【特集・論文】

The Political Economy of State Capitalism and Shadow Banking in China*

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1. Introduction

The particular expression of state capitalism and shadow banking in contemporary China rests on intersecting political and economic logics with mixed developmental implications. On the one hand, the fortification of state capitalism during the 2000s reinforced systemic tendencies towards capital-intensive growth. On the other hand, the fiscal stimulus of 2008 incentivized new expressions of state sector involvement in off-balance sheet financing. The counterintuitive juxtaposition of these trends presents an opportunity to revisit conventional theories of financial development.

One of the features of state capitalism is state-directed allocation of credit, and indeed, China has maintained a financially repressed environment that has enhanced the profit margins of state-owned enterprises (SOEs). But ironically, the monetary expansion of the late 2000s, coupled with new technologies of finance, have led to a remarkably "liberalized" financial environment, in which both state and non-state actors are involved in shadow banking. Novel forms of Internet financing, wealth management funds, and local government financing vehicles have flourished in the last five years. What distinguishes this pluralization of financial products from financial marketization in other contexts is that it did not result from de-regulation or liberalization of interest rates. Instead, this paper suggests that continued financial repression, *combined with* monetary expansion and new technologies of finance, has fueled shadow banking within the broader context of state capitalism. The case of reform-era China shows that financial development is neither a pre-requisite nor an automatic result of economic growth. This divergence from conventional expectations is largely due to the effects of competing domestic political priorities, coupled with the rapid diffusion of new technology.

2. State Capitalism, Informal Finance, and Shadow Banking

State capitalism in contemporary China has a dualistic structure. On the one hand, through SASAC the state maintains direct ownership

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of assets in strategic sectors of the economy (e.g., defense, energy, telecommunications, finance); and engages in industrial policy to promote priority sectors (e.g., high-end equipment manufacturing, automobiles, bio-tech, alternative energy). The party-state also retains *nomenklatura* control over personnel appointments for top leadership and managerial positions in state firms. On the other hand, much of China's economy operates on market principles. "Downstream" consumer-oriented light manufacturing and export industries are open to competition and dominated by private SMEs and foreign-invested enterprises. In short, China has a mixed economy that is both state-dominated and market-oriented.

Although the preponderance of registered businesses in China are private SMEs that fall within the market portion of this dualistic structure, the term state capitalism is typically used to denote the state's dominant role in key industries. A popular factoid is that the preponderance of Chinese companies on the Forbes 500 list of the world's largest companies are SOEs. Meanwhile, since their IPOs in the mid- to late-2000s, China's "big four" banks have ranked among the largest in the world in terms of market capitalization. In 2013, the Industrial and Commercial Bank of China ranked first, followed by the China Construction Bank (#2), Agricultural Bank of China (#6), and Bank of China (#9). The nexus between the state industry and state capital is further underscored by the finance companies operated by large business groups (*jituan gongsi*). The largest ones include China Petroleum Finance, China Power Finance, Sinopec Finance, China Shipbuilding Finance, SAIC Finance, China Aerospace Finance, and CNOOC Finance.

3. From Informal Finance to Shadow Banking

One of the defining features of state capitalism in China is the system's structural bias towards allocation of capital towards state, collective, and joint stock enterprises. Although over 99 percent of registered firms are small and medium enterprises, SOEs receive over 85 percent of loans extended by state-owned commercial banks, and account for over 60 percent of publicly listed businesses on China's stock markets. As a result, the domestic private sector has faced challenges in securing commercial bank loans, and raising funds from domestic equity markets.

Since the earliest years of reform, private businesses have relied on a variety of informal financing mechanisms, including those with high rates of interest. A survey of private entrepreneurs during the mid-1990s found that nearly two-thirds had used some form of informal finance. More recent research indicates that reliance on unofficial financing mechanisms has not abated. Indeed, the scope of informal finance has expanded into the broader universe of shadow banking, which involves not just private entrepreneurs, but middle-class professionals seeking wealth management products and local governments facing unfunded mandates and incentives to demonstrate economic development. Arguably, the contemporary map of informal finance and shadow banking represents a parallel political economy that complements, and therefore, is just as functionally entrenched as the vested interests in the state sector.

