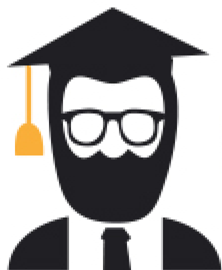

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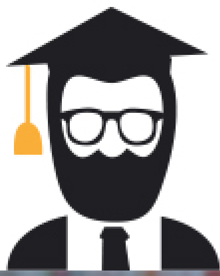
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SHADOW BANKING, CHINESE STYLE

Shalendra D. Sharma*

Abstract
Shadow banks are broadly defined as entities which conduct credit intermediation outside the formal banking system. Poorly regulated, engaging in opaque forms of intermediation, deeply interconnected with the official banking system, and operating with implicit government guarantees, they pose a major source of systemic risk. Yet shadow banks provide an important service by channeling credit to excluded investors, and can complement the formal banking sector. What explains the rapid proliferation of shadow banks in China? How large are they and what forms do they take? What types of risks do they pose to the financial system? And how best can China utilise the services of shadow banks while at the same time ensuring that they do not create systemic risks for the financial system?

JEL codes: G23, G28.

Keywords: credit intermediation; People's Bank; securitisation; shadow banking.

1. Introduction

In early January 2014, one of China's largest 'trust' companies, China Credit Trust (CCT), announced that it was about to default on its top-grade 'wealth management product' (WMP), seductively named 'Credit Equals Gold No.1'.[1] CCT first began structuring (that is, securitising) this WMP in early 2011. It was then marketed and sold by the Industrial and Commercial Bank of China (ICBC), the country's largest bank. CCT's prime purpose in creating the new product was to raise money for an unlisted coal mining company, the Shanxi Zhenfu Energy Corporation. For this it guaranteed investors a huge 10 per cent annual return (at a time when the benchmark bank rate was 3 per cent) on maturity on 31 January 2014. However, in early January 2014 it became public knowledge that Zhenfu Energy had filed for bankruptcy soon after receiving the loan and that CTT was just days away from defaulting as it could not honour the obligations it incurred on its once blue-chip Credit Equals Gold No.1 product – now valued at some RMB3 billion (US$490 million). Zhenfu's total debt stood at RMB5.9 billion, but its total assets were worth less than RMB500 million. With the issuer (CCT) unable to redeem Zhenfu Energy's debt, and the seller (ICBC) denying any responsibility, CCT was saved from imminent collapse at the eleventh hour by an 'unidentified entity' (widely believed to be the Shanxi government), which bailed out the investors' principal and a percentage of their interest.

CCT's very public woes drew attention to a hitherto hidden problem in China's financial sector: the unregulated shadow banking sector. The realisation that CCT's problems were not exceptional but endemic to the country's vast shadow banking system was underscored when,

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in early February 2014, it was reported that 'six Chinese trust firms have lent more than 5 billion yuan ($824.6 million) to a delinquent coal company . . . raising the prospect of further defaults' (Wildau 2014). Given its burgeoning and uncontrolled growth, deep interconnections with the formal financial system and the opacity of its operations, China's shadow banking sector is a source of instability with the potential to trigger a catastrophic meltdown of the financial sector reminiscent of the 2008 subprime-mortgage crisis in the United States – also triggered by opaque, poorly regulated and over-extended shadow banks. Not surprisingly, to some observers China's shadow banking sector could prove to trigger the country's 'Lehman moment' (Boone and Johnson 2014).[2]

What is shadow banking? What is the nature of shadow banking in China? What explains its proliferation? What risks does it pose for the Chinese economy? And how best can the authorities mitigate its negative effects? The following sections address these interrelated issues.

2. What is shadow banking?

Broadly, the term 'shadow banking' refers to non-bank entities which engage in bank-like activities.[3] Ghosh, Gonzalez del Mazo and Ötker-Robe (2012, p. 1) define shadow banking as comprising 'a set of activities, markets, contracts, and institutions that operate partially (or fully) outside the traditional commercial banking sector, and, as such, are either lightly regulated or not regulated at all'. According to Pozsar et al. (2012), shadow banks are 'financial intermediaries that conduct maturity, credit and liquidity transformation without explicit access to central bank liquidity or public sector credit guarantees'. In November 2011, at the request of the G-20, the Financial Stability Board (FSB 2012, p. 1) formally defined shadow banking as 'credit intermediation involving entities and activities outside the regular banking system'. Thus, like traditional banks, shadow banks function as middlemen by issuing liabilities and holding assets (Claessens and Ratnovski 2014; FSB 2011). However, unlike formal banks, they lack the security provided by a lender of last resort – for example, in the United States, the Federal Reserve's discount window or insurance provided by the Federal Deposit Insurance Corporation.

