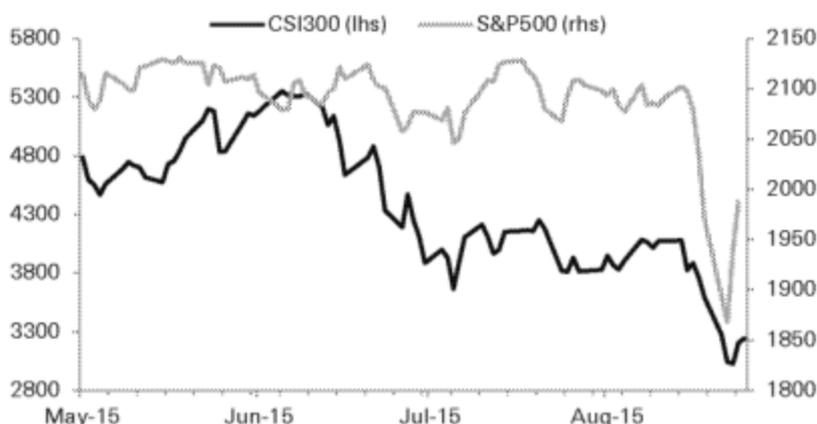




Chinese equity boom/bust had no discernible impact, but something suddenly changed in the middle of last week to force global investors to pay attention.

Figure 1: Chinese and US equity markets



Sources: Reuters and Deutsche Bank Research

China adopts a hands-off approach to the equity market...

The catalyst, as we see it, was not a reassessment of fundamentals but of the Chinese government's willingness to continue to prop up the equity market. The 6.2% decline in Chinese equities on August 18 was the second biggest daily decline since the government's intervention began on July 6. Investors worried that, after having spent perhaps CNY1.5tn or more, the government was no longer willing to support the equity market. Then, when the 3,500 level – which investors thought the government would defend – was breached temporarily on August 21 and then definitively on Monday this week, investors took flight.

If the Chinese government is now admitting that it cannot – should not – try to prop up the equity market but instead let market forces set the price of capital this is an inherently good thing. Most investors and economists were critical of the intervention in the first place and as we have argued for years the mispricing of capital has been China's biggest problem. But this apparent change in policy came as a rude shock to investors in the midst of a major correction.

...and the currency markets too?

An even ruder shock potentially lies in store if the same laissez faire attitude extends to the currency market. The PBOC made what they described as a technical adjustment to the CNY fixing mechanism on August 13, another step in the exchange rate reform process. Strictly speaking, there are at least three prices for the Chinese currency in Greater China: the onshore price (CNY), the offshore price (CNH) and the central bank's reference rate, the fixing. There is also an offshore non-deliverable market and each of the other offshore centers for renminbi trading have their own exchange rate. On August 13, the PBOC decided to unify the CNY spot rate and the fixing. But instead of intervening to lower CNY to the fixing, they re-set the fixing 1.9% higher to where spot had closed the previous day. Henceforth, they said, the fixing would follow the previous closing spot price.

This was the largest one-day devaluation in the fixing rate in more than 20 years and was five times the previous maximum daily change. And by building in a self-referential mechanism – setting the next day's fixing equal to the