INTERNATIONAL

Chinese investors blame share collapse on state

Analysts single out shadowy world of margin lending, which has pumped borrowed money into the market

GABRIEL WILDAU — SHANGHAI

At a stock trading hall for retail investors near People's Square in Shanghai, the mood is glum.

Shenyin Wanguo, like other Chinese brokerages, maintains its hall for investors to hang around, make a few trades and share tips. Among the mostly elderly investors, zest for market speculation goes hand-in-hand with the socialist conviction that the government can and should protect them from risk.

"Even I, an old party member, don't believe the regulators any more," says Ms Xu, a 76-year-old retiree.

China's main stock index lost 5 per cent yesterday, shrugging off an interest-rate cut by the central bank over the weekend. The market has now tumbled 22 per cent since hitting a seven-year high on June 12. Ms Xu blames the securities regulator for approving too many initial public offerings, siphoning demand away from existing shares.

She also lost money punting on internet stocks amid pledges by top leaders to promote the technology sector. ChiNext, the Shenzhen-based start-up index, had more than tripled in the year to June but has since plummeted 30 per cent.

"The country is promoting 'internet plus' so I bought some internet-themed stocks," she says. "Their results looked good. But then came a few days of limit-down. Now I'm stuck," she says, referring to the maximum 10 per cent limit on a stock's gain or loss on a single day.

Reflecting the surge of retail investors into the market, trading accounts holding at least some stock hit 68m by the end of May, up 27 per cent from a year earlier, according to clearing houses.

Yet analysts say the roots of China's stock boom, and its unfolding bust, lie not in old-fashioned retail trading halls. Instead, margin lending, which did not exist during China's last big equity boom and bust, has played a central role.

Official margin lending through securities brokerages peaked at Rmb2.3tn ($371bn) on June 19, up from just Rmb403bn a year earlier. Goldman Sachs estimates such lending equals 12 per cent of the free-float market capitalisation of margin-eligible stocks, and 3.5 per cent of gross domestic product.

But even that figure fails to capture the full extent of leveraged stock investing. In addition to brokerages, grey-market margin lending through third parties has pumped an additional Rmb500bn to Rmb1tn in borrowed money into the market, according to estimates from Haitong Securities.

Brokerages limit margin leverage to a ratio of two to one and require clients to put up at least Rmb500,000. By contrast, Xunqianwang, a company that connects punters with borrowed money, allows leverage of up to six to one, and requires as little as Rmb2,000 of the client's own funds. The company, whose Chinese name translates as "search for money", boasts that new clients can gain approval in an hour.

"We can still control the risk because we strictly examine and assess every client," says Zhong Jingtian, the founder and chief executive. The company restricts which stocks a client can buy and does not give loans to a single client exceeding Rmb3m.

Analysts say the proliferation of margin lending creates the risk of a snowball effect as margin investors, faced with mounting losses, are forced to liquidate their positions unless they can post additional collateral.

David Cui, equity analyst at Bank of America Merrill Lynch, estimates that the Shanghai Composite would need to fall an additional 40 per cent for large-scale margin calls to kick in on official margin lending. "However, this doesn't mean that margin call is not a serious risk right now," he wrote in a note yesterday. "The selling pressure so far has mainly come from stock-related borrowings via various unofficial channels where the leverage is much higher."

Some analysts still expect the market to rebound. They argue that the fundamental factors underpinning the rally, especially loose monetary policy and ongoing economic reforms in China, are still intact, even as valuations now look more reasonable.

Additional reporting by Ma Nan

Editorial Comment page 14

Cloudy outlook: China's main stock index lost 5% yesterday. The market has tumbled 22% since peaking on June 12 — Aly Song/Reuters

Reform 'distorted' financial system, warns World Bank

China must take urgent steps to reform a "distorted" financial system in its transition to a more balanced economic model, the World Bank has warned in its latest review of the country's economy.

"Financial reform will only prove effective if it removes the distorted incentives and poor governance structures that have affected how financial resources are mobilised and allocated," the bank said in a report released yesterday. "A fundamentally reconfigured role of the state in the financial system is essential."

The Chinese government retains effective control over almost 95 per cent of bank assets, compared with 74 per cent state control in India and about 40 per cent in Russia and Brazil, according to World Bank calculations.

As a result, state-owned enterprises have been able to secure a disproportionate share of available credit at the expense of small and medium-sized enterprises.

Karlis Smits, a senior economist at the World Bank and lead author of the report, noted that a failure to move to a more market-based financial system would exacerbate such distortions.

He also warned of the potential dangers from a sharp correction in China's rollercoaster stock markets.

"Asset price corrections are one of the risks to the growth outlook," Mr Smits said. "That would undermine consumption if there's significant volatility or a correction."

Ayhan Kose, who oversees the World Bank's macroeconomic forecasts, said: "Equity ownership is rather small in China relative to most other countries. [But] the volume of margin trading is rather sizeable. In a disorderly correction, the volume of margin trading can create balance sheet challenges."

Last year China's gross domestic product grew 7.4 per cent, the slowest rate of expansion since 1990. The World Bank is now forecasting an expansion of 7.1 per cent this year and said growth was likely to slip to 6.9 per cent by 2017. By contrast it expects 7.5 per cent growth this year in India, which Mr Kose described as the "bright spot" among the Brics economies.

But the bank described China's cooling as "desirable" and "orderly" as the government looks to find a more sustainable footing after years of credit and shadow banking-fuelled growth. "[Chinese] authorities have been able to slow down credit growth in an orderly fashion," Mr Kose said. "They are also actively taking policy measures to mitigate the risks associated with volatility in the equity markets."

According to World Bank forecasts, China's services sector will account for more than half of the country's economic growth by 2017 as the country modernises from an industrial powerhouse to a consumption-based economy. Over the past decade, the services sector has expanded from a 41 per cent share of the economy to 48.3 per cent last year.

Tom Mitchell in Beijing and Patrick Magee in Hong Kong