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China’s Volatile Stock Market and its Implications

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Significance

China’s stock market reached a frenzied peak and a dismal low this summer, as an asset price bubble months in the making suddenly burst. In response, the government rushed to stem the freefall by cracking down on short selling, injecting funds into the market via large brokerages, altering margin lending rules, and permitting trading suspensions on some stocks. While China’s stock market does not normally impact real economic growth, the involvement of the banking sectors in lending to the stock market and panic itself endangered the financial sector. All of this underscores the fact that Chinese investors have insufficient investment alternatives, that the stock market is underdeveloped, and that the government is too involved in the financial system.

What we need to know

After China’s real estate bubble burst in 2014, leaving investors without investment alternatives, funds poured into the stock market. China’s monetary loosening activity also provided liquidity to banks for margin lending. In June, the Shanghai Composite Index surpassed the 5,000 mark for the first time since January 2008. State media encouraged the growth of the stock market, airing frequent and enthusiastic stock market reports. Higher stock prices also helped state-owned enterprises reduce debt by providing an alternative method for them to repay funds.

Source: Trading Economics
Much of the new investment in the stock market was carried out by retail investors, many of them new to the market. According to the China Household Finance Survey, the largest group of new investors possessed an education level of high school or below with over 60% possessing an education level of middle school or below, somewhat lower than the education level of existing investors (Survey and Research Center for China Household Finance 2012). Few skills were employed in determining stock investment. The latest stock market bubble was not driven by improvements in profits or other firm data, but rather by hype. Ironically, this contradicts research from the period just preceding the asset price bubble which found that China’s stock market was becoming less of a casino and more reflective of fundamentals (see for example, Carpenter, Lu and Whitelaw 2015).

**Analysis**

Fueling the recent equity investment bubble was margin financing and borrowing from other sources. Margin lending was permitted by the China Securities Regulatory Commission (CSRC) on a national level after October 2011. Minimum required account holdings were relatively high, at 500,000 RMB. This was changed in 2013 when the CSRC cancelled window guidance on the minimum level of account holdings, which allowed brokers to set the minimum levels as they wished (Wildau 2015a). The 500,000 minimum was reiterated by the CSRC in January 2015, and rules on margin lending were further tightened in April when the CSRC placed limits on small, risky stocks sold over the counter and banned umbrella trusts. Outstanding margin positions as of the peak on June 18 was $365 billion USD.

Margin financing was carried out via brokerages that then passed on a portion of the loans to banks, which treated the margin loans as collateral for loans to the brokerages rather than to the individual borrowers (Tham and Sweeney 2015). The understanding was that brokerages would later purchase collateral back from banks. Some banks that used margin loans as collateral then packaged them into wealth management products, selling them to retail clients.

**Outstanding Margin Positions (Excluding Short Selling) (RMB 100 Million)**

![Outstanding Margin Positions (Excluding Short Selling) (RMB 100 Million)](image)

Source: China Securities Finance Corporation Limited
Funds from other sources also fed the stock market. These include umbrella trusts and financing companies. Umbrella trusts provided fixed returns to banks and trusts which occupy the senior tranches and variable returns to private investors such as hedge funds, brokerages, and fund-matching companies which occupy the junior tranches. Under an umbrella trust, investors could raise up to five times their margin, enabling them to trade with high leverage without registering with the China Securities Depository and Clearing Corporation (Tian 2015). By contrast, brokerages could leverage up to twice the margin. China Everbright Bank, China Merchants Bank, and Minsheng Bank were extensively involved in umbrella trust financing (Jiang 2014). Experts estimated umbrella trusts to occupy up to 200 billion RMB at the end of 2014.

“Peizi” (配) or fund matching companies lend funds at high interest rates. Many of these fund-matching companies provided margin loans to investors without sufficiently controlling for risk, and sometimes lent much more credit than permitted by official lending limits. Peizi companies opened multiple, subdivided securities accounts with brokerages, channeling about 500 billion RMB through these accounts as of June 30, 2015 (Yap 2015). These financing companies were locked out of margin financing in July 2015 after the China Securities Regulatory Commission restricted brokerages from allowing fund-matching companies to incur margin transactions. Overall unregulated borrowing on margin was estimated at RMB 500 billion to 1 trillion by Haitong Securities in Shanghai (Wildau 2015b), raising margin lending by up to 50%.

Short-selling was made easier on the Shenzhen and Shanghai Stock Exchanges and permitted via the Shanghai-Hong Kong Stock Connect. Short-selling rose after fund managers were allowed to lend shares for short-selling and the number of stocks available for short-selling was expanded in April 2015, but the scale remained far smaller than that of margin lending. After the stock market began to slide, the Ministry of Public Security stated that it would assist the China Securities Regulatory Commission in investigating “malicious” short selling of stocks and funds (Xinhua 2015). In early August, regulators required short sellers to wait one day to cover their positions in order to reduce volatility in the stock market. Foreign investors were also allowed to short-sell some mainland-listed stocks via the Shanghai-Hong Kong Stock Connect beginning in February 2015.

