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THE SECRETS OF GAO LI DAI

An informal lending network prospering in the shadows of China's economy offers important lessons for the country's troubled banks. Can the authorities bring these financiers into the light? • **By Stephen Glain**

Qian Huan Zhang knows all about the advantages of private capital. Looking to make his mark in the world after obtaining an electrical engineering degree from Zhejiang University in Hangzhou, Qian returned to his hometown of Wenzhou 15 years ago, borrowed 100,000 yuan (then worth $20,964) from his family's industrial electronics company and founded Zhejiang CAJG Electrical Co., which makes electrical circuitry. In short order CAJG expanded into everything from relay and switching systems for electrical grids to meter boxes for apartment blocks. Last year the company posted sales of 40 million yuan with a profit margin of 10 percent, according to Qian.

Mindful of his business's origins, the 38-year-old entrepreneur now extends credit to start-ups in need of capital. He typically lends 500,000 to 1 million yuan at a pop, charging interest rates of 7 percent annually to borrowers he knows well, and double that to those he doesn't.

"I've always been interested in economics and finance," says Qian with a smile. "Maybe one day I'll open my own bank."

China's would-be business moguls should hope he does. Qian is part of the country's thriving, informal lending system, known as *gao li dai* — literally, "loan-sharking." It embraces everything from borrowing the equivalent of a few thousand dollars from family or friends to high-volume, high-risk loans made by ambitious investors that can command annual interest rates of more than 100 percent. The practice is widely tolerated even though some types of informal lending are technically illegal. Many economists and business executives believe that gao li dai provides a much-needed alternative method of capital allocation for the rapidly growing economy at a time when China's banking sector continues to be hobbled by bureaucratic interference and mountains of bad debt. This financing source is especially critical for small-to-midsize businesses that lack the clout and connections to obtain bank loans, most of which go to giant, state-run conglomerates.

"There has clearly been a sharp rise in informal lending," says Margit Molnar, an economist at the Organization for Economic Cooperation and Development in Paris. "With the economy dominated by small-to-midsize enterprises, it's going to be around for many years."

Informal lending amounted to somewhere between 740 billion and 830 billion yuan in 2003, or $91 billion to $102 billion, according to an official government survey of 20 provinces released earlier this year, the first such study Beijing has conducted. That is a fraction of the banking system's annual lending volume of about $2 trillion, but the activity it finances is anything but negligible.

Although a nationwide practice, nowhere is gao li dai more prevalent than in Wenzhou, a city teeming with the kind of private enterprise that is transforming China into one of the world's most dynamic economies. The coastal city of 7 million people, about 500 kilometers south of Shanghai, is home to some 60,000 small and medium-size companies, many of them financed by private lending.

Gao li dai could be an even more important source of finance if the authorities can find ways to legitimize it, the OECD's Molnar and other economists say. Increasingly, Bei-

