China's central bank cuts rates after shares plunge

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The Chinese central bank last weekend lowered its base interest rate by 0.25 percentage points—its fourth cut since last November—in a bid to stabilise the stock market and provide a boost to the slowing economy. It also reduced the reserve ratio requirement for banks lending to agricultural and small-to-medium enterprises.

The decisions came after a wild day on stock markets last Friday. The Shanghai Composite index fell by 7.4 percent, wiping almost $700 billion from market capitalisation and bringing the decline to almost 19 percent from its peak on June 12. More than two-thirds of companies listed in Shanghai hit their daily downward limit of 10 percent. Only two stocks recorded gains.

The People's Bank of China (PoBC) said its moves sought to "stabilise growth" and "further enhance the efficiency of monetary policy to (support) economic transformations" and were in line with similar cuts last month.

As with all such statements, the central bank wanted to give the impression that it remains firmly in control. It is becoming increasingly clear, however, that financial authorities are responding to events rather than following a pre-determined strategy.

The chief Asia economist at Mizuho Securities, Shen Jianguang, told the *Financial Times* that if the central bank had not acted "there would have been real panic on the stock market" today.

In this morning's trading, the Shanghai Composite index added 1.61 percent after earlier falling by as much as 2 percent.

The problems in financial markets are being compounded by a slowing real economy. The official forecast for growth this year is around 7 percent. This is the lowest level for 25 years, and well below the rates of 10 percent experienced in the first decade of this century. However, most analysts conclude that the real growth rate will be even lower, possibly close to 4 percent.

Reflecting trends in some of the major advanced economies, in particular the US, where markets are at or near record highs, the Chinese share market has seen a spectacular rise over the past 12 months, even as economic growth rates have slowed.

Friday's plunge appears to have been triggered by a call from Morgan Stanley that, in its view, the Chinese market had reached its peak, not just a short-term dip. "Our stance on China A shares is that this is probably not a dip to buy," it stated. On the "balance of probabilities," the top of the cycle had been reached.

Augustin Eden of Accendo Markets told the London-based *Daily Telegraph*: "It's like rats leaving a sinking ship, and a terrible day for any investment trust dedicated entirely to long-term investments in mainland China."

Before the market decline began on June 12, the Shanghai Composite index had risen two and a half times in 12 months, with an average price-to-earnings ratio of 30.5, more than double the level at which concerns are usually raised about the existence of a bubble.

The past six months have seen a stock market frenzy. In the first quarter of this year, almost 8 million new brokerage accounts were opened and a further 4 million were added in May.

While the earnings growth of listed companies this year is minus 1 percent—pointing to the slowdown in the real economy—their aggregate market value has more than doubled.

The new investors are funding their purchases through borrowings, with the shares they hold functioning as collateral. At the beginning of the year, the value of outstanding loans used by securities firms to buy shares was more than $260 billion. At the beginning of this month, it was $364 billion.

The high level of debt raises the danger of a plunge resulting from margin calls as creditors respond to the fall in the share market by demanding the payment of a portion of outstanding debts. If borrowers are forced to sell shares to cover margin calls, this can set off a self-reinforcing downward market spiral.

The PoBC may be forced to make further cuts in the immediate future. This is because real interest rates are higher than they were a year ago, due to the rise in the Chinese currency's exchange rate—a product of the yuan's peg to the value of the US dollar—and the impact of deflationary pressures. The debt burden on the real economy, both in the corporate sector and for economically-important local governments, is increasing.

There is growing concern that a bursting of the stock market bubble, which seems increasingly likely, could exacerbate problems in the real estate and property markets, which have been inflated by government-backed infrastructure spending.

Writing on the Australian web site *Business Spectator*, Alan Kohler described China as a "horror show" and observed that the Chinese economy as a whole "is bloated on debt after years of economic stimulation based on debt-funded infrastructure spending by local governments and a roaring real estate boom in four major cities."

The "fundamental question" about the Chinese economy, he concluded, concerned the banks and "whether they can remain solvent in the event of a double crash of both real estate and the stock market."

Most analysts consider that the level of state control of the Chinese economy and financial system means that, in the final analysis, the PoBC will be able to intervene and has sufficient firepower to head off a major crisis, as it managed to do in response to the global financial crisis of 2008-2009.

However, like other major central banks around the world, the PoBC is now confronted with problems resulting from its own actions in trying to stimulate spending. In particular, the collapse of the debt-dependent real estate boom in many provincial areas is confronting lenders with potential defaults. The problems caused by easy money policies in this area of the economy also have been exacerbated by the turmoil on stock markets.