"China's Quest for Capital: Motivations, Methods, and Implications"

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CHINA BEIGE BOOK

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I. EXECUTIVE SUMMARY

China's financial system, like its economy, is notoriously opaque, and outside observers have long found it a challenge to report accurately on current conditions. Much of this is blamed on issues relating to the reliability of Chinese official data, which over the past two decades has spawned volumes of literature questioning its timeliness, methodologies, collection architecture, and potential susceptibility to smoothing or political manipulation.[1]

Yet within the financial system there is a *particularly opaque* segment that even Chinese officialdom may have a tenuous grip on: shadow finance. In China this sector was borne largely out of necessity, as the conventional banking system by its very structure makes it difficult for lenders to price risk,[2] and therefore a disproportionate share of lending has always been directed to "safer," often more politically-connected, firms—i.e., large and state-owned enterprises. While the terms "shadow banking" or "shadow finance" often bring to mind Ponzi schemes or toxic financial instruments, much of the shadow sector in China came to be simply to allow large chunks of the economy to remain capitalized.

But this has not occurred without great controversy—and concern. By their own telling, officials in China have been engaged in a bruising, multi-year campaign to either eliminate much of this lending or else bring it "out of the shadows"[3]—making it more transparent, subject to more oversight, and in the process taming some of its excesses. Most experts agree that a shadow crackdown over the past few years has indeed occurred. But is Chinese policy still focused so intently on taming these risks, or have other priorities now superseded that goal? More pointedly, as the slowdown in China's economy accelerates, and its trading relationship with the United States comes under greater strain, is shadow financing in China poised to make a comeback?

Our data suggest the answer is yes.[4] In fact, it is already happening.

While many areas of the Chinese financial system merit the close attention of policymakers, this statement will focus primarily on recent developments in the Chinese credit environment, with particular attention paid to the crucial issue of shadow finance. The statement will explore the evolution of Chinese economic policy from 2016 to the present, the role of shadow finance within that framework, and finally, the reasons we believe the sector has returned to prominence over the past year.

II. METHODOLOGICAL CONSIDERATIONS

a. Shadow Banking Defined

The People's Bank of China (PBOC) defines shadow banking as "credit intermediation involving entities and activities outside the regular banking system, with the functions of liquidity and credit transformation, which could potentially cause systemic risks or regulatory arbitrage."[5] The Bank of International Settlements (BIS) has adopted a similar definition, namely "all financial instruments that fulfil functions of credit intermediation typically performed by banks (such as liquidity, maturity, and credit risk transformation), but reduce the burden of, or bypass, banking regulation."[6] The common thread is recognition that the term encapsulates not just the activities of non-bank entities but also "credit intermediation activities performed by banks themselves that lower or circumvent regulatory requirements."[7]

This discussion will utilize the BIS definition spelled out above. However, to alleviate potential confusion over the bank/non-bank divide within the shadow banking universe, the more inclusive term "shadow finance" will be used instead.

b. Difficulties Inherent in Tracking Shadow Finance in China

While it is not the purpose of this statement to assess the reliability of Chinese official data or highlight the potential shortcomings of government data methodologies, two points are worth noting in the context of tracking China's shadow finance activities.

First, tracking shadow finance accurately over time is a difficult endeavor under even the most auspicious circumstances. Shadow finance derives its name from its opacity and corresponding lack of visibility to regulators; as such, the ability of regulators or other officials to effectively track evolving trends within the shadow finance universe is often limited. Moreover, financial innovators, in any system, are often highly incentivized to minimize reporting and/or evade regulation when possible, be it to minimize transaction costs or maintain lower barriers to execution. This in turn creates incentives to underreport, misreport, or simply rename financial vehicles or instruments in order to stay ahead of regulatory oversight.[8]

This is to suggest that chunks of shadow finance may at times, or at all times, go unreported through official channels. As recent Bank of International Settlements research has noted, "A key characteristic of China's shadow banking is that banks hide loans within alternative accounting categories."[9]

Second are problems intrinsic to Chinese economic data. As with all official economic figures in China, there may be various degrees of pressure on officials not to announce certain economic trends if and when they conflict with the political narrative of the Chinese Communist Party (CCP). There are ample reasons to believe this may be the case with shadow finance now, considering the overwhelming support in recent years from the Party's senior-most leadership for a crackdown on shadow banking—including from General Secretary Xi Jinping himself.[10] This may now make it politically difficult for government agencies to acknowledge a near-term resurgence.[11]

III. BACKGROUND

a. China's Shadow Finance Pullback: 2016-18

There is considerable academic debate over whether (or to what degree) China actually undertook "deleveraging" over the past several years[12], as it has claimed. However, there is relatively little question that shadow finance specifically saw a major crackdown and regulatory rethink over that same period.[13] Certain categories of shadow finance, such as unregulated peer-to-peer (P2P) lending, appear to have been largely wiped out.[14] Other categories, such as wealth management products (WMPs), saw specific regulations implemented to make them more standardized and transparent.[15] Our data, too, showed a notable drop in the proportion of bankers who reported selling WMPs as well as trust products over this period. In addition, companies reported to us an overall pullback in non-bank usage as a share of overall borrowing from 2016-18.

