

# THE NEXUS OF MONETARY POLICY AND SHADOW BANKING IN CHINA

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**ABSTRACT.** We argue that China’s rising shadow banking activity was inextricably linked to its monetary policy system and the *balance-sheet* risk within the banking system. We develop and estimate the endogenously switching monetary policy rule that is based on institutional facts and at the same time tractable in the spirit of Taylor (1993). This development, along with the two new micro banking datasets we constructed, enables us to establish the following empirical evidence. Contractionary monetary policy during 2009-2015 caused shadow banking loans to rise rapidly, offsetting the expected decline of traditional bank loans and hampering the effectiveness of monetary policy on the total credit in the banking system.

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## I. INTRODUCTION

In the aftermath of an unprecedented stimulus of multitrillion RMBs injected by the Chinese government to combat the 2008 financial crisis, the People's Bank of China (PBC) pursued contractionary monetary policy by tightening M2 supply between 2009 and 2015. The policy of persistent monetary tightening, which aimed to contract the credit supply that soared during the stimulus period, achieved the expected outcome of a simultaneous fall of M2 supply and bank loans (top left panel of Figure 1). During the same period, however, shadow banking lending rose rapidly (top right panel of Figure 1). The share of shadow banking loans in the sum of shadow banking loans and bank loans increased steadily to around 20% in 2013-2015 (bottom left panel of Figure 1).

In this paper, we establish empirical evidence that contractionary monetary policy in China, although exerting an expected effect on traditional bank loans, stimulated shadow banking lending and encouraged banks to bring shadow banking products onto their balance sheets during 2009-2015. As a result, the effectiveness of monetary policy on the total credit in the banking system was severely hampered.

We substantiate our findings with four specific contributions. First, we provide institutional details on China's quantity-based monetary system, its regulations on commercial banks, and the relationship between shadow banking and traditional banking. One unique feature of monetary policy in China is to use M2 growth as the intermediate target to support growth of gross domestic product (GDP) beyond its annual target. In fact, M2 growth has been the only intermediate target used on a quarterly basis by the central government since 2000.<sup>1</sup>

We find that China's quantity-based monetary policy works through the bank lending channel that is supported by two major regulations specific to China's banking system: the legal ceiling on the ratio of bank loans to bank deposits imposed by the PBC on each commercial bank, which we call the LDR regulation where LDR stands for the loan-to-deposit ratio, and the regulation issued by the Chinese Banking Regulatory Commission (CBRC) prohibiting commercial banks from expanding bank loans to risky industries such as real estate, which we call the safe-loan regulation. The LDR regulation controls the quantity of bank lending and the safe-loan regulation controls the quality of bank lending.

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<sup>1</sup>In 1999, the PBC officially switched its monetary policy from controlling bank credit to controlling M2 growth.

We also find that one of the most unique features in China's banking system is an institutional division of state and nonstate commercial banks. State banks are owned by the central government and the remaining commercial banks are nonstate banks. Nonstate banks as a whole represent almost half the size of the entire banking system. In 2015, the share of their assets was 47.38% and the share of their equity was 47.22%. State banks, directly controlled by the central government, are part of the government and thus adhere to the government's own policy against actively bringing shadow banking products onto their balance sheets. This is not true of nonstate banks, however. Between 2009 and 2015, contractionary monetary policy gave nonstate banks a strong incentive to take advantage of the lax regulatory environment by increasing shadow banking activities and by bringing shadow banking products into a special investment category on the asset side of their balance sheets. This special investment category, called account-receivable investment (ARI), is not subject to the LDR and safe-loan regulations.

To test whether nonstate banks behave differently from state banks in their responses of shadow banking activities to changes in monetary policy, it is essential to estimate the existing quantity-based monetary policy system and obtain the exogenous M2 growth series usable for our subsequent empirical analysis. This analysis constitutes a second contribution of this paper. The estimated monetary policy rule is based on China's institutional facts. It is tractable in the spirit of Taylor (1993, p.197) "to preserve the concept of a policy rule even in an environment where it is practically impossible to follow mechanically the algebraic formulas economists write down to describe their preferred policy rules."

As a third contribution of the paper, we construct two micro datasets at the level of individual banks and use these data to shed light on the disparate responses of shadow banking activities conducted by state versus nonstate banks to changes in monetary policy. The first dataset, named the entrusted loan dataset, covers new entrusted loans between nonfinancial firms for the period 2009-2015. The dataset enables us to identify the name of a financial trustee that facilitated each entrusted loan, which is crucial for our subsequent panel regression analysis. We follow Jiménez, Ongena, Peydró, and Saurina (2014) and control for bank-specific attributes such as LDR, size, liquidity, and profitability. We find that entrusted lending funneled by nonstate banks rose significantly in response to contractionary monetary policy, while there is no such evidence for state banks.

The second dataset, named the bank asset dataset, covers the two major categories on the asset side of an individual bank's balance sheet: bank loans and ARI excluding central

bank bills or government bonds, which we call ARIX. Bank loans are subject to the safe-loan and LDR regulations and ARIX holdings are not. One principal component of ARIX is in the form of the beneficiary rights of entrusted loans funneled by banks, which we call the entrusted rights; the rest of ARIX consists of risky investments brought onto the balance sheet from other shadow banking products. Based on the bank asset data, our panel analysis finds no evidence of an increase of ARIX holdings in state banks in response to a fall in M2 growth, but strong evidence that nonstate banks increased their ARIX holdings significantly. This finding of nonstate banks' risk-taking behavior on the balance sheet, consistent with the previous finding of their off-balance-sheet behavior, implies that these banks bear the risk of shadow banking products in the form of ARIX on their balance sheets.

A fourth contribution of this paper is to analyze how the rapid rise of shadow banking dampens the effectiveness of quantity-based monetary policy *on the banking system*. The total credit in the banking system combines both bank loans and ARIX holdings. For monetary policy to be effective through the bank lending channel, it is the total credit that matters. To lay the groundwork for our empirical work, we provide a descriptive framework on how monetary policy functions through open market operations. The framework, inspired by Bianchi and Bigio (2017), consists of balance sheets of the central bank, a typical primary dealer, and a typical commercial bank; we call it T-account analysis. Our T-account analysis describes how open market operations are carried out through primary dealers, who withdraw deposits from commercial banks that are subject to the LDR regulation. We show that contractionary monetary policy increases the risk of deposit withdrawals in individual banks from primary dealers. This risk increases the expected cost for individual banks to recoup deposit shortfalls and leads to banks' portfolio adjustments toward ARIX holdings.

To provide empirical evidence for the T-account analysis, we estimate a quarterly dynamic panel model with identifying restrictions consistent with China's institutional facts. Unlike the existing vector autoregression (VAR) literature, the model allows bank loans and ARIX holdings to be determined simultaneously. Despite the simultaneity, the econometric model is globally identified. Our estimation indicates that in response to a one-standard-deviation fall of M2 growth, bank loans fall persistently. The estimated dynamics are statistically significant. If one were to use bank loans as the only criterion, monetary policy would be rendered effective. But the estimated response of ARIX is positive over time. The rise of ARIX, therefore, makes monetary policy ineffective on the total bank credit because the ARIX rise offsets the decline of bank loans.

The rest of the paper is organized as follows. Section II presents the institutional details of China’s banking system and monetary policy. The institutional background serves as a foundation for subsequent empirical analyses. Section III estimates China’s quantity-based monetary policy system. Section IV discusses the two new datasets we constructed. Section V provides robust panel regression analyses on banks’ roles in shadow banking activities both off and on the balance sheet. Section VI explores how the rise of ARIX affects the effectiveness of monetary policy on the banking system by developing both a descriptive framework and estimating a dynamic simultaneous-equation panel model. Section VII concludes the paper.

## II. CHINA’S BANKING SYSTEM AND MONETARY POLICY

In this section, we provide a narrative of China’s institutional background on the unique features of China’s monetary policy, banking system, and banking regulations, all of which are pertinent to the subsequent empirical analysis in the paper. The discussion centers on three issues: (a) how quantity-based monetary policy works in China, (b) facts about rising shadow banking during the 2009-2015 period of monetary policy tightening, and (c) institutional asymmetry between nonstate and state banks in shadow banking and in practices of bringing off-balance-sheet products onto the balance sheet.

### II.1. Quantity-based monetary policy.

II.1.1. *The intermediate target of monetary policy.* For the U.S. monetary authority, the intermediate target of monetary policy is the federal funds rate to meet the two ultimate targets: inflation and employment (or output). For China, the intermediate target of monetary policy has been M2 growth at least since 2000; the central government’s ultimate targets are also price stability and output growth (top two panels of Figure 2). Unlike the U.S. economy with the inflation target as the primary goal of monetary policy, China is an emerging-market transitional economy and the overriding objective of the central government is to achieve the annual GDP growth target.

The monetary policy goal is to use M2 growth as the intermediate target in support of GDP growth beyond its annual target while keeping stable inflation measured by the consumer price index (CPI). According to the Chinese law, the PBC must formulate and implement monetary policy under the leadership of the State Council. GDP and M2 growth targets have been specified in the State Council’s Annual Report on the Work of Government (RWG). The Central Economic Work Conference organized jointly by the State Council and

the Central Committee of Communist Party of China (CPC), typically held in December of each year, decides on particular target values of GDP growth and M2 growth for the coming year. Once these targets are decided, it is formally announced by the Premier of the State Council as part of the RWG to be presented to the annual assembly of the National People's Congress (NPC) during the next spring.<sup>2</sup>

The central government's GDP growth target for a particular year is a lower bound of GDP growth for that year. Because of its strong desire of maintaining social stability, the government views such a lower bound as a crucial factor in keeping unemployment low by means of economic growth. For example, when explaining why 6.5% was a targeted lower bound for the GDP growth rate during a press conference for the NPC's 2016 annual assembly, Xu Shaoshi (Head of the National Development and Reform Commission (NDRC) for the State Council) remarked that "The floor is employment, the floor has another implication, which is economic growth. Therefore, we set this lower bound [of GDP growth]." The central government's GDP growth target as a lower bound is an overarching national priority for every government unit, especially for the PBC.

Important decisions on adjusting M2 growth from quarter to quarter are made by the Politburo consisting of General Secretary of CPC, Premier of the State Council, and other top central government officials including the PBC governor. Unlike the Federal Reserve System, the PBC is not independent of other central government units and its decision on quarterly changes of monetary policy is severely constrained by its obligation of meeting the ultimate goal of *surpassing* targeted GDP growth and by the central government's view about how monetary policy should be conducted. For example, the 2009Q1 Monetary Policy Report (MPR) states: "In line with the overall arrangements of the CPC Central Committee and the State Council, and in order to serve the overall objective of supporting economic growth, expanding domestic demand, and restructuring the economy, the PBC implemented a moderately loose monetary policy, adopted flexible and effective measures to step up financial support for economic growth, and ensured that aggregate money and credit supply satisfy the needs of economic development."<sup>3</sup>

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<sup>2</sup>See this link for the State Council's RWG: [http://www.gov.cn/test/2006-02/16/content\\\_200875.htm](http://www.gov.cn/test/2006-02/16/content\_200875.htm)

<sup>3</sup>Since 2001Q1, the MPR has been the only official release of how the PBC conducts monetary policy each quarter. The MPR provides an executive summary of the state of the economy along with additional descriptions of how the PBC adjusts its monetary policy actions in response to the state of the economy.

In practice, the PBC adjusts M2 growth rates on a quarterly basis in response to economic conditions but at the same time the adjustments must be consistent with the annual M2 growth target set by the State Council. The purpose of adjusting M2 growth rates on a quarterly basis is to surpass the overriding target of annual GDP growth. On an annual basis, the targeted and actual rates of M2 growth are very close (Figure 3). No other policy variables employed by the PBC, not even the market interest rates, have been used to serve as the intermediate target of monetary policy since 2000. On the contrary, a plethora of instruments are used for the purpose of meeting the M2 growth target set by the central government.

II.1.2. *Instruments for the intermediate target of monetary policy.* There are many instruments used by the PBC to meet the M2 growth target, including open market operations, central bank base interest rate, central bank lending, reserve requirement, rediscounting, and other tools specified by the State Council.<sup>4</sup> In this section, we focus our discussion on two major instruments: open market operations and changes in the reserve requirement.

The system for open market operations was established by the PBC in May 1998. Over the past 20 years, it has matured rapidly to become the main tool for the PBC to manage money supply on a regular basis. Initially, primary dealers in open market operations were commercial banks that could undertake a large number of bond transactions. Over time, however, primary dealers have been extended to security companies and other financial institutions. In May 2015, there were a total of 46 primary dealers.

Bond trading in open market operations includes spot trading, repurchase trading, and issuance of central bank bills (short-term bonds issued by the PBC) and government bonds. Repurchase transactions are divided into the “repurchase” (repo) and “reverse repurchase” (reverse repo) categories.<sup>5</sup> In 2010 and 2011, for example, the PBC used issuance of both central bank bills and repos to tighten M2 supply: issuance of central bank bills totaled about 4.3 trillion RMBs in 2010 and 1.4 trillion RMBs in 2011, and repo operations totaled about 2.1 trillion RMBs in 2010 and 2.5 trillion RMBs in 2011.

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<sup>4</sup>See the link: <http://www.pbc.gov.cn/english/130727/130870/index.html>

<sup>5</sup>In January 2013, the PBC launched short-term liquidity operations (SLOs) to supplement regular open market operations each Tuesday and Thursday. SLOs, intended to be used when the banking system experiences a large fluctuation in liquidity, are repurchase agreements and reverse repurchase contracts with a maturity of less than seven days.

The system for reserve requirements was established in 1984. Changes in the reserve requirement ratio (RRR) are used by the PBC to help meet the M2 growth target, but this instrument is used much less regularly than open market operations. Reserve requirements should not be considered as representative of China's monetary policy *on a quarterly basis*, an institutional fact presented in Section II.1.1. It is well known that a change in the RRR is one of several main instruments or tools used by the central bank to target money supply or the federal funds rate in recent U.S. history.<sup>6</sup> The logic that a change in the RRR is *not* the intermediate target of monetary policy remains the same for China, though the RRR is less frequently changed in the U.S.<sup>7</sup>

Distinction between instrument and target is essential for understanding monetary policy. For many countries, both open market operations and reserve requirements are two instruments used to meet the intermediate target of monetary policy. In the U.S. and many other developed countries, the target has been explicitly the federal funds rate. In China, the target has been explicitly M2 growth. Indeed, as shown in Figure 3, the PBC has been successful in employing various instruments to keep its targeted M2 growth on track.

A more pertinent question is whether China should use some benchmark interest rate to be the intermediate target of monetary policy. The Thirteenth Five-Year Plan for “Economic and Social Development,” approved by the NPC, pronounces one important element of China's macroeconomic reforms: transforming the monetary policy framework “from quantity-based management to price-based management” by gradually changing the intermediate target of monetary policy from M2 growth to policy interest rates.<sup>8</sup> The issue of transitioning from one policy rule to another is even more challenging because it requires, at a minimum, an understanding of the existing monetary policy framework, a focal point of Section III.

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<sup>6</sup>See the Federal Reserve Board's website for details: <https://www.federalreserveeducation.org/about-the-fed/structure-and-functions/monetary-policy>.

<sup>7</sup>Leeper, Sims, and Zha (1996) argue that because excess reserves fluctuate considerably on a regular basis, the reserve requirement is an insufficient statistic for measuring the contraction or expansion of money supply. This is certainly the case for China as shown in the top two panels of Figure 4.

<sup>8</sup>The Central Committee of CPC typically approves a plan proposal in the fall of the year before the plan's five-year period begins. The plan outlines its content in broad terms and then the NDRC hammers out the details before the NPC's annual assembly, typically held in March, votes to approve the plan. In the Thirteenth Five-Year Plan, the proposal for transforming monetary policy's intermediate target from M2 growth to some policy interest rate or a set of interest rates is still in its infancy.



II.1.3. *The bank lending channel of monetary policy.* Given M2 growth as the intermediate target of monetary policy, the PBC uses various instruments such as open market operations to influence the credit volume in the banking system with the help of China's two specific banking regulations. As a result, growth rates of M2 supply and bank loans move closely together (top left panel of Figure 1).

The first banking regulation is a 75% ceiling on the ratio of bank loans to bank deposits for each commercial bank as a way to manage the quantity of bank loans. The LDR regulation was established in 1994. To see how monetary policy interacts with the regulatory LDR constraint to influence the quantity of bank lending, consider the following episode. At the end of 2009, the PBC began to tighten M2 supply for fear of an overblown bank credit expansion after the 2008 financial crisis. As M2 growth continued to slow down, banks became more vulnerable to sudden and unexpected deposit withdrawals, which exposed banks to the risk of violating the LDR regulation.<sup>9</sup>

To meet unexpected deposit shortfalls against the LDR ceiling, the bank attracted additional deposits by offering a much higher price than the official deposit rate imposed by the PBC. The government used the phrase “the last-minute rush (*chongshidian* in Chinese)” to refer to the last-minute actions taken by banks to pay high prices to increase deposits in order to recoup deposit shortfalls.<sup>10</sup> Such high prices during the last-minute rush decreased the net return on bank loans and thus banks reduced issuance of new bank loans. As a result, growth in M2 and bank loans declined simultaneously (top left panel of Figure 1).

In addition to controlling the quantity of bank loans, the PBC uses another regulation to control the quality of bank lending. In 2006 the State Council, concerned with potential financial risks associated with bank credit to real estate and its supporting industries, issued a notice to accelerate the restructuring process of these industries. The CBRC took concrete steps in 2010 to curtail an expansion of bank credit to these industries.<sup>11</sup> These actions were reinforced by the State Council in its 2013 Guidelines. In the Introduction, we term this quality-control regulation the safe-loan regulation. This regulation gave banks incentives

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<sup>9</sup>For detailed discussions of such a risk, see the PBC's various “Financial Stability Reports” published in the early 2010s.

<sup>10</sup>See the proclamation “Number 236 Notice on Strengthening Commercial Banks Deposit Stability Management” jointly announced on 12 September 2014 by the CBRC, the Ministry of Finance, and the PBC.

<sup>11</sup>The 2010Q1 MPR stated that “in the next stage, the PBC will tightly control lending to new projects, strictly restrain lending to high energy-consuming, heavily-polluting industries, and industries with excess capacity ... .”

to invest in risky nonloan assets that deliver higher expected returns. Our own dataset (Section IV) reveals that these risky assets were associated with shadow banking products. In the next section, we provide an institutional background of the rise of shadow banking products in 2009-2015.

**II.2. Facts about the rising shadow banking during the period of monetary policy tightening.** In contrast to the slowdown of growth in both M2 and bank loans since late 2009, shadow banking activities sprang up with a rapid increase of the loan volume in the shadow banking industry (top left panel of Figure 1).<sup>12</sup> The shadow banking loan volume is the sum of entrusted lending, trusted lending, and bank acceptances, all of which are off balance sheet. The share of shadow banking loans in the sum of shadow banking loans and bank loans increased steadily to around 20% in 2013-2015 (bottom left panel of Figure 1). All these loans are an outstanding amount. A similar time series pattern holds true for newly originated loans as well. In particular, new bank loans between 2010 and 2015 declined by an average rate of 7% relative to the 2009 value, but the total new credit as the sum of new bank loans and new shadow banking loans moved in an opposite direction, increasing by an average rate of 4.2% during the same period.

**II.2.1. Entrusted lending.** From 2009 to 2015, entrusted loans became the second largest financing source of loans after traditional bank loans, and their share in entrusted and bank loans combined reached over 10% in 2015 (bottom right panel of Figure 1). In particular, the share of outstanding entrusted lending in total outstanding shadow banking lending was always high with 47% in 2009 and 49% in 2015. Given the importance of entrusted lending in the shadow banking industry, we provide a detailed discussion of this particular shadow banking product.

In 1996, the PBC issued “General Rules for Loans” that allowed entrusted lending. In May 2000, the PBC provided formal operational guidelines for commercial banks to be trustees of entrusted lending in its “Notice on Issues Related to Practices of Commercial Banks in Entrusted Lending” (No. 100 Notice). The key requirement in these guidelines was the mandatory participation of a financial institution acting as a trustee to facilitate a loan

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<sup>12</sup>Hachem and Song (2016) study a different sample period in which bank loans/GDP ratio increased by 20% from 2007 to 2014, more than an increase of non-guaranteed wealth management products (WMPs)/GDP, which was 15%. To be consistent with this observation, their theoretical model is designed to predict that both aggregate bank loans and shadow banking loans increase in response to “higher liquidity standards” (i.e., there are no opposite movements between these two types of aggregate loans).

transaction between two nonfinancial firms. This regulation required the participating financial institution to verify that all lending practices met various legal forms and requirements. An entrusted lending transaction between nonfinancial firms with a commercial bank or a nonbank financial company acting as a trustee is summarized below.



On paper, a trustee is a middleman in the transaction of an entrusted loan as a passive facilitator. If the trustee is a commercial bank, it is commonly assumed that “the bank earns a fee for its service, but does not bear the risk of the investment” (Allen, Qian, Tu, and Yu, 2015). In Section V, however, we show that the risk was brought onto the balance sheet: entrusted loans were first facilitated by banks and then their beneficiary rights (entrusted rights) were in turn purchased by banks as risky investments on the asset side of banks’ balance sheets.<sup>13</sup>

Entrusted lending activity, as well as other shadow banking activities, did not really blossom until after 2009, a period when monetary policy tightened. One important piece of direct evidence from our entrusted loan data as described in Section IV.1 reveals that most entrusted loans ended up in real estate and its supporting industries. From 2009 to 2015, over 60% of entrusted loans were channeled to real estate and supporting companies (most of them having problems with excess capacity). For the entrusted loans channeled to real estate companies, 75.33% of loan volumes were channeled to enterprises that are *not* state-owned. Real estate and its supporting industries, classified by the Ministry of Industry and Information Technology as risky industries, were funded by shadow banking loans. Table 1 reports both maturities and rates of bank loans and entrusted loans. The average maturity of entrusted loans is shorter than that of bank loans, but the interest rate is higher. These facts confirm the risky nature of entrusted loans relative to bank loans.

*II.2.2. The asset side of banks’ balance sheets.* We now describe how banks brought off-balance-sheet products into their balance sheets. In the Introduction, we discuss the category of ARIX holdings on the asset side of banks’ balance sheets. These holdings are not counted as part of traditional bank loans; they conceal risky investment assets brought onto the balance sheet from shadow banking products. As a result, they are not subject to the LDR

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<sup>13</sup>For other arguments that banks bore the risk of entrusted loans, see various Financial Stability Reports published by the PBC.

and safe-loan regulations. One principal component is entrusted rights, which are the beneficiary rights of entrusted lending facilitated by banks off balance sheet. Other components of the ARIX category include trusted rights (associated with trusted loans) and various wealth management products (WMPs). Because ARIX products are risky investments brought onto the balance sheet from shadow banking products, we use the two terms—ARIX holdings and risky assets—interchangeably.

As frequently discussed in the previous sections, one distinctive feature of China's banking system is a division of state and nonstate commercial banks. There are five state banks controlled and protected directly by the central government: the Industrial and Commercial Bank of China, the Bank of China, the Construction Bank of China, the Agricultural Bank of China, and the Bank of Communications.<sup>14</sup> The remaining commercial banks are nonstate banks, including China CITIC Bank, China Everbright Bank, China Merchants Bank, Shanghai Pudong Development Bank, the Industrial Bank of China, and the Bank of Beijing.

Commercial banks were not required to report the detailed products within ARIX until recently. Although entrusted rights form an important part of ARIX, it is still impossible to obtain a completely clean time series of entrusted rights within ARIX. To be sure, ARIX contains other shadow banking products and is broader than entrusted rights. Our empirical work based on ARIX in Sections V.3 and VI.2, therefore, provides a broad perspective on the impact of monetary policy on the banking system.

**II.3. State versus nonstate commercial banks.** The most conspicuous fact from our entrusted loan data is that nonstate banks play a dominant role in channeling entrusted loans between nonfinancial firms. In this section, we present a list of key regulatory requirements and analyze which one is likely to contribute to the difference between state and nonstate banks in their roles of promoting shadow banking activities.

**II.3.1. *The usual suspects.*** There were three major regulatory requirements of commercial banks: capital requirement, reserve requirement, and LDR requirement. We provide evidence on whether there was a notable difference between state and nonstate banks in meeting each of the three requirements for the 2009-2015 period.

First, both state and nonstate banks met the capital requirement by a comfortable margin (Table 2). One can see from the table that the difference of capital adequacy ratios between

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<sup>14</sup>The Bank of Communications, initially listed in the Hong Kong Stock Exchange, has officially become the fifth largest state-owned bank since May 16, 2006.

state and nonstate banks is statistically insignificant and economically inconsequential because both ratios are far above the capital requirement ratio of 8%.

Second, nonstate banks had more cushion than state banks in meeting the reserve requirement with a considerably higher *excess* reserve ratio than state banks. The numbers reported in Table 2 are based on our constructed panel data that are not publicly available in electronic format. We read the annual reports of 16 publicly listed commercial banks through PDF files downloaded from WIND (the data information system created by the Shanghai-based company called WIND Co. Ltd., the Chinese version of Bloomberg). We compute the excess reserve ratio of each bank for every year, take a weighted average of these ratios for all the banks within each group (the state group and the nonstate group) for each year, and then take a simple average of these ratios across years. As clearly shown in Table 2, nonstate banks were more cautious than state banks in managing their reserves to meet the reserve requirement.

Third, the LDR of nonstate banks is higher than state banks' LDR during the period 2009-2015, but the difference is statistically insignificant.<sup>15</sup> Thus, the issue for banks is not the LDR ceiling per se, but rather the risk of hitting the ceiling due to unexpected deposit shortfalls especially for nonstate banks as their average LDR was above 75% in the earlier part of the 2009-2015 period and needed the last-minute rush to keep the ratio below the 75% ceiling around the time of the PBC audit. The deposit withdrawal risk is an important ingredient in our analysis presented in Section VI.1.

In summary, the difference between state and nonstate banks in each of the three major policy requirements during 2009-2015 is statistically insignificant. It is therefore not any of these regulatory requirements that helps explain the distinctively different roles played by state and nonstate banks in promoting shadow banking products. Our empirical findings in later sections of the paper indicate that nonstate banks, not state banks, play a dominant role in shadow banking activities *after* controlling for a host of bank-specific attributes such as LDR, size, liquidity, and profitability. As for the LDR, we use either the LDR at the end of the year or the average LDR. In the next section, we argue that the difference between

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<sup>15</sup>Since only the PBC (not central banks in other countries) requires a commercial bank to report the LDR and since Bankscope (a comprehensive, global database of banks financial statements, ratings, and intelligence, provided by Bureau Van Dijk) collects variables that are common across countries, a direct measure of the LDR is not provided by Bankscope. We construct this measure as the ratio of "gross loans" to "total customer deposits." For a listed bank, we compare this measure to the reported LDR published by the bank's own annual report and verify that they match.

state and nonstate banks is mainly *institutional* in the sense that the central government's direct control of state banks make them behave differently than nonstate banks.

II.3.2. *Institutional asymmetry.* State banks, controlled directly by the central government, adhere to the government's regulations for promoting the healthy banking system rather than undermine the soundness of the banking system by circumventing the regulations. In 2010, the PBC and the CBRC issued a joint notice to reinforce the 2006 announcement made by the State Council that banks shall not partake in risky investments themselves to maintain "the soundness of the banking system." Government-controlled state banks should not and did not circumvent the safe-loan regulation imposed by their own government and therefore did not bring shadow banking products into their balance sheet in ways inconsistent with the behavior of bank loans as the evidence in Figure 5 shows.

The institutional structure for nonstate banks is different; the government does not have direct control of them. Despite the regulations intended for limiting the risk on the balance sheet, nonstate banks had largely benefitted from China's lax regulatory system for shadow banking until the end of 2015.<sup>16</sup> On November 12, 2012, for example, the PBC governor Zhou Xiaochuan told a news conference that "Like many countries, China has shadow banking. But the scale and problem of China's shadow banking are much smaller compared with its counterpart for the developed economies that was exposed during the latest financial crisis."<sup>17</sup> Indeed, before 2015 the government viewed the development of shadow banking as a new way to diversify financial services. The PBC's 2013Q2 MPR stated that rapid growth of entrusted and trusted lending was viewed positively by the PBC because "the financing structure continues to diversify." Therefore, a combination of contractionary monetary policy and the lax regulatory system allowed nonstate banks to take advantage of regulatory arbitrage by increasing ARIX that was not subject to the LDR and safe-loan regulations.

