Research Paper

The China paradox: SMEs, finance and growth in the informal lending market

Accepted 1st June, 2020

ABSTRACT

Small and medium enterprises (SMEs) are the life-blood of the Chinese economy. They have, however, little or no access to formal bank financing. They rely instead upon lenders in the largely unregulated underground financial market. Despite China’s economic downturn, this market has virtually exploded in recent years, leading to potential risk and actual crisis from unconstrained and sometimes exploitative market forces. The government’s unusual response has been a unique combination of decentralized financial liberalizing reforms balanced with some degree of increased financial repression in an attempt to preserve the market while mitigating systemic risk. This article studies these reforms and concludes that they are salutary, but that the government needs to either: (i) further loosen market constraints while providing adequate systemic and consumer protection, or (ii) loosen its grip on the formal banking system to allow SMEs access to formal bank lending. Along the way, this article makes an attempt to resolve a paradox posed by the finance and development literature: SMEs are China’s growth engine, but SMEs do not grow at an especially rapid rate.

Key words: Underground lending, regulatory measures, finance, growth.

INTRODUCTION

The law and finance literature finds strong correlation between well-developed financial systems and economic growth. China serves as a counter example. Much of its impressive private sector economic growth has been attributed to the informal lending market (ILM) (Allen and Qian, 2005). Empirical findings reveal that individual firms that rely on informal financing do not actually grow faster or have higher productivity growth than bank-financed firms (Ayyagari et al., 2010). But the extraordinary growth in the Chinese private small and medium enterprise (SME) sector is undeniable. We resolved this apparent paradox by suggesting that the cause of this growth is the number of new businesses formed as a result of the broader availability of credit provided by the ILM rather than the growth in the size of individual SMEs. This implies that the ILM and formal lending market (FLM) serve complementary but equally vital purposes in stimulating China’s economic growth: The ILM serves to launch private businesses, a role crucial to innovation and, ultimately, wealth-distribution among a population largely excluded from the FLM, and the FLM serves (or could eventually serve as the Chinese economy matures) as a source of permanent financing for these newer private enterprises once they attain economic maturity. The ILM improves the efficiency of capital accumulation and mobilization that the FLM fails to achieve alone (King and Levine, 1993).

The number of private enterprises in China exceeded 27 million by the end of 2017. The number of individual industrial and commercial households exceeded 65 million, with registered capital of more than 165 trillion yuan. Nevertheless, it appears that 80% of privately owned enterprises in China do not have any stable sources of funding. Slightly more than 56% of them relied on the owner’s personal capital. Only 21% of them were able to obtain financing from banks or collective cooperatives, while 13.5% borrowed money from friends or relatives.
Chinese privately-owned enterprises have a lifespan of only three years on average, and only five percent of them survive longer than 10 years. The key cause of this low survival rate of four percent is the lack of funding.\(^2\)

The ILM plays a vital role in many developing countries\(^3\) by filling a significant gap between credit provided by the FLM and the absence of available credit.\(^4\) In some countries, like China, India, and Thailand, the ILM comprises a significant proportion of GDP\(^5\) and is essential to the financial viability and stability of SMEs because it provides credit to poorer institutions and individuals who would otherwise lack access to capital.\(^6\) Without the ILM, economic inequality would be significantly exacerbated and economic growth diminished (Allen and Qian, 2005). But an unconstrained ILM can become a destabilizing economic force and exploit those very people it exists to help. The ILM provides an opportunity to test the boundary not only between financial liberalization and financial repression but also between the government and the market.

The Chinese ILM market has been an indispensable force in economic growth (Linton, 2006) but has also caused some of the disruption and exploitation mentioned above. We focused on China because it appears to be an exception to the correlation observed in the finance and growth literature between well-developed financial markets and economic growth (Levine, 1997; Levine and Zervos, 1996). The following go contrary: (i) China’s level of financial development (a determinant for future economic growth, capital accumulation, and technological change) is not deep enough to stimulate growth according to the models (Levine, 2005; McKinnon, 1973; Schumpeter, 1911); and (ii) China’s financial institutions are not well-functioning in terms of facilitating risk management, allocating resources, exerting corporate control, mobilizing savings, and easing the trading of goods and services (Levine, 2005). Perhaps most interesting, the literature shows that ILM-financed firms grow more slowly than those that are financed by the formal sector (Ayagari et al., 2010) calling into question the presumed reason that China’s ILM correlates so strongly with economic growth.

We tentatively resolve this apparent paradox by suggesting that the importance of China’s ILM is on a macro-level rather than a micro-level. It has not the growth of individual private firms that has been essential to China’s economic growth but rather the growth of the total number of private firms as an increasingly important complement to traditional state-owned enterprises (SOEs).\(^7\) While not all new firms succeed, we believe that the ILM’s spread of available credit over a vastly larger population than is served by the FLM is the critical factor in China’s ILM-stimulated economic and/or technological growth. These factors, along with the high risk and potentially high returns that characterize the ILM, led us to speculate that the Chinese ILM serves something of the role venture capital serves in developed countries.

We also see an increased role for the FLM. Traditionally serving SOEs, the FLM will become the source of permanent financing for maturing ILM-financed private enterprises as China’s private sector grows.\(^8\) These two systems therefore work to complement one another. The ILM stimulates innovation and early growth, and the FLM provides permanent financing into business maturity. The synergy of both markets will sustain China’s growth well into the future if these complementary functions are coordinated by the judicious use of policy and regulatory initiatives.\(^9\) China’s current relatively repressive financial regulatory environment may stifle some ILM financing. While this approach may serve China well in the short-run, we believe that long-run regulation of the ILM should be designed to facilitate the natural and market-based economic evolution of privately-owned enterprises from the formation and growth stages to maturity in the FLM.

All of this leads us to the proposition that financial liberalization is more likely than financial repression to

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\(^1\)Information is available from https://www.sohu.com/a/119448510_378279 & http://www.360doc.com/content/15/0727/20/67242_487790611.shtml

\(^2\)The informal or underground lending market is made up of private money lenders, loan sharks or pawnshops, which provide an additional source of capital for households or entrepreneurs. These financing institutions are not licensed or supervised by a regulatory or supervisory authority, which distinguishes them from formal lending institutions.

\(^3\) Lending institutions in the FLM are reluctant to lend to borrowers served by the ILF because unstable income streams, the absence of performance histories, and the absence of information increases both risk (higher default rates) and transactions costs in a manner that lending to this segment of the market is unprofitable for institutions in the FLM. At the same time, the substantial unmet demand in the IFL tends to push up interest rates resulting in less affordable credit for the institutions and individuals who most need it.

\(^4\) In India, the underground lending market is as large as 36% of GDP while the formal banking sector accounts for 52% of GDP. In Thailand, the formal and informal lending sectors are 118% and 47% of GDP respectively (Prabha & Ratnatunga, 2014).


\(^6\) It has been said that ILM has become more institutionalized while many firms have been established and specialized in providing informal lending businesses (Yue and Che, 2016).

\(^7\) Against the backdrop of the ongoing US-China trade war and the slowdown of China’s export, the CCP and State Council in April 2019 issued the Guiding Opinions on Promoting the Healthy Development of SMEs and stressed the importance of state-owned banks’ lending to SMEs and privately owned enterprises.

