# How we explain the Chinese stock market bubble?

## 1. Introduction

In the last three years, the largest developing stock markets BRIC (Brazil, Russian, India and China) to some extent subjected to an asset pricing bubble, the benchmark indexes among these four stock markets rose more than threefold.[1] However, China suffered the biggest one. The benchmark Shanghai Composite index started to rise significantly in the final quarter of 2006, and then sky rocketed in 2007, increasing almost six fold in no more than one year, finally gang into free fall rapidly at the beginning of 2008, as figure 1 illustrates. These are all the characteristics of a classic speculative and pricing bubble. In the early 2007, many a financial analysts and economics identified it was a bubble, and government also had taken actions to head it off in the mid of 2007. However, few could explain where the stock bubble comes from and why macro-economic tactic seemed so ineffective and failed to halt.

Figure 1. Shanghai Composite Index 2005-2008


[1] The indexes of BRIC

Since the movement of stock prices is caused by the actions of investors, asset pricing bubbles ultimately have to be traced back to the beliefs of investors. In this paper, we are particularly interested in analysing the role that investors' emotions have played in determining their financial investment activity during the bubble period. Such an idea comes from emotional finance, which aims to explain how the financial market's sense of reality reflects the state of mind that drives investors' behaviour, by drawing on the insights of Freudian psychoanalysis.

This psychoanalytical dimension to financial market analysis is proposed by Taffler and Tuckett (2005). They argue that during the dot.com asset pricing bubble, investors' trading activities involved emotion, especially in a large group, which unconsciously influenced their investment judgements and led dot.com stock prices to depart from underlying fundamental value in a major way. They explain this drama by using the psychoanalytic theory of mental objects and a five-stage emotional sequence: in the first phase, there is the excitement of the market at some new idea which can be viewed as investors discover phantastic objects; in the second phase, there is a domination of the market by this excitement that forces investors to rush to possess the phantastic objects; the third is that with stock prices rising very fast investors set up a psychic defence to deny the underlying risk of collapse; and then when the prices crashes, investors panic; finally investors begin to blame others as a signal of unconscious guilt and shame. In this paper, we use the Chinese stock bubble during 2006-2008 as a testing sample and discuss how this bubble can be understood by such an invoking psychoanalytical perspective. Hence, we hypothesize that the main underlying mechanisms in terms of investors' emotions are similar to the one over the dot.com mania period. By applying the psychoanalytical model and using the financial presses and media comments as the evidence, we find that the Chinese stock bubble fits this model perfectly.

This paper is organised in four parts. Section 2 presents an overview of the theory of phantastic objects and its mental function within an emotional sequence, in particular the sense of risk and momentum. Section 3 analyzes the Chinese stock bubble by using the psychoanalytical model of Tuckett and Taffler (2008) and Taffler and Tuckett (2005), based on the financial presses and media comments. We find that the emotional sequence of the Chinese stock market bubble can be matched to this model perfectly. Section 4 concludes.

## 2. A psychoanalytic theory of phantastic objects

Our basic thesis starts with the understanding of the psychoanalytic theory of Freud on mental functioning which posits that the reality of our minds follows two principles, the “pleasure principle” and the “reality principle”, and that in terms of perception in mental reality financial assets can become transformed into infantile “phantastic objects”. Tuckett and Taffler (2008) derived this concept from the term *object* and the term *phantasy*. The *object* here is a representation of a thing takes place of an image in the process of recognition, which is used in the same way as it is in philosophy. The *phantasy* is an imaginary scene in any case tends to a wishful view when the “reality principle” collides to the “pleasure principle”.

Freud (1911) defined these two principles as follows. The “pleasure principle” also called the “primary process”, makes us seek continual enjoyment and gratification, while the “reality principle” or “secondary process” forms as a psychic representation of resistance to this on the part of the world; it appeals to rationality, common sense, etc., and invokes the principle of delayed gratification. Hence, in our lives, we not only seek events which make us feel pleasure but also try to avoid any event that might arouse displeasure. “It was only the non-occurrence of the expected satisfaction, the disappointment experienced, that led to the abandonment of this attempt at satisfaction by means of hallucination. Instead of it, the psychical apparatus had to decide to form a conception of real circumstances in the external world and to endeavour to make a real alteration in them. A new principle of mental functioning was thus introduced; what was presented in the mind was no longer what was agreeable but what was real, even if it happened to be disagreeable.” (Freud, 1911, p. 302) Therefore, a *phantastic object* is neither exactly attached to its essential formation, nor its designation, but the image that suits his/her wishes better exactly when he/she wants. Then, the phantastic object takes the place of an object in reality.

Following such mental functioning, this so-called reality in our minds is only an imaginative reality but we unconsciously feel it is very real.

Tuckett and Taffler (2008) describe key insights into how unconscious forces drive investors to transfer concrete investments (internet stocks, tulip bulbs, South Sea shares, railways, junk bonds, mortgage bonds) into phantastic objects over a five phases. In the first stage, investors framed a process of setting up phantastic objects and attempted to seek the means to get closer to them. This phase can be seen as the period that investors discover some objects which can potentially lead them to sense phantasies. These phantasies generate extraordinary expectation and excitement, which are extremely compelling. In the next stage, they rushed to possess those exciting objects to meet the sense impressions, and meanwhile, rationalized their behaviour by looking for the supporting stories and evidence as well as confirming by a range of collective actions. And then, the sense of phantastic objects takes the place of the sense of real objects. In the following stage, they established a psychic defence which is made by their wishful thinking and they tried to ignore their worries. As the fears grew, they were placed in the position of “split off” and struggled with the euphoria and compelling pain and shame which are generated by the possibility of crest and fall. Finally, after the dramatic collapse, they painfully bear up the pay from their psychic objects, with blame as a symbol of unconscious guilt and shame.

Interestingly, the pleasure principle has its own momentum. In Freud’s latter work *Beyond the pleasure principle*, he explores the idea of the pleasure principle. That is the pleasure principle actually follows from the principle which is the mental item engenders us to keep the quantity of excitement and minimize the manner of displeasure. Such latter principle forces us to continue adopting the mental functioning on the track of pleasure principle. Hence, we hypothesize here that the excitement momentum is embedded in the five stages: First, investors are always trying to seize the events which can allure their phantastic objects. And in the first stage, investors are seizing the events and viewing them as phantastic object, while they are looking for the events that support the value of the phantastic object would maintain or increase. Next, during the second stages, investors are not only searching the stories which support the transformation process of phantastic objects becoming part of sense of reality, but also seeking the stories that to purchase the phantastic objects can bring them a lot of pleasant. Third, during the third stages, investors are on one hand seizing the information to reinforce the defence, but also searching the evidence which lead them to keep on believing the defence will never collapse. Forth, during the above two stages, investors tend to excess the excitement which comes from money and the satisfaction of win, they want more and more. Finally, in the fourth and fifth stage, when the stock market slides, investors are panic, shame and blaming, but they are also longing for an upturn or miracle.

Another dimension we can not ignore is group psychic over the five stages. For Freud, individual psychology focuses on the individual man and exploring the paths by which he seeks to find satisfaction for his instinctual impulses. However, the individual's mental life must involve by someone else "as a model, as an object, as a helper, as an opponent; and so from the very first individual psychology, in this extended but entirely justifiable sense of the words, is at the same time social psychology as well." (Freud, 1921, p.627) On this basis, they will struggle with the two sides. On one side to satisfy the narcissistic instinct he will probably isolate himself as the subject from a large group of people, simultaneously on the other side, such instinct is partially or totally withdrawn from the influence of other people. "Group psychology is therefore concerned with the individual man as a member of a race, of a nation, of a caste, of a profession, of an institution, or as a component part of a crowd of people who have been organized into a group at some particular time for some definite purpose." (Freud, 1921, p. 627-628) The social instinct makes it easy for us easy to regard the presence of others as stimulating in our mental life. Our expectation is therefore naturally on the path towards the social instinct that leads us not to be insusceptible and dissection.

Therefore, we hypothesize that in the first three phases, investors compete with each other, because social instinct leads them to a position in which, on one hand, one is influenced by a large group of other investors and rushes to purchase the assets, while, on the other hand the narcissistic instinct, which let one join in the race to investment. This competition itself can create further unconscious competitive excitement, which also brings prices higher and higher. And after the excited defence is set up as a product of a group, the sense of risk will be diminished. (Janis, 1982) Thus, when a large group is holding the same sense of reality, investors will not question if this mental reality is absurd, or even take more risk to keep the emotional excitement momentum. Bion (1977) writes: “The apparent difference between group psychology and individual psychology is an illusion produced by the fact the group brings into prominence phenomena which appear alien to an observer unaccustomed to using the group.” (Bion, 1977, p.461)

## 3. The morphology of the Chinese stock bubble with a real story

This section explores the Chinese stock bubble to see degree of fit of the emotional model in Taffler and Tuckett (2005) and Tuckett and Taffler (2008) in their related work on the dot.com bubble and trajectory, since the Chinese stock market bubble is almost identical in form to the dot.com bubble of the end of the 1990s. Hence, we hypothesize that the main underlying mechanisms in terms of investors’ emotions are similar. In the bubble process, investors are caught up in emotional sequence of events.

### 3.1 Before the emerging to view

Cassidy (2003) points out many bubbles, such as the 1840s railway mania in England, the Wall Street boom of the 1920s and the internet stock mania, are usually related to some exciting new inventions that create exaggerated hopes of profits, with periods of prosperity, when the future seems bright, investors are cocky, and there is easy access to money and credit. Thus, it is worth of portraying a broad scenario of the Chinese stock market in the pre-bubble period.

The story of the Chinese stock market bubble begins with a thorny problem in the stock market history. The non-tradable state shares accounted for nearly two thirds of the market capitalization of all China’s listed companies. In the mid of 2005, it was the darkness of a dawn becoming. The benchmark index had been hovering around 1000 for almost four years, but bizarrely the Chinese Economics were booming with a high GDP in the same period. The government intended to deal with the problem. But it’s tricky. After the government unveiled a cautious approach to selling the non-tradable shares in early May 2005, a growing number of complaint letters and angry calls from investors shooting at the government's plan had been arriving to Shanghai Securities News, a state-run newspaper focusing on stock-market news. [2] On the date of 2 June 2005, the benchmark Shanghai Composite Index dropped to 1016 and hit the lowest level since February 1997. Investors were desperate and hopeless with fear of the reform plan would lead to an avalanche of new issues.

On the same day when the benchmark hit the lowest, CSRC chairman Shang Fulin stood out and said at a securities industry conference in Beijing that the current structure of many listed companies, with large shareholders of non-tradable shares, "has hindered the stock market's development." He added: "Large shareholders don't pay attention to share prices, and don't care about the rights of small shareholders." And he promised the government would "take a series of measures in the near future" to ensure stable of the stock market, including the amendment of existing securities and corporate laws to protect investors' interest.[3] The securities regulator first made the plan to let listed companies buy back their shares, in an effort to inject confidence. "The CSRC wants to give some confidence to the market because lots of shares have been dampened to very low levels," said Sean Hu, manager of the Shanghai office of U.K.-based fund manager Martin Currie, which manages funds that invest in yuan-denominated Class A shares. [4] The news initially helped lift the Shanghai composite index from a sharp drop about 0.3 per cent lower at 1,030.9 points. But Fraser Howie, Hong Kong-based author of a book on China's stock market, commented that it was a panic measure, "It does not make any sense for companies with already limited financial resources to use their cash to buy back shares."[5]

10 days later, CSRC announced that 42 companies, including some of the country's largest and best known corporations were planning reform of the shareholder structure. But CSRC emphasized it would set limits on the sale of these non-tradable shares. At the same time, the State-owned Assets Supervision and Administration Commission (Sasac), which controls the state's equity holdings, said it would engage in the shareholder reform plan, but added that the state would maintain controlling positions in many state-owned enterprises, and in important sectors would establish a minimum

[2] China s Market Is Still Scornful Over Share Sale. *The Asian Wall Street Journal*, 3 June 2005
[3] China s Market Is Still Scornful Over Share Sale. *The Asian Wall Street Journal*, 3 June 2005
[4] Chinese Regulator Plans to Allow Buybacks Aimed at Aiding Stocks. *The Asian Wall Street Journal*, 8 June 2005
[5] Beijing considers allowing share buy-backs. *Financial Times*, 8 June 2005

level of shares to be retained by the state, giving the market a clearer indication of the amount of shares that might be floated. [6] But CSRC chairman Shang Fulin also highlighted that the reform was a necessity but not a panacea for the ills of the domestic stock exchanges, but he didn't offer any concrete policies on how to alleviate the impact of the pending massive share flotation on the market. One thing was sure, China intends to "gradually engage more listed companies in the reform of non-tradable shares." He also reiterated that because of making all shares tradable didn't mean selling out all shares. And this market reform was "a critical turning point".[7]

