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One of the central paradoxes of economic development in contemporary China is the rapidity of private sector growth in the absence of access to official sources of finance. In 1977, China did not even keep official statistics on private enterprises because they were illegal and negligible in number. By 2005, there were 29.3 million private businesses, employing over 200 million people and accounting for 49.7 percent of the GDP.[1] Yet as of mid-2006, less than 1 percent of all loans extended by state commercial banks were going to private businesses, and private firms constitute less than 6 percent of those listed on China's equity markets.[2] Given such limited access to capital, it should not be surprising that the vast majority of private entrepreneurs have relied on informal sources of finance, or what economists call the curb market. Based on field research conducted over 1996-2001, my book *Back-Alley Banking* estimated that during the first two decades of reform informal finance accounted for up to three-quarters of private sector credit.[3] A study conducted by a Chinese economist estimates that the total volume of curb market lending in 2003 ranged from 740.5 (US$91.42 billion) to 816.4 billion RMB (US$100.79 billion), which on average represents 28.07 percent of the total scale of lending by formal financial institutions.[4] And the People's Bank of China's 2004 survey of informal finance estimated the annual scale of informal lending to be 950 billion RMB (US$118 billion), or 6.96 percent of the country's GDP.[5] The causes and consequences of this underground dimension of private sector finance are not just economic, but also political in nature.

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[1]Xiao Ma, "Private Firms Crucial for Employment," *China Daily*, December 14, 2005. The 2005 OECD report on China estimates that the private sector accounts for two-thirds of the national economy—a level comparable to Great Britain on the eve of Margaret Thatcher's liberalizing reforms in the 1980s. OECD, *Economic Survey of China 2005* (Paris: OECD, 2005).

[2]When I first started research on this topic in the early 1990s, the private sector received less than 0.4% of all loans extended by state banks. Official statistics indicate that between June 2005 and May 2006, an average of 0.66% of loans extended by state banks were going to private and individual enterprises. See PRC National Bureau of Statistics, *China Macro-economy Statistics*, accessed from the All China Data Center on August 17, 2006.

[3]Kellee S. Tsai, *Back-Alley Banking: Private Entrepreneurs in China* (Ithaca: Cornell University Press, 2002), 37.

[4]The 2004 national survey (n=7,000 in 20 provincial-level units) was lead by Professor Li Jianjun of the Central University of Finance and Economics. See Li Jianjun, *Zhongguo dixia jinrong guimo yu hongguan jingji yingxiang yanjiu* [Research on the scale of underground financing and its economic effects] (Beijing: Zhongguo jinrong chubanshe, 2005).

[5]*Zhongguo jingying bao* [China Management News], August 6, 2005.

The paper proceeds as follows. The first section outlines the reasons why the state banking system has not been able to meet the private sector's demand for credit. The second section summarizes the primary forms of curb market finance used by private entrepreneurs. The third section discusses the nature of local variation in informal finance. The fourth section outlines recent efforts by China's financial regulators to limit informal finance. The paper concludes by explaining why merely increasing the availability of formal credit will not eliminate the use of informal finance.

Limited Private Sector Lending by State Banks

Despite repeated efforts to commercialize the state banking system, there are four main reasons why private entrepreneurs have experienced considerable difficulty in borrowing from official banks.

The first reason relates to political concerns about supporting the state sector and maintaining social stability. Until very recently, state banks have been pressured by local governments to provide soft loans to state-owned enterprises (SOEs) as a means to avoid mass unemployment. (This is also one of the main reasons why state banks have such high levels of non-performing loans.[6])

The second reason derives from the developmental priorities of central and provincial governments. State banks may extend loans to enterprises in sectors that have been identified for preferential treatment as a matter of domestic industrial policy (e.g., automobiles, pharmaceuticals, computer components). This type of targeted lending is not corrupt or illegal per se; it is policy oriented.

