Debate

Goodbye (Chinese) Shadow Banking,
Hello Market-based Finance

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ABSTRACT

Shadow banking in developing and emerging countries (DECs) oscillates between two semantic poles. One definition is typically deployed by scholars for the narrow analysis of non-bank financial intermediation as a viable alternative to banking. The other, more recent, definition circulates in the policy world to capture a new agenda of engineering (securities) market-based finance. This article argues that this second definition captures the essential but neglected aspect of shadow banking in DECs. The ‘shadow banking into market-based finance’ narrative reaffirms the celebratory tone of the financial globalization cum liberalization thesis dominant before the global financial crisis. It seeks to depoliticize contentious debates about capital flows and the constraints that financialized globalization poses to development, instead asking DECs to encourage portfolio flows, relax the regulatory grip on shadow funding markets and tap into the growing global demand for securities that marks the new age of asset management. China illustrates this argument well. In joining the global push for market-based finance with the ambition to further its RMB internationalization agenda, China underestimates the (Minsky-type) fragilities involved.

INTRODUCTION

‘In order to successfully internationalise the RMB . . . China will have to build deep and liquid financial markets open to the rest of the world’ (Eichengreen, 2015: 1).

‘The real issue isn’t the volume of debt, but rather the liability-side plumbing that underlines the debt boom . . . if there is going to be a financial crisis in China, this is where it will come from’ (Financial Times, 2016).

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The term ‘shadow banking’ has had a short yet unusually productive life. It was first coined in 2007 to account for the workings of complex chains of credit, liquidity and leverage with no systemic regulatory oversight (Ban and Gabor, 2017). By 2009, the G20 countries had thrown their weight behind it, mandating a newly created international institution, the Financial Stability Board (FSB), to map its systemic risks. By 2016, the FSB had identified the main areas for reform, proposed new rules and introduced annual reports monitoring countries’ progress in implementing reforms. If the political power of economic ideas is demonstrated by the speed with which they trigger institutional change (Ban, 2016; Blyth, 2002; Helgadóttir, 2016), then shadow banking is an exceptionally powerful idea.

What does the rise of this powerful idea mean for developing and emerging countries? At first, it seemed very little. The first FSB policy document (FSB, 2011) drew heavily on literature that offered a structural change account of the global financial crisis (Adrian and Shin, 2009, 2010a; Gorton and Metrick, 2009; Pozsar et al., 2010). According to these seminal papers, the liberalization spurt of the 1980s saw banks and capital markets in high-income countries become closely connected in a globalized finance increasingly built around securities markets (also see Mehrling, 2012; for a critical account, see Christophers, 2013). Shadow banking captured the production (via securitization of illiquid bank loans) and funding (via wholesale markets) of tradable securities or, as Mehrling et al. (2013: 2) put it, ‘money market funding of capital market lending’. Its distinctive vulnerabilities arose from the use of newly created asset- and mortgage-backed securities as collateral to tap wholesale market funding, where complex collateral valuation practices triggered runs during crises (Brunnermeier and Pedersen, 2008; Gabor, 2016). To regulate shadow banking, the FSB (2011) insisted, it was necessary to target both banks’ activities in the shadows — securitization, collateral-based wholesale funding — and shadow banks such as money market funds.

In these terms, few developing and emerging countries (DECs) had any shadow banking to speak of. For most, capital markets mainly consisted of government bond markets, while banks lent to each other without collateral. Indeed, the FSB’s first global monitoring exercise included only one (arguably) ‘emerging’ economy, South Korea. This changed quickly. By 2013, Mark Carney, the head of the FSB, warned that shadow banking in emerging countries posed serious risks to global financial stability, and called for reforms of the ‘parallel banking sector in the big developing countries’ (The Daily Telegraph, 2013). Most interpreted his remarks to mean China. With this, the FSB elevated DEC shadow banking to an equal footing with that of developed countries in terms of its relevance to global financial stability.

Since then, the literature on DEC shadow banking has been mostly concerned with establishing whether this is a ‘viable credit alternative’ to the formal banking sector (Acharya et al., 2013; Allen et al., 2016; Tsai, 2017).
It defines shadow banking as ‘other financial intermediaries’ that meet the needs of economic actors traditionally excluded by banks, such as small and medium enterprises (SMEs) (Acharya et al., 2013; Allen et al., 2016). Yet DEC regulators worry that this approach conflates well-regulated, non-bank financial institutions important to economic development with shadow banks posing systemic risks (FSB, 2014). If the FSB’s shadow banking agenda is to have a serious impact on regulating domestic financial systems, then developing countries insist that ‘each jurisdiction has the flexibility to exercise national discretion’ in designing regulatory regimes proportional to the risks posed by shadow banking entities (ibid.: 57).

This article argues that the ‘viable alternative’ literature suffers from two significant shortcomings. First, it depicts DEC shadow banking as a universe strictly confined by national borders. This is immediately apparent from the growing literature on shadow banking in China, usually portrayed as the escape valve of a financial system repressed by the long hand of the state. Second, it ignores the changing ambitions of the global regulatory community as expressed by the FSB work on shadow banking. Since 2014, the FSB agenda has changed from a regulatory intervention motivated by the rise of new systemic actors and markets, to a deeply normative project of transforming shadow banking into resilient ‘market-based finance’ that organizes financial systems around securities markets (FSB, 2014, 2016; also Engelen, 2017).

Such transformative ambitions matter for development. Market-based finance has evolved from Gerschenkron (1962) into what many describe as ‘the age of asset management’ (Braun, 2016; Haldane, 2014). Securities markets are no longer driven by the needs of economic development and industrialization à la Gerschenkron, but by the demand for securities generated by international investors, from hedge funds to asset managers investing on behalf of institutional investors such as pension funds, insurance companies and multinational corporations. For instance, with nearly US$ 6 trillion worth of assets under management by September 2017, Blackrock, the world’s largest asset managers, is twice as large as the largest global bank (Johnson, 2017). While the conventional wisdom is that asset managers, with the exception of hedge/bond funds, do not use leverage (outright borrowing as opposed to managing assets of other investors), recent research suggests that asset managers are increasingly relying on leverage when investing in DEC securities markets, and can therefore be a threat to financial stability (Avalos et al., 2015).

