China's currency and share market – market forces or state dominance?

17 August 2015

National Australia Bank

Balancing State power and the market

• The dilemma facing Chinese economic policymakers has been clear since the ruling Communist Party's "Third Plenum" meeting in late 2013. That meeting supported giving markets a "decisive role" in allocating resources but it also emphasised that public ownership had to play a "dominant role" and a powerful State was needed.

•The recent reform of currency setting and the bursting of the share market bubble have displayed the tension between accepting market outcomes and letting the State have the final say. Allowing a greater role for the market in setting the currency – which promptly fell, triggering fears of heightened "currency wars" between the economic superpowers – can be seen as a win for pro-market liberal reformers. Or was it clever timing to get the RMB into the exclusive club of currencies allowed into the IMF's SDR currency basket at the same time as boosting China's flagging export sector by letting the RMB slide?

•The official response to the bursting of the share market bubble has been anything but market oriented with a raft of highly interventionist measures designed to prop up share prices, market liquidity and funding for margin purchases. Although the impact of the massive changes in equity market wealth on household finances, corporate funding and the financial system look manageable, the government has not hesitated to tell market participants what to do, use public funds to support what look like over-valued share prices and generally stop people from doing what they might want to in a free market.

•Reconciling these differing approaches to the currency and share markets is not easy – over the medium term the authorities do face a balancing act between losing control through market oriented reform and running the risk of political intervention that wastes public funds. This could result in an ossified economy and China falling into the same middle income trap of other once fast growing nations. In the near term, however, the RMB depreciation and propping up the share market can easily be reconciled, both are good for short term growth in a slowing economy.

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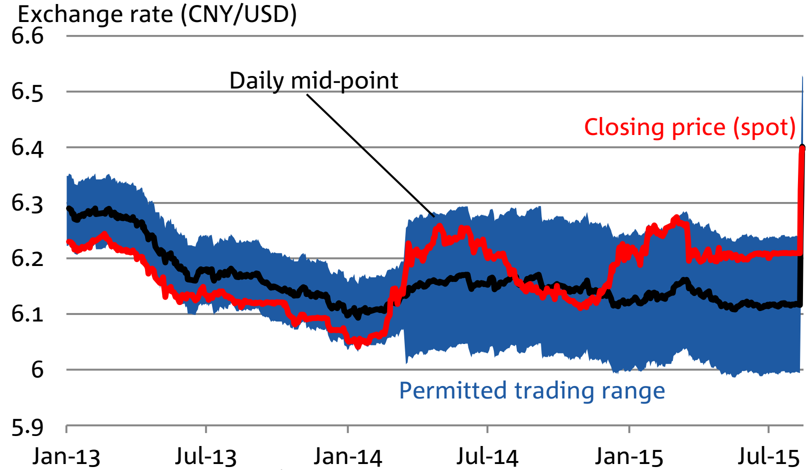
RMB falls after central bank reforms system of setting currency

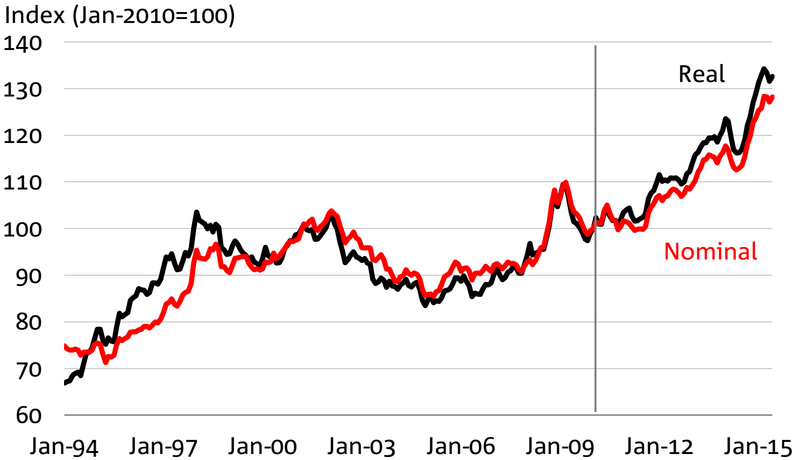
- On 11 August, the People's Bank of China (PBoC) surprised markets with a sudden devaluation of the Yuan by shifting the way it sets the central parity of the RMB versus the US$. Instead of officials setting a number, it now relies on the previous day's closing spot rate, demand and supply conditions in the forex market and moves in major global currencies. The RMB/USD subsequently fell by 4% from 6.1 and it is currently 6.4.
- This move has been presented as a market based reform for the Chinese exchange rate, although there is still a 2% limit on the extent of daily currency moves. The IMF welcomed the move, after calling for China to allow market forces a "decisive role" in its economy and supporting the creation of a fully floating currency within 2 or 3 years.
- Analysts are unsure whether this move marks the start of a sizeable fall in the RMB to regain lost competitiveness against Asian rivals and lift exports or whether the aim is the get the RMB included in the IMF's SDR currency basket. The latter is best achieved by ensuring the RMB is a "freely usable" currency but China could retain capital controls and still have a "freely usable" RMB. We see the RMB falling to 6.65 by mid-2017.

