China Needs A Robust Stock Market

By: Jack Perkowski | December 17, 2015

Small and medium enterprises (SMEs) are the lifeblood of any economy, whether it is fully developed like those in the United States or Germany, or one that is still emerging like China's.

According to **Yijiang Wang**, Professor of Economics and Human Resource Management at the Cheung Kong Graduate School of Business in Beijing, SMEs account for 99 percent of the total number of firms in China; 60 percent of the country's GDP; 70 percent of employment; 65 percent of the patents filed each year; 60 percent of exports and 50 percent of tax revenues. Despite this large contribution to the Chinese economy, SMEs only use 20 percent of China's financial resources. Per yuan of investment, SMEs are eight to 10 times more efficient than China's large companies in creating jobs and four to six times more efficient in generating GDP.

Having such a potential engine for growth starved of capital is not sustainable if the Chinese government wants to wean itself from high levels of infrastructure spending and involvement in the economy. In order to achieve its next round of growth, China needs to get more capital to its privately owned companies and its SMEs. Fortunately,37 years of economic growth has provided the raw material for accomplishing this objective, with an abundance of capital already existing in the country.

China now has $3.4 trillion of foreign currency reserves; it is the largest foreign investor in U.S treasury bonds with $1.3 trillion of holdings; and deposits in China's banks total a staggering $21 trillion. To put this amount in perspective, the deposits in China's banks are approximately twice the amount in U.S. banks — and twice China's Gross Domestic Product ("GDP")."I don't think you can find any significant economic system where deposits in the banking system are twice GDP," said **Nicholas Lardy**, who has studied China for more than three decades and is a senior fellow at the Peterson Institute for International Economics.

Like any product that is produced in China, however, the overarching challenge is distribution; i.e. getting the product to the people and companies in the country that can use it best. While a web of wholesalers and retailers, supported by fleets of trucks and a network of warehouses, comprise a distribution system for goods and services, the capital markets, which are comprised of the stock market and all of the other financial markets that stem from it, provide the foundation for the distribution of capital.

Accordingly, China's biggest problem today is that it lacks the capital markets necessary to efficiently distribute the massive amounts of capital that has already accumulated in the country, while its single biggest opportunity is the development of its capital markets. In 2012, former Premier **Wen Jiabao** summed up the problem when he urged the breakup China's bank monopoly, essentially saying that the nation's banks are too big to lend. In order to understand how robust capital markets may fuel China's next round of growth, one only has to look at the United States, where Wall Street has played an important role over the years in picking winners and punishing losers, enabling the American economy to continually re-invent itself.

In China, the stock market — to date — has been missing in action as far as being an important part of the economy. With the exception of a brief period in 2007 when it flirted with the 6000 level, the Shanghai Stock Exchange ("SSE") Composite Index has essentially been stuck at 2000 level for the first 15 years of this century. Over this 15-year period, China's economy has grown almost 10-fold from $1.3 trillion in the year 2000 to over $11 trillion today.

In order to break China's stock market out of this holding pattern, the government took several steps in late 2014 that were designed to increase the flow of foreign capital into its stock market, as well as begin the process of moving the $21 trillion in bank deposits into markets where these funds could be accessed by cash hungry private companies. In mid -November, 2014, China announced Shanghai-Hong Kong Stock Connect, a program which enables Chinese mainland investors to buy shares listed in Hong Kong and Hong Kong investors to purchase Shanghai-listed securities. Later in the month, China announced that deposit insurance for bank accounts under RMB 500,000 ($77,000) would be implemented in 2015, effectively telling larger depositors that they could no longer count on the central government to bail out bank-sponsored investments.

These two moves, coupled with six successive interest rate cuts over the past twelve months, have enabled the SSE to break out of its rut. Reacting to these reforms, the SSE popped 35 percent from 2500 in late November to over 3300 in early January. While the introduction of margin lending led to extreme stock market volatility during the first three quarters of 2015, the SSE has stabilized at 3000 or above since September, and is now trading at the 3500 level.

As the new year dawns, the SSE has reached a new, higher valuation plateau. However, the looming question in 2016 is whether foreign and domestic capital will continue to flow into China's stock market, and in the process, provide the funds that are desperately needed by China's private sector.

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