The 2015 Stock Panic of China[1]

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Abstract: *This essay documents the boom and bust of the Chinese A-share bubble in 2014-2015. The short-lived bull market started with the expectation of the state sector reform, capital market opening-up, and monetary easing. It was then fueled and heated by the flooding of new investors and the runaway leverage. The regulatory bodies failed to check the leverage in the early stage. Forceful crackdown on leverage, which came too late, finally tipped the market toward a violent crash. The 10% daily trading limits and the voluntary suspension of trading exacerbated the illiquidity problem during the crash. We also document the government responses to the crash and discuss how China may strengthen its financial system.*

Keywords: A-share, bubble, leverage, China
JEL Codes: G14, N25, O53

1. Introduction: The Case for Bull Market

Before the bull market started around July 2014, the Chinese "A-share" market was among the worst-performing stock markets in the world. The rebound from the bottom of the global financial crisis (GFC) was short-lived. From early August of 2009, when the U.S. stock market was still in the early stage of a persistent bull run, the A-share started a grinding bear market. On Jun 30 of 2014, the Shanghai Security Exchange Composite Index (SSECI) closed at 2048.33, not far from the year-low of 1974.38, or the post-GFC bottom of 1849.65 touched in June 2013 (Figure 1).

There were three key words behind the forthcoming bull market: Reform, Opening Up, and Monetary Easing. The 3rd Plenum of the 18th Communist Party of China (CPC) Conference declared that China would continue to reform. In particular, the state-owned enterprises (SOE) would be encouraged to diversify ownership (mixed-economy reform) and improve corporate governance. Since the majority of the listed companies in the A-share market were of local or central government background, reform would be a tremendous boost for the market. Indeed, the SOE reform became a fascination of investors and any news of SOE reform seemed to be good news. Sinopec, for example, gained 10% (the daily higher limit) following the announcement of mixed-economy reform on Feb 19 of 2014. With reform, even big elephants could fly.

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[1] The first draft was completed in September 2015. This version was completed in June 14, 2016, roughly the first anniversary of the stock panic.

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Figure 1: Shanghai Security Exchange Composite Index (SSECI, 2008-2015)

The same conference also stressed the need to reform and open up the financial system. The Chinese financial system had long been dominated by a few state-owned large banks. A vibrant stock market was a blessing for the desired transition from "made in China" to a more balanced economy. Partly to bolster the ailing stock market and partly to diversify investor base, the Shanghai-Hong Kong Connect was announced in April 2014 and finally put to work in November of the same year. Before the announcement, most of the large blue-chip companies in the A-share market had lower valuation than their counterparts in Hong Kong Stock Exchange. (Dual-listing companies offered ample evidence.) Indeed, stocks with dividend yields over 5% were not exceptions. Following the announcement and especially the final opening-up of the Connect, the large blue chips experienced dramatic bull runs that soon wiped out the valuation gap between Shanghai and Hong Kong (Figure 2).

And finally, the monetary policy started to loosen up, after years of tightening and with much evidence of economic slowdown across the country. As of Jun 30 of 2014, the required deposit reserve ratio for large banks was 20%, which was abnormally high (Figure 3). The benchmark deposit interest rate stood at 3% and the benchmark loan rate was 6%, both of which were actually much lower than the prevailing market interest rates. For example, retail savers could obtain about 5% by investing in "wealth-management products," which were implicitly guaranteed by the banks. Wealthier savers could also enjoy around 10% by investing in "trust products", which were implicitly guaranteed by the trust companies. If a company had to obtain financing by issuing trust products, it had to pay 15% or even more.

Figure 2: Hang Seng China A/H Premium Index (2011-2015)

