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SETTING THE RECORD STRAIGHT ON CHINA'S STOCK MARKET BUBBLE

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CHINA'S WILD BULL MARKET HAS STAGGERED TO A HALT. BUT THE DEBATE ABOUT ITS CAUSES AND CONSEQUENCES IS STILL RAGING.

Since the bursting of China's stock market bubble in mid-June, the volume of comment, interpretation, and lamentation has generated a speculative momentum all of its own. Why, people want to know, did China's stock markets inflate and pop? How much will the economy suffer as a result? What possessed the government to try to stop prices from falling, and why did its efforts enjoy so little initial success? Has the market robbed China's ruling party of its credibility, even as the party has robbed the market of its integrity? In the unruly marketplace of ideas, pundits offer competing answers to all of these questions.

The most popular account of what happened to China's stock market goes something like this: China's government engineered a speculative bubble that defied a weakening economy. It talked the markets up, brought trading costs down, and invited foreign investors in (through a scheme to connect Shanghai's stock exchange with Hong Kong's).

According to this story, the government wanted a rally to help heavily indebted state-owned enterprises and lightly capitalized banks raise money from outside investors. When the bubble burst, China's leadership panicked. They feared the wrath of millions of retail investors, many of whom had bought shares with borrowed money, as well as a narrower circle of corporate insiders who had pledged shares in their own companies as collateral for loans. They also fretted about the impact on the broader economy, still weakened by a property market slowdown, and the indirect exposure of China's more adventurous banks.

In its anxiety, China's leadership set aside regulatory scruple and market principles. Despite its celebrated November 2013 decision[1] to "let the market play the decisive role in allocating resources," the state began a rescue effort on July 4 that was both highly intrusive and, at least initially, ineffective. It blocked the supply of new shares by suspending IPOs. It obliged some institutions to buy equities and others (including major shareholders[2] holding more than 5 percent of a firm's stock) not to sell them for six months. The

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[1] Decision of the Central Committee of the Communist Party of China on Some Major Issues Concerning Comprehensively Deepening the Reform, January 2014
http://lawprofessors.typepad.com/files/131112-third-plenum-decision---official-english-translation.pdf
[2] China Securities Regulatory Commission, July 2015
http://www.csrc.gov.cn/pub/zjhpublic/G00306201/201507/t20150708_280700.htm

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state-owned China Securities Finance Corp., backed by the central bank, helped brokerages ease and extends loans to investors. Finally, the government allowed over 1,400 [3] firms to halt trading in their shares altogether, trying to stop the market's descent by suspending it in midair.

For a brutal few days, none of these efforts could stop the selling pressure. Too many stocks were overvalued; too many stockholders underwater.

For a brutal few days, none of these efforts could stop the selling pressure. Too many stocks were overvalued; too many stockholders underwater. The market falls dented the collateral value of equities bought "on margin," i.e., with borrowed money. This collateral was then sold, prompting further falls in price. By July 8, the Shanghai Composite Index was down by almost a third[4] from its June 12 peak and by almost 5 percent since the "rescue" began. The state's intervention was viewed as a chance to get out of the market, not a reason to stay in it. Only after the government's agencies and allies began buying shares directly and incautiously did prices stage a partial recovery.

This narrative contains a lot of truth, but parts of it are necessarily speculative, and other parts don't quite add up. Many questions remain.

Did the government really engineer the bubble? It is easy to find articles in China's official press last summer and autumn marveling at the bull run and the stock market's rich potential. In September 2014, Xinhua news agency ran at least eight such articles in a single week, according to Bloomberg's count[5].

But it is not hard to find similar pronouncements in earlier years that failed to make a comparable impression. Back in 2012, Reuters[6] pointed out that "Chinese officials have been busy promoting investment in domestic 'blue chip' stocks to retail investors this year." The report cited a famous speech by China's chief regulator arguing that blue chips were cheap[7]. Six months after his remarks were first reported, the blue-chip index was down by over 8 percent (according to Bloomberg[8]).

According to most accounts, the government wanted to inflate stock market valuations in order to raise money for state-owned enterprises and banks. But China's speculative mania was concentrated elsewhere[9], among start-ups and technology stocks. If the state really did provide the initial spark of life for the market, it seems to have created a monster it could not subsequently control.

