

# **Insights from China for the United States:**

## **Shadow Banking, Economic Development, and Financial Systems**

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*The growth of China's shadow banking industry has been a recent source of serious concern for the US-China Economic and Security Review Commission. US shadow banking practices contributed to the 2008 financial crisis. The proliferation of these practices in China potentially threatens not only China but also economies that are intimately tied to China through trade, investment, and financial relationships such as the United States' economy. An investigation of Chinese shadow banking, in the context of China's post-1978 debt financing experience, reveals that China poses a challenge to the established theory that strong, formal financial systems are required for economic growth. Contrary to expectation, China's outstanding economic growth in the last thirty-five years took place without a strong formal financial system that was easily accessible to private entrepreneurs. This article examines the remarkable story of how China, constrained by political and historical legacies, relied upon informal financing structures to fund Chinese private entrepreneurs who contributed significantly to China's stellar economic growth. China's story affirms the work of scholars who have emphasized the importance of sociopolitical structures and who have theorized that law does not necessarily precede economic development but is engaged in a complex relationship with other normative structures.*

*An examination of the sociopolitical underpinnings of China's informal finance sector also reveals how shadow banking has grown to concerning levels in China and the challenges ahead that China faces as it attempts to use policy and legislative responses. Interestingly, this examination also reveals commonalities between China and the United States and suggests that there is the potential for mutual enlightenment despite the vastly different political systems and histories of these two countries. Thus, China's shadow banking story advances our understanding on two fronts: (a) China's example challenges current theoretical understandings of law, finance and economic development and requires us to broaden our inquiry to include political history and informal societal structures and (b) a sociopolitically informed understanding of China also allows us to draw comparisons to the United States to isolate commonalities and differences that may inform future legislative responses and mutual understanding between both countries.*

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## I. INTRODUCTION

As of April 2014, China was the top exporter of goods to the United States<sup>1</sup> and was the third largest recipient of US goods exports.<sup>2</sup> China's significant economy<sup>3</sup> and its voluminous level of trade with the United States suggest that these two economies have a strong reliance upon each other—a reliance that has been characterized as a codependency.<sup>4</sup> The results of this codependency were apparent during the 2008 financial crisis, which originated in the United States.<sup>5</sup> Given the codependency of the United States and China, particularly with respect to trade, this crisis quickly spread to China.<sup>6</sup> China had to quickly implement economic stimulus measures in order to offset the potentially disastrous effects of the 2008 financial crisis.<sup>7</sup>

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1. *Top Trading Partners—April 2014*, U.S. CENSUS BUREAU, <http://www.census.gov/foreign-trade/statistics/highlights/top/top1404yr.html> (Canada was the second largest exporter to the United States followed by Mexico).

2. *Id.* (In terms of receiving exports from the United States, Canada was ranked first, followed by Mexico).

3. WORLD BANK, CHINA 2030: BUILDING A MODERN, HARMONIOUS, AND CREATIVE SOCIETY 4 (2013), *available at* [http://www-wds.worldbank.org/external/default/WDSPContentServer/WDSP/IB/2013/03/27/000350881\\_20130327163105/Rendered/PDF/762990PUB0china0Box374372B00PUBLIC0.pdf](http://www-wds.worldbank.org/external/default/WDSPContentServer/WDSP/IB/2013/03/27/000350881_20130327163105/Rendered/PDF/762990PUB0china0Box374372B00PUBLIC0.pdf) (“Indeed, if mainland China’s 31 provinces were regarded as independent economies, they would be among the 32 fastest-growing economies in the world (figure O.1). Such rapid growth has been accompanied by many other achievements: for example, 2 of the world’s top 10 banks are now Chinese; 61 Chinese companies are on the Global Fortune 500 list; and China is home to the world’s second-largest highway network, the world’s 3 longest sea bridges, and 6 of the world’s 10 largest container ports. The country has also made large strides in health, education, science, and technology, and is quickly closing the gap on all these fronts with global leaders.”(footnotes omitted)).

4. See STEPHEN ROACH, UNBALANCED: THE CODEPENDENCY OF AMERICA AND CHINA 36–37 (2014) (“China certainly depends on the United States—not just as a source of external demand for its export machine and an anchor to its currency regime but also as an inspiration for its ultimate goal of an innovations- and knowledge-based model of economic prosperity. And the United States certainly depends on China—not just as a source of foreign capital to fund its savings-short economy but also a provider of low-cost consumer goods for American families. The metrics of codependency confirm the role that each economy plays in satisfying the needs of the other.”).

5. For a discussion of the origins of the subprime mortgage crisis as well as proposed regulatory solutions, see generally KATHLEEN C. ENGEL & PATRICIA A. MCCOY, THE SUBPRIME VIRUS: RECKLESS CREDIT, REGULATORY FAILURE, AND NEXT STEPS (2011).

6. Roach, *supra* note 4, at 172–80 (describing how the crisis affected the United States causing a drop in global trade which then impacted export-driven countries). Roach comments that, with respect to the effect of the financial crisis, “For export-led China, the shock was especially severe.” *Id.* at 178.

7. *Id.* at 173 (Roach states with respect to China: “Its economy was at a virtual standstill, and layoffs were mounting on a massive scale. Long fixated on social stability, China responded with an aggressive stimulus program, and the economy bounced back smartly in the second half of 2009.”).

However, there have been concerns about whether the risky and irresponsible lending practices that precipitated the 2008 financial crisis in the United States might repeat themselves in China. One of the main causes of the US financial crisis was the securitization of risk-laden, subprime mortgage loans that were later bundled together to create new financial products. These financial products represented bundles of risky loans whose true risk was obscured by credit rating agencies that had outlandishly given them stellar ratings.<sup>8</sup> This contributed to a housing bubble that eventually burst when borrowers were unable to make their mortgage payments. As the prices of houses plummeted, the securitized investment products, which were secured by houses, started to fall in a domino effect. By that time, these securitized investment products, which would later become known as toxic assets, had spread throughout the United States and threatened the entire US economy.<sup>9</sup>

In retrospect, it has become clear that the practice known as shadow banking was one of the key culprits.<sup>10</sup> Despite the absence of a universally agreed-upon, technical definition for the term shadow banking,<sup>11</sup> according to the Financial Stability Board<sup>12</sup> “[t]he shadow banking system can broadly be described as credit intermediation involving entities and activities outside the regular banking system.”<sup>13</sup> Shadow banking includes the special purpose vehicles and credit default swaps that gained notoriety during the 2008 financial crisis as well as repurchase agreements<sup>14</sup> and many other lending structures. Generally, shadow banking practices “rely on short-term liabilities to support long-term assets”<sup>15</sup> and, since they are not traditional banking, they are less transparent

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8. JOSEPH E. STIGLITZ, FREEFALL 6–8 (2010) (summarizing how subprime mortgages led to the financial crisis).

9. For a more detailed description of the housing bubble and its impact, see ENGEL & MCCOY, *supra* note 5 (Chapter 4—Prelude to the Storm and Chapter 5—Meltdown provide a detailed account of the inter-relation between the subprime mortgage industry and the financial crisis.).

10. Mark Fagan, *Shadow Banking: Past, Present Future*, 31 REV. BANKING & FIN. L. 591, 591 (2011–12) (“Shadow banking is often cited as a primary contributor to the recent Great Recession . . .”).

11. *Cf. id.* (Fagan states that, with respect to shadow banking, “a precise definition of the term is lacking”).

12. The Financial Stability Board is an international organization whose members include representatives from many nations and entities, including the U.S. Department of Treasury, U.S. Securities and Exchange Commission, the People’s Bank of China, China Banking Regulatory Commission, Bank of Canada, Banque de France, Deutsche Bundesbank, Banca d’Italia, Bank of Japan, and Bank of England, as well as organizations such as the International Monetary Fund, European Commission, and World Bank. For a more detailed description, see FINANCIAL STABILITY BOARD, <http://www.financialstabilityboard.org/about/fsb-members/> (last visited Aug. 16, 2015).

13. FINANCIAL STABILITY BOARD, GLOBAL SHADOW BANKING MONITORING REPORT 2013 1 (Nov. 14, 2013), [http://www.financialstabilityboard.org/publications/r\\_131114.pdf](http://www.financialstabilityboard.org/publications/r_131114.pdf).

14. See Jonathan Macey, *It’s All Shadow Banking, Actually*, 31 REV. BANKING & FIN. L. 593, 595–99 (2011–2012) (describing repurchase agreements, special purpose vehicles, and credit default swaps.).

15. Fagan, *supra* note 10.

and less regulated.<sup>16</sup> Regular traditional banking can be connected to shadow banking, particularly through intermediaries, and this can raise the degree of systemic risk that shadow banking poses.<sup>17</sup> Shadow banking is significant and constituted 24 percent of all financial intermediation at the end of 2012 according to the Financial Stability Board.<sup>18</sup> In 2014, the Economist reported that the percentage of financial assets attributable to shadow banking could be almost as high as 50 percent, if pensions and insurance, which were not included in the Financial Stability Board's calculations, are included.<sup>19</sup>

China has recently attracted concern because shadow banking is prevalent throughout its financial system, constituting approximately 33 percent of the increase in all lending in 2013.<sup>20</sup> The codependency of the United States and China suggests that a financial crisis in China would negatively impact the United States and potentially cause two of the world's largest economies to send ripples internationally. The US-China Economic and Security Review Commission has expressed concern that China's shadow banking system "poses risks for international financial stability more broadly,"<sup>21</sup> and that "[i]t is in the interest of the United States for Beijing to curb risky, off-balance-sheet lending."<sup>22</sup> The International Monetary Fund (IMF) has echoed this sentiment and recently urged China to constrain the expansion of credit.<sup>23</sup>

This suggests that a close analysis of China's financial system and shadow banking is warranted. This is an area, which, despite its importance to the United States and other nations heavily influenced by China's economic fate, re-

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16. *Id.* ("Until the financial crisis, regulation of this sector was limited."); cf. Macey, *supra* note 14, at 593 ("'Shadow banking' is a great term. Although the term fails to impart much meaning, it manages to convey the impression that, whatever it is, it must be nefarious, somewhat clandestine and of dubious legality.").

17. FINANCIAL STABILITY BOARD., *supra* note 13, at 1. The report further states that, "Therefore, appropriate monitoring of shadow banking helps to mitigate the build-up of such systemic risks." *Id.*

18. *Id.* at 8 (noting that this level is lower than the figure of 27 percent in 2007 prior to the financial crisis). These figures are based on the Financial Stability Board's study of twenty jurisdictions and the euro area. *Id.*

19. *Shadow and Substance*, ECONOMIST (May 10, 2014), <http://www.economist.com/news/special-report/21601621-banks-retreat-wake-financial-crisis-shadow-banks-are-taking-growing> ("The Financial Stability Board (FSB), a global financial watchdog, reckons that shadow lending in all its forms accounts for roughly a quarter of all financial assets, compared with about half in the banking system. But it excludes insurance and pension funds from its calculations; add those in, and shadow banking is almost on par with the better-lit sort.").

20. *Shadow Banking in China: Battling the Darkness*, ECONOMIST (May 10, 2014), <http://www.economist.com/news/finance-and-economics/21601872-every-time-regulators-curb-one-form-non-bank-lending-another-begins>.

21. U.S.-CHINA ECON. & SEC. REV. COMM'N, 2013 REPORT TO CONGRESS 142 (Nov. 20, 2013), [http://www.uscc.gov/Annual\\_Reports/2013-annual-report-congress](http://www.uscc.gov/Annual_Reports/2013-annual-report-congress)

22. *Id.*

23. Ian Talley & Bob Davis, *IMF Urges China to Rein in Credit Even if Growth Slows*, THE WALL STREET JOURNAL (Apr. 9, 2014, 9:00 AM ET), <http://blogs.wsj.com/economics/2014/04/09/imf-urges-china-to-rein-in-credit-even-if-growth-slows/> (last visited Aug. 16, 2015).

mains understudied. For scholars studying the interrelation between law and finance, China poses many interesting questions. There is a wealth of literature that addresses whether there is a correlation between the family of legal systems to which a country belongs and the robustness of that country's capital markets<sup>24</sup> (such literature often referred to as legal origins studies). The central contention by the famous group of authors known by their acronym LLSV is that legal origins (i.e., common law vs. civil code systems) have a significant influence on the degree of legal protection offered to investors.<sup>25</sup> In turn, protecting investors was correlated with strong capital markets. Legal origins theory can be regarded as an example of legal determinism and, as Ron Harris notes, "Through their influential series of articles, LLSV convinced nonlegal scholars that law matters."<sup>26</sup>

China does not lend itself well to the legal origins approach because China's legal system, with its roots in Chinese socialism and the primacy of the Chinese Communist Party, cannot be easily stereotyped into the legal categories contemplated by LLSV. However, this article argues that insights from critiques of legal origins studies can be applied to understand China's debt financing issues including shadow banking. Inspired by some of those critiques, this article focuses on China's history and politics and their influence on the ascendancy of alternatives to traditional formal bank financing. During its post-1978 reforms, China has had remarkable economic success despite its lack of a formal financial system that was easily accessible to private entrepreneurs—contrary to what would be predicted by prevailing finance theories.<sup>27</sup> China's private entrepreneurs, who have fueled much of China's economic ascendancy, relied heavily on *informal* finance structures. As will be discussed later, it was Chinese political conditions and the actions of local private entrepreneurs and investors that encouraged the growth of informal financing, including Chinese shadow banking. The growing size of China's shadow banking has now precipitated calls for a Chinese government response to the risks that it poses.

Rather than being fixated with the taxonomy of China's current evolving legal system, this article argues that understanding the historical and political antecedents to China's current financial system explains the constraints faced by the Chinese government in addressing shadow banking concerns. It con-

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24. See generally Ruth V. Aguilera & Cynthia A. Williams, "Law and Finance:" *Inaccurate, Incomplete and Important*, 2009 BYU L. REV. 1413 (discussing the legal origins literature, including its shortcomings and importance).

25. Rafael La Porta et al., *Legal Determinants of External Finance*, 52 J. FIN. 1131 (1997) (the authors' names are Rafael La Porta, Florencio Lopez-De-Silanes, Andrei Shleifer, and Robert W. Vishny).

26. Ron Harris, *Legal Scholars, Economists, and the Interdisciplinary Study of Institutions*, 96 CORNELL L. REV. 789, 798 (2011).

27. See *infra* Part III.A (discussing the theory that financial institutions are an important part of economic development).

cludes that while law does play a role in China, it is currently a minor one compared to Western countries. Formal law is not a singular deterministic variable but rather one of several components of China's sociopolitical system that ultimately bears upon the issue of debt finance. In turn, these insights provide general direction for future research as well as enlighten comparisons between the United States and China.

Part II of this article situates its discussion of China by discussing theoretical perspectives. Part III analyzes the puzzle of debt finance in China and illustrates how China's legacy of state-owned enterprises (SOEs) affects private entrepreneurs and drives informal finance. Part IV draws upon the insights of Parts II and III, and discusses their application to China's shadow banking situation. Part V reflects upon theoretical insights gained from the previous parts as well as parallels between China and the United States, which may merit future exploration. In this article, it is argued that China's shadow banking advances our theoretical understanding of the inter-relationship between law, finance and development by directing our attention to the important role of informal structures and sociopolitical history. It is also submitted that China's experience may shed some practical insights on the policy challenges faced by both the United States and China.

## II. CRITICAL PERSPECTIVES ON THE LEGAL ORIGINS LITERATURE

This part discusses the importance of legal origins theory (particularly the work of LLSV) and the body of scholarly critiques that it has attracted. Focusing particularly on two different critiques of legal origins theory, this article notes some important themes, which will be useful in its exploration of China's debt financing and shadow banking.

### *A. The Impact of LLSV on Scholarship and Policy*

In their influential work from the late 1990s, LLSV explored the question of "Why do some countries have so much bigger capital markets than others?"<sup>28</sup> In order to answer this question, they examined a sample set of forty-nine different countries. For these countries, they analyzed legal rules relating to the protection of shareholders and creditors, and the legal origin of these rules—noting whether the country followed a common law or civil law system. They conducted a regression analysis of a set of legal indicators versus indicators relating to depth of capital markets. Their results indicated that the depth of a country's capital markets is heavily influenced by legal origin.<sup>29</sup> In particular,

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28. La Porta et al., *supra* note 25, at 1131.

29. *Id.* at 1132 ("We find strong evidence that the legal environment has large effects on the size

they associated common law countries with better capital markets. Countries with low levels of investor protection, and correspondingly shallower capital markets, tended to be French civil law jurisdictions.<sup>30</sup>

LLSV's work quickly attracted attention, and soon academics were building upon LLSV's legal origins thesis to generate an entire genre of literature, such that "[a] cottage industry was created for economists all over the world."<sup>31</sup> Aside from the quantity of literature LLSV has inspired, the broader implication of their work is that capital markets in common law countries, relative to civil law countries, perform superiorly because their legal systems provide a higher degree of legal assurances to investors.<sup>32</sup> In turn, this has had political significance as developing countries were soon faced with "policy prescriptions"<sup>33</sup> from the World Bank, which seem at least partially premised on the influence of LLSV's work.<sup>34</sup> This has prompted one leading scholar to muse, "Must transitional economies therefore adopt the rules of common-law legal systems (and possibly common-law enforcement techniques) in order to develop their economies?"<sup>35</sup>, while also noting the work of scholars who have argued against the folly of attempting to graft laws in foreign contexts without considering how those contexts may differ materially from where the laws originated.<sup>36</sup>

### *B. Critical Perspectives on LLSV's Work and Legal Origins Theory*

Despite its prominence, legal origins theory has nevertheless been the subject of various critiques from scholars.<sup>37</sup> Although it is beyond the scope of this article to comprehensively explore that critically responsive literature, there are several critiques worth mentioning that advance the approach adopted by this article. The most important line of critique questions whether LLSV have the arrow of causation in the right direction—namely, could it be possible that as a financial system develops, laws are enacted to protect investors rather than the other way around as LLSV's work asserts?<sup>38</sup>

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and breadth of capital markets across countries.").

30. *Id.* at 1149.

31. CURTIS J. MILHAUT & KATHARINA PISTOR, *LAW & CAPITALISM: WHAT CORPORATE CRISES REVEAL ABOUT LEGAL SYSTEMS AND ECONOMIC DEVELOPMENT AROUND THE WORLD* 20 (2008).