The stock market began a sharp downward descent in mid-June, after a two-week period of extreme volatility. This occurred after the China Securities Regulatory Commission capped margin trading at four times the net capital of trading securities firms on June 13.

The government had done little to stop the stock market bubble from inflating, but intervened copiously to prevent its fall. On June 27, the central bank cut benchmark and deposit interest rates as well as the required reserve ratio to ease liquidity conditions (Salidjanova 2015). On June 29, the Ministry of Human Resources and Social Security and the Ministry of Finance began to permit local government pension funds to invest in stocks. On July 1, the CSRC permitted investors to borrow funds against their homes and other assets to purchase stocks.

On July 4, 21 brokerages were requested to set up a share-purchasing fund in the amount of RMB 120 billion (Salidjanova 2015). The CSRC also suspended IPOs the same day. One day later, the CSRC and the PBOC injected RMB 260 billion into the China Securities Finance Corporation to lend to brokerage firms for the purchase of shares. These moves may be considered the most radical since they represent a state-led “bailout” of the stock market. Already, the total amount of financial injections amount to
RMB 380 billion, but analysts have estimated it at even more. Goldman Sachs put the number at up to RMB 900 billion (Wildau 2015c).

Interventions continued as the CSRC prevented shareholders with stakes over 5% from selling their shares for a period of six months starting July 8. Companies were also suspending trading on their own shares to stop the free-fall. The China Securities Finance Corporation reportedly had RMB 2.5 to 3 trillion in funding available for further injections (Bloomberg 2015).

Analysts have asked why the government took such a heavy handed position in the stock market. The reason for such heavy intervention was not because the Chinese stock market is closely woven into the real economy; it is not. Many of the investors are retail investors rather than institutional investors, unlike in other countries where large funds and other institutions bear heavy stakes in the stock market. Neither are the companies listed on the stock market strong representatives of the real economy per se. Many of them continue to be government owned and IPOs have been restricted on and off. The strong government intervention occurred instead because the latest stock market financing was carried out by institutions that sit at the heart of the financial economy—banks.

Banks indirectly lent to securities firms to fund margin loans. While there is a lack of data on banks’ exposure to margin loans, we know that the exposure had to be less than $365 billion USD, the outstanding margin loans at the market peak in June. Compared to overall bank assets, which fell at $28 trillion USD at year-end 2014, the amount is not large, especially considering that the margin exposure was not carried solely by the banks. Exposure of banks to margin loans had to be less than 1% of bank assets. Still, the atmosphere of panic riddled China’s financial markets as contagion reared its ugly head. Debt, currency and commodity markets suffered as investors feared that liquidity in the banking system would dry up. The yield on Chinese government bonds rose suddenly, and a selloff in dollar-denominated debt issued by Chinese companies as well as in the offshore Chinese RMB commenced (Hunter 2015). The frenzy contributed to the ongoing global selloff of commodities as well.

Although some have speculated that China’s government intervention in the stock market was sheer vanity in the attempt to reach the “Chinese Dream,” this reason appears unsound, especially in light of the evidence that China’s financial economy had hit the point of contagion. Financial markets became linked by panic (as opposed to being linked by counterparty or structural connections, for example) in a climate of heightened risk and potential liquidity shortages. In this way, perception of financial fragility translated into a reality.

Making matters worse was the fact that government intervention was relatively ineffective for some time. The market continued to remain volatile, sliding up and down through the present date (mid-August), and much lower than the peak reached in June. Government intervention in China is typically relatively successful, but the lack of government impact this time around heightened fear in the financial markets even further.

The attendant drama underscores the fact that China’s financial system is woefully underdeveloped—investors have insufficient investment alternatives, the stock market is unsophisticated, and the government is too involved in the financial system. China’s financial system does not efficiently reflect rational market forces. What is more, without real, strong sources of growth, China has been stuck in a pattern of financial boom and bust since the global crisis took root at the end of 2008. From the beginning of 2009 on, China’s leadership relied on asset investment and returns to prop up growth. The
The preceding asset price bubble that inflated through the beginning of 2014 and deflated thereafter was generated in the real estate sector and fueled by shadow banking.

Due to a lack of investment alternatives, savings are often funneled into the latest financial craze. To wit, according to Finance Professor Jianjun Li of the Central University of Finance and Economics in Beijing, many of the funds that went into the stock market had formerly been part of the shadow banking sector that funded the real estate bubble. Due to the ceiling on deposit interest rates, real returns on savings deposits are frequently negative, rendering bank savings a poor alternative to investments with positive returns. Retail investors are often unaware of risks associated with new investments, and the risks may be insufficiently disclosed. Furthermore, China’s financial sector has churned out new investment innovations so rapidly in recent years that the regulatory bodies have had to work double-time to keep up with them, so that in their infancy, new innovations often find themselves with few restrictions.

