

IN-DEPTH ANALYSIS

Exceptional measures: The Shanghai stock market crash and the future of the Chinese economy

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ABSTRACT

This summer has been a dramatic one for China's stocks markets, with most indices registering losses of more than 40 % from their annual high. European markets have also suffered, and many observers across the globe are now nervously focused on the Asian giant whose economy drove so many other countries' in recent years. Yet the real economic significance of the drama in China may not stem from its bourses' losses; those who lost money on China's stock market are only a small percentage of its citizens, and many are simply shaving their precipitous profits, rather than facing calamitous losses. A more significant economic outcome may result from the Chinese government's efforts to intervene in its stocks markets. The measures adopted by Beijing since the sell-off began – in some cases, measures that were quickly abandoned – would be unthinkable in a fully market economy. Many measures largely contradict the government's commitments to open and transparent financial exchanges. As the liquidity that a slowing Chinese economy badly requires is frozen, it could be Beijing's heavy-handed involvement in local markets – and not their pared prices – that determines the economic fallout from the summer losses.

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1 The Shanghai stock market crash

The Shanghai Composite Index grew exponentially before suddenly collapsing in July and August 2015.

In August 2015 the Shanghai Composite Index (SCI) fell by more than 20 %. The losses, concentrated at the end of the month, represented the second significant market drop in less than two months, following a similar plunge in July. The rout has been dramatic, but so had the gains; the recent period of financial turbulence in China has come of the heels of remarkable increases: the Shanghai stock market grew by more than 150 % between June 2014 and June 2015.

In this summer’s crash, Chinese investors have lost about EUR 5 trillion – a sum higher than China’s entire market capitalisation in 2012. In the weeks since the SCI reached its 12 June peak, the index has lost more than 40 % of its capitalisation. The smaller and technologically-oriented Shenzhen Stock Exchange (STE) has suffered even higher losses, nullifying all its 2015 gains¹.

Figure 1:
Shanghai composite index (2014-15)



Yet the impact of the stock market crash on Chinese investors has been rather limited.

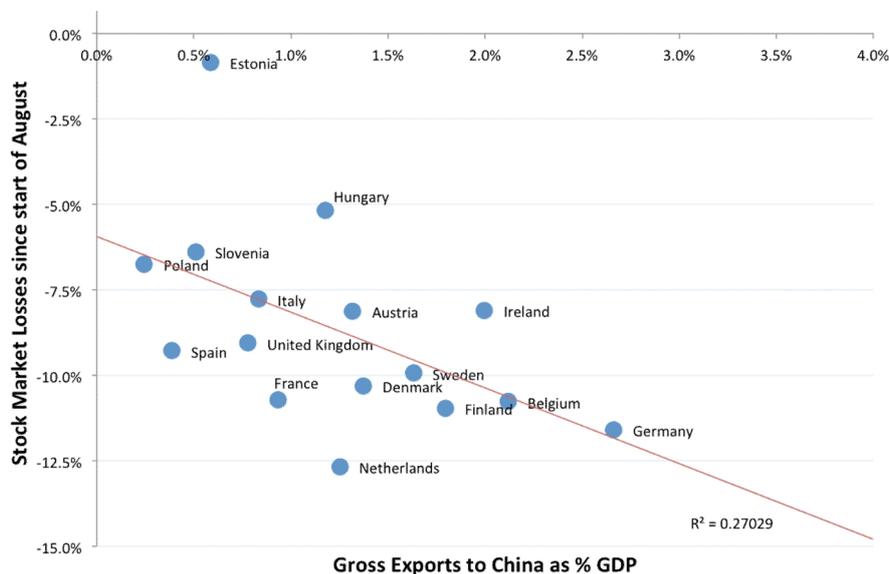
Yet as dramatic as the drop has been, the effects of the recent financial crash on the Chinese economy have been relatively limited. This is largely due to the nature of investors exposed to losses: in China, stocks account for less than 15 % of household financial assets. Just 5 to 10 % of Chinese citizens are in fact exposed to such market fluctuations. By comparison, 55 % of US citizens have savings invested in stocks. Moreover, most Chinese investors belong to the middle and upper classes and have benefitted from significant gains made in the hectic months that preceded the burst: the bubble has burst, but valuations still remain above their levels of one year ago.

