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HKUST IEMS Working Paper No. 2015-25

May 2015

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Abstract
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.

KEYWORDS: China, state capitalism, informal finance, shadow banking, financial development

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*A copyedited version of this paper will be published in *Issues & Studies*, Vol. 51, No. 2 (June 2015).

> Strong political power is necessary to push through reforms. In the first phase of reform, everyone was poor and it wasn't as hard to rally the factions around reform.
>
> - Government researcher, Beijing, December 2013

> The recently opened informal finance street in Chengdu is amazing. This is the time to invest in it before regulation sets in to constrict entrepreneurial opportunities.
>
> - Private entrepreneur, Beijing, February 2014

> We will show zero tolerance for corrupt behavior and corrupt officials. No matter who it is, or how senior their position, everyone is equal before the law.
>
> -Premier Li Keqiang (李克強), post-NPC press conference, March 2014

One of the enduring ironies in the study of political economy is that once-identified ingredients for developmental success can evolve into the very barriers for further growth. In the late 1990s, for example, the East Asian financial crisis turned the much-admired East Asian developmental state model into a popular critique of crony capitalism (Evans, 1995; Kang, 2002). More nuanced analysis appreciates, however, that the variables underlying identified models of economic development are dynamic rather than static. Structural changes, both domestically and globally, can render an earlier "formula" for growth anachronistic and ineffective. A basic question is whether states recognize those environmental changes, and adapt national policies to accommodate new realities *prior* to a major crisis that forces the issue. China is arguably at such a pre-crisis critical juncture.

Leaders in Beijing face the challenge of deepening economic reforms as China enters a phase of more moderate economic growth. Other middle-income countries have faced similar dilemmas (Eichengreen, Park, & Shin, 2013). This paper proposes, however, that the emergence of shadow banking within the broader context of state capitalism distinguishes China's transition economy from those of its regional neighbors. 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). However, ironically, the monetary expansion of the late 2000s, coupled with new technologies of finance, has 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 the 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 complex incentives underlying these trends in China’s contemporary political economy provide an opportunity to contribute to enduring debates about the relationship between economic and financial development. In brief, the case of reform-era China shows that financial development is neither a pre-requisite for 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.

The paper proceeds as follows. The first section reviews the dominant analytic frameworks for understanding the political economy of economic and financial development. Extant theories rarely combine the synergistic impact of political, institutional, and technological variables in mediating financial intermediation. The second part reviews the parallel rise of state capitalism and shadow banking in China. To understand why they have now appeared on the reform agenda, the third section delineates the types of informal finance and their associated risks. The fourth part points to the political and institutional nuances associated with curbing state capitalism and shadow banking, two pillars of China’s “partial reform equilibrium trap” (Hellman, 1998). The conclusion reflects on the present leadership’s strategy for reform in the context of how previous PRC leaders have dealt with vested interests in their reform efforts. Although reform-era China has been analyzed as a successful example of endogenous institutional change, reforming certain sectors of state capitalism and shadow banking is likely to encounter greater political resistance than earlier reforms; and therefore requires a more proactive stance towards managing adaptive informal institutions. Relying on heightened coercion, however, may alienate potential allies of reform, especially as the anti-graft campaign spirals up to senior leadership.

Revisiting Financial Development and Economic Growth

Long-standing debates concerning the relationship between financial development and economic growth fall into four general categories: 1) *causal sequence*; 2) *functionality*; 3) *institutional context*; and 4) *interest group politics*. The case of China can be analyzed through hypotheses generated from each of these approaches, but ultimately the institutional and interest group approaches provide a more substantive foundation for explaining the rise of shadow banking under state capitalism—as well as the related reform challenges.

A vast literature has accumulated on the *direction of causation* between growth and financial development. For the present purposes, the latter may be defined as, "the factors, policies, and institutions that lead to effective financial intermediation and markets, as well as deep and broad access to capital and financial markets" (World Economic Forum, 2011). Classic contributions by Schumpeter (1912), Gurley and Shaw (1960), Gerschenkron (1962), Cameron, Crisp, Patrick, and Tilly (1967), and McKinnon (1973) emphasized the importance of financial development for economic growth. Several cross-national studies have reached similar conclusions (e.g., Demirgüç-Kunt and Masimovic, 1998; King and Levine, 1993; Rajan and Zingales, 1998). Others disagree, contending that financial development results from economic growth rather than the other way around (Friedman & Schwartz, 1963; Kuznets, 1955; Robinson, 1952). A third group of studies finds that financial and economic development occurs concurrently in a mutually reinforcing manner (Wai and Patrick, 1973). Based on standard proxies for financial development such as the ratio of private credit to GDP and stock market efficiency, China's experience shows that rapid economic growth is indeed possible even with a low level of financial development. As discussed below, however, the state sector has received the preponderance of credit from China's bank-dominated financial system.

Rather than debating directional causality, the *functional approach* to the study of finance examines the extent to which any given financial system fulfills core functions that affect economic growth. In particular, Levine (1997) delineates five key functions, including resource allocation, risk management, exertion of corporate control, savings mobilization, and facilitating the exchange of goods and services. These functions, in turn, influence growth through two channels, capital accumulation and technological innovation, respectively. China has succeeded in capital accumulation and its financial system performs the five basic functions to varying degrees of effectiveness. However, Levine (1997) himself acknowledges that the functional approach does not incorporate the impact of policies in mediating the five functions. China's monetary, regulatory, and industrial policies all play a

central role in shaping the financial system. Moreover, political considerations underlie the formulation and implementation of these policies.

In the third, *institutional approach*, the main locus of debate concerns the relative explanatory weight of historical legacies in shaping contemporary institutions. An influential finding in the law, institutions, and finance literature is that countries with a Common Law tradition provide stronger protection to minority investors, have more developed equity markets, and are more financially developed in general (La Porta, Lopez-de-Silanes, Shleifer, & Vishny, 1997, 1998). In response, Haber, North, and Weingast (2007) discount the weight of British colonial origins and emphasize instead the correlation between liberal political institutions and the "openness and competitiveness" of financial systems. The institutional approach is valuable in demonstrating the importance of legal, political, and regulatory institutions in historical context. However, even the accounts that highlight political institutions do not address contemporary political realities that mediate financial development. Such political mediation may be constraining or enabling.

