CHINA'S STOCK MARKET CRISIS AND THE ROLES OF THE STATE

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Abstract

The China's stock market crisis has successfully alarmed the investors, particularly the domestic investors. China over the three decades has shown an incredible growth of its economic, particularly its investments flow. This investment flow is supported by the establishment of the China's stock markets, Shanghai stock market and Shenzhen stock market. These two largest stock markets in China have been grown much stronger and listed in the top rank of the global stock market. However, in the midst of China's stock markets rise, it experienced from the decline of its indexes. In June 2015, it jumped from the highest rate into the lowest rate. This was the first time that the China's stock markets jump drastically. This decline has worried the investors, particularly the domestic investors. In this regard, the central government of China as the absolute power within the country has the crucial roles to calm down its stock market crisis.

This research aims to find out the reason why the China's stock market crisis arise and the role of the state in addressing the stock market crisis by using the concept of casino capitalism and the role of the state by Keynesian perspective.

Key words: *Shanghai stock market, Shenzhen stock market, capital movement, stock market crisis, fiscal policy, monetary policy.*

A. Introduction

China which officially known as People's Republic of China (PRC) is one of the great nations in the world. From the ancient era, China is popular with the term of socialist state, a state in which its economy is regulated by the state. Since its establishment, China's economy is controlled and regulated by the central government. It called as the centrally planned economy. The economy activities are planned under the authority of the leader which is Mao Tze Tung. At that time, the centrally planned economy was not give any good improvement towards China's economic growth instead it create the inefficiency towards the standard of living in China. Furthermore, the centrally planned economy failed to narrow the gap of economic growth between China and other developing countries.

The economy of China has grown much stronger since the introduction of economic reform in the era of Deng Xiaoping. The China's economy was shifted into more market economy that play great role in global economy. During this period, China began to open itself to an international trading. Thus, the capital flow began to exist in China. Deng Xiaoping considered market-based method to revitalize the China's economic slowdown that happened in the era of Mao. This system of market economy in China is characterized by existence of the stateowned enterprises and the reduction of the control of the central government over the market. During this period, China began to involve in an international trading and implement the free market. Thus, in the era of Deng, China's economic growth showed good improvement rather than in the era of Mao. This economic reform is known as the foundation of the China's expansion in the twenty-first century.

In this twenty-first century, China comes as one of countries with a strong economic power in the world with the gross domestic product reached 11007.72 billion US dollar in 2015 (Trading Economics, 2017). In additional, China has also emerged as a country with a high export and the country with the largest destination for investment (foreign direct investment). Unlike its GDP that reached the incredible point as mention above, its per capita income in China remains low. Besides that, China also has emerged as the favorable place for the investment. The well growth of its economic becomes one of the reasons why the investors are targeting China as the favorable place for the investment. Seeing this development on its economy, it can be concluded that the purpose of economic modernization in China, in addition to increase the economic growth and living standard of its people, is also to attract the foreign direct investment to enter to the China's mainland. Through this effort, China can always increase the capital flow from the foreign countries to China.

In the midst of intense investment, China experiences the stock market crisis. The year of 2015 becomes the dark year for the China's stock market. It is due to the decline of its stock indexes in the two largest stock markets in China which are Shanghai and Shenzhen stock exchange. China's stock market from the Shanghai Stock Exchange Composite Index declined 8.5 percent while index composite that consists of several large companies listed in Shanghai and Shenzhen declined by 8.6 percent (VOA Indonesia, 2015). Moreover, Shenzhen stock market suffers dramatic loss. Both Shanghai and Shenzhen suffers from continuous decline until it reached the lowest rate. This is the first time that the China's stock market suffers from significant decline. As it is known that China has occupies the highest position for being the largest export country in the world. Its economic health is the important thing for other countries' economy, particularly for the investors. China, as a country with incredible gross domestic product, represents approximately 18 per cent of the world economy (Trading Economics, 2017). Therefore, its economic growth can influence the global economy, either positive growth or negative growth. The central government of China as the absolute actor within the country has the absolute power to control its economic growth so that it will not harm either China itself or other countries. This paper divided into two sections. In the first section, it will be explained about the un-controlled capital mobility in China and the second section will discuss about the role of the China's government in addressing the stock market crisis.