\(^8\) We have noted that China is treated as exceptional literature, and our tentative conclusions in the article accept that posture. We posit that the size of China’s population unleashed by a torrent of informal credit might be a reason for its uniqueness. That said, we do not actually know that China is unique because of insufficient study of ILMs in other nations. We intend in future work to do cross-country comparisons (as well as time-based comparisons given the very different economic and political histories of developing nations) to understand precisely how the ILMs operate in these countries.
The rest part of the study is organized as follows. We first lay out the scope of the ILM and description of the basic characteristics and concepts of informal lending; and then discuss risks related to underground lending and general government policies are discussed. Then we examine the risks of the ILM through the lens of the Wenzhou “runaway” crisis and the government’s attempt to legitimize and formalize part of the ILM through liberalizing local experimentation in Wenzhou period. Next we briefly discuss opening of China’s financial markets to private investors as a means of liberalization. We conclude with our resolution of the apparent paradox presented by China in the finance and growth literature, our suggestions for the direction of regulatory reform, and the implications of our analysis for informal lending in developing countries more generally.

UNDERGROUND LENDING: SIZE AND SCOPE

On-the-ground reality in China

The ILM plays an important role in the Chinese economy because the state banking system largely ignores SMEs. The World Bank’s survey shows that, on average, Chinese SMEs receive 12% of their working capital from bank loans, compared to 21% in Malaysia, 24% in Indonesia, 26% in Korea, and 28% in the Philippines (Dollar, 2011). This is partly because the normal challenges faced by SMEs in obtaining credit, unstable cash flow, absence of collateral, and paucity of information which increases transactions costs- are perhaps more severe in China than elsewhere.

It is difficult to accurately determine the size of the ILM because most informal lending is executed through undisclosed private negotiations and contracts. But some estimates are possible. In 2011, only 19% of all formal bank loans went to small businesses while total loans fell six percent from 2010 to 7.5 trillion yuan (US$1.2 trillion) (McDonald, 2012). The ILM in 2011 was renminbi 3.8 trillion (Mao and Luo, 2011), which was roughly seven percent of the FLM, while the ILM in the entrepreneurial capital of Wenzhou alone was renminbi 110 billion, which was 20% of its FLM (Wu, 2011). Only 25% of SMEs obtained bank credits and 90% were forced to rely primarily upon internal financing during the period from 2011 to 2013 (World Bank, 2012). Finally, the World Bank estimated that only 10% of China’s SMEs have access to formal bank loans although they account for 65% of the workforce and 60% of GDP (Prabha and Ratnatunga, 2014).  

Footnotes:
10. PBOC, Ministry of Finance or CBRC does not release official statistics on informal lending. Occasionally, there are news reports quoting officials’ comments, which may disclose some relevant information, which drew an incomplete picture about the underground lending market for whatever messages such information tries to deliver.
11. It is worth noting that Chinese usury laws do not apply to banks or SOEs. Some empirical studies based on manufacturing firm census data in 1994 and 2005 show that approximately 70% of the growth in industrial value added came from private sector firms between these two census years (Wei & Zhang, 2011).
As shown below, the ILM and, in particular, its underground lending segment, is essential to their survival.

The People's Bank of China (PBOC), China's central bank, and private sector analysts estimates that the ILM provides annual financing of between two to four trillion yuan (US$325 to US$650 billion) (BBC, 2011), or as much as 7% of total lending, with some estimates rising to US$2.6 trillion (Sen, 2005), the equivalent of about 10% of China's GDP (Barboza, 2011). This is close to the unofficial 2012 estimate that underground lending activities were nine percent of China's GDP while the credit provided by the formal banking sector was 135% of GDP (Prabha and Ratnatunga, 2014). While the ILM as a whole clearly is important, some sources note that undergrounding lending is the key source of informal lending in China(Farrell et al., 2006), accounting for 33% of the entire shadow banking sector in 2011 (Mao and Luo, 2011). But underground lenders are the least transparent players in China's ILM, so assessments of their behavior must be gleaned from their results.12

Essential as it is to SMEs, ILM credit began to dry up after the 2008 financial crisis. The central government tried to tighten monetary policy to clamp down on a credit boom, combat inflation, and cool an economy that had overheated after the government pumped four trillion yuan into it. Even state-owned banks eliminated the small amount of private sector lending they were doing while continuing to support the state-owned sector. This has particularly damaged China's 7.5 million or so non-state-owned SMEs.13 As a result, credit demand from SMEs has led to a surge in the underground lending market, thus undercutting the government's efforts.14

Large SOEs provide another source of lending in the ILM. Most are able to satisfy over 75% of their credit needs from state-owned commercial banks (Leung, 2014) at a 7.2% interest rate (compared with the one-year benchmark interest rate of 6.56%). Some SOE's profit by informally relending that money at considerably higher rates (36–60%) to SMEs through third-party companies such as financing firms (Chung, 2011). The government has made efforts to control this exploitative lending source by channeling bank lending to the struggling private sector with the aim of boosting investment and economic growth. But the State's mixed messages and unclear economic growth and economic growth and so we concentrate on SMEs.

The problems posed by the ILM, and fundamental concepts

There are three principal differences between the FLM and the ILM. First, the FLM is heavily regulated. Firms in the ILM are mainly monitored, if at all, by government

12 Almost half of families in China have been involved in private lending, according to a survey of more than 28,000 families published last month by the Survey and Research Center for China Household Finance at the Chengdu-based Southwestern University of Finance and Economics. The figures show that about 49 percent of families in China's western regions had participated in private lending, around 46 percent in central China and 38 percent in eastern China. Nearly 320,000 households in western regions offered high interest loans totaling 100 billion yuan in 2013 (Chen, 2014).

13 There were more than 20 million SMES and 54 million proprietors registered in 2015 in China. By the end of 2015, China had 365,000 SMES, which were 97.4% of all the manufacturing enterprises in China, and contributed taxes in the amount of remnibi 2.500 trillion (49.2% of the total taxes) with profits of remnibi 41 trillion, 64.5% of the total profits generated by manufacturing enterprises in China. These MSEs absorbed 80% employees throughout the whole country.PRC Ministry of Industry and Information Technology, The Plan of Promoting the Development of Medium and Small Enterprises (2016-2020), promulgated on 28 June 2016 and effective as of 28 June 2016.

14 Farmers also rely upon the ILM, but our focus here is on business formation and economic growth and so we concentrate on SMEs.
authorities other than bank regulators. Second, ILM institutions are not allowed to take deposits and thus do not mobilize savings from the public. Third, ILM institutions are not allowed to charge interest rates more than four times the benchmark lending rates set by the PBOC.

The ILM consists of grey and black market financing, although the boundaries between them are fuzzy. The grey market exists where ILM institutions (Wang, 2015) finance cash-constrained market players who have been excluded by the FLM but are engaged in innovative activity within the limits of their normal business activities (Vlcek, 2014; World Bank, 2012). The black market develops when these same institutions move into traditional banking activities, performing otherwise regulated activities outside the regulatory system and thus creating instability. Although most underground lending businesses are not themselves illegal, some of their activities are. For example, in jurisdictions where there is an interest rate cap, lending at rates above the cap is prohibited. And a financial market imposing restrictions on market entry also disallows unregulated lending. These are the primary lending restrictions in China that build a rigorous Chinese wall for the formal banking sector exclusively engaged in the deposit-taking businesses. Despite the heavy crackdown over underground lending (including the extreme form of loan sharking), there have continued to be frequent news reports of detained suspects in illegal underground lending cases involving billions of yuan in recent years (Xinhuanet, 2019) and creating massive P2P failures throughout the country (Chorzempa, 2018).

