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Abstract As in many other developing countries, Chinese businesses and individuals frequently fund transactions using informal, unmonitored financial methods. The impact of this phenomenon is both positive and negative: positive when funds are used for legitimate purposes, such as providing much needed working capital for businesses, and negative when funds are used for illegitimate and/or illegal purposes, such as to finance criminal activity or launder proceeds of crime. There is a dearth of literature and research on this topic. Further study is necessary to understand the precise political, economic and social reasons for this diversity of non-bank financing and its legal and economic implications. This paper aims to pave the ground for such research and analytical work by reviewing the existing literature, placing it into context and raising the main questions that must be answered in future work.

Keywords informal finance; illicit flows; political economy; China; development; regulation; policy.

Introduction

As in other parts of the world where banking is restricted, China relies on informal finance to fund individuals and businesses in a wide range
of ventures. With banking constraints, some companies simply do not receive funding, while others turn to the curb market, an unorganized group of lenders and borrowers outside of the formal banking system that engage in both legitimate and illegitimate activities. The impact of this is both positive and negative. A paradox in Chinese finance is that some borrowers face severe hurdles, while at the same time practices of banks and ‘lightly regulated’ trust companies fuel inflationary pressures by lending to other borrowers (The Economist 2011). In this context, informal finance complicates matters even further. Measures and strategies aimed at addressing this policy challenge must be based on an empirical assessment of informal finance’s net effects, as well as a good understanding and appreciation of the broader Chinese context.

However, the dearth of research on this topic, especially with regard to the legitimacy of informal financial transactions, undermines this goal and underscores the need for systematic studies. In this paper we seek to pave the ground for further research and analytical work by framing China’s informal financial sector in terms of characteristics, legitimacy and political economy, and by identifying problems associated with assessing and regulating this field.

Informal finance refers to financial transactions outside the regulation of a monetary authority (Adams and Fitchett 1992; Aryeetey and Udry 1997). It is an integral part of the financial system in countries where finance and capital flows are highly constrained. Money flowing through China outside of approved banking institutions is a large-scale phenomenon found in developing countries since an underdeveloped legal banking system leads to excess demand for certain financial services, which informal lenders provide. Some of these funds are certainly used for legitimate purposes, such as to provide working capital, while others are used for illegitimate purposes, such as to finance criminal activity.

Financial constraints have limited the banking sector to extending loans to particular sectors or activities (Steel et al. 1997). The extreme information asymmetries that have arisen due to lack of an effective credit rating system in Chinese commerce have led to a wide variety of costs of assessing and enforcing the viability of loans. Different types of costs and information asymmetries have divided Chinese financial markets not only into formal and informal markets, but into the formal market on the one hand, and many informal markets, on the other hand, directly focused to make up for information asymmetries across the Chinese economy. The same information asymmetries that allow informal financiers to thrive also prevent them from diversifying into full-scale financial intermediaries, reinforcing the segmentation problem. These segmented informal markets are important to investigate and document since they pose challenges to financial reform and law enforcement (e.g. see Passas, 1999, 2003, 2006). A type of informal finance that is used for legitimate purposes in one region may be used for illegitimate purposes in another region. Similarly, one type of
informal finance may be more easily integrated into the formal sector than another. The financial repression/restriction/control literature does not take into account segmentation between formal finance and many types of informal finance (nor practices of formal institutions seeking to circumvent official controls). In this way, it has oversimplified the impact of financial liberalization by not accounting for a variety of interest rates, legitimacy and policy implications of a diverse second sector. A well-known China scholar (Lardy 2008) recently concluded that in China, financial repression is an obstacle to growth and the informal sector, as a whole, is one of the negative outcomes. First- and second-generation financial repression models predict that financial liberalization can result in increased economic growth. Stiglitz (1993) shows that some financial repression adds to growth, but this is not the rule in China. Rather than hurting or harming the economy wholesale, the benefits and costs of diverse market responses to financial controls in China vary depending on the actual workings of the local informal finance.