B. The China's Stock Market Crisis

The China's economy growth that has being incredible over the past years makes China become the largest economy in the world after the United States. The incredible rise of China becomes meaningful with the existence of capital. As a country with the transition from planned economy into market economy, capital becomes the important part of its transition. The industrialization adopted by China since the reform period requires a lot of capital while in fact China was a poor country at that time. Therefore, with the existence of the economic reform, the China's economy is being liberalized so that it can attract the capital mobility into China. Moreover, the inception of two stock markets in China becomes a platform for the capital mobility. In the context of China, the capital mobility majority is driven by the investment rather than consumption (Lai, McNelis, & Yan, 2013). A data from World Bank shows that the China's foreign direct investment (net flow) in 2015 reached 249,858,920,111 US$ (World Bank, 2016).

That high level of investment is supported by rapid growth in credit and growing stock.

During the last three decades, China has experienced an incredible growth reached an average of 10% (Lai, McNelis, & Yan, 2013). However, for the first time, the China's economy only grows 7% over the past few years (Bloomberg News, 2015). This number perceived to be the lowest number for China's economy growth. Beside due to the surplus of international trade, the slowdown on the economy growth is compounded by the decline of the stock index in the two largest China's stock markets which are Shanghai stock exchange market and Shenzhen stock exchange market. China's stock market has been going worst during a period.

The reason of the decline in the stock market is because of the uncontrolled capital mobility in China. What meant by the uncontrolled capital mobility is the massive purchase of shares using borrowed money. This borrowed money is coming from the brokerages houses that have been proliferated in China. Since the global financial crisis in 2008, the central government of China launches the economic stimulation to re-boost it economic growth after the crisis. One of the economic stimulations is the margin trading strategy which launched in 2010 and expanded in 2012 with the formation of China Securities Finance (Wildau, 2015). This margin trading policy allows people to invest using borrowed money from brokerages or other financial institutions (Business World, 2012). Since then, the investment is going viral among investors. The high number of financial institution or intermediaries in China enables investor to borrow money. Thus, the investment becomes an affordable activity of the Chinese people.

The margin trading policy allowed the investors to buy the securities using borrowed money. Although the central government allowed borrowed money into the stock market, they still include the rule to safeguard its stock market.

However, though the government applies the rule and provisions for the margin trading, the people tend to cheat the rule and provisions. They tend to avoid the government's rule and provision to get into its stock market. Such behaviour can create more risk compared to the official rules. Due to the margin trading strategy, more investors comes and targeting brokerages to buy or lend the stocks or money while controlling the electronic data boards that shows the rise and fall of stock prices. As a result, people are using the illegal method to get into the margin trading. Therefore, during the 2014-105, the China's stock market is dominated by the margin trading.

From much investor that exists in China, more than 5 million is new investor who comes from ordinary people (Stratfor, 2015). They usually involved in short-term speculation rather than long-term investment. Since then, China's stock market is dominated by borrowed money which led to the increase of the stock prices up to 150% (Lee, 2015). During this period, the bubble economy happens. The bubble economy occurs because the capital mobility which allocated through stocks are being uncontrolled. It moves freely to the investors or even an ordinary people to join the gamble table. Investors are going crazy to invest using borrowed money. A data below from Stratfor.com shows that the China's mutual funds reached $1.18 trillion in May 2015 while the margin loans reached $360 billion (Stratfor, 2015). Besides that, the data shows the investors that exist in China which approximately reached 88 million people in May and June, making the China's stock market more like casino (Stratfor, 2015).

After the increase of the stock market, it suffered from the free-fall. The increased purchase of the shares using borrowed money will lead to the economic bubble and the possibility that it will explode. The explosion of the economic bubble perceived will give the worst effect towards the actor of the investment. Seeing this condition, the brokers shut down the trading and the investors are hit by panic. The investors worry that the decline of China's stock market will create the sentiment towards China's economy growth in the future. As a result, the investors start to sell the shares to repay the debt. The investors in China who initially flocked to buy shares using borrowed money eventually sell their shares. Massive selling in the stock market has led to the fall of stock prices and the decline of China's market. During this period, the bubble explodes. China is now deal with the effect of its own economic bubble.

The figure below shows the dynamics of the China's stock market which is Shanghai and Shenzhen stock exchange composite index from June 2014 until August 2015. June 2014 was a period in which the China's stock market experienced an acceleration growth, this stage is called as the bubble economy. Meanwhile, August 2015 was a period in which China experience the consequences of its bubble economy, this stage is the condition after the bubble exploded.

