



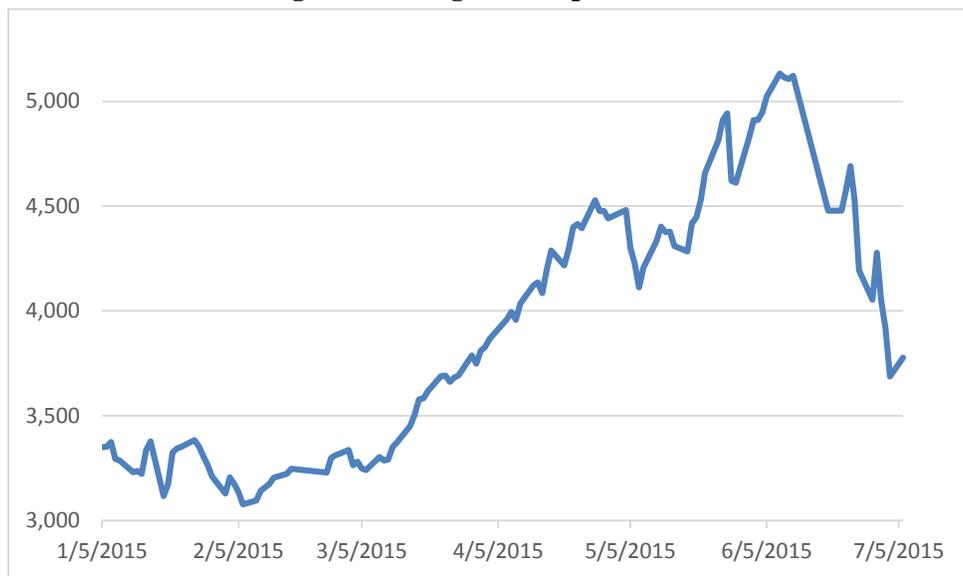
July 13, 2015

China's Stock Market Collapse and Government's Response

Nargiza Salidjanova, Senior Policy Analyst, Economics and Trade

Following a period of extreme volatility beginning in May 2015, Chinese stocks began experiencing an extraordinary fall. In the weeks since its June 12 peak, China's main exchange, the Shanghai Composite, was down 25 percent (see Figure 1), while Shenzhen, the smaller, tech-dominated exchange, was down 35 percent.¹ Since the two exchanges started their slide, investors lost about \$3.5 trillion, equal to China's total market capitalization in 2012.² This collapse challenges the government's credibility and commitment to reform.

Figure 1: Shanghai Composite Index



Source: Bloomberg. <http://www.bloomberg.com/quote/SHCOMP:IND>.

The Chinese government responded to the stock collapse with heavy interference, ordering brokerages to buy and forbidding shareholders to sell—a dramatic reversal following President Xi Jinping's pledge at the 2013 Third Plenum that the market will play a “decisive” role in all aspects of the economy.* Even as the government threw

* For more on President Xi's economic reform priorities and pledges (the Third Plenum reforms), see Nargiza Salidjanova and Iacob Koch-Weser, “Third Plenum Economic Reform Proposals: A Scorecard,” *U.S.-China Economic and Security Review Commission*, November 19, 2013.

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out new policies to intervene in the market and arrest collapse, shares continued to tumble. It was not until July 9, that Chinese shares saw gains, with Shanghai rising 5.8 percent, and Shenzhen 3.8 percent.³ Despite the fall, the two exchanges are up 74 percent and 84 percent year-on-year.⁴

Although there are early signs of a recovery, the rise, volatility, and collapse of Chinese stocks points to several important conclusions for U.S. policymakers:

