Financial Risk in China: Shadow Banks or the "Shadow of the Banks"

By Long Ke


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In 2012, the Chinese economy entered a slowdown phase. Why did the engine of the second-biggest economy in the world power down? Was it because of a fundamental change or a failure of policymaking? Premier Li Keqiang has emphasized many times that he will not enforce any stimulus policy to buttress economic growth, but he is making tremendous efforts to improve deleveraging in the financial sector and the fiscal balance sheet. He has meanwhile reiterated his intention to reform China's economic structure in order to increase the efficiency of the economy. His agenda has been dubbed "Likonomics" by many economists. Li has asserted many times that a 7% growth rate must be acceptable for today's China. In contrast with former Premier Wen Jiabao, Li has recognized the necessity and importance of changing the economic structure, lest China become unable to sustain its economic development over the next decade.

Japan's policymakers failed to spur a recovery after the country entered a recession in the early 1990s, and the nation lost two decades. By contrast, China's government has succeeded in sustaining economic development during the past three decades, making China the second-biggest economy in the world. But over the past decade under the Hu Jingtao administration, the government has postponed almost all planned reforms, including political and economic. How was the government able to sustain growth without enacting any reforms? Professor Zhang Weiying of Beijing University pointed out that the economic growth of the past decade was driven by the reforms adopted before the Hu administration, under Jiang Zemin. China's market-oriented economic system was built by former Premier Zhu Rongji. Zhang posits that the driving force during the Hu administration was the boon of reforms by Zhu. It is plausible that growth under the Hu administration was not a result of something that Hu and Wen did, but rather an effect of the reforms adopted by Zhu.

The Hu administration has ended, and the Xi Jinping administration will not be as lucky as its predecessor. This means that Xi will have no choice but to stop procrastinating and reform the political and economic systems. If he doesn't, China will experience a very hard landing and the so-called "China risk" will be realized, causing serious damage to the global economy, and the Asian regional economy in particular. Of course, it is not impossible for Xi to reform these systems and change their structures in one or two years. The key is to make clear the agenda and the roadmap of the reforms as soon as possible.

Reform priority in the coming decade

Reforming existing systems in order to build a truly free, fair and global market will be a great challenge for Xi. In some ways, today's Chinese economic system is market-oriented, but it is not a real market economy. Most public utilities like electricity, gas, oil and water are monopolized by state-owned enterprises. Even the distribution service is still controlled by the government. The market doesn't function based on the adjustment of demand and supply through price mechanisms. China first needs to privatize its state-owned enterprises. The government liberalized part of the market over the past three decades, but not enough.

Let's take a look at the financial system and the financial market in China. The banking market is monopolized by China's four mega banks, all of which are state-owned commercial banks: the Bank of China (BOC), the China Construction Bank (CCB), the Industrial Commercial Bank of China (ICBC), and the Agriculture Bank of China (ABC). These state-owned commercial banks gather approximately 54% of household savings and lend almost all of the money to state-owned enterprises. The ownership of these enterprises seems to be very important in China even today, despite the government's continued promises that private companies can enjoy the same status as state-owned enterprises.

The third plenary session of the 18th Chinese Communist Party Congress was held on Nov. 12-14, 2013. At the session the party decided how to reform the economic system in detail. According to a communique issued by the government, it had decided to pursue greater market economic reform, including liberalization of interest rates, and build a more flexible foreign exchange regime. The government decided to build a free trade area in Shanghai (SFTA) as an experiment in free trade and free financial business. The likely goal of the experiment is to confirm the conditions necessary for dealing with counterparts when building FTAs and for committing to the TPP in the near future.

Without any effort by the Xi administration to reform the system, China's economic development will become unsustainable, society will become unstable, and the communist party will cease to exist. The situation that Xi faces is no more favorable than that faced by Deng Xiaoping 34 years ago. Xi's leadership, however, is clearly weaker than Deng's was. Deng grasped the reins through his own power, but Xi was elected as leader by former leaders like Jiang and Hu. Xi understands what he needs to do but has not seized control of the situation. He is forced to negotiate with the former leaders before being able to reform the system. As a result, he has to limit reforms to the micro level instead of carrying them out at the macro level.

What's the real problem with the shadow banking system?

Before addressing the problem of the shadow banking system, let's take another look at the financial system in China. Before the open-door policy was first enacted 30 years ago, there were only four state-run banks and the People's Bank of China (PBOC). The PBOC partially filled the role of a central bank by issuing renminbi but it was not allowed to decide the interest rate. In reality, the PBOC was simply a part of the Ministry of Finance; the government had the power to decide everything, including interest rate levels and liquidity generation.

In addition to the PBOC, China also had the four state-run banks mentioned above. According to regulations, the four banks were not allowed to compete with each other. The BOC supplied foreign exchange services for international trade, and the ABC was allowed to lend money in rural areas only. The ICBC lent money to companies in the manufacturing and service industries in urban areas, and the CBC generated liquidity for infrastructure projects like dams and railways. In the Mao Zedong era, no private companies were allowed to do business and so there was no need to generate liquidity for private companies. The banks only generated liquidity for state sectors according to the government's official economic plan. In that sense, the banks were not real banks; they only lent money in accordance with a national economic plan, and they were unable to manage borrowers' risk. Furthermore, they didn't need to worry about profits and non-performing loan problems. Such a centrally planned economy, however, is not sustainable. Therefore, 34 years ago, Deng decided to liberalize economic control through an open-door policy.