China's sudden currency devaluation shifted the Yuan to its lowest level since September 2012



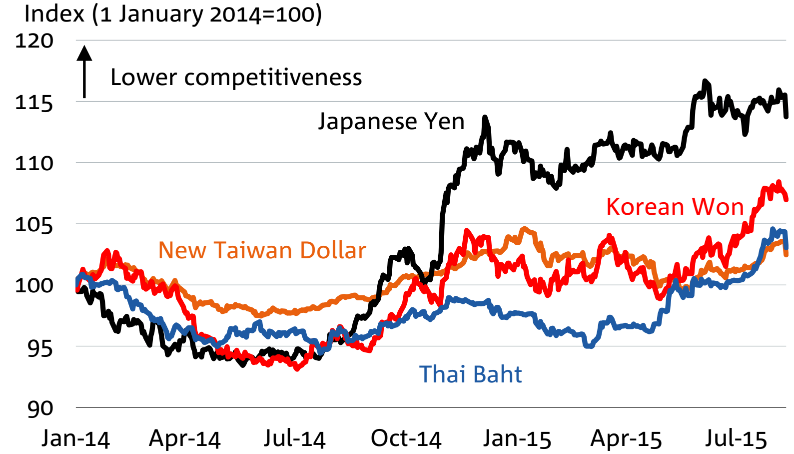
Sources: CEIC, NAB Economics

Since early 2010, China has recorded a 30% rise in its trade weighted exchange rate



Source: CEIC, NAB Economics

China's competitiveness has deteriorated since 2014, as regional currencies have depreciated against the US$



Sources: Datastream, NAB Economics

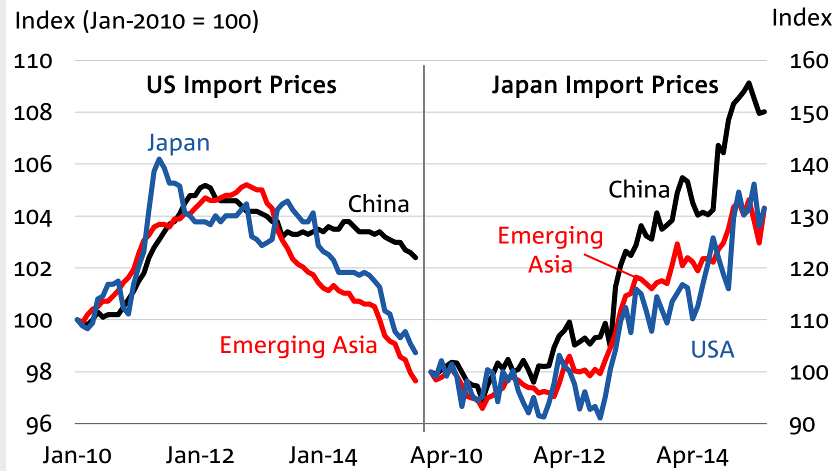
Chinese competitiveness fallen in recent years and hitting exports

- The deterioration in China's competitiveness through the last 5 years is evident in its relative export prices. The price of Chinese goods imported into the US has not fallen by anything like the extent of goods brought in from its East Asian competitors. The prices of Chinese goods landed in Japan have risen far more than competing products from other Asian countries. This highlights the clear loss of Chinese price competitiveness in key global markets – due in a large part to the Yuan's soft peg to the US dollar (which has strengthened in recent years) and recent US dollar appreciation.

- This erosion of Chinese competitiveness along with sluggish world trade has resulted in a weak Chinese export growth performance in recent years. Goods exports are trending lower, reflecting weakness in both volumes and prices.

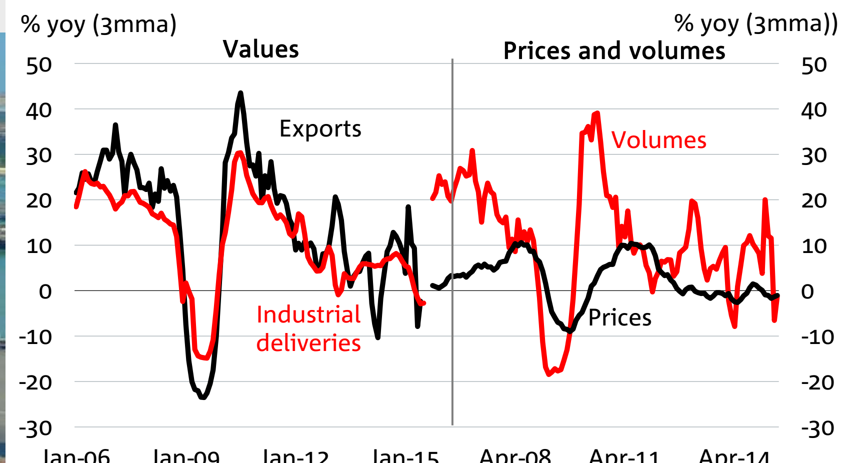
- With Chinese domestic demand not growing as fast as previously, the government sticking to a 7% economic growth target and the bursting of the share market bubble set to have an adverse impact on growth, the Chinese authorities could welcome the boost that better export volumes could bring – providing an incentive for currency devaluation.

China's soft peg to the US dollar has contributed to the loss of competitiveness versus Asian peers



Sources: Datastream, NAB Economics

The loss of competitiveness has impacted on China's exports, with minimal price growth & slowing volumes



Sources: CEIC, NAB Economics

Chinese equity markets surge then plunge

- A combination of lower interest rates, poor returns on competing assets like property and bank deposits and official rhetoric that a sustained lift in share markets was warranted fuelled a boom in equity prices between late 2014 and mid-2015.
- In the twelve months to the market peak on June 12, the Shanghai market rose by 152% and the Shenzhen market by 194%. Although both markets subsequently plunged, they remain above their end-2014 levels. Share market capitalisation rose by US$5 trillion in the boom and then fell by almost US$ 3 trillion in the bust.
- With retail investors accounting for around 80% of share trading, the number of individual investor accounts listed for Shanghai A trading climbed from 95 million to 120 million while Shenzhen investor numbers went from 119 million to 150 million through the first half of the year.
- Although wealth is very concentrated in China (the top 10% have over 60% of all assets and far more of equity), there was an influx of lower income investors with very limited formal education into the market during the boom. Handling the political and social fallout of the bust on those investors lies behind the impressive range of measures the authorities have taken to prop up the market, many of which aim to lock in what still look like over-valued share prices by using public funds.