In contrast to the preceding explanations, the *interest group politics* approach focuses on the political impact of economic interests affected by the financial system. Originally coined by Stigler (1971), the concept of "regulatory capture" has been extended to the ability of financial industry groups to shape the regulatory environment to their advantage (e.g., Baker, 2010; Pagliari, 2012). Relatedly, Rajan and Zingales (2003) observe that dominant interest groups generally oppose financial development because financial markets introduce competition by new entrants, thereby posing a threat to incumbents. However, such political pressures can be overcome in economies that are more open to international trade and capital, given the potential benefits of greater access to external sources of finance. Within the study of international political economy, the problem of regulatory capture by domestic financial interests has been extended to de facto collusion by transnational networks of financial technocrats who are entrusted with regulating international finance (Helleiner & Porter, 2010). A more nuanced interest group framework for explaining the politics of financial regulation suggests that non-financial sectors such as NGOs, labor, and consumers may be mobilized by different factions of financial industry groups (Pagliari & Young, 2014). Political competition among financial groups for support by non-financial ones introduces greater plurality to the lobbying process, and raises the possibility that non-financial groups themselves may counter-mobilize for tighter financial regulation.

Taken together, the institutional and interest group approaches provide a basis for understanding contemporary reform dilemmas associated with sustaining economic growth

and curbing the risks of shadow banking. Although China has an authoritarian regime, lobbying among business groups occurs through various formal and informal channels (Kennedy, 2009). Formal channels include working through trade and business associations; providing feedback to the All-China Federation of Industry and Commerce; and lobbying National People's Congress deputies. For those with personal connections to officials, informal lobbying is more common (Tsai, 2007, pp. 118-122). This is not to say that interest group politics is readily gleaned through associational activity or access to high-level officials, but rather that economic reforms face political constraints. The next section explains the nature of these constraints as the financial environment supporting state capitalism has evolved over time.

State Capitalism, Informal Finance, and Shadow Banking

Students of China's reform-era political economy are well acquainted with defining features of its reform process since the late 1970s—namely, gradualism and experimentalism; politically strategic sequencing; openness to foreign direct investment; and financial repression. This approach to reform corresponded with historically high rates of economic growth for three decades. The stimulus policies enacted in response to the 2008 global financial crisis also seemed to vindicate the relative benefits of China's particular mode of state capitalism, or the so-called Beijing Consensus (Ramo, 2004). However, it is now apparent that the stimulus policies also reinforced rent seeking in the public sector and introduced incentives for local governments to incur alarmingly high levels of debt through unofficial financing vehicles. The thirty-year anniversary of reform, 2008, may well become another defining date in staged-analyses of China's economic reform history. To appreciate why that may be the case, this section briefly reviews the core elements of the first three decades of reform, followed by conceptual and empirical definitions of state capitalism and shadow banking.

First, unlike socialist counterparts in the Soviet Union and Eastern Europe that turned abruptly to economic shock therapy, China's leaders adopted a more gradualistic and experimental approach towards economic liberalization (Naughton, 1996). There was never an overarching blueprint for what the post-Mao Chinese economy was intended to become. Indeed, the government continues to avoid the term "privatization" to describe the transfer of public assets to private individuals and entities.

Second, reforms were sequenced in a way that created early winners (e.g., farmers, rural industry, coastal areas, individual entrepreneurs), while delaying reforms that would threaten those privileged during the socialist-era (state-owned enterprises, heavy industry)

(Shirk, 1993). It took two decades before the 15th Party Congress in 1997 mandated the restructuring of all small and medium SOEs, which were primarily run by provincial and city/county governments. Although there was local variation in the timing and implementation of this restructuring, within four years, 85 percent of all SOEs had been merged, sold, or closed down (Zeng, 2013). The casualties in this process were primarily laid-off workers, while most SOE managers and local officials prospered. The State Assets Supervision and Administrative Commission (SASAC) was established in 2003 to manage the remaining largest SOEs in priority sectors, which had been restructured strategically to enhance their profitability. As of 2014, there were 117 state corporations under SASAC (http://www.sasac.gov.cn). Many are large multi-tiered business groups with opaque cross-shareholding structures.

Third, in contrast to post-war Japan, Korea, and Taiwan, China has been far more open to foreign direct investment (FDI) since the outset of reform. Since 2002 China has been among the top three destinations of FDI in the world. To be sure, key sectors remain restricted to external investment; nonetheless, FDI has played a defining role in fueling the economy's export industries. Exports from foreign-invested enterprises have accounted for over half of China's total exports since 2000 (Romei & Minto, 2012). This openness to FDI distinguishes China from the earlier East Asian developmental state pattern of insulating domestic manufacturers from external competition (Hsueh, 2011; Kroeber, 2013). Openness to FDI was intended in part to facilitate technology transfer from more advanced economies; and the strategy has been effective in that regard (Liu & Wang, 2003). However, the centrality of FDI has also been associated with structural issues in China's political economy, including "delayed democratization" (by dividing the working class) (Gallagher, 2002), and bias against the domestic private sector (Huang, 2008).

Fourth, financial repression—meaning governmental suppression of interest rates below market levels—represents a core feature of China's reform-era growth. In effect, household savings earning low rates of interest have been transferred through the banking system to supply subsidized credit to SOEs, capital-intensive industry, and real estate developers. The private sector's resulting reliance on informal finance is worth detailing because it represents a complementary, yet underanalyzed outgrowth of state capitalism. However, first, some operational definitions are in order.

From State Socialism to State Capitalism

The term "state capitalism" has ideologically charged connotations. Coined by Lenin to describe his New Economic Policy, it was later appropriated by socialist critics of Stalinist

rule who observed exploitation of labor in the Soviet Union's SOEs, as in capitalist firms (Tsai & Naughton, 2015). From the other end of the political spectrum, neo-liberals have used state capitalism pejoratively to describe state-led, market-distorting patterns of political economy (Bremmer, 2009). This paper employs the term in a neutrally descriptive way to distinguish China's particular expression of state capitalism from both its earlier model of state socialism, and the Anglo-Saxon ideal type of liberal capitalism.

Specifically, state capitalism in contemporary China has a dualistic structure. On the one hand, through SASAC the state maintains direct ownership 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. Others have described this hybrid state-market arrangement as "centrally managed capitalism" (Lin, 2011), "Sino-capitalism" (McNally, 2012), and "Chinese market-liberal state capitalism" (ten Brink, 2012).