Gorton (2009) points out (with reference to the United States) that the shadow banking system emerged gradually from the 1970s as traditional banking became less profitable. Specifically, banks were prevented from paying interest on demand deposits, including insurance and securities underwriting services, and faced increasing competition from interest-bearing services offered by non-banks such as money market mutual funds. As a result, banks began to shift their activities towards the more profitable activities that the shadow banking sector offered (see also Basel Committee on Bank Supervision 2010). Gorton (2009, 2010) and Gorton and Metrick (2010) point out that, although shadow banking performs a role similar to that of traditional banks, the lenders and borrowers using shadow banking are large businesses, broker–dealers and institutional investors who invest and lend millions or billions of dollars at a time. However, much of the credit intermediation in the shadow banking system takes the form of maturity transformation by the issue of short-term, liquid liabilities against longer-term, less liquid assets. This makes shadow banks inherently fragile and more vulnerable to runs. As Pozsar et al. (2013, p. 2) note, 'The emergence of shadow banking thus shifted the systemic risk–return trade-off toward cheaper credit intermediation during booms, at the cost of more severe crises and more expensive intermediation during downturns'.

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Table 1: Estimates of the size of China's shadow banking system

Source	Date	RMB (trillions)	USD (trillions)	% of 2012 GDP	% bank assets* year-end 2012
GF Securities	17 Dec. 2012	30.0	4.8	57	31
Citi Research	11 Jan. 2013	28.0	4.5	54	29
Barclays	Dec. 2012	25.6	4.1	49	27
Hua Tai Securities	14 Dec. 2012	25.0	4.0	48	26
UBS	16 Oct. 2012	13.7–24.4	2.2–3.9	26–46	14–25
ANZ Bank	Dec. 2012	15.0–17.0	2.4–2.7	29–33	16–18
Bank of America Merrill Lynch	6 July 2012	14.5	2.3	28	15

*Total assets of large state-owned commercial banks, joint-stock commercial banks and city commercial banks.
Source: Li (2013, p. 1).

3. Shadow banking in China

As their name implies, shadow banks do business in the shadows by engaging in off-balance sheet operations. Hence, it is impossible to know with certainty the precise reach, scope and depth of China's shadow banking sector. As Table 1 shows, estimates of the size and exposure of China's shadow banking sector vary considerably. However, there is a broad consensus that the expansion of credit outside the formal banking system has been so massive that it currently equals about 40 per cent of China's GDP and 16 per cent of its total banking assets – or roughly RMB20.5 trillion (US$3.35 trillion) (*Caijing* 2013).[4] Table 2, by aggregating all possible shadow banking activities in China (trust funds, wealth management products, the broker-asset management products, among others) puts the total size at RMB22.8 trillion or 44 per cent of GDP in 2012.

The Chinese shadow banking system is a complex, byzantine network of unregulated lenders made up of investment and finance companies, 'trust companies', credit guarantee companies, insurance firms, microcredit firms, brokerages, and online finance vendors. It comprises informal lenders such as pawnbrokers, including the so-called 'kerb-side bankers' and loan sharks who charge exorbitant rates to meet the country's insatiable credit needs.[5] Usually operating underground, outside formal channels yet more often than not with government connivance, shadow banks, usually with all the trappings of regular banks, raise funds (often by non-transparent means) to provide loans to businesses and local governments at high interest rates. It has been estimated that loans from the formal banking system 'which used to account

Table 2: Size of shadow banking activities in China, 2012

Activity	RMB (trillions)
Trust funds	7.5
Bank wealth management products	7.6
Broker asset management	1.9
Underground lending	4.0
LGFV corporate bonds outstanding	1.8
TOTAL	22.8
% GDP	43.9

Source: Credit Suisse (2013, p. 2).

