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Did China's Stock Market Crash Just End Economic Reform?

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The beauty of markets is that they have a mind of their own. For the Chinese government, this has been a tough pill to swallow.

Try as it might, the Chinese government was unable to arrest the decline in the domestic stock market last week. The central bank cut benchmark interest rates and the amount of money banks must keep with it on reserve. A government investment vehicle made it known that it was buying ETFs. The securities regulator eased regulations on margin trading and the Stock Exchange cut transaction fees. Despite this, the benchmark Shanghai Composite Index declined 12% over the course of the week, bringing the total decline since June 12th to more than 28%.

Investors talk in front of a board displaying share prices at a security firm in Shanghai on July 1, 2015. (STR/AFP/Getty Images)

If the government is honest with itself, it must admit that it failed to control the market. It tried, and tried some more, and the market kept doing what it wanted. Plagued by a deterioration in sentiment and deleveraging, it kept falling.

One might be tempted to rejoice that the Market triumphed over the Communist Party. Along a similar vein, Bloomberg News last week wrote: "Stock investors of the world unite! For the first time in modern China, you outnumber the Communists."

There will, of course, be many China bears highlighting the risk of social instability from the recent market collapse. It is certainly reasonable to question whether the Chinese people are losing faith in the Chinese government's willingness and ability to watch over its people after the recent crash. After all, the prevailing view in China was summed up by comments from a retail investor quoted by Bloomberg:

"The tone from the state media is particularly helpful to retail investors like me, as I have a job to do and am pretty busy," said Yao, 35. "China's stock market is really different from other countries. The government surely has some measures to control the movement."

It is likely for this reason that the securities regulator suspended IPOs and 21 securities firms released a statement on Saturday that they will spend 120bn yuan ($19.3bn) to buy stock as long as the benchmark index is below 4,500. Ultimately, the government was afraid it would lose the faith of the Chinese people.

The latest support measures will surely drive a recovery in the market regardless of how dangerous they may be. Offering investors what is essentially a risk-free return of 22% (driving the market from its current level of 3,687 back to 4,500) will mean that they pile the risk back on, leverage and all. This suggests that another crash awaits the market at some point in the future.

Instead of delighting in the power of the market or worrying about the next stock market boom-bust cycle, we should instead try and discern what lessons the Chinese government took from this whole experience. After the stock market collapse, I worry that instead of respecting the market, the government now fears it.

The core theme of China's economic reform is reducing the role of the government in the economy in order to let market forces play a larger role. Undoubtedly after the market's declines over the last two weeks, there will be those within the government that are suggesting to slow market reforms and maintain control as long as possible, citing as evidence the social unrest that was brewing during the collapse.

No one knows if this is in the conclusion that authorities will reach. If it is, and China backs away from the economic reforms that are desperately needed, then the real troubles are only just beginning.