Although the preponderance of registered businesses in China are private SMEs that fall within the market portion of this dualistic structure,[1] the term state capitalism is typically used to denote the state's dominant role in key industries. For example, Ian Bremmer (2009)'s critical popularization of the term describes it as "a system in which the state functions as the leading economic actor and uses markets primarily for political gain." He notes that the primary actors in state capitalism are "national oil corporations, state-owned enterprises, privately owned national champions, and sovereign wealth funds (SWFs)." Along these lines, a popular factoid is that the preponderance of Chinese companies on the Forbes 500 list of the world's largest companies are SOEs.[2] Among the top ten are Sinopec (#4), China National Petroleum Corporation (#5), and State Grid (#7) ("World's 500 Largest Corporations," 2013). Others on the list are vertically integrated corporate groups with complexly networked tiers of state-invested business groups and party-state stakeholders (Keister, 2000; Lin & Milhaupt, 2013). Taken together, at their peak the SOEs under SASAC

[1] In 2013 there were 44.36 million registered individual businesses (*getihu*, 個體戶) and 12.54 million registered private enterprises (*siying qiye*, 私營企業) (*Xinhua*, February 28, 2014).
[2] Out of China's 95 firms on the list in 2013, 89 are state-owned.

accounted for 62 percent of GDP in 2010. By 2013, however, the private sector accounted for 60 percent of GDP.

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) ("World's Largest Banks 2013," 2014). Although these banks are publicly traded, the state remains the dominant shareholder; and loans to SOEs dominate their lending portfolios.

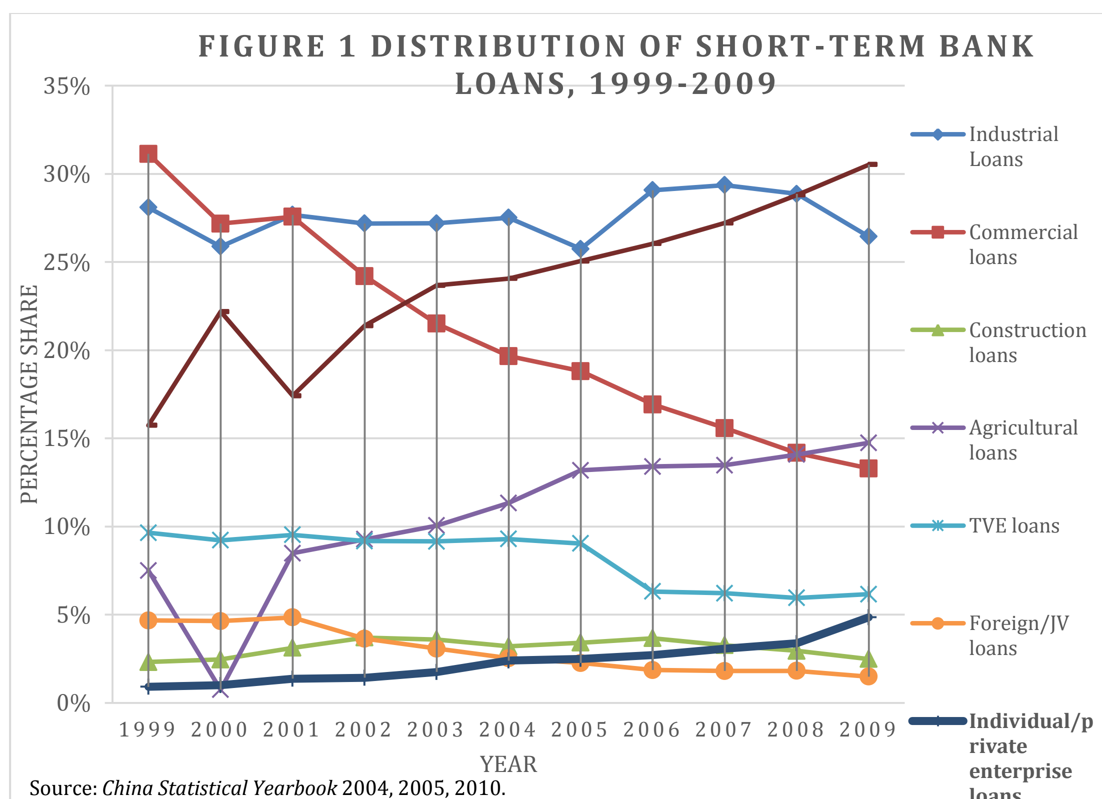
The nexus between the state industry and state capital is further underscored by the finance companies operated by large business groups (*jituan gongsi*, 集團公司) (Lin & Milhaupt, 2013, pp. 715-720). To qualify for registration as a business group, the parent company needs to have a minimum registered capital of 50 million RMB and at least five subsidiaries whose combined registered capital reaches a minimum of an additional 50 million RMB. Registered groups are permitted to operate finance companies that provide a variety of investment and commercial banking services to group members. The primary source of funds for the finance companies is deposits from member companies; in turn, the finance companies facilitate inter-company lending, underwrite securities, provide foreign exchange services, and offer consumer finance. With the exception of Haier Group Finance and a handful of others, finance companies are members of state-owned business groups at the national or provincial level. The largest ones include China Petroleum Finance, China Power Finance, Sinopec Finance, China Shipbuilding Finance, SAIC Finance, China Aerospace Finance, and CNOOC Finance (SASAC, 2011).

Table 1. Dualism of State Capitalism in China

State Sector	Market Economy
• SASAC directly owns 117 SOEs in strategic sectors • The CCP appoints top SOE managers • Top 10 on Forbes 500 list includes Sinopec (#4), CNPC (#5), and State Grid (#7) • Supported by Big 4 state-owned commercial banks: ICBC, CCB, ABOC, BOC • Declining rates of profitability since 2008 • Dominates listed companies on domestic stock exchanges	• Over 99% of businesses are private small & medium enterprises and foreign-invested enterprises • Downstream consumer-oriented light industries, manufacturing, & export industries are open to competition • Private sector accounted for 82% of employment in 2013 • Private sector generated 60% of GDP in 2013 • Receives less than 20% of bank loans • Relies on informal finance at market rates of interest

From Informal Finance to Shadow Banking

One of the defining features of state capitalism in China is the system's structural bias towards the allocation of capital to state, collective, and joint stock enterprises. In the East Asian developmental state, bank loans were allocated preferentially to the most dynamic export-oriented industrial sectors, and private firms in these sectors benefited from directed state credit (e.g., Amsden 1989; Johnson 1982). By contrast, China has pursued a combination of SOE restructuring and financial repression to support strategic state assets. 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 in 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. (Figure 1 below shows the small share of bank loans extended to private businesses.)



