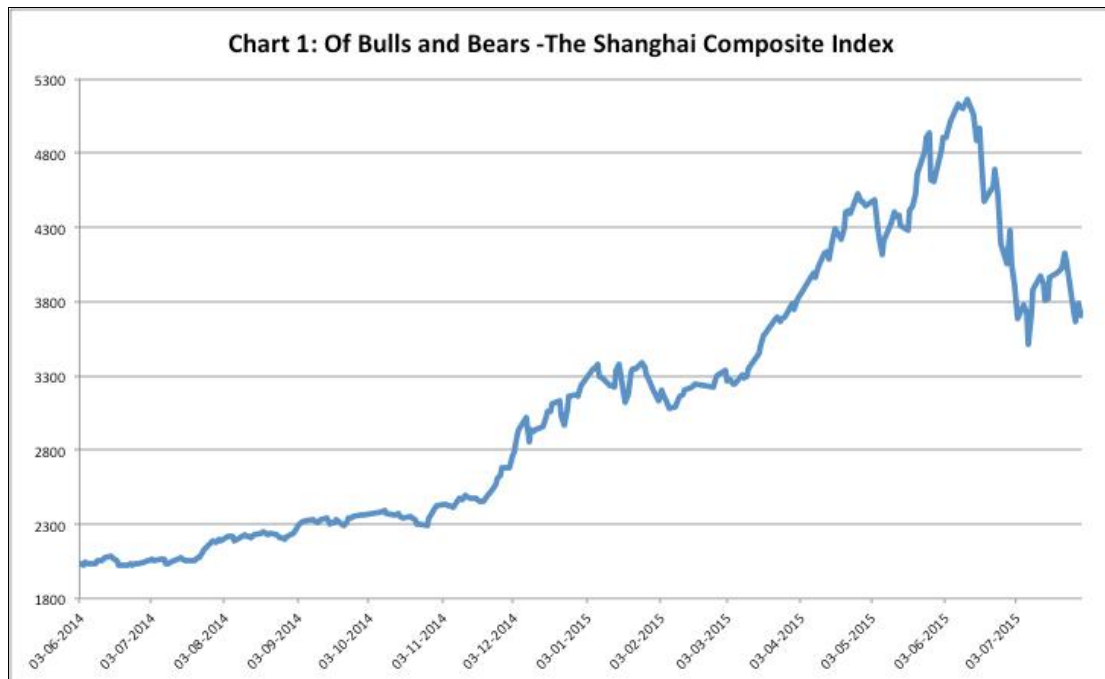


China's Troubled Stock Markets*

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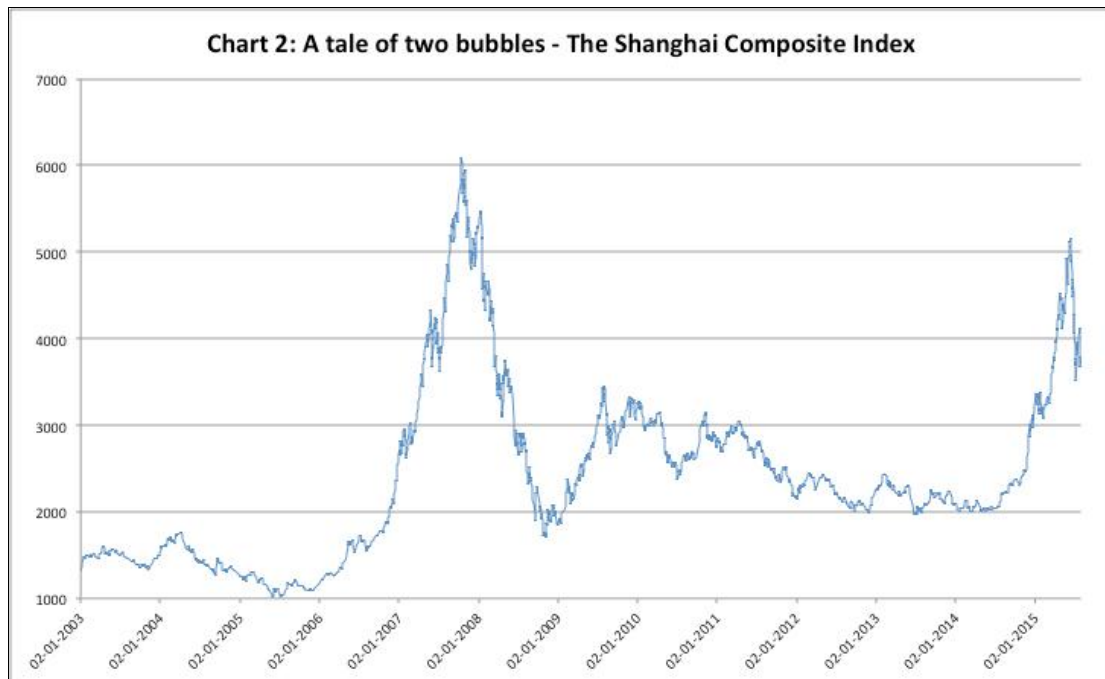
A bull run in China's stock markets has given way to what could be a crash (Chart 1). When the Shanghai Composite Index (SCI) peaked at 5166 in mid June 2015, it had risen by 150 per cent relative to its value at the corresponding time in the previous year. It then fell by more than 30 per cent over the next month to just above 3500. The market was clearly bearish to the extreme. The Chinese government chose to intervene with a host of measures aimed at propping up the market.



