NEWS

Bankless lending in China sends out a global tremor Fears grow of dent in financial confidence

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The New York Times
10 November 2004
International Herald Tribune
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WENZHOU, China:

The Wenzhou "stir-fry" is not a dish you eat. But it is giving indigestion to Chinese regulators and could prove troublesome to many investors worldwide, from New York money managers, Pennsylvania steelworkers and Midwestern farmers to Australian miners.

Here in this freewheeling city at the forefront of capitalism in China, the dish is prepared when a group of wealthy friends pool millions of dollars' worth of Chinese yuan and put them into a hot investment like Shanghai real estate, where they are stirred and flipped for a hefty profit. The friends often lend each other large amounts on the strength of a handshake and a handwritten IOU. Both sides then go to an automated teller machine or bank branch to transfer and withdraw the money. Or sometimes they do it the old-fashioned way: exchanging burlap sacks stuffed with cash.

The worry for Chinese regulators is that everyone in China will start cooking the Wenzhou stir-fry outside the banking system.

In the last few months, borrowing and lending across the country is looking more and more like what is taking place in Wenzhou. The growth of this shadow banking system poses a stiff challenge to China's state-owned banks, already burdened with bad debt, and makes it harder for leaders to steer a fast-growing economy.

The problem starts with China's low interest rates. More and more families with savings have been snubbing 2 percent interest on bank deposits for the double-digit returns from lending large amounts on their own. They lend to real estate speculators or to small businesses without the political connections to obtain loans from the banks.

Not only is the informal lending rate higher, but the income from that lending, because it is semilegal at best, is not taxed. For fear of shame, ostracism and the occasional threat from thugs, borrowers are more likely to pay back these loans than those from big banks.

Tao Dong, chief China economist at Credit Suisse First Boston, calculates that Chinese citizens withdrew $12 billion to $17 billion from their bank deposits in August and September. The outflow turned into a flood last month, reaching an estimated $120 billion, or more than 3 percent of all deposits at financial institutions. If the bank withdrawals are not stemmed in the months ahead, Tao warned, "this potentially could be a huge risk for financial stability and even social stability." And with China now accounting for more than a quarter of the world's steel production and nearly a fifth of soybean production, as well as some of the largest initial public offerings of stock, any shaking of financial confidence here could ripple quickly through markets in the United States and elsewhere.

For instance, if the steel girders now being lifted into place by hundreds of tower cranes in big cities across China are no longer needed, that would produce a worldwide glut of steel and push down prices.

On Oct. 28, when China's central bank raised interest rates for one-year loans and deposits by a little more than a quarter of a percentage point, it cited a need to keep money in the banking system. Higher official rates should "reduce external cycling of credit funds," the bank said in a statement.

Eswar Prasad, the chief of the China division of the International Monetary Fund, expressed concern about bank withdrawals in a speech in Hong Kong three days before the central bank acted. The main Chinese banks have fairly substantial reserves, but they need those reserves to cover huge write-offs of bad debts some day.

The hub of informal lending in China is here in Wenzhou, 370 kilometers, or 230 miles, south of Shanghai. Some of China's first experiments with the free market began here in the late 1970s, and the result has been a flourishing economy together with sometimes questionable business dealings.

Depending on how raw they like their capitalism, people elsewhere in China describe Wenzhou as either a center of financial innovation or a den of loan sharks. But increasingly, Wenzhou is also a microcosm of the kind of large-scale yet informal financial dealings now going on across the country.

The withdrawals by depositors and the informal money lending has spread so swiftly here that it is only in Wenzhou that the Chinese central bank releases monthly statistics on average rates for direct loans between individuals or companies. The rate hovered at 1 percent a month for years until April, when the authorities began limiting the volume of bank loans.

Borrowers default on nearly half the loans issued by the state- owned banks, but seldom do so here on money that is usually borrowed from relatives, neighbors or people in the same industry.

Violence is extremely rare, but the threat of it does exist as the ultimate guarantor that people make every effort to repay debts.

"Someone can hire a killer who will chase you down, beat you up and maybe even kill you," said Ma Jinlong, who oversaw market- driven financial changes in the 1990s in Wenzhou as director of the municipal economic reform committee and is now an economics professor at Wenzhou University.

The interest rate for informal loans jumped last spring to 1.2 percent a month, or 15.4 percent compounded over a year, and has stayed there ever since. According to the nation's central bank, total bank deposits in Wenzhou have been dropping by $250 million a month since April as companies and individuals withdraw money, either because they can no longer obtain bank loans for their investments or because they want to lend the money at higher rates to each other.

For lenders, these interest rates are much more attractive than earning a meager 2.25 percent a year, even after the recent rate increase, on a deposit at a government-owned bank. And while Beijing assesses a 20 percent tax on all interest from bank deposits, nobody pays tax on the income they receive from lending money on their own, Ma said.

Most informal loans have traditionally gone to relatives or neighbors to finance the starting of small local businesses. Wenzhou is now one of the world's largest producers of no-brand sunglasses; Dong Ganming, the owner of a 350-employee sunglasses factory here, said that his plant was just one of almost 1,000 here involved in making glasses.

Fierce competition has prompted local residents to borrow money to exploit every possible niche in the industry, with some factories making nothing but bridges for sunglasses so that they will not slide down customers' noses, other factories making only the lenses, and so forth. Any government crackdown on informal loans would carry the risk of stifling highly efficient small and medium-size businesses that have little hope of obtaining loans from the state- owned banks, which still allocate credit based partly on political connections.

Dong said that loans from friends and family allowed him to start his sunglasses company with 10 employees a decade ago; he quickly paid off the loans and has been reinvesting most of the profits ever since, putting very little into bank deposits. "The interest in the bank is very low," he said. "If you invest the money, you can get much more money."

But more recently, residents here say, a lot of money has been flowing into real estate here and in other big cities, especially Shanghai, helping to fuel double-digit increases in interest rates.

Deals increasingly involve people who have no family or neighborhood connection, raising the risk of disputes.

Kellee Tsai, a specialist in Chinese informal banking at Johns Hopkins University in the United States, said that many overseas emigrants from Wenzhou had also been sending their savings back here to be lent at much higher rates than are available in the countries they have moved to.

Some local investors have been able to pay for their investments with profits from businesses here, like Chen Shen, the owner of four shops that sell shoe-manufacturing equipment to the hundreds of shoe factories that have popped up in this area. She said she paid cash for an apartment near Shanghai's Bund, its riverfront district, that had appreciated as much as 60 percent in less than two years.

Still, Chinese regulators do not like the practice, and officials have been trying to stamp out such operations with limited success.

They have outlawed the practice of pooling savings into various kinds of informal banks that make loans for real estate and other investments: Organizers are subject to the death penalty but are rarely caught unless the informal banks collapse.

Oriental Outlook, a Chinese current affairs magazine, reported late last month on the trial of a man accused of operating an illegal banking pool northeast of here that collapsed a year ago, leading to the filing of more than 200 civil lawsuits. Another man who lost money in the scheme and went bankrupt as a result assaulted the defendant outside the courtroom, the magazine said.

The extent of such pooling is unclear. But it poses the greatest risks of damage to financial confidence if bank runs occur at these informal institutions, economists agree. Bank runs have been an occasional problem around China for years, but are always quickly contained.

"The policy with bank runs, even with illegal banks in some cases, has been to flood the bank with liquidity and pay everyone off," said Michael Pettis, a finance professor at Beijing University.

"One of the most salutary ways to let people know not to put money in these is to let two or three go bankrupt."