hand, China dominates industrially with a base as big as the US and the EU combined, or if only manufacturing is considered, bigger than the US and Japan. In Dollar terms rather than PPP (which has its own problems), US GDP appears to be 60% bigger than the China. This is misleading because there is more duplication in the US economy than in the Chinese economy. However, Chinese statisticians are quickly developing the art of the imputed sale and how to convert the mere exchange of money into value added, thereby producing the growth rate of 6.5% ordered by the Politburo.

The USA which has been accumulating capital over centuries rather than decades clearly has more assets for the time being than China does. It has also more developed financial markets. For the health of the world economy both economies need to be moving ahead, though as was admitted in the communiqué after the recent G20 meeting in China, neither seeks the role of locomotive to the world economy. Here lies the problem. The USA's economy is drooping because of a growing crisis of profitability while China's head of steam is based on a housing market bubble. Combined, these two events have the potential of breaking the back of the world economy which is already beginning to stagnate. TED (The US Conference Board) has recently downgraded global growth to 2% for 2016, far below the figures provided by the IMF. This discrepancy is due to TED valuing Chinese growth at 3.2% rather than the official 6.5% used by the IMF.

How big is the Chinese Housing Bubble?

Any cursory review of the internet shows that since 2013 many analysists have been predicting a Chinese Housing Crash. It did not occur in 2013, nor in 2014, nor in 2015. So why should the odds be higher in 2016/7. The answer is twofold. Firstly, the industrial economy has weakened sharply, especially heavy industry. To compensate, the Chinese Copitalist Party, sitting in the *"last chance saloon"* has had no option but to stoke up the housing market just as they did with the stock exchange 24 months ago, but with this difference, they are not in a position to apply the brakes this time round. Secondly, what was driven initially by surplus savings is now increasingly driven by debt. 75% of bank loans in China are now devoted to residential property loans compared to 67% in the USA prior to the 2008 housing collapse.

However, while the housing market in China is converging with that obtaining in the US prior to 2008 and to Japan prior to 1990, differences remain. Firstly, the size of the Chinese mortgage market at $2 trillion is much smaller than the US mortgage market of $10.6 trillion in 2008. However, it is growing at the startling rate of 111% p.a. meaning convergence within 24 months. Furthermore, only 17% of all properties have a mortgage though this is growing rapidly. Minimum down payments for first properties remains at 20% rising to 30% for most Tier 1 cities. 100% mortgages are not available, though this may not apply to offshore financial vehicles. Finally, Chinese banks allegedly can absorb a 40% plunge in house prices though this is only covers 15 months of price rises.

Price rises were more subdued in 2014 and 2015 when the government introduced restrictions on the buying of property in order to divert funds into the stock market. As a result, according to the Economist, house prices rose faster in Australia, Canada and the UK (2010 -2015) than it did in China. Nonetheless since 2008 prices have tripled in Shanghai.

Now that the reigns are off, the market is making up for lost time. In the absence of alternative investment opportunities in China, combined with the recent lifting of restrictions on property, the reduction in mortgage rates and the new found willingness of the state banks to lend against property, prices have soared. According to Frank Knight annual property prices are currently increasing by between 17.6% (Beijing) and 65% (Shenzhen) with the average being around 30%. (The US is currently 5.6%). The result is that Shenzhen is about to overtake San Jose in the US as the world's most expensive city with central London a trailing third.

In contrast the National Bureau of Statistics of China most recent release shows that real investment in housing only increased by 4.8%. This has resulted in an increase in floor space of around 8% but an increase in sales prices of 18% making property a source of huge profits for developers. On the negative side, the gearing of these developers (debt) has risen from 25% in 2008 to 80% today meaning that they are very vulnerable to any drop in profitability. (Reserve Bank of Australia).