32. *Id.* at 19.

33. Aguilera & Williams, *supra* note 24, at 1424. They also note the link between LLSV's works and World Bank policy prescriptions. *Id.*

34. *See id.* at 1425–28.

35. John C. Coffee, Jr., *The Rise of Dispersed Ownership: The Roles of Law and the State in the Separation of Ownership and Control*, 111 YALE L.J. 1, 5 (2001).

36. *See id.*

37. Aguilera & Williams, *supra* note 24, at 1413–14.

38. Kensie Kim, *Mixed Systems in Legal Origins Analysis*, 83 S. CAL. L. REV. 693, 699 (2010).

John Coffee, Jr. has explored this line of thought in his historical analysis of the New York and London Stock exchanges.<sup>39</sup> Rather than adhering to LLSV's general contention that law determines financial structures, he argues that "the cause and effect sequence is backwards."<sup>40</sup> His research reveals that the pattern of change is that economic changes occur first, with enactments of law following thereafter.<sup>41</sup> If one follows the logic of LLSV's works, dispersed ownership—a corporation with many minority shareholders—exists only where minority shareholders have sufficient legal assurances that their relatively minor stakes will be protected. The implication is that legal protection for minority shareholders encourages dispersed ownership (i.e. a multitude of shareholders) in corporations and leads to a developed stock market. However, Coffee's research reveals that, in the early United States and United Kingdom, there were relatively scarce legal protections for minority shareholders; yet dispersed share ownership patterns had arisen nevertheless.<sup>42</sup> As such, Coffee's work undermines the legal determinism heavily implied by LLSV and similar lines of legal origins research. More recent research has bolstered the assertion that the early US stock market did not have a strong regime of legal protections for shareholders, further eroding the claims of LLSV.<sup>43</sup>

Coffee presents a nuanced and sophisticated interpretation of the role of law. Although he contests LLSV's assertions, he finds that law continues to have relevance. His analysis extends beyond state-centered law. He explores how the common law systems in the United States and United Kingdom "protected the autonomy of the private sector"<sup>44</sup> and "accepted private ordering mechanisms for commercial disputes."<sup>45</sup> He argues that this resulted in the development of a relatively effective private sphere of self-regulation that supported the growth of dispersed US and UK stock markets.<sup>46</sup> Thus, Coffee attributes the presence of dispersed stock markets in the United States and United Kingdom to the fact that private (i.e. nonstate) mechanisms for regulating the stock market were better able to flourish under common law jurisdictions—unlike LLSV's work which credits common law legal protections for the depth of common law capital markets.<sup>47</sup> Despite the importance of private self-

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39. Coffee, *supra* note 35, at 7.

40. *Id.*

41. *Id.*

42. *Id.*

43. See Brian R. Cheffins et al., *Questioning "Law and Finance": US Stock Market Development, 1930–70*, U. CAMBRIDGE LEGAL STUDIES RESEARCH PAPER SERIES, Paper No. 14/2012 (June 7, 2012), available at <http://ssrn.com/abstract=2079505>.

44. Coffee, *supra* note 35, at 63.

45. *Id.*

46. *Id.* at 9.

47. *Id.*

regulatory mechanisms, Coffee also notes that such mechanisms might not be as effective—characterizing them as a “partial functional substitute for legal institutions.”<sup>48</sup> Moreover, he concludes that law has served an important risk-management function throughout his historical survey of stock markets remarking that the trend has been “crash-then-law.”<sup>49</sup> Coffee’s point here is that the private sphere alone is insufficient to protect the public against catastrophic market failures and that state intervention in the form of legislation assists in managing that risk.<sup>50</sup>

Interestingly, although Coffee rejects the strong legal determinism of LLSV, he also disagrees with one of the lead critiques of LLSV forwarded by Mark Roe. Roe argues that corporate structures, such as dispersed holdings, are superiorly accounted for by political analysis (as opposed to legal origins theories).<sup>51</sup> He points out that in Europe, unlike the United States, large concentrated blocks of shareholders predominate as in the case of Germany.<sup>52</sup> He explains the difference between the United States and Germany by arguing that political stability is a prerequisite toward productivity,<sup>53</sup> and how that stability is achieved varies among countries according to their political preferences.

In Germany, there are stronger social labor values, and this expresses itself under Germany’s codetermination system whereby 50 percent of the board of directors in a large corporation is represented by labor representatives.<sup>54</sup> His hypothesis is that shareholders fear that labor interests will be unduly influential and therefore form block holdings, as opposed to the dispersed shareholders in the United States, to counter this threat.<sup>55</sup> Roe then analyzes political indices as an indicator of political values (categorizing political systems) and

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48. *Id.* at 64.

49. *Id.* at 66 (internal quotation marks omitted). He also attributes the phrase “crash-then-law” to Frank Partnoy. *Id.* at n.244. See Frank Partnoy, *Why Markets Crash and What Law Can Do About It*, 61 U. PITT. L. REV. 741, 743 n.11 (2000).

50. Coffee, *supra* note 35, at 66 (“While markets can arise in the absence of a strong, mandatory legal framework, they neither function optimally nor develop to their potential in the absence of mandatory law that seeks to mitigate the risks of crashes.”). Coffee also states, “While formidable obstacles may exist to the development of liquid securities markets, both in transitional economies and in civil-law countries, a wholesale transplantation of common-law rules is not necessary. Self-help measures, including exchange self-regulation, can potentially provide functional substitutes that significantly compensate for any deficit in minority protection that the use of civil-law standards entails. This does not mean that substantive law reform is unimportant, or that self-regulation can provide a fully adequate substitute for public law enforcement, but only that adaptive strategies can be designed for nations, individual markets, and individual firms.” *Id.* at 11.

51. Mark J. Roe, *Legal Origins, Politics and Modern Stock Markets*, 120 HARV. L. REV. 460, 460 (2006).

52. MARK J. ROE, POLITICAL DETERMINANTS OF CORPORATE GOVERNANCE: POLITICAL CONTEXT, CORPORATE IMPACT 16 (2003).

53. *Id.* at 13 (referring to this as “Peace as Predicate” – the name of a subchapter in his book.).

54. *Id.* at 22.

55. *Id.* at 27–33.

the degree of concentrated shareholdings in various countries. His analysis demonstrates a correlation between social democracies and concentrated shareholdings.<sup>56</sup>

However, Coffee contends that early US and UK experiences do not fit neatly into Roe's theory because dispersed ownership does not appear to be significantly influenced by politics during those periods—bolstering his claim by pointing to research that suggests that dispersed holdings arose in the United Kingdom during a period when labor influences were dominant.<sup>57</sup> Later, Roe addresses this point by first acknowledging that Britain does not *apparently* fit into his politically based theory.<sup>58</sup> However, Roe explains that a closer inspection of the historical timeline reveals that strong legal institutions for markets developed during an era of conservatism, which were then inherited later by leftward-leaning parties.<sup>59</sup>

In retrospect, the theories advanced by Coffee and Roe do not necessarily conflict with each other completely though they may decidedly place the weight of emphasis on different factors. In Roe's 2006 article, it is clear that the proposition he advances is one of relativity—where Roe assesses the merits of his theory against the backdrop of legal origins theory.<sup>60</sup> When he places his own political economy analysis against legal origins theory, he comes to the conclusion that his political economy analysis has greater potential than legal origins theory in shedding light upon the formation of financial structures such as stock markets.<sup>61</sup> Although Coffee might not agree with Roe as to the primary reason for the formation of block holdings versus dispersed structures, Coffee nevertheless directs our attention to a political dimension when assessing why law might follow rather than precede the formation of stock markets. Coffee argues that it is only once a market has formed that there will be groups with enough of a vested interest to call for legal enactments that can protect the sta-

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56. *Id.* at 55. (Chapter 6 contains Roe's statistical analysis, which includes countries such as the United States, the United Kingdom, Germany, Japan, France, and Italy).

57. Coffee, *supra* note 35, at 73–74. Coffee cites Brian Cheffins' work in support of his contention. *Id.* See Brian Cheffins, *Putting Britain on the Roe Map: The Emergence of the Berle-Means Corporation in the United Kingdom*, SOC. SCI. RESEARCH NETWORK (Feb. 2000), available at [http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=218655](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=218655). For a related study, see also Cheffins et al., *supra* note 43.

58. Roe, *supra* note 51, at 508 (referring to his theory and the example of early Britain and stating: "True, Britain at first seems at odds with it at a superficial level because it had left-oriented politics after World War II and relatively deep financial markets.").

59. *Id.* at 508–09.

60. *Id.* at 463. ("Here I assess which approach—legal origin or political economy—is the better bet for future research . . . .")

61. *Id.* at 517 ("But, using the same influential data set of twenty-seven rich nations that the legal origins literature has used, I show that indicators from the early twentieth century of economic destruction and national occupation, as well as simple indicators of post-World War II legislative policy, are usually as strong or stronger than legal origins in predicting financial outcomes in the last half of the twentieth century.")

bility of that market—a causality phenomenon that he states makes “obvious political sense.”<sup>62</sup> With respect to China, this aspect of Coffee’s theory has been supported by scholarship from outside the field of law. Zhiwu Chen, a finance professor from the Yale School of Management, studied China’s capital market and found that Coffee’s observations of legislative reform being driven by interested stakeholders are well-supported by China’s modern developmental history.<sup>63</sup>

This article finds that both Coffee and Roe’s critiques of legal origins theory are useful for understanding China’s post-1978 debt financing and shadow banking environments. However, in passing, it is also worth noting other critiques of LLSV’s work as well as underscoring LLSV’s vitally important contribution. Aguilera and Williams concluded that legal origins theory (particularly as exemplified by the work of LLSV) is “inaccurate, incomplete, and yet important.”<sup>64</sup> In addition to the strong arguments proffered by Coffee and Roe against legal origins theory, critiques about legal origin studies from other scholars have included questioning whether the categorization of country legal systems into stereotyped categories is sound,<sup>65</sup> that legal origin studies ignore other potentially enlightening areas of research by focusing mainly on corporate legal regimes,<sup>66</sup> and that such studies may not necessarily reflect whether laws are actually enforced.<sup>67</sup>

Yet, rich and contested dialogues between academics have taken root based on the work of LLSV—providing an intellectual sounding board and focal point for analysis.<sup>68</sup> One mediating view is that the statistical analysis employed in legal origins studies should not be viewed as mutually exclusive to

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62. Coffee, *supra* note 35, at 7. Coffee also states, “Hence, the constituency (here, dispersed public shareholders) must first arise before it can be an effective lobbying force and an instrument of legal change.” *Id.*

63. Zhiwu Chen, *Capital Markets and Legal Development: The China Case*, 14 CHINA ECON. REV. 451, 451 (2003). Chen also remarks: “Indeed, it is the large and clearly defined constituency of investors that has been a key driving force behind much of the recent legal progress.” *Id.*

64. Aguilera & Williams, *supra* note 24, at 1413.

65. See Matthias Siems, *Legal Origins: Reconciling Law & Finance and Comparative Law*, 52 MCGILL L.J. 55, 62–72 (2007); cf. Andreas Engert & D. Gordon Smith, *Unpacking Adaptability*, 2009 BYU L. REV. 1553, 1570 (arguing that “[t]he impossibility of measuring adaptability directly has prompted Legal Origins Theory to rely on the role of the courts as a proxy for adaptability”).

66. John Ohnesorge, *Legal Origins and the Tasks of Corporate Law in Economic Development: A Preliminary Exploration*, 2009 BYU L. REV. 1619, 1630–31.

67. John W. Cioffi, *Legal Regimes and Political Particularism: An Assessment of the “Legal Families” Theory from the Perspectives of Comparative Law and Political Economy*, 2009 BYU L. REV. 1501, 1512–17.

68. See Aguilera & Williams, *supra* note 24, at 1424. Also generally remarking with respect to LLSV, “[T]hey have established and defined the field of law and finance, and then elaborated upon it with prodigious productivity. Few academics can point to similar accomplishments. They are, quite simply, academic rock stars.” *Id.*

qualitative studies but rather as an “extension of traditional scholarship”<sup>69</sup> and that quantitative methods have the potential to enrich comparative law scholarship.<sup>70</sup> This sentiment parallels other commentary, suggesting that a merger of ideas can lead to better scholarship: “And thus, standing on the shoulders of giants from law and economics and from comparative law, we may be able to achieve what these giants did not: a truly interdisciplinary approach to comparative law.”<sup>71</sup>

Progress in comparative law is exemplified by studies such as that of Curtis Milhaupt and Katharina Pistor who have advanced our collective insights through a series of case studies by examining corporate crises in six different countries—revealing the complex interaction between law and economic development.<sup>72</sup> Another important study more rigorously tested the assertions of legal origin studies over various time periods (as opposed to more limited points of time as was done by previous legal origin studies).<sup>73</sup> This study’s findings erode the legal determinism implied by legal origin studies—particularly, the authors state,

More generally, the new evidence casts doubt on the suggestion that legal origins operate as an “exogenous” force, independently shaping both the content of law and economic outcomes. It is more plausible to see legal systems as evolving in parallel with changes in economic conditions and political structures at the national level.<sup>74</sup>

The above studies contribute to this article’s understanding of the interrelationship between sociopolitical structures, including law, and economic development. The works of both Coffee and Roe, discussed earlier, have especially influenced this article’s perspective. Roe’s work stresses the importance of political structure and social stability and how this might affect a nation’s approach to corporate governance. Coffee’s work observes how the private sphere may construct alternatives to legally-mandated structures, resulting in economic growth, but perhaps later requiring law to control the risks generated by private sphere activity—as in the case of early stock markets in the United States and United Kingdom. Although the works of Coffee and Roe discussed here

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69. John Reitz, *Legal Origins, Comparative Law, and Political Economy*, 57 AM. J. COMP. L. 847, 847 (2009).

70. *Id.* (“[C]omparative law needs to explore the utility of quantitative methods for developing and testing generalities of legal systems and we should be aware of a disciplinary bias against using them.”).

71. Ralf Michaels, *The Second Wave of Comparative Law and Economics?*, 59 U. TORONTO L.J. 197, 213 (2009).

72. MILHAUPT & PISTOR, *supra* note 31.

73. John Armour, Simon Deakin, Viviana Mollica & Matthew Siems, *Law and Financial Development: What We Are Learning From Time-Series Evidence*, 2009 BYU L. REV. 1435 (2009).

74. *Id.* at 1435.

address legal origins theory in the context of equity (i.e. dispersed corporate ownership), this article finds that their contributions are sufficiently broad enough to be useful in understanding China's debt financing and shadow banking.

### III. THE CHINESE LENDING PUZZLE?

This part reviews the broader landscape of China's debt financing situation as a means to understand the context under which China's shadow banking industry has grown. A central puzzle is how China's post-1978 reforms managed to generate such phenomenal economic growth despite China's lack of an easily accessible formal financial system. What emerges from this exploration is a fascinating story of how informal financing emerged in China. It turns out that a key driver of informal financing is the preferential lending policy of Chinese banks—such preference being towards SOEs. In the discussion below, it is revealed that informal financing arose as an alternative structure to traditional bank financing and was heavily influenced by the sociopolitical context of China.

#### *A. The Theoretical Link Between Financial Systems and Economic Prosperity*

LLSV explored the difference between common law and civil law jurisdictions with respect to capital markets development (i.e. equity and debt financing). A separate complex question is whether having well-developed capital markets is necessary for economic prosperity.<sup>75</sup> The prevailing theme is that strong financial development is important for a nation's economy as argued in King and Levine's 1993 seminal work entitled *Finance and Growth: Schumpeter Might be Right*.<sup>76</sup> Their work assessed Austrian economist Joseph Schumpeter's claim that economic prosperity can be fueled through a robust financial system where intermediaries provide important services.<sup>77</sup>

Their data set covered the time period 1960–1989, and they investigated more than eighty countries.<sup>78</sup> They prepared a set of indicators that measured the degree of financial development and compared that to measures for real per capita GDP, rate of physical capital accumulation, and efficiencies in deploy-

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75. Rafael La Porta et al., *Law and Finance*, 106 J. POL. ECON. 1113, 1152 (1998) (LLSV refer to research which suggests that capital markets are associated with economic growth).

76. Robert G. King & Ross Levine, *Finance and Growth: Schumpeter Might be Right*, 108 Q. J. ECON. 717 (1993). Later, LLSV refer to King and Levine's work as support for the argument that capital markets and economic growth are linked. See La Porta et al., *supra* note 75, at 1152.

77. King & Levine, *supra* note 76, at 718.

78. *Id.* at 717.

ment of physical capital.<sup>79</sup> The results of their study indicate a strong correlation between the robustness of a financial system and overall economic growth.<sup>80</sup> They thus concluded that “Schumpeter might have been right about the importance of finance for economic development.”<sup>81</sup> Other scholars have built upon King and Levine’s influential work with further studies that establish a link between financial development and economic growth.<sup>82</sup>

### *B. China’s Challenge to the Established Theory*

However, China’s developmental history, with its meteoric economic growth in the last thirty years, poses a problem for the above literature supporting Schumpeter’s assertions. A study from 2005 revealed that “China is an important counterexample to the findings in the law, institutions, finance and growth literature: Neither its legal nor financial system is well-developed, yet it has one of the fastest growing economies.”<sup>83</sup> The authors of this study found that, despite a lack of access to regular financing (e.g., banks), private businesses in China grew faster than state enterprises and listed public companies.<sup>84</sup> The authors argued that private businesses managed to secure financing through “alternative financing channels and corporate governance mechanisms”<sup>85</sup> and concluded that this “system of alternative mechanisms and institutions plays an important role in supporting the growth in the Private Sector.”<sup>86</sup>

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79. *Id.* at 718. King and Levine admit that their use of financial indicators has weaknesses but assert that “[a]lthough each financial indicator has shortcomings, using this array of indicators provides a richer picture of financial development than if we used only a single measure.” *Id.*

80. *Id.* at 719.

81. *Id.* at 735. For an analysis that draws upon another Austrian economist, but as applied to legal systems, see Paul G. Mahoney, *The Common Law and Economic Growth: Hayek Might be Right*, 30 J. LEGAL STUD. 503 (2001).

