Good Idea at the Time: China Eyes Cost of Relying on Stocks

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It sounded like a good idea at the time: encourage growth in China's stock market as a way for companies to raise capital. And if that paid down some of the nation's record debt load in the process, so much the better.

The problem: promoting a market where retail investors dominate daily trading left policy makers vulnerable to swings in sentiment that are tough to control. That's a reality Premier Li Keqiang's government faces now as it steps up efforts to stop the bleeding in China's volatile equity market.

Policy makers were largely silent as the Shanghai Composite Index doubled in seven months, and central bank Governor Zhou Xiaochuan lauded the equity market in March as a fundraising vehicle. Now, their actions show concern about the plunge into a bear market, with interest rates cut to a record low, a targeted reserve-ratio cut, money-market cash injection and loosened rules on margin lending rolled out in the past week.

Such policy changes are a shift from what, until last week, had been a disciplined approach toward stimulating the economy, said Shuang Ding, chief China economist at Standard Chartered Plc. in Hong Kong.

"The government was progressing in a systematic way" before stocks plunged, said Ding, who previously worked at the People's Bank of China and the International Monetary Fund. Now, "it's doubtful whether the government can control the market, especially when interest rate and reserve-ratio cuts couldn't stop the market decline."

Sentiment Swing

Sentiment has swung violently from greed to fear as margin traders continued to unwind positions amid doubts over the effectiveness of government measures to support equities. Officials can take solace that absent for now from the swings is any big change in the outlook for the world's second-largest economy.

The Shanghai Composite was 3.3 percent lower at 11:26 a.m. local time, extending its plunge from a June 12 peak to 27 percent.

"It's too early to call a crisis, but the butterfly wing has swung and ripple effects are expected," said Zhou Hao, a Shanghai-based economist at Australia & New Zealand Banking Group Ltd. Zhou said the stock price plunge may spread to cause interbank liquidity strains, and banks may become more cautious in lending to firms with large exposure to equities.

Mixed Messages

The PBOC's lack of transparency compared with other central banks complicates its response to financial turmoil. Without a public narrative from key policy makers on their objectives, investors are left to trawl through state newspapers and statements from regulators for guidance.

After the rate and reserve ratio cut, "the government's propaganda works intentionally played down the 'save the market' meaning, which undermined the effects," Xu Gao, chief economist with Everbright Securities Co. in Beijing, wrote in a note this week. "The government should be more high profile in future policies."

Officials have encouraged development of equity markets as a ways for companies to raise financing and for savers to get better returns, said Eswar Prasad, a senior fellow at the Brookings Institution in Washington and a former head of the IMF's China division. He said the stock market seems to have become an important tool for propping up both investment and consumption, generating froth in equities -- and risk.

'Significant Risks'

"Using the stock market as a tool of short-term economic stimulus poses significant risks to the longer-term goals of financial market development and balanced growth," Prasad said. "Steps in recent months to ease monetary policy appear to have boosted the stock market but gained at best limited traction in reversing the weakening momentum of the economy."

New rules announced by regulators make real estate an acceptable form of collateral for margin traders, who borrow money from securities firms to amplify their wagers on equities. That means if share prices fall enough, individual investors who pledge their homes could risk losing them.

"It's still unknown how much and how widely bank money is involved in the unofficial margin trading," said Chen Xingdong, head of macroeconomic research at BNP Paribas SA in Beijing. "It's an unprecedented situation in China's stock market history. A stock market bubble was partly inflated by the visible hand, and then the bubble burst, causing panic."

If market sentiment changes, it will be harder for companies to sell shares, which has potential to ripple into other capital markets, said Chen.

No Contagion

Still, slumping shares probably won't spur contagion or broader financial and economic woes, according to Zhang Bin, a researcher with the Chinese Academy of Social Sciences, a Beijing-based research agency that advises the government.

Zhang said officials may respond to turmoil in equities by using public resources to support stocks, as Hong Kong's monetary authority has done in the past.

"But the government has to be very careful in doing so, and be very clear in explaining that the public funds are spent for the sake of the overall country, not some grumpy stock speculators," he said.

Systemic dangers tied to traders using margin will be contained because among those investors "very few have serious amounts of money involved," according to Andy Rothman, an investment strategist who helps oversee $32 billion at Matthews Asia in San Francisco.

'Very Nervous'

“What policy makers are focused on is creating a more stable and solid stock market,” Rothman said. “They’re getting very nervous about the pace of the decline in stocks. I think they planned the rate cut, but brought forward the timing of it to try and influence the market.”

Michael Shaoul, chief executive officer of Marketfield Asset Management LLC in New York, said plunging Chinese stocks have cost him sleep lately, but the economy “is a long way from falling apart,” and regulators are in the process of taking more pro-market steps.

“But that won’t control the direction of the market,” said Shaoul, who oversees $5 billion, including Hong-Kong listed Chinese shares. “They’ve learned the limits of their powers if they have a market that’s open to the public. They can influence sentiment, but they can’t control it.”