Source: *China Statistical Yearbook* 2004, 2005, 2010.

Since the earliest years of reform, private businesses have relied on a variety of informal financing mechanisms, including those with high rates of interest.[3] A survey of private entrepreneurs during the mid-1990s found that nearly two-thirds had used some form of informal finance (Tsai, 2002, pp. 55-57). More recent research indicates that reliance on unofficial financing mechanisms has not abated. For example, a 2012 survey of SMEs in fifteen provinces found that 57.5 percent had participated in informal credit markets (Li & Hu, 2013). 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 is therefore just as functionally entrenched as, the vested interests in the state sector.

A key reason for this functional entrenchment is that most forms of informal finance and shadow banking are not technically illegal. Within China's context, informal finance

[3] Of course informal finance in China not only pre-dates the reform era, but has been traced back to the emergence of the private lending contract in the Xi-Zhou Dynasty (1046 BC). For a brief overview, see S. X. Jiang (2009).

refers to a range of financing, savings, and investment vehicles that are not sanctioned by the People's Bank of China.[4] 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 (Tsai, 2002).

Table 2. "Traditional" Forms of Informal Finance
(1980s through mid-2000s)

Least Institutionalized	*Semi-Institutionalized*	*Institutionalized*
• Interest-free uncollateralized lending among friends, family, & businesses • Trade credit among businesses • Money lenders & money brokers (with interest & collateral)	• Rotating savings and credit associations (會) • Non-governmental investment alliances • Reciprocal loan guarantee networks	• Pawnshops • Trust & investment companies • Credit guarantee companies • Microfinance companies • Rural credit unions • Mutual aid societies • Financing branches of companies

Note: Informal finance has a long history in China, dating back to the Xi-Zhou Dynasty (1046 BC). This table focuses on the re-emergence of informal finance during the reform era.

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 (Yano & Shiraishi,

[4] Scholars have also referred to informal finance as "unobserved finance" and "underground finance," which is further divided into "gray finance" and "black finance" (Li, 2006).

2012). Borrowing from individual money lenders and money brokers (called *qian zhong, yinbei*, or *dui deng zhe*, sometimes with high rates of interest and the 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. In ROSCAs, group members contribute a set amount each month and take turns in collecting the pot. The manner in which the pot is rotated and the calculation of interest rates may be determined by relative need, lottery (*biaohui*), or more complicated calculations of compounded interest (*paihui, taihui*). Traditional ROSCAs comprising networks of individuals known to one another typically function smoothly, but larger ones involving unsustainable promised rates of return have collapsed and triggered official intervention. 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,[5] 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. (See Figure 2 and Table 3.) The term "shadow banking" gained prominence in 2007 in the context of non-bank financial institutions in the United States that engaged in "maturity transformation" by using short term funds (e.g., deposits) to finance longer term assets (Kodres, 2013). 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

[5] In 2008, microfinance companies were jointly recognized and legalized by the People's Bank of China and China Banking Regulatory Commission. Since then, over 5,000 microfinance companies have been established and are managed by the Finance Office of local governments.

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 ("Parent of China," 2014). Although local governments have been prohibited from incurring debt since the 1994 fiscal reforms, over 10,000 loosely regulated local finance companies sprang up to broker off balance sheet loans between state banks and local governments that offered revenues from land sales and real estate as collateral.

Table 3. Rise of Shadow Banking and Internet Finance
(since 2007)

Type	Examples	Estimated Scale
Local government financing vehicles (LGFVs)	>10,000 established by local governments	¥17.9 trillion (June 2013) (a)
Wealth Management Products (WMPs)	>400 banks issue 50,918 types of WMP	¥13.97 trillion (May 2014) (b)
Internet finance		
3rd party payment services	Alipay (2004), Tenpay (2006)	¥5.37 trillion (c)
Crowdfunding	DemoHour (2011) DreamMore (2007) FundingDream (2013) Gongyi.net (Tencent)	¥ 30 billion (d)
Peer-to-peer (P2P) platforms	CreditEase.com (2006) Ppdai.com (2007) Renrendai.com (2010) Dianrong.com (2011) Rong360.com (2011) Wangdaizhijia.com (2013)	¥125 billion (e)
On-line WMPs		[sub-set of WMPs]
On-line insurance services	Zhonglebao, Zhong An insurance	¥29 billion (c)
On-line securities platforms	Guotai Junan Securities (2013)	?
On-line money market funds	Yu E Bao (2013)	¥574 billion (July 2014) ¥534 billion (Oct. 2014)

Sources:

(a) PRC National Audit Office (http://www.audit.gov.cn), June 2013.
(b) China Banking Regulatory Commission, 2014.
(c) 2014 中國互聯網金融深度研究報告 (In-depth Research Report on Internet Finance in China).
(d) 中國金融穩定報告 2014 (China Financial Stability Report).
(e) 網貸之家, www.wangdaizhijia.com, Industry Data, accessed 30/10/2014.

These "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. Alarmed by the potential impact on the banking system, in mid-2012 the central government ordered an audit to assess the true extent of local indebtedness. The National Audit Office (2013)'s investigation of 36 local governments in 15 provinces found that they had 3.85 trillion yuan ($624.6 billion) in debt. A subsequent national audit revealed that 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 (WMP) to investors seeking higher returns than the 3.3 percent deposit rates in regular savings accounts.[6] As of May 2014, the China Banking Regulatory Commission 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.

[6] By the second half of 2013, an increasing number of WMPs were offering returns in the range of 5 to 8 percent (M. Zhang 2014).

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 has been 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 ("Parent of China," 2014; Weinland, 2014). The largest ones include CreditEase.com (*Yixin*, over 10 billion RMB in loans), Renrendai.com (2 billion RMB in loans), Ppdai.com (over 1 billion in turnover), Wangdaizhijia.com (Online Lending House), and Dianrong.com (Sinolending, over 100 million RMB in volume).

