THE XI JINPING PUT

To save its stock markets, China is putting its whole financial system at risk

Behold the "Xi Jinping put."

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China's Transition

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Reporter

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> "We must deepen economic system reform by centering on the decisive role of the market in allocating resources…." — President Xi Jinping, "The Decision" of the Third Plenum, Nov. 2013

That *was* the plan, anyway. Not anymore.

In recent days, the Chinese government unfurled a series of measures to stop its stock markets' free-fall the scale of which has never before been seen. It is essentially giving investors a "Xi Jinping put," as Joyce Poon of Gavekal Dragonomics calls it (referring to Mario Draghi's European Central Bank put) in a note

today—meaning, the government is assuring investors it will do what it has to to keep the market aloft.

The measures stanched the bleeding a bit today (July 6); Shanghai Composite closed up 2.4%. However, much more is at stake than hitting numbers. Not only does the Xi Jinping put threaten to scuttle critical financial reforms; it also leaves China—and untold millions of its residents—in a bigger financial mess than ever.

China's intervention is far bigger than TARP

First some perspective on this weekend's activities. The most important of the salmagundi of actions is the security regulator's promise of an initial 120 billion yuan ($19.3 billion) via 21 brokerages to stabilize the market, alongside the People's Bank of China's agreement to provide liquidity support for the margin-trading clearinghouse—what David Cui, strategist at Bank of America/Merrill Lynch, says might be its first step toward becoming the ailing market's buyer of last resort.

The government also vowed to make sure the Shanghai Composite hits 4,500. The scope of this gambit is breathtaking, says Anne Stevenson-Yang, founder of J Capital Research. She notes that analysts comparing China's current rescue efforts to the Troubled Asset Relief Program, the US government's 2008 bank bailout package, miss the fact that TARP rescued operating companies, not a stock index. "[TARP] focused on the viability of operating companies, not the optics that a speculative derivative of the economy represented."

"There is no way to characterize these measures other than as a 'double or nothing' wager," Stevenson-Yang writes in a note today.

The party is gambling away its credibility

The downside of that wager is profound indeed. The government's creation of the Chinese bull market has disproportionately benefitted state-owned companies—and therefore the Communist

Party—by replacing government-guaranteed debt with equity. That equity, of course, has been funded by the little guy—the second, and much bigger, part of the problem. When the state press and government officials began pumping stocks about a year ago, they essentially made a promise to protect the savings of tens of millions of households.

However, the stated strategy might leave them high and dry, says Andrew Collier, head of Orient Capital Research. Given the intensity of Beijing behind the operations, the liquidity the PBoC provides to the market via brokerages is likely to be many times larger than the announced 120 billion yuan.

"[The government] will have to focus on the indices and the big cap [companies] to affect the market, which will completely leave out the small caps that retail investors have been buying," Collier tells Quartz. "If these stocks fall, there will be a lot of protesting unhappy investors. More problems for the leadership. They can support it short-term but not long-term."

The more China stokes risk-taking, the more painful it will be to withdraw government support

Then there's what this means for reform. The quote above is the most celebrated of Xi's much-vaunted Third Plenum policy metamorphosis: to let markets—and not government policy—determine the value of money and risk.

These reforms were ostensibly important to Xi at one point because, ultimately, China's miracle is getting risky and expensive to maintain. When the government deems an enormous swath of China's economy—e.g. the property market, state-owned companies, financial products, now the stock market—Too Big to Fail, it encourages wanton risk-taking. If the investment pans out, big returns; if not, no worries—you'll be bailed out. That's become very expensive; China has racked up at least $28 trillion in debt, more than half of which is corporate.

The more wanton risk-taking there is, the more it will cost, both financially and politically, when the government begins removing

its support, letting the market do its job.

The government-induced stock rally puts a lot more people at risk

Chinese stocks are a good example of this. Politically, when the government decided to create the stock rally, Xi and the Communist Party put their credibility on the line with more people than ever before. Past policy decisions might outrage a region, or an interest group, but usually not millions of households across China.

Financially, hundreds of billions of borrowed yuan have flowed into equities. If that wealth is lost, those debts can't be repaid—which is why the government-rigged Chinese stock rally may have left the whole financial system at risk, says Orient Capital's Collier.

"The real danger in all this may be the banks," he says. "They have an undetermined exposure in loans to the stock market, directly to consumers or indirectly through intermediaries, such as the shadow banking sector (e.g. trusts). A collapse in share prices could have a strong negative effect on bank balance sheets."

The government may be too late to change course

There's still a chance to keep reform on track, argues Gavekal's Poon. The volatility of the last few weeks will alert China's leaders to these systemic vulnerabilities, she writes, prompting them to accelerate economic and financial reform.

JCap's Stevenson-Yang is less optimistic.

"Chinese institutions are too outdated, too inflexible, too lacking in coordination to be of any use when the one thing the government can do—aggregate and direct flows of money—is undermined as a tool," she says. "The sell-off is similar to a bank run, in which each player's only real motive is to capture as much of the value of his assets as possible before the whole edifice collapses."