The rise of asset managers is a manifestation of the growing inability of high-income countries to tax powerful corporations and collectively provision for future uncertainties via the welfare state (Gabor, 2016; Helgadóttir, 2016; Streeck, 2014), prompting individuals to turn to the market via private insurance and pension funds in a new regime of asset-based welfare (Finlayson, 2009). The same pressures are manifest in DECs, which are advised by international development organizations to adopt market solutions (such
as the privatization of public pension funds), and encourage the entry of foreign investors into local currency debt markets. Indeed, asset managers have absorbed a growing share of the rapidly expanding DEC local currency securities since 2008 (Feroli et al., 2014). Foreign holdings of DEC local currency bonds more than doubled from 12.7 per cent in 2008 to 30.1 per cent in 2015, as total DEC local currency debt increased fourfold to US$ 17.2 trillion in the same period (IMF and World Bank, 2016).

Thus, the new shadow banking agenda seeks to define the terms on which DECs join the global supply of securities, re-invigorating a pre-crisis plan pursued by G8 countries, the World Bank and the International Monetary Fund (IMF) to accelerate the reach of financialized globalization (G8, 2007). This policy-engineered financial globalization seeks a clean break from ‘policy-engineered industrialization’ in DECs which involved capital controls, bank credit guided by the priorities of industrial strategies and competitive exchange rate management (Storm, 2017). It seeks to accelerate the global diffusion of the architecture of the US securities and securities-funding markets, with its well-documented fragilities (FSB, 2012, 2013; Gabor, 2016; Tarullo, 2015) and contested social efficiency (Epstein, this issue), in order to support business models predicated on daily volatility in the market price of securities.

This is important for broader questions of development and economic stability in DECs, historically more vulnerable to volatile capital flows (Dutt, 2013; Rey, 2015). In the wake of the global financial crisis, for the first time since the Washington Consensus, developing countries successfully questioned the purported benefits of free capital flows and normalized the use of capital controls to deal with ‘currency wars’ ignited by large central banks. Using China as a case study, this article will argue that the project to transform shadow banking threatens DEC’s new ‘monetary power’ (Gallagher, 2014) — a hard-fought victory to deal with the dilemmas posed by global financial cycles (Gabor, 2015; Kaltenbrunner and Painceira, 2017; Rey, 2015) and financialization more broadly (Bortz and Kaltenbrunner, this issue). On the longer term, the turn to market-based finance prepares the terrain for organizing development interventions via securities markets, as suggested by the growing popularity of green bonds, social impact bonds and digital financial inclusion approaches to poverty reduction (Gabor and Brooks, 2017; Mader, this issue).

This contribution to the Forum 2018 Debate on financialization and economic development zooms in on the revival of policy-engineered financialized globalization via the shadow banking agenda. It shows how the project of regulating shadow banking in high-income countries morphed into a project of transforming DEC financial systems into securities market-based finance, with the specific aim of meeting a growing global demand that in turn reflects increasing inequalities and a shift in welfare provision from the state to securities markets. The article first examines the literature on DEC shadow banking; it then argues that China’s efforts to transform
shadow banking into market-based finance (alongside those of India and other DECs) should be understood in the context of a renewed global push, led by Germany in the G20, to extend the reach of financialized globalization. It finally reflects on the implications of this for the policy space available to DECs for managing their engagement with globalized finance.

**DEC SHADOW BANKING AS ‘Viable Credit Alternative’**

The concept of shadow banking emerged to capture new processes that ‘decompose the process of credit intermediation into a sequence of discrete credit operations’ (Ghosh et al., 2012: 3) through opaque chains of bank and non-bank companies (Pozsar et al., 2010). The chains were connected through two important shadow activities: the production (via securitization markets) and financing (via wholesale funding markets) of tradable securities (Claessens et al., 2012; FSB, 2011; Mehrling et al., 2013).

The production and financing of tradable securities reflected structural changes in financial markets of high-income countries. Relationship banking made way for two broad types of non-bank investors populating the universe of asset managers: those hungry for higher returns (via leverage) and those demanding safety. Shadow banking connected the two. The first — hedge funds, bond funds — driven by the ‘imperative to find new assets to fill expanding balance sheets’ (Adrian and Shin, 2009: 13), could finance securities portfolios by pledging them as collateral in repo funding markets to institutional cash pools. The latter — multinational companies, insurance companies, money market and pension funds — demanded the kind of safe vehicles for their cash that traditional banking provided to retail bank depositors under deposit guarantees and lender of last resort support from central banks (IMF, 2014; Pozsar, 2011). Large banks with activities in securities markets would sit in between, moving idle funds and collateral between institutional cash pools and leveraged funds (Adrian and Shin 2009; Gabor, 2016). The presence of collateral created the (perception of) safety that institutional cash pools required to lend to leveraged investors via bank balance sheets (Claessens et al., 2012; Pozsar, 2011).