The relative isolation of Chinese stock markets, in which foreign investors control only 1.5 % of shares, initially limited the spread of the crisis to foreign markets. The second crash had more dramatic effects beyond China. The risk of contagion in emerging and developing economies has become more evident. In EU markets, too, July’s drop in China had only a limited impact on European indices, but the situation has worsened in

¹ U.S. China Economic and Security Review Commission, [China’s Stock Market Collapse and Government’s Response](#), 13 July 2015

August. European countries with strong trade connections to China have generally suffered severe losses in their stock markets. The Chinese crisis has affected all EU Member States, although Germany, Belgium and the Netherlands have been among those that suffered significantly from the Shanghai Stock Exchange crash (see chart below).

Figure 2:
Decline in European stock markets and trade exposure to China



Source: *Bruegel* (26 August 2015)

Coupled with a more general slowdown in the Chinese economy – whose growth rates are projected to hover around 7 % over the next five years, lower than the double-digit growth recorded for about two decades² – the stock markets’ disturbance has greatly reduced foreign investors’ confidence in China’s model of development. The crash has also cast serious doubt on Beijing’s management of the financial markets.

The recent stock market crash has concealed a more worrisome crisis in China’s economic model.

Even more disconcerting than the recent stock market crisis, however, is the fundamental crisis of the Chinese economic model. This issue deserves a careful analysis to understand the long-standing implications on global economic growth.

2 Beijing's reaction

The emergency measures adopted by the Chinese government have addressed the crisis.

While the Chinese government initially appeared reluctant to intervene in the financial turmoil, Beijing ultimately responded to the stock collapse with a set of exceptional measures, intervening in the operations of the country’s stock exchanges.

The government's measures included compulsory orders that brokers buy shares, as well as a prohibition that shareholders (in particular SOEs - state owned enterprises) sell. Other measures included a suspension of initial public offerings and a further relaxation of the rules governing insurance

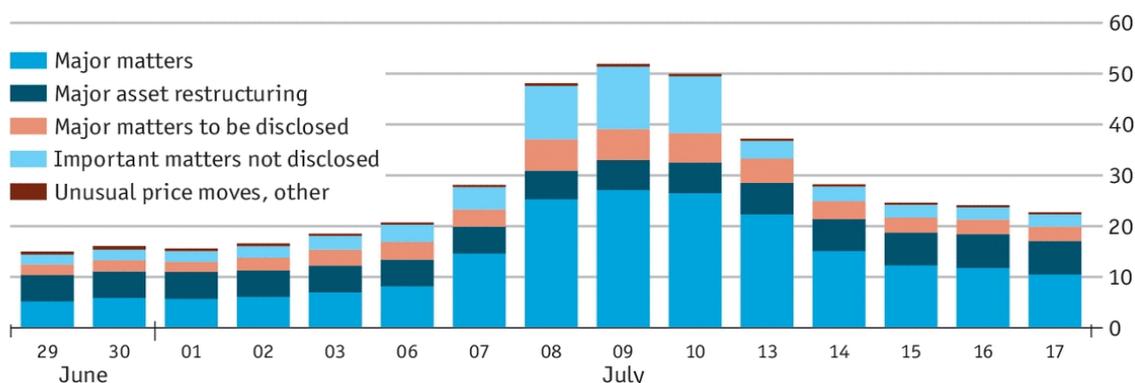
² World Bank, page on [China](#) (2015)

companies' stock purchases. The Chinese Central Bank also pledged to lend 260 billion renminbi (about EUR 36 billion) to major brokerage firms via the China Securities Corporation, thereby avoiding a scenario in which the firms ran out of liquidity.