Chart 1: Banker Reports of Sales of Wealth Management Products

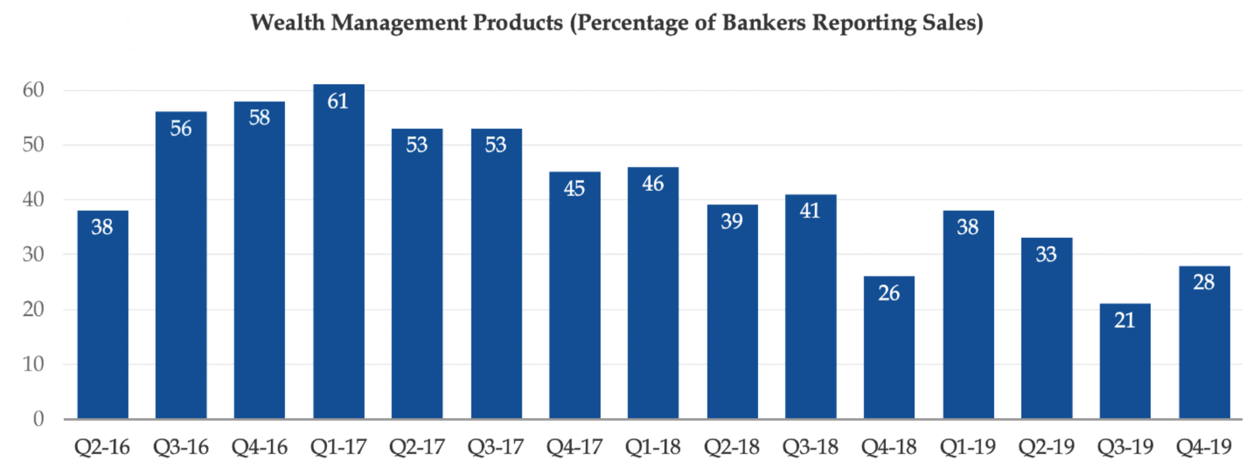
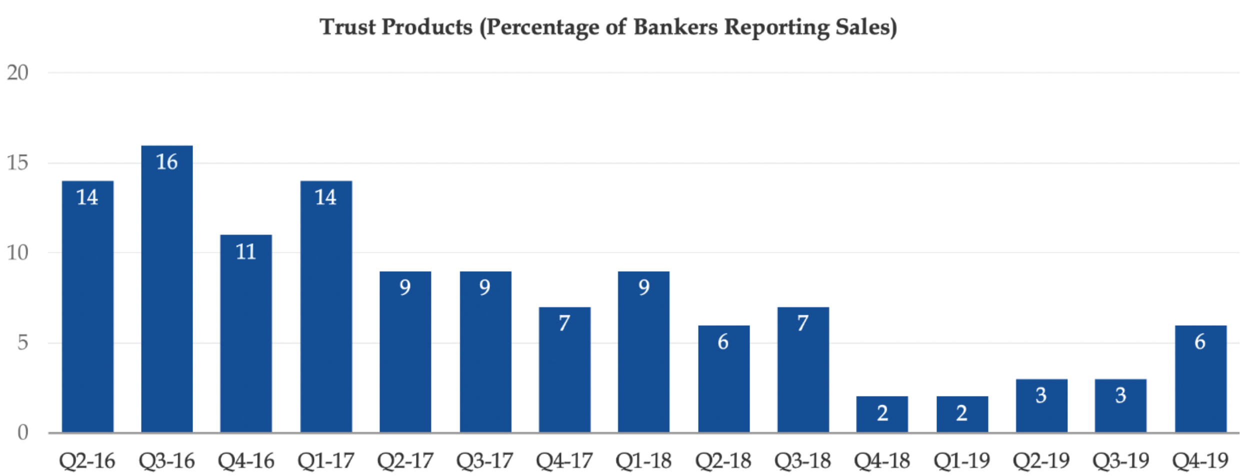
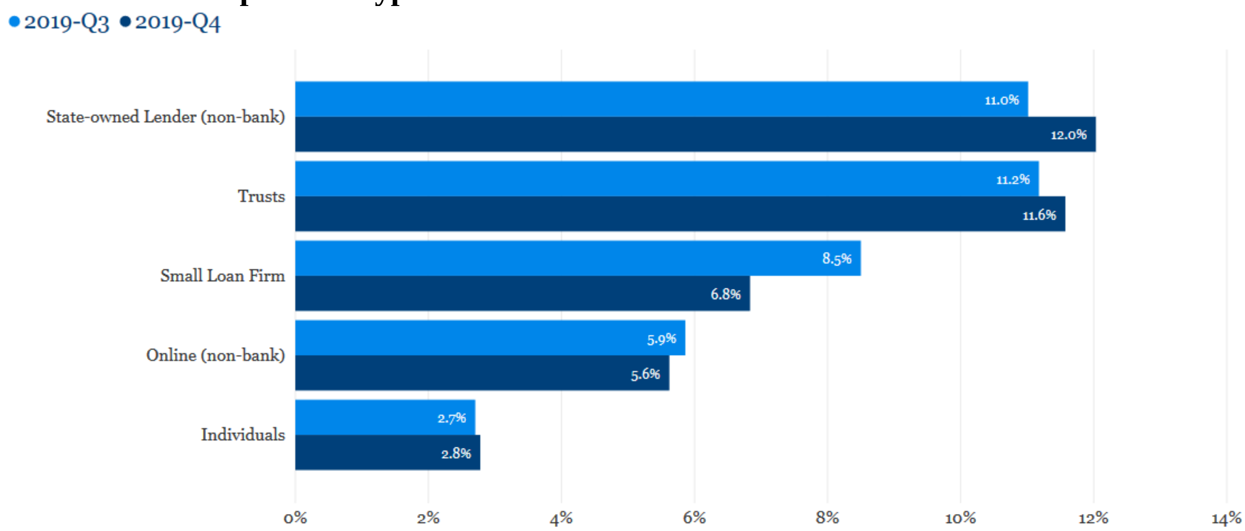


Chart 2: Banker Reports of Sales of Trust Products



Yet certain of these results shifted materially in 2019. While bankers in our survey continued to report that sales of WMPs and trust products were decelerating, corporates reported a surprising reversal in non-bank usage—and not merely to previous levels, but to the highest share of overall borrowing that we've tracked in eight years. The most prominent driver of this jump: borrowing from "state-owned non-bank" intermediaries—indicating that Beijing may not be as oblivious to this shift in posture as official credit data suggest.

