

Chapter 4

Informal Finance: Encouraging the Entrepreneurial Spirit in Post-Mao China

Michael Gonzalez

Kellee Tsai vividly remembers visiting the “Reading Here and Reading There Club,” also known popularly as the 3D Club (short for *Dulai, Duqu, Dushu She*), a magazine-reading club in the capital of Henan Province. One room resembled a public library, which was to be expected. It was the other room that was out of place. People were lining up to hand over wads of cash at the deposit windows while armed guards stood by. The place resembled more a bank in a major metropolis—and a very active one at that—than a reading club in a backwater province. That’s because it *was* a bank, albeit an illegal one.

The 3D was just a particularly ingenious example of a phenomenon that makes up the very sinews of capitalism in China. Without 3D and the many permutations of what is generically known as “informal finance,” China’s capitalist revolution would have been stillborn.

This is no hyperbole. Economists estimate that the money taken in as deposits by 3D and other “shadow banks” goes on to finance fully three-fourths of private-sector needs. 3D is also a particularly poignant example of human creativity and of how

freedom seeps into every crevice that government abandons, either because it lacks enforcement capacity or the will to use it.

In China, back-alley banks do most of the intermediation between savers and private businesses. In 2000, only 0.5 percent of loans extended by the state banks went to the private sector. It is estimated that even today, this number is not much larger than 1 percent.

Even when you count lending by the few legal private banks that do exist, such as the Minsheng Banking Corporation—or lending by state-owned enterprises that take in the loans they get from the state banks and then pass them on to put them to better use—informal finance accounts for 75 percent of private-sector finance. Foreign businessmen often complain about the difficulties of getting finance in China. Well, it isn’t much easier for the Chinese either.

VARIETIES OF INFORMAL FINANCE

Informal finance takes many forms. The illegal institutions that intermediate between China’s millions of savers and hundreds of thousands of small and medium-sized enterprises range from the large and imaginative,

The 3D was just a particularly ingenious example of a phenomenon that makes up the very sinews of capitalism in China. Without 3D and the many permutations of what is generically known as “informal finance,” China’s capitalist revolution would have been stillborn.

Informal banking is organic and has sunk deep roots, with the nearly three decades of Maoism constituting the only hairline fracture in the continuum of China's 5,000-year history.

like 3D, to simple associations. They can be groups of family members, neighbors, or friends who pool their cash and then lend it. Borrowers can be members of the associations or enterprises.

These rotating credit associations, which go under the general term of *hui* in Mandarin, can be as small as five to 10 people. They resemble other similar investing groups around the world, from the microfinance lenders in places like Bangladesh to the ladies' quilting clubs in the Midwest whose stock portfolios did so well in the 1990s. The main difference is that they inhabit a grey area of illegality.

Their resourcefulness is legendary. When Ms. Tsai, a finance professor at Johns Hopkins University in Baltimore, asked the 3D manager why there was a need for tellers, he gave her a knowing look and murmured something about the club members needing to "make deposits for their magazines." He added: "The more ambitious ones could make larger deposits, as large as 50,000 RMB. In a good year they could get 20 percent on that deposit."

The second-floor offices revealed the extent of 3D's reach. "I went upstairs with him and it looked like the trading floor at Morgan Stanley, and I know because I used to work at Morgan Stanley," Professor Tsai related to me. "They even had computer screens hooked up to Reuters, Bloomberg and UPI." The finishing touch was a banner hanging outside the premises that proclaimed proudly in giant characters: "the Communist Party of Henan Supports This Club Because It Promotes Spiritual Civilization and Helps Our Literacy Campaign."

The 3D Club does that and more. Private financing is an activity that is still mostly illegal in China almost three decades after Mao's death and little more than a year before China must fulfill its obligations to the World Trade Organization (WTO) and open its banking sector to foreign entities. Only a very few private financial institutions have been allowed to come into being legally. Minsheng remains the best-known example of a legal private bank, though many question the extent to which it is truly private. But the authorities cannot really stomp on

the informal institutions that have risen through the cracks because they are essential to the private sector.