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 (J. Zhang, 2014). 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 the following three examples. 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.

Loan Guarantee Networks in Zhejiang.

Businesses have a tradition of guaranteeing loans for one another in Zhejiang, which has provided a more favorable environment for private sector development in China since the earliest years of reform. Most of the time, loan guarantees prove to be a mutually beneficial arrangement. When a critical node in the network of reciprocal loan guarantees runs into difficulties, however, financial institutions tend to worry about the viability of loans premised on those guarantees.

In 2008, for example, the bankruptcy of Zhejiang Hualian Sunshine Petro-Chemical Company affected not only the over 8 billion yuan in loans that it owed eight banks, but also all the debt incurred by others that were guaranteed by Hualian (Zhang, Zhang, Shen, Wen, & Zheng, 2012). In total, Hualian had guaranteed over 100 billion yuan in bank loans for enterprises in a provincial-wide reciprocal loan guarantee network. Ultimately, the Shaoxing

government diffused the simmering crisis by transferring half the debt to a SOE, and offered support to businesses in the loan network.

The bankruptcy of Tianyu Construction Company in Hangzhou in late 2011 had a similar effect. Because Tianyu had served as a guarantor for the loans for dozens of local companies, banks throughout Hangzhou started calling the loans that relied on the backing of Tianyu. In total, about 6 billion yuan (nearly $1 billion) in loans affecting over 60 companies were at stake. Provincial leaders were alerted of the impending liquidity crisis. To contain the damage, the Hangzhou government offered to provide bridge loans to companies that needed to repay debts to local financial institutions.

Concurrently, Wenzhou—the locality best-known for informal finance—has been experiencing a credit crisis for the last couple of years. The Wenzhou People's Bank of China estimates that 89 percent of households and 60 percent of businesses in the locality participate in informal financing (Zhang, Zheng, & Zhao, 2011). When bank credit became tighter in the third quarter of 2010, private entrepreneurs and real estate speculators turned to high-interest borrowing from the local curb market. In July 2011, a high profile venture capitalist, Wang Xiaodong, disappeared, leaving behind 1.2 billion yuan in unpaid loans to private lenders. This triggered a crisis of confidence in the curb market and creditors started calling their loans. By September two indebted private entrepreneurs committed suicide, and over two dozen business owners facing payment difficulties fled town, leaving behind large networks of investors and lenders ("Subprime Crisis," 2011). At the beginning of 2012, another 60 indebted business owners left town and local economic growth dipped to 5 percent, the lowest Wenzhou had experienced in over two decades ("China Slowdown," 2012). At the end of 2013, Wenzhou was the only city out of China's major 70 real estate markets where housing prices had declined each month for over two years ("Wenzhou Drops," 2013). Properties are now listed at a 40 to 50 percent lower than during their peak in 2009-10 (Ren, 2013; "Property Speculators," 2014), and stretches of unoccupied and uncompleted buildings were observed during fieldwork in spring 2014.

Meanwhile, in 2011-12, the China Banking Regulatory Committee tightened restrictions on registered credit guarantee companies. Since then, about a third of China's over 5,000 credit guarantee companies have been shut down (J. Zhang, 2014, p. 84). However, Wenzhou has since been selected as a pilot reform zone for private lending through informal intermediaries such as private capital management firms, financial information service firms, and lending service institutions.

Wealth Management Products (WMPs) and Trusts

WMPs offered through trust companies appeal to investors because they offer higher returns than savings deposits in banks; but they also carry risk because, unlike banks, which are required to set aside 20 percent of deposits to protect savers against loan defaults, trusts are not subject to a reserve requirement. In addition, there is ambiguity regarding how the WMP intends to generate "expected returns" because WMPs pool funds that may be invested in trusts, bonds equities, and money market instruments. Investments made by trusts are particularly sensitive to industrial conditions because short-term WMP returns (typically distributed every three months) may be linked to capital-intensive ventures with longer-term payoffs.

In January 2014, for example, China Credit Trust (CCT) warned investors that the "Credit Equals Gold No. 1" product might not be able to make its next payment to investors. (Chang, 2014; "Shadow Banking," February 1, 2014). The Industrial and Commercial Bank of China had marketed CCT's Credit Equals Gold No. 1 to wealthy clients as a product that would generate 10 percent annual returns. CCT then lent 3.03 billion yuan ($496.2 million) to the Zhenfu Energy Group, a private coal mining operation in Shanxi. However, the owner of Zhenfu never obtained a mining license and was arrested for illegally mobilizing deposits from the public. An unidentified entity stepped in to purchase rights to Credit Equals Gold No. 1 and guaranteed repayment of the principal to investors ("China Credit Trust," 2014).

Shortly thereafter, in February 2014 Jilin Province Trust indicated that one of its largest clients, the coal mining Shanxi Liansheng Group, was unable to make its debt payments, which in turn would affect the payout of a product that had raised 973 million yuan (US$160 million) ("China Has 12 mln Private Firms," 2014). The China Construction Bank had offered the product to clients promising annual 9.8 percent returns. Liansheng is now undergoing restructuring, as its total debt exceeds 5 billion yuan to six trust companies. The examples of CCT and Jilin Trust follow on the heels of several dozen other reports in 2013 of trust companies facing liquidity challenges relating to investments in the coal industry. Other trusts were expected to report difficulties throughout 2014 as an unprecedented high level of products, totaling 5.3 trillion yuan, were maturing that year (Chen, 2014).

Overall, assets held by trusts have ballooned since the 2008 stimulus plan. According to the China Trust Association, they grew from less than 1 trillion yuan (US$165 billion) in 2007 to 3 trillion by the end of 2010. Although the CBRC introduced a capital adequacy requirement of 40 percent on trusts in 2010, their assets have continued to expand, expanding

to 10.9 trillion yuan (US$1.8 trillion) by the end of 2013.[7] Trusts now account for approximately 10 percent of total loans outstanding in the financial sector; yet the advertised returns on their products are not guaranteed by the banks that market them.

