BEIJING—China is readying a massive injection of funds to try to reverse the country’s worst share selloff in years, people familiar with the matter said.

Under the planned move, China’s central bank will indirectly help investors borrow to buy shares in a market that had already seen a rapid buildup in debt...
from so-called margin financing.

An unprecedented frenzy of measures over the past week culminated in weekend meetings by regulators and officials including Premier Li Keqiang, these people said. The result: a halt to new stock listings and a plan for the central bank to come to the aid of a market that has erased about $2.4 trillion in value during a three-week decline.

On Monday morning, the Shanghai Composite Index opened 7.8% higher at 3975.21. An editorial in the official People’s Daily newspaper, the mouthpiece of China’s Communist Party, said markets would stabilize. “Rainbows always appear after rains,” the editorial said. It said China has the “conditions, ability and confidence in maintaining capital market stability.”

In a statement late Sunday, the top securities regulator said the People’s Bank of China will “provide liquidity assistance” to China Securities Finance Corp., a company owned by the stock regulator. The company will use the money to lend to brokerages, which could then make loans to investors to buy stocks.

This is the first time that funds from the central bank will be directed to institutions other than banks, a dramatic move that indicates leaders’ deep concern over a brewing stock-market crisis.

The exact amount to come from the central bank hasn’t been disclosed. The people with direct knowledge of the plan said no upper limit had been set.

During the weekend, pledges have come in from China’s big state-controlled securities firms, mutual funds and a unit of China’s giant sovereign-wealth fund to buy, buy and buy.

In a statement by the Securities Association, 21 brokerages pledged to try to increase investments in the stock market as long as the Shanghai Composite Index stays below 4,500. The index closed down 5.77% on Friday at 3686.92.

Until the recent selloff, the stock rally had been one of the few bright spots in China’s economy. But a string of several-percentage-point market drops over the past weeks have served as near-daily economic mood dampeners.

The drastic intervention to rescue the market suggests leaders are concerned not only that the disorderly selling could spread to other parts of the financial system but that it could signal a wider loss of faith in the government’s ability to manage the economy.
By inserting what appears to be unlimited liquidity support from the central bank, the government “will effectively contain panic,” said Zhong Zhengsheng, director of economic research at Hua Chuang Securities, a state-owned brokerage.

Some economists question the wisdom of the all-out effort to protect stocks, saying that risks of significant damage to China’s broader economy are small, even if stocks were to fall further. One reason, they say, is that much of Chinese household wealth sits in banks or is tied up in real estate, with only a small portion invested in stocks.

The market-rescue measures could mean more harm down the road, they say, by reinforcing the idea that the government will come to the rescue whenever there is a crisis, undermining the progress China has made in allowing more room for risk in its financial system.

“The market simply went up too high and valuation was overstretched. There is no other alternative to a natural correction,” said Fred Hu, chairman of Primavera Capital, a private-equity firm in Beijing. With measures such as freezing initial public offerings, the government is “just repeating a policy mistake China has made over and over again in the past,” Mr. Hu said.

At an emergency meeting presided over by Mr. Li on Saturday, officials from

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China’s central bank and the Finance Ministry cautioned against using huge amounts of government funds to directly purchase beaten-down shares, for fears that would lead to more reckless investment behavior down the road, according to the people with knowledge of the matter.

Getting the central bank to indirectly provide financing to brokerages represents a compromise, they said, as that will make the PBOC the lender of last resort as opposed to a source of bailout funds.

Beijing helped stocks start rising around a year ago with pro-market policies, including by giving investors new investment tools, such as the ability to buy stocks with borrowed funds. More access was granted to foreign investors in a link to the Hong Kong market, which also gave Chinese investors a new way to buy shares internationally. And investors were encouraged that credit would get easier because of the slowing in economic growth.

As the market more than doubled in a year, some of the world’s most respected financial firms said it made sense to buy stocks in China, including U.S. mutual fund giant Vanguard Group.

Then, China’s stock-investing public rushed for the exits starting in mid-June, when a government effort to rein in margin trading forced many investors to unwind their leveraged bets. The stampede continued over two-plus weeks even as policy makers announced measure after measure aimed at slowing the selling.

The last dramatic fall in Chinese equities occurred in 2008, when the benchmark Shanghai Composite Index plunged 70% in about a year. At the time, the authorities fiddled with fundraising requirements, nudged financial firms to buy shares and cut interest rates. The government’s seeming inability then to prop up the market caused widespread anger among investors but appeared to result in little economic damage to an economy that never depended much on a stock market.

Chinese shares eventually stabilized when Beijing introduced a $568 billion stimulus plan in November 2008 that shielded the country from the global financial crisis but resulted in a property bubble and saddled the economy with debt.

What makes it more challenging for Beijing this time is the rapid buildup of debt in the latest bull run. Debt incurred by so-called margin financing, or investors borrowing funds to buy stocks, has risen almost fivefold over the past year to about two trillion yuan last month. Z-Ben Advisors, a consultant in Shanghai,
estimates that margin debt today is the equivalent of up to 15% of the value of China’s tradable shares.

“This is a very high ratio,” said Ivan Shi, an analyst at Z-Ben. “In 2008, it didn’t exist.”

With many borrowers taking out loans using stocks as collateral, a drop in stock prices would mean banks are owed much more than the collateral is worth, resulting in more losses for the lenders while bad-loan levels already are rising.

Officials at China’s top banking regulator say they are looking into banks’ exposure to the stock market. But at the moment, there is no sign of any big bank or brokerage firm in severe distress as a result of the stock slide.

The recent government effort has also led to doubt over Beijing’s resolve to further open its financial markets to cross-border fund flows—a stated goal as China seeks to turn the yuan into a global currency. Until now, the stock market had been an area where the government had made substantial progress with implementing market-based changes, such as setting up a more-transparent process for Chinese companies to sell shares. It has also made it easier for foreign investors to trade Chinese shares.

“A sharp correction in stock prices could put economic reformers on the defensive and prompt a reconsideration of measures to reform financial markets, open up the capital account, and allow the currency to float more freely,” said Eswar Prasad, a Cornell University professor and former China head of the International Monetary Fund.

Meanwhile, many investors don’t regret their bets on stocks even in the face of the latest drops.

Li Ping was among those who sold homes to free up cash to invest in stocks, hoping for better returns.

In April, 51-year-old Ms. Li sold her three-bedroom apartment in Beijing’s eastern Chaoyang district for 7 million yuan ($1.13 million). Since then, she has parked 4 million yuan in the stock market via a fund manager.

“The fund that I have invested in is very mature and professional,” she said, adding that she thinks the market will stabilize and rise again.

Ms. Li has a lot at stake. She now lives in a rented apartment with her husband
near his workplace. Her older daughter is married but her younger daughter is
going to high school in the U.S. Ms. Li, who works in the insurance industry, said
she needs her stock investment to yield more than 20% a year to cover her
daughter's school fees and other expenses. “The yield I’m getting is definitely
more than the rent I pay,” she said.

—James T. Areddy and Esther Fung in Shanghai contributed to this article.

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