The government-initiated-and-driven response was heavy handed. It mobilised a “national team” of state-controlled brokerages and institutions such as the China Securities Finance Corp (CSF). Working through that team the government implemented a number of emergency measures. It sought to infuse cheap liquidity into the system by lowering the reserve requirement for banks and cutting an already trimmed interest rate. It directed controlling shareholders, senior executives of companies and State controlled brokers not to sell their holdings. And the China Securities Regulatory Commission (CSRC), besides reducing lending margins, announced that state-controlled China Securities Finance will be provided liquidity by the central bank to finance (through brokerages) purchases of stocks. In sum, if the market did not work the way the State wanted it to, the government would intervene to force it to do so.

This initially seemed to make a difference, with the index gaining ground to touch 4124 by late July. But those gains could not be held, and by the end of July the loss relative to the previous peak stood at 28 per cent. The market had not lost all the gains it had registered during the previous boom, but clearly a major correction was underway, which even the heavy hand of the State could not prevent.

This is not the first boom-bust episode since the Chinese government decided to establish the [Shanghai](#) and [Shenzhen Stock Exchanges](#) at the end of 1990. In fact, in the not too distant past, during the period between end-July 2006 and mid-October 2007 (a period of less than 16 months), the SCI rose by 275 per cent (Chart 2). Thereafter, over the year ending July 2008, the market crashed returning the SCI to its pre-boom level.



This recurrence of boom-bust cycles in China's short stock market history has questioned the government's belief that there is need to consciously promote stock market activity in the country. There are two roles often attributed to the market in China. The first is that it is a means of mobilizing finance for investment by the private sector. The second is that it is a means to improving corporate governance, by bringing in shareholder scrutiny and market performance pressures to discipline managers. The first of these arguments is difficult to buy. Stock markets are not major sources of finance even in developed economies with predominant private ownership. And, inadequate finance for investment cannot be a problem in a country where investment rates, or the ratio of investment to national income, have approached 50 per cent.

The second role attributed to the stock market also loses relevance because, even after share market growth and the explosion in market capitalization, the share of private ownership in the public companies that remain and perhaps need managerial improvement (such as the big banks) is small. Moreover, Chinese companies, like many of their counterparts elsewhere in the world, are by no means transparent, allowing for shareholder scrutiny of any significance.

There remain two other reasons that could explain the government's obvious desire to promote share market growth. The first is the sheer symbolism of a buoyant share market that points to successful transition to a market economy. The second is the need for a vehicle that can ease the process of privatizing public ownership in the economy.

It is these reasons that seem to explain the measures taken to boost markets established a quarter of a century ago. Initially, China's experiment with stock markets was cautious. Only few companies were allowed to list. Shares were split into two kinds: A-shares denominated in renminbi (RMB) and B-shares in US or Hong Kong dollars. Till 2000, the A-share market was not open to foreigners and the B-share market to domestic investors. It was from 2001 that the government's effort to give stock markets an important role in the economy began. To that end, it chose to spur the market, by allowing individual Chinese investors to invest in B-shares and chosen foreign institutional investors to invest in the A-share market.

But the first real boom was experienced when around 2006 a second set of market-boosting measures were adopted. More companies were allowed to list themselves in the stock market, the so-called non-tradable shares were phased out, and a one-year ban on initial public offerings (IPOs) was lifted. Moreover, rules were relaxed making it easier for foreign

companies to buy A-shares in larger volumes. With rules in what was then the fastest growing economy relaxed, China became the new frontier for international finance. IPOs by Bank of China and Industrial and Commercial Bank of China (ICBC), two of the country's four big banks were a roaring success, mobilizing more capital than expected and evincing huge investor interest. This pointed in two directions. Liquidity in the global economy was huge and China's stocks were the season's favourite. The government had a big hand in making those issues such a success. Prior to the IPO, it used \$60 billion from the country's foreign reserves to wipe out large volumes of problems loans from their balance sheets and recapitalize the banks.

In a high savings nation, this official push to render stock markets buoyant soon attracted domestic retail investors and corporates as well. Along with housing and real estate, stock investment received a boost, resulting in the 2006-7 and 2015 bubbles. However, the presence of individual retail investors is still small relative to population: according to one estimate only 7 per cent of urban Chinese have money in the market, and the figure is far lower for rural China. But given China's large urban population, 7 per cent is not a small absolute number, and corporate investors too had joined the party. Moreover, domestic investors were not constrained by their own capital, since the system encouraged borrowing facilitated by cheap liquidity. Speculative domestic investors borrowed money from the banks and shadow banks to buy shares, and used those and other shares as collateral to borrow more money to invest. This implies that if a downturn occurs, it would not only hit the investors themselves but the rest of the financial system.

The 2014-2015 bull run seems to have been triggered by two developments. First, the infusion of large volumes of liquidity into the system after the government launched a huge recovery programme to counter the 2008-09 global recession. Central to that package was credit expansion aimed at kick-starting real investment. But if opportunities for speculation exist, investors would use cheap credit for speculative investments as well. The second trigger, was the end of the real estate bubble which cheap credit initially contributed to. With the economy slowing, there were few alternative avenues into which surplus liquidity could flow. So as Matt O'Brien noted in [The Washington Post](#) in March: "China's housing bubble is starting to pop, so, right on cue, its stock bubble is starting to re-inflate." The process was helped by the government's decision to withdraw restrictions on the creation of margin accounts that helped finance stock investment with borrowed funds. A speculative boom was triggered, which had to be followed by a crash.

As of now it appears that despite the State's heavy-handed intervention the market downturn continues, with the ripple effects of that downturn still unclear. The State's perception that even when it deregulates markets and gives market players more freedom and flexibility, it can exercise control whenever needed has been challenged. Since there is not much to be gained from the presence of such markets, Beijing should perhaps reconsider its decision to unleash them rather than rein them in.

* This article was originally posted in the Business Line on August 3, 2015.