Global Counsel

The 'Chinese Put'

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Summary

The full financial force of the Chinese state has been on display over the past few weeks as the authorities have responded to collapsing stock prices with an array of interventions that now appear to have established a floor under the Shenzhen and Shanghai indices. The episode is revealing about the nature of risk in the Chinese financial system and the willingness of the state to socialise risks. It suggests that Chinese reformers have not solved the conundrum of how to introduce market disciplines based on the alignment of risk and reward in a system unable to tolerate the consequences of widespread losses. Until they do, the 'Chinese put' – by which substantial downside risk from speculative investment is implicitly absorbed by the state – will continue to distort the allocation of capital. This means stability now may come at the cost of a much bigger crisis in future.

Chinese policymakers have been in a spin since the country's main equity markets began dropping sharply in the second half of June. The falls prompted a wide-ranging if somewhat chaotic sequence of interventions which initially misfired but eventually managed to stabilise the markets, at least for now. What does this episode tell us about the relationship between private and social risk in China and the ability of the system to introduce the reforms that are required if the market really is to play a decisive role in the economy?

China's erratic stock markets

The stock markets in China are the poor relation in a financial system dominated by bank lending, accounting for less than 5% of corporate financing. That proportion is, however, increasing and equity financing is an important source of funding for private firms, especially in the burgeoning Chinese tech sector.

The stock markets have a history of volatility and are notorious for behaving in a manner that appears to be desynchronised with the rest of the economy. The Shenzhen and Shanghai stock markets were flat in the first half of last year. In the second half they increased 28% and 58% respectively, with most of the gains coming towards the end of the year. It was this year, however, that both markets really took off. From the start of the year until their peak on 12 June the Shenzhen and Shanghai markets rose 122% and 60% respectively.

This is in part explained as a side effect of the monetary easing by the People's Bank of China that began in November last year, which meant more funds chasing higher returns in the country's equity market. In addition, financial innovation and the increasing use of margin finance provided by both official brokers and informal lenders meant a surge in leveraged stock investments. This was despite the fact that the Chinese economy had been cooling and underperforming against expectations for much of this period.

Sentiment turned in the middle of June partly because of worries that stock prices increasingly bore little resemblance to fundamentals. There were also concerns that leveraged investors would be very exposed if the market turned sour and investors had to close out their positions. And that is exactly what happened. In less than four weeks from 12 June the Shenzhen and Shanghai markets lost 40% and 32% respectively, accelerating the pace of margin calls, triggering the automatic suspension of an increasing number of stocks, and panicking officials who feared they had lost control of the market.

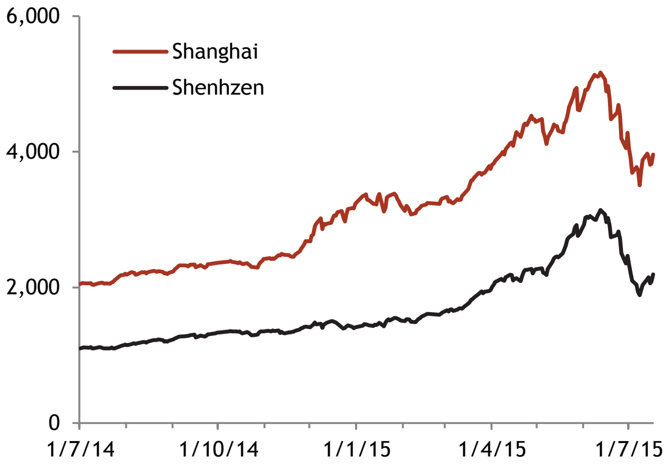

Figure 1: Composite stock market indices
Source: CEIC

The response by the authorities was initially piecemeal and underwhelming, reinforcing the selling pressure. But since 9 July the sheer weight of interventions has had the desired effect, with both the Shenzhen and Shanghai indices managing to recover some of their losses.

The instruments used by the authorities have been many and varied. At the end of June the PBOC again loosened monetary policy and proposals were published to allow national pension funds to invest in equities. At the start of July the China Securities Finance Corporation was given additional funds to help stabilise the market both through direct purchases and by lending on to official brokers. At the same time, 21 of the main brokers announced the creation of a joint market stabilisation fund. Soon after, IPOs were suspended and both the extent and range of instruments used for direct intervention in the markets by the CSFC and other state-backed groups was increased. Finally on 8 July the authorities announced a package of measures that included a ban on share sales by senior executives and large shareholders and an instruction to state-owned enterprises to maintain or increase their shareholdings. The PBOC also coordinated financial support to the CSFC from China's state-owned banks reported to total more than $200bn.

