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China: Credibility on the line

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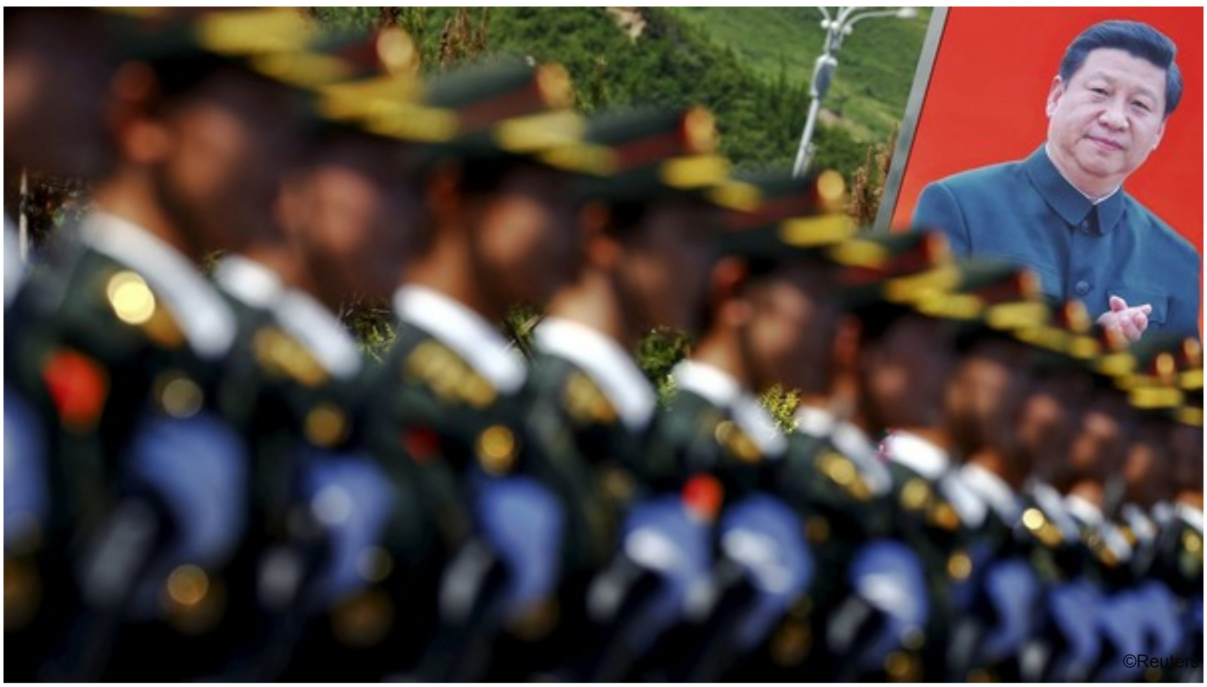
The Beijing leadership's efforts to control the stock market turmoil have dealt a serious setback to plans for economic reform



A poster of President Xi Jinping looks out over Chinese soldiers preparing for next week's parade to commemorate the 70th anniversary of the end of the second world war

As Chinese stocks plummeted on "Black Monday", triggering waves of panicked selling around the globe, China's leaders seemed strangely unperturbed.

Premier Li Keqiang was quoted in state media calling for development of China's 3D printing industry. President Xi Jinping attended a Communist party meeting, where he vowed to crush followers of the Dalai Lama and urged Tibetans to absorb "Marxist values".

In the days that followed, under strict orders from the Communist party's propaganda department, the country's heavily censored media was no longer dwelling on the global sell-off or China's role in it. In the rare reports on the worst multi-day Chinese equity rout since 1996, they admonished "global financial markets [that] have overreacted like a burnt child fearing fire".

In a way they were right.

Behind the global headlines declaring the "great fall of China" nothing actually changed in the country's "real" economy, which has been slowing for years but is still growing in line with the government's target of around 7 per cent — at least according to official figures.

But what did change this week is the perception, pushed by many on Wall Street and in the City of London, that China's authoritarian leaders were the world's most competent technocrats.

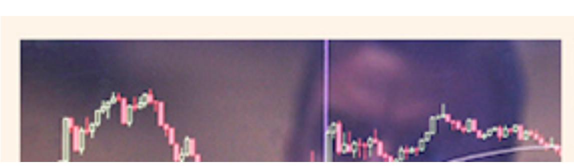
The mishandling of a bursting stock bubble — and especially the decision on August 11 to break a two-decade taboo and devalue the renminbi — have badly shaken global faith in the Chinese model of market authoritarianism.

"Many of the market's substantive worries (economic collapse, financial collapse, competitive devaluation) are overblown," says Arthur Kroeber, head of research at Gavekal Dragonomics. "But markets trade as much on policy signals as on economic reality, and there has clearly been a breakdown of communication between Beijing and the rest of the world."

The problem is not just one of public relations or global perception, however. Many of the actions the authorities have taken since late last year now appear badly mistaken. More recently, the moves have smacked of panic.

Not only have global investors lost faith in China's mandarins but within China itself the reform-minded officials who have overseen the turmoil have also been widely discredited, their plans for market-oriented economic reforms now in tatters.

In April, as investors were questioning whether China's benchmark Shanghai Composite Index was approaching a bubble after doubling in less than a year, the Communist party's main mouthpiece, the People's Daily, ran a prominent editorial dismissing those fears and declaring the start of a long-term bull market. "The capital markets can be a true reflection of the 'China dream'," the paper crowed. "As carriers of the 'China dream' [the markets] hold enormous opportunities for investors."