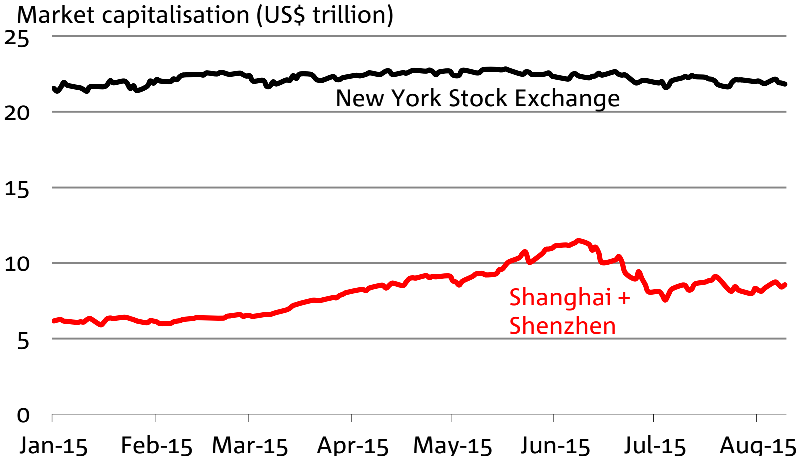
A flood of new investors from late 2014 contributed to surge in China's equity markets

Sources: CEIC, NAB Economics

Angry small investors present political problem to authorities

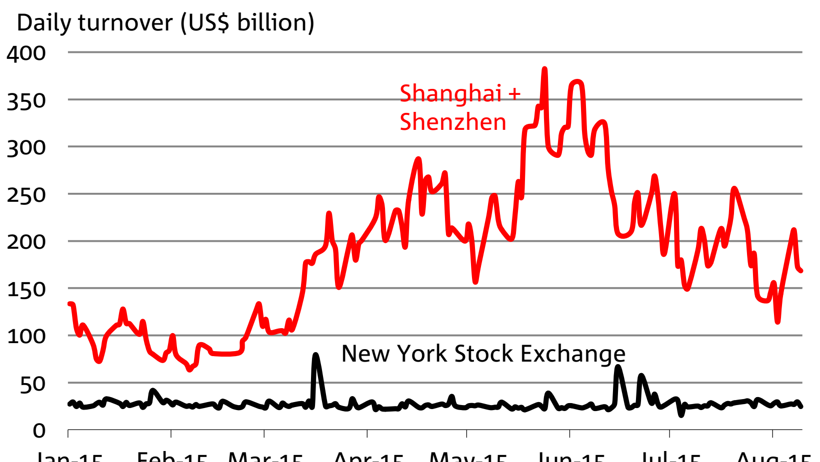
- The burst equity bubble is particularly awkward for the Chinese authorities as official media outlets and spokesman were seen as having talked the market up. Back in 2014 the State news agency was calling for a "quality bull market", an April 2015 opinion piece in the People's Daily said that the Shanghai index of 4000 then prevailing was just the start of the bull market and the head of the securities regulatory agency said he applauded the concept of a "reform bull market" and that higher equity prices had some reasonableness and inevitability.
- This official rhetoric must have eased the concerns of the millions of Chinese investors entering the market who might have been worried by those commentators warning that this was just another bubble. No less than 27 million new individual investor accounts were opened for A share market investors on the Shanghai exchange between March and July with another 33 million at the Shenzhen market.
- CSDC data shows almost 90% of the growth in investor numbers involved accounts of under RMB100K - small investors were coming into the market. A late 2014 China Household Finance Survey also found that the majority of new investors in China's equity markets had little formal education, with only one-third having completed high school. Hence there is considerable political and social sensitivity for authorities related to the share market collapse.

China's markets have been highly active – market capitalisation lags US markets…



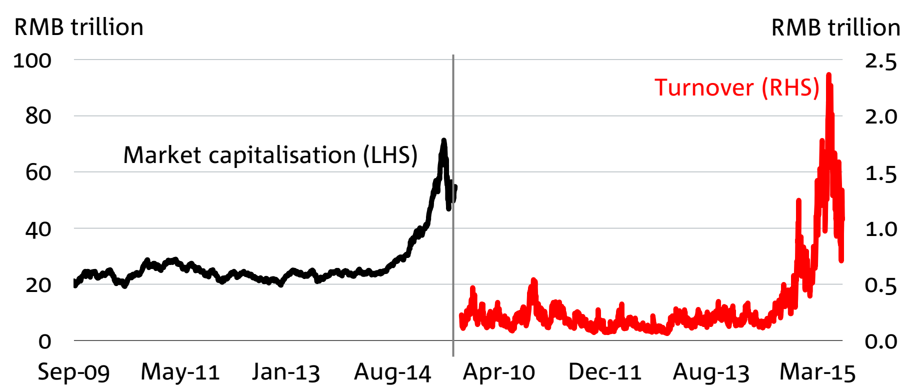
Source: CEIC, NAB Economics

…but daily turnover of shares far exceeds US markets – significant churn in shares



Source: CEIC, NAB Economics

The flood of small investors flooding the market drove a rapid increase in market turnover