Collateral-intensive relationships, the early literature argued, made financial systems built around securities markets more fragile (Adrian and Shin, 2010a, 2010b). In drawing attention to the fragility of collateral, the shadow banking literature resurrected a prescient insight from Hyman Minsky: ‘the viability of loans mainly made because of collateral, however, depends upon the expected market value of the assets that are pledged . . . . An emphasis by bankers on the collateral value and the expected values of assets is conducive to the emergence of a fragile financial structure’ (Minsky, 1986: 234). Without explicitly referencing Minsky, the early shadow banking literature echoed his observation. It connected financial instability to the collateral valuation mechanism deployed in securities financing (known as
repo) transactions (Adrian and Shin, 2010b). In a repo contract, a bank buys securities from a hedge fund, which in turn promises to repurchase them at a later point in time. For the hedge fund, the repo (repurchase) agreement is a mechanism for funding securities, by borrowing from the bank using those securities as collateral. For the duration of the repo contract, the hedge fund and the bank calculate the market value of collateral on a daily basis (marking it to market), with the purpose of maintaining the market value of collateral equal to the cash lent. If collateral increases in price, the bank is obliged to send the hedge fund the difference, either in cash or in securities. The bank has two incentives in the repo transaction: it charges an interest rate on the cash it has loaned to the hedge fund and it also becomes legal owner of the collateral securities (although it is obliged to send interest payments on those securities to the economic owner, the hedge fund). Collateral ownership allows it to repo those securities for its market-making activities, making profit from the spread between the purchase and the sale price (CGFS, 2017). The profitability of the hedge fund and of the market-making bank depends on daily variation in the price of securities (Lindo, 2013). In Minsky’s terms, both the bank and the hedge fund put emphasis on the daily changes in the price of the collateral security.

This emphasis on collateral value lies at the heart of shadow banking fragility. During good times, daily increases in the prices of securities free up balance sheet space, encouraging the hedge fund to take further leverage (Adrian and Shin, 2010b). In bad times, falling securities’ prices trigger runs as the hedge fund needs to find additional collateral, and when it cannot, it resorts to ‘fire sales’ of its assets that push asset prices lower (Brunnermeier and Pedersen, 2008; FSB, 2012, 2013; Gorton and Metrick, 2009). It was the destabilizing potential of daily collateral valuation that prompted the FSB to dedicate the repo work-stream on shadow banking to collateral fragility, imperative to ‘reduce the cycle of excessive borrowing in economic booms that cannot be sustained when liquidity dissipates in core fixed-income markets’ (Carney, 2014).

The early literature on DEC shadow banking found little evidence of such structural phenomena built around tradable securities. DEC shadow banking, one World Bank study argued, ‘does not involve long, complex, opaque chains of intermediation’ found in high-income countries (Ghosh et al., 2012: 3). In the absence of complex, collateral-intensive financial engineering, scholars equated shadow banking with non-bank financial institutions (NBFIs) and reframed the analytical questions from the original ‘how is this new financial landscape systemically fragile?’ to ‘is shadow banking a viable alternative to traditional banking in emerging countries?’.

This, it turned out, would be a question mainly asked of China. In one of the few exceptions, Acharya et al. (2013) examine the case of India. Shadow banking, they argue, provides a ‘completeness of credit spectrum in the economy’ (ibid.: 209) because it can reach borrowers (SMEs, rural areas, infrastructure developers) that traditional banks cannot or will not
Yet the authors caution that equating shadow banking with NBFI (or, as these are known in India, NBFC — non-bank financial companies) is misleading in that the Indian regulators had first developed a complex prudential regime for deposit-taking NBFCs, and then in 2016 introduced capital requirements for systemic non-deposit NBFCs. Acharya et al. (ibid.: 212) dismiss the idea that NBFCs are Lehman-type shadow banks, systemic nodes in complex collateralized networks, since ‘none of these NBFC may be large enough on their own to cause systemic collapse’. The danger, if any, arises from traditional bank lending to NBFI, but not from opaque financial engineering of tradable securities.

The literature on shadow banking in China documents in great detail the (admittedly eye-watering) growth in ‘shadow’ credit creation since 2010. It identifies three broad drivers: financial repression; the fiscal-monetary policy mix; and the distinctive politics of local–central government relationships. The China literature turns the US story on its head. Whereas US shadow banking emerged from competitive pressures pushing banks into the shadow, encouraged by light-tough regulation, China’s shadow banking is a market response to financial repression (Elliot et al., 2015; Wang et al., 2016). The network of trust companies, brokerage firms, small lenders and financial guarantors grew rapidly in response to the Chinese state’s intervention in loan and deposit markets (for example with caps on deposit rates for regulated banks), directed credit policies (regulators discouraging lending to sectors such as real estate), costly reserve requirements and prohibitive loan-to-deposit ratios (Elliot et al., 2015). Banks were key nodes in these shadow networks, seeking to boost profits and circumvent tight credit conditions (Dang et al., 2014; Elliot et al., 2015). The most illustrative example is the rapid growth in Wealth Management Products (WMPs), off-balance sheet funding instruments (Awrey, 2015). Small and medium banks structured WMPs to ward off competition for retail deposits from big banks, whereas the latter use WMPs to refinance their local government loans (Acharya et al., 2016). Some ‘shadow’ products — such as entrusted loans extended by cash-rich corporations to other corporations via banks — provide important sources of alternative financing, a market solution to credit shortage (Allen et al., 2016). Big non-financial corporations often tap subsidized bank credit and re-lend it to the private sector (Du et al., 2016). In sum, shadow banking steps into the void created by the long hand of the state, extending credit to SMEs and other private firms neglected by the Chinese developmental strategy.

China’s significant fiscal stimulus of 2009/10 (approximately 12 per cent of GDP) cast a long ‘shadow’ in two ways. One involved the Chinese

1. The total assets of ‘systemic’ NBFCs rose from around 9 per cent of bank assets in 2006 to around 14 per cent of bank assets in 2015 (RBI, 2016).
2. Trust companies, insurance companies, brokerage firms and private equity funds not related to banks also issue Wealth Management Products.
central bank (the PBOC) tightening the monetary policy stance to contain the inflationary potential of the fiscal expansion. Since the country’s four biggest banks dealt with the burden of supporting the Stimulus Plan by aggressively bidding for deposits and shadow financing (via WMPs) in an environment of tighter liquidity, smaller banks were forced into the shadows (Acharya et al., 2016). The other saw the central government use local governments’ access to shadow credit as a quasi-fiscal lever. Beijing allowed local governments to fund social services and ambitious infrastructure projects via shadow banking, by creating Local Government Financing Vehicles (Bai et al., 2016). These were set up as companies that could issue bonds and borrow from banks, circumventing rules in place since 1994 which banned direct local borrowing. This marks the distinctiveness of Chinese shadow banking, benefiting in most parts from implicit state guarantees.

