The Volatility of Mainland Chinese Stock Market and Financial Stability

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Since mid-2023, the mainland China's stock market has been continuously declining. The net outflow of funds through the Shanghai-Hong Kong Stock Connect and the Shenzhen-Hong Kong Stock Connect (Northbound Capital) totaled 14.4 billion yuan, marking the sixth consecutive month of net outflow. The sudden withdrawal of liquidity from the securities market ultimately triggered the stock market crash of 2024. In the first 25 trading days of the year, the Shanghai Composite Index and the Shenzhen Component Index plummeted by 9.2% and 16.4% respectively, with the number of A-share companies whose market value fell below net assets soaring to 850, setting a new record.

There are three main reasons for the current stock market turmoil: first, weakening growth expectations. Thirty-three institutional investors estimated that the average economic growth rate for 2024 would be 4.6%, a decrease of 0.6 percentage points from the previous year. A key factor is the withdrawal of foreign investment in mainland China. In the third quarter of 2023, foreign direct investment (FDI) saw a net outflow for the first time. Meanwhile, foreign trade has experienced 15 consecutive months of negative growth, dragging down trade in high-tech products.

Second, the ongoing financial storm. In 2023, the sales of commercial housing decreased for six consecutive months, while the unsold area continued to grow positively for 30 consecutive months. Oversupply led to a decline in housing prices. The selling prices of newly built commercial residential buildings in 70 major cities have seen 21 consecutive months of decline. Affected by this wave, financial giants such as Zhongzhi Enterprise Group and Ding Yi Feng Holdings Limited, and even large central state-owned enterprises like China Energy Engineering Group, have declared bankruptcy one after another.

Third, the divergence in US-China monetary policies. By the end of January 2024, the China 10-year government bond yield had fallen to 2.43%, while conversely, the US 10-year government bond yield had risen to 3.99%. The gap between US and Chinese bond yields widened from 0.62 percentage points in the same period of the previous year to 1.56 percentage points. As a result, the spot exchange rate of the Renminbi against the US dollar depreciated by 5.1% to 7.104, inducing a capital flight of $659.7 billion, reaching a new historical high.

Lastly, geopolitical conflicts. In 2023, the Beijing authorities, citing national security concerns, successively arrested international business consulting firms and investment banks. This triggered the exodus of foreign capital from the securities industry, including BlackRock, Vanguard, and sovereign wealth fund from Canada and Norway. In response, the United States updated the list of Chinese Military-Industrial Complex Companies (CMIC) in January 2024, adding a total of 73 military-related companies, prohibiting US individuals and institutions from investing in related companies.

In response, the State Council has urgently implemented three market rescue measures. First, expansive fiscal and monetary policies. The securities transaction stamp duty was halved, and the statutory reserve ratio was lowered twice, with a cumulative reduction of 0.75 percentage points, releasing 1.5 trillion yuan in long-term funds. In particular, the China Investment Corporation increased its holdings of index ETFs by 300 billion yuan and urged listed companies to repurchase shares.

Second, tightening the outflow channels of the stock market. The Beijing authorities have successively compressed the margin ratios for securities lending and private equity funds, the ratios and methods of strategic investor allocations, total return swap (TRS) transactions, newly added securities lending, direct market access for quantitative hedge funds, and intraday stock borrowing for margin trading. Regulatory agencies have also issued "short-selling bans" and initiated criminal investigations.

Finally, expanding the opening of the financial industry. In January 2024, the People's Bank of China expanded the trial of the "cross-border wealth management connect" and included national bonds and policy financial bonds under the "bond connect" in the list of eligible collateral. The State Council also announced the complete removal of shareholding ratio restrictions on foreign banks and insurance companies. However, at the same time, the Beijing authorities suspended offshore securities trading and tightened review thresholds for foreign exchange purchases, tightening capital account controls.

In summary, the new measures to rescue the mainland Chinese market are limited in innovation, but they are more forceful than before. Particularly, the current stock market crash is rooted in fundamental factors, including weakening growth expectations, the ongoing financial storm, divergence in US-China monetary policies, and geopolitical conflicts, which may not be reversed by short-term measures. Subsequently, particular attention should be paid to whether the "national team's" intervention in the market to stabilize prices exacerbates the "government advancing, private retreating" trend and further distorts the economic structure.