The double blow for reformers

The interventions appear to be working for now and to have succeeded in limiting the losses for private investors. But what are the broader implications of this episode for market reforms and systemic risk in China?

It is tempting to dismiss both the macroeconomic and the financial stability implications of the market gyrations, particularly given China's decades-long record of combining high growth and stability. The case for playing down the macroeconomic consequences is largely based on the still relatively small scale of the equity market both as a source of finance and as a portion of the wealth of Chinese consumers. Moreover, 30 to 40% falls in stock markets that very recently more than doubled in value should not be such a big deal. On the financial stability side while some leveraged investors are clearly nursing losses the sanguine view is that the authorities have shown once again that their deep pockets can be used to contain the damage. Moreover, while interventions of this sort may create moral hazard, this is hardly a new concern in China.

There are, however, several reasons to be concerned. Most immediately the prices of Chinese stocks now look artificially high, having been propped up a combination of trading suspensions, large scale interventions and restrictions on divestments. This means a further correction may be required before prices move into line with fundamentals.

The authorities are already introducing new restrictions to curb highly-leveraged investments and are clamping down on informal providers of margin financing. Experience has shown, however, that investors will look for – and most likely find – ways to circumvent these restrictions as the implicit guarantee by the state that it will prevent large losses makes leveraged investment more attractive.

For reformers in China the disorder in the equity markets is a double blow. First, it undermines a central policy objective announced by President Xi at the Third Plenum in 2013 which is for the market to play a "decisive role" in the economy. More equity finance arranged through stock markets that are transparent, have clear rules, are not subject to heavy handed intervention, is essential if this is to happen, particularly as the private sector is always a lower-priority for the state-owned banks when it comes to the allocation of credit.

The second blow is because the stock market is itself an important instrument for another key reform, which is to introduce more market discipline to state-owned enterprises through governance reforms and partial private ownership. The irony is that many SOEs are helping to prop up the stock market, just when they are supposed to be broadening their ownership by issuing shares onto the market.

The reform conundrum

The problems in the stock market highlight a more fundamental problem for policymakers in China that are intent on liberalising the financial sector. An efficient market economy requires an alignment between risk and reward. But the interventions to prop up the stock market are a reminder that the imperative of social and political stability in China means the system's tolerance of private losses remains very low. The result is what might be termed as the 'Chinese put' – by which substantial downside risk from investment is implicitly absorbed by the state. This phenomenon is not only a feature of equity markets. It is much broader and applies to other parts of the financial system too, as is illustrated by the continuing reluctance by the state to allow either failing investment trusts to fold or firms to default on corporate bonds.

This creates a conundrum. Whenever reforms create new risk-taking opportunities – as they must if they are to be meaningful – individuals have an incentive to maximise their exposure, knowing there is a good chance the state will bail them out. Moreover, the likelihood of a bailout is increased when individuals take on risks that are correlated with the risks taken by others, given the state's particularly low tolerance for systemic risks. This behavioural pattern makes it more likely that reforms create systemic risks, which is why the process of reform is itself both slow and subject to reversal.

The authorities in China have not yet solved this conundrum. Until they do the system of capital allocation is likely to remain largely directive with the state-owned banks continuing to play a dom¬inant role. The same clash between individual incentives and the actions of the state applies to reforms in all areas of the financial sector, including the banking sector. While progress has been made in some areas, including towards interest rate liberalisation, this is incremental. This means risk in general, but especially credit risk, will continue to be under-priced from a social perspective.

At best this means the system of capital allocation is inefficient. At worst it is inherently unstable as the failure to reform means a build-up of slower burning risks as the balance sheets of the banks, many corporates, and different parts of the state, including local government, could deteriorate quickly if the credibility of the Chinese put is ever called into question. The problem is not that the authorities are unaware of the risks – they are and they also know what should be done about them, at least in principle. The difficulty is instead that the reforms that are required themselves entail risks that are both more immediate and intolerable. This means that stability now may come at the cost of a much bigger crisis in future.

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