# ***Shadow Banking Threatens China's Economybut What Is It, Exactly?***

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## Body

Zhou Xiaochuan (R), Governor of the People's ***Bank*** of ***China***, is tasked with tackling excesses in ***China***'s ***shadow banking*** system.(Molly Riley/AP)

Last week, the Shanghai interbank offered rate (Shibor), ***China***'s once-anonymous version of London's LIBOR, made news around the world when it suddenly spiked at all time high. Expected to lower this rate by injecting cash into struggling Chinese ***banks***, the People's ***Bank*** of ***China*** (the country's equivalent of the Fed) instead did nothing, leading to speculation that ***China***'s leaders were finally prepared to tackle the economy's overheating problem. In the process, the media appears to have finally taken notice of the potential dangers that lurk within the byzantine industry that is Chinese finance. Reviewing the headlines, a series of arcane, sinister terms leap out: Off-balance sheet lending. Inter-corporate finance. And, most prominently, ***shadow banking***.

Such terms, nebulous as they may be, are keeping Chinese policy makers up at night: According to *Fitch*, ***China***'s ***shadow banking*** sector may be hiding as much as $2 trillion worth of risky assets in off-balance sheet lending. But what does that really mean? And, more importantly, how did ***China*** find itself in this situation? Before we can answer these questions, it's worth ***going*** back and having a look at what ***shadow banking*** really is, and how it presents a risk to ***China*** -- and the world economy as a whole.

Firstly, the concept of ***shadow banking*** has an unfortunate reputation and is in dire need of rebranding. Despite the macabre connotations its name conjures, it's not inherently a bad thing. Generally, ***shadow banking*** simply refers to the lending and borrowing -- basic financial activities -- that occur outside the traditional deposit and loan model; that is, anything other than putting money in the ***bank*** and occasionally borrowing for things like buying a house. In Western nations such as the U.S, hedge funds, venture capital firms and private equity -- all forms of ***shadow banking*** -- form a major part of economic life. In ***China***, however, the structure of ***shadow banking*** is very different.

Until around 2007-8, conventional ***banks***, in the form of loans, undertook the vast bulk of all lending in ***China***, and because the Communist Party controls the vast majority of ***banks***, this structure allowed the government to retain a handle over the economy at large. However, in the aftermath of the financial crisis, as export-oriented businesses -- the companies that form a major pillar of the Chinese economy -- saw markets shrink, two important things happened.

The Shibor rate hike and the government's refusal to step in with additional funds, then, is a not-so-subtle statement that the party's over and that it's time to solve debt addiction the old fashioned way -- ***cold turkey***.

First, in response to the global financial crisis in 2008, the Chinese government enacted a stimulus package worth $586 billion, more than half of which was financed through new ***bank*** lending. This package won praise around the world for its speed and decisiveness and kept the country on track in the short term, in noted contrast to a similar plan implemented by the United States. But the stimulus also flooded the economy with cheap credit,

thereby fuelling a speculative housing bubble, propping up inefficient state-owned enterprises (SOEs), and undoing years of work spent trying to instill ***China***'s ***banks*** with financial discipline.

In the two decades leading up to the financial crisis, a lot of hard and sincere work was done to try to teach profligate SOEs, local governments, and ***banks*** to live and work within their means, but that doesn't mean these institutions suddenly forgot how to take advantage of a free lunch. In fact, it probably heightened their appetite for it. As a result, much of the money was sunk -- almost literally -- into local government financing vehicles (LGFVs), which are municipal government-owned companies often responsible for infrastructure investment. These companies, for the most part, exist to keep local government debt off the books -- since local governments have a very limited capacity to borrow money directly -- by allowing them to borrow indirectly and finance construction projects through companies they own, built on land often acquired and sold below market price by them.

Surprisingly, this system constituted a huge source of revenue for cash-strapped local governments, which have few real sources of tax revenue. Less surprisingly, it is also an endemic, institutionalized form of corruption. A recent OECD report estimated that total public debt reached 57 percent of GDP by the end of 2010, with LGFVs accounting for about three quarters of this figure. Given that some people familiar with LGFVs see them as little more than holes in the ground into which seemingly endless amounts of perfectly good money are poured, it is likely this borrowing generated a wave of future defaults.