The China literature has little to say about the systemic risks of shadow banking, beyond the obvious warning that shadow banks’ involvement in rapid credit growth, and their interconnectedness with the regulated banking sector, may result in a financial crisis. China’s shadow banking is not built around tradable debt and complex securitization but rather ‘non-standard debt instruments’ that are rarely if ever traded (Liao et al., 2016). It generates perverse incentives for market participants to front-run gradual policy moves (Brunnermeier et al., 2017). When the day of reckoning comes, it will be the state-owned banks and the state that will have to pay for it. China’s shadow banking may pose a threat to the global economy, it is argued, but not the Lehman-type ripples propagating through wholesale funding chains.

This is a critical omission. Busy condemning financial repression (and implicitly the developmental state3), scholars have both underestimated China’s willingness to tighten regulations and neglected the broader political economy of RMB internationalization driving a new approach to shadow banking. Indeed, events since 2014 suggest that we should not simply read Chinese shadow banking as an elaborate artifice of regulatory arbitrage, but rather as a gradual policy experiment with liberalizing the financial sector by encouraging securities markets. This has led to a rapid change in structure and complexity that increasingly fits the picture of pre-crisis US shadow banking.

**CHINA: A CASE STUDY OF TRANSITIONING TO MARKET-BASED FINANCE**

In 2014, China announced a series of reforms intended to put a brake on shadow credit to the real economy. It removed the ceiling on bank deposit rates and the binding loan-to-deposit ratio, and tightened rules on banks’

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3. See Michell (2012) for an account of the role of the financial system in China’s high growth performance.
involvement with entrusted loans, trust beneficiary rights, directional asset management plans and wealth management products⁴ (Chen et al., 2016; Keohane, 2016). While analysts remain divided on the overall tightening impact, or China’s willingness to carry the reforms through, the widely used proxy for shadow credit to the real economy, non-bank credit in ‘Total Social Financing’ (TSF, including trust loans, entrusted loans and bankers’ acceptance bills), fell from 30 per cent of total credit extended to non-financial corporates in 2013 to around 5 per cent towards the end of 2016 (see Li, 2016).

Arguably more important than the clampdown on regulatory loopholes, China introduced measures to reorganize shadow banking into securities markets. The share of capital raised by firms in securities markets increased from 12 per cent of TSF in 2010 to 30 per cent in 2016 (Li, 2016). One such policy encouraged local governments to move from shadows into securities markets. The central government would allow local authorities to issue municipal bonds and create the legal framework for switching (short-term, high-interest) Local Government Financing Vehicles (LGFV) debt into municipal bonds. With this, China aimed to transform a symbol of ballooning leverage, equivalent in 2014 to 38 per cent of GDP, into market-based finance, and replace the implicit guarantees with the principle of self-issue, self-replacement (Wildau, 2016).

As a result, the local government bond segment expanded from less than RMB 1 trillion in 2014 to around RMB 12 trillion by March 2017, making it the country’s fastest growing securities market (see Figure 1). Securitization also took off, rising to RMB 600 billion outstanding by 2017 from less than RMB 100 billion in 2014. With it, the Chinese securities markets became the third largest in the world, behind the USA and Japan. Commercial banks own the largest share of securities, directly and via WMPs. It is important to note the growing share of domestic institutional investors, with mutual funds, insurance and securities companies collectively holding around 23 per cent of outstanding securities (Figure 2).

China is not alone in experiencing a rapid growth in local institutional investment. In 2014, DEC pension funds and insurance companies held assets of US$ 6 trillion (IMF and World Bank, 2016). By mid-2016, India’s asset management industry had reached US$ 1 trillion, with China reaching US$ 8.5 trillion. This reflects the growing cash reserves of DEC corporations, rising inequality and market-based provisions for health (insurance) and pensions.

Historically, the provision of credit via securities markets has been accompanied by rapid growth in wholesale money markets where securities are financed (Gabor and Vestergaard, 2017; Lindo, 2013). This has also been

⁴ Since January 2017, banks cannot issue WMPs off balance sheet, while the on-balance sheet holdings are targeted by the new macro-prudential framework. The policy pressures for de-leveraging saw WMP issuance fall by around 10 per cent by June 2017.
Figure 1. Growth in Securities Markets, China 2014–2017 (RMB trillion)  
[Colour figure can be viewed at wileyonlinelibrary.com]

the case in China. Its repo market reached an estimated US$ 8 trillion by June 2017 (RMB 50 trillion), similar in volume to European and US repo markets (see Figure 3). To put this in perspective, in 2010 it was just a fifth the size of those markets. In that period, Chinese banks and shadow banks increased their repo funding from 10 per cent to 30 per cent of total funding (IMF, 2016).

The Chinese repo market has two distinctive segments: the interbank repo and the Shanghai Stock Exchange (SSE) repo5 (Kendall and Rees, 2017). The former, an over-the-counter market, dwarfs the latter in size. The term ‘interbank’ is a misnomer in that market participants include institutional investors alongside banks. Interbank repos can be either pledged or executed outright (see Figure 3). The Chinese central bank is an active participant in the larger pledged market, which it uses to inject liquidity into the financial system and support credit extension via securities markets. Together with large policy banks, the PBOC provides around 80 per cent of pledged repo funding to smaller (rural and cooperative) banks and a growing array of local institutional investors. In the outright segment, commercial banks fund securities companies (see Figure 4). The SSE mostly trades outright repos.

