



The Economic Psychology of China's stock market bubble

By Prof Shujie Yao

This year has seen a series of major economic explosions – not least of these has been the spectacular bursting of the Chinese stock market bubble, which has shattered the dreams of millions of ordinary Chinese investors. In this keynote lecture delivered at the launch of GEP's centre in Ningbo, China, Prof Shujie Yao looks at the economic psychology behind the bubble and the consequences for Chinese investors.

Background

The bubble started developing in late 2005 when the stock market began to pick up momentum. By the end of 2006 it was clear that the bull had become a bubble. By September 2007 the P/E ratio of the Shanghai Stock Exchange (SSE) was 73; the P/E of the SZSE – the Shenzhen Exchange – peaked at 69.6. In comparison, in the US the P/E ratio of the S&P, which peaked a few months later, only hit 21.8 and American companies were significantly more efficient and profitable.

The turning point in China was November 2007 when PetroChina became the world's first trillion dollar company after it listed on the Shanghai exchange, attracting fevered trading from ordinary investors speculating on the price. (The labour force of PetroChina was 10 times greater than that of Exxon Mobil, yet its US rival was three times more profitable).

The SSE Composite Index had risen in two years from just over 1000 to over 6000.

Today the picture looks very different. In the space of ten months to mid September 2008 the SSE Composite Index fell by over 70%.

The bursting of the Chinese bubble happened before the meltdown in the West and should be seen as separate –

it was not caused by the West's Credit Crunch.

Reasons for the bubble

So why did this happen?

The first cause may have been poor government management around the process of listing mega-state-owned enterprises on the stock market. The haste to list so many in such a short time (and dressing them up for sale by stripping off debts and injecting billions of dollars to improve their balance sheets, making them look more efficient than they were) created a false impression for investors who were encouraged to believe they could make huge and quick profits.

The second was the poor and irrational economic psychology of Chinese investors – especially small investors who have little knowledge about the markets and their capacity to go down as well as up (the Shanghai and Shenzhen Exchanges were both opened only in the early 1990s as part of the Chinese government's attempts to develop a capital market for domestic and foreign investors).

Key points:

- Bubble caused by mismanagement and driven by greed, envy and speculation
- Small, household investors who invested a third of their savings worst hit
- Should be seen as separate from the Credit Crunch and part of China's story of achieving economic maturity

The stock market bubble was driven by three key psychological factors: greed, envy and speculation.

It was greed – the desire to get rich in a spectacular way that led to householders gambling on the stock market to the point that they invested as much as a third of their savings (9.31 trillion RMB) in the stock markets.

It was envy – seeing others prospering and not wanting to be left behind – that lured around one in 10 Chinese to be directly involved in stock trading and many more indirectly.

Finally this was speculation – most investors bought only for short-term gain. Partly this was due to the lack of alternatives – returns on bank deposits (the only other way for householders to invest in China) tend to be negative in real terms. But lack of professional knowledge made these investments highly speculative in nature. Householders either purchased shares randomly or just followed others without analysing the performance of listed companies. They pooled all their available funds, which not only included savings deposits, but also mortgages, or even pensions, to trade in stocks. When the markets turned, they held on for recovery and further gains.

Big interest groups that exploited the boom were the biggest winners; small investors the net losers – fuelling the already serious inequality problem in today's China.

When these investors no longer had any cash to speculate, the bubble burst and the psychology moved to the opposite extreme.

Conclusion

In the long term, Chinese investors will become more aware of the potential risks and returns of the stock markets and become less volatile, avoiding the huge and abrupt boom and bust evident in the last two years. Then stock markets will become a more reliable avenue

GEP in China

GEP – the Globalisation and Economic Policy Centre – is one of the major centres in the world studying the impacts of globalisation and economic policy.

The centre has an international reputation. Its academics have advised the WTO, the World Bank, the OECD and the Commonwealth.

GEP is based at the University of Nottingham in the UK and is substantially funded by grants from the Leverhulme Trust, one of Britain's largest funders of education and research.

In November 2008 GEP opened in China at the University of Nottingham Ningbo. It also has a centre in Malaysia.

of investment, supporting China to become a mature market economy. The government can play an important role in this process, providing more information and legal protection to investors and preventing the listed companies, especially the state-owned companies, from deliberately acting against small investors.

But for now fear, disappointment and lack of confidence characterise the market. It will take some time for the market to become bullish again.

Professor Shujie Yao



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scholars specialising in the country's economy. This brief is a summary of the inaugural *World Economy Annual China Lecture*, which Prof Yao delivered in Ningbo on 6th November 2008.

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