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Financial Networks and Informal Banking in China: From Pawnshops to Private Equity

China has emerged as one of the fastest growing economies in the world, despite a relatively weak financial system dominated by state-controlled banks and extremely limited access to capital for private entrepreneurs and consumers. In 2008, Chinese firms in the private sector continued to rely heavily on informal lending networks, even though they are technically illegal, because their access to formal financing through bank loans remained limited. According to a 2007 academic survey by the Beijing Central University of Finance and Economics, informal loans amounted to 28% of the total lending by official banking institutions in China.¹ With the recent credit crunch and global economic downturn hitting Chinese small business enterprises particularly hard, the Chinese government finally announced in November 2008 that it would reorganize the informal banking sector. The central bank has drafted a regulation which would make it legal for individuals to extend loans. And in provinces like Zhejiang, a hotbed of private entrepreneurship, regulators have now allowed firms that do not take deposits to start extending loans to small businesses.² Evaluating the beginning of drastic reforms, researchers at China's top policy institute project that "the government is going to accept what it previously wanted to crack down on, or even get rid of".³

Informal finance has a long history in China where modern banking institutions and instruments of finance did not develop until the first decades of the 20th century. These Chinese traditional financial networks and organizations providing credit and creative financial instruments have shown a remarkable level of sophistication. China's resilient informal financial market past and present presents a safety valve and alternative to the constraints set by a heavy-handed government controlling the economy and the financial realm attached to it. The fact that Chinese informal financial networks and institutions still play such an important role in China's economy of the 21st century tells us a lot about its political economy and the cultural and ideological agenda supporting it.

Professor Elisabeth Köll prepared this note as the basis for class discussion.

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The Historical Dilemma: China's Commercial Revolution without a Modern Financial Market

Unlike the West, China still lacked an effective medium of exchange as late as the eighteenth century. The use of paper money had vanished completely, so exchange took place through a bimetallic monetary system of silver and copper “cash” (round coins with square holes) (see **Exhibit 1**). From the sixteenth century onward silver had been imported from abroad into China in exchange for Chinese products such as porcelain, silk, and tea in large quantities which led to an increasing monetization of the Chinese economy.⁴ This commercial revolution not only increased the number and size of businesses in imperial China but also created the need for financial, social and professional networks necessary to support producers, traders, and merchants. These Chinese commercial institutions were successful in facilitating the spectacular economic growth from the sixteenth to the eighteenth century, but they were “inadequate for handling the scale of operations needed in the nineteenth-century world of steam-driven enterprises” such as factories, railroads, and steamers.⁵ In contrast, the sixteenth-century Western economies had developed the principles of commercial law, banking, and the concept of incorporation which enabled the emergence of credit instruments and a financial market catering to the needs of trade and industry. In China, the lack of a financial market meant that the development of banking institutions and paper instruments such as paper money, commercial bonds or shares came about only at the end of the 19th century, slowing the pace of industrialization.⁶

The early 20th century saw the emergence of modern banking institutions and credit instruments in China. However, this development did **not** lead to the disappearance of traditional financial networks or institutions but rather created a symbiotic relationship between the two realms of finance that lasted until the communist revolution in 1949. Interrupted by the first decades under full-fledged socialism and a planned economy that prohibited any type of private financing, the economic reforms since 1978 have led to a resurgence of informal financial networks. Despite the fast pace of market-oriented reforms in many sectors of the Chinese economy, the banking sector today is considered as one of the most conservative sectors under state control. Informal financial networks and organizations are dubbed “illegal” or “underground” by the Chinese government, although they provide invaluable financial resources for private entrepreneurs as well as for state-owned SME (Small and Medium Enterprises) which are unable to qualify for loans from state-owned banks. This informal or “underground” banking constitutes an important aspect of today's Chinese economy. A brief overview of financial instruments and organization in imperial China before the 20th century is important as they shaped the institutional and managerial evolution of financial networks in place today.