The stock market itself, despite its recent boom, remains underdeveloped, with lack of sophisticated institutional investors, intermittent accounting and trading scandals, and inadequate representation of the greater real economy. Investors focus on stock price gains rather than fundamentals for a number of reasons. Principally, shareholders have very limited control over management, in contrast to stock markets in other nations, leading them to care less about fundamentals and more about stock price movements (Elliott and Yan 2013). Second, most investors are retail rather than institutional investors, with fewer resources to interpret fundamentals and other important firm-level information, again resulting in more focus on stock price changes. Turnover rates are higher than in developed economies, pointing to the fact that much of the trading is speculative. The majority of investors are unsophisticated. In terms of fraud, corporate insiders may include unlisted assets in listed companies in order to profit from them and auditors may look the other way when fraud occurs. Retail investors focused on price changes may not know or even care about accounting or trading fraud. Finally, listed firms are not representative of the greater economy. The percentage of revenue of listed firms made by SOEs was 80% in 2012 (Allen et al 2015). Much of the output and growth has come from unlisted companies and not by companies represented on the stock market. That discrepancy, then, between real economic growth and stock market performance boils down to the fact that China’s stock market is underdeveloped.

The government is also excessively involved in the financial system—too much so to represent a true market-based system. Certainly, financial bailouts as a last resort make sense where systemic risk is present, but the number of interventions carried out by the Chinese government is excessive, reliance on independent legal institutions for recourse by shareholders is minimal to nonexistent, and firm failure/ market fallout is frequently prevented by government action. In other words, the government ends up putting a ceiling on financial losses but not always on financial gains, promoting asset price bubbles with limited downside. In the last stock market boom and bust, it is clear by now that the government should have better instituted or enforced margin lending rules, reducing the potential for contagion to the banking system, and limited interventions to ensuring liquidity in the rest of the financial system so that a liquidity crisis would not arise. Government intervention was ineffective anyway in the recent stock fallout; investors panicked despite the extensive involvement of the government in trying to stop the bleeding, perhaps indicating that government intervention has lost some credibility.
Policy insights

First, strong investment alternatives are necessary not only for generating yield for retail investors, but also, as has become increasingly apparent, for establishing financial stability. Second, the stock market must better reflect the real economy and provide more control to shareholders. Concomitantly, the government must withdraw from intervention in financial markets in order to promote marketization of its financial system.

It has long been noted that investment alternatives are necessary to satisfy consumer demand for investment products, but it is only in the past few years that we have seen the large consumer desire for investment diversification lead to an increased tolerance of risk on the part of consumers, financial intermediaries, and officials. This is in part because the pace of financial innovation has sped up, to some extent outstripping regulation or regulatory enforcement. It is also due to a slowdown in real growth that has induced some to look to growth in asset prices.

However, we have learned from the real estate and stock market booms and busts that growth in asset prices alone is insufficient to generate long-term (or even medium-term) growth. Strong investment alternatives must be present to cater to an increasingly sophisticated consumer base and promote growth. In this case, complex products that obscure risks such as wealth management products should be eschewed in favor of more readily understood instruments such as bonds. Extensive financial innovation is unnecessary when classic instruments are available and have yet to be properly reformed. China would do well to beef up its bond market.

China should also attempt to reorient its stock market toward more growth-oriented firms, especially those that are not state-controlled, and whose fundamentals more transparent to foreign analysts too. This would allow consumers to have better investment alternatives and may serve to attract more institutional investors, who trade more on firm fundamentals rather than on price alone. Shareholders should also have more voting power for listed firms, even if they are state owned enterprises; this would provide an incentive to shareholders to improve corporate governance of these firms.

Last but not least, the government must play less of a role in its financial sector in order to induce markets to operate properly. Government intervention prompts excessive risk taking and allows poorly functioning markets and firms to perpetuate themselves, with some executives and investors believing the government would consider theirs a firm too big to fail.

Bail-out mentality is the opposite of what China intends to accomplish through its reform process, so it is counterproductive. In order for the government to withdraw from financial markets, sufficient institutional infrastructure must be put into place, especially legal and regulatory enforcement and information transparency. This has long been reiterated but cannot be stressed enough, for China’s financial markets will never modernize if the government, rather than the market, removes all signs of weakness.

China’s stock market boom and bust, despite causing chaos in financial markets over an extended period of time, does not come as a surprise to those who recognize the underdeveloped nature of the financial system. It can only be predicted that, without sufficient reform, history can only be expected to repeat itself.
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References