- The increasingly desperate actions by the Chinese government bring into question President Xi's commitment to allow increased market pricing in the economy. If the past few weeks are any indication, the government will continue prioritizing growth over free capital markets. In addition, the inability of the government to quickly stop the rout dented President Xi's image as a leader in absolute control of all aspects of economy and society, though it is unlikely to lead to major political change.⁵
- Policies pursued by the government in search of new sources of growth (beyond the traditional emphasis on fixed asset investment) are at least partly to blame for the creation of the bubble. Investment in the stock market was viewed as a way to generate capital for SOEs, to boost funding for private companies, and to provide households with means of realizing returns. Official media outlets, including *People's Daily*, ran laudatory editorials describing the stock market growth as a sign of economic strength.⁶ At the same time, regulators were reluctant or unable to step in because of interagency infighting and the political pressure to allow stock growth.⁷ This strengthens doubts about the government's willingness to enforce regulations and market discipline if that means slower growth.
- The isolation of Chinese stock markets, where foreign investors own only about 1.5 percent of Chinese shares, means global markets will remain relatively unaffected.⁸ The effect on China's domestic consumption will likewise be contained, since stocks account for less than 15 percent of household financial assets.⁹ Nevertheless, this market rout is a major source of domestic concern in China. Chinese stocks remain overvalued and the economic fundamentals remain weak.
- Although real impact on the global economy is limited, the crash sent a signal that Chinese economic slowdown and instability are becoming entrenched, undermining the confidence of foreign investors.¹⁰ On June 9, MSCI, a provider of global equity indexes, announced that Shanghai and Shenzhen will not be included in its Emerging Markets Index. Although MSCI couched its decision in positive terms, it pointed to three areas where Chinese stock markets need substantial improvements: allocation of investment quotas for foreign investors, restrictions on capital mobility, and ambiguous ownership rules for foreign shareholders using the Shanghai-Hong Kong Stock Connect.¹¹ The Chinese stock market bubble—though not mentioned directly in the MSCI announcement—was a major source of concern for foreign investors.¹²
- Impact on U.S. markets has been limited, and concentrated primarily on Chinese companies listed on the U.S. exchanges. When the China Securities Regulatory Commission (CSRC) suspended all new initial public offerings to reduce volatility, it left stranded U.S.-listed Chinese tech companies, which as early as March started delisting in the United States to re-list in China and take advantage of the surging stock markets there.¹³ Chinese U.S.-listed companies, which did not de-list, were affected in a different way: Their shares lost value on U.S. exchanges, as investors were spooked by the Chinese market collapse.¹⁴

What did the Government Do to Prop up Stock Markets?

According to research firm Gavekal Dragonomics, the financial sector contributed 1.4 percentage points to China's gross domestic product (GDP) in the first quarter of 2015—in other words, without the surging stock market, the economy would not have reached Beijing's goal of 7 percent GDP growth.¹⁵ This explains the series of measures announced by Beijing to stimulate growth and prop up the stock market. These include:

- On June 24, the State Council released a draft proposal to relax the maximum loan-to-deposit ratio, currently at 75 percent. If it becomes law, the new proposal could be another step in the liberalization of China's domestic financial system. However, it is not clear if this change will achieve its immediate goal—an expansion of credit—given weak demand from borrowers.¹⁶

- On June 27, the People’s Bank of China (PBOC) stepped in to stop a sell-off in Chinese stock markets, cutting benchmark interest and deposit rates by 25 basis points each (to 4.85 percent and 2 percent, respectively) and the reserve requirement ratio (RRR) for some banks by 50 basis points. In a statement, PBOC said the measures were aimed at reducing borrowing costs and “stabilizing growth,” but did not provide implementation details.¹⁷ This is the fourth time the PBOC has cut lending and deposit interest rates since November 2014; it is also the first time since October 2008 the central bank cut both interest rates and the RRR.¹⁸
- On June 29, the Ministry of Human Resources and Social Security and the Ministry of Finance published draft regulations allowing pension funds managed by local governments to invest in stocks, funds, private equities, and other stock-related products. The proportion of investment in stocks will be capped at 30 percent of the pension fund’s net value.¹⁹ The funds have combined assets worth more than \$322 billion (RMB 2 trillion), of which up to \$97 billion could flow into the stock market.²⁰
- On July 1, the CSRC allowed investors to use homes and other real assets as collateral to borrow money to purchase stocks.²¹
- On July 4, 21 brokerages set up a fund worth about \$19 billion (RMB 120 billion) to buy shares.²²
- The same day, CSRC suspended all new initial public offerings to reduce volatility.²³
- On July 5, the CSRC said the PBOC will “uphold market stability” by providing funds (about \$42 billion, or RMB 260 billion) to a state agency, the China Securities Finance, to lend money to brokerage firms for purchases of shares.²⁴ The PBOC also announced that the China Securities Finance will receive liquidity to “hold the line” against systemic risks—in essence using PBOC money to directly buy shares—a radical departure from its traditional role as a lender to brokerages.²⁵
- On July 8, CSRC banned shareholders with stakes above 5 percent from selling shares for six months.²⁶
- The Ministry of Finance is considering lowering the stamp duty on share purchases to stimulate higher investment. The amount of stamp duties collected by Beijing reached \$5 billion (RMB 31.2 billion) in May 2015, 11 times the amount last year.²⁷