On average Chinese housing at $171 per square foot is now 30% more expensive than housing in the USA. With price increases diverging between the two countries, the gap in prices will double to 60% within 12 months and to 100% within 24 months. However, as significant as these differences are, they are eclipsed when adjusted for average earnings which are 3.3 times higher in the USA. The result is that the average house price to income ratio is currently 9.2x in China with the expectation it will exceed 10x by year end. When looking at individual cities the ratio soars to 33.5x in Beijing and 30.2x in Shanghai.

The question is not so much, are these ratios sustainable, but how have they managed to rise to this point in the first place? The answer is the inequality of society in China together with the role property plays as an investment. The top 5% of Chinese society account for 69% of total savings. In turn the saving rate in China is exceptionally high amounting to 50% of GDP or a sum equal to almost $6 trillion annually. It is this source of funds that is the underlying driver of property prices not only in China but around the world as well. This is why a collapse in property prices in China will cause a collapse in property prices in all the principle cities around the world as rich Chinese are forced to sell up. Hence the argument that any financial crash in China will be limited to China because it is fuelled by the Chinese themselves and not foreigners is wrong. The transmission belt will be forced property sales across the world.

The final question that needs addressing is how big is the Chinese housing market itself. That it is big is without question, otherwise the growth in residential, non-residential and infrastructural spending in China post 2008 would not have lifted the world economy out of its rut nor paid for the super-cycle in commodities which uplifted not only companies but whole continents.

The best approach is to use household wealth. Total household wealth in China is $32 trillion (Yu Xie & Yongai Jin (2015) Household Wealth in China, Chinese Sociological Review, 47:3, 203-229) versus $84 trillion (Credit Suisse 2015). In China 75% of household wealth is invested in housing versus only 28% in the USA meaning that by year end, China's housing market will be two trillion dollars bigger than the US.

In terms of physical units, comparisons are difficult as China only counts urban homes and not rural homes. Nevertheless, China lists 240 million urban homes versus 133 million throughout the US. However, average house sizes differ with the US boasting 139 square metres (US Census Bureau 2013 survey) and China only 60 square metres. In terms of square metres or feet the totals are reversed with the US having built 20% more residential space than has China with its much larger urban population.

However, whereas the US is only building 1.2 housing units currently, China is building nearly 8 million and with Chinese floor space increasing (while it is decreasing the US), China is building over 6.5 times as many housing units as is the USA. For those who claim the housing boom is not a boom because China is still in the realm of population shift from rural to urban, the figures speak for themselves. 8 million new homes is sufficient to house 24.8 million people (the average household size in China is 3.1) compared to a population growing at 5.3 million. This yields excess housing equal to 19.5 million people. (China Statistical Year Book). Since 2008, 80 million new urban homes have been constructed or one third of the current housing stock sufficient to house an additional 248 million Chinese compared to the growth of the urban population during that time amounting to 180 million (urban births less deaths plus migration from the country side).

Superficially therefore, housing growth exceeds population growth by one third. It may be argued, that the excess housing replaces less habitable properties and it is therefore not an excess. However, at 9.2x earnings and rising, most new arrivals from the country side are priced out of these properties and it is they who form the biggest component of the growth in the urban population. Most new arrivals have ended up living in dormitories as social housing represents less than 5% of housing starts due to the reluctance of property developers to build social housing because of (soon to be relaxed) price controls.

It is this surplus housing that accounts for the high rate of empty urban properties (27% at the end of 2015) as measured by electricity usage. The glut of properties has had it effect on rental returns. Gross rents attract a return that is typically closer to 2% rather than the 3% considered the danger level for house price/rent ratios. In other words, gross rents are half the average mortgage rate in China which results in a real loss for properties bought primarily to be let. In the USA a typical one-bedroom inner city apartment rents for $1215 p.m. while in China it fetches only $633 despite the fact that these Chinese flats cost $6290 per square metre compared to $2279 in the USA. This yields a monthly return per square metre of just 10 cents in China versus 53c in the USA.

It demonstrates that Chinese property is bought for either future use (children), or as a store of value or for speculative purposes (flipping). This behaviour is ingrained. When the Shanghai City Council announced they would be limiting house buying to only 1 per married couple, they were overwhelmed by couples seeking a divorce. Evidently the rich Chinese love their homes more than each other and they are more faithful to their multiple homes than they are to their partner.

