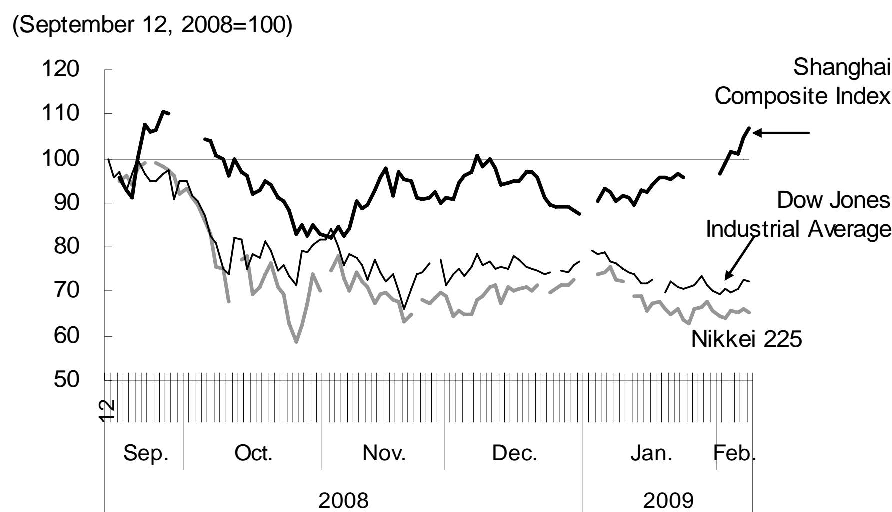
Shanghai Market Turning the Corner

C. H. Kwan
Senior Fellow,
Nomura Institute of Capital Markets Research

When the "Lehman Shock" hit major global stock markets in mid-September 2008, the Shanghai Composite Index, which had already lost some 65% from its peak level almost a year ago, plummeted further. In response, the Chinese authorities promptly eased monetary policy and took measures to shore up stock prices. Thanks also to the stimulus fiscal package announced on November 9, 2008, the Shanghai Composite Index has subsequently rebounded despite further declines in stock prices on overseas markets (Figure 1).

Figure 1: Performance of major markets since the "Lehman Shock"



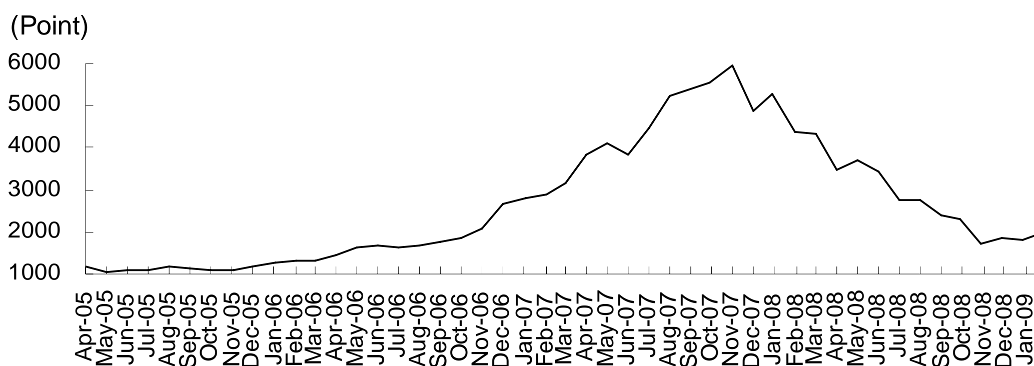
Source: Nomura Institute of Capital Markets Research, based on Bloomberg data

I. Stock bubble burst

Since the U.S. subprime mortgage crisis erupted in the summer of 2007, share prices have been collapsing on a global scale. Initially, the correction to share prices in China remained small, and the so-called decoupling phenomenon, whereby the Chinese economy would not be as significantly affected by overseas economies

because of its high growth rate, attracted attention. However, as the impact of the subprime crisis spread from international financial markets to real economic activity worldwide, the fallout from the spontaneous decline in overseas stock prices finally reached the Chinese market. Particularly since mid-January 2008, the decline in the Shanghai Composite Index has been the largest among the major markets. The Shanghai Composite Index dropped sharply by approximately 10% during the Beijing Olympic Games, and it headed further downward in September, triggered by the Lehman Brothers bankruptcy. The Index fell to 1706 points on November 4, which was more than 70% lower than the historical high level of 6092 points recorded on Oct.16, 2007 (Figure 2).

