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MAKING SENSE OF THE MARKET 'FRET-FEST'

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The gyrations of global stock markets over the past week have certainly given investors some food for thought, but stepping back and putting them in context can help avert unnecessary panic.

China's battered equity markets regained some ground in the final days of August inspired perhaps by reports that Beijing's market rescue fund was raising more money.

Although the share price falls had been interrupted the debate about their significance has not.

To make sense of a stock market plunge, you have to decide whether it is *reflecting* economic woes, *anticipating* them, or *causing* them. Some people worry that the dramatic tumble in China's markets in recent weeks is a forewarning of economic dangers to come. But that gives China's stock markets too much credit. These are the same markets that attracted ridicule earlier this year for their bubbly detachment from fundamentals. One should not set too much store by the divinatory powers of China's equity investors.

China's stock market drop instead reflected two things we already knew. The economy had already weakened and so had the government's appetite for preventing market falls. The government and its proxies, which tried to rescue the stock market in July, were reluctant to buy more equities if they could possibly help it. They already own a big chunk of China's freely-floating shares and their efforts to date have allowed many retail investors, who bought stocks with borrowed money, to repay their loans and retreat out of harm's way. On 14 August China's securities regulator posted a notice on its website, explaining that CSF corporation would not step in to the market again unless systemic risks loomed. That left the equity investors without a government-issued comfort blanket in the face of bad news.

The bad news then duly arrived on Friday 21 August when the Caixin manufacturing Purchase Managers' Index fell to a 77-month low. That worrying piece of data played into broader fears for China's economy. It lent credence to the idea that China's surprise decision to devalue the yuan earlier in the month was a desperate bid to prop up exports, rather than a liberalising institutional reform (with some potentially expansionary side-effects). It also gave weight to the idea that China's earlier stock market collapse in July had seriously damaged its real economy. Despite its limited informational value, that fall succeeded in spooking US markets, and the US sell-off then spooked Chinese investors in turn. It was a mutual fret-fest.

By 27-28 August, Beijing may have decided that it could no longer sit on its hands. China's vice-finance minister said that local-government pension funds would be allowed to invest in equities, as soon as possible, although he insisted that the timing of any such investment would be left to professional managers. It was also reported that CSF corporation was raising another 1.4 trillion yuan, in case another rescue effort was required. That was enough to drive the market up by almost 5% on Friday 28 August.

These gestures to prop up the market were preceded by more orthodox and justifiable measures to prop up the economy. China's central bank reacted by cutting interest rates for the fifth time since November and easing reserve requirements. (This stimulative measure was accompanied by a liberalising reform, removing interest-rate ceilings on deposits of over one year.) Monetary easing will lighten existing debt burdens. But its impact on spending will be limited if loan demand remains weak. For that reason, investors should keep a careful eye on China's various fiscal efforts. Public spending has been unusually inhibited in recent quarters, thanks in part to Xi Jinping's crackdown on corruption and Beijing's clean-up of local-government finances. China is undershooting

its fiscal deficit target for the year, allowing government deposits to pile up in the banking system. That gives it room now to do more.

Many commentators will groan at the prospect of further fiscal stimulus, recalling the wasteful investment spending of 2009 and 2010. But although that spending spree did misdirect some resources, much of that labour and capital would have been entirely squandered without it. In what was a time of crisis, the alternative to poorly planned production was no production at all.

Furthermore, stimulus this year need not take the same form as the stimulus efforts of the past. It could involve tax cuts and higher social spending, rather than heavy public investment. Where it does involve public investment, the spending appears to be devoted to China's many 'under capacity' sectors, such as drainage systems, affordable housing and water decontamination. Through these efforts, China should be able to restore its growth rate in future quarters, without slavishly replicating the growth patterns of past years.

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