82. See, e.g., Raghuram G. Rajan & Luigi Zingales, *Financial Dependence and Growth*, 88 AM. ECON. REV. 559 (1998); G. Bekaert et al., *Does Financial Liberalization Spur Growth?*, 77 J. FIN. ECON. 3 (2005). For a more recent affirmation of King and Levine’s work, see Filomena Pietrovito, *Does Financial Development Help to Align Growth Opportunities with Growth? Evidence from Industry-Level Data*, 150 REV. WORLD ECON. 421, 421 (2014) (“The results, obtained in a cross-section framework including 37 developed and developing countries over the period 1992–2006 confirm the relevance of financial development to promote economic growth and to help industries in taking advantage of global and local growth opportunities.”).

83. Franklin Allen, Jun Qian, & Meijun Qian., *Law, Finance, and Economic Growth in China*, 77 J. FIN. ECON. 57, 57 (2005).

84. *Id.* at 59. More specifically, the authors use the following definitions: “(1) the *State Sector* includes all companies such that the government has ultimate control (state-owned enterprises, or SOEs); (2) the *Listed Sector* includes all firms that are listed on an exchange and are publicly traded; and, (3) the *Private Sector* includes all the other firms with various types of private and local government ownership.” *Id.*

85. *Id.*

86. *Id.* at 99. Note the authors state that “[t]he Private Sector includes the following types of firms: (1) collective- and jointly-owned companies, where joint ownership among local government, communities, and institutions is forged; and, (2) privately owned companies (but not publicly listed and traded), where controlling owners can be Chinese citizens, investors (or companies) from Taiwan or Hong Kong,

Since the time of that original article in 2005, the term “alternative financing channels” has now grown to be more commonly known as informal financing (the two terms often being used interchangeably). This is reflected in a more recent paper (whose three authors include two of the authors in the paper referred to immediately above) which makes reference to informal financing instead of alternative financing channels.<sup>87</sup> In that more recent paper, the authors acknowledge informal financing has generally been defined in the negative as “a variety of financing sources apart from banks and stock markets.”<sup>88</sup>

The fact that Chinese private entrepreneurs obtain much of their financing through informal channels is a significant revelation. Through its generation of goods and services, as well as providing opportunities for employment, China’s nonstate sector has been at the forefront of fueling China’s incredible economic growth.<sup>89</sup> Figures from China reveal that, in 2012, 60 percent of China’s GDP was attributable to the more than ten million private business that comprise China’s burgeoning private sector.<sup>90</sup> In 2011, it was reported that during the preceding decade the wealth growth rate of both state enterprises and foreign-funded enterprises had been overtaken by China’s private sector.<sup>91</sup> In short, this means that a significant portion of China’s phenomenal economic growth can be attributed to informal financing, contrary to what one might have expected according to the finance literature supporting Schumpeter’s economic theories.

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or foreign investors (or companies)” and refer the reader to their Appendix A.4 for further details. *Id.* at 59 n.3.

87. Franklin Allen, Meijun Qian & Jing Xie., *Understanding Informal Financing*, (May 3, 2013) (Working paper presented at the Asian Bureau of Finance and Economic Research Annual Conference 2013 – Academic Workshops – Corporate Finance and Economic Growth May 22–23, 2013), <http://abfer.org/docs/track2/track2-understanding-informal-financing.pdf>.

88. *Id.* at 3.

89. Jun Zhang, *Assessing China's Economic Transformation and Growth Since 1978*, in *ECONOMIC TRANSITIONS WITH CHINESE CHARACTERISTICS: THIRTY YEARS OF REFORM AND OPENING UP* 11, 21, (Arthur Sweetman & Jun Zhang eds., 2009) (“The non-state sector has become the most important component of the Chinese economy, both in industrial and service sector. It performs vital roles that the state sector cannot cover, such as filling gaps in the production of goods and services. The non-state sector also provides employment opportunities for surplus labour in urban and rural areas and investment opportunities for private savings, which would otherwise fuel consumer demand and inflationary pressures.”). See also LINDA YUEH, *ENTERPRISING CHINA: BUSINESS, ECONOMIC, AND LEGAL DEVELOPMENTS SINCE 1979*, 187 (2011) (noting with respect to the nonstate sector that it “started to outweigh the importance of SOEs in generating industrial output by the late 1990s”).

90. Ying Yiyuan, *Private Sector Contributes over 60% to GDP*, CCTV (Feb. 6, 2013, 15:52 BJT), <http://english.cntv.cn/program/bizasia/20130206/105751.shtml>. Also quoting Professor Shi Jingchuan, Zhejiang University as saying, “Take Zhejiang Province for example, over 90% of new jobs created over the last 30 years are from the private sector. Zhejiang’s export value has exceeded 200 billion US Dollar in 2012. Over half of it comes from the private sector.” *Id.*

91. *Wealth of China's Private Enterprises Rising Rapidly*, PEOPLE’S DAILY ONLINE (May 19, 2011, 16:14), <http://english.people.com.cn/90001/90778/90862/7385668.html> (noting the exception was during the years 2008–2009 due to the financial crisis).

### C. *Why Informal Finance? Understanding the Chinese Context*

Why would China's private entrepreneurs turn to informal financing as opposed to regular bank financing? The answer is that China's private entrepreneurs are crowded out by China's SOEs. China's state banks continue to favor lending to SOEs, even though they may not repay their loans.<sup>92</sup> Kellee Tsai, basing her calculations on the *China Statistical Yearbook* for 2008, estimated that in 2007 private enterprises received approximately 1.3 percent of all state bank loans.<sup>93</sup> Thus, private entrepreneurs are being starved of bank credit due to the preferential lending policies of state banks and leads to the "irony that losing state enterprises can obtain credit more easily than profitable, promising private enterprises."<sup>94</sup> Below, this article explores, in greater detail, how informal financing grew in China.

#### 1. *Gradualism: Vestiges of the "Iron Rice Bowl" and State-Owned Enterprises*

Understanding the prevalence of the discriminatory lending policies of Chinese state banks requires background knowledge of the political history of banking in China. When China commenced its economic reforms in 1978, it was still very much a centrally planned economy recovering from the chaos of the Cultural Revolution. In essence, at that time there was no bank or banking in the sense that is recognizable under Western, market-based economies. Rather, the state bank was an extension of central state planning and acted as a funnel through which funds were allocated according to the government's economic blueprint.<sup>95</sup>

China's banks have played an important role in China's post-1978 reforms. Those reforms have been a cautious exercise in gradualism, with the slow privatization of what used to be a single, massive state-economic entity. Arguably, this spared China the looting and asset stripping that occurred in Russia under

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92. See Ho-fung Hung, *A Caveat: Is the Rise of China Sustainable?*, in *CHINA AND THE TRANSFORMATION OF GLOBAL CAPITALISM* 187, 192 (Ho-fung Hung ed., 2009).

93. Kellee S. Tsai, *Beyond Banks: The Local Logic of Informal Finance and Private Sector Development in China*, in *INFORMAL FINANCE IN CHINA: AMERICAN AND CHINESE PERSPECTIVES* 80, 80 (Jianjun Li & Sara Hsu eds., 2009). Tsai states that she based her calculations from the *China Statistical Yearbook 2008*. *Id.* at n1. See also NATIONAL BUREAU OF STATISTICS CHINA, *CHINA STATISTICAL YEARBOOK 2008*, <http://www.stats.gov.cn/tjsj/ndsj/2008/indexeh.htm> (last visited Aug. 16, 2015).

94. Hung, *supra* note 92.

95. KENNETH LIEBERTHAL, *GOVERNING CHINA: FROM REVOLUTION THROUGH REFORM* 262 (2d ed. 2004) ("Under the Maoist socialist system, the banks merely served as vehicles for economic transactions. They did not impose real costs on capital, did not independently evaluate the economic prospects of potential borrowers, and often did not collect the loans they made. They simply provided a means of handling money and of keeping track of the flow of funds." (footnote omitted)).

the accelerated privatization of SOEs in the 1990s.<sup>96</sup> In contrast to the accelerated Russian reforms, Deng Xiaoping, the leader of China during the early days of reforms, advocated a cautious, gradual approach to reform. This was colorfully encapsulated in his well-known slogan<sup>97</sup> of “crossing the river by groping for stones” (*mo shitou guo he*).

This conservative, economic reform approach manifested itself under Deng’s dual-track system. This system allowed the coexistence of both the traditional state-planned economy and an emerging private market<sup>98</sup> rather than rapidly privatizing the entire state sector. Essentially, the dual-track system required that state enterprises meet the government’s specified goals, in terms of producing goods, set by the central planning authorities. However, any goods that exceeded the goals were available to be sold on the developing private market in accordance with free market principles.<sup>99</sup>

However, such a transition to an increasing role for free market forces could possibly mean having to lay off workers. In a nation that was still formally committed to socialist principles (i.e., the clichéd “workers’ paradise”), such an occurrence could have dangerous consequences. In the previous part of this article, Roe’s political perspective was explored, including his notion that social peace and stability are prerequisites for productive economic activity. Applied to China’s historical context, such a perspective anticipates that China had to ensure that its reforms would not disrupt social expectations too rapidly. Under the tenets of Chinese socialism, one of the important societal “bargains” struck between the state and its citizens was the concept of the iron rice bowl (*tie wan fan*).<sup>100</sup> Essentially, the iron rice bowl was guaranteed lifetime employment for SOE employees regardless of their performance.<sup>101</sup> While it could be expected that such a policy could result in great inefficiency,<sup>102</sup> it was an important societal norm that nevertheless could not be taken away easily, par-

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96. See Bernard Black et al., *Russian Privatization and Corporate Governance: What Went Wrong?*, 52 STAN. L. REV. 1731 (2000) (discussing why privatization failed in Russia).

97. DOUG GUTHRIE, CHINA AND GLOBALIZATION: THE SOCIAL, ECONOMIC AND POLITICAL TRANSFORMATION OF CHINESE SOCIETY 38 (3d ed. 2012) (explaining the famous slogan). Guthrie translates the slogan as “groping for stones to cross the river” (internal quotation marks omitted). *Id.* He also notes the Chinese phrase as being “*moshitou guohe*.” *Id.*

98. BARRY NAUGHTON, THE CHINESE ECONOMY: TRANSITIONS AND GROWTH 91–92 (2007).

99. *Id.* at 92–93. Naughton also states: “After 1984, though, the quantity allocated by the central government leveled off, and nearly all the increment in output was channeled onto the market, that is, left to the control of enterprises to sell at the best price they could obtain.” *Id.* at 93.

100. Daniel Z. Ding & Malcolm Warner, *China’s Labour-Management System Reforms: Breaking the ‘Three Old Irons’ (1978–1999)*, 18 ASIA PAC. J. MGMT. 315, 316 (2001).

101. *Id.* at 318 (“In other words, a worker would never lose his job unless he or she violated the law or did severe damage to the work-unit (or *danwei* as it was called) through misconduct. It did not matter whether or not the worker worked at the performance standard. Even if suspended for misconduct, the worker was paid a basic wage; the most drastic penalty was ‘re-education through labour.’”).

102. *Id.* (referring to it as a “dysfunctional employment system”).

ticularly since being associated with a work unit included an array of welfare benefits.<sup>103</sup>

During this time of transition, underperforming SOEs were spared having to lay off workers due to soft loans from the state-controlled banking system.<sup>104</sup> These inefficient “zombie firms”<sup>105</sup> were more likely to default on their loans. This was attributable to the fact that Chinese banks were all state-controlled and made lending decisions based on political considerations rather than commercial, profit-maximization dictates.<sup>106</sup> By the late 1990s, it was estimated that, alarmingly, 40 percent of all loans were nonperforming loans.<sup>107</sup>

After the dual track system had been shelved, in 1994 the Chinese government incrementally pursued deeper reforms by announcing that it would privatize smaller SOEs but would continue to hold onto the larger, important SOEs—a policy that was captured in the phrase “grasp the large and release the small.”<sup>108</sup> However, as of 2003, there were still approximately 2600 local and 100 central SOEs.<sup>109</sup> It would be a mistake to think that SOEs presently have an insignificant role in China. Although the Chinese government has led many of its SOEs through the painful process of privatization and layoffs of workers, maintaining employment levels continues to be a priority in the maintenance of social stability,<sup>110</sup> albeit not as pressing as during the days when the iron rice bowl was still fresh in the memories of the general population. Moreover, bank subsidization of SOEs will continue as long as SOEs remain an important aspect of the Chinese political system. China persists as a nation whose government continues to be characterized as a top-down authoritarian hierarchy.<sup>111</sup> Maintenance of control in such a structure is greatly enhanced by retaining

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103. *Id.* (“Enterprises also provided a wide coverage of welfare benefits, ranging from baby-minding facilities to retirement homes.”).

104. NAUGHTON, *supra* note 98, at 460. Naughton also states: “Soft budget constraints implied continuous bank lending to unviable clients.” *Id.*

105. *Id.*

106. *Cf. Id.* (“Given the pervasive politicization of the economy and the continuing rule of the Communist Party, it was inevitable that many unproductive projects were funded for patronage or show-case purposes, or from simple lack of economic analysis.”).

107. JOHN KNIGHT & SAI DING, CHINA’S REMARKABLE ECONOMIC GROWTH 41 (2012). The authors also remark: “The proportion of NPLs [nonperforming loans] fell over the 2000s, but mainly because the government had assumed much of their bad debts.” *Id.*

108. YUEH, *supra* note 89, at 111 (internal quotation marks omitted). The phrase is also referred to as “*zhuangda, fangxiao*.” *Id.*

109. *Id.* at 112.

110. See Hung, *supra* note 92 (“The state banks’ motive in extending loans to keep unprofitable state-owned enterprises afloat is to maintain social and political stability by slowing massive layoffs on the part of these units.”).

111. *Cf. Barry Naughton, China’s Distinctive System: Can it be a Model for Others?*, 19 J. CONTEMP. CHINA 437, 455 (2010) (“China possesses an authoritarian political system which has evolved over the course of 30 years in conjunction with the development of a market economy...the hierarchical system has been steadily tuned, pruned, focused and rebuilt in order to keep it functioning in the pursuit of economic growth.”).

government oversight in the market through SOEs.<sup>112</sup>

## 2. *Banking as an Instrument of State Policy on Developmental Reform*

On the banking side, although China has reformed its banking system during its post-1978 reforms, during that time Chinese banks remained an instrument through which the government could implement policies rather than truly commercially-oriented financial intermediaries. In 1984, China formed a two-tier system consisting of a central bank (the Peoples Bank of China or “PBoC”) overseeing commercial banks, but in actuality, this system continued to mimic the old system whereby banks remained as financial arms of the government’s planning.<sup>113</sup> From 1998 to 2005 the Chinese government provided strong financial support to the current four dominant banks.<sup>114</sup> These banks are the Bank of China, Industrial and Commercial Bank of China, China Construction Bank, and Agricultural Bank of China—commonly referred to as the “Big Four banks.”<sup>115</sup>

While the original intent may well have been to move these banks toward truly commercial-based banking, they remain extensions of the state because, ultimately, all of the top managers are selected by the government.<sup>116</sup> In addition, the central bank, PBoC, also remains under the tight reins of the government as another extension of the state and is vulnerable to “the dictates of the national political leadership.”<sup>117</sup> The economic goals of the all-powerful Chi-

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112. Cf. *Id.* at 454 (“Indeed, taking the lowest common denominator, we could say that in the Chinese development model ‘government ownership and government investment play a strong role in the economy’.”). Cf. *The State Advances*, *ECONOMIST* (Oct. 6, 2012), <http://www.economist.com/node/21564274> (“Though fewer in number, today’s SOEs are more powerful than ever.”).

113. MARK A. DEWEAVER, *ANIMAL SPIRITS WITH CHINESE CHARACTERISTICS: INVESTMENT BOOMS AND BUSTS IN THE WORLD’S EMERGING ECONOMIC GIANT* 106 (2012) (specifically using the term “two-tier” to describe the banking system). Also noting: “This system worked poorly because local governments could generally provide political cover for bankers to exceed their quotas. When this happened, the PBoC would simply have to provide additional funds. Formerly, the PBoC had funded enterprises and government units directly. Now they borrowed from the commercial banks, which then turned to the central bank for funding. From the point of view of monetary policy, this was a distinction without a difference.” (footnote omitted) *Id.*

114. *Id.* at 107. Deweaver states that “steps were taken to recapitalize the banks and address their nonperforming loan (NPL) problems.” *Id.*

115. *Too Big to Fail*, *ECONOMIST* (Aug. 31, 2013), <http://www.economist.com/news/leaders/21584342-chinas-banking-behemoths-are-too-beholden-state-it-time-set-finance-free-too-big>.

116. See DEWEAVER, *supra* note 113, at 107 (“Party approval is required for the appointment of top officials at all the banks, even the privately owned Minsheng Bank. The Party can also transfer or fire bank executives at will.” (footnote omitted)).

117. LIEBERTHAL, *supra* note 95, at 263. Lieberthal also states: “Therefore, although the banking system moved in the direction of becoming a key vehicle for deciding how to allocate capital efficiently, it did not achieve the degree of independence from the political system necessary for it to play this role effectively.” *Id.*

nese Communist Party are then furthered through policy-based lending practices.<sup>118</sup> From the bank officers' perspective, two reasons to favor lending to SOEs and government projects, over private enterprises, are that bank officers are less likely to face repercussions for approving a bad loan to SOEs,<sup>119</sup> and that they lack the proper training and experience for truly commercial-based lending.<sup>120</sup>

The discussion thus far in this article has focused on the historical and political reasons why Chinese banks lend to SOEs on what frequently appears to be a noncommercial basis. As stated earlier, the result of this preferential policy is that it discriminates against and ultimately excludes private enterprises from obtaining credit through traditional banking channels. Yet, private enterprise has not only managed to survive under these austere conditions but, remarkably, it has been at the lead in fueling China's GDP growth.<sup>121</sup> This represents an incredible difference from the political environment in the late 1970s when engaging in private business could have resulted in being labeled a bourgeois and being subjected to persecution. The opening sentence in an article on China.org.cn (an official Chinese government website)<sup>122</sup> speaks mountains: "Private businesses deliver great contributions to China's economy after they had been banned for decades."<sup>123</sup>

### 3. Informal Finance: Chinese Innovation from the Bottom Up

Facing financial repression through bank lending policies that heavily, if not exclusively, favored SOEs over private business, Chinese private entrepreneurs have turned to alternative or informal financing. Sara Hsu notes that despite its importance, Chinese informal finance remains under-researched alt-

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118. Yasushi Suzuki et al., *China's Non-Performing Bank Loan Crisis: The Role of Economic Rents*, 22 ASIAN-PAC. ECON. LITERATURE 57, 61 (2008) ("Policy loans are given by government on non-market terms, often on the excuse of correcting market failure—a reason used frequently in the case of huge public investments such as infrastructure."). The authors also state "Therefore, in spite of the financial reforms, policy lending—which can be considered synonymous with directed credit—has remained a characteristic of the Chinese financial system. For this reason, [nonperforming loans] in China are fundamentally different from those of privately owned banks in market economies." *Id.*

119. KELLE S. TSAI, BACK-ALLEY BANKING: PRIVATE ENTREPRENEURS IN CHINA 35 (2002) ("Loan officers may expect forgiveness for making bad loans to state entities because, after all, they are essentially different parts of the same 'state'—a rationalization that could not be used for bad loans to private businesses.").