The ILM clearly poses significant systemic risks despite its important role in stimulating new business development by making credit available to excluded and underserved borrowers. An excessively large and unregulated underground lending market impedes economic development because its higher interest rates, heightened costs of borrowing, and coercive measures for debt collection lead to larger household debt and potentially massive social disruption. Social risks become the main concerns with regard to the ILM. Systemic risk also exists because the regulated FLM is exposed to ILM risk when banks become involved in ILM creditor financial (re-) intermediation chains. Bank loans guaranteed by a business may be at risk when that business faces debt service challenges in a reciprocal loan guarantee network. The black market, more distant than the grey one from the banking system, may pose more limited systemic risk to the banking sector because those two markets are disconnected.

The government has intensified its efforts to minimize these risks, pushing away borrowers from informal lenders. But these attempts to ensure stability also risk depriving the economy of the important growth-enhancing activities of the ILM. Finding the balance between regulation and market freedom is the challenge.

### Table 1: Comparison between SOEs and SMEs.

<table>
<thead>
<tr>
<th>Type of Firms</th>
<th>Number of firms</th>
<th>Contribution to GDP</th>
<th>Contribution to employment</th>
<th>Access to loans</th>
</tr>
</thead>
<tbody>
<tr>
<td>SOEs</td>
<td>10%</td>
<td>60%</td>
<td>20%</td>
<td>70%</td>
</tr>
<tr>
<td>SMEs</td>
<td>90%</td>
<td>40%</td>
<td>80%</td>
<td>30%</td>
</tr>
</tbody>
</table>

20 P2P platforms in China are not well regulated. As a result, these platforms, acting as shadow banks, provide guarantees and issue wealth-management-type products.

21 Banks are exposed to systemic risk when participating in the gray market (Shen, 2016).

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2 This probably explains why they are excluded from the banking regulatory regime. As a result, they are only monitored as regular firms instead of banks or financial institutions. Obviously it is the case that these lenders raise cash from individuals that are similar to deposits but they do not mobilize “savings” which is a term with a very specific meaning in the Chinese context.

3 On 6 August 2015, the Supreme Court of the People’s Republic of China issued the Regulations on Application of Laws to Certain Issues For Hearing of Private Lending Cases (Fa Shi [2015] No. 18) (the Private Lending Regulations), which came into effect on 1 September 2015. The Private Lending Regulations are introduced at a time when the increasing financing needs of SMEs cannot be fully satisfied by the banking system, and alternative financing solutions (including funding provided by an online peer-to-peer network, which is also covered by the Regulations) are being developed. The Private Lending Regulations provide a much needed legal framework for regulation of the increasing onshore lending activities undertaken by non-bank entities, and present new opportunities and structuring options for both investors and lenders. The Private Lending Regulations apply to lending activities between natural persons, corporates and other organisations, but exclude loans made by financial institutions.

4 For example, some credit guarantee agencies have effectively become banks by illegally taking deposits and providing loans. Some investment brokers and private fund managers also use their capital to provide illegal commercial and personal loans. Pawnshops can be offering some banking services to individuals and firms. Michael F. Martin, “China’s Banking System: Issues for Congress”, 20 February 2012, p.6.
credit (McKinnon, 1973), increasing instability and uncertainty, and choking industrial growth by starving SMEs of necessary funding (Honkapohja, 2010).

Financial repression has an economic history suggesting its utility. Developed countries used financial repression after World War II to secure cheaper funding to reduce war debts (Honkapohja, 2014). Many of these countries continue to practice a light form of financial repression by imposing some financial market restrictions. However, financial repression is now more common in debt-constrained developing economies because government control over the market allows it to direct funding to sectors the state deems to be most important. Although financial repression appears in different forms, it is often heavy-handed (Reinhart and Rogoff, 2011). Typical measures include restrictions on market entry and cross-border capital flows, deposit rate caps, compulsory purchases of government bonds, and facilitating bank or SOE lending monopolies.

China’s regime is financially repressive (Miller, 2010), imposing credit, interest rate, exchange rate, capital flow, and market entry controls. Credit controls aim at achieving broader economic, social, and political objectives by requiring state-owned lenders to grant loans to borrowers based on imposed quotas or other specified criteria. This use of non-financial criteria leads banks to accumulate underperforming and non-performing loans. Deposit rate controls are designed to hold borrowing rates lower than a market would set them, but banks nonetheless opportunistically increase their profits by charging higher lending rates. Depositors thus subsidize this profit, while also benefitting politically favored industries that borrow at below-market rates (Pettis, 2013; Lardy, 1998). The Big Five’s extraordinary combined profit during the financial crisis illustrates the consequences of this restriction.

Despite the subsidies SOEs receive as a result of financial repression, market inefficiencies resulting from fiat have led their economic performance to significantly lag that of the private sector. Privately owned companies account for 70% of total mainland employment and 60% of China’s GDP. SOEs account for two-fifths of GDP and employ one-tenth of Mainland China’s workforce. Since the onset of the global financial crisis, SOEs (excluding banks) have delivered virtually no earnings growth while private sector profit growth was in double digits, at an average 18% rate. Average return on assets for SOEs was at about 4.6% in 2014 compared with 9.1% for private businesses (Wildau, 2015). SOEs, compared to private enterprises in China, remain a drag on growth due to the mismatch between their earnings and cost of capital (Lardy, 2014), demonstrating their inefficiency in capital allocation and utility.

All of these suggest that Chinese economic performance would be improved by liberalizing finance - reducing banking and commercial restrictions to provide more room for market price-setting and capital allocation that would decrease the cost of capital to SOEs. Greater financial liberalization would also have the desirable effect of redistributing profit from the state sector to the private sector.

**Wenzhou: Crisis and a path to reform**

The recent “runaway episode” in Wenzhou provides a good illustration of the extent of the underground lending market and the dangerous economic and social consequences of the private lending craze. Wenzhou is a moderately large city in Zhejiang province, famed for its savvy, risk-taking merchants and entrepreneurs, as well as for the underground banking industry that finances the majority of them. A 2012 PBOC survey reported that approximately 60% of local Wenzhou businesses and 89% of households had outstanding underground loans, representing approximately 20% of Wenzhou’s overall lending market (Martin, 2012). There are approximately 2.4 million private enterprises in Zhejiang province with output valued at more than 1.5 million yuan. About 80% of these SMEs borrow from underground banking sources despite exorbitant interest rates, circulating approximately 600 billion yuan annually through the province’s underground banking system.

The Wenzhou runaway episode began with the 2008 global financial crisis. The rise of raw material and labor costs led to the yuan gaining more strength, making Chinese exports more expensive, thus contributing to a severe drop in overseas demand. At the same time, staggering interest rates, at more than 15 times China’s benchmark lending rates, pushed some firms to the limit. SME defaults increased, exposing fractures in the thriving underground banking system and new fault lines in China’s economy (Bloomberg, 2014).

