Special Briefing

# China's Stock Market Crash (July 2015)

## OVERVIEW

China's Shanghai and Shenzhen stock exchanges peaked in June 2015. Their benchmark composite indices had risen 150% and 191% respectively in the previous year, in a bull run that saw stocks in favourite sectors approach heady three-digit price-to-earnings ratios. However, the two exchanges' market values lost well over USD3trn in market capitalisation by July – close to one-third China's GDP – as their indexes fell 32% and 40% respectively. The fall in values was arrested by concerted efforts by all regulatory agencies, the central bank and finance ministry, and at the cost of disruption to the market, including a suspension of 1,442 out of 2,781 listed shares from trading in early July and wide-ranging bans on share sales and short selling.

The tremendous run-up in market values was encouraged by state media and speculation over new merger and acquisition plans for the state sector's leading industries. However, the new element was the liberal extension of margin financing, eclipsing the earlier 2007-08 stock market boom and bust. Margin financing registered with securities brokers hit a peak of CNY2.27trn (USD373bn) in mid-June, up from CNY400bn in July 2014. To this was added grey-market borrowing to buy stocks with much higher multiples on capital, of up to six times, anecdotally (against a maximum of two times via brokers). The best-informed estimate of this higher-multiple borrowing, far more sensitive to smaller falls, is that it stood at over CNY2trn.

The market regulator, China Securities Regulatory Commission (CSRC), made a belated bid to rein in high-multiple margin finance on 13 June, forcing the removal of bank-mediated 'umbrella trust' products from official broker accounts. This came at the same time that MSCI, the global publisher of stock market indices, made the decision to exclude Chinese stock exchanges from its benchmark indices for the time being. Together, the steps initiated a sharp bear market, which caught regulators by surprise, forced sales of margin-financed holdings and was amplified by social media.

As of 26 June, the CSRC still insisted the ongoing correction was healthy. But cuts to policy interest rates and to banks' reserve requirements, the next day, suggested near-panic. By 4 July, China's 21 brokerage companies had been tapped for CNY120bn in government-mandated stock purchases; another CNY260bn in funds to buy majority state-owned blue-chip stocks was announced in days. Brokerages pledged not to sell until the Shanghai A-share index had recovered to 4,500. The market hit a nadir of just over 3,500 on 8 July, down from almost 5,180 at the June peak.

What had been seen as a side-show by other policy agencies became a national emergency for the Communist Party, as its credibility came into question. Banking and insurance regulators joined in, and bans on sales of stocks held indirectly by the finance ministry and by 120 state-owned corporations (along with all major shareholders, directors and senior executives) came into play, and all new share issues were banned indefinitely.

By late July, the scale of official support became clear with the revelation that 17 state-owned banks had lent the China Securities Finance Corporation (CSF), a state-owned body dating from 2011 co-owned by China's stock exchanges, CNY1.3trn (USD209bn) to buy stocks, a sum augmented by a CNY800bn CSF interbank bond sale. In all, this has seen the state push CNY2trn in securities loans to replace the roughly similar sum of high-multiple margin financing for speculators.

As of late July, the market had avoided the levels likely to force mass selling on the part of broker-financed buyers of shares (a level thought to be close to 3,200 in the case of the Shanghai index), and 80% of firms' shares could be traded again. However, sharp day-to-day movements in the broad indices of 5-10% remain plausible and the consequences of the episode are manifold. First, regulators have had to make a second abrupt U-turn on margin finance that expands links between the banking system and stocks. Second, share prices have lost what little connection they had to value and company prospects, and will reflect anticipation of policy even more uniformly. Finally, investors have reason to fear future sudden repeat freezes of the market.

## COMMERCIAL IMPLICATIONS

- China's bid to have the yuan acknowledged as a reserve currency by the IMF in 2016 will be damaged by the failure to maintain a liquid equities market, lowering future financial inflows.
- The post-crash ban on new stock market issuance could continue for months, cutting off an avenue for the refinancing that the debt-burdened Chinese economy badly needs.
- The outsize contribution to economic growth of the financial sector in Q2 is likely to reverse in Q3-Q4, dragging on output nationally and putting at risk the official 7% target for 2015.
- Capital flight, driven in part by wealthy Chinese looking for safe havens, is likely to accelerate into 2016, removing liquidity from the economy and drawing down the yuan, or FX reserves.

## RECOMMENDATIONS

- Be aware that a sharp increase in delinquent payments by Chinese customers could indicate that company funds were gambled on the stock market and lost, or their shares cannot be sold.
- Expect some corporate and retail investors to sell at the earliest opportunity, leading to waves of selling pressure into late Q4 and capping the Shanghai index at close to 4,500.
- Monitor official FX reserves for signs of official intervention to support the yuan, which may be used to mask capital flight; official FX reserves already fell 8% to USD3.69trn in Q2 2015.
- Do not expect a rapid return to a well-functioning, liquid stock market; extensive, locked-up, state-held stakes and the stop-start dynamic of the market will instead continue.