120. *Id.* ("Credit officers in post-1949 were trained as bureaucrats, not a commercial bankers, so minimal precedence existed for extending loans on a profit-oriented rather than political basis.").

121. See Yiyuan, *supra* note 90.

122. About Us, CHINA.ORG.CN (Sept. 28, 2009), [http://www.china.org.cn/2009-09/28/content\\_18620394.htm](http://www.china.org.cn/2009-09/28/content_18620394.htm) ("The authorized government portal site to China, China.org.cn is published under the auspices of the State Council Information Office and the China International Publishing Group (CIPG) in Beijing.").

123. Xu Lin, *Top 10 Private Enterprises in China*, CHINA.ORG.CN (Nov. 12, 2013), [http://www.china.org.cn/top10/2013-11/12/content\\_30542813.htm](http://www.china.org.cn/top10/2013-11/12/content_30542813.htm).

though there are a few important studies in existence.<sup>124</sup> Hsu refers to one such important study by Jianjun Li<sup>125</sup> from 2005 and Hsu summarizes Li's study as stating that "the informal sector [in China] amounted to a nonnegligible portion of GDP in 2003—at 7.6 percent to 8.6 percent of GDP."<sup>126</sup>

Informal finance has a long history in China, with pawnbroking being practiced amidst the Six Dynasties era (317–589 A.D.) by Buddhist monasteries.<sup>127</sup> One informal finance practice that continues to be presently used in modern China is the rotating credit practice known as the *hui*. A pool of money is rotated among the participants (e.g., friends) who have each contributed and continue to contribute to the pool on a periodic basis.<sup>128</sup> In addition to this traditional form of rotating credit, there currently exists an array of informal financing practices throughout China. Kellee Tsai has categorized the most common forms in China broadly as (1) *legal* (interpersonal lending, trade credit, rotating credit associations (in some areas), pawnshops (in some areas)); (2) *quasi-legal* (rural cooperative associations (until 1999), fake collectives, red hats and hang-on enterprises, mutual assistance societies or cooperative savings foundations, and pawnshops (in some areas)); and (3) *illegal* (professional brokers and money lenders (loan sharks), private money houses, rotating credit associations (in some areas), and pyramid investment associations (Ponzi schemes)).<sup>129</sup>

There are two important features to note about Chinese informal financing. First, informal financing involves activities that could be either illegal or, at least, questionably legal. This is apparent from the three categories listed above. Tsai explains that, in her taxonomy, the category of "legal" is determined by whether the PBoC and Central Banking Regulatory Commission have approved the practice.<sup>130</sup> However, confusion arises from the fact that whether certain practices are recognized as legal or illegal can differ among different regions in China.<sup>131</sup> The category of "quasi-legal" evidences this murky legal status and refers to practices that are not formally approved by the PBoC yet

124. Sara Hsu, *Introduction*, in *INFORMAL FINANCE IN CHINA: AMERICAN AND CHINESE PERSPECTIVES* 3, 6 (Jianjun Li & Sara Hsu eds., 2009) ("There have only been a handful of major studies on informal finance in China.").

125. *Id.* at 7.

126. *Id.* Hsu attributes these statistics to JIANJUN LI, *RESEARCH ON THE VOLUME OF UNDERGROUND FINANCING AND ITS ECONOMIC EFFECTS* (2005). *Id.*

127. TSAI, *supra* note 119, at 25.

128. *Id.* at 25–26. Tsai also describes another type of *hui* known as a *biaohu*: "[T]he order of pot recipients is determined by secret bidding, whereby the member who bids the highest interest rate receives the pot." *Id.* at 26.

129. Tsai, *supra* note 93, at 82 tbl. 5.1 (I have used Tsai's categories and terminology (except for Chinese names and characters) from Table 5.1: Summary of Financing Mechanisms Employed by Private Entrepreneurs in China—essentially providing an almost exact replication of her table of information here in sentence format.)

130. *Id.*

131. *Id.* at 83–84 (using rotating credit associations and pawnshops as examples of this point).

still are recognized as legal by other government entities.<sup>132</sup>

The ambiguous legal status of some common informal financing practices suggests that law is not a single determining factor in the creation of sources of financing for China's private entrepreneurs. In some cases, lending and commercial activities that lie outside of the legal sphere have been the primary drivers of economic growth. The city of Wenzhou is an example of a Chinese city where private enterprise took the lead in providing economic growth.<sup>133</sup> Wenzhou is located in the province of Zhejiang, which has been described as being "at the forefront of private sector development in China."<sup>134</sup> The people of Zhejiang have been described as "enterprising."<sup>135</sup> With respect to Zhejiang, it has been remarked, "Accounts of robust entrepreneurial action and private wealth accumulation are commonplace here and follow a familiar rags-to-riches narrative."<sup>136</sup> Wenzhou's stellar rise to entrepreneurial prominence has led to it being viewed, in the past, as one of the main developmental models for China—referred to as the Wenzhou model.<sup>137</sup> Other past developmental models include the Jiangsu model and Pearl River Delta model.<sup>138</sup> Wenzhou's fame eventually made it into mainstream Western media with an article in *National Geographic* describing the vibrant entrepreneurial frenzy there.<sup>139</sup>

Wenzhou is remarkable not only for its entrepreneurial zeal but also for how the fast rise of informal financing accompanied its economic growth. Wenzhou locals developed "an impressive repertoire of savings and credit mechanisms"<sup>140</sup> that had not yet received approval from Beijing.<sup>141</sup> This brazen attitude was evident in how Wenzhou local officials enacted their own regula-

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132. *Id.* at 84.

133. For general information about Wenzhou, see Wenzhou's official government portal at <http://english.wenzhou.gov.cn> (last visited Aug. 16, 2015); see also the Foreign Affairs Office of Wenzhou City portal at <http://www.wzfao.gov.cn/en/index.jsp> (last visited Aug. 16, 2015).

134. ZHIKAI WANG, *THE PRIVATE SECTOR AND CHINA'S MARKET DEVELOPMENT* 1 (2008).

135. VICTOR NEE & SONJA OPPER, *CAPITALISM FROM BELOW: MARKETS AND INSTITUTIONAL CHANGE IN CHINA* 41 (2012).

136. *Id.*

137. See WANG, *supra* note 134.

138. *Id.* (referring to the different models and commenting that "each one has its own advantages and has contributed to the creation of a vast land of industrial clusters, giving China the reputation of manufacturer for the world").

139. Peter Hessler, *China's Instant Cities*, NAT'L GEOGRAPHIC (June 2007), <http://ngm.nationalgeographic.com/2007/06/instant-cities/hessler-text/2> ("The Wenzhou airport bookstore stocks a volume titled, *Actually, You Don't Understand the Wenzhou People*. It shares a shelf with *The Feared Wenzhou People*, *the Collected Secrets of How Wenzhou People Make Money*, and *The Jews of the East: The Commercial Stories of Fifty Wenzhou Businessmen*. For the Chinese, this part of Zhejiang Province has become a source of fascination, and the local press contributes to the legend. Recently, Wenzhou's *Fortune Weekly* conducted a survey of local millionaires. One question was: If forced to choose between your business and your family, which would it be? Of the respondents, 60 percent chose business, and 20 percent chose family. The other 20 percent couldn't make up their minds.").

140. TSAI, *supra* note 119, at 120.

141. *Id.* at 121.

tions addressing commercial activity before Beijing had even penned its own legislation or policies on the matter.<sup>142</sup> As various forms of informal financing arose, the central government would “either attempt to ban the unusual financial practices, or sanction them as if the center had proposed such advanced reforms in the first place.”<sup>143</sup> The after-the-fact sanctioning of certain reforms by central authorities clearly revealed the ability of Wenzhou to initiate bottom-up reforms.<sup>144</sup> Overall, the resilient attitude of the Wenzhou people prevailed with a flurry of various forms of informal financing emerging locally.<sup>145</sup> In Wenzhou, during the period 1983–1985, it is estimated that informal financing constituted 95 percent of total capital flows.<sup>146</sup> In short, law did not appear to play a very significant role in this environment where financial innovation flourished first, with legal action often coming as a central government afterthought.

The continued prevalence of informal financing in China naturally leads to the question of whether the government should try to regulate it. In part, the answer to that question depends upon whether one feels that informal financing is a desirable societal phenomenon. One recent study’s results suggest that informal financing is a poor substitute for formal financing and that better firm growth is associated with formal financing.<sup>147</sup> Even if that is true, it does not address the dilemma faced by Chinese private entrepreneurs who continue to have difficulties accessing channels of formal financing. As one group of scholars has suggested, “formal and informal financing can be complements as well as substitutes”<sup>148</sup>—a view that has been supported by the development of an economic model by another researcher.<sup>149</sup> One researcher suggests informal

142. NEE & OPPER, *supra* note 135, at 4 (“Wenzhou Municipality . . . responding to local commercial activity, put in place local private firm regulations already in 1987, one year before the central government launched a first official document to regulate private firms.”).

143. TSAI, *supra* note 119, at 121.

144. *Id.*

145. *Id.* at 125 (“The nongovernmental financing practices in Wenzhou include trade credit (*hangye xinyong*); professional money lenders, middlemen (*yinbei*); raising capital from banks and state-owned enterprises by posing as a collective enterprise (*dai hongmaozi, guahu qiye*); pooling capital and issuing shares in the form of shareholding cooperative enterprises (*gufen hezuo qiye*); credit associations (rotating—*lunhui*, bidding—*biaohui*, escalating—*taihui*; private money houses (*qianzhuang*); rural cooperative foundations (*nongcun hezuo jijinhui*) and pawnshops (*dangpu*).”).

146. *Id.* at 124–25 citing Yia-Ling Liu, *Reform from Below: The Private Economy and Local Politics in the Rural Industrialization of Wenzhou*, 1992 CHINA Q. 293, 298 (1992).

147. Meghana Ayyagari et al., *Formal vs. Informal Finance: Evidence from China* 7 (World Bank Policy Research, Working Paper No. 4465, Jan. 1, 2008), available at [http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=1080690](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1080690) (“We find no evidence that alternative financing channels are associated with higher growth. While we have some limited evidence that informal finance might help the smallest micro sized firms, we find that all firms irrespective of size, benefit from access to formal finance. Our findings suggest that the role of reputation and relationship based informal financing and governance mechanisms in supporting the growth of private sector firms is likely to be limited and unlikely to substitute for formal mechanisms.”).

148. Allen et al., *supra* note 87, at 2.

149. See Andreas Madestam, *Informal Finance: A Theory of Moneylenders*, 107 J. DEV. ECON. 157

lending among family and close acquaintances may prevail over microfinancing.<sup>150</sup> Another scholar states that informal financing persists in China and India despite attempts by government to prohibit it and attributes this to several factors including the lack of formal credit.<sup>151</sup>

The prospect of governments being able to successfully place an outright ban on all forms of informal financing seems unlikely. The practice continues to prevail, even among Chinese who live in other countries, such as Brazil,<sup>152</sup> and can be readily found in other economically ascending countries, such as India.<sup>153</sup> Moreover, informal financing can be an important source of funds for rural Chinese who often need money yet have difficulty obtaining loans from banks who lack the information that local informal lenders possess.<sup>154</sup> A realistic attempt to rein in informal financing, if desired, would be to segregate socially undesirable forms of informal financing (e.g., loan sharking, pyramid schemes) from those that promote economic development.<sup>155</sup>

In summary, the critical perspectives discussed earlier in Part II, promote an understanding of how informal debt financing structures have advanced the interests of private entrepreneurs in China in response to a dearth of formal debt financing channels available to them. Although Chinese banks existed, they were quite different from typical Western financial intermediaries. Rather, Chinese banks were extensions of the government prompted by political concerns. A politically informed approach, inspired by Roe's work, reveals that the Chinese government has faced constraints in reforming its economy—seeking to maintain social peace in the face of socialist legacies, such as state planning; a waning iron rice bowl; and the desire to maintain control through SOEs. This has necessitated the subsidization of SOEs through soft bank loans, which acted as an indirect political driver of the type of financing that excluded private entrepreneurs have to seek—informal financing. The Chinese reaction to this sit-

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(2014).

150. See Calum G. Turvey & Rong Kong, *Informal Lending Amongst Friends and Relatives: Can Microcredit Compete in Rural China?*, 21 CHINA ECON. REV. 544, 545–46 (2010).

151. See Kellee Tsai, *Imperfect Substitutes: The Local Political Economy of Informal Finance and Microfinance in Rural China and India*, 32 WORLD DEV. 1487, 1487 (2004) (arguing that the factors are “the limited supply of formal credit, limits in state capacity to implement its policies, the political and economic segmentation of local markets, and the institutional weaknesses of many microfinance programs”).

152. See Hsia Hua Sheng & Wesley Mendes-Da-Silva, *The Big Family: Informal Financing of Small- and Medium-Sized Businesses by Guanxi*, 56 THUNDERBIRD INT'L BUS. REV. 157 (2014).

153. See Franklin Allen et al., *Financing Firms in India*, 21 J. FIN. INTERMEDIATION 409 (2012).

154. See Zhou Li & Hiroki Takeuchi, *Informal Lenders and Rural Finance in China: A Report from the Field*, 36 MOD. CHINA 302, 305–06 (2010).

155. See Allen et al., *supra* note 87, at 27 (arguing that the Chinese government's prohibition on informal financing is, in part, agreeable to the extent that it “attempts to eliminate some informal sources that involve violence, potentially social-destructive, and fail to bring constructive values to firms and the overall economy”).

uation, at the general abstract level, bears some semblance to Coffee's observation of how US and UK stock markets developed through private sector initiatives that were later followed by formal legislation. The Chinese market for informal finance developed from the bottom-up by the private sector. Local residents provided the financial innovation to satisfy the demand for financing—with policy and laws from the Chinese central government coming afterward.

#### IV. CHINA'S SHADOW BANKING DILEMMA

China's current shadow banking concerns are directly related to the preceding discussion on informal finance. This is because shadow banking and informal finance can be thought of as overlapping—they both refer to activities that occur outside of the traditional banking sector. However, in the case of shadow banking, some of that activity could be more strongly connected to the traditional banking sector. This is particularly so if the traditional bank has merely moved some of its liabilities “off balance-sheet” through the use of intermediaries. In addition, what is commonly referred to as shadow banking usually involves monetary interests on a much larger scale than the informal financing practices (e.g., borrowing from family and friends) described in Part III. For these reasons, including, of course, the association of dodgy shadow banking practices with the 2008 financial crisis, shadow banking potentially evokes a greater sense of alarm than smaller-scale informal financing practices. Nevertheless, as will be discussed below, the insights of the preceding parts of this article apply to shadow banking as well.

##### *A. China's Shadow Banking Captures Western Attention*

Concerns about shadow banking have transcended the attention of finance professionals and academics, and entered into the general public's consciousness through the news media. For example, the cover of *The Economist* recently featured shadow banking with an entire section dedicated to it.<sup>156</sup> In terms of figuring the scale of Chinese shadow banking, the Chinese Academy of Social Sciences (a renowned Chinese government-affiliated think tank) has estimated that it may be equal to 40 percent of China's GDP.<sup>157</sup> Cindy Li, an economic analyst, collected estimates from various sources and found that, for 2012, the upper range of estimates calculated Chinese shadow banking as being equal to

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156. *The Lure of Shadow Banking*, *ECONOMIST* (May 10, 2014), <http://www.economist.com/news/leaders/21601826-shadow-banks-helped-cause-financial-crisis-better-regulated-they-could-help-avert-next>.

157. Editorial Board, *China's Shadow Banking Problem*, *N.Y. TIMES* (Jan. 7, 2014), [http://www.nytimes.com/2014/01/08/opinion/chinas-shadow-banking-problem.html?\\_r=0](http://www.nytimes.com/2014/01/08/opinion/chinas-shadow-banking-problem.html?_r=0).

57 percent of GDP or 31 percent of bank assets.<sup>158</sup> However, put into comparative perspective for the year 2011, in the United States, shadow banking assets were estimated to be 152 percent of GDP, while in the United Kingdom, shadow banking assets were estimated to be 370 percent of GDP.<sup>159</sup>

Although China's shadow banking sector is proportionately smaller than that in the United States (based on GDP comparisons above), the US-China Economic and Security Review Commission noted the risks that it poses in its 2014 Annual Report<sup>160</sup> and, perhaps indicative that not much has changed since the year before, refers the reader to its 2013 Annual Report for more detailed analysis.<sup>161</sup> In the 2013 Annual report, it was clear that concerns about China are not merely borne out of a sense of international altruism—China is an integral part of the global economy and a financial crisis there could potentially destabilize the world economy<sup>162</sup> or as has been remarked, “If China catches a cold, the rest of the world won’t be sneezing—it will be headed for the emergency room.”<sup>163</sup>

### *B. Shadow Banking in China*

In Part III this article discussed how Chinese private entrepreneurs turned to informal financing as a source of loans after being largely cut off from state bank financing due to preferential lending policies that favored SOEs. Below, this article explains the other side of the equation—how the Chinese government policy on deposit interest rates has contributed to a demand for invest-

158. Cindy Li, *Shadow Banking in China: Expanding Scale, Evolving Structure*, Asia Focus (April, 2013), <http://www.frbsf.org/banking-supervision/publications/asia-focus/2013/april/shadow-banking-china-scale-structure/>. Sources are credited in Tbl.1 as “Various newsletters and media reports, FSB (2012), World Economic Outlook (October 2012), China Banking Regulatory Commission.” *Id.*

159. *Id.* (Referring to Tbl.2 which credits its sources as “FSB (2012)” and “World Economic Outlook (2012)”). Also stating: “Therefore, the relative size of China’s shadow banking system is still small as compared to advanced economies.” *Id.*

160. U.S.-CHINA ECON. & SEC. REV. COMM’N, 2014 REPORT TO CONGRESS 51–52 (Nov. 20, 2014). [http://www.uscc.gov/Annual\\_Reports/2014-annual-report-congress](http://www.uscc.gov/Annual_Reports/2014-annual-report-congress) (briefly noting that China’s shadow banking poses risks).

