The default of a large number of informal finance schemes in China has caused enormous financial losses, and therefore has potential social and political significance. Analysing 334 defaulted schemes from 1989 to 2015, this study defines how they differ from other types of informal finance. It also produces an ideal-type representation of the default process and concludes that the default results from greed, increasing financial pressure at the individual level and private enterprises’ restricted access to state bank loans at the institutional level. China’s financial system should be more flexible in order to prevent further financial losses through informal financial relations.

INTRODUCTION

The importance of an informal economy, including informal finance, in promoting economic growth, particularly in developing countries, is indisputable.¹ For the case of China, many researchers have documented and explained how informal institutions and relations have played a significant role in China’s rapid economic growth over the past three and a half decades. For example, Kellee Tsai made a powerful case for the rise of “an amazing array of informal financing mechanisms” when they were banned by the Chinese state.² Meanwhile, employing the notions of “double entrepreneurship” and “institutional holes”, Yang Keming explained the rise of private enterprises in China by revealing how private entrepreneurs manipulated both the formal and informal aspects of their businesses.³ There is also literature on how informal finance, mostly in the forms of private

lending and rural cooperative funds,\textsuperscript{4} has helped farmers finance farming, expand their non-farming businesses or cover the costs of family functions (marriage, funerals, real estates, etc.).\textsuperscript{5}

The central argument that the authors develop in this article is that these positive contributions made by the informal economy should not lead specialists and observers of China to believe that all is well in the informal economy and finance; rather, they should pay serious attention to the significantly high prices that many businesses and ordinary people have to pay for being involved in under-regulated informal financial transactions. Some researchers have noted the negative effects of informal financial activities on local financial markets, but they tend to rely on a small number of anecdotal cases.\textsuperscript{6} One particular type of informal finance—shadow banking—has attracted some attention from major news outlets in the West but not from academic researchers.\textsuperscript{7} A more systematic approach is needed in order to assess the scale and scope of defaulted informal finance schemes, uncover the process of informal financial transactions and to understand why many informal financing schemes have collapsed and caused enormous financial as well as non-

\textsuperscript{4} It should be noted that most rural cooperatives funds were official (or formal) rather than informal institutions, but eventually turned out to be a failure. W. Leigh Ribble, Jr., "Why Did the Rural Agricultural Cooperation Funds Fail?: A Look at Changde, Hunan Province", \textit{China: An International Journal} 4, no. 1 (March 2006): 135–50.


\textsuperscript{6} In \textit{Back-Alley Banking}, Kellee Tsai mentioned an event in Zhengzhou (Henan province) in November 1998, where “over two thousand people staged a demonstration in the provincial capital after their savings are lost in a failed investment firm” (p. 1). Li Jianjun presented a few cases of failed investment schemes in “Informal Finance, Underground Finance, Illegal Finance, and Economic Movement: A National Analysis”, in Li Jianjun and Sara Hsu, eds., \textit{Informal Finance in China: American and Chinese Perspectives} (Oxford Scholarship Online, 2010).

financial damage (depression, suicide, broken families, social unrests, etc.). More importantly, studying the damage caused by informal finance schemes will give us a special perspective for better understanding the role of the Chinese state in China’s financial market, the motivation behind some private business owners in soliciting investments from individual investors, and the behavioural rationales followed by individual investors.

This study focuses on the default of one particular type of informal financing in China’s context from 1989 to 2015\(^8\) that gave debtors of a large number of informal finance schemes—typically private entrepreneurs or business owners—access to an investment or business opportunity with high rates of return. As these private business owners could not obtain loans from state banks or other official financial institutions, they had no option but to secure investment funds via informal channels, including networks of personal connections, or to appeal to the general public, non-official or even underground financial institutions (money brokers, non-licenced financial intermediaries, etc.). To many individual investors, the promised high interest rates or dividends were too attractive to resist, despite the potential risks that they had to take. Nevertheless, for a variety of reasons to be outlined below, many schemes soon became financially unsustainable, eventually reaching the point of collapse, and in the end the debtors did not intend, or were unable, to pay their investors the high rates of return (interests or dividends) that they had initially promised, thereby burdening the investors with unrecoverable financial, psychological and social losses. In many cases, only a small proportion of the invested capital was recovered.

In examining these defaulted informal finance schemes, the authors aim to achieve three interrelated objectives: (i) to present an initial assessment of the prevalence of failed informal financing schemes in China over the past three decades; (ii) to understand and reveal the mechanisms of their default by studying the key steps in the process of default; and (iii) to identify the social and institutional factors behind these cases of collapsed informal finance. The authors formulated the following research questions: How has the number of defaulted informal financial schemes changed over the years? Who were the creditors and debtors? Where did most of the crises occur? How many people and how much money were usually involved in each defaulted scheme? How did a debtor obtain funds from the creditors? How did an informal finance scheme become unsustainable? Who should take the responsibility for their collapse and, perhaps more importantly, what could be done to prevent the collapse of such schemes?

As the informal investment schemes studied in this article are considered a special type of shadow banking, which has attracted much attention from the media and academic researchers, the

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\(^8\) In particular, due to the lack of systematic and reliable evidence, the authors were not able to include the default of informal financing transactions or schemes that were conducted on the internet, such as peer-to-peer (P2P) schemes.
authors prepare the ground by defining the differences between the two in the first section. In the next section, they explain how the database of these cases of collapsed informal investment schemes was constructed from selected media outlets in China as the main source of empirical evidence for the study observations. The third section presents the common features, and the scale and scope of the collapsed cases. In the fourth section, the authors explain the rise of the number of collapsed schemes at both the individual and institutional levels. The conclusion offers some reflective observations about the implications of these defaulted schemes of informal finance for China’s financial and economic reforms.

