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Economics Group

Special Commentary

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Chinese Stock Market Crash: A Bad Omen for China?

Executive Summary

The two major stock market indices in China have plummeted more than 30 percent over the past month. Similar-sized declines in the American stock market surely would portend bad omens for the U.S. economy. However, the Chinese and American economies clearly have different structures. Specifically, the Chinese economy is largely bank financed, unlike its American counterpart where equity markets play a more important role in corporate finance, and equities constitute a smaller share of household net worth in China than they do in the United States.

Consequently, growth in business fixed investment (BFI) spending in China may slow in coming quarters, but it is unlikely to collapse, based solely on the recent decline in Chinese share prices. Similarly, growth in Chinese consumer spending, although it may slow somewhat in coming quarters, is not likely to weaken significantly due to the swoon in the stock market. Although we look for the overall rate of real GDP growth in China to trend lower in coming quarters from the 7.0 percent year-over-year rate that was registered in Q1 2015, we do not believe that the collapse in Chinese share prices over the past month portends a sharp downturn in the Chinese economy.

Chinese Stock Market Has Swooned over the Past Month

Media attention has been focused on Greece over the past few weeks, so many readers could be excused if they have not been paying attention to recent developments in China. The Shanghai Composite stock market index has plunged 32 percent since peaking on June 12, and the Shenzhen Composite index has nosedived 40 percent over the same period (Figure 1). In less than one month, 24 trillion Chinese yuan (about $4 trillion) has been erased from the market capitalization of the Chinese stock market.

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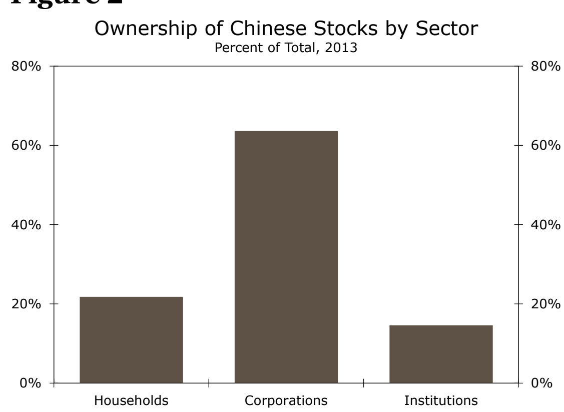
Figure 1

Figure 2



Source: Bloomberg LP, CEIC and Wells Fargo Securities, LLC

We are not experts on the Chinese stock market, so a detailed discussion about its meteoric rise and subsequent nosedive is beyond the scope of this report. However, the eye-popping rise in

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margin buying—margin debt rose by tenfold last year and it doubled again the first six months of this year—undoubtedly helped to fuel the sharp increase in Chinese share prices over the past two years. The sharp decline in equity prices in recent weeks may reflect, at least in part, an unwinding of this previous margin buying.

We are more concerned in this report about the implications of the recent stock market collapse for the outlook for the Chinese economy. Won't the loss of financial wealth have deleterious consequences for consumer spending in China? Could business investment spending, which had been weakening already, soften further due to the rise in the cost of capital in recent weeks? Does the downturn in the Chinese stock market signal that a recession in China is imminent?

Effects on Consumer Spending

Let's start with the implications for consumer spending. Figure 2 shows that at the end of 2013 (latest available data), households directly held about 20 percent of the market capitalization of the Shanghai stock market.[1] Assuming that households own a similar proportion of the Shenzhen stock market capitalization (a breakdown is not readily available) and assuming that the ownership proportions shown in Figure 2 have not changed significantly over the past two years, then households would have lost more than CNY 5 trillion (nearly $900 billion) since the market peak on June 12. If we assume that households are the ultimate owners of the shares held by institutions (see Figure 2), then their losses would approach CNY 9 trillion (about $1.4 trillion).

Despite the recent swoon, the Chinese stock market is still up on a year-to-date basis.

Financial losses for households on this order of magnitude should not be dismissed lightly. That said, there are reasons to believe that the hit to Chinese consumer spending may not be as large as the recent losses in the stock market seem to imply. Despite the recent nosedive in share prices, the Shanghai Composite index is still up 8 percent year to date and the Shenzhen index remains more than 30 percent higher than its December 31, 2014 close. Unless stock market gains and losses instantly affect spending decisions by Chinese households, which seems doubtful, then the recent swoon in Chinese share prices may not have as large an effect on consumer spending as the CNY 9 trillion loss in "paper wealth" may imply.

