

Think you need nerves of steel to invest in China's stock market? Try regulating it.

The government promise of investor protection runs deep in China. To stand by and let the stock market seek its own level will take a strong stomach. In a country where markets are routinely managed and defaults are rare, investors may feel betrayed by the government's lack of direct stock market intervention to mitigate the 15 percent drop this past Monday and Tuesday, especially after the propping up we saw last month. To let the market reveal new pessimism about China's growth prospects will even further test the nerves of a government accustomed to managing information flow.

However, while this week's monetary policy measures targeted at the broader economy may be warranted, direct stock market intervention causes more problems than it solves. If China's regulators can stand their ground, this week's turmoil will provide them with an opportunity to clarify their stock market regulatory stance, reduce distracting policy uncertainty, let China's stock prices find their fundamental value, and continue on the promised reform path to more sustainable economic growth.

Stock markets are messy and the price discovery process can be roiled by exuberance on the upside and panic on the downside. But these same emotions are precisely what underlie the market's ability to generate new information so effectively. Greed and fear drive investors to produce private information about potential gains and losses and buy and sell stocks accordingly. The clearing of these trades then aggregates this diffuse information into public signals to corporate managers and other investors, leading to more efficient corporate investment and capital allocation across firms.

Our research suggests that, contrary to perception, China's stock prices have been surprisingly informative about future corporate earnings and have been generating useful signals for managers. Specifically, the predictive power of prices for future earnings in China is comparable to that in the United States, and the strength of that predictive power is significantly correlated with corporate investment efficiency.

But propping up stock markets blunts incentives for investors to produce information. And uncertainty about stock market regulatory policy further diverts investors from the work of producing information about future corporate profits and turns them to reading the policy tea leaves. Furthermore, policy uncertainty creates additional risk that investors discount, depressing stock prices.

Stock markets around the world plunged over the last week as global investors digest new economic data and parse its implications for corporate earnings growth. The future of China's economy, which appears to be slowing, is one of the most important sources of fundamental uncertainty. The path of its reform and development will have broad global impact as well differential effects on resource stocks, infrastructure stocks, tech stocks, and other consumer stocks. But the signals from China's stock prices are now clouded by uncertainty about regulatory policy on trading and liquidity, margin lending, short selling, and government-directed stock purchasing. The potential effects of investor disappointment about the government's lack of direct stock market intervention this week

makes it impossible to tell how much of the market drop was really on bad news about corporate prospects.

The informational and allocational role of the stock market is now more important than ever, as China moves away from a faltering growth strategy based on centrally planned investment. Moreover, although banking reform, interest rate liberalization, and exchange rate liberalization may need to proceed more slowly to ensure financial stability, China has comparatively little to fear from stock market turbulence. Although some investors reached a high degree of leverage buying stocks on margin earlier this year, on average Chinese households use low leverage and hold primarily bank deposits and other products, with only a small fraction of their financial portfolio in stocks. A stock market crash would be much less likely to precipitate a significant negative consumption shock than it would in the United States, where household balance sheets are more highly levered and stock market participation is broad and deep.

Because of its political heritage and deep pockets, China has the biggest implicit guarantee problem in the world. That is, there is an unwritten understanding that financial products issued and marketed by banks and other state-sponsored institutions will not be allowed to default. Implicitly insuring investors in the banking and shadow banking system blunts their incentive to perform credit analysis and allocate capital efficiently. But the expectation of the government guarantee is so deeply ingrained that China will have to roll it back very slowly and carefully to avoid a destabilizing run on the banking sector. The temptation to protect equity investors from downside risk must also be strong, but such protection is unnecessary and counterproductive.

Now is the time for China to clarify that its stock prices will be determined by markets and let equity investors go to work. They will produce the information that the global economy needs most right now.