

China's Recent Stock Market Volatility: What Are the Implications?

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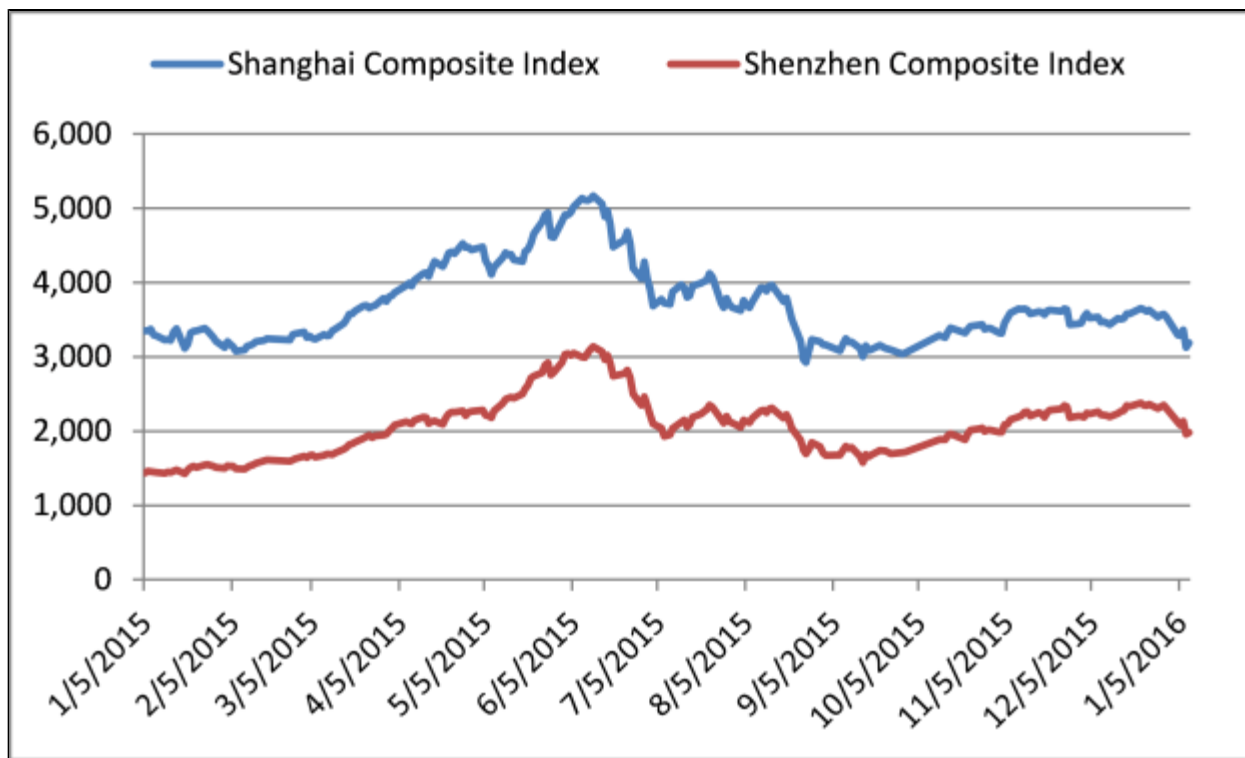
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China's two main stock markets, the Shanghai Stock Exchange (SSE) and the Shenzhen Stock Exchange (SZSE), experienced rapid price increases from about mid-2014 to mid-2015. However, from June 12 to July 7, 2015, the Shanghai and Shenzhen Composite Indices fell by 32% and 40%, respectively. The Chinese government intervened to halt the slide via stock purchases and other measures. Stock prices later stabilized, but experienced sharp declines in mid-August 2015 and again during the first week of 2016. The volatility of China's stock exchanges, and the government's interventionist policies, have raised concerns over the health of the Chinese economy as well as the government's commitments to implement free market reforms. Such concerns may have contributed to volatility in global stock exchanges over the past year.

