INSIGHT

Wild ride

G. Bin Zhao says the ride may be scarier than expected, but this crash isn't the end of China's bull market

If you have never ridden a roller coaster at a theme park, perhaps because you worry your heart might not take all the excitement, then the thrills and chills of buying Chinese stocks may not be for you.

There has been severe turbulence in the Shanghai and Shenzhen markets over the past three to six months, very rare occurrences in the short 25-year history of the Chinese capital market, and international investors are stunned. What has caused this phenomenon, and what should be done to prevent the sudden surges and declines in the future?

First, it is generally known that the recent round of rapid rises in the stock market lacks fundamental economic support. China's macroeconomic growth rate has hit a record low of 7 per cent, and the stock market, after a seven-year bear market that persisted since 2008, started its gradual recovery in the second half of last year, and increased dramatically this year. This phenomenon contradicts the basic principles whereby the stock market acts as a barometer for the economy. So, in the absence of both strong macroeconomic support and profitability among a majority of Chinese companies, the rapid growth of the market in such a very short period planted the seeds for disaster.

Of course, the Chinese market is still developing, and historically, its ups and downs have rarely followed any economic laws. This has made it difficult for it to become a channel for investors to share the fruits of growth in recent years.

Second, margin trading and short selling, namely leveraged trading, which started in 2010, boosted uncertainty in the market. During the downturn, it was uncommon for stocks to be bought and sold through leveraged trading, but once the bull market seemed certain, investors gradually increased this trading method. The amount of funds used for leveraged trading through formal and legal channels such as securities and fund companies is estimated at about 2.3 trillion yuan (HK$2.9 trillion).

> **The Chinese market's ups and downs have rarely followed any economic laws**

Obviously, compared with the total floating value of about 40 trillion yuan in the Shanghai and Shenzhen markets, this 2 trillion yuan, which accounted for about 5 per cent of current total tradeable market capitalisation, may have great influence on market swings, but will not quickly change the entire market in the short term.

Third, one of the major reasons, or the core factor, that has resulted in the current turbulence is that a large number of individual investors buy and sell stocks by financing five to 10 times the value of their own funds. Since the start of the stock market recovery late last year, many investors, believing the bull market and high returns were just around the corner, borrowed money through different channels to invest. Thus, the entire stock market was transformed into a margin trading mechanism similar to a futures market. For example, investor C has one million yuan for stocks, and he uses this as margin to finance five to 10 million yuan from friends, banks or other sources. Their agreement may stipulate that if they make money, they will share the earnings according to certain percentages; but if they start to lose money, the fixed limit is only one million yuan. When the market declines, if investor C is financed at a ratio of 10:1, a 10 per cent drop means he has lost his one million yuan; according to the agreement with his lenders, he must sell all his stocks to stop the loss. Such sell-offs are a major reason for the continuous fall in the market over such a short time.

Previous funds invested in the stock market had been relatively limited, but many greedy individual investors, betting that the bull market had finally arrived, borrowed to invest without understanding or fearing the risks. As a result, a lot of money flooded the market, causing it to rise sharply.

This financing usually takes the form of individual loans. There is no risk for the lenders, and the loan participants include not only individuals, but also banks and businesses, so the size of the funding can be very large. According to expert estimates, the amount is between five trillion and 10 trillion yuan, but because it is hard to get complete information about these loans, it is difficult to determine a more exact total, so the full amount is still debatable.

In short, the Chinese stock market is like a futures market because of massive leveraged trading, and many participants are individuals who lack expertise or training. That is the main reason for this crash.

Thankfully, the roller coaster seems to have come to the second half of the ride. Although we cannot predict what will happen next, we must believe in the philosophy of value investing. Bubbles do not often persist, and investigating and resolving the reasons they formed is the key for the long-term development of the market.

The regulators who promoted margin trading and short selling intended to boost stocks out of the bear market as soon as possible, but to their great surprise, many individual investors got involved in leveraged transactions through informal channels. The market was a mess within a few months.

Institutional investors should be forced to deleverage, and stricter regulations put in place, but the effects of these initiatives may be limited. More large-scale private investment involved in leveraged lending is hard to define and hard to control. One effective measure would be to require banks and other institutions to monitor the use of funds to prevent them flowing into the market. In addition, if applicable, legal means must be considered to combat third-party service providers who arrange financing for individuals.

In the interim, when the development of the entire national economy is slowing, overall economic and financial stability is crucial. Sharp changes in the stock market may lead to other risks, which shouldn't be overlooked. Some have criticised the central government for its multiple bailouts, but I believe policy interventions are necessary until mature market mechanisms are formed.