161. *Id.* at 44.

162. U.S.-CHINA ECON. & SEC. REV. COMM’N, 2013 REPORT TO CONGRESS, *supra* note 21, at 142 (referring to the gap in credit arising from insufficient access to regulated sources of finance and stating, “The shadow banking system that Beijing has allowed to step into this credit gap is insufficiently regulated and, if left unchecked, will pose an increasingly serious threat to Chinese and global economic stability.”).

163. Nathan Vanderklippe & Eric Reguly, *China’s Looming Debt Bomb: Shadow Banking and the Threat to Growth*, THE GLOBE AND MAIL (May 3, 2014, 5:00 AM EDT), <http://www.theglobeandmail.com/report-on-business/chinas-looming-debt-bomb-shadow-banking-and-the-threat-to-growth/article18409275/?page=all>. Also remarking that, “China holds more U.S. Treasuries than any other nation outside of the U.S. itself. It uses 46 per cent of the world’s steel and 47 per cent of the world’s copper. By 2010, its import-and export-oriented banks had surpassed the World Bank in lending to developed countries. In 2013, Chinese companies made \$90-billion (U.S.) in non-financial overseas investments.” *Id.*

ment vehicles with higher rates of return. It then explains several of the most popular forms of shadow banking in China which help fulfill that demand. This article then focuses on one particularly unique structure—the local government funding vehicle—and its relationship to national budget legislation and China’s developmental path.

### *1. The Pursuit for Higher Returns and Chinese Shadow Banking*

China’s policy of financial repression, which places a maximum limit on the interest rate on deposits of traditional banks,<sup>164</sup> can be viewed as an important cause of shadow banking. The maximum limit is usually quite low,<sup>165</sup> and this creates an incentive for depositors to seek a better interest rate elsewhere, thus opening the way for shadow banking products that offer a higher return on investment.

Trust companies are an important part of the Chinese shadow banking system. In the world of non-bank financial institutions—when ranked by size of asset holdings—trust companies are number one in China.<sup>166</sup> Although Chinese trust companies control high amounts of capital, they are not subject to the same scrutiny and regulation as banks and are thus able to participate in riskier investments. A large part of the systemic danger posed by trust companies is that they are able to act as intermediaries between banks and investments that banks would otherwise not be able to participate in. Trust companies, like other intermediaries, can earn fees for acting in the capacity of an intermediary.

Trust beneficiary rights (TBRs) allow a bank to make a loan to a private entity appear as if the loan is a safe interbank transaction while circumventing prohibitions on banks transacting with trust companies. Assume a bank (“Lender Bank”) wants to lend to a borrower but doesn’t want to reflect that on its records. Another bank (“Intermediary Bank”), a company (“Intermediary Company”) and a trust company (“Trust Company”) can collude with Lender

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164. See DEWEAVER, *supra* note 113, at 125 (“The PBoC dictates commercial bank rates directly, setting ceilings on deposit rates and floors under lending rates. In the process, it also sets a minimum level for the banks’ loan-deposit spreads (the difference between comparable deposit and lending rates), thereby mandating a key determinant of bank sector profitability.”); see also *The Credit Kulaks*, ECONOMIST (Jun. 1, 2013), <http://www.economist.com/news/finance-and-economics/21578668-growth-wealth-management-products-reflects-deeper-financial-distortions> (“The disease itself is financial repression. China imposes a ceiling on the interest rate that banks can pay to depositors. This keeps banks’ cost of funding low, making them eager to lend. To curb their enthusiasm, the regulators must impose offsetting limits on their spending as Dong He and Honglin Wang of the Hong Kong Institute of Monetary Research have pointed out.”).

165. See generally Nicholas Lardy, *Financial Repression in China*, Policy Brief 08-8 Peterson Institute for International Economics (Sept. 2008), <http://www.iie.com/publications/interstitial.cfm?ResearchID=999> (discussing the effects of the policy of financial repression adopted by Chinese banks).

166. Li, *supra* note 158. (“Shadow banking credit is often extended through trust companies, the largest group of nonbank institutions as measured by total assets.”).

Bank to accomplish this. Trust Company loans the money to the borrower. Trust Company then sells the loan to Intermediary Company, which then sells the right to the loan income to Intermediary Bank—this right is known as the TBR. Intermediary Bank then sells the TBR to Lender Bank.<sup>167</sup> Since Lender Bank purchased the TBR from Intermediary Bank, Lender Bank gets to record that transaction as an interbank transaction—thus making “risky corporate loans look like safer lending between banks, thereby evading capital requirements and minimum loan-to-deposit ratios, among other rules.”<sup>168</sup> Intermediary Bank has passed the risk and made a profit by selling the TBR.<sup>169</sup> Lender Bank, on the other hand, takes the loan risk but doesn’t reflect that on its records.<sup>170</sup>

Another form of shadow banking is the entrusted loan,<sup>171</sup> where investors are connected to borrowers through banks that act as intermediaries. This serves as a method of circumventing regulations that prohibit nonbanks from engaging in commercial lending.<sup>172</sup> Although the bank receives a fee for acting as an intermediary,<sup>173</sup> it does not share in any of the loan’s risk (e.g. default on the loan) since it is merely an intermediary, not a principal party. Aside from circumventing the rules, the issue becomes much more serious when one considers that the investors that are trying to lend the money can be SOEs.<sup>174</sup> As discussed previously, SOEs are given preferential treatment in the form of soft loans by the government through banks. If banks facilitate SOEs’ lending to borrowers, thus circumventing the rules, it is the equivalent of SOEs entering the financing business. In fact, SOEs can become a major competitor in the fi-

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167. Cynthia Koons & Dinny McMahon, *Banks Work Around China’s Spending Limits*, THE WALL STREET JOURNAL (Aug. 19, 2013, 12:38 PM ET) <http://www.wsj.com/articles/SB10001424127887323423804579022451713979242> (providing a similar explanation of how TBRs work); see also Vanderklippe & Regul, *supra* note 163 (“‘It’s totally sneaky. I hate it,’ says Jason Bedford, a Canadian who recently stepped down from nearly a decade with KPMG as an auditor and consultant in China . . . ‘This is like the worst conspiracy theories that I’ve been hearing about for the last four years suddenly coming true. Banks really are hiding loans,’ he said.”).

168. *Shadow Banking in China*, *supra* note 20. Also explaining TBRs in the following manner: “Trust beneficiary rights products (TBRs) are another way around the restrictions on dealings between banks and trusts. A bank sets up a firm to buy loans from a trust; it then sells the rights to the income from those loans to the bank—a TBR is born. The bank can then sell the TBR to another bank.” *Id.*

169. Koons & McMahon, *supra* note 167 (“The bank transferring the loan gets a fee and holds the loan on its books but doesn’t bear any risk.”).

170. *Id.*

171. US–CHINA ECON. & SEC. REV. COMM’N, *supra* note 21, at 126.

172. Aileen Wang, Lu Jianxin & Pete Sweeney, *Analysis—Another China Central Bank Worry: Companies Push into Lending*, REUTERS (Jun. 24, 2013, 4:58 AM BST), <http://uk.reuters.com/article/2013/06/24/uk-china-shadowlending-analysis-idUKBRE95N02U20130624> (“With entrusted loans, a company provides the funds but, to circumvent a ban on direct lending to other firms, it designates a commercial bank to lend the money to a specific borrower.”).

173. *Id.*

174. *Id.* (“Big state companies in industries struggling with over-capacity but with easy access to credit are borrowing funds, not to invest in their business but to lend to smaller firms sometimes at several times the official interest rate . . . .”)

nancial market in this fashion.<sup>175</sup> Given the soft loans of government money available to SOEs, this exposes the government and public to the potentially risky investment decisions made by SOEs. Therefore, it is not surprising that the Chinese government issued draft regulations in early January 2015 to attempt to restrict the use of entrusted loans.<sup>176</sup>

Wealth management products (WMPs) have been attracting the most attention lately as “the fastest-growing investment vehicle in China.”<sup>177</sup> WMPs are investment products sold to investors through banks as well as other entities such as trust companies.<sup>178</sup> The higher rate of return offered by WMPs (compared to bank deposit interest rates) contributes to their popularity.<sup>179</sup> The marketing of these products is not by any means clandestine—with banks directly targeting affluent individuals by text message.<sup>180</sup> Since WMPs are not regulated like banks, the fear is that investor money is being placed into investments that carry much higher risk than investors appreciate—“speculating on teas, spirits or even graveyards.”<sup>181</sup> Aware of the potential risks inherent in WMPs, the China Banking Regulatory Commission has, during the last five years, increasingly attempted to control WMPs through a series of directives (in the form of notices and circulars) to banks.<sup>182</sup>

In summary, the PBoC’s low cap on deposit rates has provided incentive for the regulatory arbitrage that has contributed to the proliferation of shadow banking structures.

## 2. Local Government Funding Vehicles—A Legacy of China’s

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175. *Shadow Banking*, *supra* note 20 (“Entrusted loans are yet another fast-growing form of shadow banking. These involve cash-rich companies, often well-connected state-owned enterprises (SOEs), lending to less well-connected firms. There are so many SOEs now competing with Yangzijiang to offer loans, reports Liu Hua, the shipbuilder’s chief financial officer, that her firm has been forced to reduce the interest rates it charges from around 15% a year to closer to 10% a year.”).

176. Lu Jianxin and Pete Sweeney, *China Issues Draft Rules Restricting Entrusted Lending*, REUTERS (Jan. 18, 2015, 9:07 PM EST), <http://www.reuters.com/article/2015/01/19/china-banks-loans-idUSL4N0UY0N120150119>.

177. U.S.–CHINA ECON. & SEC. REV. COMM’N, *supra* note 20, at 127.

178. Li, *supra* note 158.

179. *Id.* Li notes that, in comparison to real deposit rates, “higher-yielding alternative investments like WMPs have become increasingly attractive for depositors.” *Id.*

180. David Barboza, *Loan Practices of China’s Banks Raising Concern*, N.Y. TIMES (July 1, 2013), [http://www.nytimes.com/2013/07/02/business/global/loan-practices-of-chinas-banks-raising-concern.html?\\_r=0](http://www.nytimes.com/2013/07/02/business/global/loan-practices-of-chinas-banks-raising-concern.html?_r=0) (“Text message solicitations began arriving on the mobile phones of many of China’s wealthy last month, promising access to lucrative wealth management products with yields far above the government benchmark savings rate. . . . The offers are not coming from fly-by-night operators but some of China’s biggest banks. They are raising huge pools of cash to finance a relatively new and highly profitable sideline business: lending outside of the scrutiny of bank regulators.”).

181. *The Credit Kulaks*, *supra* note 164.

182. See Sara Hsu, *China’s Regulation of Wealth Management Products*, THE DIPLOMAT (May 15, 2014), <http://thediplomat.com/2014/05/chinas-regulation-of-wealth-management-products/> (describing how the China Banking Regulatory Commission has tried to control WMPs since as early as 2005).

### *Developmental Path*

Local government funding vehicles (LGFVs) allow the local government to raise money for projects without directly borrowing money. Instead, the local government forms a separate corporate entity (i.e. the LGFV), which is then used for financing purposes.<sup>183</sup> LGFVs are an illustrative example of how broader political legacies can heavily affect both official and unofficial financing channels in a nation. Local Chinese governments established LGFVs primarily as a method of circumventing a central government provision in the 1994 Budget Law<sup>184</sup> that prohibited local governments from borrowing money.<sup>185</sup>

The Budget Law's restriction on local government borrowing was a product of the decentralization of power from the central government. This decentralization was part of China's post-1978 economic development that had its roots in Deng Xiaoping's gradual and experimental approach toward reform. That approach was summarized in his saying "seek truth from the facts,"<sup>186</sup> where Deng felt that experimental reforms could be deployed in specific localities as a form of cautious testing ground.<sup>187</sup> One leading scholar notes that much research supports the proposition that China's innovative reforms were a result of the central government providing local governments with flexibility for testing new economic policies<sup>188</sup> and he refers to that testing process as a "pervasive feature of China's economic transformation."<sup>189</sup> In addition, decentralization as a part of reform was important because even a strong central government at Beijing would still have difficulty assimilating and acting upon information from the local level.<sup>190</sup> A consequence of fiscal decentralization in 1994 was

183. Yuanyan Sophia Zhang & Stephen Barnett, *Fiscal Vulnerabilities and Risks from Local Government Finance in China*, IMF Working Paper No.14/4, (January, 2014) at 5–6, <https://www.imf.org/external/pubs/ft/wp/2014/wp1404.pdf> (describing the nature of LGFVs).

184. Budget Law of the People's Republic of China—1994 (Adopted by the Second Session of the Eighth National People's Congress on Mar. 22, 1994, promulgated by Order No 21 of the President of the People's Republic of China on Mar. 22, 1994, and effective on Jan. 1, 1995), [http://www.npc.gov.cn/englishnpc/Law/2007-12/12/content\\_1383623.htm](http://www.npc.gov.cn/englishnpc/Law/2007-12/12/content_1383623.htm) (last visited Aug. 16, 2015) [hereinafter Budget Law].

185. See Budget Law art. 28 ("The local budgets at various levels shall be compiled according to the principles of keeping expenditures within the limits of revenues and maintaining a balance between revenues and expenditures, and shall not contain deficit. The local governments may not issue local government bonds, except as otherwise prescribed by laws or the State Council.").

186. PETER NOLAN, CHINA AT THE CROSSROADS 7 (2004) (internal quotation marks omitted).

187. *Id.*

188. See Sebastian Heilmann, *Policy-Making Through Experimentation: The Formation of a Distinctive Policy Process*, in MAO'S INVISIBLE HAND: THE POLITICAL FOUNDATIONS OF ADAPTIVE GOVERNANCE IN CHINA 62, 62 (Sebastian Heilmann & Elizabeth Perry eds., 2011).

189. *Id.*

190. See Yongqin Wang et al., *The Costs and Benefits of Federalism, Chinese Style*, in ECONOMIC TRANSITIONS WITH CHINESE CHARACTERISTICS: THIRTY YEARS OF REFORM AND OPENING UP 141, 142 (Arthur Sweetman & Jun Zhang eds., 2009) ("Since China has a large land mass and a high population,

more rigorous competition between local governments.<sup>191</sup>

The Budget Law's prohibition on local government debt financing accompanied the 1994 fiscal decentralization and served as a check on the otherwise free rein that the central government had just provided to the local governments. While the goal of decentralization was to spark the generation of innovation at the local level, it is interesting how one of the innovations generated was the creation of LGFVs in order to avoid the Budget Law's prohibition on local government borrowing. The blame for the current Chinese shadow banking situation does not lie solely on the shoulders of the local government. Fiscal decentralization meant that local governments still had to provide social benefits to citizens even though their tax base had been greatly reduced.<sup>192</sup> This placed pressure on local governments to find sources of funding, and the use of LGFVs naturally arose as a consequence of this increased fiscal pressure. By 2008, LGFVs were the recipients of large amounts of funds directed by the government through state banks, the purpose being to stimulate the economy.<sup>193</sup> However, afterwards it has become clear that a significant amount of LGFV investments are poor. In 2012, it was estimated that 30 to 40 percent of LGFV loans could potentially default and the total amount of those loans was estimated to be approximately US \$1.7 trillion.<sup>194</sup>

### *C. China's Gradual Attempt to Control Shadow Banking Practices*

Perhaps most symbolic of the difficult rebalancing process ahead for China is the plight of Wenzhou. Earlier in this article, Wenzhou's entrepreneurial success and innovative use of informal finance was discussed. In hindsight, the consequences of overreliance on credit have now come to bear upon Wenzhou. By 2012, some of Wenzhou's shadow banks failed, and this was accompanied

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supervision of local governments is expensive for the central government. Therefore, it has become important for China to decentralize.”).

191. See Changyuan Luo & Jun Zhang, *Market Distortion, Fiscal Decentralization, and FDI Penetration in Post-Reform China: An Overview*, in ECONOMIC TRANSITIONS WITH CHINESE CHARACTERISTICS: THIRTY YEARS OF REFORM AND OPENING UP 69, 81 (Arthur Sweetman & Jun Zhang eds., 2009) (“The fiscal decentralization scheme in 1994 echoed the market-oriented reform, which empowered local governments at different levels to promote their own economic growth. These regions competed with each other to provide high-quality infrastructures and preferential policies, which released China’s potential to attract foreign investment.”).

192. *Emerging from the Shadows*, ECONOMIST (Apr. 19, 2014), <http://www.economist.com/news/special-report/21600803-seizing-land-and-running-up-debts-no-way-finance-local-government-emerging>. (“[T]he [Communist Party] reorganized the tax system to boost the centre’s takings. But it failed to reduce the burden on local governments, which have remained responsible for such coffer-draining activities as providing education and health care. . . . Local governments receive half the nation’s fiscal revenue but are responsible for 80% of spending.”).

193. Elliot Wilson, *LGFVs: China's \$1.7 Trillion Hangover*, EUROMONEY (April 2012), <http://www.euromoney.com/ARTICLE/3005991/LGFVS-CHINAS-17-TRILLION-HANGOVER.HTML>.