Stocks play a relatively minor role in the portfolios of many Chinese households.

Second, the share holdings of Chinese households need to be put into perspective in terms of their overall household wealth. As shown in Figure 3, Chinese households hold the majority of their financial wealth in the form of bank deposits. In 2013 (latest available data), stocks accounted for less than 10 percent of household financial assets.[2] Although the sharp run-up in share prices over the past two years would have pushed up this ratio, the value of housing, which is not included in financial assets, plays an important role in measures of Chinese household wealth.[3] In short, the recent nosedive in the Chinese stock market, as dramatic as it has been, has imparted a decline in household net worth on the order of only 3 percent or so. In sum, the recent swoon in the Chinese stock market may weaken, but not depress, growth in real consumer spending in China because stocks play a relatively minor role in the portfolios of many Chinese households.

History provides some interesting insights. The past two years is not the first episode of volatility in the Chinese stock market. The Shanghai Composite index shot up more than fourfold between the end of 2005 and October 2007. It then subsequently swooned 70 percent between its peak in October 2007 peak and its subsequent trough in November 2008. Unfortunately, a breakdown of Chinese real GDP into its underlying demand components is not readily available. However, our constructed measure of real personal consumption expenditures (PCE) shows that the stock market swings during this period do not appear to have had a major effect on Chinese consumer spending.[4] Figure 4 shows that real PCE growth did strengthen in 2007, when the stock market was booming, and that real PCE growth did downshift a bit in 2008 when share prices were

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[1] The 64 percent share accounted for by corporations in Figure 2 represents government holdings of the shares of state-owned enterprises. In other words, the "free float" (i.e., shares that are publicly available for trading) of the Chinese stock market is only 35 percent or so of the total market capitalization.

[2] The comparable ratio for American households in 2013 was between 20 percent and 25 percent.

[3] The value of housing is included in non-financial assets.

[4] A breakdown of nominal GDP into its underlying demand components is available on an annual basis. We use growth in nominal PCE less CPI inflation as our measure of real PCE growth.

collapsing. That said, overall growth in real PCE remained near 10 percent in 2008 even though the Chinese stock market was collapsing during that year. Clearly, there are more important factors influencing growth in Chinese consumer spending than simply changes in share prices.

Figure 3

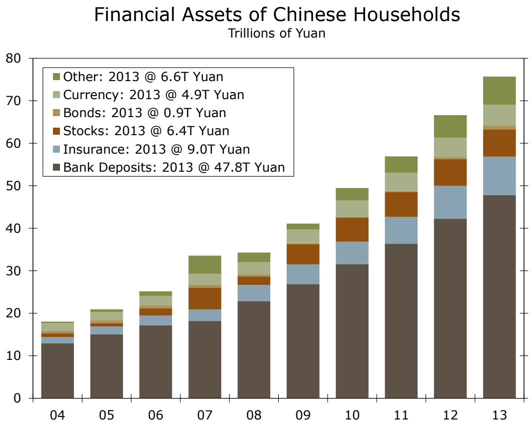
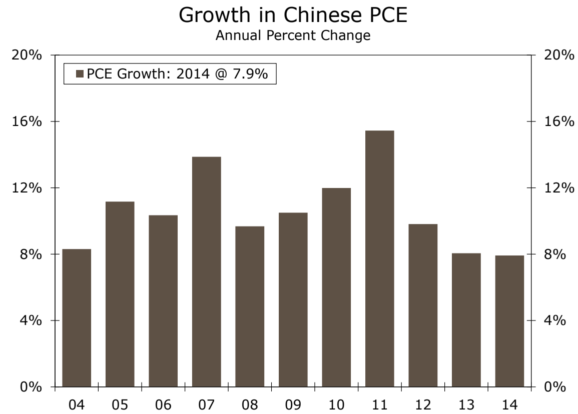


Figure 4



Source: CEIC and Wells Fargo Securities, LLC

More broadly, the nosedive in the Chinese stock market in 2008 did not portend a collapse in the Chinese economy. Real GDP growth in China slowed from more than 14 percent in 2007 to 10 percent in 2008 and to 8 percent in 2009. However, the global recession in 2008-2009 played more of a role in this slowdown in China than the swoon in the Chinese stock market did.