In addition to all these initiatives, most of the companies listed on the two Chinese stock exchanges were either suspended or put under strict control by the Chinese financial authorities³.

Figure 3: Shanghai Stock Exchange suspensions (June-July 2015)

As % of shares listed in Shanghai and Shenzhen, 2015



Source: Wind Information

Economist.com

Beijing's exceptional measures include a six-month freeze on stock sales above a certain threshold.

China's stock regulator also introduced the 'Announcement 18', threatening 'severe punishment' for any senior manager or major shareholder (one holding a stake of 5 % or more) selling shares of a listed company during a period of six months. With a single announcement, trillions of RMB in assets belonging to some of China's wealthiest investors were frozen for half a year. The securities regulator announced that there were no plans for how and when major shareholders could resume selling their shares, stating instead that the rules for future selling would be outlined in 'further decrees'.

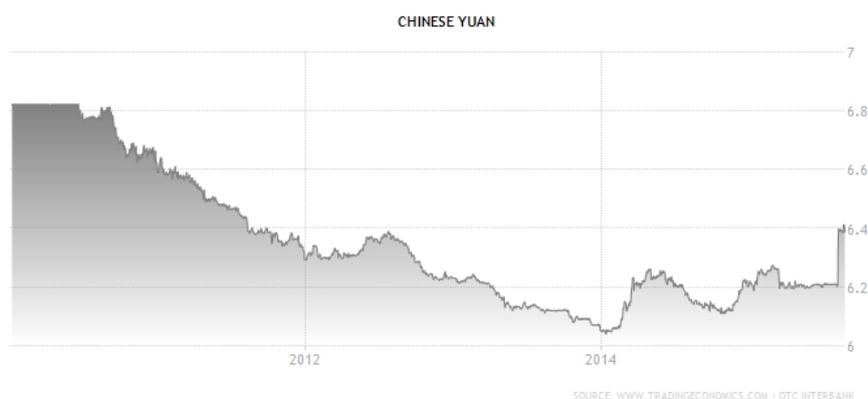
It is still unclear when the Chinese government will scrap these exceptional measures. Some have already been lifted, but most exceptional measures remain in place at the time of writing. In the medium and long term, they may well disappoint major Chinese and foreign shareholders and reduce the liquidity available to finance private sector investments. If the measures are not rapidly terminated, they may also effectively delay urgent structural reforms and jeopardise growth over the long term.

Another government intervention has involved China's currency. On 11 August 2015, the People's Bank of China (PBOC) announced its decision to liberalise the RMB reference rate, traditionally set by the central bank. The move triggered an immediate, significant depreciation of the Chinese currency, suggesting Beijing's intention was to depress the currency to

³ The Economist, [China's botched stock market rescue](#), 30 July 2015

boost exports and support the domestic economy. This move did not, however, please international markets, which perceived the decision as a sign of weakness.

Figure 4:
Exchange rate USD/CNY 2010-2015



Source: Trading economics OTC interbank (August 2015)

3 Beijing's dream of market reform

The measures implemented by Beijing implicitly contradict the government's earlier commitment to liberalise financial markets.

Many of the measures adopted recently by Beijing stand in contradiction with its declared intentions to reform the country's financial markets. At the 2013 Third Plenum, President Xi Jinping stated that the market needed to play a 'decisive' role in all aspects of the Chinese economy. Xi committed to making Chinese bourses more open and transparent. In fact, the government's recent efforts to soften the fall of Chinese stocks are far from what could be envisaged in an open, transparent and free-market economy.

Beijing's efforts may be explained by the fact that the Chinese executive has always considered stability to be one of the country's highest priorities and therefore could not accept any disruption in an economic landscape already displaying signs of distress⁴.

The reform of Chinese financial markets have proved useful but of limited impact.