<H1>TYPES OF INFORMAL FINANCE</H1>

Two forms of informal finance have attracted much attention from academic researchers in the West: shadow banking and rotating credit savings associations (ROCSAs). As this study focuses on financial schemes in the informal finance category, the authors attempt to highlight the differences between China’s informal finance schemes and the Western informal finance that exists in two forms.

Shadow banking in developed economies is well established, transparent and managed on a large scale; by contrast, shadow banking in China remains precarious, opaque and limited in terms of its share of the financial market. In the West, although shadow banking operates outside the regulated and official financial system, it is tightly connected to formal banks as intermediaries; in other words, shadow banks work “in the shadow” of formal banks in the sense that they manage and market financial products offered by or through formal banks. In practice, however, there are various types of shadow banking schemes, which lead researchers to adopt different classifications. Generally speaking, there are three major types of shadow banking: (i) shadow banking with direct connection to formal banks as intermediaries, including commercial financial institutions and wealth management products; (ii) independent financial institutions including trusts,
brokers, insurance or security firms, and credit guarantee companies; and (iii) microlenders, pawn shoppers and underground black markets.\footnote{12}

In light of these categories, the informal finance schemes in this study can be seen as a special type of shadow banking for the following reasons. First of all, very few of these schemes fall into the first category of shadow banking as they have no opportunity to work with an official (state) bank for the purposes of buying or selling financial products, and while some organisers of these schemes might be fortunate to have special access to obtain loans from state banks,\footnote{13} they simply do not work with or through state banks. Therefore, informal finance in China since the launch of economic reforms fits the criteria of the second and third types of shadow banking as defined earlier. More specifically, private business owners are usually the ones who need to obtain new capital within short periods, and because most of them do not have the privilege of borrowing from state banks, or even for those who can borrow, the amount that state banks can lend is very likely to be much less than what they request. Conversely, they have no choice but to either seek help from other informal financial institutions (trusts and brokers), or borrow directly from people with whom they have personal relations, or from the general public through a scheme with or without the protection by a credit guarantee company. In short, these informal finance schemes may be classified as type 2 and type 3 of shadow banking. It should, however, be noted that the third type as defined above does not explicitly include the lending or borrowing of financial credits through networks of personal relations or marketing to the general public, although they could be classified as “underground black markets” despite operating publicly.

It is important to take into account the number of investors involved in each scheme of informal financing because the number reflects and relates to the scheme’s legality, an issue being hotly debated in today’s China. After an informal finance scheme breaks down (whether the debtor disappeared or was arrested or declared bankrupt), it is usually regarded as being “illegal”. However, legal specialists in China have not reached a consensus on the definition of “illegal capital raising”

\footnote{12} It should be noted that this classification is not completely consistent with the official classification in China. On 1 March 2014, the State Council of China issued an official document on regulating and monitoring shadow banking 2013, 107, at <http://www.hbxtsw.gov.cn/show_news.asp?id=3558> [18 March 2015], in which three types of shadow banking are listed: (i) credit intermediaries with no financial licence and are not under any regulation, including new internet financial companies and third-party wealth management institutions; (ii) credit intermediaries with no financial licence and are under insufficient regulation, including guarantor companies for capital raising and small loan firms; (iii) institutions with financial licence but are under insufficient regulation and monitoring, including monetary market funds, shareholding capitals and some wealth management services. However, institutions of the third category defined herein (i.e. microlenders, pawn shops, and underground financial markets) are not included in the classification of the Chinese government.

\footnote{13} In this article, the authors use “formal bank”, “official bank” and “state bank” interchangeably and this is deemed appropriate in China because all banks need state-sanctioned licence, and just a very small number of banks are not state-owned.
Nevertheless, the authors recognise that it is appropriate to understand “illegal capital raising” as any type of informal finance schemes that target 30 or more people in the general public. In reality, there are some overlaps in the term “illegal capital raising”—some informal finance cases started as illegal capital-raising activities, but not all of them break the law since they do not necessarily target the general public or deceive investors from the outset. The intention of this article is not to discuss legal details as the authors are not particularly concerned with the number of investors involved in defining the legality of such cases; rather, of greater significance to them is whether organisers of informal finance schemes hide any crucial information from their investors. Based on their database of case studies on the collapsed schemes, the authors learnt that there were varying degrees of information suppression. For instance, some organisers started with a malevolent intention from the outset, by providing false information and not planning to return the funds at all; there were indeed others who were truly in need of investment capital for a genuine business project but were alleged to infringe the laws due to events beyond their control; while there were others who were between the two extremes, i.e. having a genuine investment plan but needing to resort to illegal means to raise funds.

The rotating credit savings associations, or ROCSAs in short, are another type of informal finance that do not fit neatly into the three shadow banking classifications; they have, nevertheless drawn attention from academic researchers. Probably due to the underdevelopment or inaccessibility of formal banks, the ROCSAs are mostly found in developing countries. Research on the ROCSAs in China can be traced to the 1930s, and after the economic reforms, these informal financing associations were revived in a variety of forms. However, the ROCSAs are not the focus of this study because they differ from the authors’ case studies in terms of the number of people as well as the amount of money involved—the case studies typically involve a larger number of people and larger loan amounts than those of the ROCSAs. In addition, the case studies include a much

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14 For example, an official document on the “Explanation for Some Questions Regarding Trials of Illegal Fund-Raising”, published by China’s High Court on 1 April 2011, postulates that any individual who attracts funds from more than 30 people in the general public should be prosecuted for criminal liability according to the law; for organisations, those that attract more than 150 members of the public will be prosecuted. The authors also consulted the definition of “public economic crimes” given by the Department of Public Security, which set 30 as the threshold of being “illegal”.

