Box A

The Recent Decline in Chinese Equity Prices

After rising by 150 per cent over the year to mid June, equity prices in China have since fallen by 30 per cent (Graph A1). The fall was broad based across sectors, but was larger for small- to medium-sized companies and for technology stocks, which are more commonly listed on the Shenzhen Stock Exchange than on the Shanghai exchange. As with the preceding rapid increase, the decline was driven by retail investors and did not seem to be associated with a marked change in the outlook for the economy or the fundamental value of stocks.[1]

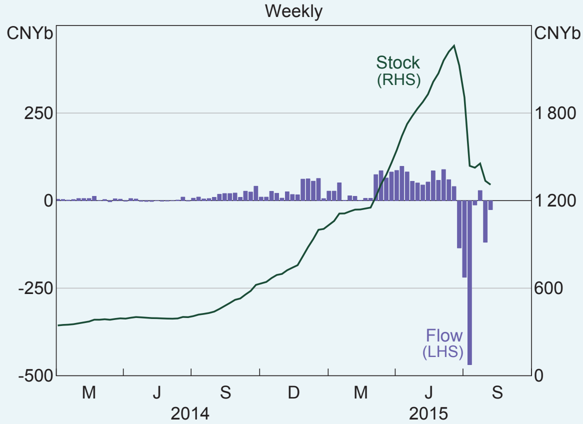
Leverage, that is share purchases partly financed by borrowing, has played a notable role in the share market movements over the past year, unlike previous episodes when leveraged purchases were prohibited. Outstanding margin lending through brokers, the largest providers of funds, has declined by 40 per cent since its peak in mid June to around CNY1.3 trillion, with much of this fall concentrated in the first week of July (Graph A2). It appears more likely that this decline in broker margin financing was the result of voluntary deleveraging than of widespread forced selling to meet margin calls. One indication of this is that brokers would have only been compelled to issue a margin call to investors who had bought an entire portfolio of shares at the peak of the market (that then fell in line with the broad indices) if the initial loan-to-value ratio (LVR) was close to the 50 per cent maximum available from brokers. This is well above the average LVR of 36 per cent across all investors prior to the sell-off.

1 For a discussion of the rapid increase, see RBA (2015), 'Box B: Recent Developments in Chinese Equity Prices', *Statement on Monetary Policy*, May, pp 32–33.

Graph A1
Chinese Share Prices
1 January 2014 = 100

Source: Bloomberg

Graph A2
Chinese Margin Financing
Weekly



Source: WIND Information

It is likely, however, that there has been greater stress for investors who sourced finance from institutions other than brokers, as leverage financed through these channels can be considerably higher. Such lending is extended by a wide variety of entities and through a number of different structures, but the largest providers appear to be banks (including via off-balance sheet entities) and trust companies.[2] Margin loans from such providers reportedly have LVRs as high as 90 per cent, although they seem to be more commonly between 50 and 67 per cent. At these LVRs, investors who bought shares at close to the peak using non-broker margin financing would have little to no equity left. The aggregate size of such leveraged equity trading is unknown, but market analysts' estimates suggest it could be as large as formal margin financing.

The Chinese authorities responded to the decline in share prices by announcing a number of different policies. The government appears to have been a very significant buyer of stocks, largely via China Securities Finance – a state-owned financial institution that previously specialised in margin financing loans. Demand for shares was also supported by the announcement in early July that 21 brokers would contribute CNY130 billion to a market stabilisation fund to purchase stocks, among a number of other measures.

In addition, the authorities prohibited a range of investors from selling, including major shareholders, company directors and managed funds, while also relaxing margin call requirements and placing tighter limits on short selling. The authorities also agreed to a large number of companies being suspended from trading, with around half of listed companies suspended on 9 July (compared with a usual proportion of around 20 per cent). A large proportion of many Chinese companies' shares are not typically available to trade at normal times due to state ownership (i.e. they are not part of the 'free-float' market capitalisation) and the suspensions further lowered the proportion that is tradeable to around 25 per cent of total market capitalisation on 9 July. Considerably less than this could be sold during the day as most stocks hit their 10 per cent daily price change limit.[3]

The combination of these actions supported a partial recovery in share prices, but there have been some more large price falls subsequently as investors questioned the continuation of this government support. Share valuations remain stretched and brokered margin financing as a share of free-float market capitalisation remains well above that in other countries, at 6½ per cent (down from a peak of 10 per cent).

It is unlikely that the decline in equity prices will have a large impact on economic activity through its effect on consumer wealth. While the value of shares held by households has fallen sharply in recent weeks, household wealth in equities is still higher than it was at the beginning of the year and shares are a relatively small share of households' assets in China. ✠

2 Internet brokers and peer-to-peer platforms have also been rapidly growing and high-profile sources of funds, but the total extended via such entities appears to still be small.

3 Share prices in China must trade within a daily range of plus or minus 10 per cent, except those issued on that day.