CHINA'S STOCK MARKET TURMOIL: LESSONS AND IMPLICATIONS

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Executive Summary

1. China’s stock market had remained calm since the last turmoil in 2007. However, it went on an upsurge from August 2014, with the stock index doubling within nine months, a record for all global markets. However, from mid-June 2015, the stock market began to dive.

2. Unlike the last stock market downturn in 2007, the government had made strenuous efforts, including encouraging investors to join and save the stock market through its official media, to uphold the market.

3. The government has plans to further develop and restructure China’s financial sector through expanding the stock market. The move is to reduce the heavy reliance on indirect financing from commercial banks. Developing a healthy and strong stock market is for firms to obtain financing through IPO issuing.

4. Several factors contributed to the market crash in 2015. One was the use of leverage trading. This includes both official margin trading as well as trading through various unofficial channels, or the “*changwaipeizi*”. The other was the introduction of the stock index future.

5. By early July 2015, the government had recognised the harmful effects of ‘*changwaipeizi*’ and stock index future and took measures to rein in the two activities.

6. Commercial banks were heavily involved in stock trading in this crash, mainly through providing leverages. Almost all the leveraged credit for the stock market is believed to have come from commercial loans.

7. Borrowers who were involved in margin trading faced liquidity problems, generating a contagious effect on the real economy through the over-involvement of the commercial banks.

8. The latest stock market fluctuations have taught the Chinese government several valuable lessons. First, a market upturn based on stimulated public expectation can be very difficult to manage and risky. Second, the application of various financial innovations needs to be accompanied by sophisticated risk management and better regulation.