Information asymmetries have also led to difficulties in distinguishing between legitimate and illegitimate or illegal activities that may flourish due to a lack of transparency. Legitimate uses of informal finance include capital investment for production or payment of wages, while illegitimate uses include funding for various types of insider trading and funding for drug trade, other criminal enterprises or money laundering. Reuter and Truman (2004) and Naylor (1999) discuss the difficulties associated with quantifying the volume of money laundering and illegal wealth or income. This is a complex task because of the relatively scant and often inaccurate information, but arriving at a reasonable estimate is vital given the wide circulation of baseless figures affecting policy considerations. Quantifying the illegitimate and illegal sources and uses of informal finance is an important step toward a strategy and policy initiatives aimed at a model of financial integration between the formal and informal financial sectors. This is critical since legitimate uses of informal finance run the risk of being severely curtailed, while illegitimate uses of informal finance pose a threat to the economy and society.

As Naylor (1995) notes, it is essential to address issues of financial crime not just as a police matter, but as economic policy. This is because the modern underground economy blurs the line between informal finance and criminal enterprises, such as the production and distribution of drugs, counterfeit or pirated material, endangered species, body parts and other goods and services. Illegitimate activities extend into the legitimate economy in various shades of legitimacy that render law enforcement inconsistent and more difficult. Financial crime combined with economic transitions in developing countries has exacerbated inequalities and other serious negative consequences for certain segments of society, driving some of them to criminal activity as a means of making money or preserving livelihoods. China’s complex informal financial system illustrates and can help elaborate Naylor’s views on how legitimate and illegitimate
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In order to avoid throwing out the baby with the bath water, legitimate informal finance should be promoted or replaced by better-regulated functional alternatives, while illegitimate informal financial practices must be controlled and prosecuted.

Informal lending in the Chinese context

Now we examine informal lending in the Chinese context. Studies on informal finance in China have been mainly empirical, rather than theoretical. This is in part because this field is relatively unexplored, making it necessary to perform research on the ground, particularly given the wide variety of informal finance types and practices within China. The precise modus operandi, social organization and other characteristics of legitimate informal financial institutions are somewhat known.

Informal finance is not a small element of the economy, and is particularly important to the many small and medium enterprises (SMEs) in China, since they lack the collateral required for formal finance (S. Jiang 2009). SMEs have come to depend on informal finance for both start-up and working capital. It is particularly critical in rural areas, where loans may not be available or sufficient, and is also quite common in urban areas, comprising almost half of business financing (Hsu 2009).

Most informal financial transactions do not involve written contracts, but are based on oral agreements, and do not entail collateral (S. Jiang 2009). This type of financing, therefore, is very different from formal financing because the risk of default is offset by a close relationship between debtor and creditor. The debtor can lose face, or in extreme cases, be physically harmed if he or she defaults on a loan. There is very little information asymmetry between two informal parties – that is, both parties know each other equally well. Hence, an essential requirement for loan approval and enforcement is fulfilled.

Informal finance is difficult to track since it varies by region; for example, the turnover is greater in southeastern China, in areas in which the private economy is well developed (X. Jiang 2009). In contrast to northern areas, which use more conservative forms of informal finance, such as enterprise funds and personal loans, the southeastern areas are dominated by rotating savings and credit associations (ROSCAs), in which individuals take turns to contribute money to a pot that goes to a designated member of the group, underground banks and private investment groups. On the whole, the type and scale of informal finance that has developed is local, due to differences in local government attitudes (Tsai 2009) and in cultural orientation (X. Jiang 2009). Informal finance adapts, through a variety of methods, to local financing needs left unfilled by the formal sector.