15 The literature on anthropological studies of the ROCSAs is large; to begin, interested readers could refer to Clifford Geertz, “The Rotating Credit Association: A ‘Middle Rung’ in Development”, Economic Development and Cultural Change 10, no. 3 (1962): 241–63.


wider range of financial relationships between lenders and borrowers, i.e. private business owners and local residents, whereas members of a ROCSA are normally from the same small community. Besides, most of the ROCSAs are found in China’s rural areas rather than in cities, while most of the authors’ case studies originate from medium to large cities.

In sum, the informal finance schemes in this study are different from shadow banking and the ROCSAs in the following ways: (i) at a certain point of time, most of the cases studied here culminated in financial frauds and defaults—i.e. borrowers did not intend, or were not able, to pay the capital and promised high interest rates back to their investors; (ii) among all informal financial cases in China since the 1980s, informal financial schemes involve probably the largest total amount of money invested and total number of investors (as explained in subsequent sections); (iii) personal relations and networks played a highly significant role—a large proportion of investment or perhaps all of it came from networks of interpersonal relations (relatives, friends, colleagues, neighbours, etc.); for instance, even when debtors attempted to lure the general public to participate in their schemes, investors usually made the decision to invest after consulting other investors they personally knew, thus these schemes are considered informal.

**A DATABASE OF DEFAULTED INFORMAL FINANCE**

The biggest challenge in collecting evidence of defaulted schemes of informal finance in China is that local authorities would routinely suppress media coverage of people who were affected until the number grew so large that it became impossible to cover up. As is shown later, some of the investors also had their own reasons to conceal their involvement in such schemes. It is therefore virtually impossible to obtain an accurate estimate of the prevalence of the defaulted schemes among all cases of informal finance in China.

Recognising that the defaulted schemes have significant impacts—like a local financial crisis—on ordinary investors and their relatives, other businesses and local economies, the authors were determined to overcome the challenges of data shortages and limited resources at their disposal. A database of defaulted informal finance schemes constructed from media reports sheds some new light on this important phenomenon despite the limitations described later. At the time

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18 Some institutions in China have tried to collate information on defaulted informal finance. Unfortunately, none of them offers systematic and reliable evidence. For example, the People’s Bank of China has been monitoring the informal financial market in China; however, the sample size monitored varies from year to year, and the data is not available to academic researchers. Some local legal courts collect data on disputes over unpaid loans involving ordinary citizens and private enterprises, but they do not classify the cases consistently over time and tend to confuse disputes over debt default with violations of contractual terms.
of writing, the collected media reports on 334 defaulted informal finance schemes. Temporally, these cases spanned 1989 to 2015. Geographically, they were spread across 28 provincial-level regions (23 provinces, four metropolitan cities and one autonomous region). The authors believe that this database contains the most newsworthy defaulted schemes of informal finance in China over the past three and half decades. As many of the cases were covered by multiple media agents, an attempt was made to corroborate the information from different sources in order to ensure the comprehensiveness, reliability and accuracy of each case.

The authors did recognise that selection bias poses a potentially serious limitation to this database. Most of the selected cases involved a large number of people and large loans—the very reason why large cases drew much intense media attention than the smaller cases involving a smaller number of people or smaller loans. The authors caution that their database should not be taken as a representative population sample of defaulted informal finance schemes in China between 1989 and 2015, i.e. the time frame of the study, and that the observations and conclusions made are therefore only applicable to such type of cases. With the lack of reliable information about the number of cases of defaulted informal finance schemes, they were unable to assess the severity of the section bias. Instead, they looked beyond the difficulties to identify the common features of these schemes and to understand the underlying mechanisms of their collapse.

Another relatively less serious limitation of this database is the wide variations in detail in each case across media agents and reports. Left with few options, the authors chose to concentrate on a select few important characteristics found in most of the cases, such as the time, location, total amount of loans and number of people involved. They have provided detailed information of the cases’ characteristics.

To facilitate readers’ understanding, the authors summarised two of the cases in the database as follows. According to the Hurun Report, Liao Rongna was the richest man in Liuzhou city in China’s Guangxi province. He has been on the run since August 2014, and is now in the cross hairs of international police because his company, Zhengling Group, was unable to pay back seven billion yuan in loans to the banks and return another three billion yuan in loans to approximately

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19 The cases for this study came from the following major websites: Renmin wang (People’s Daily Online), at <http://www.people.com.cn/>; Fazhi ribao (Legal Daily), at <http://www.legaldaily.com.cn/>; Guangming wang (Guangming Online), at <http://www.gmw.cn/>; Xinhua Net, at <http://www.xinhuanet.com/>; Fenghuang New Media, at <http://www.ifeng.com/>; Xinlang (Sina News), at <http://www.sina.com.cn/>; and 21 shiji (21st Century), at <http://www.21cbh.com/>. The authors evaluated the validity of the cases by the level of detail provided and their relevance to their definition of informal finance.

2,000 individuals. These individual investors put their own money, which, in many cases, belonged to their relatives and friends, into Liao’s company as it was a highly reputable firm; and the interest rate was irresistibly attractive at two per cent per month versus the annual interest rate of slightly above three per cent offered by state banks for fixed-term savings.

It is not verified whether Liao intended to run with the money at the time that he borrowed it. In many other cases, the vicious intention was indisputable. The case of Wu Ying was probably the most notorious. She was given the death sentence for collecting 389 million yuan illegally in less than two years (May 2005 to February 2007). Starting as a hairdresser in Dongyang city in Zhejiang province, Wu set up a firm with her husband by borrowing more than 14 million yuan from several people with a promised interest rate of at least 30 per cent per quarter. To ensure sustainability of the chain of borrowing, she created several markers of trustworthiness (discussed in the next section), such as registering several companies (with no investment projects) in different industries, making house purchases and donating a large sum of money to charities. But she spent much of the rest on luxury goods.

