Chinese state banks commit $200 billion to stem market selloff

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The extent of the massive government intervention to halt the plunge in the Chinese stock market was revealed last week by figures showing that major state-owned banks have made available more than $200 billion to boost share prices.

The intervention, organised through the Chinese Securities Finance (CSF) corporation, has halted the share market plunge that saw the Shanghai Composite Index lose 30 percent in the period June 12 to July 9, wiping out more than $3 trillion from Chinese share market capitalisations. Markets have since rebounded, rising by 17 percent in the past two weeks. But whether the recovery is sustainable is another question.

The massive bank intervention was one of a series of measures initiated by the government and financial authorities to halt the plunge that was threatening economic and political stability. Other measures included: the withdrawal of major companies from share trading; police investigations of “malicious” short selling; and restrictions on the ability of company executives and CEOs to trade in shares. Some 17 percent of listed companies still have share trading activities suspended.

The bank intervention was carried out via two channels. Money was provided to the CSF to lend to share brokerages and sustain their liquidity and to directly purchase mutual funds.

The Chinese finance magazine *Caijing* reported that the country’s five largest banks were directly involved, each providing 100 billion renminbi and that 17 banks participated in total, providing loans worth 1.3 trillion renminbi.

While the intervention appears to have halted the market slide, at least for the present, there are concerns over what it indicates not only for the Chinese market but for the global financial system as well.

Last week Standard & Poors (S&P) warned of an increasing prospect of debt defaults in China and in the US junk bond market. It said these threats represented an “inflexion” point in the financial cycle. The Chinese corporate debt market is equivalent to 160 percent of the country’s gross domestic product. According to S&P, companies will need to sell around $57 trillion of debt over the next four years, with 40 percent coming from China and 20 percent from US markets. The credit rating agency said it expected that the rate of debt defaults will accelerate in the coming period.

S&P analyst Jayan Dhru told the *Financial Times:* “Rapid debt growth, opacity of risk and pricing [due to the involvement of banks in the market], very high debt to GDP, and the moral hazard risk of the Chinese market make it a high risk to credit.”

Moral hazard refers to the assumption by investors and speculators that financial authorities, governments and central banks stand behind the market and will intervene to prevent a collapse, encouraging them to take on ever-riskier investments in the search for higher yields.

The S&P analysis pointed to the risks posed to markets by the rise of financial parasitism. It said four out of five new US debt issuers from 2012 to 2014 were B-rated companies, issuing higher yielding junk bonds. These securities have increasingly been used to finance share buybacks and for what it called “less productive investment,” rather than for spending on capital equipment to expand productive activity.

These speculative ventures have been fuelled by the near-zero interest rate regime set in place by the US Federal Reserve and other major central banks and could be at risk if the Fed moves to increase its base interest rate, even by a relatively small amount.

Fed chairman Janet Yellen has indicated that the Fed may start to lift interest rates as early as September but, in an effort to sooth markets, has made it clear that any lift-off will be very slow and monetary policy will continue to remain "accommodative." The problem, however, is that even with these reassurances no one really knows how many speculative operations may be affected by any interest rate rise.

A rise in interest rates, leading to a fall in bond prices (which move in an inverse relationship to interest rates) could lead to bonds being sold off. This would mean there is less liquidity in the market, with the result that lower-rated companies that have been able to raise funds because of easy money conditions may not have access to money they had in the past.

According to Bank of America Merrill Lynch, around $28 billion left bond markets last week, the biggest outflow in two years. That outflow could increase if and when interest rates start to rise.

By and large global markets were able to weather the storm in Chinese stocks. But the increasing fragility of the Chinese financial system and its potential global implications were underscored last week by an extraordinary decision by the World Bank.

Last Wednesday, it released an assessment on the state of the Chinese economy in which it warned that "the poor performance of the financial system" had confirmed previous assessments that it was "unbalanced, repressed, costly to maintain and potentially unstable." The report also pointed to "risks stemming from wasteful management, over-indebtedness and a weakly regulated shadow-banking system" and made critical comments about the level of government involvement in financial markets.

Two days after the report was released the critical remarks were removed.

Defending the decision at a press conference on Friday, World Bank president Jim Yong Kim said the deleted comments had not gone through the proper international reviews and had been published in error.

Kim's press conference, which was held in Beijing, came after a series of meetings with top Chinese government officials, including Premier Li Keqiang, who took direct charge of the stock market crisis, Finance Minister Lou Jiwei and the chairman of the People's Bank of China, Zhou Xiaochuan.

However, Kim insisted the deletions from the report were not the result of pressure from the Chinese government and financial authorities. "The release of that particular section was simply an error," he said. "There was no pressure or communication with the Chinese government at all."

The assurance is likely to be taken with a large grain of salt.

The World Bank's country director for China, Bert Hofman, also tried to ease concerns, saying the contentious section had not gone through the proper vetting channels. He denied any pressure from the Chinese government.

"We have worked with the government on the financial sector for many years and the report didn't fully reflect the type of discussion that we had with the government," he said.

The World Bank and the Chinese government have been collaborating on the introduction of so-called reforms to the Chinese financial system as part of Beijing's efforts to integrate it more fully into global financial markets. The share market boom, which was directly promoted by the government as it lured small-scale investors into share market trading, was part of those efforts.

However, the massive government and bank intervention to halt the share market collapse could undermine its longer-term agenda.

Larry Fink, the head of BlackRock, the world's largest hedge fund, warned that Chinese government intervention to prop up the stock market had damaged the country's financial reputation and could repel institutional investors. "By putting in these blockages and restrictions, it looks like the markets are artificial," he said.