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for more than 90 percent of total credit, fell to little more than half of new financing last year [2012]. Lending by shadow banks now totals RMB47 trillion, or 84 percent of gross domestic product' (Rabinovitch 2014).

Unlike advanced economies, such as the United States, shadow banks in China offer basic if not simple financial products. Since complex securitisation (or the repackaging of an array of loans into a single loan before they are sold) is still new and limited in scope, high-risk derivatives and collateralised debt obligations are also scarce.[6] This makes the sector relatively immune from problems associated with counterparty risks and contagion. Nevertheless, the proliferation of shadow banks offering a wide array of higher-yielding products has placed tremendous competitive pressure on China's formal commercial banking sector. Specifically, it has forced the formal banking sector to forge deeper and deeper links with the shadow banks – with the unregulated shadow banks obliging as they are not licensed to raise deposits or make loans. Indeed, the formal banking sector has conspicuously utilised and created shadow banking services by exploiting loopholes in the regulatory and supervisory frameworks which limit their activities – as illustrated by the example of commercial banks acting as agents for the shadow banks by selling WMPs (for hefty transaction fees) to raise funds for Zhenfu Energy. For their part, official banks are also happy to channel or 'outsource' funds to trust companies, which in turn lend to small enterprises and businesses that generally have difficulty obtaining credit from commercial banks. In fact, securitising their risky loans into unguaranteed WMPs enables the formal banking sector to keep these loans off their own balance sheets, and in the process overcomes the constraints imposed by the loan-deposit rates and loan quotas (Xia, Schwartz and Herrero 2013).

As Ghosh, Gonzalez del Mazo and Ötker-Robe (2012, p. 5) point out,

> Banks are involved with shadow banking entities and products, primarily through the letters of credit they issue and the role they play in entrusted loans. Banks have also used off-balance sheet wealth management products to attract deposits – short-term products to savers that pay high interest rates but allow the banks to bring the deposits back on their balance sheets at the end of each month to meet their regulatory requirements . . . commercial lenders issued RMB8.5 trillion in wealth management products in the first half of 2011, compared to RMB7.0 trillion for the whole of 2010. Problems in the shadow banking system would hence affect banks directly through these links.

However, the collusion between the formal and the shadow banks has spawned speculative (indeed reckless) lending, resulting in the official banking sector being burdened with large exposure to shadow banking. This systemic problem has the potential to set off a destructive chain reaction of defaults triggering a wider financial crisis. In fact, this was precisely the concern expressed by Fitch Ratings (Xiaotian 2012). When in April 2013 China's total credit reached 200 per cent of GDP, the agency downgraded China's long-term local currency debt rating by one notch to A-plus (from AA-minus).

Joe Zhang (2013, p. 17), drawing on years of experiences as a shadow banker in Guangdong province, compellingly argues that the proliferation of shadow banking in China is 'more a symptom than the disease itself'. First, the disease, he argues, is pervasive 'financial repression': commercial banking in China is still dominated by state-owned banks which tend to favour large state-owned enterprises and other state monopolies at the expense of medium-sized and small private enterprises. This is because the Chinese government, through the central bank, the

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People's Bank of China (PBoC), which is responsible for the implementation of monetary policy, maintains tight control over the formal banking system. The government can control bank liquidity as it has the power to decide the banks' loan-to-capital ratio and yearly loan quotas by industry and sectors. This enables the PBoC to limit or restrict the availability of credit and to maintain artificially low interest rates, ostensibly to provide cheap loans to favoured state-owned enterprises (in particular the large state-owned enterprises, SOEs) and also those with good connections.[7] Indeed, the PBoC's policy of maintaining negative real deposit interest rates by setting an upper limit to the rate of interest paid on deposits has meant that real (inflation-adjusted) deposit rates have been much lower than inflation. In fact, investors actually lose money and purchasing power given the negative real interest rates on bank deposits. Second, the maintenance of stringent capital controls has meant that there are limited investment opportunities for individual Chinese investors, including private businesses, beyond those offered by the stock and real estate markets. Third (and as discussed below), the low (indeed negative) real interest rate environment resulting from the massive government stimulus to mitigate the negative effects of the 2008 global financial crisis forced private investors, including small depositors with fresh disposable incomes, to seek funds and yield elsewhere, especially among the high-yield financial products offered by shadow banks. Finally, exacerbating this effect, the new restrictions placed on China's formal banking system in 2010 to curb rapid credit growth and reduce inflationary pressures sharply reduced credit availability, especially to small to medium-sized companies. This forced many to turn to shadow banks for credit.