II.4. **Roadmap.** Given all the institutional details, we provide a roadmap with Figure 6 for our subsequent empirical analyses. The lines connecting "Central bank" through "Investors"

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<sup>16</sup>Since late 2015, the government has gradually enforced stricter guidelines to restrict fast growing off-balance-sheet products that eventually showed up in the ARIX category of nonstate banks. At the beginning of 2016, for example, the government incorporated the so-called Macro Prudential Assessment System, which requires that the "broad credit" growth rate should not deviate from the targeted growth rate of M2 by more than 22%.

<sup>17</sup>Reported in the Chinese edition of 15 January 2014 Wall Street Journal.

and “Banks” capture the effects of monetary policy shocks on bank loans. To obtain monetary policy shocks, Section III estimates the quantity-based monetary policy rule based on China’s institutional facts. The lines on the top of Figure 6 connecting the two regulations to bank loans highlight the importance of these regulations. These lines, taken together, summarize the interactions between monetary policy and regulatory policies: the bank lending channel.

The lines connecting “Lenders” and “Risky borrowers” capture the off-balance-sheet activities and the role of banks as passive facilitators. Sections V.1 and V.2 conduct a panel regression analysis on these lines. The curly line connecting “Banks” and “Lenders” reflects how nonstate banks, as active participants in shadow banking, brought off-balance-sheet shadow banking products onto the balance sheets through ARIX. Section V.3 provides another panel regression analysis on this particular line. Section VI provides a VAR analysis of the effectiveness of monetary policy by combining the lines connecting “Central bank” through “Investors” and “Banks” and the curly line connecting “Banks” and “Lenders.” Section IV constructs two new bank-level data for all the empirical analyses conducted in the paper.

### III. THE QUANTITY-BASED MONETARY POLICY SYSTEM

In this section, we develop and estimate a tractable rule that characterizes the essence of the otherwise intractably complex operations of China’s monetary policy. With the estimated rule, we estimation an exogenous M2 growth series to be used for subsequent empirical analyses in this paper.

**III.1. Estimating the monetary policy rule.** The original interest rule of Taylor (1993), called the Taylor rule, is inapplicable to the Chinese economy for two reasons. First, China is an emerging-market economy and its transitional path is characterized by unbalanced growth with the rising share of investment in GDP since the late 1990s (Chang, Chen, Waggoner, and Zha, 2016). For such an economy, it is practically difficult, if not impossible, to define what constitutes potential output or trend growth. Second, financial markets in China have yet to be fully developed and no interest rate has become the intermediate target of monetary policy.<sup>18</sup> The intermediate target of China’s monetary policy has been to control M2 growth in support of rapid economic growth as discussed in Section II.1.1.

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<sup>18</sup>In Appendix A, we show that the conventional monetary policy rules using either market interest rates or potential GDP yield no significant empirical results and thus fail to describe China’s monetary policy.

The PBC's Monetary Policy Committee (MPC) is an integral part of the policymaking body.<sup>19</sup> At the end of each year, the central government sets the target of M2 growth consistent with targeted GDP growth for the next year. Within each year, the MPC meets at the end of each quarter  $t$  (or the beginning of the next quarter) to decide on a policy action for the next quarter (i.e., quarterly M2 growth  $g_{m,t+1} = \Delta M_{t+1}$ ) in response to CPI inflation  $\pi_t = \Delta P_t$  and whether GDP growth ( $g_{x,t} = x_t - x_{t-1}$ ) in the current quarter meets the GDP growth target ( $g_{x,t}^*$ ).<sup>20</sup> The GDP growth target set by the State Council serves as a lower bound for monetary policy. When actual GDP growth in each quarter is above the target, therefore, M2 growth increases to accommodate such output growth as long as inflation is not a serious threat (see various issues of quarterly MPR).

The above description of China's monetary policy can be formalized as

$$g_{m,t} = \gamma_0 + \gamma_m g_{m,t-1} + \gamma_\pi (\pi_{t-1} - \pi^*) + \gamma_{x,t} (g_{x,t-1} - g_{x,t-1}^*) + \varepsilon_{m,t}, \quad (1)$$

where  $\varepsilon_{m,t}$  is a serially independent random shock that has a normal distribution with mean zero and time-varying standard deviation  $\sigma_{m,t}$ . Every quarter, the PBC adjusts M2 growth in response to inflation and output growth in the previous quarter, a practice consistent with the PBC's decision-making process. The inflation coefficient  $\gamma_\pi$  is expected to be negative.<sup>21</sup> Since the GDP target serves as a lower bound, we allow the output coefficient to be time-varying with the form

$$\gamma_{x,t} = \begin{cases} \gamma_{x,a} & \text{if } g_{x,t-1} - g_{x,t-1}^* \geq 0 \\ \gamma_{x,b} & \text{if } g_{x,t-1} - g_{x,t-1}^* < 0 \end{cases},$$

where the subscript “a” stands for “above the target” and “b” for “below the target.” These coefficients represent two states for policy response to output growth: the normal state when actual GDP growth meets the target as a lower bound, and the shortfall state when actual GDP growth falls short of the government's target. During the period when

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<sup>19</sup>The MPC is composed of the PBC Governor, two PBC Deputy Governors, a Deputy Secretary-General of the State Council, a Deputy Minister of the NDRC, a Deputy Finance Minister, the Administrator of the State Administration of Foreign Exchange, the Chairman of China Banking Regulatory Commission, the Chairman of China Securities Regulatory Commission, the Chairman of China Insurance Regulatory Commission, the Commissioner of National Bureau of Statistics (NBS), the President of the China Association of Banks, and experts from academia (three academic experts in the current MPC).

<sup>20</sup>All three variables,  $M_t$ ,  $P_t$ , and  $x_t$ , are expressed in natural log. For construction of the quarterly time series of these variables and other variables, see Appendix B.

<sup>21</sup>Discussions in the MPRs indicate that the annual CPI inflation target is around 3% – 4%. We set  $\pi^*$  at 0.875% (i.e., an annualized quarterly rate of 3.5%).



GDP growth is above the target, we expect the coefficient  $\gamma_{x,a}$  to be positive. On the other hand, when actual GDP growth is below its target, we expect the coefficient  $\gamma_{x,b}$  to be negative. This asymmetric response reflects the central government's determination in making economic growth an overriding priority in this transitional economy.<sup>22</sup> Accordingly, the heteroskedasticity is specified as

$$\sigma_{m,t} = \begin{cases} \sigma_{m,a} & \text{if } g_{x,t-1} - g_{x,t-1}^* \geq 0 \\ \sigma_{m,b} & \text{if } g_{x,t-1} - g_{x,t-1}^* < 0 \end{cases}.$$

The sample period for estimation is from 2000Q1 to 2016Q2. This is a period in which the PBC has made M2 growth an explicit policy instrument. The endogenously switching rule is estimated with the maximum likelihood approach of Hamilton (1994). Table 3 reports the results, which show that all the estimates are significant statistically with the p-value much less than 1%. The persistence coefficient for M2 growth is estimated to be 0.39%, implying that monetary policy is somewhat inertial. When GDP growth is above the target, annualized M2 growth is estimated to rise by 0.72% ( $0.18\% \times 4$ ) in support of a 1% annualized GDP growth rate above its target. When GDP growth falls short of the target, the estimate of  $\gamma_{x,b}$  indicates that annualized M2 growth rises by 5.20% ( $1.30\% \times 4$ ) in response to a 1% annualized GDP growth short of its target. Thus, the negative sign of  $\gamma_{x,b}$  and its estimated magnitude reveal that monetary policy takes an unusually aggressive response to stem a shortfall in meeting the GDP growth target. The asymmetry in China's monetary policy is also reflected in the volatility of its policy shocks (0.10 vs. 0.005). Our estimate of the inflation coefficient in the monetary policy rule, which is negative and highly significant, indicates that annualized M2 growth contracts 1.6% ( $0.40\% \times 4$ ) in response to a 1% increase of annual inflation.

We test the endogenously switching policy rule, represented by equation (1), against other alternatives. One alternative is the same rule without any of the time-varying features (i.e.,  $\gamma_{x,t} = \gamma_x$  and  $\sigma_{x,t} = \sigma_x$ ). The log maximum likelihood value for the constant-parameter rule is 192.42. We then allow  $\gamma_{x,t}$  to depend on the two different states of the economy (the normal and shortfall states). The log maximum likelihood value for this rule is 198.49. The log maximum likelihood value for our endogenously switching rule (i.e., allowing  $\sigma_{m,t}$  to be time varying in addition to  $\gamma_{x,t}$ ) is 203.78. The likelihood ratio test for a comparison between the rule with time-varying  $\gamma_{x,t}$  only and the constant-parameter rule rejects the

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<sup>22</sup>See Kahneman and Tversky (1979) and Chen, Xu, and Zha (2017) for theoretical justifications.

constant-parameter rule at a 0.05% level of statistical significance, implying that the data strongly favor the time-varying parameter  $\gamma_{x,t}$ . The likelihood ratio test for a comparison between the rule with both time-varying  $\gamma_{x,t}$  and  $\sigma_{m,t}$  and the rule with only time-varying  $\gamma_{x,t}$  rejects the latter rule at a 0.11% level of statistical significance, implying that the data strongly favor additional time-variation in volatility.<sup>23</sup> These econometric tests rationalize the statistical results of high significance reported in Table 3.

**III.2. Exogenous M2 growth.** The bottom two panels of Figure 2 display the decomposition of M2 growth into the endogenous component and the exogenous component according to the estimated monetary policy rule. All the series in the figure are expressed in annual changes. Endogenous monetary policy tracks the series of actual M2 growth rates very closely (third panel of Figure 2). This suggests that a large fraction of the variation in M2 growth can be attributed to the systematic reaction of the policy authority to the state of the economy, which is what one would expect of endogenous monetary policy.

The series of exogenous M2 growth is the gap between actual and endogenous M2 growth rates, displayed in the bottom panel of Figure 2. As discussed in Section II.1.2, changes in various instruments such as the reserve requirement aim at helping achieve the intermediate target of monetary policy mandated by the State Council and thus should be encompassed by the endogenous part of monetary policy. To see whether this argument is supported by empirical evidence, we regress the endogenous M2 growth series on contemporaneous or lagged changes in the RRR. The testing hypothesis is that the coefficient of RRR changes on the right hand side of the regression is zero. The p-value is 0.6% for the contemporaneous coefficient and 2.4% for the lagged coefficient. The hypothesis is thus rejected. When we regress the estimated exogenous M2 growth series on the same variables, however, we find the regression coefficients statistically insignificant: the p-value is 15.5% for the contemporaneous coefficient and 74.7% for the lagged coefficient. These results indicate that the estimated series of exogenous M2 growth is orthogonal to changes in the RRR and thus reflects only the outcome of open market operations.<sup>24</sup>

As shown in Figure 2, both endogenous M2 growth and exogenous monetary policy shocks have been steadily declining since 2009, contributing to the prolonged decline of output as

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<sup>23</sup>The two tests are supported by both the Bayesian information criterion (BIC) and the Akaike information criterion (AIC).

<sup>24</sup>Chen, Higgins, Waggoner, and Zha (2017) document that the estimated monetary policy shocks are also orthogonal to changes in the exchange rate and net exports.

well as the fall of inflation (with a lag). After controlling for endogeneity of monetary policy, the exogenous series allows us to analyze how contractionary monetary policy contributed to the rise of shadow banking products off banks' balance sheets as well as the rise of risky assets in the form of ARIX on banks' balance sheets in 2009-2015.

#### IV. MICRODATA OF ACTIVITIES OFF AND ON THE BALANCE SHEET

While the aggregate time series on shadow banking reported in Figure 1 are informative, it does not show the degree to which commercial banks are involved in shadow banking. In this section, we provide such information by constructing two datasets at the level of individual banks. These datasets help show the level of banks' involvement in shadow banking and enable us to conduct an empirical analysis of the effects of monetary policy shocks on banks' activities in shadow banking both off and on their balance sheets.

**IV.1. Off balance sheet: a quarterly panel entrusted loan dataset.** We have constructed an entrusted loan dataset that maps each loan transaction between two nonfinancial firms to a particular trustee. The trustee information is most important for this paper. During the long construction process, we manually collected all the PDF files of raw entrusted loan announcements made by firms that were listed on China's stock exchanges. By definition, listed firms are those that issue A-share stocks. The Chinese law requires listed lending firms to make public announcements about each entrusted loan transaction. Listed borrowing firms may choose to make announcements but are not required by law. China Securities Law Article 67, published in 2005, also requires all listed firms to announce major events which may have influenced their stock prices.<sup>25</sup> According to Article 2 of the CSRC's "Rules for Information Disclosure by Companies Offering Securities to the Public" published in 2011, listed firms had responsibility to disclose all entrusted loan transactions. Moreover, according to two disclosure memoranda provided by the Shenzhen Stock Exchange in 2011, a listed company must disclose information of entrusted loans as long as its subsidiary firm was a lender of entrusted loans, even if the company itself was not a direct lender.

A raw announcement made for each transaction concerns either a newly originated loan or a repaid loan. Information in each raw announcement contains the names of both lender and

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<sup>25</sup>The Chinese Securities Regulatory Commission (CSRC) published such documents at the link: [http://www.sac.net.cn/flgz/flfg/201501/t20150107\\_115050.html](http://www.sac.net.cn/flgz/flfg/201501/t20150107_115050.html)

borrower, the amount transacted, and the trustee name.<sup>26</sup> For each year between 2010 and 2013, we verified the number of collected *raw* announcements against the number published by the PBC’s 2011-2014 Financial Stability Reports. (The number was always published in the next-year report and the PBC no longer published this number after 2014.) Figure 7 plots the number of announcements. One can see from the figure that the discrepancy between our data and the PBC’s published data is of little importance. Although both our data source and the PBC’s data source were from WIND, at the time the PBC reported the number of announcements, some companies had not yet made announcements until a later year. Some of these delayed announcements are included in our data collection, which explains part of this inconsequential discrepancy.

We cleaned up raw announcements by removing announcements of repayment to the existing entrusted loans and duplicated announcements and by correcting inaccurate reports of loan amounts (see Appendix C for details). We call our cleaned-up announcements “announcements” to be distinguished from “raw announcements.” For the period from 2009 to 2015, the total number of announcements is 1379. Prior to the year 2009, there are only a handful of data observations (announcements). From the announcements of entrusted loans, we constructed a quarterly panel dataset that contains the total loan volume, the average loan amount, and the number of loans facilitated by each financial trustee. We have 80 individual banks and 45 nonbank trustees, a total of 125 trustees. These 80 individual banks include the five state banks; the rest are all nonstate banks.

**IV.2. On the balance sheet: a quarterly panel bank asset dataset.** The second dataset we have manually constructed is a quarterly panel dataset of bank loans and ARIX holdings on the balance sheets of 16 publicly listed banks. There are a total of 19 banks listed in the Hongkong, Shenzhen, or Shanghai Exchange, but only 16 of them have information about ARIX. These 16 publicly listed banks include the five state banks; the rest are all nonstate banks. We read through annual reports of these 16 publicly listed banks, collected the data on bank loans and ARI, and constructed the data on ARIX by excluding central bank bills or government bonds.

The annual reports are downloaded from WIND. Our quarterly panel of entrusted loan data are bridged to the balance-sheet information from WIND. When a particular entrusted

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<sup>26</sup>Allen, Qian, Tu, and Yu (2015) use the annual reports of listed nonfinancial companies to gather information about entrusted lending. Most of the trustee information, however, was missing in the annual reports.

loan transaction is announced, we first identify the name of the bank and then link the transaction to the WIND information of this bank. This allows us to compute the correlation of entrusted lending off balance sheet and ARIX on the balance sheet as discussed in Section V.4. Bankscope provides another data source for obtaining financial information such as LDR, size, capital, liquidity, and profitability of a particular bank, but Bankscope does not have information on ARIX or bank excess reserves, which we manually collected from banks' annual reports.

Using these two panel datasets we estimated panel regressions on the impact of monetary policy on both shadow banking loans off balance sheet and risky assets on the balance sheet. For the entrusted loan dataset, we did not run regressions on the data at the transaction level as in Jiménez, Ongena, Peydró, and Saurina (2014). Since the bank asset dataset is not transaction-based, we need to run panel regressions on both datasets at the bank level in order to establish the link between the findings based on entrusted lending off balance sheet and risky investments on the balance sheet. Such a link provides a perspective on the degree of how representative the estimated impact of monetary policy is from our entrusted loan dataset (Section V.3).

## V. IMPACT OF MONETARY POLICY ON BANKS' SHADOW BANKING ACTIVITIES

In this section, we use the two sets of panel data constructed in this paper to show that state and nonstate banks behave differently in response to changes in monetary policy in their shadow banking activities. We establish first that state and nonstate banks behave differently as *passive facilitators* of entrusted loans (illustrated by the OffBS arrows in Figure 6) and then that they behave differently as *active participants* in bringing shadow banking products onto their balance sheets (illustrated by the OnBS arrow in Figure 6). We argue that these two empirical findings reinforce each other in the sense that the different behaviors between state and nonstate banks are similar whether their activities are off balance sheet as passive facilitators, or on the balance sheet as active participants.

**V.1. Banks as passive facilitators: off-balance-sheet activities.** With the entrusted loan dataset, we run the following panel regression<sup>27</sup>

$$\log \mathcal{L}_{bt} = \alpha + \alpha_g g_{t-1} + \beta_{nsb} g_{t-1} \mathcal{I}(\text{NSB}_b) + \beta_{sb} g_{t-1} \mathcal{I}(\text{SB}_b) + \text{Control}_{bt} + u_{bt}, \quad (2)$$

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<sup>27</sup>The panel regression is unbalanced because it is not uncommon that a trustee may have facilitated one entrusted loan in the whole sample, or a few loans but in distant intervals separated by years.

where NSB stands for nonstate banks, SB stands for state banks,  $\mathcal{J}(\text{NSB}_b)$  returns 1 if the trustee is a nonstate bank and 0 otherwise, and  $\mathcal{J}(\text{SB}_b)$  returns 1 if the trustee is a state bank and 0 otherwise. The subscript “bt” stands for a particular trustee ( $b$ ) that facilitates entrusted lending at time  $t$  and  $\mathcal{L}_{bt}$  represents the total loan amount facilitated by trustee  $b$  at time  $t$ . The variable  $g_{t-1}$  is an annual change in exogenous M2 supply in the previous year. The regression residual is  $u_{bt}$ . The control variables, denoted by  $\text{Control}_{bt}$ , include  $\text{GDP}_{t-1}$  (an annual change in GDP in the previous year),  $\text{Inf}_{t-1}$  (an annual change in the GDP deflator in the previous year), and the types of trustees  $\mathcal{J}(\text{NSB}_b)$  and  $\mathcal{J}(\text{SB}_b)$ . GDP and inflation variables control for macroeconomic effects other than those of exogenous monetary policy. Including nonbank trustees as a control group helps obtain the accurate estimate of double interactions between monetary policy and the type of trustee. The sample size for this panel regression is 583.

Column (1) of Table 4 reports the estimated results of panel regression (2). The coefficient  $\alpha_g$  reflects the impact of monetary policy on entrusted loans facilitated by *nonbank trustees*. The positive coefficient value indicates that the amount of entrusted lending facilitated by nonbank trustees decreases, not increases, in response to a fall in M2 growth (and the coefficient is statistically significant at a 10% level). This result indicates that nonbank trustees did not actively participate in entrusted loans during the period of monetary policy tightening.

The coefficient  $\beta_{sb}$  of the double-interaction term  $g_{t-1}\mathcal{J}(\text{SB}_b)$  captures how much entrusted lending is intermediated by state banks in addition to the lending channeled by nonbank trustees when M2 growth changes. From column (1) of Table 4, one can see that this marginal effect is statistically insignificant, indicating that state banks’ activities in facilitating entrusted loans did not increase when monetary policy tightened.

The coefficient  $\beta_{nsb}$  of the double-interaction term  $g_{t-1}\mathcal{J}(\text{NSB}_b)$  captures how much entrusted lending is intermediated by nonstate banks in addition to the lending channeled by nonbank trustees when M2 growth changes. This marginal effect is estimated to be negative and the estimate is highly significant. The negative sign means that a fall in M2 growth leads to an increase, not a decrease, in entrusted lending. The estimates of overall impacts of monetary policy tightening on entrusted lending facilitated by state and nonstate banks are given at the bottom of Table 4. As one can see, the overall impact of M2 growth on entrusted lending intermediated by state banks,  $\alpha_g + \beta_{sb}$ , has an opposite sign. That is, monetary policy tightening reduces entrusted lending facilitated by state banks with a decrease

of 17.42% (at a 10% level of statistical significance) in response to a one-percentage-point fall in M2 growth. On the other hand, the overall impact of M2 growth on entrusted lending intermediated nonstate banks,  $\alpha_g + \beta_{nsb}$ , is large and highly significant. Indeed, the total volume of entrusted lending intermediated by nonstate banks increases by 10.65% (at a less than 1% level of statistical significance) in response to a one-percentage-point fall in M2 growth, an empirical result showing that nonstate banks' activities in facilitating entrusted loans increased in response to contractionary monetary policy.

**V.2. Robustness analysis.** In this section, we perform a robustness analysis of the previous regression results. The analysis centers on two questions. Is an increase of entrusted lending driven by an increase in the number of transactions (extensive margin) or an increase in the average loan amount (intensive margin)? And do the empirical results for nonstate banks simply reflect the effects of bank-specific attributes such as LDR, size, capital, and liquidity?

*V.2.1. Intensive versus extensive margins.* The significant role played by nonstate banks in funneling entrusted loans may reflect the number of loans (extensive margin), not the average loan amount (intensive margin). The large number of loans may reflect the diversification strategy of nonstate banks, not necessarily a concentration of risk. To see whether nonstate banks' promotion of entrusted lending stems from the increasing number of loans or the increasing average loan amount, we run two additional panel regressions as

$$S_{bt} = \alpha + \alpha_g g_{t-1} + \beta_{nsb} g_{t-1} \mathcal{J}(\text{NSB}_b) + \beta_{sb} g_{t-1} \mathcal{J}(\text{SB}_b) + \text{Control}_{bt} + u_{bt}, \quad (3)$$

where  $S_{bt}$  represents either the log value of the average loan amount facilitated by trustee  $b$  at time  $t$  or the number of loans facilitated by trustee  $b$  at time  $t$ .

Column (1) of Table 5 reports the regression results on the average loan amount. As one can see, the estimated values in column (1) of Table 5 are comparable to those in column (1) of Table 4. For the number of loans, the estimates of  $\alpha_g$ ,  $\beta_{sb}$ , and  $\beta_{nsb}$  are all statistically insignificant (thus not reported). These results indicate that the increase of the total loan amount channeled by nonstate banks is driven by the intensive margin. There is no evidence that state banks or nonbank financial companies intermediated more entrusted lending when monetary policy tightened in terms of either the number of loans or the average loan amount.

*V.2.2. Individual bank attributes.* One critical question is whether the bank variable  $\mathcal{J}(\text{NSB}_b)$  is an outcome of other bank characteristics such as LDR, size, liquidity, and capital position. A significant portion of our data sample contains entrusted loans facilitated by nonbank

financial trustees. Because the data on characteristics of these trustees such as size and liquidity do not exist, we need to reduce our sample by selecting the data intermediated by commercial banks only. With this reduced sample (342 observations), we extend regression (2) by adding control of various bank-specific attributes as in Kashyap and Stein (2000) and Jiménez, Ongena, Peydró, and Saurina (2014). These attributes are the LDR (China-specific), log value of total assets (size), the ratio of bank equity to total assets (capital), the ratio of liquid assets to total assets (liquidity), the ratio of total net income to total assets (ROA), and the nonperforming loan ratio (NPL). Table 6 reports the summary statistics of these bank characteristics. As one can see, there are considerable variations across banks for each of these characteristics.

We add all these bank attributes to the existing control variables and run the following panel regression:

$$\log \mathcal{L}_{bt} = \alpha + \alpha_g g_{t-1} + \beta_{nsb} g_{t-1} \mathcal{J}(\text{NSB}_b) + \text{Control}_{bt} + u_{bt}, \quad (4)$$

where the control variables, represented by  $\text{Control}_{bt}$ , are  $\text{GDP}_{t-1}$ ,  $\text{Inf}_{t-1}$ ,  $\mathcal{J}(\text{SB}_b)$ ,  $\mathcal{J}(\text{NSB}_b)$ , and single and double-interaction terms with all the bank-specific attributes listed in Tables 6. A key question is whether the bank-type indicator  $\mathcal{J}(\text{NSB}_b)$  in its double-interaction term remains statistically significant after we control for bank-specific attributes. The results are reported in column (3) of Table 4. We do not find that the LDR is an important factor in influencing entrusted loans. Although the bank size and ROA in the double-interaction terms are significant (column (3) of Table 4), the coefficient of the double-interaction term  $g_{t-1} \mathcal{J}(\text{NSB}_b)$  continues to be highly significant after these bank-specific attributes are controlled for.

After we control for these bank-specific attributes, the bank-type indicator  $\mathcal{J}(\text{NSB}_b)$  does not reflect whether the bank is small or large, whether the bank's LDR is different from the LDRs of other banks, how strong the bank's capital position is, or whether the bank's other characteristics differ from those of other banks. Furthermore, the demand of entrusted loans has no bearing on whether a trustee is a state bank or a nonstate bank, *ceteris paribus*. As long as the borrower's loan demand is met, the borrower does not care whether the loan is facilitated by a nonbank trustee, a state bank, or a nonstate bank.

In regression (4), the overall impact of monetary policy on entrusted lending funneled by nonstate banks is the sum of  $\alpha$ ,  $\beta_{nsb}$ , and the coefficients of double-interaction terms related



to all bank-specific attributes at the mean bank level.<sup>28</sup> Recall that the regression is run on a smaller sample because there is no data on the balance-sheet information of nonbank trustees. With the smaller sample, the estimated impact is expected to differ from the estimate in regression (2):  $-10.65\%$  vs.  $-14.00\%$  reported at the bottom in columns (1) and (2) of Table 4. To see whether bank-specific attributes severely affect the estimated impact of monetary policy, we need to compare the results based on the same sample. For that purpose, we run regression (4) on the same reduced sample with and without bank-specific attributes included in the control variables. The estimated impact without any bank-specific attribute is  $-14.00\%$  (reported at the bottom in column (2) of Table 4). Given the standard error  $5.73\%$ , this estimate is not statistically different from the estimated impact of monetary policy with inclusion of all bank-specific attributes as control variables ( $-17.97\%$  reported at the bottom of column (3) in Table 4). By contrast, the estimated impact of monetary policy on total entrusted lending channeled by state banks has an opposite sign and is statistically insignificant for the smaller sample. Comparing the results for the smaller sample with and without bank-specific attributes at the bottom of columns (2) and (3) in Table 5, one can see the similar results when the average entrusted loan amount is used. In summary, we establish robust evidence that nonstate banks facilitated more entrusted lending when monetary policy tightened while state banks did not.

Despite the statistical significance of some bank-specific attributes in double-interaction terms, these results suggest that the bank-type indicator  $\mathcal{J}(\text{NSB}_b)$  in regressions without any bank-specific attribute as a control variable is a good approximation to capturing the institutional asymmetry between state and nontate banks, not the difference in individual attributes such as LDR, size, capital position, and liquidity. In other words, the institutional asymmetry discussed in Section II.3.2 is, to a large extent, orthogonal to individual bank characteristics.

**V.3. Banks as active participants: on-balance-sheet activities.** In the preceding two sections we establish evidence of banks' activities as passive facilitators in channeling entrusted loans between nonfinancial firms. In this section, we obtain evidence of banks' activities as active participants in bringing shadow banking products onto their balance sheets. In the section that follows this one, we provide a general perspective of the connection among the results obtained in this and previous sections.

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<sup>28</sup>We use mean bank to indicate that the average value of each characteristic across banks is used as an input for computing the overall impact of money growth when bank characteristics are controlled for.

The bank asset dataset is constructed from 16 publicly listed banks, which include all the state banks as well as the largest nonstate banks. Their assets take up, on average for the period 2009-2015, 81% of total bank assets and 83.4% of total bank loans in the entire banking system. Thus, these banks are representative of the Chinese banking system.

