CHAPTER III

THE CHINA'S STOCK MARKET CRISIS

The stock market has been considered as the profitable aspect as a source of financial growth in China. The China's financial growth has always been interesting to discuss since it becomes one of the driver of the industrialization and economic growth in this twenty-first century. Unlike the other countries, China's financial sector is dominated by banking system and non-banking system. The banking and non-banking system creates the China's financial system alive. In addition, it also emerged the China's stock market which is Shanghai stock exchange market and Shenzhen stock exchange market. These two stock markets are the biggest stock market in China mainland. These two stock markets help to provide the platform for the investor to invest. With the easiness offered by the central government of China, much investor joined the investment activities in China's stock market. However, in the mid of it rise, China's stock market suffers from the decline of the in June 2015. This decline triggered panic among the investors. As it know that China is known with the great economy in the world. This great economy perceived will be able to support the business within the country. However, with the decline of the China's stock market, it is feared that it

will creates the sentiment towards the investment activities. To explain how the crisis which is believed will create the sentiment towards the investment activities, setting up the history of the China's financial system would be to portray the basic condition in China.

A. China's Financial System

1. Banking System

China is a country with the highest population in the world with more than 1.33 billion people (Zhou, 2016). This high number of the population gives the influence towards the social, political and economy of China itself. In terms of economy, China has been considered as the new emerging super power in the world with the Gross Domestic Product (GDP) achieved 11007.72 billion dollar USD in 2015 that represent 17.75 per cent of the world economy (Trading Economics, 2017). Meanwhile, the China is in the second largest economy after the United State using Purchasing Power Parity (PPP) (Allen, Qian, & Qian, 2005, pp. 57-116). In this twenty-first century, China has become a country with a strong economy in the world that will rival the United States economy. The success of China's economic growth is perceived to be supported by the financial sector. It plays an important role as the driving force of the China's expansion which led to the greater economy in the world. Since the economic reform, the financial system becomes more important for China's economy as it becomes integral to its economic policy.

The financial system in China is dominated by banking system. In the late of 1978, China's financial system consisted only of a single bank which is People's Bank of China (PBOC) (Allen, Qian, Zhang, & Zhao, 2012). This bank is owned and controlled by the central government under Ministry of Finance (MOF) and acted as the central bank and commercial bank. The People's Bank of China controlled the country's total financial asset amounted 93% (Allen & Qian, 2014). However, in the end of 1979, the People's Bank of China (PBOC) separated itself from the Ministry of Finance and became an independent institution. Meanwhile, there were four banks that emerged to take over the commercial banking role, that were: "the Bank of China (BOC) that has role to specialize the foreign trade and investment, the People's Construction Bank of China (PCBC) which has role to handle the transaction related to fixed investment particularly in manufacture sector, the Agricultural Bank of China (ABC) which has role to manage all banking business in rural areas, and the latest formed of the bank is the Industrial and Commercial Bank of China (ICBC) that took over the commercial transaction of the PBOC" (Allen & Qian, 2014, p. 504). Besides these big five banks, the development of the financial system in China was also highlighted by the rapid growth of non-banking system outside these major banks. The "regional bank were formed in special economic zones (SEZs) which partly owned by the .local government, the Rural Credit Cooperatives (RCC) was formed under the control of Agricultural Bank of China (ABC), the Urban Credit Cooperatives (UCCs) also emerged, and the non-bank financial intermediaries such as Trust and

Investment Corporations also emerged" (Allen, Qian, Zhang, & Zhao, 2012, p. 6). The intermediaries refers to "the institutional or organizations that connect the government with the enterprises, producers and distributions, or individuals and organization that provide market entities, such as brokerage" (China.org.cn, 2003). In China, the intermediaries are mostly owned by private while some of them are still owned by central government. The emergence of the intermediaries in China's financial system is a result of the market economy implementation. The rapid development of the banking system and intermediaries happened in 20th century when Shanghai became the international financial centre in Asia. During this period, Shanghai transformed itself from an agricultural-based trading into advance financial market. In the end, China's financial sector is dominated by banking system. According to Narayan (2015, p. 3):

> The number of banking institutions in China has declined from 8,721 (2007) to 3,639 (2010). However, the value of total assets has almost doubled from 51.6 trillion RMB to 93.2 trillion RMB, and its share of GDP has increased from 194.2% to 234.2% over the corresponding period. On the other hand, the number of non-banking financial institutions has increased from 690 (2007) to 782 (2010), contributing around 33.1% to GDP with total assets valued at 13.2 trillion RMB.

