Orient Capital Research

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Seven Effects of China's Stock Crash

Politics Rules

The economic impact of the collapse of the Chinese stock markets is likely to be minimal. The political effect will be larger. I can see a number of economic problems caused by the stock market fiasco. They include:

1) **CSRC Chairman Xiao Gang is Fired.** Someone has to take the blame. He's in charge of the markets. Whether he was forced to act or did so willingly won't matter in the end. This could have the benefit of reducing antagonism with Zhou Xiaochuan at the PBOC.

2) **The Leadership Becomes Walled Off.** Xi jinping already has taken control of the small leading groups that direct most policy. This will further solidify his desire for control. This is not a good direction for bold policies or negotiating between interest groups.

3) **New IPOs are Delayed.** China raised $29 billion in 220 IPOs in the first five months of 2015. That avenue will be closed for many months. There is a backlog of 20 companies that privatized in the U.S., including Qihoo 360, that won't relist for some time. Infighting between CSRC and the PBOC, and blame for the crash, will further delay new issuances.

4) **Rebalancing Delayed.** Rebalancing from fixed asset investing to consumer spending will be further delayed due to lack of consumer confidence. This was looking rather remote in any case but the crash didn't help.

5) **PBOC Becomes Stronger.** PBOC Governor Zhou Xiaochuan was reportedly out of the country during the crucial Sunday July 5 meeting. Premier Li took the chair and is thus responsible. The PBOC generally has been wisely low key during this debacle, which strengthens their bureaucratic hand. It's interesting that the CBRC (China Banking Regulatory Commission) was behind bank lending to country's margin lender – not the PBOC. The PBOC has been immensely influential in market reforms so these indications are positive.

6) **No Interest Rate Reform in the Near Future.** State firms, ordered to not sell

shares and which can't raise additional equity, are going to fight to the last man to avoid higher interest rates at a time of weak profits.

7) **Lower Asset Prices Due to Less Liquidity.** Banks will curtail lending, and may face constraints due to outstanding loans to SOEs; investors will put their savings into cash (probably avoiding less liquid real estate); and shadow lenders such as Trusts will be confront either government restrictions or margin calls. As a result, an overall decline in liquidity will constrain asset prices, including property, equities, and indirectly, commodities.

Little Impact on the Real Economy

Equities account for approximately 15% of the average person's financial portfolio, and this excludes property. So it's not a big part of total savings. Many of them may have made money as the Shanghai index is up 74% over the past year despite a 30% decline in a month. The capitalization of China's stock market on a free-float basis is just about 40% of GDP, compared with more than 100% in most developed economies. New equity issuance was just 4% of total social financing last year. So the relationship between the market and the overall economy is minimal.

There is a confidence factor in the markets but they have never been treated more than a casino by investors and this is no different. While the Chinese press quoted investors saying they believed the government generally is able to "save" the market, there hasn't been a backlash against the government for the current failures. My guess is the average citizen just assumes the markets are a casino.

Modest Bank Exposure

The bank exposure could be a greater concern. But even there the effects are likely to be modest. Goldman Sachs estimates outstanding margin financing, at 2.2 trillion yuan ($355 billion) earlier this week, was the equivalent of 12% of the value of all freely traded shares on the market, or 3.5% of China's GDP. With Shadow loans from Trusts and P2P companies, total margin financing could be 50% higher. Banks have channeled an estimated 1.5 trillion yuan from wealth management products to the stock market through structured financial derivatives called "umbrella trusts," but these funds are relatively safe because investors who borrowed the money to buy stocks would absorb losses first.

According to Caixin Magazine in Beijing, Banks they have lent about 1 trillion yuan to companies who used their stock as collateral. When the prices of those stocks fall, the value of the collateral shrinks too. But for most banks this will not affect their balance sheet unless the share price of the company falls by more than 60 percent. Overall, the exposure is still a fraction of the banks' 301 trillion yuan in assets or the state banks' 151 trillion yuan. Their combined equity and profits in 2013 was 22 trillion yuan. There could be some pain, particularly for more exposed banks, but it wouldn't be a crisis. ***The real significance is that the chaotic planning by China's top leaders shows that the leadership is failing tackle the bigger issues – local debt, corruption, and state squandering of resources.*** The confusing question is why the State Council did the bailout. What does that mean for economic decision-making? Even the pro-reform but usually cautious Caixin Magazine wrote an editorial slamming the government's involvement. "The bottom line is this: Only a systemic risk that threatens financial stability justifies a government bailout." And the stock market rout is not a systemic risk.

Politburo Infighting

There's a theory that the bailout occurred because ***Xi Jinping is setting up Li Keqiang for a fall***. This doesn't seem likely given that the leadership probably was over estimating their power to influence the markets. However, why hasn't Xi been involved in the key decisions? And why was the meeting on Sunday trumpeted with Li at the head? Although Xi Jinping is in charge of the Finance and Economics Leading Small Group, he made a point when he came to the office of ensuring the surprising admission of propaganda chief Liu Yunshan. This seemed to suggest that Xi was determined to be the architect of all economic policy. Liu has no previous economic experience and clearly was brought in as the political czar over economic reform.

According to China economist Barry Naughton, "Liu's membership in the FELSG makes little sense in terms of the traditional division of responsibility, under which economic issues are led by the premier and the State Council more broadly. Thus, Liu's membership seems to reflect increasing direct party oversight of economic issues, and cements Liu's position as one of the more powerful members of the Standing Committee. Indeed, Liu may today be the second most powerful person in China after Xi Jinping." Although, Li is in charge of economic policy, it is unusual that in something as important as confidence in the stock market Xi was not involved.

Weak Policymaking Amid Confusion

More broadly, it's clear that the stock market bailout is another example of confusion at the top -- and a tug and pull between several factions. Xiao Gang of the CSRC and Zhou Xiaochuan of the PBOC are rumored to dislike each other (Gang wanted the PBOC job), which doesn't help coordination of policy. The bond swap was an idea whose execution has become a factional battle between the banks, the local governments, and the PBOC. It is impressive they got the policy out the door but the effectiveness is questionable, particularly after the State Council agreed to continue to fund ailing local government companies.

Another Casualty – Rising Jingoism

Most worrisome is the nationalistic tone of what should be fairly straightforward economic policy. A message making the rounds of China's Wechat contains the jingoist statement: *"This is a major battle for China's financial markets, for reform, reform, and national security. We must succeed and cannot be allowed to fail. We and our country cannot sell shares, we cannot sell the market short. We will witness the great rejuvenation of the motherland during this historic moment!"* With economic policy tough as it is, given the looming problems of debt, inefficient state firms, and declining growth, the bailout was an unnecessary distraction. It will blow over but suggests a government with its back to the wall.

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