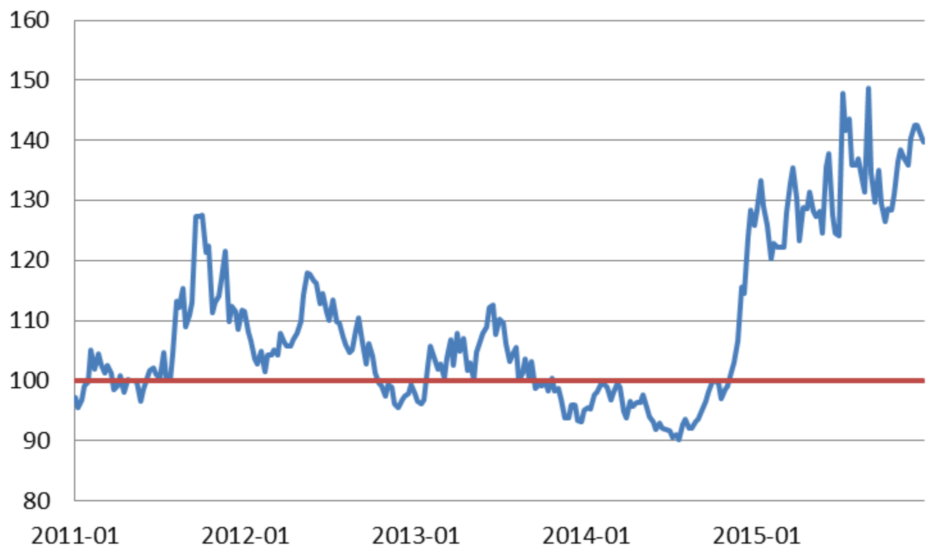
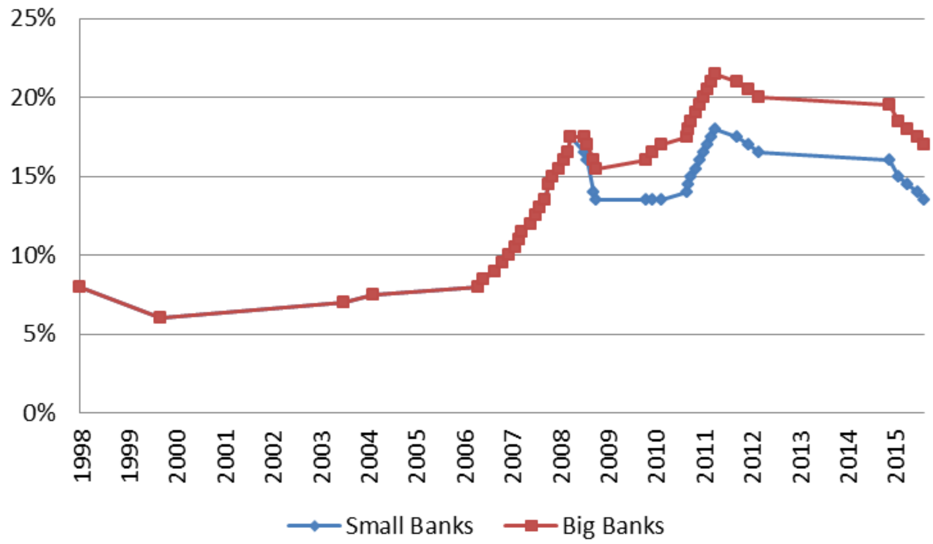


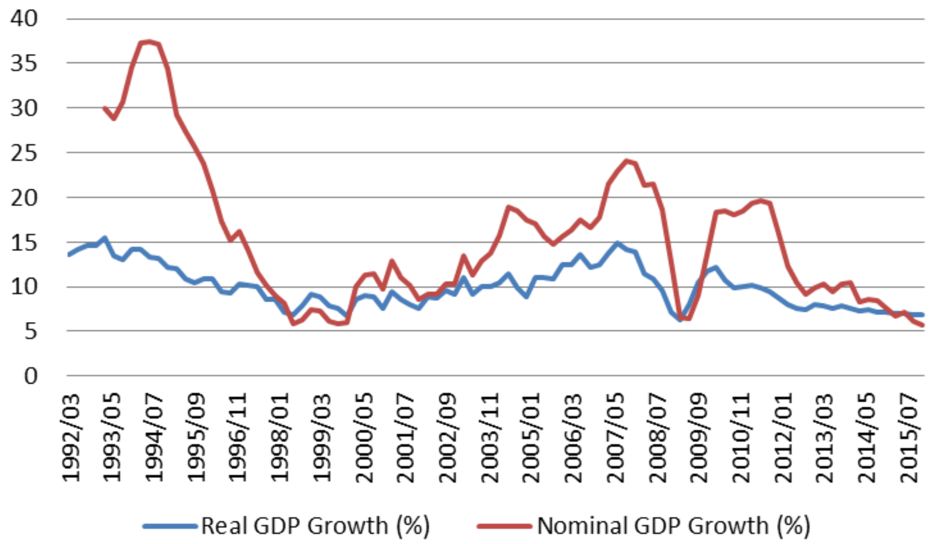
Figure 3: Required Reserve Ratio for Banks



With monetary tightening at such a scale, it is not surprising that the economy started to slow down. And in 2014, the slowdown already seemed ominous. Although the real GDP growth remained above 7%, the official target, the nominal GDP growth fell to single digits, implying either an inflated real GDP growth or a steep disinflation (Figure 4). The growth rate in industrial value-added, which was usually in the double digits, fell to single digits since the end of 2013. The generated electricity, a widely respected measure of macro performance, fell to levels only seen during past crises. The producer's price index (PPI) fell into negative territory in early 2012 and stayed negative after that. Even the housing market, which had been hot for over ten years despite stringent government measures to restrict demand, started to cool down. Given such a dire macroeconomic situation, it was all but certain that monetary policy would loosen up, or at least stop tightening.