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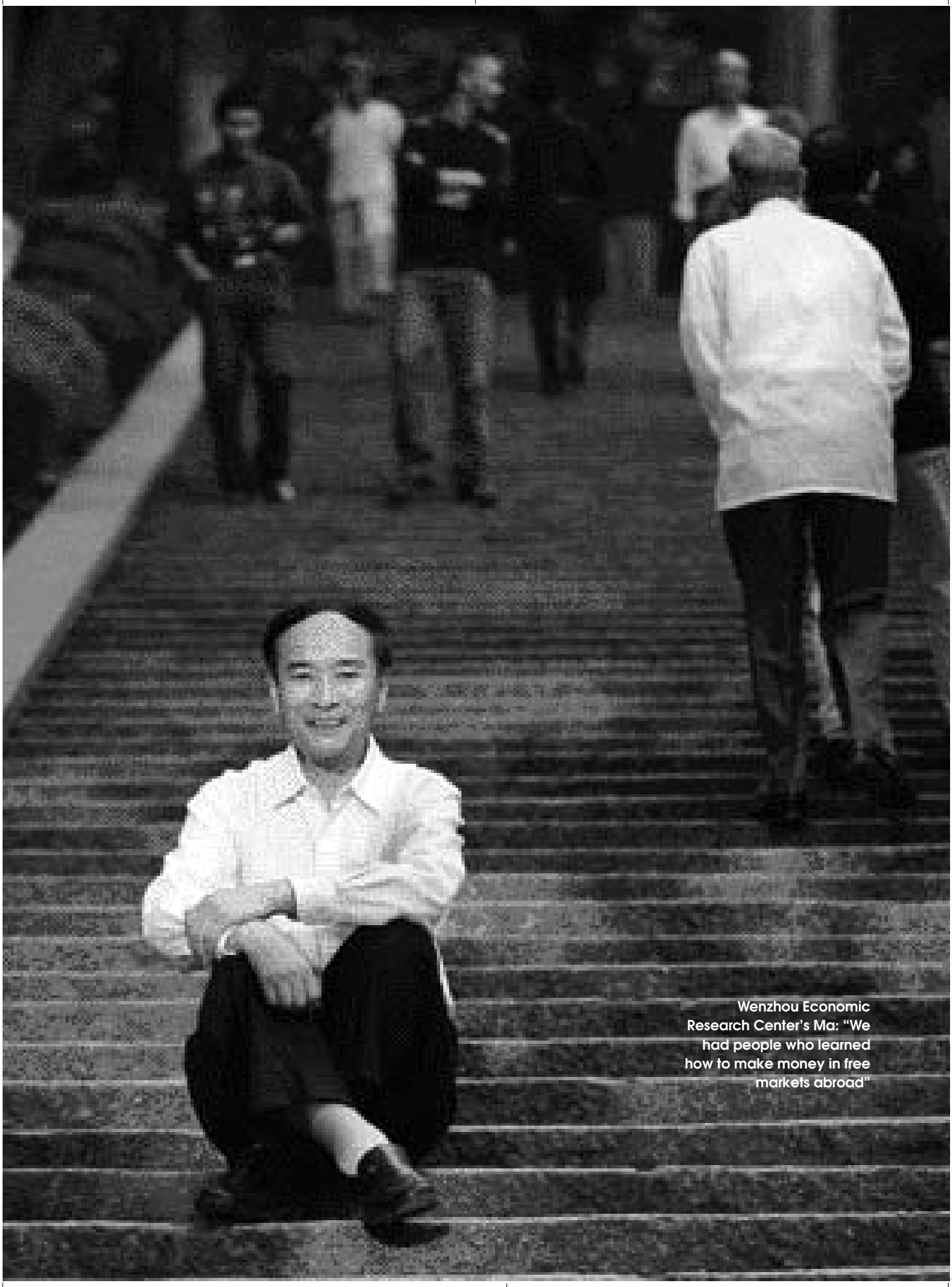


Wenzhou Economic Research Center's Ma: "We had people who learned how to make money in free markets abroad"

jing shows signs of wanting to do just that. This summer the government unveiled a plan to begin licensing at least part of the gao li dai market — de facto recognition that small, private lenders are vital to the country's burgeoning class of entrepreneurs. China is scheduled to open its banking sector to both local and foreign investors by the end of 2006, and the government has said it will welcome license applications from small, private lenders, a move that could facilitate a convergence of the country's informal and formal banking sectors. (Beijing's central bank, the People's Bank of China, did not respond to requests for interviews.)

The significance of China's private lending transcends economics. Although the authorities are betting that strong economic growth can preserve the country's social and political stability, the formal banking sector appears incapable of financing such growth on its own. State-owned companies, which account for less than half of China's industrial growth, receive nearly three quarters of the commercial loans extended by the banks, estimates David Von Emloh, principal and head of Asia-Pacific risk management at McKinsey & Co. in Shanghai.

Small and medium-size businesses, by contrast, generate more than half of the country's economic output but receive less than 10 percent of all bank loans, according to a recent OECD report co-authored by Molnar. More than half the companies surveyed for the report identified a lack of collateral as a major barrier to obtaining bank credit, and one fifth said banks discriminated against them, favoring state-owned companies.

Notwithstanding the enormous demand for investment capital in China and the country's prodigious savings rate, banks are capable of sustaining loan growth of only 5 to 7 percent a year over the next decade or so, Matthias M. Bekier, Richard Huang and Gregory P. Wilson write in the latest edition of *McKinsey Quarterly*. That's just half the pace required to sustain economic growth of 7 to 8 percent, the minimum level needed to absorb new laborers entering the workforce, the authors contend. The banking sector's 1.6 trillion yuan of nonperforming loans and its lack of basic skills, particularly in risk assessment, are restraining credit growth, economists say.