4. The global financial crisis and shadow banking

However, the meteoric expansion of shadow banking in China is one of the unintended consequences of the policies Beijing introduced to combat the negative effects of the 2008 global financial crisis. Specifically, in early 2008 Beijing implemented a massive RMB4 trillion (about US$600 billion) stimulus package to boost the economy. The central government's total funding was around RMB1.18 trillion, with the rest funded by the local governments via local government financing vehicles (Sharma 2012). Monetary policy also played a key role in supporting the stimulus programme. To this effect, the PBoC cut the policy rate four times, from 7.5 per cent in August 2008 to 5.3 per cent in December 2008, and maintained the rate until September 2010. Moreover, the PBoC lowered the required reserve ratio on RMB deposits from 17.5 per cent in August 2008 to 13.5 per cent in December 2008, while relaxing bank loan quotas and lifting broad money (M2) growth targets until end-2010 (see Table 3). Yang (2014) notes that broad money (M2) 'ballooned to 110.7 trillion yuan (HK$140 trillion) – almost twice the country's gross domestic product' by end-2013.

Because the programme was mainly a credit (rather than a fiscal) stimulus, financed mainly through new bank lending, stimulus spending drastically increased bank lending, with

Table 3: Broad money growth in China (% GDP), 2004–2012

2004	2007	2008	2009	2010	2011	2012
151.6	151.8	151.3	179.0	180.8	180.0	187.6

Source: Broad Money (% of GDP), World Bank Open Data.[8]

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traditional banks issuing new financial products in order to capitalise on the credit bonanza. Predictably, this only added to the money supply. According to Pei (2012),[9] between 2009 and June 2012,

> Chinese banks have issued roughly 35 trillion yuan ($5.4 trillion) in new loans, equal to 73 percent of China's GDP in 2011. About two-thirds of these loans were made in 2009 and 2010, as part of Beijing's stimulus package. Unlike deficit-financed stimulus packages in the West, China's colossal stimulus package of 2009 was funded mainly by bank credit (at least 60 percent, to be exact), not government borrowing.

Although this large-scale injection of liquidity helped the Chinese economy to withstand the adverse contagion effects stemming from the global financial crisis, such an excessive volume of loose money also fueled a credit and real estate bubble, besides triggering a spending spree by local governments.[10] Although local governments are expected to deliver the bulk of social services, they have limited revenue sources as the central government collects (and discretionally distributes) tax revenues.[11] In fact, since the introduction of the 1994 Budget Law, 'the central government has rapidly centralised the most lucrative sources of revenue, including value-added tax (VAT), resource tax, and personal and enterprise income tax. In 2002, the central government further ordered local governments to channel 50 percent of personal and enterprise income tax to the central government' (Lu and Sun 2013, p. 6). On the other hand, although their spending burdens have increased, local governments are statutorily prohibited from borrowing from the formal banking system, and until recently were not even allowed to issue municipal bonds.[12]