Tsai (2002), for that matter, records over 12 classes of informal financing used by businessmen. For example, rotating credit associations exist in the form of biaohui, or interest-charging groups, in Fujian, but ROSCAs have
lost their appeal in Henan. Loose norms govern the lending of money to friends and relatives, but these also differ depending on the region. Inter-personal loans among individuals in the north tend to be for longer terms and lower interest rates than in the south, which has both a longer history of post-reform economic development and a stronger orientation toward profit making (Li and Hsu 2009). Local government support for private enterprise also has a positive relationship to informal lending. Wenzhou in Zhejiang province, a prime example, is well known for its burgeoning entrepreneurial class and supportive government officials, as well as for its many types of informal lending practices. This suggests that officials recognize the problems and adopt a lenient stance towards at least some types of informal finance, with the exception of comparatively big underground banks and large informal financial institutions.

The way that informal finance operates places it on different parts of a continuum between legality and illegality. On the legal end of the spectrum, it has served the purpose of providing much-needed financing to enterprises and individuals in the face of a tightly constrained, overburdened formal banking system. According to Tsai (2002), legal informal finance may be used by individuals in a *hehui*, or ROSCA, to provide a setting in which people can save. Legal finance may also take place between two individuals for personal use, or between two individuals or enterprise owners for business purposes. Quasi-legal informal finance includes organizations outside the formal financial system, such as red hat enterprises (fake collectives), mutual aid societies and pawnshops. These methods of funding provide legitimate financial services to smaller entities and are dependent on mutual trust (Lou 2003).

Illegal finance also includes illegal financial sources, such as money lenders, who may charge extortionate rates of interest, and underground money houses, which sometimes become quite large and are unregulated by the government. Underground money houses pose a risk to the economy due to their size and impact on macroeconomic regulation. They may engage in domestic and/or international illegal finance associated with money laundering, corruption or criminal enterprises. Illegal finance can also serve criminal activities, such as pyramid schemes, or *taihui*, in which first-moving individuals receive a high profit on their savings but last-moving depositors/investors lose all of their savings. These pose security and governance risks to individuals, enterprises and the economy as a whole.

Informal finance, including both illegal and legal funds, is a large-scale phenomenon. The balance of informal loans reached RMB 5.4 trillion at the end of 2008 (Li 2010). Because informal funds are large and growing, macroeconomic regulation effects are weakened. In surveys conducted on thousands of SMEs and individuals engaged in commerce in 2003 and 2006, Li found that informal finance was heavily influential on firms (43 per cent of whose financing comes from informal sources). For this reason, tight macroeconomic controls imposed in the same years did not achieve their
goals and anticipated results. Instead of curtailing fast economic growth and reining in inflation, the policies had a much milder effect. This is because excess funds were circulating outside of the formal economy and providing investment funds to businesses.

J. Li (2005) analysed in detail the macroeconomic effects of informal financing on China’s economy, assessing its impact on bank deposits, currency, capital and gross domestic product (GDP). It is meaningful to judge the effect of unobserved loans in economic movements by estimating the size of the loans from the perspective of credit demand. Unobserved loans also often flow into and out of the formal banking sector.

Li found that the lack of small and medium-sized financial institutions generates demand for informal finance’s involvement in legitimate activities in support of private enterprises. Consequently, Li recommended policies advancing the reform of the rural financial system and fostering the development of small and medium-sized banks toward the formation of a multi-level credit market.

