The Other Side January 14, 2016

China's Impact on Global Markets

Two centuries back Napoleon Bonaparte is supposed to have said: "Let China Slip. For, when she wakes up, the world will tremble." I was reminded of this while observing the developments in the global asset markets last week, incidentally the first full week in the New Year. Stock markets from advanced industrial countries to emerging economies, including India fell sharply: by one estimate I have come across global stock markets lost $ 2.3 trillion in market capitalisation last week; this is slightly more than India's GDP! So did commodity prices including, interestingly, oil, despite the growing tension between Saudi Arabia and Iran. Many emerging market currencies plunged. The weeks development reminded George Soros, perhaps the best known and certainly one of the most successful hedge fund managers, of 2008. George Osborne, the UK Chancellor, warned of, a dangerous cocktail of new threats" to the global economy. It may be recalled that the US interest rate rise was supposed to lead to such consequences. As per advanced analysis; when the actual rise took place last month, there was hardly a rappel in the market. Has the Chinese market become the most important driver of the global economy? Market participants commented on how China is playing a bigger role: "*This is the new reality and markets have to accept that."*

It may be recalled that the Chinese stock market and the movements in the yuan dollar exchange rate have been making headlines since August last year. The market was unusually volatile last week and it fell 7% on Monday the 4th January, and again on Friday, when the trading was stopped by the so-called "circuit breakers". The yuan also fell despite huge intervention and sale of dollars by the Chinese central bank: the pressure on the yuan was the result both of outflows on the part of foreign portfolio investors, as also Chinese companies investing abroad. Even our Commerce and Industry Minister was forced to take note of the development and expressed worries that the yuan fall may well increase our trade deficit. One only hopes that she is keeping an equally close watch on the rupees significant and continued appreciation in real terms. Or perhaps her patriotic pride is bolstered when the rupee is described as, say, "the best performing currency in Asia".

But to come back to the stock and markets in China Tom Mitchell of the Financial Times (January 9th) mocked the "*comic series of policy miscalculations ..... such events have* *raised questions about .... the competence of its top leaders."* What is truly amazing is how policy makers of such questionable competence succeeded in leading a once backward economy to 10% p.a. growth for decades, something which no advanced country today has ever achieved.

To put the issue of trading suspension in perspective, one needs to have some of the risk management systems followed by Clearing Corporations who guarantee settlement of all trades on an exchange. Broadly speaking the process is in two parts:

⇒ The Clearing Corporation collects and initial margin from the traders, based on the current daily volatility of the prices. The expectation is that price changes during the day will be covered by the initial margin;

⇒ Mark-to-margin is collected everyday depending on the price changed. Sometimes intra-day trading is suspended to give time to traders to pay the margin calls;

⇒ On days of extreme volatility trading is suspended for collection of mar-to-market margin.

In other words, if guaranteed settlements are to work, occasionally trading does need to get suspended for the functioning of the margin system. In fact, over the years, the system had worked extremely well – so much so that I do not recall the failure of any stock exchange in honouring guaranteed settlements. (This is the reason why the G-20 wants derivatives trading to move from the over-the-counter market to exchange trading.)

The main reason why the Chinese Stock Market has been extremely volatile is that in the first half of last year, the index had climbed almost 70%, reminding one of the last 1990s .Com craze in the US. The index fell sharply in June, July and August and has been volatile since then. As for the exchange rate over the last 10 years, the Chinese Central Bank had deliberately appreciated to reduce the trade surplus and re-balance the economy from exports to domestic consumption. From its peak last year the currency had fallen around 7%. Currency pairs like dollar:euro or dollar:yen move that much over a much shorter period without attracting any comment.

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