Discussion.

If higher priced housing is treated as the product of Department 2B (or 3 if you like) therefore as a luxury good, then production is not imperilled by the growth in the stock of housing. As long as the rich buy houses production continues. If the top 5% all want five houses so that they can live in Beijing on Monday, Shanghai on Tuesday, so be it. They will spend their surplus value unproductively but the economy will continue to supply them with more homes. Steel, copper and cement prices will be propped up.

However, it is highly unlikely that the mere acquisition of property is the driving force in this market. It is the opportunity to make money that is the driving force. The vortex created by rising house prices is sucking in more and more money into the housing market. However, in common with all speculative bubbles, the housing bubble is self-limiting. The same amount of money which earlier achieved a 10% price rise when prices were lower, now achieves only a 2% increase. That is why all speculative bubbles are not infinite.

In the US in 2008, it was the dicing and splicing of sub-prime mortgages that acted as the detonator. The inflexion point came when incomes started falling as the economy deteriorated making the servicing of these loans impossible. In China the market is not being driven from the bottom but from the top. It is therefore likely that the detonator here will be the inability to flip properties. Whereas in the USA the speculative bubble arose out of leveraging the mortgage market, in China we have a speculative bubble in its purest form.

Typically, during the latter stages of a bubble, debt becomes the main driver. This is currently true for China. It is the multiplication of debt that is making this bubble dangerous for the first time. The value of mortgages has more than doubled (111%) as bulging banks have reduced mortgage rates and extended lending to new layers of borrowers. The gearing of property developers has shot up to 80% while local government finances are increasingly intertwined with the property market through off-bank financial vehicles and finally shadow banking activities such as peer to peer lending is increasingly focusing on property.

The crash of the Chinese stock markets last year is a salutary lesson. Chinese speculators are just as quick to exit a hot market as they are to enter it. Similarly, the Chinese authorities could once again be caught off guard and shown to be just as inept as they were during stock market crash last year. Together with corporate debt, the Chinese housing bubble is the biggest threat to the world financial order.

A housing crash is not imminent but it is maturing. The annual rate of 111% in mortgage growth equal to 75% of new bank loans is unsustainable. At this rate it will take less than two years for Chinese mortgages to reach the same share of GDP as occurred in the USA in 2008. To this must be added the growing indebtedness of local governments whose finances are merged with the property market and on whose revenues they have become dependent. Currently at $3.5 trillion and growing at a rate of 40% some of this debt must be added to that of mortgage debt. In many ways this is the sub-prime element as local government debt servicing has shot up from 153% in 2013 to 195% in 2015.

The contrary argument, that a government debt to GDP ratio of only 40% (combined national and local governments) makes any crisis manageable misses the point. Government debt ratios are not comparable to that of other countries because of the large state sector. Much of this debt belongs to the state banks whose liabilities in 2015 approached $30 trillion (China Daily) compared to that of the USA with only $13.8 trillion (FED) or in terms of GDP 270% vs 80%. Indeed, the recent BIS release on September 19, showed that Chinese credit to GDP had risen to 30.1% in the first quarter a critically elevated level. Since then it has risen sharply.

Although profitability throughout the economy picked up recently because of the housing bubble, average industrial profits (the bulk of profits in the economy) have flat lined since 2013. This means that inflation adjusted profits are below their 2013 peak and given the high rates of investment over the interim, the rate of profit has fallen steeply. This accounts for the collapse in the growth rate of private investment from 18% in 2014 to 10.5% in the first half of 2015 to just 2.1% today despite the housing boom. (National Bureau of Statistics of China August release).

It is clear that the G20 stance following their recent meeting in China is not to add to liquidity nor to subtract from it. In other words, the stance is neutral where words have replaced actions and intentions have replaced decisions. Despite the marginal tightening in September compared to August by the PBC, it is unlikely that either the US or the Chinese central banks will adhere to this stance as and when their economies take a sharp turn for the worse.

