

The impact of the

subprime crisis in China

Frankfurt University of Applied Sciences

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**Table of contents**

Foreword 5

Market Bubble 6

U.S. Subprime Mortgage Crisis 2008 8

Impact on China’s economy and financial sector 13

China’s responses to the Subprime Crisis 16

Result of China’s stimulus package 20

Conclusion 20

References 21

**Table of figures**

Figure 1: Stock Market and the Burst of Bubble …………………………….7

Figure 2: U.S.: House Price Appreciation ……………………………………9

Figure 3: U.S.: Unemployment, total (% of total labor force) ……………. 10

Figure 4: Household final consumption expenditure (annual % growth) ..11

Figure 5: U.S.: growth (annual %) …………………………………………...11

Figure 6: U.S. imports of trade goods: Percentage of change in volume .12

Figure 7: U.S. import growth of trade from China ………………………….13

Figure 8: FDI, net inflows (BoP, current US $) ……………………………..14

Figure 9: China: Unemployment, total (% of total labor force) ……………14

Figure 10: China: GDP growth (annual %) …………………………………..15

Figure 11: Shanghai Composite Chart ……………………………………….16

Figure 12: Project costs ………………………………………………………..17

Figure 13: China’s Stimulus Plan ……………………………………………..18

**List of abbreviations**

U.S. United States

WTO World Trade Organization

Etc. et cetera

GDP Gross Domestic Product

FDI Foreign Direct Investment

CCB China Central Bank

CDO Collateralized Debt Obligation

FED Federal Reserve

BoP Balance of Payments

SSEx Shanghai Stock Exchange

**Symbol directory**

% Percent

$ Dollar

Foreword(XXX)

Since the terrorist attack on September 11th, the global market was hit by a concatenation of several economy crisis, which was also the main reason that has caused the enormous financial crisis 2008 in the United States (U.S.). Many countries were concerned and affected due to the recession, that has been caused by the participants in the U.S. property market (tagesschau.de 2008). China’s and U.S. trading systems were one of the global outstanding foreign trade (ustr.gov 2017). Especially, China’s entry in the World Trade Organization (WTO) on 11 December 2001 has secured the trade bondage between the two growing countries (wto.org 2017). Although, our main concern is the Chinese economy (and the financial sector) which was affected by the subprime crises, we will also explain the market bubble and its main characteristics, the Subprime crisis 2008, the impacts on China’s economy, the responses of the Chinese government and the stimulus package, which also has taken a greater part of the development in China’s economy, in the following pages.

Market Bubble (YYY)

The market bubbles, which can appear in all markets for example stock, property market etc., occur in all global financial crisis. To give a better overview of the development of a market bubble, I will focus on shares and bond prices.
A typical market bubble is characterized by the effects of long-term and short-term cycles. These effects are mainly about the fluctuations of share prices. The interdependency of share prices and the macroeconomic conditions, which are defined by the demand and supply of the market, take a greater part for the development of stock market bubbles.

The effect of a long-term business cycle occurs when investors influence the share prices. One the one hand, investors tend to invest in more stable and rising companies, who are likely to gain a lot of profit and give out higher dividends. Investors associate the rise in profit with a profitable share. This will lead to an increase in demand and to an upturn of share prices.

On the other hand, when the global conditions are unfavourable**,** firms are more likely to reduce payment of dividends to shareholders. This will have a negative impact on the sales and the prices of shares.

Stock market bubble can also be affected by short-term effects for example changes in interest rates, trade balances, exchange rates, employment and inflations.
The volatility of share prices is a fundament of the stock market, since the future movement of the market cannot be predicted because of the non-transparent of the markets. The different subjective judgements of the investors based on their own analysis and expectation play a significant role due to their own analysis and expectations. Thus, it appears that investors cannot share information and therefore stakeholders tend to speculate with an uncertainty (Yao & Luo 2009, p. 670).