The Weight of the Visible Hand: Trade and Finance under Imperial Control

In the Confucian order of imperial Chinese society (i.e. before 1911), scholars and government officials occupied the highest position, followed by farmers, then artisans, with merchants at the bottom of the order. According to narrow Confucian interpretation, merchants did not engage in scholarship upholding the fabric of society and implicit imperial state-making nor did they produce anything of vital importance for the benefit of society like farmers and, to a lesser degree, artisans. Merchants' activities were considered motivated purely by self-interest and the desire for making profit at the cost of the people and their livelihood. This traditional social order was propagated and supported by the Chinese imperial government over centuries. Power and prestige in Chinese society came through academic success by passing the multi-tiered government exams and entering the imperial bureaucracy, but not by showing entrepreneurial talent and economic success. For example,

the sons of merchants were not allowed to sit for the imperial exams until the 19th century. Commercial activities and financial instruments necessary for the conduct of trade like credit were suspicious in the eyes of imperial officials. More important, there was **no concept of a market independent of the state**.⁷ Although the imperial government exerted control over commerce through strict regulations including trade monopolies, taxation policies and close monitoring within urban communities, it refused to promote and regulate private business enterprises and financial organizations.⁸ Without institutions for financial transactions sanctioned by the state, without a commercial law code until 1904 and legal representation of businessmen vis-à-vis the state, without social clout against the bureaucratic elite, merchants were always in a vulnerable position, prone to official extortion and arbitrary regulations. In Chinese cities, whose primary function was being the seat of the imperial bureaucracy, merchants kept their business locations physically as distant as possible from the government offices. (See **Exhibit 2**). The institutional void and constant tension between government and private business led to the creation and perfection of informal financial networks and institutions which became core factors enabling impressive economic growth in imperial China.

Raising Money and Establishing Trust: Pawnshops and Traditional Banks

Considering China's agricultural nature and the government's anti-commercial stance, it is not surprising that the earliest money-raising institutions can be traced back to Buddhist temples and monasteries. Pawnshops, owned by and operating in Buddhist monasteries, put the monasteries' huge donated wealth to use as early as the 5th century AD.⁹ By the 11th century, wealthy laymen took advantage of the tax-exempt status of Buddhist monasteries and formed partnerships for operating pawnshops.¹⁰ Pawnshops emerged as important informal banking institutions and nationally continued to grow well into the 20th century until the emergence of modern banks. These pawnshops with various levels of capitalization financed the needs of the poor and wealthy across society, especially tiding over impoverished farmers before harvest income and allowing more prosperous clients to pawn assets ranging from jewelry to land deeds. By 1933, Shanghai alone had 500 pawnshops which charged interest rates between 2% and 4.5% per month.¹¹ The impressive buildings housing major pawnshops in Chinese cities document their role as successful financial institutions in the local economies (see **Exhibit 3**).

By the end of 18th century, so-called native banks (*qianzhuang*) emerged as local, independent merchant banks which provided credit for individual merchants and traders. These traditional banks performed an important role in financing China's commercial revolution, and coastal cities such as Ningbo or Shanghai became known for the financial services of their native banks. (see **Exhibit 4**) The banks were financial firms, often owned in partnership by members of a family or lineage, and issued notes and used a clearinghouse.¹² However, there was no government backing of these banks' deposits or any regulatory framework protecting their investors and clients. As the 1858 observation of a government official quoted below shows, the notion of trust in the financial stability and honesty of the families and owners of the traditional banks became a key component in the success of these informal financial networks and institutions:

"The port of Ningpo has long had a reputation for money-lending.... This has been true since the time when the wealthy families of Ningpo opened *chien chuang*, and everyone who had any money wanted to deposit it in these shops, receiving a certain rate of interest... In turn, merchants in every line of business have borrowed money from these *chien chuang*, likewise paying interest on it. They simply record their transactions in a passbook, eliminating the need for an exchange of cash... Since the *chien chuang* have the backing of wealthy families,

no one cares that the notes are not personal ones. **Thus the Ningpo merchants need only their word, not money, when they trade.**"¹³

Although the native banks provided substantial capital for individual businessmen, they were unable to finance large merchant firms engaged in trans-regional trade within the empire and outside China, for example in Mongolia and Russia. These merchant companies came to rely on the so-called Shanxi banks (the most famous bank houses were located in Shanxi province) which were able to offer large-scale financing and maintained a branch network across the country due to higher levels of capitalization. The Shanxi banks were family-run businesses which beyond the remittance business were also invested in various trades and land holdings. A particular characteristic of the Shanxi banks was their extremely close association with the home province, and the banks' headquarters remained located in Shanxi province, even after the rise of commercial hubs like Shanghai.¹⁴ The Shanxi banks in particular profited from their role as principal remitters for government funds in Northern China. However, their business declined after the 1911 revolution when the tax remittances to the imperial government had discontinued.