A string of Chinese entrepreneurs went into hiding to

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22 After the latest financial crisis, there has been a revival of financial repression in the developed countries where the governments used explicit or implicit caps on interest rates, tighter regulation on cross-border capital movements, and more directed lending to government by captive domestic investors. These measures are put in place to reduce debt rollover risks and curb rising interest expenditures.

23 It has been pointed out that liberalization in developed economies has been uninterrupted and mature financial markets are on average less regulated than emerging economies (Kaminsky and Schmukler, 2003).

24 Beim & Calomiris (2001) lists six aspects to define a jurisdiction as a repressed or liberalized one: interest rate ceiling on bank deposits, high bank reserve requirements, government credit and direction of bank credit, government ownership and micromanagement of banks, restrictions on foreign bank and domestic non-bank entry, and restrictions on capital flows.


26 Some statistics claim that China’s SMEs absorb 80% of urban employment (Luo and Prasso, 2013). Note that China’s GDP excludes the territories such as Hong Kong and Macau.


28 Ibid.
avoid repaying loans (Zhao and Qing, 2011). Nearly 100 business owners fled their factories, leaving piles of unpaid loans behind (Zhao and Qing, 2011). More than 80 suicides or bankruptcies by indebted businessmen were reported as occurring in a four-month period (Luo and Prasso, 2013). Lawsuits concerning private lending disputes surged to 19,446 in 2012 from 2,896 in 2007 (Chen, 2014). More than 7,300 companies in Zhejiang were forced to close from January to April in 2011 due to the central government’s monetary tightening measures taken in response to the crisis. However, the demand for private lending remained. Underground lending market risks have led the government to shut down over 500 underground banks since 2002, with over 100 cases involving more than 20 billion yuan in illegal funds (Xinhua, 2010). Yet the government allowed the underground lending market to grow after the global financial crisis, apparently seeing it as necessary to support entrepreneurs (McDonald, 2012).

NATURE OF THE RISKS

The Wenzhou episode demonstrates that underground lending risks come from both the lending and borrowing sides and are both individual and systemic. The central government’s response demonstrates its attempt to experiment with regulation by providing local authorities with highly unusual and significant autonomy to craft appropriate controls. High – sometimes excessively high – underground lending rates ranging from 18 to 200% create significant risks of repayment delays and defaults, especially when combined with the tenuous credit of borrowers that is, households and entrepreneurs. That default risk threatens the stability of lenders and the underground system as a whole while these borrowers are trapped in a cycle of debt and predatory lending practices.

Threats posed by default risk extend beyond the borrowers and lenders directly involved in underground lending to the entire network of SMEs. Lenders must seek funds from somewhere other than depositors. Lengthy credit chains that could fail at any link are created, increasing credit risk and systematic risk. The credit woes of one small firm can infect other businesses through “debt triangles” formed when a cash-strapped firm delays payments to its suppliers, in turn causing those suppliers cash flow problems, and so on up the supply chain. The resulting domino effect could threaten the wider financial system. Among anecdotal evidence of the growth in loan sharking, media reports said Inner Mongolia saw an “explosion” in the number of court disputes over underground loans in 2013 (as many as 43,000) (Woo, 2014), the sheer number of which indicates a connection among lenders and borrowers in the underground lending market.

FLM banks are also affected by default risks posed by the underground lending market. Banks with lendable deposits diverted to the ILM because of the significantly higher deposit rates paid by the informal sector become part of the underground lending market when they seek to compensate for fewer loans by channeling capital into the more profitable underground lending market (Zhang et al., 2011).

Allocative inefficiency in the broader economy is caused by the absence of a balanced financial sector. Regulated interest rates and other restrictions in the FLM preclude banks from pricing loans to reflect the trade-off between profit and risk. But the scale of the underground lending market itself shows the severity of the distortion in the FLM and poses the systemic risks on the banking sector we have discussed. These can have a severe negative impact on economic growth. Related to this is the very considerable risk to monetary policy which slips out of the central bank’s control if lending diverts significant amounts of money away from the formal banking system, resulting in a clear regulatory or policy failure.

We believe that the solution to these problems is to rebalance the distorted financial sector through the interplay of market-oriented approaches and relatively light regulation. The result would be something of an integration of the FLM and ILM while retaining, for the moment, the distinctive characteristics of each. In order to lay the groundwork for this discussion, we now turn to an examination of the government’s responses to the overheated underground lending market.

REGULATORY RESPONSES TO RUNAWAY CRISIS: WENZHOU PRIVATE LENDING REGULATIONS

A matter of balance

Social stability is necessary for both political and economic stability and thus is a major governmental concern. The turmoil in the underground lending market caused by high interest rates and rising defaults threatens to aggravate social tensions and increase criminal activity. The absence of a centralized pool for funding, as in a bank bailout or bail-in, hamstrings the government when attempting intervention. The accumulation of economic risk in connection with the ILM is likely to transform into political risk that shakes the legitimacy of the ruling party or the government. Governmental intervention is seen as an attempt to use regulatory policy to downgrade potential political risk to more manageable economic risk. (Xiang, 2016) Financial capital reflects the level of development and prevailing social relations of the society, so the regulation of capital is vital to a country’s rule of law (Piketty, 2017). The


30 The bail-in process is superior to bailouts in the case of idiosyncratic failure but is still possible to entail risks (Avgouleas & Goodhart, 2015).
government’s move to effectively regulate and formalize the ILM is likely to ease the government’s political and regulatory burden and benefit the society as a whole.

In response to Wenzhou’s problems, and with fears that Wenzhou’s economic stumble could reverberate throughout the rest of China, the Chinese government in 2012 launched a pilot scheme to funnel more money to private enterprises in Wenzhou by permitting private lenders to register as private financing institutions operating with the blessing of the State. This experiment was legislated in Wenzhou’s Private Financing Regulations (the “Regulations”), the first of their kind in China, which aim at turning underground lending into lawful credit.31

This experiment is notable for two reasons. The first is the market-based nature of the reforms. While these reforms fall well short of giving the underground lending market the freedom it needs to be truly efficient, the regulations nevertheless provide wide parameters to give the market reasonable running room.32 Equally notable is the localized nature of the regulations. In a political environment characterized by extreme central control,33 the delegation of enforcement and even substantive regulatory development of such an important segment as financial regulation to a municipal-based agency is remarkable given its nation-wide importance to relaxing financial repression, even if a relatively small part of the overall economy and the policy imperatives have been established by the state. Although local experimentation might provide good reform models, the systemic importance of financial market regulation suggests that local experiments may not be sufficient for deep-down or wholesale reform (Friedland and Alford, 1991). In other words, regulators at the central level should deal with any problems or externalities arising out of financial repression. While local experiments might result in effective solutions, would not produce such corrective measures that can repair nation-wide market or regulatory failures.