**AN OVERVIEW OF DEFAULTED INFORMAL FINANCE IN CHINA SINCE 1989**

*The Rise and Spread of Defaulted Informal Finance Schemes*

It is reasonable to expect that the wide media coverage of the cases of Liao Rongna and Wu Ying in the early years of economic reforms would act as a precaution to the public and result in a decline in the number of cases or non-occurrence. However, in reality, the contrary occurred: the number of such cases increased over the subsequent years. For example, the first half of 2008 and the second half of 2011 witnessed several waves of private business owners evading unpaid debts in Wenzhou (Zhejiang), which is reputed for its fast-developing private sector. In addition, similar cases of debt evasion by private business owners in some areas of Guangdong province were reported between the end of 2011 and early 2012. In 2011, the borrowing and lending chains started to default in Erduosi (Inner Mongolia) and Anyang (Henan). Waves of breakdowns swept the informal banking and financial markets in Shenmu (Shaanxi) and Liulin (Shanxi) at the beginning of 2013 and then in Handan (Hebei) in 2014, with some even evolving into local financial crises. From 2005 to June 2011, there were more than 10,000 such cases, involving more than 100 billion yuan.

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21 There are many reports about this case in the media; for the most recent updated report, see <http://www.chinanews.com/sh/2014/08-13/6490410.shtml> [5 March 2015].


23 Reported on 5 January 2011 in *Renmin fayuan bao* (People’s Court Daily).
More recent data published by the Supreme People’s Court show that the number of cases received by legal courts nationwide was relatively stable until 2008 when the total number of cases of “civil financial disputes” reached 488,301. The number jumped substantially in 2012 to 747,809, an increase of 53 per cent in four years. The average amount of money involved in each case increased 1.4 times. During the 1990s, most of the disputes and frauds revealed by the media seemed to occur in only two places, namely Wenzhou and Erduosi. Since the beginning of this millennium, many cases have been reported in Langfang (Hebei), Luoyang (Henan), Xi’an (Shaanxi) and other cities. The authors expect the actual occurrence rate to be higher than the reported ones, although the secretive nature of informal finance implies that reliable information about the prevalence of default remains scant.

Figure 1. Number of Defaulted Informal Finance Schemes Reported in the Chinese Media (1989–2015); Number of Private Enterprises (unit in 100,000, 1989–2008); Percentage of Total Loans to Individual and Private Enterprises (2002–2012); and Urban Household Savings Rate (1989–2007) in China

Sources: Number of defaulted informal finance schemes: compiled by the authors; number of private enterprises: China Yearbook of Private Enterprises, selected years; percentage of total loans to individual and private enterprises: Table 3.9 in Lardy, Markets over Mao; urban household savings rate: Table 3 in Dennis Tao Yang, Zhang Junsen and Zhou Shaojie, “Why Are Saving Rates So High in China?”, IZA Discussion Paper no. 5465, January 2011.

24 Ji Tong, “An Analysis of the Data of Informal Financing Cases Processed by Courts across China” (in Chinese), Legal Daily, 19 February 2014. It should be noted that not all financial disputes are illegal fundraising cases; there is no information in this report about the percentage of illegal fundraising cases.
Broadly consistent with the aforementioned official figures, results from the analysis of the database presents a fuller picture of the largest cases. As shown in Figure 1, before 2002, the total number of defaulted informal finance schemes remained relatively small (below “6”) and stable; since 2002, there was an obvious increase, which peaked in 2014, even though the figures fluctuated slightly.

What is the explanation for the increase since 2002? While a rigorously researched answer is beyond the scope of this article, the authors can however offer educated speculation. For factors outside China, the financial crises in the West starting in 2008 naturally comes to mind. Nevertheless, among the major economies in the world, China was reportedly one of the least affected countries thereof. The connection between the global crises and the informal financial schemes in rural China thus remains theoretical. For aspects within China, the authors proposed examining the following three factors: the number of private enterprises; the share of bank loans made to private businesses; and the rate of savings by urban residents. It is not surprising that the growth in the number of private enterprises almost parallels that of the defaulted informal finance schemes. Although it is premature to assert the causal effect of the number of private enterprises on the occurrence of defaults, there is an undeniably close association between the two. This is not totally unexpected because the majority of these schemes were started by private business owners. When business owners are in need of credit to start a new business, or to expand an existing one, they face great difficulty in obtaining bank loans. As shown in Figure 1, the percentage of bank loans offered to private enterprises represented only about seven per cent of all bank loans in 2002 and 16 per cent in 2012, despite the fact that a vast majority of enterprises were private. On the other hand, China is a country well known for its high savings rate, even though there are controversies over the calculation of the savings rate. The authors highlighted that the savings rate of urban households should be used instead of the rate of the whole country as savings rates of corporations and institutions are much higher than those of households. The urban private savings rate increased gradually from 11 per cent in 1989 to 27 per cent in 2007. More recent data has suggested that the average amount of savings per person in China in 2015 reached 40,219 yuan, a historic high. If some of those people who made the savings were looking for investment opportunities or better returns, while at the same time some private business owners were desperate to secure credits for their businesses, then even if only a very small number of these businesses defaulted, the absolute scale of damage would be significant.

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Figure 2. Number of Defaulted Informal Financial Schemes Reported in the Media by Provincial Region in China, 1989–2015

Source: Compiled by the authors.

The authors also identified and ranked the provincial regions by the number of defaulted schemes reported in the Chinese media (Figure 2). Zhejiang, Jiangsu, Guangdong and Shandong, where private enterprises experienced the most rigorous growth, topped the chart. As explained earlier, the vast majority of local businesses are medium and small private firms with relatively restricted access to loans from state banks and are therefore the most active in obtaining loans through informal channels. By contrast, regions where private enterprises are relatively underdeveloped, such as Guizhou, reported a smaller number of defaulted informal financial schemes. For other regions, surprisingly, Beijing has more reported cases than Shanghai because the capital is not known for its vibrant private sector and informal finance. This suggests that the development of private firms might not be the sole factor responsible for the rise of informal finance. A plausible explanation for the large number of defaulted informal finance schemes in cities like Beijing could be found on the supply side; that is, in these cities, the proportion of people who look out for opportunities to invest their savings is relatively higher than that of other cities.