Using the bank asset dataset, we run the following quarterly panel regression<sup>29</sup>

$$\log \mathcal{A}_{bt} = \alpha + \alpha_g g_{t-1} + \beta_{nsb} g_{t-1} \mathcal{J}(\text{NSB}_b) + \text{Control}_{bt} + \varepsilon_{bt}, \quad (5)$$

where  $\mathcal{A}_{bt}$  represents ARIX for bank  $b$  at time  $t$  and the control variables, which include  $\text{GDP}_{t-1}$ ,  $\text{Inf}_{t-1}$ , and  $\mathcal{J}(\text{NSB}_b)$ , are similar to those used in previous regressions. Column (1) of Table 7 reports the estimated results. The impact of monetary policy tightening on state banks' ARIX is estimated to be a 26.56% decrease in response to a one-percentage-point decrease in M2 growth (see the bottom part of Table 7). By contrast, the impact of monetary policy on nonstate banks' ARIX is estimated to be a 37.69% increase in response to a one-percentage-point decrease in M2 growth and the estimate is highly significant statistically. The estimation of regression (5) is carried out without controlling for various bank-specific attributes.

As shown in Section V.2.2, the bank-type indicator  $\mathcal{J}(\text{NSB}_b)$  is a good approximation of the institutional feature of nonstate banks even after we omit individual bank attributes. To see whether this result continues to hold for the bank asset dataset, we run the same regression as (5) but add single and double-interaction terms with all the bank-specific attributes listed in Table 6 to the existing control variables. This exercise results in a loss of 37 observations because the data on several bank-specific attributes in certain years are missing for some banks. When we run the same regression on this reduced sample without including any bank-specific attribute as a control variable, the estimated impact on nonstate banks' ARIX is a 45.73% increase in response to a one-percentage-point fall in M2 growth (bottom of column (2) of Table 7). As expected, this value is different from the estimated 37.69% based on the original and larger sample (bottom of column (1) of Table 7).

As shown in column (3) of Table 7, the coefficients of double-interaction terms are statistically insignificant except for those of the terms involving  $\mathcal{J}(\text{NSB}_b)$  and ROA. The statistical significance for the coefficient of the double-interaction term involving  $\mathcal{J}(\text{NSB}_b)$  is particularly high. Taking into account all bank-specific attributes, the impact of monetary

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<sup>29</sup>The panel regression is unbalanced because some ARIX observations are missing in the original annual reports. These missing data are only a handful, however.

policy on nonstate banks' ARIX is estimated to be a 42.33% increase in response to a one-percentage-point fall in M2 growth (reported at the bottom of column (3) of Table 7). With the estimated standard error (8.89%), this estimate is not significantly different from the estimated 45.73% without an inclusion of any bank-specific attribute as a control variable. Such a finding is similar to the result discussed in Section V.2.2 where the entrusted loan dataset is used.

Our estimated results hold when the end-of-year LDR is replaced by the average LDR. In regression (5) with all bank-specific attributes included as control variables, the estimated impact is  $-42.33\%$  when the end-of-period LDR is used and  $-43.68\%$  when the average LDR is used (reported at the bottom of columns (3) and (4) of Table 7). As for double-interaction terms, the coefficient of  $g_{t-1}\mathcal{J}$  ( $\text{NSB}_b$ ) is  $-108.58\%$  when the end-of-year LDR is used and  $-113.84\%$  when the average LDR is used instead (reported at the top of columns (3) and (4) of Table 7). The difference between the results for the end-of-year and average LDRs is negligible.

To determine the degree to which we underestimate the significance of nonstate banks' behavior in funneling entrusted loans, we compare the regression results when all individual bank attributes are controlled for. That is, we compare the estimated 17.97% based on the entrusted loan data (bottom of column (3) of Table 4) to the estimated 42.33% based on the bank asset data (bottom of column (3) of Table 7). Because the entrusted loan dataset pertains to new loans (flow) and the bank asset dataset concerns outstanding loans (stock), we convert the flow estimate 17.97% to its stock value as  $(1 + 17.97\%) * 30.10\% = 35.51\%$ , where 30.10% is an average quarterly growth rate of ARIX between 2009 and 2015. Comparing the stock coefficient 35.51% based on the entrusted loan data to the stock estimate 42.33% based on the bank asset data, we conclude that although the regression result based on the entrusted loan dataset may underestimate nonstate banks' activity in funneling shadow banking loans, the degree of underestimation may not be large, especially when one takes into account the standard error of the estimate.<sup>30</sup>

The impact of monetary policy on state banks' ARIX is estimated to be a 26.56% decrease, *not an increase*, in response to a one-percentage-point fall in M2 growth and the estimate is at a 5% level of statistical significance (bottom of column (1) in Table 7). This finding indicates that ARIX on state banks' balance sheets did not increase when monetary policy tightened. By contrast, the impact of monetary policy on nonstate banks' ARIX is estimated to be a

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<sup>30</sup>This conclusion also holds if we compare the regression results without any bank-specific attribute.

37.69% *increase* in response to a one-percentage-point fall in M2 growth, with an extremely high statistical significance. This sharp contrast is consistent with the estimation results in Table 4 based on the entrusted loan dataset. In sum, our evidence shows that nonstate banks invested in more ARIX on their balance sheet when monetary policy tightened while state banks did not.

The finding of a highly significant impact of monetary policy on nonstate banks' ARIX holdings provides an additional support for the argument that nonstate banks' activity in funneling entrusted loans when monetary policy tightens is not driven from borrowers' demand for entrusted loans. The reason is that the demand itself would not explain why only nonstate banks, not state banks, would actively bring shadow banking products onto their balance sheets via ARIX. The results from our panel regressions on both entrusted lending and ARIX are mutually consistent; together they show that nonstate banks were willing to use the ARIX category to take the credit risk of shadow banking products for higher profits.

Because controlling for bank-specific attributes reduces the size of the sample and because we have shown that the bank-type indicator  $\mathcal{J}$  ( $NSB_b$ ) does not reflect any of these attributes in a significant way, we continue to use the original and larger sample in which bank-specific attributes are omitted in our panel regressions. Since only a handful of ARIX observations are missing, we interpolate these missing ones and run panel regression (5) with the balanced dataset. The estimated value of  $\alpha_g$  is 26.35% with the standard error 12.63 (at a 5% significance level) and the estimated value of  $\beta_{nsb}$  is  $-63.65$  with the standard error 16.68 (at a 1% significance level). A comparison of these estimates and those reported at the top of column (1) of Table 7 indicates that the regression results are similar with and without interpolated ARIX data. The balanced dataset is thus used for our panel VAR analysis of monetary policy in Section VI.

#### V.4. The connection between off-balance-sheet and on-balance-sheet activities.

The empirical findings in the preceding sections reveal that the disparate behaviors between state and nonstate banks in their entrusted loan activities off balance sheet are reinforced by the similarly disparate behaviors in their responses of on-balance-sheet ARIX to changes in monetary policy. Had off-balance-sheet shadow banking products never been brought onto the balance sheet in the form of ARIX, we would not have obtained these consistent results. Such consistency implies that nonstate banks were not only passive facilitators but also active in bringing off-balance-sheet shadow banking products onto the balance sheet.

As extensively documented in the preceding sections, the different behaviors between state and nonstate banks persist even after we control for individual bank attributes. Thus, the bank-type indicator  $\mathcal{I}(\text{NSB}_b)$  captures only the *institutional* difference between state and nonstate banks in that state banks do not circumvent the government's own regulations against bringing risky shadow banking loans onto the balance sheet while nonstate banks do take advantage of regulation arbitrage.

The contrast of nonstate banks to state banks in their off-balance-sheet entrusted lending activities is manifested by the findings in Table 8, which reports the correlations of entrusted lending channeled by banks off balance sheet and ARIX on their balance sheets. During 2009-2015, the correlation between new entrusted loans and changes in ARIX is significantly positive for nonstate banks, while the same correlation is statistically insignificant for state banks. A similar result holds for the correlation between entrusted lending and  $\frac{\text{ARIX}}{\text{ARIX}+B}$  where  $B$  stands for bank loans. These correlation facts are not a mere accident; they suggest that nonstate banks had a penchant for bringing shadow banking products onto their balance sheets as investment assets in the form of ARIX.

The correlation evidence presented in Table 8 is further substantiated by the share of ARIX in total credit (the sum of ARIX holdings and bank loans on banks' balance sheets). Figure 5 shows that the share for state banks was unimportant (below 3% for most of the period 2009-2015). By contrast, the share of ARIX for nonstate banks was substantial, increasing rapidly during the period 2009-2015 until it reached almost 30% in 2015.

Since ARIX includes all possible shadow banking products brought onto the balance sheet, it is not essential that we obtain an accurate share of entrusted rights within ARIX. What is most important is the share of ARIX in total credit. Table 9 provides more summary information about the importance of ARIX in total credit. As previously argued, state banks do not avail themselves of regulatory arbitrage against the government's own policies. As a result, the share of ARIX in total credit on their balance sheets remained at a very low level and the high 70<sup>th</sup> percentile for the share was only 4.8% in 2009 and 5.3% in 2015. The opposite is true for nonstate banks, which rapidly brought shadow banking loans onto their balance sheets in the form of ARIX during the same period. The 30<sup>th</sup> percentile for their share increased from 0.5% in 2009 to 20.6% in 2015 and the 70<sup>th</sup> percentile gave an even higher share.

In a recent paper, Chen, He, and Liu (2017) demonstrate that as bank loans declined, local government debts that funded shadow banking products such as entrusted loans and

wealth management products increased. How much of this off-balance-sheet activity was brought onto the balance sheet in the banking system? The consistent results based on both entrusted loan and ARIX datasets establish evidence that the issue with nonstate banks is not just their shadow banking activities but also their active engagement in risky investment on their balance sheets. In the empirical analysis presented in the following section, we treat ARIX as a whole so that risky assets on banks' balance sheets do not depend on any single product of shadow banking. What matters to the effectiveness of monetary policy is the ARIX in the banking system, which encompasses all shadow banking products that are brought into the banking system.

## VI. THE EFFECTIVENESS OF MONETARY POLICY ON THE BANKING SYSTEM

In the preceding sections, we establish micro evidence that nonstate banks responded to monetary policy tightening first by helping increase entrusted loans as passive facilitators and then by bringing shadow banking products onto their balance sheets via investment in ARIX as active participators. As monetary policy tightening is expected to reduce (traditional) bank loans (top left panel of Figure 1), a potential influence of shadow banking products on the effectiveness of quantity-based monetary policy has been a serious concern for the central government of China. In this section, we analyze the extent to which the use of shadow banking products in the form of ARIX reduces the effectiveness of monetary policy in China. We first provide a descriptive analysis of how monetary policy shocks affect the banking system and then build a panel VAR model to obtain the dynamic impact of changes in monetary policy on the total credit.<sup>31</sup>

**VI.1. A descriptive analysis of the effect of monetary tightening.** Monetary policy consists of two components: endogenous growth of money supply in response to economic fundamentals and an exogenous change in money growth. To determine the extent to which monetary policy causes a rapid rise of shadow banking in China, it is necessary to extract from the data a series of changes in exogenous money growth (i.e., unexpected monetary policy shocks) as in the empirical macroeconomic literature (Christiano, Eichenbaum, and Evans, 1996; Leeper, Sims, and Zha, 1996; Christiano, Eichenbaum, and Evans, 1999, 2005; Sims

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<sup>31</sup>In Appendix D, we construct a dynamic theoretical model to formalize the key component of our descriptive analysis. When the model is calibrated to the Chinese economy, we find that the simulated impulse responses of bank loans, risky assets, and total credit are broadly consistent with our empirical results.

and Zha, 2006). In Section III, we estimate both endogenous and exogenous components of China's quantity-based monetary policy and show that exogenous shifts in money supply are carried out through open market operations, not through changes in the reserve requirement. Denote exogenous money growth by  $\varepsilon_{m,t} = \Delta \log M_t^{\text{exog}}$ , where  $M_t^{\text{exog}}$  represents exogenous money supply. Changes in  $\varepsilon_{m,t}$ , therefore, affect bank deposits directly through open market operations.<sup>32</sup>

Consider an economy populated by a continuum of banks whose identity is indexed by  $j \in [0, 1]$ . All banks are infinitely-lived and are subject to idiosyncratic withdrawal shocks to deposits with a fraction  $\omega_t$  of deposits withdrawn in the economy. We follow Bianchi and Bigio (2017) in modeling the shock process of  $\omega_t$ . Specifically, the idiosyncratic shock  $\omega_t$  is continuously distributed with the probability density function  $f(\omega_t)$  that is uniformly distributed with the support of  $[\mu(\varepsilon_{m,t}), 1]$ , where  $\mu(\varepsilon_{m,t})$  is a function of  $\varepsilon_{m,t}$ . Bianchi and Bigio (2017) provide an informative discussion of why the support of the idiosyncratic withdrawal shock should lie in  $[-\infty, 1]$ . In our framework, the lower bound is influenced by an *aggregate* shock and we derive the functional form of  $\mu(\cdot)$ .

This novel derivation has two purposes. First, it formalizes Anna J. Schwartz's informative description of how monetary policy changes influence total (aggregate) deposits in the banking system, as evidenced in the bottom panel of Figure 4.<sup>33</sup> Second, it illustrates that the risk of deposit withdrawal will reduce bank loans and increase risky assets before an actual withdrawal from an individual bank is realized. We denote the deposits of bank  $j$  at the beginning of period  $t$  by  $D_t(j)$ . The deposits of bank  $j$  *after* the realization of an idiosyncratic withdrawal shock to deposits, therefore, is  $D_t(j)(1 - \omega_t)$ . To understand the mechanism of how changes in monetary policy influence the banking system, we first show that  $\varepsilon_{m,t}$  has direct impact on aggregate deposits. That is,

$$\begin{aligned} \varepsilon_{m,t} &= \Delta \log M_t^{\text{exog}} \\ &= \log \int_0^1 \int_{\mu(\varepsilon_{m,t})}^1 D_t(j) (1 - \omega_t) f(\omega_t) d\omega_t dj - \log \int_0^1 D_t(j) dj \end{aligned}$$

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<sup>32</sup>For example, when the PBC tightens money supply by selling central bank bills to a primary dealer, the dealer's deposits at its clearing bank typically fall.

<sup>33</sup>We thank a referee for bringing out this important point to us. As Anna J. Schwartz succinctly stated, absent movements of currency in circulation, "deposits and M2 move together almost by definition" (<http://www.econlib.org/library/Enc/MoneySupply.html>).

$$\begin{aligned}
&= \log \left[ \int_0^1 D_t(j) dj \int_{\mu(\varepsilon_{m,t})}^1 (1 - \omega_t) \mathfrak{f}_t(\omega_t) d\omega_t \right] - \log \int_0^1 D_t(j) dj \\
&= \log (1 - E[\omega_t \mid \mu(\varepsilon_{m,t})]) \\
&\simeq -(1 + \mu(\varepsilon_{m,t}))/2,
\end{aligned}$$

which leads to

$$\mu(\varepsilon_{m,t}) \simeq -(2\varepsilon_{m,t} + 1).$$

The approximation is accurate as long as the range of variations for  $\varepsilon_{m,t}$  is small. The estimated results reported in Section III indicate that annual changes of  $\varepsilon_{m,t}$  are between  $-0.05$  and  $0.05$ . Thus, this result shows that contractionary monetary policy leads to a fall of aggregate deposits by changing the distribution of the idiosyncratic deposit withdrawal.

We now illustrate how a contractionary monetary policy shock can lead to a fall in bank loans and a rise in risky assets on the bank's balance sheet.<sup>34</sup> When the central bank conducts its contractionary monetary policy (i.e.,  $\varepsilon_{m,t}$  falls) through open market operations, it increases the risk of deposit withdrawal by changing  $\mu(\varepsilon_{m,t})$ . We call this stage at time  $t$  “Stage 0.” The following diagram presents the balance sheets of three economic agents: the central bank, a typical primary dealer, and a typical bank (the median or average bank in the distribution of  $\omega_t$ ). The diagram illustrates how open market operations work in Stage 0.

Stage 0 (before  $\omega_t$  is realized)

Central bank		Primary dealer		Bank	
DPD <sub>0</sub> ↗	CBB <sub>0</sub> ↗	CBB <sub>0</sub> ↗	DPD <sub>0</sub> ↗	$B_0 \searrow$	$D_0$
	C <sub>0</sub>	$D_0$		ARIX <sub>0</sub> ↗	
				C <sub>0</sub>	$(\mathcal{E} - \text{DIV}_0 \searrow) \nearrow$

The central bank performs open market operations by selling central bank bills (CBB<sub>0</sub>) to the primary dealer while debiting the primary dealer (DPD<sub>0</sub>) with an amount equal to CBB<sub>0</sub>. DPD<sub>0</sub> is a short-term liquidity loan (within the period). To keep the notation simple, we omit the equity variable on the central bank and the primary dealer's balance sheets, but the bank's equity ( $\mathcal{E}$ ) is kept on its balance sheet.

At this stage, the bank observes the open market operations initiated by the central bank and anticipates a higher risk of deposit withdrawal from the primary dealer. The bank then

<sup>34</sup>To keep our illustration clear, we abstract from other factors such as bank reserves. For an extensive analysis on these issues, see Bianchi and Bigio (2017).



decides on dividend payout ( $DIV_0$ ) and a portfolio allocation among three assets: bank loans ( $B_0$ ), risky assets ( $ARIX_0$ ), and cash ( $C_0$ ). On the liability side of the central bank's balance sheet (e.g., the PBC's balance sheet),  $C_0$  represents the "deposits at central bank." Bank loans are default free but subject to the regulatory constraint on the loan-to-deposit ratio. By contrast, risky nonloan assets are not subject to the LDR constraint, but are subject to a default risk. When deposits are short of what is required by the LDR regulation, the bank incurs an extra cost to recoup the deposit shortfall (the last-minute rush discussed in Section II.1.3). As a result, the effective return of bank loans is reduced by the expected regulation cost. The bank chooses between bank loans and risky assets according to the no-arbitrage condition that equates the effective return of bank loans and the expected return of risky assets adjusted for the default premium. In other words, the bank trades off the regulatory cost of traditional bank loans for the default risk of risky nonloan assets.

When monetary policy tightens, the bank, in anticipation of a higher probability of deposit shortfalls in the future, optimally adjusts its portfolio by decreasing traditional bank loans ( $B_0 \downarrow$ ) and increasing risky nonloan assets ( $ARIX_0 \uparrow$ ). Bank loans decline because monetary policy tightening increases the risk of deposit withdrawal and thus the expected cost for the bank to recoup a deposit shortfall. As a result, the effective return of bank loans declines. Because  $ARIX$  is not subject to the safe-loan and LDR regulations, on the other hand, it is optimal for the bank to raise  $ARIX$  as an effective way to compensate the expected cost associated with these two regulations.

Not only does a contractionary monetary policy shock shift the bank's portfolio toward risky assets, but also it exerts a dynamic impact on the total credit within the banking system, measured as the sum of bank loans and  $ARIX$ . As shown by the previous T-account analysis, changes in the total credit are linked to changes in the ex-dividend equity. An increase in the expected regulation cost reduces the return of the bank equity, which generates two opposing effects. The first is an income effect under which the dividend declines and ex-dividend equity increases ( $(\mathcal{E} - DIV_0) \uparrow$ ). The second is a substitution effect (the substitution between today's and tomorrow's dividend payoffs), which reduces the bank's incentive to save via the equity. When the income effect dominates the substitution effect, it is optimal for the bank to expand the total credit through an increase in risky assets to compensate for the extra cost of recouping deposit losses. From the T-account analysis above, one can see the ex-dividend equity and thus the total liability rise as  $DIV_0$  falls. The increase of the total liability on the bank's balance sheet, together with the decline in

bank loans in response to monetary policy tightening, implies that risky assets  $ARIX_0$  must increase by more than the fall of bank loans  $B_0$ .

In Stage 1 at time  $t$ , as illustrated below, an idiosyncratic withdrawal shock  $\omega_t$  is realized so that the primary dealer pays off its loans ( $DPD_1 = 0$ ) from the central bank by withdrawing deposits from the commercial bank.<sup>35</sup> As a result, the bank's cash  $C_1$  falls until  $C_1 = C_0 - \omega D_0$ .<sup>36</sup>

Stage 1 (after $\omega_t$ is realized)			
Central bank		Primary dealer	
$DPD_1 = 0$	$CBB_1 = CBB_0$	$CBB_1 = CBB_0$	$DPD_1 = 0$
	$C_1 \searrow$	$D_1 \searrow$	
Bank			
	$B_1 = B_0$	$D_1 \searrow$	
	$ARIX_1 = ARIX_0$		
	$C_1 \searrow$	$\mathcal{E} - DIV_0$	

In addition to central bank bills, China's central bank also sells and purchases government bonds (GB) as in many other countries. In that case, the central bank's balance sheet in Stages 0 and 1 is changed accordingly as follows.

Central bank in Stage 0 and Stage 1			
Central bank		Central bank	
$DPD_0 \nearrow$		$DPD_1 = 0$	
$GB_0 \searrow$	$C_0$	$GB_1 = GB_0$	$C_1 \searrow$

The balance sheets of the primary dealer and the commercial bank are the same except CBB is now replaced by GB.

**VI.2. Panel VAR evidence.** Our descriptive analysis suggests that the *aggregate* impact of monetary policy tightening will reduce bank loans but increase risky nonloan assets. If

<sup>35</sup>For analytical clarity, we omit the trading of central bank bills between primary dealers and commercial banks and focus on primary dealers' deposits in commercial banks. For a description of open market operations through primary dealers who have depository accounts in commercial banks, see also the Federal Reserve Bank of New York webpage: <https://www.newyorkfed.org/aboutthefed/fedpoint/fed32.html>

<sup>36</sup>When  $C_0 < \omega D_0$ , the bank can borrow directly from the central bank to meet depositors' withdrawal needs and repay the central bank in the next period ( $t + 1$ ). In this case,  $C_1 = 0$ , and the bank's liability side and the central bank's asset side have an additional item equal to  $\omega D_0 - C_0$ . On the balance sheet of the bank, this item is termed "Liability to Central Bank."

the income effect dominates the substitution effect, we argue that the total credit within the banking system will increase. This effect would hamper the intended impact of monetary policy. In this section, we provide VAR evidence of the effectiveness of monetary policy on the banking system during the shadow banking boom. Specifically, we extend the Romer and Romer (2004) methodology and develop a dynamic panel model that is estimated against our bank asset data.

The dynamic quarterly panel model is of simultaneous-equation form as

$$A_0^b \begin{bmatrix} \Delta B_{bt} \\ \Delta \text{ARIX}_{bt} \end{bmatrix} = c^b + \sum_{k=1}^{\ell} A_k^b \begin{bmatrix} \Delta B_{bt-k} \\ \Delta \text{ARIX}_{bt-k} \end{bmatrix} + \begin{bmatrix} \sum_{k=0}^{\ell} c_k^b \varepsilon_{m,t-k} \\ 0 \end{bmatrix} + \eta_{bt}, \quad (6)$$

where the subscript  $b$  represents an individual bank,  $B_{bt}$  represents bank loans made by bank  $b$  at time  $t$ ,  $\text{ARIX}_{bt}$  is accumulated by bank  $b$  at time  $t$ ,  $\eta_{bt}$  is a vector of i.i.d. disturbances that capture other shocks that are orthogonal to monetary policy shocks,  $\ell$  is the lag length set to 4 (one year), and for  $k = 0, \dots, \ell$

$$c^b, c_k^b, A_k^b = \begin{cases} c^{nsb}, c_k^{nsb}, A_k^{nsb}, & \text{if bank } b \text{ is a nonstate bank} \\ c^{sb}, c_k^{sb}, A_k^{sb}, & \text{if bank } b \text{ is a state bank} \end{cases}.$$

Both  $\Delta B_{bt}$  and  $\Delta \text{ARIX}_{bt}$  are scaled by nominal GDP to keep the panel VAR stationary. The lagged variables  $\Delta B_{bt-k}$  and  $\Delta \text{ARIX}_{bt-k}$  on the right hand side of the panel equations are used to capture changes of  $B_{bt}$  and  $\text{ARIX}_{bt}$  influenced by different maturities at which some bank assets are retired. After controlling for these lagged variables, the dynamic impact of  $\varepsilon_{m,t}$  reflects the effect only on new loans and new investment. The inclusion of all exogenous M2 growth rates for the last four quarters captures both the current quarterly change and an annual change of M2 supply.

The only identifying restriction imposed on system (6) is that exogenous changes in M2 growth, represented by  $\varepsilon_{m,t}$ , affect bank loans  $B_{bt}$  but not risky assets  $\text{ARIX}_{bt}$ . In practice, changes in monetary policy affect deposits directly, which in turn affect bank loans contemporaneously due to the LDR regulation. On the other hand, monetary policy does not aim at influencing either banks' shadow bank activities or their incentives to bring those shadow banking products onto the balance sheet. Thus, we impose a zero restriction on the contemporaneous effect of monetary policy shocks on risky assets  $\text{ARIX}_{bt}$ .<sup>37</sup>

Note that  $B_{bt}$  and  $\text{ARIX}_{bt}$  are simultaneously determined and unlike the existing literature, there are no strong and controversial assumptions such as the Choleski restriction. Because

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<sup>37</sup>This identifying restriction is also consistent with our theoretical framework presented in Appendix D.

of such a simultaneity in the dynamic panel system, a key question is whether the dynamic responses of  $B_{bt}$  and  $ARIX_{bt}$  in response to  $\varepsilon_{m,t}$  are uniquely determined. Since  $\varepsilon_{m,t-k}$  for  $k = 0, \dots, \ell$  enters the first equation but not the second equation and because  $\varepsilon_{m,t-k}$  is exogenously given, the dynamic system represented by (6) is globally identified according to Theorem 1 of Rubio-Ramírez, Waggoner, and Zha (2010). With the bank asset data on  $B_{bt}$  and  $ARIX_{bt}$ , all the coefficients  $c^b$  and  $A_k^b$  for  $b = nsb, sb$  are uniquely determined by maximum likelihood estimation.

The coefficients in system (6) have two different values, depending on whether the bank is state controlled. Allowing for different values captures the institutional asymmetry between state and nonstate banks as well as other potential differences between these two groups of banks. These restrictions are consistent with the institutional facts of China and remain minimal to avoid “incredible restrictions” as advocated by Sims (1980).

Given the estimated coefficients, the next step is to calculate the dynamic responses of  $B_{bt}$  and  $ARIX_{bt}$  in response to  $\varepsilon_{m,t}$ . As an illustration, we consider the following simple one-variable process

$$\Delta x_t = a_0 + \sum_{k=1}^{\ell} b_k \Delta x_{t-k} + \sum_{k=0}^{\ell} c_k \varepsilon_{m,t-k} + \eta_t.$$

For this simple example, the dynamic responses of  $x_{t+h}$  for  $h = 0, 1, 2, \dots$  to a one-standard-deviation unit of  $\varepsilon_{m,t}$  can be calculated as

- $x_t$  ( $h = 0$ ):  $c_0$ ;
- $x_{t+1}$  ( $h = 1$ ):  $c_1 + b_1 c_0 + c_0$ ;
- $x_{t+2}$  ( $h = 2$ ):  $c_2 + b_2 c_0 + b_1(c_1 + b_1 c_0) + c_1 + b_1 c_0 + c_0$ .

Although the complete formula for the dynamic responses to  $\varepsilon_{m,t}$  in the dynamic panel system is much more involved, it has a calculation method similar to the above example.

With the panel structure, the estimated dynamic responses of ARIX and bank loans for all banks (the banking system) to a one-standard-deviation fall in M2 growth are a simple sum of the dynamic responses for each bank. The responses are plotted in Figure 8. Bank loans steadily decline in response to contractionary monetary policy as expected. ARIX holdings, however, respond in an opposite direction, increasing and reaching the peak at 2.5% in the fourth quarter. The response of nonstate banks contributes to most of the rise in ARIX. According to the error bands displayed in Figure 8, the estimates of the aggregate dynamic

responses are statistically significant.<sup>38</sup> As a result, the total credit in the banking system (bank loans and ARIX holdings combined) increases steadily over time for the first year with the estimated increase marginally significant above zero (judged by the error bands). Afterward, the response of the total credit becomes statistically insignificant. From the view point of monetary policy, the effect of contractionary monetary policy on the banking system is ineffective because the responses of ARIX holdings offset those of bank loans. These empirical findings are consistent with our theoretical predictions discussed in Appendix D.