The balance sought by the Chinese government and financial industry is that between financial repression and financial liberalization, with repression more dominant at the moment as perhaps an understandable if, in our view, unfortunate, reaction to the Wenzhou runaway crisis and the systemic fears created by the rapid and unconstrained growth of the underground lending market. Financial regulations or measures that are excessively repressive would constrain market forces that shape vibrant and efficient financial markets leading to the misplacement or misallocation of financial resources and the ultimate failure to sustain long run financial development and economic growth. We remain optimistic that the government’s observation of the increased efficiency of the market will, in the long term, lead to greater liberalization.

While market-based reform might seem to be an obvious solution, we think it is important to remember that China’s modern economy is barely four decades old, growing from a position in which the market was dismissed as evil and therefore virtually nonexistent. We think that market-based reform is properly seen as the innovation or experiment that it is in the Chinese context.

Defining the market

It is technically difficult to regulate private lending because of its high degree of heterogeneity, opacity, and diversity. The State Council, China’s cabinet, issued Circular No. 107 in 2013, which indicated its rudimentary and superficial attempts to tackle the shadow banking sector without touching upon the fundamental defects or shortcomings of financial markets and regulations. It divides the private lending sector into two categories: (i) underground financing, which is largely unregulated, and (ii) micro-finance firms consisting of petty-loan companies, pawn shops, and finance leasing companies, which are regulated, albeit poorly.

These micro-finance firms are not allowed to take deposits, make shark loans, or collect loans through illegal means.34 Petty loan companies are supposed to use their own funds for lending and obtaining operational financing from commercial banks35 while pawnshops and finance leasing companies are not regarded as financial institutions in nature and their business scope is strictly regulated.36

Types of lenders

We have previously described the heterogeneity of the underground lending market. It should thus be clear that there are a number of sub-markets. The regulations first attempt to impose order on the market by defining each of the various types of lenders. Three kinds of ILM intermediary agencies are authorized to lend money. Private lending public service institutions serve as a government resource for private lenders and borrowers. Private capital management firms operate in a manner similar to mutual funds. Private financing information service firms engage in funds-matching and financial products promotion. Private lending public service

31 The Regulations, passed at the 6th session of the 12th Standing Committee of the Zhejiang Provincial People’s Congress in November 2013 came into effect as of 1 March 2014. The Regulations, though brief (in the sense that it has 7 chapters and 50 clauses), specify regular private financing operations, risk control measures and legal liabilities.
32 At the same time, we are concerned that the reforms do not go far enough in restraining exploitive lender behavior, at least in the short term. We acknowledge (with a smile) that nothing is perfect, and achieving balance here is difficult for the reasons we’ve provided.
34 Circular No. 107, Article 3(5).
35 Ibid.
36 Ibid.
institutions emerged in 2012 when the State Council allowed Wenzhou to serve as a test site for liberalizing private lending. There are currently seven of such service institutions in Wenzhou, with registered private capital of seven billion yuan and 2.5 billion yuan in outstanding loans by December 2013. Wenzhou also has 11 private capital management firms, which specialize in offering financial services from private placement to project investment. By December 2013, private capital management firms had directed two billion yuan to 618 commercial projects.\(^{37}\) Free competition among these firms helps drive down loan rates.

The Regulations’ restriction of market diversity by limiting private lending to these three types of institutions is excessively repressive. Specifically excluded are guarantee companies, investment consulting companies, pawnshops, and consignment shops, all of which serve a different (and generally poorer) segment of the market.\(^{38}\) While data is lacking, it appears that these types of firms provide significant financing to new businesses. Therefore, the Regulations significantly limit one of the principal benefits of the underground lending market, the provision of greater economic opportunity to a wider segment of the population, and thus are likely to limit the primary growth channel through which underground lending grows GDP.

We are concerned that this approach risks both diminished efficiency and social stability, especially if the Wenzhou regulations or something like them are extended on a broader scale.

The Wenzhou local financial management authority

Local control comes in the form of the local financial management authority (FMA) in Wenzhou. The FMA serves as the general supervisor of the private financing sector\(^{39}\) and also possesses enforcement powers, including the powers to impose fines and engage in public shaming.\(^{40}\)

The FMA is required to monitor, calculate, analyze, manage, supervise, and check private financing.\(^{41}\) It is charged with the task of instructing private financing institutions to establish management risk monitoring systems\(^{42}\) and possesses fairly broad powers to ensure disclosure and compliance through its investigatory\(^{43}\) and supervisory powers.\(^{44}\)

This type of local supervision is still innovative and progressive in China in the sense that no equivalent supervision has been attempted at the local level (below the provincial level). The local authority has a natural intimacy with the market and market players and consequently has a close understanding of the risks in the market place. This is especially important in a top-down society like China in which the central government has limited information but imposes tight control over financial markets.

Increasing transparency: The mandatory filing requirement

Private bond financing and private fund management enterprises must register with the FMA and engage in regular reporting and disclosure,\(^{45}\) ameliorating the information asymmetry between lenders and borrowers. This allows lenders to make better credit decisions and the government to monitor overall credit risk in the economy. In addition to traditional enforcement mechanisms, registration is also encouraged by granting greater probative force to recorded private lending contracts than to contracts which are not recorded.\(^{46}\)

The rules provide for other improvements as well, like a credit checking system covering both institutions and individuals.\(^{47}\) Some of these additional regulations have not yet been implemented and it remains to be seen what their role will actually be in stabilizing without stifling the underground lending market. Public credit registries exist in the form of an underground lending service center run by an underground lending registration and service company invested by both private enterprises and individuals with the support of the local government (Xiang, 2016). Their main task is to collect information on the standing (that is, credit histories and current indebtedness) of various borrowers and share it with lenders\(^{48}\) and they are said to be an important factor in determining credit availability (Djankov et al., 2007). Empirical study also affirms the functionality of such registries (Pagano and Jappelli, 1993; Sapienza, 2002). Better information ex ante can work as a substitute for stronger ex post credit rights. Putting public


\(^{38}\) Ibid., Article 34.

\(^{39}\) Private financing is defined by regulation as financing between individuals and non-financial institutions, and between non-bank organizations through private lending, bonds issuances, or private placement.

\(^{40}\) Public shaming is also termed public humiliation which is one way of dishonoring a person. The purpose of public shaming is to create negative psychological effects so as to deter any wrongdoing. Public shaming is also a judicial punishment imposed on a convicted criminal that includes humiliation in public instead of imprisonment. In the regulatory regime, public shaming is also termed reputational sanctioning, which is often used to penalize wrongdoers in capital markets. Public shaming as a regulatory tool has been used in many contexts (Liebman & Milhaupt, 2008).

\(^{41}\) Wenzhou Private Financing Regulations, Article 28.

\(^{42}\) Ibid. Article 29.

\(^{43}\) Ibid. Article 35.

\(^{44}\) Ibid. Article 27.

\(^{45}\) Wenzhou Private Financing Regulations, Articles 20 & 26. The Wenzhou administrative system to is composed of a financial management bureau, a financial arbitration institution, a financial crime investigation team and a court.

\(^{46}\) Wenzhou Private Financing Regulations, Article 17.

\(^{47}\) Circular No. 107, Article 5(3).