The increase of the total assets, even though the number of banking institution declined, portrays the good productivity of China's banking sector. It also proves that the financial sector in China is dominated by banking system. In addition, the foreign financial institution also emerged in China. The emergence of domestic and foreign banks and other financial institutions in China triggered the

competition among the institutions as they have similar role which is providing the fund in order to support the growth of the hybrid sectors. The success of China's economy helps to support the foreign banks that exist in China. Based on the survey conducted by PwC (PricewaterhouseCoopers Limited) in 2012, there were 181 banks from 45 countries and regions in China by the end of 2011 (PwC, 2012). PwC also adds that the total assets of the foreign bank itself reached 23.6% (PwC, 2012). These developments on the financial institutions will make China's banking system alive.

2. Financial Regulatory System

The success of the economic growth in China becomes more interesting as it becomes an example of government interference in the economic activities. In China's financial system, the regulators are divided by the types of the activity itself. "Banks are regulated by the China Banking Regulatory Commission (CBRC), the securities and financial markets are regulated by the China Securities Regulatory Commission (CSRC), and insurance by the China Insurance Regulatory Commission (CIRC)" (Elliott & Yan, 2013, p. 10). Elliot & Yan (2013) adds that while the regulatory responsibility of People's Bank of China (PBoC) is managing the monetary policy, the Ministry of Finance is on the shareholding in major commercial banks and controlling the Central Huijin Company which owns substantial stakes in commercial banks (Elliott & Yan, 2013). Besides, the financial intermediaries such as Rural Credit Cooperatives,

Urban Credit Cooperation and others are also controlled by the China Banking Regulatory Commission (CBRC).

However, beyond these responsibilities, the central government have absolute control towards the activity in the financial system. The dominant party which is Communist party has great influence towards the decision to determine the personnel in financial institution. In China, the government maintains its control towards the assets of bank for almost 95 per cent (Mitchell & McGee, 2015).