To square the mismatch between their revenues and expenditures, local governments have had to find ways around the prohibitions on borrowing (Shih 2010). Specifically, local governments, with the tacit approval of central authorities, have created 'local government financing vehicles' (LGFVs; sometimes also called 'local government financing platforms', LGFPs), as well as urban development and investment companies (UDICs) to serve as their principal financing agents to facilitate borrowing as well as to tap the stimulus largesse by issuing bonds.[13] By the end of 2010, over 6,500 LGFV's had been set up (IMF 2013). Indeed, Zhang and Barnett (2014, p. 6) aptly note that 'many local government financing vehicles were established as intermediaries to channel funding from the financial market, mostly banks'. Because local governments are responsible for implementing the infrastructure investments funded by the stimulus, they enjoyed a free rein when it came to borrowing – and they borrowed heavily via the LGFVs. As their responsibilities, not to mention their outsize ambitions, have far outstripped their revenues, local governments have accumulated massive debts. The heart of the problem is that the LGFVs have built up huge mismatches between their short-term borrowing and the long-term investments they have been (and still are) financing. Investments in infrastructure and real estate may not generate sufficient cash flow to service the debts, since the majority of the LGFVs are dependent on land sales and high property prices to meet their obligations. Moreover, the significant misallocation of resources at the local level resulting from politically motivated lending to wasteful 'white elephant' ventures, including funds 'missing' through corruption, has only exacerbated the debt problem (Shih 2010). In short, the majority of local governments lack a sufficient cash flow to service their debt and related obligations. Lu and Sun (2013, p. 3) aptly point out that 'since the receipts

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from the sale of land lease rights are the main sources for debt repayment, a correction in real estate prices could hurt the debt servicing ability of local governments and LGFPs, and impair banks' asset quality. In the worst case scenario, it may trigger contagion between the financial sector and the sovereign.'

Since LGFV debts are not explicitly guaranteed by local governments, the Beijing government may have to pay for a bail-out in case of insolvency – and the debt bill keeps growing. Pei (2012) notes that 'the National Audit Office of China acknowledged in June 2011 that local government debt totaled 10.7 trillion yuan (US$1.7 trillion) at the end of 2010', though other estimates put 'the real amount of local government debt at between 15.4 and 20.1 trillion yuan, or between 40 and 50% of China's GDP. Of this amount. . . . the local government financing vehicles (LGFVs), which are financial entities established by local governments to invest in infrastructure and other projects, owed between 9.7 and 14.4 trillion yuan at the end of 2010.'[14] Indeed, a report released on 30 December 2013 by China's National Audit Office puts the total 'borrowing by provinces, counties and townships at 17.9 trillion yuan (about $2.96 trillion) as of June 2013'. In other words, 'local debt has grown 63 percent since the end of 2010, much faster than the 40 percent expansion of the economy' (Roberts 2014).

Seemingly alarmed by the rapid and uncontrolled growth of credit (and poor- quality credit), and by the potential risks of uncontrolled shadow bank lending posed to the wider economy, the PBoC, along with China's key regulatory agency, the China Banking Regulatory Commission (CBRC), in August 2010 sprang into action and implemented a series of measures to restrict the activities of the banking sector, especially the shadow banks.[15] Most notably, in June 2011 the PBoC raised the bank reserve requirement ratios to an unprecedented 21.5 per cent for large institutions; imposed deposit reserve requirements on collateral deposits; made it mandatory for banks to bring their high-risk off-balance-sheet activities back on to their books; and imposed new capital requirements on trust companies (see World Bank 2013).

Yet not only were these measures too little and too late (as a large debt build-up and the overall poor credit quality of many of the new loans already posed a huge problem); the authorities' half-hearted attempts to cool the economy by limiting the money supply and tightening the regulation and supervision of commercial and shadow banks also backfired. It created a huge demand for credit outside the formal banking system. As credit dried up, the need of individual investors, real-estate developers, private and state-owned enterprises, and local governments for financing grew even more desperate. In their search for badly needed cash infusions they turned to the shadow banks. The shadow banks were only too happy to oblige, raising cash by floating all manner of products – with the WMPs being the most ubiquitous.

Predictably, in a short period of time shadow banks had fuelled an alarming build-up in the debt owed by private businesses, property developers, state-owned and private enterprises and local governments, which at the same time were carrying liabilities they could not possibly honour. For example, local governments have invested massively in infrastructure and, in collusion with property developers, in real estate projects. There are already growing numbers of 'ghost cities' or blocks of empty units – a costly testament to excessive construction – alongside an under-supply of affordable housing. Similarly, investments in infrastructure have not been commensurate with either need or budgetary wherewithal. As China's growth slows the returns will decline still further, but debt burdens will explode – with serious ramifications for the already weak local government fiscal base. Thus, the concern voiced by Joe Zhang and

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others that unsustainable local government debt has the potential to trigger a financial tsunami reminiscent of the US subprime mortgage crisis is not as far-fetched as it is sometimes made out to be. As Rabinovitch (2014) notes, 'in all, there are about $660 billion of trust products up for repayment or refinancing this year. . . . Chinese shadow banks, by definition, have been focused on customers – miners, property developers and local governments – that regulators have deemed too risky for banks, so more problem loans are a certainty.' If China's real-estate bubble bursts, local governments default on their debts, and the balance sheets of Chinese banks deteriorate and non-performing loans pile up, the Beijing government will face an unprecedented crisis.

