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CHI TIME

THE TRUE RISK OF CHINA'S A-SHARE SAGA

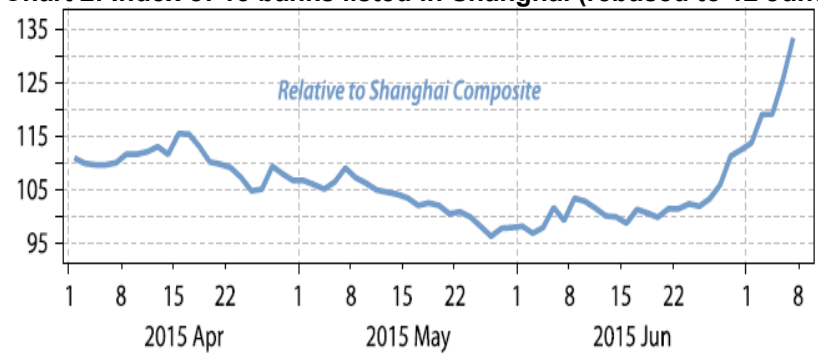
The stock market has predicted nine out of the last five recessions
Paul A. Samuelson

The 32% correction in the Shanghai Composite index between 12 June and 8 July does not portend a financial crisis in China, as it will not have a major impact on China's GDP growth and the renminbi exchange rate. The true risk of the sell-off lies in delaying the process of capital account liberalisation and financial reform. But it also serves as a wake-up call for Beijing to re-think its structural reform strategy.

It is noteworthy that the Shanghai 50 index (comprises the large cap stocks, dominated by banks, that foreign investors are most interested in owning) and Chinese bank stocks significantly outperformed the broader Shanghai Composite index (Chart 1 and 2) in the market crash. This is because when margin debt financed a stock bubble, financials should have led the boom/bust dynamics, yet this was not the case in China.

Large caps and bank stocks underperformed the broad market when the bubble was inflated, but outperformed it when the bubble burst. This suggests that the market's boom-bust was not a result of financial flaws but rather of market bubble dynamics. If there was an impending financial crisis, bank stocks would not be spared in the sell-off.

Chart 2: Index of 15 banks listed in Shanghai (rebased to 12 June 2015)



Source: Wind, Dragonomics

There is little risk of the market correction hurting China's GDP growth because of the absence of any wealth effect on consumption and corporate funding. Fundamentally, the wealth effect on consumption is based on the permanent income hypothesis, which argues that households plan their consumption and saving behaviour based on their life-cycle income rather on short-term income fluctuations.

So the three-week market correction was too short to have any impact on consumption. In fact, retail sales (a proxy to consumption) in China do not correlate highly with A-shares' performance (Chart 3). This is also because equities account for a small (less than 6%) share of household wealth. Even if we include wealth management products (WMPs), which invest in equities and other asset classes, the total equity exposure of Chinese households account for less than 12% of their wealth (Table 1).

The swift correction mainly involved wealth transference between the winners and losers rather than the permanent destruction of wealth or of future income streams. Even after the 32% correction, the Shanghai index is still up 122% from June 2014. Last but not least, China's consumers' marginal propensity to consume is very low (estimated at 0.34, see *"Chi Time: Reform is What the China "Bubble" Advocates Have Missed"*, 27 May 2015), which means income changes only trigger a small response in consumption.

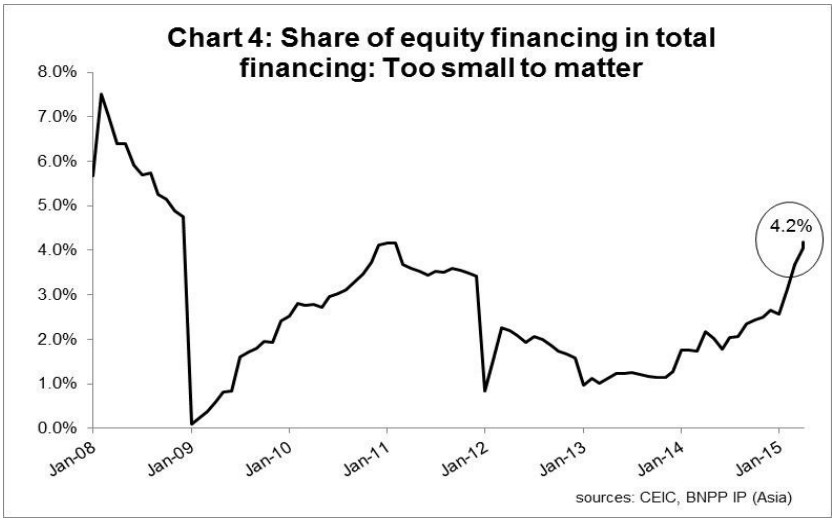
Table 1: Estimated household wealth

	RMB trn	% total
equities	13	5.6%
wealth management products	15	6.5%
bank deposits	54	23.3%
housing	150	64.7%
total assets	232	

source: BNPP IP (Asia)

The impact of the market sell-off on corporate funding is also small, as equity financing accounts for only 4% of total social financing in the system (Chart 4), despite Beijing's effort to reduce the reliance of the economy on bank loans and to increase the sourcing of funds from equity financing. Banks have indirect exposure to the stock market via lending to, and purchasing of WMPs from, trust and securities companies that offer margin financing to the stock market and lending to listed companies which put up their shares as collateral. But the total value of these loans is estimated at less than 3% of total bank assets, implying a small impact on banks from stock market volatility. In a nutshell, systemic risk is manageable.

The sharp stock sell-off has prompted some market players to forecast as much as a 10% fall in the renminbi exchange rate in the coming year. In my view, this is based on the unrealistic assumption of free capital outflow from China, which is not going to happen unless Beijing opens up the capital account suddenly. China's basic surplus (current account balance plus net long-term capital inflows) is still large at over 4% of GDP, with the current account surplus rising. Together with a stable exchange-rate policy, this will underpin the renminbi in the medium-term.



The true risk of the market rout lies in slowing China's economic liberalisation, including capital account opening. Market volatility and the suspension of IPOs will impede mergers and acquisitions and capital raising, as well as delaying privatisation and the implementation of mixed-ownership reform of state companies and the deleveraging plans of local governments. Beijing may also reduce its tolerance for financial innovation, such as margin financing, which is essential for capital market reform.

The stock market saga has revealed Beijing's old habit of micro intervention, raising doubts about whether it is ready to let market forces run and thus hurting its reform credibility Crucially, as China moves towards the Impossible Trinity paradigm, where opening the capital account will make it impossible for Beijing to control both the exchange rate or the interest rate, it will have to give up control on one of the policy levers and to deliver deep structural reforms to prepare China for handling economic volatility stemming from free capital flows and the loss of a monetary lever.

However, the market rout has revealed the inherent regulatory and implementation vulnerabilities in the system and hurt Beijing's confidence in liberalising the capital account by opening up to market forces. On one hand, this could make Beijing more risk-averse by slowing the pace of capital account opening. On the other hand, this should serve as a wake-up call for it to review its structural reforms strategy.

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