Additional scholars on Chinese informal finance studying mainly its legitimate uses include Hsu (2009), Liao et al. (2003), Molnar and Tanaka (2007), Ayyagari et al. (2008) and Lu et al. (2009). Hsu (2009) conducted surveys in Shanghai and Nanjing on firms’ financial and personal safety risks of borrowing associated with informal and formal finance. Hsu found, comparing informal and formal finance, that transaction costs and financial costs are quite different for informal and formal finance, but both can be relatively high. The time it takes to obtain an informal loan is shorter than the time it takes to obtain a formal loan, but the number of informal loans needed to equal a formal loan on average is large. Interest rates in informal finance can vary greatly but are particularly low when borrowing from family and friends, while collateral costs in borrowing from formal institutions are high. Liao et al. (2003) focus on entrepreneurial financing; 222 surveys were conducted in Wuhan, China, using the Entrepreneurial Profile Questionnaire (EPQ), an instrument that has been administered in other countries in transition and that is designed to study the effect of individual, societal and environmental factors on entrepreneurship by obtaining demographic and other information. These researchers found that most venture financing was obtained from personal savings and financial support of family and friends (68 per cent), followed by the mortgaging of own assets (10 per cent). Molnar and Tanaka (2007) used 2002 data from the State Administration for Industry and Commerce, which surveyed over 2,000 private firms. They found that firms’ past and present difficult access to bank financing increases the size of informal borrowing. They also noted that over 90 per cent of these private enterprises have trouble accessing bank financing. Ayyagari et al. (2008), using the Investment Climate Survey administered in 2003, found that only 20 per cent of firm financing (in a database of 2,400 firms) rely on formal financing, and of these, most are larger enterprises. They also found that bank financing is associated with faster firm
growth and higher profit reinvestment rates than is informal financing. Lu et al. (2009) used interviews with money lenders in Yiwu, China, to model a lower rate of loan default among informal loans. This work compared loan characteristics of informal loans to those of formal loans and criteria used in Fair Isaac Corporation (FICO) credit scoring, with a view to improving formal loans based on what was found from informal loans.

**Legitimacy and illegitimacy of Chinese informal finance**

In contrast to characteristics of Chinese informal finance, there are few studies into the legitimacy of informal financial activity. As a generalization, it can be said that criminal activity in informal finance (such as money laundering) is clearly illegitimate. Although informal finance provides much-needed funds for businesses and individuals, the fallout from financial distress in the informal sector has been disastrous in many instances, because of the absence of formal regulation. When official action is taken against informal financiers, distress can have deep ramifications. For example, when the People’s Bank of China (PBC) began to investigate illegal financial businesses in 1998, beginning with the Three Star Holding Company in Zhengzhou, the organization experienced a dramatic run on its holdings due to investor fear. The city government forced the company to shut down two months later, bringing out a massive protest, with thousands of depositors taking to the streets (Tsai 2009). Once investors and depositors begin to panic, additional bank runs can be expected. This occurred shortly after the Three Star incident, when another private financial organization, White Flower Company, suddenly shut down. All 16 of the privately owned financial organizations in Zhengzhou faced sudden runs on their deposits.

Panic and fear have also been aroused by financial organizations used to trick investors, through pyramid schemes, which have been reported in Chinese newspapers and other publications (e.g. Y. Li 2005). These taihui are schemes in which individuals borrow or lend at very high interest rates. These began in 1985 in southern Zhejiang and, in the first organization, involved over 300,000 people (S. Jiang 2009). When the growth of new members slowed, panic spread and individuals tried to recoup their money. By the end, nearly 80,000 farm households had lost their savings.

At the same time, some legitimate activities, such as using certain types of informal finance for start-up capital, are still outlawed. Since 2005, the Chinese government, through the China Banking Regulatory Commission (CBRC), began to introduce laws in order to guide and regulate legitimate informal financial entities, such as rural financial cooperative societies and private capital associations, which are used for everyday individual and firm borrowing activity and are supervised by governmental institutions including the CBRC and the PBC. The PBC also permitted private entrepreneurs to build micro-credit companies in Shanxi, Guizhou, Sichuan...
and Shaanxi. Now, most provinces have several private micro-credit companies. The PBC and the CBRC are slowly paying more attention to the development of micro-credit companies and other small loan institutions such as rural banks and local middle and small banks. A multi-level credit market is the final goal of banking reform.\(^8\)

Because many informal financial methods are still considered illegal in China, businessmen are afraid of being punished for obtaining the capital necessary to start up or continue their own business through illegal means. Chinese law states that financial resources belong to the state, which must use the resources for the economic good (Zhang et al. 2010). Hence, data on informal finance are quite difficult to obtain. Research projects on informal finance are also difficult to statistically sample, since many businesses are also informal. Many small businesses, such as street stalls or home businesses, are unregistered.