In Liaoning province, the heart of China's industrialized northeast, many state-owned enterprises have been sold to crony capitalists as part of a corrupt privatization program, prompting Beijing to make a series of high-profile arrests and prosecutions, including the conviction of Shenyang mayor Mu Sui Xin on corruption charges. He was sentenced to death and died in prison of lung cancer. Notwithstanding the crackdown, privatized companies have laid off hundreds of thousands of workers in subsequent restructurings. Small wonder, say China experts, that Liaoning leads China in violent unrest.

By contrast, Wenzhou and its legion of private lenders generate an abundant supply of capital to finance small enterprises and fuel economic opportunity. Not coincidentally, Wenzhou enjoys an enviable degree of political stability.

"Social unrest is one of the unintended consequences of reform, and the regime is rightfully concerned about it," says Kellee Tsai, an assistant professor of political science at Johns Hopkins University and author of *Back-Alley Banking*, a book on China's informal lending industry. "That's what makes the relatively egalitarian nature of Wenzhou and its success at indigenous capital formation so extraordinary."

Corruption in the banking sector also has fueled unrest lately. In remote provinces bank clerks have looted entire branches, according to local news reports, and defaults among rural credit cooperatives — often under murky circumstances — are routine. In July, according to the official Xinhua News Agency, a string of cooperatives in the western province of Qinghai suffered a run on deposits following rumors that they had been stripped of funds. The central government provided 70 million yuan in bailout money while ordering the banks to shut down.

To be sure, gao li dai doesn't have an entirely unblemished record. Underground lending has fueled some scams and asset bubbles, most notably in 1986 when speculators in Zhejiang and Fujian provinces took out discount loans from private lenders and invested the proceeds with money changers charging market rates. "The amount of arbitrage activity was so intense that when it finally collapsed, it nearly destroyed the whole private lending system," says Xia Xiao Jun, a Wenzhou native and director of Shanghai Wincom Capital Management Co., a private investment firm.

The unregulated nature of the curb market draws criticism from the country's established banks. "Gao li dai is not beneficial to the people or to the Chinese government," says Jason Shi, a customer relationship officer at the Shanghai branch of Bank of China (Hong Kong). "Private banking in China must only develop through a long period managed by the Chinese government, without input from anyone underground."

PRIVATE LENDING CERTAINLY ISN'T LIMITED TO Wenzhou. In the northeast, for example, state-owned companies take out loans and parcel them out to members of associations known as *duifeng*. The members, mostly owners of medium-size businesses, are charged annual interest rates of 10 percent and pledge inventories as collateral. They can make one or two borrowings a year with a total annual ceiling of 2 million yuan. Maturities are three or six months.

That structured market stands in stark contrast to the free-wheeling ways of Wenzhou, where loans are sealed with a handshake and entered into musty ledgers or even on scraps of paper. The most common form of private lending is *hui*, or "coming together," a kind of revolving credit association. The concept grew out of a Wenzhou tradition known as *meng*, lifelong fraternities of a dozen or so young men that can be called upon to help a member finance a home, find prompt medical attention for a loved one or ensure that all the seats at his wedding will be impressively filled.

Applied to underground finance, meng are a primal but effective means of leverage. "We've preserved a tradition that was perfect for the growth of a curb market," says Xia.

A hui is an informal association of family and friends who pool their savings to finance anything from a wedding to a home renovation. It is convened by a *hui dong*, or chairman, and typically lasts no more than a year. Members make monthly deposits, and loans are extended to different members of the group each month. The rate of interest is agreed upon by all the participants at the outset.

"This is all very flexible and informal; there are no specific

rules," say Liang Shi Yan, a business journalist from Wenzhou who has participated in many hui. "It's a means of helping friends and relatives as much as it is a way to make money."

The chairman is responsible for paying depositors, usually by visiting them at home. Occasionally, hui members might hold a kind of shareholders' meeting over dinner in a restaurant. (They take turns picking up the bill.) There are no lending counters dispensing gao li dai, let alone bank offices. Most types of formal lending are illegal, even though the practice is tolerated, and no one wants to push his luck.

"Everyone knows everyone else, and the circle is really small," says Liang. "If you fail to pay, your credit will be zero, and you can never borrow money anymore. It's a high price to pay, but it controls risk."

Meng brothers Chen Chuang and Dai Wei Xin, business partners since they were schoolmates, say they mobilized a hui to raise money to launch Gelin Shidun, one of Wenzhou's many shoe manufacturers. The company produces 100,000 pairs of shoes a year at a cost of two to three yuan per pair. They hope to double capacity within a year.

"Gao li dai is very popular," say Chen. "You can get loans if you have the collateral, but not many of us do, so you turn to friends and family."

