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China’s Incendiary Market Is Fanned by Borrowers and Manipulation

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An investor monitored stock prices at a brokerage house in Beijing. Chinese officials promoted stock rallies and intervened when prices plummeted. Credit Ng Han Guan/Associated Press

SHANGHAI — At the height of the frenzy for Chinese stocks, just about every company was a winner.

An online gaming start-up was valued at $7 billion. Shares in a fireworks company that had moved into finance shot up 300 percent. A struggling property developer was transformed into a stock market darling, just by changing its name to suggest it was an Internet company.

Then there was the case of Beijing Baofeng Technology, an online video company whose stock price soared 4,200 percent in the three months after it went public early this year. The company's shares climbed by 10 percent — the maximum amount allowable under exchange rules — nearly every day for more than 30 days.

Viewed through the lens of the recent market tumult, experts said China's stock bonanza bordered on the insane.

Before things fell apart a few weeks ago, China's remarkable bull run was reminiscent of the Internet bubble that gripped the Nasdaq stock market between 1998 and 2000, when companies like Pets.com and Webvan that had no profit quickly became more valuable than some industrial stalwarts. At the time, everyone talked about how technologies and industries would transform society, justifying eye-popping valuations. They were right about the future, just not necessarily about specific companies and the high stock prices.

Chinese officials introduced rescue measures after the markets plunged. Credit Johannes Eisele/Agence France-Presse — Getty Images

The same may now be said of China in early 2015. Even as stocks have stabilized in recent days, investors have continued to pummel such smaller companies, the same ones they had bid up in the boom.

“People got too enthusiastic,” said Teng Bingsheng, who teaches strategic management at Cheung Kong Graduate School of Business in Beijing. “There was a huge amount of energy, like a nuclear bomb, and they let it go off.”

The madness was driven, in part, by the peculiar dynamics of China’s stock market. Unlike in the United States, where institutions and big funds are the primary investors, trading here is dominated by smaller players — speculators, day traders and inexperienced retail investors, many of whom started financing stock purchases with borrowed money.

China’s market is also shaped by the heavy hand of the government, which makes decisions about what companies can list shares, when to promote stock rallies and, now, how to intervene when prices plummet. The government, in other words, views the market as a policy instrument, a mechanism to fulfill its political and economic goals. The result can be a volatile market that swings from boom to bust.

“In China, the regulators aren’t neutral,” said Chen Zhiwu, a professor of finance at Yale University and an expert on China’s financial system. “The government’s stated intention this time was that they wanted to use the stock market boom to fuel innovation and start-ups. This isn’t how a market is supposed to work.”

This helps explain why some of China’s most dynamic companies have chosen to list overseas, primarily in Hong Kong and New York. Although prices tend to be higher in China, mainland exchanges are often not the first choice for homegrown companies. Companies seeking to list in China complain about the long queue to list, the government approval process and various restrictions like the amount of foreign ownership, which eliminates many of the hottest start-ups.

It is a source of embarrassment for the authorities. Chinese citizens can’t, for instance, purchase shares in the e-commerce goliath Alibaba, which chose to list on the New York Stock Exchange. The company raised $25 billion last September in the world’s biggest initial public offering.

“There’s a lot of opting out of the domestic market by bigger, better groups,” said Peter Fuhrman, who runs China First Capital, a Shenzhen-based investment bank and advisory firm. “There’s no analogous situation in any other country in the world.”

For years, government reformers have pushed to loosen the state’s grip on the economy and financial markets, hoping to create a more efficient marketplace to aid private companies, particularly small businesses that have a difficult time borrowing from state banks. The idea was to restructure the stock market, moving it away from its roots where it served mostly state-owned companies.

A breakthrough seemed to come last year, when the government put innovation and the development of tech start-ups high on its agenda. It began to consider using the stock market as a way to aid young companies while also bolstering a slowing economy.

Following a one-year moratorium on new listings, regulators began approving public stock offerings in late 2013. The floodgates opened soon after, and hundreds of companies went public