The current spurt in house prices differs from that in 2013/4 because the Chinese economy is more vulnerable and the political position of the Chinese Copitalist Party more precarious. The continued flight of capital from China represents a clear vote of no confidence in the future of China. This time around, unlike the events around the stock exchange last year, there will be a greater reluctance by the CCP to haul in the housing market. There are simply no other drivers for the economy or sponges for savings. Stock market turnover in China for example is at a two year low.

The housing bubble is not a sign of economic strength but of weakness as China transitions - really downgrades - to a service based economy (which is really a euphemism for Capitalism's inability to dynamically develop an economy beyond a certain point). In this sense the actions of the Chinese Central Bank (PBC) mirrors the predicament of the FED in which both are caught between bubbles and a hard place. Both are scared to pop the bubble because of the underlying state of the real economy.

The USA.

The results of the FED's September meeting on interest rates was predictable. The FED talked tough but took a step back. They would have been foolish to raise interest rates despite the pressures put on them by the banking, pension and insurance industries. The determining factor was the deterioration in the real economy though you would not have read that into their statement. The FED's statement concluded that the economy continued to expand moderately, that it estimates economic activity to have picked up from the first half and that labour conditions are strengthening. The only note of caution in their statement is that economic risks are now balanced, instead of diminishing as previously concluded.

What they are alluding to is the growth in the first half of quarter three speeding up from the second half ensuring that third quarter GDP growth will exceed the growth of 1.2% registered in Q2. However, since July the economy has begun to contract again whichever measure is used. And this contraction has extended into September. The recent sharp fall in the manufacturing ISM for August and projections into September underscore the downward trajectory of the US economy. Notably, profits which were expected to increase in Q3 are now projected to decline. On July 30, the consensus was for a profit rise of 0.5%, this was reduced to -1.4% at the beginning of September and is now assessed as -2.1% (S&P 500 earnings - FactSet).

Indeed, if the mass of profits contracts this quarter it will be an unprecedented 6 quarters of profit falls. This has never happened outside a recession before. Although FactSet projects a profit rise in the fourth quarter it is clear that the market does not. The complacency noted two months ago has given way to "a sea of fear". The Conference Board (TED) has issued its corporate profit forecast anticipating long lasting and severe headwinds while noting that the 3rd quarter of 2014 appears to have been the high point for corporate profits. To this may be added, it also marked the beginning of the end of the long wave of profit revival and consequent economic expansion dating back to 1982.

Given the rise in US labour costs, stagnant productivity, falling investment, the sources of corporate profit in the US are diminished. Above all, the failure of US corporations to continue their monopolisation of the surplus value generated by the international value chain because of the rise of China, means a key source of profit is drying up with profound consequences for the country that has most benefited from globalisation. In short the outlook for the US economy is deteriorating contrary to the outlook of the FED. It is likely therefore, that the next move from the FED will be to ease monetary conditions and not to tighten them.

In common with China, the exuberance of the bond and share market is driven by the top 5% who have nowhere else to put their hard earned money. Predictions of a potential fall in the stock market ranges from 15% to 50% with the former figure being more credible. A host of large investors such as Larry Fink of Blackrock gravitate to the lower figure. The current EPS figures which are based on pro-forma profit figures and which understate this ratio, if adjusted, are nowhere near the elevated ratios found in 2000. While EPS ratios are historically elevated they are not hysterically elevated.

A 15% fall would wipe out two years of share price gains (including buybacks). Its significance will be the undermining in confidence of those at the top who spend the bulk of society's income. Additionally, in a world of low interest rates, a fall in the return from shares will add to the deficits of pension funds and insurance companies. This will add to the downward pressures on the economy.

The cumulative effect of the fall in the mass of corporate profits has resulted in a sustained fall in the aggregated cash holdings of US corporations for the first time since 1996. This is not so much to do with the holdings of the top 50 corporations but to the rising deficits of the smaller corporations. It is now becoming more difficult to service the acquired debt that low interest rates encouraged let alone fund share buy backs which are now subsiding.