Given the existing quantity-based monetary policy system, what regulatory remedy would make the bank lending channel of monetary policy more effective? The difficulty in dealing with ARIX is that the degree of its risk is largely unknown partly because the detailed assets contained in the ARIX category are murky and partly because the extent to which ARIX is implicitly guaranteed by the government is unknown. The lack of precise knowledge about risk factors within ARIX and the unknown degree of implicit guarantee make it difficult, if not impossible, to make necessary risk adjustments to capital adequacy related to ARIX. The CBRC recognizes this difficulty and has begun to impose a direct restriction on growth of the total credit by requiring it to be in line with M2 growth targeted by the PBC.

In light of our panel VAR results, such a regulatory change is moving in the right direction to improve the effectiveness of monetary policy on the banking system. In China, the quantity-based monetary policy system works through the bank lending channel to influence the total credit on the asset side of banks' balance sheets. This system was set up long before shadow banking became popular. But the rise of ARIX allowed banks to bypass the LDR and safe-loan regulations by promoting shadow banking activities. Consequently, it marginalized the effectiveness of monetary policy tightening on total bank credit.

Alternative and comprehensive reforms would require simultaneous changes in monetary and regulatory policies: moving the monetary policy system toward using some policy interest rate as the intermediate target of monetary policy, removing the LDR regulation in its entirety, and strengthening the criterion of capital adequacy requirements by appropriately adjusting the risk associated with the detailed assets within the ARIX category. The central government is moving gradually toward these reforms, but their speed and success depend on how the government will address much broader issues such as liberalizing financial markets

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<sup>38</sup>The estimates and error bands have somewhat zigzag paths due to possibly minor seasonal effects. Such effects are not uncommon as shown in Romer and Romer (2004).

and restructuring government-protected industries with excess capacity, a topic that merits thorough and separate research in the future.

## VII. CONCLUSION

As noted in various reports by the Financial Stability Board and by the central government of China, the rapid rise of shadow banking increased the incentive for China's banking sector to bring the shadow banking risk onto its balance sheet.<sup>39</sup> In this paper, we establish empirical evidence that contractionary monetary policy during 2009-2015 caused the rise of both shadow banking lending off balance sheet and risky assets in the form of ARIX in the banking system. Grounded in China's institutional facts, we estimate the tractable monetary policy rule and obtain a time series of monetary policy shocks. This time series, together with the two micro banking datasets we constructed, enables us to perform robust analyses on our findings, especially about the role nonstate banks played in shadow banking activities both off and on the balance sheet.

Our research focuses on the banking sector: how monetary policy affects the asset side of banks' balance sheets. It abstracts from other important issues. One issue is how the bank lending channel is transmitted into the real economy. It is possible that the transmission mechanism for bank loans differs materially from transmission for ARIX holdings. The importance of this topic merits future research.

Another issue relates to policy reforms. In a recent paper, Brunnermeier, Sockin, and Xiong (Forthcoming) provide a discussion on how financing flexibility may erode the effectiveness of the government's well-intended policies. In particular, Brunnermeier, Sockin, and Xiong (Forthcoming) argue that China's liberalized financial system, by loosening financial regulations on the shadow banking system, does not allow its government to experiment with a temporary stimulus such as the post-2008 stimulus program, that can be easily reversed afterwards. Our paper provides strong empirical support for their argument and is consistent with calls for establishing a macroprudential framework to coordinate with monetary policy while financial markets are liberalized. Although our empirical findings are specific to China, we hope that their broad policy implications as well as our empirical methodology for analyzing the banking data will be useful for studies on other economies.

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<sup>39</sup>In 2009, the G20 countries created the Financial Stability Board from their previous financial stability forum to promote the goal of achieving global financial stability.

TABLE 1. Bank loans versus entrusted loans (averages for 2009-2015)

Loan type	Loan maturity	Loan rate
Bank loans	30.91	6.51
Entrusted loans	20.99	7.59

*Note.* Loan maturity is expressed in months and loan rate in percent. Both measures are averages weighted by loan amount. Data sources: CEIC and our constructed entrusted loan dataset.

TABLE 2. Capital adequacy ratios (CAR), excess reserve ratio (ERR), and LDR for state and nonstate banks in 2009-2015 (%)

Description	CAR	ERR	LDR (EOY)	LDR (Average)
State banks	13.07	1.45	68.06	68.69
Nonstate banks	12.16	3.32	73.02	76.68
Overall	12.71	1.90	69.15	70.4
Std. Err.	4.49	0.46	1.48	1.86
P-value	0.85	0.00	0.4	0.27

*Note.* EOY stands for end of year. Average means an average value of the LDRs within each year for each bank. Each ratio for each year is weighted by bank assets and the reported ratio is a simple average across years. The calculation is based on the balance-sheet information of commercial banks reported by Bankscope and WIND. Capital adequacy ratios for all commercial banks are downloaded directly from Bankscope. LDRs and excess reserve ratios are manually collected from listed banks annual reports, which are downloaded from WIND. “Str. Err.” stands for standard error. The standard error for the difference between the ratio for state banks and the ratio for nonstate banks, along with the corresponding p-value (not expressed in percent), is reported in the last two rows of the table.

TABLE 3. Estimated monetary policy

Coefficient	Estimate	SE	p-value
$\gamma_m$	0.391***	0.101	0.000
$\gamma_\pi$	-0.397***	0.121	0.001
$\gamma_{x,a}$	0.183***	0.060	0.002
$\gamma_{x,b}$	-1.299***	0.499	0.009
$\sigma_{m,a}$	0.005***	0.001	0.000
$\sigma_{m,b}$	0.010***	0.002	0.000

*Note.* “SE” stands for standard error. The three-star superscript indicates a 1% significance level.



TABLE 4. Estimated results for panel regressions on total entrusted lending

Main finding: nonstate banks facilitated more entrusted lending during monetary policy tightening while state banks did not. The table presents estimates from the panel regressions in which the dependent variable is the logarithm of total entrusted loan amount. Column (1) uses a total of 583 trustee-quarter observations from 2009Q1 to 2015Q4, including observations of entrusted loans facilitated by nonbank trustees. Columns (2) and (3) report the regression results based on a smaller sample with bank-specific characteristics. The smaller sample has a total of 342 bank-quarter observations from 2009Q1 to 2015Q4. The bank-specific characteristics include LDR, size, capital level, liquidity ratio, return on assets, and non-performance loan ratio. We also include GDP at  $t - 1$  (an annual change of GDP in the previous year) and Inf at  $t - 1$  (an annual change of the GDP deflator in the previous year) as control variables. A constant term is included but its coefficient is not reported. The superscript  $\dagger$  means that the overall impact has no standard error but the double-interaction term between  $g_{t-1}$  and  $\mathcal{J}(\text{NSB}_b)$  is statistically significant at a 1% level. Standard errors are reported in parentheses. The symbols \*\*\*, \*\*, and \* denote statistical significance at 1%, 5%, and 10% levels, respectively.

	(1)	(2)	(3)
Dependent Variable: Log of total entrusted lending	Trustee Sample	Bank Sample	Bank Sample
$g_{t-1} : \alpha_g$	13.12* (7.51)	16.50 (10.14)	253.6*** (85.76)
$g_{t-1}\mathcal{J}(\text{NSB}_b) : \beta_{nsb}$	-23.77*** (7.70)	-30.46*** (9.838)	-55.30*** (13.49)
$g_{t-1}\mathcal{J}(\text{SB}_b) : \beta_{sb}$	4.306 (10.72)		
$g_{t-1} * \text{Liquidity ratio}$			0.51 (0.90)
$g_{t-1} * \text{Return on assets}$			90.47*** (30.22)
$g_{t-1} * \text{Log of total assets}$			-18.87*** (6.35)
$g_{t-1} * \text{Capital}$			-4.17 (2.59)
$g_{t-1} * \text{NPL}$			9.62 (14.77)
$g_{t-1} * \text{LDR}$			-0.37 (0.590)
Observations	583	342	342
Single term controls for bank characteristics	No	No	Yes
GDP, CPI controls	Yes	Yes	Yes
<i>Impacts of money growth via state banks</i>	17.42* (9.29)	16.50 (10.14)	37.33
<i>Impacts of money growth via nonstate banks</i>	-10.65*** (4.39)	-14.00*** (5.73)	-17.97†

TABLE 5. Estimated results for panel regressions on average entrusted lending

Main finding: nonstate banks facilitated more entrusted lending on average (intensive margin) during monetary policy tightening while state banks did not. The table presents estimates from the panel regressions in which the dependent variable is the logarithm of average entrusted loan amount. Column (1) uses a total of 583 trustee-quarter observations from 2009Q1 to 2015Q4, including observations of entrusted loans facilitated by nonbank trustees. Columns (2) and (3) report regression results based on a smaller sample with bank-specific characteristics. The smaller sample has a total of 342 bank-quarter observations from 2009Q1 to 2015Q4. The bank-specific characteristics include LDR, size, capital level, liquidity ratio, return on assets, and non-performance loan ratio. We also include GDP at  $t - 1$  (an annual change in GDP in the previous year) and Inf at  $t - 1$  (an annual change in the GDP deflator in the previous year) as control variables. A constant term is included but its coefficient is not reported. The superscript  $\dagger$  means that the overall impact has no standard error but the double-interaction term between  $g_{t-1}$  and  $\mathcal{J}$  (NSB $_b$ ) is statistically significant. Standard errors are reported in parentheses. The symbols \*\*\*, \*\*, and \* denote statistical significance at 1%, 5%, and 10% levels, respectively.

	(1)	(2)	(3)
Dependent Variable: Log of average entrusted lending	Trustee Sample	Bank Sample	Bank Sample
$g_{t-1} : \alpha_g$	13.24** (6.38)	12.95 (8.41)	175.4** (79.76)
$g_{t-1}\mathcal{J}(\text{NSB}_b) : \beta_{nsb}$	-21.80*** (6.61)	-27.63*** (8.12)	-34.85** (16.10)
$g_{t-1}\mathcal{J}(\text{SB}_b) : \beta_{sb}$	3.36 (9.26)		
$g_{t-1} * \text{Liquidity ratio}$			-0.32 (0.82)
$g_{t-1} * \text{Return on assets}$			87.38*** (27.25)
$g_{t-1} * \text{Log of total assets}$			-12.98** (6.12)
$g_{t-1} * \text{Capital}$			-6.88** (3.10)
$g_{t-1} * \text{NPL}$			12.91 (12.42)
$g_{t-1} * \text{LDR}$			-0.25 (0.53)
Observations	583	342	342
Bank Characteristics single term controls	No	No	Yes
GDP, CPI controls	Yes	Yes	Yes
<i>Impacts of money growth via state banks</i>	16.60** (7.96)	12.95 (8.41)	17.75
<i>Impacts of money growth via nonstate banks</i>	-8.56** (4.18)	-14.68*** (4.09)	-17.09 $\dagger$

TABLE 6. Summary statistics of individual bank characteristics from 2009 to 2015

Attribute/Variable	Obs	Mean	Std. Dev.	Min	Median	Max
LDR	396	69.49	7.11	47.43	71.70	85.16
Size	396	14.86	1.20	11.42	14.84	16.84
Capital	396	6.05	1.25	3.18	5.99	12.34
Liquidity	396	27.01	7.13	12.21	25.44	48.10
ROA	396	1.06	0.19	0.42	1.06	1.58
NPL	396	1.08	0.56	0.38	0.96	4.32

*Note.* All variables except size (log value of total assets) are expressed in percent.

TABLE 7. Estimated results for panel regressions on ARIX

Main finding: nonstate banks invested in more ARIX on their balance sheets during monetary policy tightening while state banks did not. The table presents estimates from the panel regressions in which the dependent variable is ARIX, which includes all shadow banking products on the balance sheet. The sample period is from 2009Q1 to 2015Q4. Column (1) uses a total of 410 bank-quarter observations from 2009Q1 to 2015Q4 without inclusion of bank-specific characteristics. Columns (2)-(4) report regression results based on a smaller sample with bank-specific characteristics. Column (3) reports the regression results with the end-of-year LDR. Column (4) reports the regression results with the daily average LDR. We also include GDP at  $t - 1$  (an annual change in GDP in the previous year) and Inf at  $t - 1$  (an annual change in the GDP deflator in the previous year) as control variables. A constant term is included but its coefficient is not reported. The superscript  $\dagger$  means that the overall impact has no standard error but the double-interaction term between  $g_{t-1}$  and  $\mathcal{J}$  (NSB<sub>*b*</sub>) is statistically significant at a 1% level. Standard errors are reported in parentheses. The symbols \*\*\*, \*\*, and \* denote statistical significance at 1%, 5%, and 10% levels, respectively.

	(1)	(2)	(3)	(4)
Dependent Variable: Log of ARIX	Bank Sample	Bank Sample	Bank Sample	Bank Sample
$g_{t-1} : \alpha_g$	26.56** (12.55)	23.57* (13.01)	245.9 (189.8)	341.1 (215.3)
$g_{t-1}\mathcal{J}$ (NSB <sub><i>b</i></sub> ) : $\beta_{nsb}$	-64.26*** (15.45)	-69.30*** (15.48)	-108.6*** (32.83)	-113.8*** (32.59)
$g_{t-1} * Liquidity\ ratio$			1.006 (1.15)	0.992 (1.35)
$g_{t-1} * Return\ on\ assets$			196.2** (93.56)	190.7** (87.09)
$g_{t-1} * Log\ of\ total\ assets$			-24.26 (16.60)	-27.34 (18.40)
$g_{t-1} * Capital$			-13.29 (12.47)	-14.73 (12.89)
$g_{t-1} * NPL$			-18.74 (24.62)	-29.19 (21.09)
$g_{t-1} * LDR$			0.731 (1.37)	0.448 (1.29)
Observations	410	373	373	373
Bank Characteristics single term controls	No	No	Yes	Yes
GDP, CPI controls	Yes	Yes	Yes	Yes
<i>Impacts of money growth via state banks</i>	26.56** (12.55)	23.57* (13.01)	66.27	70.12
<i>Impacts of money growth via nonstate banks</i>	-37.69*** (9.85)	-45.73*** (8.89)	-42.33 $\dagger$	-43.68 $\dagger$

TABLE 8. Correlation between new entrusted loans ( $\mathcal{L}$ ) channeled by banks and changes in ARIX or the share of ARIX in 2009-2015

Description	State banks	p-value	Nonstate banks	p-value
$\text{Corr}(\Delta\text{ARIX}, \mathcal{L})$	0.224	0.197	0.621***	0.000
$\text{Corr}\left(\frac{\text{ARIX}}{\text{ARIX}+B}, \mathcal{L}\right)$	-0.179	0.304	0.458***	0.001

*Note.* The symbol “B” stands for bank loans.

TABLE 9. ARIX shares in 2009-2015 (%)

Year	State banks				Nonstate banks			
	p30	median	average	p70	p30	median	average	p70
2009	2.82	3.89	3.87	4.79	0.50	1.68	1.59	4.56
2010	1.77	3.35	3.20	4.43	0.65	1.12	1.71	6.78
2011	1.03	3.02	2.84	3.54	0.59	1.13	1.50	2.20
2012	1.78	2.00	2.10	2.27	3.35	9.25	7.14	11.37
2013	1.64	1.86	2.02	2.58	9.84	17.67	14.18	18.70
2014	1.29	1.86	2.35	4.12	17.98	20.80	21.98	25.88
2015	2.18	2.27	2.98	5.31	20.58	22.28	29.03	31.06

*Note.* The average values are the same as in Figure 5. The distribution demarcations p30 and p70 stand for the 30% and 70% percentiles. These percentiles, as recommended by Sims and Zha (1999), contain two thirds of the pointwise probability for the distribution of each group of banks.

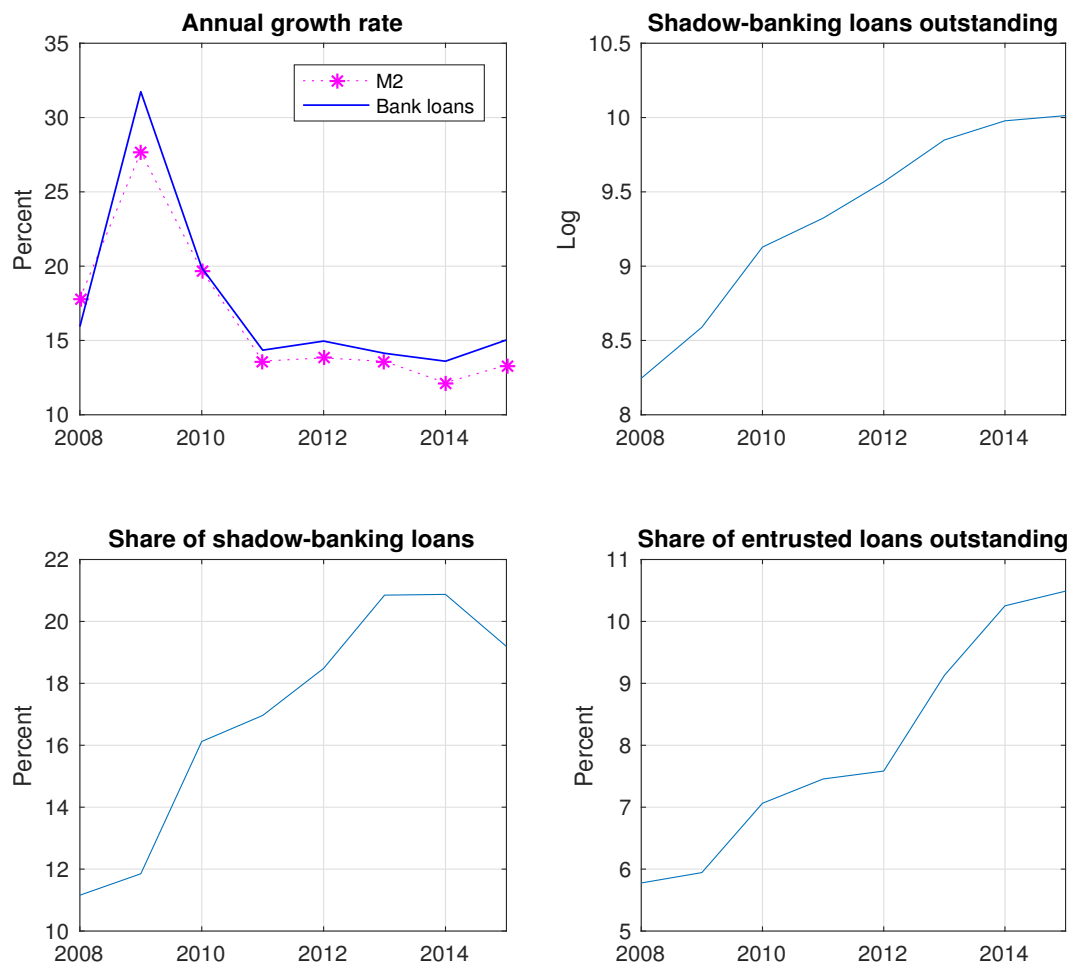


FIGURE 1. Aggregate data. The share of shadow banking loans is the ratio of shadow banking loans to the sum of shadow banking loans and bank loans. The share of entrusted loans is the ratio of entrusted loans to the sum of entrusted loans and bank loans. Entrusted loans are the most important component of shadow banking loans. Data sources: PBC and CEIC (the database provided by China Economic Information Center, now belonging to the Euromoney Institutional Investor Company).

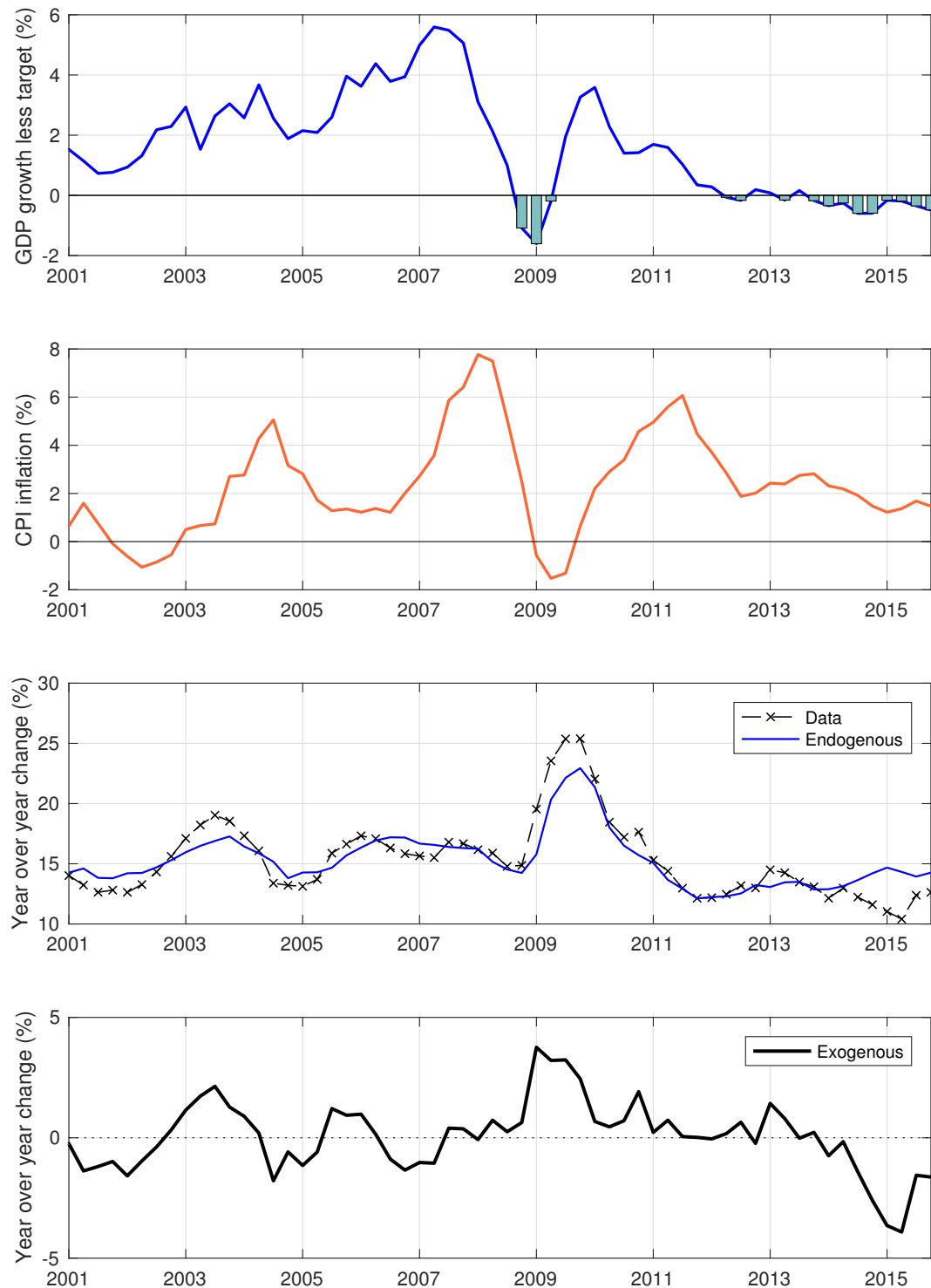


FIGURE 2. Top two panels: year-over-year real GDP growth rate minus the growth target set by the State Council and year-over-year CPI inflation rate. The small bars mark periods in which an actual GDP growth rate is less than the GDP growth target. Bottom two panels: annual M2 growth rates, estimated systematic response of monetary policy, and monetary policy shocks. The gap between the actual M2 growth path and the systematic response path represents the series of monetary policy shocks.

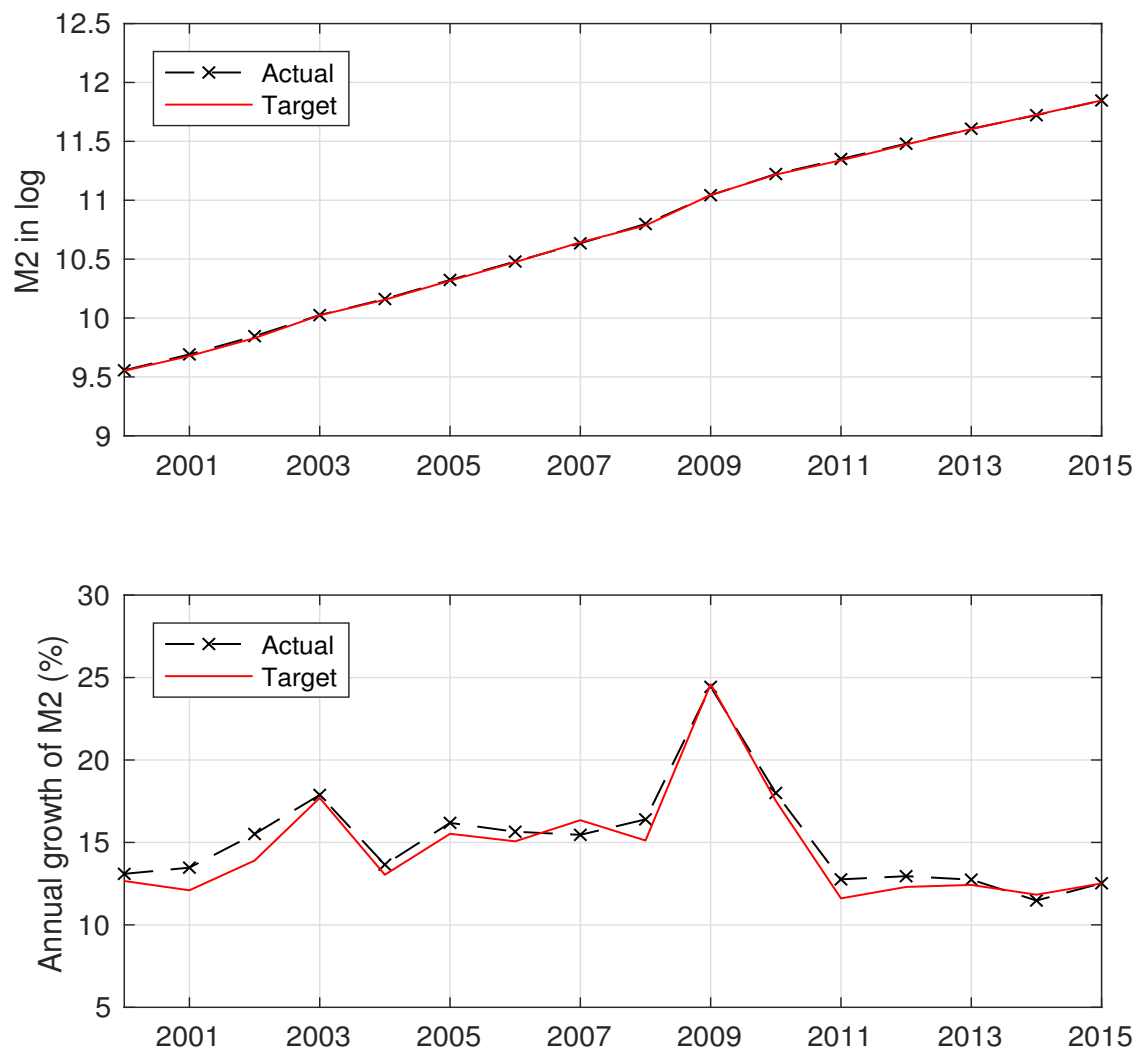


FIGURE 3. Actual and targeted end-of-year M2 series. Data source: various RWG issues published by the State Council and PBC.



