FINANCIAL TRANSITIONS IN THE PRC: BANKING ON THE STATE?

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The reappearance of substantial debt in China after 2008 has refocussing attention on the sustainability of the existing financial "model". It's not just that "traditional" forms of bank centred debt has re-emerged, but that the informal "shadow banking" sector also seems to be increasingly fragile, generating debts that do not seem easy to repay. Explanations for the current situation tend to focus on the way in which China responded to the global financial crisis, and the incentives that exist to go outside the formal and more regulated banking system into often more riskier activities. But in addition to these short term events, there are more fundamental structural issues. As the current financial system has evolved from the old (state planned) one, it contains within it some of the DNA of its predecessor. In addition, the spatial distribution of power and authority is inextricably linked to the way the financial system functions. So while it might be possible to tinker with some elements of current financial problems, the relationship between local government financing, land, the banking system and key economic sectors make it difficult to resolve more structural issues without taking a holistic approach; a holistic approach that would have fundamental consequences for the nature of the Chinese state, and the distribution of power within it.

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Introduction

There seems to be something of a consensus (both within China and also from external China watchers) that something needs to be done about the Chinese financial system; and the sooner the better. Having spent considerable time, effort and money cleaning bad debts and non-performing loans (NPL) out of the banks in the late 1990s and early 2000s, the reappearance of substantial debt after 2008 has refocused attention on the sustainability of the existing financial 'model'. It's not just that traditional forms of bank centred debt has re-emerged, but that the informal 'shadow banking' sector also seems to be increasingly fragile, generating debts that do not seem easy to repay. Just how urgent the problem is remains much debated. Though some see impending doom, others point to the ability to roll NPLs over and to recycle debt. And as this paper will argue, financial activity still seems to be influenced by the basic understanding that the state can and will step in to prevent catastrophe. But even those who are more sanguine about the short term prospects accept that the current system can't continue forever; indeed, the party leadership has announced a range of proposed reforms aimed at bringing about fundamental change.

Explanations for the need for reform tend to focus on two factors; first, the consequences of China's response to the global financial crisis, and second, the incentives that exist to go outside the formal and more regulated banking system into often more riskier activities and utilising various forms of shadow banking activities. And these really are important. But there are more fundamental structural issues as well that have their origins in policy arenas that have been at the heart of political debates for many years.

On one level, we have to consider the type of capitalism that has been constructed in China, and the relationship between the state and the market. While the financial system might appear at first sight not to work – not to do what financial systems in free market capitalist economies are 'supposed' to do – it has actually been quite successful in its own terms. For example, it has providing a safety net to mediate the uncertainties of being part of a potentially volatile global economy. Perhaps more important, despite moves towards marketization of sorts, the financial system has allowed the state to retain effective (and profitable) control over those economic sectors that are deemed essential to the functioning of the economy, and to retain a strong influence over the rest of the economy. Banks have not exactly replaced the plan as a tool of state control, but they have at least meant that the state retains a key tool of control despite the introduction of more market forces. They have been a key way in which capital is appropriated and allocated to preferred sectors and industries. Moreover, while the state depends on the banks to help deliver its objectives, the banking system, and all those connected to it, expects the state to step in if and when financial difficulties arise.

Crucially, in other ex-socialist economies, new financial structures have been created (often with external help and based on external models) to replace the plan with market based structures. In the Chinese case, the system that has emerged was not based on a coherent conception or blueprint, but instead a result of the accumulation of "a plethora of *ad hoc* institutional, administrative and other adjustments reached by consensus building and compromise".[1] As a result, the current system contains within it some of the DNA of the old state planned mechanisms for providing finance and financial governance. It is important, then, to spend a little time considering how this process of change has unfolded in order to understand how the old has come to influence the new.

On another level, this paper argues that it is a mistake to separate analysis of the financial and banking sector(s) from debates over the spatial distribution of power and authority in China. This is not just an issue that has been part of political debates in China since the founding of the PRC, but arguably from much early than 1949. The way in which local governments are funded today – or more correctly, underfunded – is very much influenced by previous eras and the attempt to find the best balance between central control and local freedom to act. And the way in which local governments today try to fill the gap between what they are expected to do and what they are funded to do (by the centre) has much to do with not just the expansion of debt, but also the growth in land prices that threaten to create bubbles that might burst.

