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Removing the Veil for Shadow Banking System in China

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Abstract

The paper aims to analyze the development of the shadow banking system in China and its role in the rapid economic growth in China for the past three decades. The shadow banking system supports small and medium sized firms and agricultural development projects. This has an important impact on poverty reduction in China as farmers largely refer to informal financial channels to get credit support for seeds, chemicals and animals. The shadow banking system offers credit supplies to lenders who cannot easily obtain credit from the official banking system. The credit supplies they offered use different financial instruments, come with higher interest rates, and were often disguised as financial products landing within the regulatory framework of the administration. The commercial banks also used the shadow banking financial instruments to meet capital thresholds from the People's Bank of China. As a result, the shadow banking products create longer credit chains, distort credit flows in the financial system by diverting investments into short-term, high return, more risky financial markets. The turbulences in the interbank transaction market, the financial derivative market, the stock exchange markets (including the main-board, the "second tier" market for SMEs and the "third tier" market for start-ups), and the real estate market are all heavily involved in transactions conducted by the shadow banking entities. The shadow banking system in China has been expanding at a pace beyond the current regulatory structure. The internet P2P investment platforms, for instance, become popular with investors and raise funds up to RMB 1 billion each platform. There exist over thousands of internet investment portals, the most popular one being "Yu E Bao", offered by Alibaba.com. The traditional regulatory institutions, however, do not cover shadow banking investment activities made online. Neither are insurance offered to insurance made online; as the new deposit insurance scheme only cover deposits made in the official banking system.

With the ambition of boosting the internationalization of the RMB, financial deepening and economic reforms in China, the financial regulators in China face the dilemma resulting from the regulatory arbitrage associated with the expanding shadow bankinBBC system. Individual investors in China purchase the shadow banking investment products and assume their purchases come with implicit government guarantees, such as wealth management products sold by commercial banks for trust companies and local government investment platforms. On the other hand, it is critical for investors to make rational investments; thus, regulators are obliged to remind investors of risks related to the shadow banking products, that the fantasy of governments repaying failing shadow banking investments will be not realized. It is also the responsibility of the regulators to divert funds collected by the shadow banking entities to long-term investments to build up industrial bases.

The financial deepening in China required the transformation of the shadow banking entities and financial products offered into ones with adequate capital cushions and sufficient liquidity. The internationalization of the RMB necessates the opening up of the capital, hence financial account in China. However, the 1997 Asian financial crisis, and the hyperinflation resulting from the dollarization in Latin America has led the Chinese regulators to be cautious

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in conducting currency liberalization and financial reforms. The opening up of the financial account with the liberalization of the exchange rate regime doubles the financial risks, increases the possibility of financial crises, and may result in the stagnation of economic growth. The function of the central bank as the lender of the last resort demands effective and prudential regulations for SIFIs, and also seeks to functioned to boost market confidence. At this critical turning point of the Chinese economy, defining the role of the shadow banking system, bringing them into the regulatory framework, and identifying risks created should be the priority of the financial regulators in China.

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