Another method for Chinese merchants to raise funds through a trust-based network involved loans from Western commercial houses like Jardine, Matheson and Co. Jardine's had started out as an agency firm in the opium trade of the early nineteenth century and quickly developed into a major mercantile firm with financial networks and transactions all over the Treaty Ports in China. As these Western trading firms considered their Chinese merchants as business partners and important "native friends", they advanced loans often "without obtaining substantial security except in the form of promissory notes of native banks".¹⁵

It is important to note that neither the native banks, Western commercial houses nor the big Shanxi banks took care of the needs of small-scale traders and ordinary customers. These customers turned to so-called money-changing shops (*qianpu*) which specialized in exchanging the copper coins which were used for everyday transactions, into silver for conducting larger transactions such as paying tax or buying an expensive item. Although these money-changing shops made their profit from charging a fee on the fluctuating copper-silver exchange, some of them also became small-scale credit institutions which advanced modest loans to customers at lower interest rates than pawnshops.¹⁶

Funding and Risk Management through Private Financial Networks

Another informal way for individuals to raise money was to join a mutual financing association. Originally, these cooperative loan societies functioned very much like today's rotating credit and savings associations and provided funds needed to cover wedding, funeral, and travel expenses. However, over time the use of funds expanded to business purposes.¹⁷ By the 19th century some of the mutual financing associations had become quite sophisticated and competitive in terms of negotiating interest rates and priority access to the funds. According to an observer of village life in China in the late 1890s:

"In societies where the rate of interest is fixed, the only thing to be decided by lot, or by throwing dice, will be the order in which the members draw out the common fund... But if, as often happens, the interest is left open to competition, this competition may take place by a kind of auction, each one announcing orally what he is willing to pay for the use of the capital for one term, the highest bidder taking the precedence, but no member ever has a second term."¹⁸

Despite the lack of an integrated capital market at the national level, local and regional financial institutions and networks negotiated interest rates in a competitive, market-oriented manner. Lineages and temple alliances operated along similar lines, but investment in and access to funds was more limited. Family firms, especially in South China, preferred internal investment to outside banking and invested in new businesses of their sons and members of their kinship network which cemented close relationships with the investors and among the family. While this form of internal investment reduced the financial risk of outside lending in a volatile financial environment, the “cross-holding of equity and credit adds to the trust that is built on family and kinship relationships”.¹⁹ The fact that these firms were called “linked firms” (*lianhao*) shows that financial networking was consciously the strategic core of these business operations. Large family firms with internally linked and financed businesses effectively managed long-distance trading and business ventures overseas. This structural characteristic is one of the reasons why Chinese lineage and kinship networks were so successful in establishing and maintaining businesses overseas, especially throughout Southeast Asia.

The use of integrated, multi-tiered financial networks including native banks, money-changing shops, and Shanxi banks gave Chinese merchants with business operations in Japan and Korea a substantial competitive advantage over their local rivals.²⁰ These integrated financial networks also financed Chinese mainland merchants engaged in the cross-strait trade with Taiwan in the 19th century.²¹ For Chinese competitors in the domestic market, business networks facilitating credit for specific firm groups involved at different stages of a trading process meant the most significant competitive advantage. According to Linda Grove, “credit was transmitted from one level of the system to the next in outwardly extending circles” which lowered the transaction costs for all parties involved in the value chain.²² For example, in the Tianjin yarn trade of the early 20th century Chinese wholesale dealers purchased about 70-80% of their goods on credit granted by agents of Chinese spinning mills. At the same time, Tianjin yarn wholesale firms supplied credit to regional wholesale firms in the southern part of the province which were organized in an informal but powerful trade-based network. These so-called regional trading cliques (*bang*) were instrumental in negotiating access to credit at favorable conditions for members of their network.²³