US corporate debt at 70% is less than half the debt of corporations in China. Much of this debt in China is held by SOEs (state firms) and it was their growing inability to service these debts because of falling profitability that encouraged the government to first stimulate the stock market, and when this failed to stimulate the housing market. The main market for these SOEs is the housing market and associated infrastructure. They dominate the production of cement, steel, glass, transportation equipment etc. all of which rely on the state of the housing market. Increased demand and prices has restored a degree of profit to these industries. While this has alleviated problems in this sector, the indebtedness of the SOEs has merely been transferred to the property sector. Instead of having to defuse one bomb, Li has now to deal with two ticking bombs.

While the US is more vulnerable to economic shocks in the near future, it is the sheer magnitude of Chinese debt that will play a larger role in the coming world depression. Given the November elections in the USA, the market has put the FED on the back burner till December and will thus concentrate more on the economic data. It is unlikely that the markets can withstand a constant stream of economic bad news. Sustained bad news in September will mean that third quarter growth will be projected down and fourth quarter growth will become suspect. This should be sufficient to undermine the stock exchange in October.

This does not mean the FED is without ammunition. It could cut interest rates back to zero, but this would deprive it of ammunition in the future. The governments of the world can unite to increase fiscal spending but whether this can offset the crash in China remains to be seen. This is the significance of what is happening in China now. Capitalism has bought time with its bubbles and low interest rates, but time is now against them. All they have left is the passivity of the international working class, but its growing restlessness shows that even here time is running out for them.

Postscript Britain.

The triumph of the “Leave” vote did not cause the economy to melt down as many predicted. This was due to the Pound taking the strain, the Tories temporarily consolidating around Theresa May and the delay in enacting Article 51. One of the unanticipated consequences after Brexit and the fall in sterling was the in rush of foreign consumers taking advantage of the cheap Pound. Swiss watch exports to the UK went up 13.4% while at the same time falling in every other European country as customers flocked to the UK. The UK became the emporium for luxury goods sales as it was now on average 18% cheaper than anywhere else. However, such a fillip is short lived as prices will rise once the older stock is sold off. But it does explain the unexpected 4% increase in retail sales that occurred over summer but which is now subsiding.

Little by little the bad news is coming through. Latest projections for the City of London is the loss of 100,000 jobs. Already starting salaries for various grades in the finance sector has fallen by 30%. This loss of jobs and salary adds up to a £10 billion loss of spending power in London and this is only the beginning. The narrowly avoided commercial property shake out is back on the table as the demand for office space falls away because of job losses.

On the other side the stimulus given to industry by the weak Pound and later by the tearing up of regulations once Article 51 is signed, will boost the real economy. However, the disproportionate size of the finance sector means that its losses will overwhelm the gains made by industry. Many will welcome the realignment of the economy, but as in all things capitalist, this realignment will be convulsive occurring as it does in a world economy that is itself beginning to contract.

Finally, whether or not the space for this realignment exists is indeterminable. Britain is held hostage to foreign finance. It runs the largest trade deficit in the world courtesy of the City of London and its insatiable appetite for luxury goods. Even the long term perspective of the scaling down of the finance sector may be insufficient to assure foreign investors that lending in the here and now is secure.

The government will clearly seek to get the best deal for the City of London while pretending all the time that immigration is the key issue. But this unlikely. There are too many European cities drooling at the prospect of dismembering the City. Therefore, the coincidence of a growing crisis over the future of the City of

London and an unfavourable divorce deal with Europe, means that this unbalanced economy which has relied on hot money for so long, is uniquely vulnerable to an economic crash. It is likely that the smile on the face of the Brexiteers will soon be wiped off as they dive below the pub tables to avoid the consequences of the Leave vote. Britain may have survived the vote, but it could not have chosen a worse time to leave. A contracting world market takes no prisoners.