5. Kendall and Rees (2017) document the use of dai chi instruments. These are informal agreements equivalent to repo contracts that allow financial institutions to circumvent curbs on leverage, to re-hypothecate collateral, and in some cases, to fraudulently obtain funding.
The difference between pledged and outright repos resides in the legal status of collateral. To illustrate: a securities company funding corporate bonds on the outright segment would sell those bonds to a commercial bank, and promise to repurchase them at a later point in time (overnight or longer). The commercial bank becomes legal owner of collateral (the corporate bonds) for the duration of the repo, and can re-use it for market-making activities or for short-selling. If the commercial bank accepts the corporate bond as collateral in a pledged repo, it only becomes the legal owner if the securities company defaults. A pledged repo does not enable re-use of collateral, and therefore market-making activities for banks (and other financial institutions). Put differently, the repo plumbing of Chinese securities markets is quite different from the FSB definition of repos that guides its shadow banking regulatory framework.

It is important to note that the shift to market-based finance documented above is not simply a project of cleaning up shadow banking. Rather, it should be viewed through the lens of the RMB internationalization strategy, designed to attract foreign investors to China’s securities markets. Indeed,
Figure 3. The Interbank Repo Market, China, 2001–2017 (RMB trillion)

Sources: ChinaBond (www.chinabond.com.cn/d2s/cbData_eng.html); WIND (www.wind.com.cn/en/)

Figure 4. The Outright Repo Market, China, 2007–2017 (RMB trillion)
[Colour figure can be viewed at wileyonlinelibrary.com]

Sources: ChinaBond (www.chinabond.com.cn/d2s/cbData_eng.html); WIND (www.wind.com.cn/en/)
pointing to the low share of foreign ownership of Chinese securities, scholars and the international policy community have consistently argued that ‘in order to successfully internationalize the RMB, in the sense of enhancing its attractiveness as an international unit of account, means of payment and store of value, China will have to build deep and liquid financial markets open to the rest of the world’ (Eichengreen, 2015: 1; see also Helleiner and Kirchner, 2014; Mersch, 2014). Deep, liquid markets would attract foreign investors (such as institutional investors) that prefer to hold foreign assets in liquid securities.

While tightening controls of residents’ attempts to move capital abroad, China has cautiously welcomed foreign portfolio investors. In February 2016, it extended the list of foreign institutions that can enter securities markets without approval or quota limits to include commercial banks, asset managers and institutional investors. In July 2017, it introduced Bond Connect that allows foreign investors to trade Chinese bonds in Hong Kong. Market analysts expected this to generate around US$ 3 trillion inflows by 2025 (Bloomberg, 2017). Critically for the metamorphosis of shadow banking into market-based finance, China continued to grant access to shadow funding (repo) markets to only a handful of foreign institutions: foreign reserve (central bank) managers and offshore RMB clearing banks (Deutsche Bank, 2016). Its reluctance to open up the repo market offers an entry point to examine shadow banking as a terrain for broader political struggles over the shape of financialized globalization since the collapse of Lehman Brothers.

‘THE WORLD NEEDS TO DEVELOP MISSING MARKETS’: FROM THE G8 TO FSB

The academic literature on DEC shadow banking has stopped short of theorizing it as a phenomenon intricately linked to financial globalization. Yet this is precisely what the FSB agenda has gradually evolved into, reinvigorating a pre-crisis plan initiated by high-income countries to actively engineer market-based finance in DECs.

The story officially begins in May 2007, at the Potsdam meeting of the G8 Ministers of Finance. Together they announced an Action Plan for developing DEC local bond markets, drawn up under the leadership of the German central bank, the Bundesbank, with cooperation from the World Bank and the IMF (G8, 2007). The plan argued that deeper securities markets would reduce dependency on external financing and improve the ability of DECs to withstand volatile capital inflows, learning an important lesson from the East Asian crisis. While acknowledging capital flow volatility, the Action Plan called for carefully phasing out capital controls, eliminating first those capital controls that hamstrung local securities markets (such as withholding taxes on foreign investors’ bond earnings). Domestic institutional investors were also to be encouraged, by privatizing pension funds, and promoting
mutual funds and insurance companies. These later became known in the shadow banking literature as ‘institutional cash pools’, the demand side driving shadow banking (Pozsar, 2011).

To demonstrate its commitment to the process, the World Bank set up Gemloc, a Global Fund for Emerging Markets Local Currency Bonds. Gemloc raised US$ 5 billion in a public–private partnership with PIMCO, then the world’s largest asset manager, to ‘transform local bond markets into a mainstream asset class’. ‘Investability’ — measuring the attractiveness for large foreign investors — would be further improved by a private global index, GEMX (GEMLOC, 2007).

At first, the global financial crisis seemed to deal a serious blow to this German-driven G8 project. Brazil’s Finance Minister coined the term ‘currency war’ in 2010 to describe what he, and other DEC policy makers, thought the unconventional monetary policies of the US Federal Reserve meant for DEC markets (Gabor, 2015). The Federal Reserve was flooding the developing world with cheap dollars, triggering widespread concerns that the ‘wall of money’ surging from the West would bring back the asset bubbles, currency overvaluation and loss of export competitiveness that afflicted DECs at one point or another throughout the Washington Consensus era, episodes that inevitably culminated in currency and financial crises (Gabor, 2012; Kaltenbrunner and Panceira, 2017). The global financial crisis did what the East Asian, Russian, Brazilian and Argentinian crises failed to do, weakening the political clout of what Jagdish Bhagwati (1998) termed the ‘Wall Street–Treasury complex’ that successfully pressured developing countries to open their capital accounts.

This time, the DECs pledged, would be different. In the regulatory community, the conceptual framework was shifting from the celebratory narrative of free capital flows to a new vocabulary of global liquidity, the global financial cycle, carry-trade speculation, interconnectedness on the balance sheet of global banks and financial instability (CGFS, 2011; Gabor, 2015; Rey, 2015). Marking the growing ‘monetary power’ of DECs (Gallagher, 2014), the IMF abandoned its notorious opposition to capital controls in 2010 (Gabor, 2012). Scholars celebrated the normalization of capital controls as the ‘the single most important way in which policy space for development has widened in several decades’ (Grabel, 2011: 806). One after another, large developing countries imposed controls on portfolio flows and foreign investors entering their local securities markets (Gabor, 2015).