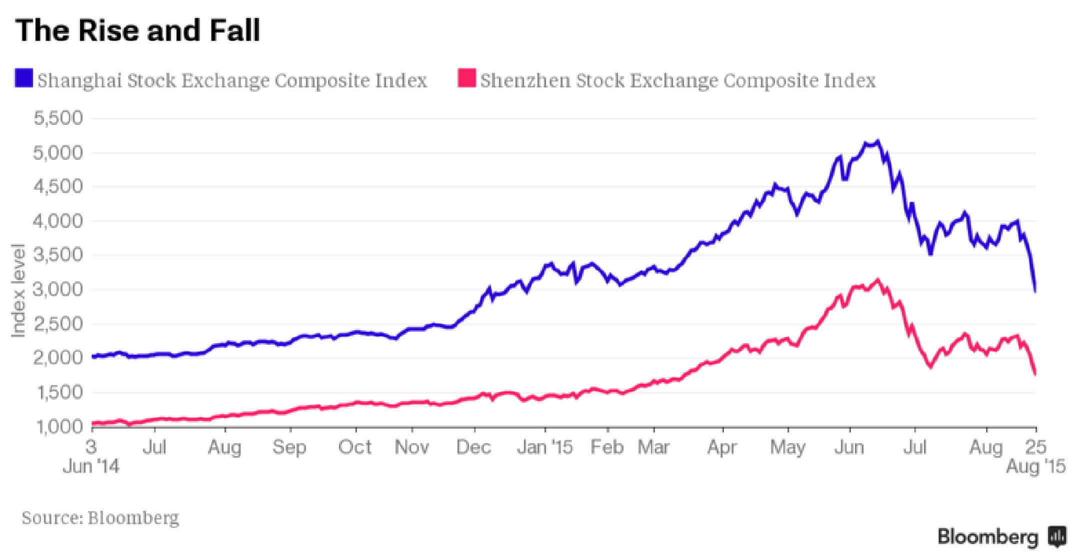

Figure 1: The rise and fall of Shanghai and Shenzhen stock composite index (Bloomberg News, 2015)

China is experiencing the consequences of the dynamics of the uncertain market shares. China's stock market fell dramatically. It is worrying investors that have been registered on the Chinese stock market. Therefore, they demanded the central government of China to immediately issue policies to calm down the stock market crisis. Thus, investors will find it convenient to invest again in China's stock market.

C. The Roles of the State

The significant decline in stock index makes the China’s authorities worried. This financial market turbulence in China reflects the issue whether China’s economy would “heading into a hard landing or slowing too sharply” (Walker, 2015). The explosion of economy bubble which led to the decline on the stock index is exacerbating the economic growth in China and harms the actor of the investment. Therefore, the investors and brokerages demanded the China’s government to immediately overcome the financial market turbulence. As the regulator in economic activities, the central government of China is responsible to overcome the financial market slowdown through the public policies which is fiscal policy and monetary policy. These policies will be used to correct the slowdown of the capital market in China.

1. Monetary policy

General understanding of the monetary policy is how the central banks manages the supply of money or called as liquidity, credit and interest rate. According to Niculae (2013) the monetary policy explains the way in which the central banks adjust the policy as a response towards the economic circumstance (Niculae, 2013). The monetary policy generally conducted by the central bank through adjusting the interest rate (Mathai, 2009). When the policymaker is trying to influence the market, they have only two policy instruments whether it is fiscal policy or monetary policy. Monetary policy is one of the main policies as a tool to direct the balance of economic in certain country. The effectiveness of the monetary policy itself still becomes the debates among the experts. The question whether the monetary policy is really works during the recession/crisis or not is still become the main debate among the experts. It cannot be denied, in answering this question there is some pros and contras.

The China's stock market crisis in China influences the sustainability of its economic growth and the investors. In the context of China, the central government issued monetary policies (called as the patriotic policy) which addressing the stock market crisis. According to Long (2015), these monetary policies includes: First, the China's Securities Finance (CSF) will lend money to the market amounted US$ 40 billion which equivalent to 250 billion Yuan. This stimulus is given to 21 brokerages firms to encourage them to purchase the blue chip stocks. The China's authority believed that this effort will help to lift up the stock indexes in its stock market. The China's Securities Finance (CSF) will also purchase the small and medium shares. The purchase of the shares whether it is small shares or medium shares, will help to increase the stock indexes. Second, the central government of China issued new stimulus which amounting US$ 40 billion to stimulate the economic growth. This new stimulus is used in order to direct the economy so that it will not trap in a slowdown. Furthermore, it can help to boost the economic growth when the slowdown happens. Third, the central bank of China has cut the interest rate into the lowest rate. This effort aims to pump the money supply to the system. (d) The China's government to devaluate Yuan towards the US dollar. This effort aims to boost the export. Now, it sets the Yuan's daily fixing to the United States' dollar based on the currency closing level in the previous day (Curran, 2015). Curran (2015) adds that by keeping the currency, the mechanism can protect China from the financial crisis or market turmoil.