Foreign Banks and the Emergence of China's Modern Financial System

The last decades of the 19th century saw a spectacular increase in international trade and the establishment of foreign banks and brokerages in the Treaty Ports. Shanghai developed into the most vibrant of the Treaty Ports and became the financial and commercial center of late imperial China. The fiscal situation of the Chinese government in the late 19th century was dire because its finances had been exhausted by the costly Taiping civil war (1850-64). This financial crisis, however, created an opportunity for Chinese native banks based in Shanghai to deal closely with foreign banks such as the Hongkong & Shanghai Banking Corporation, the banking arm of Mitsui, the Yokohama Specie bank, Bank of Chosen, Deutsche Asiatische Bank etc. (See **Exhibit 5**) The native and foreign banks together financed the commodity flow between Shanghai and the cities in the interior with the foreign banks functioning “as foreign exchange banks while the native banks provided the bills which serviced Shanghai's internal trade”.²⁴ Financing foreign trade became the primary task of foreign banks which extended loans to merchants covering the gap time between purchase of Chinese goods and payment on delivery of the goods abroad. By the early 1930s altogether 32 banks in China and Hong Kong financed about 90 per cent of China's foreign trade.²⁵

Since China still lacked a government-run issuing bank by 1900 as well as modern banking institutions with easy access to funds, foreign banks filled an increasingly large void in China's

financial market. Foreign banks extended credit to the Chinese government, private enterprises, Chinese native banks and individual customers alike. Although Chinese native banks offered higher interest rates on deposits than foreign banks, Chinese customers preferred to invest their funds in foreign banks in the Treaty Ports because these banks were located in the international settlement and protected by laws of extraterritoriality. Foreign banks also served the Chinese government which repaid foreign loans, for example for railroad construction, and indemnity payments resulting from the Boxer Rebellion in 1900 through these institutions.²⁶

China's transition to a nation-state was accompanied by various attempts to create an appropriate modern economic and fiscal system. Throughout the 1910s we see the emergence of private modern Chinese banks such as the Bank of Communications, the Jincheng Bank, or the Shanghai Commercial and Savings Bank which all established their headquarters in Shanghai's international settlement. Many of these modern Chinese banks adopted western-style management practices and successfully financed the growth of Chinese trade and industry.²⁷ Unfortunately, Chinese modern banks became co-opted by the political agenda of the Nationalist government during the Nanjing decade from 1927-1937 when Chiang Kaishek pushed for a consolidation of national economic interests.²⁸ The dangerously close relationship between the Chinese banks and the government came to climax in 1935 when the government took control over the major Chinese banks gaining 70 % of the nation's banking assets. China's financial instability was magnified by the catastrophic impact of the Japanese invasion and occupation in 1937. Once inflation hit the economy in the 1940s, the Nationalist government demonstrated its inefficiency by simply ordering the banks to print paper currency guaranteed only by paper securities. The Communist victory in 1949 was greatly aided by the fact that the Nationalist government was unable and unwilling to bring China's hyper-inflation of the 1940s under control. This issue became top priority for the PRC government during reconstruction of the Chinese economy after 1949 and ideologically justified a strong state presence and control over the financial sector and its institutions which is still in place today.

Under Reform: Credit and Lending Practices in the PRC

After the establishment of the PRC, the government adopted the model of the Soviet monobank system, i.e. one main state-bank with several specialized supporting financial institutions, and private banking (together with private enterprise) was prohibited during the Mao era until 1976. Under the threat of expropriation, all foreign banks moved their operations abroad. The People's Bank of China became the main state bank, and domestic banks existing from the Republican era were merged into it. According to Kellee Tsai, "the combined monopoly of local governments and banks over official credit resulted in a situation where individuals effectively were denied access to formal bank credit".²⁹