P2P Lending Platforms

P2P lending has proliferated rapidly in an unregulated environment in the past few years. Between 2012 and 2013 alone, the volume of lending brokered through nearly 1,000 P2P platforms tripled, reaching 68 billion yuan (US$11 billion) (Zhu, 2014). P2P is also attracting attention from venture capital and private equity firms. China's first P2P site, Ppdai.com, was established in 2007 and now reports about two million registered users. It attracted $25 million of Series A financing from Sequoia Capital in 2012 ("Alibaba Finance," 2013). Renrendai.com, established in 2010, received $130 million, the largest single investment in the P2P lending industry, from the private equity firm TBP Capital ("Parent of China,", 2014). Established in October 2011, Rong360.com received $7 million of Series A financing within its first five months of operation, followed by $30 million in Series B financing in 2013 (Xiang, 2013). The "bullish" trend in China's nascent P2P lending market is further reflected in vigorous competition among lenders, which has pushed interest rates on loans up to 20 percent/year (vs. the benchmark one-year lending rate of 6 percent in state banks), and has led firms to promise annual rates of return as high as 48 percent (Xiang, 2013).

While operations such as Renrendai have managed to maintain high repayment rates, Wandaizhijia.com reports that in 2013 over 70 P2P lending portals shut down or froze withdrawals from registered users. Thus far, the largest scale P2P bankruptcy is that of Wangying Tianxia in Shenzhen, which extended over 780 million yuan (about $130 million) in loans between its establishment in March 2013 and collapse seven months later (Rabinovitch, 2014). Lenders were told that Wangying Tianxia's assets were guaranteed by a trust company, but it turned out that the owner of the trust was the same person. Another two high profile P2P failures in Hangzhou and Shanghai have been traced to Wangying's owner. Some cases of P2P bankruptcies have been traced to the fact that the operators were operating ponzi schemes. However, a more prevalent scenario is that operators find themselves enticing investors with high rates of return to make up for short-term liquidity constraints, which unwittingly snowballs into unsustainable payout promises (Hsu, 2014). As of July 2014, an

[7] In 2013, trust assets grew by 46 percent. Financial details about trusts are available at China Trustee Association, at http://www.xtxh.net/hysj/index.html.

additional 45 P2P platforms had ceased operations due to fraud, "with managers making off with the money" ("Regulator Reveals," 2014).

Irrespective of initial motives, the fact that P2P lending is not subject to clear prudential regulation leaves ample room for mismanagement. P2P's financial activities have not been monitored by the Central Banking Regulatory Commission (CBRC), People's Bank of China, or the Industrial Commercial and Management Bureau ("Supervision Urged," 2013)—although the CBRC is expected to issue regulations. Until that occurs, it does not take much capital or experience to set up a P2P lending site. As Du Xiaoshan, Director of the China Microfinance Association points out, "It has become too easy to run a P2P. Anyone can register a company, set up a webpage, and cheat people out of their money" (Interview in Beijing, April 16, 2014).

Space prohibits discussion of many 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 loans 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 of the scale of shadow banking in China ranged from 15 to 30 trillion RMB (US$2.4-4.8 trillion).

Table 4. Estimated Scale of China's Shadow Banking System

Source	Date	RMB trillions	USD trillions	% of 2012 GDP	% of bank assets, 2012
JP Morgan Chase	Dec. 2012	36	6	69%	39%
GF Securities	12/17/2012	30	4.8	57%	31%
Citi Research	1/11/2013	28	4.5	54%	29%
Barclays	Dec. 2012	25.6	4.1	49%	27%
Hua Tai Securities	12/14/2012	25	4.0	48%	26%
UBS	10/16/2012	13.7-24.4	2.2-3.9	26-46%	14-25%
ANZ Bank	Dec. 2012	15-17	2.4-2.7	29-33%	16-18%
Bank of America Merrill Lynch	7/6/2012	14.5	2.3	28%	15%

Sources: *Wall Street Journal*, January 14, 2014; Cindy Li, "Shadow Banking in China; Expanding Scale, Evolving Structure," *Asia Focus*, Federal Reserve Bank of San Francisco, April 2013.

Economist Li Jianjun of the Central University of Finance and Economics has been conducting national surveys on "unobserved finance" for the past decade and estimates that by the end of 2012, the scale of shadow banking assets had reached 24 to 25 trillion yuan (Wang and Li, 2013). (See Table 5.)

Table 5. Distribution of Shadow Banking Assets in 2012

Asset Type	Amount (RMB trillions)
Wealth Management Products (in trusts & banks)	7
Asset-backed securities, repos, & money market funds	3
Shadow banking activities in Big 4 banks (asset management, trusts, financial leasing)	10
Informal finance (credit guarantee companies, pawn shops, investment companies)	3-4
Other underground financing (private money houses, money brokers, business association financing, etc.)	.5-1
TOTAL	24-25

Source: Wang and Li (2013), cited in nt. 55.

In short, 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. To put things in comparative perspective, the total for shadow banking assets around the world accounted for 110 percent of global GDP in 2011, and accounts for a larger proportion of national GDP in the US, where shadow banking accounted for 152 percent of GDP in 2011; and the UK, where it accounted for 370 percent of GDP in 2011 (Li, 2013). In other words, the relative scale of shadow banking in China is much more modest compared to that of advanced industrialized economies. The forms of shadow banking also differ. China's shadow banking activities entail direct lending and are often linked to banks, while shadow banking in the US is dominated by complex derivatives such as securitized loans, asset-backed commercial paper, repurchase agreements, and money market funds (Li, 2013).

Despite the comparatively modest scope of China's shadow banking sector, the rapidity of its expansion since 2010 (when banks reduced lending) and on-going cases of

financial failure in the sector have raised concerns about inadequate/absent supervision. As such, at the beginning of 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. Document No. 107 is meant to apply to: 1) "unlicensed, unregulated credit intermediation" (e.g., online finance companies); 2) "unlicensed but lightly regulated credit intermediation" (e.g., credit guarantee and microcredit companies); 3) "licensed but insufficiently regulated financing activities (including those conducted by money market funds, informal finance securitization, and some wealth management businesses" (Badkar, 2014). If implemented, No. 107 would empower the People's Bank of China (over the China Banking Regulatory Commission, CBRC) by granting it leadership over the Financial Stability Coordinating Committee, an interagency group recently formed to oversee shadow banking activities (Wei & Davis, 2014).

Meanwhile, 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 the 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. Nonetheless, 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.