The China's government efforts to respond the decline on the stock market has already been done. Public polices, one of them is monetary policy has been issued by the central government. All the major action taken by the government has been done. However, China's stock market has not been calm yet. After the government issued policies, its China's stock market is still experiencing the uncertainty in which its indexes are going up and down. Sometimes, when it is opened, it will increase highly but when it is closed it will go down significantly (Supriadi, 2015). The efforts done by the central government of China considered not effective to calm down the stock market crisis in China. It seems that the investors do not trust the China's government because the China's stock market continuous to move erratically.

2. Fiscal policy

In term of economy, fiscal policy is one of the important policies beside the monetary policy. "Fiscal policy means the use of the public revenues and expenditures for the realization of the goals of economic policies" (Krasniqi, 2013). According to Krasniqi (2013), the fiscal policy has to do with the long-term effect that can accelerate the economic growth. Fiscal policy usually works through incentives (such as tax reduction) and spending (such as government spending) (Silvia & Iqbal, 2011). The public spending is the important tools to boost the economy particularly during the crisis which can increase the aggregate demand. The government influence the economy through taxes and spending. Fiscal policy is divided into 2 kinds which is expansive fiscal policy and tight fiscal policy. According to Horton & El-Ganainy (2009), the expansive fiscal policy is when the government increase the spending in order to increase the aggregate demand. Meanwhile, the tight fiscal policy is when the government decrease the spending. (Horton & El-Ganainy, 2009).

The decline on the stock index in China has sparked panic among the investors and also neighbouring countries. The decline which was followed by the economic slowdown perceived will become a threat of the global economic downturn after Greece. In response to this event, the China's authority issued the fiscal policy. This fiscal policy is done through allocating more funds to the infrastructure project (Long, 2015). The fiscal policy becomes the main method for increasing the demand and investment. In China, the infrastructure becomes the driver of its economic growth since it is the profitable investment for China. The adequate infrastructure will support the economic growth. The allocation of fund in infrastructure is expected to help the economic growth better. Moreover it can be the way to save the stock market crisis in China. The stock market crisis in China perceived much like casino which more speculative. With the infrastructure development, it will avoid the speculative investment.

The MGI (McKinsey Global Institute) report shows the China's infrastructure spending that is more stronger than the other countries such as United States, Middle East, India, etc (Coy, 2016). The fiscal policy that emphasizes the infrastructure development is seen as a policy that can rescue the stock market crisis. Moreover, it can also increase the aggregate demand. Unlike the speculative, the infrastructure development is closely linked to long-term investment that can stimulate investors. The long-term investment considered more secure rather than the short-term investment that is more speculative. Unlike the monetary policy, the result of the fiscal policy whether it is effective or not is still cannot be decided. It can directly be answered whether the monetary policy is useful or not during the crisis. However, it is different with the fiscal policy. The fiscal policy which operates in the government spending and tax needs some times to decide whether or not it is effective. It needs some time s to complete the infrastructure project until it can be said effective or not. It also applied in the case of China, the China's fiscal policy that operates in building the infrastructure needs long time to complete it. Therefore, no, it cannot be said yet whether it is effective or not.

D. Conclusion

The stock market crisis in China happened because of the uncontrolled capital mobility. This capital mobility is in the form of the borrowed money. The borrowed money is obtained from brokerages and other financial institutions that had long been proliferated in China. Most of buyers are coming from an ordinary people who focused on the short-term investment. Such thing like this makes the stock market in China much like casino. The massive purchase of shares using borrowed money led to the economy bubble. Seeing this economy bubble which bubbling constantly, has alarmed the investors. Therefore, many investors sold their shares to pay the debt. During this period, the bubble exploded. Over half of the companies listed in China's stock market decide to shut down the trading and sell their shares. Thus, China's stock market has lost more than half of the companies listed in its stock market.

The massive sell of shares makes the stock price fell. China's stock market has plunged from its highest rate into the lowest rate. Seeing the decline in the stock market, the investors worried that this will lead to the slowdown of China's economic growth. Therefore, the investors are demanding the China's authority to immediately issue policies to save the stock market crisis. Therefore, the China's authority issued the public policies which are fiscal policy and monetary policy. The fiscal policy of China's government focuses in the infrastructure development in China. The central government of China will disburse the funds to accelerate the infrastructure development as a means of the investment. The infrastructure development is perceived to be able to generate the long-term productive investment and increasing the aggregate demand. The monetary policy is done through lending some money to the market by the central bank, cutting the interest rate, and devaluating Yuan towards US dollars. However, this effort considered failed to calm down the stock market crisis. The China's stock market still move erratically in which it can be increase highly and down significantly.

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