The government also reached for propaganda tools, appealing to patriotism to encourage stock purchases and sending policy to the CSRC to investigate “malicious short selling.”²⁸ Listed state-owned enterprises (SOEs) were ordered not to sell shares and to buy their own stocks, with 292 committing to do so.²⁹

At the same time, companies started voluntarily suspending trading of their shares to prevent further loss of value. By July 9, 1,476 stocks, or more than 50 percent of all companies listed on Shanghai and Shenzhen stock exchanges, stopped trading.³⁰ Companies listed on ChiNext, a board for tech startups on the Shenzhen stock exchange, took a disproportionate hit: As of July 10, only 205 of 484 stocks were trading, with the rest suspended.³¹ Since most companies listed on ChiNext are small and private, the suspension of so many stocks bodes ill for their ability to raise money.

It is not clear when the government will start rolling back these emergency measures.

Volatility before the Fall

The dramatic fall in Chinese stocks was preceded by extreme volatility. On June 1, Shanghai was up 4.7 percent after falling 6.5 percent on May 26, 2015. Shenzhen, the smaller, technology- and media-dominated exchange, was up 4.8 percent after falling 5.5 percent.³² The fall marked a glitch in an otherwise dramatic upward trend in Chinese share prices. Despite the drop, Shanghai remained up 52 percent year-to-date, and 149 percent year-on-year, while Shenzhen was up 115 percent year-to-date and 190 percent year-on-year.³³ The short-term surge was attributable to investors’ confidence in China’s economy after China’s official purchasing managers’ index (PMI)* increased from 50.1 in April to 50.2 in May 2015 (official PMI tends to focus on larger, state-owned companies).³⁴ The unofficial

* A PMI below 50 indicates a contraction.

estimate from HSBC, which focuses on small and medium-sized factories, was 49.2 for May 2015, up from 48.9 in April.³⁵

Analysts cited several reasons for the May 26 fall in prices: Central Huijin, a subsidiary of China's sovereign wealth fund, sold shares in two state-owned banks, the Industrial and Commercial Bank of China (ICBC) and China Construction Bank; the central bank drained liquidity from commercial banks by selling them bond repurchase agreements; and brokerages tightened restrictions on giving credit.³⁶

Before the drop, some observers started sounding the alarm over a potential bubble in the Chinese markets. With Chinese GDP growth falling below 7 percent in the first quarter of 2015 and debts on the rise, the speed with which stocks were increasing in value seemed "increasingly disconnected from reality."³⁷ Because Chinese stock markets have always been volatile, however, some analysts warned this decline may not necessarily be the beginning of a broader correction.³⁸

The *Economist* pointed to two reasons why China may be entering bubble territory. First, the price-to-earnings ratio on ChiNext, reached 130, "more than twice a reasonable level."³⁹ Second, companies listed both on the Mainland and in Hong Kong saw their shares trade at a 30 percent premium on the Mainland.⁴⁰ The Shanghai-Hong Kong Stock Connect, launched last year, was meant to prevent such gaps by allowing investors to arbitrage between the two, which would presumably bring them into alignment. Investors, however, have been piling into the Mainland markets with the expectation that the Chinese government will act to boost the economy, given the weakness in key sectors.

The gains came amid the announcement of a new investor scheme to allow for freer movement of funds between Hong Kong and China. Under the new agreement, starting July 1, asset managers in Hong Kong and on the Mainland will be able to sell their funds "to retail investors on the other side."⁴¹ The new program has the potential to allow Chinese investors, who have few domestic options, to invest overseas. However, the main beneficiaries are expected to be global fixed-income investors, who will have easier access to China's domestic bond market.⁴² The program will be capped at \$48 billion (RMB 300 billion) flowing in and out of China each way.

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