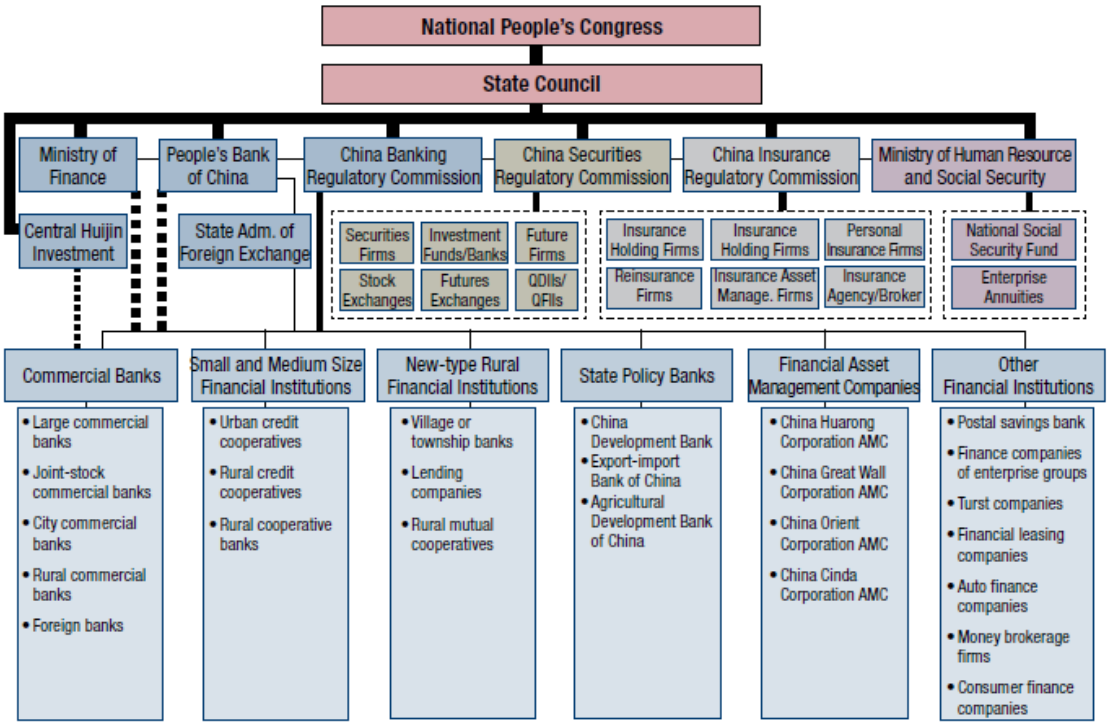

Figure 3.0.1 China's Financial Regulatory System (Elliott & Yan, 2013)

3. China's Stock Market Crisis

The year of 1990s became the important year for China's financial growth as it emerged the two stocks markets, Shanghai stock market and Shenzhen stock market. The Shanghai stock market was established in 1990 meanwhile Shenzhen stock market was founded in 1991 (China.org.cn, 2009). Since then, the China's stock market has grown well. The listed companies in China achieved 1.160 at the end of 2001 (Gao, 2002). Gao (2002) then adds that this number was higher than in the early 1990s which only 10 companies listed. During its development, these two largest stock markets in China were listed in the top rank of the world's stock market as the following.

Table 4-A: A Comparison of the Largest Stock Markets in the World in December 2013

Ranking	Stock Exchange	2013 Dec Market cap US bn	2013 Dec share turnover
1	NYSE Euronext (US)	17,950	70.9%
2	NASDAQ OMX (US)	6,085	144.6%
3	Tokyo SE Group	4,543	129.6%
4	London SE Group	4,428	46.5%
5	NYSE Euronext (Europe)	3,584	355.2%
6	**Hong Kong Stock Exchange**	**3,101**	**40.9%**
7	**Shanghai SE**	**2,497**	**151.6%**
8	TMX Group	2,114	62.6%
9	Deutsche Börse	1,936	67.8%
10	SIX Swiss Exchange	1,541	45.4%
11	**Shenzhen SE**	**1,452**	**269.3%**
12	Australian SE	1,387	57.7%
	China (SHSE, SZSE, HKSE)	7,050	127.14%

Figure 3.0.2 A comparison of the largest stock market in the world in 2013 (Allen & Qian, 2014)

The two China's stock markets, Shanghai stock market and Shenzhen stock market, were listed in the top world rank in 2013. These two stock exchanges have been growing into top ranking global market and put China on the second place of the world's largest market capitalization after the United States (Iskyan, 2016). According to Shanghai Stock Exchange (2015), in the end of 2012, the investors account reached more than 200 million with the listed companies amounted to 2.602. This high number helps to push the total market capitalization of shares up to CNY 3 trillion (Shanghai Stock Exchange, 2015). In the period of 2001-2011, the China's stock market achieved 63% of its GDP which is larger than the 57% of GDP average of other emerging countries (Allen & Qian, 2014). Since the emergence of the Shanghai stock market and Shenzhen stock market, China's stock markets are often relates to a casino supported by the speculative and high volatilities (Elliott & Yan, 2013). It is because the China's share is dominated by non-tradable that owned by the central government.

The China's economy growth that has been incredible over the past years has made China become a country with the largest economy in the world after the United States. The incredible rise of China becomes meaningful with the existence of capital. As a country with a transition from planned economy into market economy, capital becomes the important part of its transition. The industrialization in China required a lot of capital while in fact China was a poor country at that time. Since the economic reform, the China's economy is being

liberalized gradually so that it can help to boost its growth. Therefore, there exists the capital flow in China. Moreover, the inception of two stock markets in China becomes a platform for the capital mobility. In the context of China, the capital mobility is driven by the investment rather than consumption (Lai, McNelis, & Yan, 2013). China is one of the countries that has a highest rate of investment which is over 40% of its GDP (Economy Watch, 2016). A data from World Bank shows that the China's foreign direct investment (net flow) in 2015 reached 249,858,920,111 US$ (World Bank, 2016). That high level of investment was supported by rapid growth in credit and growing stock.