The Bundesbank and its partners were quick to find a strategic response to the changing politics of portfolio flows. The desirability of free flows was reaffirmed through a ‘missing markets’ narrative (Braasch, 2012). According to this narrative, the global financial crisis showed that short-term portfolio inflows (into securities/equities markets) were a destabilizing factor because international investors hurried for the exit without paying much attention to distinctive fundamentals (also see Dombret, 2011). The solution, the institutions insisted, was not capital controls but more markets. Pushing
ahead with the original plan would deepen local securities markets and expand the investor base to domestic institutional investors that could act as a buffer, increasing DECs’ capacity to absorb large capital inflows. Solving the problem of missing markets would also reduce global imbalances, since large DECs (read China) would no longer need to recycle their savings in US financial markets (including shadow banking). At the 2011 Cannes Summit, the G20 endorsed an extended Action Plan to develop local currency bond markets (G20, 2011).

The revised Action Plan stressed that developing capital markets is a long-term project that requires carefully sequenced structural measures. With this, the G20 ensured that the wording accommodated, albeit not explicitly, the use of capital controls by calling to expand ‘the range of instruments available to manage volatile short-term flows’ (ibid.: 2). Buried deep within the technical appendix of this cautious approach, however, lurked shadow banking. The appendix of the G20 plan described the modernization of repo markets as an immediate priority, to ‘enhance the money and bond market nexus’ (ibid.: 7). The 2013 Diagnostic Framework identifying the barriers to DEC securities market development provided further detail: ‘the money market is the starting point to developing ... fixed income (i.e. securities) markets’, integral to financial stability, and to the emergence of market makers6 (IMF et al., 2013: 10). It recommended the introduction of global standards for repo collateral (known as classic repos) that protected both lenders and borrowers, but failed to connect the repo-building project with the FSB view of repo markets as the critical, fragile plumbing of the shadow banking universe.

The synergies between the Local Currency Bond Market plans and the FSB agenda on shadow banking became apparent in 2014. That year, the FSB’s progress report (FSB, 2014) identified a new priority, to transform shadow banking into resilient market-based finance (Engelen, 2017). At first, this appeared to be political semantics, responding to DEC concerns that the FSB’s definition cast a pejorative tone, and required the tightening of regulations, on an alternative system of credit intermediation that played an important role in countries in which the absence of collateral excluded borrowers from bank lending (FSB, 2014). The 2015 FSB reports on shadow banking in the Americas and Asia adopted this framing, extending the definition to ‘intermediation through non-bank or market-based channels’ (FSB, 2015a: 3).

The 2015 FSB report on China elaborated the meaning of resilient market-based finance further. It called on authorities to: ‘continue to promote a more diversified and resilient financial system by increasing reliance on market-based pricing mechanisms via financial liberalization and the removal of implicit guarantees, and by encouraging the development of capital markets

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6. In securities markets, market makers, usually banks, stand ready to buy and sell, thus making a market in that debt instrument.
and of an institutional investor base as an alternative pillar to bank financing’ (FSB, 2015b: 15). The FSB also stressed that this approach was not unique to China. Many other DECs, it argued, ‘are in the process of improving their monitoring and developing appropriate policy tools to ensure that non-bank activities develop into a transparent, resilient and sustainable source of market-based financing’ (ibid.: 22).

Repo market reforms were central to the FSB’s (2015b) recommendations on shadow banking reform in China. Using the language of the sister initiative, the Local Currency Bond Markets Action Plan, it called for China to ‘upgrade the regulatory and operational repo market framework to increase market liquidity, enhance risk management and reinforce the money and bond market interest rate nexus’ (ibid.: 63). The FSB (2016: 80) report on India similarly commended national regulators for their decision to ease repo market restrictions in the effort to create ‘vibrant secondary market liquidity’.7 Put differently, the FSB country reports intimated that it was important to redesign repo markets according to global standards if DECs wanted to develop local securities markets, thus tapping into the growing global demand.

In this approach to engineering ‘resilient market-based finance’, the FSB and other international financial institutions are now fully aligned with the demands of the global asset management industry. For example, the Asia Securities Industry and Financial Markets Association (ASIFMA), whose mission is to promote liquid and efficient capital markets in Asia, has produced two important policy notes: the 2013 ‘India Bond Market Roadmap’ and the 2017 ‘China’s Capital Markets: Navigating the Road Ahead’. Echoing the position of the Financial Stability Board (FSB, 2016), both reports stress that secondary market liquidity, a sine qua non of resilient securities markets, require the two countries to open up repo markets to foreign investors and replace idiosyncratic repo market architectures with ‘classic’ repos (ASIFMA, 2013, 2017).

Why this seemingly innocuous demand matters for DECs becomes immediately apparent in the Chinese repo market. The challenge, ASIFMA (2017) warns, is that China has no classic repos in any of the repo market segments. Chinese pledged repos bear little resemblance to a classic repo because there is no transfer of legal title to collateral securities to the cash lender (see Table 1). Without the title transfer underpinning a classic repo, banks or shadow banks cannot use repos for making markets in private and government securities, re-use collateral to get funding, cover short position, or swap securities. The liquidity of securities markets thus suffers. On the outright repo segment, the lack of collateral valuation affects creditor

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7. These included corporate bond repos with maturity of less than a year, easier collateral requirements for money market funds (no longer restricted to AAA securities in repo lending) and fewer restrictions on foreign institutional investors’ collateral policies (FSB, 2016).
Table 1. Chinese vs Classic (Western) Repo

| Legal transfer of title to collateral | Classic repo | Chinese pledged repo | Chinese outright repo | Chinese SSE repo |
|--------------------------------------|--------------|----------------------|----------------------|-----------------|
| Collateral valuation                  |              |                      |                      |                 |
| 1. Mark to market                     | Yes          | No                   | Yes                  | No              |
| 2. Haircuts                           | Yes          | No                   | No                   | No              |
| 2. Margin calls                       | Yes (daily)  | No                   | No                   | No              |

Paradoxically, the FSB and industry advice on classic repos ignores the lessons from the collapse of Lehman Brothers. Lehman turned out to be systemic to global finance precisely because it used classic repos to fund leveraged securities portfolios — classic repos that created complex chains of interconnectedness and fragility via collateral values. A classic repo is what fundamentally orients the shadow banker towards the daily market value of collateral, and validates business models predicated on daily volatility in the price of collateral securities. It creates fragile financial structures where fire sales of collateral, haircuts and liquidity spirals are typical occurrences.

