Economic analysis

China’s rekindled market selloff prompted strong monetary easings

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Today the People’s Bank of China (PBoC) cut its policy rates by 25 bps and the Required Reserve Ratio (RRR) by 50 bps, in response to the rekindled selloff in China’s stock market which has trimmed the Shanghai Composite Index by 544 points (or -15.5%) on Monday and Tuesday. (Figure 1) Amplified by the unanticipated RMB devaluation in August, Chinese market turbulence has sparked selloffs around the global financial markets. (Figure 2 and 3)

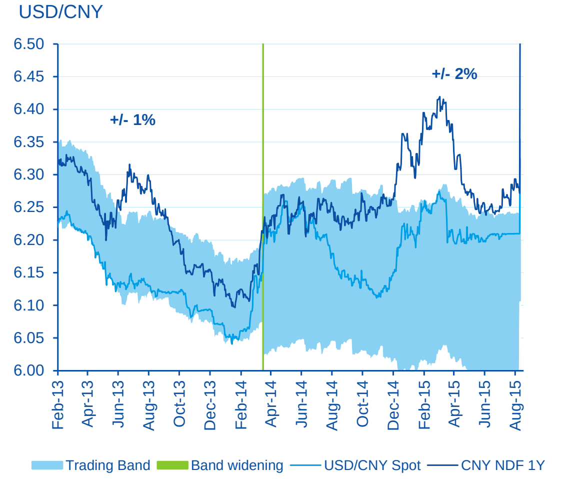
The policy rate cut is symmetric given both the lending rate (from 4.85% to 4.60%) and deposit rate (from 2.0% to 1.75%) have been reduced by the same magnitude of 25 bps. Moreover, the PBoC lifted the cap of deposit rates with tenors beyond 1 year, marking another step of interest rate liberalization. (Figure 4) On top of the universal RRR cut, the PBoC also deployed selective RRR cuts for banks focusing on SMEs businesses and the agriculture sector (additional 50 bps) as well as financial leasing and auto-finance companies (by additional 300 bps) in a bid to support SMEs and stimulate consumption. (Figure 5) The combined policy rate and RRR cuts are reminiscent of the similar move in June through which the authorities intended to rescue the stock market from collapse. However, their real effectiveness is questionable in terms of the previous experience. Moreover, such a strong dose of monetary easing could aggravate the pressure on the RMB depreciation by encouraging more capital outflows.

- **Why the stock market selloff comes back again?** Several factors are at play: first, the previous price correction in the stock market has been interrupted by the authorities’ heavy-handed market interventions. However, these interventions can’t artificially depress market forces forever. Second, the unanticipated RMB devaluation has added substantial uncertainties to global financial markets and dampened investors’ confidence in China’s economy, which, as a result, made it more contagious to other countries’ financial markets than the previous selloff in June-July. Last but not least, as the Fed’s prospective interest rate hike is approaching, investors’ sentiment has become very fragile and is vulnerable to any external shock.
- **Fortunately, the recent round of selloff appears to be less detrimental to China’s domestic economy.** Compared to the previous selloff in June-July, the leverage in the stock market has been largely reduced since then. (Figure 6) It means that investors are in a better position to withstand large-scale price corrections. More importantly, both the banking sector and shadow banks have greatly diminished their exposure to the stock market, making it unlikely for the turmoil in the stock market to spill over to the interbank market.
- **Policy dilemma could force China to resort to capital restrictions.** Monetary easing could heighten the downward pressure on the RMB exchange rate as they tend to diminish the interest rate differentials between the RMB and other currencies. On the other hand, given the sluggish growth and the stock market selloff, the PBoC need to continue its easing efforts in the coming months. In our opinion, the only viable way to overcome this policy dilemma is to tighten the control of capital flows across borders.

Figure 1
China's stock market selloff was rekindled

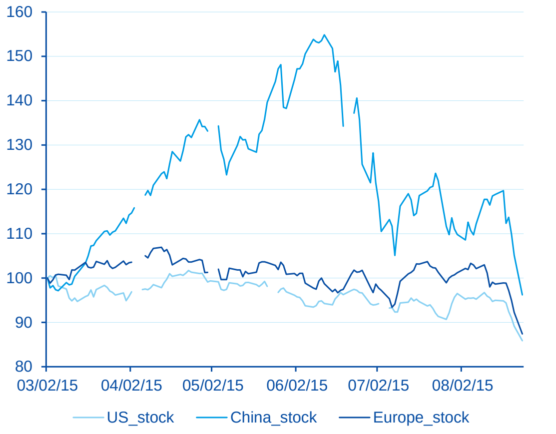
Source: CEIC and BBVA Research

Figure 2
RMB depreciated significantly right after the PBoC reformed the RMB fixing price mechanism



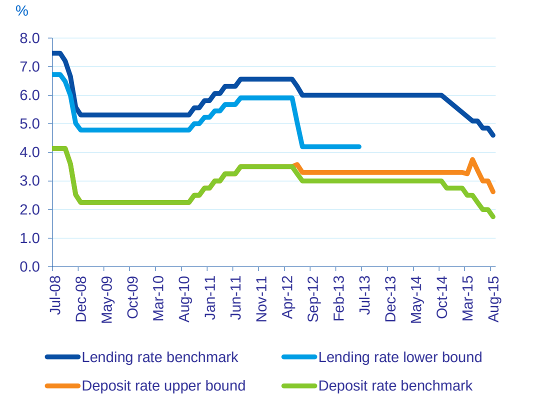
Source: CEIC and BBVA Research

Figure 3
China's stock market crash spills over to other countries' stock markets (starting point=100)



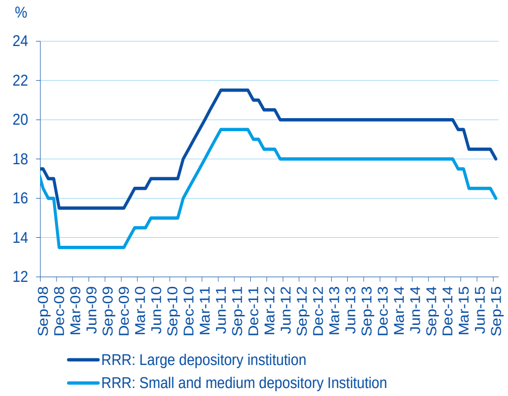
Source: CEIC and BBVA Research

Figure 4
China's interest rate cut by 0.25%



Source: CEIC and BBVA Research

Figure 5
RRR cut by 50 basis point



Source: CEIC and BBVA Research

Figure 6
Margin trading is one of the main reasons for the stock market crash