In a society characterized by agricultural collectivization and a state-controlled economy, cash began increasingly to disappear, limiting opportunities for informal finance. Especially during the high tide of mass collectivization in the 1950s and 1960s, people received work points instead of cash wages and salaries for their work based on a piece-work system.³⁰ During the climax of the Great Leap Forward campaign in 1958, agricultural communes even issued "substitute banknotes" in various denominations of Chinese currency. These "substitute banknotes" were embellished with official symbols of national political authority but limited to the use for transactions within the issuing commune only.³¹ This resulted in a drastic reduction of cash circulation in the Chinese economy. In some cases people turned to informal banking schemes like rotating credit associations which were based on the agreement among a group of individuals to save and borrow together. Each member contributed the same amount of money at each meeting, and each member was allowed

once to obtain the pooled sum during the limited lifespan of the rotating credit association. This informal access to credit was important for people to fund events such as weddings and funerals which required more public display and expenses in the countryside. For example, marrying off a son in rural China meant that the family had to save and raise funds in order to pay a bride price (which did not have to be in cash), host a wedding feast and provide a house for the newlyweds.³² In the cities, workers in the state-owned enterprises sometimes used rotating credit associations to fund the purchase of an expensive consumer item like a bicycle.³³

The reforms of the post-Mao era beginning in 1978 officially designated the People's Bank of China as China's central bank and established a number of officially designated commercial banks as well as nonbanking financial institutions (NBFI) to finance specific developmental objectives. NBFIs such as credit cooperatives and trust and investment companies were mostly designed to fund the non-state sector. Throughout the 1990s, lending to private businesses by officially designated financial institutions remained extremely low. For example, state banks provided only 19.2% of the official lending to China's private sector in 1996, whereas urban credit cooperatives accounted for 76% of official lending to the private sector in the same year.³⁴

Funding through foreign direct investment (FDI) has played a major role in accelerating the growth of the Chinese economy after 1978. The first Special Economic Zones opened for foreign investors in 1979/1980 and improved the regional economies of provinces such as Guangdong and Fujian. However, FDI began to impact the growth of China's national economy only from 1992 on when major policy shifts reinvigorated the economic reform agenda and the domestic marketplace in many sectors was made accessible to foreign investors. Since then, FDI contributed to investment in China at a large scale; in 2004 the cumulative inflows of investments amounted to more than \$500 billion.³⁵ As China's domestic saving and investment rate is extremely high and gross domestic capital formation exceeds 40% of the GDP, with a GDP growing faster than the FDI inflows, the share of FDI in China's GDP is slowly decreasing since the late 1990s.³⁶

Access to credit is still difficult for Chinese private enterprises and consumers, even for those firms with hybrid ownership structures. Although the central bank has encouraged state banks to follow more commercial-based lending standards, state banks still face a lot of pressure to extend loans to state-owned enterprises, even if they are likely to default on the loans. From the perspective of potential investors, unattractive interest rates of state banks which were held artificially low by government mandate to curb inflation in a fast growing economy, did not encourage them to deposit their funds with state banks. As a result, from 1993 onwards when the economic reforms began to show profitable results at an ever-increasing rate, the banking sector saw the active outflow of capital into the "black interbank market, real estate ventures, the recently established stock market, and other speculative investments" often referred to as China's back-alley banking sector.³⁷

Due to the continuing bias of state banks against lending to private borrowers and the lack of institutional incentives to service the private sector with loans, Chinese private enterprises and customers have to resort to informal banking institutions and financial networks. At present China's financial sector experiences an amazing renaissance of these mechanisms which present themselves in legal and illegal forms. As **Exhibit 6** demonstrates, so-called curb market activities range from legal networks/institutions such as interpersonal lending, trade credit, rotating credit associations and pawnshops to illegal institutions such as professional brokers and money lenders, private money houses and pyramidal investment schemes.

The Return of Informal Banking Networks and Pawnshops

In 1976, government propaganda publications still celebrated the forced disappearance of pawnshops in China after 1949 as one of the biggest success stories of socialist construction. Pawnshops, characterized as operations run by “cold-blooded greedy usurers” and “money-sharks”, were contrasted with the benevolent nature of the People’s Bank of China accessible to all citizens. For example, a widely circulated government source quoted an old, former rickshaw-puller gratefully acknowledging that “in the old society, I borrowed from pawnshops; now, I have a bank account”.³⁸ Considering the strong moral and political condemnation of pawnshop businesses, the re-emergence of pawnshops as informal financial institutions in contemporary China is nothing short of amazing. In 2002 about 1,400 pawnshops operated nationwide with a combined registered capital of 6.3 billion yuan.³⁹ As of November 2008, there were 144 pawnshops in the city of Shanghai alone.⁴⁰ (See Exhibit 7)

