A STUDENTS' JOURNAL OF SHRI RAM COLLEGE OF COMMERCE

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STRIDES

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Principal's Message

The mission statement of the College, signifying the existence and its road map to the achievement of its vision, reads as:

"To achieve and sustain excellence in teaching and research, and enriching local, national and international communities through our research, the skills of alumni, and the publishing of academic and educational materials"

To achieve and promote excellence in publications and applied research, the College has taken the initiative to launch a new journal exclusively to publish students' research papers and articles. It will be an add-on to the enriched catalogue of College publications and academic literature.

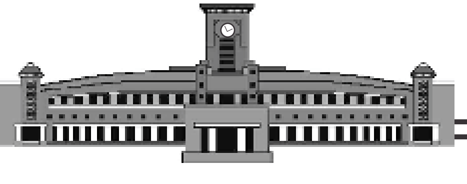
The journal has provided an opportunity to the students of our college to focus on research at the undergraduate level. Since the students were not opened to the research methodologies at the undergraduate level, they were mentored by *experienced senior faculties* of our College. Simultaneously, their articles were also reviewed by the referees and tested for plagiarism before publication. After reporting all the suggestions recommended by the referees, the articles were revised and then finally published. The College is successfully releasing the foundation issue of the journal i.e. *STRIDES – A Students' Journal of Shri Ram College of Commerce, Volume 1, Issue 1, 2016-17* on the occasion of 91st Annual Day of College held on 13th April 2017. The Journal is released by Shri Prakash Javadekar, Honb'le Minister of Human Resource Development, Government of India.

The college has already applied for *International Standard Serial Number* (ISSN) for the Journal. The application for ISSN is still under process.

I would like to congratulate the students whose papers are published in the foundation issue of the journal and simultaneously, encourage all the students to contribute their research papers and articles for the successive issues of the Journal.

Best wishes for their future endeavor.

Dr. R.P. Rustagi
Principal (Officiating)



Editor's Message

Shri Ram College of Commerce is well known for its academic excellence and dedicated approach towards dissemination of knowledge in the academic world. The College appreciates the role of research in education and is committed to developing an inclination towards research in both faculty and students. In this pursuit, the College has taken the initiative to launch a new Journal named 'STRIDES – A Students' Journal of Shri Ram College of Commerce' to encourage students to pursue research under the guidance of the faculty of Shri Ram College of Commerce.

It is an annual journal launched exclusively to publish academic research papers and articles by students on contemporary topics and issues in the area of commerce, economics, management, governance, policies etc.

In order to maintain high standards of publication, a Committee on Publication Ethics (COPE) has been constituted. The COPE shall be the apex authority to take all decisions related to publication of research papers and articles in STRIDES. The decision of the COPE shall be final and binding.

To maintain the *academic standards, academic ethics* and *academic integrity*, a rigorous process of blind review of articles is followed after screening for plagiarism of each manuscript received by the college for publication. The research work published in STRIDES is original and not published or presented at any other public forum.

The foundation issue of the Journal i.e. *STRIDES – A Students' Journal of Shri Ram College of Commerce, Volume 1, Issue 1, 2016-17* is successfully released on 91st Annual Day held on 13th April 2017 by Shri Prakash Javadekar, Honb'le Minister of Human Resource Development, Government of India.

Successive issues of STRIDES will be released every year on the occasion of College Annual Day.

Dr. Santosh Kumari
Editor

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CONTENTS

ARTICLES

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Is China heading towards the next financial crisis? A case study of the parallels between the pre-crisis US Economy and Chinese Economy

This paper analyses the recent trends in Chinese Economy of rising credit and increasing property prices which herald the possibility of a financial crisis in China. Though the conditions of rising housing prices and increased penetration of shadow banking activities, bear resemblance to those in the pre-crisis US economy, differences exist in the intensity and complexity of situations in the two economies. A comparative analysis of the parallel trends between the two reveal that the situation in pre-crisis US economy were far worse than in China at present, giving the Chinese authorities the scope to control prices in the real estate sector and rein the unregulated shadow banking activities. The authorities are not in a state of denial but acknowledge the worrying trends and have also come up with reforms and regulations in the concerned areas.

