Taking stock of China's stock market crisis

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Banking & Finance analysis: The Chinese stock market has fallen dramatically in the past month, culminating in more than $3trn being wiped off share values. Linda Yueh, Fellow in Economics, Oxford University and Adjunct Professor of Economics, London Business School, examines the crisis in more detail and assesses its impact on the UK economy.

Original news

China: CSRC taking further measures to stabilise markets, LNB News 13/07/2015 21

City AM, 13 July 2015: The China Securities Regulatory Commission (CSRC) has issued new rules as it attempts to stabilise markets, following sell-offs which wiped trillions of dollars' value from Chinese equities.

What has led to the stock crisis in China?

Global markets were weakening and the government clamped down on margin lending (whereby the broker can make a demand for more cash or other collateral if the price of the securities has fallen) to buy stocks, so unsurprisingly China's stock markets followed suit. Because some 85% of trades are rather unusually done by retail investors, China's stock market experiences high volatility since it is more likely to follow 'herd' behaviour. Small investors assume that others have better information, so when selling (or buying) happens, there is herd-like movement as investors pile in. The market has also risen sharply (up to over 150% in the past year and is the best performing major market in the world), so some want to cash in, which leads others to do the same. To put it in context, the market is still up from the start of the year despite recent dramatic falls.

What are the challenges with the structure of corporate debt and shareholdings in China?

It is an unusual stock market in that it was only in the past few years when most of the shares were made tradable. Up until 2005 when reforms began, two-thirds of the market was not liquid as it was held by state-owned enterprises and legal persons which were usually state-controlled entities. Now it is dominated by privatised state firms and subsidiaries of state firms, which raises challenges over corporate governance and transparency. It is another driver of herd behaviour because the high level of opacity contributes to small investors thinking someone else has better information, and so they tend to act in packs. It also means that until the market is further reformed and globally integrated, this sort of volatility is to be expected in the future. Think back to the early 2000s when the market lost half of its value and when China was growing strongly. Now, as the housing market deflates, investors have piled into stocks, creating more problems. Developing the bond market is another way of reducing the pressure on the stock market, but the corporate debt market is still in its nascent stages.

How might the crisis in China affect UK individuals and businesses?

The Chinese financial markets are not globally integrated so the direct impact would be minimal. For instance, there are restrictions on foreign investors buying shares directly--so it is largely a domestic market where similarly restricted Chinese savers invest their money as they have few options. But, if the crash were to lead to a hit to wealth and affect the economy, then the British economy would be somewhat exposed and affected by a dramatic slowdown of the world's second largest economy.

What impact will the restricting of equity capital have for businesses?

The suspension of initial public offerings (IPOs) and the holding period barring sales of stocks by directors and others for six months raises questions over whether China is intent on using market tools to govern financial markets that would be on the radar of foreign businesses. Chinese businesses are, of course, used to this.

What techniques are available to the Chinese government to support the markets? How does China differ from other stock systems/government regulations?

In theory, the tools are similar, with more of a reliance on administrative tools such as suspension of IPOs. However, this crash has shown that the Chinese Government will continue to use unusual methods. These include the pledge by large brokerages to buy shares, which is not something seen in other markets. As I mentioned earlier, allowing over 70% of listed firms to suspend their shares for fear of decline is also rather unique. All of this points toward China's long road ahead to become a fully marketised economy.

Interviewed by Susan Ghaiwal.

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