Equally important, the pledged opening up of the financial market would make a strong case of convergence between the domestic risk-free rate and the world level, which was close to the zero bound thanks to the quantitative easing (QE) measures taken by major central banks.

Figure 4: Quarterly GDP Growth (1992-2015, %)



So the stage was set for a bull run. The market was obviously oversold, especially the big blue chips. The talk of reform was a free option with unlimited upside. The opening up of the financial market would both bring external demand for shares and global liquidity, which was abundant. The macroeconomic slowdown necessitated a turn of monetary policy toward more accommodative of investing. The bull was ready.

2. The Bull Run

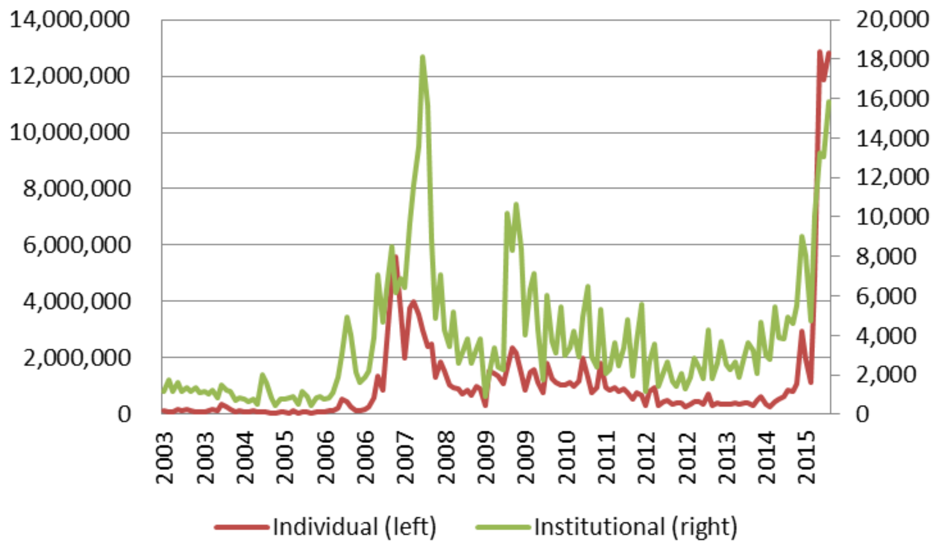
Sensing the tremendous opportunities ahead, smart money started to enter the A-share market and push up stock prices. On November 14 of 2014, the last trading day before the opening of the Shanghai-Hong Kong Connect, SSECI closed at 2478.82, which was a gain of 21% over the June 30 closing. On December 31, SSECI was already at 3234.68, a further 30.5% gain in one and a half months. And the market was still rising.

Four factors may account for the continued strength of the market. First, the central bank of China (People's Bank of China, PBC in short) was indeed easing its policy. On Nov 22 of 2014, PBC cut the benchmark interest rate by 25 basis points to 2.75%, the first time since July 2012. On Feb 5 of 2015, PBC lowered the required deposit reserve ratio by 50 basis points to 19.5%, the first time since May 2012. And once again, on March 1 of 2015, PBC again cut interest rate by another 25 basis points.

Second, the rising share price stimulated economic activities. The so-called wealth effect was not the only channel. The rising share price lowered financing costs for listed companies. This, in turn, stimulated new investment and merger & acquisition activities. The rising market also allowed the China Security Regulator Committee (CSRC), the government body that regulated the stock market, to release more IPOs. Indeed, the pipeline of companies waiting for IPO was full, thanks to the suspension of IPO during the bear market. The grandiose return of IPO's stimulated the full spectrum of equity investment, which further stimulated entrepreneurship across the country. In places like Shenzhen, Beijing and Shanghai, entrepreneurs seemed to have infinite money to burn, experimenting with all kinds of new products and new ways of life. The future could not be brighter. In all, the rising stock index brought a convincing boost of confidence to all cautious observers, factory owners in particular, that the Chinese economy was not as bad as they experienced and that the economic transition would ultimately succeed.