\(^{48}\) The service centre’s other tasks include consultancy, information publicity, lending matching, asset evaluation, legal advisory, notarization, among others. Although the service centre is privately owned, the official name makes it look like a governmental body. Other local governments in Changsha, Zibo, Changzhi also set up a similar service centre serving identical or similar purposes (Xiang & Zhang, 2014).
credit registries in place is an integral part of the wide-ranging efforts to publicize and legalize the ILM to a certain extent. In addition, improving the transparency of ILM is also a public good offered by the local government to financial consumers and investors even though effective regulation over the ILM is still a great challenge to both the central and local government. In this vein, an experimental reform strategy testing the water is a sensible and cautious policy move.

From the perspective of endogeneity, the purpose of ILM regulation is to resolve information asymmetries concerning borrowers’ creditworthiness. These asymmetries are mainly reflected in the distortion of interest rate information throughout the ILM. Where demand is fixed, supply and demand suggests that the more capital that moves into private finance, the lower the average interest rate will be, which will help expand the demand for private finance, leading to more creditworthy borrowers flocking to the market. Lenders in the ILM, relying on borrowers’ creditworthiness, will offer preferential rates to more reputable borrowers but higher interest rates to less reputable ones in order to discount risks. Under these circumstances the ILM’s interest rate seems to be an efficient mechanism for allocating credit. Due to information asymmetry, however, borrowers tend to conceal information. In this sense, the disclosure rules may help cure the problem of information asymmetry.

The existence of the “lemon market”, which results in increased interest rates, will squeeze borrowers with better credit ratings out of the market, triggering adverse selection. At this point, the spread between premium and default risk will achieve a dynamic non-cooperative equilibrium between formal finance and private finance, but this equilibrium may lead to higher spreads in supply and demand and generate greater default risk when financial demand is strong. This risk is likely to be transmitted across the market as borrowers participate in the formal financial market, which in turn triggers a chain reaction. Viewed from this perspective, the Wenzhou crisis was caused by the break of the private financial chain.

**Raising capital**

Banks finance their activities by taking deposits. Lenders in the underground lending market are prohibited from taking deposits. Yet there are several permitted ways that private lenders can raise capital to finance their loans. In addition, in search for higher returns, banks are attracted to the ILM lending.

Underground lending firms may issue private bonds. Each such issuance requires maturity of at least one year, and may be made only to a maximum of 200 qualified investors per issue. Coupon rates must be capped at no more than three times the official benchmark-lending rate. Other conditions to issuance include a post-financing asset-liability ratio of less than 70%, a requirement that significantly limits the number of private firms able to finance in this manner.

A private fund management firm is allowed to conduct further private fundraising from individuals if it has sustainable profitability, which is demonstrated by net assets of at least renminbi 20 million (of which at least 20% must be registered capital). It must also satisfy a loan-to-asset ratio cap on raised capital of eight times net assets. Because a bank is subject to a loan-to-asset ratio cap, this restriction may suggest a more tolerant attitude taken by the regulator towards private lenders. In addition, the total funds raised by such a firm through private fundraising must be placed in the custody of a state bank with conditions prescribed by the state authority in Wenzhou. The private fund management firm is required to make a contribution to the custodial bank of no less than 10% of funds raised, thus diminishing their lendable assets. Such lenders are only allowed to lend self-owned funds (in the manner of a private equity firm) and may not “illegally absorb public funds to do so in disguised form, or fraudulently obtain credit funds from a banking institution to make illegal incomes through lending them.” This requirement is meant to decrease leverage and reduce the way these institutions intertwine and rely upon one another in order to protect overall financial stability. While assuring soundness and stability, each of these limitations individually, and all of them taken together, may severely restrict the supply of credit and increase its cost for borrowers. The concern is that in its attempt to restrain the exuberance of the underground lending market, the state may unintentionally stifle it to a point where it no longer serves its essential role in China’s overall economic growth.

**Lending**

The economic functionality of the underground lending market and the channel through which it stimulates growth lie in its lending capacity and the breadth of its range across SMEs, poorer citizens, and farmers. The broader policy is to permit some flexibility for market players in the regulatory space. The key is the effective responsiveness of the market which have corresponding risk identification and undertaking capabilities, and which presumes either or both financial sophistication and the ability to bear losses by the lenders. Wenzhou Private Financing Regulations, Article 19.

50 Wenzhou Private Financing Regulations, Article 20.
51 Wenzhou Private Financing Regulations, Article 22.
52 Wenzhou Private Financing Regulations, Article 23.
53 Bank capital to assets ratio in China was reported at 8.1003% in 2016, according to the World Bank collection of development indicators. Trading Economics, https://tradingeconomics.com/china/bank-capital-to-assets-ratio-percent-wb-data.html
54 Wenzhou Private Financing Regulations, Article 23.
55 Wenzhou Private Financing Regulations, Article 12.
56 Ibid.

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49 *Qualified investor* is defined as a natural person with financial assets of over 300,000 yuan, or organizations with net assets of over 1 million yuan, all of
to regulations. Private lending firms may set interest rates to the market without limitation as long as they do not violate national regulations, in contrast to the limitation applied outside the Wenzhou zone of four times the official benchmark rate.\(^5\) Considering that China's shadow banking system emerged out of a desire to circumvent tight regulation that restricts the flow of credit, governmental delegation of a fair amount of control to the market is a significant and positive change.

Interest rate liberalization in Wenzhou should be understood on the background of central state policy. For example, the Supreme People's Court in the early 1980s set out both the legality of interest free loans and loans set at market rates of interest without restriction. At the same time, it expressed its concern that market-set interest rates could become exorbitant and therefore exploitive and would thus be disallowed in collection proceedings. In general, interest rates at greater than four times the state owned bank mandated interest rate would be considered excessive.\(^5\) In practice, the rates could be as high as 15 times China's benchmark lending rates.\(^5\) Chinese courts, with some exceptions, largely apply the four-time-cap rule to the interest rates in private lending transactions, which effectively discourages private lending, effectively restricting Wenzhou lending institutions to the nationally limited rate.

Unfortunately, the opinion is ambiguous. While the court is clear that a high interest loan is a forbidden form of exploitation, the interest rates that the PRC courts may consider to be “suitably higher” than the national bank's interest rate or “extremely high” rates of interest are not clear. But there are market limitations to the rates of interest most borrowers will accept, so the reasonable expectation is that market-based interest rates will set a natural limit on the amounts of interest charged by lenders.

All of this said, in China as everywhere else, borrowers desperate for credit may be willing to promise almost anything in order to obtain needed funds.\(^6\) In order for lending liberalization to function properly then, continued monitoring by the state and the courts is required. If the Wenzhou regulations manage to establish the market's parameters (including sufficient transparency) to ensure that interest rates are set in a truly efficient market, market operations themselves will ensure that interest rates do not reach exploitative levels and that the state will, over time, become much more comfortable with market behavior such that regulation can once again be loosened in a manner appropriate to well-functioning markets. These conditions are necessary to permit the underground lending market to supply sufficient capital to its natural population.