In May 2005, China’s biggest pawnshop, the Shanghai Orient Pawnshop Co. opened its doors in Shanghai with a registered capital of 50 million yuan. According to Wang Fuming, the managing director of the company, between 2001 and 2007 70% of the loans (an estimated 15-18 billion yuan) were extended to SMEs and about 30% to private individuals.⁴¹ Reports about business owners pawning their luxury cars to borrow money for distributing the payroll on time are quite common.⁴² Smaller pawnshops usually offer loans under 1,000 yuan (US\$ 120) with a time limit of 10 to 15 days, providing short-term credit without a paper trail. According to the secretary of the Nanjing Pawnbroking Society, gold jewelry still accounted for more than half of all pawns in 12 Nanjing pawnshops, but now people have started to pawn “paintings, antiques, negotiable securities and even cars”.⁴³

The continuing and increasing demand for private capital forces entrepreneurs and investors into the informal sector which Chinese government officials like to condemn as “underground” banking. Especially small and medium-sized firm depend on informal loans, often extended by cash-rich companies looking for higher returns on their unused funds. Another option involves companies obtaining bank loans and then passing these on to third parties. Especially in China’s real estate sector, banks are known to facilitate direct loans between companies.⁴⁴ Informal loans are usually short-term maturing at three months and carry higher interest rates than loans from government-controlled banking institutions. For example, in July 2008 member firms of the Small and Medium Enterprise Development Promotion Federation in Wenzhou, a hot-bed of private entrepreneurship in southern Fujian province, paid “about four times that of the central bank’s benchmark one-year lending rate, currently set at 7.47%”.⁴⁵

Fearing an overheating economy and inflation, the Chinese government has repeatedly put limits on lending by the official banking institutions under its control. Whereas larger state-owned enterprises continue to obtain long-term loans as preferred customers with collateral of state-controlled banks, the demand for informal loans from smaller clients has increased. The substantial financial scope and ubiquitous presence of informal banking institutions and networks all over China are no longer a secret and now even publicly discussed in the media. *China Daily*, a government-controlled newspaper, quoted an informal banker with the following comments:

“A lot of small firms come to us. Only the bigger enterprises go to the banks”, said an underground lender who declined to be named. He has lent out 10 million yuan – he declined to say how he made that kind of money – at 30 percent annual interest. “Interest is not an issue. They will go bankrupt if they don’t get our short-term loans”, he said. “Our money is available at short notice. We can deliver the cash within 24 hours, while a bank loan might take at least

six months. But I am only small fry. There are bigger fishes out there with more than 100 million parked in underground financing.”⁴⁶

In recent years reports have surfaced in the media describing lending rackets and the more unpleasant sides of informal financial practices. The government used these incidents to point out the danger of investing in informal banking institutions, especially if it involved wide-spread public discontent and even local riots as noted below. However, in the case below from 2008 the situation was particularly ironic as a large number of government employees had invested in the collapsing loan scheme:

“Nine people were detained in two days of riots between armed police and thousands of investors protesting against banned investment schemes, the Xiangxi prefecture government in Hunan province said yesterday.... The unrest indicated the extent of underground fund-raising activities in the region in which up to 150,000 had invested in illegal schemes in the prefecture of 2 million people....But in June, the prefectural government banned civil servants from participating in such schemes, causing a withdrawal of investment funds of at least 300 million yuan in July and early last month.”⁴⁷

Low interest rates on bank deposits continued to entice families with increasing savings from higher income to lend to real estate speculators or informal financial businesses which promise a double-digit return on their investment. In the case above, small lenders had deposited 6 billion yuan between 2004 and 2008 for a promised monthly interest rate of 10%.⁴⁸ The collapse of the loan scheme showed the lack of security for investors because although the provincial government ordered the companies involved in the racket to return all loan principle without the interest to the lenders but also stipulated that “any lenders who earned interest in the past must return it to improve the companies’ balance sheets”.⁴⁹ As underground borrowing and borrowers are not protected by law, another risk and insecurity emerge when private borrowers default on their loans and sometimes become victims of criminal acts. It is quite commonly known that certain lenders try to force their clients to pay up by hiring gang members to kidnap the borrowers or their family members.⁵⁰