The Political and Institutional Nuances of Reform

When political scientists (and politicians, for that matter) refer to "vested interests" as posing a challenge to reforming the status quo, they generally mean the economic and political elites who derive disproportionate benefit from existing policies and institutions (cf. Rajan and Zingales 2003). From the outset of China's reform era, it was apparent that the state sector, including capital-intensive industries such as oil and steel, were vested interests from the Mao era. Joel Hellman's now-classic discussion of the "partial reform equilibrium

trap" in transitional economies hones in on recent beneficiaries of reform who oppose deeper reforms that may threaten those recently acquired gains (Hellman, 1998; Pei, 2009). In the former-Soviet Union, privatization of SOEs gave rise to industrial monopolies and oligopolies that then lobbied the government for various privileges. In the case of China, the directors and top-managers of SASAC-managed SOEs fall squarely into the category of reform beneficiaries—albeit with socialist-era roots. Officials in centrally administered SOEs are (politically) appointed by the Organization Department of the CCP and SASAC, and the positions are lucrative. Even though executive compensation in SOEs is officially capped at 30 times that of the average worker's salary, those employed in top-level SOEs or subsidiaries of central enterprises may earn millions of yuan annually, well beyond the limits on executive pay outlined in 2009 regulations (Jiang, 2013).

Along similar lines, the state banking sector represents a group whose political mandate to serve SOEs has not changed notably during the reform era, but due to restructuring in the late 1990s and early 2000s has become exponentially wealthier and more significant. As mentioned earlier, China's "big four" banks are not only domestically dominant, but three now rank among the top ten capitalized banks in the world. They have played an essential role in China's transition to state capitalism, and are vested in the political economy that facilitated their transformation from administrative shells for central-local budget transfers to global banking behemoths.

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.

While it may be a stretch to draw a direct line between financial repression and China's startling production of individual billionaires, the consolidation of state capitalism in the last decade is at least temporally correlated with the growing concentration of extreme wealth. In the most recent Hurun (2013) billionaire list ("Hurun Rich List 2013"), China ranks second after the United States (358 vs. 481 billionaires). A plurality (23.5%) on the Hurun list earned their fortunes in real estate, followed by manufacturing (20.3%), finance (9.6%), and information technology (7%) (Robin, 2013). Other leading sources of wealth

include pharmaceuticals, natural resources, apparel, iron and steel, and retail. Such high levels of wealth have of course has been generated through more than financial repression, and are not limited to the state sector. At the same time, a growing portion of the super rich are represented in formal political institutions. Out of the 358 billionaires on the list, 155 (43.8%) served on either the National People's Congress (NPC) or the Chinese People's Political Consultative Conference (CPPCC) in 2014.

These figures should not be over-interpreted, however. Mere membership in the NPC, CPPCC, and even the CCP itself does not correspond with support for the status quo or a "partial reform equilibrium." Indeed, during field interviews in 2013 and 2014, both successful and less fortunate entrepreneurs continue to cite a litany of much-needed economic reforms, often starting with more direct access to credit from the state banking system and domestic equity markets (Author interviews in Beijing, Guangzhou, Shanghai, Wenzhou, and Hong Kong, 2013 and 2014). Furthermore, Hurun reports that 64 percent of China's high net worth individuals are "emigrating, or planning to do so, up from 60 percent, mainly as a result of one third of super-rich now already emigrated" ("Hurun Report," 2014). Diversifying ones assets and pursuing exit options is a popular strategy for those with the resources to do so. They are not vested domestically.

The segments of China's political economy that stand the most the lose with interest rate liberalization and the 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 from 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 would require writing off bad assets.

The other major group of vested interests consists of local governments that 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. As Nicholas Lardy and others have pointed out, however, relying on short-term bank loans to finance projects with payoffs extending over decades is fundamentally unsustainable—particularly when the government then underprices the services (Lardy, 2012). Central efforts to reduce local indebtedness will

require reforming the fiscal system so that localities do not have to turn to off-balance sheet sources of revenue. By the same token, recent reforms to the cadre evaluation system have placed “debt reduction” as a performance target, which disincentivizes new borrowing to finance old debts. This fiscal dimension of shadow banking will be challenging to dismantle as LGFVs need to be systematically regulated (if not dismantled). However, campaign-style financial rectification targeting various forms of informal finance has occurred on a reactive, as-needed basis during the reform era. Meanwhile, at the NPC in March 2014, Li Keqiang (李克強) announced that the Ministry of Finance would develop a regulated framework for local borrowing, starting with experimental municipal bond markets (“Local Bond Bill,” 2014). The Ministry plans to authorize the issuance of 400 billion yuan in bonds by local governments as part of the projected total government deficit of 1.35 trillion yuan in 2014 (Wei, 2014). Although Li’s NPC statements framed local government debt as being “under control,” establishing a more sustainable system of local public finance is on the current administration’s reform agenda.

Table 6 summarizes the relative winners and losers from financial repression. Although financial repression has had an adverse impact on savers, SMEs, first-time homebuyers, and importers, they are not organized as interest groups, and even if they were, it is unlikely that they would lobby explicitly for interest rate liberalization. The beneficiaries of financial repression, however, would see their profit margins erode as the cost of capital increased. The rents generated by financial repression have been concentrated among SOEs, state banks, and property developers who also have better access to officials involved in policy-making. As in other transitional contexts, counterintuitively, restraining the winners of reform under financial repression poses a greater political challenge than compensating the losers (Hellman, 1998).

Table. 6 Financial Repression Balance Sheet

Winners	Losers
• SOEs in capital-intensive pillar industries • Property developers • Commercial banks • Local governments • Coastal provinces • Ministry of Commerce • Ministry of Finance	• Savers • Private businesses, especially SMEs • Importers • Consumers, first-time homebuyers • Inland provinces • People’s Bank of China

Source: Adapted from Nicholas Lardy, “Sustaining China’s Economic Growth After the Global Financial Crisis,” PPT Presentation delivered to the National Committee on US-China Relations, February 27, 2012, Slide 14.

Conclusion

During the first three decades of reform, state banks and informal finance operated as parallel modes of political economy that served the state and the private sector, respectively. Financial repression supported this bifurcated system as low interest deposits were mobilized through the banking system to provide subsidized loans to capital-intensive sectors prioritized under state capitalism. Meanwhile, despite occasional local financial crises, informal finance remained relatively contained to the private sector in a self-regulating manner (Tsai, 2002). To be sure, there were gray areas. Some private enterprises wore red hats to enhance their access to bank credit, and others were large enough (or sufficiently well-connected) to qualify for commercial loans. However, for the most part, the formal financial system served SOEs, collective enterprises, and large private businesses, while SMEs relied on informal finance and various non-banking financial institutions. Informal financial intermediation facilitated rapid private sector growth despite a low level of financial development (Allen, Qian, & Qian 2005).