Chart 3: Firm Reports of Types of Shadow Lenders Accessed



The story behind these 2019 developments in shadow finance, and the larger credit story that undergirds it, are explored in more detail below.

IV. CREDIT CONDITIONS IN CHINA 2018-19: WHAT PRIVATE DATA SAY

a. Late 2018 Economic Weakness Portended 2019's Shadow Finance Comeback

A key inflection point for Chinese economic policy was the fourth quarter of 2018. That quarter Chinese companies in our survey reported the worst national results in three years.[16] Growth weakened across virtually every headline metric we track, including on-quarter declines in each of our eight geographic regions and in every major sector. The performance was nearly as bad when viewed on-year.

Until these gloomy Q4 results came in, Chinese economic policy appeared stuck in an unusual state of limbo, with the central government sending conflicting signals[17] over how aggressively it was willing to support its now increasingly faltering economy. These circumstances were exacerbated by a major escalation in the U.S.-China trade war in September, when President Trump announced tariffs on $200 billion worth of Chinese imports on top of the $50 billion worth that had already been implemented earlier that year.[18] The president additionally threatened to place tariffs on the remaining $267 billion worth of imports if his actions were met with Chinese retaliation.[19]

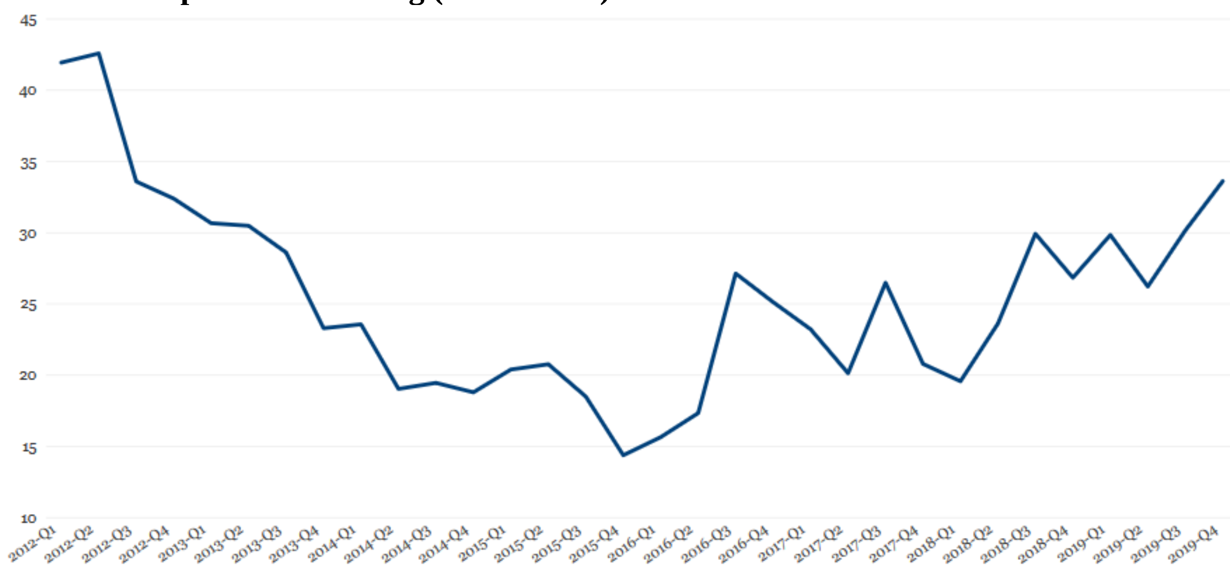
Amid this rapid deterioration of the U.S.-China trading relationship, and faced with faltering Q4 growth, plummeting sentiment,[20] and sharp weakness in investment and hiring,[21] a decision appears to have been made in Beijing to reprioritize short term growth and materially ease credit conditions across certain parts of the economy. While this looser corporate credit policy would look very different from the infrastructure-heavy stimulus programs of 2016 (discussed further in Section V), it represented a clear policy pivot—marking an end to any even notional commitment to deleveraging, and setting the stage for a reemergence of shadow finance the following year.

b. 2019: Anatomy of a Credit Surge

In the wake of fourth quarter 2018's worrisome results, our first quarter 2019 data saw "an unmistakable economic recovery,"[22] highlighted by a marked surge in borrowing reported by Chinese corporates. The idea of a credit-fueled recovery is of course nothing new for China. However, the breadth and intensity of this new wave of credit support proved exceptional even by typical Chinese standards:

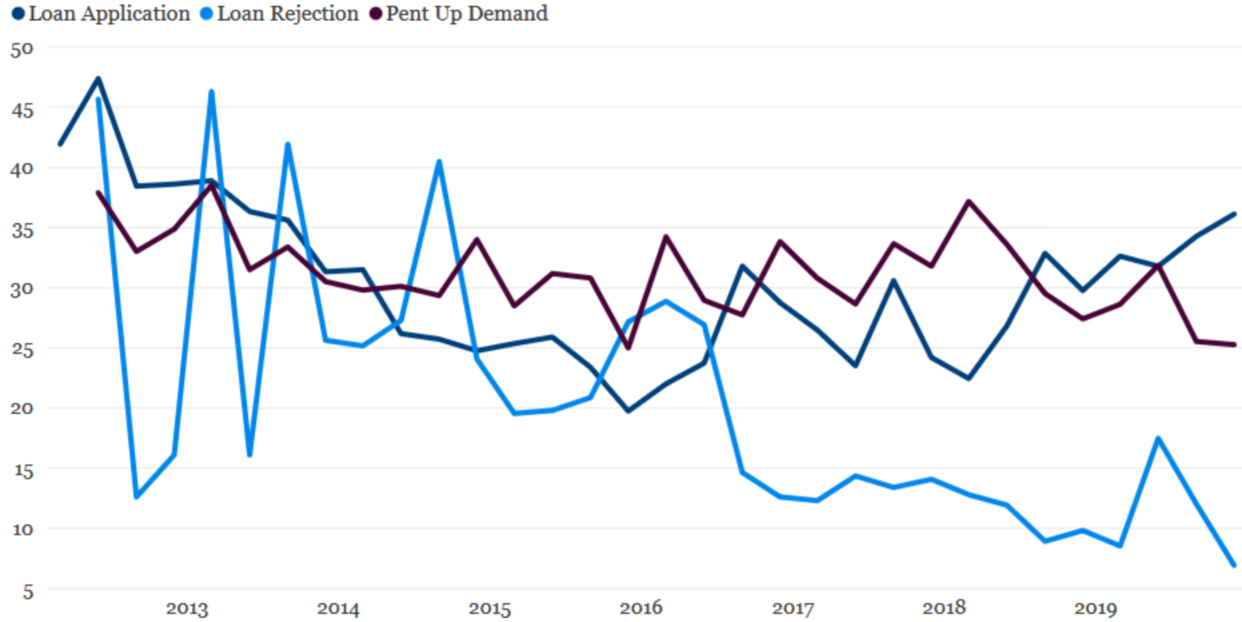
1) **Corporate Borrowing Jumped.** In the first quarter of 2019 corporate borrowing notched a six-year high in China Beige Book data, hitting a level not seen since the PBOC's response to the country's mid-2013 credit panic.

Chart 4: Corporate Borrowing (% of Firms)



2) **Credit Standards Fell.** Loan applications surged to a six-year high in Q1-19, while loan rejection levels slid to what at the time was an all-time low.

Chart 5: Loan Application & Rejection Rates & Pent Up Demand



3) **Credit Access Broadened.** Most notably, *traditionally disadvantaged borrowers* were the clearest beneficiaries of these newly eased conditions. Publicly, Beijing has long lamented that private firms, and especially small and medium sized enterprises (SMEs), receive far inferior credit access than their state and large firm counterparts.[23] This trend reversed in Q1, at least for the short term: private firm borrowing outpaced that of state-owned enterprises (SOEs) in Q1—and continued to outpace it throughout all of 2019—while SMEs saw lending temporarily jump past larger companies.

Chart 6: Corporate Borrowing: SOEs vs Private Companies (% of Firms)