In 1994, during the Jiang era, former premier Zhu began to reform the financial system towards a more market-oriented one. He commercialized the state-run banks and put an end to intervention in the banks by the government, including local governments. China's local governments often pressed the state-run banks to generate liquidity for their rapid development projects. Zhu promised to guarantee the independence of the banks through the establishment of "the law of commercial banks" while requesting the banks to strengthen their risk management by themselves. Under the central planning economy, the government, especially local governments, interfered with the banks' decision-making, forcing them to lend money to the state-run enterprises. This meddling caused the banks to give non-performing loans, and it also caused inflation sometimes. Before reforming the banking system, the government established stock exchange markets in Shanghai and Shenzhen in 1990 and 1991, respectively. Although only state-owned enterprises were allowed to list on the markets, the markets still played a very important role as an intermediary for moving liquidity from households to investors.

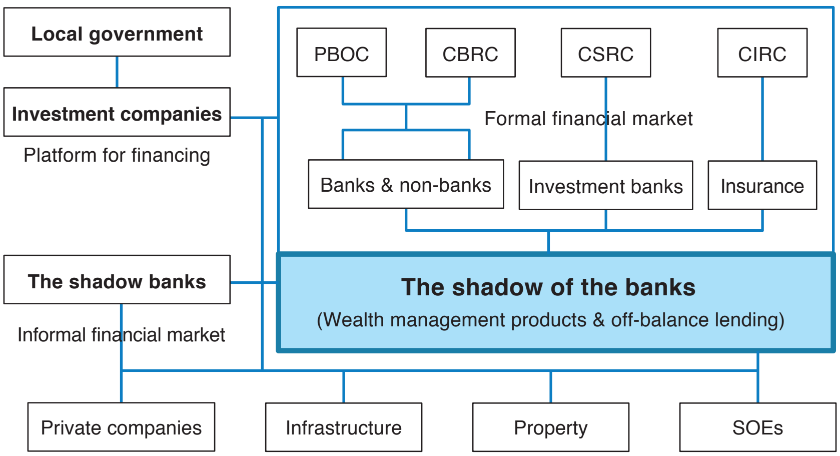
The biggest problem with the current financial system is that the banks only generate money for state-owned enterprises but refuse to lend money to private companies, even if the private companies have enough assets to guarantee their borrowing. Most of China's private companies are small, however, and don't have enough assets to guarantee a loan. Japan's government has established many organizations and associations to supply a loan guarantor service for small companies, but China has no such public agencies to supply such services to small private companies

In *Chart 1* we can see that Chinese banks not only act as intermediaries moving liquidity from households to enterprises formally, but they also work closely with trust companies and other entities by packaging trust loans into wealth management products. Shadow banking in China has mainly taken the form of wealth management products (WMPs) and off-balance-sheet lending. In fact, WMPs and off-balance-sheet lending used to be operated by the main banks, so one might call this area "the shadow of the banks". The real shadow banking system in China is an underground financing system, which is generally an illegal finance business, although it plays an important role in generating liquidity for small companies. During the Hu era, premier Wen tried to reform this informal financing system by making it more formal, but he made no more progress than his predecessor.

In China, the underground financing business is especially developed in coastal areas like Zhejiang and Fujian provinces. For example, Wenzhou is a city famous for its small-scale manufacturing industries; it is the biggest supplier of buttons and disposable lighters. Wenzhou is also famous for having a very well-developed underground financing business. Wen wanted to conduct an

CHART 1

The shadow banks & "shadow of the banks"



Source: © FRI 2013

experiment in Wenzhou to formalize the underground finance system, but the reform was not that easy. Most of the underground financing organizations prefer to lend money underground. In 2007 the government arrested businesswoman Wu Ying because she borrowed 770 million yuan from the underground financing system and was unable to repay the interest rate she had promised to the lenders. Macroeconomically speaking, such off-balance-sheet lending could reduce the effects of the government's financial policy. It is necessary and important to formalize the informal financing system.

The real problem is borrowing by local governments

Although the underground financing system may adversely affect China's financial policy, the business itself is at risk. Underground financing banks contribute to small business in China, so instead of shutting down such illegal financial business, the government's best solution is to license these underground financial organizations and let them do business formally.