It has been argued (correctly in my view) that one of the reasons that the reform process in China has proceeded so successfully (notwithstanding some downturns) is because of the incremental and experimental nature of economic reform in China.[2] The suggestion here is that while it might be possible to tinker with some elements to deal with current financial problems, the relationship between local government financing, land, the banking system and key economic sectors make it difficult to resolve more structural issues without taking a holistic approach; a holistic approach that would have fundamental consequences for the nature of the Chinese state, and the distribution of power within it.

The chinese financial system: a very brief overview

One of the notable features of the Chinese financial system is the extent to which enterprises in China rely on internal sources of funding.[3] But when it comes to external sources of funding, then the banks dominate, accounting to close to 80 per cent of total financing since the 1990s.[4] Although a securities market is developing in China, it remains very much a secondary source of finance, and very low by international comparison. Within the banking system itself, the big four commercial banks dominate – the Bank of China (BOC), the Industrial and Commercial Bank of China (ICBC), the Construction Bank of China (CBC) and he Agricultural Bank of China (ABC). Along with the Bank of Communications, they account for over half of total market share. Add on the 12 Joint stock commercial banks and the figure gets closer to 65 per cent. Add the three policy banks - the Eximbank, the China/State Development Bank (CDB) and the Agricultural Development Bank of China (ADBC) and the figure is edging up to three-quarters. Below this City Commercial Banks (formerly Urban Credit Cooperatives) and different forms of rural cooperative financial institutions account for roughly 7 and 11 per cent of overall market share by assets.[5]

We noted in the introduction the importance of tracing the way that the old planning system was dismantled and the new financial system constructed in order to understand how what is a *more* market oriented system nevertheless still fulfils some of the functions of state planning. In order to do so, we need to take a two stage approach; the first to trace the way in which changes have come about, and the second to understand the nature of Chinese capitalism, and what the financial system is meant to achieve.

How did we get here?

Although the reform process in China is usually dated as starting from the Third Plenum (of the 11th Central Committee) in December 1978, in many ways 1984 marks the key turning point for the financial system. This was the year that saw a significant devolution of power from centre to provincial level governments, the onset of urban industrial management reforms, and the initial steps at banking reform. The People's Bank of China (PBOC) stepped back from normal daily banking activities to be designated as the central bank, and four large specialist banks were introduced to channel capital for different sectors of the economy: the Industrial and Commercial Bank of China (ICBC) was responsible for State Owned Enterprises (SOEs), the CBC for new investment projects, the ABC for agricultural procurement and rural investment (including rural industry), and the Bank of China took control of foreign exchange business. In 1985, China switched from a grant based (through the plan) to loan based (through banks) investment system. In order to facilitate the transition from central grants to bank loans, the power of specialized banks in the localities was also increased. An immediate consequence was an explosion of local government spending and from around the mid-1990s, restoring central control (or at least re-balance the relationship between centre and localities) became a major policy goal – an issue that re-emerges time and again in this paper.

A second major reform occurred a decade later in 1994, when the existing four policy banks were replaced as policy based lenders by three policy banks. The CDB took responsibility for long term projects: notably infrastructure, and the development of strategic industries. The ADBC took responsibility for procurement of agricultural produce and agricultural development projects, and the Exim Bank was established primarily to provide credit to promote exports. In 1995 the Central Bank Law confirmed the PBOC as the central bank, while the Commercial Bank Law theoretically at least, introduced effectively commercial banks for the first time, and also fostered the development of competition between banks at both central and local levels.

The growth of debt

So rather than the sort of 'shock therapy' financial reform in (former) communist party states further west, financial reform in China entailed the gradual introduction of new market based structures alongside the gradual dismantling of old planning structures. Moreover, the function of the new system largely remained unchanged from the old – to channel funds into state projects, including funding investments in the state sector. After the 1994 reforms, the commercial banks held more than 90 per cent of all credit funds and extended 90 per cent of them to state owned enterprises.[6] Perhaps not surprisingly, many enterprises that had been used to receiving funding as grants through the plan simply continued to view bank loans as free money to support their activities – and so did many of the local governments that controlled them.

As a result, one key consequence of the way in which the transition from socialism evolved was the growth in bank debt and non-performing loans. Indeed, as the Asian financial crisis broke out (a crisis that had a real impact on Chinese thinking on financial reform), the Chinese banking system was described as essentially bankrupt and ‘a serious threat to the sustainability of the country’s economic development’.[7] Official figures for bad debts in the major state banks were only 20 per cent of all loans, but by including non-performing loans (that were not yet due but would never be paid back), unofficial figures reached a high of 70 per cent of all loans,[8] with a similar amount of bad debt held by local banks (*Wall Sreet Journal*, April 12, 2004). In response, in 1998 the government issued RMB270 billion worth of special treasury bonds to replenish the capital of the four major state owned banks. The following year, a new Debt-to-Equity scheme was announced with four Asset Management Companies (AMC) created to help clear the debts of the four big commercial banks.[9] The extent to which this fundamentally solved the problem, or simply disguised the level of debt (and in the process preventing fuller commercialization) is an issue we will return to shortly

Towards commercialization?