Sources: CEIC, NAB Economics

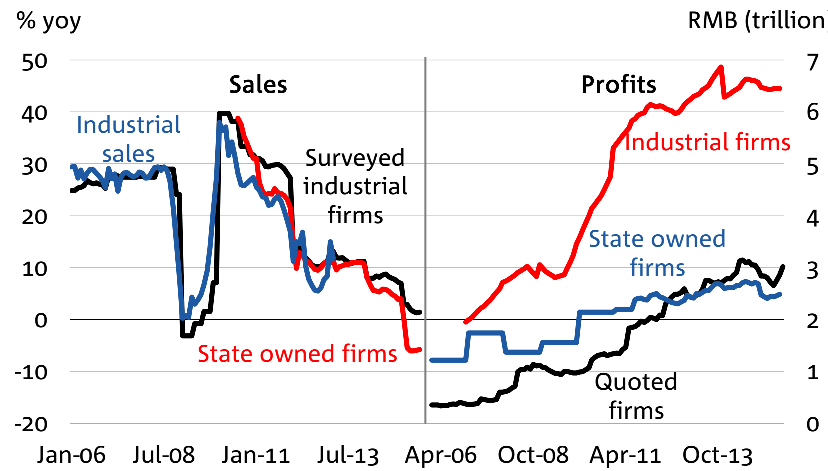
Economic trends did not support surging stock market

- Economic fundamentals did not support a sudden surge in equity prices. Chinese economic growth is on a slowing trend, the housing market has been weak and growth in residential construction has slowed sharply, consumer price inflation is very low and producer prices are falling.

- At an industry level, excess capacity is depressing margins and returns, aggregate profits have stagnated and there has been minimal growth in the nominal value of sales among surveyed industrial and state owned (SOE) firms.

- The surge in share prices reflected a rise in the market's price to earnings ratio rather than in underlying profits – which were flat, in line with the industrial and SOE surveys. It is hard to see why market expectations of future corporate earnings would support higher equity valuations, given the economy is on a slowing trend with overcapacity weighing on prices and the growth outlook.

China's industry sales have slowed sharply with little growth in profits

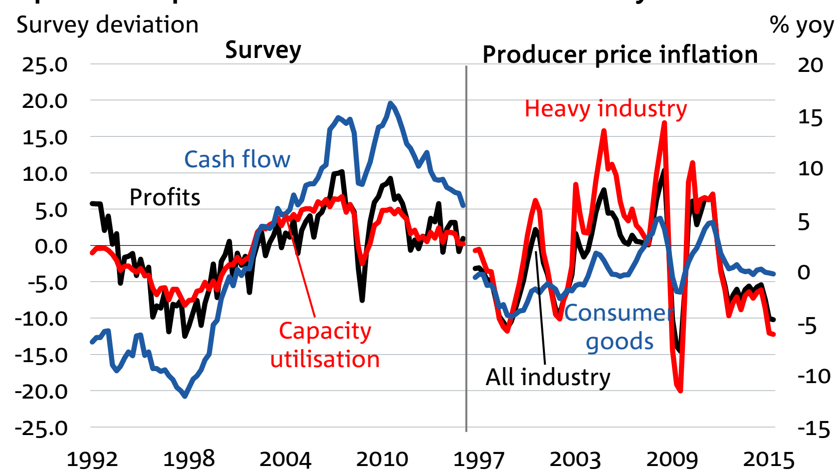


Sources: CEIC, NAB Economics

Price-to-earnings ratios rose significantly from late 2014 – particularly on the Shenzhen market

Source: CEIC, NAB Economics

Industrial surveys show deteriorating conditions, while producer prices have fallen for over three years

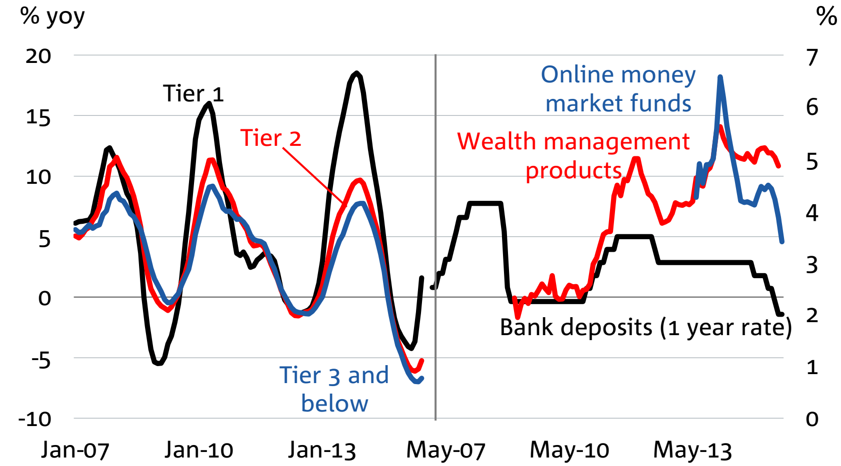


Sources: CEIC, NAB Economics

Impact Number 1 – on investors

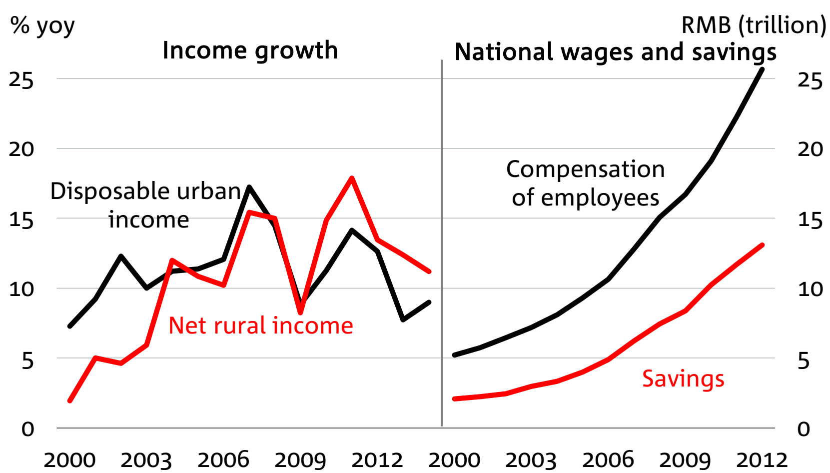
- While economic growth is slowing, incomes continue to expand at quite a rapid pace, boosting the amount of household income, creating spare cash to save and invest. The Chinese savings rate is very high with a 70% rate for the top 5% income group and around 50% for the top 25%.
- The problem is that controls have held down the returns available on bank deposits (a deliberate policy of financial repression) and there has been a downturn in the property market, a source of large capital gains for Chinese investors on previous occasions.
- Better returns can be found in wealth management products and online money market funds (where funds raised are put into higher return riskier projects). However shares offered by far the best returns through the first half of 2015 as interest rate cuts starting in late 2014 and official rhetoric that a sustained "reform bull market" was under way gave investors confidence.