Indeed, as the rally gathered pace, the regulator seemed increasingly ambivalent about it. It appeared reluctant to give the bubble more air. But it was not prepared to pop it either. On Jan. 16, it stopped[10] three brokerages opening new margin accounts. In response, the market suffered its worst daily drop in more than six years. On April 17, the authorities tightened margin rules and relaxed restrictions on short selling. But a day later, they

[3] Caixin online, How Beijing Intervened to Save China's Stocks , July 2015 http://english.caixin.com/2015-07-16/100829521.html
[4] SSE Composite Index, Bloomberg
[5] Bloomberg, China's State Media join Brokerages saying Buy Equities, September 2014 http://www.bloomberg.com/news/articles/2014-09-03/china-s-state-media-join-brokerages-saying-buy-equities?utm
[6] Reuters, REFILE-CHINA MONEY-Selling blue-chips will take more than low PEs, May 2012 http://www.reuters.com/article/2012/05/14/markets-china-stocks-idUSL4E8GE00I20120514
[7] China Stocks Drop Most in Week as FDI Slump Adds to Economy Risk, February 2012 http://www.bloomberg.com/news/articles/2012-02-15/chalco-leads-state-stock-rally-on-pledge-to-help-europe-china-overnight
[8] Bloomberg, Shanghai Shenzhen CSI 300 Index http://www.bloomberg.com/quote/SHSZ300:IND
[9] CSI 300 Information Technology Index, ChiNext Index, Bloomberg
[10] Reuters, RPT-UPDATE 1-China bars 3 brokerages from opening new margin trading accounts, January 2015 http://www.reuters.com/article/2015/01/19/china-brokerages-idUSL4N0UY06520150119

felt the need to clarify[11] that they were not trying to depress the market. In sum, the government wanted a rally — not a bubble. But it was not prepared to do what was necessary to stop one.

Will the stock market collapse ruin the economy? Most economists say no. The losses will not heavily damage consumption spending because equities account for a modest share of household assets (only about one in 30 people own shares, according to the consultancy Capital Economics). Nor will the collapse greatly hurt investment because stock issuance accounts for a tiny share of corporate fundraising (less than 5 percent in the first half of 2015).

The securities companies and other financial institutions that serve the stock market are, of course, part of the economy. When trading volumes pick up, their business grows, adding directly to GDP. China's surprisingly fast growth of 7 percent[12] in the first half of 2015 owed a lot to the growth of financial services, which contributed almost 1.5 percentage points to the total, according to my calculations based on official data[13].

That contribution will diminish as the market flags and brokers' business slows. The stock market's woes may also pose a more insidious threat to the financial system. Market losses might bankrupt a trust company or a securities company that has bet too much of its own money or lent too much to a failed investor. Even China's banks, the heart of its financial system, may suffer indirectly. They have lent to businessmen who pledged their shares as collateral and to nonfinancial firms that may have gambled on the exchanges. They have also helped to fund trust companies and securities companies, both of which borrow actively on China's "interbank" markets.

Banks have also participated in so-called umbrella trusts, which offer fixed-income quasi-deposits to their customers, then have lent the proceeds to trust companies. The trust companies, in turn, lend the money to rich individuals or institutions to invest in the stock market. These umbrella trusts offer higher leverage than ordinary margin loans, leaving the end borrower more vulnerable to the sell-off. But these end borrowers are also wealthier and provide a broader range of collateral (which can include any deposits or financial assets the rich individual holds at the bank), according to a report by Jason Bedford and Stephen Andrews of UBS. That should give the banks some insulation from the worst of the trouble.

When all of these exposures are added together, the total still looks small relative to the size of China's banking system. But losses will not be evenly spread: China's smaller lenders are more likely to take the hit. Moreover, distress can feed on itself if confidence is shaken.

In all likelihood, the government doesn't think the stock market mess will seriously hurt the real economy. But it probably does not know for sure that it won't. And it does not want to find out either way. If you don't want to know whether someone's swimming naked, don't let the tide go out.

[11] Reuters, China securities regulator denies encouraging short selling, April 2015
http://www.reuters.com/article/2015/04/18/china-shorting-idUSL4N0XF05J20150418

[12] National Bureau of Statistics of China, July 2015
http://www.stats.gov.cn/english/PressRelease/201507/t20150716_1216024.html

[13] National Bureau of Statistics of China, Preliminary accounting results of GDP for the first half of 2015, July 2015
http://www.stats.gov.cn/english/PressRelease/201507/t20150716_1216024.html

Does the government's intervention make a mockery of its promise to "let the market play the decisive role in allocating resources"? That famous promise was made in November 2013, as part of a 60-point decision [14] adopted at the Communist Party's third plenum. The decision was celebrated as proof that President Xi Jinping was serious about economic reform.

But no one at the time thought that the decisive "market" in question was primarily the *stock* market. Reformers were more focused on breaking down barriers to entry in monopolistic product markets, liberalizing energy prices, and freeing up the price of credit. One useful guide to the dreams of the reformers is the "China 2030 report," coauthored by the World Bank and an official think tank in 2012, which provides a bold blueprint for China's economic future. Did that report envisage a decisive role for the stock market? Not really. It argued[15] that, if anything, China's stock market was too big relative to the market for corporate bonds. It also complained about the waste "arising from bouts of irrational exuberance," like the dot-com bubble.