**Experimental nature of the regulations and deeper reform**

The Regulations are designed to achieve a difficult balance between financial market growth and stability. The partial legalization of formerly underground lending institutions is directed toward stability by allowing for regulation through a system of loan registration (similar to public credit registries as discussed above), disclosure, and obligation that is meant to improve transparency and discipline both between the government and private lenders and between lenders and borrowers. The more effective information-sharing scheme was put in place to overcome the heterogeneity of borrowers leading to more efficient large scale of lending with lower costs (Pagano and Jappelli, 1993). While these regulations are a good start, there is much more that the government could do in order to curb the risks. The most glaring deficiency is the failure to liberalize interest rates, a measure that would likely be the simplest and most effective way of curbing illegal lending. This can effectively increase the use of formal banking and decrease the regulatory arbitrage between the FLM and the ILM.

The local character of the regulations in Wenzhou sets a good example for other cities and provinces where underground banking is active, and represents a bold move by the traditionally highly centralized state. Local regulation recognizes that the local government is likely to be more sensitive than the state to the economic needs of its population and may be privy to local information of which the state is not aware. The proximity of local regulators better positions them to monitor and regulate systemic risks in their particular markets.

The Wenzhou regulations go a long way towards addressing and restraining the excesses of the underground lending industry while attempting to liberate the market to work within broad constraints. Nevertheless, the test of their suitability will be the underground lending market's continued ability to finance new businesses and provide for the financial needs of less-advantaged populations in a non-exploitive manner. We recognize the difficulty in achieving a workable balance between regulation and control (or governance, in the Chinese government's terminology), but remain concerned that the regulations as they currently stand may stifle the underground lending market's substantial contribution to economic growth by unduly restricting the number of lenders, their fundraising capabilities and, ultimately, the amount of credit they can provide. In the absence of a significant liberalization of the FLM, the ILM remains the lender of last resort for a segment that has become the primary driver of China's economic growth. While we would prefer that the FLM is liberalized sufficiently to serve the entire Chinese population, we

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\(^6\) The Wenzhou failure demonstrates the extent to which entrepreneurs may be willing to over borrow.
acknowledge current political and cultural realities and thus, for the time being, advocate careful monitoring of the capital supply in Wenzhou to ensure that it is adequate to the population’s needs and sufficiently affordable. We now turn to examine the potential for greater financial innovation in the ILM more broadly.

THE NON-UNDERGROUND BANKING SECTOR AND THE POTENTIAL FOR INNOVATIVE FINANCE: THE “INDUSTRIALIZATION OF CHINESE FINANCE”

Financial innovation in the SME sector is unlikely to come from State-owned banks, which generally are unfamiliar with the needs and operations of SMEs, even at the local level (Wang, 2004). Further, given the “Wild West” quality of the existing underground lending market, it would be more efficient and effective for market solutions to come from that segment of the private commercial lending market that consists of experienced informal lenders (Lin and Li, 2001). The booming Fintech sector is a good example, showing the robustness of the private sector and high-tech sector and their ability to penetrate into the tightly closed and heavily regulated financial market. By relying on high-tech, some private players are able to become part of the financial sector without seeking approvals or licenses from financial regulators. Financial innovation can assist high-tech companies in entering into the financial market and also widen the boundaries of the financial sector. As a matter of fact, the Fintech sector largely serves consumers who are not well served by large state-owned banks. In other words, the imbalance between demand and supply in the financial sector creates very strong incentives for financial innovation.

That market includes two types of institutions. Most important in terms of market share are twelve State-owned joint-stock commercial banks. That market also includes a growing number of foreign-owned banks including wholly foreign-owned banks, foreign-Chinese joint-venture banks, and wholly foreign-owned finance companies (which thus far have attained a market share of only 1.83% of total banking assets).61

CBRC approved five new privately held banks in 201462 as part of an attempt to develop a private financial sector. As part of this reform effort, China will allow qualified private investors to set up small and medium-sized financial institutions. Even as regulation catches up to reality, innovative finance continues to grow and will change the landscape of entrepreneurship, finance, and innovation in China by attracting non-traditional lenders who have achieved great success in other businesses. More than 20 listed industrial companies including air conditioner maker Gree Electric Appliances Inc., home appliance retailer Suning, and personal computer maker Lenovo have expressed interest in the banking business, suggesting both their perception of the size of the market and its potential profitability.

The entry of already well established, transparent, and mature businesses into the private lending market increases the potential for that market to mature along the lines of the FLM and eventually be absorbed therein. Online shopping giant, Alibaba Group Holding, has aggressively been taking deposits and lending to small businesses through its affiliate, Alibaba Small and Micro Financial Services. By February 2014, Yu’e Bao (literally meaning “leftover treasures”), Alibaba’s proprietary internet money-market fund, had accumulated more than 400 billion yuan in assets with more than 81 million investors,63 becoming the world’s fourth-largest mutual fund by early 2014, ranking in size with Vanguard Group and Fidelity Investments (Anderlini, 2014). By 2017, it further surpassed JP Morgan Chase’s US government market fund of US$150 billion to become the world’s largest money market fund with the total amount of US$165 billion (Guo, 2017). Media and entertainment giant Tencent Holdings has attracted 50 billion yuan to its Licaitong fund (Deng, 2014). In some cases, like that of Alibaba, development of on-line payment systems has led non-farm, non-financial companies into the informal banking sector.

THE ILM: A MATTER OF QUANTITY

The need for credit to enable SMEs (and poor households in a social development context) to produce, innovate, and grow is almost self-evident. Empirical evidence confirms that the availability of credit is likely to facilitate the formation and growth of SMEs and to stimulate overall economic and social development (Beck et al., 2004). Available credit helps to distribute income opportunities more evenly and effectively among various constituents in the community, helping to ensure social stability. Securing access to finance is perceived as a catalyst for attainability of the Millennium Development Goals.64

The FLM remains vital not only as a credit source for larger SOEs but also as a stabilizing force in the economy, a role the ILM does not serve with its (definitionally) less stringent monitoring and enforcement practices. Thus the dominant scholarly view (and ours) is that, as matters now stand, informal financial institutions complement the formal financial system.

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61 The combined assets of these establishments was valued in 2010 at US$1.74 trillion yuan. PWC, Foreign Banks in China, May 2010.
63 Compared with 77 million equity trading accounts in China (Anderlini, 2014).
The law and finance literature finds strong correlation between well-developed financial systems and economic growth. China serves as a counter example. Much of its impressive private sector economic growth has been attributed to the ILM (Allen et al., 2005). Empirical findings reveal that individual firms that rely on informal financing do not actually grow faster or have higher productivity growth than bank-financed firms (Ayyagari et al., 2010). But the extraordinary growth in the Chinese private SME sector is undeniable. We resolved this apparent paradox by suggesting that the cause of this growth is the number of new businesses formed as a result of the broader availability of credit provided by the ILM rather than the growth in the size of individual SMEs. This implies that the ILM and FLM serve complementary but equally vital purposes in stimulating China's economic growth: The ILM serves to launch private businesses, a role crucial to innovation and, ultimately, wealth-distribution among a population largely excluded from the FLM, and the FLM serves (or could eventually serve as the Chinese economy matures) as a source of permanent financing for these newer private enterprises once they attain economic maturity. The ILM improves the efficiency of capital accumulation and mobilization that the FLM fails to achieve alone (King and Levine, 1993).