5. Conclusion: what Beijing can do

At first sight, China's financial position remains sound. As noted (Roberts 2014), according to China's National Audit Office, local government debt stood at RMB17.9 trillion (31 per cent of GDP) in June 2013. Central government debt stands at around RMB12.4 trillion. Cumulatively, China's government debt stood at around 53 per cent of GDP in mid-2013 (PBoC 2013; Roberts 2014) – much lower than the debt levels of many advanced economies, including several whose debt-to-GDP ratios are excess of 100 per cent. Second, the bulk of government debt is denominated in renminbi and held domestically. Third, China's very high national savings rate (totalling about half of GDP) more or less guarantees that the banking sector's deposit base will remain healthy. Coupled with $3.8 trillion in foreign-exchange reserves and a banking sector whose overall health remains robust (the average capital adequacy ratio for China's 17 major banks is around 13 per cent), the Chinese economy can certainly absorb a significant volume of bad debt without serious repercussion.[16] At worst, defaults seem likely only to erode the quality of the official banking sector's loan portfolios. Finally, the risk of contagion is small as shadow banks offer only relatively simple financial products consisting mostly of direct credit, not complex securitised products.

And yet the unchecked proliferation of shadow banks is an acute worry for Beijing, largely because the shadow banks are deeply interconnected with the formal banking system. The marketing of shadow bank products like WMPs through the official banking sector gives the impression to market participants that their investments are safe. Of course, in order to sell their products, both the formal and the shadow banking sectors do little to avoid giving the impression that their products carry implicit government guarantees. The danger is that, if investors were told otherwise, their confidence in products like WMPs would greatly diminish – and, if they refused to roll over their existing investments, the entire banking system could face a massive liquidity risk. The resultant credit crunch and the growing mountain of bad loans that shadow banks (and their official banks partners) have piled up could trigger a financial meltdown like the US subprime mortgage crisis in 2008. All this makes China's banking and financial sectors vulnerable to adverse shocks, besides being a potential source of systemic risk.

Arguably as a warning to shadow bankers (and their formal banking partners) that the era of easy money was over, the PBoC did nothing to alleviate a liquidity squeeze that China's interbank market experienced in June 2013. In fact, the liquidity shortage began in May when the benchmark overnight and seven-day repo rates rose to 5 per cent after staying in the 2–3 per cent range over the previous several months. These rates jumped close to 10 per cent in mid-June and then skyrocketed to a record high of 30 per cent on 20 June before dropping to 8

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per cent on 25 June. The PBoC, by allowing the interbank lending rates to rise to such record highs (with the seven-day repo rate reaching 25 per cent) before intervening to provide the much-needed liquidity and lower rates, underscores the Chinese government's concern and desire to rein in the shadow banking sector (Hong 2013).

Yet deterring (or disciplining) shadow banking by ad hoc methods such as the use of short-term interbank funding is not only woefully ineffective but also potentially destabilising. For example, too severe a credit tightening which prevents banks and related entities from rolling over their financing could trigger a chain reaction of defaults and bankruptcies with adverse consequences for the wider financial system and economic growth. After all, shadow banks provide desperately needed credit to companies and businesses such as small and medium-sized enterprises which have difficulty in obtaining loans despite being important generators of employment. Therefore, a punitive crackdown to restrict access to credit could further slow economic growth. Similarly, abrupt monetary and fiscal tightening designed to limit credit growth has the potential to undermine GDP growth. Rather, what Beijing needs to do is better regulate the off-balance sheet activities of the commercial banks and ensure more efficient credit allocation.