194. *Id.*

by an alarming three percent spike in the nonperforming loan ratio for Wenzhou commercial banks<sup>195</sup>—with the observation in 2012 that “last year a series of scandals erupted in Wenzhou as some of the shadow banks became insolvent, leaving thousands of locals to pick up the pieces.”<sup>196</sup> The struggle faced by Wenzhou’s citizens eventually precipitated local government assistance<sup>197</sup> and other cities have also felt the pain of shadow banking loan defaults.<sup>198</sup> Notwithstanding the global concerns about shadow banking, Ann Lee, a leading expert on China, feels that China is still in a stable position and should be able to manage the situation, pointing to the relatively low shadow banking/GDP ratio as justification for a cautiously optimistic outlook.<sup>199</sup>

China is keenly aware of the potential threat that its shadow banking sector poses. There have been initiatives to address Wenzhou’s situation. Rather than simply outlawing the existing informal financing practices, the government seems to appreciate that such a move could simply result in a more clandestine shadow banking sector. In a move that seems reminiscent of Deng’s experimental approach in the early 1980s, the government announced a new program in 2012 such that informal lenders in designated areas would be allowed to legitimately operate upon registration.<sup>200</sup> In terms of policy, an important test for China is whether it will allow shadow banking institutions to fail, thus sending home the message to investors that they cannot rely upon bailouts from the government and encouraging more prudent, risk-based lending. In early March 2014, Chaori Solar Energy Science & Technology Co. (“Chaori”) defaulted on a corporate bond and there did not appear to be any immediate bailout forthcoming by the Chinese government.<sup>201</sup> However, by mid-October, 2014, the

195. Daniel Ren, *Paying the Price in Wenzhou’s Underground Banking System*, SOUTH CHINA MORNING POST (Oct. 15, 2012, 8:39 AM), <http://www.scmp.com/business/banking-finance/article/1061186/paying-price-wenzhou-underground-banking-system>.

196. *Id.*

197. Linda Yueh, *The Shadowy Threat from China’s Lenders*, BBC NEWS (Mar. 6, 2014), <http://www.bbc.com/news/business-26335304> (“A whole network of people and organisations threatened to come crashing down. There was a quiet rescue by the local government.”).

198. See, e.g., Keith Bradsher, *Easy Credit Dries Up, Choking Growth in China*, N.Y. TIMES (Aug. 15, 2013), [http://www.nytimes.com/2013/08/16/business/global/easy-credit-dries-up-crippling-chinese-cities.html?\\_r=0](http://www.nytimes.com/2013/08/16/business/global/easy-credit-dries-up-crippling-chinese-cities.html?_r=0) (describing the plight of the city of Shenmu in northwestern China).

199. Ann Lee, *China Has Its Economy Under Control*, N.Y. TIMES, (Jul. 20, 2015, 4:27 PM), <http://www.nytimes.com/roomfordebate/2014/04/08/chinas-coming-economic-crisis/china-has-its-economy-under-control> (“Along practically every measure of financial stability—in other words, the percentage share of China’s shadow banking system to its G.D.P. or to its total credit outstanding, its leverage ratios, its absence of mark-to-market mechanisms, its sources of domestic liquidity—none show the vulnerabilities that existed in the United States prior to Lehman’s downfall.”) (last visited Aug. 16, 2015).

200. *The Wenzhou Experiment*, ECONOMIST (Apr. 7, 2012), <http://www.economist.com/node/21552228>.

201. *China Allows First Ever Corporate Bond Default*, TELEGRAPH (Mar. 7, 2014, 9:11 AM GMT), <http://www.telegraph.co.uk/finance/china-business/10682394/China-allows-first-ever-corporate-bond-default.html>. However, only a month earlier, China Credit Trust was the recipient of a bailout by anon-

Chinese government initiated a rescue plan for Chaori through the China Great Wall Asset Management Co.'s provision of guarantees for Chaori's debt.<sup>202</sup>

The Chinese government's stance on defaulting companies will have to navigate a very difficult balance. Although allowing companies to default may encourage market discipline to emerge in China, allowing too many defaults could cause panic in the market and trigger a run. By delaying its rescue of Chaori for quite some time, the Chinese government may have sent home the message that reliance on government bailouts is becoming increasingly risky, while avoiding the destabilization of a default. This gradualist approach toward reacting to events based on China's political goals is consistent with China's history. With respect to China's use of gradual experimentalism, it has been remarked,

In some intensely disputed policy areas, such as state-sector bankruptcy, experimental programs with varying priorities came and went for almost twenty years until a finalized law was eventually issued. Over and over again, those national policy makers who attempted to change the way the economy was run instrumentalized the results of experimental programs for asserting the initiative and overcoming opposition from rival policy makers who tried to defend the old rules of the game.<sup>203</sup>

The latest episode in China's shadow banking saga is a series of new developments. The Budget Law was recently amended to finally allow local governments to borrow money through the issuance of bonds, albeit under close supervision of the central government.<sup>204</sup> Also, in late 2014, the central government issued a policy directive stating that local governments are not to use LGFVs to generate any more debt nor are they allowed to pay down the debts of LGFVs.<sup>205</sup> However, by mid-May of 2015, the central government softened

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ymous source. See *Credit Paroled*, ECONOMIST (Feb. 1, 2014), <http://www.economist.com/news/finance-and-economics/21595483-big-default-averted-credit-paroled> ("An unnamed third party stepped forward to buy an equity stake in the underlying venture. . . . Does this bail-out represent a dangerous precedent? Perhaps not. The government's role, if any, is unclear.").

202. Shen Hong, *China Puts Stability Ahead of Reform with Shanghai Chaori Bailout*, WALL STREET JOURNAL (Oct. 16, 2014, 12:07 PM ET), <http://www.wsj.com/articles/china-puts-stability-ahead-of-reform-with-shanghai-chaori-bailout-1413434237>. Also remarking, "The surprisingly generous settlement package—and the state's conspicuous presence in it—suggests that Beijing is now prioritizing economic stability and issuers' access to capital over reform." *Id.*

203. Heilmann, *supra* note 188 (footnote omitted).

204. See *Xinhua Insight: China Revises Law to Better Manage Government Money*, XINHUA, (Aug. 31, 2014, 21:04:41), [http://news.xinhuanet.com/english/china/2014-08/31/c\\_133609499.htm](http://news.xinhuanet.com/english/china/2014-08/31/c_133609499.htm). See also Xin Zhiming, *Revised Budget Law to Have Far-reaching Effect*, CHINA DAILY (Sep. 1, 2014, 11:25), [http://www.chinadaily.com.cn/business/2014-09/01/content\\_18523193.htm](http://www.chinadaily.com.cn/business/2014-09/01/content_18523193.htm).

205. See Shen Hong, *Beijing Directive Cuts Into Debt Issuance*, THE WALL STREET JOURNAL (Feb. 11, 2015, 6:40 PM ET), <http://www.wsj.com/articles/beijing-directive-cuts-into-debt-issuance-1423690460>.

its position—allowing local governments to once again use LGFVs<sup>206</sup> and directing loans from banks to LGFVs for the financing of on-going projects.<sup>207</sup> In order to entice banks to buy municipal bonds issued by local governments, the central government recently accepted the municipal bonds as collateral when banks borrow from the central bank.<sup>208</sup> While this promotes the purchase of municipal bonds, it can also be viewed as “back-door bailout”<sup>209</sup> of the local governments by the central government.

On another front, there have been remarkable changes with respect to private banks. In the past, the sole private bank in China was the China Minsheng Bank.<sup>210</sup> However, in an unprecedented move, the Chinese government approved the establishment of five privately owned banks last year with more to possibly come.<sup>211</sup> Finally, in May, 2015, the Chinese government initiated its deposit insurance plan—insuring deposits up to a maximum of ¥500,000.<sup>212</sup> State mandated deposit insurance is an important step in protecting the public and can be viewed as part of the banking reforms mentioned above.

In summary, the insights of Part II and III apply to China’s current shadow banking situation. The development of China’s shadow banking industry was intimately tied to its political legacy. China’s shadow banking was driven by investors who turned away from the low interest rates offered by traditional banks, such low interest rates being mandated by the central Chinese government. An array of shadow banking mechanisms arose locally to fulfill the demand for higher yielding investments. The political legacy of the government was also discernable through the LGFVs that were created to circumvent the

206. See Lingling Wei, *China Backtracks on Local Government Debt*, THE WALL STREET JOURNAL (May 15, 2015, 8:23 AM ET), <http://www.wsj.com/articles/china-urges-banks-to-continue-lending-to-local-financing-vehicles-1431682151>.

207. See Lu Jianxin & Nathaniel Taplin, *China Urges Banks to Keep Funding Local Govt Projects Amid Shadow Banking Crackdown*, REUTERS (May 15, 2015, 2:54 AM EDT), <http://www.reuters.com/article/2015/05/15/china-debt-lgfv-idUSL3N0Y623B20150515>.

208. Xiaowen Bi, Hongmei Zhao & Zheng Li, *China to Boost Muni Bond Market with Collateral Rules*, REUTERS (May 13, 2015, 1:23 AM EDT), <http://www.reuters.com/article/2015/05/13/us-china-economy-bonds-idUSKBN0NX10U20150513>.

209. Nathaniel Taplin & Pete Sweeney, *Reform Takes Back Seat as China Drives Muni Debt Swap*, REUTERS (May 21, 2015, 3:09 AM EDT), <http://www.reuters.com/article/2015/05/21/china-debt-swap-idUSL3N0YB21920150521>.

210. *Applications Pour in to Open Private Banks*, XINHUA (Jun. 26, 2015, 23:08:05), [http://news.xinhuanet.com/english/2015-06/26/c\\_134359779.htm](http://news.xinhuanet.com/english/2015-06/26/c_134359779.htm).

211. Don Weinland, *China’s Privately Owned Banks: Boom or Bunk?*, SOUTH CHINA MORNING POST (July 5, 2015, 8:24 PM), <http://www.scmp.com/business/banking-finance/article/1832939/chinas-privately-owned-banks-boom-or-bunk> (“Five banks were approved late last year and five more were in the last stages of approval in what has been called one of the biggest regulatory shifts in the mainland banking sector in decades.”).

212. LingLing Wei, *China to Begin Deposit Insurance in May*, THE WALL STREET JOURNAL (Mar. 31, 2015, 1:19 PM ET), <http://www.wsj.com/articles/china-to-begin-deposit-insurance-from-may-1427794649>; see also Kevin Yao, *China May Free Up Bank Deposit Rates Soon: Central Bank Official*, REUTERS (Jun. 3, 2015, 10:09 PM EDT), <http://www.reuters.com/article/2015/06/04/us-china-economy-rates-idUSKBN0OK05120150604>.

austerity of the Budget Law. As shadow banking activities started to alarm the government, such as the problems arising in Wenzhou, the central government reacted by amending the Budget Law and allowing local government to borrow money through the issuance of bonds; experimenting with its policy on LGFVs; gradually approving privately owned banks and, finally, establishing a government-mandated deposit insurance system.

#### V. INSIGHTS FROM CHINA FOR THE UNITED STATES

This part addresses two areas of insight from China that may be useful for the United States and other Western countries. First, this part discusses China's implications for our theoretical understanding of financing. It analyzes how China's Communist Party dominated political structure can subordinate the role of law and erode the legal determinism implied by legal origin studies. It then argues that our theoretical understanding of the importance of financing to a nation's growth needs to be specifically adjusted to include informal channels of financing as well as the sociopolitical norms that support informal financing. Second, this part then concludes by discussing the possibility of the United States and China gaining mutual understanding from each other's shadow banking experiences—particularly as it relates to critical industries and the maintenance of a nation's stability.

##### A. *Theoretical Implications: Broadening the Institutional Scope of Finance*

As discussed earlier, LLSV's work postulated a correlation between a country's legal system and the robustness of its capital markets.<sup>213</sup> With respect to the importance of financial systems, it was also earlier noted that there is a significant body of scholarship (primarily building upon the seminal work of King & Levine<sup>214</sup>) that argues that a country's economic prosperity is strongly correlated with the strength of its financial system. However, in China, banks have been extensions of state policy rather than the commercially driven financial intermediaries familiar to many Western nations. Yet, China's outstanding rate of economic growth since embarking on reforms<sup>215</sup> has catapulted China into the realm of being an economic superpower. Below, there is a discussion of why China's experience is not well accounted for by legal origins theory. This is followed by the observation that the importance of Chinese informal financing suggests that, although financing is important to a nation's growth, the term

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213. See Rafael La Porta et al., *supra* note 25 (generally discussing their work and the posited relationship between country legal systems and the level of capital finance development in those countries).

214. See King & Levine, *supra* note 76.

215. ROACH, *supra* note 4, at 14 ("The reforms' effects were phenomenal. Over the thirty years from 1980 to 2010, China's growth rate in real GDP averaged 10 percent per annum.").

“financing” needs to be broadened to specifically include informal financing.

China’s financial system does not fit easily into the theoretical framework established by LLSV and subsequent works in the legal origins literature. The foundational core of the legal origins literature is that “law matters.”<sup>216</sup> However, the “law matters” thesis that is proffered by legal origins studies is not merely a quiet pronouncement that law is an important aspect of society. Rather, legal origin studies in the tradition of LLSV are deterministic and provide a reified status to an analysis that distinguishes on the basis of whether the country’s legal origin is common law or civil law.<sup>217</sup>

China could technically be regarded as a civil law country as its laws are primarily codified statutes with no tradition of judge-made law (in the tradition of common law judgments). However, such a broad categorization of China’s legal system, for the mere sake of fitting into legal origins analysis could be misleading. For example, one traditional method of distinguishing between common law systems and civil law systems is to focus on the role of the judge.<sup>218</sup> Under common law systems, the judge plays the role of a neutral arbitrator who passively adjudicates an adversarial proceeding.<sup>219</sup> In a civil law jurisdiction, the judge plays a more active role such that the legal proceedings are characterized as being inquisitorial.<sup>220</sup> By focusing so closely on the role of the judge, the implication is that the judge plays a meaningful part in the overall legal system. This meaningful part can be understood in light of the typical separation of powers that occurs in many Western countries (both common law and civil law) where there is an independent judiciary that provides a check on the other branches of government.

Therein lies the problem. Under China’s legal system, there is no Western-style separation of powers, resulting in a Chinese judiciary that does not enjoy nearly the independence that its Western counterparts do. At the top of the Chinese government hierarchy is the National People’s Congress (NPC).<sup>221</sup> The

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216. Harris, *supra* note 26.

217. The title of LLSV’s seminal work—“Legal Determinants of External Finance” clearly indicates the deterministic nature of their work, see Rafael La Porta et al., *supra* note 25.

218. See, e.g., GERALD GALL, *THE CANADIAN LEGAL SYSTEM* 334 (5th ed., 2004); see also Amalia D. Kessler, *Our Inquisitorial Tradition: Equity procedure, due process, and the search for an alternative to the adversarial*, 90 CORNELL L. REV. 1181, 1184 (2005) (arguing that the American adversarial system has an inquisitorial history); Keith A. Findley, *Adversarial Inquisitions: Rethinking the Search for the Truth*, 56 N.Y.L. SCH. L. REV. 911, 940–941 (2011/12) (criticizing the American adversarial system and suggesting a new system that is a hybrid of adversarial and inquisitorial approaches).

219. GALL, *supra* note 218 (“The essential nature of the adversarial system is that the judge acts as the objective decision-maker in the face of opposing interests, with each interest arguing and articulating the merits of its position. In contrast, the inquisitorial, or continental European, judge takes carriage of the proceedings and is ultimately responsible for the ascertainment of truth within the court.”).

220. *Id.*

221. Lay-Hong Tan, *Unravelling the Complexities of the Chinese Legal System: A Primer for Foreign Investors*, 79 AUSTRALIAN L.J. 97, 110 tbl.2 (2005) (depicting the organization of the Chinese gov-

all-powerful NPC enacts laws in China,<sup>222</sup> but contrary to what Western legal scholars might expect, its standing committee (the NPC Standing Committee) has the right to ultimately interpret the law.<sup>223</sup> Although Chinese courts may still express their implementations of the law through the use of written opinions, these are ultimately subordinate to the NPC Standing Committee's right to interpret laws<sup>224</sup> (although the opinions of the Supreme People's Court would be considered to at least carry a strong degree of persuasive weight<sup>225</sup>). Based upon this diminished role of courts compared to the West, other branches of the Chinese government may not regard the Chinese courts as anything more than a different department of the same government at the same level of power.<sup>226</sup> Thus, compared to Western courts, Chinese courts may not be as effective a check on the legislature in general.

There are two more issues that make legal analysis considerably more complicated in China. First, Chinese local government bodies are known to issue their own policy documents with instructions to their officials on how certain matters should be handled. This practice can be traced to China's political history where interested government bodies dealt with matters by issuing policy directives through what have been termed "normative documents."<sup>227</sup> To the extent that subordinate bodies and citizens adhere to these normative documents, they represent a complementary source of obligations running parallel to the formal legal system. Second, Chinese judges can be subjected to political pressures and interference with their independent judgment. This is particularly

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ernment in chart form); *see also* Constitution of the People's Republic of China ((Adopted at the Fifth Session of the Fifth National People's Congress and promulgated for implementation by the Announcement of the National People's Congress on December 4, 1982—Amended in accordance with the Amendments to the Constitution of the People's Republic of China adopted respectively at the First Session of the Seventh National People's Congress on April 12, 1988, the First Session of the Eighth National People's Congress on March 29, 1993, the Second Session of the Ninth National People's Congress on March 15, 1999 and the Second Session of the Tenth National People's Congress on March 14, 2004) (hereinafter "PRC Constitution") Art. 57, [http://www.npc.gov.cn/englishnpc/Constitution/2007-11/15/content\\_1372965.htm](http://www.npc.gov.cn/englishnpc/Constitution/2007-11/15/content_1372965.htm) (last visited Aug. 16, 2015), which states "The National People's Congress of the People's Republic of China is the highest organ of state power. Its permanent body is the Standing Committee of the National People's Congress.").

222. PITMAN B. POTTER, CHINA'S LEGAL SYSTEM 59–60 (2013) (describing the role of the NPC within the political structure of the Chinese government).

223. *Id.* at 70 ("The People's Courts are generally not authorized to interpret the meaning of legislation, which is reserved under the Constitution for the [NPC Standing Committee]"). *See also* PRC Constitution, *supra* note 221, Art. 67(1) and 67(4) (authorizing the NPC Standing Committee to interpret the Chinese Constitution and to interpret laws generally).

224. Potter, *supra* note 222, at 70.

225. *Id.*

226. Stanley Lubman, *Looking for Law in China*, 20 COLUM. J. ASIAN L. 1, 29 (2006) ("In the bureaucratic hierarchy, courts are only parallel to, rather than superior to, other units of the Chinese bureaucracy.").