In the later month, China's stock-market regulator issued new guidelines to encourage listed companies to be more transparent, part of an effort to better protect the rights of retail investors. The *China Securities Journal* pointed out according to the guidelines, listed companies must inform investors of their growth strategies and business plans, as well as provide information about major events in order to engender companies to improve governance and strengthen shareholder rights. [8] In parallel, listed companies were allow to give shares, options or warrants as employee incentives totaling up to 10 percent of a company's stock, which investors and analysts said may help improve corporate governance. But "it would also depend on the management's quality. It's going to be good to the company only if the system is well managed," Standard Life investment manager Agnes Deng said. Nonetheless, "the stock market is moving into a right direction," said Shenyin Wanguo Securities executive director Feng Zhenyu. [9]

A few days later, the government scrapped the yuan's decade-old peg to the U.S. dollar and shifted to the use of an undisclosed basket of currencies to manage the currency. As part of the move, the central bank revalued the currency to 8.11 yuan to the U.S. dollar, effectively a 2% increase in the local currency's value. However, this revaluation was commented "too modest" and its likely economic effects "too mixed" to result in changes in market weightings in the Asian-Pacific region, international fund managers said. "We expect a limited impact from this move and will not be adjusting our portfolios on the back of it," said Peter Hames, a Singapore-based fund

[6] FT.com site : China adds big names to stock market reform plan. *Financial Times (FT.Com)*, 19 June 2005
[7] China Regulator Says Share Float Is a Key Overhaul. *The Asian Wall Street Journal*, 28 June 2005
[8] China Promotes Transparency. *The Asian Wall Street Journal*, 14 July 2005
[9] Incentives plan for Chinese firms. *The Standard*, 22 July 2005

manager at Aberdeen Asset Management Asia Ltd. "The baby-step nature of the move suggests that the global economic impact will be minor." said Shane Oliver, head of investment strategy and chief economist at AMP Capital Investors. The signal was ambivalent and it seemed too risky to make market-allocation bets based on possible fund flows resulting from the yuan revaluation. "If the market interprets this as the beginning of a series of similar moves to come, it could cause another wave of hot-money inflow and speculation. The Chinese economy could remain overheated. If the market views this as a disappointment it could cause hot money to leave and exacerbate the investment downturn," said Morgan Stanley chief economist Andy Xie, who believed the possibility of further appreciation in the near future was low.[10]

China's flexible currency was a good place to start, which gave economists a rare moment of excitement.[11] *Barron's* on 1 August commented that the revaluation was not a back-door effort to lift China's stock market. But the point was neither to let more foreign (or domestic) investors will take a look at the markets, nor about to lower the cost of outbound mergers and acquisitions from China into America or elsewhere. Rather the revaluation was: "Primarily a first step toward China's longer-term goal of becoming a full-fledged member of the global economic and financial community. This can't be done with the yuan tied directly to the dollar…China wants to [be] a developed economy, not an emerging or developing one. It wants to hold sway over world affairs, along with the big boys-the U.S., U.K., the Continent, Russia . . . And above all, China wants to have a steadily rising standard of living. The 2.1% revaluation does not accomplish all of this, but it fits." [12]

Even though, the overhang of state-owned share was still disputable. The main method of overcoming investor resistance had been a compensation plan. All but one of the companies in the pilot—the biggest and best-known of these firms—Baosteel, the mainland's leading steelmaker had offered new shares to holders of the tradable stock to assuage their concerns. Weijian Shan, managing director of Newbridge Capital, a Hong Kong venture-capital house, and one of Baosteel's four independent directors, said its particular scheme for non-tradable shares was both wrong and

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[10] Revaluation Unlikely to Alter Market Weightings in Region --- Fund Managers Say Bets On Possible Fund Flows Into China Are Too Risky. *The Asian Wall Street Journal*, 25 July 2005
[11] Finally time to cash in on the China syndrome? *The Independent*, 30 July 2005
[12] A Sampling of Advisory Opinion. *Barron's*, 1 August 2005

illegal. “There has to be a clear delineation of property rights,” said Mr Shan. “There is no reason to give away property rights especially when it will cost taxpayers, who are, in effect, the legal-person shareholders.” He also argued that announcing a guaranteed dividend amounts to share-price manipulation, breaking Chinese securities laws. The steel group planed to compensate its current minority investors (some 22% of the total) for the fact that the state shares (the other 78%) would flood on to the market, further depressing the share price. Minority investors will get 2.2 extra shares for every ten they hold; and Baosteel promised to buy back shares and to pay an annual dividend of at least 0.32 yuan until 2007, which equates to a fat yield of 7.7% at the current share price. Not surprisingly, he voted against Baosteel's scheme. The board, though, approved it, 10-1. A shareholder vote on August 12th was also expected to give it the nod. The economist said the debate had shown the authorities’ position was so tricky and concluded that the fallen of Shanghai A-share market was largely because of the state-share overhang. “This has stymied the development of proper capital markets and a real equity culture, which would help wean China off its dependence on bank lending. At some point, someone will have to pay to fix all this. It is likely to be the taxpayer.”[13] “China is still only haltingly accepting the realities of reforming their equity markets,” wrote economist Donald Straszheim, who runs a financial-consulting firm specializing in China. “Baosteel's difficulties have put all of the stock-market reforms in doubt.”[14]

However, the government’s ambition was indisputably apparent and decisive. Beijing announced that after a reasonably successful pilot test it was about to give the green light to all listed companies to offload $270 billion worth of state-owned shares. However, the wrinkle was that there were nearly 130 companies already had international shareholders, through dual listings of hard-currency B shares or Hong Kong-listed H shares. But no rule was on whether overseas investors would receive compensation. [15] In a joint announcement by five government departments, including the CSRC, said companies that had completed the reform of their shareholder structure would be given priority in raising new funds. They also said the mainland stock markets would become much healthier. But the statement established no timetable for completing the reform. However, it was welcomed. “This is exactly

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[13] Hangover cure? China’s stockmarket. *The Economist*, 13 August 2005
[14] Ahead of the Tape. *The Wall Street Journal*, 28 September 2005
[15] FT.com site : Lex: China’s stock market. *Financial Times (FT.Com)*, 24 August 2005

what the authorities need to do," said Frank Gong, head of China research at JPMorgan, the investment bank. "We expect most of the companies to resolve the issue of non-tradable shares by the end of this year." "The plan is a pragmatic response to certain interests in the market that would otherwise not have been willing to support the scheme," says Stephen Green, economist at Standard Chartered in Shanghai. Some investors started to believe that, with the reform plan in place, the market has turned a corner. [16]

Mr Shang had fallen back on two responses. First, he said the offers of new shares were a decision of individual companies, not government edict. And rather than using the term compensation, he had described them as a fee for changing the terms of the companies' initial public offering prospectuses, which said the non-tradable shares would not be listed. He used a similar tactic to avoid another thorny issue - whether companies that have listed in Hong Kong and on the mainland should compensate overseas investors. But this subject was highly controversial because it would involve giving public funds to foreign investors. "Investors have been discounting the increase in the supply (of shares) for years," said Frank Gong, head of China research at JPMorgan. "They now know what the solution will be and can focus on the fact that it will put the market on a much healthier footing." [17] However, foreign investors who did not participate in this win-win spirit began to complain the main weakness - the domestic and international markets are not fungible.

This problem has to trace back to the different types of shares in China's stock market. The tradable shares of Chinese listed companies in the Chinese stock market are categorized into three types: A shares, B shares and H shares. The A shares and B shares are trading on mainland stock markets, while H shares are trading in Hong Kong. A shares are quoted in RMB, and currently can only be traded by mainlanders and authorized QFII. B shares are quoted in foreign currencies. On the Shanghai Stock Exchange they are quoted in US dollars, with the 1000-share minimum trading unit, while on the Shenzhen stock exchange they are quoted in Hong Kong dollars,

[16] FT.com site : China to free up trading in all listed companies. Financial Times (FT.Com), 24 August 2005

[17] China commits to market overhaul - SHAREHOLDER REFORMS. *Financial Times*, 25 August 2005

with a 100-share minimum trading unit. [18]Initially, B shares were only allowed to be traded by foreign investors. The establish motto of the B-share market was designed to allow Chinese companies listed in this market to raise foreign currency from overseas, as the RMB was not freely exchangeable.

Although QFIIs did have a $4 billion quota, and as the government promised soon to be increased to Dollars 10bn, to buy A shares, they still account for less than 1 per cent of daily trading on the Shanghai bourse. The other issue is due to a market rife with insider dealing and dodgy companies, and where accounting was more a state of mind than a set of rules, A shares were seemed more risky than its H or B shares' peer. As a result, the performances of Chinese companies listed abroad and at home had been diverging for years. This is where the "discount" of H or B shares comes from. Therefore, unlike A-shareholders, overseas investors did not told the government never sell non-tradable shares - and that it is politically unpalatable to have foreigners vote on internal financial matters. Plus, they were possible to look to profit from the change in the rules. The A share valuations of Yanzhou Coal and Tsingtao Brewery, for example, were hovering around the levels of their H shares, with estimating that the planned compensation could make A shares up to 20 per cheaper, investors could look over the border. Hedge funds never shy away from a risky market - could buy A shares through QFII and short the corresponding H shares, something they have never been able to do before.[19]

"QFIIs have played an active role in China's stock market," Shang Fulin, to pump more capital into the Chinese stock market, chairman of the China Securities Regulatory Commission (CSRC), uncover their decision on 28 June 2005 at a press conference which would steadily increase the investment quota. [20] *The Wall Street Journal* commented that "expanding the limits on QFII money is China's latest effort to boost foreign investment in its stock markets"[21], also CSRC said it has allowed J.P. Morgan Chase &Co. to raise its stake in a mutual-fund joint venture to 49%, which was seen as a sign that the quota was attractive. "There will be demand" for the new quotas, said David Huang, a fund manager in Shanghai for Dynasty Asset

[18] Shanghai and Shenzhen Exchanges' websites.
[19] Investors green around the gills. *Financial Times*, 27 August 2005
[20] Quota for QFIIs set to increase. *China Daily - Hong Kong Edition*, 28 June 2005
[21] China to Relax Foreign Quotas --- Overseas Investors Will Get Chance to Buy $6 Billion More in Shares. *The Wall Street Journal*, 12 July 2005

Management. To buy Class A shares, the U.S.-registered company's three mutual funds must get an allocation from a quota holder; Mr. Huang said it sometimes couldn't get the amount it requests, curtailing its investments in Chinese yuan-denominated stock.[22]

However, a competition of QFIIs seemed to start. "On a clear day, I can see all the competition," said the founder and manager of the Golden China hedge fund, noting the dozens of foreign investment firms and Chinese fund companies with offices in nearby buildings. Pudong, "what was once a small community is rapidly becoming a large fraternity of money managers looking for opportunities in the China's securities markets," he said. "Valuations are extremely attractive right now on China's B-share and Hong Kong's H-share markets," said Terry Zhang, Golden China's head of research. "You can find many top-rated companies trading at prices only 15 times future earnings, compared with 25 times a year ago," he added, "We see these markets as buying opportunities."[23] The first baseman was to acquire the A-share buying amount or in the very least the title of QFII. But the selected few largest and oldest QFIIs demanded more. UBS, the leading QFII in China, with $800 million of the initial $4 billion of QFII allocations, was determined to get at least some of the $6 billion new allotment. Nicole Yuen, head of China equities at UBS Global Asset Management said, "The fact that the A-share market has gone down makes the QFII allocation even more compelling." [24]

Good news arrived for foreign investors in December 2005. The State Administration of Taxation announced the tax exemption applying to foreign investors licensed to buy yuan shares and bonds, in a statement dated Dec. 1 albeit did not specify the level of the tax. The intention was obvious, which is to spur trading by QFIIs. "This is good news for foreign investors, as it removes all ambiguity on the issue of capital gains tax," said Sean Hu, a fund manager at Martin Currie Investment Management in Shanghai. "This was a gray area in the past. It may encourage more investment." "The new rule finally gives QFII investors certainty on the tax front, which is extremely

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[22] China Expands Quotas for QFII --- Global-Investor Program Is Pushed to $10 Billion In Yuan-Denominated Stock. *The Asian Wall Street Journal*, 12 July 2005
[23] The Newest China Hands. *Barron's*, 25 July 2005
[24] Asia 100. *Institutional Investor - International*, 15 September 2005

important if the QFII regime is to continue to expand in scale," Nicole Yuen, head of China equities at UBS, said. [25]