A key reason for this functional entrenchment is because most forms of informal finance and shadow banking are not technically illegal. Within China's context, informal finance refers to a range of financing, savings, and investment vehicles that are not sanctioned by the People's Bank of China (PBC). This definition leaves room for the reality that various types of informal financing arrangements and non-banking financial institutions are either registered with other official entities?or quietly condoned because they provide financial services to underserved local markets. In other words, "not sanctioned" by the central bank does not mean that they are explicitly banned. The latter typically occurs only when a particular type of financing mechanism triggers a local financial crisis. Categorizing the expressions of informal finance according to their relative degree of institutionalization provides a proxy for their relative visibility to officials.

At the least institutionalized end of the spectrum of informal finance, interest-free, uncollateralized loans among friends, families, and business associates are commonplace and do not attract official attention. Similarly, extending trade credit (supplying merchandise prior to payment) is a standard operating practice among private vendors. Borrowing from individual money lenders and money brokers (called *qian zhuang, yinbei, or dui deng zhe*) sometimes with high rates of interest and use of collateral, is also common among business owners.

Some forms of informal finance come with written terms and greater organizational complexity, as with various types of rotating credit and savings associations (ROSCAs or *hui*), which are primarily found in southeastern provinces. Other types of unregistered, quasi-institutionalized informal finance include nongovernmental investment alliances and reciprocal loan-guarantee networks.

Within the more institutionalized end of the spectrum are a host of non-banking financial institutions that may be registered with the Industrial and Commercial Management Bureau or other official entities. These include pawnshops, trust and investment companies, leasing companies, credit guarantee companies, microfinance companies, rural credit unions, and financing arms of registered companies. Underground money houses may or may not be conducted through commercial operations registered in the guise of a legitimate non-financial business; but either way, they are not legal.

In addition to reinforcing the types of informal finance used by private entrepreneurs and investors, China's massive 2008 stimulus plan fueled the rapid expansion of shadow banking among government entities. The Financial Stability Board (2013) defines the shadow banking system more broadly as "the system of credit intermediation that involves entities and activities fully or partially outside the regular banking system, or non-bank credit intermediation in short." In China's case, shadow banking includes the types of informal finance discussed above, but has come to be associated more closely with local government debt and wealth management products in the last several years. Between 2008 and 2010, the central government's original 4 trillion RMB ($586 billion) package ultimately raised 12 trillion RMB in funds, primarily through shadow bank lending to local governments. Local government financing vehicles (LGFVs) became the primary channel through which sub-national governments financed public goods and large-scale infrastructure projects. They also (over)invested in other types of capital-intensive industries such as real estate, mining, shipbuilding, solar energy, and steel. By 2011, it was clear that the stimulus had contributed to excess capacity in these industries, which meant that many local governments faced cash-flow challenges in meeting debt service obligations and repaying short-term loans. A national audit revealed local government debt had reached 17.9 trillion yuan ($2.9 trillion) by mid-2013.

Besides contributing to expansion in local government debt, the stimulus incentivized banks, SOEs, and state-affiliated entities with ready access to bank credit to provide loan guarantees for private borrowers. They also extended loans to real estate developers and private businesses through trust companies. In turn, trusts connected to state banks issued wealth management products (WMPs) to investors seeking higher returns than the 3.3 percent deposit rates in regular savings accounts. As of May 2014, the China Banking Regulatory Commission (CBRC) reported that banks held 13.97 trillion yuan ($2.2 trillion) in outstanding WMPs through trust companies.

Finally, the stimulus coincided with the spread of Internet access and social media in China. By 2014, over 60% of China's online population had used internet financing products. The main types of Internet and mobile finance include the following:

1) *Third-party payment services:* Enable online consumers to make payments to merchants.
2) *Crowdfunding:* Mobilize online contributions to support charitable causes and commercial start-ups.
3) *Peer-to-peer (P2P)* platforms: Broker online loans between businesses seeking funding and ordinary lenders and investors.
4) *Online wealth management products (WMPs):* Offer investment products to clients of state banks and trust companies.
5) *Online insurance services:* Offer insurance to Internet sellers and buyers on potentially disputed transactions.
6) *Online securities platforms:* Enable clients to trade stocks and bonds online.

