Box 3

RECENT DEVELOPMENTS IN CHINESE EQUITY MARKETS

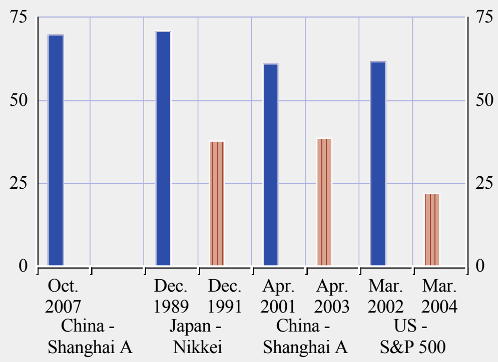
The marked increase in valuations in Chinese equity markets between early 2006 and the autumn of 2007 and the correction that occurred after the finalisation of the last FSR have given rise to financial stability concerns about the potential consequences of a bubble burst. While implications for euro area financial stability should not be overstated, this box reviews recent developments in Chinese equity markets, as they have attracted significant attention since the publication of the last FSR.

From January 2006 to its peak in October 2007 the main Chinese equity market index in local currency (the "Shanghai A-share" index) rose by nearly 425%. In 2007 alone it almost doubled. Reflecting rising concerns about a possible market overvaluation, price-earnings (P/E) ratios of Chinese equities were comparable in October 2007 to those of Japanese equities in the late 1980s and of US equities in 2002, when bubbles in those markets burst (see Chart A). In addition, the increase in P/E ratios was widely distributed among Chinese firms and sectors, which could be also interpreted as a further sign that valuations were stretched. In this context, the index corrected sharply, by around 40% between October 2007 and April 2008 (see Chart B).

These developments should be seen against the background of the structural characteristics of the Chinese stock markets. As a consequence of the ongoing financial sector reforms, Chinese equity markets tend to be small, not very liquid and largely closed to foreign investors. Regarding size, stock markets accounted for less than 40% of GDP at the end of 2007, against 210% of GDP for domestic banking sector assets. Only a small fraction of Chinese (mainly state-owned) companies are listed. Retained earnings and, to a lesser extent, bank loans are the main sources of financing of firms. Regarding liquidity, only a small proportion of shares of listed firms are actively traded (around 25%), while the rest is generally held by public entities and is not allowed to be traded. Moreover, the development of derivatives is still in a stage of infancy.

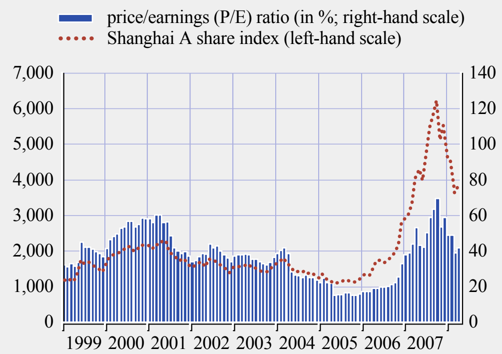
Chart A Comparisons of selected episodes of "overvaluation"

(P/E ratios: value at peak and two years later; %)



Sources: Bloomberg and CEIC.

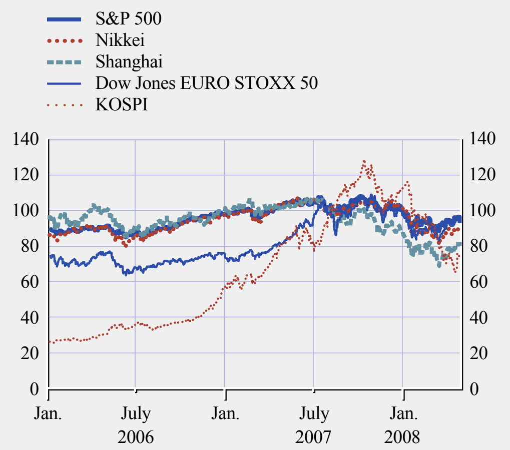
Chart B Recent evolution of the Shanghai A share market



Source: CEIC.

Chart C Recent evolution of selected equity indices

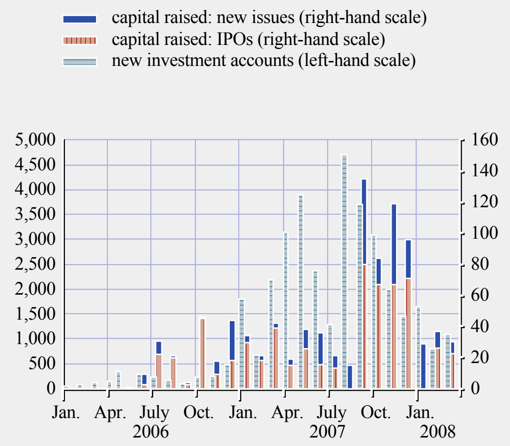
(index: 9 August 2007 = 100)



Source: Bloomberg.

Chart D Capital raised and securities deposits opened by Chinese firms and households

(RMB billions)



Source: CEIC.

In terms of openness, foreign investment is strictly regulated through quotas in local currency markets or confined to the foreign currency equity markets (the "B-shares markets"), which are even smaller and more illiquid. All in all, overseas investment represented less than 5% (less than USD 40 billion) of tradable shares as at end-2007. Therefore, stock price developments have traditionally been accounted for by domestic determinants.

Several factors explain the increase in stock market valuations after 2006. Among the structural factors, Chinese authorities have introduced market-oriented regulations since 2005, including provisions to facilitate capital raising and IPOs by firms and provisions that allowed the gradual conversion of non-tradable shares into tradable ones. Transparency of listed companies and better corporate governance has also been encouraged. Moreover, high profitability of listed companies and strong expectations about Chinese economic growth also underpinned the rally in stock prices until the autumn of 2007. Non-structural factors were also at play, including ample domestic liquidity, negative interest rates on deposits, and the lack of alternative financial assets, all of which contributed to shifting an increasing proportion of private savings into equity markets.[1] Relative market illiquidity and obstacles to arbitrage further tended to make prices sensitive to demand changes.[2] Finally, investors' perception of implicit government protection and the lack of a financial culture are believed to have possibly blurred investment risk assessments.

Notably, since the start of the financial turmoil last year, Chinese equity market performance has tracked foreign market developments more closely (see Chart C). Return correlations, albeit remaining low, have also increased. This seems to have triggered the correction in valuations as reflected also by a change in expectations and behaviour among Chinese firms and savers. Firms are scaling back the magnitude of capital raisings and IPOs, while the number of securities

1 As reflected in, for example, the premium paid in China for those companies listed simultaneously on the mainland and in Hong Kong.
2 The Chinese government raised its concerns about the price rally and attempted to dampen it through measures such as raising taxes on equity transactions and reducing the tax burden on incomes related to bank deposits. The authorities have also tried, with little success, to encourage domestic capital outflows.

deposit accounts opened has significantly declined and the balance of existing accounts has begun to shift to risk-free deposits (see Chart D). In the context of a languishing market in April 2008, Chinese authorities limited the tradability of recently converted tradable shares and reduced taxes on equity transactions.