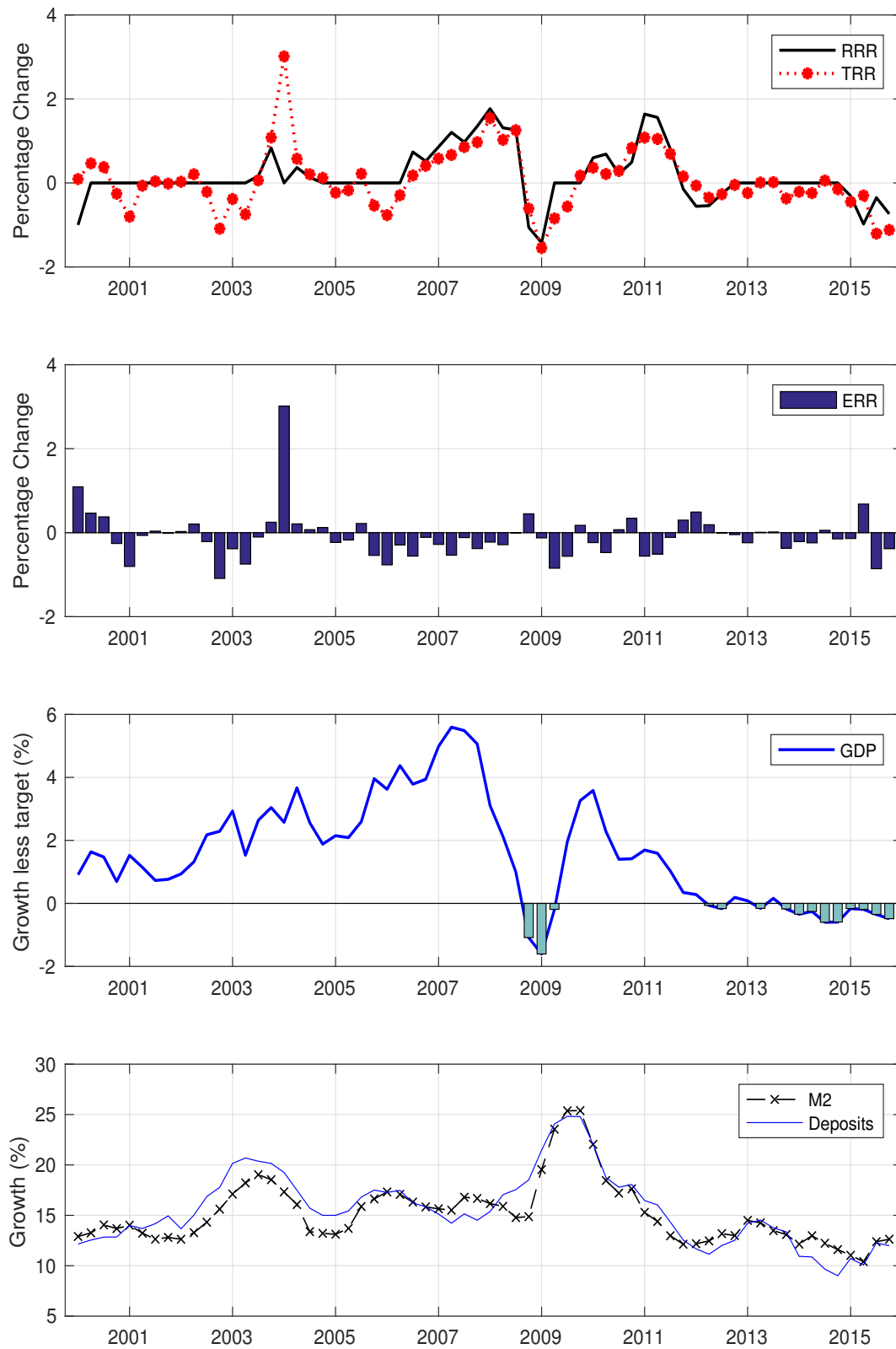


FIGURE 4. Quarterly time series for the reserve requirement ratio (RRR), total reserve ratio (TRR), excess reserve ratio (ERR), real GDP growth (year-over-year) less the target, M2 growth (year-over-year), and growth of bank deposits (year-over-year).

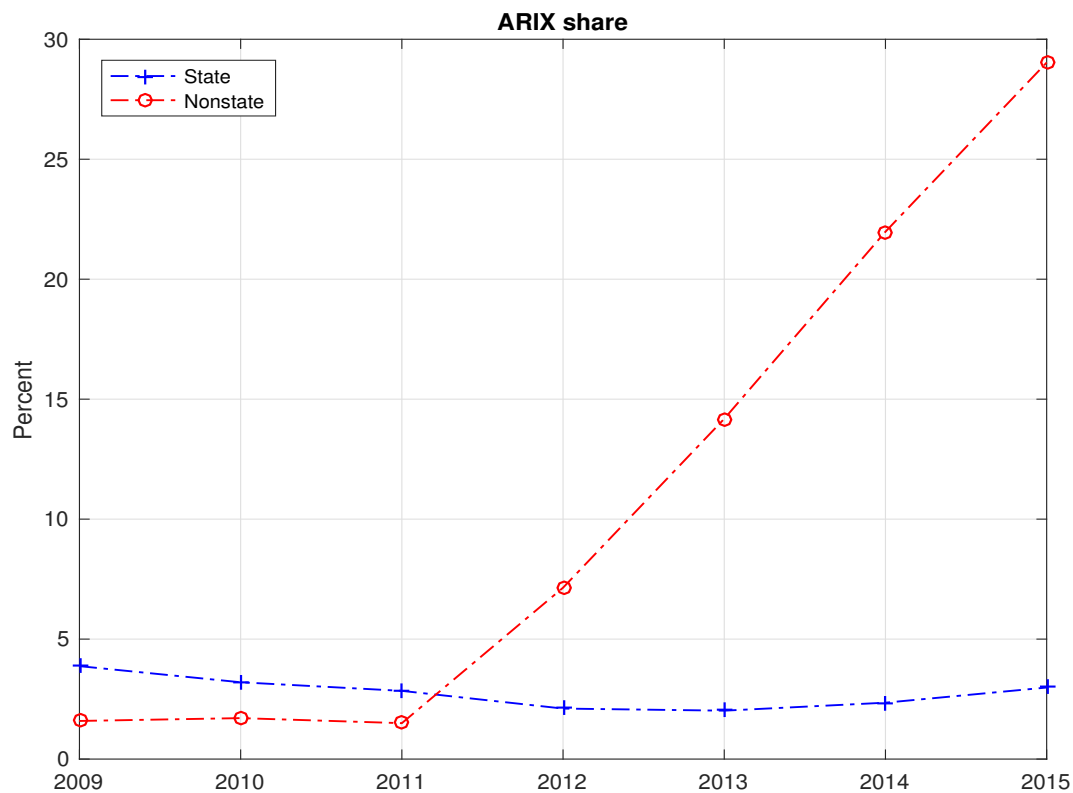


FIGURE 5. Micro data. “ARIX share” is the ratio of ARIX holdings to the sum of ARIX holdings and bank loans on the balance sheets of the 16 publicly listed commercial banks. Based on the bank asset data from these individual banks, the data are categorized into state banks as one group and nonstate banks as another group. ARIX holdings and bank loans are aggregated for each group. Data sources: PBC and WIND.

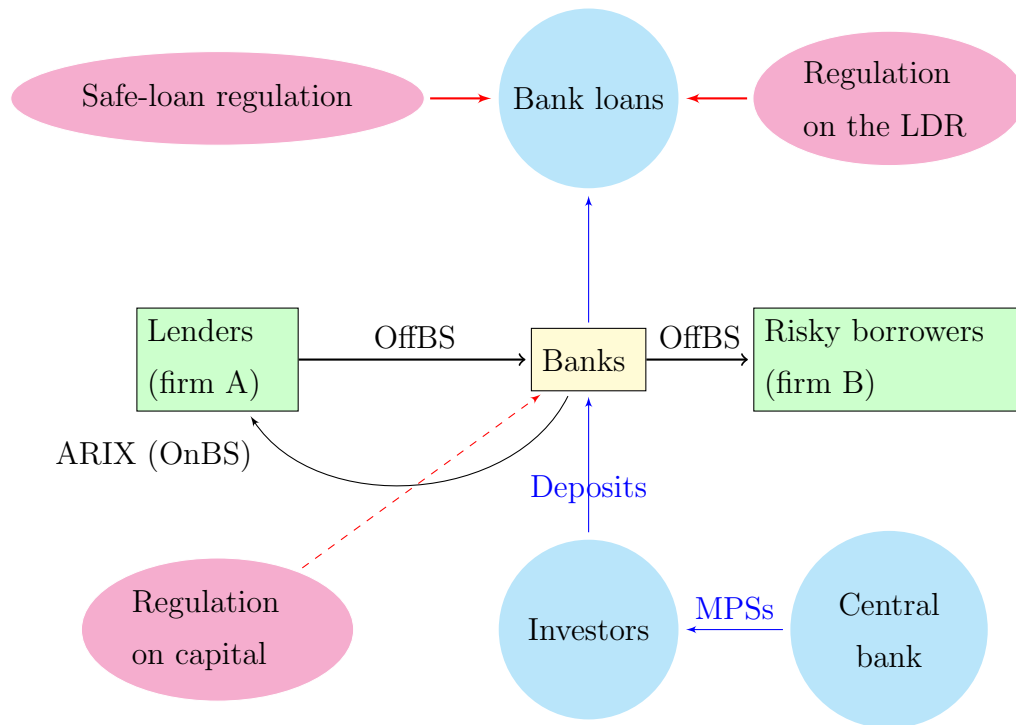


FIGURE 6. An illustration of the nexus between monetary policy, the banking system, and shadow banking. “Banks” refers to nonstate banks. “Safe-loan regulation” refers to a series of 2010-2013 laws that strictly banned commercial banks from expanding bank loans to the risky industry. “OffBS” refers to off balance sheet, “OnBS” on the balance sheet, and “MPSs” monetary policy shocks. The dashed line arrow indicates that the current capital requirement regulation is far from binding.

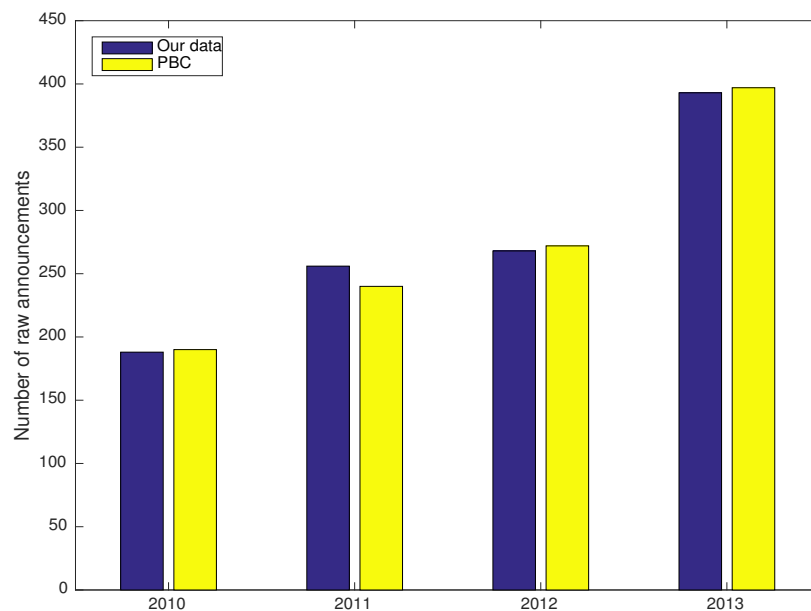


FIGURE 7. Cross-check. The number of raw announcements we collected is plotted against the number published by the PBC's Financial Stability Reports. There were no numbers published by the PBC in years other than 2010-2013. Data source: PBC and WIND.

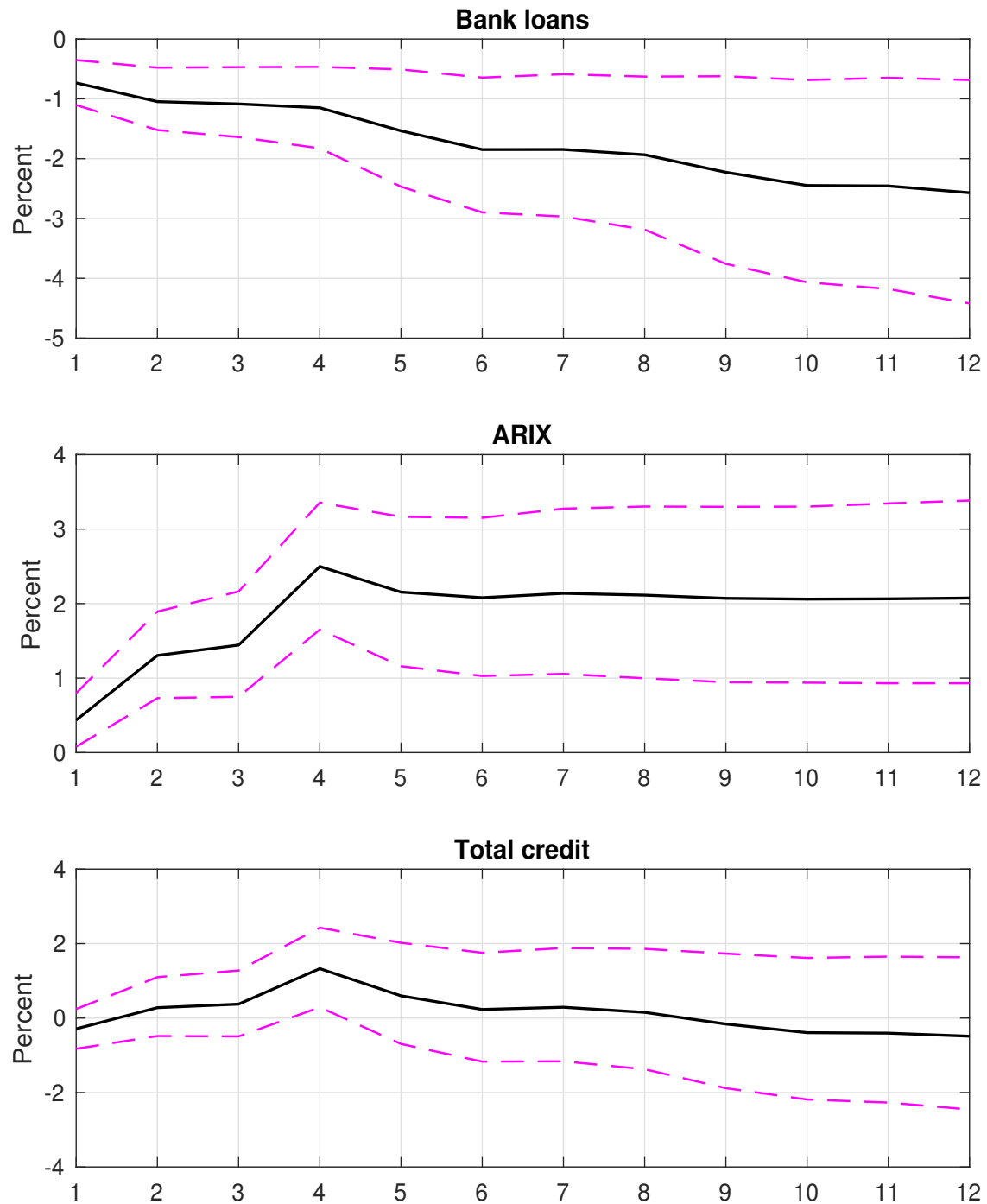


FIGURE 8. Estimated quarterly dynamic responses to a one-standard-deviation fall of exogenous M2 growth. The estimation is based on our constructed banking data. Solid lines are the estimates and dashed lines represent the .68 probability bands as advocated by Sims and Zha (1999).

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In the following appendices, all labels for equations, figures, tables, definitions, and propositions begin with S, standing for *supplement* to the main text.

#### APPENDIX A. CONVENTIONAL MONETARY POLICY RULE SPECIFICATIONS

In this section, we show that mechanically applying various policy rules in the existing literature without taking into account China’s institutional facts leads to weak or misleading results. We start with the conventional money growth rule and end with the standard interest rate rule using various market interest rates in China.

**A.1. Conventional money growth rules.** The existing Taylor-type rules in the dynamic stochastic general equilibrium (DSGE) literature, whether money growth or the interest rate is used as a monetary policy variable, require one to specify potential GDP or output. As discussed in the text (Section III.1), there is no applicable concept of potential GDP for emerging-market economies like China. Nonetheless, if one wishes to estimate conventional monetary policy rules mechanically with the Chinese data, one could obtain the potential GDP labeled as  $\bar{x}_t$  or the corresponding growth rate  $\bar{g}_{x,t}$  using either the HP filtered series with the smoothing parameter set at 1600 for the quarterly series or the fitted log-linear trend. In the spirit of Sargent and Surico (2011), we estimate the following conventional monetary policy rule using “output gap” constructed from one of these detrended series:

$$g_{m,t} = \gamma_0 + \gamma_m g_{m,t-1} + \gamma_\pi (\pi_{t-1} - \pi^*) + \gamma_x (g_{x,t-1} - \bar{g}_{x,t-1}) + \sigma_m \varepsilon_{m,t}. \quad (S1)$$

For comparison, the inflation and output growth variables on the right-hand side are lagged one period to be consistent with the timing specification of practical monetary policy represented by equation (1).

Table S1 reports the regression results. As one can see, the estimated coefficient of “output gap” is statistically insignificant for the HP filtered approach or carries a wrong sign for the log-linear detrending method. The positive sign of output coefficient implies destabilizing monetary policy; that is, when output growth is below the potential, monetary policy contracts instead of expanding to stabilize the macroeconomy. These results confirm our argument that the standard concept of output gap is inappropriate for understanding China monetary policy.<sup>40</sup>

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<sup>40</sup>In a recent paper, Li and Liu (2017) do not use potential output but instead use long-run output growth in their money growth rule. All coefficients in that rule are statistically insignificant, supporting our argument that researchers should not ignore China’s institutional facts when developing China’s monetary policy system.

TABLE S1. Estimation of conventional monetary policy rules for M2 growth

Coefficient	HP filtered			Log-linear detrended			$\bar{g}_{x,t} = g_{x,t}^*$		
	Estimate	SE	p-value	Estimate	SE	p-value	Estimate	SE	p-value
$\gamma_m$	0.607***	0.095	0.000	0.514***	0.096	0.000	0.568***	0.093	0.000
$\gamma_\pi$	-0.551***	0.191	0.005	-0.628***	0.155	0.000	-0.554***	0.159	0.000
$\gamma_x$	0.131	0.142	0.358	0.085***	0.032	0.009	0.094	0.063	0.138

*Note.* “SE” stands for standard error. The three-star superscript indicates a 1% significance level.

We also estimate the conventional monetary policy rule represented by (S1) by setting  $\bar{g}_{x,t} = g_{x,t}^*$ . The estimates are reported in Table S1. As one can see in the table, their magnitude is remarkably similar to that when potential GDP is approximated by either HP filter or log-linear trend. What is common across the three cases (HP filter, log-linear trend, and  $\bar{g}_{x,t} = g_{x,t}^*$ ) is that monetary policy is strongly anti-inflation. But the output coefficient for the  $\bar{g}_{x,t} = g_{x,t}^*$  case has a wrong sign and is statistically insignificant.

**A.2. The interest rate rule.** Another conventional specification for monetary policy is the widely-used empirical Taylor rule for many developed economies as described in Rotemberg and Woodford (1997):

$$R_t = \alpha_0 + \alpha_R R_{t-1} + \alpha_\pi (\pi_t - \pi^*) + \alpha_x (x_t - \bar{x}_t) + \varepsilon_{R,t}, \quad (\text{S2})$$

where  $R_t$  is the (net) nominal interest rate. Table S2 reports the estimated results with various short-term market interest rates, where potential GDP  $\bar{x}_t$  is the HP-filtered series. As one can see, although the persistence parameter  $\alpha_R$  is statistically significant,  $\alpha_\pi$  is statistically insignificant at a 10% level for all four cases while  $\alpha_x$  is statistically significant only at a 10% level for three out of four interest rates. These results imply that monetary policy does not care at all about inflation pressures, contradictory to the MPRs (the central bank’s own reports). Worse than this implication, these results are unstable as they are sensitive to how potential output is computed. When log-linear trend is applied to output as potential GDP and the 7-day Repo rate is used, for example, the output coefficient becomes statistically insignificant at a 49% significance level but the inflation coefficient is now significant at a 1.6% significance level. When lagged output gap and inflation are used as regressors instead of the contemporaneous counterparts,  $\alpha_\pi$  is often statistically significant

TABLE S2. Estimation of the widely-used Taylor rule

Coefficient	1-day Repo			7-day Repo		
	Estimate	SE	p-value	Estimate	SE	p-value
$\alpha_R$	0.706***	0.078	0.000	0.770***	0.063	0.000
$\alpha_\pi$	0.007	0.103	0.948	0.144	0.098	0.144
$\alpha_x$	0.139*	0.078	0.079	0.147*	0.076	0.057
Coefficient	1-day Chibor			7-day Chibor		
	Estimate	SE	p-value	Estimate	SE	p-value
$\alpha_R$	0.707***	0.078	0.000	0.779***	0.063	0.000
$\alpha_\pi$	-0.010	0.101	0.919	0.149	0.096	0.123
$\alpha_x$	0.132*	0.076	0.085	0.117	0.074	0.119

*Note.* “SE” stands for standard error. The one-star superscript indicates a 10% significance level and the three-star superscript a 1% significance level.

at a 1% significance level but  $\alpha_x$  is statistically insignificant even at a 10% significance level, a result similar to the conventional monetary policy rules for M2 growth. Clearly, the results for the interest rate rule vary widely, depending on which interest rate, which potential output, or which variable (lagged or contemporaneous) is used.

Such unstable and contradictory results are unsurprising; they support the argument that Chinese financial markets are yet to be fully developed and that the standard interest rate rule may be incompatible with the central government’s ultimate target of *real GDP growth*. This target is achieved by carefully planning M2 growth to support the central government’s strategy of promoting economic growth by allocating medium and long term bank credit to investment. The standard interest rate rule represented by (S2) does not take into account these key institutional facts.

## APPENDIX B. QUARTERLY TIME SERIES DATA

The methodology of collecting and constructing the quarterly data series used in this paper is based on Higgins and Zha (2015) and Chang, Chen, Waggoner, and Zha (2016). The main data sources are China National Bureau of Statistics, People’s Bank of China, CEIC, Bankscope, and WIND. The X11 method is used for seasonal adjustments. We do not use the X12 software package because there are no independent regressors used

to seasonally adjust our quarterly data.<sup>41</sup> All series bar interest and exchange rates are seasonally adjusted. All interpolated series are based on the method of Fernandez (1981), as described in Higgins and Zha (2015).

- **Aggregate bank loans:** quarterly series of bank loans aggregated from all commercial banks within the banking system.
- **ARI:** quarterly series of account receivable investment (ARI) on the asset side of an individual bank's balance sheet. The series is based on WIND, which collects the ARI series from quarterly reports of 16 publicly listed commercial banks. See Appendix C.2 for details.
- **ARIX:** quarterly series of ARI excluding central bank bills and government bonds. See Appendix C.2 for details.
- **Bank loans:** quarterly series of bank loans for each individual bank. The series is based on WIND, which collects the bank loan information from quarterly reports of 16 publicly listed commercial banks. See Appendix C.2 for details.
- **Chibor rates:** The 1-day and 7-day China interbank offered rates, quarterly average.
- **CPI:** Consumer price index monitored by the central government of China.
- **Deposits:** Deposits in the banking system (RMB billion), quarterly average of monthly deposit series. The monthly series is constructed based on CEIC ticker CKSAB and CEIC ticker CKAAAB.
- **Entrusted loans:** quarterly series of entrusted loans facilitated by an individual trustee, constructed from the transaction-based data from announcements of entrusted loans. See Appendix C.1 for details.
- **ERR:** Excess reserves ratio computed as TRR - RRR.
- **GDP:** Real GDP by value added (billions of 2008 RMB).
- **GDP growth target:** Real GDP growth target set by the central government of China.
- **M2:** M2 supply (RMB billion), quarterly average of monthly M2 series.
- **Repo rate:** The 7-day market rate for national interbank bond repurchases, quarterly average.

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<sup>41</sup>For monthly series, one should use the X12 package by incorporating independent regressors to account for the Chinese New Year effect that may cause problems for data in January and February. The Census Bureau's X13 program removes outliers before seasonal adjustments using TRAMO/SEATS software from the Bank of Spain. For this paper, the quarterly series since 2000 does not appear to have serious outliers.

- **RRR**: Required reserve ratio based on CEIC ticker CMDAAJM “CN: Required Reserve Ratio.” The original CEIC series is available daily; it is converted to a monthly average and then an average of the three months. Daily series starts in September 2003. The values prior to 2003Q4 are constructed as follows. We first average the contemporaneous and end-of-month values of CEIC ticker CMAAAA “CN: Required Reserve Ratio” and then take an average of these monthly values within the quarter.
- **TRR**: Total reserve ratio computed as the ratio of total reserved divided by total deposits.

## APPENDIX C. DETAILS OF THE MICRODATA CONSTRUCTION

This section provides a detailed description of how we constructed the two micro datasets. We first show in detail how we constructed the data on entrusted loans and then describe the construction of balance sheet data of individual commercial banks.

**C.1. Construction of entrusted loan data.** The data on entrusted loans are off banks’ balance sheets. We read all the raw announcements of entrusted lending between nonfinancial firms from 2009 to 2015. One main reason we must read raw announcements line by line is that there were often multiple announcements made by an individual lender for the same transaction. In such cases, we manually combined these raw announcements into one announcement. Some announcements were for repayment of entrusted loans. To avoid double counting, we drop those announcements because the same transaction was recorded in previous announcements. Another reason for reading through raw announcements relates to the nuances of the Chinese language in expressing how the transaction of a particular entrusted loan was conducted. For some announcements, the amount of an entrusted loan was planned but never executed or executed with a different amount in a later announcement. During the loan planning stage, the name of the trustee was often not given in an announcement. If we had not been careful about these announcements, we would have exaggerated the number and the amount of entrusted loans collected. A fourth reason is that we must remove announcements about loans that had already been paid to avoid duplication. The announcements organized this way are the ones we use for the paper and we call them “announcements” rather than “raw announcements” with the understanding that those announcements have been already cleaned up from raw announcements.

Our data construction involves extracting the transaction data, manually, from our cleaned-up announcements of new loans. For each announcement, we recorded the names of the

lender and the borrower. Because the same transaction may be announced by both lender and borrower, two announcements may correspond to only one transaction. In these cases, we manually compared both announcements to ascertain the accuracy of our processed data set.<sup>42</sup> After the comparison, we merged the two announcements for the same transaction into one unique observation. It turns out that there was only one such announcement for the period 2009-2015. Subtracting this double-counted announcement gives us 1379 unique observations. The timing of the observation corresponds to the exact timing of the transaction and does not necessarily correspond to the time when an announcement was made. The transaction data constructed from these unique observations are used for our empirical analysis.

The announcement data we constructed is the most important source for off-balance-sheet activities. These data were also used by the PBC in their financial stability reports and we cross-checked our data with these reports. We read through more than a thousand relevant announcements line by line and cross-checked the data from different sources to decipher the reporting nuances in the Chinese language, eliminate redundant and duplicated observations, and obtain accurate and comprehensive data for entrusted lending facilitated by banks and nonbank trustees. During this construction process that has taken us many years to complete, we identified lending firms, borrowing firms, and, most important of all, trustees that facilitated entrusted lending between nonfinancial firms. Our empirical work shows how and why, among different types of trustees, banks behaved differently from nonbank trustees and how and why, among banks, nonstate banks behaved differently from state banks. Our data sample begins in 2009 and ends in 2015. There are relatively few observations before 2009. China's shadow banking accelerated during the period of monetary tightening after the government's 2008-2009 unprecedented economic stimulus and was heavily regulated from the beginning of 2016 forward.

Table S3 shows the number of unique observations without duplicated announcements. The total number of unique observations must equal the sum of "NLA" and "NBA" minus "NLABA" (the number of duplications). Clearly, the number of announcements made by lenders was considerably greater than the number of announcements made by borrowers, a fact that is consistent with the legal requirement that listed lending firms must reveal all the details of entrusted loan transactions.

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<sup>42</sup>We find that the lender's announcement typically contains more information than the borrower's.

Table S4 shows a breakdown of transactions by different types of trustees and different types of loans. Affiliated loans involve both lending and borrowing firms within the same conglomerate. While most entrusted loans facilitated by nonbank trustees were affiliated ones, a majority of affiliated loans were channeled by banks, a fact that is not well known. As one can see from the table, no matter whether entrusted loans were affiliated, small banks facilitated more transactions than large banks, and large banks facilitated more transactions than nonbank trustees. Thus, banks played a critical role in facilitating both affiliated and non-affiliated entrusted loans.

Nonstate banks accounted for the largest fraction of both loan transactions (number) and loan volume (amount). Table S5 shows that the number of entrusted loan transactions facilitated by nonstate banks took 50% of the total number and the amount of entrusted loans 47% of the total amount in 2009-2015. Thus, nonstate banks played a special role in funneling entrusted loans.