Having moved to reform the financial system in response to the growth of debt (and informed by the consequences of the Asian financial crisis for), the process of joining the World Trade Organization required another round of changes. The Central Bank Law and Commercial Bank Law were both revized to comply with initial obligations and foreign banks were allowed to engage in foreign currency services the following year (albeit in a constrained manner). In 2003, the China Banking Regulatory Committee (CBRC) took control of banking regulation and supervision from the PBOC, with the latter retaining authority over monetary policy. Walter and Howie see this as a key example of how the system evolved through compromise and fudging, arguing that the PBOCs preference for full reform was obstructed by more 'conservative' organizations like the Ministry of Commerce. The result was a half-way reform that resulted in some moves towards greater commercialization, but without establishing real independence from state control (for the big four banks at least) in any meaningful manner.[10]

This half-way policy included the expansion of non-state holdings in the 12 Joint Stock Commercial Banks. It also entailed moving towards limited listings of the big four policy banks in ways that introduced new capital and knowhow and subjected them to international standards, but while maintaining the state's control over them. Crucially, government control ensured that the banks did not just 'go for profit', and therefore take increasing risks (with the consequences that we saw in Europe and the US). Rather, the government promotes the importance of stability in the financial system, and uses the banks to support its stimulus activities during periods of economic downturn (as was the case in 2008).[11]

As part of this process Central Huijin was established in December 2003 to manage state assets in the financial system. Huijin's job is to invest in financial enterprises, and it claims that it 'does not conduct any other business or commercial activity' or 'intervene in the day-to-day business operations of the firms in which it invests'.[12] But its directors are appointed by, and responsible to, the State Council, and it remains very clearly a state agent. Moreover, although it was initially established as part of the regulatory regime under the PBOC, Huijin was later bought by the Ministry of Finance and placed under the direct control of the China Investment Corporation as part of the latter's initial capitalization in 2007.[13]

Although the Asian Development Bank had taken a stake in the Everbright Bank in as early as 1996, foreign participation in the banking system had remained strictly limited. In 2003 the CBRC announced that up to 25% foreign ownership would be allowed, with the amount owned by a single overseas investor limited to 20%. Two years later, the CBC, the BOC, and the ICBC all announced deals to bring in minority foreign ownership (actually implemented in 2006).[14] In order to increase their attractiveness to foreign partners, this move also entailed a further cleaning up of the banks' finances – for example, in 2003, the government took US$45 billion out of its foreign currency reserves to recapitalize the BOC and the CBC. According to Allen et al, the ICBC, which had already had RMB408 billion of bad loans transferred to its AMC and a RMB85 billion injection of funds previous to this plan 'received another round of capital injection (RMB124 billion) from Huijin and land use rights worth RMB20 billion from the central government, disposed of a total of RMB705 billion of non-performing assets from its books'.[15]

Chinese state capitalism

That China's financial system has evolved, rather than changed through big bang revolution, gives us a partial understanding of why an increasingly commericalized and market based banking system still looks and behaves like an instrument of state control and guidance at times. As a result of the above mentioned reforms, the governance structures of the major banks look from the outside more like 'normal' (foreign) banks than ever before [16] Furthermore, listing on the Hong Kong market not only raises capital, but also subjects the lister to international standards.[17] China is moving towards Basel II and III compliance for its "systemically important banks". [18]

But despite these changes, the banks are not independent of the state. The three policy banks are explicitly major facilitators of state policy. They remain formally government owned, do not just rely on deposits as a source of funding but instead on bonds directly guaranteed by the state and other fiscal sources, and are tasked with supporting state policies and objectives. Thus, for example, the job of the ADBC is to 'serve as an agent for the state treasury to allocate the special funds for supporting agriculture'.[19] The CDB also supports rural development through its financing of grassroots social and developmental projects (education, low cost housing, rural development and so on), as well as being mandated to support the development of infrastructure, regional development. In this way, the ADBC and CDB fulfil some of the funding functions of the old planning system.