Turning back to the market reform, the CSRC in the early September 2005 issued comprehensive rules outlining how listed companies can float their non-tradable shares, several dozen have unveiled overhaul plans. The response from investors had been positive: the Shanghai Composite Index has risen 4.3% since the end of August. [26] At the end of September, the government officially launched the compensation fund which was designed to protect investors who had money in failed brokerages. However, it added that it could also be used "in other ways approved by the State Council". "Among other things, it could clearly be used to prop up the market, especially if it grows to a large size," said Fraser Howie, co-author of a book on the Chinese stock market. A fund manager in Shanghai said: "If the market remains weak over the next few years, I would not be surprised to see the fund being used to buy stocks." [27] By the end of 2005, 300 listed companies, out of 1,370 or so, had announced plans by their non-tradable shareholders to pay tradable shareholders. Over 100 of them had completed making payments and had thus become what is referred to as "G share" companies. On average, tradable shareholders would receive about 30 free shares for every 100 shares they hold. [28]

In parallel, an evidence of strength in China's economy was reported by Citigroup Inc. and Moody's Investors Service Inc. The 27-page report compared 686 of China's largest listed companies with nearly 5,000 other publicly traded companies around the world, and concluded the average big Chinese company was behind the global curve in developing a flexible financial structure. [29] This seemed weird. Since the stock market usually mirrors the performance of the broad economy. The market may run ahead, but it almost never goes in the opposite direction of the economy. *Far Eastern Economic Review* pointed that "rarely, if at any time, can a bubble be built when the

[25] China gives foreigners a tax break Exemption seeks to fight stock slump. *Bloomberg News*, 14 December 2005
[26] Oil-Price Woes Turn Up Values In China Energy, Airline Stocks. *The Asian Wall Street Journal*, 21 September 2005
[27] Chinese fund could be used to prop up market'. *Financial Times*, 30 September 2005
[28] The Mystery of China's Sinking Stocks. *Far Eastern Economic Review*, 16 December 2005
[29] China Boom Masks Firms' Woes --- Report Shows How Exposed Big Companies Are to Debt, Curbing Room for Maneuver. *The Asian Wall Street Journal*, 13 October 2005

economy is fundamentally weak; equally rarely does a stock market go into a continued decline when the economy is booming."[30]

China looked odd out in the BRIC - the stock market in Russia in 2005 rose more than 100% and those in Brazil and India climbed more than 50%, while that in China, the country with the world's fastest-growing economy, was the worst performer. Hence, why China seems to be an exception to the rule? To be more precise, is the Chinese stock bubble directly associated to the Economic prosperity? If the answer is yes, why the stock market bubble was coming so late?

### 3.2 The emerging to view phase: a wave of phantastic objects

Taffler and Tuckett (2005) term the beginning phase of dot.com asset pricing model "emerging to view", since financial journalists and brokerage house analysts presented all the publicizing of the debut of internet stocks, which were alluring investors' phantasies. In the case of the Chinese stock bubble, the development of such emotional euphoria development can be captured by the process of transforming the concrete materialization in the stock market to phantastic objects which were shaped by the news of how the market reforms successful and its following hypes. After the Shanghai and Shenzhen Exchanges move from a four-and-half-year slump to a 16 percent rise[31] at the end of 2005, in the year of 'dog' (2006), which is named as the "man's best friend", there was a renewed sense of optimism about the fate of the mainland stock market[32]. The stock market reform no matter whether it was succeed or not. It turned to be a phantastic object which further enhanced the optimism about the market prospects. The Chinese stock market seemed "absolutely" different. A brand new stock market was in town.

*China Daily* put it like this: "For the last five years, one of the things in China that has constantly generated despair is its capital market. And finally, analysts say, there is hope that 2006 may see a change." Some of them have even gone so far as to suggest that there will be a sustained recovery. "The share reform has achieved the effect of removing an uncertainty that has been plaguing the mainland stock market for years,"

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[30] The Mystery of China's Sinking Stocks. *Far Eastern Economic Review*, 16 December 2005
[31] On Asia: China's Stock market in the year of the dog. *Financial Times*, 27 January 2006
[32] Market insight: Growing optimism in the Chinese stock market. *Financial Times*, 26 January 2006

said Hu Ruyin, a professor with the Shanghai Stock Exchange's research bureau. [33] "This is definitely a turning point in the stock market," Han Zhiguo, a Chinese economist said on January 26 2006. And he also commented that "All these policies are boosting investors' confidence in the market." Nicole Yuen, head of China equities at UBS in Hong Kong, was also optimistic about the prospects for the A-share market [34]. "It realigns the interests of companies to those of the minority shareholders and restores market confidence," said Zhang Jie, a senior broker at Xiangcai Securities in Shenzhen. He continued "It will mean that the market price of state shares can be used to assess the management's performance and will attract retail investors back to the sector." [35] Foreign investors were piling pressure on regulators to get bigger QFII quotas, their gateway to China's insulated capital markets.[36] Hedge funds find China was captivating. Edward Mullen, who after had sold out all his internet stocks, took a few million dollars of his own money and co-founded an Asian hedge fund firm, Shanghai-based Dynasty Asset Management forecasted an imminent recovery in China's markets. For him, the China puzzle was to translate the country's vigorous economic growth into robust investment returns.[37]

The performance of market did not disappoint investors. The benchmark Shanghai Composite Index climbed 8.1% in January, and has added another 3.1% in February. On April 3, the index passed the key level of 1,300 points - the ceiling most analysts had set - and has succeeded in staying above it.[38] The powerful rally was offering a glimmer of hope to investors.[39] And even, there was a "Feng Shui Index" which projected that investors in China would enjoy a relatively sustained run-up in 2006,

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[33] Stock market expected to see a bullish year. *China Daily - Hong Kong Edition*, 24 January 2006

[34] Nicole Yuen, head of China equities at UBS in Hong Kong, is optimistic about the prospects for the A-share market, says but says: "The government has …." *Financial Times* 26 January 2006

[35] Moves to restore sector confidence and balance. *South China Morning Post*, 6 February 2006

[36] China's barking dog lacks bite FRANCESCO GUERRERA ON ASIA. *Financial Times*, 28 January 2006

[37] China bound. *Institutional Investor - Americas*, 15 February 2006

[38] Running with the bulls tests courage Despite bitter memories of false dawns, Shanghai's soaring stock market is winning over sceptics as foreigners lead the way. *South China Morning Post*, 17 April 2006

[39] Bulls in China join others around Asia Hot economy brings optimists back after five-year decline in stock market. *International Herald Tribune*, 12 May 2006

the Year of the Dog on the Chinese calendar.[40] In May 2006, the Chinese stock market had soared to a level more than 50 percent higher than a year ago.[41]

The soaring index gave a hard evidence of how successful the market reform, which lifted up the stock market. Investors seemingly forgot they used to think how scornful the decision was, and started to fantasize the stock market reform as an omnipotent engine which could generate extraordinary expectations that the stock market was entering into a long-term and healthier condition along with a bright and constant growth of GDP. A survey formed part of the 2006 ISS Global Institutional Investor Study, which polled 322 firms across the world found that investors believed corporate governance had been shifting from a compliance obligation to a business imperative by this market reform, with three out of five believing that helped to enhance investment returns. It also highlighted the extent to which hedge funds focused on corporate governance, with nearly half saying it offered them a "competitive advantage" in their investments. Dean Paatsch, operations director of ISS (Australia), said: "The core principles of corporate governance are now well-established in Asia, with China set to be the next global hotspot."[42]

The phantasy of the market reform was on horizon. And subsequently it gave the born of an intensive attention of the stock or equity fund which was likely to be view as the ticket to get closer to share the fruit of the stock market reform. The new mutual funds and IPOs, thus, debut at a perfect timing.

China's mutual fund industry concealed a series of shock announcements in April 2006, while some of the country's biggest funds reported total gross asset outflows of about $2.5 billion, such as Credit Suisse's joint venture with Industrial and Commercial Bank of China, whose maiden equity fund lost more than half of its assets in the first three months, China International, JP Morgan's fund management joint venture, unveiled a new Rmb6.4bn mutual fund - the biggest equity fundraising in two years.[43] In June 2006, JF Asset Management Ltd., a unit of J.P. Morgan Chase & Co., launched the JF China Pioneer A-Share Fund with a $150 million investment

[40] Advice for investors in China: Consider an 11-month vacation. *The Wall Street Journal Asia*, 28 February 2006
[41] China Stock Market Up 50% in a Year. *The New York Times*, 12 May 2006
[42] China told to refine corporate governance. *Financial Times*,16 April 2006
[43] A market for iron stomachs only MUTUAL FUNDS: Massive outflows have not deterred the tough. *Financial Times*, 15 May 2006

quota, which was the first authorized fund in Hong Kong to invest directly in China's Class A shares. [44]By the end of July it had approved a total of $7.5 billion worth of quota for 45 such investors, about three quarters of the planned total quota of $10 billion.[45] A few month later, the president of the Shanghai Stock Exchange, Zhu Congjiu, said "China should expand direct stock investments by insurance companies," in a speech to a financial conference in Shanghai. "Development of institutional investors is crucial to China's stock markets."[46]

"The market is changing. Retail investors are leaving and institutional and foreign investors are replacing them," said Peng Yunliang, strategic analyst at Shanghai Securities.[47] But QFIIs had a slightly different phantasy of the Chinese stock market. For them, the stock investment was a path to join and share the profits generated by the Chinese economic growth. Their views were long-term and tend to keep blue chip stocks they bought for much longer periods, and their investment style was relatively stable.[48] "We think the China domestic market has just started its bull turn even though it has rallied over 40 percent since the beginning of the year," said Sunny Li, who is the Co-Founder and CIO of Pinpoint Asset Management Company. Chinese government reforms to convert state- owned shares into tradable stock "will make it one of the most interesting and rewarding markets in the next 10 years," he added. [49] Hence, the phantasy of the stock market reform seemed to be guarded and guided by a horde of widely stable and professional institutional investors.

About 50 overseas firms had secured the right to invest in China under QFII, including the investment fund of Yale University in the United States that secured a $50 million quota in August. In part, more than 20 firms had set up joint fund ventures in China with stakes of up to 49 percent, the maximum allowed by the Chinese government.[50] For example, Nikko Asset Management Co., Ltd. received an

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[44] J.P. Morgan to launch China fund. *The Wall Street Journal Asia*, 16 June 2006
[45] QFII less speculative than other institutional investors in China: regulator. *Xinhua News Agency*, 28 August 2006
[46] Beijing urged to let insurers buy more shares Measure seen as crucial to markets. *Bloomberg News*, 21 September 2006
[47] Running with the bulls tests courage Despite bitter memories of false dawns, Shanghai's soaring stock market is winning over sceptics as foreigners lead the way. South China Morning Post, 17 April 2006
[48] QFII less speculative than other institutional investors in China: regulator. *Xinhua News Agency*, 28 August 2006
[49] Fund places its bets on liquor and tourism. *Bloomberg News*, 23 May 2006
[50] Investec cautiously weighs China options. *Reuters News*, 24 November 2006

additional investment quota of $200 million directly from the State Administration of Foreign Exchange (SAFE) in China on May 17th 2006, and became world's largest asset management company for managing local China assets.[51] South African fund house Investec cannot ignore the opportunity, which derived more than half of its $50 billion under management from abroad to scour China for opportunities. Hendrik du Toit, its chief executive said on 24 November 2006 in an interview, "China is clearly on the radar screen."[52] Consultants Mercer Oliver Wyman reckoned the value of assets managed by institutional investors in China could grow to more than $2 trillion by 2015 from $335 billion.[53] 52 foreign or joint venture financial institutions had been authorized to become QFII, by the end of 2006, which were holding $12 billion stock and surpassed brokerages to become the second-largest category of institutional investors in China, behind securities funds.[54] Lipper, a subsidiary of Reuters and a global leading fund researcher, reported that iShare FTSE/Xinhua A50 China Tracker, a fund managed by a QFII, produced a total yield of 21.6 percent in November 2006, the highest among all the foreign and Chinese equity funds invested in the domestic stock market.[55]

In line with the wave of new launch funds, a series of huge IPOs had debut. On May 24 2006, the Chinese flagship lender, Bank of China, raised $9.7 billion- at that time, the world's biggest public share offering in six years. Bank of China, the second of Chinese four large state-run banks to go public, attracted an avalanche of funds as the sale of a 10.5 percent stake was heavily oversubscribed ahead of its stock listing in Hong Kong. Having raised $9.2 billion earlier, China Construction Bank went public in October with its $11 billion IPO. In the same month, Industrial & Commercial Bank of China, the nation's biggest lender, launched around $ 20 billion dual listings in Hong Kong and Shanghai, at which time it surpassed Japan's Mitsubishi UFJ - valued at $135 billion - to become the world's fifth largest bank. China Life Insurance Group Co, which was listed in Hong Kong and New York in 2003, was also issued a $3.62 billion mainland stock offering by December 31st 2006.

