CHINA’S SHADOW BANKING:
A CALL FOR FINANCIAL REFORMS

YANG Mu & YAO Jielu

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Executive Summary

1. In March 2012, the Chinese authorities approved a pilot project on financial reform in Wenzhou. The move clearly demonstrates Beijing's concerns over China's informal financing sector which may pose systematic risks to financial stability and the country's ill-structured formal banking sector which inhibits loans to small borrowers.

2. Shadow banking in China encompasses a wide range of informal financing activities including both underground lending and banks' off-balance sheet credit. The overall size of China's informal lending by the end of 2011 should exceed 14 trillion *yuan*, an amount equivalent to 26% of China's formal bank loans.

3. The lack of formal credit access prompted the development of China's underground lending. China's central bank put the size of underground private lending at 3.38 trillion *yuan* as of May 2011. In recent years, such lending has changed from financing small and medium businesses in the real sector to funding speculators in the property and financial markets.

4. Without regulatory supervision, risks to underground financing activities are inherently high. If a link of the debt chain is broken, the entire debt chain might collapse. Isolated cases of default could easily lead to massive redemption and social instability.

5. Banks' off-balance sheet credit refers to various contingent liabilities of commercial banks such as bank acceptances, entrusted loans, trust loans, and credit-related wealth management products. Off-balance sheet loans of Chinese banks stood at 11 trillion *yuan* as of December 2011.

6. The recent surge in banks' off-balance sheet credit has been largely due to negative real interest rates, the tightening monetary policy and the funding strains faced by the banks. Such credit poses challenges to Chinese

policy-makers as they understate banks' leverage and lessen the effectiveness of the central bank's quantitative monetary tools.

7. Beijing has taken measures to lower risks posed by shadow banking since 2011. While the central government is mulling moves to permit informal capital in the financial arena, it is determined to crack down on underground lending that fuels asset bubbles.

8. To regulate banks' off-balance sheet credit, the government requires banks to bring some products back onto their balance sheets. The central bank has also introduced a new indicator, total social financing, to obtain systematic data on several activities unavailable previously.

9. In the long run, however, the Chinese government needs to further reform its financial markets as well as to move toward more market-determined loan and deposit interest rates. Conditions are "basically ripe" for liberalising China's interest rate policies, according to central bank governor Zhou Xiaochuan.