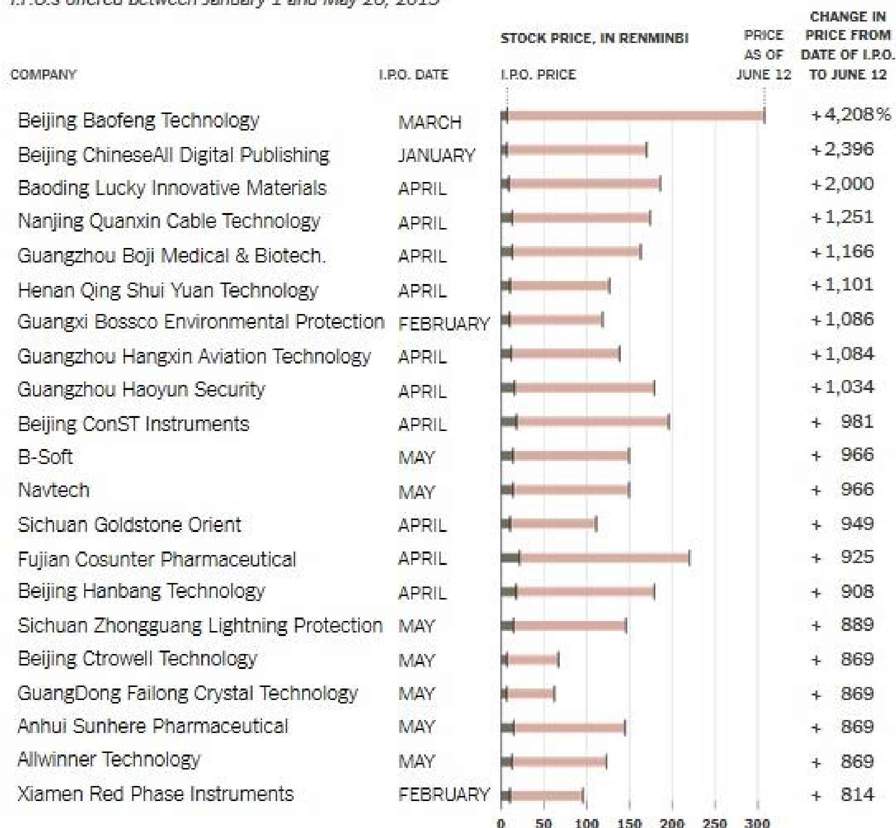
in Shanghai and Shenzhen, helping China overtake New York as the world’s biggest I.P.O. market in the first half of this year.

Investors went mad for the shares of new companies, bidding them up to stratospheric levels. On Shenzhen’s ChiNext board, a kind of Nasdaq-style marketplace, 69 companies went public this year. Those stocks, on average, gained 672 percent through June, when prices peaked. Three companies rose more than 2,000 percent, including Beijing Baofeng Technology.

During this time, the government also began promoting the National Equities Exchange and Quotations, also known as the New Third Board, an experimental over-the-counter market with looser listing standards. There was no government approval system to list and no requirement to show earnings, a boon to young tech start-ups that had yet to book a profit.

Little noticed, the Third Board soared along with the country’s major exchanges. In early 2014, the board had 642 listed companies. Today, there are 2,700 companies listed on the exchange, where trading is restricted to institutions and wealthy individuals.

White-Hot Stocks



The flood of initial public offerings this year on the ChiNext, a mainland Chinese exchange for young and emerging companies, all experienced huge gains in the stock market boom. The average gain for the 69 offerings on the ChiNext was 672% through June 12.

Jason Zhao, a managing partner at CGF Capital Management, a Shanghai-based investment fund, said the government wanted to experiment with a more market-oriented system, much like that in the United States. “The government knows the current system is flawed and they can’t put patches on it, so that’s why they set up the third market,” Mr. Zhao said. “It mimics the Nasdaq. They were trying to create a new market to fit the current stage of development.”

As share prices soared, another government goal seemed within reach. Chinese companies listed in the United States began considering a return home, where valuations were higher. This year, more than 20 United States-listed Chinese companies announced management-led buyouts in an attempt to eventually re-list their shares in China. Among them: Momo, a mobile social networking company that had listed on Nasdaq for just six months.

“The government has been strongly supporting bringing these companies home,” said Paul Gillis, who teaches accounting at the Guanghua School of Management at Peking University.

With share prices rising, the government also put its imprimatur on a raging bull market. The state media began promoting a new golden age of stocks. As recently as April, the state media editorialized that the bull market was “just beginning.”

The first signs of trouble came in May, when prices began to slump. The next month, in the face of a flood of new listings and warnings about overpriced shares and a possible market “correction,” share prices began to plunge. Even after China’s central bank cut interest rates in late June, making stocks relatively more attractive than bank deposits, the market continued to slide.

Worried that a stock market crash could lead to social unrest and weaken an already slumping economy, the government announced a raft of measures to pump up shares. In recent weeks, the government has funded purchases, suspended new public offerings and opened an investigation into stock manipulation.

While the measures had stabilized stocks at the end of last week, the situation had created confusion about what signal the government was sending. Regulators who had pushed for a more market-oriented system now seemed to be setting a precedent for more intervention by the government, said Professor Teng at the Cheung Kong School.

“The logic of the new government was to jump-start the stock market to generate cash into the economy,” he said. “They thought it would be a virtuous cycle. But it became a vicious cycle.”

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