Figure 1. Changes in the Shanghai and Shenzhen Stock Exchange Composite Indices at Close:
January 5, 2015-January 8, 2016



Background and History

The SSE and SZSE are the world's third and fifth largest stock exchanges, respectively, based on domestic market capitalization. Both were established in 1990 as part of the Chinese government's effort to move toward a market-based economy. Only domestic Chinese firms are listed on the SSE and SZSE. Foreign ownership of Chinese equities is relatively small and strictly regulated. According to the [U.S. Department of the Treasury](#), U.S. holdings of Chinese stock at year end 2013 totaled \$98 billion, which was 1.6% of total U.S. global stock holdings, and 2% of China's market capitalization.

China's stock indices have experienced periods of high volatility in the past, similar to what has occurred recently. The Shanghai Composite Index rose from 1,838 on October 1, 2006, to 5,955 (a historical high) on October 1, 2007, a 224% increase. But soon afterwards, the index began a steep decline, and by October 1, 2008, it had fallen back below 1,800. Although the decline was partially the result of the global financial crisis, [many analysts contend that the market correction was inevitable](#) because much of the stock market's rise was largely driven by speculation rather than market fundamentals.

The recent price drops in China's two stock exchanges appear to be similar to what happened in 2007. From June 2014 to June 2015, the Shanghai and Shenzhen indices increased by 108% and 177% respectively. [Olivier Blanchard, chief economist at the International Monetary Fund](#), said in July 2015 that this was "obviously a stock market bubble." From June 15 to August 25, 2015, the SSE and SZSE declined by 43% and 44%, respectively (including losses of 15.5% and 14.2% from August 21-25). The SSE and SZSE exchanges generally stabilized afterwards, and from August 25 to December 31, 2015, they rose by 19.4% and 32.0%, respectively. However, the SSE and SZSE declined by 10.0% and 14.3%, respectively during the first five trading days of 2016.

Underlying Causes of the Bubble

According to [a Brookings Institution report](#), China's stock markets are more heavily affected by speculative investment than markets in Western countries. This situation exists in part because shareholders in Chinese markets generally have less influence over companies than their Western counterparts and so focus more on short-term movements in stock prices. Chinese stock exchanges are also dominated by individuals (retail investors), who total [200 million](#) and account for an estimated [90% of market trades in Chinese-based firms](#) <http://www.reuters.com/article/2015/07/08/us-china-stocks-idUSKCN0PI04Q20150708>. Reportedly, more than [30 million new trading accounts](#) were added during the first

five months of 2015. Many of these investors bought stocks on margin (i.e., using borrowed money), betting that stock prices would continue to rise. According to [one estimate](#), margin financing may account for as much as one-fifth of all money in the Chinese stock exchanges.

The Chinese Government's Response

The Chinese government took a number of steps to halt the slide in stock values, including forcing [cuts in transaction costs](#) and easing the rules on margin trading, in order to guard against a potential wave of defaults. In an effort to mitigate the impact from panic selling, the government also [bought up shares in state-owned firms](#) and [limited the sale of stock](#) by controlling shareholders or company executives. Authorities also reportedly [threatened to arrest individuals](#) that they view as market manipulators.

Some analysts contend that the government's intervention may indicate an unwillingness to fully embrace market liberalization. [According to one analyst](#), "the scale and aggressiveness of these measures make a mockery of the leadership's claim to allow the market to play a 'decisive role' in determining the allocation of resources and the direction of the economy." [Another analyst stated](#) "Stock markets play an essential role in developed economies, directing resources to businesses where they'll be used most productively. But they can only serve this role if governments let them... The government's actions may have prevented a politically embarrassing stock market meltdown, but in the process, they've made the task of modernizing China's economy more difficult."

At the start of 2016, the China Securities Regulatory Commission (CSRC) implemented a new stock market circuit-breaker mechanism to halt trading after certain benchmark percent level changes occurred. The intent was to limit sharp swings in the exchanges by imposing a "cooling off" period. Trading in the SSE and the SZSE was halted on January 4 and January 7 after the circuit-breaker mechanism was triggered. Trading on the SSE was halted less than 30 minutes after opening on January 7, and led the CSRC to suspend the mechanism, stating it had not worked as intended and may have had a "magnet effect" on certain investors. The CSRC announced new limits on stock trades.