To determine the veracity of these theories, the authors analysed the relationship between the number of defaulted informal financial schemes and the three factors at the provincial level,
namely the gross domestic product (GDP); the number of private enterprises; and the amount of resident savings. The descriptive statistics are presented in Table 1.\textsuperscript{26}

<table>
<thead>
<tr>
<th>Variable</th>
<th>Range</th>
<th>Mean</th>
<th>s.d.</th>
</tr>
</thead>
<tbody>
<tr>
<td>Number of defaults</td>
<td>(2, 44)</td>
<td>12.64</td>
<td>10.22</td>
</tr>
<tr>
<td>Mean GDP*</td>
<td>(2.2, 46.76)</td>
<td>15.80</td>
<td>11.17</td>
</tr>
<tr>
<td>Mean number of private enterprises\†</td>
<td>(2, 79)</td>
<td>20.00</td>
<td>19.66</td>
</tr>
<tr>
<td>Mean amount of resident savings\‡</td>
<td>(2.84, 29.88)</td>
<td>9.04</td>
<td>6.02</td>
</tr>
</tbody>
</table>

Notes:
* This is the mean of GDP (in 100 million yuan) in each provincial region from 1993 to 2014.
\† This is the mean of the number of registered private enterprises (in 10,000) in each provincial region from 2010 to 2014.
\‡ This is the mean of the amount of savings held by residents in each provincial region (in trillion yuan) from 2002 to 2014.

Sources: Number of defaulted informal financial schemes: compiled by the authors based on online media reports; GDP: National Bureau of Statistics; number of private enterprises: National Bureau of Statistics; amount of resident savings: Bank of China.

To explore the overarching relationship, a scatterplot for each pair was produced with an imposed locally smoothing line, which is more effective than a simple linear regression line (Figure 3). The three pairs of relationships clearly share a very similar linear shape: at the provincial level, the number of defaulted informal financial schemes increases with GDP, the number of private enterprises and the amount of resident savings. It is particularly noteworthy that Guangdong, Zhejiang, Jiangsu and Shandong stand out from other regions with high values on all variables. Among the four provinces, Zhejiang has the largest number of defaulted schemes, although the values on the three predictors are not the largest. Overall, these empirical findings corroborate the specified theories specified.

\textsuperscript{26} These statistics and graphs were produced with the available data of 28 provincial regions.
Figure 3. Relationship of Number of Defaulted Informal Finance Schemes with GDP, Number of Private Enterprises, and Amount of Resident Savings

Source: Data computation by authors.

<H2>An Ideal-Type of Informal Finance Scheme</H2>

This section provides an overview of the process for an informal finance scheme default and the common features of default cases. In social sciences, such a conceptualisation is usually referred to as “an ideal type”, an idealised representation of the studied phenomenon with common key elements abstracted from real-life cases. An informal finance scheme usually starts with a number of people who have learnt that a businessperson (or a company) is in need of money for a legitimate reason, such as manufacturing and selling a new product with a very promising rate of return. They are asked to invest their money (or money that they could borrow from their relatives or friends) in the said business, with promise of a payback after a certain period of time at an interest rate much higher than that offered by state banks. The investors are aware of—and are sometimes even warned of—the risk of losing their money. Nevertheless, they still decide to invest based on at least one of the following reasons: (i) the interpersonal relationship (guanxi) between the investor and the business owner (or someone on behalf of the owner), which serves as a form of collateral; (ii) business owner’s trustworthiness, which other investors, who already earned enviable interests without any loss, have vouched for; (iii) the business owner’s good reputation, locally or even nationally; and (iv) the business owner’s ability to pay back the capital and interests as demonstrated by the “markers of trustworthiness” accumulated (discussed in the next section). For the first few weeks or months, the investors receive the interests as promised, hence serving as a precedent for them to invest more money or to convince other people in their social circles to invest as well. However, upon learning that they have stopped receiving the interest in their bank accounts

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27 It is widely recognised that German sociologist Max Weber was the first to systematically define “ideal-type” as a conceptual and theorising tool in social sciences. Interested readers can find the most recent translations of his expositions in Hans Henrik Bruun and Sam Whimster, eds., Max Weber: Collected Methodological Writings (New York: Routledge, 2013).
and that they have lost contact with the business owner, the investors then begin to panic and are informed to report their losses at the police station.

**THE RISE AND FALL OF INFORMAL FINANCE IN CHINA**

*The Supply and Demand of Credit in China*

To understand why many informal financing schemes defaulted, it is necessary to first find out why they came into existence. The fact that the growth of the private sector is pivotal to China’s rapid economic growth implies that private business owners aspiring to set up or expand their businesses need immediate access to a large sum and number of loans. However, it is widely recognised that their limited access to bank loans is a significant obstacle to their growth. To what extent the situation has been improved remains unclear as information on this is not consistent. Some argue that state regulations on private firms’ access to bank loans remain as restrictive as they were many years ago. However, using data obtained from China’s Society of Banking, Nicolas Lardy showed that the situation improved from 2009 as more than half of state bank loans had gone to private firms, but it should be noted that Figure 1 shows otherwise with a lower percentage compared to other years.