The reason is simple enough, though still perverse. State banks—meaning the "Big Four" commercial lenders: Agricultural Bank, China Construction Bank, Industrial and Commercial Bank, and Bank of China—must carry the state-owned enterprises created in the communist era, which in some localities still employ the lion's share of the working population. Many of these companies are already bankrupt, but the state banks sustain their existence, making them the walking dead.

Foreign investors would dearly love to come in and fill the void, acting either as angels that give Chinese entrepreneurs a shot at life early in the process, or in mezzanine investment that provides capital to a company already providing a product downstream, or even as banks. Despite its towering reputation as the place to be, however, China continues to maintain a regulatory steel gossamer that prevents foreign capital from coming into the country. It is still not very clear how China will implement its obligation, made when it became a member of the WTO in 2005, to throw open its banking sector to foreign competition.

INFORMAL FINANCE AS MAINSTAY OF CAPITALISM

Until foreign banks come in and shake up the system, the local informal system will continue to be the mainstay of capitalism. This is the way it has been since time immemorial. Informal banking is organic and has sunk deep roots, with the nearly three decades of Maoism constituting the only hairline fracture in the continuum of China's 5,000-year history. In the ancient past, Buddhist monasteries used to act as pawnshops and to take in deposits as well. The system grew over time, and before Mao and the communists took over, the network was extensive and no longer limited to monasteries. The communists, desiring that the state have a monopoly on all things big and small, finance first and foremost, wiped out the system.

After Mao's death in 1976, and after the

end of the convulsions of the Cultural Revolution, China's new rulers decided to take a softer approach. Informal finance was one of the first things to crop up. Of course, China is a vast country, and not every part developed equally. In this way, the informal finance system became living proof of the value of localizing decision-making to the greatest extent possible.

The shadow banks have worked out different arrangements with local authorities, as the example of 3D shows. Today, areas where the communists invested heavily, such as Manchuria in the northeast, make up China's decaying rust belt and have little informal finance activity. Local authorities do not want depositors to have a choice of outlets. On the other hand, provinces or areas where the communists did not want to invest, such as Zhejiang Province, which was seen as sensitive because it is across from Taiwan, have seen a veritable mushrooming of back-alley banks and have thrived, with thousands of private businesses feeding off the illegal banks.

Informal finance cropped up first in regions where local proclivities and peculiarities contributed to its return. In the city of Wenzhou in Zhejiang Province—an area that has perhaps become, more than any other part of China, most closely associated with private finance—it was a combination of bad topography and worse linguistics.

Wenzhou is all mountains and water, so the lack of arable land always meant that its people had to depend on something other than farming. It has always been very difficult to reach, and even today a complicated combination of buses and trains is needed to get there. But as Professor Tsai reminds me, that can be said of thousands of places in China. The arable land of this hardscrabble country is less than 30 percent.

What helped Wenzhou to become even more isolated is that its geographical remoteness also encouraged a dialect that even people nearby cannot understand. The combination forged a people reputed to be among the best at "wheeling and dealing" in all of China.

In 1949, the communists had a very difficult time taking the area. Even during the

Cultural Revolution, there were stories of how Wenzhou people who were sent to hard labor in the countryside tried to supplement their income by selling dumplings to their tormentors, the Red Guards. As soon as the dead hand of the state began to be lifted following Mao's death, the city fathers once again allowed freedom to reign. Their attitude, says Professor Tsai, was "we're going to let our enterprises do whatever it takes to get ahead." The city became the first in China to ignore government ceilings on lending.

As with all new experiments, there were problems at first. Some of the shadow banks metastasized into pyramids and Ponzi schemes. Scandals broke out as some people absconded with the nest eggs of many. State authorities in Shanghai also blamed Wenzhou financial entrepreneurs for revving up the Shanghai real estate market in 2003, calling them "wandering ghouls."

Despite these kinks, however, informal finance has generally been very good at regulating itself. The system thrives exactly because it is informal. This self-policing keeps initiative-killing, artificial regulation away. As Wu Jianguan, the owner of a restaurant that specializes in such delicacies as shark's fin soup and large snails and whose business depends on illegal borrowing, told Matthew Forney of *Time* in 2004, "if the bank repossesses my home I have nowhere to live, but I can still do business. But if I fail to repay my friends, I'll never do business in this town again."