The CDB is also involved in facilitating and funding cross-border economic activity and along with the Eximbank has played a major role in supporting the state's "Go Global" policy. The CDB issues loans and credit to other countries, typically with commercial consequences in the form of partial repayments in resources. The Eximbank is the major provider of concessional loans to other countries – loans that typically ensure generating favourable economic returns for Chinese companies, including sourcing the majority of the procurement of equipment, services, technology and materials coming from China. And it is this state support for Chinese firms operating overseas – including securing supplies of key resources – that has generated much interest (and often concern) in the West.

Banking on the state

But if the three policy banks are clearly part of the state system, the independence of the other banks (or not) is a little less clear. One important issue here is the state's residual control over appointments to top positions in the banks,[20] and the fact that they tend to appoint former party and state officials rather than banking experts regardless of political affiliation.[21] Indeed, William Allen and Han Shen argue that real power in the banks lies in the hands of the party committee (and not just in the banks) rather than in the formally more powerful board of directors.[22]

Responsibilities and relationships get more complicated when you add on implicit guarantees and interlinking ownership structures. When the AMCs were first established, they were partly funded by selling bonds back to the banks themselves. These bonds were due for repayment in 2009. But as the debts had been bought at full value (rather than at a lower rate as is usually the case when this type of arrangement has happened elsewhere) and by definition were not highly attractive assets, the AMCs were been unable to recover enough money to cover their obligations. As part of the solution, the four banks themselves have become the biggest individual shareholders in the AMCs.[23] The original bonds were also rolled over for another ten years,[24] with the Ministry of Finance subsequently taking over responsibility for the interest payments of Cinda – apparently from tax paid by the CCB (*Wall Street Journal*, March 9, 2012). So what we see here is an interlocking set of financial relationships between the big banks and the AMCs that are underwritten by support from the PBOC and the Ministry of Finance. This is possible because if there are stockpiles of money stored up elsewhere in the financial system. But perhaps more importantly, they can do it because people have confidence that they will do it!

Capital accumulation and utilization

Perhaps the first task of any state is to try and find means of getting the funds it requires to achieve its (typically self defined and imposed) objectives. Taxation, of course, is a primary means of raising capital. But in the Chinese case, through the way that the financial sector works, savings form an indirect way of funding state priorities. And one of the unusual features of the Chinese economy is very high savings rates over a number of years. To be sure, if household, enterprise and government savings are all considered separately and by international comparison, they look highish, but no dramatically so. But as Ma and Yi point out, what marks China out as rather different from the norm is that all three in China are high at the same time. Savings are now roughly 50 per cent of GDP and private consumption at around a third of GDP is the lowest in all of the world's major economies,[25] and deposits by savers have formed the main source of bank finance.[26]

One reason for this high level of savings is that while the provision of health, education and welfare has been extended, and is still in the process of being universalized, there remains an overwhelming concern that welfare provision will not be adequate in old age. But while there is an incentive to save, the rewards remain very low; indeed, real interest rates have not just been low, but negative for large periods of time.[27] So effectively, 'financial repression' [28] built on the insecurity of Chinese citizens has become a key source of profits in the banking sector,[29] and a major means of funding the states industrial and investment policy.

Savings have also helped the state maintain its exchange rate policy. China's massive holding of foreign currency reserves has become the focus of much international attention, and is considered by some to be at least one cause of the global imbalances that created the potential for a global crisis. But the massive inflow of currency needs to be sterilized in order to prevent it leading to inflationary tendencies. This is partly done by the central bank forcing the commercial banks to buy bonds and maintaining high liquidity ratios. In this sense, at least some of the money supply is kept within the banking sector rather than getting out into the real economy, and the central bank shares the costs of sterilization with the commercial banks. For Lardy[30] and Ming Zhang,[31] the cost that this entails for the banks in sterilizing excess liquidity is offset by the way in which they are allowed to maintain a high spread between deposit and loan interest rates. It is a prid pro quo for taking part of the responsibility for sterilization. Thus, through the interest rate policy, the banks ensure that the burden of sterilization is shared between themselves and household savers. It also means that there is an umbilical link between households and China's managed exchange rate.

Funding the state sector

Despite the growth of the private sector, and the shedding of millions of jobs in smaller loss making SOEs, the state still monopolises production in 'strategically important sectors' (such as armaments, electrical power and distribution, oil and chemicals, telecommunications, coal, aviation, and shipping (*China Daily*, December 18, 2006). The state also retains a strong presence in 'pillar' sectors of the economy like machinery, automobiles, IT, construction, steel, base metals, chemicals, land surveying, and R&D.[32] And the banks (as well as the broader financial system) have played a key role in maintaining these SOEs dominant positions in different sectors.