To mitigate these risks, policymakers must address a number of core problem areas facing the Chinese economy. First, in order to rein in credit growth, Beijing must rebalance the Chinese economy away from its current investment-led growth model to one based more on domestic demand and services. Second is the problem of moral hazard. As long as individuals and businesses believe (even implicitly) that their investments are guaranteed by the government and the formal banking system, funds will continue to flow into the shadow banking sector because investors will continue to buy products promising lucrative returns. Indeed, the bail-out of CCT only confirmed the widespread belief among investors that the government and the big banks would come to their rescue if their investments went sour. Sending a clear message that the government will no longer provide future bail-outs for unregulated and insured investments and that investors will have to take a 'haircut' for their poor and irresponsible decisions would go a long way to curb speculative and risky activities by forcing both the official and the shadow banking sectors to price risk more realistically.

Third, since China's partly deregulated financial sector creates opportunities for regulatory arbitrage, drastically reducing (if not altogether eliminating) this problem through better supervision of the official banking sector's interbank business and requiring shadow banks to maintain sufficient net capital reserves could help alleviate the problem of leverage. Specifically, greater oversight of the various WMPs through tighter disclosure of their off-balance-sheet activities is essential. Most important is interest rate liberalisation. Specifically, although the Chinese government has over the years adopted measures to liberalise interest rates, it has to date refused to remove deposit rate ceilings, ostensibly to prevent instability to the financial system (Liu 2013). This is understandable as the correct timing and sequencing of liberalisation is essential to limit market volatility and instability.

However, as is well known, interest rate controls invariably result in an inefficient allocation of financial resources, besides punishing savers by imposing a hidden tax, while rewarding borrowers and spenders with cheaper credit. Inevitably, interest rate distortions result in the unproductive use of credit – a fact vividly underscored in China by high levels of non-performing loans in the banking system and frequent recapitalisation of banks by the Beijing government. Therefore, market-determined interest rates would not only generate greater

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competition and better and fairer pricing options for depositors and borrowers, but also force banks with highly leveraged deposit bases to undertake necessary reforms.[17] After all, shadow banks thrive in China because both interest rates and the cost of money are kept artificially low. If these controls were removed there would really be no need for shadow banks – at least, not to the current extent.

Finally, the Chinese government should impose hard budget constraints on local governments to rein in uncontrolled spending and limit the current diversion of credit to speculative borrowers. In this regard, the CBRC's decision to impose a ban on guarantees for LGFV bonds is a good start as it provides banks with some degree of protection from contingent liabilities. On the other hand, the decision to allow local governments to issue bonds as a way of rolling over their debt postpones the inevitable deleveraging, even though local governments are thereby given a breathing space to improve their finances.

