

RESEARCH PROJECTS 2015

Project Title

A Model of China's Shadow Banks and Market Determined Interest Rate Reform

Principle Investigator(s)

Xi Li

Assistant Professor, Department of Accounting

Co-Investigators(s)

Yikai Wang

Assistant Professor, Department of Economics, University of Oslo

Tong Zhang

PhD Candidate, Department of Economics, University of Zurich

Fabrizio Zilibotti

Professor (Chair) of Macroeconomics and Political Economy, Department of Economics University of Zurich

Abstract

We plan to develop a dynamic general-equilibrium model to show that the lack of market determined interest rates is critical in explaining the rapid rise of the unstable shadow banks and a range of related misallocation about China's economy: lower real interest rates do not stimulate consumption, consistent asset bubbles, the liquidity trap through which funds cannot go to small and medium enterprises and private owned enterprises (POEs) but instead go to high risk sunset industries, economic imbalance in terms of overreliance on investment, state owned enterprises' (SOE) predatory acquisitions of POEs. We show the importance of a specific sequence for interest rate reform, which so far has not been adopted by Chinese government and thus leads to even bigger misallocation that that if China has not conducted the current partial interest reform. Specific policy recommendations and other macroeconomic implications of this model and for other emerging economics are discussed.

