



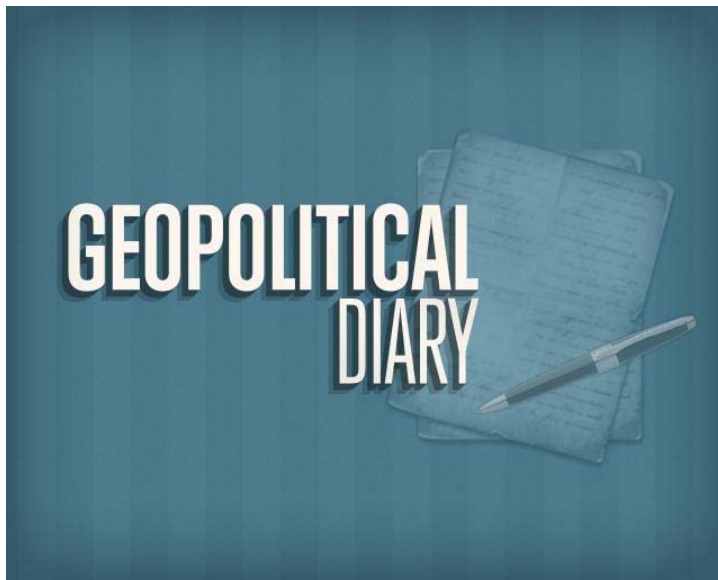
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## China's Stock Market Bubble Bursts

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The Shanghai Composite Index fell 5.9 percent on Wednesday. The Shenzhen Stock Exchange, China's second largest stock market, fell 2.5 percent for the day and nearly 40 percent since it peaked in mid-June. Well before markets closed in Shanghai, stocks for more than a third of listed companies had suspended trading, having plummeted below the minus 10 percent daily threshold set by the Chinese government. In Shenzhen, more than 50 percent of shares had been taken off the market by day's end. Had the government not suspended trades on more than 1,300 companies' stocks, overall declines would almost certainly have been steeper.

China's [stock market bubble](#) — at least this iteration of it — has burst. In the three weeks since market capitalization across the country's largest exchanges peaked at around \$10.3 trillion, China's markets have lost more than \$3.2 trillion in value. That is greater than the economy of the United Kingdom. For all its efforts, the Chinese government has been unable thus far to stop, or even slow, the decline. What began as a series of soft, sporadic nudges from the country's securities regulator — for example, light restrictions on access to margin loans, or loans used to invest in stocks, to contain irrational exuberance — has over the past

week become a torrent of increasingly substantial and overt interventions by a range of government authorities and government-affiliated financial institutions, such as the central bank, the securities regulator, China's largest brokerages, state-owned enterprises and mutual funds. For all intents and purposes, none of it has worked. The market continues to fall.

Does the decline of China's stock market matter? Yes, but not only — or even primarily — for the reasons being proffered in mainstream media coverage of the bubble's bursting. Media attention has focused on the risk of systemic financial instability within China stemming from the rapid buildup of margin loans in the weeks and months leading to June 12, when the market peaked. There is the threat of social unrest as tens of millions of ordinary Chinese watch some or all of their savings disappear overnight. The media has also given attention to the risk of international financial contagion as the Chinese market collapse intersects with political and economic chaos in Greece to drive worldwide investor confidence down.

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To be sure, these are real concerns. The expansion of margin lending — which doubled between January and June, only to lose 40 percent of its value since July 1 — makes the current bubble a far greater threat to nationwide financial stability than any before. But at their peak, the value of outstanding margin loans was \$365 billion, a hefty but by no means unmanageable sum for Beijing. The unwinding of more than \$100 billion in margin loans over the past week has yet to upset the broader financial system, and it is unclear what difference another \$30 billion to \$60 billion (which would bring the total outstanding margin loan value back to its pre-bubble levels) would make.

Likewise, though the decline has certainly hurt the bottom lines of tens of millions of Chinese, signs of social unrest have yet to emerge. The vast majority of investors are still up handsomely from where they were three to six months ago, and those who have been in the market since the boom began in June 2014 are doing quite well.

Finally, though the decline has undoubtedly stirred jitters across markets globally, the fact that few overseas businesses are listed in China reduces the real, long-term impact of the decline beyond China's borders. Certainly Hong Kong and perhaps Japan and Singapore will suffer from the general dip in investor confidence, but with the exception of some companies listed in Hong Kong, their businesses will remain relatively unaffected by deflating equity prices in China.

In Stratfor's view, the significance of the stock market decline lies elsewhere. First, there is the question of whether and to what extent the collapse of stock prices will affect corporate financing in the Chinese economy. Historically, Chinese companies (state-owned enterprises and well connected private companies, at least) have relied on credit lines from state-controlled banks for virtually all of their financing. Stock markets, while a useful ancillary source of capital and a good diversion for Chinese citizens looking to gamble some portion of their savings, were far too fickle and opaque to be a significant means of raising funds in the real economy.