TABLE S3. Number of announcements made by lenders and borrowers

Description	NLA	NBA	NLABA	Total
Number of observations	1152	228	1	1379

*Note.* NLA: number of lenders' announcements; NBA: number of borrowers' announcements; NLABA: number of the same transactions announced by both lenders and borrowers.

TABLE S4. A breakdown of the total number of transactions by types of trustees and types of loans

Description	NBTs	State banks	Nonstate banks	Total
Non-affiliated loans	5	11	255	376
Affiliated loans	304	256	443	1003
Total	309	372	698	1379

*Note.* NBTs: nonbank trustees.

**C.2. Construction of bank asset data.** The bank asset data contain bank loans and ARIX on banks' balance sheets. We constructed the bank asset dataset using banks' quarterly reports downloaded from the WIND database. Each report contains more than 100 pages for us to read through and collect the relevant information. The Bankscope database is also used for obtaining annual balance sheet information such as LDR, capital adequacy

TABLE S5. Proportions (%) of loan transactions and loan volume according to different types of trustees

Description	NBTs	State banks	Nonstate banks	Total
Number of transactions	22.41	26.98	50.62	100
Loan volume	28.73	24.03	47.24	100

*Note.* NBTs: nonbank trustees.

ratio, liquidity ratio, and size for all Chinese commercial banks, including banks other than the 16 large publicly listed banks. Quarterly series of bank-specific attributes are unavailable for most private banks. Our panel regression analyses in Sections V.1 and V.2 include private banks as facilitators of entrusted lending.

As for bank loans and ARI, we downloaded the quarterly reports for each of the 16 commercial banks listed in the Hongkong, Shenzhen, or Shanghai Exchanges from WIND. Chinese commercial banks publish a first quarterly report (Q1), an interim report (Q2), a third quarterly report (Q3), and an annual report (Q4). The ARIX series is equal to ARI subtracting the amount of central bank bills and government bonds. We organize all these data into a quarterly panel dataset from 2009Q1 to 2015Q4.

During the process of constructing our bank asset dataset, we discovered that commercial banks were not required to report the detailed products within ARIX until recently and there was no breakdown of the ARIX series until recent years as the CBRC regulations have been increasingly enforced over time. We find that during 2014-2015, a breakdown of ARIX may include asset management plan, trust plan, wealth management products, and various bonds issued by corporations, financial institutions, and local governments (see Figures S1 and S2 for examples). The name “trust plan” or “asset management plan” can be deceiving because the beneficiary rights of entrusted loans (entrusted rights) were repackaged by trust companies or asset management companies into a trust plan or an asset management plan to be sold to banks and other investors. In other words, investors (e.g., banks) did not buy entrusted rights directly from the firm who was the lender of entrusted loans, but rather they invested in a trust plan or an asset management plan used to transfer entrusted rights. As an example of a trust plan, on July 8, 2010 CICTC trust announced a trust plan to transfer the beneficiary right of an entrusted loan made by Guangzhou Electronic Real Estate Development Co. Ltd to its affiliated company (see Figures S3-S5). As an example of an asset management plan, Zhongrong (Beijing) Asset Management Co. Ltd



issued an announcement describing an asset management plan that was created to transfer entrusted rights between two nonfinancial companies (see Figures S6-S7). We approximate the amount of entrusted rights as the sum of trust plan and asset management plan, which has an average 78.04% (43.64%) share of ARIX for nonstate (state) banks during 2014-2015. The high share for nonstate banks is consistent with the high correlation between entrusted loans off balance sheet and ARIX on the balance sheet documented in Section V.4.

Bonds issued by local governments within ARIX are related to Chen, He, and Liu (2017) as part of shadow banking products showing up on banks' balance sheets. But unfortunately, this portion is not always available on banks' annual reports. Although we suspect that entrusted rights and bonds issued by local governments are important components of ARIX, we do not separate them from ARIX.

#### APPENDIX D. A DYNAMIC EQUILIBRIUM MODEL

In this section, we formalize the intuition outlined in Section VI.1 regarding the impacts of monetary policy shocks on banks' portfolio allocation and total credit by constructing a dynamic model consistent with China's institutional facts. The purpose of this section is to provide a mechanism that shows that contractionary monetary policy causes bank loans to decline as expected (the bank lending channel) but risky nonloan assets to increase (dampening the effectiveness of monetary policy).

We begin with a description of the model and a display of the key equilibrium conditions. We then calibrate the model to the Chinese economy and simulate the impulse responses to be comparable with the point estimates of VAR impulse responses presented in Section VI.2. In the next section (Appendix E), we provide details of how to solve the bank's optimization problem, the precise definition of the competitive equilibrium, a derivation of all the equilibrium solutions, and an algorithm for solving the model numerically.

To maintain tractability, we abstract from a host of factors such as reserve requirements to highlight the bank lending channel. Instead, we focus on the two regulatory constraints (LDR and safe-loan constraints) and regulatory costs associated with deposit shortfalls. Because the model is dynamic, the notation in our model may differ from Section VI.1.

The economy is populated by a continuum of infinitely-lived banks whose identity is denoted by  $j \in [0, 1]$ . Each bank is subject to an idiosyncratic withdrawal shock to its deposits with a fraction  $\omega_t$  of deposits withdrawn. Specifically, the idiosyncratic shock  $\omega_t$  is continuously distributed with the probability density function  $f(\omega_t)$  that is uniformly distributed

with the support of  $[\mu(\varepsilon_{m,t}), 1]$ , where  $\varepsilon_{m,t}$  is an i.i.d. monetary policy shock as in previous empirical sections. As shown in Section VI.1, a contractionary monetary policy shock leads to a fall of aggregate deposits by changing the distribution of idiosyncratic deposit withdrawals. That is,

$$\mu(\varepsilon_{m,t}) \simeq -(2\varepsilon_{m,t} + 1).$$

In the subsequent analysis of an individual bank's problem, we omit the subscript  $j$  as we show that the bank's equity is a sufficient statistic for that bank's individual state. The dynamic aggregation problem is postponed to Appendix E (see in particular equation (S56)). The bank has three types of assets to choose: (i) cash represented by  $C$ , (ii) traditional bank loans,  $B$ , subject to both LDR and safe-loan regulations, and (iii) risky investment assets,  $I^r$ , subject to a default risk but not to the two regulations as  $I^r$  is not regarded as a part of bank loans. Bank loans have a longer maturity than risky investment assets.<sup>43</sup>

Within each period, the banking activity involves two stages as in Bianchi and Bigio (2017): lending and balancing stages.

**D.1. Lending stage.** At the lending stage, the bank decides the amount of deposits to demand, how much of the dividend to distribute, and how to allocate three types of assets for investment: inter-temporal bank loans, within-period risky nonloan assets, and cash. Bank loans,  $B_t$ , are safe (default free) but subject to the regulatory constraint on the LDR, and are purchased at a discount price  $q_t$ . Risky assets,  $I_t^r$ , have a default probability  $p_t^r$  and are purchased at a discount price  $0 < q_t^r < 1$ .

The law of motion for bank loans evolves as

$$B_t = \delta \tilde{B}_t + S_t, \tag{S3}$$

where  $\tilde{B}_t$  represents outstanding bank loans at the beginning of time  $t$ ,  $(1 - \delta)\tilde{B}_t$  represents a fraction of loans that are retired, and  $S_t$  represents new bank loans. Denote cash at the beginning of  $t$  by  $\tilde{C}_t$  such that

$$C_t = \tilde{C}_t + \varphi_t, \tag{S4}$$

where  $\varphi_t$  represents additional cash holdings chosen by the bank.

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<sup>43</sup>This feature is consistent with our empirical finding that entrusted loans had a shorter maturity than bank loans (Table 1).

At the beginning of period  $t$ , the repayment of the bank loan that is retired reduces the bank's liability by  $(1 - \delta)\tilde{B}_t$ . Accordingly, the bank's balance sheet constraint is

$$\tilde{D}_t - (1 - \delta)\tilde{B}_t + \mathcal{E}_t = \tilde{C}_t + q_t\delta\tilde{B}_t, \quad (\text{S5})$$

where  $\tilde{D}_t$  denotes deposits before the bank loan is repaid and  $\mathcal{E}_t$  the bank's equity or capital. Table S6, below, represents the balance sheet in which the left column indicates the asset side and the right column the liability side.

TABLE S6. Balance sheet at the beginning of the period

Asset	Liability
Cash $(\tilde{C}_t)$	Deposits $(\tilde{D}_t - (1 - \delta)\tilde{B}_t)$
Loans $(q_t\delta\tilde{B}_t)$	Equity $(\mathcal{E}_t)$

The bank's balance sheet constraint, after choosing  $C_t$  (or  $\varphi_t$ ),  $I_t^r$ ,  $B_t$  (or  $S_t$ ),  $D_t$ , and dividend  $\text{DIV}_t$ , is

$$D_t/R_t^D + \mathcal{E}_t - \text{DIV}_t = C_t + q_t^r I_t^r + qB_t, \quad (\text{S6})$$

where  $R_t^D$  is the deposit rate. Without loss of generality, we assume  $R_t^D > 1$ . Rearranging the above equation yields the following balance sheet equation

$$\underbrace{D_t/R_t^D}_{\text{deposits}} + \underbrace{\mathcal{E}_t - \text{DIV}_t + (1 - q_t^r)I_t^r + (1 - q_t)B_t}_{\text{equity}} = \underbrace{C_t}_{\text{cash}} + \underbrace{I_t^r + B_t}_{\text{assets}}. \quad (\text{S7})$$

The balance sheet now becomes Table S7.

TABLE S7. Balance sheet after the bank's optimization

Asset	Liability
Cash $(C_t)$	Deposits
Risky assets	$D_t/R_t^D$
$I_t^r$	Equity
Loans	$\mathcal{E}_t - \text{DIV}_t +$
$B_t$	$(1 - q_t^r)I_t^r + (1 - q_t)B_t$

Substituting (S3), (S4), and (S5) into (S7) gives us the flow-of-funds constraint as

$$\underbrace{D/R_t^D - \tilde{D}_t}_{\Delta \text{deposits}} + \underbrace{(1 - q_t^r)I_t^r + (1 - q_t)S_t - \text{DIV}_t}_{\Delta \text{equity}} = \underbrace{\varphi_t + I_t^r + (B_t - \tilde{B}_t)}_{\Delta \text{assets}}. \quad (\text{S8})$$

The leverage ratio constraint is

$$D_t/R_t^D \leq \kappa [\mathcal{E}_t - \text{DIV}_t], \quad (\text{S9})$$

where  $\kappa$  is the leverage ratio and the term in brackets after  $\kappa$  represents the equity net of the dividend payout. The liquidity constraint, as a proxy for a regulation on the sufficiency of the bank's liquid assets, is a lower bound for cash holdings in the model:

$$C_t \geq \psi [\mathcal{E}_t - \text{DIV}_t]. \quad (\text{S10})$$

**D.2. Balancing stage.** In the balancing stage, two random events occur: an idiosyncratic withdrawal shock to deposits and a default shock to risky assets. When the first random event occurs, the volume of bank loans is constrained by the LDR regulation as

$$qB_t \leq \theta \frac{(1 - \omega_t) D_t}{R^D},$$

where  $\theta$  is the LDR ceiling set by the government. The LDR is the key ingredient of both our model and Hachem and Song (2016). Hachem and Song (2016) argue that a tightening in the LDR regulation (isomorphic to a decrease in  $\theta$  in our model) is the key to increasing shadow banking loans, but in our model we focus on monetary policy because evidence shows that a decrease in M2 growth leads to a decrease in deposits. We thus fix the value of  $\theta$  in our model.

Denote

$$x_t = qB_t - \theta \frac{(1 - \omega_t) D_t}{R^D} \quad (\text{S11})$$

and

$$\chi(x_t) = \begin{cases} r^b x_t & \text{if } x_t \geq 0 \\ 0 & \text{if } x_t < 0 \end{cases},$$

where  $r^b > 0$  is an extra cost of acquiring additional deposits  $x$ .

When the default on  $I_t^r$  does not occur (the no-default state), the bank's liability is reduced at the end of the period because of repayment of the principal of risky assets. If  $I_t^r$  is defaulted (the default state), the bank's equity is reduced. We use the stochastic variable  $\varepsilon$  to denote this default contingency:

$$\varepsilon_t = \begin{cases} 1 & \text{with probability } 1 - p^r \text{ (the no-default state)} \\ \phi & \text{with probability } p^r \text{ (the default state)} \end{cases},$$

where  $0 \leq \phi < 1$  represents the recovering rate of risky assets in the default state. The balance-sheet constraint for each bank is

$$\underbrace{D_t/R_t^D - \varepsilon_t I_t^r}_{\text{liabilities}} + \underbrace{\mathcal{E}_t - \text{DIV}_t - (1 - \varepsilon_t) I_t^r + (1 - q_t^r) I_t^r + (1 - q_t) B_t}_{\text{equity}} = \underbrace{C_t + B_t}_{\text{assets}}.$$

At the end of period  $t$  (the beginning of period  $t + 1$ ), the stock variables are balanced as

$$\tilde{D}_{t+1} = D_t(1 - \omega_t) + \chi(x_t) - \varepsilon_t R_{t+1}^D I_t^r, \quad (\text{S12})$$

$$\tilde{C}_{t+1} = C_t - \omega_t D_t, \quad (\text{S13})$$

$$\tilde{B}_{t+1} = B_t. \quad (\text{S14})$$

When there is a liquidity shortfall ( $C_t < \omega_t D_t$ ) due to a deposit withdrawal, the bank can borrow from the central bank to satisfy depositors' withdrawal needs and repay the loan at the beginning of the next period.<sup>44</sup> Accordingly,  $\tilde{C}_{t+1}$  corresponds to the net balance with the central bank. A negative value of  $\tilde{C}_{t+1}$  simply means a net borrowing from the central bank. Note that the balance sheet constraint (S6) makes sure that the bank repays the borrowed amount to the central bank at the beginning of the next period.<sup>45</sup>

**D.3. The bank's recursive optimizing problem.** The bank takes  $\mu(\varepsilon_{m,t})$ , as well as  $r^b, q_t, q_t^r, R_t^D$ , as given when solving its problem. In Appendix E, we show that a combination of the two stages leads to the single-state dynamic-programming problem as

$$V(\mathcal{E}; \varepsilon_m) = \max U(\text{DIV}) + \beta E_{m,\omega,\varepsilon} [V(\mathcal{E}'; \varepsilon'_m) | \varepsilon_m] \quad (\text{S15})$$

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<sup>44</sup>A major task of the PBC is to maintain the stability of liquidity within the banking system to prevent default. For instance, the PBC provides short-term liquidity to the bank in need of liquidity via central bank liquidity loans or the standing lending facility (SLF). The practice of these policy instruments is documented in the PBC's quarterly MPRs.

<sup>45</sup>To highlight the costs associated with a deposit shortfall and its impact on the bank's portfolio choice between bank loans and risky non-loan assets, we assume that the interest rate for the bank to borrow from the central bank is zero.

subject to

$$\mathcal{E} - \text{DIV} = C + q^r I^r + qB - D/R^D, \quad (\text{S16})$$

$$D/R^D \leq \kappa [\mathcal{E} - \text{DIV}], \quad (\text{S17})$$

$$x = qB - \theta \frac{(1 - \omega) D}{R^D}, \quad (\text{S18})$$

$$\mathcal{E}' = C - \omega D + q'\delta B + (1 - \delta)B - [(1 - \omega)D + \chi(x) - \varepsilon R^D I^r], \quad (\text{S19})$$

$$C \geq \psi [\mathcal{E} - \text{DIV}]. \quad (\text{S20})$$

where  $\beta$  is a subjective discount factor,  $\mathcal{E}$  is the single state for this optimization problem,  $E_m$  represents the mathematical expectation with respect to the distribution of monetary policy shocks, and  $E_{\omega, \varepsilon}$  is the mathematical expectation with respect to the  $(\omega, \varepsilon)$  probability measure.

Define the two asset returns and the regulation cost as

$$R^I = \frac{\varepsilon R^D}{q^r}, R^B = \frac{q'\delta + 1 - \delta}{q}, R^x = \chi(w_b - \theta(1 - \omega)w_d), \quad (\text{S21})$$

and the ex-dividend equity return as

$$R^E(\omega, \varepsilon; \varepsilon'_m, \varepsilon_m) = w_c + R^I w_i + R^B w_b - R^D w_d - R^x,$$

where

$$w_c = \frac{c}{1 - \text{div}}, w_i = \frac{q^r i^r}{1 - \text{div}}, w_b = \frac{qb}{1 - \text{div}}, w_d = \frac{d/R^D}{1 - \text{div}},$$

$$[\text{div}, c, b, d, i^r, e'] = \frac{[\text{DIV}, C, B, D, I^r, \mathcal{E}']}{\mathcal{E}}. \quad (\text{S22})$$

Under the assumption

$$R^D < R^B - r^b, \quad (\text{S23})$$

the borrowing cost  $R^D$  is lower than the effective return on bank loans. As a result, the leverage ratio constraint represented by (S9) is binding in equilibrium as shown in Appendix E. The low borrowing cost is a unique Chinese institutional feature that the deposit rate imposed by the government was kept artificially low. Together with the assumption that  $R^D > 1$  (a positive deposit rate), Equation (S23) implies that the liquidity constraint represented by (S20) is also binding in equilibrium. The intuition is simple: with the return for cash lower than the borrowing cost, the bank would like to hold the minimum cash in this economy to satisfy the liquidity constraint.

The solution to the optimality problem (S15) leads to the following no-arbitrage asset pricing equation between bank loans and non-loan risky assets as

$$E_\varepsilon(R^I) - \underbrace{\left[ -\frac{\text{Cov}_\varepsilon(R^I, E_\omega(R^E)^{-\gamma})}{E_\varepsilon[E_\omega(R^E)^{-\gamma}]} \right]}_{\text{default risk premium}} = R^B - \underbrace{E_\omega[R_b^x(w_b, w_d; \omega)]}_{\text{expected regulation cost}} - \underbrace{\frac{\text{Cov}_\omega(R_b^x, E_\varepsilon(R^E)^{-\gamma})}{E_\omega[E_\varepsilon(R^E)^{-\gamma}]} }_{\text{regulation risk premium}}, \quad (\text{S24})$$

where  $R_b^x(w_b, w_d; \omega)$  is the partial derivative of  $R^x(w_b, w_d; \omega)$  with respect to  $B$ :

$$R_b^x(w_b, w_d; \omega) = \frac{\partial R^x(w_b, w_d; \omega)}{\partial w_b} = \begin{cases} r_b & \text{if } \omega > 1 - w_b/(w_d\theta) \\ 0 & \text{otherwise} \end{cases}.$$

In equation (S24), the left side is the expected return on risky nonloan investments, adjusted for the risk premium due to the default risk. The right side is the expected return on bank loans, adjusted for the expected (marginal) regulation cost and regulation risk premium. The risk premium is always positive. The expected regulation cost is the expected marginal cost of recovering deposit shortfalls associated with lending amount  $B$  under the LDR regulation. The non-negativeness of  $R_b^x$  implies that the expected regulation cost is always positive.

The necessary condition for (S24) to hold is

$$E_\varepsilon(R^I) > R^B - E_\omega[R_b^x(w_b, w_d; \omega)] - \frac{\text{Cov}_\omega(R_b^x, E_\varepsilon(R^E)^{-\gamma})}{E_\omega[E_\varepsilon(R^E)^{-\gamma}]}. \quad (\text{S25})$$

Equation (S25) states that the expected return on risky investments is greater than the effective return on bank loans such that the bank has an incentive to invest in risky assets, even if the bank is risk averse. Thus, it is optimal for the bank to increase the share of risky assets in its total investment on the asset side of the balance sheet.

To understand the effects of monetary policy shocks on banks' portfolio choice, note that the expected regulation cost can be expressed as

$$\begin{aligned} E_\omega[R_b^x(w_b, w_d; \omega)] &= r^b \times \underbrace{\text{Prob}(\omega \geq 1 - w_b/(w_d\theta))}_{\text{Probability of deposit shortfalls}} \\ &= r^b \frac{w_b/(w_d\theta)}{1 - \mu(\varepsilon_m)}. \end{aligned}$$

Contractionary monetary policy causes the risk of deposit withdrawal to increase (i.e.,  $\mu(\varepsilon_m)$  increases), which in turn increases the expected regulation cost. This tends to reduce the effective return on bank loans. According to the no-arbitrage condition (S24), the decline of

the effective return on bank loans encourages the bank to substitute risky nonloan assets for bank loans.<sup>46</sup>

**D.4. Calibration.** To obtain quantitative implications of the dynamic model, we calibrate the key model parameters. These parameters are  $\{\beta, \kappa, R^D, \delta, q^r, q, \psi, p^r, \gamma, \mu, r^b, \phi, \theta\}$ . The time period of the model is calibrated to be quarterly.

Following Bianchi and Bigio (2017), we set  $\beta = 0.98$ . We set  $\theta = 0.75$ , which is the PBC's official LDR limit. We set  $\kappa = 7.2$  so that the capital adequacy ratio  $\mathcal{E}/(C + qB + q^r I^r)$  is 12% in steady state as in the data. The quarterly deposit rate  $R^D = 1.0068$  corresponds to an annual interest rate of 2.7%, which is the mean deposit interest rate between 2009 and 2015. We set  $\delta = 0.33$  such that the average maturity of bank loans is 1.5 times that of risky assets to be consistent with the data. We set  $q^r = 0.9882$  such that an annualized return of a risky investment is 7.5%  $\left(\frac{R^D}{q^r} \times 4\right)$ , consistent with the mean return on entrusted lending during the 2009-2015 period (Table 1). We set  $q = 0.9762$  such that an annualized loan rate is 6.5%  $\left(\left(\delta + \frac{1-\delta}{q}\right) \times 4\right)$ , consistent with the average loan rate for the 2009-2015 period (Table 1). The parameter for the lower bound for the liquidity constraint is set at  $\psi = 2.354$  such that the liquidity ratio,  $\frac{C}{C+qB+q^r I^r}$ , is targeted at 27%, which equals the average liquidity ratio for the 2009-2015 period (Table 6).

According to Sheng, Edelmann, Sheng, and Hu (2015), the NPL rate for China's shadow banking is 4% under their optimistic scenario and 10% under their benchmark scenario. Therefore, we take the median and set the probability of default for risky investments at  $p^r = 0.07$ , which is much higher than the average NPL rate for bank loans reported in Table 6. Such a low NPL rate for bank loans is consistent with the assumption that bank loans are safe.

Without loss of generality, we set the risk aversion parameter at  $\gamma = 2$ . The steady state value of  $\mu$  is set to be  $-1$  for  $\varepsilon_m = 0$  (no monetary policy shock in the steady state). The cost of meeting deposit shortfalls is set at  $r^b = 1.75\%$  according to the recent WIND data. The recovery rate of risky assets is set at  $\phi = 0.85$ . This high rate reflects the reality in China that banks benefit from the government's implicit guarantees on their deposits as well as on risky investments.<sup>47</sup>

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<sup>46</sup>The effect of a monetary policy shock on the covariance terms in (S24) is of second order in magnitude when compared with its effect on the expected regulation cost.

<sup>47</sup>See Dang, Wang, and Yao (2015) for a formal model of implicit guarantees of China's shadow banking.



**D.5. Impulse responses.** We use the calibrated model and simulate the dynamics of bank loans and risky nonloan assets in response to contractionary shocks to monetary policy. The simulation is based on the aggregate (average) bank loans and risky assets to be comparable with the VAR results (the aggregation problem is discussed in Appendix E).

The impulse responses of aggregate bank loans and risky assets are computed as the sum of the impulse responses for state and nonstate banks. To obtain the impulse responses of state banks, we simulate a counterfactual economy in which the response of  $I_t^r$  to contractionary monetary policy (a one-standard-deviation fall of  $\varepsilon_{m,t}$ ) is restricted to be zero, while all parameter values are the same as in our benchmark economy. This setup stems from the institutional fact that state banks are part of the government and hence have no incentive to exploit shadow banking activities for regulatory arbitrage.

The initial state at  $t = 0$  is in the steady state. A negative shock to monetary policy,  $\varepsilon_{m,t} < 0$ , occurs at  $t = 1$ .<sup>48</sup> In response to a one-standard-deviation shock, we simulate the dynamic paths of new bank loans  $S_t$  and risky investments  $I_t^r$  for  $t \geq 1$  with the initial response of  $I_t^r$  set at 0.5%, the same value as the estimated one for the empirical panel VAR model studied in Section VI.2.

Figure S8 displays the cumulative impulse responses of  $I_t^r$  and  $S_t$ . Risky assets increase and reach 1.9% at the tenth quarter. Note that the response of aggregate risky assets to contractionary monetary policy shocks is equal to the response of nonstate banks. By contrast, bank loans of both state and nonstate banks decline in response to contractionary monetary policy shocks via the bank lending channel. The economic intuition behind the opposite effects of contractionary monetary policy on risky assets and bank loans comes directly from the asset pricing equation governing the tradeoff between bank loans and risky investment assets (equation (S24)). When  $\varepsilon_{m,t}$  falls, the probability of deposit shortfalls increases. This leads to a rise of the expected regulation cost. As a result, the return on risky assets relative to the return on bank loans increases, making it optimal for the bank to rebalance its portfolio by increasing risky assets in total assets.

The bottom panel of Figure S8 shows that the response of total credit for the whole banking system is slightly above zero for most periods, indicating that the decline of aggregate bank loans is offset by the increase of aggregate risky assets. In Appendix E, we show that a sufficient condition for a contractionary monetary policy shock to increase the total credit is  $\gamma > 1$ , under which dividend payout (ex-dividend equity) falls (increases) when there is

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<sup>48</sup>Without loss of generality, we assume that the path of money growth after  $t = 1$  is perfectly foresighted.

monetary policy tightening. This can be seen from Equation (S6) in which the left side term increases when  $DIV_t$  falls. This increase of total liability on the bank's balance sheet, together with the decline in bank loans in response to monetary policy tightening, implies that  $q_t^r I_t^r$  must increase more than the drop in bank loans, implying an increase in total credit.

Intuitively, when the income effect of a reduction in the expected return on equity ( $E_{\omega,\varepsilon} R^E$ ) due to an increase in the expected regulation cost dominates the corresponding substitution effect (the substitution between today's and tomorrow's dividend payoffs), it is optimal for the bank to expand total credit via risky assets to compensate for extra costs of recouping deposit losses. Note that in our theoretical model, the expected net return for leverage adjusted for the risk premium is always greater than  $R^D$ . Hence, when the risk of deposit withdrawals increases due to monetary policy tightening, it is profitable for banks to borrow as much as possible at the lending stage until the credit constraint binds. The resource from deposits, together with ex-dividend equity, is used to purchase risky nonloan assets to compensate for the costs associated with actual deposit shortfalls in the balancing stage.

## APPENDIX E. DERIVATION OF SOLUTIONS TO THE DYNAMIC MODEL

In this section, we derive the solutions to the dynamic model described in Appendix D. We start with establishing important features of the model, which makes it tractable to solve an individual bank's optimization problem. We then define the competitive equilibrium and characterize the equilibrium solutions on banks' portfolio and dividend choices. Finally, we describe the algorithm to solve the model numerically.

**E.1. Features of the bank's optimization problem.** We show that the original bank's optimization problem can be simplified into the single state-space representation. Moreover, it satisfies two nice properties: homogeneity in bank equity and separability of portfolio choice from dividend choice.

The bank's original optimization problem is complex. To avoid notational glut and make our theory transparent, we omit the time subscript whenever no confusion arises. The optimizing behavior at the lending stage can thus be described as

$$V^l(\tilde{C}, \tilde{B}, \tilde{D}; \varepsilon_m) = \max U(DIV) + E_{\omega,\varepsilon} [V^b(C, B, D; \varepsilon_m)],$$

where  $V^l$  is the value function at the lending stage,  $V^b$  is the value function at the balancing stage, and  $E_{\omega,\varepsilon}$  is the mathematical expectation with respect to the  $(\omega, \varepsilon)$  measure. The bank

takes  $\{\varepsilon_m, \mu, r^b, q, q^r, R^D\}$  as given when solving its problem. By choosing  $(\text{DIV}, \varphi, S, I^r)$ , the bank solves the above problem subject to

$$D/R^D = \tilde{D} - (1 - \delta)\tilde{B} + \text{DIV} + \varphi + q^r I^r + qS, \quad (\text{S26})$$

$$C = \tilde{C} + \varphi, \quad (\text{S27})$$

$$B = \delta\tilde{B} + S, \quad (\text{S28})$$

$$D/R^D \leq \kappa [C + q^r I^r + qB - D/R^D], \quad (\text{S29})$$

$$C \geq \psi [C + q^r I^r + qB - D/R^D], \quad (\text{S30})$$

where constraint (S26) corresponds to (S8), and constraint (S29), derived from (S7) and (S17), represents the credit constraint on the bank's optimization problem.

