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Transcript

CHINA IN THE WORLD PODCAST

Host: **Paul Haenle**
Guest: **Yukon Huang**

Episode 53: What Caused the Chinese Stock Market Crash?
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Haenle: Welcome to the China in the World podcast, a series of conversation with Chinese and international experts on China's foreign policy, international role, and China's relations with the world, brought to you from the Carnegie–Tsinghua Center for Global Policy, located in Beijing. I'm Paul Haenle, the director of the Carnegie–Tsinghua Center, and I'll be your host.

Today, I'm delighted to be at the Carnegie Endowment for International Peace in Washington D.C., and speaking with a colleague, Yukon Huang, senior associate in the Carnegie Asia program, where his research focuses on China's economic development and its impact on Asia and the global economy. Previously, Yukon was the World Bank's country director for China and for Russia, he served as an advisor to the World Bank team that worked with the State Council in China that prepared the joint report "China 2030." Yukon is an A-list commentator for the Financial Times on China. He's also working on a new book to be published later this year, entitled *Why do views on China differ so much?* Yukon, thank you very much for being with us today.

Huang: Pleasure being here.

Haenle: So we are speaking today, several weeks after China A-shares plummeted, in the early July, China's equity market is now at levels around 30 percent below the peek in early June—June 12—but only after heavy-handed intervention by the Chinese government, including virtual ban on short-selling, restrictions on selling by major shareholders, loosening of margin-landing regulations. These interventions in China's stock market have raised questions in global financial community about China's commitment market forms, and has also had an impact on the credibility on the Chinese leadership. Many observers have noted that Chinese stock market began to surge last summer—in the summer 2014—despite the conflicting evidence of a slow down in China's economy. There was a similar disconnect between the stock market and China's real economy in the 2000s, when China's economy was growing a double-digit but yet the Chinese stock market tumbled. What explains the disconnect between China's stock market and its economic fundamentals? And in your view, what caused the stock market to surge so dramatically over the past year, and will this crash have a meaningful impact on the real economy?

Huang: First to understand what's going on today, we have to go back to the last time such an incident occurred, which was basically the 2006-2008 period. If you look at that period, a decade ago, China was growing at 10 percent a year. It generated huge trade surplus, but the stock market wasn't moving. And all of a sudden it took off. And for many people, they were wondering why it was that free economy was doing so well but the market, in fact, hadn't moved at all. And the answer is the market really wasn't reflective of the economy. It's largely dominated by state enterprises, it wasn't actually link to the well-being of [certain aspects of the] economy, [including] private firms that were not being on the list. It also had reputation of being like the gambling in the casino. You never knew what was going on or what the information was. So skepticism about the market 10 years ago was very strong.

Then what happened? Well at some point people began ask the question, 'how come the market is not taking off?' There were actually speculations in the West that there was a surging market globally. So in fact the market started to respond. That was actually a—what I would call a market-driven, greed-driven surge. So the Shanghai index went from 1,000 to 6000 and very quickly fell back to 2,000. And then interestingly enough, for 5 or 6 years it didn't change. So you go through the global financial crisis, [and] you wouldn't expect it to change. There was a lot of

uncertainty. Then China was actually doing it very well post global financial crisis, and then of course, in last three or four years, it began to slow down. So you wouldn't have expected that the market actually changed much—there's uncertainty, then there's slow down [and so on]. What happened? Why—all of sudden, a year, a yeah and a half ago—did the market take off? And it clearly was not driven by economic fundamentals because economic factors were not strong.

It was driven by government policies. And which policies? Two major decisions were taken by the government. One, China is having a debt problem. Corporations were borrowing too much from the banks. So why not encourage them to go equity market float shares and fund their expansion through stocks rather than borrowing, that will be good to the debt issue. The second problem—not second problem—the second objective was, China wants to internationalize its RMB, wants open its capital markets to the world, it wants people to invest in options besides the property market, which seemed to be over extended. So why not encourage them to go to equities? Now, both these objectives are actually reasonable. China should have a stronger equity market. China does have a debt problem. Companies should be going to the equity market. So this a the case where objectives were what I would call sensible. But how it was being implemented turned out to be not carefully thought through. But once the sentiment got out there, and you have a very strong leadership, and the leadership says the market has got to be stronger and it's got to get higher and people should use it, there's lot of faith in the system, and the buyers are largely individual retailers, not so much mutual funds or big corporations but individuals. And they have a lot of faith in their government, a lot of faith in their leadership, so they are buying. And at the time they are buying, China also has margin trading, something they didn't have ten years ago. So you can borrow, and margin trading was basically there since 2010, so it's been there for a few years.