Turbulence in the stock market will hit investor confidence in the short term, volatility will probably continue for some time, but the bull market is not over yet; the prelude was just a bit more thrilling than expected. China is suffering a slowdown, but its economy is still thriving compared with others', and so is its stock market.

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Migrant energy can power China's growth

Winston Mok says shifting people from poorer areas to more affluent regions could be the best investment for a sustainable economy, to help China avoid the middle-income trap

With slowing growth, will China fall into the "middle-income trap" as Finance Minister Lou Jiwei (樓繼偉) has warned? With a per capita gross domestic product of US$7,600, China looks like a middle-income country. But the national average masks great regional variations.

The affluent coastal areas of the Yangtze and Pearl river deltas have achieved "first-world" status. Some cities in these regions, with per-capita GDPs comfortably above US$12,000, have surpassed the middle-income level; at US$24,000, Shenzhen's is higher than Taiwan's.

Most regions are in the "second world", with per capita income in the US$5,000 to US$10,000 range. China's third-world regions are not confined to remote areas; next to affluent Beijing are poor areas in Hebei (河北) with a per-capita GDP of just US$3,000.

China's leaders face tough choices. Do they focus on making the coastal regions more successful, which may widen the gap with inland regions, or do they upgrade the poorer regions to achieve better balance?

China's entry into the first world will be powered by its key economic regions on the coast. Following the lead of Shenzhen and Suzhou (宿州), more coastal cities will join the US$20,000 club in the next few years. In the next decade, most of the Yangtze River Delta and Pearl River Delta may approach the income level of Taiwan, if not South Korea. As China's coastal regions represent more than 60 per cent of its economy, they will play a decisive role in the nation's economic performance. In a recent visit to Zhejiang (浙江), the province he once led, President Xi Jinping (習近平) met leaders from key coastal provinces – highlighting their continued importance in China's next stage of innovation-driven growth.

Some cities down the development ladder, such as Wuhan (武漢) and Changsha (長沙), are approaching the US$10,000 mark. Below them are many cities that need to find smarter ways of productive growth – given the rising labour, welfare and environmental costs.

> **Migrants filled the factories on the coast and turned Shenzhen into a global technology powerhouse**

The most challenging are poor regions with a per capita GDP well below US$5,000. Some located near vibrant economic regions may be worth investing in. But it may not make economic sense for some remote regions. So the real issue is whether stagnant growth in some regions will trap China as a whole.

For China to break through the middle-income trap, there are two options. One is to upgrade its third- and second-world regions to first-world economies. The other is to shift people from poorer areas to more affluent regions. The people have chosen the latter path – a path that is also more capital efficient and market driven. It is through such sustainable growth that China may have the best chance of entering the first world.

Migration was how China's rapid economic development was accomplished in the first place. Migrants filled the factories on the coast and turned Shenzhen into a global technology powerhouse. Using reforms, Guangdong elevated its economy from the fifth largest to the largest in China.

However, developing selected poorer regions is also important. Beijing's key initiatives include Greater Beijing integration and the Yangtze Economic Belt. Lou recognised that as wealthy as the country is, it does not have unlimited funds. Capital deployment can be more efficient with better labour allocation. In this context, improving labour mobility is a central theme underlying Lou's recommended measures to overcome the middle-income trap.

Lou has called for better implementation of residential registration (or *hukou*) reforms, particularly among affluent regions. The "temporary" flow of migrant workers into China's first- and second-world regions cannot be reversed, but will crystallise into a fundamental redistribution of the population. Lou has rightly urged the central government to finance this massive migration – which may well be the best investment Beijing can make to drive sustained economic growth, escape the middle income trap and enter the first world.

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The "temporary" flow of migrant workers into first- and second-tier cities can't be reversed. Photo: Xinhua

HK must guard its citizen rights, now and post Article 23

Tim Collard says while China's progress on human rights and rule of law is indisputable, individual rights remain a step too far for authorities, a key difference between the SAR and the mainland

China's newly promulgated national security law has sparked concern and debate in Hong Kong. Although there is as yet no question of this law being applied in its entirety to the special administrative region, no one will have forgotten that the city is required by Article 23 of the Basic Law to bring in a security law of its own. It can be assumed that the mainland authorities will expect such a law to be broadly aligned with the national legislation, or at least not to set itself up in overt opposition.

The details will need to be left to the legal experts in Hong Kong and Beijing but, as an outside observer, I believe there is a wider issue we must not shy away from.