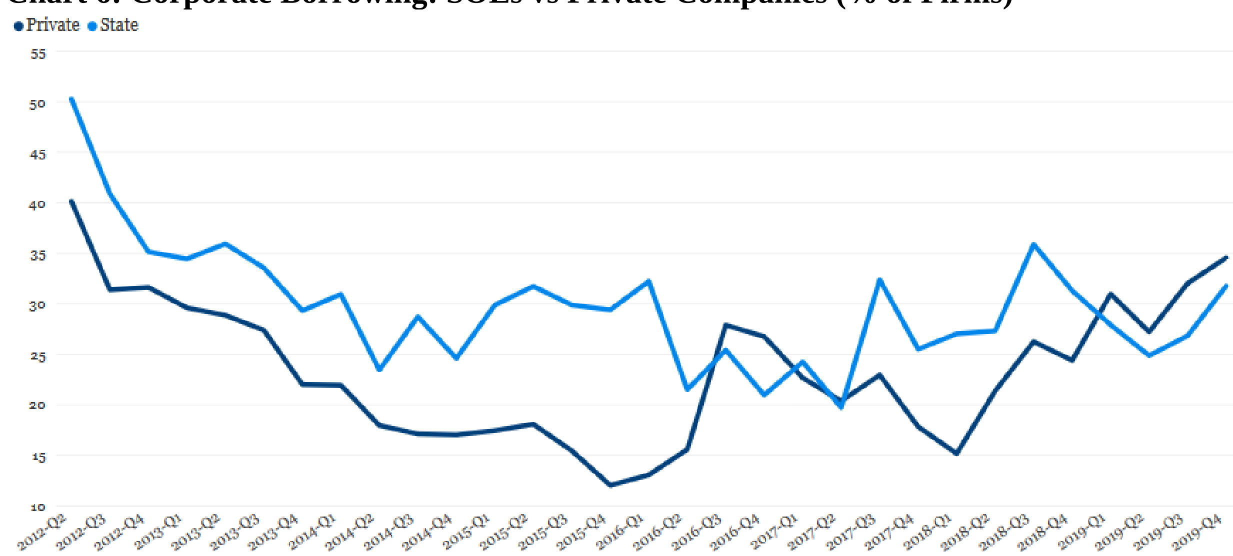
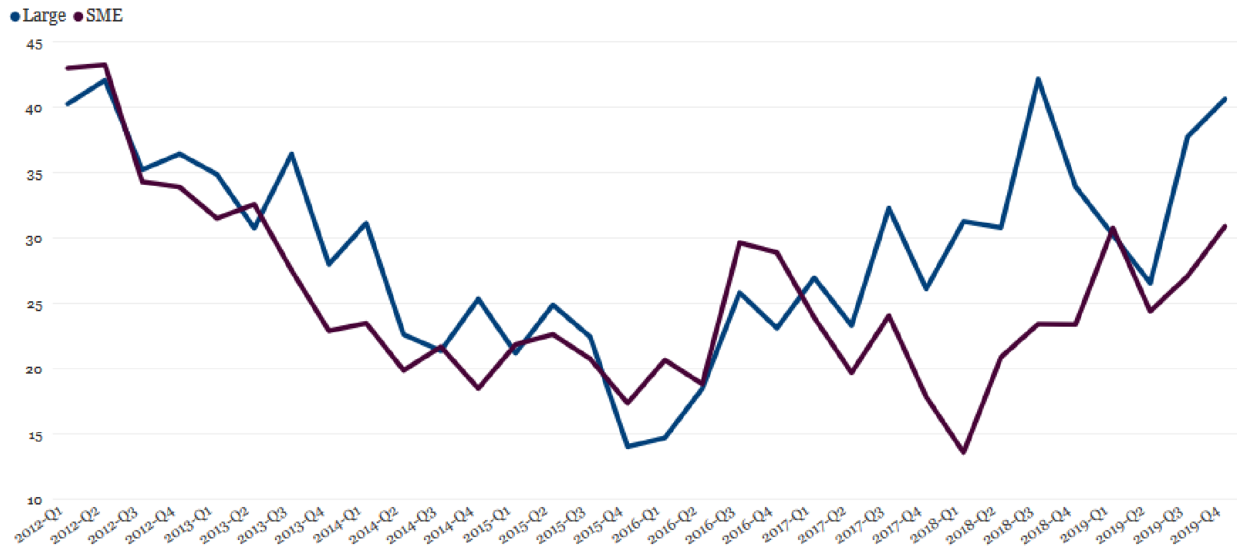
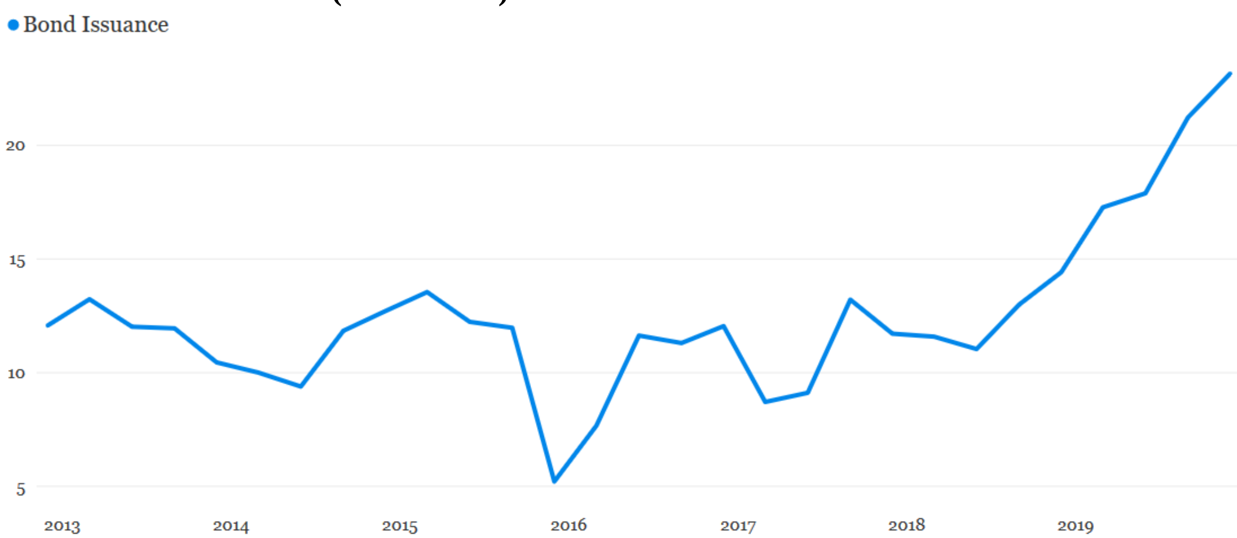


Chart 7: Corporate Borrowing: Large Firms vs SMEs (% of Firms)