The authors believe that these two observations are not necessarily unrelated. Bearing in mind that the vast majority of businesses in China are now privately owned, even though the total amount of bank loans that private businesses received is slightly more than the total amount loaned to state enterprises, as shown by Lardy, each private enterprise, on average, receives only a small

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29 In April 2014, Huang Rong, vice chairman of National Federation of Business and Commerce, pointed out that small private businesses still found it very difficult to obtain bank loans, thus forcing them to resort to informal fundraising and paying an annual interest of 20 to 30 per cent (or 4.5 to 5.5 per cent monthly). Li Zibin, head of the National Association of Medium and Small Businesses, depicted a more accurate picture: by the end of 2012, one-third of the 13 million medium to small registered enterprises relied on informal fundraising, at [http://www.bjnews.com.cn/finance/2014/02/26/306439.html](http://www.bjnews.com.cn/finance/2014/02/26/306439.html) [18 March 2015]. Results from the China Household Finance Survey (CHFS) show that obtaining bank loans remains very difficult for very small and individual businesses, and the most widely reported reasons include not having sufficient collateral or guarantors and not knowing the bank agent personally. The CHFS was conducted under the leadership of Professor Li Gan by researchers at Southwest University of Finance and Economics. See also Terence Tai-Leung Chong, Lu Liping, Steven Ongena, “Does Banking Competition Alleviate or Worsen Credit Constraints Faced by Small- and Medium-Sized Enterprises? Evidence from China”, _Journal of Banking & Finance_ 37 (2013): 3412–24; Patrick Behr, Lars Norden and Felix Noth, “Financial Constraints of Private Firms and Bank Lending Behaviour”, _Journal of Banking & Finance_ 37 (2013): 3472–85.

30 See Lardy, _Markets over Mao_, chap. 3.
fraction of what state banks have loaned to a state enterprise. In other words, while a very small number of private enterprises, typically the largest and most successful ones, have no difficulty in obtaining loans from state banks, the majority of small- and medium-sized private firms are still painfully constrained by strict conditions such as unattainably high levels of collateral and the need for the support of guarantors. Although certain flexibilities and market mechanisms have been introduced, China’s financial market remains heavily regulated and controlled by the state; competition among banks for both savings and loans does exist, but only to a very limited extent. When releasing loans, most banks tend to favour state-owned enterprises (SOEs) or projects affiliated with or supported by government agents.

Given that the Chinese economy has become much more market-oriented in the past three and a half decades through a series of reforms, it is indeed puzzling that state banks still treat private enterprises in a discriminatory manner. A pragmatic explanation that the authors find plausible: it is simply too risky for banks to offer loans to private firms—few of these firms have sufficient collaterals; uncertainty abounds in their businesses; monitoring and tracking the development of their businesses is difficult; and chance of a bailout is slim if their businesses go bust. By contrast, state banks and SOEs are all assets of the Chinese state. As shown in Figure 1, only about 15 per cent of state bank loans were provided to private enterprises in recent years; and only the most successful and the biggest private enterprises possess sufficient assets for obtaining credits from state banks.

While private enterprises’ access to state bank loans remains mostly restricted, a significant amount of cash is now in the hands of China’s ordinary people, especially the emerging middle and upper classes, who are seeking investment opportunities. By analysing the data collected from the China Health and Nutrition Survey (CHNS), some researchers have shown that the mean household income increased from 12,830 yuan in 1989 to 32,040 yuan in 2006, and exceeded 40,000 yuan in 2015. The increase in the percentage of disposable income from savings from just above 15 per cent in 1989 to about 32 per cent in 2006 is of interest. Taking the findings together into consideration, the average amount of savings worked out to be at least 10,000 yuan per household in 2006.\textsuperscript{31} Data collected more recently from the 2013 wave of China Household Finance Survey (CHFS)\textsuperscript{32} suggests that the median of household assets was 252,000 yuan, and that an average household was able to lend 100,000 yuan to others.


\textsuperscript{32} See relevant information in footnote [31].
The findings in selected cases confirm that many ordinary people, including retirees and low-skilled workers, were able to invest tens of thousands of yuan into informal financial schemes. The same can be alluded to residents in urban areas who are able to pool together hundreds of thousands of yuan or even in millions from their extended families and social circles for investment purposes, although further information is needed to ascertain an accurate estimate of the level of savings and investments among different groups of Chinese citizens. It seems therefore safe to imply that the pool of savings among ordinary Chinese citizens is large, and even much larger among professionals, business owners and government officials. Understandably, many choose not to stash their money at home or save it in state banks. Instead, most are motivated to use their savings to generate as much returns within a short period of time.

Chinese investors are clearly aware of the potential risks of investing their savings in informal financial schemes. But why would they take such risks? Why do they have such strong motivations to generate more money? This is particularly puzzling given that, as shown earlier, the majority of Chinese people seem to have enjoyed a considerable increase in income and quality of life over the past three and a half decades. The authors have not found any satisfactory evidence to answer these questions, but their findings on the cases clearly suggest that the increased income has failed to alleviate the emerging pressure on people to make more money. More specifically, ordinary Chinese people are under much greater pressure than before to meet several “money-draining” objectives, including children’s (ideally overseas) education, adult children’s weddings, housing and other related expenditures, healthcare bills (if a family member is hospitalised), and luxurious goods and holidays. However, these expenditures add up and to most people, the increased incomes appear to be less than adequate. Consequently, many are keen to earn more money with their savings.

The Trade-Off between Risk and Gain
With financial investments, risk and gain go hand in hand. For instance, high profits always accompany with high risks; conversely, low-risk investments bring minimal returns. The risk of investing in financial products offered by state banks or officially licenced financial institutions is usually very low due to state protection, but the rate of return is disappointingly low. In fact, the rate of return could be even lower than the rate of inflation, making the return, in real terms, negative over time. The Chinese state wants to maintain a very low savings rate at state banks for the following reasons: to make borrowing less costly for businesses and to encourage ordinary people to spend. Investing in the stock market, on the other hand, poses a dilemma for ordinary investors that is the exact opposite of investing in formal financial products. For example, the rate of
return may be attractive but the risk is typically higher. Chinese investors are therefore keen to search for new opportunities that simultaneously generate high financial gain and very low risk.