During the last three decades, China has experienced an incredible growth which reached an average of 10% (Lai, McNelis, & Yan, 2013). However, for the first time, the China's economy only grew 7% over the past few years (Bloomberg News, 2015). This number is perceived to be the lowest number for China's economic growth. Besides due to the surplus of international trade, the slowdown on the economic growth perceived to be compounded by the decline of the stock indexes in the two largest China's stock markets, Shanghai stock exchange market and Shenzhen stock exchange market. Though the decline of the China's stock market gives only a little impact towards the China's economic growth, it still feared that this decline will give the adverse impact towards the investors itself. Beginning in 2015, the China's stock markets have been going worst during a period. It happened when its stock market experienced a decline

from its highest rate into the lowest rate. Initially, Shanghai stock index dropped at the number 8.5% in June 12, 2015 (Business and Finance, 2015), meanwhile, the dramatic losses also happened in Shenzhen stock exchange market. The China's joint-stock index from Shanghai and Shenzhen fell 12% in August 2015 and the total of the decline from the joint-stock index was 30% since June (BBC Indonesia, 2015).

China's stock markets continued to decline until it reached the lowest rate. The Shanghai stock market fall 35% in just nine months (Stewart, 2015). Meanwhile, Shenzhen stock market, that often compared to the America's Nasdaq index, fell 41% since June (Riley, 2015). Seeing this condition, the companies traded in China decided to shut down the trading and pull their shares. As a result, China lost over thee half of its listed companies in stock market and this decline of the business in China seem to increase. The China's stock market crisis has worried the investors, particularly the domestic investors. In China, the foreigner only owned 1.5% of China's shares (Riley, 2015). Therefore, the foreigner's portfolio investment will not be directed affected by the decline of China's stock market. Still, they worried that this decline will influence the economic growth of China. Conversely, the China's stock market crisis gave the worst impact to the domestic investors since there are many people who join the investment activities in China.

The figure below shows the dynamics of the China's stock market, Shanghai and Shenzhen stock exchange composite index, from June 2014 until August 2015. June 2014 was a starting point for the China's stock market in which it experienced a rapid growth. This rapid growth led to the bubble on China's stock market. This rapid growth achieved its peak on June 2015. Started from June 2015, China's stock market decline from its highest rate into the lowest rate for the first time. Since then, the China's stock markets have been going worst. Meanwhile, August 2015 was a period in which China experienced the consequences of its bubble on its stock market. One of its consequences is the deterioration of the China's stock market growth. The China's stock markets are experiencing the volatility and vulnerable.