The research on informal finance to date has been groundbreaking, but because the policy implications can be so consequential (e.g. rooting out particular informal financial institutions), the need for research into the legitimacy versus illegitimacy of informal financial flows is urgent. Access to information such as the extent and make-up of underground banks, in particular, would assist the planning and implementation of the regulation of the informal financial sector.

**Underground banks**

So far, underground banks have been singled out for detection and eradication by police authorities (Xinhua 2010), since they straddle the line between legitimate and illegitimate activities. Underground banks operate clandestinely and it is usually policemen who have access to specific information on these entities through case investigation and evidence collection.

Chu (2008) lays out a framework for understanding underground money houses. The main business of the underground money house, in terms of remittance services, is to transfer funds across borders and to exchange currencies. This evades financial regulation and anti-money laundering supervision and supplies a hidden channel for transferring money into the developed coastal regions and border trade areas of China.

There are several types of underground money houses, including:

- Underground banks under the guise of a different commercial company. Such a company usually cooperates with foreign commercial companies to transfer money through trade.
- Underground agents. These are branches of overseas informal money transfer institutions that do not have permission under Chinese rules to do business in China, but that are providing remittance services for local residents and expatriates.
• Underground banks under the guise of foreign investment companies and foreign trade companies. This kind of company does business on the scale of commercial banks.

• Underground banks under the guise of chop shops. These organizations offer remittance services under the cover of grocery stores, cafe bars and restaurants. The chop shop takes a form that is culturally specific to China. This system is referred to as fei chi en, or flying money, in Mandarin, and nging sing kek, or money letter shop, in Cantonese. In this system, a broker in one country would send a request to a broker in another country to remit money to an individual, through a chit or chop, which can include symbols or pictures, something that is secret and known to the corresponding broker. These shops are normally not advertised and are in locations hidden from regulatory eyes, such as in the premises of a separate established business or in a secluded residential building. Most of the chop shop operators have established a reputation over years and through the use of guanxi. The chop shops can reach even remote areas where there are no banks at all (Shehu 2003).

About RMB 200 billion flows through all types of underground banks into and out of China (Chu 2008). This money is used to obtain fraudulently exported tax rebates, purchase goods for smuggling, transfer illegal income, evade taxes, illegally transfer business profits and speculate in the stock market.

Underground banks are mostly characterized by a pyramid, family-like structure. The core members (members of the family) stay at the top level and the big money houses stay under it. Small and medium-sized money houses also comprise a middle level. Between the small money house and customers, there are brokers named Huang Niu (cattle), who serve as a bridge between customers and money houses (Chu 2008). The real net transfer business of the underground bank is done by cash, since underground banks transfer money through the commercial banking system as well.

Getting to know the financial ties and flows involved in underground banks is much more difficult than understanding their overall structure. The Chinese government has studied them but no reports or results of investigations have been published.9

Financial crime in Chinese informal finance

Ping (2006) argues that money laundering through Chinese underground banks and its associated criminal activity including corruption, smuggling, terrorism and organizational crime, is a serious problem fuelled by poverty, inequality and ineffective supervision. After a lengthy operation, money houses typically have a stable customer base, as well as a healthy
cooperation with informal businesses and networks with underground banks formed in a special area (Chu 2008). Chu divides customers into two categories according to the nature of their business: the first category includes customers who remit or borrow legitimate funds, while the other category includes customers whose purpose is to launder money or engage in illegal activities.

Investigative efforts keep uncovering illegal money shops (PBC 2008a). Cases in Guangdong accounted for more than 33 per cent of all cases in 2007, and coastal regions accounted for the majority of cases overall. Over 20 per cent of all 2007 cases involved narcotics-related activities, nearly 12 per cent involved financial offenses and more than 49 per cent related to offenses outside the scope of law. Most of the cases were reported in Shandong, Guangdong, Zhejiang, Liaoning, Yunnan and Shanghai.