[51] QFII less speculative than other institutional investors in China: regulator. *Xinhua News Agency*, 28 August 2006
[52] Investec cautiously weighs China options. *Reuters News*, 24 November 2006
[53] Investec cautiously weighs China options. *Reuters News*, 24 November 2006
[54] QFIIs Held CNY97.1B China A Shares At End-2006 – Report, Dow Jones International News, 26 January 2007
[55] QFII A-share Funds Shine in November. *SinoCast China Business Daily News*, 7 December 2006

Initially, there was scepticism about Bank of China going public, since it had been mired in bad loans and some of its top executives had been imprisoned for corruption. After the government injected $22.5 billion and it reduced the bank's non-performing-loan ratio to 4 percent in mid-2005, from 33 percent in 2003,[56] it priced its Hong Kong IPO near the top of the range, raising $9.7 billion in the world's biggest equity offering since 2000, with a soaring 15 percent on the day it became available in Hong Kong.[57] Its price seemed to be high in comparison with that of Hong Kong banks, but cheaper than its A-share peers.[58]

In Hong Kong stock market, Bank of China's shares were highly sought after by retail investors, who were allocated 5 percent of the IPO.[59] One Hong Kong resident Sindy Wong planned to apply for HK$3 million (about $430,000) worth of Bank of China shares, betting almost three times her annual salary on it.[60] As pointed out by Pauline Dan, executive director of equities at Manulife Asset Management in Hong Kong on May 25 2006, "The shares priced on the high end, which made them expensive, but this is understandable given the strong demand for the stock". [61] This scenario was exactly the same as that back in the days of the technology-stock boom, when U.S. investment bankers were criticized for handing out all-but-sure-money IPO shares to favoured clients "like candy".[62] Fresh from a share listing in Hong Kong, Bank of China announced its plan to move ahead with a $2.5 billion IPO in Shanghai.[63] Its IPO in Shanghai was also successful, shares rose a substantial 23 percent on their trading debut on the Shanghai stock exchange and the volume of IPOs increased by 56 percent to $102.2 billion, from $65.4 billion over the same period in 2005, according to figures from Dealogic. [64]

In the autumn of 2006, the Industrial and Commercial Bank of China, Chinese largest lender raised around $20 billion through a Shanghai and Hong Kong dual listing. Twenty-three institutional investors in China, including China Life Insurance, Ping

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[56] Bank of China Prices IPO Near Top Range. *Associated Press Newswires*, 25 May 2006
[57] Bank of China IPO gains 15 per cent on first day. *Herald News Services*, 2 June 2006
[58] Lex live: Bank of China IPO. *Financial Times*, 24 May 2006
[59] Bank of China IPO Raises US $9.7 B-Source. *Dow Jones Asian Equities Report*, 24 May 2006
[60] Hong Kong's gamblers take lead in Bank of China's record IPO. *Bloomberg News*, 20 May 2006
[61] Bank of China Prices IPO Near Top Range. *Associated Press Newswires*, 25 May 2006
[62] Hong Kong tycoons score special deals in hot IPOs. *The Wall Street Journal Aisa*, 2 June 2006
[63] Bank of China IPO hearing due Friday, regulator says; exact timing of listing unclear. *Associated Press Newswires*, 6 June 2006
[64] China shares edge up, ore price hike hits steal. *Reuters News*, 21 June 2006

An Insurance and China Pacific Insurance, subscribed to a combined $2.25 billion worth of the A-shares. Merrill Lynch, China International Capital, Credit Suisse Group and ICEA Securities were also handling the H-share offering of ICBC.[65] "I've never seen such strong demand in the first week for a Hong Kong IPO," said Horace Kwan, a director at Celestial Securities on 17 October 2006. [66] "The A-share IPO investors will for sure make money." Dai Jie, an analyst at ABN Amro TEDA Fund Management in Beijing said.[67] "We rate the insurance sector highly in the long run." said Liu Qingshan, the chief investment officer of ABN Amro Teda Fund Management, which manages 15 funds with assets valued at more than around $2.8 billion. "The institutional investors in China have a lot of money, so they can easily absorb new stocks." he said.[68]

The positive news reported by the financial press and websites drew attention of a series of banks and insurance companies, and stimulated the desire of investors after the five-year stock market stagnation. Nowhere was the euphoria more pronounced than in the initial public offering of Industrial and Commercial Bank of China, the biggest IPO in history.[69] More important, they commented that a spate of big IPOs weighing heavily on China's domestic-stock indexes could lay the foundation for a healthier market -- and solid gains in Chinese share prices in coming years. "The increase in high-quality stocks helps the market develop in a virtuous circle," said Jiang Jianrong, an analyst at Shenyin & Wanguo Securities. [70] Therefore, investors not only have the evidence to support their phantasy of the stock market reform, but also find that this phantasy was a long-term and potentially growing image. They realised a potentially huge excitement was about to appear. And the stocks and funds materialised their phantasy of the stock market, and were easily fantasized as an omnipotent engine of money, which to some extent were fulfilling their magic wealth dreams. And for QFIIs, buying shares in Chinese companies was the same thing as buying into China's growth story.

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[65] Facts about ICBC, China's largest bank and world record IPO. *Agence France Presse*, 27 October 2006

[66] Investors line up for ICBC sale Share offering draws crowd in Hong Kong. *Bloomberg News*, 17 October 2006

[67] China Life Insurance raises $3.62 billion in mainland. *Bloomberg News*, 28 December 2006

68 Ping An plans 36b yuan Shanghai A-share offer First-quarter timing will be scheduled to avoid clash with industry leader China Life's secondary listing next month. *South China Morning Post*, 15 December 2006

[69] Chimerical? Think again. *The Wall Street Journal Asia*, 6 February 2007

[70] China bets on blue-chip IPOs to lay strong market foundation. *The Wall Street Journal Asia*, 10 August 2006

3.3 The rush to possess phase

Early share sales by Bank of China and Industrial & Commercial Bank of China contributed to the more than doubling of the Shanghai Composite index in 2006.[71] When ordinary people realised the stocks and equity funds were the ones which led them to the phantasies, investors could barely wait and rushed to possess the stocks. They rushed to open stock trading accounts, kept eyeing the screens filled with stocks and patterns of prices, and frequently bought and sold them. According to Freud (1911), "A special function was instituted which had periodically to search the other world in order that its data might be already familiar if an urgent inner need should arise; this function was attention. Its activity meets the sense impressions half-way instead of awaiting their appearance." (Freud, 1911, p. 302) Blanco (1988) proposes the principle of symmetry when we are thinking in the unconscious. When this principle tracks, "a part of something is equal to the whole and is therefore indistinguishable from it." On the way to invest into the stocks market was transforming equally to earn the money. In other word, as long as they invest they win, if not they lost.

In November 2006, the Shanghai Composite Index surpassed 2000 which was the first time after 5 years up 74% in 2006, and up 99% from an eight-year low in July 2005. However, it was also the first time in five years bank savings of Chinese citizens slipped, falling $1 billion in October from the previous month as people put money into stocks, according to the central bank. [72] Investing seemed as a brand new fashion and the only way to past time. College students, office workers, retirees and even a pregnant woman in suede boots all jostled into the brokerage, eager to buy stocks or mutual funds and buy them now. One mutual fund raised $5 billion in a single day. In Shanghai, one of the most popular local television programs was "Stock Market Today". Everyone seemed to want a stock tip with a simple goal 'want to get rich'. "When I go to the beauty salon, even the girls who give me a manicure are talking about stocks!" said Shirley Lei, a consultant in Shanghai who worries that

[71] China Life Insurance raises $3.62 billion in mainland BUSINESS ASIA by Bloomberg. *Bloomberg News*, 28 December 2006

[72] Chinese Turn to Stocks --- Key Index Tops 2000-Point Mark for the First Time in Five Years. *The Wall Street Journal*, 21 November 2006

inexperienced buyers could be cheated. “They ask me, ‘What should I invest in?’ They say they are doing research.”[73]

The performance of funds in 2006 was not disappointing. Chinese mutual funds became profitable in 2006, with a total net gain of 124.8 billion yuan ($17.8 billion). In the fourth quarter alone, the country’s 278 funds, run by 53 management companies, made a combined profit of 54.15 billion yuan ($7.7 billion) from stock trading.[74] The assets of QFIIs in China totalled 75.5 billion yuan ($9.5 billion) by August 2006 and earned more than 20 billion yuan on their aggregate inward capital remittance. [75] These dizzying numbers attracted many other multinationals. Chinese citizens have about $2 billion in bank deposits earning negative real interest rates, which is potentially looking for a more lucrative berth.[76]

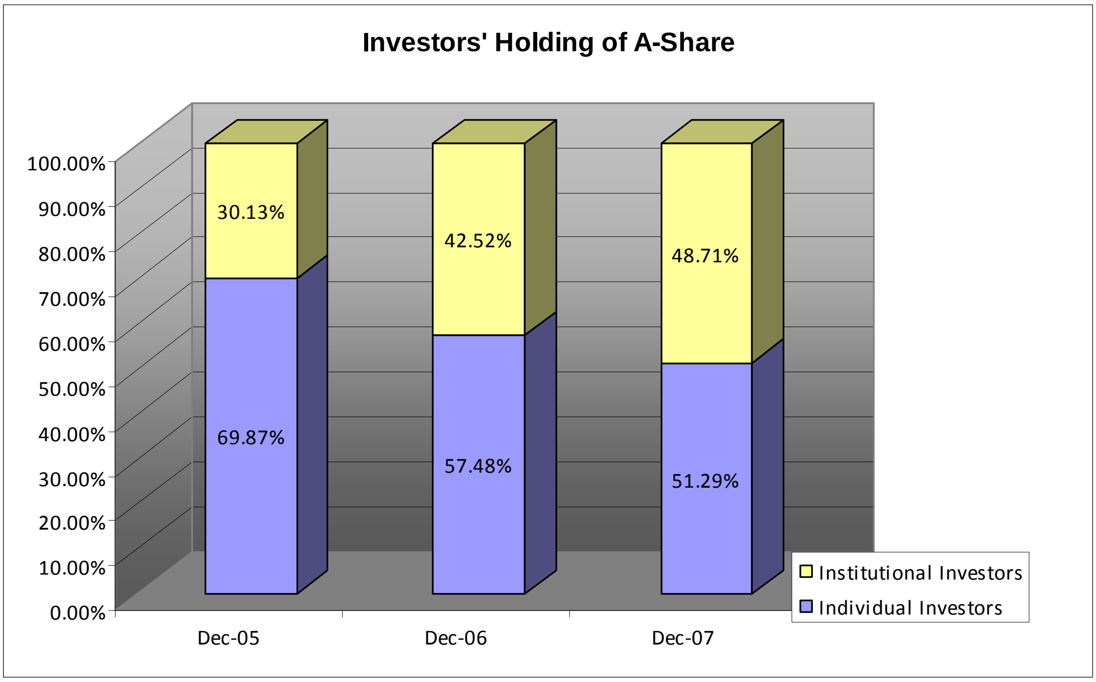
For retail investors the amazing returns of funds turn out to be an alternative of stocks as a phantastic object. Therefore, feverish investment in funds was wide spread in China - what McKinsey & Co Inc. describes as the world’s fastest growing funds market.[77] Additionally, they preferred brand new funds[78], in particular, those with one unit in 1 yuan net asset value, which was seen as cheap. From the psychoanalytic perspective, the words as like “new” and “cheap” gratified the intriguing of investment assets as phantastic objects. New mutual fund accounts amounted to 6.73 million by the end of November 2006, while only 4.3 million new yuan-denominated A-share stock accounts were opened at the same time, according to figures from China Securities Depository and Clearing Corporation. Some 270,000 new fund accounts were opened in three days December 1, 4 and 5 three times the number of new yuan-denominated A-share stock accounts opened at the same time.[79]

The dramatically increasing number of new opening stock and fund trading accounts signalled how massive investors jumping into the carnival. Since the excitement was widely spreading to all walks of life, and the phantasy of investing was a sense of

[73] Chinese United by Common Goal: A Hot Stock Tip. *The New York Times*, 30 January 2007
[74] Chinese stock market unstable, regulator says. From news reports Reuters, AP, Bloomberg, *International Herald Tribune*, 23 January 2007
[75] Annual yield of QFIIs in China exceeds 10 percent. *Asia Pulse*, 26 September 2006
[76] Warning of bubble in Chinese stock market. *Financial Times*, 30 January 2007
[77] Funds investment fever runs high in China. *Chinadaily*, March 15 2007
[78] Equity funds face Chinese wall. *Financial Times*, 6 April 2007
[79] Mutual feelings over bullish stock market. *Industry Updates*, 8 January 2007

group mental, if one decided not to invest, he or she would probably feel eccentric. This feeling would be likely to make them feel dissected and painful, which unconsciously drove them to follow others. In other word, everyone who wants to be rich must join the team to invest stocks or funds. And buying stocks or funds means he or she may well be rich quickly and easily. Oppositely, if one decides not to buy stocks, then he or she may well be not rich. And given everyone is getting rich, if he or she is not, he or she would unconsciously feel pain. To avoid the feeling of pain, every one thus rushed to purchase without a second thought.