The third reason for the private sector's exclusion from official credit relates to the limited organizational and technical capacity of state banks to serve the non-state sector. Credit officers have not been trained to evaluate loan applications according to commercial standards of creditworthiness, and until the late 1990s, they were not held accountable for high levels of non-performing loans in their portfolios.[7]

The fourth and related reason why bank lending to private entrepreneurs represents a miniscule proportion of official credit is due to the ideological and political sensitivity of using party-state resources to support capitalist ventures. Especially during the first two decades of

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[6]Official statistics indicate that the level of non-performing loans (NPLs) in the main four state commercial banks decreased from 15% to 10.5% in 2005. However, the disposition of NPLs is largely due to the transfer of NPLs into four state-owned asset management companies (AMCs). Furthermore, real estate loans extended between 2002 and 2004 may lead to additional NPLs. A controversial—and now recalled—report issued by Ernst and Young earlier this year estimated that the total NPL liability from all formal financial institutions, including banks, AMCs, investment companies, and credit cooperatives exceeds US$900 billion.

[7]Between 1998 and 2002 bank managers were especially cautious about their lending decisions because reducing NPLs was a key component of their job performance evaluations. In 2002, bank managers received new incentive contracts, which rewarded them for reducing NPL ratios. This has had perverse effects: bank managers have tried to increase the denominator of the NPL ratio, total loans, in order to reduce the ratio. In June 2006, the China Banking Regulatory Commission attempted to curb lending growth by asking 14 banks to halt or curtail new loans (Bank of China and the Industrial Commercial Bank of China were allowed to maintain current lending levels).

reform, loan officers were reluctant to work with private entrepreneurs due to uncertainty about the potential consequences. Even though credit officers are now encouraged to lend to profit-making businesses regardless of ownership type, they remain wary about making bad loans to private individuals.[8] In short, state banks remain institutionally biased against private sector clients.[9]

Informal Sources of Private Finance

In my *Back-Alley Banking* survey of private entrepreneurs, over 70 percent of the respondents admitted to relying on the curb market. The following table shows that the informal financing mechanisms used by private entrepreneurs have varying degrees of legality within China.

Table 1. Overview of Curb Market Activities in China

Legal	***Quasi-Legal***	***Illegal***
Interpersonal Lending	Rural Cooperative Foundations (illegal since 1999)	Professional Brokers and Money Lenders (Loan Sharks)
Trade Credit	Red Hat/Hang-on Enterprises	Private Money Houses
Rotating Credit Associations (in some areas)	Financial Societies/ Capital Mutual Assistance Associations	Rotating Credit Associations (in some areas)
Pawn Shops (in some areas)	Pawn Shops (in some areas)	Pyramidal Investment Schemes (scams)
Shareholding Cooperatives		Diversion of bank loans via state units

Note: None of the practices/institutions in the second and third columns are sanctioned by the People's Bank of China. Those in the first column are only "legal" if they do not entail the use of interest rates. "Quasi-legal" practices are those registered by a bureaucracy outside of the financial hierarchy. Source: Adapted from *Back-Alley Banking*, Table 2.3, p. 37.

Starting from the legal end of the spectrum, financial regulators generally condone casual lending among friends and relatives as an innocuous form of mutual assistance at the grassroots level. In most parts of China, rotating credit and savings associations (ROSCAs) fall into this benign category of "popular finance" (*minjian jinrong*). ROSCAs became illegal in certain localities because they mutated into ponzi schemes that adversely affected large portions of the local population, but generally speaking, informal financing strategies such as personal loans,

[8]Over the last three years, credit-tightening measures intended to quell excessive investment in overheated sectors has reinforced this reluctance.

[9]Note that the conversion of urban credit cooperatives into city commercial banks starting in 1997 was intended to enhance the availability of commercial credit to urban residents, including business owners. As of 2006 there were 117 urban commercial banks, some of which are starting to attract investment by foreign banks. See "China to Merge 10 City Banks into One," August 7, 2006 and "City Lenders Lure Foreign Investors," *China Daily*, April 5, 2005.

trade credit, and ROSCAs fall within the realm of legality—or at least, not explicitly illegal in China.

The dividing line between legal and illegal forms of informal finance is that those involving interest rates above the state mandated interest rate ceilings are not sanctioned.[10] Thus, for example, short-term interest-free lending between merchants is acceptable, but by definition, loan sharks generally violate interest rate ceilings. And with the exception of Minsheng Bank, private commercial banks and private money houses are illegal.