In a document titled 'Decision on Major Issues Concerning Comprehensive and Far-Reaching Reform', Beijing outlined a reform agenda for the financial sector to promote progressively integrating the country into global financial markets. Major steps foreseen included establishing private financial institutions, developing capital markets, liberalising interest rates, and promoting capital account convertibility⁵.

With the launch of the 'Hong Kong-Shanghai Connect' initiative in November 2014, control over capital markets was significantly reduced. The programme made it easier for foreigners to access China's domestic stock markets. In April 2015, financial controls were further relaxed, and domestic

⁴ Brookings, [Xi Jinping's Ambitious Agenda for Economic Reform in China](#), 13 November 2013

⁵ RT, [Economic overhaul: China opens doors to more private competition](#), 15 November 2013

financial institutions were allowed to freely access Hong Kong's stocks.

To reinforce China's role in the global economy, Beijing has also made the inclusion of its currency in the IMF's special drawing rights (SDR) currency basket a national priority. This goal cannot, however, be reached unless China further opens up its financial system.

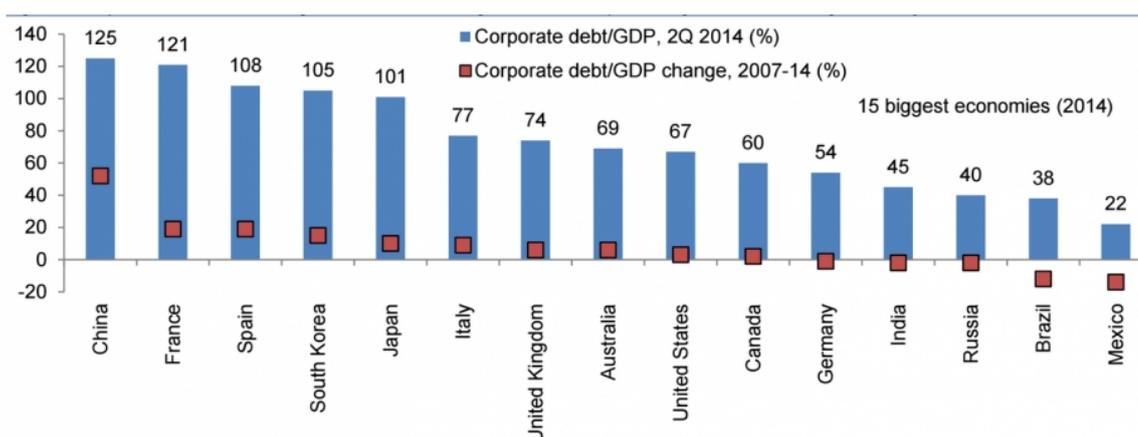
In general, the Chinese government considers the financial sector a key element of its 'New Normal' reforms, aimed to soften China's transition to lower economic growth rates and reduce the economy's excessive reliance on exports. According to a Beijing-based research firm, the financial sector contributed to 20 % of the country's GDP growth (1.4 percentage points) in the first quarter of 2015. Without the financial sector's contribution, China's growth figures would therefore likely be well below the revised forecasts for the current year.

The importance of the financial sector underpins the initiatives launched by Beijing to stimulate growth and boost financial markets. Retail investors have been encouraged to enter stock markets by falling borrowing costs – the result of the looser monetary policy of the People's Bank of China (PBOC) and of recent measures easing small businesses' access to credit. In an effort to rebalance the economy, the Chinese government had also actively supported investors' asset diversification, spurring investment in equity rather than property.

Corporate debt in China is one of the biggest in the world. It has steadily increased in the last decade, and at a pace higher than in any other major economic power.

Beijing attaches greater importance to the role of financial markets in boosting China's growth.