Returns on alternative investments have been trending downwards – encouraging equity investments



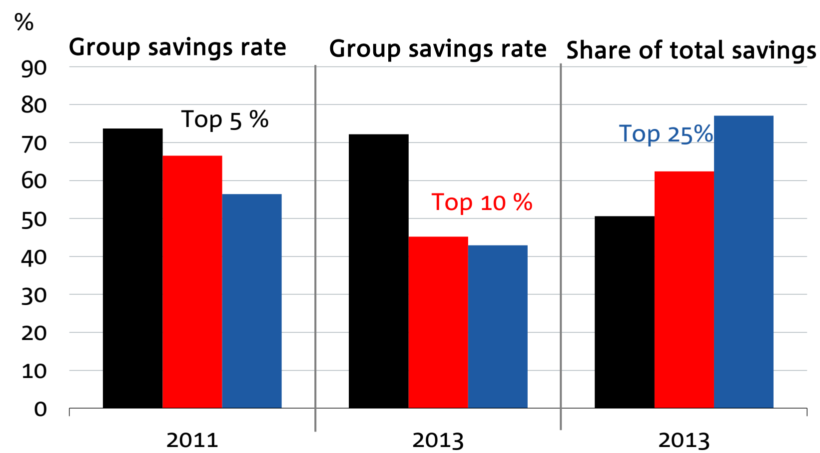
Sources: CEIC, NAB Economics

China's income growth has continued at a rapid pace – creating a pool for saving and investment



Sources: CEIC, NAB Economics

China's savings rates remain high, despite poor returns (highlighting limited investment options)



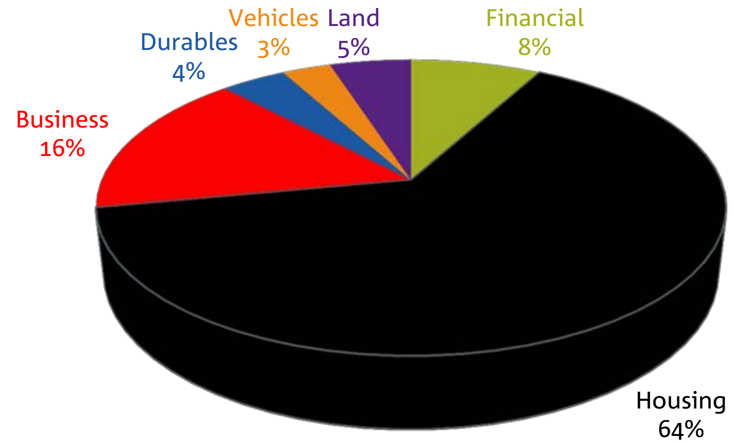
Sources: Southwestern University of Finance and Economics, NAB Economics

Equities a small share of household wealth

- The equity bubble added RMB 31 trillion to Chinese wealth from January to mid-June and then wiped out almost RMB 20 trillion of those gains. As retail investors account for 80% of the market, these enormous sums of money impacted on household wealth (for comparison 2014 GDP was RMB 64 trillion, household financial wealth RMB 76 trillion in 2013 and household labour income RMB 26 trillion in 2012).

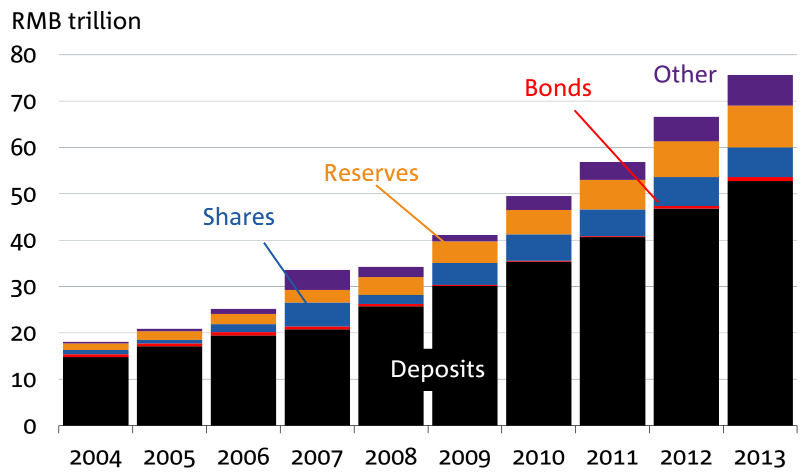
- Nevertheless, the bubble should not have too much impact on household spending as it was so short-lived, meaning that most households did not have time to adjust spending habits or debt to their higher wealth. Moreover property remains the mainstay of Chinese household wealth, accounting for around two thirds of asset values, while financial wealth is only 10% of the total. Most of that financial wealth is bank deposits with NBS data showing equities were less than 10% of 2013 financial assets and household financial survey data showing only 9% of households had shares and they accounted for 15% of financial assets – meaning that the impact of the equity correction on China's household wealth is less significant than would be the case in the United States.