227. Tan, *supra* note 221, at 103 (internal quotation marks omitted). Tan notes how various levels of government, including local government, have used the system of normative documents since 1949 to address local circumstances. *Id.* at 102–03.

so in local courts where financial decisions which can impact judges rests in the hands of the local government.<sup>228</sup>

In short, in China the current role of law, particularly as a check and balance on the power of nonjudicial government bodies, is diminished in comparison to the part that it plays in many Western societies.<sup>229</sup> In China, the law is prone to the political influence of government interests who may implement their desires through policy directives rather than legislation. The high level of determinism ascribed to the law, at the heart of legal origin studies, is questionable when political preferences can so powerfully influence economic outcomes in China whilst subordinating the role of law. This does not suggest that law is necessarily irrelevant in China, only that it may not have the same level of influence as in Western countries and that it may not be singularly determinative of the development of financial structures in China.

Consistent with studies on law and development that emphasize local context,<sup>230</sup> particularly the exercise of political power,<sup>231</sup> a central factor in Chinese finance has undoubtedly been the Chinese Communist Party and its powerful influence. This has led to the observation that the Chinese experience has been that “policy is the foundation of law and law is the mature form of policy. In other words, law is, to a large extent, to be used to generalize and institutionalize Party and state economic reform policies and measures.”<sup>232</sup> This was exem-

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228. ALBERT CHEN, AN INTRODUCTION TO THE LEGAL SYSTEM OF THE PEOPLE'S REPUBLIC OF CHINA 203–04 (4th ed. 2011). Chen also remarks that “[m]any leaders of local government view the local courts as subordinate members of the local government, and sometimes express their views on individual cases pending before the courts. Judges who without fear or favour apply the law to the detriment of local interests may therefore suffer in terms of their career prospects or their employment benefits.” (footnotes omitted) *Id.*

229. *Cf.* Potter, *supra* note 222, at 47 (“The role of law in China today remains conflicted . . . . Hundreds of pieces of legislation have been enacted at the national level alone since 1979, not to mention the multitude of administrative regulations and provincial and municipal enactments. And through this steady litany of legislation, administrative regulations and, policy pronouncements, the government continues to extol the Party’s leadership over socialist law.”).

230. *See, e.g.,* Mariana Prado & Michael Trebilcock, *Path Dependence, Development, and the Dynamics of Institutional Reform*, 59 U. TORONTO L.J. 341, 377 (2009) (generally reviewing the literature on law and development and stating that “[b]ecause of context-specific factors that explain the evolution of existing institutions (and networks of institutions), no one-size-fits-all blueprint for legal reform or broader institutional reform in developing countries is likely to be optimal.”); *see also* Kevin E. Davis & Michael J. Trebilcock, *The Relationship Between Law and Development: Optimists versus Skeptics*, 56 AM. J. COMP. L. 895, 895 (2008) (“We show that there is ongoing debate about fundamental questions such as whether law is an important factor in determining social or economic outcomes in developing societies given the existence of informal methods of social control . . .”).

231. *See* O. Kahn-Freund, *On Uses and Misuses of Comparative Law*, 37 MOD. L. REV. 1, 27 (1974) (“[B]ut any attempt to use a pattern of law outside the environment of its origin continues to entail the risk of rejection. The consciousness of this risk will not, I hope, deter legislators in this or any other country from using the comparative method. All I have wanted to suggest is that its use requires a knowledge not only of the foreign law, but also of its social, and above all its political, context.”).

232. Jianfu Chen, *Policy as Law and Law as Policy: The Role of Law in China’s Development Strategy*, in LAW AND DEVELOPMENT IN EAST AND SOUTHEAST ASIA 251, 256 (Christoph Antons ed., 2003) (citations omitted).

plified in the earlier discussion of Wenzhou where local officials forged ahead with their own policies for informal financing only to later have them ratified by central government officials (assuming such policies were successful in promoting desired economic outcomes). Rather than being singularly determinative of finance, Chinese law appears to be one of several important factors influencing financial development. Chinese financial development has been an engaging tale of the mix of path-dependent trajectories from China's history as a socialist country whose culture traditionally subordinated the role of law to Confucian principles.<sup>233</sup>

Despite the vital importance of the Chinese Communist Party and its exercise of power through various channels, the significant contribution of informal financing to private entrepreneurship (and hence, to China's remarkable economic ascendancy in the last thirty-five years) reveals that there is also an important influence on financial development that lies outside of formal political and legal structures. The surge of financial innovation from cities like Wenzhou illustrates that there is a complex interrelation between political policies; grass-roots demands from local citizenry; and, finally, reaction by the government. In the case of Wenzhou, a policy of decentralization, budget cutbacks and financial discrimination in favor of SOEs from the central government created pressures on local government to promote private entrepreneurship. Private entrepreneurs, in turn, created a demand for informal financing structures that were later legitimized through local government policy or legislation and, ultimately, the central government would either ratify those structures or attempt to control them, through policies or legislation.

These observations are consistent with Nobel laureate Douglass North's theory on the importance of institutional structures and economic development.<sup>234</sup> While North is known for his observation that law and its enforcement are important in economic development, he has also emphasized that a myopic focus on only formal structures is insufficient. He states,

[A]lthough explicit rules provide us with a basic source of empirical materials by which to test the performance of economies under varying conditions, the degree to which these rules have unique relationships to performance is limited. That is, a mixture of informal norms, rules, and enforcement characteristics defines the choice set and results in outcomes. Looking only at the formal rules themselves, therefore, gives us an inadequate and frequently misleading notion about the relationship be-

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233. See H. PATRICK GLENN, *LEGAL TRADITIONS OF THE WORLD* 306–09 (3d ed. 2007) (discussing the influence of Confucian principles on how the Chinese traditionally regarded the role of law).

234. See generally DOUGLASS C. NORTH, *INSTITUTIONS, INSTITUTIONAL CHANGE AND ECONOMIC PERFORMANCE* (1990) (discussing the importance of institutional structures, including property and contract law, on a nation's economic development).

tween formal constraints and performance.<sup>235</sup>

Despite the importance of North's qualification that informal institutions can play a vital role, such as in the case of informal financing in China, the focus of scholarly inquiry has tended to unfortunately overlook this understudied area.<sup>236</sup>

The observations above suggest that a more accurate understanding of China's financial system, as well as the applicability of its experiences for Westerners, could be pursued through the study of the informal institutions that underpin and influence financial development in China. Deployment of North's insights about the importance of informal norms and culture may also help reconcile informal financing with the literature on debt financing. King and Levine's seminal work focused on the importance of financial intermediaries as being an important key to economic development,<sup>237</sup> but their study focused on formal financial intermediaries.<sup>238</sup> China's financial development suggests that the term "financial intermediary" needs to be broadened to include the significant informal sector, including the sociopolitical norms that underpin its workings. Kellee Tsai's work on informal finance,<sup>239</sup> as well the more recent work on finance in India by Franklin Allen et al.,<sup>240</sup> are excellent platforms for legal scholars. Moreover, work conducted by scholars on factors influencing corporate governance can serve as a model for subsequent research on debt financing in China. For example, Peter Gourevitch and James Shinn have examined how various political coalitions influence corporate governance,<sup>241</sup> while Amir Licht has explored how differences in cultural preferences may influence the choice

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235. *Id.* at 53.

236. See Frank Upham, *From Demsetz to Deng: Speculations on the Implications of Chinese Growth for Law and Development Theory*, 41 N.Y.U. J. INT'L L. & POL. 551, 564 (2009) (With respect to Douglass North's emphasis on the importance of informal institutions, Upham states that "[i]t is important to note that, particularly in North's later work, 'institutions' includes formal and informal rules as well as organizations like courts or governments that are the more familiar referent of the term. Institutions, therefore, is a very wide category that includes virtually all the 'rules of the game' for markets in a given society. Unfortunately, this broad definition of institutions has not survived the transition from academic theory to law and development practice, and the term 'institutions' has come to mean the statutes, courts, judges, and lawyers of a country's formal legal system.").

237. King & Levine, *supra* note 76.

238. *Id.* at 734–35 ("We find that (1) indicators of the level of financial development – the size of the *formal financial intermediary* sector relative to GDP, the importance of banks relative to the central bank, the percentage of credit allocate to private firms, and the ratio of credit issued to private firms to GDP – are strongly and robustly correlated with growth, the rate of physical capital accumulation, and improvements in the efficiency of capital allocation; and (2) the predetermined components of these financial development indicators significantly predict subsequent values of the growth indicators." (italic emphasis added)).

239. TSAI, *supra* note 119.

240. Allen et al., *supra* note 153.

241. PETER A. GOUREVITCH & JAMES SHINN, *POLITICAL POWER & CORPORATE CONTROL: THE NEW GLOBAL POLITICS OF CORPORATE GOVERNANCE* (2005).

of corporate governance structures.<sup>242</sup> Thus, China's apparent nonconformance to the prevailing theories should not be viewed with iconoclastic despair. Rather, it is an invitation to developing richer theories that can inform our understanding of the complex interaction between law, politics, and informal normative structures.

*B. Comparison Between the United States and China: Possibilities of Mutual Learning*

Here, this article reflects upon what the United States (as well as other Western countries) and China might learn from each other's experiences with financial systems, particularly with respect to shadow banking after the 2008 financial crisis. While it is beyond the scope of this article to comprehensively address the myriad complex financial instruments that are related to shadow banking,<sup>243</sup> the general goal is to identify relevant social and political factors at the macroeconomic level. Although China and the United States have vastly different political structures and legal systems, some common themes arise that suggest the possibility of mutual enlightenment.

China's strong economic ascendancy in the last three decades, as well as the fact that it was able to weather the 2008 financial crisis comparatively well, speaks to the resiliency and success that its sociopolitical system has enjoyed thus far. China's mix of authoritarian rule and incremental, experimental market reform has attracted the attention of developing nations who may view it as a viable alternative to the free market values that are often offered to them as a singular developmental path toward economic prosperity. In the late 1990s and early 2000s, one popular package of recommended reforms came to be known as the Washington Consensus<sup>244</sup> whose recommendations included "financial liberalization,"<sup>245</sup> "privatization of state enterprises,"<sup>246</sup> as well as the "provision of secure property rights especially to the informal sector."<sup>247</sup> However,

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242. Amir N. Licht, *The Mother of All Path Dependencies: Towards a Cross-Cultural Theory of Corporate Governance Systems*, 26 DEL. J. CORP. L. 147 (2001).

243. For an overview of the basic types on instruments involved in U.S. shadow banking, see Macey, *supra* note 14. For a more detailed discussion on how various instruments and shadow banking practices relate to the real estate market, see Steven L. Schwarcz, *Shadow Banking, Financial Markets, and the Real Estate Sector*, 32 REV. BANKING & FIN. L. 179 (2012–2013). For an interesting discussion of shadow banking from the perspective of various institutional cash pools, see Zoltan Pozsar, *Institutional Cash Pools and the Triffin Dilemma of the U.S. Banking System*, 22 FIN. MKTS., INSTRS. & INSTRUMENTS 283 (2013).

244. See generally John Williamson, *The Strange History of the Washington Consensus*, 27 J. POST KEYNESIAN ECON. 195 (2004–2005) (describing the prescribed reforms contained in the original Washington Consensus).

245. *Id.* at 196.

246. *Id.*

247. *Id.*

corporate law failures, such as the infamous Enron scandal<sup>248</sup> in the early 2000s and the devastating 2008 financial crisis, tarnished the luster of Western liberal models. This brought the wisdom of conventional free market thought into question as the United States struggled to keep its economy from disintegration with an unprecedented government intervention in the form of a US \$787 billion bailout package<sup>249</sup> and more vigorously regulating its economy through the Dodd-Frank Act<sup>250</sup> (which then also reduced the authorized bailout package to US \$475 billion to be used under the Troubled Asset Relief Program (TARP) and administered by the Office of Financial Stability (OFS)).<sup>251</sup>

While the foundational precepts of the Washington Consensus fell under intense scrutiny and questioning,<sup>252</sup> China received renewed attention as a possible model for economic development for developing countries, a proposition that would most likely have been met with derision a scant three decades earlier in 1978. Indeed, the focus on China reached a level such that this competing paradigm of development came to be known as the Beijing Consensus.<sup>253</sup> The name likely arose in order to draw a comparison to the Washington Consensus.<sup>254</sup> One of the key points about China was that it did not advocate or rec-

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248. See generally John C. Coffee Jr., *What Caused Enron? A Capsule Social and Economic History of the 1990s*, 89 CORNELL L. REV. 269 (2004) (analyzing the events that led to the Enron scandal as well as evaluating the government's response).

249. ENGEL & MCCOY, *supra* note 5, at 124–25 (discussing how the Obama administration put the funds to use to alleviate the consequences of the 2008 financial crisis and to avoid further loss). The US government had legislated this bailout through The American Recovery and Reinvestment Act of 2009, Pub. L. No. 111-5, 123 Stat. 115 (2009). *Id.* at 125.

250. Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, 124 Stat. 1376 (2010) [hereinafter Dodd-Frank Act]. For a discussion on this statute and its application to non-bank financial intermediaries, see generally Brent J. Horton, *When Does a Non-Bank Financial Company Pose a "Systemic Risk"? A Proposal for Clarifying Dodd-Frank*, 37 J. CORP. L. 815 (2012).

251. THE DEPARTMENT OF THE TREASURY – OFFICE OF FINANCIAL STABILITY – TROUBLED ASSET RELIEF PROGRAM, AGENCY FINANCIAL REPORT – FISCAL YEAR 2014 3 (Nov. 2014), <http://www.treasury.gov/initiatives/financial-stability/reports/Documents/FY2014%20OFS%20AFR%20FINAL%20-%20Nov%206%202014.pdf>. Also stating “While the total disbursed for TARP was \$425.9 billion, OFS has collected \$422.9 billion (or \$440.4 billion if including the \$17.5 billion in proceeds from the additional Treasury AIG shares [sold by the government]) through repayments, sales, dividends, interest and other income. As of September 30, 2014, only \$2.9 billion in investments remain outstanding.” *Id.* at viii.

252. See Joseph E. Stiglitz, *Is There a Post-Washington Consensus Consensus*, in THE WASHINGTON CONSENSUS RECONSIDERED: TOWARDS A NEW GLOBAL GOVERNANCE 41, 41 (Narcis Serra & Joseph E. Stiglitz eds., 2008) (“If there is consensus today about what strategies are most likely to promote the development of the poorest countries in the world, it is this: there is no consensus except that the Washington Consensus did not provide the answer.”). Nobel Laureate Stiglitz further remarks that “[t]o most people, the Washington Consensus represents a set of policies predicated upon strong faith—stronger than warranted either by economic theory or historical experience—in unfettered markets and aimed at reducing, or even minimizing, the role of government.” *Id.*

253. For a recent general discussion of the Beijing Consensus and how it affects US–China relations, see generally STEFAN HALPER, THE BEIJING CONSENSUS: HOW CHINA'S AUTHORITARIAN MODEL WILL DOMINATE TWENTY-FIRST CENTURY (2010).

254. See JOSHUA COOPER RAMO, THE BEIJING CONSENSUS 3–4 (2004), available at <http://fpc.org.uk/publications/TheBeijingConsensus>.

commend its own sociopolitical structures to developing countries nor did it attach conditions to the financial assistance it provided to them.<sup>255</sup> Instead, it has been building economic relationships with other countries such as those in Africa.<sup>256</sup> From a political viewpoint, the challenge posed by China lies not purely in its economic prowess but in the growing influence of its paradigm of development. As one commentator notes,

As these pages have argued, the intervening period has seen China grow to pose a serious challenge to the United States, not by virtue of its military power or accumulation of U.S. dollar reserves, but as the catalyst for a global shift in development economics and toward a new type of capitalism, which can flourish without the values and norms of Western Liberalism.<sup>257</sup>

Although it would be tempting to regard China's experience as a ready-made template for developmental economics, such an exercise would be fraught with folly, merely substituting an imperialism of Western ideals with that of ascending Chinese ideals. It would also be ignoring the repeated findings of law and development scholarship that emphasizes the importance of local context and culture.<sup>258</sup> China's sociopolitical system arises from a distinct blend of socialist thought infused with Chinese culture and history—a unique host environment that is not likely to be easily found nor replicated anywhere else. For example, Gu Weixia has specifically studied the case of China's securities markets and situates the study in the context of law and finance literature.<sup>259</sup> While acknowledging that further development of China's securities law regime is necessary in light of a plethora of recent scandals, Weixia con-

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255. Halper, *supra*, note 253, at 30 (“The critical distinction between Chinese and Western assistance is that China provides hard-currency loans without the conditions imposed by the West. There is no obligation to create a civil society in the Western sense, no requirement to abide by international accounting standards or accepted legal standards—and certainly no attempt to interfere in the recipient's internal affairs.”).

256. For a discussion on the relationship between China and Africa, see generally Won Kidane & Weidong Zhu, *China-Africa Investment Treaties: Old Rules, New Challenges*, 37 FORDHAM INT'L L.J. 1035 (2014); see also Ronald I. McKinnon, *China in Africa: The Washington Consensus Versus the Beijing Consensus*, 13 INT'L FIN. 495 (2010) (reviewing DEBORAH BRAUTIGAM, *THE DRAGON'S GIFT: THE REAL STORY OF CHINA IN AFRICA* (2009)); VIVIEN FOSTER, WILLIAM BUTTERFIELD, CHUAN CHEN & NATALIYA PUSHAK, *BUILDING BRIDGES: CHINA'S GROWING ROLE AS INFRASTRUCTURE FINANCIER FOR SUB-SAHARAN AFRICA* (2009) and STEFAN HALPER, *THE BEIJING CONSENSUS: HOW CHINA'S AUTHORITARIAN MODEL WILL DOMINATE TWENTY-FIRST CENTURY* (2010)).

257. HALPER, *supra* note 253, at 251. Halper also states, “[T]here's been a new joke in London since the recent crisis on Wall Street: *Capitalism saved China in 1989; China saved capitalism in 2009.*” *Id.* But see Yasheng Huang, *Debating China's Economic Growth: The Beijing Consensus or the Washington Consensus*, 24 ACAD. MGMT. PERSPECTIVES 31, 31 (2010) (arguing that, with respect to the Washington and Beijing Consensus, “the Washington Consensus view fits with the Chinese growth experience better”).