Figure 5:
Corporate debt in the world's largest economies



Source: The Economist

The practice of buying assets 'on margin' – which allows investors to buy stocks with borrowed money – has increased further in the past year, and now represents about 20 % of the stock market holdings. (Investors who buy a given stock on margin need fund only the 'margin' between the assets' present and future value.) This practice may well help support financial growth, as it increases sales beyond what would be possible if

The prospect of a more complete financial crash

cannot be completely excluded.

investors were limited by their liquid capital, but it is a double-edged weapon. Any downturn in the market may well result in a spiral effect if lenders demand that investors pay back the debts they have accumulated in buying shares that have lost value⁶.

Although the Chinese government's measures have mitigated stocks' falls, preventing a complete collapse of the bourses, the market's financial bubble may still burst. With declining GDP and corporate debt on the rise (see chart above), the values of the Chinese stock markets have appeared 'increasingly disconnected from reality'⁷. This analysis is shared by *The Economist*, which noted that the market's overall price-to-earnings ratio was 'more than twice a reasonable level' and that companies listed both in Hong Kong and on the Chinese mainland have preferred the latter because they expected higher gains and further public stimulus there⁸.

Figure 6:
Spread between shares traded both in Hong Kong and mainland China



Source: Bloomberg

Economist.com

4 The crisis of the Chinese economic model?

The recent stock market crash has not directly affected the China's real – and ailing – economy.

Given the distance between China's financial markets and its real economy, the recent stock market crash is not in itself likely to seriously and directly affect the Chinese economy. However, the sudden downturn in the Chinese financial market has forced investors to pay attention to a fact that many seemed happy to ignore as long as stock prices rose: China's short-term

⁶ 'Why bull calves and bear cubs are responsible for China's crazy share prices', *The Economist*, 27 July 2015

⁷ Chao Deng, 'Shanghai Stocks Plummet after Months of High-Flying Gains', *Wall Street Journal*, 28 May 2015

⁸ 'A Crazy Casino', *The Economist*, 26 May 2015

economic growth outlook is mediocre at best, and another year or two of deceleration is all but unavoidable⁹.

The annual rate of GDP growth has slowed from 10.4 % in 2011 to 7.4 % in 2014, and the decrease may further accelerate in the coming years. (In 2017, the growth rate could well fall under the 7 % threshold¹⁰).

Figure 7:
Chinese GDP - annual growth rate



Export performance has also further deteriorated, prompting the Chinese government to devalue the yuan twice in the course of a single week. The trend for industrial production is also clearly negative, as demonstrated by the remarkable fall in domestic demand for oil and raw materials.

Figure 8:
China's industrial index (2014-2015)



The real estate sector, which previously accounted for some 15 % of growth, is now facing a significant contraction. New property starts fell by nearly a fifth in the first two months of 2015 compared with the same period a year earlier. This could have serious ramifications, as acknowledged by the IMF: 'In China, exposures to real estate (excluding mortgages) are almost 20 % of GDP, and financial stress among real estate firms could lead to direct cross-border spillovers¹¹.'

After decades of sustained growth, China is

Three decades of impressive growth have left China with an economy that

⁹, [China's economic problems are everyone's economic problems](#), The Business Insider, 21 June 2015.

¹⁰ The World Bank, [China](#) (2015)

¹¹ IMF [Global Financial Stability Report](#) (April 2015)

experiencing a gradual slowdown.

is at once massive and increasingly affected by distortions that, in the long run, may prove problematic. Given that further marginal increases in the China's economy will become more and more difficult, the latest slowdown may be considered inevitable.