Figure 2: Rise and collapse of share price on the Shanghai market



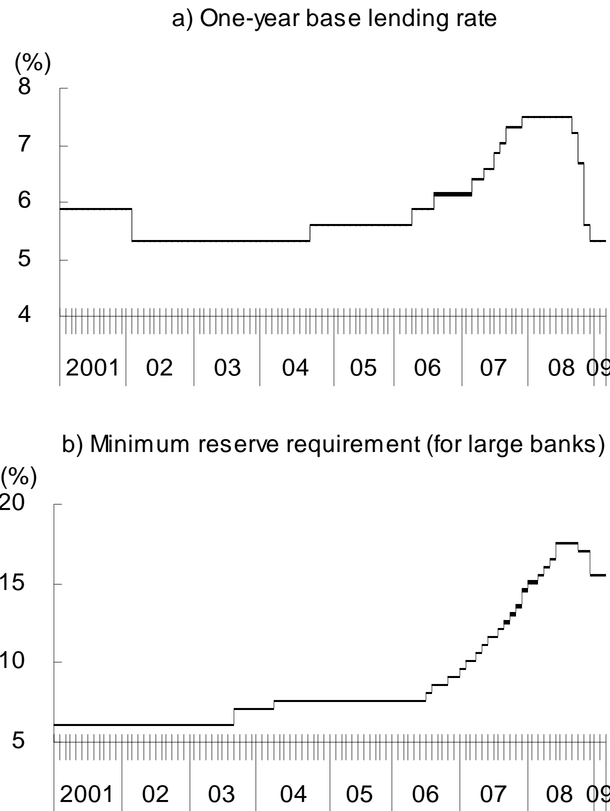
Source: Shanghai Stock Exchange

Fortunately, foreign currency assets make up only a very small portion of the total assets of Chinese financial institutions as China has maintained relatively strict capital controls. According to announcements made by leading Chinese financial institutions, their exposure to subprime loans and direct losses incurred as a result of the Lehman Brothers bankruptcy are limited. Nevertheless, funds throughout the world have been flowing out of the stock market and into “safe assets” such as government bonds and gold, reflecting rising financial instability, and the flight from shares has also put downward pressure on China’s stock markets.

II. Monetary policy shifting from tightening to easing

In response, the Chinese authorities changed their monetary policy stance from tightening to easing in order to restrict the impact of the international financial market turmoil on the domestic economy (Figure 3). The sharp decline in the inflation rate in terms of the CPI from a peak of 8.7% (year-on-year) in February 2008 to 1.0% in January 2009 has created more room for monetary easing.

Figure 3: Monetary policy shifting from tightening to easing



Source: Nomura Institute of Capital Markets Research, based on the People's Bank of China

The People's Bank of China announced a rate cut on September 15 2008 for the first time since February 2002 (effective the following day), with the one-year base lending rate reduced by 27 basis points from 7.47% to 7.20%. At the same time, it also announced a reduction from 17.5% to 16.5% in the minimum reserve requirement for small-and-medium-sized deposit-taking financial institutions, to be implemented on September 25. The minimum reserve requirement was raised 19 times from April 2004 to June 2008 by a total of 10.5%, and the adjustment made this time was the first cut since November 1999.

Subsequently, both deposit rates and lending rates were cut further on October 9 (by 0.27%), October 30 (by 0.27%), November 27 (by 1.08%) and December 23 (by 0.27%), while the minimum reserve requirement not only for small-and-medium-sized deposit-taking financial institutions but also for large ones was further reduced on October 15 and again on December 5 and December 25.

III. Measures to shore up share prices are put in place

To stabilize the financial market, the authorities have not only eased monetary policy, but also launched a series of measures to shore up share prices ("price-keeping operations").

On September 18, the Ministry of Finance and the State Taxation Administration announced that the requirement for both parties to pay stamp duty on stock transactions would be changed to the transferor alone, with the revision implemented the following day. This followed a cut of the stamp duty rate from 0.3% to 0.1% on April 24. The purpose of these moves was to bolster the lackluster stock market by reducing stock trading costs.