The balancing stage behavior can be described as

$$V^b(C, B, D; \varepsilon_m) = \beta E_m [V^l(\tilde{C}', \tilde{B}', \tilde{D}'; \varepsilon'_m) \mid \varepsilon_m]$$

subject to

$$\tilde{D}' = (1 - \omega)D + \chi(x) - \varepsilon R^D I^r, \quad (\text{S31})$$

$$\tilde{C}' = C - \omega D, \quad (\text{S32})$$

$$\tilde{B}' = B, \quad (\text{S33})$$

$$x = qB - \theta(1 - \omega)D/R^D, \quad (\text{S34})$$

where  $\beta$  is a subjective discount factor and  $E_m$  represents the mathematical expectation with respect to monetary policy shocks. Constraints (S31), (S32), and (S33) correspond to (S12), (S13), and (S14), respectively, and constraint (S34) corresponds to (S11).

Combining the two stages, we describe the overall optimization problem as

$$\begin{aligned} V^l(\tilde{C}, \tilde{B}, \tilde{D}; \varepsilon_m) = \max U(\text{DIV}) \\ + \beta E_{m, \omega, \varepsilon} [V^l(C - \omega D, B, (1 - \omega)D + \chi(x) - \varepsilon R^D I^r; \varepsilon'_m) \mid \varepsilon_m] \end{aligned} \quad (\text{S35})$$

subject to (S26), (S27), (S28), (S29), and (S30). The choice variables for this optimization are  $(\text{DIV}, \varphi, S, I^r)$ . Given  $\mathcal{E} = \tilde{C} + q\delta\tilde{B} - (\tilde{D} - (1 - \delta)\tilde{B})$ , we have the following proposition:

*Proposition S1.* The optimization problem (S35) can be simplified and collapsed into the single-state representation

$$V(\mathcal{E}; \varepsilon_m) = \max U(\text{DIV}) + \beta E_{m, \omega, \varepsilon} [V(\mathcal{E}'; \varepsilon'_m) \mid \varepsilon_m] \quad (\text{S36})$$

subject to (S29), (S34), and

$$\mathcal{E} - \text{DIV} = C + q^r I^r + qB - D/R^D, \quad (\text{S37})$$

$$\mathcal{E}' = C - \omega D + q'\delta B + (1 - \delta)B - [(1 - \omega)D + \chi(x) - \varepsilon R^D I^r], \quad (\text{S38})$$

where the single state is  $\mathcal{E}$ , (S37) corresponds to (S6), (S38) is derived from (S5), (S12), (S13), and (S14) (by moving time  $t$  in (S5) forward to time  $t + 1$ ), and the choice variables are  $(\text{DIV}, C, B, D, I^r)$ .

*Proof.* The proof for Proposition S1 follows from the fact that  $\mathcal{E}$  is a sufficient statistic for the bank's problem. In other words, once  $\mathcal{E}$  is determined, the bank's optimal decision does not depend on the sources from which the equity  $\mathcal{E}$  is accumulated.  $\square$

Since constraints (S29), (S37), and (S38) are linear in  $\mathcal{E}$  and the objective function is homothetic in  $\mathcal{E}$ , the solution to the bank's problem not only exists but also is unique and the policy function is linear in equity  $\mathcal{E}$ . Moreover, thanks to the Principle of Optimality, the bank's dynamic problem can be separated into two subproblems, one concerning an intertemporal choice of dividend payoffs and the other relating to an intratemporal portfolio allocation. The following proposition formalizes these two results.<sup>49</sup>

*Proposition S2.* Let

$$U(\text{DIV}) = \frac{\text{DIV}^{1-\gamma}}{1-\gamma},$$

where  $\gamma \geq 1$ . Optimization problem (S36) satisfies the two properties: homogeneity in  $\mathcal{E}$  and separability of portfolio choice from dividend choice.

• **Homogeneity.** The value function  $V(\mathcal{E}; z)$  is

$$V(\mathcal{E}; z) = v(z)\mathcal{E}^{1-\gamma},$$

and  $v(z)$  satisfies the Bellman equation over the choice variables  $\{\text{div}, \tilde{c}, \tilde{i}^r, \tilde{b}, \tilde{d}\}$

$$v(z) = \max U(\text{div}) + \beta E_{m,\omega,\varepsilon} \left[ v(z') (e'(\omega, \varepsilon; \varepsilon'_m, \varepsilon_m))^{1-\gamma} \mid z \right] \quad (\text{S39})$$

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<sup>49</sup>The homogeneity and separability properties in Proposition S2 are similar to Bianchi and Bigio (2017).

subject to

$$d/R^D \leq \kappa [c + q^r i^r + qb - d/R^D], \quad (\text{S40})$$

$$1 = c + \text{div} + q^r i^r + qb - d/R^D, \quad (\text{S41})$$

$$e' = c + (q'\delta + 1 - \delta)b - d - \chi (qb - \theta(1 - \omega)d/R^D) + \varepsilon R^D i^r, \quad (\text{S42})$$

$$c \geq \psi [c + q^r i^r + qb - d/R^D], \quad (\text{S43})$$

where

$$[\text{div}, c, b, d, i^r, e'] = \frac{[\text{DIV}, C, B, D, I^r, \mathcal{E}']}{\mathcal{E}}. \quad (\text{S44})$$

- **Separability.** Problem (S39) can be broken into two separate problems. The first problem is for banks to make an optimal portfolio choice by choosing  $\{w_c, w_i, w_b, w_d\}$  to maximize the certainty-equivalent portfolio value as

$$\Omega(\varepsilon'_m, \varepsilon_m) = \max\{E_{\omega, \varepsilon} [w_c + R^I w_i + R^B w_b - R^D w_d - R^x]^{1-\gamma}\}^{\frac{1}{1-\gamma}} \quad (\text{S45})$$

subject to

$$1 = w_c + w_i + w_b - w_d, \quad (\text{S46})$$

$$w_d \leq \kappa(w_c + w_i + w_b - w_d), \quad (\text{S47})$$

$$w_c \geq \psi(w_c + w_i + w_b - w_d), \quad (\text{S48})$$

and taking the following prices as given

$$R^I = \frac{\varepsilon R^D}{q^r}, R^B = \frac{q'\delta + 1 - \delta}{q}, R^x = \chi(w_b - \theta(1 - \omega)w_d), \quad (\text{S49})$$

where

$$w_c = \frac{c}{1 - \text{div}}, w_i = \frac{q^r i^r}{1 - \text{div}}, w_b = \frac{qb}{1 - \text{div}}, w_d = \frac{d/R^D}{1 - \text{div}}.$$

The second problem is to choose  $\text{div}$  in response to aggregate shocks:

$$v(\varepsilon_m) = \max_{\text{div}} U(\text{div}) + \beta(1 - \text{div})^{1-\gamma} E_m [\Omega(\varepsilon'_m, \varepsilon_m)^{1-\gamma} v(\varepsilon'_m) \mid z]. \quad (\text{S50})$$

*Proof.* We begin with the proof of *homogeneity*. We use the conjecture-verify approach to this complicated problem. We conjecture that the form of the value function is

$$V(\mathcal{E}; \varepsilon_m) = v(\varepsilon_m) \mathcal{E}^{1-\gamma}.$$

Because

$$\mathcal{E}' = e'(\omega, \varepsilon; \varepsilon'_m, \varepsilon_m) \mathcal{E},$$

the optimization problem (S36) can be rewritten as

$$\begin{aligned} V(\mathcal{E}; \varepsilon_m) &= \max U(\text{div } \mathcal{E}) + \beta E_{m, \omega, \varepsilon} \left[ v(z') (e'(\omega, \varepsilon; \varepsilon'_m, \varepsilon_m) \mathcal{E})^{1-\gamma} \middle| \varepsilon_m \right] \\ &= \mathcal{E}^{1-\gamma} \left\{ \max U(\text{div}) + \beta E_{M, \omega, \varepsilon} \left[ v(\varepsilon'_m) (e'(\omega, \varepsilon; \varepsilon'_m, \varepsilon_m))^{1-\gamma} \middle| \varepsilon_m \right] \right\} \end{aligned}$$

subject to (S40), (S41), and (S42). Let  $\tilde{v}(\varepsilon_m)$  be the solution of

$$\tilde{v}(\varepsilon_m) = \max U(\text{div}) + \beta E_{m, \omega, \varepsilon} \left[ \tilde{v}(\varepsilon'_m) (e'(\omega, \varepsilon; \varepsilon'_m, \varepsilon_m))^{1-\gamma} \middle| \varepsilon_m \right] \quad (\text{S51})$$

subject to (S40), (S41), and (S42). Hence,  $v(\varepsilon_m) = \tilde{v}(\varepsilon_m)$ , which verifies the conjecture of our Bellman equation

$$V(\mathcal{E}; z) = v(z) \mathcal{E}^{1-\gamma}.$$

We turn to the proof of *separability*. From (S54) we have

$$(e'(\omega, \varepsilon; \varepsilon'_m, \varepsilon_m))^{1-\gamma} = (1 - \text{div})^{1-\gamma} (R^E(\omega, \varepsilon; \varepsilon'_m, \varepsilon_m))^{1-\gamma}$$

so that

$$E_{\omega, \varepsilon} \left[ (e'(\omega, \varepsilon; \varepsilon'_m, \varepsilon_m))^{1-\gamma} \right] = (1 - \text{div})^{1-\gamma} E_{\omega, \varepsilon} \left[ (R^E(\omega, \varepsilon; \varepsilon'_m, \varepsilon_m))^{1-\gamma} \right]. \quad (\text{S52})$$

Since the utility is a power function, the certainty equivalence of  $E_{\omega, \varepsilon} \left[ (R^E(\omega, \varepsilon; \varepsilon'_m, \varepsilon_m))^{1-\gamma} \right]$ , denoted as  $\Omega(\varepsilon'_m, \varepsilon_m)$ , follows as

$$\begin{aligned} \Omega(\varepsilon'_m, \varepsilon_m) &= \max_{\{w_c, w_i, w_b, w_d\}} \left\{ E_{\omega, \varepsilon} \left[ (R^E(\omega, \varepsilon; \varepsilon'_m, \varepsilon_m))^{1-\gamma} \right] \right\}^{\frac{1}{1-\gamma}} \\ &= \max_{\{w_c, w_i, w_b, w_d\}} \left\{ E_{\omega, \varepsilon} \left[ (w_c + R^I w_i + R^B w_b - R^D w_d - R^x)^{1-\gamma} \right] \right\}^{\frac{1}{1-\gamma}} \end{aligned} \quad (\text{S53})$$

subject to (S46), (S47), and (S48). Substituting (S52) into (S51) and using the definition of  $\Omega(\varepsilon'_m, \varepsilon_m)$  in (S53), we obtain (S50).  $\square$

Note that equations (S40), (S41), and (S42) are derived from equations (S29), (S37), and (S38) and that equation (S42) implies  $e'$  is a function of  $\omega, \varepsilon, \varepsilon'_m$ , and  $\varepsilon_m$  such that

$$e'(\omega, \varepsilon; \varepsilon'_m, \varepsilon_m) = (1 - \text{div}) R^E(\omega, \varepsilon; \varepsilon'_m, \varepsilon_m), \quad (\text{S54})$$

where  $R^E$  is the return on the bank's equity after dividend payout

$$R^E(\omega, \varepsilon; \varepsilon'_m, \varepsilon_m) = w_c + R^I w_i + R^B w_b - R^D w_d - \chi(w_b - \theta(1 - \omega)w_d). \quad (\text{S55})$$

Proposition S2 breaks the potentially unmanageable problem into two tractable problems by separating dividend decision about DIV in response to monetary policy shocks from portfolio choice of  $\varphi, S, I^r$ , and  $D$  in response to idiosyncratic risks.

Thanks to the homogeneity feature, banks during the lending stage are replicas of one another scaled by equity, making aggregation a straightforward exercise. In other words, the equilibrium sequence of the aggregate variables  $\{\text{DIV}_t, C_t, B_t, D_t, I_t^r, \mathcal{E}_t\}_{t=0}^\infty$  is the same as its counterpart in an otherwise identical representative bank environment in which the representative bank faces a deposit withdrawal shock  $\mu(\varepsilon_m)$  in each period. This allows us to simplify the problem by solving the competitive equilibrium of the representative bank's problem numerically.

**E.2. Equilibrium.** Define  $\bar{\mathcal{E}} = \int_0^1 \mathcal{E}(j) dj$  as the aggregate of equity in the banking sector. The equity of an individual bank evolves according to  $\mathcal{E}'(j) = e'(\omega, \varepsilon; \varepsilon'_m, \varepsilon_m) \mathcal{E}(j)$ . The measure of equity holdings of each bank is denoted by  $\Gamma(\mathcal{E})$ . Since the model is invariant to scale, we only need to keep track of the evolution of the average equity, which grows at the rate  $E_{\omega, \varepsilon}[e'(\omega, \varepsilon; \varepsilon'_m, \varepsilon_m)]$  because

$$\begin{aligned} \bar{\mathcal{E}}' &= \int_0^1 \mathcal{E}'(j) dj = \int_0^1 \mathcal{E}(j) dj \int_{\varepsilon, \omega} e'(\omega, \varepsilon; \varepsilon'_m, \varepsilon_m) f(\omega, \varepsilon) d(\omega, \varepsilon) \\ &= \bar{\mathcal{E}} \times E_{\omega, \varepsilon}[e'(\omega, \varepsilon; \varepsilon'_m, \varepsilon_m)]. \end{aligned} \quad (\text{S56})$$

We define the (partial) equilibrium for the banking sector as follows.

*Definition S1.* Given  $M_0, D_0, B_0$ , a competitive equilibrium is a sequence of bank policy rules  $\{c_t, d_t, b_t, i_t^r, \text{div}_t\}_{t=0}^\infty$ , bank value  $\{v_t\}_{t=0}^\infty$ , government policies  $\{\mu(\varepsilon_{m,t})\}_{t=0}^\infty$ , and the measure of equity distribution  $\{\Gamma_t\}_{t=0}^\infty$  such that

- (1) Given policy sequences  $\{\mu(\varepsilon_{m,t})\}_{t=0}^\infty$ , the policy functions  $\{c_t, d_t, b_t, i_t^r, \text{div}_t\}_{t=0}^\infty$  are a solution to problem (S45). Moreover,  $v_t$  is the value for problem (S50).
- (2)  $\Gamma_t$  evolves consistently with  $e'(\omega, \varepsilon; \varepsilon'_m, \varepsilon_m)$ .
- (3) All policy functions satisfy  $[\text{div}, c, b, d, i^r, e'] = \frac{[\text{DIV}, C, B, D, I^r, \mathcal{E}']}{\mathcal{E}}$ .

**E.3. Characterizing the optimal portfolio allocation.** The separability feature of the bank's optimal problem allows us to solve the bank's optimal portfolio choice separately from its dividend choice. In this section, we characterize the optimal choice of cash holdings, deposits, and a portfolio allocation between bank loans and risky assets. The next section characterizes the dividend choice and how it responds to monetary policy shocks. We establish the following lemma:

*Lemma S1.* With the low deposit rate satisfying (S23), the bank's optimal portfolio choice  $\{w_c, w_i, w_b, w_d\}$  satisfies

- (1) Both the liquidity constraint (S48) and the credit constraint (S47) are always binding;
- (2) The equilibrium portfolio allocation between  $w_b$  and  $w_d$  is governed by the following no-arbitrage condition

$$R^B - \underbrace{E_\omega [R_L^x(L, 1; \omega)]}_{\text{expected liquidity cost}} - \underbrace{\frac{\text{Cov}_\omega (R_L^x, E_\varepsilon(R^E)^{-\gamma})}{E_\omega [E_\varepsilon(R^E)^{-\gamma}]}_{\text{regulation risk premium}} = E_\varepsilon(R^I) - \underbrace{\left[ -\frac{\text{Cov}_\varepsilon (R^I, E_\omega(R^E)^{-\gamma})}{E_\varepsilon [E_\omega(R^E)^{-\gamma}]} \right]}_{\text{default risk premium}},$$

where  $L \equiv w_b/w_d$ .

*Proof.* We first prove that the liquidity constraint (S48) is always binding. Substituting (S46) into (S45), (S47) and (S48) transforms the optimization problem (S45) to

$$\max_{\{w_c, w_i, w_d\}} \left\{ E_{\omega, \varepsilon} [(-(R^B - 1)w_c + (R^I - R^B)w_i - (R^B - R^D)w_d - R^x(w_b, w_d; \omega))]^{1-\gamma} \right\}^{\frac{1}{1-\gamma}} \quad (\text{S57})$$

subject to  $w_d \leq \kappa$  (with the Lagrangian multiplier  $\phi_d$ ) and  $w_c \geq \psi$  (with the Lagrangian multiplier  $\phi_c$ ). The first order condition with respect to  $w_c$  gives

$$\tilde{\phi}_c = R^B - E_\omega(R_b^x) - \frac{\text{Cov}_\omega (R_b^x, E_\varepsilon(R^E)^{-\gamma})}{E_\omega [E_\varepsilon(R^E)^{-\gamma}]} - 1. \quad (\text{S58})$$

where

$$\tilde{\phi}_c \equiv \frac{\phi_c}{E_{\omega, \varepsilon} [(R^E)^{-\gamma}]^{\frac{\gamma}{1-\gamma}} E_{\omega, \varepsilon} [(R^E)^{-\gamma}]}$$

We now show that  $\tilde{\phi}_c > 0$ . Note that

$$\begin{aligned} \text{Cov}_\omega (R_b^x, E_\varepsilon(R^E)^{-\gamma}) &= E_\omega [E_\varepsilon(R^E)^{-\gamma} R_b^x] - E_\omega(R_b^x) E_\omega [E_\varepsilon(R^E)^{-\gamma}] \\ &= r^b E_\omega \left[ E_\varepsilon(R^E)^{-\gamma} \mid \omega > 1 - \frac{L}{\theta} \right] - r^b \text{prob} \left( \omega > 1 - \frac{L}{\theta} \right) E_{\omega \varepsilon} [(R^E)^{-\gamma}] \\ &\leq r^b E_{\omega \varepsilon} [(R^E)^{-\gamma}] - r^b \text{prob} \left( \omega > 1 - \frac{L}{\theta} \right) E_{\omega \varepsilon} [(R^E)^{-\gamma}] \\ &= r^b \left[ 1 - \text{prob} \left( \omega > 1 - \frac{L}{\theta} \right) \right] E_{\omega \varepsilon} [(R^E)^{-\gamma}] \end{aligned}$$

Hence,

$$\frac{\text{Cov}_\omega (R_b^x, E_\varepsilon(R^E)^{-\gamma})}{E_\omega [E_\varepsilon(R^E)^{-\gamma}]} \leq r^b \left[ 1 - \text{prob} \left( \omega > 1 - \frac{L}{\theta} \right) \right] \quad (\text{S59})$$



Accordingly, we have

$$\begin{aligned}
& R^B - E_\omega [R_b^x] - \frac{\text{Cov}_\omega (R_b^x, E_\varepsilon (R^E)^{-\gamma})}{E_\omega [E_\varepsilon (R^E)^{-\gamma}]} \\
& \geq R^B - r^b \times \text{prob} \left( \omega > 1 - \frac{L}{\theta} \right) - r^b \left[ 1 - \text{prob} \left( \omega > 1 - \frac{L}{\theta} \right) \right] \\
& = R^B - r^b \\
& > R^D.
\end{aligned} \tag{S60}$$

Plugging (S60) into the right side of (S58), we have

$$\tilde{\phi}_c > R^D - 1 > 0.$$

Hence, the liquidity constraint (S48) is always binding. In other words,  $w_c = \psi$ .

We now derive the optimal allocation between  $w_b$  and  $w_d$ . With  $L \equiv w_b/w_d$ , the portfolio choice of the representative bank can be rewritten as

$$\max_{L, w_d} \left\{ E_{\omega, \varepsilon} \left[ R^I - w_c (R^I - 1) + w_d \left[ (R^I - R^D) - (R^I - R^B) L - R^x (L, 1; \omega) \right] \right]^{1-\gamma} \right\}^{\frac{1}{1-\gamma}}$$

subject to  $w_d \leq \kappa$  and  $w_c = \psi$ .

The first order condition with respect to  $L$  is

$$R^B - \underbrace{E_\omega [R_L^x (L, 1; \omega)]}_{\text{expected liquidity cost}} - \underbrace{\frac{\text{Cov}_\omega (R_L^x, E_\varepsilon (R^E)^{-\gamma})}{E_\omega [E_\varepsilon (R^E)^{-\gamma}]} }_{\text{regulation risk premium}} = E_\varepsilon (R^I) - \underbrace{\left[ -\frac{\text{Cov}_\varepsilon (R^I, E_\omega (R^E)^{-\gamma})}{E_\varepsilon [E_\omega (R^E)^{-\gamma}]} \right]}_{\text{default risk premium}}. \tag{S61}$$

Finally, we prove that the credit constraint (S47) is always binding. Define  $R^L \equiv (R^I - R^D) - (R^I - R^B) L - R^x (L, 1; \omega)$ . The first order condition with respect to  $w_d$  is

$$E_{\omega, \varepsilon} \left[ (R^E)^{-\gamma} R^L \right] = \frac{\mu}{E_{\omega, \varepsilon} [(R^E)^{-\gamma}]^{\frac{\gamma}{1-\gamma}}} \equiv \tilde{\mu}, \tag{S62}$$

where  $\mu$  is the Lagrangian multiplier associated with the inequality constraint  $w_d \leq \kappa$ . Plugging the definition of  $R^L$  into (S62) and reordering the terms, we have

$$E_\varepsilon \left\{ [(R^B - R^I) L + (R^I - R^D)] E_\omega [(R^E)^{-\gamma}] \right\} - E_\omega [E_\varepsilon (R^E)^{-\gamma} R^x (L, 1; \omega)] = \tilde{\mu},$$

which gives

$$\begin{aligned}
\frac{\tilde{\mu}}{E_{\omega,\varepsilon}[(R^E)^{-\gamma}]} &= LR^B - R^D + (1-L) \left[ E_\varepsilon(R^I) + \frac{Cov_\varepsilon(R^I, E_\omega(R^E)^{-\gamma})}{E_\varepsilon[E_\omega(R^E)^{-\gamma}]} \right] \\
&\quad - \frac{E_\omega[E_\varepsilon(R^E)^{-\gamma} R^x(L, 1; \omega)]}{E_{\omega,\varepsilon}[(R^E)^{-\gamma}]} \\
&= LR^B - R^D + (1-L) \left[ R^B - E_\omega[R_b^x(w_b, w_d; \omega)] - \frac{Cov_\omega(R_L^x, E_\varepsilon(R^E)^{-\gamma})}{E_\omega[E_\varepsilon(R^E)^{-\gamma}]} \right] \\
&\quad - \frac{LE_\omega[E_\varepsilon(R^E)^{-\gamma} R_b^x] + E_\omega[E_\varepsilon(R^E)^{-\gamma} R_d^x]}{E_{\omega,\varepsilon}[(R^E)^{-\gamma}]}, \tag{S63}
\end{aligned}$$

where the second equality is derived by utilizing equation (S61) and

$$R^x(L, 1; \omega) = LR_b^x + R_d^x,$$

$$R_b^x = \begin{cases} r^b & \text{if } \omega \geq 1 - \frac{L}{\theta} \\ 0 & \text{otherwise} \end{cases},$$

and

$$R_d^x = \begin{cases} -r^b\theta(1-\omega) & \text{if } \omega \geq 1 - \frac{L}{\theta} \\ 0 & \text{otherwise} \end{cases}.$$

Note that

$$\begin{aligned}
\frac{E_\omega[E_\varepsilon(R^E)^{-\gamma} R_b^x]}{E_{\omega,\varepsilon}[(R^E)^{-\gamma}]} &= \frac{E_{\omega,\varepsilon}[(R^E)^{-\gamma}] E_\omega[R_b^x] + cov_\omega[E_\varepsilon(R^E)^{-\gamma}, R_b^x]}{E_{\omega,\varepsilon}[(R^E)^{-\gamma}]} \\
&= E_\omega[R_b^x(w_b, w_d; \omega)] + \frac{cov_\omega[E_\varepsilon(R^E)^{-\gamma}, R_b^x]}{E_{\omega,\varepsilon}[(R^E)^{-\gamma}]} \tag{S64}
\end{aligned}$$

Substituting (S64) into (S63), we have

$$R^B - E_\omega[R_b^x(w_b, w_d; \omega)] - \frac{Cov_\omega(R_L^x, E_\varepsilon(R^E)^{-\gamma})}{E_\omega[E_\varepsilon(R^E)^{-\gamma}]} - R^D - \frac{E_\omega[E_\varepsilon(R^E)^{-\gamma} R_d^x]}{E_{\omega,\varepsilon}[(R^E)^{-\gamma}]} = \frac{\tilde{\mu}}{E_{\omega,\varepsilon}[(R^E)^{-\gamma}]}.$$

We now show that  $\tilde{\mu} > 0$ , which implies that the collateral constraint is binding. It is easy to show that

$$\begin{aligned} & -\frac{E_{\omega} \left[ E_{\varepsilon} (R^E)^{-\gamma} R_d^x \right]}{E_{\omega, \varepsilon} [(R^E)^{-\gamma}]} \\ &= r^b \theta E_{\omega \varepsilon} \left[ (R^E)^{-\gamma} (1 - \omega) \mid \omega \geq 1 - \frac{L}{\theta} \right] \\ &> 0 \end{aligned}$$

Together with (S60), this implies that  $\tilde{\mu} > 0$ . Hence, the credit constraint (S47) is always binding.  $\square$

**E.4. Characterizing the optimal dividend choice.** Because of the homogeneity and separability features, the policy function for the portfolio choice of the bank, scaled by ex-dividend equity, is the same every period. We now solve the value function and dividend payout for transitional dynamics as well as the steady state. It follows from the first-order condition for problem (S50) that

$$\text{div}^{-\gamma} = \beta (1 - \gamma) (1 - \text{div})^{-\gamma} E_M [v(\varepsilon'_m) \mid \varepsilon_m] \Omega(\varepsilon'_m, \varepsilon_m)^{1-\gamma} \quad (\text{S65})$$

which gives

$$\text{div} = \frac{1}{1 + \{(1 - \gamma) \beta E_M [v(\varepsilon'_m) \mid \varepsilon_m] \Omega(\varepsilon'_m, \varepsilon_m)^{1-\gamma}\}^{\frac{1}{\gamma}}}. \quad (\text{S66})$$

Substituting (S66) into (S39) and reorganizing the terms, we obtain the value function

$$v(\varepsilon_m) = \frac{1}{1 - \gamma} \left\{ 1 + [(1 - \gamma) \beta E_M [v(\varepsilon'_m) \mid \varepsilon_m] \Omega(\varepsilon'_m, \varepsilon_m)^{1-\gamma}]^{\frac{1}{\gamma}} \right\}^{\gamma}. \quad (\text{S67})$$

At steady state,  $\varepsilon_m = \varepsilon'_m$  and  $v(\varepsilon_m) = E_m [v(\varepsilon'_m) \mid \varepsilon_m]$ . Hence, (S67) implies the steady state value function as

$$v^{ss}(\varepsilon_m) = \frac{1}{1 - \gamma} \left[ \frac{1}{1 - \beta^{\frac{1}{\gamma}} \Omega(\varepsilon_m)^{\frac{1-\gamma}{\gamma}}} \right]^{\gamma}. \quad (\text{S68})$$

Substituting (S68) into (S66), we obtain

$$\text{div}^{ss} = 1 - \beta^{\frac{1}{\gamma}} \Omega(\varepsilon_m)^{\frac{1-\gamma}{\gamma}}. \quad (\text{S69})$$

To understand the impacts of monetary policy shocks on the total credit, we establish the following lemma:

*Lemma S2.* With  $\gamma > 1$ ,  $\frac{\partial \text{div}}{\partial \varepsilon_m} > 0$ .