Lending to small and medium sized enterprises (including those outside the state sector) has increased in recent years.[33] Larger non-state enterprises seem to do quite well,[34] and smaller ones can as well if they build close relationships with local governments.[35] But even the PBOC recognizes that much more needs to be done to support the non-state and non-large sectors to stimulate long term growth.[36] This situation partly stems from the banks' lending decisions, and partly from political elites sometimes stepping in to directly instruct them to make politically inspired lending decisions by political elites.[37] Indeed, while the Commercial Bank Law mandates the banks to consider commercial criteria before extending loans, Article 34 specifically mandates the banks to "conduct their business of lending in accordance with the needs of the national economic and social development and under the guidance of the industrial policies of the State".[38] And this mandate seems to have been very much heeded when it came to responding to the impact of the global crisis on China.

A 2011 report by the Chinese think tank, Tianzi (known as Unirule in English), explained the way in which the SOEs benefit from an uneven playing field when it comes to the financial system.[39] In addition to their monopoly or dominant position in key sectors, they benefitted from: massively subsidized rent on land that would have soaked up 63 per cent of their overall profits if they had paid the market rate; and subsidized energy supplies worth RMB497.7 billion between 2001 and 2009; a tax rate less than half of that for private companies; fiscal subsidies of RMB194.3 billion from 2007 to 2009; other direct injections of capital from the central government when required; and easy access to bank loans at a third of the market interest rate. In addition, the report calculated that they only remitted 2.2 per cent of their profits to the state in 2010 – and didn't remit any at all from 1994 to 2007.

Chinese state capitalism and centre-local financial relations

When talking about state ownership and the Chinese state in general, it is important to distinguish between different levels or tiers of state power. It is actually very difficult to find agreed, reliable, and up to date figures for the number of SOEs in China. The last full economic in 2008 put the figure at 143,000, but more recent surveys suggest 114,000.[40] Of these, 117 are controlled by the national government, and between 900 and a thousand by provincial level authorities. So even if we leave room for some mergers and closures, there must still be around 100,000 SOEs that are owned by lower levels of government. A structural bias in favour of the state sector seems to be particularly strong at the local level where there is even stronger influence (if not downright control over) financial institutions than at the centre.[41] Local financial institutions have been encouraged to dilute the level of government ownership by finding new sources of capital and shareholding. But local governments still retain strong formal control, not least over personnel and promotion issues, and exert considerable informal influence to get local institutions to support favoured projects. This has been described as akin to providing a quasi "fiscal subsidy, with correspondingly little expectation of repayment."[42]

These local sets of state-enterprise-bank relations are shaped by the way in which local governments are funded. In dismantling the planned financial system in the 1980s, the central leadership deliberately and consciously devolved considerable financial authority to local governments. It seems, however, that they were not prepared for 'the magnitude and rapidity' of the shift in financial power,[43] as reforms in different policy sectors (finance, industry, fiscal, foreign trade and investment and so on) collided with each other to produce unintended dysfunctional consequences. The attempt to restore the balance in favour of the central government included banking reforms in 1998 designed to reduce local governments' abilities to pressure local branches of banks to make politically inspired lending. More important, changes to the fiscal system in 1994 created three categories of taxes (central, local and shared) and a new collection agency designed to reduce local financial autonomy – an issue we will return to later. Crucially, the fiscal reforms were not accompanied by corresponding budgetary reforms, leaving local governments desperately short of the money they needed to fulfil their obligations. Faced with this dilemma, local governments had little choice other than to find new innovative ways of raising money, like establishing International Trust and Investment Corporations (ITICs) that borrowed money on international markets, charging ad hoc fees for government services, raising money from the agricultural tax, siphoning off money from local rural and urban credit cooperatives (renamed City Commercial Banks in the 1990s), and turning to the banks for loans. The centre eventually responded by banning them from charging fees and abolishing the Agricultural

Tax in 2006. Although financial transfers from the centre were increased, these were not large enough to cover lost revenues, and the shortfall is still a key challenge for local governments today.[44]

As part of the new arrangements in 1994, local governments were given control over land use.[45] And as other sources of finance were closed off, then they became increasingly reliant on selling land use rights to raise local revenue, particularly in the years following the global financial crisis. This source of income increased by over 40 per cent in 2009,[46] and then by a further 100 per cent in 2010,[47] and then a more modest 14 per cent in 2011. Although the figure fell back in 2012 (partly because of the increase of other sources of funding), this still left selling land use rights as the single biggest source of revenue that local governments collect and manage themselves (as opposed to transfers and payments to them from the centre). According to the 2013 budgetary report, over 80 per cent of the expenditure of local government-managed funds was funded this way (*Xinhua*, March 19, 2013).

