Capital Markets Experiment in Wenzhou

By: Jack Perkowski | April 1, 2012

In China, reforms often come about from the ground up. Over the years, the country has shown an uncanny knack for taking what is otherwise an illegal activity according to its own laws and regulations, experimenting with it, legitimizing it, and then incorporating it into an overall reform program on a step by step basis.

Perhaps the most famous, and far reaching, experiment was conducted in Anhui Province where the "contract responsibility" system took hold in the late 1970s. Another such experiment, this time in capital markets, is now being conducted in the wealthy city of Wenzhou in Zhejiang province on China's east coast. Before getting to Wenzhou, though, let's look at what happened in Anhui 30 years ago to see how it has worked in the past.

As the story goes, the farmers in this predominantly rural province in China were having a particularly hard time in the late 1970s. After several years of bad harvests, a severe drought in 1978 finally pushed them to the breaking point.

In order to find a way out of their predicament, 21 peasants and team leaders of the Xiao Gang Production Team in the Li Yuan People's Commune in Feng Yang County signed a contract in December, 1978, which stipulated that the production team would not turn over all of its production to the commune, as required by China's Constitution at the time, but would instead contract to deliver a set amount, keeping all of the production over that amount for themselves. The contract assigned all of the land to the 20 households that promised to deliver their quota of grain to the state. In the contract, the signatories also promised to look after the children of the team leaders if they were prosecuted, reflecting their concern over the political risk the team leaders were taking.

With a profit motive now in place, the Xiao Gang Production Team had a bumper harvest in 1979 and delivered to the state 15,000 kilograms of grain, the highest amount in 23 years. In July, 1979, **Deng Xiaoping** visited Anhui and encouraged its agricultural leaders to use whatever methods it could to help the peasants get rich, the sooner the better. In 1979, similar experiments began in other areas and provinces throughout China, all resulting in dramatic increases in agricultural productivity. Deng Xiaoping openly praised these experiments in 1980, and the system was adopted nationally in 1981. Deng later extended the contract responsibility system to other sectors of the economy, touching off the economic reform that has lifted hundreds of millions of Chinese out of poverty and has made China the second-largest economy in the world today.

Last week, China's State Council said it would launch experimental financial reforms in entrepreneurial Wenzhou. Dating back to 2000 BC, Wenzhou has a population of just over 9 million people, including 2.3 million urban residents. When China began economic reforms in 1978, Wenzhou was the first city in the country to set up individual and private enterprises, as well as a shareholding cooperative economy. In 1980, Wenzhou authorities granted China's first private business license to a Wenzhou woman. As testimony to its entrepreneurialism, Wenzhou has a total of 240,000 individually-owned commercial and industrial units and 130,000 private enterprises.

Wenzhou is now taking the lead in carrying out financial system reform. Due to its underlying wealth, and the difficulties faced by the city's private companies in obtaining loans from China's state-owned banking system, Wenzhou has become known as a hub for underground finance, an illegal activity in China today. The shadow banking system came to prominence in 2011 and developed as a way to supply credit to private companies, although at exorbitant interest rates.

While the government has cracked down on what it considers the most egregious cases, grey market lending has become a big business in Wenzhou—and in other parts of China. In October, UBS estimated that "private lending," the term used for the informal networks of money lenders that have developed outside of China's banking system, could be between two trillion yuan ($317 billion) and four trillion yuan ($634 billion).

The reforms announced last Wednesday include measures to formalize gray-market lending, and to allow capital to flow out of China more freely. In its statement, the State Council said it would establish rules and regulations for private lenders in Wenzhou, encouraging them to establish legal "investment companies" or "investment management organizations."

The State Council statement also proposed various ways to channel more credit to small and medium enterprises. These include encouraging China's state-owned banks to establish special units devoted to making loans to small and medium enterprises and allowing small firms to issue bonds in Wenzhou.

Like the Anhui peasants in 1978, Wenzhou authorities have been pushing the envelope as far as gaining greater economic freedom for the city's residents. Early last year, the Wenzhou government proposed to give its locals more freedom to invest overseas, only to be turned down by Beijing. Wenzhou officials then worked out a new proposal and submitted it for approval as part of a broader plan to make the city a testing ground for financial reforms.

As a result, the State Council also said it is studying whether to allow Wenzhou residents to invest directly overseas. Under the proposal, residents in Wenzhou would be allowed to spend up to $200 million per year—or as much as $3 million per person—to set up, acquire, or invest in nonfinancial companies in foreign markets. Currently, China strictly limits such investments.

China's future development, and its transition to a more sustainable, long-term growth model, depends upon the development of its capital markets. The State Council's announcement is a sign that the country is moving ahead with financial reforms and is seeking to channel more capital to private and smaller firms. For this reason, the Wenzhou experiment could turn out to be every bit as significant as the experiment conducted in Anhui over 30 years ago.

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