China's household survey (2012) shows housing the dominant asset for investors



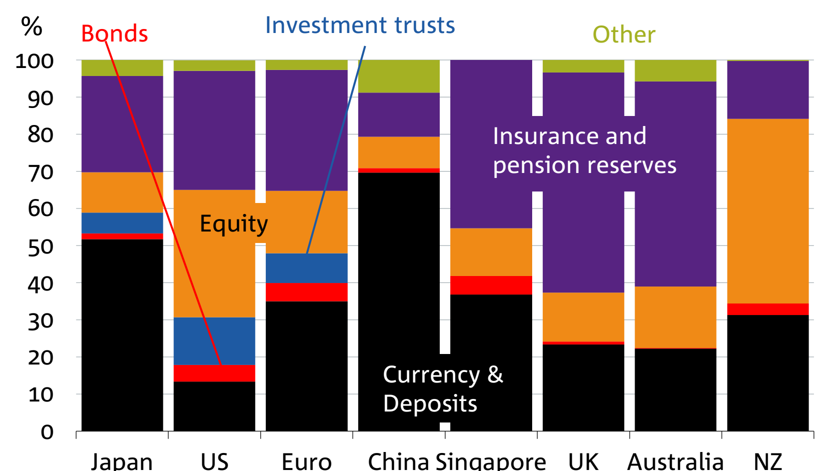
Sources: Southwestern University of Finance and Economics, NAB

Equities represent a small share of China's household financial wealth (flow of funds approach)



Sources: CEIC, NAB Economics

On a global basis, China's equity exposure is relatively small – with deposits the major financial assets

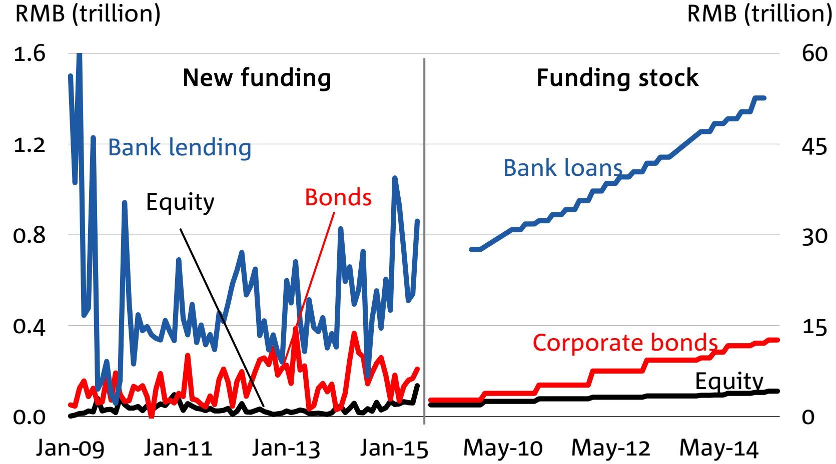


Sources: BOJ, ONS, RBNZ, ABS, NAB Economics

Impact Number 2 - on Business. Heavily indebted, more equity needed

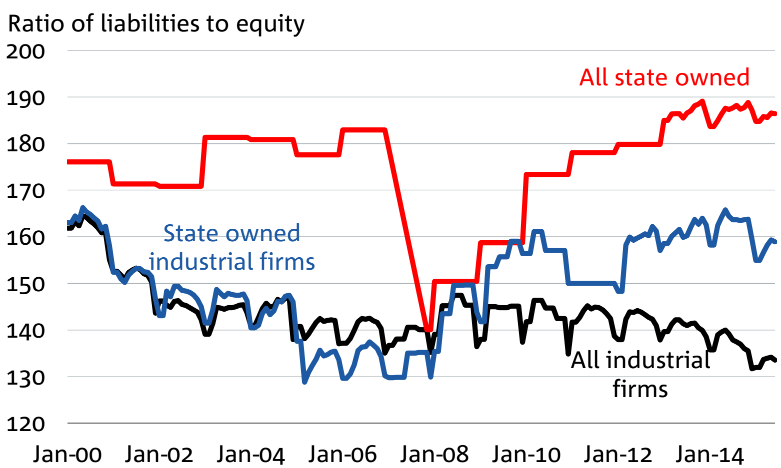
- The bursting of a share market bubble can make it harder for firms to raise the capital they need to finance expansion or lower gearing.
- Chinese firms have historically been highly dependant on debt (funding via bank loans) rather than the equity markets. The stock of net equity funding is RMB 4.3 trillion as opposed to RMB 12.6 trillion in corporate bonds and RMB 53 trillion in bank loans – limiting the immediate impact of the share market bubble on corporate funding.
- Over the longer run, however, the latest bubble has to be a setback to the growth in equity markets able to fund Chinese business. The Chinese economy is heavily geared and the corporate sector carries debt equal to 150% of GDP, around 70% of the national debt/GDP ratio (which stands at around 215%). Private firms have been de-leveraging but state owned businesses carry very high levels of debt. The hope was to inject more equity into these SOEs and the bubble's bursting makes that harder.