Effects on Investment Spending

As noted above, the sharp decline in share prices in recent weeks implies that the cost of capital for Chinese businesses has risen, which could exert a depressing effect on BFI spending. However, the ongoing stock market crash in China may not have as large a depressing effect on BFI spending in China as a similar-sized market downturn in the United States would exert on U.S. BFI spending. As shown in Figure 5, the equity market in China is relatively small in relation to the size of the overall financial system. Whereas the American stock market represents about one-third of the overall U.S. financial system, the comparable ratio in China in 2013 (latest available data) was 12 percent. Although the run-up in share prices in China over the past two years would have pushed up the ratio, the larger point is that China is, and remains, an economy that is largely bank financed.

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Figure 5

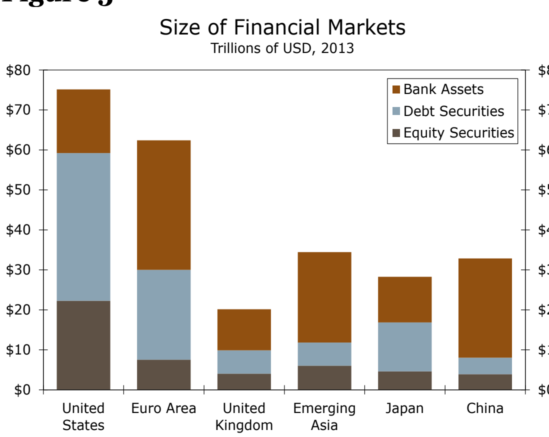
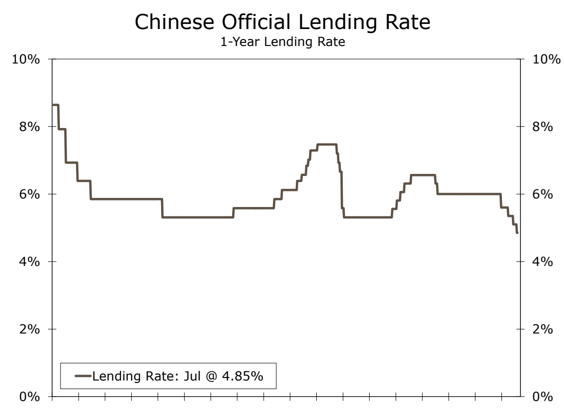


Figure 6



Source: International Monetary Fund, CEIC, Bloomberg LP and Wells Fargo Securities, LLC

In that regard, the People's Bank of China (PBoC) is easing monetary policy. As shown in Figure 6, the PBoC has reduced its benchmark lending rate by 115 bps since November and further rate cuts seem likely. Moreover, banks appear to be reducing the interest rates they actually charge business and consumers more or less in line with the reduction in the PBoC's policy rate. The bottom line is that BFI spending in China may be less affected by the recent swoon in equity prices than many observers may naively assume.

Conclusion

The declines that have been registered in the Chinese stock market over the past month are staggering, and similar-sized declines in the American stock market surely would portend bad omens for the U.S. economy. However, the Chinese and American economies clearly have different structures. Specifically, the Chinese economy is largely bank financed, unlike its American counterpart where equity markets play a more important role in corporate finance, and equities constitute a smaller share of household net worth in China than they do in the United States.

Consequently, growth in BFI spending in China may slow in coming quarters, but it is unlikely to collapse, based solely on the recent decline in Chinese share prices. Similarly, growth in Chinese consumer spending, although it may slow somewhat in coming quarters, is not likely to weaken significantly due to the swoon in the stock market. Although we look for the overall rate of real GDP growth in China to trend lower in coming quarters from the 7.0 percent year-over-year rate that was registered in Q1 2015, we do not believe that the collapse in Chinese share prices over the past month portends a sharp downturn in the Chinese economy.[5]

5 We forecast that real GDP in China will grow 6.5 percent in 2015, which would represent the slowest annual growth rate in 25 years, and 6.2 percent next year. The Bloomberg consensus forecast looks for 6.9 percent real GDP growth this year and 6.7 percent next year.

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