Why Informal Financial Networks Still Matter

The resurgence and resilience of informal or non-market financial institutions speak to the political climate, the economic regulatory environment and specific social attitudes towards finance and lending practices in China. Although it is difficult to obtain hard data on the informal financial sector operating outside government control and official statistics, recent studies have validated its importance for firms trying to raise working capital and investment funds. According to a survey by China’s central bank (most likely offering estimates on the conservative side) reported in 2006, underground lending amounted to 950 billion yuan (\$118 billion), i.e. about 7 % of the country’s GDP.⁵¹

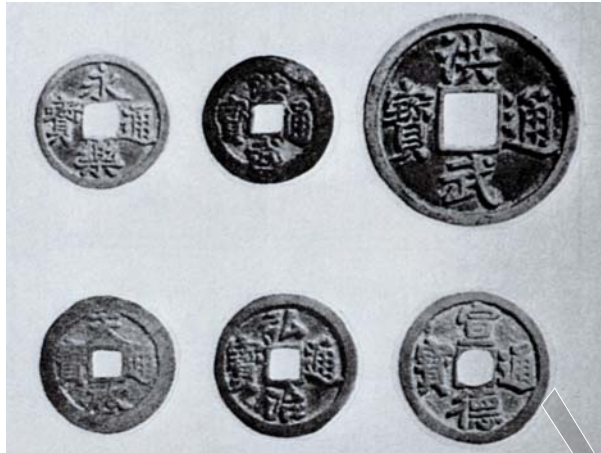
Strong informal banking networks and institutions indicate weak formal financial market mechanisms. As a result, since 2004 private entrepreneurs have increasingly tried to get into the banking business themselves in order to be able to compete better with state-owned enterprises which still benefit from their superior political connections. As the president of the Aokang Group Co., China’s biggest shoemaking company, described the unfair advantage, state-owned enterprises “don’t bother with the bank manager; they go straight to the mayor”.⁵² Even more important, SME enterprises do not qualify for loans because they lack the necessary collateral, and as the interest rates of the state-banks are set by the government, state banks are unable to adjust them even if they wanted to reflect the lending risk. The size of the curb or underground market in China is substantial

and in exceptional cases even recognized by the government. For example, the central government monitored and published the interest rates of the flourishing underground financial market in Wenzhou which became the most prominent center of private entrepreneurship during the economic reforms of the 1990s. In 2004, Wenzhou's average curb market rate was 11.6% compared to a bank lending rate between 5.31% and 9%.⁵³

China's formal banking system only provides funds for a small sector of the economy, and the allocation of capital is uneven. However, academic research has also demonstrated the limits of informal finance and its potential negative impact on firm performance. For example, according to a detailed survey of 2,400 Chinese firms based on 2003 data, private firms using informal financial channels did not experience faster firm growth than firms using official financial institutions.⁵⁴ The study tried to contradict "the belief that nonstandard financing mechanisms provide effective substitutes to formal financing channels in promoting growth".⁵⁵ However, the issue with this argument is that without access to capital via informal financial channels, most of these private enterprises would not have been able to get off the ground in the first place nor reached the stage of further business expansion. Yet, one can agree with the authors of the study that a better developed formal financial system in China will bring benefits for all participants, private SME as well as state-owned enterprises.

