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China's Share Plunge Casts Lengthening Shadow over Global Markets

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Global stock exchanges appear to have weathered the initial shock wave from the powerful "no" vote in the Greek referendum, largely in the belief that the Syriza-led government is even more anxious to secure an agreement with the European Union and the International Monetary Fund to impose austerity.

At the same time, however, the financial markets could soon be hit by the ongoing meltdown of Chinese share prices.

Yesterday the New York the Dow Jones index was down by only 47 points, or 0.3 percent, while European markets fell by between 1 and 2 percent.

The relatively muted reaction of the markets to Greece—at least so far—is not only based on an assessment of the further move to the right by the Syriza government. It also reflects changes in the composition of the Greek debt over the past seven years.

In 2008, when the global financial crisis erupted, private banks were exposed to Greece to the tune of $US300 billion. That has been cut to $54 billion today as a result of bailout operations organised by the EU, the IMF and the European Central Bank. In 2012, when markets were last gripped by fears of a Greek exit from the euro zone, around 80 percent of Greek debt was owed to private banks and 20 percent to public institutions. Those ratios have now been reversed.

Of the more than €200 billion in the bailout, only 11 percent has gone to the Greek government. The rest has been used to pay off private bank debts, an operation financed by the impoverishment of millions of Greek workers and youth. Gross domestic product has fallen by around 25 percent. Moreover, this money provided for the bailout of the banks has also contributed to the escalating demands by the ruling elites for austerity throughout Europe.

While financial speculators were breathing a sigh of relief that Greek-caused turbulence has not yet been as marked as might have been expected, the crisis in the Chinese markets and financial system looms as a new threat.

Emergency measures taken by the Chinese government over the weekend, including an explicit commitment by the country's central banks to provide an unlimited amount of money, have largely failed to halt the slide, which has wiped out almost $3 trillion in market capitalisation over the past month.

The Shanghai Composite Index opened yesterday with a rise of 7.8 percent but then closed with a gain only 2.4 percent for the day, after twice slipping into negative territory. The Shenzen Index, which is described as “tech-heavy,” finished down by 2.7 percent after experiencing major swings during the day’s trading.

Last week, Shanghai stocks fell by 12.1 percent, bringing to almost 30 percent the decline in the market since it peaked on June 12. Had the markets not rallied, at least somewhat, yesterday, the government would have faced a major crisis. Even though the Shanghai index rose slightly, some 649 stocks experienced a decline, while only 259 rose.

The government was hoping that, having undertaken market-boosting measures—including the provision of funds, moves against short selling, bans on the issuing of initial public offerings to maintain the flow of cash into existing stocks, and a direction of the state pension fund to buy and not sell—the market would have lifted significantly. But yesterday’s reaction only raised further questions about its capacity to halt the slide.

According to Fraser Howie, managing director of Newedge Singapore, who is regarded as an expert on Chinese capital markets:

> “Clearly the reaction from the market was nowhere near what was hoped for. When you look at the raft of measures … everything including the kitchen sink was thrown at the market and yet the performance come the end of the day was pretty dismal, frankly.”

The extent of the government’s concern is reflected in a propaganda offensive conducted by the government-owned press, which described the Chinese Communist Party (CCP) leadership as “capable and confident” of ensuring that markets remain “stable and sound.”

An editorial published yesterday in the *People’s Daily*, the CCP’s major newspaper, said:

> “It is an urgent task to bring the A-share market [those stocks only quoted in renminbi] back to a rational track, as volatility of the market is detrimental to the sound and stable development of the capital market.”

It is not only the capital markets that are threatened. The crisis threatens to pass into the broader economy under conditions where growth is at its lowest levels in almost quarter of a century. Most predictions are that Chinese growth will not reach its official target of around 7 percent this year and could fall as low as 4 percent.

The share-market boom began a year ago when the Beijing government encouraged better-off middle class families to enter the market with the implicit pledge that the state-backing of the financial system would ensure they could increase their wealth.

The decision was an attempt to find a new source of growth as the investment and infrastructure boom, which the government organised after the financial crisis of 2008–09, ran into problems amid the construction of unsold apartment blocks and the accumulation of high-levels of debt by local government authorities.

Under the leadership of President Xi Jinping, the government also hoped the creation of a share-holding middle class layer would provide a source of political and social stability as it sought to open up the Chinese economy to financial market forces.

The result has been that Chinese stock market is dominated by small individual investors, who held more than 80 percent of shares at the end of 2014, rather than large institutions. There are between 70 and 80 million trading accounts operating on Chinese markets—40 million of which were started this year, many of them using borrowed funds to finance share purchases.

It is estimated that some 17 percent of the Chinese market is financed by margin lending, where shares are used as collateral for loans, subject to repayments in the event of a fall in their price.

Having been lured into the market by the government, these people now face being ruined financially if the plunge continues, with major political consequences for the regime.

"If the stock market collapses then the economy is finished and this [will] cause social instability," Yang Fan, senior economist from the China University of Political Science and Law told the *Australian Financial Review.*

Harry Harding, a professor at the Hong Kong University of Science and Technology, told the *New York Times* that a continuing fall in the market could produce three consequences: investment losses for households, slower economic growth and a political backlash against the Xi leadership.

"There are significant forces who have their knives out for him and are waiting for him to fail," Harding said, pointing to the struggle within the CCP leadership, in which Xi has mounted an anti-corruption drive against his opponents.

In addition to the effects cited by Harding, there is the impact on the global economy and financial system. By some measures, China is already the world's largest economy and accounts for about 30 percent of global economic growth. A financial crisis would be transmitted internationally, both because of the dependence of major economies on China and its ties to the global financial system, particularly through purchases of US treasury bonds.

In another sign of international financial turmoil, the American commonwealth of Puerto Rico is on the verge of a collapse. After years of trying to pay back debt, the governor announced that it is unable to continue and needs to restructure its $72 billion debt. Having suffered a 13 percent cut in real gross domestic product over the past decade, and entering what the governor called a "death spiral," its situation makes clear that Greece is not an exception, but the expression of a global process.

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