It cannot be denied that there has been considerable progress in the reform and revision of legislation in China since the lawless days of the "Gang of Four". President Xi Jinping's (習近平) administration has nailed its colours to the mast regarding the need to adopt a system based on the comprehensive rule of law, and the abuses caused by the arbitrary or corrupt exercise of power. It is also true that the legal framework of Hong Kong has largely been maintained in its established form, as promised at the time of the transfer of sovereignty in 1997. So it can be compellingly argued that Beijing has pursued, and continues to pursue, the reform of Chinese jurisprudence in good faith.

But one issue has always been a step too far for Chinese legislators. Laws have always centred on the rights and responsibilities of governmental authorities, and on the duties of the citizen. Nowhere is there any reference to any enforceable rights of citizens themselves.

Western criticism of China has frequently focused on what we like to call "human rights" issues. Sensible nations have now instead adopted a strategy of conciliation: offering practical assistance and cooperation in drawing up mechanisms by which the rule of law can be strengthened, and giving credit for improvements. By any standard, China's "human rights record" is improving. But the phrase is just shorthand for a government's treatment of its citizens; it is not because they have been able to claim or enforce any rights to better treatment.

As far as I know, there is nothing in the laws or the administrative practice of the mainland that entitles a citizen to say to an official or police officer: "Unless you can show that I am breaking the laws as agreed and set out by the national legislature, you have no right to stop me doing what I am doing". That is what has always been seen as a step too far in China.

Given the internal difficulties faced by many Western countries, particularly the US, no nation should feel that it can lecture the Chinese on what makes a perfect system of law or governance, nor can any nation claim to have got the balance between the rights of the individual and those of society exactly right. We also know that this balance is viewed differently in Asia to how it is in the West, and that we have no inherent right to consider our view superior. Even so, no society can call itself successful if there is a complete absence of citizens' rights.

This is especially relevant in Hong Kong: the difference between Hong Kong and the mainland can no longer be seen as the difference between a capitalist and a communist system. It is the difference between the presence and the absence of the rights of the citizen.

No one can demand that China conform to any rules imposed from outside. The issue, whether it pertains to the national security law or any other law, is whether the citizens can be sure about where their powers begin and end. On this depends not only the immediate future of Hong Kong when Article 23 is implemented, but also the entire future of China.

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America's ignorant other half

Jonathan Power says with 50 per cent of the US out of touch with reality, the nation is in danger of abandoning reason, despite Obama's best efforts

About half of the US is a "culture of ignorance", and they appear to feel no shame about it. In the south, the total probably goes up to around 65 per cent, whereas in the north, including California, it goes down to 35 per cent.

It is a rough and ready way of putting it, but the other 50 per cent voted for Barack Obama for president. Obama types are less religious, more scientifically orientated, less racist, more pro health care for the poor, more aware of the world outside, more convinced that war solves little, and knowledgeable to the extent they know their immediate neighbour, Canada, does a much better job of making a good life.

It's the "culture of ignorance" half that is now pushing for a tougher military response to the menace of Islamic State, for pumping up military muscle vis-à-vis Russia, and is persuading itself that more troops in Iraq could sort out what eight years of military occupation didn't and couldn't. It's this half that tried to sabotage America's economic recovery after the 2008-09 crash by demanding tax cuts for the wealthy and cuts in social welfare for the poor, and refusing to study or countenance Keynesian uplift economics.

I love America. But I also despise America. I'm afraid of America's footprint in the world. I think Europe and Canada make sense and America doesn't.

Dylan Roof, the young man who went into a black church in Charleston, South Carolina, and murdered nine worshipers, is a child of the 50 per cent who make up the "culture of ignorance". He may be an extreme form of it, but the ingredients are all around him. Fifty years after Martin Luther King won historic civil rights legislation and after nearly seven years of Obama, the undercurrent of racism is alive and well. Tied into a knot with the culture of gun ownership and the murders it breeds, it shows no sign of abating.

Half of America sincerely believes that the country both invented and perfected the idea of freedom and that its quality of life is the highest on the planet.

Yet international rankings place America barely in the top 10. Its rates of murder and other violent crime dwarf the rest of the Western world and that of much of the Muslim world. So does the prison incarceration rate, not least of young black men, often convicted of non-violent, petty, crimes. The US' average levels of educational achievement and scientific literacy are, in world terms, embarrassingly low. The southern "Bible Belt" rejects Darwinian explanations of mankind's creation and insists the notion that God created the human race in seven days be taught in schools.

America teeters on the edge of abandoning reason. Obama has tried to fight this. He has only partly won. Sad to say, I doubt any successor will do better.

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