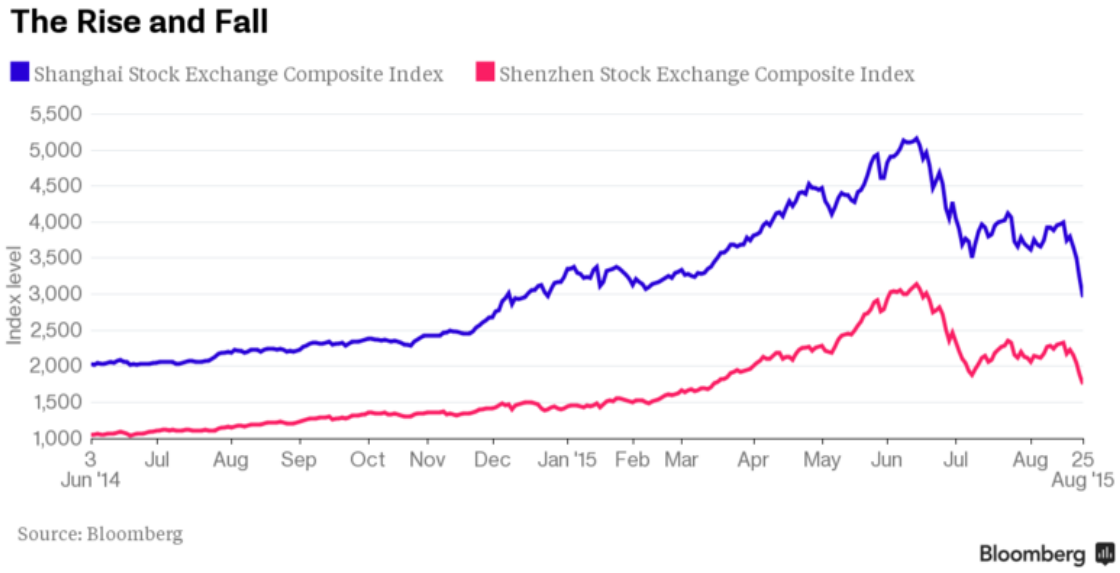

Figure 3.0.3 The rise and fall of China's stock market (Bloomberg News, 2015)

B. The Un-controlled Capital Mobility in China

The reason of the decline in the stock market was because of the uncontrolled capital mobility in China. What meant by the uncontrolled capital mobility is the massive purchase of shares using borrowed money. This borrowed money is coming from the brokerages houses that have been proliferated in China. Since the global financial crisis in 2008, the central government of China launched the economic stimulation to re-boost its economic growth after the crisis. One of the economic stimulations is the margin trading policy which was launched in 2010 and expanded in 2012 with the formation of China Securities Finance (Wildau, 2015). This margin trading policy allowed people to invest using borrowed money from brokerages or other financial institutions (Business World, 2012). Since then, the investment is going viral among investors. The high number of financial institution or intermediaries in China enabled investor to borrow money. Thus, the investment becomes an affordable activity of the Chinese people.

The margin trading policy is prompted the investors to buy the securities using borrowed money. Although the central government gave the flexibility toward its stock market through margin trading strategy, it still included the rule to safeguard its stock market. However, though the government applied the rule and provisions, the people tend to cheat the rule and provisions. They tend to avoid the government's rule and provision to get into its stock market. Such behaviour could create more risk compared to the official rules. As a result,

people are using the illegal method to get into the margin trading. As a result, there are more than 5 million investors in China who are a new investors come from an ordinary people who know nothing about the investment, it makes the total numbers of investors in China reached 90 million (Stratfor, 2015). Due to the margin trading policy, more investors came and targeted the brokerages houses to buy or lend the stocks or money while controlling the boards that shows the fluctuation of the stock prices (Schell, 2015). They usually involved in short-term speculation rather than long-term investment. Thus, it treats the China's stock market much like casino that vulnerable to the speculative. Therefore, the China's stock market is dominated by the margin trading. The easiness to invest in China's stock market stimulated people to join the gamble table. In addition, the central government of China also always promote and encourage the people to join the investment activities.

The uncontrolled capital mobility led to an incredible boom in China's stock market. The massive purchase of shares using borrowed money led the rise of the stock prices up to 150% (Lee, 2015). It happened because the capital mobility which allocated through stocks are being uncontrolled. Investors are over excited to invest in China's stock market, in which it helped to push the stock prices. This massive purchase of shares gave an impact towards the China's stock market in which it experienced a great bubble. The China's mutual funds doubled from $720 billion to $1.2 trillion during January-April 2015 (Stratfor, 2015).

Meanwhile in May 2015, the China's mutual fund reached $1.18 trillion. In addition, the China's margin loans achieved $360 billion in June. The figure below shows an increase in China's mutual fund and China's margin loans since January until May 2015. Through the increase of China's mutual fund and margin loans, China becomes the largest stock market in the world which is replacing Japan (Stratfor, 2015).