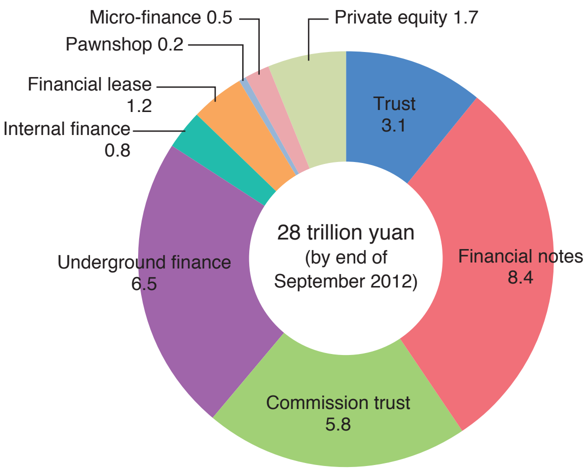
The shadow of the banks could be at big financial risk if China's economic growth continues to slow down. If the property market bubble were to burst, that would mean that the banks, including the mega state-owned commercial banks, would face a large amount of non-performing loans, since most of the off-balance-sheet lending by the banks is concentrated in the property market. This is why investors are extremely worried about the American sub-prime loan crisis making its way to China. *Chart 2* shows the scale of the shadow banking business and the shadow of the banks in China.

But the biggest concern with the Chinese financial system is not the shadow banking system or the shadow of the banks, but the local governments' borrowing problem. In China, local governments are not allowed to raise finance in the financial market. The central government is concerned about the local governments' borrowing irresponsibly if they are allowed to borrow money from the banks or raise debt in the financial market. Such concerns are reasonable, since local governments are not elected by the people democratically. The people would not be able to govern their own local governments, which would see the borrowing as a free lunch.

On the other hand, local governments need a lot of money for the upkeep of their cities, for example, maintaining roads and building underground railways and other infrastructure. The problem is that local governments need money but are not allowed to finance. There is a famous expression in China which goes "Those above have policies while those below have their own ways of getting around

CHART 2

Financing in formal & informal financial markets



Source: The People's Bank of China

them." In this case, local governments established many investment companies as financing platforms to borrow money from the banks and raise finance in the financial market *(Chart 1)*. Such investment companies were established, controlled, and operated by local governments. There was no transparency or governance in the management of these companies. For example, the investment companies financed the money to build underground railways initially, but the managers used parts of the loan to invest in the property market to realize higher returns. This is not an uncommon case; most of the investment companies invested in the property market. In some provinces, the investment company's CEO even used the money to invest privately as a result of the lack of governance and transparency.

The risk arising from the local governments' debt problems is a problem of moral hazard for them. There is little hope that the central government will forbid financing by local governments to control such risks. The only effective solution is to reform the political system and to build a democratic system which will allow the people to govern and monitor their own governments.

The road towards a market-oriented economy

The financial system plays an important role as an intermediary for moving liquidity from households to investors. Under a central planning economy, the government allocates the liquidity through an economic plan to every economic sector, especially state-owned enterprises. Over the past few decades, China has transitioned into a market economy, although it is not yet a real market economy. The government is still playing an important role in allocating liquidity, and the financial market plays the role of financial intermediary. As a result, the economy is not effective. The communist party decided to create a "social market economy" instead of a socialist one, but market mechanisms do not play a large enough role in market transactions.

In the communique issued following the third plenary session of the 18th Chinese Communist Party Congress, the party decided to improve the market so that it would play a more decisive role in the allocation of resources. This is the first time the party has made such a decision in such a document. In China the third plenum is known as "a new historical starting point" for restarting and deepening the reform of the economic system. It is clear that the current financial system needs to be reformed, but "how?" The communique showed a vision for reform, but it contains no roadmap. Reform is certainly necessary, but it will not be easy to enforce.

Let's focus on the financial system reform. The state-owned commercial banks need to be privatized as soon as possible, and the interest rate needs to be liberalized. Privatizing the state-owned commercial banks would mean that more liquidity would be generated for the private sector instead of for state-owned enterprises. We find in the same communique, however, that the party still insists that the state-owned sector is the most important part of Chinese society. If so, the state-owned commercial banks cannot be privatized, and private companies will face the same difficulties for financing, i.e. they will still need to pay very expensive interest rates to borrow money from the underground financial system. The interest rate of the formal financial market is quite a bit lower than that of the informal financial market, but only the state-owned enterprises enjoy the advantage of market competition.

Governor Zhou Xiaochuan has propounded many times the "marketization" of the interest rate, which is in fact a good idea. But the liberalization of interest rates would mean that the banks would tighten their risk control on lending. Some state-owned enterprises would be required to pay more expensive interest rates than the basic rate because of enterprises' management risk. In the long term, some state-owned enterprises would go into bankruptcy. The question is whether such an outcome is acceptable for the communist party. The current answer: absolutely not. In the party communique, the Xi administration gives a clear message that the party and the government do not want to take any undue risk in reforming the economic system. The stability of Chinese society is of the utmost importance. Reform must provide a soft landing for society and for the party. A soft-landing reform would be an ideal outcome, but the most important thing is to reform the economic system and build a real market system. The party and the government need to take on the difficult challenges of reform. Courage is a much more important attribute for Xi than charisma; he must bravely provide strong leadership to carry out successful reform.

The Hu administration postponed almost all proposed reforms, leaving behind a legacy of an inefficient economy and industry. Chinese society is facing very difficult times. The government needs to bear large fiscal expenses simply to maintain social stability. The Xi administration should learn its lesson and stop postponing reform. If it is afraid to take on difficult reforms, they will only become more difficult to achieve in the future. JS

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