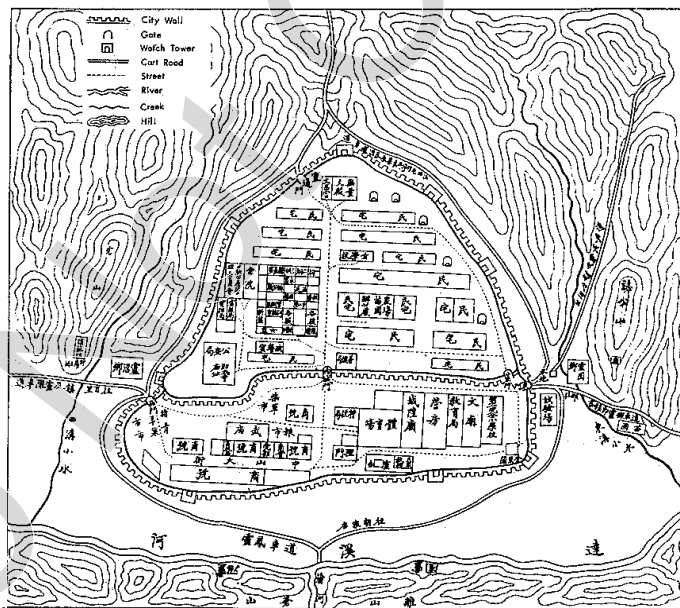
In 2008 the Chinese government is continuing reforms in the official banking sector, and steps towards legalizing the informal market will not only give people the freedom to better invest their own money but may also present an opportunity to reduce the economic gap between urban and rural areas. In 2007, 31 nontraditional financial institutions were established, including 19 banks operating in the countryside based on the model of village and township shareholding cooperatives. This development might also offer future investment opportunities for foreign banks. For example, in October 2008 Citigroup won permission from the Chinese government to set up two lending firms in rural China.⁵⁶ Any changes in China's financial sector will not be straightforward or converge toward a familiar model of market capitalism, but will rather produce diverse forms of economic interaction and organization with continuing challenges to private Chinese entrepreneurship. Political scientist Kellee Tsai concludes that "within this context of developmental diversity and possibility...private entrepreneurs have conducted their banking — behind the state, with the state, and despite the state".⁵⁷ These entrepreneurial financial strategies are not likely to disappear in China anytime soon.

Exhibit 1 Chinese Copper Coins (minted during the 14th and 15th century)



Source: Image from <http://www.cultural-china.com/chinaWH/html/en/History2379bye6902.html>, accessed on December 9, 2008.

Exhibit 2 A typical county city (Lingtai in Gansu province) in imperial China with businesses and markets placed **only** in the southern part of the city, far away from the government offices in the Western quarter.



Source: Sen-dou Chang, "The Morphology of Walled Capitals" in G. William Skinner, *The City in Late Imperial China*, Stanford University Press, 1975, pp. 33-100, p. 84.

Exhibit 3 A Fortress-Like Pawnshop in Guangzhou (Canton) at the turn of the 20th century

Source: <http://chestofbooks.com/travel/china/John-Stoddard-Lectures/images/Cantonese-Pawn-Shops.png>, accessed on December 8, 2008.

Exhibit 4 Entrance to the Guild of the Ningbo Bankers running Native Banks (*qianzhuang*) in Shanghai, late 19th or early 20th century.

Source: http://virtualshanghai.ish-lyon.cnrs.fr/Image_Thematic.php, accessed on December 10, 2008.

Exhibit 5 The building of the Hongkong and Shanghai Banking Corporation on the Bund in Shanghai, early 20th century



Source: http://virtualshanghai.ish-lyon.cnrs.fr/Image_Thematic.php, accessed on Dec. 8, 2008.

Exhibit 6 Private Entrepreneurs Financing practices

Name	Description	Degree of Institutionalization
Interpersonal Lending	Lending among friends, relatives, neighbors, and work colleagues	Low (interest-free)
Trade Credit	Short-term merchandise credit extended by wholesalers to retailers, typically interest-free	Low-Medium
Brokers, Money Lenders, Middlemen	Financial brokering among savers and borrowers at high interest rates	Medium
Shareholding Cooperative enterprises	Pooling of operations and capital among enterprises via the issuance of shares	High
Credit Associations 1) Basic 2) Escalating	1) Lending and savings among a set of group of peers 2) Pyramidal investment scheme (scam)	Medium-High
Underground Private Money Houses	Provision of savings and credit services under the guise of a nonfinancial operation	Medium
Private Money Houses	Provision of savings and credit services	High
People-Run Enterprises Capital Mutual Assistance Society	Provision of financial services to private entrepreneurs	High
Rural Cooperative Foundations	Village-operated savings and lending institutions	High
Pawnshops	Collateralized discount lending	High

Source: Table adapted from Kellee S. Tsai, *Back-Alley Banking: Private Entrepreneurs in China*. Ithaca: Cornell University Press, 2002, p. 39, Table 2.4.

Exhibit 7 A pawnshop in China today, easy to recognize from the large character for “pawn”.



Source: Li Yahong, “Fizz Returns to an Old Biz” in Chinatoday.com.cn, <http://www.chinatoday.com.cn/English/e2008/e200803/p24.htm>, accessed on December 14, 2008.

Endnotes

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