(Figure 1: own representation based on Yao & Luo 2009)

The construction of a market bubble starts with the fundamental continuously rise in share prices for a giving period. As I have mentioned above, there are only impulsions for stakeholders to invest in shares at the stock market, when companies gain an increasingly higher profit during the period. The companies assume a remarkably higher profit and earnings ratio than expected (Yao & Lou 2009, p. 671). Investors will start to invest in the stock market dramatically, therefore it will cause the asymmetric psychological reaction (Yao & Lou 2009, p.672). This market phenomenon appears when investors aren’t satisfied with their gains. Therefore, stakeholders tend to be more over-optimistic and invest more and more in the rising stock market. The optimistic expectations cause an inflation and an overvalue in share prices. As a result, the market bubble starts to grow and appear in its final form (Yao & Lou 2009, p. 673). After reaching its peak, the share prices collapse significantly and lose its value (Yao & Lou 2009, p. 671). The shares will turn into undervalued shares. The actual market index could go beneath the normal fluctuations and because of the trough, stakeholders will change their point of view from over-optimistic to an over-pessimistic view. This is where the bubble bursting will start to happen (Yao & Lou 2009, p.672). At this point the asymmetric psychological reaction will lead the investors to uncomfortable situation since the trough has settled in, stakeholders will be afraid of losing more money. In addition, the over-optimism will make it difficult for the market to recover (Yao & Lou 2009, p. 673).

The interval during the peak and trough will not extend the time of one year but it will take a long time to recover after the market bubble has burst, which can take longer than two years (Yao & Lou 2009, p. 671).

U.S. Subprime Mortgage Crisis 2008 (XXX)

To discuss the effect on China’s economy during the subprime crisis in 2008, it is necessary to go back to the origin of the U.S. subprime crisis.

The U.S. subprime mortgage crisis was the trigger for many global crisis, for example in China. In the following pages, the reasons for the U.S. subprime mortgage crisis and how it affected China’s economy and financial system will be explained.

The U.S. citizens have felt into a depression due to the recession in the U.S., caused by the attack on September 11th. This has led to a dramatic fall in the consumption. As a result, the economy in the U.S. suffered. Therefore, the U.S. Federal Reserve (FED) lowered the federal fund rate to 1% in order to increase the economic growth (tagesschau.de 2008). Consequently, the banks have claimed the opportunity to raise their capital by granting more credits.

Banks usually fund their mortgage lending with the payments they get from their customers. In recent years, banks have found a new way to finance their mortgage lending much easier by selling mortgages to bond markets (news.bbc.co.uk 2007). At first, everything went well but then, everyone who was qualified for a mortgage already had one and the problems arose. How could banks still supply credits and benefit from it? Therefore, banks had the idea to grant mortgages also to “subprime” borrowers who had a low degree of creditworthiness (economist.com 2013). They were known as “Ninjas - No Income, no Job, no Assets“ (bpb.de 2012).

Banks started putting many of these risky mortgages together in pools to turn them into apparently low-risk securities, known as collateralised debt obligations (CDOs). In addition, those banks paid rating agencies to rate their CDOs with Triple-A’s to make them more attractive and trustworthy. This is why investors bought those CDOs without knowing the drastic risk. Obviously, no one was worried because as soon as the risky mortgage is sold to another bank, it was the other bank’s problem (economist.com 2013).

Since the mortgage brokers never mentioned that the interest rate will increase after 2 years, homebuyers finally started struggling with the repayment of the credit. Thus, homebuyers default on their mortgage and a flood of repossessions began, so that the supply of properties soared. Consequently, the supply was higher than the demand, leading to a fall in the value as well as in the prices of houses. Builders almost been forced to drop prices below the value to get rid of unsold properties (news.bbc.co.uk 2007). Everything was linked together and began to break down.

Figure 2 shows the house price appreciation in the U.S. which dropped almost 10% from 2005 to 2008 and led to a plunge of the property prices.

(Figure 2: own representation based on fhfa.gov 2009, p. 7)

Accordingly, the trust of all financial systems started to disappear. Banks could not sell their CDOs anymore and nobody wanted to lend credit. The complicated chain of debt between counterparties began to struggle. Non-financial companies were not able to borrow money in order to pay suppliers or workers and stopped spending instead of supplying cash (economist.com 2013). Finally, banks went bankrupt and the rate of unemployment rose dramatically from 4.70% to 9.70% between 2007 and 2009 (figure 3). Millions of people, especially in the building industry, lost their jobs because of the low production. Therefore, people lowered down their consumption as it can be seen in figure 4. From 2004 to 2008 the household consumption expenditure stopped growing and decreased by 1.6%. This caused a slowdown in the U.S. economy as it can be seen in the U.S. Gross Domestic Product (GDP) growth in figure 5 and a decrease in the U.S. imports of trade goods (figure 6) (news.bbc.co.uk 2007).