Mentor

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INTRODUCTION

"A financial crisis is often an amalgam of events, including substantial changes in credit volume and

asset prices, severe disruptions in financial intermediation, notably the supply of external financing, large scale balance sheet problems, and the need for large scale government support." (Claessens & Kose, 2013)

The Financial Crisis of 2008, also known as the Sub-Prime Mortgage Crisis, had its genesis in the expansion of mortgage credit through the momentum of rising sub-prime housing prices. The cheap availability of high-risk mortgages, later repackaged into securitized asset pools and sold to investors, spurred the expansion of credit to home buyers and pushed the U.S economy into increased indebtedness. In the past years, China's economy has been under constant scrutiny around the world; the anxiety being triggered by a deceleration of growth in 2015 and further heightened by both, the inability of policymakers to tame the rapid credit growth and the presence of a supposed housing bubble in the country. The idea that the conditions in the economy have an eerie resemblance to those present in the pre-crisis period in U.S. has further exacerbated the worry and has many into believing that China is headed towards another financial crisis, which shall bring down the global growth.

Chinese Economy: The Current Scenario

From its independence in 1950 to the early 2000's, public sector investment and export had been the major drivers of China's economy. Investment in industrial production and export-oriented production of relatively cheaper goods propelled the country's economic growth enabling it to emerge as the world's second largest economy. After experiencing robust growth in what is being termed as "**30-year growth miracle**", China finally embraced the idea that capital investment and exports alone cannot sustain growth in the long run, thus prompting the country's transition to a consumption driven economy, with the focus of its five-year plans shifting to increasing domestic consumption, thriving on a rise in disposable income, and encouraging services innovation.

However, in the past years, the country's economy has seen rapid credit growth and the emergence of a supposed housing bubble. With the demand in the rest of the world slowing down, increased input credit is being used to propel the growth to unsustainable levels. Yet, as debt rose to 247% of GDP in 2015, the Chinese economy remained sluggish, rendering government's efforts to boost economy with fiscal stimulus precarious (Sun, 2016). This has prompted economists around the globe to reckon the events as the 'second coming' of the crisis. Between the pre-financial crisis and the current Chinese economy, a few parallels and divergences can be drawn on the following parameters in their respective roles:

1. Housing Bubble -The progenitor

In comparison to the initial U.S. real estate sector, the trends in real estate sector of China have not moved in tandem with average prices for new homes in Tier 1 cities, (consisting of affluent metropolises like Shanghai) rising by about 28 percent while the increase in Tier 2 and Tier 3 (less wealthy) cities has been 10 and 2 percent respectively, in the first eight months of 2016 (Einhorn, 2016).With the migrants moving to bigger cities in the prospect of better welfare and job opportunities, these cities are facing a tight supply while the smaller Tier 3 cities are confronted with a situation where the number of apartments is increasing without complementing buyers. Economist view the situation as a mismatch between supply and demand, whereby some cities need tightening while others having excessive inventory of unoccupied apartments need relaxation, rather than anticipating an impending bubble.

Yet, Chinese banks haven't resorted to the subprime loans that shook the foundations of the banking system in U.S back in 2008.Comparably, the level of household debt is far below than the levels in U.S in 2007 with the present level of average household savings almost double the debt. According to China Household Finance Survey, the average household debt in urban areas amount to only 11% of the home loan in 2012 (Sun, 2016).Chinese properties are purchased with significant down payments unlike the situation in U.S where the major propellant to buy the home was easy availability of credit. To add to that, the policy makers in the country have not only been alert to the hysteria revolving around rising housing prices but have also come up with timely reforms to rein the situation which include increasing the buying restrictions as well as the down payment requirements in premier cities.

Thus, the high savings rate, low leveraged households and the government's latest restrictions to curb the rising prices (which are yet to deliver the results) make the households or household debt an unlikely culprit in the prospective financial crisis, if any.

Though the households aren't guilty of unsustainable level of borrowings but the corporate sector of China is highly leveraged, specially the real estate sector. An important dimension in the China's rising mountain of debt is the shadow banking system which has seen rapid development in the country, discussed below.

2. Shadow Banking -The propeller

Shadow banks are financial firms that perform similar functions and assume similar risks as traditional banks but operate outside the realms of regulation, unlike traditional banking sector. While the housing and credit bubbles were growing in U.S.A., a series of factors had weakened the foundations of the financial system rendering it fragile. Policymakers did not recognize the increasingly important role played by financial institutions such as investment banks and hedge funds which formed the shadow banking system and unlike the deposit based banks, were not subject to strict regulations. As such, these institutions were able to mask the extent of their risk with the aid of complex off-balance sheet derivatives and securitizations while not possessing a sufficient financial cushion to absorb large loan defaults.

