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Issue Brief

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China's Stock Market Meltdown Shakes the World, Again

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After the stock market turmoil last August,[*] Chinese regulators were hoping for a peaceful start to the year, preparing to wind down the ban on sales for big shareholders and launching a new mechanism (a circuit breaker) designed to prevent dramatic falls on par with those seen last year. The plan backfired. China's Shanghai and Shenzhen stock markets crashed on January 4, the first day of trading, followed by another crash on January 7; in both cases, the circuit breaker halted trading. The combined rout erased more than $1 trillion of value.[1] The government's attempts to stem the meltdown only worsened the situation, confusing investors and raising fresh doubts over the ability of the Chinese government to manage a slowdown in the economy. They also exposed the contradiction inherent in the Chinese Communist Party (CCP) leadership trying to introduce market-oriented policies for the broader economy while maintaining control over the composition and behavior of the Chinese stock markets—an approach that leads to greater volatility and moral hazard.

What Happened?

On January 4, the first day of trading in 2016, the Shanghai and Shenzhen stock markets fell rapidly (see Figure 1), causing the new circuit breaker system to kick in and stop the trading for the day about 80 minutes earlier than scheduled.[2] The circuit breaker mechanism, developed in the wake of the stock market meltdown last year, was designed to prevent excess volatility, and involved an automated process: After a 5 percent move by the index (the benchmark CSI 300, which tracks the largest listed companies in Shanghai and Shenzhen), the trading would pause for 15 minutes; a 7 percent move would stop the trading completely for the rest of the day.

The exact causes of such sales runs are always difficult to pinpoint, since stock markets—China's especially so—are inherently driven by investor sentiment. In this case, however, there are several culprits:

- *New data reflecting the poor health of China's economy*. Caixin's[†] unofficial estimates of China's manufacturing purchasing managers' index (PMI) were weak for the tenth month in a row—48.2 in December, down from 48.6 in November—spurring fresh fears among investors.[3] A PMI below 50 indicates a contraction. In contrast, the official manufacturing PMI showed a slight improvement—49.7 in December, up from 49.6 in November—but investors are watching the unofficial index more closely because unlike the official one, it tracks smaller companies whose performance is viewed as a better indicator of the health of the Chinese economy.[4]
- *Expiration of the selling ban*. The ban on selling by major shareholders (i.e., investors holding at least 5 percent of a listed stock), introduced during a period of market volatility in summer 2015, was scheduled to end on Friday, January 8. Fearing that big investors would start selling once the ban expired, many small investors rushed to get ahead of any sell-off.

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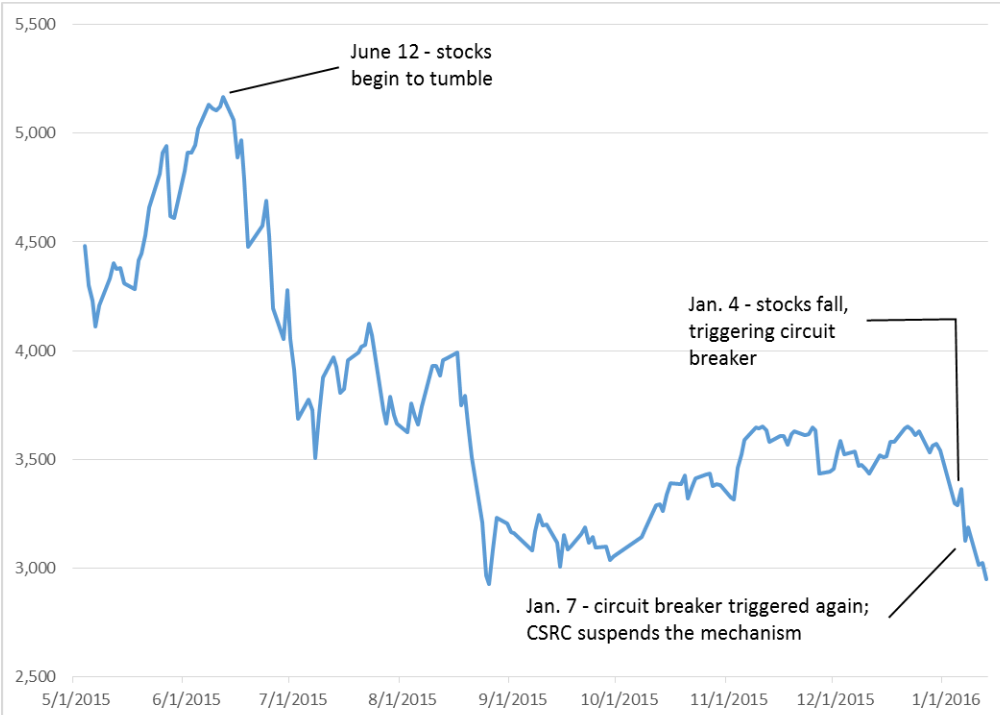
[*] For a discussion of the stock market collapse in August 2015, see Nargiza Salidjanova, "China's Stock Market Collapse and Government's Response," *U.S.-China Economic and Security Review Commission*, July 13, 2015. *http://1.usa.gov/1fCBn9a*.
[†] Caixin is China's well-regarded media group dedicated to providing financial and business information.