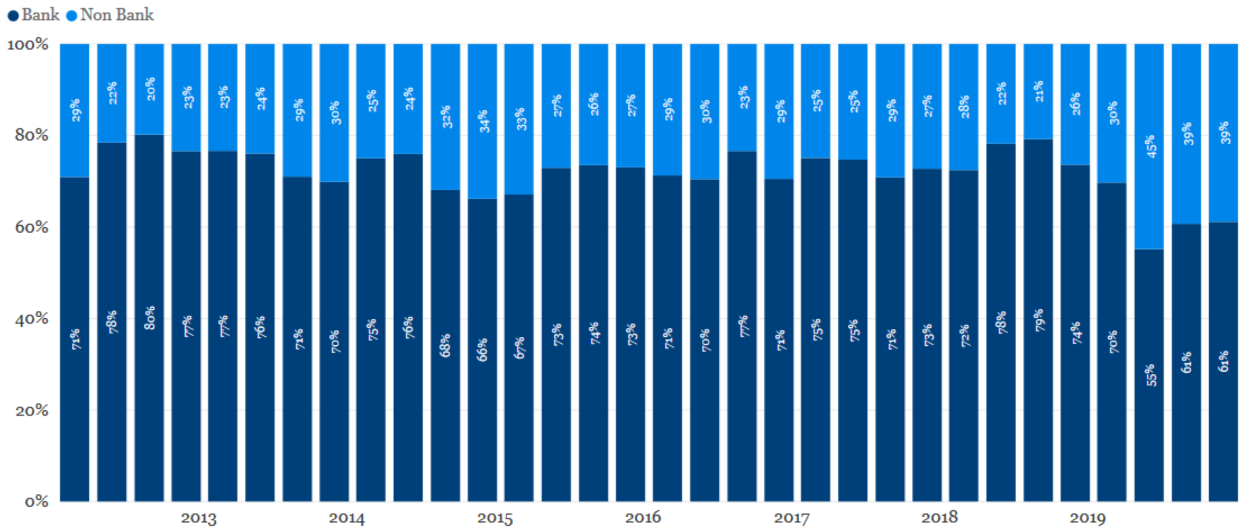
4) **Bond Issuance Surged in Tandem.** Bond issuance also continued to rocket upward, rising in Q1-19 for the third of what would ultimately be six (and counting) consecutive quarters of rising sales.

Chart 8: Bond Issuance (% of Firms)



By spring 2019, as Chinese state media continued to trumpet the need for proactive policy support,[24] it became clear that this substantially looser credit access for corporates was not a one-quarter aberration. In fact, the second quarter of 2019 was in certain critical ways an escalation. While corporate borrowing fell a notch, and bank lending showed some signs of retrenchment, **the crucial development was a resurgence of shadow finance to help fill the vacuum.** In Q2 2019 Chinese companies reported the highest share of shadow borrowing as a share of overall borrowing, and the sharpest on-quarter jump in shadow usage, in our survey history.[25] This de facto stimulus was still not enough to jumpstart the economy, but it did help Beijing arrest what would've likely been a substantial second-quarter fall.[26]

Chart 9: Bank vs Non-Bank Borrowing (% of All Loans)



The third quarter saw a continuation of this robust credit provision, yet with far less impact. Despite the fact that company borrowing, shadow bank usage, and bond sales all remained at or near record highs, our third quarter corporate sector results were the weakest of 2019.[27] Nationally, growth in revenue, profits, output, sales volumes, and hiring all slowed from the previous quarter, as did both domestic and export orders, indicating weakness in future demand. It is thus notable that as the year progressed, even these high levels of credit support to corporates were not just failing to grow the economy, by Q3 they were not even enough to keep it stable.

c. Into 2020: Where China's Credit Environment Is Now

Entering 2020, China Beige Book data show no sign of retrenchment of either overall credit provision or shadow finance specifically. In Q4-19 overall corporate borrowing rose yet again, hitting a level not seen since 2012, and bond sales notched another record high. Over the past three quarters—the second through fourth quarters of 2019—companies reported the three highest shares of shadow bank usage to overall borrowing in the history of our survey. Even so, the economy's fourth quarter performance barely improved over a weak Q3 (though the improvement was much more noticeable over a year ago).

Meanwhile, lenders overall do not seem to be getting much pickier, perhaps because resistance to higher risk lending in the banking sector is being compensated by a pickup in non-bank lending. Loan applications in Q4 remained at multi-year highs, even as loan rejections slid to a new low.

Moreover, other evidence also suggests that credit provision has been much more vigorous than Beijing has publicly admitted: "Pent up demand"—our metric highlighting those firms that report wishing to access capital but chose not to apply—is currently at its lowest level in four years. (See Chart 5 above.)

V. A TALE OF TWO STIMULI: 2016 vs 2019

a. 2016 Stimulus

There are at least two key reasons why this view of robust 2019 corporate credit support is not consensus amongst observers of the Chinese economy. The first is that the vast majority of China watchers rely on official government credit data, so if Beijing is not acknowledging a trend publicly, and in real time, then these observers have no way of recognizing that anything interesting may be happening beneath the surface.

The second is that the 2019 policy stimulus described above, though fairly characterized as "aggressive credit easing," was of a fundamentally different nature than the much heavier-hitting Chinese stimulus of 2016.

In 2016, following a panic in Chinese markets during the first few months of that year, the government responded in overwhelming fashion via its traditional policy lever of heavy infrastructure spending. As 2016 carried on, this became increasingly evident in our data: our construction indicators[28] shot upward, followed soon after by remarkable rallies in both the manufacturing and commodities sectors.[29] As has often been the default, Beijing's response to economic weakness in 2016 was to try to build its way out of the problem.

b. 2019 & Beyond

This was clearly not the case in 2019. In fact, far from seeing a pickup in infrastructure spending our data at year-end 2019 show the transport construction sector suffering from several quarters of sharp weakness, and the commodities sector mired in a Q4 correction.

On the other hand, credit support directly to corporates continues apace, and at record levels. This is a reflection, perhaps, of Beijing's evolving policy goals. In the past, Party leadership repeatedly proved itself willing to trade a jump in risky debt for a short-term surge in growth. Today's priorities may be more modest. Rather than try to stimulate itself out of every crisis, Beijing appears focused on simply keeping struggling firms afloat. This won't solve China's structural problems, nor fully arrest the slowdown of its economy. But it may buy time, pushing off a more serious downturn until the government feels better prepared to address the shortcomings of its financial system.

