China's shoppers will shrug off market shudders

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January 8 2016

Note: This article appeared in the *Australian Financial Review*, January 8 2016.

China's stock markets have greeted 2016 with a bang. Or a pop might be a better description.

On Monday the China CSI 300 index plunged seven percent by 1.34pm, triggering an automatic close to the day's trading, almost 90 minutes earlier than scheduled.

Yesterday, things moved even faster: it was all over before 10am, less than half an hour after opening. Local markets have responded to these dramatic events by shedding $75 billion in value.

This makes now a very good time to recall some basic lessons about China's financial markets and its economy from 2015. Between June and August last year, stock prices in China fell by more than 40 per cent.

But the response of Chinese consumers to this turmoil was, as Westpac's Huw McKay eloquently put it, to "offer a collective shrug".

That's important because consumption now drives China's economy more broadly. In the first three quarters of last year, consumption accounted for nearly 60 per cent of GDP growth, a far greater share than the combined contribution of investment and net exports, the old engines of economic activity.

Weakness in construction and manufacturing is being offset by a vibrant services sector and resilient household spending. On Wednesday, the Westpac-MNI China Consumer Sentiment Survey reported confidence being up in December compared with November. The current reading is now higher than it was a year ago.

Economic indicators up

Retail sales expanded by 10.6 per cent in November. Online sales were up 34.5 per cent. Express parcel deliveries jumped 48.1 per cent, while air passenger traffic rose 11.2 per cent. Wednesday also saw the release of the Caixin China Services Purchasing Managers Index. This fell in December but remained above 50, meaning the services sector continued to expand month on month.

In short, all the leading indicators of China's new economy continue to provide comfort. As a result, later this month it's expected to be confirmed that China's GDP grew by nearly seven percent last year.

Put another way, nearly 50 per cent more purchasing power was added in 2015 than in 2010.

One of the main reasons being given for China's stock market collapse is that the People's Bank of China has allowed the RMB to depreciate more rapidly than expected. It shed more than 4 per cent of its value against the US dollar last year and has fallen another 1.2 per cent this year.

A more flexible currency might be disconcerting for investors in the short term, but make no mistake it's a much-needed reform that will contribute to a more stable Chinese economy over time.

A decade ago a fixed exchange rate might have made some sense. China's economy was less than half its current size, growth was driven by exports, particularly to the US, and its borders were far more closed to international capital flows.

But now it's the world's largest economy in purchasing power terms, growth is driven by domestic spending and over the past year capital controls have rapidly been removed.

Economic theory suggests that in this environment persisting with a rigid exchange rate is downright dangerous, for both China and the global economy.

If a market-driven exchange rate is added to the complete liberalisation of interest rates achieved in October last year, the scorecard for China's economic reformers starts to look impressive.

These are some of the more fundamental developments that local investors might wish to ponder, rather than how quickly the bell calling it a day in China's stock markets rings.