Put differently, the international community is advising China to make its (shadow) bankers more sensitive to the daily dynamic of securities markets by remodelling their repo plumbing according to a ‘Western’ blueprint. But Chinese repo markets already bear the hallmarks of financial fragility: over-the-counter, concentrated on the overnight segment, enabling growing levels of leverage, with collateral mostly issued by government and policy bank securities. Adopting a classic repo design without a strong regulatory framework would only sharpen China’s financial fragilities further.

In extending this advice to China, the Bundesbank in particular is illustrating Marx’s observation that history repeats itself, first as a tragedy, then as a farce. Thus, finance lobbies with an interest in promoting securities markets successfully persuaded high-income countries, including Germany, to adopt classic repos in the 1990s, with now well-documented consequences for global financial stability. Indeed, while it is common to retrace the history of shadow banking as a story of regulatory arbitrage and idiosyncrasies of the US/European financial systems (Thiemann, 2014), a more careful examination points to changing macroeconomics paradigms in an era of rapid financial globalization. The 1990s saw the emergence of a repo market liberalization project as the Keynesian state made way for independent central bank and market financing of government debt. To attract international investors, G7 countries adopted the institutional blueprint of the US government bond market, including a classic repo designed according to the preferences of globalized finance. Investors required repo markets free of regulatory intervention, the narrative went, if they were to enter local...
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securities markets. A liberalized repo market could be used to fund securi-
ties portfolios, to temporarily borrow securities for shorting and to enter 
and exit securities markets easily, lubricating liquidity and lowering funding 
costs. The policy engineering of liquid bond markets has been, since the 
1980s, a shadow banking project of liberalizing repo markets (Gabor, 2016).

Paradoxically, the Bundesbank was one of the few G7 central banks 
(alongside the Bank of England) to first resist loud calls from its large banks 
and Ministry of Finance that it relax its grip on the repo market in the early 
1990s. It invoked concerns with financial stability and monetary policy 
effectiveness (ibid.). But the threat that France, a more eager liberalizer, 
might dominate the Euro area capital markets proved more effective. By 
1997, Bundesbank abolished repo rules and instead began to quietly power 
the G7 ‘local bond markets’ project that would roll out free repo markets to 
DECs. When Lehman’s collapse proved its earlier concerns about financial 
stability correct, the Bundesbank warned that repo markets can trigger a 
‘spiral of destabilization’, including for German banks, that requires careful 
regulation (Bundesbank, 2013: 57). Despite such warnings, the Bundesbank 
is yet to produce a single paper that explores the possibility of ‘spirals of 
destabilization’ were DECs to adopt classic repos.

WHAT IS AT STAKE IN BUILDING ‘RESILIENT’ MARKET-BASED 
FINANCE?

The more careful supporters of financial globalization would find little to 
worry about in the FSB/G20 new agenda. After all, the FSB work on shadow 
banking has produced in a short period of time — unusual for global financial 
reforms — a comprehensive regulatory regime. The FSB introduced rules 
for increasing transparency and aligning incentives for securitization; it 
tightened regulations for one important type of shadow banks (money market 
funds); and for the first time it also outlined rules on the use of repos for 
funding securities portfolios, reducing its propensity to feed leverage and 
asset bubbles. While these rules are not legally binding for FSB members, 
the combination of moral suasion and peer pressure has thus far proved 
effective. Indeed, as Mark Carney suggested in 2017, the FSB’s reform 
agenda means that shadow banking is no longer a systemic danger to global 
financial stability (The Guardian, 2017). The age of asset management may 
be upon us, but the FSB has made it safer and more resilient than the age 
of global banking that led the world into the global financial crisis (see 
Christophers, 2013).

Such optimism is unwarranted for three reasons. First, it is now clear that 
FSB repo collateral rules have been watered down significantly since the 
first proposals in 2012. From an approach that targeted any financial insti-
tution using repos, the most recent FSB proposals only seek to make more 
expensive those repos between non-banks that use non-government bond
collateral. That reduces the scope of collateral rules to around 20 per cent of the global repo market (Gabor, 2016). While Basel III liquidity and leverage rules may restrict banks’ use of classic repos, the FSB abandoned the push to treat large asset managers as ‘too-big-to-fail’ global institutions. This would have generated stricter oversight and capital requirements in order to reduce well-documented pro-cyclicality (Jones, 2016). Blackrock wrote to the FSB in September 2016 to congratulate it for rethinking its position, the result of years of intense lobbying (Brush, 2016). The Trump administration in the US is likely to put another nail in the coffin of repo regulation. The US Treasury (2017) report on recalibrating financial regulation identified a freer repo market as a key priority for an administration worried about market liquidity.

Developing countries would be unwise to rely on FSB rules to contain the fragilities of market-based finance and the fragilities engendered by classic repos. For DEC regulators reluctant to liberalize repo markets, the Committee on the Global Financial System report (CGFS, 2017) makes grim reading. First, it echoes the FSB (2015, 2016) and AFISMA (2017) view that repo markets are liquidity-enhancing rather than systemic shadow markets feeding leverage and fragility. One annex, however, notes that a more volatile market environment, which could easily be triggered by tightening of US monetary policy, will put significant pressure on asset managers active in repo markets. This admits that the age of asset management will be riddled with shadow banking fragilities, as it is with pro-cyclical pressures (Jones, 2016).