In reality, however, most forms of informal finance that private entrepreneurs use fall into the gray area of *quasi-legality*. By "quasi-legal," I mean the financial institutions that are not sanctioned by the People's Bank of China, but are legally registered by another governmental agency. A fitting example of this is rural cooperative foundations (RCF's), which were established in the late 1970s by the Ministry of Agriculture and run by township and village governments to provide farmers with grassroots credit. The People's Bank opposed RCFs from the outset by refusing to recognize them as legitimate financial institutions. Yet RCFs flourished in provinces with large agricultural sectors, including Sichuan, Jiangsu, Henan, Hunan, Shandong, and Jiangxi. By 1998 there were over 18,000 branches serving over five million depositors, and RCFs had mobilized over 100 billion RMB in deposits.[11] After an extended tug of war between the People's Bank on the one hand, and the Ministry of Agriculture and local governments on the other, in 1999 the PRC State Council ordered RCFs to either shut down or merge with rural credit cooperatives.[12]

Other examples of quasi-legal financial institutions include mutual assistance societies and cooperative savings foundations. They are registered with the Civil Affairs Bureau as non-profit organizations that are meant to help the poor and/or retirees; but in reality, they often extend loans to private enterprises and offer high interest rates on savings deposits. Financial rectification campaigns occasionally succeed in identifying and closing down such operations, but the curb market operators generally find a way to revive their businesses, e.g., by re-registering with a different regulatory entity such as the Industrial and Commercial Management Bureau.

Besides turning to informal financial intermediaries, private entrepreneurs also rely on deceptive ways of raising capital such as registering a business as a collective enterprise even

[10]However, legally registered rural credit companies and certain microfinance institutions have been granted the authority to float their interest rates.

[11]Cheng Enjiang, Christopher Findlay and Andrew Watson, "Institutional Innovation without Regulation: The Collapse of Rural Credit Foundations and Lessons for Further Financial Reforms," in Christopher Findlay, Andrew Watson, Cheng Enjiang, and Zhu Gang, eds., *Rural Financial Markets in China* (Canberra: Asia Pacific Press, 2003), 89-104; and Carsten A. Holz, "China's Monetary Reform: The Counterrevolution from the Countryside," *Journal of Contemporary China* 20, 27 (2001): 189-217.

[12]The impetus for the closure of RCFs was due to the failure of certain RCFs to honor deposits and the center's concern that left unregulated, RCFs could threaten social stability in the countryside. Ironically, after the forced closure of RCFs was announced, farmers' protests broke out in at least six provinces. See Tsai, *Back-Alley Banking*, 244, nt. 79.

though the business is actually privately owned. This is called "wearing a red hat" because the color red symbolizes communism. A related strategy is registering as a subsidiary of a SOE, which is called a "hang-on" enterprise because the private business basically hangs on to the SOE's name for the purpose of getting credit from state banks. Both red hat and hang-on enterprises are quasi-legal and generally left alone because they have formal registration status.[13]

Finally, an illegal channel through which private businesses may gain access to bank loans is by borrowing from state units that have access to formal sector credit. Such diversion of bank loans by SOEs and governmental entities constitutes corruption (i.e., embezzlement/*tanwu* or misappropriation/*nuoyong* of public funds exceeding 5,000 RMB).[14]

The actual scale and volume of each of the financing mechanisms in the table is difficult to assess at the national level because they reside beyond the official banking system. But a conservative estimate would be that informal finance has accounted for at least one quarter of all financial transactions in the Chinese economy, and as mentioned above, the curb probably accounts for up to three-quarters of private sector finance. During periods of tighter credit controls, investors seeking higher returns divert their savings from formal financial institutions into the curb market. For example, this was reflected in the declining growth in savings deposits over the first three quarters of 2004, which prompted the People's Bank to increase interest rates by 27 basis points in October 2004. My interviews with various economists and bankers suggest that the interest rate increase was motivated in part by the desire to bolster savings deposits and limit curb market activities. In April 2006, the People's Bank increased the benchmark rate on loans by another 27 basis points (bp), but left the deposit rate unchanged; and on August 18, 2996, both the benchmark lending and deposit rates were raised by another 27 bp.[15] The recent rate increases are intended to limit "excessive investment." Despite the rate increases, however, rates are still much lower than the market-clearing levels. At present the one-year deposit rate is 2.52 percent and the one-year lending rate is 6.12 percent. In contrast, mutual assistance societies can offer savers approximately 24 percent annual returns on deposits, while ROSCAs in the coastal south can offer members returns as high as 36 percent/year. Meanwhile, lending rates in the curb market also exceed the benchmark lending rate of state banks.[16] The People's Bank's 2004 study found that interest rates on informal loans average 12 percent annually, but range up to three times higher than the level of official bank rates.[17]

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[13]While deceptive, the phenomenon of "wearing a red hat" is not a secret. It was especially widespread during the 1980s when the political status of the private economy was still uncertain. The practice became so common that it became and remains a part of everyday discourse in China. Even officials and newspapers refer openly to "red hat enterprises."