Are market forces silly or sacred? When the bubble was inflating, critics of China's economy scoffed at its speculative excesses. China seemed to be recreating America's dot-com bubble, just as its architects had replicated Western landmarks like the Eiffel Tower[16]. On the way up, these market forces seemed silly.

But on the way down, the tone changed. China's critics began talking about the stock market as if it were a venerable and vital institution that would be desecrated by the government's clumsy intervention. The market forces that were lampooned during the bubble were canonized when the government trampled all over them.

Fans of the stock market argue that it should help China become a more innovative, entrepreneurial economy, financing bold commercial experiments and unearthing new engines of growth. It was supposed to aid China's transition away from state-owned industries financed by cheap loans from state-owned banks and their captive depositors.

China's bubbly market instead created a parody of capitalist creative destruction.

But China's bubbly market instead created a parody of capitalist creative destruction. Firms reinvented themselves wholesale, abandoning long histories in one industry to take advantage of market fads for another. In an economy supposedly run by apparatchiks and princelings, the bubble promoted arrivistes and pretenders. One Shenzhen-listed company [17] transformed itself from a restaurant chain serving spicy Hunan food into a cloud-computing business. In so doing, it was paying heed to the stock market's signals. Unfortunately, those signals were not worth very much. In the end, the company's chief innovation was to become the first Chinese company to default on the principal of an onshore bond.

In the United States, many people revere the market, even as they laugh at some of its excesses — just as they revere democratic elections, while scoffing at the politicians who contest them. In China's Communist Party, the

[14] Decision of the Central Committee of the Communist Party of China on Some Major Issues Concerning Comprehensively Deepening the Reform, January 2014 http://lawprofessors.typepad.com/files/131112-third-plenum-decision---official-english-translation.pdf
[15] Google books, China 2030: building a modern, harmonious, and creative society https://books.google.com/books?id=IPNSOPBskeQC&pg=PA180&dq=arising+from+bouts+of+irrational+exuberance&hl=en&sa=X&ved=0CCcQ6AEwAGoVChMIsfL_vabqxgIVUtSOCh08LAEM#v=onepage&q=arising%20from%20bouts%20of%20irrational%20exuberance&f=false
[16] Citylab, Glimpse the Absurd Parisian Ghost Town in the Middle of China, August 2013 http://www.citylab.com/design/2013/08/glimpse-absurd-parisian-ghost-town-middle-china/6413/
[17] Wall street journal, China's Cloud Live Defaults on Local Debt, April 2015 http://www.wsj.com/articles/cloud-live-first-chinese-company-to-default-on-principal-on-local-debt-1428385363

attitude is perhaps different. If a freewheeling stock market does not reflect the economy's fundamentals or guide resources to their best uses, what is the harm in meddling with it?

What are the long-run implications of the stock market mess? The government's meddling will have lasting consequences for the stock market itself, setting an awkward precedent that will take years to overcome. Retail investors will expect similar help in the future, and institutional investors will fear similar limits on their future freedom to trade.

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But the long-run damage to China's economic evolution is easy to exaggerate. China is still an emerging economy, with a GDP per person of $12,900, measured at purchasing power parity — only about a quarter[18] of America's. By this metric, China is still decades behind the world's mature economies, including some of the earlier Asian tigers like South Korea or Taiwan. At China's middling stage of development, banks and retained profits finance the bulk of investment; the stock market is something of a sideshow.

And China's sideshow is not the first to provide lots of melodrama. Taiwan in 1989 experienced a stock market bubble just as spectacular as China's. Its madcap bull run was full of "financial slapstick" (as Steven Champion calls it in his book *The Great Taiwan Bubble*[19]). It was also full of moral hazard, with retail investors assuming the government would help if anything went wrong. When the bubble finally burst in 1990, Taiwan's economy did briefly slow. But within a year it was growing[20] again by 8 percent.

Thanks to this rapid recovery, Taiwan soon achieved the kind of "moderately prosperous[21]" economy that China aspires to become. Despite the turmoil of recent weeks, China can still fulfill that aspiration. And by the time it does, the moderately prosperous Chinese will have put the Great Bubble of 2015 far behind them. This month's interference in the equity market should not prevent that growth because the untrammeled stock market was not contributing much to it in the first place.

[18] International Monetary Fund, World Economic Outlook Database, April 2015
http://www.imf.org/external/pubs/ft/weo/2015/01/weodata/weorept.aspx?pr.x=21&pr.y=18&sy=1985&ey=2014&scsm=1&ssd=1&sort=country&ds=.&br=1&c=924%2C528%2C111&s=PPPPC&grp=0&a=

[19] The Great Taiwan Bubble, Champion S.

[20] International Monetary Fund, World Economic Outlook Database, April 2015
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[21] Xinhua News, Full text of Hu Jintao's report at 18th Party Congress, November 2012
http://news.xinhuanet.com/english/special/18cpcnc/2012-11/17/c_131981259_4.htm

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