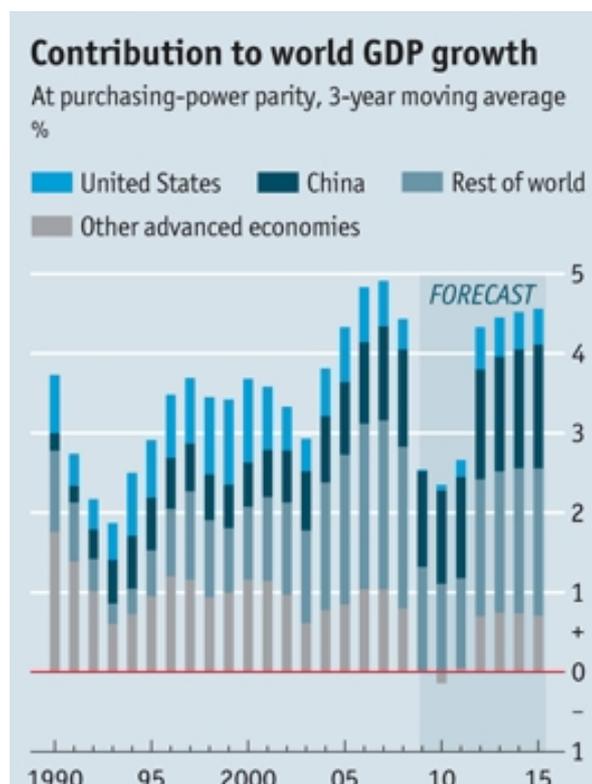
For now, Beijing is seriously considering a new package of 'stimulus' measures similar to those adopted in 2008 and 2009 in the aftermath of the subprime crisis and the subsequent vertical collapse of world trade¹²; the current economic slowdown is being taken seriously by China's leaders. But the Asian giant's persistent state of weakness may make further corrections – and reforms – unavoidable.

This economic slowdown may well have a serious social effect and increase unrest.

The issue is not only economic but also social. If millions of middle-class Chinese lose their savings, the crisis could become politically dangerous for China's rulers. More generally, any slowing of the country's GDP growth means fewer new jobs, lower wages and increasing youth unemployment. This, in turn, increases the risk of unrest spreading across the country and the possibility that citizens begin questioning the leading role of the party.

How Beijing handles its current economic crisis will affect not only the China but also third countries. China's resilience during the 2008 financial meltdown helped the global economy to recover; China accounted for a significant percentage of global economic growth in the two-year period of 2008-2009 (see chart below).

Figure 9:
China's contribution to global economic growth



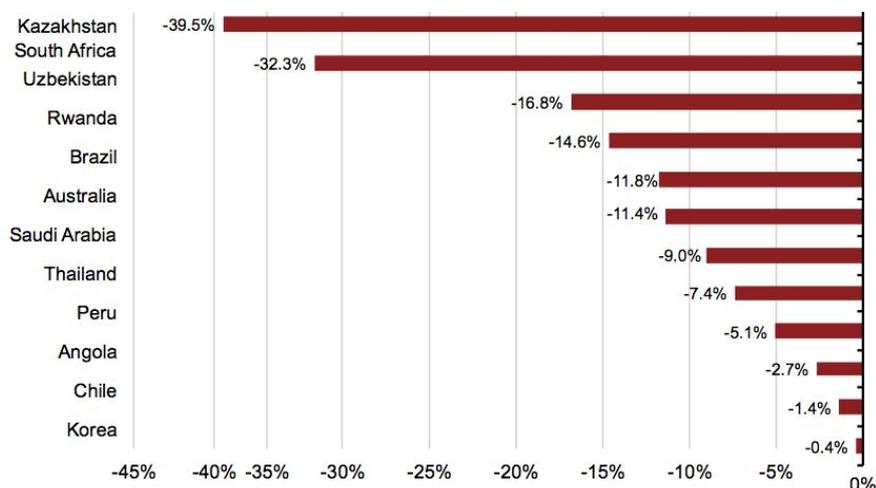
Source: The Economist

¹² Oxford Analytica, 'China bond plan reverts to investment stimulus', 5 August 2015

China's economic slowdown is deeply affecting emerging and developing countries.

China's declining economic performance is a matter of concern for a number of developing and emerging countries that have adapted their economic structures to satisfy their neighbour's growing hunger for oil and raw materials. As demonstrated by the chart below, many countries' exports to China have fallen, creating huge gaps in these countries' budgets¹³.

