China's "shadow banking" after the 2007 global crisis yields unexpected results

China's 2009 economic stimulus program after the global financial crisis led to the growth of shadow banking as local governments scrambled to pay off their obligations under the program. Regulators loosened borrowing rules to avoid a debt crunch, posing risks to the financial system, but in doing so accelerated China's financial liberalization.

Asian Development Bank Institute research details the unintended effects of the four-trillion-yuan stimulus plan launched to insulate China's economic growth from the global financial crisis.

Much of the responsibility for funding the stimulus fell on local governments. They mostly took on bank loans to pay for the infrastructure projects that formed the bulk of the stimulus plans. It could take decades for those projects to start paying returns, but the loans came due after about four years on average, leaving local governments searching for ways to service their debts while keeping the stimulus going.

Rules imposed on local governments in 1994, after a burst of over-enthusiastic borrowing, meant they could not directly issue bonds. By 2013 those governments had debt of some six-and-a-half trillion yuan, raising concern that China had a growing debt crisis. Regulators allowed local governments to set up companies to issue bonds to finance their debt.

The market for those bonds quickly expanded, and by 2016 they accounted for more than 61% of the market for corporate bonds, up from just under 13% at the end of 2010. Investors scooped up the bonds, on the assumption they were guaranteed by local governments, even though the issuers were technically a step removed.

The biggest buyers were China's major banks. As the market grew, and banks bought more bonds, regulators began to worry, and the central government tightened the reins on the banking system. The task for the regulators was tricky—they needed to keep banks from becoming dangerously overextended, while ensuring money continued to flow to local governments and their investment projects. With the rules tightened on traditional lending, banks began to increase their use of nontraditional products to exploit gaps in the regulations.

Those products form the bulk of what is known as shadow banking.

The two main products are trust loans, which allow companies to buy bank debt at attractive rates, and wealth management products, which offer consumers a higher interest rate than bank deposits.

By the end of 2015, the market for trust loans and wealth management products was about the same size as traditional bank lending in China. Forced to decide between a potential debt crisis for banks and local governments and the growth of less-regulated shadow banking, the government chose the latter, which merely shifted the danger, not avoided it.

But the dance between the regulators, investors, and China's banking system had a positive result as well. The growth of the corporate bond market, and the rush into nontraditional products to fund borrowing, has speeded up China's financial market liberalization. More players have been allowed to invest in the bond markets, making them less of a playground for the big government banks. And interest rates, which used to be tightly controlled, have had to be loosened to allow banks to compete for investor money in both traditional and nontraditional products.

This episode was based on research done for ADBI by Zhuo Chen of Tsinghua University, Zhiguo He of the University of Chicago and Chun Liu of Tsinghua University.

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