

Chinese Shadow Banking: Bank-Centric Misperceptions

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Summary

The rapid rise of shadow banking in China has brought profound changes to how credit is priced and intermediated in the economy. Our paper provides a systematic analysis of activity in the shadow banking system, the rationale behind their fast growth, and the risks which they pose to financial stability. We show that rapid growth in shadow banking is closely associated with the collective desire of banks, non-bank financial institutions, private-sector borrowers and savers to circumvent credit and interest rate regulations. The authorities have also given a green light to shadow banking development for its contribution to financial liberalization. We show that China's experience of shadow banking growth induced by financial regulation is similar to growth of equivalent activity in the US in the 1970s. However, there is a critical difference in the structure of the two systems: shadow banking in China relies on banks to perform basic credit intermediation, making it a bank-centric system whereas the US system revolves more around capital markets making it more market-based. We formalize this and other features of the system with our theoretical model, building on the concept of "information sensitivity". Our model demonstrates that the negative consequence of this "bank-centricness" is a severe misperception of risks among different parties in the system. Properly addressing this risk misperception will be critical for the sustainability of shadow banking developments going forward. We suggest that this can be done by transforming the system from a de-facto reliance on banks towards more emphasis on capital markets.