A common issue with investing is much as investors are expected to be rational, the uncertainty and lack of full information often render them to lose the ability to think rationally. There would be no financial fraud if everyone would accept the fact that it is impossible to resolve the trade-off between risk and gain. Starting from as early as 1989, and in most regions of China, some business owners would claim that they could offer investors opportunities that yield high returns but low risks. These investors often have confidence about the high rate of return, as certain industries (real estate, energy and raw materials such as steel) indeed generate enviable profits. A key challenge, then, is about dealing with the notion of risk. And the solution is often a trade-off between risk and gain by maximising levels of trust and confidence in the borrower. If investors have sufficient trust and confidence in the borrower and his/her products, then the dilemma is resolved. This explains why borrowers invest much effort and resources in establishing and maintaining a high level of trust among investors, and this is achieved by presenting or producing a series of markers of trustworthiness. In developed Western economies, financial markets do not rely on interpersonal trust as loans are protected by collateral and legal regulations, although financial fraud does occur in the West.33 In China, the costs of obtaining collateral and legal protection, including time, administrative approvals and legal expenses, remain prohibitively high; thus, investors eventually have no choice but to bet on informal but less secure forms of protection for their investments.

Markers of Trustworthiness

How can business owners establish and maintain their trustworthiness in the minds of investors? Or, from the investor’s perspective, which attributes (or markers) of business owners can be taken as convincing indicators of trustworthiness? Analysing the cases in the database, the following markers are most typical of trustworthiness:

- personal relationships between the two sides;
- the business owner’s tangible assets;
- profits received by the investor or by other investors personally known to the investor;
- the business owner’s status and reputation; and
- the business owner’s relations with government officials.

To minimise the risk of losing their capital, Chinese investors normally try to collect evidence of multiple markers rather than to rely on just one particular marker. At least at the initial period of the scheme, investors and borrowers usually already share some form of interpersonal relationship, such as being family members, relatives, friends, colleagues, neighbours and acquaintances through common experience, which is effectively taken as an informal form of collateral. In situations in which the borrower cannot pay back the borrowed sum, they would be “punished” with strained relations with the investor. However, the severance of personal ties would serve as a form of punishment only if the relationship is more valuable to the borrowers than the amount of money borrowed; in other words, personal relationships are binding only under the assumption that the borrowers regard them as a form of social capital from which they can benefit repeatedly in the long term. Otherwise, the borrowers would rather sacrifice the relationship with the investor. While it is perhaps impossible to measure the worth of interpersonal relationships (or guanxi) in monetary terms in China today, it is not unreasonable for borrowers in desperate situations to forego personal relations, particularly when a large sum of money is involved.

These considerations pertain to the more general issue of the extent to which Chinese people still value interpersonal relationships, thus generating controversial arguments in studies of business and employment in China. On the one hand, Douglas Guthrie argues that the significance of guanxi has declined in China’s labour market, particularly in metropolitan cities such as Shanghai. On the other, Mayfair Mei-Hui Yang and Bian Yanjie have demonstrated that the power of interpersonal relationships remains endurable in the urban areas. Other researchers have adopted a more sophisticated approach, highlighting that interpersonal relationships have an advantage in market competitions and business relations only under some strong favourable conditions; they also pointed out some of the “darker sides” of guanxi, such as corruption. While the cases in the database relate to a relatively different area (informal financial relationship), interpersonal relationships evidently play a highly significant and active role among ordinary residents in China.

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34 In a few cases, the borrowers did approach and lure potential investors with whom they did not have any personal relations, but such cases are rare as they knew this approach was illegal and likely to incur suspicion, therefore run the risk of being prosecuted; those who did successfully raise funds from the general public usually already have the support from a government official.


People in China rely on relatives and friends to obtain financial information, and place their total trust on those whom they know personally when investing their savings. They also condemn those who value money more than friendship and loyalty. For instance, it would be impossible for most private business owners to reach hundreds, thousands or even hundreds of thousands of people and involve them in the financial schemes without such informal social networks. Although some borrowers solicit people’s savings by launching campaigns, personal connections are still the avenues that make expansion and sustainability of informal financial schemes possible.

In addition to personal relationships, the following attributes of borrowers—such as a profitable business, ownership of valuable assets (e.g. several properties or luxurious cars) and an official position (even a nominal one) at local government level—will enhance investors’ trust and confidence in them. Other indicators of trustworthiness include a variety of awards (permits, prizes, honours, etc.) issued by local government; and even photos of the borrower with a local government leader could be seen as a booster. The most convincing marker, however, is financial gains in the form of interest or dividends that new investors or other existing investors have already received during the first few months. Based on the case studies in the database, before 2004, borrowers would typically pay a monthly return of two per cent, when the annual savings interest rate offered by state banks was only 0.1875 per cent; in other words, the informal rate was 10 times higher than the official rate in 2004. From 2004 to 2011, the informal monthly rate increased to around three per cent; after 2011, it increased to five per cent or even to as high as 10 per cent, probably due to the credit-tightening policies of the People’s Bank of China. To many Chinese investors, such offers of high returns are irresistible. Due to the attractiveness of high rates of return, a small number of business owners with a large sum of cash have taken up informal financing as their new form of business.

The breakdown of informal financial chains

To investors, the inconvenient truth is that no marker of trustworthiness is a sure guarantee of high rates of return or security of investment. For instance, personal relations can be strained if the business runs into difficulties, fixed assets may not represent the borrower’s true financial worth, connections to government officials may be just a façade, and the interest paid out during the first few months may not necessarily mean the boom times will continue.