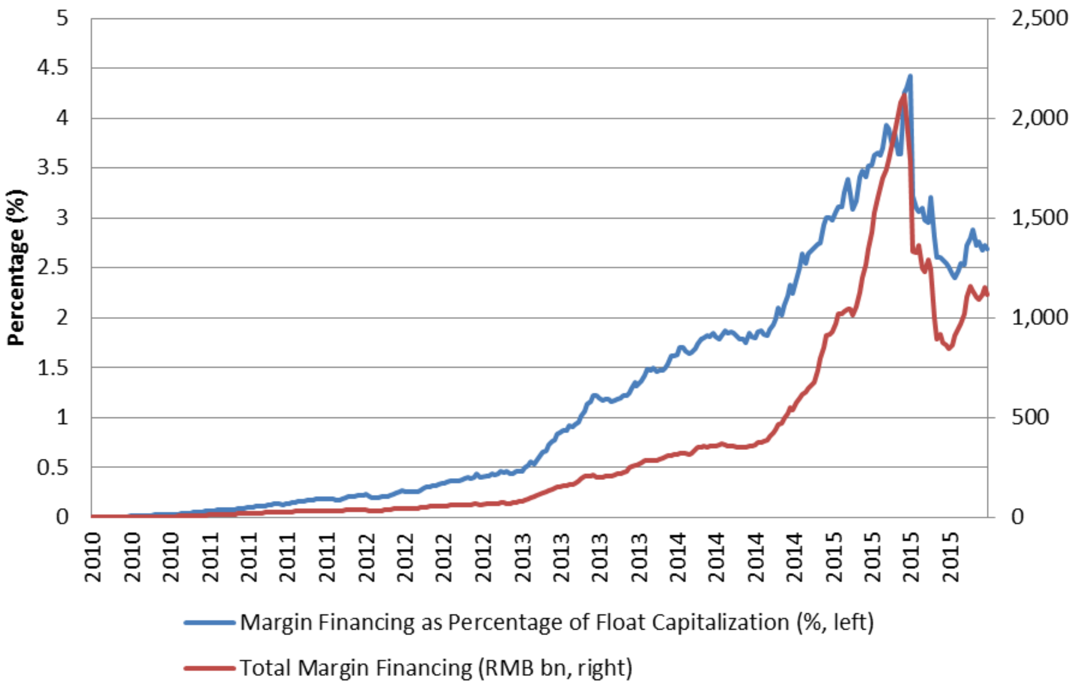
Third, new investors kept flooding in, in unprecedented numbers. In April of 2015 alone, over 12 million new A-share accounts were opened for retail investors (Figure 5). Even in the great bull market of 2005-2007, the biggest month (2007 May) had only seen less than 5.6 million new A-share retail accounts. The contrast may be explained by the efficient information sharing in the mobile internet age. Through the popular app WeChat, people were more connected than ever before and were exchanging information constantly. People with little financial knowledge were attracted to the market, often with the false belief that they had profitable stock tips. The lure of making big and fast money was simply overwhelming. In addition to retail investors, new institutional investors were also in a hurry to join the game, including new mutual funds and hedge funds. The number of new institutional accounts quickly climbed to a level last seen in 2007 (Figure 5).

Figure 5: Number of New A-Share Accounts



Fourth, perhaps most importantly, there was an unchecked building up of leverage. As share prices rose and broke every resistance level easily, demand for margin financing naturally increased. The brokerages were more than happy to accommodate that (Figure 6). To compete for more consumers, in fact, most brokerages secretly lowered qualification criteria for opening margin accounts. (To be eligible for a margin account in China, an investor was required to have RMB 500,000 in stocks and cash. At the same time, the investor needed to pass an exam.) In addition, mutual fund companies were also eager to offer leveraged ETFs to retail investors. A typical Level-B ETF had a leverage ratio of 2 and could be traded at a price far beyond its intrinsic value.

Figure 6: Margin Financing



As margin financing rose rapidly along with the market, CSRC became worried and started an investigation of brokerages in December 2014. In January 2015 CSRC criticized a few major brokerages for negligence in the margin business. Three major brokerages, in particular, were forbidden to open new margin accounts for three months.

These cautious measures by CSRC, however, had an unintended consequence. Many would-be margin traders that did not qualify for margin accounts at regular brokerages turned to “fund-matching” companies, which provided un-regulated margin loans to traders. A typical fund-matching company would use the HOMS system (developed by Hundsun Technologies) to create individual trading accounts. For traders, it had everything the regulated brokerages had, but it permitted a much lower entry barrier and much higher leverage. In addition, regular brokerages only allowed a limited pool of securities to be traded in margin accounts, most of which were blue chips with large capitalizations. At fund-matching companies, however, traders can trade all listed shares. As a result, the fund-matching business flourished.

Another form of unregulated leverage also became popular. That was “umbrella-trust,” most popular among high-net-worth investors and some institutional investors. A typical umbrella-trust investor would, in legal terms, obtain financing from the retail savers who bought “wealth-management-products” at banks. In effect, however, since banks had implicit guarantees on these WM products, it was nothing but bank lending to the speculators. Of course, the trust companies, as financing vehicles for the engineering, collected handsome fees. Like the fund-matching companies, umbrella-trusts offered much more flexibility for traders than the regulated brokerages. Traders could trade any stocks and the leverage ratio could be as high as 3. With the front-door leverage restricted, the back-door leverage ballooned, with dire consequences later.