(Figure 3: own representation based on data.worldbank.org 2016)

(Figure 4: own representation based on data.worldbank.org 2016)

(Figure 5: own representation based on data.worldbank.org 2016)

(Figure 6: own representation based on statista.com 2017)

To sum up, the U.S. subprime crisis is a very good example for a market bubble. It has all started with an over-optimism in the property market due to the increasing value of lands. After reaching the peak, caused by irresponsible mortgage lending, the housing bubble began to burst. Hence, the house prices dropped immediately which has led to a trough in the property market.

Impact on China’s economy and financial sector

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The U.S. subprime crisis caused a chain of crisis worldwide, concerning even the Chinese economy negatively.

The U.S. is the biggest export customer of China. Due to the recession in the U.S. and its reduction in the quantity of imports (figure 7), the Chinese export sector started to struggle. Many orders from Chinese factories have been cancelled which led to the drying up of capital and a decline in production (Hock & Wong 2010, p.6). In addition, the U.S. Foreign Direct Investment (FDI) plunged from 171,54 Billion in 2008 to 131,06 Billion in 2009 as shown in figure 8 (Morrison 2009, S.3). The liquidity of several companies in China decreased due to the lack of FDIs. The factories finally became insolvent which caused an increase of China’s unemployment rate from 3.8% in 2007 to 4.4% in 2008 (figure 9). Consequently, China’s economic growth began to fall as it can be seen in China’s GDP growth in figure 10 (Hock & Wong 2010, p.6).

(Figure 7: own representation based on statista.com 2017)

(Figure 8: own representation based on data.worldbank.org 2016)

(Figure 9: own representation based on data.worldbank.org 2016)

(Figure 10: own representation based on data.worldbank.org 2016)

China’s financial sector suffered far less than their “real economies” (production, export and employment). Many predicted that the Chinese economy could be “decoupled” from the crisis in the U.S., because its financial sector was separated (Hock & Wong 2010, p.6). Besides, the exposure of the riskiest toxic financial products was minimized. Only a few investors, who had owned a restricted license “Qualified Foreign Institutional Investors”, had access to the global market. The licence allowed them to buy the toxic financial products (Heilmann 2010, p.6). Nevertheless, China’s stock market has still been debilitated. The main stock market in Shanghai (Shanghai Stock Exchange Composite Index SSEx) lost two-third of its value during December 31 in 2007 to December 31 in 2008 (figure 11) (Morrison 2009, S.4). The reduction of export orders from the United States could be the main reason for this drop. Like mentioned before, many Chinese factories became insolvent which led to a loss in value of its shares. Those shares were listed in the SSEx.



(Figure 11: *Shanghai Composite Chart*: finanzen.net 2017)

China’s responses to the Subprime Crisis (YYY)

China’s government and central bank have taken a huge part in alleviate the impacts of the global financial crisis. Banks and firms were controlled by the government due to the government’s ownership in this sector. This has led to an easy way to intervene its own economy with microeconomic tools (Park 2012, S.63).

During the crises, the head of the administration, the Chinese Premier Wen Jiabao and the individual public sectors already have thought about an implementation concept, which would prevent the economy of China and reduce the drastic effect of the global crises (Morrison 2009, S.5).

On 8 October 2008, the China Central Bank (CCB) has announced to decrease the interest rates including the reserve requirement ratio. The CCB, which has cooperated with China’s government, has targeted a stable economy with a strong focus in growth rate.

Two weeks later, on 21 October 2008, China’s State Council has published a new economic stimulus package which represented the implementation concept against the global crisis and slowing the economy in China. The government itself wanted to achieve:

* Acceleration of construction projects
* Export tax rebates
* Minimization in housing transaction tax
* Rising agriculture subsidies
* Expansion in lending to small and medium enterprises.

On 9 November 2008, this concept was implemented, which the government has estimated of a period of two-years. Furthermore, the enforcement of this project had a prognosticated cost around 4 trillion yuan (about US$586 billion). The program was mainly focused to the stabilization of china’s infrastructure (Park 2012, S.61).

(Figure 12: own representation based on worldbank.org 2010)

The stimulus package included investment volume of different sectors in China. The central government (US$173 billion), local government (US$180 billion) and bank lending (US$232 billion) had a counterbalanced and major percentage in the costs of the stimulus project (worldbank.org 2010).