## OUTLINE SCENARIOS

- **Scenario A**: "Benign Serendipity" – the net of cross share-holdings created by the authorities' emergency rescue, involving the China Securities Finance Corporation, brokerages and state-owned banks and enterprises, brings a new management style and more responsible decision-making to managements and boards. The new 'China Inc.', as it is dubbed, becomes a giant, decentralised conglomerate, akin to Japan's 'convoy' system that helped Japan's financial-industrial complex pull through the financial crisis of the early 2000s. Counterintuitively, the lock-ins on investment in shares promote a long-term view and improves financial regulation, reducing the usual gaming of the system among a critical mass of well-placed market actors in the state sector. This post-crash enforced 'value' investing style in fact helps the stock market up on the basis of better fundamentals. Market bulls are justified. **Probability: 15%.**

- **Scenario B:** "Peak China" – historians look back on the crash from the bull market, which had no obvious connection to China's clearly deteriorating fundamentals, as the moment when the truth about China's wrecked economic model came home to foreign investors. Within months of the crash, it becomes clear that new share issues will be banned and a large part of the stock market will not be traded for an indefinite period, lasting years. The ugly truth about the refinancing burden of China's reckless upstream industrial firms and local governments starts to bring about a slow-burn debt crisis, with government bond yields and interbank rates rising despite desperate liquidity injections and rate and reserve requirement cuts. Real GDP growth keeps printing near 7% but the figure becomes increasingly meaningless as industrial deflation continues. FX reserves are no longer reported on a regular basis as the authorities seek to hide capital flight, and all talk of China as the world's largest economy by 2020 crashes out of the media and blogosphere: China enters a depression-like era characterised by a physical landscape marked by excess construction and abandoned industrial capacity, and a demographic contraction as the services sector and disposable income suffer contagion from industry. Commodities globally enter a decade-long bear market. **Probability: 25%.**

- **Scenario C:** "Muddlethrough" – the embarrassing record-screeching-to-a-halt debacle that ended the stock market bubble in mid-2015 highlights the Party's paranoia over anything that could injure its credibility, but the outcome is far short of disastrous and well short of the kind of financial imbalances that the US suffered in 2008. Companies with the right connections and prospects for getting finance find another way besides the stock market. The story of a heavy-but-bearable recession in industry, northern China and real estate, while services sectors broadly keep up their expansion, continues. Real GDP growth declines to average 5% over the next decade but public finances successfully absorb the shocks. Talk of China's imminent collapse gives way to measured assessments. The 2015-20 adjustment is comparable in pain terms to that of the US in the 1980s, when it weathered a tough retrenchment of unproductive industrial sectors and the Savings & Loan crisis. **Probability: 60%.**

Our central scenario is a combination of aspects of scenarios B and C in an approximate 40:60 ratio.

## BACKGROUND AND CONTEXT

China's institutional competence at managing equity markets is now substantially in question. China's policymakers may have shown effective crisis management by some counts, but also how poor they are at preventing crises. This is hardly atypical of financial regulators' difficult position worldwide. Nevertheless, both the crash and the policy response have damaged China's institutional credibility. Financial stability over the short-to-medium term, if it can be secured, will come at the cost of a liquid stock market.

The hunt for 'illegal' market actors to scapegoat, as the crash unfolded, did succeed in highlighting suspected sharp practice and gaming of the system, but knee-jerk restrictions on short-sellers may have exacerbated the June-July crunch by forcing market actors who could not short shares to dump shares. Trading suspensions also forced stock dumping. In addition, exchange-traded funds suffered from highly erratic day-to-day movements when trading in constituent stocks was frozen.

China's share market was substantially undervalued with an average price-to-earnings ratio of under 10 in mid-2014. The stock market should have been a safe way to channel capital into corporations worthy of financing as economic growth slowed nationally. With private and corporate-sector debt close to double GDP and longer-term interest rates still close to 5%, China's debt servicing burden is by far the bigger concern for the central bank and banking regulator, as there is also a public financing crunch: much of the CNY22trn in off-balance-sheet local government debt also needs to be rescheduled, refinanced or written off. The debacle of a bull market gone wrong will overshadow China's further steps towards capital market liberalisation in 2015-16, and spur capital outflows.

As of July, interbank rates appeared in safe territory, suggesting no broader financial contagion. The expiry of the share boom in the short term will actually relieve other sectors from which it had been taking liquidity. The 'wealth effect' of the stock market crash is limited by narrow share ownership (with 90m brokerage accounts, in a population of 1.3bn, against the half of all Americans owning shares directly or indirectly), while equity financing is only 5% at most of all corporate finance.

However, the official response suggested financial system risks would have come to light had the market declined further, for example via bank loans collateralised with shares, or mass defaults by margin borrowers. Such loans collateralised with shares were only 1% or so of bank loans, but with non-performing loan ratios already growing rapidly, albeit from a low official ratio of 1.25% at end-2014 (independent estimates are in the 5-10% range), that would not have been welcome. Indeed, many of the share suspensions of July were to prevent banks' selling such shares as collateral.

In response to these vulnerabilities, China has had to bring about a *de facto* quasi-renationalisation of 7% of market value (at July prices) via state-owned entities buying or holding shares, or loans from state-owned banks collateralised by shares. This is comparable to the Hong Kong authorities' buying up of 11% of the Hang Seng market capitalisation in 1998, which ended profitably, but with China's shakier medium-term prospects, there is no guarantee of a repeat of such a success.

The CSRC, the securities regulator, is among the most junior of market regulators, with an average employee age of 36, where department heads earn 10 times less than what they could in the private sector. It calibrated its policy stance badly and ended up triggering an emergency response going all the way to top levels of the Communist Party, to stabilise the situation. Adding to the government's contingent financial liabilities, this could damage its ability to respond to more serious future crises.

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