Chinese firms reliant on bank loans for funding – equity finance still very limited



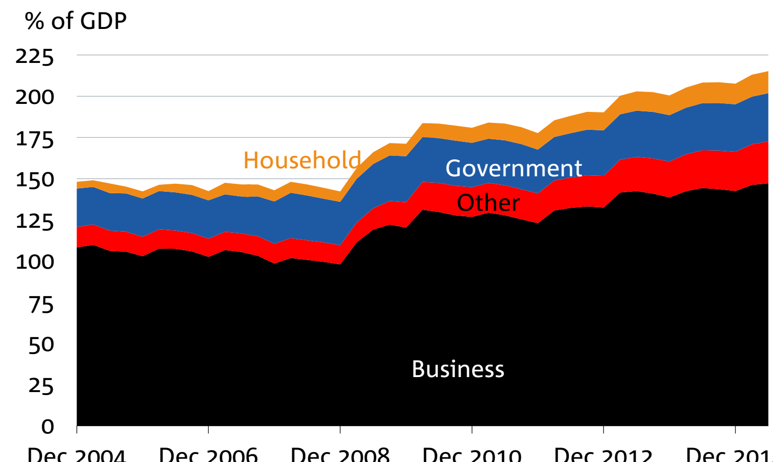
Sources: CEIC, NAB Economics

China's industrial firms are highly geared, with SOE leverage rising markedly since the GFC



Source: CEIC, NAB Economics

Chinese firms hold the majority of the country's debt, given limited equity financing

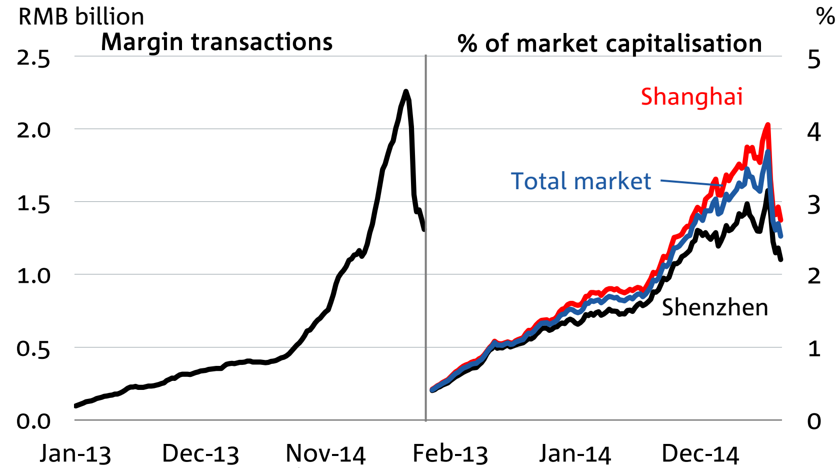


Sources: CEIC, NAB Economics

Impact Number 3 – on finance. Margin lending risks contagion

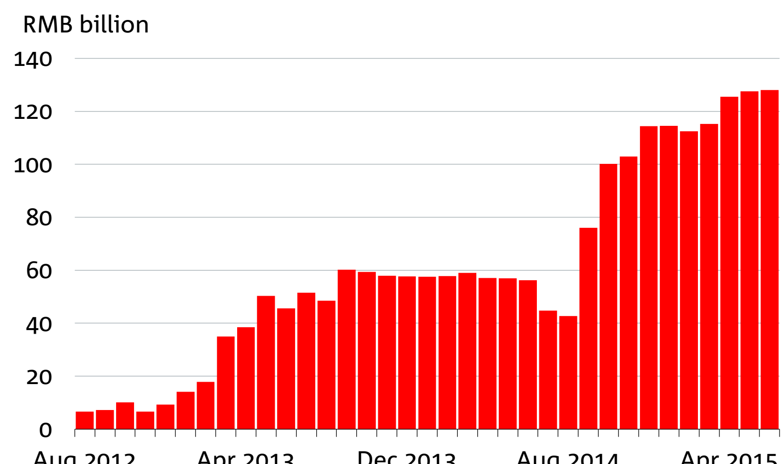
- Experience from previous share market slumps shows that they can cause problems for the finance sector. This occurs as indebted investors face margin calls that force selling into already weak markets, triggering a downward spiral in liquidity and share prices. If share prices fall enough, investors can become insolvent, imposing losses on financial institutions.
- Transactions involving margins increased during the equity boom, reaching 3 or 4% of market capitalisation (higher than the New York Stock Exchange), before falling sharply as the bubble bust. As many shares are effectively locked away in State agencies, the share of margin related transactions in “free float” was probably double that of market capitalisation.
- Only partial data is available on the level of debt built into these margin transactions but the ramping up in the stock of loans made by the CSFC to securities brokers suggests a big increase in debt tied to share prices. Estimates vary but there could well have been RMB 3½ to 4 trillion in loans for margin trading on the share market – which is sizeable given that home mortgage lending is RMB 12 trillion and credit cards RMB 2.5 trillion.
- Losses should be manageable for banks with core tier 1 capital of RMB 10 trillion and assets of RMB 188 trillion, but leveraged brokers look more vulnerable.

Margin transactions surged from late 2014, with the share of market capitalisation exceeding global peers



Sources: CEIC, NAB Economics

China Securities Corporation stock of lending to securities brokers RMB billion (to June)

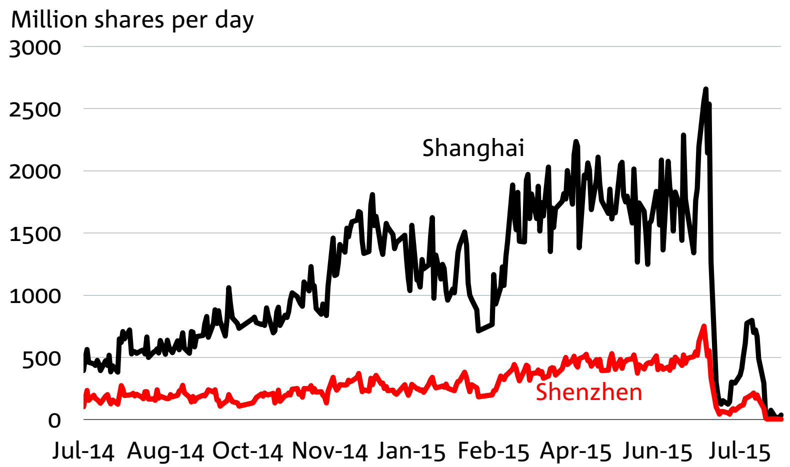


Sources: CEIC, NAB Economics

Government throws in the kitchen sink to stabilise share market

- Given the prominence of official agencies in talking up the equity boom and the way that many new small investors with limited means and formal education went into the market, it was always going to be hard for the government to stand back from the crash.
- Furthermore, experience in advanced economy share market meltdowns showed just how crucial it was to support market liquidity, find a buyer of last resort and limit the disorderly unwinding of margin funded trades that could start a downward spiral in values and liquidity.
- Given this experience and the potential for equity market problems to flow into the finance sector via margin funding, the Government has taken a series of measures to prop up the market. This episode serves to reinforce the view that state dominance will take precedence over allowing markets to freely operate in China.