Into the Shadows

With finance still difficult to get from the banks for many outside the state system, the majority (in terms of numbers, if not market share) of Chinese enterprises have been forced to look elsewhere for capital. This partly entails relying on internal sources of finance. But it also entails utilising what Kelley Tsai termed “back alley banking”.[48] In reality, what is known as the “shadow banking” sector is actually more than one entity. Some of it is closely related to the formal banking system. For example, Chinese banks and trust companies have developed a range of Wealth Management Products in recent years. The banks like this “off balance sheet lending” as it allows them to get around restrictions on loan to deposit ratios (as these shadow loans do not count as “formal” loans” that form part of the 75% loan to deposit restrictions). They also allow them to speculate on commodity prices, invest in real estate projects, or provide high interest loans to enterprises and local government projects that face restrictions in the formal sector (*The Economist*, June 1, 2013). Although provided by bodies that are part of the formal financial system, the products themselves typically fall outside the regulatory framework and are thus more risky (though also potentially more rewarding) than the normal banking sector. Even though these are less shadowy than some financial products, the still less than transparent nature of this sector, the speed at which new schemes have emerged, and the sheer number of different projects on offer (over 20,000) make it hard to put an exact value on their collective worth. But they are probably now more important than insurance as the second largest financial sector in China (*China Daily*, Ocotber 12, 2013).

Beyond these bank related schemes, 'a vast underworld of informal financial intermediaries' have emerged to fill the funding gap.[49] These shadow activities range in levels of formality and legality from financial leasing (buying equipment to lease out), a small but growing number of private equity firms, financing guarantees, investment companies, online P2P lending, ponzi schemes underground banking and money laundering.[50] As these activities are even more shadowy than bank related schemes, it is even more difficult to know the exact importance of them, but Hsu estimated in 2012 that 30-40 per cent of all enterprise funding had come through informal means, and primarily gone to small and medium enterprises.[51] Crucially, it is not just that there is an ample demand for such financing, but also an ample supply of finance, with savers looking for better returns than saving with the banks offers. And we also need to bring local governments back into the equation here. Land has been commoditized, but as we have seen, not privatized.[52] This means that local governments can benefit from speculation on real estate projects – and this has become even more important as they struggle to pay off the debts that were accrued in 2009 and 2010 (more of which shortly).

Given that many enterprises have no real option other than to go outside the formal banking system to get loans, Sarah Hsu concludes that shadow banking is a “pro growth”" phenomenon and is an “institution” in its own right.[53] And it is undeniable that this form of flexible experimentation and innovation has proved essential in filling gaps in the formal financial system. Without it, the non-state sector would not have been able to make the contribution to growth and job creation that it has. Indeed, even the announcement of new controls over the shadow banking sector in 2014 contained within it praise for the “positive role” the shadow system played “as a complement to the traditional banking system” in providing finance to “the real economy.[54]

Nevertheless, there are a number of problems – some of them potential, some of them very real – in allowing a shadow banking sector to do what the formal financial system either can’t or won’t. First, it makes exercising macroeconomic financial control somewhat difficult, as it provides ways of getting round regulatory restrictions on how much they can loan, to whom, and at what rates; particularly when overall macroeconomic policy is attempting to cut liquidity flows. And evidence suggests that the significance of the informal sector increases at times of official credit tightening through the banks.[55] Second, informal financing is more expensive - sometimes very much more expensive – than bank loans, often exists beyond state regulation, and is very risky. It is not surprising, then, that schemes sometimes collapse. Informal finance has been most important in those parts of the country where small and private producers are most represented - most notably Zhejiang Province and even more notably, Wenzhou; a city that has flourished despite the virtual total domination of private companies that would struggle in the formal banking system. And it was here that local informal private banking schemes imploded in September 2011. The response has been to experiment in a pilot scheme to bring private lending schemes under official approval and local oversight. But the Wenzhou experience shows both the benefits and the pitfalls of living in the shadow financial sector.