Second, the re-engineering of shadow banking comes with pressures for DECs to import the institutional structures for producing liquid securities markets from the high-income countries, entangling money and bond markets. While this is narrated as a modernization of arcane/archaic money (repo) markets, it imposes a structure for generating liquidity that is known to be highly fragile. The classic repo amplifies liquidity shocks and triggers fire sales in securities markets and wholesale funding runs (Claessens et al., 2012; FSB, 2012, 2013). Repo markets, the Lehman Brothers collapse showed, are resilient to the extent that central banks extend their mandate to become market makers of last resort, arresting the collapse in collateral prices (Mehrling, 2012; Mehrling et al., 2013). Put differently, shadow banking as market-based finance relies on implicit, and in several countries explicit (see Gabor, 2016), state guarantees in the form of direct central bank interventions in securities markets. Paradoxically, China’s repo markets would become a source of systemic risk if the PBOC followed through with the recommendations of the FSB and finance lobbies to adopt ‘modern’ repo markets and open them up to foreign investors. Collateral fragility is not a mark of systemic risk in Chinese (shadow) banking while the existing legal regime does not allow lenders to sell or mark collateral to market. These ‘archaic’ rules may hurt individual investors but they do protect the financial system from (shadow) bankers oriented to the daily value of collateral securities.
Third, few traces remain today of the gung-ho attitude of financialized globalization pushing for capital account liberalization in the 1990s (Bhagwati, 1998). A new suave stage comes with arguments that DECs need to solve the ‘missing markets’ problem by transforming shadow banking into deep, resilient securities markets. Supported by sound macroeconomic policy, market-based finance will allow DECs to harness the benefits of financialized globalization. But the perils remain. The entry of foreign investors in local bond markets is a mixed blessing: it may improve liquidity, but often in a pro-cyclical fashion (Avalos et al., 2015; Feroli et al., 2014). The new position of the international financial institutions on how to address these pro-cyclical forces — that capital controls are warranted once countries have strengthened their macroeconomic policies — is also misleading (Gabor, 2012). Large capital inflows bring structural change, financializing currency markets (that is, currency trading driven by financial rather than real economy motives; see McCauley and Scatigna, 2011) and interbank money markets (that is, interbank liquidity determined by banks’ market activities rather than lending to the real economy). With financialized currency and interbank money markets, DECs often had no other choice when faced with currency market pressures, including speculative attacks, than to hike interest rates, potentially harming ‘real’ economic activity (Gabor, 2015). Furthermore, Kaltenbrunner and Painceira (2017) convincingly articulate the Minskyan paradox faced by central banks in developing countries: credibility and predictability in monetary and exchange rate policies breed instability by encouraging speculative, one-sided bets. More currency volatility reduces the build-up of speculative positions, but also acts as a deterrent to the entry of foreign investors, as China discovered recently. In sum, the project of building local currency bond markets attractive to foreign institutional investors will run into serious policy dilemmas — dilemmas that regulators in high-income countries have confronted for some time, but failed to solve.

CONCLUSIONS

The shadow banking reform agenda in developing and emerging economies has undergone fundamental changes. It started as a project of understanding and regulating — and for DEC regulators protecting — alternative sources of credit that are socially useful given the credit rationing exercised by the formal banking sector. However, it has morphed into a project of transforming DEC financial systems into market-based finance, of policy engineering the production and wholesale funding of tradable securities that can feed the growing global demand, in its turn a reflection of growing inequalities and the demise of the welfare state. In practice, the project resuscitates pre-crisis ideas about the benefits of financial globalization, and threatens the policy space for managing DECs’ integration in global finance, space won through
long struggles to normalize capital controls in the face of large and volatile capital flows.

This contribution raises several questions for future research. It is important to map out how DECs are engaging with the ‘shadow banking into market-based finance’ agenda. While India and China, two of the largest, have so far maintained a cautious approach, particularly towards liberalizing systemic shadow funding markets, the rapid changes in their financial systems may generate additional pressures to fully embrace the ‘missing markets’ approach outlined by high-income countries. For instance, in April 2016, China’s Yu’E Bao (owned by Alibaba) became the largest shadow bank (money-market fund) in the world, overtaking the US’s largest fund, JP Morgan Government Money Market Fund. What policies are available for countries faced with rapidly growing domestic institutional investors? How can these be harnessed into a stabilizing force? And what are the implications for a research agenda in international political economy that takes seriously the plea of Blyth and Matthijs (2017) for re-engagement with the global macroeconomy?

Furthermore, future research could critically examine the longer-term implications of the policies to engineer market-based finance at the intersection with climate and poverty reduction strategies. While this article has examined the efforts to deepen DEC government and private bond markets, the turn to market-based finance can be viewed through longer historical lenses. It prepares the terrain for generating new asset classes in developing countries. For instance, the Climate Bonds Initiative, supported by the global bank HSBC, promises to mobilize the global investor community for market-based climate action, allowing investors to finance low-carbon, climate-resilient infrastructure via ‘climate-aligned’ bonds. In 2016, China was the lead issuer of green bonds, a ‘zero to hero’ story applauded by foreign investors (Hornby, 2017). What are the implications for our understanding of the financialization of the environment (Keucheyan, this issue)?

Meanwhile, international development interventions to fight poverty have been re-framed through financial inclusion (Mader, this issue). This new development paradigm promises to solve poverty with big data. A new alliance of DECs, international financial organizations, ‘philanthropic investment firms’ and fintech companies celebrate the power of technology to simultaneously achieve positive returns, philanthropic goals and human development (Gabor and Brooks, 2017; Mader, 2015). Fintech companies promise to create, collect and commodify behavioural data from the poor’s digital footprints, under the motto ‘all data is credit data’. In thus advancing the risk frontier towards the world’s poor, the new digital financial inclusion agenda creates new opportunities for market-based finance (poverty bonds and the securitization of digital loans) and the financialization of development.
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