The general contours of China's experience during the first three decades of reform were somewhat comparable to those of its regional neighbors. Until the late 1980s, Taiwan exhibited a similar pattern of financial repression with SOEs receiving subsidized bank loans and SMEs relying on informal finance (Wade, 1985). Post-war industrialization was also correlated with financial repression in Japan and Korea, although private industrial conglomerates, rather than SOEs, were the beneficiaries of policy loans (Johnson, 1982; Amsden, 1989). Nonetheless, the East Asian industrializers had in common bank-dominated financial systems and financial repression during their rapid growth decades. In this sense, despite its openness to FDI, China provides another major example of an economy that grew rapidly despite expectations of the financial liberalization literature (Cameron et al., 1967; Gurley & Shaw, 1960; and McKinnon, 1973).

However, rough parallels between China and its regional neighbors in financial development diverge with financial liberalization in the latter during the late 1980s and early 1990s, followed by the East Asian financial crisis. There is retroactive recognition even within the World Bank (2005) that financial deregulation in the absence of deeper institutional reforms made the East Asian economies more vulnerable to crisis. It is premature to speculate on whether future financial liberalization in China would have similar effects. Furthermore, one may question whether financial liberalization is necessary if shadow banking can be regulated within the confines of a financially repressed system. Regulation without liberalization is plausible. As Beijing considers moving towards a broader

national goal of RMB internationalization, however, preparing the domestic economy for interest rate liberalization is an important foundation for avoiding capital flight once capital controls are lifted. This was one of the core lessons from the East Asian financial crisis.

Ultimately, however, China's contemporary reform challenges extend beyond those faced by Japan, Korea, and Taiwan in the 1980s and 1990s. In particular, this paper proposes that China's response to the 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 within 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. In recognition of the recent accumulation of local government debt and "subprime" lending in general, Premier Li Keqiang has expressed intent to tighten the regulation of local debt and shadow banking (Y. S. Cai, 2014).

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. In preemptive anticipation of skepticism about the government's willingness to encroach on the interests of privileged groups, Li has stated that these reform measures will be pursued irrespective of (political) opposition. These reforms represent an implicit admission on the part of the party-state that it

no longer monopolizes the allocation of capital in China's political economy, even as it endeavors to minimize the risk associated with new financing products. However, for now, the foundations of state capitalism remain intact.

The public stance of the Xi-Li administration towards reform has been cast with more defensive urgency than by the previous two generations of leaders even though Jiang Zemin (江澤民) and Hu Jintao (胡錦濤) both re-shaped the country's priorities in substantive ways during their respective tenures. The present context of reform also poses different political challenges. Many of the policies introduced between 1997 and 2011 were less costly to implement. The "easiest" reforms sanctioned practices that were already occurring informally (e.g., capitalist membership in the CCP) (Tsai, 2006). More controversial reforms created losses for less powerful groups within society (e.g., rank-and-file state workers and pensioners), which inspired protests in a number of cities. However, at least partially compensating investment occurred under Hu Jintao in social services and employment opportunities through the stimulus. Arguably, the last time that China's leaders faced such a seemingly intractable obstacle to deepening reform was during 1989-1992. However, Andrew Wedeman (2003) argues that China was able to implement price reform in 1992 due to local governmental subversion of price controls. In other words, he believes that a partial reform equilibrium never existed in the first place because rent-seeking and local protectionism had already undermined the state's fixed price system.

Reaching further back in PRC history does not provide encouraging examples of how leaders have attempted to break through identified vested interests of the time. The Cultural Revolution, for example, could be read as an extreme effort to overturn the privileges and apparent abuses of power associated with party-state elites who had been empowered in the preceding decades. Mao era tactics came with a high cost to human life and Party legitimacy. More recently, Bo Xilai's (薄熙來) populist policies, as well as his reliance on Maoist rhetoric and symbols, and anti-criminal "strike black" campaign in Chongqing garnered popular support for breaking down local syndicates (vested interests); but his bid for a seat on the Standing Committee—and subsequent scandal and sentencing to life imprisonment—delegitimized that approach.

Xi Jinping's (習近平) 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 (Hatton, 2014). Meanwhile, the vigorous anti-corruption campaign has reached senior leadership in the petroleum industry

(Jiang Jiemin (蔣潔敏) and Zhou Yongkang (周永康)); and internet and media controls, including expulsion of foreign journalists, has intensified. Indeed, Li Keqiang reportedly threatened reporters with blacklisting if they inquired about Zhou Yongkang's case at the post-NPC press conference in March (J. Cai, 2014). 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" (Pei, 2014).

Deep cynicism about the anti-corruption campaign was pervasive throughout my interviews with private entrepreneurs and officials in Beijing, Guangzhou, Shanghai, and Wenzhou from late 2013 to mid-2014. Businesses geared towards serving the lavish consumption habits of the "cadre economy" have suffered losses. Local cadres are reluctant to launch new initiatives to avoid responsibility for projects and expenditures that may later be cited as unauthorized by anti-corruption inspectors. Many entrepreneurs are reluctant to invest in long-term investment projects. They are also diversifying their assets to avoid attracting attention. "It hasn't been this extreme since the days of Mao," a former county mayor observed. Even party members are complaining.

However, if the relentless hunt for "tigers and flies" does not backfire on the present leadership, then a more sanguine perspective can be found in Y. S. Cai (2014)'s observation that sometimes reforms benefit unorganized interests because they are prioritized by political leaders. The stated priorities of Xi Jinping's leadership are to reduce/eliminate official graft and deepen "comprehensive market reforms." During the 1980s and up until June 4, 1989, intellectuals had vigorous debates about the economic and political consequences/desirability of neo-authoritarianism in China (Sautman, 1992). Twenty-five years later, following stunning rates of economic growth and the accumulation of wealth by senior leadership and their families, the need for such public deliberation has grown, but remains repressed. Whether clean government and economic liberalization can be achieved through strongman rule remains to be seen. If successful, however, the casualties of the process may well include the legitimacy of the CCP itself.

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