

MANAGING CHINA'S EXPANDING SHADOW BANKING

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Executive Summary

1. Since late 2013, the Chinese government has issued a number of documents to strengthen the regulation on shadow banking. This reflects the gradual recognition of its potential risks and the efforts to contain possible negative impact on the financial sector.
2. China's shadow banking is conducted via commercial banks. High-yield investment products known as 'wealth management products' (WMPs) are believed to account for an ever-expanding and major part of shadow banking. They are created and managed by trust companies and distributed by commercial banks.
3. China's shadow banking is intimately related to local government debt and real estate development. The major expansion in local government debt is the result of shadow banking and worsened by real estate developers. The prosperity of the Chinese economy largely lies on the continuous rise of land prices.
4. Micro-level problems of China's shadow banking include maturity mismatch, high leverage and asymmetric information. In addition to these problems, China's shadow banking sector may also pose risk to the overall financial sector.
5. Macro-level problems are impact on the money multiplier, potential possibility of the need to bail out trust products, risks of misallocation of credit resource, drawbacks of the crowding out effects on small and medium-sized enterprises, and risks from rapidly expanding local government debt.
6. Shadow banking does serve the function of a supplement to the current financial sector. What is needed is the imposition of proper regulation.
7. Besides the ongoing execution of those newly issued policies, China needs more specific counter-cyclical policies to cool down its pro-cyclical economic behaviour. More emphasis could be put on improving the financial market order, developing

healthy interbank business, containing financial risks and directing credit resources into real productive sectors.

8. A systemic financial crisis is not likely. There are fundamental differences between the defaults facing China today versus those faced by the United States a few years ago. The Chinese government's strong policy capacity and sufficient funding of the domestic banking system imply the low possibility of a systemic financial crisis outbreak.