Institutional investors, including equity funds, social security funds, QFII, insurance companies, enterprise annuities, securities companies, increased their holdings of A shares, which looked like one of the mainstreams of capital resource injecting into the mainland stock market. Richard Wong Chi-lung, investment director of equities at Halbis, said "There was a lot of capital going into [mainland] equity funds in December. As regulations require fund managers to put at least 60 percent of the capital received into play within 10 days, the market was pushed by the strong capital inflow."[80] The Standard Figure 2 demonstrates the increasing institutional investors' proportion of A shares. Figure 2. Investors' Structure of A-share Holding over 2005-2007




[80] Halbis finds A-share values acceptable. *The Standard*, 8 February 2007

Source: China Securities Depository and Clearing Corporation

"As fund companies and other institutional investors grow, so will their impact on the market," said Ye Xiaomei, an analyst with United Securities. "As the market and investment becomes more sophisticated, the edge of institutional investors is becoming more apparent," Bi Qiuxiang, an expert with Guangfa Securities, the country's sixth largest brokerage, said on 6 January 2007. Many individual investors had inadequate time and expertise to do research on companies, the analyst said, while institutional investors have specialized professionals such as industry analysts and fund managers to do the job. "So entrusting investment matters to fund managers is undoubtedly a wise move," Bi said. "The Chinese stock market is set to become more rational and less speculative as institutional investors' impact increases," says Xie Jing, a fund manager at China Nature Asset Management Co Ltd.[81]

However, the breathless pace of expansion experienced by many Chinese fund managers brought its own challenges, yet even under such favourable conditions. According to Morningstar, 95 percent of China-based funds underperformed the market in the first quarter of 2007.[82] In the first half year of 2007, the top-performing China Asset Management Large Cap Enhanced fund was up 99.29 percent, but numerous other funds racked up returns of more than 60 percent, while the stock index rose 84.4 percent. One issue was that many Chinese investors viewed mutual funds as a substitute for stocks, buying and selling them like individual stocks. More crucially, since the speed of returns from funds was not as rapidly high as stocks, some retail investors pulled their money from funds into stocks. That led to a series of highly successful fund launches often followed a few months later by equally dramatic withdrawals of money. For example, Harvest's Strategic Growth fund was resulted an almost half of its assets' losses from investors from whom pulled their money.[83]

### 3.4 The phase of psychic defence

Taffler and Tuckett (2005) describe the third phase as a stage that the value of Internet stocks was remaining high, despite growing evidence showing that it was absurd. This

[81] The Feeling's Mutual. *China Business Weekly*, 6 January 2007
[82] On Asia: Equity funds face Chinese wall. *Financial Times*, 6 April 2007
[83] The China 20. *Institutional Investor - International*, 22 October 2007

is because the phantasy representations are established in psychic reality, which means what investors mentally imagine was transform into what they assumed was real.

Investors' wishful reality strongly supported by what the real reality was, and the reality that they assumed became true and genuinem, which subsequently and constantly allured their phantasies. According to a survey by the China Securities Journal in 2007, about 70 percent of Chinese investors said they had made profits from 2006's bullish stock market, with losers accounting for only 16 percent. The survey involved 7,735 small and medium-sized investors. About 30 percent of those polled said the yields on their stock investment ranged from 20 to 50 percent. Another 14 percent found their stock investment grew by 50 to 95 percent while 5 percent saw their investment double. This evidence was likely to convey the information that most people who invested in the stock market earned. Following the pleasure principle and its momentum, investors will probably idealise to a thought that was as long as he or she invest, he will win. In January 2007, there were about 80.5 million individual investment accounts in China with a $1 trillion overall stock-market capitalization. While the New York Stock Exchange had a total capitalization of $26.5 trillion as of Dec. 31 2006, that didn't make it a big market globally -- it placed China as third in Asia, behind Japan and Hong Kong.[84]

However, the warning of a 'bubblelike' stock market was growing. Cheng Siwei, vice-chairman of the National People's Congress and an influential figure in Beijing's financial circles, warned the mainland stock market could be overheating, after a rise of 130 percent in 2006. "There is a bubble going on. Investors should be concerned about the risks." he said in an interview with the Financial Times on January 30 2007.[85] Xie Guo Zhong, Morgan Stanley's former Asian chief economist, commented at the end of January that the market bubble was on the horizon, reflecting excessive liquidity from the extremely low ratio of deposit to loan in the Chinese banking system.[86] He added that "It may have to experience a painful readjustment in the future, echoing a similar bust in 2001." In his view, the normal

[84] Stock Frenzy In China Stokes Official Concern --- Investors Pile In, Using Homes as Collateral, Tapping Credit Cards. *The Wall Street Journal*, 30 January 2007
[85] Warning of bubble in Chinese stock market. *Financial Times*, 30 January 2007
[86] http://finance.sina.com.cn/stock/stocktalk/20070202/02183305356.shtml In Chinese.

average P/E ratio should be around 15-20, in light of the decreasing quality of earnings of listed companies, "but the P/E ratio was more than 25, which means it must be a bubble." During the same period, concerns also emerged along China's neighbours, such as, Vietnam-where stocks appeared overvalued-and the Philippines and Indonesia- where stocks appeared to be peaking.[87] Chairman of CSRC Mr Shang fulin warned, "We should keep a clear head in judging the current market."[88]

Increasing concern was reflected in the comments of various financial experts, which has brought a new headache for the regulators. Having spent several years being criticised for the prolonged market slump, they confronted the opposite problem - trying to prevent a bubble developing in the equity market. "The main concern of China's monetary tightening policies in the past has been to keep the country's economy under control," said Robert Kuhn, a senior adviser to Citigroup in New York and author of a flattering, state-sanctioned biography, called *The Man Who Changed China: The Life and Legacy of Jiang Zemin*. "But the stock market has recently caught their attention because prices have risen too much, too soon," he continued.[89] "What China really needs is 20 years of steady 15 per cent increases in the market, but it got 130 per cent in one year," says Jonathan Anderson, an economist at UBS. [90] For the fear of the government tightening policy, the stock market did falter in February 2007.

However, not everyone believed the China's stock market had formed a bubble. The value of the A-share market remained acceptable even before the recent correction, according to HSBC's fund- investment arm, Halbis.[91] There are grounds for believing this was a correction, not the prelude to a crash. Chinese companies continue to generate impressive returns. Corporate profits should be up more than 20% this year, reckoned Jing Ulrich, of JPMorgan. Also, the pipeline for new listings remains packed. On February 5th China's Industrial Bank went public in Shanghai and its shares closed up 39%. [92] More important, tracking in the pleasure principle, investors

[87] On Asia: China's loss in SE Asia's gain. *Financial Times*, 2 February 2007
[88] Stock Frenzy In China Stokes Official Concern --- Investors Pile In, Using Homes as Collateral, Tapping Credit Cards. *The Wall Street Journal*, 30 January 2007
[89] Foreign Investment --- Asian Trader: For Once, China Lags as Asia Leaps Ahead. *Barron's*, 5 February 2007
[90] Concerns at market bubble float over China. *Financial Times*, 31 January 2007
[91] Halbis finds A-share values acceptable. *The Standard*, 8 February 2007
[92] Hot and cold – China's stockmarket. *The Economist*, 10 February 2007

was trying to seize the events which support their wishful thinking, and also keep the excited quantity which was generated by previous events. This time, they started to pin their expectation on the constantly growing economics. And from this perspective, China's bull market was almost like an unstoppable train, with solid fundamentals underpinning its long-term ascent.[93] Hence, despite concerns that the China's stock market could be overheating, the country's benchmark stock index was nearing the psychologically important 3000 point after a brief and small slump.[94] Some investors even bet their house for mortgage in pawnshop.[95] And the Chinese lunar New Year in 2007 turned out to be a stock holiday. "The stock market will be one of the major topics during Spring Festival," predicted Ji Lingyun, an analyst at Beijing Capital Stock Investment Consulting Ltd. He said people spent the week swapping stock tips.[96]

For frenzy investors, any news turned to be good news. For example, when Tianjin Global Magnetic Cards failed to report quarterly earnings, its stock jumped 137 percent. Another one, after Shanghai Haixin Group said that its chief executive was under investigation for "irregular activities," the company's shares doubled over the next two months. "If I hear a stock mentioned on the TV news, I will pay attention to it," said Xu Xiaochun, a 55-year-old retiree. "I don't know how to choose a stock," a 61-year-old retiree, "But I trust those technology companies. Maybe some companies' names sound lucky to me so I choose to buy these stocks." Interestingly, presumably backed by more sophisticated investment analysis, was also piling in, according to J.P. Morgan Chase, and few analysts were betting against the Chinese stock markets. Pettis at Beijing University, for example, had long been sceptical about the Chinese stock market structure. But he was raising a fund to invest in Chinese stocks. "You can't be a fundamental investor in China," he said. "You can only speculate. Fundamental investors make long-term cash flow projections. In China, there's not good information or corporate governance." "Purchasing stocks is not an investment, it's gambling," said Wang Wei, a 41-year-old pharmaceutical company executive in

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[93] Bubble Economics. *The Wall Street Journal Asia*, 14 February 2007
[94] China shares surge again --- Holiday could spur even more buying despite concerns. *The Wall Street Journal Asia*, 16 February 2007
[95] Chinese bet the house on share prices going through the roof - Brisk trade at the pawnshops points to a streak of recklessness. *Financial Times*, 3 February 2007
[96] China's Other Celebration: Stocks Holiday Respite Could Spark Even More Buying. *The Wall Street Journal*, 16 February 2007

Shanghai. “The only reason I stay here is I trust the government won’t let prices go straight down.” [97]

However, Chinese investors were not the only optimists. Foreign investors were clamouring to get into China’s stock market. They wanted to invest ahead of the Chinese, who were yanking money out of their savings accounts, selling property and even taking out bank loans to get in on the stock-buying frenzy.[98] In response, China indirectly reassured that the government might allow greater foreign investment in Chinese stocks -- up to 10 percent of the market -- and would not impose capital gains taxes on stocks soon.[99] “Fueling interest in the emerging markets has been China itself,” said Joseph Quinlan, the New York-based chief market strategist at Bank of America Capital Management. That’s particularly true of U.S. investors. Over the past two years, Quinlan said, U.S. investors sank just over $10 billion into Chinese equities, $5.2 billion in 2006 alone, with an overall $52.7 billion in emerging-market equities. [100]

Curiously, at the end of February, the Chinese stock market had its largest one-day decline in a decade (nearly 9 per cent) and US stock indices had their worst day since the terrorist attacks of September 11 2001. These two markets were previously thought to have a very small correlation. On March 1, a majority of financial presses shed their warnings to hedge funds that the risk of Chinese market remained. However, like Chinese investors, foreign investors also had the tendency to seize the supporting stories. After a week, *Financial Times* entitled “Time to stop worrying and start investing”[101], and said worrying was something many people do. *The Wall Street Journal* put “Taking Stock in China”, [102] and suggested to improve the Chinese stock market, China should approve more new mutual funds, increase quotas under the QFII scheme to let more overseas institutions enter the market. While emerging markets had taken a battering, the mood among most analysts and investors remained distinctly calm. Juliet Sampson, chief economist, emerging Europe, Middle East and

[97] Where corruption is a buy signal Millions of Chinese seek stocks amid 'blind optimism'. *International Herald Tribune*, 17 February 2007

[98] Unworried investors buy again in Shanghai. *International Herald Tribune*, 1 March 2007

