HOUSE OF LORDS

In Focus

China's Stock Market 'Crash'

In recent weeks, the value of China's stock markets has plunged. After a 12 month rise, the value of shares in both of China's main stock exchanges reached a peak on 12 June 2015, then fell severely, with the Shanghai Composite Index and the Shenzhen Composite Index losing 32 and 40 percent of their value respectively. According to the *Washington Post,* this wiped out $3 trillion in share value since mid-June, which is "more than the value of France's entire stock market". Commentator Timothy Lee observes that shares started to fall after 12 June 2015, the same date as the China Securities Regulatory Commission (CSRC) announced draft rules to cap margin lending in response to concerns about an equity bubble. The crash follows a year-long stock market boom, which some commentators have compared to the dot-com bubble of the 1990s. In the twelve months leading up to the crash, the Shanghai Composite saw gains of more than 150 percent. Likewise, in late-May 2015, the *Economist* reported that the Shenzhen Composite had tripled over the past year.

In recent days, China's stock markets have shown signs of recovery, amid significant intervention by the Chinese Government to stabilise the markets. Over 9–10 July 2015, the Shanghai Composite saw gains of 10.9 percent—the biggest since 2008—while on 10 July 2015 the Shenzhen Composite also finished up 4.1 percent. These gains have continued into the following week, with the Shanghai Composite and Shenzhen Composite finishing up 2.4 and 4.2 percent respectively on 13 July 2015.

China's Stock Market Boom

Many commenters have drawn attention to the possible role of margin financing in driving China's stock market boom. Margin financing is where an investor borrows money from a broker to buy stock. The loan is secured against the stock purchased, and if the value of the stock falls, the investor is required to provide more cash to the broker. According to the *Financial Times*, "trading on margin magnifies gains and losses and regulators often limit the amount investors can borrow". The *Washington Post* claims that following the relaxation of rules governing these practices, margin finance "now plays a bigger role in the Chinese market than it has in perhaps any other market in history". The paper also suggests that the rise in margin financing was underpinned by an expansion in China's money supply through interest rate cuts and "easy monetary policy". This point is also picked up in the *Financial Times,* which notes that margin financing increased from Rmb698 billion at the end of October 2014, to Rmb2.7 trillion by 18 June 2015. In addition, the paper suggests that an "unknown amount" of margin lending was funded by shadow banks through financial structures called 'umbrella trusts'. These allow for higher levels of leverage, and are less regulated than traditional margin lending.

Observers have also noted the effect of an influx of new investors into China's stock markets. For example, the *Economist* reasons that retail investors—as opposed to institutional investors—account for 90 percent of daily turnover, and could have contributed to market volatility. Equally, the *Washington*

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Post suggests that the Chinese boom was driven by novice investors entering the market, who were often "uneducated and inexperienced". However, the *Financial Times* disputes these arguments, and suggests that while "retail investors do make up a large share of overall market participants, their share of overall market value is probably 5 percent or less".

China's Response

China's Government has recently intervened heavily in an effort to tackle the stock market's fall. In late-June 2015, China's central bank cut benchmark interest rates from 5.10 to 4.85 percent, while early-July saw the CSRC announce a relaxation of margin financing rules and an investigation into market manipulation. Meanwhile, the Chinese Government has banned listed company shareholders with five percent or more stakes from selling their share for six months, and 1,476 out of 2,808 of China's Shanghai and Shenzhen listed companies have suspended trading in shares. On 5 July 2015, the CSRC announced that China's central bank would provide liquidity to China Securities Finance Corporation. This state-entity provides margin financing to brokers, and commentators have described the intervention as "quantitative easing with Chinese characteristics". The *Financial Times* reasons that this "casts the central bank as buyer of last resort for assets shunned by investors", and is similar to emergency measures taken by Western central banks at the height of the 2008 financial crisis.

Risks to the Wider Economy?

Commentators are divided over the effect China's stock market crash will have on the wider economy. Timothy Lee writes that the question for China's economy is "whether the plunge is just an ordinary correction after a year of big gains, or if it's the first sign of deeper problems in the Chinese economy". According to the *Economist*, the problems in China's stock market appear to be "disconnected from economic fundamentals", observing that China's economy remained sluggish despite the stock market boom, and that the stock market is a small part of the Chinese economy. The *Economist* also observes that, while the value of freely floating shares in most rich countries can exceed 100 percent of GDP, in China, it is only about a third of GDP. Similarly, the BBC reports that "there does not seem to be any correlation between this crash and the health of the wider economy", and suggests that while there could be a wider impact, estimates indicate that only 15 percent of households could be effected directly.

However, the *Financial Times* argues that it is unclear how much money has been borrowed to buy stocks and how many shares have been used as collateral against loans. As a consequence, the paper claims it "raises the spectre of a series of brokerage or bank failures", and states that it is the "unknown potential impact of these two 'transmission mechanisms' in the wider economy that appears to have spooked the Chinese Government". Meanwhile, writing in the *Telegraph,* Jeremy Warner suggests that there are a number of parallels between the current issues in China's stock market and the 1929 Wall Street Crash that preceded the Great Depression. Warner believes that, as in the run up to the Wall Street Crash, China's stock market boom has been fuelled by an expansion of credit and coincided with a speculative real estate bubble. He also argues that the macro-economic backdrop is "surprisingly similar", with rapid urbanisation and increased industrial activity but also a number of warning signs indicating a potential economic slowdown, such as a lack of global trade growth.