Notes

1. WMPs are generally higher-yielding notes issued by trust companies. They are usually sold through banks' retail channels and the funds are then used to issue loans. WMPs are not guaranteed by the banks, even though individual investors assume they are implicitly guaranteed (see IMF 2010, 2011). As Das (2014) notes, WMPs come 'with a variety of seductive monikers – Easy Heaven Investments, Quick Profits and Treasure Beautiful Gold Credit'.
2. Indeed, *The Economist* (2014) notes that 'over $400 billion-worth of trust products are due to mature this year [2014] – and borrowers will want to roll over many of those loans. Many observers worry that investors will lose faith in trusts, prompting a run, which may, in turn, blight certain industries and other parts of the financial system. No country, pessimists point out, has seen credit in all its forms grow as quickly as China has of late without suffering a financial crisis.'
3. The Financial Stability Board (FSB 2013) estimates that the global shadow banking sector accounted for $71.2 trillion of assets at the end of 2012 – a dramatic increase from $26.1 trillion in 2002. The FSB's report also notes that the shadow banking system is mainly concentrated in the advanced economies, which account for 85 per cent of the sector. In 2012 the US held $26 trillion in assets, the Eurozone held $22 trillion, the UK $9 trillion and Japan $4 trillion. Emerging economies which saw their shadow banking sector grow by over 20 per cent in 2012 include China, India, Argentina and South Africa.
4. Similarly, Moody's Investor Service (2013) 'estimates that core Chinese shadow banking products – those that are relatively non-transparent, loosely regulated, and carry elevated credit risk – totaled a large RMB21 trillion at end-2012, or 39% of 2012 GDP'. Similar figures are reported by Wei and McMahon (2012).
5. In China's Wenzhou district, it was reported that over a six-month period in 2012 some 80 businessmen declared bankruptcy, some committing suicide because they could not meet the high payments on their shadow bank loans. See *Bloomberg News* (2013).
6. At best, China's shadow banking system is involved in 'informal' securitisation as it plays a key role in pooling funds provided by the formal banks. The official banks also help distribute the financial products pooled by the shadow banks.
7. Lu, Thangavelu and Hu (2005), using a panel data set of public listing companies in China, show not only that SOEs get more loans than other firms, but SOEs with high default risks are also able to borrow more than low-risk SOEs and non-SOEs. They note that this suggests that Chinese banks have a systemic lending bias in favour of SOEs. On the other hand, according to the People's Bank the artificially low interest rate is designed to prevent 'hot money' from flowing into China and to prevent speculation through interest rate arbitrage.
8. Available at http://data.worldbank.org/indicator/FM.LBL.BMNY.GD.ZS (accessed 22 May 2014).
9. See also Walter and Howie (2011).
10. In China 'local governments' cover a broad range of entities, including provinces, prefectures, cities, counties, townships and villages.
11. The major source of income for local governments has been the sale of land under their jurisdiction as altogether they received about 25 per cent of the VAT revenue.
12. However, a pilot project in 2011 approved by the central Chinese government in Beijing now allows Shanghai, Shenzhen, Guangdong and Zhejiang to issue bonds.
13. According to a recent report, 'Regional governments set up more than 10,000 local financing units to fund construction projects after they were barred from directly issuing bonds under a 1994 budget law. Local-government debt swelled to 17.9 trillion yuan ($2.96 trillion) as of June, compared with 10.7 trillion yuan at the end of 2010, according to data compiled by the National Audit Office' (*Bloomberg News* 2014).
14. According to the IMF (2013), China's general government debt might be close to 45 per cent if 'government debt' also includes local government infrastructure spending. See also National Audit Office of the People's Republic of China (2011).

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15. The CBRC was established in 2003 and is responsible for regulation and supervision of the banking sector. Its functions are separate from those of the PBoC, which is responsible for monetary policy and financial system stability. To its credit the CBRC has help to strengthen prudential standards and overall improvements in bank governance. The five large state-controlled banks include the Industrial and Commercial Bank of China (ICBC); China Construction Bank (CCB); Bank of China (BOC); Agricultural Bank of China (ABC or AgBank); and the Bank of Communications (BoCom). China also has three state-controlled 'Policy Banks': the Agricultural Development Bank of China (ADBC); China Development Bank (CDB); and the Export–Import Bank of China. Altogether, the five state-controlled banks account for about 50 per cent of Chinese banking assets and deposits and are majority-owned by the Chinese state, though they do have private shareholders.
16. Boone and Johnson (2014) note that 'China luckily has substantial scope for absorbing losses. For example, the Industrial and Commercial Bank of China, one of China's largest banks, reported $59 billion of operating profit (before loan loss provisions) over the last 12 reporting months . . . It can use that profit to offset losses on its $1.5 trillion loan book (over and above the $38 billion that it has already provisioned). Even if 10 percent of loans were to eventually default, with 50 percent recovery on those loans, the losses to equity capital could be offset with just two years of profits. Share issuance (already priced into equity markets) could raise further capital if needed. This high profitability of Chinese banks makes them far more resilient than American and European banks. For example, Washington Mutual, which eventually was taken over by the Federal Deposit Insurance Corporation, reported roughly half the profitability of the Chinese banks in the boom years before it collapsed.'
17. That is, savers will earn higher interest incomes, while borrowers will pay a higher (fairer) rate for borrowing.

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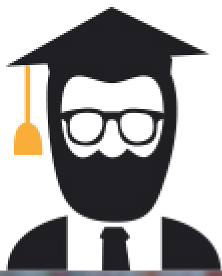

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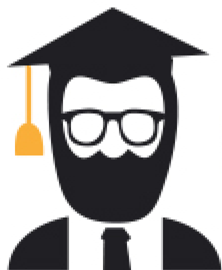

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