Banks in China are largely state controlled with the state providing them with guidance and direction through numerous regulations which have more often than not proved binding on their activities. People's Bank of China restricts the bank lending volumes by imposing caps which is not applicable to shadow banks. Similarly, non-bank channels have comparatively lower capital and liquidity requirements. While the state prohibits the banks to serve certain sectors like private and other small scale enterprises, the gap is conveniently filled by non-bank channels which fulfills the borrowing demands of these unserved segments. As observed by Elliott & Qiao, (2015), "*Perhaps two-thirds of the flow of business into shadow banking is effectively "**bank loans in disguise**," where bank is at the core of the transaction and takes the great bulk of the risks and rewards, but pays non-banks to participate in order to avoid regulatory constraints and costs*."

Though shadow banking system in China is growing rapidly but is yet to achieve the gargantuan size and doesn't entail products or scheme as complex or as convoluted as seen in U.S. during 2008. Amidst the housing and credit booms, the amount of financial agreements called mortgage-backed securities (MBS), which derived their value from mortgage payments and housing prices, greatly increased.As housing prices declined, major financial institutions that had borrowed and invested in MBS reported huge losses.Shadow banking in China is relatively simpler to understand mainly because it has so far abstained from making use of complex financial derivatives. China's shadow banking system operates as a parallel activity which complements the traditional banking sector, by catering to those segments which are out of the reach of conventional banks that operate within the boundaries of state controls.

This parallel banking activity with its comparative advantages is fast becoming popular and has emerged almost as important as the formal banking sector but lacks the safety net offered by the latter and hence adds risk to financial stability. The recent expansion of such less-regulated lending has made it tough for the government to contain the ballooning debt.

3. Wealth Management Products-The new "off-balance sheet" assets

One of the fastest growing products in and the biggest penetrator of Shadow Banking in the Chinese economy are the Wealth Management Products which have grown to a size of approximately 3.9 trillion dollars (Luo, 2016). WMPs are short term financial instruments issued directly by banks or third parties in China carrying fixed interest rate returns higher than that offered by bank deposits. However, unlike bank deposits, they do not have to fulfill capital adequacy or reserve requirements. The proceeds so generated are then invested in a wide variety of assets. WMPs are not inherently bad for they help to fill important gaps in the massive economy of China. They provide an alternative to depositors specially households to park their excess funds with higher returns and also fulfill the borrowing needs of many private and small scale enterprises, unserved by the state owned formal banking system.

However, these advantages come at certain costs. WMPs can be sold by banks either directly or through third parties known as channel firms and also by any NBFIs (Perry & Weltewitz, 2015). Though these products resemble mutual funds to some extent, a stark difference is that while mutual funds have a prospectus and subsequently, transparency, the depositors investing in WMPs do not have knowledge of the underlying assets as they believe in the bank implicitly associated with their issuance. Such belief lies in the state controlled bank and not in the product itself. Over the years, the WMPs have been increasingly used by banks to move their non-performing loans off the balance sheets and improve their performance metrics. Short term funds are being used to finance medium and long term projects specially housing development and coal mine having long gestation periods which leads to a huge asset/liability mismatch prompting further issues to keep the cash flows going Nunlist, 2016). The excessive use of WMPs increasingly driven by regulatory arbitrage specially when about 50% of the instruments are held by mass market individual investors has got the economists worried around the world.

The authorities have woken up to the rising shadow banking woes and have actively responded with restrictions and efforts to bring some shadow banking activities under regulation. The China Banking Regulatory Commission has formulated new rules to restrict small and medium tier banks and to limit the involvement of mass market investors in WMPs. The involvement of smaller banks and retail investors in WMPs that invest in equities will be forbidden. PBOC is working towards making these products more transparent by necessitating the banks to reveal the underlying assets and their associated risks at the same time counting them in their overall credit.

CONCLUSION

While the conditions in China are not unprecedented, the Financial Crisis of 2008 serving as a perfect example of how excessive and complex unregulated banking activities can bring down entire financial system thus harming not only the growth in the economy but also public trust. While the similitude of conditions in China of rising debt and mounting property prices, mirror those in U.S prior to the financial crisis in 2008, a closer look does reveal many differences. Rising to the alarm raised by experts, from around the world as well as in the country, the authorities have responded with appropriate policies and regulations in the concerned areas. Increasing demand for property in Tier I cities of China is being tackled by introducing buying restrictions like, cap on the number of houses that can be owned, rise in down payment requirements. Interest of retail investors is being prioritized while regulating Shadow Banking activities by prohibiting their participation in WMPs and making it compulsory for lenders to reveal the underlying assets. Be it the rising property prices or the mounting debt, the situation in China is a far cry from that in the pre-crisis US economy. This, combined with government reforms (which are yet to yield results) moderates the possibility of a financial crisis in China if not dispel it completely.

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