Government restrictions on short selling drastically curtail this activity



Source: CEIC, NAB Economics

Summary of measures introduced since crash

- Securities firms told to buy RMB 120 billion in shares and not sell till market reaches 4500 points
- China Securities Finance Corporation buys shares supported by central bank funds and lends funds to brokers for share buying
- Big mutual funds pledge to buy shares and hold them for at least a year
- Lift ceiling for insurers investments in blue chip shares with increased insurer buying
- Finance Ministry and State owned firms stop sales of shares
- Large percentage of firms suspend trading on the share markets
- Suspend launch of new public offerings
- Heightened scrutiny of short selling
- U-turn on margin trading sees controls liberalised after a round of tighter rules
- Ban directors and senior managers of big firms from selling their own firms' shares

Reconciling currency liberalisation and share market intervention

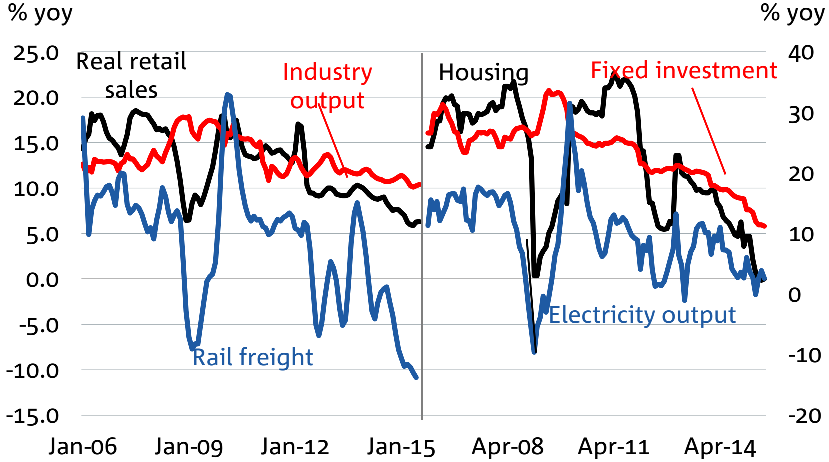
- The inconsistency between China's approach to its currency and equity markets stands out in the latest IMF assessment. The IMF called for more reliance on market forces in setting the exchange rate, advocating precisely the reform option the Chinese have just implemented and calling for yet more liberalisation. When it came to the share market, however, the IMF was clearly unimpressed and said such heavy handed official intervention called into question China's appetite for market-based reform and that the authorities should exit the market as soon as possible.

- From the Chinese viewpoint, this coincidence of market oriented reform in the currency market and heavy handed official intervention in the share market may be easily reconciled in both the short and long term. Securing a lower RMB exchange rate and propping up household share market wealth may support economic activity. Recent indicators show China's economy is slowing down and some of the hard data its leaders focus on (rail freight, steel output, power generation) looks particularly worrisome.

- The question is whether China's economy is slowing too fast, especially given the extent to which first half growth relied on finance sector activity that was driven by a now burst share market bubble. Facing the need to sustain solid growth to create jobs, limit over-capacity and to keep bad debt ratios under control, the Chinese authorities would be expected to err on the side of keeping growth up and hope that further expansion will, yet again, take care of any adverse medium term consequences.

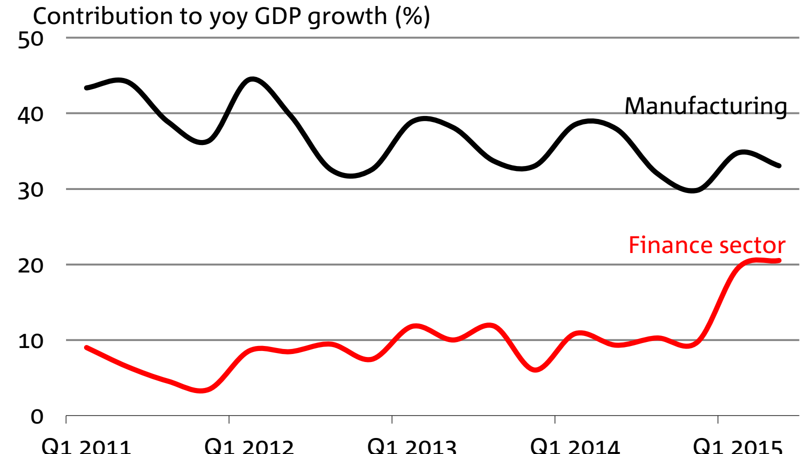
- Over the longer term it may well be that market forces take on a greater role in driving the economy but we never expected the authorities to simply or rapidly relinquish the field to purely market driven outcomes. Instead they will continue to use their considerable leverage to ensure that market outcomes fall within a politically acceptable range. However, experience elsewhere suggests that even the Chinese Government might one day find free markets harder to control than it expects.

Partial economic indicators are negative, with currency devaluation a potential tonic



Sources: CEIC, NAB Economics

Industrial share of GDP has declined, with finance (related to the share boom) driving growth in H1 2015



Source: CEIC, NAB Economics

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