*Proof.* Equation (S65) expresses  $\text{div}$  as an implicit function of  $\varepsilon_m$ . Taking the partial derivative of  $\text{div}$  with respect to  $\varepsilon_m$ , we have

$$\frac{\partial \text{div}}{\partial \varepsilon_m} = \frac{\beta (1 - \gamma) (1 - \text{div})^{-\gamma} \left[ E_M [v(\varepsilon'_m) \mid \varepsilon_m] \frac{\partial E_{\omega, \varepsilon} [(R^E)^{1-\gamma}]}{\partial \varepsilon_m} + E_{\omega, \varepsilon} [(R^E)^{1-\gamma}] \frac{\partial E_M [v(\varepsilon'_m) \mid \varepsilon_m]}{\partial \varepsilon_m} \right]}{-\gamma \text{div}^{-\gamma-1} - \beta (1 - \gamma) (1 - \text{div})^{-\gamma-1} E_M [v(\varepsilon'_m) \mid \varepsilon_m] E_{\omega, \varepsilon} [(R^E)^{1-\gamma}]} \quad (\text{S70})$$

Given  $\gamma > 1$ , the denominator on the right side of (S70) is negative.<sup>50</sup> Hence, to prove  $\frac{\partial \text{div}}{\partial \varepsilon_m} > 0$ , we only need to show the numerator is negative. We now show

$$\frac{\partial E_{\omega, \varepsilon} [(R^E)^{1-\gamma}]}{\partial \varepsilon_m} < 0 \quad (\text{S71})$$

Since  $\frac{\partial \mu(\varepsilon_m)}{\partial \varepsilon_m} < 0$ , this is equivalent to  $\frac{\partial E_{\omega, \varepsilon} [(R^E)^{1-\gamma}]}{\partial \mu(\varepsilon_m)} > 0$ . Note that

$$\begin{aligned} E_{\omega, \varepsilon} [(R^E)^{1-\gamma}] &= \int_{\mu}^{1-L/\theta} E_{\varepsilon} (R^E(\omega))^{1-\gamma} f(\omega) d\omega + \int_{1-L/\theta}^1 E_{\varepsilon} (R^E(\omega))^{1-\gamma} f(\omega) d\omega \\ &= E_{\varepsilon} (R^E(R^x = 0))^{1-\gamma} \frac{1 - L/\theta - \mu}{1 - \mu} + \int_{1-L/\theta}^1 E_{\varepsilon} (R^E(\omega))^{1-\gamma} \frac{1}{1 - \mu} d\omega \end{aligned}$$

Hence,

$$\frac{\partial E_{\omega, \varepsilon} [(R^E)^{1-\gamma}]}{\partial \mu(\varepsilon_m)} = -E_{\varepsilon} (R^E(R^x = 0))^{1-\gamma} \frac{L/\theta}{(1 - \mu)^2} + \int_{1-L/\theta}^1 E_{\varepsilon} (R^E(\omega))^{1-\gamma} \frac{1}{(1 - \mu)^2} d\omega \quad (\text{S72})$$

Given the definition of  $R^E$  as in (S55), it is easy to show that  $\forall \omega \in (1 - L/\theta, 1]$ ,  $\frac{\partial R^E(\omega)}{\partial \omega} < 0$ .

Hence, with  $\gamma > 1$ , we have  $\forall \omega \in (1 - L/\theta, 1]$

$$E_{\varepsilon} (R^E(\omega))^{1-\gamma} > E_{\varepsilon} (R^E(\omega = 1 - L/\theta))^{1-\gamma} = E_{\varepsilon} (R^E(R^x = 0))^{1-\gamma}.$$

Therefore,

$$\begin{aligned} \int_{1-L/\theta}^1 E_{\varepsilon} (R^E(\omega))^{1-\gamma} \frac{1}{(1 - \mu)^2} d\omega &> \int_{1-L/\theta}^1 E_{\varepsilon} (R^E(R^x = 0))^{1-\gamma} \frac{1}{(1 - \mu)^2} d\omega \\ &= E_{\varepsilon} (R^E(R^x = 0))^{1-\gamma} \frac{L/\theta}{(1 - \mu)^2}. \end{aligned} \quad (\text{S73})$$

Plugging (S73) into (S72), we have

$$\frac{\partial E_{\omega, \varepsilon} [(R^E)^{1-\gamma}]}{\partial \mu(\varepsilon_m)} > -E_{\varepsilon} (R^E(R^x = 0))^{1-\gamma} \frac{L/\theta}{(1 - \mu)^2} + E_{\varepsilon} (R^E(R^x = 0))^{1-\gamma} \frac{L/\theta}{(1 - \mu)^2} = 0.$$

<sup>50</sup>Equation (S67) implies that when  $\gamma > 1$ ,  $E_M [v(\varepsilon'_m) \mid \varepsilon_m] < 0$ .

Therefore,  $\frac{\partial E_{\omega,\varepsilon}[(R^E)^{1-\gamma}]}{\partial \varepsilon_m} < 0$ . Since  $\varepsilon_m$  is serially independent random shocks,  $\frac{\partial E_M[v(\varepsilon'_m) | \varepsilon_m]}{\partial \varepsilon_m} = 0$ . Hence,

$$\begin{aligned} & \beta (1 - \gamma) (1 - \text{div})^{-\gamma} \left[ E_M[v(\varepsilon'_m) | \varepsilon_m] \frac{\partial E_{\omega,\varepsilon}[(R^E)^{1-\gamma}]}{\partial \varepsilon_m} + E_{\omega,\varepsilon}[(R^E)^{1-\gamma}] \frac{\partial E_M[v(\varepsilon'_m) | \varepsilon_m]}{\partial \varepsilon_m} \right] \\ &= \beta (1 - \gamma) (1 - \text{div})^{-\gamma} E_M[v(\varepsilon'_m) | \varepsilon_m] \frac{\partial E_{\omega,\varepsilon}[(R^E)^{1-\gamma}]}{\partial \varepsilon_m} < 0. \end{aligned}$$

□

Equipped with Lemma S2, we have the following proposition regarding the impacts of monetary policy shocks on total bank credit.

*Proposition S3.* With  $\gamma > 1$ , a contractionary monetary policy shock increases the total credit. In other words,

$$\frac{\partial (q^r i^r + qb)}{\partial \varepsilon_m} < 0.$$

*Proof.* By definition,

$$\begin{aligned} q^r i^r + qb &= (1 - \text{div}) (w_i + w_d) \\ &= (1 - \text{div}) (1 - w_c + w_d) \\ &= (1 - \text{div}) (1 - \psi + \kappa) \end{aligned}$$

By Lemma S2, with  $\gamma > 1$ ,  $\frac{\partial \text{div}}{\partial \varepsilon_m} > 0$ . Hence,  $\frac{\partial (q^r i^r + qb)}{\partial \varepsilon_m} = -(1 - \psi + \kappa) \frac{\partial \text{div}}{\partial \varepsilon_m} < 0$ . □

## E.5. Algorithms for a numerical solution.

E.5.1. *Steady state.* Given  $\mu(\varepsilon_m), r^b, q, q^r$ , and  $R^D$ , we need to solve for

$$\{L^*, w_d^*, w_b^*, w_i^*, R^{B*}, \Omega^*, \text{div}^*, v^*, w_\varsigma^*\},$$

where  $\varsigma = \{c, i, b, d\}$  and the superscript  $*$  indicates that the values are at steady state. The algorithm for computing the steady state is as follows.

- (1) Guess  $q$ , the price for  $B$ .
- (2) Calculate  $w_d^* = \kappa, w_c^* = \psi, R^B = \delta + \frac{1-\delta}{q}$ .
- (3) Solve  $L^*$  according to the no-arbitrage equation

$$R^B - r^b \times \text{prob} \left( \omega > 1 - \frac{L}{\theta} \right) - \frac{\text{Cov}_\omega(R_b^x, E_\varepsilon(R^E)^{-\gamma})}{E_\omega[E_\varepsilon(R^E)^{-\gamma}]} = E_\varepsilon(R^I) - \left[ -\frac{\text{Cov}_\varepsilon(R^I, E_\omega(R^E)^{-\gamma})}{E_\varepsilon[E_\omega(R^E)^{-\gamma}]} \right],$$

where

$$\text{Prob} \left( \omega > 1 - \frac{L}{\theta} \right) = \frac{L/\theta}{1 - \mu}.$$

(4) Calculate  $w_b^* = Lw_d^*, w_i^* = 1 - w_b^* - w_c^* + w_d^*$ .

(5) Solve  $\Omega^*$  according to

$$\Omega(\varepsilon'_m, \varepsilon_m) = \{E_{\omega, \varepsilon} [R^I w_i^* + w_c^* + R^B w_b^* - R^D w_d^* - R^x]^{1-\gamma}\}^{\frac{1}{1-\gamma}},$$

where  $R^I = \frac{\varepsilon R^D}{q^r}$ ,  $R^x = \chi(w_b^* - \theta(1 - \omega)w_d^*)$ .

(6) Solve the value function and dividend payout according to (S68) and (S69).

(7) Calculate

$$c = w_c^* (1 - \text{div}), q^r i^r = w_i^* (1 - \text{div}), qb = w_b^* (1 - \text{div}), d/R^D = w_d^* (1 - \text{div})$$

(8) Calculate  $E_{\omega, \varepsilon} [e'] = c + [q\delta + (1 - \delta)]b - r^b \left[ qb \frac{L/\theta}{1 - \mu(\varepsilon_m)} + \frac{\theta d/R^D (L/\theta)^2}{2(1 - \mu(\varepsilon_m))} \right] + R^D (1 - p^r) i^r$ .

(9) If expected equity growth equals zero (i.e.,  $E_{\omega, \varepsilon} [e']$  does not change within the numerical tolerance), stop. Otherwise, adjust the value of  $q$  and continue the iteration.

E.5.2. *Transitional dynamics.* Given the sequence of  $\{\mu(\varepsilon_{m,t})\}_{t=0}^\infty$ , the algorithm for computing the dynamic responses is as follows:

(1) Calculate  $w_{d,t} = \kappa, w_{c,t} = \psi, R_t^B = \frac{q\delta + 1 - \delta}{q}$ .

(2) Solve  $L_t$  according to the no-arbitrage equation

$$R_t^B - r^b \times \text{prob}_t \left( \omega_t > 1 - \frac{L_t}{\theta} \right) - \frac{\text{Cov}_\omega (R_b^x, E_\varepsilon (R^E)^{-\gamma})}{E_\omega [E_\varepsilon (R^E)^{-\gamma}]} = E_\varepsilon (R^I) - \left[ -\frac{\text{Cov}_\varepsilon (R^I, E_\omega (R^E)^{-\gamma})}{E_\varepsilon [E_\omega (R^E)^{-\gamma}]} \right],$$

where

$$R_t^E = R_t^I - w_{c,t} (R_t^I - 1) + w_{d,t} [(R_t^I - R_t^D) - (R_t^I - R_t^B) L_t - R^x (L_t, 1; \omega_t)],$$

$$R_t^I = \frac{\varepsilon_t R_t^D}{q^r},$$

$$R^x (L_t, 1; \omega_t) = \chi (L_t - \theta (1 - \omega_t)).$$

(3) Calculate  $w_{b,t} = L_t \kappa; w_{i,t} = 1 - w_{b,t} - w_{c,t} + w_{d,t}$ .

(4) Solve  $\Omega_t$  according to  $\Omega_t = \{E_{\omega, \varepsilon} [R_t^E]^{1-\gamma}\}^{\frac{1}{1-\gamma}}$ .

(5) Solve the value function and dividend payout according to (S67) and (S66).

(6) Calculate

$$c_t = w_{c,t}^* (1 - \text{div}_t), q^r i_t^r = w_{i,t}^* (1 - \text{div}_t), qb_t = w_{b,t}^* (1 - \text{div}_t), d_t/R^D = w_{d,t}^* (1 - \text{div}_t).$$

(7) Calculate  $E_{\omega, \varepsilon} [e_{t+1}] = c_t + [q\delta + (1 - \delta)]b_t - r^b \left[ qb_t \frac{L_t/\theta}{1 - \mu(\varepsilon_{m,t})} + \frac{\theta d_t/R^D (L_t/\theta)^2}{2(1 - \mu(\varepsilon_{m,t}))} \right] + R^D (1 - p^r) i_t^r$ .

(8) Calculate  $\bar{\mathcal{E}}_{t+1} = E_{\omega, \varepsilon} [e_{t+1}] \bar{\mathcal{E}}_t$ .

(9) Calculate  $[\overline{\text{DIV}}_t, \overline{C}_t, \overline{B}_t, \overline{D}_t, \overline{I}_t^r] = [\text{div}_t, c_t, b_t, d_t, i_t^r] \bar{\mathcal{E}}_t$ .

## China Construction Bank

中国建设银行股份有限公司  
财务报表附注  
(除特别注明外, 以人民币百万元列示)

### 16 应收款项类投资

注释	本集团		本行	
	2015 年	2014 年	2015 年	2014 年
政府				
- 特别国债 (1)	49,200	49,200	49,200	49,200
- 其他	82,177	781	82,177	530
银行及非银行金融				
机构	91,717	78,320	91,717	78,320
企业	60,348	27,470	60,348	27,470
其他 (2)	87,967	15,975	69,420	-
合计	371,409	171,746	352,862	155,520
减值准备(附注 26)	(1,908)	(945)	(1,896)	(944)
净额	369,501	170,801	350,966	154,576
于香港以外地区上市 (3)	191,407	47,585	191,407	47,334
非上市	178,094	123,216	159,559	107,242
合计	369,501	170,801	350,966	154,576

(1) 特别国债是指财政部于 1998 年为补充原建行资本金而发行的面值为人民币 492 亿元的不可转让债券。该债券于 2028 年到期, 固定年利率为 2.25%。人行已批准本行将特别国债视为存放于人行的超额存款准备金的合资格资产, 可用于清算用途。

(2) 其他包括资产管理计划和资金信托计划等, 到期日为 2016 年 1 月至 2025 年 9 月, 预期年利率为 2.86%至 9.5%。本报告期间本集团未出现已到期未收回金额。

(3) 于香港以外地区上市债券包含在中国内地银行间债券市场交易的债券。

2015 ARIX: ¥ 369,501 - ¥ 49,200 - ¥ 82,177 = 238,124

2015 Entrusted rights proxy: ¥ 87,967

FIGURE S1. A snapshot of the balance sheet of China Construction Bank (state bank). Source: an annual report of China Construction Bank.

# Industrial Bank

## 11. 应收款项类投资

	本集团		本银行	
	12/31/2014 人民币百万元	12/31/2013 人民币百万元 (已重述)	12/31/2014 人民币百万元	12/31/2013 人民币百万元
政府债券	436	528	436	528
金融机构债券	8,881	8,719	8,881	8,719
公司债券	19,723	17,747	18,782	17,747
理财产品(注 1)	15,413	5,936	15,413	5,936
信托及其他受益权(注 2)	669,516	297,939	663,167	295,405
应收款项类投资总额	713,969	330,869	706,679	328,335
减：应收款项类投资减值准备	(5,523)	(1,372)	(5,523)	(1,372)
应收款项类投资净额	708,446	329,497	701,156	326,963

注 1：理财产品为购买的其他金融机构发行的有确定期限的理财产品。

注 2：信托及其他受益权系购买的信托受益权、资产管理计划等，该等产品的投资方向主要为信托公司、证券公司或资产管理公司作为资金受托管理人运作的信托贷款或资产管理计划等。

Arix: ¥ 708,446- ¥ 436

Entrusted rights proxy: ¥ 669,516

FIGURE S2. A snapshot of the balance sheet of Industrial Bank (nonstate bank). Source: an annual report of Industrial Bank.



**中信信托有限责任公司**  
**中信乾景·广电地产工行委托贷款收益权**  
**集合资金信托计划清算报告**

尊敬的委托人/受益人：

感谢您投资“中信乾景·广电地产工行委托贷款收益权集合资金信托计划”（以下简称“本信托计划”），中信信托有限责任公司（以下简称“本公司”或“中信信托”）很荣幸作为受托人为您提供理财服务。

本信托计划于 2010 年 7 月 8 日成立，已于 2011 年 5 月 10 日终止。本公司为该项目设立了信托专户：

开户名称：中信信托有限责任公司

开户银行：中国工商银行股份有限公司广州市天河支行

银行账号：3602013429200642236

按照信托合同约定，项目所募集的信托资金全部用于受让广州广电房地产开发集团有限公司通过中国工商银行广东省分行营业部向其旗下武汉广电海格房地产开发有限公司发放的金额为人民币 25,000 万元的委托贷款的收益权。

根据信托合同的约定，本公司已经将信托资金本金和信托收益按期划拨至受益人指定的银行账户。

本计划存续期间的总体支付情况是：

	项目	总额(元)	收益率(%)	支付日
1	信托本金	250,000,000.00	-	2011 年 5 月 13 日

1

FIGURE S3. A snapshot of the description of a trust plan that was created to transfer entrusted rights (see the circled portion). Source: a public announcement by a trust company.

2	收益分配	14,909,326.10	300 万元（不含）以下 投资者年收益率为 6.8%；300 万元（含） 以上的投资者年收益率 为 7.2%；	2011 年 5 月 13 日
3	合计	264,909,326.10	-	-

请您及时核查资金到账情况。

欢迎您继续投资中信信托的信托产品，我们将“勤勉尽职”  
地为您提供优质服务。

祝您身体健康，事业顺利！

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FIGURE S4. A snapshot of the description of a trust plan that was created to transfer entrusted rights (continued). Source: a public announcement by a trust company.

Email: wanglit@citic.com

信托执行团队成员：王汝鹏

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Email: wangrp@citic.com

中信信托有限责任公司

二〇一一年五月三十一日

3

FIGURE S5. A snapshot of the description of a trust plan that was created to transfer entrusted rights (continued). Source: a public announcement by a trust company.

6/2/2016

中融资产-融慧开源36号-招财金服-最权威的信托-资产管理平台！

欢迎来到招财金服-最权威的信托-资产管理平台！投资有风险，选择需谨慎

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中融资产-融慧开源36号			
发行机构	中融资产	发行规模	1 亿
产品期限	24个月	付息方式	每半年付息
投资领域	房地产	募集状态	已售罄
预期收益	100≤认购<300	9.5%	
	300≤认购	10%	
募集帐号	预约中（详细信息请咨询400-8800-209）		
收益计算器： 投资金额： <input type="text" value="300"/> 万元 收益率： <input type="text" value="10"/> % 计算收益 收益总额： <b>300000元</b>			

### 预约送超大红包

姓名:	<input type="text" value="请输入您的姓名"/>
电话:	<input type="text" value="请输入您的联系电话"/>
金额:	<input type="text" value="请输入您的金额"/>
邮箱:	<input type="text" value="请输入您的收件邮箱"/>

两融余额连续八天低于9000万  
国企改革十项试点将推出 央  
油气资产拖累四季度巨亏

### 资金用途

本计划募集的资金拟用于受让新润通租赁通过民生银行兰州分行向兰州伦华发放人民币委托贷款而享有的全部委托贷款债权收益权（兰州伦华以该委托贷款用于中央商务区改造项目拆迁及开发建设，该委托贷款项目流动性情况分批次发放）

### 产品亮点

- 一、区位优势：兰州中央商务区位于省政府对面，是兰州市的最核心的行政中心和传统商业中心，属于最核心地段。
- 二、土地成本低！！预期收益高收益率较高。
- 三、项目还款来源有保障！项目还款来源为新润通租赁对资管计划进行到期回购，中泰创展对其提供回购担保

### 还款来源

- 1：用款项目自身收入；
- 2：用款项目公司本身的经营收入；
- 3：充分有效的抵押质押及保证措施。

### 风控措施

- 一、土地抵押：兰州正和房产将其持有的土地编号为兰国用（2006）第A0450号、国有土地使用权证40532.4平方米的土地提供抵押担保。
- 二、连带责任担保：兰州正和集团及实际控制人对贷款项目到期回购承担连带责任担保。
- 三、全面监督：中融国际信托有限公司旗下子公司中融惠诚对项目公司兰州伦华实行全面监督。
- 四、回购担保：资管计划到期由新润通国际融资租赁有限公司回购，中泰创展控股有限公司提供回购担保。

### 融资方简介

中融（北京）资产管理有限公司

### 发行方实力

<http://www.zccscs.com/detail.aspx?cid=1242>

### 最新热销资管

	长江证券-民生2号
	华宇国信-政兴32号资管计划
	联储证券-捷融1号
	国信证券-嘉恒 901
	中电投先融-锐义2号
	国信证券-金元5号南通券
	东海瑞京-瑞信27号
	东海证券-河南高速公路资产管理计划
	国信证券固收7号资产管理计划
	德邦创新资本-华赢1·资产管理计划
	政基1号-四川平昌安置资产管理计划

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FIGURE S6. A snapshot of the description of how an asset management plan was created to transfer entrusted rights (see the circled portion). Source: a public announcement by an asset management company.

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中融资产-融慧开源36号-招财金服-最权威的信托-资产管理平台!

中融(北京)资产管理有限公司是中融基金管理有限公司的全资子公司,于2013年9月26日注册登记并取得营业执照,并于2013年10月14日取得中国证券监督管理委员会核发的《特定客户资产管理业务资格证书》。在国内金融创新和泛资管趋势的推动下,中融(北京)资产管理有限公司积极发挥资源优势、专业优势和集团协同优势,打造公司在产品创新、投资及风险控制、渠道销售等方面的核心竞争力。公司为客户提供横跨一二级市场本市的全面资产管理,涉及股权类投资、二级市场权益投资、收益权融资、债权融资等多元化业务。力争在3-5年左右的时间里,发展成为国内知名度高、在特定客户资产管理业务领域处于领先位置的资产管理公司。

### 相关产品

财富资产-中金前海-兴华安防特定专项资产管理计划

财富资管-财智定增2号定增类资产管理计划(A级)

	DHRJ-瑞信27号
	国泰元鑫-东旭光电
	中信信诚-西安航天新(项资产管理计划)

### 热门资管推荐

 <b>华宇信国-政兴32号资产管理计划</b> 预约中 <b>收益: 9.8%</b> 期限: 24个月 起点: 100万 <b>产品优势:</b> 央企独基金基金公司管理, AA 级主体信用评级政府融资平台公司拟提供连带责任担保	 <b>联储证券-捷融1号</b> 预约中 <b>收益: 9.5%</b> 期限: 24个月 起点: 100万 <b>产品优势:</b> 真正券商资管! 稀缺苏南无锡项目	 <b>国信证券-嘉恒 901</b> 预约中 <b>收益: 10%</b> 期限: 24个月 起点: 100万 <b>产品优势:</b> 高收益项目, 担保方连带责任担保, 人大常委会决议, 财政承诺函, 且具有较强的偿债能力	 <b>中电投先融</b> 预约中 <b>收益: 8%</b> 期限: 24个月 起点: <b>产品优势:</b> 国家级经济开发+政府文件+应收账款+平+信托资管双层监管
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### 理财知识 [更多>>](#)

 <b>什么是信托</b> 信托, 通俗讲是出于信任将资产付给他人代为管理的一种理财方式。是一种特殊的财产管理制度和法律行为...	 <b>什么是固定收益类信托产品?</b> 固定收益类信托产品是指由信托公司发行的, 收益率和期限固定的信托产品。融资方通过信托公司...	 <b>什么是私募股权投资 (PE)</b> 私募股权投资 (PE: Private Equity) 于非上市股权, 或者上市公司非公开: 通过上市或者并购退出...
 <b>最新信托公司信托理财能力排名</b> 中信信托、中融信托、平安信托、建信信托、华润信托、兴业信托、外贸信托、华能信托、长安信托...	 <b>信托有哪些优势</b> 信托产品以它低风险高收益的特点越来越受到高净值客户的欢迎, 截止2015年信托总规模也已突破了15.87万亿...	 <b>信托的构成要素</b> 信托的构成要素:(一)信托行为 (二)信托客体

### 主要合作机构

首页 信托产品 资管产品 阳光私募 海外保险 理财知识 加入我们 帮助中心

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### 联系我们

服务热线: **400-8800-209**

渠道合作: 0755-33545573

公司地址: 深圳市龙华新区大道3号鼎耀大厦B

<http://www.zcscs.com/detail.aspx?cid=1242>

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FIGURE S7. A snapshot of the description of how an asset management plan was created to transfer entrusted rights (see the circled portion)—continued.  
Source: a public announcement by an asset management company.

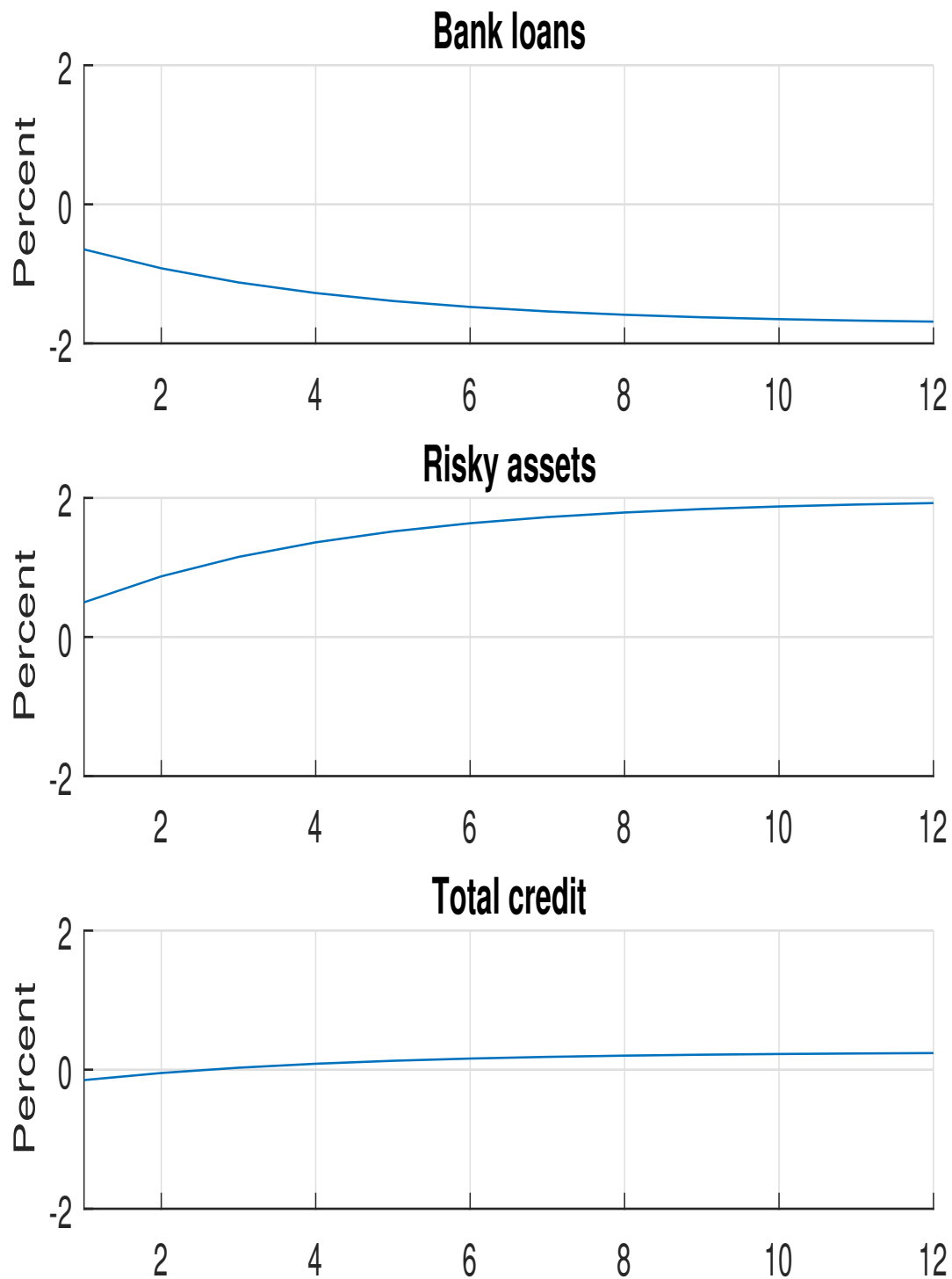


FIGURE S8. Dynamic responses to a one-standard-deviation fall of exogenous money growth in the theoretical model.