On the same day, the State-owned Assets Supervision and Administration Commission (SASAC) of the State Council announced that it would support state-owned companies under its direct control in repurchasing shares in their listed companies. Central Huijin Investment Company Limited (CHICL), a state-owned investment company, also said that it would increase its purchase of shares in the Industrial and Commercial Bank of China, China Construction Bank, and Bank of China, which CHICL already owned. The reform of non-tradable shares that was introduced in 2005, whereby non-tradable shares (state-and-corporation-owned stocks), which accounted for two-thirds of market capitalization, would become tradable after a certain lock-up period (maximum three years), led to fear of a worsening demand-supply balance and pushed share prices down. In contrast, the further purchase of shares by state-owned companies and investment firms is expected to improve the demand-supply balance and, in turn, lead to a rise in share prices.

IV. Fiscal stimulation to sustain economic growth at above 8%

On November 9, 2008, China announced a stimulus package estimated at 4 trillion yuan (about US$570 billion), which will be spent over the next two years to finance programs in 10 major areas, such as low-income housing, rural infrastructure, water, electricity, transportation, the environment, technological innovation and rebuilding from several disasters, most notably the Sichuan earthquake. The policies include a comprehensive reform of value-added taxes, which will cut the tax burden of the corporate sector by 120 billion yuan a year. Commercial banks' credit ceilings will be abolished to channel more lending to priority projects, rural areas, smaller enterprises, technical innovation and industrial rationalization through mergers and acquisitions.

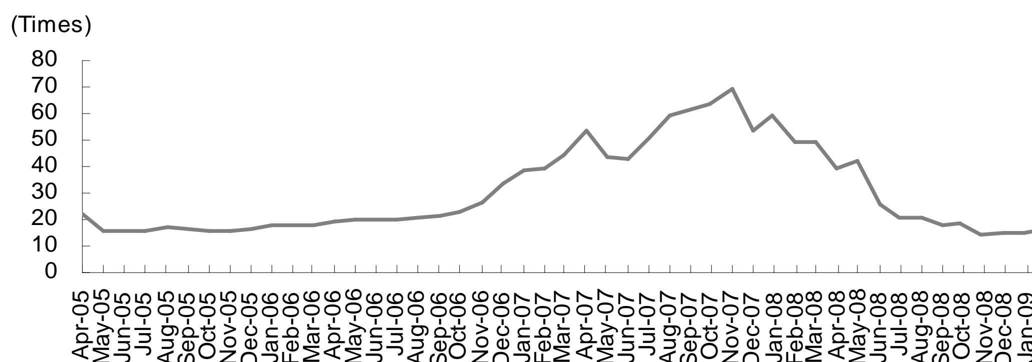
Four trillion yuan is equivalent to one third of China's total fixed asset investment in 2007. Around 280 billion yuan will go to housing projects for low-income earners, about 370 billion yuan to rural infrastructure and projects to improve the living standards of rural dwellers, some 40 billion yuan to healthcare, education and cultural undertakings, approximately 350 billion yuan to ecological conservation and environmental protection, and 1 trillion yuan for post-disaster reconstruction projects. Besides, 1.8 trillion yuan will be used for building railroads, highways, airports and

other transportation infrastructures. Another 160 billion yuan will pay for technical innovation and industrial restructuring. By expanding domestic demand, this stimulus package should help China sustain an economic growth rate above 8% in 2009.

V. A brighter outlook for stock prices

Thanks to these measures, the Shanghai Composite Index has started to recover from its trough, but the shares of Chinese companies are still substantially “undervalued” relative to their “fair values”. The average price-earnings ratio (PER) of the Shanghai market was 70 in October 2007, when share prices were at their peak, reaching nearly the same level as that of the Tokyo market during its bubble in the 1980s, but it had fallen to around 15 by October 2008, the same as that of the sluggish Tokyo market at that time (Figure 4). Given that China is an “emerging economy” with high growth potential, the appropriate PER level is considered to be around 30. Taking this as a benchmark, both the PER of 70 at the peak and the PER of 15 at the bottom are extreme, and the current level of 18 is still relatively low. Although the slowdown of the Chinese economy is likely to continue for some time to come, the resulting fall in inflation will allow the authorities to ease monetary policy further, providing more room for stock prices to rise.

Figure 4: PER of Shanghai A-shares



Source: Shanghai Stock Exchange