258. See, e.g., Prado & Trebilcock, *supra* note 230.

259. Gu Weixia, *Securities Arbitration in China: A Better Alternative to Retail Shareholder Protection*, 33 NW. J. INT'L L. & BUS. 283, 283 (2013).

cludes that attempts to adopt a US class action model are “quite unlikely to work well in China’s sociopolitical and socioeconomic context.”<sup>260</sup>

Rather than categorizing the issue as a false dichotomy between US and China models, a more productive exercise is to identify common problems between both countries with a view to enlightening perspectives and promoting new ways of thinking about the policy challenges. One common problem faced by both the United States and China is the degree of support that they are prepared to provide to sectors of the economy that are critically important—so important that allowing market failure is not an option. During the 2008 financial crisis, it became clear that the US automotive industry was too critical to the US economy to allow to fail, resulting the disbursement of US \$79.7 billion of bailout funds to ensure its continued survival.<sup>261</sup> As the repercussions of the US-originated 2008 financial crisis spread to China, the Chinese government responded with its own economic stimulus package of US \$586 billion as a preventative measure.<sup>262</sup> However, there were some notable differences due to the nature of the Chinese political economy. There was less need to legislate in relation to banks presumably because the Chinese government could simply act based on its policy directives as having the equivalent of the force of law—in other words, banks would simply have to follow government orders.<sup>263</sup> With respect to banks and other entities closely associated with the Chinese government, there was an implicit understanding that the government would not allow these entities to fail.<sup>264</sup>

Thus, the United States and China have faced a similar problem—deciding which core businesses and industries must be supported for the sake of the macroeconomy. Although both nations provided economic stimulus packages, the Chinese perspective was in some ways the inverse of the US experience. For decades, the Chinese government has been indirectly subsidizing many SOEs through the soft loans and discriminatory banking practices discussed earlier. However, as a result, Chinese private enterprise was starved of credit,

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260. *Id.*

261. THE DEPARTMENT OF THE TREASURY – OFFICE OF FINANCIAL RESPONSIBILITY – TROUBLED ASSET RELIEF PROGRAM, *supra* note 251, at 12. (“In total, OFS disbursed \$79.7 billion in loans and equity investments to the auto industry through the [Automotive Industry Financing Program]. As of September 30, 2014, OFS has collected \$68.9 billion through sales, repayments, dividends and interest under this program.”).

262. *See China Seeks Stimulation*, ECONOMIST (Nov. 10, 2008), <http://www.economist.com/node/12585407>.

263. *See* Richard Cudahy, *From Socialism to Capitalism: A Winding Road*, 11 CHI. J. INT’L L. 39, 59 (2010) (referring to China and stating “its banks were owned by the government and were required to lend, so there could be no comparable credit freeze”).

264. *Id.* at 60 (“In the US, there was also a program to provide funds for banks and other financial institutions in danger of failure. This was a measure not needed in China, where the government owned these institutions and guaranteed their solvency.”).

thus creating the demand for informal financing and, ironically, contributing to the conditions for the development of shadow banking in China. In the United States, shadow banking practices contributed to the 2008 financial crisis which, in turn, resulted in the subsequent need to heavily subsidize key industries via bailout packages (e.g., financial, housing, and automotive industries).

Reflecting upon the US bailout of the US automotive and financial industries may engender a degree of empathy for China's reform experience to date. When China commenced its reforms in 1978, everything was publicly owned (i.e. no privatization yet). One might even think of this as one large "China Inc.," and the starting position was that this "China Inc." was, of course, too big to allow to fail—it was comprised of the entire nation. As discussed earlier, SOEs were more than merely an ownership structure reflecting government interests. This structure represented a social contract underpinning in large part the legitimacy of the Chinese Communist Party. In addition to the iron rice bowl discussed earlier, one integral societal feature of SOEs was the legacy of the *danwei* or "work unit." Urban workers belonged to a *danwei*, which assured them of a job as well as social benefits, but the worker's life was subject to the control of the *danwei*.<sup>265</sup> In short, the *danwei* served "multiple social, political and economic functions"<sup>266</sup> and was "[t]he fundamental building block, or cell, of urban society . . . The *danwei* was a microcosm of urban society, into which individuals were born and in which they lived, worked and died."<sup>267</sup>

Thus, the Chinese government's preferential lending policy toward SOEs can be viewed as providing an economic cushion for the dramatic transformation from embedded social institutions like the *danwei* and iron rice bowl—institutions that were, at one time, so closely intertwined with prevailing Chinese sociopolitical expectations that they could not be allowed to fail or be disbanded all at once. Thus, it is not surprising that "it is precisely in those firms where the institution of the *danwei* was most highly developed that change has been the smallest."<sup>268</sup> Much like the important US automotive sector, which was deemed too economically important to be allowed to fail, so, too, has China been struggling with the degree and pace at which it can allow expose seg-

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265. See LIEBERTHAL, *supra* note 95, at 184 ("A major urban enterprise would, for example, be a source of many things for its employees: housing, recreational activities, schooling for the children, health-care facilities, and so forth. The *danwei* also provided ration coupons for food, clothing, and furniture; administered the birth-control program; mediated marriage disputes; and provided pensions and burial funds. The *danwei*'s permission was required to get married, obtain a divorce, or change jobs."). Lieberthal also states, "Key to the *danwei*'s importance was that fact that very few individuals ever obtained permission to transfer from one *danwei* to another." *Id.* at 185.

266. Barry Naughton, *Danwei: The Economic Foundations of a Unique Institution*, in DANWEI: THE CHANGING CHINESE WORKPLACE IN HISTORICAL AND COMPARATIVE PERSPECTIVE 169, 169 (Xiabo Lu & Elizabeth J. Perry eds., 1997).

267. NAUGHTON, *supra* note 98, at 118.

268. NAUGHTON, *supra* note 266, at 190.

ments of society to the market without excessively destabilizing the macroeconomy.

In addition to having to address the delicate problem of what industries may require government support to prevent failure, the United States is confronted with the issue of dealing with those that may seek to profit from the comfort of knowing that the government will bail out certain industries.<sup>269</sup> Reliance on government bailouts promotes moral hazard and encourages investors to make suboptimal investment decisions based, not on the merits of the industry or business, but rather on the comfort that the government will ultimately rescue what would otherwise be an unwise investment. China presently struggles with this issue but continues to rescue companies to preserve economic stability.<sup>270</sup> In the United States, the partial response has been to more closely regulate financial institutions.<sup>271</sup> The intractable nature of the problem in the United States has resulted in different recommendations. For example, one scholar has questioned recommendations to have deposit insurance for securitized banking because the comfort of deposit insurance could also increase the risk of moral hazard.<sup>272</sup> Another recommendation has been to holistically attack the problem by regulating “money-like instruments.”<sup>273</sup>

Jonathan Macey has noted the relationship between important banks and government regulators – one that he characterizes as being “symbiotic.”<sup>274</sup> This symbiotic relationship may result in a form of regulatory capture such that the regulator’s objectivity is compromised—resulting in the regulator being more likely to consent to requests from banks that are critically important to the economy.<sup>275</sup> This bears some resemblance to the situation in China where government banks and regulators have a decided bias in favor of SOEs resulting in lending on policy preferences rather than purely commercial objectives. Given

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269. See ENGEL & MCCOY, *supra* note 5, at 238.

270. See Hong, *supra* note 202.

271. See Dodd–Frank Act, *supra* note 250, § 113 (titled “Authority to require supervision and regulation of certain nonbank financial companies”).

272. Zachary J. Gubler, *Regulating in the Shadows: Systemic Moral Hazard and the Problem of the Twenty-First Century Bank Run*, 63 ALA. L. REV. 221 (2012).

273. Morgan Ricks, *Money and (Shadow) Banking: A Thought Experiment*, 31 REV. BANKING & FIN. L. 731, 746 (2011–2012). Ricks suggests that “[t]he proposed regime would largely confine the issuance of money-like instruments—including, but not limited to, deposit obligations—to a designated set of licensed firms.” *Id.*

274. Macey, *supra* note 14, at 609 (“Regulators of the big banks that are too-big-to-fail inevitably generate a close – indeed, a *symbiotic* – relationship with the bankers who run such institutions.” (italic emphasis added)).

275. *Id.* (“For the regulators this means, for example, protecting those that are considered too-big-to-fail from the vagaries of competition from small institutions whose survival is not deemed critical. It also means acquiescing to the requests by the too-big-to-fail shadow banks for accounting rules that allow such banks to portray themselves as healthier than they actually are and by entering into new, risky but profitable lines of business, such as shadow banking, that require a ‘too-big-to-fail’ status.”).

Macey's critique of regulatory capture in the US financial system, one of his recommendations attempts to mitigate the favoritism that may be enjoyed by financial institutions that are deemed too critical to allow to fail. He suggests that, when financial institutions become so large and critical that allowing market failure is not a viable option, such financial institutions should be broken up.<sup>276</sup> Correspondingly, Macey's recommendation may find some traction in China now that shadow banking investments like WMPs have grown alarmingly in size and risk.<sup>277</sup>

Both China and the United States face a delicate task with respect to the regulation of shadow banking. Overtly blunt attempts at overregulation are unlikely to be successful. In the United States, excessively tightening regulation of traditional banks may increase the desirability of shadow banking as an alternative<sup>278</sup> by both lenders and borrowers. The Chinese experience confirms this as a possibility since it was Chinese state banks' policies (i.e., government-mandated preferences for SOEs and low-yield interest rates on deposits) that fueled the rise of shadow banking in China. In addition, an overzealous targeting and regulation of shadow banking and informal lending practices could negatively impact the economy as well. The Financial Stability Board has acknowledged that the intermediation provided by the shadow banking sector "appropriately conducted, provides a valuable alternative to bank funding that supports real economic activity."<sup>279</sup> Again, the Chinese experience is illuminating here because it was informal financing structures that provided credit-starved Chinese private entrepreneurs with money—those entrepreneurs subsequently contributing to China's economic prosperity.

When viewed in this light, the issue of shadow banking in both China and

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276. *Id.* at 616 (arguing that a solution "could be achieved by dismantling any financial institution, shadow or traditional, that has grown to the point at which it is too-big-to-fail").

277. For example, it was reported on July 1, 2014, that one of China Credit Trust Co Ltd.'s WMPs was in danger of defaulting although it had received US \$209.62 million from investors in 2011. *See China Trust Firm Warns of Possible Default on Wealth Management Product*, REUTERS (July 1, 2014, 9:02 AM EST), <http://uk.reuters.com/article/2014/07/01/china-trust-default-idUKL4N0P81DX20140701>.

278. Steven Schwarcz, *Regulating Shadow Banking*, 31 REV. BANKING & FIN. L. 619, 624 (2011–2012) ("[T]he fact that shadow banks tend to be less regulated than traditional banks inevitably means that regulatory arbitrage drives the demand for shadow banking to some extent. Therefore, increasing bank regulation will almost certainly increase shadow banking demand. If driven exclusively by regulatory arbitrage, shadow banking may not represent a public good. For instance, regulatory arbitrageurs might use deal structures that carry higher transaction costs than the regulated alternative, but that offer a net gain to parties because they avoid regulation. Regulatory arbitrage also disadvantages market participants that lack the wealth, expertise and, often, political connections to capitalize on arbitrage opportunities." (footnotes omitted)).

279. FINANCIAL STABILITY BOARD, STRENGTHENING OVERSIGHT AND REGULATION OF SHADOW BANKING: AN OVERVIEW OF POLICY RECOMMENDATIONS iv (Aug. 29, 2013), [http://www.financialstabilityboard.org/wp-content/uploads/r\\_130829a.pdf?page\\_moved=1](http://www.financialstabilityboard.org/wp-content/uploads/r_130829a.pdf?page_moved=1).

the United States transcends a singular focus on reckless financial intermediaries, though this is obviously a critically important component of the problem. China's attempt to address shadow banking problems is intimately tied to broader issues borne of its historical, social, and political legacies, and, in studying these Chinese perspectives, prompts Western scholars to more critically evaluate the corresponding legacies in their own countries.

## VI. CONCLUSION

The codependency of the US and Chinese economies has recently received renewed attention in light of the potential threat of shadow banking practices. Although contemporary concerns about shadow banking practices had their genesis in the US originated 2008 financial crisis, the significant growth of shadow banking practices in China has engendered the fear that such practices could threaten the Chinese economy—with grave repercussions for the United States and the rest of the world. Prompted by this practical concern, an investigation into China's shadow banking situation yields both theoretical insights for Western theories about the relationship between law, finance, and development as well as useful comparative insights on the commonality of problems faced by the United States and China.

Understanding China's current shadow banking dilemma requires a grasp of the contours of its financial system as well as its political history. Exploration of China's financial system reveals that it does not situate well with prevailing finance theories. Schumpeter-inspired theories about finance anticipate that economic prosperity is correlated with a strong, formal financial system. In this regard, China's economic ascendancy—an ascendancy that transpired with China lacking a strong formal financial and legal system—poses a challenge to those established theories on debt financing. In order to explore that challenge, this article analyzed the significant and influential contribution made by legal origins literature (especially LLSV's influential works). While legal origins studies are very influential, the legal determinism that they imply remains incomplete as an explanation for China's economic development. Critiques by scholars such as Roe highlight the importance of politics in understanding a country's corporate structures. Coffee directs attention to the many ways law may play an important role even if that role is not determinative while also emphasizing the significance of the private sphere.

Although Roe and Coffee's broader insights were in response to legal origin studies as applied to dispersed ownership and stock markets, they nevertheless are informative to an exploration of China's debt financing structures, including shadow banking. Rather than rely on formal bank financing, Chinese private entrepreneurs—a significant driving force behind China's remarkable economic development—relied upon informal financing channels. The prolif-

eration of informal financing was deeply path dependent and a vestige of China's sociopolitical legacies. China's socialist history meant that economic reform had to proceed gradually while continuing to support a responsible transition from socially embedded structures that underpinned the legitimacy of the reigning Chinese Communist Party. These structures included the social assistance provided by the government through institutional structures such as the "iron rice bowl" and the *danwei*. Supporting these structures however came at a cost. It meant that the Chinese government and its banks had a preferential lending policy that favored SOEs to the exclusion of private entrepreneurs.

The devolution of authority from the central to local governments coupled with increased fiscal responsibility for local governments created the fertile ground for the rise of informal financing. Drawing upon traditions of informal financing, private entrepreneurs, with the nod of local governments, fueled the development of more robust and diverse streams of financing that lay outside of the formal structure of traditional banking. Paradoxically, while propelling the economic activity that became the pride of Chinese reform, China's sociopolitical conditions also laid the groundwork for potentially destabilizing Chinese shadow banking practices. Some of the most worrisome Chinese shadow banking practices can be traced to long-standing government preferences. The popularity of shadow banking products is partially a result of the government mandated low interest rates on deposits. The ascendancy of LGFVs is related to the Budget Law, which restricted the ability of local government to raise money at a time when it faced an increased need for revenue. This suggests that shadow banking must be addressed by changes in Chinese government policy (and potentially laws which reflect those policies). Correspondingly, the Chinese government has recently started to move in this direction. For example, it has recently amended the Budget Law—allowing local governments to issue bonds; experimented with LGFV policy—tightening and relaxing its stance depending on circumstances; gradually allowed privately owned banks and, instituted a deposit insurance system to protect depositors.

China's shadow banking experience advances Western theoretical understandings of law, finance and development. It reminds Western scholars of North's observation that informal structures can play a vitally important role in tandem with a formal legal system. China's example confirms that observation—China's informal financing structures and government policies helped propel Chinese private entrepreneurs to economic prosperity despite a weak legal environment. Attempts to predict Chinese outcomes on the premise that law is determinative will encounter the problem that, to date, law has played a reactive rather than determinative role in China's financial development. Yet there may be reconciliation between China's reform experience and prevailing financial theories about economic development. China reveals that although financial

development does require intermediaries, those intermediaries may not necessarily be part of the formal financial structure. While government policies and laws might circumscribe the formal landscape, in so doing, the ground left behind potentially forms the basis for informal structures that fill policy and legislative gaps. This reveals a complex interaction between formal and informal structures that does not necessarily reify one over the other but reflects mutual complements. The Chinese Communist Party's formal policies and laws preferred supporting institutions such as SOEs and, in so doing, preserved a degree of social peace as China made a gradual transformation to a more market-based economy. This precipitated the rise of informal financing structures, which then provided a basis for successful private entrepreneurship but was also accompanied by the growth of worrisome shadow banking. In full circle, the Chinese Communist Party must now re-evaluate its policies and laws in light of the risks posed by shadow banking.

Although the United States and China are both economic super-powers, it would be incorrect to portray a false dichotomy of attempting to choose whose economic model is superior. Law and development studies have demonstrated the importance of local context. Each of the United States' and China's unique sociopolitical circumstances could hardly be replicated elsewhere. However, a close investigation of shadow banking in the United States and China reveals commonalities and parallels that merit future research. In both countries, beyond the technical nature of specific laws, the problem faced is the degree of intervention that the government is willing to expend on key industries. In the United States this was apparent in the unprecedented bailout package that was expended on the finance, housing, and automotive industries—areas that were deemed critical to the economy. In China, this intervention has been in the form of ongoing implicit subsidies in the form of soft loans to important government-associated entities such as SOEs. While shadow banking practices contributed to the 2008 financial crisis, which, in turn, led to the US bailout of key industries, from another perspective, it could be argued that, in China, the converse was true. In China, the ongoing government support of SOEs was indirectly one of the main reasons for the growth of shadow banking. This implies a relationship between important industries and how formal and informal financial practices impact the growth of shadow banking. Further, both China and the United States face the delicate task of fine-tuning their legislation and policies to control the threat posed by shadow banking. An overzealous approach by the United States might actually harm the economic productivity that is provided by having alternate forms of banking. This is confirmed by the useful and significant role that informal financing played in China's economic development but tempered by the fact that shadow banking is arising as a potential threat in China as well.

Thus, China is engaged in a complex interaction with (1) historical legacies that constrain the politically acceptable range of implementations of the law; and (2) elements of civil society that generate their own financial innovations—such innovations perhaps requiring the assistance of the law in mitigating the risks associated with their implementation. One fascinating aspect is how the problems faced by the United States have parallels to China, despite the vastly different sociopolitical systems of both countries. The challenge for the future will be to investigate how those parallels and the differences in approaching common social problems can inform legislative policy.