- *The new circuit breaker*. The mechanism itself fueled panic among investors, who rushed to sell before it kicked in.

Figure 1: Shanghai Composite Index, May 2015–January 2016

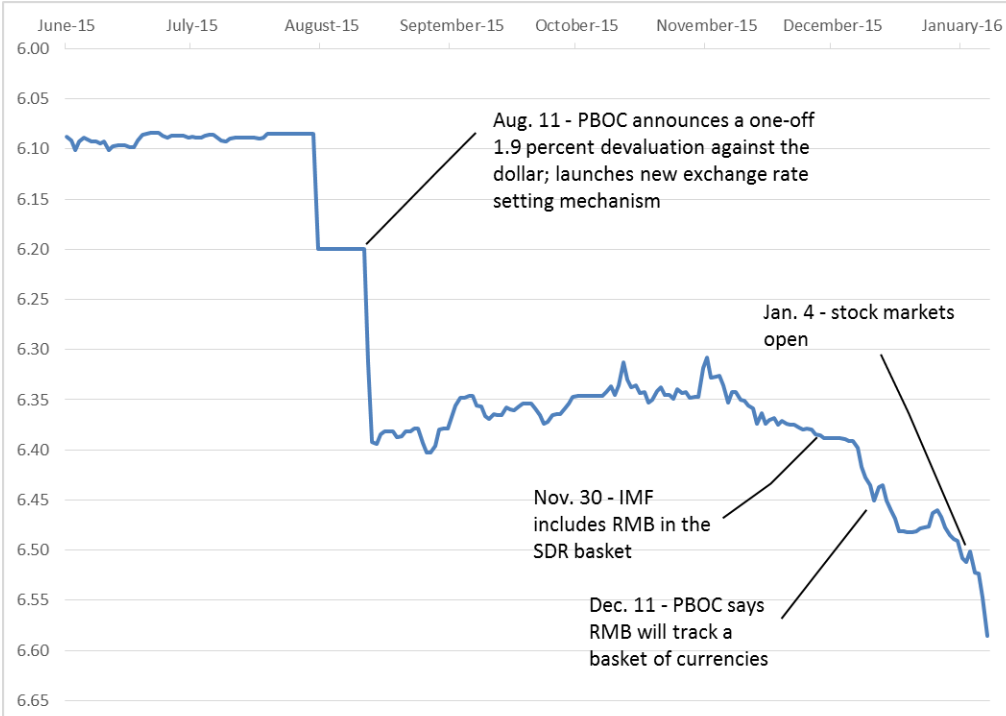


Source: Shanghai Stock Exchange via CEIC database.

The story repeated itself just two days later on January 7, when trading on the Shanghai Stock Exchange was shut down for the day only 30 minutes after opening, resulting in the shortest day in the stock market's history.[5] The slide was triggered when the People's Bank of China (PBOC), the central bank, set the daily renminbi (RMB) reference exchange rate[*] against the U.S. dollar 0.5 percent lower (see Figure 2), which investors interpreted as a sign the government was concerned about the weak state of China's economy.[6]

[*] The PBOC manages the value of the RMB by setting a new value for the RMB-dollar exchange rate each trading day, even while permitting fluctuations in intra-day trading within a 2 percent trading band. In August 2015, in order to allow more flexibility in the exchange rate and to counter expectations of a persistent appreciation of the RMB, the PBOC announced it will set the RMB daily trading rate according to the market-determined closing price within its trading band from the previous day. The PBOC continues to intervene heavily in the foreign exchange markets, however, selling dollars and buying the RMB to keep the latter from depreciating too quickly. For more, see U.S.-China Economic and Security Review Commission, *2015 Annual Report to Congress*, November 2015, 50–52. *http://1.usa.gov/1PIucJk*.

Figure 2: RMB to U.S. Dollar Exchange Rate, June 2015–January 2016*



Note: The vertical axis is inverted to show RMB depreciation.
Source: Oanda.