But what changed was that people began to encourage people to borrow margins. And those were limited money, particularly those who came at the later stages, they began to borrow. So when margins was going to surge, and it goes to 2,000 and 3,000 and 4,000, probably the system should have been saying, 'hey, this is going too fast.' Who should be saying that? The answer should be the regulatory agency—the China Securities Regulatory Commission—because their role is to regulate and identify risk. But they weren't doing that, they were actually talking of the market as were all the other officials. So basically the market started to climb even faster and faster. Now there were actually some other underlying factors which people have not been aware of. China wanted membership in the merging market indices that are used globally. And if they qualified to be included in these indices, they would have triggered actually a global demand for Chinese securities, because they would've had to have China in the system. That would have led to a very significant bump into the indices beyond this. So some smart people were staying, 'if this actually happens, I can make a lot of money.' But in June, that decision was suspended—postponed. And that's triggered the whole selling-off, because the smart people realized that extra surge from being included into the global market were not being materialized. And then when it started to go down, margin trading, calling in the margins, accentuated decline. People began to panic and they realized the government couldn't support this and now you have the equity crash. So this is a very different kind of a market bubble. It's not a market bubble, it's government policy given bubble. We've never seen anything quite like this in other parts of the world. And this is what makes this particular case very difficult from other examples.

Haenle: You've argued the political consequences for this China equity market bubble are the most serious for the leadership. We haven't heard much from Present Xi Jinping and Premier Li Keqiang on this. There's some speculation out there why that is. What do you make of this?

Huang: Well this is actually a serious problem, because it's not a market-driven bubble. It was a bubble driven by the faith of the leadership, confidence in the top leadership, and the top leadership actually stepped [the effort up]. So you had the senior leaders actually making speeches saying the market is going to go higher. And any other regulatory agency says this is going to go up. So those who might normally be introducing in caution are actually talking in another way. Now that it is the bust, now that it's going down, the credibility of the political system is at major risk. The risk is not an economic risk. After all, about 7 percent of the households that own stock. The total wealth of Chinese household in the equity markets is probably between 10 to 15 percent. Most of it is still in property markets, savings accounts, and other options. So it is not an economic problem in the sense that this is going to wipe out assets and then they're going to have a ripple effect. The problem is the credibility of the leadership because the surge was based upon faith in the leadership. So now people begin to wonder, 'do they really have control, can I trust their words?' And this is going to be, I think, a very delicate issue for the leadership now.

Haenle: As you look ahead, what do you expect to see in the equity markets going forward?

Huang: Well, the question is, when the markets surge and they go up—and they got very rapidly because of margin lending and speculation—the downturn is also exaggerated. It will tend to fall below what probably makes sense. So in a normal surge up, [if] you go up to high, usually you go down too high. So precisely when the index, let's say a couple [of] weeks ago was heading around 3,700, 3,500, the government started to step in with draconian measures to basically buy and prop up the market. And the question then is, if you think about it intrinsically, what is the bottom [line]— what is the reasonable level? And personally, I would say that it's actually arount what it was. So there's no particular reason [why] actually say it shouldn't be much higher, or you don't really necessarily want it go much higher. You try to actually make that the floor. But instead the government went the other way. They actually talk about pushing it back to 4,500, and it's actually above what it should be. Now there's 3,000 for example—2,500 is too low. In my view, it is too low. But if you didn't interfere, would it go that far? The answer is, it possibly could, because you also go and overshoot on the [way] down. So where I think there was also a mistake, is that if you want to support it, don't try to say it's going to go way up. Try to support it by saying 'we are trying to cushion the downfall [because] it's going beyond what we think it should be.' Don't try to actually say, 'that's going to go much higher,' because when you do, what happens? Some people come in to buy it and the expectations are going to go up. If the market can't support it you're introducing additional difficulties in actually trying to stabilize this. So I think the actual way the government deal with it was not actually well done.

Haenle: Well, thank you very much. I know you just came back from China, so I appreciate you spending time. It's sort of the middle of the night your time right now with the jet lag. But thank you for spending time with us today, we always appreciate it. That's it for this edition of the Carnegie–Tsinghua China in the World podcast. If you'd like to read Yukon's new paper on China debt, you can find this one and other articles on the Carnegie website, at www.ceip.org. I

encourage you to see all the work of our scholars at the Carnegie–Tsinghua Center. Thanks for listening and be sure to tune in next time.