“Shadow banking,” in the parlance of finance, refers to money raised outside the formal banking sector. In China, shadow banking is much more developed than in the U.S., although its role in the U.S. has increased in recent years. Due to its shadowy nature, few people have a good grasp of how it works. Lucy Hornby, a Nieman Fellow for Journalism at Harvard University, was able to bring China’s secret world of shadow banking into the public light. Hornby had lived in China for 20 years with her last post as the Deputy Bureau Chief in Beijing for the Financial Times before she came to Harvard.

Hornby explained that money demand in China, spurred by decades of economic reforms, substantially exceeded money supply controlled by the central government. This excess demand had given rise to shadow banking, a euphemism for a black market for credit. Consequently, two sets of interest rates have developed in China, with one set for the formal sector and the other for the informal sector, unable to get cheaper loans through formal banking channels.

Shadow banking went into hyper drive following the global financial crisis of 2008 and ultimately contributed to some Chinese companies’ shopping spree overseas and their rapid transformation into multinational conglomerates. Anbang Insurance Group exemplified this trend under its chairman and founder Wu Xiaohui, who built deep connections with the Chinese elite through his marriage. Among Anbang’s large acquisitions was the Waldorf Astoria Hotel, a landmark building in the center of Manhattan, from Blackstone for $1.95 billion. It intended to refurbish and convert the hotel into luxury apartments and then sell them. But Wu, who had an ebullient personality and claimed to be a self-made man, was detained in 2017. In 2018, the state insurance regulator took complete control of Anbang, and Wu was sentenced to 18 years in prison for fraud and embezzlement.

Why hasn’t China liberalized its money supply after four decades of market reforms? Hornby briefly delineated China’s banking history. When China was a planned economy, money was tightly controlled by the central government and allocated to various industries and state-owned enterprises as needed. The economy stagnated and contracted for several decades since the founding of the PRC in 1949. Starting in the 1980s, the reform period, the four large state-owned banks were founded to lend to local industries. In 1999, under the leadership of Premier Zhu Rongji, these four large banks were significantly recapitalized, and their
non-performing loans were moved into newly established asset management companies.

Meanwhile, private lending networks began to emerge as more business opportunities sprouted. A swath of young entrepreneurs became rich and were able to raise money at low interest rates from formal banking channels and lend this money to short-term projects at much higher interest rates on the black market. Wu Ying, a 25-year-old entrepreneur from Wenzhou, was representative of this group. When she was charged with fraud and embezzlement in 2007, she was the sixth richest woman in China. Some real estate tycoons came to her defense, because without people like her providing liquidity outside the formal banking channels many private companies could not have thrived. Private lending made positive contributions to real economic growth, at least early on.

The problem was that private lending went wild. Prime Minister Wen Jiabao wanted to curb lending to the housing market. However, after the world economy was hit by the 2008 financial crisis, Wen was compelled to promulgate a stimulus package of four trillion RMB. Against this backdrop, shadow banking further took off and made loans at record high interest rates, about 15-20 percent for reasonable projects and 40-45 percent for riskier projects. Lured by these incredibly high rates, even middle-class Chinese bought into related trust products of questionable quality. Many of these financial products claimed to raise money for one purpose, but the money was in reality used for another.

Over the last five years, internet companies have democratized financing. When liquidity to small- and medium-sized private companies dried up, they turned to these private companies for loans at much higher interest rates. It is hard to estimate the actual size of this lending outside the formal banking sector. This is why Zhou Xiaochuan, Governor of the People’s Bank of China (PBOC), proclaimed in 2018 that M2, a standard measure of broad money supply, was no longer an accurate measure of China’s money supply.

In 2015 and 2016, some of these shadow banks began to default on their promises. Many middle-class Chinese who had bought their financial products, feeling swindled, went on street protests to vent their rage and demanded their money back. While China tries not to default on Chinese companies’ overseas debt obligations, many domestic investors have experienced losses. In terms of the international implications, the burst of China’s foreign direct investments (FDI) led many foreign politicians to view China as a source of investment and economic growth. However, with Beijing’s 2017 crackdown on capital outflows tied to shadow banking, China’s FDI has dried up.

What are possible solutions to deal with the risks posed by shadow banking? One way is to tighten regulations to squeeze out shadow banking and roll back to a reliance on the formal banking sector to satisfy the market demand for credit. Another way is to allow interest rates to rise and eliminate the arbitrage opportunities for shadow banking. In conclusion, Hornby returned to the U.S. situation. The role of shadow banking in the U.S. used to be peripheral but has become more prevalent in recent years. The amount of credit from non-bank channels grew from 20 percent of the total credit in 1992 to 70 percent in 2014. The non-bank share of U.S.
mortgages doubled from 2007 to 2015. These figures raise the question of whether the traditional debates over U.S. monetary policy and the right balance between the interests of Wall Street and those of Main Street capture this new reality. Hornby recommended that Americans study the pros and cons of China’s experience as they grapple with this new factor in the U.S. economy.