The form of private lending that most closely resembles commercial banking involves a so-called *qian zhong*. This person acts as an intermediary between borrower and lender, typically paying depositors a monthly interest rate of 1 percent while charging borrowers 1.5 percent or so. Depositors tend to be related to the *qian zhong*, but, says Liang, "they don't care who borrows their money. So long as they know and trust the moneylender, they feel safe."

On the other end of the risk spectrum is *fen hong hu*, in which lenders finance bold ventures at interest rates of 100 percent or more. A typical, if ill-fated, fen hong hu deal, according to Liang, took place last year when a group of high-rolling Wenzhounese formed a hui to invest in a proposed mining company in Shanxi province. Through an intermediary the investors bought shares in the company ranging in worth from 500,000 to 4 million yuan. Under the all-or-nothing terms of fen hong hu, the investors were to redeem their shares a year later for double their money. (Fen hong hu translates as "dividing the good shares.") Not long after the investors provided the financing, however, the Shanxi provincial government canceled all requests for new mining licenses. The hui lost everything.

As the head of Wenzhou City's People's Government Economic Research Center, Ma Jin Long is something of a godfather to China's private lending boom and the entrepreneurs who thrive under it. He remembers the lean years before Deng Xiaoping's economic liberalization campaign started the country's economic boom in the late 1970s and early '80s. The central government made industrial centers out of the northeast and the western interior, but neglected Wenzhou and other coastal areas deemed vulnerable to attack by the Soviet Union or the United States. There wasn't a railway or highway linking the city to the rest of China until the 1990s.

"As late as 1986 people were begging in the street," says Ma. "The five poorest counties in China were in Zhejiang province, and the average income in Wenzhou was well below the national average."

So the people leveraged their biggest asset, a rich diaspora of Chinese who had gone abroad to seek a better life. In the process, says Ma, the Wenzhounese have developed a worldwide curb lending market underwritten by hui.

The 13th arrondissement in Paris, for example, is dominated by Wenzhou émigrés, who first began arriving in 1917 as laborers for a wartime France in need of manpower. A prime example is Xia Shang Zhong, the 52-year-old brother of Shanghai

CAJG Electrical's Qian: "Small-business men would starve without lenders like us because we're comfortable with risk"

Wincom's Xia. He came to Paris in 1980 and proceeded to make a fortune by importing Wenzhou-made eyewear to France while lending to businesses back home.

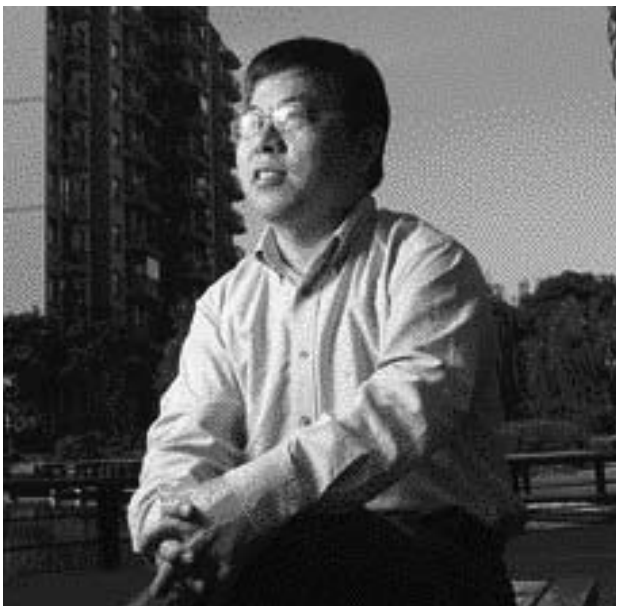
"It's ironic," says Ma. "Conditions were so poor here that so many of us had to go overseas. That's why, when so few Chinese had good business sense, we had the best — the people who learned how to make money in free markets abroad."

Today the dividends are obvious. Wenzhounese enjoy an average annual income of $2,500, nearly double the national average of $1,295 and the third-highest in the country. The city is a beehive of commerce, producing everything from chemicals and car parts to sporting goods and shoes. It is home to two of China's largest private electrical equipment producers, Chint Group Corp. and Delixi Group, which have combined annual sales of more than $2 billion. Corruption is not nearly as rampant in Wenzhou as in other parts of China, thanks in large part, economists and businessmen say, to the leveling impact of gao li dai and the relative lack of government meddling.