Classical liberal philosophers, who have long argued that the case for a "meta-enforcer" (the government) is a weak one, could not ask for a better real-life example to buttress their beliefs. The case against the meta-enforcer is twofold.

First, there is the problem of who regulates the meta-enforcer. In democracies there is an answer, albeit an imperfect one: The voters regulate the meta-enforcer at regular intervals with the ever-present threat of turning out the government. In China, there is no such check. Despite the incredible advances that have been made since the death of Mao, the meta-enforcer gets its legitimacy from the barrel of a gun. Witness Tiananmen Square.

Second, the classical liberal argument is

China is a vast country, and not every part developed equally. In this way, the informal finance system became living proof of the value of localizing decision-making to the greatest extent possible.

that the meta-enforcer is not really needed. Classical liberal thinker Anthony de Jasay sought to prove that people really do have an incentive to behave ethically and will do so without a regulator enforcing anything because there really is no escape. The world is not that big a place. In the Chinese universe, even if you become a stowaway on a boat and steal away to New York, your reputation will catch up with you.

INFORMAL FINANCE AND THE MONEY SUPPLY

Informal finance even damages the case for a monetary authority. Despite the recognition that shadow banks are needed to keep the private sector alive, the central government has seriously considered cracking down on them when it has feared that they will get in the way of central bank authorities' attempts to control the growth of the money supply. But the informal banks are closer to the people and have a much better intuitive sense of what the demand for money is. The supply they create through credit does not outstrip demand.

The interest rates in the curb market come closer to approximating the actual cost of money than do the rates charged by the central People's Bank of China. "China's curb market is remarkably efficient," says Professor Tsai.

One of the main reasons why unregulated rates are closer to the mark is that the "official" market has numerous distortions, "including most obviously, artificially depressed interest rates," says Professor Tsai. "The official banks also have stringent collateral requirements. They won't take your ox or your motorcycle as collateral. The informal financiers will." People who pay 20 percent for a loan, or higher, have fully worked out the likelihood of whether they will be able to pay back the money.

This should put to rest another question about informal finance: whether it is "usurious" or extortionary in any way. We are, after all, talking in some instances about pawnshops and loan sharks. Pawnshops have been, however, one of the earliest intermediators of capital. Whenever a king's favorite (an early form of prime minister)

or a financial official wanted to extend the financial elbow room in his realm, one of the first things he would do would be to send out the signal that pawnshops would be tolerated.

Under Mao, where everything happened in reverse, pawnshops were one of the first institutions to be repressed by the communists, and it later became standard communist propaganda to decry their existence under the Kuomintang: so much so that after the period of reform began and informal finance began to take off, authorities, even local ones, sometimes found it difficult to tolerate pawnshops. Despite their bad reputation, however, pawnshops can be viewed as little banks where a personal possession such as a ring becomes collateral for a small loan. It is not more usurious, parasitical, or predatory than a mortgage on a house; the only difference is in scale.

ENCOURAGING THE ENTREPRENEURIAL SPIRIT

Economists such as Hernando de Soto have rightly put an emphasis on the need to legalize underground activity. And in a sense, the important role that informal finance plays in China shows how dysfunctional the place remains. I prefer to think the glass is half full, however, and see the informal finance phenomenon as proof of how the entrepreneurial spirit of the Chinese people shines through any crack in the great wall of repressive government.

China is often seen as a capitalist powerhouse: too often, in fact. China is doubtlessly a manufacturing phenomenon that churns out billions in exports, but its potential remains shackled by dysfunctional policies left over from its recent communist past.

The dead hand of the state continues to restrain people's economic freedom in China more than it does in France or Germany—countries that are commonly thought of as socialist infernos. The reason China seems to have a more exciting future is perhaps that the government and its writ suffer from a deficit of legitimacy unknown in democracies and that the people are used to bypassing the law.

As the growing phenomenon of infor-

China is a fascinating study in the economic truths advanced by Adam Smith, Frederick Hayek, and Hernando de Soto, illustrating that its recent communist past continues to feed many serious policy distortions.

mal finance reveals, the Chinese are quick to open shop in any nook or cranny abandoned by the state. China is a fascinating study in the economic truths advanced by Adam Smith, Frederick Hayek, and Hernando de Soto, illustrating that its recent communist past continues to feed many serious policy distortions.