VI. KEY POLICY RECOMMENDATION

a. Establish a China Data Coordination Center Inside the US Treasury Department

China is the second largest economy in the world, behind only the United States, and the largest U.S. trading partner. How the Chinese economy fares obviously has enormous implications for both America and the world. Yet due to the limits of publicly available economic data on China, including well-documented problems related to the country's "official" data, U.S. policymakers often have very little idea of how China's economy is actually performing.

This makes it a severe oversight that there is no single entity tasked by Congress to monitor the Chinese economy from the data perspective and track it comprehensively from the ground up, utilizing all available public and private data sources.

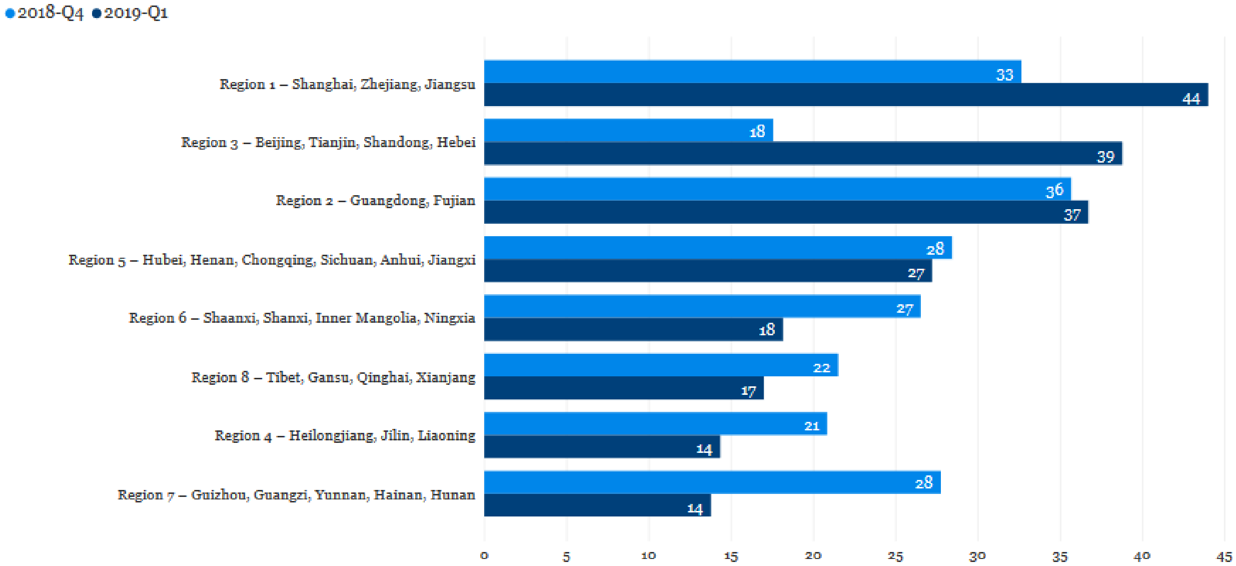
Congress could rectify that shortcoming through the creation of a China Economic Data Coordination Center (CEDCC). Such a Center would be mandated to 1) collect and synthesize all existing sources of China economic data; 2) commission independent research and data tracking to fill holes in the informational infrastructure; and 3) provide analysis and data to Congress and the Executive on all China economy or finance-related issues.

In my view locating the Center inside the Treasury Department makes the most sense simply because analyzing and tracking China's financial system—the foundation of any understanding of the broader economy—will require a team with a sophisticated finance skillset. But there are certainly reasonable arguments to house such a data coordination center elsewhere: The Commerce Department has the most experience collecting and utilizing data. The State Department has the most obvious portfolio to subsume it into. And the traditional coordination role of the National Economic Council makes it a sensible candidate as well.

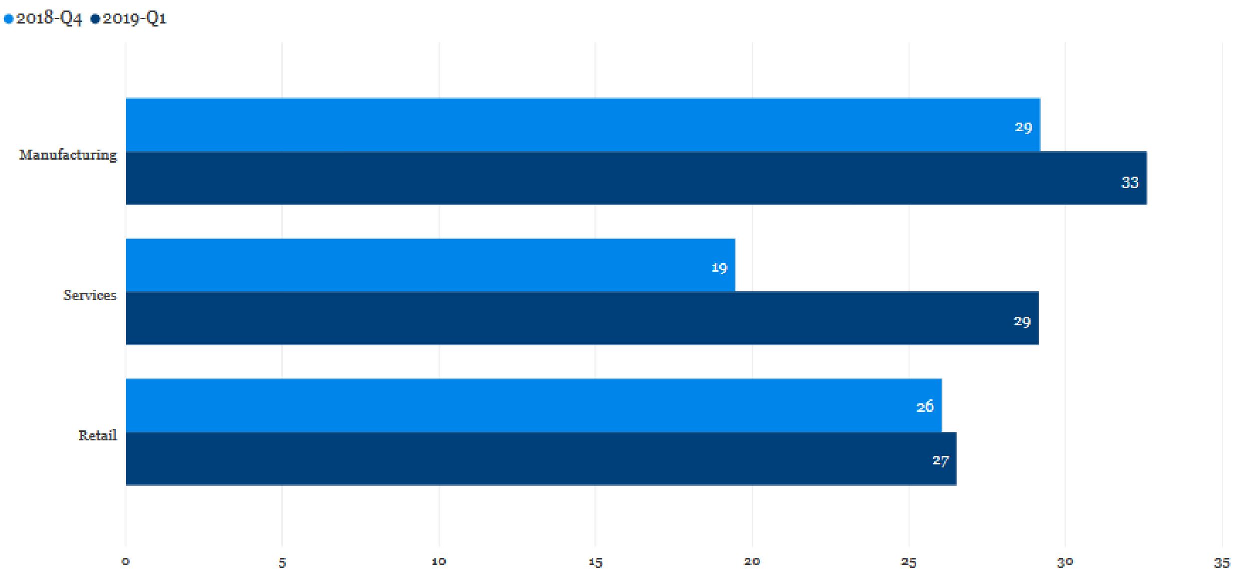
Yet wherever such a Center might be housed, it is sorely needed. A CEDCC would play an invaluable role in identifying and plugging USG information gaps on China, while ensuring that Congress and the White House are always fully informed of key economic dynamics in China that may have important implications for bilateral, regional, or even global stability.