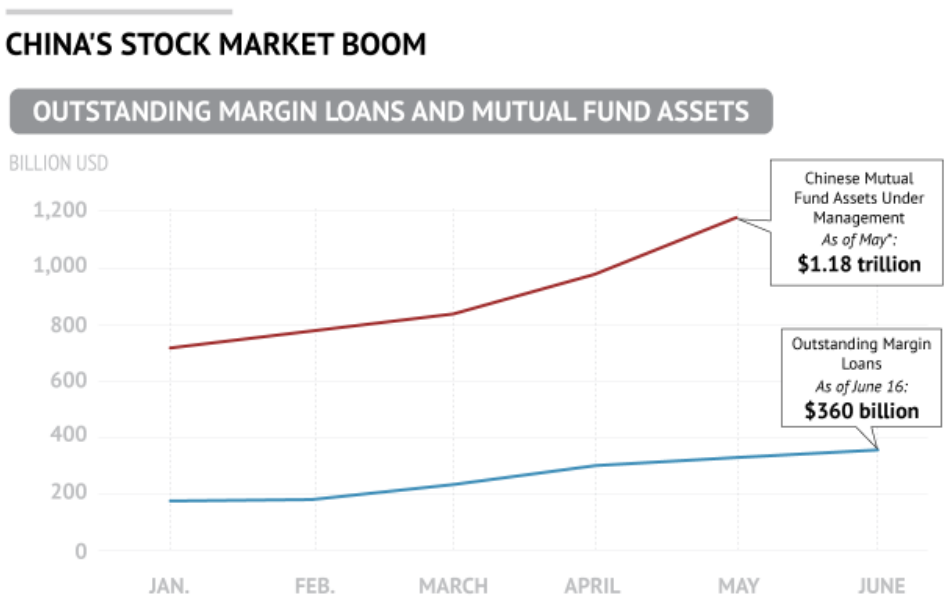

Figure 3.0.4 China's stock market boom (Stratfor, 2015)

This increase of the stock market was the strategy of the central government to fix the decline in real estate prices and excessive debt after the global financial crisis in 2008 (Hsu, 2016). However, after the increase of the stock market, it suffered from the free-fall. The increased purchase of the shares using borrowed

money led to the great bubble and the possibility that it will explode. The explosion of the bubble perceived will give the worst effect toward the actor of the investment itself. Seeing this condition, the brokers shut down the trading and the investors were hit by panic. The investors worried that this condition will influence the future growth of the investment activities in China. Seeing the uncertainty condition in the China's stock market, the investors started to sell the shares to repay the debt. The investors in China who initially flocked to buy the shares using borrowed money eventually sell their shares. The massive sell in the stock market led to the fall of the stock prices and the decline of China's market. China is now deal with the effect of its own bubble.

This event of bubble and crises are also explained by Franklin Allen and Douglas Gale (2000). Allen and Douglas (2000) said that bubble in asset price is often followed by the financial crisis (Allen & Gale, 2000). They also add that:

> The first phase starts with financial liberalisation or a conscious decision by the central bank to increase lending or some other similar event. The resulting expansion in credit is accompanied by an increase in the prices for assets such as real estate and stocks. This rise in prices continues for some time, possibly several years, as the bubble inflates. During the second phase the bubble bursts and asset prices collapse, often in a short period of time such as a few days or months, but sometimes over a longer period. The third phase is characterised by the default of many firms and other agents that have borrowed to buy assets at inflated prices. Banking and/or foreign exchange crises may follow this wave of defaults. The difficulties associated with the defaults and banking and foreign exchange crises often cause problems in the real sector of the economy which can last for a number of years.

The China's stock market crisis is the exact sample of the phenomenon. Before the crash, the stock market showed the increase of the prices up to 150% (Lee, 2015). The increase of the stock prices was due to the many people joined the investment activities through the China's stock market. Thus, the people start to purchase much shares since it was facilitated by the central government of China. As a result, it caused the massive purchase of shares in China. This massive purchase was lasted for a year until it reached the peak in the early 2015. After the uncontrolled capital mobility, the bubble is finally exploded. This explosion was followed by the decline of the companies listed in the China's stock market. Most of the companies that listed in Shanghai and Shenzhen stock exchange market decided to shut down the trading. As a result, China's stock market loss over a half of the companies listed in its stock market and China's stock indexes dropped into its lowest rate.

In summary, the stock market crisis happened due to the uncontrolled capital mobility which was the massive purchase of shares using borrowed money from brokerages. The more investment using borrowed money will harm the economy because it created the instability economic. In the context of China, this downfall was the effect of the surge in the stock market. Investing using borrowed money originally gives the advantages since the market rose. However, when the market starts to fall, the investors will suffer from huge losses as well.