99 Chinese Shrug Off Losses As Market Swings Back. *The New York Times*, 1 March 2007

[100] The surprise that wasn't. *Bloomberg News*, 1 March 2007

[101] Time to stop worrying and start investing. *Financial Times*, 6 March 2007

[102] Taking Stock in China. *The Wall Street Journal*, 6 March 2007

Africa at HSBC, said: “Emerging markets had been at all-time highs and seen excessive rises. Equities are not in freefall; it looks like a correction.”[103] Jun Ma, the chief economist for greater China at Deutsche Bank in Hong Kong, said, “We do not see any significant impact of this market correction on China’s real economy. We remain bullish on the fundamentals of the economy,” which was still steaming ahead this year at a growth rate of nearly 10%. [104] The evidence was hard, the Shanghai stock market was up 13.8% in a few days.[105] Foreign investors psychic defence was set up, they optimistically believed that the slump of Chinese stock market was just like a wake-up call prompting a reassessment of risk that had increased credit spreads and returned market volatility to more normal levels. But all of this had happened without any real change in the underlying economic fundamentals, which was remaining strong.[106]

Soon, the Chinese stock market welcomed a rapid rebound and set a new record. “The market is promising in the long run,” said Cao Zitao, an analyst at Guotai Junan Securities in Shanghai. “Since the economy is doing well, there’s no doubt the stock market will continue to grow over the next year or two.”[107] Investors believed that the rise in many ways mirrored the blistering pace of economic growth in this country. The excitement of phantasy had shifted from the stock market reforms to the economic growth prosperity, and upgraded their psychic defence of the phantasy of stocks. The index, which tracks both A shares and B shares, advanced 0.8% to 3197.54, its seventh-straight record and ninth-consecutive session of gains. Commodities and investment guru Jim Rogers told a media “I own Chinese shares,” after a speech in Hong Kong, according to Reuters. “I’m not selling Chinese shares. If the Chinese stock market doubles again this year I’ll have to sell, because then it’s a full-fledged bubble.”[108]

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[103] Investors remain calm in the face of correction Emerging equity funds seem to have weathered most of the storm, say Rachel Morarjee in London and Joanna Chung in Hong Kong. *Financial Times*, 7 March 2007
[104] Fear Factor. *Time International Asia Ed*, 12 March 2007
[105] Early worm catches the world unawares. *Financial Times*, 13 March 2007
[106] A Resilient World Economy; Beneath recent tremors, the underlying fundamentals remain strong. *BusinessWeek*, 19 March 2007
[107] A Rapid Rebound: Chinese Stocks Set Record. *The New York Times*, 22 March 2007
[108] What Plunge? Shanghai at New High --- Chinese Shares Stay Hot Ahead of Index Futures Launch. *The Wall Street Journal*, 30 March 2007

A rich and spicy excitement was dominant in a capital market. Yes, the stock market was identified as a bubble. No, it wouldn't burst. The emotion was fusing both hope and possibility of loss. Melanie Klein (1935) describes two basic struggling mental states, the depressive state of mind and the paranoid-schizoid state of mind in context of dealing with difficulties. Bion (1970) explores this idea and stresses that these two mental states cause our sense of reality to experience a struggle between the depressive state and the paranoid-schizoid state. In the depressive state of mind, we recognise the imperfection of reality and feel it is real but painful, and then we shift to the paranoid-schizoid state of mind, deliberately evacuate the painful thinking. In the Chinese stock market, the sharp plump in March and the "bubble" statement led investors to realise that investment of stocks was uncertain and the situation might not be as perfect as they wished. Greater uncertainty and greater provoking loss in the market lead them to the depressive state, which makes them feel it was real. And then investors shifted to the other extreme, in the paranoid-schizoid state of mind: they unconsciously idealised the returns on their investments and believed the pay is worthwhile. At the very least they had a chance to enjoy with others watching the price going up. As Taffler and Tuccket (2008) define, the formula of the recognition of investments of stocks turned out to be: investment=uncertainty=anxiety.

New offerings were doubling in value on day one and shareholder accounts were multiplying at a phenomenal rate. Just after the first quarter of 2007, the A-share market was up 43 percent and daily turnover exceeded \$30 billion.[109] Between January and April 2007, the selling and buying exchange rate was 400 percent and 440 percent, respectively on the Shanghai and Shenzhen Exchanges.[110] Many new investors, often with little understanding of market mechanics, were also jumping into stocks, opening more than 100,000 accounts on an average day.[111] The dramatically increasing stock trading accounts and continuously joining of neophytes were showing that the psychic defence was among a huge group. Group psychic in this phase will likely generate three effects. First, the individual sense of reality was a huge group sense of reality. Consequently, this group sense may well influence the judgement of individual. At the meantime, group psychic drives a competing excitement of individuals. Bion (1952) estimates that in the basic assumption group

[109] China's stock market. *Financial Times*, 6 May 2007
[110] "Policy" change "Potential" no change. *Shanghai Securities News*, 4 June 2007
[111] Chinese Investors Crunching Numbers Are Glad to See 8s. *Wall Street Journal*, 24 May 2007.

the accumulation of information is used to make one feel good, rather than for rational thought. In that a group of people share in common with the same wishful thinking, investors emotionally assumed what they wished was not just gut feeling, but the right feeling. They rationalise their seemingly irrational behaviour and imagined a solid defence introduced by a deposit from the results of such periodical activity.

However, international institutional investors seemed to be nervous, they lowered their exposure to China in May, moving to a neutral position from slightly overweight while the country's stock markets continued surging to records. [112] Goldman Sachs commented on 19 April 2007 that there were increasing "risks" of policy tightening in China to cool the economy and the "over-exuberant" domestic equity market. However, they also added that the gross domestic product (GDP) data confirmed that growth in China was "firing on all three cylinders again" and had clearly decoupled from that in the US.[113] Yet as Mr Xiang Huaicheng, chairman of the National Social Security Fund, China's largest institutional investor, on 30 May 2007 said, "The Chinese stock market is like a glass of beer. If there are too many bubbles it doesn't taste good but if there were no bubbles who would want to drink it?"[114] "This market seems to be defying gravity. It's got to come down at some point. We can't risk that, especially given the nature of our fund," Mr Gao Xiqing, vice-chairman of the National Council for Social Security Fund (NCSSF) on 26 April 2007 told a JPMorgan conference in Beijing.[115] The NCSSF, which placed 39 percent of its $58 billion, in assets in mainland China stocks and which was among the largest shareholders in the Chinese big banks, reduced its exposure to 30 percent of its portfolio. In a report issued on 26 April 2007, HSBC strategist Steven Sun said he was reminding investors "to expect a correction soon," noting risks in what he called a frenzied market that include a possible slowdown in earnings growth in the second quarter. In a survey of regional fund managers published in April, Merrill Lynch & Co. found that 7 percent fewer were bullish on China stocks than in March. [116]

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[112] Global funds lighten up on China. *The Wall Street Journal Asia*, 1 June 2007
[113] Global Overview: China overheating fears hit markets. *Financial Times*, 19 April 2007
[114] China's various share types thrown into focus. *Financial Times*, 30 May 2007
[115] Top China investor in alert on market. *Financial Times*, 26 April 2007
[116] Beijing fund pulls back from China stock market --- Official warns rally has lasted 'too long'; big investors are wary. *The Wall Street Journal Asia*, 27 April 2007

Tim Harris, JPMorgan Private Bank's chief investment strategist in Europe, argued that "When a liquidity-inspired bull market takes to the wing, it is difficult to judge its scope and momentum by traditional valuation tools alone. The Middle East provides clues on the outcome of the meteoric recent rise of the Chinese stock market."[117] Asia's famed "Superman" investor, billionaire Li Ka-shing on 24 May 2007 warned, "As a Chinese, I am worried about the stock market."[118] Former Federal Reserve chairman Alan Greenspan on 25 May 2007 warned that China's stock market was heading for a crash. He said that the rally in Chinese stocks was "clearly unsustainable" and "there's going to be a dramatic contraction at some point."[119] But investors pay little heed to Greenspan.[120] For many in China's new shareholder class, stock picking is more art than science. Li, for instance, couldn't resist a bargain: "I like stocks that cost no more than 8 renminbi [$1]."[121] "I believe good codes will bring good luck," said Mr. Yan, who parked himself most days in front of a trading screen at a Shanghai brokerage, Shen Yin Wan Guo Securities. Indeed, shares in Jilin Yatai (Group) Co., the cement company he bought, promptly tripled, earning him about $50,000. Mr. Yan gave credit for the performance to the two "8s" in the stock's numeric ticker symbol, which he considered a lucky combination. In contrast, investors get nervous when they see the number "4" since its pronunciation "si" can mean "death." As proof of its destabilizing force, many pointed out that Chinese stocks began to 'wobble' in early May, when the Shanghai Composite Index traded around the 4,000 level for the first time.

China's leaders were unsure what to do to cool the market. They did hike a string of interest-rate rises and increase in banks' reserve requirements, but had little effect. [122]The authorities faced a stark choice: act now to deflate the bubble or wait for the inevitable implosion - and equally inevitable street protests.[123] But finally they made the decision when most investors were asleep. The Ministry of Finance announced through the state media service Xinhua at midnight of May 30th 2007 that the stamp tax on securities trading would be raised from 0.1 percent to 0.3 percent. In response

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[117] View of the day: Tim Harris, JP Morgan Private Bank. *Financial Times*, 10 May 2007
[118] Chinese Investors Crunching Numbers Are Glad to See 8s. *Wall Street Journal*, 24 May 2007.
[119] China's stock market faces the threat of a 'marked correction'. *Times*, 25 May 2007
[120] Investors pay little heed to Greenspan. *Bloomberg*, 25 May 2007
[121] Chinese Investors Crunching Numbers Are Glad to See 8s. *Wall Street Journal*, 24 May 2007
[122] The people's republic in the grip of popular capitalism – China. *The Economist*, 28 April 2007
[123] China's stock market. *Financial Times*, 6 May 2007

Chinese mainland A-shares plunged overnight by no more than 6 percent on the day time of 30 May, which is called "5.30". Chinese markets opened sharply lower, and after briefly recouping some of their losses, and fell again. The Shanghai Composite Index was off 6.1 percent at the close of the morning session. Most other Asian markets following suit. Stocks also fell in Hong Kong, Australia, Japan and South Korea, and the yen rose against most major currencies as investors engaged in the carry trade unwound positions to reduce risk[124], but produced only a modest ripple around the world. Charles Dumas, at Lombard Street Research, on 30 May stress that: "China is a self-contained issue. It's not going to cause contagion in any normal sense of the word." [125]

Jun Ma, chief China economist for Deutsche Bank in Hong Kong on the same day has argued that the stamp duty hike was the most aggressive attempt yet by the government to intervene in the stock market. After Beijing raised the stamp duty in 1997 from 0.3 percent to 0.5 percent, the A-share market fell 30 percent in the next four months, according to Ma.[126] However, the forecast failed to become true, after a brief breathtaking plunge, the stock market come back again. After hitting the lowest 3860 point around 10 am on June 1st 2007, it made a U-turn and started climbing oscillated to 320 points higher at the closing point.[127] "We believe this adjustment is mainly temporary. It could be shorter than a week," said Li Xianming, analyst at Ping An Securities in Shenzhen.[128] "I'm not dramatically worried," Edward Menashy, a strategist at brokers Charles Stanley, said. "Beijing is not going to stop speculators by raising stamp duty by this very small amount. Price-earnings ratios are uncomfortably high so you are going to get sell-offs from time to time, but I don't think this will knock the market much lower."[129] China's "move was expected, as the rise in the market was irrational and went beyond logic," Simone Freschi, head of equity trading at Banca Monte dei Paschi di Siena in Italy, told Bloomberg News. "The psychological impact on investors could be larger than the actual effect of the duty adjustment," Shen Minggao, an economist at Citigroup, wrote in a research note.[130]

[124] Chinese Stocks Plunge On Hike In Trading Tax. *Forbes*, 30 May 2007
[125] China contagion limited. *Financial Times*, 30 May 2007
[126] Beijing to Shanghai: "Slow Down". *Forbes*, May 30 2007
[127] Stocks come back after 'breath-taking' plunge. *China Daily*, 1 June 2007
[128] FT.com site : Markets relaxed on China stocks plunge. *Financial Times (FT.Com)*, 30 May 2007
[129] S&P hits new high despite plunge in Shanghai. *The Independent*, 31 May 2007
[130] Setback for red-hot Chinese stock market. *International Herald Tribune*, 31 May 2007