A high degree of risk doesn't seem to bother the Wenzhounese. The city's private lenders — Johns Hopkins's Tsai calls them "financial entrepreneurs" — can easily gather several million yuan within 24 hours and several hundred million in

two to three days. "The average value of a private loan used to be in the tens of thousands," says Shanghai Wincom's Xia. "Now it's in the tens of millions."

As they grow their businesses, many entrepreneurs are able to make the transition from the informal to the formal financial sector. Consider CAJG's Qian. He recently celebrated the grand opening of a new factory and headquarters that cost 10 million yuan. Thanks to the considerable collateral he has built up over the years, he was able to finance the construction with a bank loan at only 7 percent annual interest. The offices have wood floors, a rarity in Wenzhou, made from one of area's few natural assets, pine. In the bright, air-conditioned factory rooms downstairs, young men and women in blue smocks assemble gadgetry, stack empty meter boxes and pack



Shanghai Wincom Capital's Xia: "We've preserved a tradition that was perfect for the growth of a curb market"

finished products into styrofoam boxes bound for customers in China, Pakistan and Russia. Qian eventually plans to open an electronics factory in California's Silicon Valley that he estimates will cost about $10 million.

"Gao li dai and the official banks are not incompatible," says Qian. "When you get to a certain level in size, you no longer need private lending. But small-business men would starve without lenders like us because we're comfortable with risk."

Though a key growth engine, private lending is also a tiger that monetary officials ride by the tail. The central bank's most potent inflation-fighting tool is to ration bank loans, but attempts to restrain bank credit typically push borrowers and savers to the curb market, where interest rates of 12 to 15 percent are more than double the 6 percent rates that banks charge their best customers, according to the OECD.

Last November, after the government declared an embargo on new credit, an estimated $17 billion fled the banking sector in search of the higher rates available on underground loans. Rates charged by state-owned banks rose by just 25 basis points after the embargo, while rates on the curb market jumped by several hundred basis points, according to the OECD.

The larger the curb market becomes, the harder it will be for monetary officials to control the economy. Loan rationing has had a limited impact on China's red-hot housing market, for example, in part because so many property deals are financed underground.

The central bank regularly deploys officials to the countryside to track informal lending rates as a reliable gauge of credit demand and circulates the findings among its senior staff. The enhanced vigilance reflects fears of a curb market meltdown similar to the one that occurred in 1986 in Zhejiang and Fujian provinces, according to Xia.

Faced with a mushrooming informal lending network it cannot control, the government is trying to flush moneylenders to the surface and integrate them into a formal banking system. In July the People's Bank of China announced a pilot program that would effectively legalize, license and regulate curb lending. The provinces of Guizhou, Shanxi, Shaanxi and Sichuan would serve as laboratories for ways to encourage informal lenders to come in from the economy's twilight world, according to the *Chinese Business View*, the Xi'an-based monthly that carried the announcement.

Officials are also hoping that underground financiers will use their grass-roots expertise and bid for licenses when China opens its banking sector to private investors next year. Weaving private lenders into the banking sector "would have a profound impact on our financial system," Zhou Haowen, a professor at Xi'an Jiaotong University's School of Economics and Finance, told *Chinese Business View* in July. "Private loans are seldom mentioned and are never publicized, but they have empowered a growing number of small borrowers."

Since 2000, China has worked closely with Grameen Bank, the Bangladeshi microfinance pioneer, to learn how to register and regulate local financial expertise without extinguishing it. "This is a fundamental policy dilemma that faces a lot of developing economies," says Johns Hopkins's Tsai. "How does the state leverage the best aspects of community lending without driving it deeper underground?"

Some observers are skeptical that the authorities can successfully bring informal lending into the banking system. "Anytime Chinese officials try to control something, they end up killing it," says Minxin Pei, a China specialist at the Carnegie Endowment for International Peace.

Much rides on the outcome. Gao li dai may be financing many innovative, hardworking Chinese, but its leverage goes only so far. The country is in dire need of a transparent and efficient banking system and credit markets that can finance small business as well as large corporations and public works.

"With 9 percent growth, there has been a lot of easy catching up," says McKinsey's Von Emloh. "But to stabilize the economy, you need a banking sector that can nurture small commerce. Imagine if Bill Gates was born in China and he couldn't launch Microsoft because no banker would give him a loan."

That thought should concern Chinese policymakers. But for the country's underground financiers, it suggests ample opportunity ahead. **ii**