For example, in 2007 a large underground bank that had operated for seven years out of the Guangdong province was exposed (Xinhua 2007). The bank transacted over 4.3 billion yuan in 2006. Its clients came from all over China, but the largest were based in the middle and southern coastal provinces, with most illegal transactions relating to export, real estate and securities investment, and oil sales.

More recently, a 2008 report intended for internal circulation only revealed that corrupt officials had funded $123.6 billion dollars out of China through various methods, including through illegal money shops, before escaping to developed or developing countries, depending on how much money they had to cover the cost of illegal documents and networks (PBC 2008b).

From a PBC report in 2005 entitled Illegal Money Shop Cases (PBC 2005), we can tell that the PBC is able to trace illegal money houses by looking at accounts that receive, store and pay out large quantities of cash, and that receive and remit funds in foreign currency. The PBC looks for:

1. Frequent large-quantity cash receipts (which the PBC believes to come possibly from smuggling rings).
2. Large cash withdrawals.
3. Large quantities of cash order transfers and account settlements, particularly for gold exchange tickets.
4. Excess cash supplies. The smuggling groups usually keep much cash for their operations and frequently receive cash after ordinary business hours, so they cannot deposit excess cash into their bank accounts.
5. Short-term, frequent receipts and disbursements of large quantities of cash in individual savings accounts.
6. Attempts to fraudulently obtain foreign exchange. The smuggling groups often submit false declarations or commit fraud against banks and the State Administration of Foreign Exchange in order to obtain foreign currency needed to pay their foreign suppliers or for remitting illegal gains abroad.
7. Monitoring individual large foreign exchange transactions not for speculation. Some individuals process a large volume of foreign currency transactions in foreign markets in a short time, not for the benefit of differential exchange rates, but for exchanging currencies to remit funds abroad. Those money exchange shops related to money laundering groups usually exchange foreign currency in this way.

8. Large amounts of foreign currency remitted abroad frequently. The smuggling groups remit large amounts in foreign currency abroad, often through legal and illegal channels, in order to conceal and use their illegal income and to escape official supervision.

The above methods of looking at domestic and foreign exchange transactions facilitate criminal investigations and preventive efforts. These methods could be enhanced if they could rely on better knowledge of underground banks and associated money houses within informal finance. The legalization and integration of legitimate informal institutions with formal banks would also assist in such efforts.

One difficulty in assessing the legitimacy of activities underlying informal finance is the connection of Chinese underground banks with informal financial flows to and from other countries. Some of these money flows are simply income remittances from migrants to family members, while some money flows are linked to criminal enterprises. For example, in 2008 an underground bank in Israel was uncovered that provided remittance services for Chinese workers in Israel. However, the underground bank owner used the funds to engage in currency speculation and lost a large amount of depositor money. Because the bank was illegal, the workers had no legal recourse in prosecuting him (People’s Daily 2009). Separating the legal versus illegal and legitimate versus illegitimate uses of funds is a challenge.

The PBC monitors and analyses suspicious financial transactions. Currently, this is the best available system for tracking such flows, since local officials are often unaware of the extent of underground finance, even though they may be aware of more visible manifestations of underground finance, such as the degree to which informal finance is used in enterprise financing. The necessity felt by the PBC to uncover activities of underground banks stems from the desire to control illegal activities as well as to implement its monetary policy. Some of these activities grew out of China’s political economic circumstances that evolved over the reform period from 1978 to now.