Third, shadow banking activities are contributing to the growth of real estate prices and creating the possibility of bubbles that might burst. Or perhaps it might be more correct to say that they way that local governments are funded combine with investor's search for higher returns than the banks offer are contributing to the emergence of bubble like activity. In this respect, it is not so really that the shadow sector that is the problem; rather shadow banking is the consequence of other problems in the broader financial system.

The case for reform

In its own terms, the Chinese financial system has proved to be very successful. It has provided a way of continuing to fund state projects, and it has supported the state's currency strategy. It has also provided a bulwark that provides some protection from the vagaries of the global economy. When financial crisis in the major western economies saw Chinese exports falling off a cliff in November 2008, the IMF called the Chinese response "quick, determined, and effective".[56] A RMB4 trillion stimulus package was quickly announced and the first part of it immediately rolled out. But while it was relatively clear what the stimulus was meant to do, it was less clear where the money was meant to come from.[57] Although the central government committed its own funds (RMB1.8 trillion), and issued RMB200 billion of bonds to help fund local government projects, the banking sector became the key source of increased liquidity across the country. By the end of 2009, new bank loans in China had reached more than double the figure for the previous year at RMB9.6 trillion with a further RMB7.96 trillion of new loans lent in 2010. According to Chovanec, the total provision of credit in China rose by US$15 trillion in five years from the end of 2008 – equivalent to "the size of the entire U.S. commercial banking sector".[58]

The biggest recipients of these loans were local governments. Although they are strictly speaking not allowed to take loans from the banks, they got round the restrictions by establishing Local Government Finance Vehicles (LGFVs) that took the loans and then invested on their behalf. As there are thousands of these companies – perhaps as many as 10,000[59] – it is extremely difficult to work out exactly how the money was spent. Best estimates suggest that the LGFVs used around half of the new loans lent in 2009 to fund infrastructure projects.[60] This suggests that rather than using budget finance, between 80-90 per cent of local governments' infrastructure spending was instead funded by loans (primarily through the LGFVs).[61]

The growth of debt (again)

The response to the crisis was, in the short term at least, highly successful. But it did not take long for questions to emerge over how many of the loans would ultimately be repaid. When the CBRC surveyed the LGFVs in 2010, they suggested that 70 per cent of the loans they had taken would not generate enough profit to meet their interest payments.[62] A National Audit Office (NAO) investigation the same year put LGFV debt in 2010 at just under RMB5 trillion with local governments holding slightly double that in direct liabilities to get to a combined total of RMB10.71 trillion. More than two thirds of this debt was held by local governments at the city and county level, with massive regional variations; debt levels tending to be higher, and the ability to pay back lower, in central and western regions.[63]

A second audit was undertaken in 2013, with the results supposed to come out in October, but the final report was not issued until 30 December. The scale of the audit perhaps excuses the delay – through August and September 2013, some 544,000 auditors directly surveyed 730,065 projects and nearly two and a half million different debt liabilities across a massive range of local government departments and other funding institutions. The delay might also, though, have been partly to allow expectations of the extent of the problem to grow before the report was finally published. Initial Chinese press reports as the audit was coming to a conclusion suggested that local debt would have doubled between 2010 and 2012 (*Xinhua*, August 27, 2013). A Chinese Academy of Social Sciences report on debt to year end 2011(though not published until December 2013) suggested total local government debt of RMB19.94 trillion.[64] This was not out of keeping with private sector reports with Nomura's survey coming in even higher by estimating that LGFVs debt ***alone*** had reached RMB19 trillion in 2012.[65] So when the NAO reported that local government debt had reached RMB17.9 trillion (10.6 trillion in direct liabilities and the rest in contingent debt that local governments could fall responsible for through guarantees),[66] what was still a big increase since 2010 could be reported as falling lower that widely held expectations as a result of prudent government policy.[67] Indeed, as this audit had burrowed down into lower levels of government than its predecessor, then even this lower headline figure exaggerated the extent of the increase.

