There is no need to panic about falling stock markets in China

China has hurdles to overcome but its economy continues to grow and develop

By Roger Bootle

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Ever since China started to grow very rapidly, there have been those who have seen it as heading for a fall. Today is no exception. By contrast, I believe that it will continue to grow strongly for many years to come — albeit not quite so fast as before —and with a few bumps on the way.

The latest source of worry has been the performance of the stock market. Since June 12, the Shanghai Composite Index **has fallen by 20pc**. At one point it had fallen by a third. On occasions the index has fallen by as much as 7pc in one day. **There has been widespread anxiety**, in China and outside, that these sharp falls might cause not only financial chaos but also a severe hit to the real economy.

These fears are grossly overdone. Even after recent falls, the stock market is still up by about 100pc over the past year. Indeed, it is up by a quarter from the beginning of this calendar year. So the notion that massive losses on stocks are going to cause a plunge in the Chinese economy looks far-fetched.

As it happens, the stock market is not that significant in relation to China's economy. The ratio of tradeable equities to GDP is running at just under 30pc. In most economies, including other emerging markets, the equivalent figure is over 100pc. Moreover, only one in 30 Chinese people owns shares directly, compared with about one in seven in the United States. And for all the popular enthusiasm for shares, China's share owners are, on the whole, rich. They are unlikely to want, or be forced, to scale back their spending by incurring stock market losses. Nor is the equity market important as a channel for companies to raise finance.

One major concern is the degree of leverage in the market and the possibility of brokerages getting into trouble. More important than this, there is the embarrassment factor.

Via the state media, the Chinese government has encouraged people to invest in equities – right up to the moment the market crashed. This made policy-makers look inept and is one of the key reasons why they have stepped in to support the market.

This carries with it a serious degree of moral hazard. That is to say, Chinese investors may come to feel, as their US counterparts used to, that if equity prices get into trouble the authorities will step in to support them.

Even so, the danger posed by the Chinese stock market has been greatly overdone. There are more serious concerns about the real economy.

First is the inevitable slowing in the trend, or sustainable, rate of growth that arises as a result of **China's now higher level of development**. Putting it simply, when a country is extremely poor and undeveloped it is easy to register rapid growth rates. China's slowdown, from the 14pc or so economic growth that it registered at its peak **to about 7pc now**, is fully in line with the experience of other east Asian countries, including Japan, Taiwan and South Korea.

Over and above this, there are serious concerns that it may suffer a shortfall of demand even in relation to this slower growth of full capacity output. The most likely cause is a drop in investment. China has been investing about 50pc of its GDP – unheard of outside Stalin's Russia. And we all know how that ended.

There has to be a serious risk that investment will fall sharply, thereby triggering much weaker demand growth and accordingly a much lower rate of GDP growth – or even, in extreme cases, an outright drop. Concerns are particularly acute in the property sector where there has been a combination of substantial overbuilding and speculative buying.

Yet there are some reasons for reassurance, if not optimism. Unlike most Western countries, the Chinese authorities have ample room to support the economy through policy measures. They have already cut interest rates four times and are ready and able to cut them more if necessary.

This also applies to injections of liquidity. They also have scope to relax fiscal policy, if necessary. Moreover, the banking system is still publicly owned and if the economy were to weaken severely, the authorities would be able to instruct the banks to lend.

Nevertheless, if China is to become a normal economy and to realise its full potential for the benefit of its people, then the share of the economy taken by private consumption will have to rise from its current remarkably low level of 38pc.

Correspondingly, the share taken by investment, and to a lesser extent by net exports, will have to fall.

The Chinese government recognises this. Mind you, recognising it is one thing; taking effective and determined measures to bring it about, while avoiding serious mishap, is quite another.

As and when China becomes more of a consumer society, the impact on the world will be huge. For example, believe it or not, travel out of China by Chinese people already exceeds arrivals into China by a factor of four.**Chinese tourism is going to grow substantially** as the country becomes richer. Currently, only one in 20 Chinese people has a passport.

Imagine the number of Chinese tourists who will descend upon Western attractions, including London, in 10 or 20 years' time.

If you accept my sanguine message about the outlook for the Chinese economy, this does not mean that it necessarily makes sense to pile into Chinese stocks. One of the oldest investment mistakes in the book is to believe in a close connection between economic growth and stock market performance. In practice, the two can diverge quite considerably. The issue is mainly about where the proceeds of growth accrue. They are not necessarily going to land up in the reported profits of Chinese enterprises – especially those with substantial overseas ownership.

The other major issue concerns what is already in the price. As it happens, the Chinese stock market does not currently look fantastically overvalued. But nor does it look cheap. And the leading actors in the market have been behaving in the manner of classic gamblers. The message for investors must surely be “buyer beware”. But for the rest of us, there is no need to panic. The world can withstand many a large drop in emerging market share prices.

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