As the Chinese stock market had been dominant with a solid sense of exciting reality, no one would like to damage the imaginary picture and the space of a potential imaginary access. Like the wave in February 2007, investors unconsciously oscillated between the depressive state of mind and the paranoid-schizoid state of mind. The greeting replaced the national anthem with a call for all investors to rise up and buy, buy, buy stocks. “Get up, ye who refuse to be slaves,” from the national anthem, had been replaced on the greeting by: “Get up, ye who haven’t opened an account! Pour your gold and silver into the hot market.”[131]

At the same period, the World Bank raised its forecast for China’s economic growth in 2007 would be up to 10.4% from 9.6% with an emphasis that the nation’s economy didn’t appear to be overheating.[132] Although in many ways, the stock market had come in line with China’s phenomenal economic growth trajectory, yet it created twin worries about the possibility of hypergrowth ending in inflation, stock market crash and unrest.[133] Jeff deGraaf, head of technical research at New York-based investment research group ISI, said the excessive liquidity drove a boom in Chinese stock prices, and it may take months for that market to implode or deflate. “That is the looming danger in global markets,” he predicted. The more that happens, the greater the risk.[134] Curiously, the pork price was sky-rocketing, which made the Chinese most scare. The annual inflation rate zoomed to 5.6 percent in July, the highest in more than 10 years, the Chinese National Bureau of Statistics said. Food prices jumped 15 percent, driven by a 45 percent surge in meat and poultry.[135] Investors were “hard to reassure right now because they believe more tightening measures will come if the markets continue to rise,” said Zhang Gang, an analyst at Central China Securities. But the dream would never sleep. “The end of a bull market is when you have earnings erosion, and we haven’t seen that yet,” said James Yuan, chief investment officer at Everbright Pramerica Fund Management Co., Prudential Financial Inc.’s joint venture in China with Everbright Securities Co.[136]

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[131] Setback for red-hot Chinese stock market. *International Herald Tribune*, 31 May 2007
[132] U.N. lender lifts forecast for China's growth in '07. *The Wall Street Journal Asia*, 31 May 2007
[133] Setback for red-hot Chinese stock market. *International Herald Tribune*, 31 May 2007
[134] Charting the Bull's Next Move. *Barron's*, 4 June 2007
[135] Blame money, not pigs. *Bloomberg*, 15 August 2007
[136] Big stock drop tests anew Beijing's balancing act. *The Wall Street Journal Asia*, 5 June 2007

Foreign investors backed up the Chinese stock market, which is one of the largest emerging markets in the menus.[137] But, why China? why this time? Emerging markets was “a kind of amorphous concept, and nobody cared one way or another about the differences between the individual countries that made up the category,” Mobius, a Franklin Templeton director, recalled.[138] The attractions of emerging markets are many. One was high profits. From the beginning of the year 2007 to the end of May, the Hedge Fund Research index of emerging market hedge funds rose 12.19 per cent. That trounced the 7.19 per cent gain for the index of overall hedge fund performance.[139] However, the chief reason overseas investors had remained calm to the Chinese stock market was that it was a very closed market, and a very speculative market, said Richard Gao, portfolio manager of the $1.2 billion Matthews China Fund.[140] According to fund researcher Lipper Inc., the average China stock fund sold in the U.S. was up about 25% in 2007.[141] After Alan Green-span, former chairman of the Federal Reserve warned in February 2007 that the US economy might slip into recession by the end of 2007[142], the US stock market had grappled with worrisome trend surrounding issues about sub-prime mortgages, from concerns about the housing slump and energy costs hurting the economy, which drove down the prices of stocks, and even more so those of bonds and derivatives based on bonds. Hence, the feature of Chinese stock market definitely met with overseas investors’ wishful thinking and seduced their phantasy. The U.S. credit problem “can’t affect China directly,” says Andy Xie, an independent economist in Shanghai.[143]A “closed and safe stock market” phantasy was coming into the stage.

In August 2007, the Shanghai Composite index rose to a fresh record close of 4,628.11 high, when the US stock market was enveloped in turbulence in global credit markets.[144] This cemented China’s “closed” and “safe” stock market phantasy of overseas investors. And as for Chinese, when the index reached above 4000, they

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[137] FT.com site: Chinese securities groups back on foreign menus. *Financial Times (FT.Com)*, 5 June 2007
[138] Quarterly Mutual Funds Review --- Seeking Value in BRICs. *Barron's*, 9 July 2007
[139] Emerging club mixes cocktail of high gains. *Financial Times*, 10 July 2007
[140] Why Investors Look Past China's Slide. *The Wall Street Journal*, 5 June 2007
[141] When China isn't China --- Portfolios that invest in Hong Kong shares trail mainland gains. *The Wall Street Journal Asia*, 3 July 2007
[142] The wind of Chinese turbulence may yet blow some good into Western markets. *The Independent*, 28 February 2007
[143] Growing debt crisis slams Asian markets, blurs outlook --- How China continues to defy share slump; a 'rational bubble'. *The Wall Street Journal Asia*, 20 August 2007
[144] FT.com site : China shrugs off Asia equity malaise. *Financial Times (FT.Com)*, 6 August 2007

would expect it to climb over 5000. The buoyant Chinese stock market IPO in 2006 left the expectation to host more than $50 billion worth of new issues in 2007, according to Price Waterhouse Coopers.[145] Just at this time, a new round of restructurings by state-run companies was pushed into public, such as infrastructure and shipbuilding.[146] The continuing inject of IPOs capitals and the gradual development of mainland capital market, which were believed as an important underlying trend in the Chinese economy.[147] After the continuing IPOs, the Chinese stock market was bigger in terms of market value than the Japanese market, taking into account the Chinese companies listed in Hong Kong.[148] The phantasy of the stock market reform and the phantasy of the growing economic seemed to be merged, so did their sense of reality. The stock market was viewed as the mirror of the Economic, and vice versa. As well as, the stock market was also tested as a closed market, which would be unaffected by the turmoil of the US stock market. Thus, investors began to believe their wishful thinking—the stock prices would never fall, even though it might be a bubble—was becoming the reality.

This euphoria was quickly spreading; soon, it became a common sense for almost everyone. Institutional investors who became the top movers and shakers in China's securities markets holding 44 percent of the total capitalization of A-share markets by the end of July 2007[149] were optimistic. They shared a lot in common on the bullish market view with approaching to a more rational level, especially, after the market correction in the second quarter.[150] According of the survey[151] conducted by China Securities Investment Protection Fund in July 2007, 60 percent of investors, both institutional and individual investors believed the rally would sustain itself until 2008 Olympic Games. Meanwhile, the *China Securities Journal* reported a survey on its front page, which was conducted on July 6-16 and involved 73 managers in domestic fund management companies showed that about 88 percent of Chinese fund managers said that the domestic stock market would continue to rise in the next 12 months, with

[145] Chinese IPOs. *Financial Times*, 4 July 2007
[146] As more China assets go public, shipping, autos are bright spots. *The Wall Street Journal Asia*,15 August 2007
[147] Shenhua shares nearly double on debut in year's biggest IPO. *Financial Times*, 10 October 2007
[148] Chinese stock market bigger than Japan's. *Financial Times*, 27 August 2007
[149] Institutional investors hold 44 percent of China's A-share market cap. *Xinhua News Agency*, 27 August 2007
[150] http://www.cs.com.cn/tzjj/03/200707/t20070718_1165198.htm. In Chinese
[151] Chinese Investors in the Stock Market Survey Report. *Xinhua News*, 3 August 2007

55 percent believing that it would rise sharply.[152] The journal also concealed that in the third quarter of 2007, the average exposure of equity funds to mainland stock market was up to 80 percent, 2 percent more than the second quarter.[153] Interestingly, so-called momentum investing strategy now turned out to be anchored on the emotional momentum of institutional investors. Not surprisingly, the Shanghai composite index, on 16 October, peaked at 6092.06 point, a climb of nearly six fold over the previous two years[154]. Even Shanghai stocks trade on a price-earnings ratio of more than 60 times in Oct 2007.[155] Absurd valuations were rationalised. Hence, the means of marcro-economic were out of control. Even the central bank had raised the interest rate six times from 6.12 percent to 7.5 percent between March 2007 and December of that year, and the reserve requirement ratio from 10.0 percent to no less than 14.5 percent, it still failed to calm down the market.

To foreign investors, the Chinese stock market was the ideal investment to hedge the risk of sub-prime crisis. Most analysts shared the view that economic growth in the US will falter but not spread contagion through Asia's financial markets.[156]In the Chairman's statement of JP Morgan Chinese Investment Trust PLC on 8 November 2007, it said:

> "We believe that government policies will remain accommodating given its 'pro-growth' stance and that overall economic growth should remain promising, despite some moderating in 2008. …Global growth downgrades are likely, especially in the US. That said, China stands out in terms of relative insulation from a global growth slowdown, having ample excess liquidity (in contrast to most other markets where liquidity is tightening)."[157]

[152] China fund managers see stock market continuing to rise in next 12 mths – report. *Xinhua Financial Network (XFN) News*, 23 July 2007
[153] http://www.cs.com.cn/tzjj/03/200711/t20071101_1237730.htm. In Chinese
[154] Buffett highlights dangers in rising Chinese stock market. *Financial Times*, 25 October 2007
[155] Bursting China's bubble could hurt. *Financial Times*, 5 November 2007
[156] Asia safe as houses China's growing consumer spending power should protect the region from the fallout of the subprime crisis and, while markets will be volatile, the US Federal Reserve ought to keep the ball rolling. *South China Morning Post*, 25 September 2007
[157] JPMorgan Chinese Inv Tst PLC - Final Results. *Regulatory News Service*, 8 November 2007

However, the anxiety of 'when the bubble burst' was there, but the hope always remains.[158] Just few days after the index peaked, *Financial Times* pinned a title "China's bubble may burst but the impact will be limited".[159] *The New York Times* gathered the bubble risks in China.[160] Warren Buffett on 26 October 2007 urged investors to be cautious about the Chinese stock market. "We never buy stocks when we see prices soaring. We buy stocks because we are confident of the company's growth," he said.[161] At the end of October 2007, Alan Greenspan again said China's stock market was a speculative bubble that would burst[162]. James Murdoch, on 1st November 2007 in a wide-ranging interview, said that commenting on the Chinese stock market was "a little bit tricky". "It's a little bit above my pay grade at this point," he added.[163] But few seemed to care.[164] The market appeared to be saying that the emerging markets growth would be fine, even if there turned out to be a recession in the US, even if banks were afraid to lend money and even if the western consumer decided to start saving instead of spending.[165] The manic state deep-seated in the investors and the continuous struggle between the depressive and the paranoid-schizoid states of mind made them reluctant to be aware of the potential loss that evokes unpleasant feelings. So they believed what they did was rational and reasonable.

The credit crash in US caused deep concerns about its effects in East Asia. The Chinese government issued a report warning that a US recession could be "devastating" to China's manufacturing sector. [166]And QFII funds had been sold for about USD 2.2 billion as of end of November 2007,[167] which was dedicating a cautious attitude. Many equity fund manager began reduced their exposure to A-share from average 80.1 percent to 79.41 at the end of the third quarter and were going to reduce more than 10 percent in the final quarter.[168] Albeit, at the beginning, determinedly optimistic investment bankers had two favourite statements: one was "It

[158] On Asia: How long can China remain in orbit? *Financial Times*, 26 October 2007
[159] China's bubble may burst but the impact will be limited. *Financial Times*, 17 October 2007
[160] The bubble risks in China OFF THE CHARTS. *International Herald Tribune*, 20 October 2007
[161] On Asia: How long can China remain in orbit? *Financial Times*, 26 October 2007
[162] Greenspan Says China's Stock-Market Bubble May Burst. *Bloomberg*, 30 October 2007
[163] From broadband to Caesar. *Financial Times*, 1 November 2007
[164] Bursting China's bubble could hurt. *Financial Times*, 5 November 2007
[165] Nick Louth: Keep it in cash and hold nerve. *Financial Times*, 23 November 2007
[166] China's Market Mood Swing. *Time*, 22 November 2007
[167] QFII Funds Sold for USD2.2bn by 2007 Nov. *SinoCast China Business Daily News*, 9 January 2008
[168] http://www.cs.com.cn/tzjj/03/200801/t20080123_1354424.htm. In Chinese

will all bounce back in the second quarter" and the other "Asia is still booming".[169] The World Bank forecasted that it would be "significant but no disaster". East Asia's economies were likely to weather the effects of any slowdown in the US economy, but China would continue to drive the region's economic expansion, with expected growth of 11.3 percent in 2007 and 10.8 per cent in 2008. The consequences of a Chinese stock market correction for the wider economy were "likely to be fairly limited", said Bert Hofman on November 16th 2007, the World Bank's lead China economist.[170] Lipper senior research analyst Liang Zhou said that international investors would still favor renminbi-denominated assets in a short period in spite of the expected variable Chinese economy in 2008.[171]

The Shanghai Composite was down 21 per cent from its peak at the end of November 2007, and the weekly trading volumes were falling in line with share prices from 17 billion to 3.3 billion[172], suggesting that the Chinese mainland market was no longer insulated. "The Chinese market is becoming more and more integrated into the global market and its movements will be correlated with movements overseas," Zhong Hua, an analyst at Changjiang Securities in Shanghai said on January 23 2008.[173] Mainland shares had attracted a huge amount of overseas interest, not only because of the two-year surge in share prices but also because foreign investors believed China's relatively insulated capital market could act as a hedge against more inter-linked global markets. Burton Malkiel, economics professor at Princeton University, author of the classic investment study *A Random Walk Down Wall Street* and leading advocate of the efficient market hypothesis, proposed several ways in which international investors could access the Chinese stock market in his new book *From Wall Street to the Great Wall*.[174] But not everyone was convinced; according to Jonathan Anderson, economist at UBS, the apparent link between markets was likely to be a "one or two month thing".[175] Indeed under the government's quota system, foreign investors were only a small part of the market, but they could change the psychology of mainland investors by launching international equity funds for Chinese

[169] Asia half full. *Financial Times*, 4 December 2007
[170] East Asia likely to surge on amid US slowdown**.** *Financial Times*,16 November 2007
[171] QFII Funds Sold for USD2.2bn by 2007 Nov. *SinoCast China Business Daily News*, 9 January 2008
[172] The Short View. *Financial Times*, 29 November 2007
[173] China's parallel universe fades. *Financial Times*, 23 January 2008
[174] Investing in Chinese equities. *Financial Times*, 19 February 2008
[175] China's parallel universe fades. *Financial Times*, 23 January 2008

investors, which also boosted awareness of overseas markets among mainland share-buyers.

