

China's Impact on Global Markets

Two centuries back, Napoleon Bonaparte is supposed to have said: "Let China sleep. 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, global stock markets lost \$ 4.5 trillion in market capitalisation last week, slightly more than twice India's GDP! Commodity prices, including oil, softened despite the growing tension between Saudi Arabia and Iran. Many emerging market currencies plunged. The week's developments reminded George Soros, the hedge fund Guru, 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: when the actual rise took place last month, there was hardly a ripple in the markets. Has China become the most powerful driver of the global economy? Many market participants seem to think so: to quote one, "*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 Thursday: on both days, trading was suspended for the day by applying "circuit breakers". The yuan also fell despite huge intervention and sale of dollars by the Chinese central bank: the pressure on the yuan seems to be the result of outflows by foreign portfolio investors selling out, and Chinese companies investing abroad. Even our Commerce and Industry Minister 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 rupee's significant and continued appreciation in real terms. Or is her patriotic pride bolstered when the rupee is described as, say, "the best performing currency in Asia"?

But to come back to the stock and currency 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 come back to the issue of trading suspension, which has attracted a lot of criticism, one needs to have an idea of the risk management systems followed by clearing corporations who guarantee settlement of all trades on an exchange:

- ⇒ The clearing corporation collects an initial margin from the traders taking long or short positions, 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. On volatile days, the margin is increased;
- ⇒ Mark-to-market margin is collected/paid every day depending on the price change;
- ⇒ On days of extreme volatility trading is suspended for collection of mark-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 has 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 Japan in the late 1980s, and the dotcom craze in the US in the late 1990s. The index fell sharply in June, July and August 2015, and has been volatile since then. As for the exchange rate, over the last 10 years, the Chinese central bank had deliberately appreciated the yuan to reduce the trade surplus and re-balance the economy from exports to domestic consumption. From its peak in the middle of last year, the currency has fallen around 7%. Currency pairs like dollar: euro or dollar: yen move that much over a much shorter period without attracting any comment!

A.V.Rajwade (avrajwade@gmail.com)