COMMENT

China's stock market gyrations will keep markets spinning

The recent volatility in China's domestic markets will have serious effects at least for the medium term, says **DILIP PARAMESWARAN***

WHILE THE WORLD'S attention was focused on Greece's negotiations with its lenders, another crazy spectacle was unfolding on the other side of the world. After running up 150% in the 12 months to June 12, the Shanghai stock market plunged by nearly a third in the next month.

There had been no fundamental reasons for the exuberance. China's economy had in fact been slowing, with GDP growth at 7% in the first two quarters, down from 7.4% for the last year. The property sector, an important contributor to the economy, had also been struggling, with both volumes and prices showing a marked slowdown. Corporate profitability had been squeezed and unofficial estimates of non-performing loans in the Chinese banking system had been rising. The central bank only started cutting rates in November 2014, by which time the rally was already in full swing.

On the contrary, the run-up had been related primarily to a significant flow of financing to the stock market through a variety of channels: margin financing, collateralized lending, shadow financing through trusts, and direct peer-to-peer lending. While the overall value of borrowed funds in the stock market is difficult to judge, some estimates put the value as high as a third of all floating shares.

This diversion of funds could be in part a result of cooling property markets. As the property markets began to cool, the private savings that had been invested in it through shadow-banking channels began to be diverted to lending against stocks, in search of returns in the high teens.

Retail investors got caught up in the frenzy in the late stages of the rally, helping push the markets even higher. According to reports, more than 80 million retail broking accounts were opened towards the end of the rally.

As the market crashed, there was panic all around. Listed firms chose to suspend trading on their shares (nearly 50% of the Shanghai index was suspended at one point), and investors tried to cash out. But regulators panicked too. They organised a coordinated rescue by injecting Rmb120bn, first tightening and then relaxing the rules for margin financing, stopping IPOs, and changing the rules for opening of trading accounts. The central bank also announced another cut in interest rates, and authorities are now looking for foreign funds that might have shorted the market (and have started suspending some trading accounts of foreign fund managers). The stock market then went through several days of further volatility, but the precipitous crash had been arrested.

WHAT IMPACT IS the recent stock volatility likely to leave in its wake – assuming that the worst is indeed over for now? First of all, there is no doubt that faith of the common man in the stock markets has again been shaken, making Chinese investors question the viability of the equity market as a repository for their savings, at least in the medium term.

What China needs in the long run is to develop the equity market as a stable avenue for financing for businesses, particularly private-sector companies and small and medium enterprises. At the end of 2014, China relied on bank credit to finance its private sector to the extent of 142% of GDP, far higher than the ratio of 50% in the US, according to the World Bank. Conversely, China's stock market capitalization was only 44% of GDP versus 116% in the US in 2012, again on World Bank data.

This reliance on bank credit leads to distortions in the allocation of capital to the most profitable and deserving businesses. Developing domestic stock and bond markets is a key necessity in improving the efficiency of capital. This year's stock volatility – and another IPO freeze – is a setback in that process.

The government's actions have also given rise to a version of moral hazard. There is already a persistent belief in the bond markets that the government will rescue troubled companies, leading to mispricing of risk. Last month's intervention has created a similar belief among equity investors.

FOREIGN INVESTORS HAVE also been caught in the maelstrom, with monthly net purchases of mainland stocks under the Shanghai-Hong Kong Stock Connect scheme turning negative in July for the first time since the scheme was launched last November. Investors also found that some of the eligible Chinese stocks had been suspended from trading.

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For the property sector, the crash may turn out to be a blessing, since savers may turn back to buying property as their preferred saving method. Already, there are mounting signs of stability in the property market, and the stock crash may further help strengthen the sector.

In February this year, US academics published a paper for the National Bureau of Economic Research arguing that "China's stock market no longer deserves its reputation as a casino".

The authors measured the ability of market valuations to differentiate between firms that will have high profits in the future from those that will not, concluding that "the informativeness of stock prices about future corporate earnings [in China] has increased steadily, reaching levels that compare favourably with those in the US."

Had they sought to measure the rationality of the overall market valuation (as opposed to the ability to differentiate between firms), I wonder if they might have reached a rather different conclusion.

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