One can thus see in the channel used by the ILM to stimulate growth, an analogy to the role of domestic venture capital (VC) in developed economies. At one level, ILM plays the same role as financial intermediaries in FLM in terms of granting credits to entrepreneurs (Schumpeter, 1911), thereby stimulating financial activities, innovations, and encouraging economic circulations and growth. However, like VC, typical ILM lending finances the early stages of business development and growth. Like VC, ILM lending is a high-risk, high-return proposition, even under the more regulated new environment. According to market statistics, the highest average return rate for the companies listed on the Shenzhen Growth Enterprise Market (highest-return capital market among others) in 2012, was 4.31 times. In the equity control market, the average return rate was 1.1 times in 2012. Other empirical research indicates a 10-times return annually for VC-backed investment, which not only outperforms the public equity funds in China but also US VC-backed IPOs (Weng, 2011). Accordingly, we suspect that as this economy of private SMEs evolves, ILM lenders, like VC lenders, will exit, possibly after converting to equity, to be replaced by permanent capital raised in the FLM or even public equity. Moreover, on default, ILM lenders may be only concerned about the repayment of the loan instead of the borrower's business operation. In this sense, ILM acts as VC or PE that basically only focuses on the preference rights over the return rate and distribution of remaining assets when the target company is bankrupt. This may be even more desirable to the target company compared to bank loans as banks usually impose affirmative or negative covenants on the borrowers, restricting their freedom to run the business. Of course, there are significant differences, both theoretical and practical, in the way the ILM currently operates in China, and we hope to explore these ideas in a future broader article dealing with the ILM in developing countries. However, we think that these suggestions are helpful in understanding that the actual economic growth role of the ILM looks more like equity than it does conventional debt. Market liberalization that aids in valuation thus attains even greater importance.

With these thoughts in mind, we can turn again to the question of the repression–liberalization balance by surveying some of the additional reform suggestions that have been made to mitigate negative effects of the ILM. It should be clear, especially in light of our understanding of the growth role of the ILM, that we see continuing market liberalization as the crucial motivating theme. Market liberalization is necessary to allow interest rates achieve proper levels. It is even more necessary to aid ILM lenders in the proper valuation of new and growing SMEs, a function that will reduce the misallocation of resources among new and growing SMEs.

While the liberalizing (within limits) reforms in Wenzhou are important and will likely remedy some of the negative effects of underground lending, the extent of the problem, the role of government, and the range of sophistication in the financial systems may affect the efficacy of these solutions. For instance, formalizing underground lending firms may increase bureaucratic and monitoring costs, which negatively affect both borrowers and lenders for the sake of market efficiency and transaction costs. Lowering interest rates will shrink the lender’s profitability margin, leading to a cut of the overall amount of lending. This pushes borrowers back to the underground lending markets.

Without proper policy actions, the negative impacts on private firms and the ILM could potentially cause deeper economic distress and unexpected political unrest. The policy should place more emphasis on the supply side of the financial market by offering more formal funding. Some

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65 The informal or underground lending market is made up of private money lenders, loan sharks or pawnshops, which provide an additional source of capital for households or entrepreneurs. These financing institutions are not licensed or supervised by a regulatory or supervisory authority, which distinguishes them from formal lending institutions.

66 Our argument is not dissimilar to Richard Booth’s evaluation of the US junk bond market in the 1990s (Booth, 2001 & Booth, 1987).

67 Zero2IPO Research, China Private Equity Statistical Report 2012, p.83. The other research, taking 146 GEM listed companies with VC investment as research samples and applying an empirical study, concludes an average 10.9-time return rate (Zhou et al, 2013).

market economy approaches can help strengthen the supply side. A recent example was a legislative reform in 2008 of widening the collateral pool to allow the SMEs’ use of movable collateral in financing. Moveable assets account for over half of their assets, compared to real estate collateral that SMEs do not possess. This reform triggered 36 trillion yuan transactions in its first five and a half years (IFC, 2013).

Microfinancing can be the other solution as it brings broad access to credit. To make microcredit firms work, government support or public funding is a must. In a larger context, China needs to turn its financial market from a repressed one to a liberalized one. With credit controls and interest rate controls in place, the state-owned sector, large firms, favored industries, and well-connected clients are more likely to secure more formal bank lending at more favorable terms and conditions, that is, a lower interest rate. By contrast, small firms and start-up firms will have to pay higher interest rates or be subject to less favorable terms in lending transactions. The equilibrium can be adjusted or rebalanced through the relaxation of financial controls and an increase in market competition.

Financial repression, even in a weaker form, can be used to maintain and drive up consumer deposits as a stable and less expensive source of revenue and funding, which is necessary to keep China’s economy growing. In the foreseeable future, the ILM may continue to grow because of the following: (i) the demand for informal finance may still grow as formal finance may not satisfy the need; and (ii) the supply may also grow as the financial market is still repressed and formal lenders try to maximize their profitability.

Given the benefits of financial repression and the huge size of non-performing loans and local government debts, maintaining the status quo may make sense for the time being so as to ease the repayment of growing debts in the face of a potential debt bomb. Getting a handle on debt without disrupting economic stability and social harmony probably suggests that China should continue to practice its opaque financial repression as the preferred approach to minimize side effects of its slowing economy instead of suddenly switching to a financial market liberalization strategy. Nevertheless, in the long run, China needs to reform its financially repressed regime, which is not compatible with the needs of a modern consumer finance industry.

Empirical work has revealed that the more concentrated a nation’s financial resources tend to be, the higher is that nation’s level of poverty (Claessens and Perotti, 2005). Access to finance can be used as a device to improve this imbalance, which favors some constituents over others.

 Widening the channels to funding can be achieved through the opening-up and strengthening of the capital markets or the reform of the existing financial regime in a manner that erodes the power of incumbent elite groups (Rajan and Zingales, 2004). Deeper financial market reform, as empirical studies claim, is not only a precondition to effective financial liberalization (de Haan and Sturm, 2016) but also a far-reaching policy instrument to help overcome barriers to market entry, thereby increasing economic growth and reducing inequality (Claessens and Perotti, 2005). Nevertheless, broader and deeper financial reform may be blocked by concentrated political powers and vested economic interests and, indeed, requires an effective institutional structure, which China does not currently possess. Ironically, perhaps, a top-down reform is needed to have a liberalized and bottom-up consumer-based financial regime, which not only presents citizens more economic benefits but also economic and political rights.

ACKNOWLEDGEMENTS

This study was supported by the SJTU Global Strategic Partnership Fund (2019 SJTU-UNSW), and the major project of China’s National Social Science Foundation under Grant 20ZDA062.

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20 All real property in China is owned by the state.


22 An effective institutional structure is critical to the operative performance of banks. It was claimed that institutional differences between China and India caused efficiency differences between banks facing banking crises in these two countries. Sapna Khurana, "Comparative Study of India and Chinese Banking Sector and Its Role in Their Economic Growth and Development", available at http://tmgs.lsrj.in/SeminarPdf/177.pdf.

23 There is a dynamic relationship between financial liberalisation, financial development and inequality reduction (or economic growth). Empirical studies have produced contradictory results, which can be a useful caution to the over emphasis on financial liberalisation or financial development (de Haan & Sturm, 2016).

In brief, the disconnection between the conventional wisdom in law and finance theory and China’s financial development may lie in the mysterious relationship between the visible hand of the government and the invisible rights (in terms of equal and fair treatment or competition neutrality).