CSRC’s investigations exerted temporary pressure on big blue chips. But after some consolidation around 3,000, the SSECI continued to climb. In April, it went above 4,000 and 4,500. In early June, it went above 5,000 and reached the year-high of 5178.19 on June 12. The small-cap stocks performed even more spectacularly, partly thanks to the back-door leverage. CS 500, which tracked 500 small-cap stocks, closed the year 2014 at 5322.71. At the end of the first quarter of 2015, it was already at 7253.1. When SSECI peaked, CS 500 also peaked at 11616.38, more than doubled in less than half a year.

3. The Government Attitude toward the Bull Market

During the bull-run, there was a persistent conjecture that the government was behind the bull market. Adding to the credibility of the conjecture was an insurance company, Anbang Insurance, which had princeling connections and made conspicuous investments in banks and property developers at the early stage of the bull market. While this conjecture was not provable or refutable, it could be certain that the top leaders were happy to see the bull market, given all the difficulties they had in managing the economic transition.

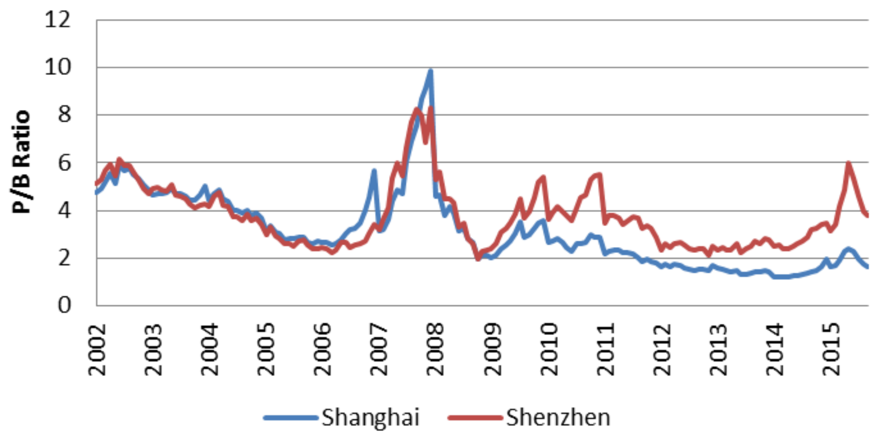
The bull market, if it could be sustained, would solve many problems facing the policymakers. It would make the corporate and the local government balance sheets healthier. It would encourage private-sector investment by lowering financing costs for them. And given the risk appetite of the stock market, especially compared with the banks, a vibrant stock market would also encourage innovation and entrepreneurship. Finally, a bull market would make the middle class wealthier and more willing to consume. All these would point to a more balanced and sustainable economic growth for China.

At the same time, however, at least some of the policymakers were concerned with the risk that was quickly building up. CSRC, for example, repeatedly warned of risk in margin financing, both in brokerages and outside (fund-matching companies, umbrella-trust, etc.). Decisive actions, however, were lacking. Two factors might contribute to the regrettable inaction. First, risk warning was unpopular in a bull market that was making everyone wealthier and happier, including government officials at every level. Second, more importantly, the lack of coordination between CSRC and CBRC (China Banking Regulatory Commission) hindered any action from being taken. For example, banks and trust companies, which channeled bank money into umbrella-trusts, were both regulated by CBRC, which did not respond to CSRC's warning until too late. The lack of coordination among regulatory bodies, or even conflicts of interests among them, proved to be fatal. Without proper coordination, only when the top leader intervened could any decisive and effective actions be taken. This problem was also apparent in the later rescue efforts.

4. The Crash

When SSECI reached 5,000, the overall valuation of the market was already high, although the valuations of the blue chips were at most moderate, especially by historical standard (Figure 7). Over-valuation alone, of course, would not make the market crash. As previously mentioned, the rising market had positive effects on the economy. It was not foolish to project that as the bull market continued, the economy would improve, and so would the profits of the listed companies, starting beneficial cycles. However, three factors tipped the balance toward a disaster.

Figure 7: Aggregate P/B for A-Share Markets



First, the central bank kept ambiguous about its policy direction. SHIBOR (Shanghai Inter-Bank Offering Rate) had been rising since early June, confirming a rumor that the central bank had turned its course to tightening. A sudden surge in the housing price in Shenzhen seemed to provide the background for the rumored tightening. Even after the first week of rout (June 15-Jun 19, SSECI lost 13.32%), PBC did not move.

Second, CBRC (the banking regulator) finally started to be concerned with the unregulated leverage. As late as in early May, CBRC was still denying that the banking sector was channeling money into the stock market. But on June 16, it was reported in China Securities Journal that CBRC was conducting a survey with trust companies on “umbrella-trust” and other structural trust products. CBRC’s slight change in attitude sent a shock wave through the market.