[14]On the various ways in which loans may be embezzled or misappropriated, see Yan Sun, *Corruption and Market in Contemporary China* (Ithaca: Cornell University Press, 2004).

[15]For more detail, see the People's Bank of China website at http://www.pbc.gov.cn.

[16]For example, prior to the 27 bp increase in April 2006, one report found that pawnshops in Beijing charge 4.7 percent/month on regular loans and 3.2 percent/month for loans secured by property. "China's Trapped Entrepreneurs Fuel Pawnbroking Boom," *China Daily*, February 27, 2006.

[17]Private correspondence, August 18, 2006.

Local Variation in Curb Market Activity

Although China's private entrepreneurs share the structural condition of restricted access to formal bank credit, substantial variation exists among localities in the scope and scale of curb market finance. These differences are due to a combination of infrastructural, economic, and political factors.

First, the official supply of credit in rural areas has become increasingly limited. In 1999, 31,000 rural branches of state banks were closed down. Meanwhile, the loan-to-deposit ratios of rural credit cooperatives (RCCs) have steadily declined; by the end of 2002, savings deposits in RCCs exceeded their loans by 535 billion RMB (US$64.5 billion), and over 300 billion RMB (US$36.1 billion) in deposits had been transferred from rural to urban areas. As a result, it is estimated that farmers and individual entrepreneurs in rural areas derive at least 70 percent of their capital requirements from the curb market.[18]

Second, the volume of curb market activity is higher in areas with more developed non-state sectors because the demand for credit outstrips its official supply. This is especially the case in the coastal south. According to local estimates, for example, the scale of informal lending in Guangdong province may be as high as 500 billion RMB (US$60.3 billion) annually.[19] Along similar lines, the monthly individual contributions for rotating credit associations in Fujian province are sometimes as high as 100,000 RMB (US$12,195), resulting in complex networks of associations that have reached 300 million RMB (US$36.6 million) in scale.[20] In the rural locality of Wenzhou in Zhejiang province alone, the volume of informal lending was 96.4 billion RMB (US$11.8 billion) in 2003.[21] (The sum of these three local estimates suggests that official surveys of informal finance have vastly underestimated the true scale of China' s curb market.)

Third and relatedly, vibrant informal financial markets have flourished where the local government has protected curb market operators from the repeated disciplining efforts of state banking regulators. This variation in curb market activity reflects differences in the developmental orientation of local governments. In areas dominated by the state sector, local governments have pressured state banks to extend soft loans to local SOEs or collective enterprises, while private firms face greater restrictions in the types of informal financing

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[18]OECD, *Rural Finance and Credit Infrastructure in China* (Paris: OECD, 2004); and Xu Dianqing, "Farmers Lack Funding Sources," *China Business Weekly*, July 20, 2004.

[19]Wu Zhong, "Gray Money Pays its Way," *The Standard: China's Business Newspaper*, January 24, 2005.

[20]Tsai, *Back-Alley Banking*, Ch. 3; and Raymond Zhou, "Money Game: Rotating Illusion of Getting Wealthy," *China Daily*, June 30, 2004.

[21]As of year-end 2003, out of a total of 134.3 billion RMB in loans, 96.4 billion were informal. "Informal Money Lending is Still Hot in Wenzhou," *Nanfang shibao*, January 18, 2005.

mechanisms that are implicitly permitted.[22] In certain areas that were less industrialized on the eve of reform, however, local officials have allowed the establishment of quasi-legal and illegal financial institutions that compete with one another and infringe upon the business of official state banks. The case of Wenzhou in Zhejiang is the archetypal example of this situation.

