

China's Market-Intervention Folly

WSJ (A-11)
07/28/15

By **Burton G. Malkiel**

The biggest drop in Chinese stocks in eight years Monday is another sign that Beijing's efforts to prop up prices have failed. Moreover, the interventions themselves have made China's equity markets more volatile and damaged their credibility in the long run.

To stabilize stock prices, Beijing has employed numerous techniques, including suspending trading for a time on well over half of listed A-shares. Short sales were banned, and major shareholders were prohibited from selling. New initial public offerings were disallowed.

China needs more professional participants in its equities markets. But why should institutions buy when the government can control if and when they can sell? And ordering state-owned enterprises and brokerages to buy stocks with borrowed money to shore up prices only reinforces the notion that the market is rigged.

Ultimately such actions increase risk levels and the required rates of return on equities. After all, it was the government's encouragement of the public's margin buying of stocks that contributed to the 150% increase in prices before China's equity markets went south this summer.

The lesson from the stock-market instability is that continued economic growth will depend on

continued economic restructuring, but growth will be compromised by endless bureaucratic interventions. A retreat from economic reform is the prime obstacle to continued Chinese progress.

When President Xi Jinping took office in March 2013, his two main goals were ending pervasive corruption in the economy and giving markets a "decisive role" in allocating resources. Progress on these two fronts, he said, would modernize the economy and lead to "the great renaissance of the Chinese nation."

A retreat from economic reform is the prime obstacle to continued Chinese progress.

Mr. Xi recognized that too much economic activity was controlled by inefficient, corrupt and complacent state-owned enterprises and that (at least partial) privatization should be encouraged. By subjecting their ability to obtain financing to market forces, the companies could become more accountable and efficient, and domestic innovation could be fostered. Selling stakes in locally owned enterprises could also help heavily indebted local governments pay down debt.

But reducing the government's dominant role in the economy can

only be accomplished by free and well-functioning capital markets. Unfortunately, recent events suggest that the Chinese government is in danger of reverting back to its traditional command-and-control approach to financial markets.

Chinese leaders appreciate the important role that a smoothly functioning stock market can play in allocating investment capital to its most promising use. A well-functioning capital market is one of the important factors making the U.S. a leader in efficiency and innovation.

But China has misread the lessons from U.S. success. One cannot control capital markets and still believe that they will provide the correct signals to influence the allocation of capital resources toward innovation and new technologies.

Moreover, it is not possible for a government to permanently influence either the level or structure of securities prices. The Chinese government's actions have very likely made the domestic stock market even more volatile in the long run, reducing the market's effectiveness in allocating real resources.

China desperately needs more-efficient and better-developed capital markets if it is to continue its economic transformation. This can only be accomplished by freeing up these markets, not by manipulating them.

Mr. Xi should be encouraging professional institutional inves-

tors from around the world to freely buy and sell Chinese shares. A market where more than 90% of the activity is generated by unsophisticated, individual "stir-fry" investors who buy and sell stocks excessively will be unstable. Beijing also needs to allow cross-border investments in the fledgling Chinese bond markets.

The Chinese government's proper role is to eliminate accounting fraud, encourage better corporate governance, and require full and fair disclosure. And the markets would be much better off if relatively substantial and stable margin requirements were enforced. Leverage has always been associated with greater instability.

China's economic "miracle" is a testament to the virtues of relaxing controls and encouraging market incentives. Backing away from economic reform in the face of stock-market instability presents the greatest threat to the country's growing prosperity.

The lesson from the recent market turmoil is that future economic gains will not come from economic tinkering and increased leverage but from painful restructuring of inefficient state-owned enterprises and poorly functioning capital markets.

Mr. Malkiel, chief investment officer of Wealthfront, is the author of "A Random Walk Down Wall Street" (W.W. Norton), now in its 11th edition.