More precisely, the stimulus package had many major areas for example affordable housing, expansion measurements in rural infrastructure (including irrigation, drinking water, electricity and transport), health and education, expansion of transport (including railways, highways, airports and ports), environment projects, technological innovation and rebuilding areas, that had suffered from several earthquakes (Morrison 2009, S. 6).

(Figure 13: own representation based on wolrdbank.org 2010)

Major investments were operated in the infrastructure with a percentage of 38% and reconstructions with 26%. Furthermore, these spending were also used in housing with a percentage of 10%, rural livelihood and infrastructure with 10%, infrastructure with a quota of 9%, health and education with 4% and environment projects with 3% (worldbank.org 2010).

In fact, Basic researches, public health, education and infrastructure were the principal investment. The government wanted to achieve a long-term growth including the increase of domestic consumption, stabilization and expansion of industries, raising incomes of farmers and rural poor (Morrison 2009, S. 5). From this follows that the head of China also has intended to support the 10 pillar industries: cars, steel, shipbuilding, textiles, machinery, electronics and information, light industry, petrochemicals, non-ferrous metals and logistics. The regime has announced new policies, which has supported the 10 pillar industries. The policies have covered up trading and tax issues for instance tax cuts (export tax rebates), industry subsidies, subsidies for consumers to buy products (especially products that has boost China’s industry), fiscal supports, directives to banks to provide financing, funds to support technology upgrades and development of domestic brands, government procurement policies, export credits and funds to help to invest overseas (Morrison 2009, S.7).

Additionally, China had decided to decentralize its monetary conditions by cutting the interest rates once more. Due to this fact, the lending limits increased rapidly in commercial banks. The lending rates decreased from 7.2% to 5.6% during August 2008 to November 2008. Additionally, on December 2008, the central bank has cut its reserve requirements ratio for banks from 16.5% to 16% resulting to a rapid increase of the money supply. Furthermore, banks in general had a massive foreign reserves and favourable trade surplus, which stabilized China’s currency and additionally increased China’s competitiveness of its economy. The FDI turned in to attractive investments for a lot of abroad companies (Park 2012, p.62).

On January 2009, China’s regime has pushed banks to increase their credits supply. New loans were giving out with an approximately amount up to 1.62 trillion yuan ($237 billion) (Park 2012, p. 63). The market in China experienced a tremendous increase in liquidity.

On the other side fund~~s~~ policies, that has been announced by the regime, did not favour companies with strong assets but rather enterprises, who were close to insolvency (Park 2012, p.64).

The real estate market also has developed adversely. In some parts of China, the real estate market has shown signs which indicate a bubble that burst on the verge of bursting. Prices in these cities were plunging radically and increased the sector of unoccupied buildings.

On 7 April 2009, the regime has also invested in an universal health care system with an amount of $124 billion, which has been assumed to take 3 years of regulation and structure. This system should have help to narrow the gap between the poor and rich and upgrade the living standards (Morrison 2009, p.7).

Result of China’s stimulus package (XXX)

The stimulus package has contributed to a growing economy. The Shanghai Stock Exchange Composite Index rose to 45% after a poorly year for the stock market in China. Furthermore, the industrial output has increased by 7.3% and therefore retail sales grew up to 14.8%. The real estate investments improved to 6.4%. The GDP in China has grown gradually after the rapid downturn in the years 2008 – 2009, which is shown in the figure 5. All the benefits, that has led to an expanding economy, were an advantage for Chinas domestic economy.

On the other side, FDI and Chinas trade especially export numbers have declined during the crises from 2008 to 2009. This affected the U.S. significantly since their economic growth decreased (Morrison 2009, S.7).

The rising boost in the domestic economy in China, after launching the stimulus package, has secured China’s title from third world to an important country for foreign trade.

Conclusion (YYY)

In conclusion, the subprime crisis in the United States had a huge impact on China. Since the U.S. is the biggest Chinese export customer, China’s foreign economics have been weakened. China is very dependent on foreign trades and payments, especially on exports of trade goods. Therefore, the Chinese economy suffered far more, in comparison to the financial sector in China.

In addition, the strong regulation, through strengthening the domestic economy, caused a stagnation of the Chinese economy.

However, the crisis led not only to disadvantages in China, it also led to advantages. The infrastructure in China developed due to the stimulus plan and the Chinese government also invested in an universal health care system. The living standards in China were improved since then. Furthermore, the gap between poor and rich converged. These plans have contributed to a growing domestic economy.

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