More broadly speaking, Wenzhou is also an example of a locality that consistently ignored national economic policies—but eventually managed to receive concessions from the center to experiment with alternative financial instruments.[23] For example, on the eve of reform in 1978, a rural credit cooperative (RCC) in Jinxiang Township/Wenzhou, only had 230 RMB (US$69.70) in savings deposits and was unable to meet the local demand for credit. The manager of the cooperative thus autonomously decided to float its interest rates well above the official ceiling of 3.6 percent annual interest.[24] By 1980, the credit cooperative had mobilized over 400,000 RMB (US$117,994) in savings and was making a profit. This remarkable resuscitation of a RCC attracted Beijing's attention, so the central government sent a group of economists down to the backwater locality of Jinxiang to conduct an investigation. The economists met with the RCC staff, interviewed small business owners, and concluded that the Jinxiang RCC should be permitted to float its interest rates on an experimental basis.

It was also in Wenzhou that private money houses (*siren qianzhuang*) first re-emerged in post-1949 China. The local government was able to protect them throughout most of the 1980s, but after the political crisis of 1989, national banking regulators forced them to shut down. Despite the explicit prohibition on private banks, Wenzhou's entrepreneurs found alternative ways of registering their financial service operations (e.g., as urban credit cooperatives or regular businesses). Meanwhile, local officials maintained a highly defensive, if not defiant attitude towards national policies that constrained the innovative activities of its entrepreneurs. In 2003, when 71.8 percent of all financial transactions in Wenzhou were occurring outside of the formal banking system,[25] the People's Bank of China designated Wenzhou as an official experimental district for financial and banking reforms. Although Beijing is watching it closely, Wenzhou and other cities in Zhejiang province now have legal, commercial banks that are allowed to accept private investment, extend small loans (less than half a million RMB or about US$60,975), and float its interest rates. In this sense, Wenzhou may still be considered a case of inspiring "reform from below"[26] and at least partial formalization of its informal institutions. Rather than continuing a losing regulatory battle with Wenzhou's officials and entrepreneurs, the People's

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[22]"Chinese Lawmakers Urge Crackdown on Local Protectionism in Debt Cases," *Xinhua*, August 24, 2002.

[23]The case of Wenzhou is discussed more extensively in Wang Xiaoyi, Kellee S. Tsai, and Li Renqing, *Nongyehua yu minjian jinrong: Wenzhou de jingyan* [Rural industrialization and informal finance: Wenzhou's experience] (Taiyuan: Shanxi jingji chubanshe, 2004).

[24]Interview with Jinxiang Rural Credit Cooperative director, Jinxiang Township, Wenzhou, Zhejiang, November 21, 2001.

[25]"Informal Money Lending is Still Hot in Wenzhou," *Nanfang shibao*, January 18, 2005.

[26]Ya-Ling Liu, "Reform from Below: The Private Economy and Local Politics in the Rural Industrialization of Wenzhou," *China Quarterly* 130 (June 1992): 293-316; and Parris, "Local Initiative and National Reform."

Bank finally succumbed to adjusting the rules of the game to accommodate the locality's economic conditions.[27]

Official Reactions to Informal Finance

Most economists explain the rise of curb markets as reflecting the inability of the formal financial system to meet the needs of some portion of the economically active population. In other words, when the demand for credit exceeds the official supply of credit, would-be borrowers will turn to unofficial sources. This explanation makes particular sense for China during the 1980s when state banks engaged mainly in policy lending to state and collective enterprises, while private businesses were excluded from official bank credit. The credit crunch was especially severe in places such as Wenzhou where rural industrialization was lead by non-state firms early in the reform era, but state banks were unable and unwilling to lend to private entrepreneurs. The People's Bank recognizes that this is why official efforts to close down informal financial intermediaries are often ineffective.

Based on the assumption that the private sector relies on informal finance due to its exclusion from the formal financial sector, both the central and local governments have implemented various reforms and initiated various experimental measures to increase the availability of credit to private entrepreneurs. The 1997 conversion of urban credit cooperatives into city commercial banks (CCB), for example, was not only meant to improve the efficiency of credit cooperatives, but also to provide financial services to credit-worthy private businesses.[28] Given that many CCBs were still reluctant to undertake the risk of lending to private clients, in 2001 local credit guarantee companies began to emerge to serve the market of potential private borrowers.[29] And in July 2005, the China Banking Regulatory Commission issued "Guidelines on the Credit Business of Commercial Banks to Small Enterprises," which was intended to enhance the access of small businesses to various financial services. Since then, various commercial banks have established special credit facilities for small and medium sized businesses. Furthermore, at the end of 2005 two private microfinance institutions were established in Pingyao in Shanxi province; given their special status as experimental projects, the microfinance institutions are permitted to charge interest rates up to four times the official benchmark lending rate.[30] All of these measures reflect the fact that the People's Bank seeks to reduce widespread reliance on informal finance by either increasing the availability of formal credit or regulating viable types of informal financial intermediaries.

