Economist Insights

The 'Greater Fools' of China

The rise and then recent rapid decline of the Chinese stock markets could have had its origins in investors' expectations that it was China's turn to get a monetary policy boost. Other factors such as 'limit up' restrictions and the regulator cracking down on margin lending exacerbated the slide. The main question now is what impact has the market slide had on the Chinese economy?

Joshua McCallum
Head of Fixed Income Economics
UBS Global Asset Management
joshua.mccallum@ubs.com

Gianluca Moretti
Fixed Income Economist
UBS Global Asset Management
gianluca.moretti@ubs.com

There is something to be said for only checking your investments once every year. If you had bought Chinese equities in early July last year and somehow managed to avoid checking the price (or watching the news or even talking to anyone else), you would probably be pleasantly surprised to find that the Shanghai Composite index had almost doubled. You would have been blessedly unaware of the meteoric rise of prices by 150% in the interim, and the subsequent even more rapid fall to earth. You would probably also be happier and less stressed than the investors who checked the price every day.

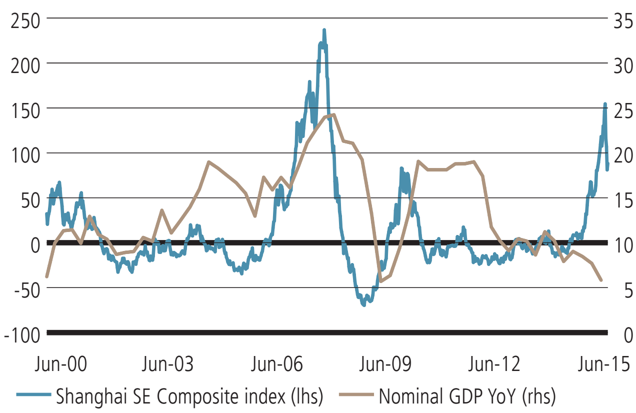
Bubbles are almost by definition difficult to identify at the time, and the causes are always debated in retrospect. The cause this time may be something as simple as an expectation that it was finally China's turn to get a monetary policy boost. First the US and the UK initiated quantitative easing (QE) and stock markets rose rapidly from their lows. Then it was Japan's turn and sure enough Japanese equities soared. More recently the ECB shifted to a looser monetary policy stance, and European equities are the highest they have been since the financial crisis.

Chinese financial conditions have been tightening over the last year, and monetary policy has been falling behind (see *Economist Insights*, 25 May 2015). In November the People's Bank of China started cutting interest rates, and in February began cutting the reserve requirements for banks. If this was going to mark the start of an aggressive monetary easing stance, then investors wanted to anticipate the effect on the stock market and started buying equities. After all, it worked in all those other economies. Sure enough the equity market started rising and pretty soon share prices were rising fast enough to hit the daily 'limit up' restrictions.

While the equity market has not always risen when nominal GDP rose, it has never before been rising when the economy was shrinking (see chart). The recent increase came against a backdrop of a slowing economy, which really only leaves monetary policy as the rationale for the run-up in prices.

Not the first fool

Shanghai Stock Exchange composite price index YoY (lhs) in %, and nominal GDP YoY (rhs) in %



Source: Thomson Reuters DataStream

Limit up restrictions that prevent shares from rising too much in one day are meant to restrict the growth of bubbles, but may even encourage them. Investors who are buying for momentum in the hope of selling shares quickly at a profit, rather than buying them for their expected dividends, will look at this as a price signal. Hitting the limit up shows that there are other investors out there who are willing to pay a higher price. It makes sense then to buy those shares in the morning in the hope of riding some of that increase. But if everyone thinks the same thing, they all buy and the share price rises again in a self-fulfilling prophecy. If the limit up is hit, the pattern becomes self-perpetuating. One share hit its limit up for 30 straight trading days.

Equity market bubbles are usually driven by the 'greater fool' theory. Investors buy a share because they believe that someone else is willing to buy it later for a higher price, even if it is priced well above anything justified by expected dividends. They may well know it is foolish to buy the share at the price, but they also believe that there is a greater fool out there who they can sell it to for an even higher price. The only fools are the ones left holding the shares when the music stops.

The supply of 'greater fools' in China is reinforced because Chinese investors are among the most restricted in the world. Savers in China really have only four options. They can receive artificially low interest rates in savings accounts. They can buy so-called 'wealth management products', but these turned out to be riskier than expected. They can invest in real estate, but property prices turned a bit sour over the last year. This leaves equity as the only remaining option. When faced with not much choice, it is little wonder that many savers were willing to take a bet on growth.

The music stopped when the regulator introduced limits on margin lending. Margin lending is when investors buy shares on borrowed money, leaving only a deposit (the margin) and the remainder secured against the price of the share. When share prices are rising this is all fine, but once share prices fall there is a margin call and borrowers have to supply more cash.

Concerned about the rapid increase in margin lending, the regulator started to crack down. This quickly restricted the supply of 'greater fools' and sure enough the equity market plunged. It is always difficult to pick the low point; just as the peak depended on the degree of irrational optimism, the trough will depend on the degree of pessimism. But for those who are not exposed to the stock market, the question is whether this has any effect on the economy.

Beyond Shanghai

Share ownership is fairly rare in China, with various estimates putting the proportion of households with equity trading accounts at between 5 and 10%. Many of those will have fairly small exposures. Even those households with heavy exposure to equity may have had little time to spend their temporary gains, given how quick the move up and down has been. There will undoubtedly be some clear losers: those who bought on margin and have found themselves heavily in debt, for example. And of course there will be some winners (those who sold while the share price was higher).

The Chinese stock market is not as crucial to the economy as it is elsewhere. The market capitalisation of Chinese listed companies in 2014 was about 44% of GDP, as compared to about 115% in the USA and UK. And China is still a largely planned economy: the market pricing signal from the stock market is also not as important. The experience of the stock market crashing in 2007-2008 seemed to have a relatively small effect on the economy (it took the global financial crash afterwards to have a significant effect). But there is still the potential that the crash could lead to nonperforming loans in the banking sector, as people default on the margin calls or firms that over-reached themselves on the basis of stock valuations run into trouble.

But perhaps the biggest challenge is not faced by the economy, but by policy-makers. The Chinese government has a reputation of mastery over the economy, but the attempts to prevent the slide in the stock market have been met with mixed success at best. At worst, the reaction could be interpreted as panic by some in China, which could damage confidence. Recent announcements of efforts to identify "malicious short sellers" could be interpreted as an attempt to find scapegoats. The global experience is simple: when you have an equity market it will go up and down in ways that governments can neither predict nor control. The best strategy for the authorities may be to expand the investor base: the Chinese equity market is dominated by many small investors who have less information and are likely to be more flighty. Institutional investors such as pension funds or asset managers are likely to be less volatile (though still volatile).

So what is next? For now the Chinese stock market has stabilised and even bounced back somewhat, but where can things go from here? Even if the government is somehow successful in preventing a further slide, they are taking a gamble that they have picked the 'correct' level. If the sustainable level is even lower then they have simply kept the bubble going and troubles will come back to haunt them later. Perhaps they would also be well advised to only look at the stock market once a year.