Third, on June 10, the international index provider MSCI decided not to include the A-shares. If MSCI included the A-share in its indexing business, HSBC estimated that close to $50bn global funds would add to the A-share market, which would be a significant boost to investor confidence. The unfulfilled hope became a reason to sell. Two days later, the SSECI topped along with other indices.

As the market started to dive, Chinese investors, for the first time in recent history, experienced the terror of leverage. Investors with a leverage ratio of 10, at fund-matching companies, first went bust. Their portfolios were liquidated, expediting the fall of share prices. Then those 9-timers, 8-timers, 7-timers…, fell in turn, triggering more and more forced selling. The forced liquidation soon spread to umbrella-trusts, which allowed leverage ratio of 3, and even the margin accounts in brokerages, which allowed a maximum of 2.

The daily limits (10%) on stock trading, which were intended as a stabilization mechanism, became a nightmare for investors, mutual funds, and even those who provided leverage financing, including trusts and fund-matching companies. Liquidity for a stock would simply vanish as soon as it was beaten down to the lower limit. And this extreme form of illiquidity would spread quickly to other stocks. When mutual funds, for example, were forced to sell under redemption pressure, they had to sell those stocks still with liquidity. This would often push those stocks to the lower limit. On June 19, a total of 1096 stocks closed at the lower limit. It was the first time during the crash that the headline read “Thousands of Stocks on Lower Limit,” which soon became the norm. June 26 was the darkest day during this phase of the crash when SSECI dropped 7.4% with 2049 closed at the lower limit (Table 1).

Table 1: Number of Stocks on the Lower Limit (2015.6-2015.9)

Date	Number of Stocks on the Lower Limit		Number of Stocks on the Lower Limit
2015/6/19	1096	2015/7/8	915
2015/6/26	2049	2015/7/15	1287
2015/6/29	1578	2015/7/27	1861
2015/7/1	941	2015/8/18	1647
2015/7/2	1525	2015/8/24	2179
2015/7/3	1475	2015/8/25	2018
2015/7/6	964	2015/9/1	1159
2015/7/7	1765	2015/9/14	1446

Voluntary suspension of trading on the part of listed companies also contributed to the vanishing of liquidity. It was a common practice for major shareholders to use their holdings as collateral to obtain bank loans. When the stock price plunged, say 10% off every day, the debtors were fearful of bankruptcy or at least losing the control of their listed companies to the banks. Under such pressure, some listed companies voluntarily suspended the trading of their stocks, using some cooked-up excuses. This practice was quickly emulated by other companies, most of which were small-caps, further withdrawing liquidity from the market. On the dark day of July 7, 787 listed companies suspended trading, along with 1765 stocks at the lower limit. It was a nightmare from which investors, retail and institutional alike, were trying to wake.

5. The Government Response to the Crash

From June 12, the day when SSECI topped, to July 9, the day when the market finally found a temporary bottom, there were roughly three phases differing in how the government dealt with the deepening crisis.

In the first phase, the government was cool on the supposed "correction" in the bull market. During the long weekend (June 20-22), after the bloodbath of June 19, nothing was done to bolster investor confidence. At the press conference following the market close on June 19, CSRC did not even mention the market rout that day or that week. At the same time, the central bank failed to lower interest rate or required deposit reserve rate, confirming the rumor that the monetary policy had turned toward tightening.

As the second week drew to another bloody close, individual regulatory bodies started to come up with rescue measures. This started the second phase, which could be characterized by un-coordinated rescue efforts by different agencies.

On June 27, the central bank announced cuts in benchmark interest rate by 25 basis points and in the required deposit reserve ratio by 50 basis points, apparently responding to the market crash. The central bank's action refuted the rumored turn of policy direction, but it was too late and too little. The magnitude of cuts failed to exceed expectations. It was a stretch, in fact, to regard the rate cuts as a rescue effort. In the announcement, the central bank kept ambiguous about its purpose and did not even mention the stock market or financial instability. Furthermore, during the weekend, there were no other rescue efforts from other regulatory bodies. Unsurprisingly, the market opened high on the next Monday (June 29) but finished with yet another rout. The small-caps were especially vulnerable, with 1578 stocks closed at the lower limit.

After the market closed on June 29, CSRC stepped in, trying to talk up the market. It pledged to tackle insider trading and market manipulation, to continue to crack down unregulated margin financing, and to punish unlawful selling of shares by corporate management. In addition, CSRC warned of the negative reporting or commentary in the financial media. On June 30, the Securities Association of China (SAC), under the direction of CSRC, provided to the media with some details on the unregulated margin financing. On July 1, the Shanghai and Shenzhen Stock Exchanges lowered settlement fees. Also, on July 1, CSRC pledged more channels for brokerages to raise funds. On July 2, CSRC announced to investigate manipulations in the index futures market. This was the beginning of scapegoating on the futures market, with dire consequences later. These token measures achieved little. The market staged a dead-cat-bounce on Tuesday (June 30), but continued to slide for the rest of the week.

