Chinese stocks continue to fall despite attempted counter-measures

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Chinese share prices fell again yesterday, adding to fears that the plunge of the past three weeks could impact on the financial system as a whole and the broader economy.

The Shanghai Composite Index dropped 3.5 percent. The market has declined by almost 25 percent since it reached a high on June 12, despite continuing efforts by financial authorities to boost markets lest the fall produce major spill-over effects.

In the latest counter-measure, on Wednesday the Chinese Securities Regulatory Commission (CSRC) eased collateral rules on margin loans. These loans, in which borrowed money is used to make share purchases, were the main driving force behind the 150 percent rise in the market during the past year.

According to stock exchange data, outstanding margin loans rose to as much as 2.27 trillion renminbi ($US366 billion), from 401 billion renminbi a year ago. Margin debt as a percentage of China's share market capitalisation is now higher than on the New York stock market.

Regulatory authorities are treading a fine line. On the one hand, they are trying to curb some of the excesses in the market, while on the other they fear that if the share market bubble collapses too rapidly it will create major crises elsewhere in the financial system.

The CSRC has maintained restrictions on lending to stock market investors from sources other than securities brokerages. However, it has allowed brokerages to set their own rules for demanding more collateral from clients when shares purchased with borrowed money fall in value, rather than the brokerages adhering to official stipulations.

According to a note published by Hao Hong, the research director at Bocom International, reported in the *Financial Times*, the CSRC moves should help to calm the market in the short term, but would create problems in the longer term. "The premise of margin trades is that asset process will rise perpetually," he said. "It simply cannot be true."

The Peoples Bank of China has also intervened. The central bank has made four cuts in its base interest rate since last November, as well as eased regulations to make it easier for banks to expand credit. The cuts have been in line with official government policy aimed at encouraging more investment in financial markets as the regime seeks to carry out market-based reforms in the financial sector. This has helped fuel the creation of a financial bubble, however.

In the wake of sharp falls last week, the Asset Management Association of China issued a statement on Tuesday encouraging investors to get back into the market. Entitled "Beautiful sunlight always comes after wind and rain," the statement called on its members to "seize the investment opportunity."

This followed an official statement from the government's securities authority, which declared that an "excessively fast correction" was not healthy.

The finance and social security ministries have published draft rules that allow the state pension funds to buy stocks. As much as 30 percent of the funds can now be invested in stocks, allowing some 600 billion renminbi to enter the market.

Warning about the longer-term future of the entire Chinese financial system, the World Bank made an unusually blunt assessment about the potential for instability in its latest update on the Chinese economy, issued on Wednesday.

The World Bank said the Chinese government must accelerate its program of "reform" of the state-dominated financial and banking system. Failure to address the issue would end "three decades of stellar

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performance" for the economy.

"Wasteful investment, over-indebtedness and a weakly regulated shadow banking sector" had to be addressed if the government's program of moving toward a more market-based system were to succeed, the bank said.

In a report issued three years ago the World Bank said the Chinese financial system was "unbalanced, repressed, costly to maintain, and potentially unstable." It repeated this description in the update and added: "The poor performance of the financial system in recent years has confirmed these fragilities. That system will need to be transformed to increase the efficiency of new investments and widen access to finance, enabling China to sustain solid growth and rebalance its economy."

The bank said "urgency for fundamental reform has further intensified as excess capacity and indebtedness in many economic segments accumulate, amid growing evidence of financial distress."

The World Bank noted that the state had formal ownership of 65 percent of commercial banks and de facto control of 95 percent of these assets, pointing to what the bank called the "unique and distorting role of the state."

The Chinese government is in fundamental agreement with the policy prescriptions of the World Bank and collaborated with it in drawing them up. But the government faces the problem of how to implement the restructuring without setting off a financial crisis.

Those problems are being compounded by the rapid slowdown of the Chinese economy. Official predictions are that growth this year will be 7 percent—already well below the rates of 10 percent of just a few years ago. Most analysts, however, believe that the real rate may be closer to 4 percent.

The Chinese economy has been hit by falling prices, which have impacted heavily on indebted companies. While official figures show real growth at or near 7 percent, the revenues that indebted companies receive have been growing at just 0.7 percent per year. This is no faster than the rate of growth experienced during the 2008–2009 global financial breakdown.

In response to the international meltdown, which quickly saw the loss of some 23 million jobs in China, the central government actively promoted credit-funded spending by local government financing vehicles (LGFVs) on infrastructure and property development. As a result, about 10,000 LGFVs across the country hold debts, which exceed 40 percent of the country's gross domestic product.

The mounting financial crisis has far-reaching political implications. The Beijing regime long ago abandoned any commitment to social equality in its drive to turn China into a fully-fledged capitalist economy. Representing the country's financial oligarchs, both inside and outside the Communist Party, the regime has sought to maintain its grip on power by holding out the prospect of continuing economic growth.

The massive expansion of spending and credit following the global financial crisis, particularly to LGFVs, was aimed at trying to prevent mass unemployment and head off opposition in the working class.

Likewise, the opening up the financial sector has been motivated by the desire to provide new avenues for enrichment by better-off sections of the upper-middle class and thereby provide a new social base for the regime.

Both these measures have created the conditions for an economic crisis, which, if and when it erupts, will have a far-reaching global economic impact and see the development of large-scale political upheaval in China.

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