Encouraged by what appeared to be an apparent ironclad guarantee from the ruling party, small investors poured money into already overpriced

'Global investors look at the witch-hunt going on in the equity market and they ask what the hell is going on'

PARTNER, HONG KONG HEDGE FUND

stocks.

The benchmark index peaked on June 12 then began to slide, accelerating as the government watched helplessly, until July 8 when a plan approved by Premier Li and vice-premier Ma Kai was rolled out to save the market.

China's stock exchanges, set up in the early 1990s, have been through several booms and busts, and every time they have peaked the government has halfheartedly tried to prop up share prices before giving up and allowing them to fall. But this time Beijing went all-out: banning short sellers, encouraging margin trading, halting initial public offerings, prohibiting share sales by all major investors and ordering state-owned funds and investors to buy up shares on a massive scale.

This unorthodox intervention convinced many Chinese punters to pile back in. But the moves were viewed with deep scepticism by investors abroad, especially after Beijing effectively criminalised large share sales.

"The Chinese authorities' instinctive reaction to everything is control and retribution," says a Hong Kong-based partner at a large hedge fund. "Global investors look at the witch-hunt going on in the equity market and they ask what the hell is going on?"

Currency intervention

The biggest shock was still to come. Just before China's markets opened on August 11, the People's Bank of China announced it would devalue the currency by around 2 per cent against the dollar in a "one-off" move.

The central bank also said this devaluation, the first by China since 1994, would be accompanied by a new "market-oriented" mechanism for setting the daily benchmark from which the currency can rise or fall by up to 2 per cent on a given day. This effective de-pegging of the renminbi from the dollar led to two more days of devaluation before the central bank decided to halt the slide by buying the Chinese currency and selling US dollars.

Total market value wiped out since the stock market peaked in early June

Estimated amount spent by the People's Bank of China trying to prop up the currency

In a hastily called — and extremely rare — press conference two days later, the PBoC vowed to intervene in the market whenever Beijing saw the need, reversing the earlier decision to allow the market to set exchange rates.

The PBoC has since spent roughly $200bn in the onshore and offshore currency markets to keep the renminbi from devaluing further, begging the question of why it decided to de-peg its currency to begin with.

"Before they announced this reform they had a credible peg to the US dollar and they hardly needed to intervene in the [foreign exchange] markets, but now they are having to spend huge amounts just to achieve the same effect," says a person with ties to the PBoC. "It's like they decided to cross the river because it looked nice and calm but then they slipped and got dragged downstream, and now they are having to use all their strength to get back to the shallow water they were in before."

At the end of July, China's foreign exchange reserves stood at $3.65tn, the largest in the world. If the PBoC were to keep intervening in the currency markets at the current rate (and no other cash flowed in) those reserves could be gone within a year.

The apparent mishandling of what could have been an important step towards a freely floating currency — a key part of becoming a rival currency to the dollar, a cherished policy objective — has left reform-minded officials within the regime deeply discredited.

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"The government clearly has the right intentions to proceed with reforms but is fumbling the communication and implementation of those reforms," says Eswar Prasad, former China head at the IMF. "Internal support for market reforms is eroded every time they see big volatility and that is why we have seen this whipsawing between liberalisation and control."

Contradictory policy

That same tension can be seen in the attempts to prop up the stock market.

State-owned entities have spent more than $200bn buying stocks to reverse the stock spend huge amounts to get the same effect'

market crash, say people familiar with the matter. Monday's crash, when Chinese stocks fell 8.5 per cent in their worst day since February 2007, appears to be largely due to the Chinese government's decision to cut its losses and stop buying shares to prop up the index.

The fall was also blamed on the fact the government did not cut interest rates or inject cash into the banking system over the weekend, as many investors had expected. The PBoC did both on Tuesday, after the benchmark index had already fallen by more than a quarter in just one week.

There was more support to come. A group of state-owned stock investors known as the "national team" poured back in to buy shares in the last hour of trading on Thursday and lifted the index from a small loss to close up more than 5 per cent. The market closed up another 4.8 per cent yesterday, but the total market value wiped out since the peak in early June is around $4.5tn — more than the entire German economy.

The main reason for renewed state intervention late this week was a directive from top party leaders to provide a backdrop of rising markets when Beijing hosts a huge military parade next Thursday to commemorate the 70th anniversary of the "Victory of the Chinese People's War of Resistance Against Japanese Aggression", according to market participants and people familiar with the matter.

In private, some officials say the incoherent and contradictory policy reversals of recent weeks have much to do with the planning and preparation of the parade.

Because President Xi Jinping is preoccupied with making this display of military might and "national rejuvenation" a success, he has left the economic response to other leaders, these people say. But since taking power in 2012, Mr Xi has concentrated decision-making power in his own hands to such an extent that his weakened underlings are unable to make firm decisions and stick with them.

"People are finally starting to realise the Chinese government is not omnipotent and omniscient," said Jim Chanos, the hedge fund manager and long-term bear on China, in an interview with CNBC. "The way they handled the run up in their stock market, the panicked responses, the devaluation, the non-devaluation, the various different mixed signals coming out of the various different ministries, I think has started to give investors pause [and realise] that in fact, like many of us, sometimes they don't have a clue."

Additional Reporting by Christian Shepherd

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