Figure 10:
Changes in exports to China (2014-15)



Source: Business Insider

The EU has been – until now – relatively unscathed.

The position of EU Member States appears less dramatically compromised. It is true that sales of up-market and brand products are stagnating, and exports may further slow. However, given that financial markets in China remain relatively closed, European banks' exposure for is limited.

Within the EU, the UK is the most exposed Member State as the country's largest banks – HSBC and Standard Chartered – have significant business in Asia. France (and to a lesser extent the German), countries that have heavily invested in China, may also suffer from a further depreciation of the Chinese stock markets.

A possible slowing of the Chinese economy also may hit the EU manufacturing sector. China has gradually become the EU's largest trading partner, second only to the US, and most European Member States have increased exports of goods (and to a lesser extent services) to China. Germany alone provides close to half of all EU exports to China and would therefore be far more exposed via trade channels than other EU states from a further chilling of China's economy. The automotive sector is likely one of the most endangered.¹⁴

¹³ In 2014 China was the main export destination for no less than 40 countries around the world.

¹⁴ Forbes, [How Exposed Is Europe To A Chinese Economic Slowdown?](#) (25 August 2015)

5 Conclusions: The fallout

The Shanghai stock exchange crash has been dramatic, but its effects on real economy are still limited.

China needs to restore investors' confidence and avoid an infection of its real economy.

While analysts are not unanimous, most believe that a full collapse of the market is not likely to occur in the foreseeable future.

The real and larger problem – overshadowed by the recent financial crisis – is the serious slow-down of the Chinese economy.

The recent crisis plaguing Chinese stock markets has been dramatic, but has not – yet – completely burst of the bubble of valuations that could directly affect the country's 'real' economy.

The Chinese government has reacted quickly to the crisis, so far managing to avoid a full-blown financial crisis. The exceptional measures Beijing has deployed – including depreciation of the domestic currency in an attempt to boost declining export performance – would hardly be available in a full-fledged market economy.

These measures are obviously limited in time and may be lifted relatively quickly if the situation in financial markets improves and China does not abandon its efforts to gradually enter the global financial system.

Investors' confidence in the growth and smooth operation of Chinese stock exchanges has, however, been shattered by recent turbulence. This is especially true for a less experienced group of private, middle-class savers who enthusiastically invested in the stock market over the last year.

The current situation is also unfortunate as it has created expectations of further state intervention to support the economy. By freezing stocks and assets, the markets may also drain much-needed liquidity from the real economy.

Analysts do not agree on the likely outcome of the crash. Economist Nouriel Roubini has argued that 'there is only a moderate chance of the stock-market slump snowballing into a full-blown financial crisis'. However, this scenario is not excluded by other analysts, who consider 'there are reasons to believe that this [the financial crisis] could turn out to be a more fundamental cooling of China than previously thought'¹⁵.

In any case, the recent financial crisis has overshadowed a certainty in the Chinese economy: a major slowdown. The engine that was able to produce double-digit growth for decades seems to have been deactivated. Beijing's 'new normal' strategy has not yet produced its intended effects, and new and deeper reforms are needed to bring the Chinese economy back on track. The crisis may also call into question the financial sustainability of key government projects, such as the Asia Infrastructure Investment Bank, the 'One Belt, One Road' initiative and a domestic infrastructure plan based on urban development¹⁶.

In addition, Beijing will now have to respond to a fundamental question that it has avoided for years: will China become a well-functioning market economy, or will state capitalism continue to drive the operations of the world's second largest economy?

¹⁵ Nouriel Roubini, 'China's A-Share Rout: The Challenge of Weaning the Market Off Government Support' (24 August 2015) and Bruegel 'The dragon sneezes, Europe catches a cold' (26 August 2015)

¹⁶ Oxford Analytica, Stock crash cracks in 'China model' (26 August 2015).