Implications

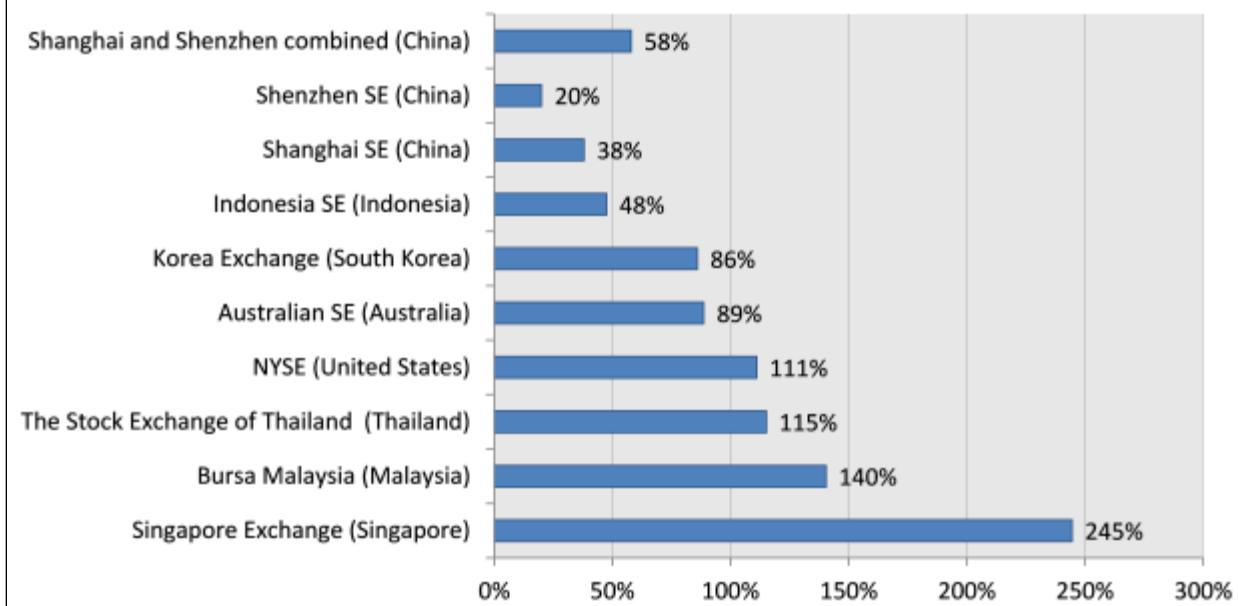
Some observers raise concerns that a continued fall in stock prices could have a significant impact on the Chinese economy, leading to lower consumer demand because of losses by retail investors. However, the Chinese stock market is far smaller, as a percentage of economic activity, than in many countries. It is estimated that only about [5-10% of the Chinese population](#) is directly exposed to the market (compared to 54% in the United States). This suggests that even in the wake of a large and sustained downturn, there may only be a [limited impact on household wealth](#) and the domestic economy.

Of greater concern might be the implications of the government's intervention for economic decision-making in coming years. If, as [some analysts suggest](#), recent measures serve as an indicator of future policy, then they could indicate a departure from [China's stated objective](#) of "centering on the decisive role of the market in allocating resources." This may have implications for [U.S. efforts to find common ground with China on key issues](#) such as bilateral investment and market access.

China's stock market decline, coupled with the central bank's depreciation of its currency relative to the dollar since August 2015 (it fell by 7.2% from August 10, 2015, to January 9, 2016) may have contributed to volatility in global stock markets. This may reflect growing concerns by some analysts that official Chinese statistics may be overstating the health of China's economy, as well as skepticism over the ability or willingness of the Chinese government to meet its stated commitments to free-market reforms. Some analysts contend that continued volatility in China's stock exchanges will likely occur until the government establishes an effective and predictable regulatory regime.

Figure 2. Market Capitalization of Regional Stock Exchanges, as Percent of GDP

Ratio of market capitalization to GDP (2014)



Source: GDP data from [World Bank](#), market capitalization data from [World Federation of Exchanges](#).

Notes: The ratio of market capitalization to GDP is an indicator of the relative importance of equity markets within a national economy.