[27]As a former director of the Wenzhou branch of the People's Bank explained to me, "The higher-level People's Bank kept telling us to get rid of illegal financial institutions, but we knew that there was really a local need for them…It was a losing battle: for every one illegal financial institution that we succeeded in closing down, another five would spring up."

[28]See nt. 9.

[29]See http://www.chinaguaranty.net for some of their locations.

[30]Wu Xiaoling, "Create a Favorable Social Environment for the Development of Micro-Credit Business," Speech delivered at the Asia Pacific Micro-Credit Forum, Beijing, China, March 22, 2006; and *Economic Daily*, December 28, 2005.

Why Informal Finance will Persist

While conditions in the formal financial sector certainly influence the relative popularity of informal finance, I would like to conclude by emphasizing that local political and social factors also mediate the workings of the curb market. This means that increasing the availability of formal bank credit (and indeed, even microfinance) may reduce the overall volume of curb market transactions, but is not likely to eliminate them completely.[31] The rationale for this contention is based on the observation that local political and economic actors in China often have interests that diverge from that of Beijing.

One of the key reasons that repeated efforts to crackdown on informal finance have failed is because local cadres have incentives to permit informal finance. Economically, cadres in certain localities see no reason to interfere with the local curb market when it functions efficiently because local entrepreneurs clearly depend on it to run their businesses.[32] When the latter prosper, cadres receive professional rewards for promoting local economic development. Local governments also have a fiscal incentive to permit curb market activity.[33] Approximately two-thirds of China's township and village governments are operating in a deficit situation. In areas where informal finance is well developed, local governments rely on the curb to finance basic public services such as paying teachers salaries and building roads.[34] And finally, in many cases local cadres have a personal incentive to allow informal finance because they participate in and profit from the curb market themselves. Ultimately, local officials are also a fundamental part of the local political economy; they, too, are entrepreneurs.

In addition to the local political factors supporting the persistence of informal finance, the other main reason why increasing the supply of formal credit may not translate into a matching decline in curb market activity is because local credit markets are segmented. In most localities, credit markets are segmented along gender and economic lines, but in some localities, kinship ties and Communist Party affiliation also mediates access to both formal and informal sources of credit. Both within and beyond China, examples abound of cases where government-distributed microloans that are intended for impoverished women and farmers end up going to higher-income men for non-agricultural and consumption purposes. In short, the dynamics of local social stratification can be expected to shape access to many types of resources, including credit.

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[31]This argument is further developed in Kellee S. Tsai, "Imperfect Substitutes: The Local Political Economy of Informal Finance and Microfinance in Rural China and India," *World Development* 32, 9 (2004): 1487-1507.

[32]My research found that even in cases where large entrepreneurs have access to formal bank credit, they still prefer to work with informal moneylenders because it is more convenient. Some informal financiers are known for operating 24 hours/day, 365 days/year and since most are now available by cell phone, in some localities they are popularly called "cell phone banks" (*shouji yinhang*).

[33]On the accumulation of "extra-budgetary funds" and "extra- extra-budgetary funds" at the local level, see Kellee S. Tsai, "Off Balance: The Unintended Consequences of Fiscal Federalism in China," *Journal of Chinese Political Science* 9, 2 (Fall 2004): 7-26.

[34]For more detail, see Wang, Tsai, and Li, *Nongcun gongyehua yu minjian jinrong.*

Summary of Main Points

The main points of this testimony are as follows:

First, the main engine of China's reform-era growth, the private sector, has relied on informal rather than formal sources of credit.

Second, the People's Bank of China and the China Banking Regulatory Commission seek to limit informal finance by increasing private sector access to the banking system and experimenting with regulation of certain informal financial institutions.

Third, the above efforts are worth taking, but not likely to eliminate informal finance completely due to local political, economic, and social factors.