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China Tests Financial Relaxation in Wenzhou

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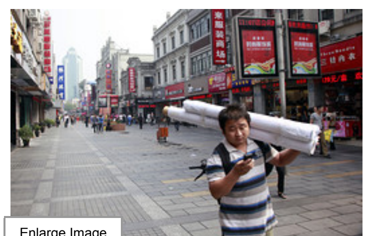
BEIJING—China approved a broad package of financial reforms in Wenzhou, a city known for entrepreneurship and underground lending, in what may be a prelude to a national effort to liberalize China's creaking financial system.



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Bloomberg News

A man operates a mobile phone as he walks among shoppers and pedestrians in Wenzhou, where officials have launched a new attempt to allow residents of the city to invest directly offshore.

The move by the State Council, China's cabinet, represents an important symbolic step toward overhauling a system long seen as a barrier to developing a more substantial and sustainable growth model for the world's second-largest economy.

The key test will be whether the Wenzhou reforms are rolled out in other parts of the country. Other promised reform efforts in recent years have failed to materialize, and the government's tendency toward overregulation could squelch innovation and keep its important but shadowy informal lending system underground.

In a statement, the State Council said it would allow private lenders in Wenzhou, whose legal status has been in limbo, to operate as investment companies to augment the financing available to small and medium-size enterprises. Smaller companies have long complained they have been starved for funds because China's giant state-owned banks favor other state-owned enterprises, whose ability to repay is considered guaranteed by the cash-rich Chinese government.

In addition, the State Council said it is studying allowing Wenzhou residents to invest directly overseas, giving them a way to earn better returns than in Chinese banks, whose deposit rates frequently lag inflation. Currently, China strictly limits such investments.

Under the investment proposal, residents in Wenzhou would be allowed to spend up to $200 million a year—or as much as $3 million a person—to set up, acquire, or invest in nonfinancial companies in foreign markets. Wenzhou residents would also be able to reinvest abroad any profits generated abroad. Still, there could be "revisions" in the details pending the State Council's approval, said Su Xiangqing, head of the Wenzhou Bureau of Commerce.

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The move comes amid increased calls both inside and outside the country for change, with Chinese Premier Wen Jiabao himself telling a news conference this month that China's informal finance system "has still not adapted to the development of our economy and society." Elsewhere, the World Bank and a Chinese government think tank in February called for scaling back state-owned enterprises. Meanwhile, newly appointed securities regulator Guo Shuqing has been pursuing wide-ranging changes in China's stock and bond markets.

The Wenzhou approvals are "very significant," said a senior executive at a large Chinese bank. "Right now, China's banks are ill equipped to lend to small- and medium-size enterprises partly because of a lack of expertise in assessing risks."

Some business leaders in Wenzhou welcomed the moves. "Formalizing private lending can help us reduce funding costs," said Qu Guoning, who runs one of the hundreds of small makers of electric wires and cables in Wenzhou and has been fretting about how he will fund a planned business expansion.

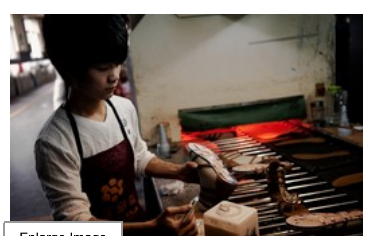
Mr. Qu said he is planning to expand his business into making household appliances, a line of business that promises greater profitability but would need "tens of millions" of yuan in investment. Bank financing, he said, is difficult to get.

It is unclear how big China's underground lending might be. In October UBS estimated it could be between two trillion yuan and four trillion yuan in total, or $316 billion to $632 billion. The process of legitimizing informal finance could involve giving existing underground lenders a license to operate as small-loan companies whileimposing deposit collection requirements, experts say.

Such moves would reflect that the informal sector is also ballooning as a deposit base, with money being drawn in by the potential for high returns but where savers could stand to lose everything if things turn sour. In recent months the local Chinese press has contained many examples of informal lenders going bust, leaving irate depositors behind.

Eswar Prasad, a China scholar at the Brookings Institution, said that the government is concerned that the informal banking sector has been gaining so much steam that it could "pose risks to overall financial stability" by eating away at the depositor base of the big banks. That's why, he said, "they are taking steps to bring these informal banks under the regulatory umbrella."

Even if it begins to roll out some of these initiatives elsewhere, China still has major work to do. Mr. Prasad said China still must liberalize interest rates, so that China's largest banks respond more to market forces, or proposed changes won't be sufficient. "These steps to formalize the underground banking system are no substitute for more basic financial-sector reforms," he said.



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Gilles Sabrie for The Wall Street Journal

China cleared financial changes in Wenzhou. Above, a worker at the Feidian Shoe factory in Wenzhou.

There was no indication from the State Council statement that the government was yet ready to move on interest-rate liberalization, even though central-bank Gov. Zhou Xiaochuan said recently that the time was "basically ripe" for such a move. The People's Bank of China reports to the State Council.

Early last year, the Wenzhou government proposed to give its locals more freedom to invest overseas, only to suspend the move due to a lack of consent by the central government. Wenzhou officials then worked out a new proposal—similar to the original one—and submitted it for approval as part of the broader plan to make the city a testing ground for financial reforms.

While it appeared that the government has now sided with Wenzhou, the State Council statement didn't give unambiguous approval, and it's unclear how much freedom the government is ultimately willing to give Wenzhou residents to invest overseas.

Chinese officials are buffeted by crosswinds. On the one hand, some in the State Council worry about large capital outflows as the economy slows. On the other hand, the central bank is continuing its drive to encourage Chinese businesses to invest overseas as part of its effort to diversify its $3.2 trillion worth of foreign-exchange reserves, by far the world's largest.

Wenzhou, in Zhejiang province, drew attention to the funding pressures faced by China's private sector last year when Beijing tightened monetary policy, making it harder for the city's small companies to get credit or roll over loans. More than a dozen business owners shut their factories and skipped town, leaving creditors behind, according to state media reports.

In China's traditional financial system, banks play the dominant role and interest rates for savers and borrowers are set by the state. That model, designed to shovel low-cost credit from households to state-owned firms, works well to finance investments in infrastructure and capital-intensive industry.

But with China's economy now pushing against the limits of a growth model based on investment, the costs are starting to outweigh benefits, analysts say. Cheap capital for state-owned enterprises and real estate developers has led to wasteful investment. Meanwhile small private businesses have been unable to get credit.

The State Council statement proposed various ways for big state owned firms to increase lending to private firms by encouraging the establishment of special lending units. But in the past such efforts have proved disappointing. State-owned banks complain that China lacks credit bureaus that would enable them to assess the riskiness of such loans.

The shadow banking system—which sprang up in the cracks of the traditional banking system and came to prominence in 2011—sought to supply credit, albeit at often exorbitant rates. The government cracked down on what it considered the most egregious cases, including sentencing to death Wu Ying, an entrepreneur in Zhejiang, for "fraudulent fundraising."

She was found guilty after allegedly raising as much as 770 million yuan illegally from the public by promising them high investment returns. Ms. Wu's attorney has contended that she merely borrowed the money from her friends and invested the funds in profitable businesses. The case has prompted widespread sympathy for Ms. Wu.

—Yang Jie and James T. Areddy contributed to this article.

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