**Political economy of informal and illegal finance**

The political economy of informal and illegal finance can be analysed through both empirical work on the subject (e.g. Tsai 2002) and more general studies into the evolution of China’s political economy. The interplay between informal and illegal finance on the one hand, and measures
and levels of legal enforcement on the other, reflects largely local socio-economic conditions and actions of local political institutions. The types of informal financial structures that emerge are a result of the degrees of local economic needs, local political acceptance and legal enforcement. Varieties in these factors, combined with local cultural differences, have brought about numerous informal financial structures, serving both legitimate and illegitimate objectives. There are several characteristics of the local political economy that reinforce a multitude of informal financial practices.

First, the pattern of reform has, until recently, focused on the economic development of coastal regions. This adds to the importance of informal finance in these regions with a large number of small, private enterprises, and maintains the need for informal finance in poorer inland areas. Since the central government’s tacit endorsement of privatization in the mid-1990s, local informal financial practices along the eastern seaboard have become more diverse – due also to the fact that some areas have a longer history of and capacity for promoting entrepreneurship. For example, private enterprise, and along with it, informal finance, easily expanded in Zhejiang and Jiangsu province since tacit permission for privatization. These areas flanking Shanghai have traditionally been centers of creative economic activity and entrepreneurship, and this has been reflected in the rapid resurgence of informal financial and economic activity. The type of activity encouraged is legitimate productive activity.

Second, Communist Party membership strongly affects performance and financial access of private firms, and is especially important in underdeveloped areas (Li et al. 2008). Hence, not accounting for additional legal privileges (as those mentioned in the following paragraph), areas with greater Communist Party membership may be less likely to engage in informal or illegal finance, since private firms with Party membership have better access to bank loans. Communist Party members have been found to be 9.2 per cent more likely to obtain a loan than non-members (Talavera et al. 2010).

Third, informal relationships and practices apply not only to the business realm, but to the law enforcement realm. Local officials use their own discretion in enforcing regulations, and decisions are dependent upon both interpretation of the law and of the informal social and political connections of parties involved (Potter 2001). Where officials are corrupt, legal decisions may also depend on the monetary means of individuals affected by such decisions and on how prone they are to pay bribes or offer illegal favors. Moreover, the Communist Party has ultimate training and supervisory authority over the political-legal system. Judges are appointed based on Communist Party loyalty and military service, rather than on legal education or other types of experience (Potter 2001). Hence, informal and illegal financial practices are influenced by the local legal culture, extent of local corruption, Communist Party appointments and connectedness of informal financial participants. Corruption in the legal sector can lead to the flourishing of both legitimate and illegitimate informal financial practices.
So far, the link between corrupt officials and the permitting of legitimate or illegitimate informal financial practices has not been empirically established, but it is well known among street vendors and small businesses that extra ‘fees’ (i.e. bribes) may be collected any time against these disempowered entities.

Fourth, inequality in income, land ownership and opportunity has led to social unrest in some circumstances that has undermined the legitimacy of the Communist Party within socially discontented groups (Breslin 2007). Most public protests are quashed by the military rather than resolved by the legal system (Keidel 2005). It may be that in areas of economic desperation, coupled with discontent with the legal system, citizens may be more in favor of engaging in informal or illegal financial activities, even though in areas of such desperation, informal finance remains relatively scarce. This is a hypothesis that has not been tested, although we know that the eastern coastal regions were rapidly developed and lifted from poverty once opportunity, in the form of private enterprise and a variety of informal financial resources, presented itself.

Discussion

We have discussed the characteristics, legitimacy and political economy of informal finance in China and identified certain important gaps in our knowledge. In particular, there has been little effort so far to classify informal financial transactions in terms of legitimate versus illegitimate and legal versus illegal sources and uses. Further, there is a need to construct a theoretical framework that explains and analyses the interaction between the diverse formal and informal banking sectors. To this end, the main areas that require further focus are the following:

- Further general examination of informal financial flows: informal finance has been quantified based on calculations from surveys of officials and businesses, as well as from official data, but more specific numbers with regard to various types of informal financial practices have yet to be quantified.
- Examination of legitimate versus illegitimate informal financial flows and the factors that contribute to them: informal financial flows that supply working or fixed capital for legal businesses or individual purposes should be denoted as legitimate and separated from the illegitimate ones.
- Examination of legal versus illegal informal financial flows and the factors that contribute to them: determine which informal financial flows between legal parties should be denoted as legal and separated from those that involve illegal acts or take place between one or more illegal parties.
• Assessment of the size and network of underground banks: informal finance that is part of the network of underground banks needs to be identified and quantified, sources of demand specified and causes of unmet legitimate demand analysed.