APPENDIX: SUPPLEMENTARY CBB CREDIT CHARTS

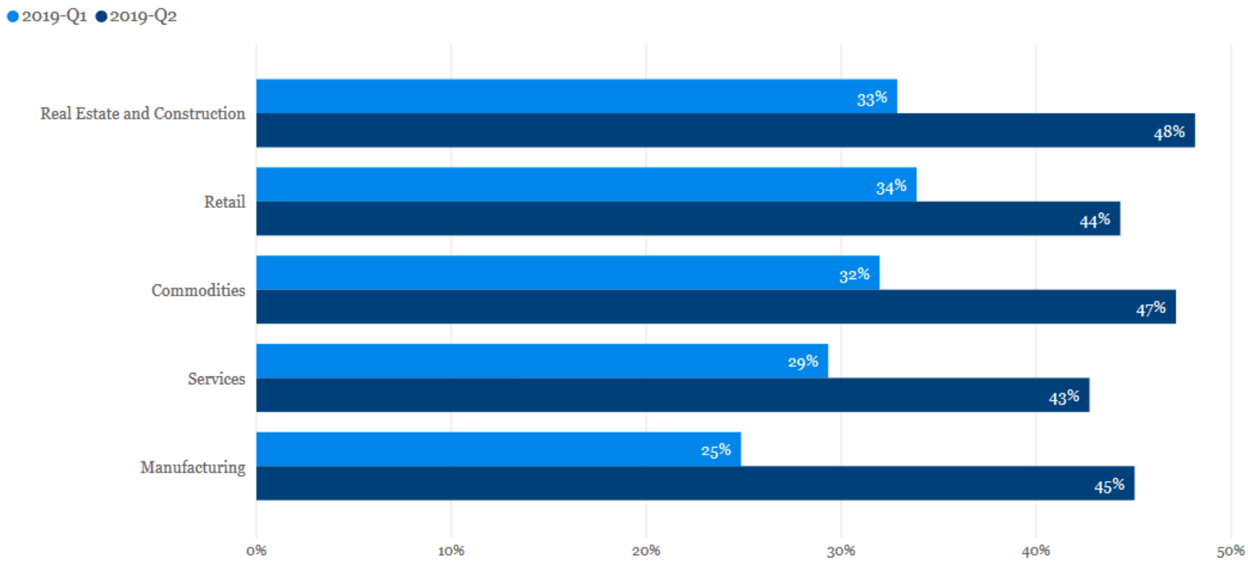
1. Chart 10: Corporate Borrowing by Region (% of Firms)



2. Chart 11: Corporate Borrowing by Sector (% of Firms)



3. Chart 12: Proportion of Loans from Non-Bank Lenders by Sector



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[4] China Beige Book is the world’s only large-scale independent data focused exclusively on the Chinese economy. The platform tracks every key component of China’s diverse economy—from growth dynamics to labor market and inflation trends to the formal and shadow credit environments. The nation-wide data collection tracks over 3,300 Chinese firms across key sectors, sub-sectors, regions, city tiers, firm size, firm ownership, as well as the crucial state/private divide. Data are released eight times a year. http://www.ChinaBeigeBook.com.

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[6] Ehlers, Torsten, Steven Kong, and Feng Zhu. “Mapping Shadow Banking in China: Structure and Dynamics.” Bank for International Settlements. Last modified February 2018. https://www.bis.org/publ/work701.pdf.

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[8] Maliszewski, Wojciech et al. "Resolving China's Corporate Debt Problem." International Monetary Fund. October, 2016. https://www.imf.org/external/pubs/ft/wp/2016/wp16203.pdf.

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[11] It is important to clarify that the data cited herein do not rely on Chinese government figures, nor derivatives of those data, nor does China Beige Book (CBB) extrapolate trends from other public or private data. CBB's methodology is to directly survey thousands of Chinese corporates independently (nearly 14,000 firms in 2019 alone) and document what those companies report: e.g., how often they're borrowing, from what sources they are borrowing, and how much they are paying for capital. The large sample size of our data collection allows trends to be further broken down granularly—e.g., by sector, sub-sector, firm size, geography, firm ownership, city tier, state vs private, etc. While CBB also tracks credit dynamics via a separate Chinese banker (lender) survey, we have generally found the borrower/demand-side lens provided by companies themselves to be the single most effective tool to track China's credit and shadow finance environments. The observations and conclusions presented in this statement therefore reflect that particular universe of China Beige Book data, unless designated otherwise.

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