There is considerable doubt over whether these audits really capture the full extent of government debt – or rather, what might become debt that could eventually fall on local governments to sort out. For example, Lowenstein argues that these audits only count official debt, and miss the significance of LGFVs holdings of Bankers Acceptance Notes issued by local banks (often at the behest of local governments) that do not appear in the official accounts.[68] And corporate debts that do not formally form part of local governments' contingent debt might indeed eventually become public debt if local governments decide to bail out favoured local governments that face problems.[69] So by taking into account all forms of debt that will eventually fall on them to account for (even if they aren't legally responsible, the highest estimates of debt in 2010 doubled the official NAO figure to reach over RMB20 trillion.[70]

The extent of local government related debt has been referred to as the Chinese equivalent of the US subprime crisis (*Global Times*, April 7, 2010). This is partly because of the size of the debt itself and partly because there is no real sign of loans generating sufficient returns to pay back liabilities. Although regulation changes have seen local government related investment bonds issued to raise working capital (*South China Morning Post*, 9 July 9, 2013), debts seem to be increasingly serviced by rolling them over or taking out new loans to finance old debts – including through the shadow banking system. [71] The central government has also let local governments issue bonds to refinance projects,[72] transferred debt from some local governments to the state banks, and introduced new policies allowing the extension of loan repayments and/or the rolling over of old debt into new loans.[73] But this has not stopped some projects having to be bailed out by the AMCs, local governments and the banks (*China Daily*, July 1, 2013) and it is likely that at least some local governments are going to find themselves in severe financial problems in coming years.

Conclusions: Still Muddling Through?

So is China's financial glass half full or half empty. On the positive side, China's financial system has looked on the verge of a crisis before, and we would do well to remember that it didn't materialize. With Chinese GDP in 2013 reaching RMB56.9 trillion, the extent of Chinese local government related debt does not look as severe as it might appear at first sight, and that the state – be that in its local or central manifestation – can and does intervene when things go wrong is a significant (informal) component of the Chinese financial system. More pessimistic perspectives argue that it's not the overall size that poses the problem, but the inability of local governments to service their debts,[74] and the dangerous linkages between banks, their more shadowy lending projects, local governments, LGFV projects and land/real estate prices.

A key argument in this paper is that it is increasingly difficult to tinker with elements of the financial system and hope that problems will be resolved. The banking sector is linked, in different ways, to local government finances, exchange rate policy, land prices (and property bubbles), and the insecurity driven saving inclination of many ordinary Chinese citizens. Any change in one area could easily have dysfunctional consequences elsewhere. And then there is the question of if the sort of capitalism that China has and that Chinese leaders want it to have. If the state sector is to retain its dominant role in specific sectors that then impact on the broader economy as a whole, then they need to be funded. Moreover, whilst China might not have a free and liberal market, it does have market actors whose response to government policy can have a big impact. Indeed, when the PBOC withheld liquidity from the interbank market in June 2013 to try and cut credit expansion, share prices fell and rumours of a bank default abounded causing a degree of panic. What we see in the financial sector is a complex mix of issues that emerge from short term policy and responses to the global crisis, from dilemmas of reform that have created new interests and thus potential new winners and losers, and more fundamental structural questions relating to the nature of Chinese capitalism, and indeed, the nature of the Chinese state.

And then there is the question of reform to what? The Chinese financial system might not serve the interests of the normal Chinese citizen particularly well (particularly savers). But it has served the interests of Chinese state capitalism, facilitating continued state direction and influence (and at times, straightforward control) whilst also allowing the private and the non-state to grow. In this respect, even the shadow banking sectors have done an effective job. As this paper has shown, there are indeed problems in the financial system and a real danger that things could get (much) worse. But even if we hadn't witnessed the crisis of western (neo)liberal financial systems during and after the crisis, it is unlikely that this is where China's leaders want to go.

At the Third Plenum of the 18th Central Committee in November 2013, a number of reforms were announced to deal with some of the causes of potential financial disorder that give us some indication of what the desired alternative might be.[75] In terms of explicit financial reforms, this included the introduction of new private banks, moving towards interest rate liberalization, and the promise that resources would in the future be allocated according to market forces. In addition, a range of other reforms were promised that should have collateral impact on the financial system; strengthening property rights, breaking down monopolies, ending local protectionism, readjusting centre-local financial relations, fiscal reforms and so on. It appears that one of the main objectives of these reforms (or 'decisions') is to centralise control – to stop the banks avoiding attempts to control their innovative ways of providing credit, and to stop local governments from developing their own economic priorities at the expense of a more 'rational' national spatial distribution of economic activity. Indeed, it might well be the case that locally owned SOEs, local monopolies and the 'irrational' distribution of resources at the local level are targeted with more vigour than the major national level SOEs and 'national champions'. In this respect, a financial crisis for local governments is beneficial for the central government, as it gives them a source of leverage. So while we see manifestations of a financial crisis (of sorts) in China, at its heart lie questions of governance; and crucially, what the best site of effective governance should be. This could well prove to be much harder question to find a solution to, and one with far deeper implications, than that of how to deal with the short term growth of debt.

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