In the face of an uncertainty of global economic future, Chinese investors entered into an extensively explicit anxious state of mind that influenced their buying and selling of stocks. When they sensed the bubble was about to burst, any news which supported this feeling would be amplified. This unconscious anxiety forces drove their investment judgements and led them to give priority to leaving the stock market sooner or later. According to the survey[176] conducted by China Securities Investment Protection Fund in 2008, by January of 2008, only one quarter of investors had an optimistic view of the market, even though only 17 percent investors had lost money in 2007. A total of 38 percent investors believed the market rally would be sustained until the 2008 Olympic Games, compared with 60 percent just few months before; 52 percent of investors responded would more conservative to avoid risk, although still 33 percent of investors thought China would be unaffected by global economics; 16 percent investors were planning to reduce their exposure to the stock market. Another survey conducted by Hexun, a well-known stock market website in China, in February 2008, with the scope among three largest cities in China—Beijing, Shanghai, Guangzhou—showed that around 35 percent of investors believed that the extremely high liquidity, combined with the credit crash in the US were warning signs for China's stock market in 2008. 23 percent investors thought a bearish market had started and 52 percent had changed to invest in funds, especially after the first crash in January 2008. According to a third survey, which interviewed 20 financial professionals from securities research institutes and senior directors in Ministry of Finance, also conducted by Hexun, in March 2008, 70 percent of them conceived the market would be violently shaken in 2008 and 35 percent of them thought the bullish market would not end but mildly slow down. However, 40 percent of them thought the Olympic Games would play no positive role in the stock market. Equity funds in China steeply reduced their investments in financial and insurance stocks by 4.02

[176] The second individual investors in securities market survey and analysis report. *China Securities Journal*, April 1st 2008. In Chinese.

percent in the first quarter of 2008, according to a report by Beijing-based investment consulting company TX Investment Consulting Co., Ltd.[177]

3.4 The panic phase

In the first quarter of 2008, the Shanghai Composite Index was down by between 34 percent and 43 percent off its peak on 16th October 2007. The world's best performing market had suddenly turned into one of the worst.[178] Almost as soon as these mind-numbing statistics came to light, panic replaced euphoria among the Chinese retail investors virtually overnight.[179] They realised that reality was no longer as they felt it to be. Their euphoria was overcome by the compelling acceptance of the tough truth. In the second quarter of 2008, Shanghai University of Finance and Economics conducted a survey of individual investors' confidence in Chinese market, and they found that the individual investors were seriously lack of confidence. Investors were becoming aware that their investment judgements were based on an ideal expectation rather than rational analysis. They kept struggling between the depressive state of mind and the paranoid-schizoid, and rationalizing that their irrational behaviour under that circumstance was reasonable.

Due to the stock market slump in the first half, stock-based funds suffered huge losses, valued at $132 billion, accounting for 97.52 percent of total losses, according to the China Securities Journal citing the Chinese data provider, while nation's 361 mutual funds reported a loss of $195 billion.[180] Institutional investors have shaken their heads. According to a survey[181] conducted by Guo Tai Jun An Securities, half of institutional investors thought the market would continuously fall in the second half of 2008, and 80 percent believed the Shanghai Composite Index would level out between 2500 points and 3500 points. Steven Sun, China equity strategist at HSBC in Hong Kong, on 11 June 2008 said the dramatic market falls had been made worse by panic among inexperienced portfolio managers who control about $360 billion of local mutual funds. Surveys suggest, he said, that about three-quarters of mainland China's fund managers had spent less than three years in the profession. "Most of

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[177] Funds Q1 Cut Investments in Financial and Insurance Stocks. *SinoCast China Business Daily News*, 22 April 2008
[178] The CEQ on FT.com: Shanghai market making. *Financial Times*, 14 April 2008
[179] China's bubble bursts. *The Independent*, April 23rd 2008
[180] China's $195bn loss. *Bloomberg*, 10 September 2008
[181] http://www.china.com.cn/economic/txt/2008-07/01/content_15915649.htm In Chinese.

them have only bull market experience and they haven't seen past bubbles bursting. They're seeing it for the first time and they're scared. They behave like super retail investors."[182]

3.5 Revulsion and blame

As the market continued to slide, the inflation rate was soaring at 8.5 percent in April, which was near its highest level for 12 years. This pushed the People's Bank of China into a corner. Instead of increasing the interest rate the central bank raised reserve requirement ratio five times from 14.5 percent to 17.5 percent in the first half of 2008. However, from 3 to 17 in June (a merely ten transaction days), the Shanghai Composite Index plunged suddenly 23.7 percent from 3460 to 2800. Investors could no longer accept reality, and turned to blame with denial and anger. They began to doubt the market reforms and the continuing IPOs, which had previously stirred their phantasies and aroused their excitement.

The downward action was partly due to fear of the upcoming release of the shares, which can now be floated after a lock-up period. They were previously prohibited from trading prior to share-and-merger reforms in 2005. It was estimated the shares could reach 210 billion yuan ($30.7 billion) in August, compared with 45.5 billion yuan ($6.6 billion) in July and 99.4 billion yuan ($14.5 billion) in June. Han Zhiguo, a Chinese economics on 17 June 2008 pointed out that, the continuing slide of the stock market was due to its inherent contradictions. The market reforms allowed previously listed SOEs to liberalise their non-tradable shares. However, the market was stuck, after a huge amount of non-tradable shares that were liberalised and new SOEs' IPO shares had been continuously flooding into the stock market. Simultaneously, these new listed SOEs also created a tremendous burden, as a large number of non-tradable shares were waiting to be liberalised in future.[183] "It (large-scale floating of such shares) is impossible," said Li Rongrong, minister of the State-owned Assets Supervision and Administration Commission (SASAC).[184] Hence, even though the market had been reformed but the total free-float rate will not profoundly change. Yet the huge supply with limited demand capacity crucially triggered the sharp fall, Cao Honghui, director of Financial Market Department of the Research Institute of

[182] Chinese shares tumble on profit fears. *Financial Times*, 11 June 2008
[183] http://opinion.hexun.com/2008-06-17/106753670.html In Chinese
[184] State wants to keep close watch on its enterprises. *China Daily*, 11 August 2008

Finance under the Chinese Academy of Social Sciences, said on 18 August 2008.[185] But this time, investors seemed to be convinced. Holders of newly unlocked A-shares sped up to cash their holdings according to Xinhua News agency statistics.

"Higher-than-expected producer price inflation for July may have further dented investor confidence and pushed the Shanghai Composite Index below the 2500 threshold," said Jing Ulrich, chairman of China Equities at JPMorgan Securities. This sentiment was reflected in the heavy beating taken by the metal and energy counters. "Before the Games opened, many investors had pinned high expectations on it, which they thought would help lift market sentiments and lead to a significant rebound," said Mao Nan, an analyst at Orient Securities in Shanghai. "When the Games began, they started to unload Olympics-related stocks, which weighed down the market."[186]

In parallel, the combined assets of 364 funds managed by 59 fund management companies fell $157.59 billion in the first six months of 2008, according to figures compiled by TX Investment Consulting Co based on companies' interim reports. Losses of equity funds amounted to around $102 billion and that of hybrid funds totalled $43 billion. Meanwhile, closed-end funds posted a loss of $9 billion. The loss of all stock-linked funds, consisting of equity funds and some hybrid funds, accounted for 97.52 percent of the total loss. In addition, QDII funds also posted a loss of $4 billion.[187] Equity funds analysts began to point out in their first half annual reports that the loss was in reaction to tightening monetary policy, the economic slowdown and pressure of huge freed-up non-tradable shares coming onto the market. The US sub-prime mortgage crisis and global inflation also dented investor confidence.[188]

At the same time, some retail investors charged some Chinese fund managers had acted "inappropriately or irresponsibly" after the "rat hole" event and a QFII's lawsuit. In April 2008, Chinese securities regulator banned two fund managers Tang Jian and Wang Limin from the country's capital markets, who had bought shares in companies their funds had invested in and then sold them for a profit, which is known as "building a rathole" in Chinese. Tang, a former manager for China International Fund Management, a joint venture between JPMorgan and Shanghai International Trade

[185] Supply-demand relationship crucial in China's stock market fall. *Asia Pulse*, 18 August 2008
[186] Stocks slide to lowest in 19 months. *China Daily*, 12 August 2008
[187] Equity funds hit by crash. Industry Updates, 1 September 2008
[188] Funds report record-high losses in H1. *China Daily*, 29 August 2008

and Investment Corp, had stored up $220 thousand in his rathole, according to the China Securities Regulatory Commission. Wang, formerly a manager at China Southern Fund Management, had similarly made a profit of $200 thousand.[189] Moreover, one of QFIIs was also sued in June 2008. The lawsuit by Nanning Sugar Manufacturing Co Ltd against Martin Currie Ltd for allegedly selling too many A-shares before the end of lock up period also pointed to growing risks as China's share markets slide, lawyers said.[190]

Zhou Liang, head of investment and advisory, China, Thomson Reuters, commented that losses were caused by the past volatile investment environment. Retail investors had no excuse to place the blame solely on the fund managers, instead, they should be aware of the potential risks in equity investment, Zhou said. "Many retail investors used to regard funds as a safe capital refuge and pumped more and more money into equity funds even when the market was obviously overheated when the lead indicator hit the historic high in excess of 6,000 points last October," he said, in the rush to cash in on the bull run, "many investors turned a blind eye to the risks". To Liang and others, fund managers had actually outperformed the stock market, albeit by a small margin. He pointed out that the rate of decline in fund assets was actually lower than that of the index. The CSI300 index fell an aggregate 47.7 percent in the first half of 2008, while the combined value of all funds depreciated 42.8 percent in the same period.[191] The curious thing is that there is no evidence that investors blame their own judgement.

## 4. Conclusion

This paper set out to explain the Chinese stock bubble during 2006-2008, by invoking a psychoanalytical dimension. We found that during the stock bubble, investors' emotions became involved in their investment judgements, which led the stock prices to leave their fundamental value. And investors' emotional sequence matched the model of Taffler and Tuckett (2005) and Tuckett and Taffler (2008) perfectly. In the mood of the Chinese stock bubble, investors first discovered the excitement of a

[189] FT.com site : China cracks down on market 'ratholes'. *Financial Times*, 22 April 2008
[190] Landmark lawsuit in China seen as wake up call for foreign institutions. *Xinhua Financial Network (XFN) News*, 18 June 2008
[191] Equity funds hit by crash. *Industry Updates*, 1 September 2008

different era, and then rushed to acquire the phantastic objects. Subsequently, they unconsciously adopted the sensation of reality that supports their wishful thinking and rationalized what they were doing, at the same time avoiding the reality that triggers pain. Finally, when the stock market collapsed, they panicked and resorted to blame.