Due to its unregulated character, Internet finance is also regarded as part of shadow banking in China. Since the late 2000s, one of the fastest growing segments of Internet finance is online lending in the form of peer-to-peer (P2P) networks that bypass the banking system. Also called "person-to-person" lending, P2P platforms match lenders and borrowers who are typically unknown to one another, and perform credit checks on the borrowers in a more streamlined manner than banks. By August 2014, there were 1,350 P2P sites in China with an annual transaction volume of over 100 billion yuan.

Despite continuing private sector demand for loans from trust companies and higher returns from WMPs and P2P platforms, shadow banking carries risk to the entire network of participants. The subprime crisis in the United States provided a particularly vivid demonstration of how initial losses associated with a novel, under-regulated product—mortgage-backed securities—could catalyze devastating effects reverberating into the global economy. Indeed, a similar logic has already triggered a number of local shadow banking crises within China, as shown in three examples that are presented in the full-length paper. The first demonstrates the risks associated with networks of reciprocal loan guarantees; the second discusses wealth management products offered by trusts; and the third case concerns the recent proliferation of P2P lending portals.

There are other examples of shadow banking that carry risk to the formal financial system and the participants who have turned to informal finance. These risks derive from the structural constraints of state capitalism and financial repression. Private entrepreneurs have engaged in financial arbitrage between state-mandated ceilings on interest rates on the one hand, and market demand for SME financing and higher returns on savings, on the other. If China's commercial banks were not state-dominated and extended loans on the basis of market potential, then interest rates on both savings and lending rates would approach the curb market rates of 15 to 20 percent on deposits, and an additional margin of five to ten percent on short-term loans. Instead, shadow banking has flourished, and expanded significantly in volume since the 2008 fiscal stimulus.

In 2012, estimates on the scale of shadow banking in China ranges from an estimated 26 to 69 percent of the country's GDP, and nearly half of shadow banking activity involves off-balance sheet activities of official state banks. The rapidity of its expansion since 2010 (when banks reduced lending) and on-going cases of financial failure in the sector has raised concerns about inadequate/absent supervision. As such, in early 2014, the State Council issued Document No. 107 to outline a framework for ensuring that each of the specific forms of shadow banking is subject to regulation by a specific agency or institution.

Then in May 2014 the PBC, CBRC, and three other financial authorities jointly issued a Notice on Regulating Interbank Business of Financial Institutions ("Notice No. 127"), which outlines an initial framework for regulating interbank lending. The CBRC concurrently issued a supporting Notice No. 140 on Regulating the Governance of Interbank Business of Commercial Banks. These notices represent an unusual degree of coordination on the part of PBC and CBRC. Ever since the establishment of the CBRC in 2003, the two ministerial-level bureaucracies have co-existed in tension, if not mutual distrust. The PBC's official mandate is monetary policy, while the CBRC is charged with bank supervision. In practice, however, the PBC and CBRC have overlapping areas of jurisdiction and may support divergent approaches in dealing with informal finance and new technologies, such as P2P lending and on-line banking. But bureaucratic politics provides only a partial explanation for why shadow banking has flourished in a regulatory void. The next section examines the political and institutional nuances of reforming shadow banking within the broader context of state capitalism.

4. The Political and Institutional Nuances of Reform

A core challenge to deepening market reform is the fact that both SOEs and state banks are vested in financial repression. The maintenance of a wide spread between the ceiling on savings deposit rates and a floor on bank lending rates has enabled banks to generate substantial profits. By the same token, SOEs and other large businesses have benefited from subsidized credit. The private sector's reliance on informal finance and the expansion of shadow banking involving participation by state entities is a direct result of financial repression. Much of China's real estate boom can also be traced to financial repression, given the combination of subsidized credit and savers seeking higher returns.

The segments of China's political economy that stand the most the lose with interest rate liberalization and opening of previously restricted sectors to private investment would be the "middle class" beneficiaries of state capitalism. Pillar industries (such as finance, petroleum, energy, steel, petrochemicals) have thrived under a host of financial, fiscal, and production benefits. Increases in the cost of credit, the amount of taxes remitted to the center, and price of inputs would diminish profit margins under current operating conditions. State banks and SOEs in select industries would be exposed to greater competition by private entrepreneurs and investors. In addition, the rate of non-performing loans in state banks, while low compared to the late 1990s, would continue to rise and require writing off bad assets.