But during the past year, with the government's increased focus on market-oriented reforms and its effort to consolidate key industries, the flow of credit from China's banks has tightened, creating a growing financing gap for many enterprises. The stock market helped fill that gap. Its decline could exacerbate hundreds of Chinese companies' already immense difficulties in repaying outstanding debts — debts that are now well in excess of 100 percent of China's GDP. If the market declines too rapidly and banks or shadow lending markets fail to ramp up credit, China could begin to experience destabilizing corporate debt crises in the months ahead.

In addition, as we wrote earlier this week, a collapsing stock market affects private household consumption. The Chinese government looks to private household consumption not only as the basis for the new economic model China's leaders want to put in place but also as a means of maintaining stable employment in consumption-related industries while the housing and heavy industrial sectors decline. As more Chinese citizens lose more money on the market, the impact on spending on nonessential goods will likely become more pronounced, especially considering that stock market participation is highest in cities — the central drivers of household consumption nationwide. Slower growth in consumption and consumption-related services and employment could be highly destabilizing at a time when the housing construction and heavy industrial sectors are starting to shed employment in many parts of the country.

Finally, in trying and visibly failing to stem the stock market decline, China's leaders run a political risk of losing the confidence of citizens but also, and perhaps more concerning, members of the upper echelons of the Communist Party and government apparatuses. China is approaching a period of unprecedented economic change and hardship. The economic slowdown of the past year is merely the start of a much longer process of economic restructuring being forced on China by a confluence of factors. Weathering that process, and enacting and enforcing the reforms needed to ensure that China comes out stronger at the other end, will require the country's central leadership to have a firm grasp of the political structure. It will also require the confidence of the tens of millions of low- and mid-level politicians who constitute the machinery of daily governance.

Though there is no reason yet to believe that Chinese President Xi Jinping or any other central leaders have lost the Party's or the people's confidence because of the government's troubles with the stock market, the risk remains. And if such a loss of confidence materializes, it could well change China's fate.

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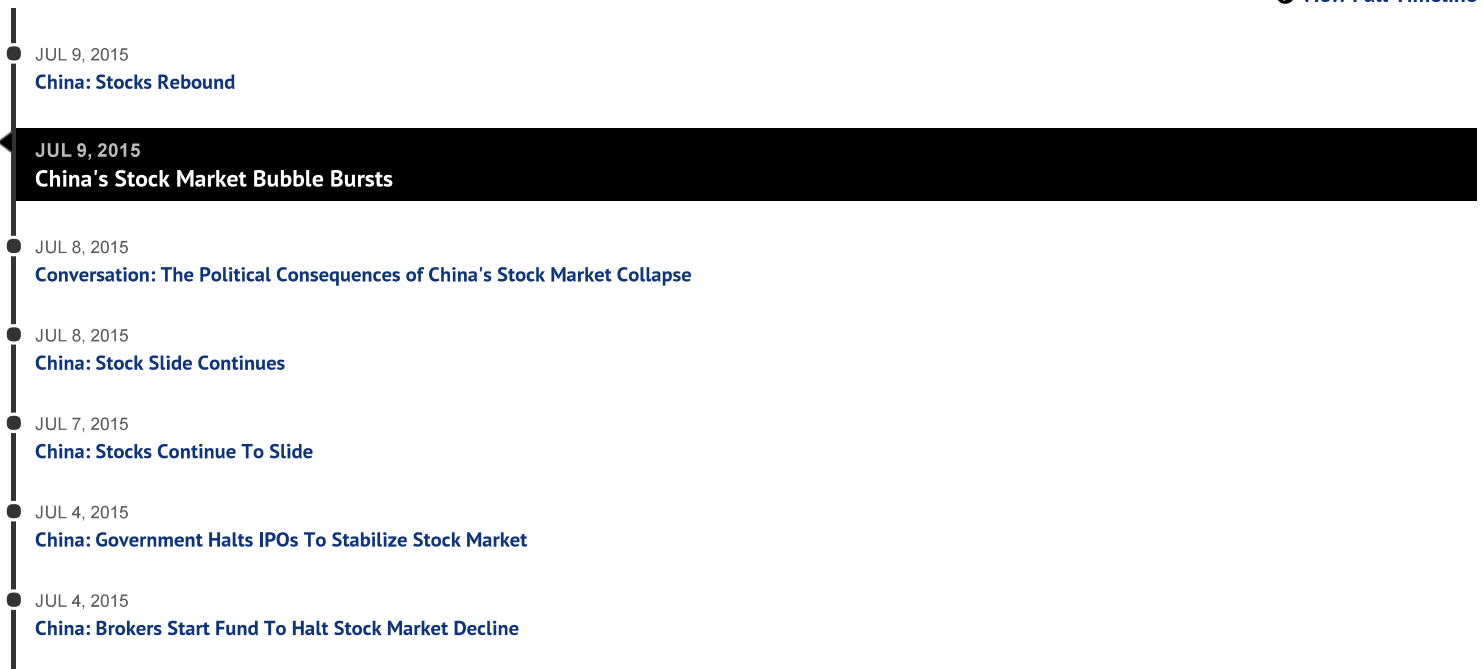
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