Chapter 10
China’s Shadow Banking: Dynamics of Policy and Economy

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Abstract This study examines the linkages between Chinese shadow banking, monetary policy and macroeconomic variables. This analytical work is original as compared to most of the studies which are descriptive and theoretical in nature. Based on the survey of past literature and empirical model, our results indicate that money supply and gross domestic product have an impact on the scale of shadow banking. We provide a few key propositions with respect to China’s shadow banking. On the supply side, the money supply and interest rate must be controlled to optimize the capital allocation and drive the capital flow back to formal financial institutions. On the demand side, excessive bank lending to unproductive activities must be curbed. Lately, unregulated wealth management and investment products must be controlled for investors’ protection and also to scale down the size of shadow banking. These policies are important to slow down the speculative bubble and burgeoning debt level in the Chinese economy.

1 Introduction

Shadow banking system is another type of financial solution provider along with the conventional bank. It has similar features and obligations as the conventional bank. Additionally, it also bears similar risk as conventional bank and plays a complementary role in the formal banking system. There has been no agreed definition for shadow banking system. Financial Stability Board (FSB 2013) broadly considers the “shadow banking system as “credit intermediation involving institution and operates outside the regular banking system.” The Board also defines Narrow shadow banking as a system that “could lead to systemic risk (including maturity transformation, liquidity transformation, incomplete credit transfer, high leverage) and regulatory arbitrage (regulatory standards for banks and non-bank inconsistent) of non-bank credit agency.”

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