• Interaction between horizontal and vertical linkages between formal and informal financial sectors: flows between formal and informal financial sectors are complex and must be studied to better understand the mechanics and monitor legal and illegal transactions, and to construct policy that aims at a convergence between the illegal and illegitimate transactions on the one hand, and a closer alignment of legal and legitimate transactions on the other.

• The nature and theoretical implications of multiple fragmented markets within the informal financial sector: rather than constructing theories of segmented financial markets based on the concept of one informal sector, theories with respect to various types of informal financial sector markets must be modeled, empirically tested and elaborated. This would in turn lead to policy-useful conclusions and recommendations.

• The role of information asymmetries in maintaining fragmented markets within the informal financial sector, and between the informal and formal financial sectors: information asymmetries need to be investigated and reduced in order to remedy market fragmentation problems.

• The political economic environment that creates variation in informal financial practices: further understanding of how the local political economy interacts with and gives rise to different informal financial practices must be cultivated.

This research requires more sophisticated theoretical analysis and access to information that is at this point considered highly sensitive. The policy implications of research on informal finance are many, from both an economic, social and legal perspective. Which types of informal financial practices are encouraged, prosecuted or integrated into the formal financial sector determine China’s prospects for social stability and economic growth, and ultimately for China’s role in the global economy.

**Conclusion**

Chinese informal finance is complex and its study remains in its infancy. In this paper, we have discussed the most important aspects of what is known about informal finance, as well as issues that require further research. Understanding what types of informal finance are helpful versus harmful is essential to crafting best legal and economic policy. The pace of economic reform shows no sign of slowing, and banking reform must encompass continuing and expanded support of SMEs and individuals. Legal practices and
enforcement need to be properly aligned with the interests of legitimate economic growth and national security.

Notes
1 Even as regulators seek to monitor and constrain non-banking financial institutions, which undermine official anti-inflationary and development policies (see e.g. http://www.businessinsider.com/china-is-cracking-down-on-real-estate-financing-2010-3).
2 The recent global financial crisis led to similar severe credit constraints in the USA and Europe, but developed countries have long ago expanded their financial systems to reach smaller customers.
3 For example, the hui may be financially constructive in one region, but may develop into a taihui, a destructive form, in another region.
4 Institutionalized and legitimate informal finance (e.g. red hat enterprises, etc.) may be more easily integrated than non-institutionalized (e.g. borrowing from a local money lender) and/or illegitimate informal finance (e.g. money laundering), since institutionalized informal financial organizations have quasi-legal rather than illegal standing.
5 Literature on financial segmentation has focused on segmentation between domestic and international access to domestic financial products, as in Hietala (1989), Poon et al. (1998) and Errunza and Miller (2000).
6 Tsai (2004) argues that because informal finance varies by region in China, it cannot be perfectly substituted by micro-finance, the type of formal finance that has been used in some rural areas. Many of the micro-finance loans offered in China are used for poverty alleviation and do not address other types of demand, or other forms of supply.
7 This is very similar to informal credit available in Pakistan communities – these are called ‘committees’ (personal interviews).
8 On 1 April 2010, the PBC held a conference on the financial and legal system, where Liu Siyu, the vice-president of the PBC, addressed revisions on ‘General Rules on Loans’ to build a multi-level credit market (see Yan 2010).
9 The PBC has set up a number of informal finance monitoring points in Wenzhou and Ordos and has carried out a periodical investigation in recent years.

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