After the market closed on Friday (July 3), CSRC was obviously in a panic state. In just three weeks, SSECI lost 28.6%. The small-cap index lost even more. CSRC announced a series of measures to boost investor confidence. First, it announced that the China Securities Finance Corporation (CSF) would raise capital to approximately RMB 100bn. CSF would then obtain financing from various sources, with the mission to safeguard capital market stability. Second, CSRC punished several media for misreporting or spreading rumors. Third, CSRC announced that it would continue to attract long-term investors such as pension funds, insurance companies, QDII, QRDII, and so on. Fourth, CSRC pledged to slow down the pace of IPO.

During the weekend, Premier Li Keqiang intervened and CSRC kept busy. On Saturday (July 4), it convened 21 major brokerages, and separately, 25 mutual fund companies, to discuss further rescue measures. The 21 brokerages made a joint announcement after the conference pledging: (1) they would make a joint fund (no less than RMB 120bn) to purchase blue-chip ETFs; (2) they would not sell their proprietary holdings when SSECI was under 4500; (3) listed brokerages would push for share buy-backs; (4) they would implement the counter-cyclical adjustment mechanisms and ensure smooth handling of customer defaults. Echoing the joint announcement of the brokerages, SAC published a proposal that called for unity among all brokerages to safeguard market stability.

The 25 mutual fund companies also made a joint announcement pledging: (1) they would make restricted funds open for new subscription; (2) they would push for the introduction of new stock funds and complete building the positions; (3) the board chairmen and CEO of the 25 mutual fund companies would actively subscribe to their stock mutual funds, and they would hold the funds for at least one year.

On Sunday (July 5), CSRC announced the following measures: (1) IPOs of 28 companies were suspended; (2) some CS 500 futures accounts were restricted, and "malicious shorting" and market manipulations would be severely punished; (3) CSRC would work with the police and the media regulatory bodies to punish misreporting or spreading rumors. Finally, CSRC announced that the central bank would provide financing for CSF, the main vehicle for market rescue efforts.

What was conspicuous about all these efforts, however, was the absence of other government agencies such as the powerful ministry of finance, CBRC (the banking regulator), China Insurance Regulatory Commission (CIRC), and even the central bank. The fact that CSRC announced the central bank's liquidity assistance for CSF, with the central bank in silence, was curious enough. The silence of all other agencies gave the market an ominous signal that all these rescue efforts were coming from one man, Xiao Gang, who headed CSRC, or the angry Premier Li Keqiang[3]. Political unity was in question, exactly when it was most needed.

When the Monday market opened (July 6), many stocks reached the daily higher limit, thanks to the bombardment of rescue measures by CSRC over the weekend. In fact, SSECI opened 7.8% higher than the previous close. However, bears soon took control and the market started to slide. SSECI ended the day with a mere 2.4% gain. Even this gain was achieved by the newly formed "national team" (CSF), which apparently started buying big blue-chips in the afternoon session. For the day, there were 964 stocks closed at the daily lower limit. The gain in the index masked the continued nightmare and the extreme despair felt by most investors.

On the next morning (July 7), Premier Li was quoted as saying that China had the confidence and ability to deal with challenges faced by its economy. He did not mention the recent stock market crash, which was a signal to market observers that he was no longer in charge of the market rescue efforts[4]. The market continued to slide. SSECI lost 1.3% for the day, while CS 500 lost 6.5%, with 1765 stocks closed at the daily lower limit.

On July 8, SSECI dropped another 5.9%, while CS 500 lost 2.4%, with approximately one-third of all listed companies suspended trading and 915 of remaining stocks beaten down at the daily lower limit. From June 15 to July 8, SSECI lost 32.1%, while CS 500 dropped 42.8%. In less than a month, the roaring bull market became a violent bear market. Threatened was not only the middle-class wealth but also the balance sheet of the brokerages and state-owned banks. Thus the very stability of the Chinese financial system was now in question. Many people, indeed, started to convert their cash into the US dollar. Capital flight was not far away.

At this critical moment, the leadership apparently reached a consensus on rescuing the market. From July 8, the third phase of the government response was started: the concerted rescue effort. First, the central bank announced that it would provide liquidity to CSF, the "national team." It made it explicit that this action was to safeguard the stability of the stock market. Second, CSRC encouraged large share-holders and managers to purchase shares. In particular, those who sold shares in the past six months were required to buy back 10% or 20% of the total proceeds from

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[3] FT: Angry Chinese premier takes charge of market fightback, July 7, 2015.