The other major group of vested interests are local governments who developed reliance on LGFVs over the last five years. LGFVs provided a means for local governments to match central stimulus funds by investing in local real estate and infrastructure projects, and financing various public goods. This fiscal dimension of shadow banking will be challenging to dismantle as LGFVs need to be systematically regulated (if not dismantled). But campaign-style financial rectification targeting various forms of informal finance has occurred on a reactive, as-needed basis during the reform era. Meanwhile, the Ministry of Finance is planning to develop a regulated framework for local borrowing, starting with experimental municipal bond markets.

5. Conclusion

This paper proposes that China's response to global financial crisis disrupted the preceding equilibrium of financial dualism under state capitalism. Unprecedented expansion of bank lending after 2008 created opportunities for a host of state economic actors—including SOEs, state banks, and local governments—to expand their participation in off-balance sheet activities. Yet the resulting vibrancy of the shadow banking markets did not result from financial deregulation. Financial repression remains. Instead, the government's Keynesian effort to avoid recession inadvertently incentivized the very agents of state capitalism to partake in shadow banking. The concomitant spread of Internet and social media fueled an equally unexpected "liberalization" in the technologies of and participants in informal finance. Middle class savers are investing in wealth management products through mobile devices, and those same products are being invested in a variety of private business ventures promising high returns. State capitalism and shadow banking have now intersected and developed areas of mutual dependence, or more accurately, mutual liability.

The risks associated with such mutual liability are not trivial. The increased engagement of public sector actors in shadow banking practices means that crises in informal finance are less likely to be contained to a particular locality or network of private business owners because both banking and non-banking financial institutions are engaged in off balance sheet transactions that are supposedly collateralized by state assets and real estate.

During the March 2014 NPC, the Premier announced various reform measures, which if implemented, would erode the edges of state capitalism and reduce some of the risks associated with shadow banking. These include deepening SOE reform, increasing market access in the services sector, establishing private small- and medium sized banks, and setting up channels for the issuance of debt by local governments.

Xi Jinping's strategy towards governance has been decidedly centralizing, disciplinary, and repressive thus far. He has appointed himself to three major new committees overseeing national security, restructuring and the internet. Meanwhile, the vigorous anti-corruption campaign has reached senior leadership in the petroleum industry (Jiang Jiemin and Zhou Yongkang); and internet and media controls, including expulsion of foreign journalists, has intensified. In this cyber-networked milieu, such threats heighten speculation about the leadership's underlying political motives. The casualties of contemporary campaigns can no longer be re-packaged in a bubble with a time lag, as they were during the Mao era. Despite censorship efforts, electronic networks communicate, define, and re-shape the message instantaneously. As Chen Yun warned earlier, "Corruption will destroy China, but fighting corruption will destroy the Party."

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The Xi-Li administration faces the dual challenge of managing state capitalism and shadow banking as China enters a phase of more moderate economic growth. During China's first three decades of reform, private sector development occurred in parallel with prioritization of state-owned enterprises in strategic industries, and growth surged. This pattern of state capitalism rested on an unarticulated bifurcated financing arrangement whereby the formal banking system primarily served public enterprises, while private businesses relied primarily on informal finance. However, China's response to global financial crisis disrupted the preceding equilibrium of financial dualism under state capitalism. Unprecedented expansion of bank lending after 2008 created opportunities for a host of state economic actors—including SOEs, state banks, and local governments—to expand their participation in off-balance sheet activities. Yet the resulting vibrancy of the shadow banking markets did not result from financial deregulation. Financial repression remains. Instead, the government's Keynesian effort to avoid recession inadvertently incentivized the very agents of state capitalism to partake in shadow banking. The concomitant spread of Internet and social media fueled an equally unexpected "liberalization" in the technologies of and participants in informal finance. Middle class savers are investing in wealth management products through mobile devices, and those same products are being invested in a variety of private ventures promising high returns. State capitalism and shadow banking have now intersected and developed areas of mutual dependence, or more accurately, mutual liability. China's present leadership has thus signaled intentions to curb the scope of state capitalism and shadow banking, including official corruption associated with both. These efforts, however, face a variety of political and institutional challenges.