Just as it did in the summer of 2015, the government chose to intervene and attempted to stabilize the stock markets through the following measures:

- *State-ordered purchasing*. The "national team" comprising the China Securities Regulatory Commission (CSRC) and state-owned brokerages resumed share purchases, undermining the pledge to allow market forces to play a deciding role.[7]
- *Cash injection*. The PBOC channeled RMB 130 billion ($20 billion) in short-term funds into the financial system to support the currency and calm investors.[8]
- *Currency strengthened*. On January 8, the PBOC tried to stop RMB depreciation, setting the reference rate higher.[9]
- *Ban on big share sales extended*. Under new rules announced by the CSRC, for the next three months, large shareholders will not be permitted to sell more than one percent of their stake, and must provide 15 days' notice before doing so.[10]
- *Circuit breaker suspended*. Rather than calm tensions, the circuit breaker escalated the panic, as people rushed to sell before the stocks went down enough to trigger the trading halt. Realizing the circuit breaker was doing more harm than good, the CSRC announced it was suspending the mechanism on January 7—four days after initiating it.[11]

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* For discussion of RMB's inclusion in the SDR basket, see U.S.-China Economic and Security Review Commission, *Economics and Trade Bulletin*, December 4, 2015. *http://1.usa.gov/1Zq8D85*; for information about the new multicurrency index for the RMB see U.S.-China Economic and Security Review Commission, *Economics and Trade Bulletin*, January 6, 2016. *http://1.usa.gov/1OZ8HqF*.

Implications

The panicked response of Chinese investors masks the fact that China's stock markets remain a very small part of the country's economy, and have limited bearing on its overall health.[12] The Shanghai Stock Exchange in particular is dominated by state-owned enterprises and heavy industries—all ailing sectors that do not represent the most productive segments of the economy.[13] Yet, the factors informing investor behavior and the government's attempts to interfere and control market outcomes speak a great deal about the problematic way in which the government approaches economic policy.

In 2013, the Chinese government pledged it would allow the "market to play a decisive role" in all aspects of the economy,[*] but when it comes to some sectors of the economy, the financial sector among them, Beijing's view appears to be that the market can play a role as long as it does what Beijing wants it to do. The Chinese government places a great emphasis on maintaining stability, so the impulse to control the stock market stems from a desire to head off any possible unrest or criticism of the CCP. China's government has a poor record of managing the stock markets. Policies pursued by the government in search of new sources of growth are at least partly to blame for the creation of the bubble that burst in the summer of 2015. Investment in the stock market was viewed as a way to generate capital for SOEs, to boost funding for private companies, and to provide households with a means of realizing returns. Official media outlets, including *People's Daily*, ran laudatory editorials describing the stock market growth as a sign of economic strength.[14]

By once again intervening and reasserting control, the government is raising expectations that the "national team" will be called in any time there is volatility. In addition to firmly entrenching moral hazard as a major byproduct of Chinese government's policymaking, this kind of intervention is expensive. The government spent billions on futile attempts to stabilize the stock markets in the summer of 2015 and again in January 2016.[15] Efforts to manage the value of the currency—which so rattled the stock markets this time around—are likewise pricy. Following the transition in August 2015 to the new exchange rate setting mechanism, the PBOC permitted the RMB to weaken, though it continued to intervene heavily in the foreign exchange markets to manage the decline very slowly. As of the end of December 2015, China's foreign reserves slumped a record $107.9 billion from the previous month, reducing the overall total of reserves to $3.33 trillion. For the full year, reserves fell $512.7 billion—another record.[16] Most of the drop can be attributed to the PBOC's efforts to support the RMB's value.

The direct impact of this latest meltdown on foreign investors may turn out to be limited, but sentiment matters—especially in stock markets. World markets responded to the meltdown in China with some volatility of their own. More than $2 trillion of value was erased from global stock markets in the first trading week of the year.[17] As of January 13, though, Asian markets mostly traded higher.[18] However, there is a danger of spillover into the real economy, with emerging markets most likely to be affected. A weaker RMB would boost Chinese exports, but also raises fear among investors that the weakness is a symptom of bigger structural problems in China's economy. As the latest stock market rout demonstrates, such perceptions can lead to harmful economic consequences. The weaker RMB also risks sparking beggar-thy-neighbor devaluations across Asia.[19]

U.S. equity markets have not been immune to the panic spreading from China. On January 7, the Dow Jones Industrial Average fell nearly 2.3 percent, while the S&P 500 dropped 2.4 percent.[20] U.S. stocks showed some volatility in the following days, going into a steep sell-off on January 13, but rallying the next day.[21] Market sentiment aside, the Chinese government's response (including lack of coordination, conflicting policy initiatives, and poor communication) presents a more long-term challenge, raising questions about the government's commitment to economic reform and its ability to execute it.

[*] For more on President Xi Jinping's economic reform priorities and pledges (the Third Plenum reforms), see Nargiza Salidjanova and Iacob Koch-Weser, "Third Plenum Economic Reform Proposals: A Scorecard," *U.S.-China Economic and Security Review Commission*, November 19, 2013. *http://1.usa.gov/1nfpyt0*.

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