[4] The stock crash and economic weakness left Li Keqiang fighting for his political future, according to a Financial Times report: Questions over Li Keqiang's future amid China market turmoil, August 26, 2015.

their previous sales. In addition, CSRC announced that CSF would start buying small-cap stocks. Third, CBRC (the banking regulator) announced that it would allow banks to extend loans backed by share collateral. Fourth, CIRC (the insurance regulator) raised the limit on the maximum ratio of equity in insurance companies' investment portfolios. Fifth, the State-owned Asset Supervision & Administration Commission (SASAC) announced that the central-government-owned enterprises should not sell shares during the periods of market instability. For those companies with share prices seriously diverging from the value, SASAC pledged particular support. Sixth, the ministry of finance pledged to "protect market stability." Finally, the Ministry of Public Security intervened and threatened to investigate and prosecute "malicious" shorting.

There were other measures to follow. But these were already enough for halting the slide. In fact, SSECI touched a temporary bottom of 3373.54 the next day (July 9) and staged a forceful rally. The stocks that were still trading, especially the small caps, were one by one pushed to the daily higher limit. The CS 500 index gained 4.45%, the maximum it could go, given that the majority of its component stocks had suspended trading. The panic was finally over, and liquidity came back to the market. The temporary bottom would not be broken until August 24.

6. Epilogue and Concluding Remarks

The great boom and bust of the A-share market exposed fundamental weakness in the financial governance of the second-largest economy in the world. In particular, the fragmented financial regulatory structure hindered the effective regulation and supervision of the dynamic financial markets.

The Chinese financial regulatory authority resided in four agencies (1B3C), the central bank (People's Bank of China) and three commissions (China Securities Regulatory Commission, China Banking Regulatory Commission, China Insurance Regulatory Commission), all of which shared the same political ranking (ministerial level). When this structure was formed during 1997-2003, it was intended to facilitate specialized regulation and supervision in each major financial sector. Without efficient communication and coordination, however, this structure was prone to breed regulatory arbitrages, unable to evolve with various forms of financial innovations that often involved different specialized institutions, and was increasingly challenged by the development of financial conglomerates. Communication and coordination, indeed, was difficult. Self-interests often trumped the common mission, and custodian battles prevented corroboration. For example, the liquidity crunch of June 2013 vividly illustrated the conflict of interests between the central bank and CBRC on the issue of shadow banking[5]. In 2015, the lack of coordination between CSRC and CBRC allowed the uncheck building-up of leverage in the stock market. And with the lack of unified leadership, the subsequent rescue efforts repeatedly failed to boost

5 WJS: Regulators at Odds on Reining In China's Shadow Lending, Jan 14, 2014.

investor confidence and arguably prolonged crisis.

Also apparently lacking were people with an understanding of the market and expertise in handling crises. One possible reason for the inability of reining in leverage in the early stage was that no one fully understood the dynamics and the ultimate risk of the leverage. In particular, CSRC failed to anticipate, let alone forestall, the growth of unregulated leverage. In addition, when the "national team" of the rescue was put together, it did not have a clear strategy and, with almost zero communications with the market, it kept the market guessing about its intention and action. No considerations were given to the lawfulness of their action. For this, many individuals would pay dear personal prices[6].

Furthermore, some rescue measures were counterproductive. The most regrettable measure was the restrictions on the index futures market. The Chinese index futures market was one of the most liquid index futures markets in the world, providing valuable hedging services for institutional investors. Under the pressure of CSRC, however, a series of ever-more-strict restrictions were put in place against the so-called "malicious shorting." Under these restrictions, the once abundant liquidity of the market simply vanished. As a result, the rolling of hedging positions to the next month became prohibitively expensive. This forced many formerly hedged portfolios to unwind, adding to the selling pressure, especially on the blue chips. The market slide from Aug 18 to Aug 26 was widely believed to the product of the hedge fund liquidation.[7]

In summary, to develop a more robust financial market, China would have to strengthen regulation and supervision of financial activities. For this purpose, China should consider re-unifying the currently segmented regulatory and supervisory bodies into a new powerful authority above the ministerial level. The financial regulatory structure had to evolve with the market. In recent decades, the UK and Germany had similar experiences that China might follow. Trading restrictions, such as the daily trading limits and the restrictions on index futures, should be scrapped for good. Finally, it would take able men and women to run institutions and implement reforms. China should improve its financial education of the next generation and find ways to attract talents to serve in the regulatory and supervisory authorities.

[6] FT: China widens market clampdown with detention of senior regulator, Sep 17, 2015.

[7] Another example was the "circuit breaker" that was introduced at the end of 2015 and became operational in the new year. The poorly designed circuit breaker was not only useless, given the 10% daily trading limits in place, but also counterproductive since it induced market-wide panic over trading suspension. Indeed, the circuit breaker was triggered twice in the first week of 2016 and the mechanism was abandoned on Jan 7, 2016.