How, and why, was the money spent this way? To answer this question, it's important to understand the love affair between the Chinese government and infrastructure projects. Over the past two decades, Beijing has relied on building roads, power grids, and other fixed assets in order to facilitate the rapid expansion of the economy, but this method of growth inevitably leads to declining returns over time. As a result, Chinese policy makers understand that to decrease the economy's dependence on investment and export markets (which depend too much on the whims of the global economy) domestic consumption needs to pick up the slack. Unfortunately, however, this "rebalancing" is tricky.

One problem is this: Contrary to popular belief, ***China***'s manipulation of the yuan isn't the golden goose Western critics make it out to be. Even if the currency were allowed to float freely, Chinese labor would still cost a fraction of what it does in the U.S. This discrepancy is mainly achieved through the hukou, a household registration system that prevents workers from becoming fully entitled residents in the regions to which they have migrated to work, as well as restricting the rights of children born in these regions to services like education and health care.

In short, the hukou ensures that workers remain in the ***shadows*** -- and wages remain low -- by constantly recycling labor out of factories and back to the place of registration. Factors like this have made it increasingly difficult to rebalance the economy and have contributed to the yawning wealth gap in Chinese society. Though Chinese leaders have hinted at reforming the hukou, they nonetheless face a vexing dilemma: How do they increase domestic demand without significantly upsetting a social order upon which the economy depends for its competitive advantage?

Historically, the answer to this question was infrastructure development, and for good reason: Infrastructure is politically neutral, theoretically benefits the whole of society, is generally dominated by massive State and quasi-State owned enterprises, and in the past generated massive returns. However, over the last four years, the GDP growth generated by each yuan of additional loan has fallen from 0.85 to 0.15, an indicator that the limits of debt-fuelled growth are being reached. In effect, the very engine that caused ***China***'s growth ---fixed asset investment fuelled by local debt -- wasn't sustainable, and the government began to worry about the negative consequences of an overheating economy: inflation, real estate bubbles, and overcapacity.

So in 2009 they slammed on the breaks. An economy that was addicted to credit needed to ***go*** somewhere else to get its fix. This was where ***shadow banking*** came in.

Desperate for credit, ***banks*** began working closely with trust companies and other entities to refinance bad loans by bundling them up and repackaging them as "wealth management vehicles", or WMVs. These vehicles, which require a tenure ranging from a year to a few days, offered a higher rate of return than conventional ***bank*** deposits. They also allowed ***banks*** to keep their lending off their balance sheets and were sold through their

branches or online, effectively turning ***banks*** into middle men between recipients and investors. In theory, this should have solved the problem of obtaining local financing. But the problems have only begun.

As more and more of these loans turned bad they were simply recycled into high yield WMVs, a fact that ***China***'s policy makers have acknowledged. In an uncharacteristically stark warning aired in a ***China*** Daily *op-ed*, Xiao Gang, the former head of the ***Bank*** of ***China***, said that there are more than 20,000 WMVs in circulation -- compared with "a few hundred" five years ago. Worse, many of these WMVs lack transparency or are linked to empty real estate, long term infrastructure projects or collections of assets which have no sure fire way of generating the revenue needed to repay them at the given time, creating the real possibility of a liquidity crisis.

Has this crisis already begun? There's evidence that ***banks*** and trusts have colluded to circumvent a shortage of liquidity by issuing ever greater numbers of WMVs -- with still higher rates of return to attract the cash necessary to finance the short fall. But if the music stops and investors pull their money or stop purchasing new issuances, then the rollover for the ***bank*** to pick up could potentially be huge. The consulting firm *KPMG* estimates that ***shadow banking*** and WMVs overtook insurance to become ***China***'s second largest financial sector in 2012 and represent assets roughly equivalent to 15 percent of total commercial ***bank*** deposits.

This situation has arisen in a country whose people, facing restrictions on investing abroad and nervous about ***China***'s volatile stock market, have so few other investment options. In addition, most simply don't believe ***banks*** will let them lose their money and will support their investments, no matter how risky they are; essentially, the basic ingredients of a Ponzi scheme. The Shibor rate hike and the government's refusal to step in with additional funds, then, is a not-so-subtle statement that the party's over and that it's time to solve debt addiction the old fashioned way -- ***cold turkey***. The question, then, is this: how bad was the addiction, and how big will the comedown be?

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