39 For example, a study estimates that a private enterprise could achieve 30 to 48 per cent in profits by lending out informal loans; see Han Ping, “A Study of Chinese Private Financing”, International Journal of Managerial Studies and Research 1 (2015): 1–4.
The findings from the database suggest that the informal financial schemes seem to undergo a similar process when they default. The default seems to come about rather unexpectedly as a large number of business owners were conducting normal and legal financial transactions at the beginning, or at least there was no information to prove otherwise. However, upon establishment of a financial relationship, many borrowers began to take advantage of the investors’ trust and greed for high returns, either to expand the business at an unsustainable rate, or to trap investors into a financial fraud by making up some markers of trustworthiness and disguising the true intention of collecting money for their own personal gain. There are only a very rare few cases, such as coal mining or real estate, that possibly yield a profit margin as high as the promised interest rate. In most cases, the promise of such high returns is either a wishful illusion or an outright lie. Thereafter, it is simply a matter of time when the borrower runs out of new sources of funds to pay out interest (or even capital) at the promised high interest rates to their investors.\(^4\)

In order to raise sufficient funds quickly so as not to miss a valuable business opportunity, borrowers have to up the ante by promising a very high rate of interest to their investors. Whether the borrowers’ activities are fraudulent or not is a separate issue, but as some borrowers do not have any projects that can generate the promised returns, the only option available to them is to pay the promised interest to one group of investors with the money borrowed from another group, thus building a chain of lending and borrowing. If the borrowers cannot find any new investors, or if the new source of borrowed money is not sufficient to pay out the promised interest, the financial chain breaks down and the borrowers have to seek an exit—in actual cases, most ran away, a few turned themselves in to the police and a few others committed suicide. For most investors, the interest earned was less than the capital being invested. There are cases in which investors simply laid claim on any valuables they could find in the borrowers’ residences or companies. No information was found in the case studies about the amount of capital the investors eventually recouped from the police or the local government.

\(<\text{H1}>\text{WHO IS TO BLAME?}\)</br>When news of a meltdown by an informal financial scheme breaks out in the public, the media, usually the mouthpiece of the Chinese state, unanimously condemns the borrower for violating the mandatory laws and for causing financial as well as other damage to the investors and local

\(^4\) In this sense, such informal financial schemes share some similar features with the Ponzi schemes in Western countries and other parts of the world; see a recent study on the Ponzi scheme by Tamar Frankel, *The Ponzi Scheme Puzzle: A History and Analysis of Con Artists and Victims* (Oxford: Oxford University Press, 2012).
Without a doubt, these business owners must be held responsible for the damage caused—in fact, only a very few informed their investors about the true nature of their businesses, the level of risks and their true intentions. The compelling desire (or greed) for commercial success and ultimately for a luxurious lifestyle has obfuscated their sense and rationality to comply with state regulations or moral codes.

The pertinent question is: are business owners the only ones to pin the blame on and should investors be blamed as well? Upon learning about their losses, all of the investors were shocked, and many became depressed; some even committed suicide, but few would blame their greediness and foolishness to join the schemes, considering that many similar schemes had defaulted before and that there were ample precautions issued by the government in the media. Despite the warnings, many investors would rather believe that bad luck would not befall them. A small number of investors even attempted to hide their true identities. When a default case was reported, the police would call the investors to come forward to the police station to register their losses and report other relevant information. Most of the small investors complied in order to recover as much as possible of their losses, but some of the larger investors who invested millions of yuan would rather lose their money than to tell the media or the police who they were. For these investors, coming forward to report a fraud in fact presents the police with the opportunity to question the legitimacy of large sums of money in their bank accounts. Another reason why investors did not want to reveal their identity was to avoid paying 20 per cent tax on the interest they earned, and this explains why 90 per cent of informal financial transactions were not registered.\(^{42}\)

In this sense, the business owners and their investors share a common mission: to earn as much money as possible for a better material life. While pursuing a better quality of life is normal, such pursuits can easily lapse into materialism or consumerism. In a large-scale survey of 16,000 people conducted across 20 countries, the Chinese were found at the top of the league for

\(^{41}\) It is extremely difficult to obtain reliable estimates of the amount of financial damage for each case because accurate information is required for the following variables: total amount of debt, total amount of interest paid, number of investors and the amount of money recovered or paid in kind. The authors know with certainty that the total amount of debt varies enormously from hundreds of thousands to tens of billions of yuan, and the number of investors involved varies from less than 50 to tens of thousands. Information about other variables is typically unavailable.

\(^{42}\) Zhang Zhenyu, head of the Wenzhou Bureau of Financial Administration, reported these figures when he commented on the effectiveness of the newly established centre for monitoring informal financing schemes; see Dongfang zaobao, Shanghai, 24 November 2014. The government of Wenzhou set up the centre for registering and regulating informal fundraising in 2012 in order to maintain the legality of informal finance. The new centre requires that any scheme be registered if it involves a single transaction valuing more than three million yuan, a total sum exceeding 10 million yuan or has more than 200 investors. However, anecdotal information seems to suggest that the centre has not been very successful, as it charges an administration fee that most investors want to avoid paying.
materialism, with 71 per cent claiming that they measure their success by what they own.\textsuperscript{43} There are numerous media reports about how luxurious goods enjoy brisk sales in China and how the \textit{nouveau riche}\textsuperscript{44} show off their conspicuous consumption. The precept that material wealth is a symbol of success and status and it should thus be a source of pride has been an element of Chinese culture for thousands of years and has been reinforced since the economic reforms. Hence, it is not far-fetched to posit that the desire to earn high returns from informal financial schemes is a representation of such a cultural value.

In addition to the personal attributes of business owners and investors that are responsible for the default of these schemes, China’s institutional structure is also a fundamental cause. It is indeed questionable that the Chinese state has failed to regulate informal financial transactions. In one of the cases studied, investors, holding a banner in front of a local government building, protested that the government should be held responsible for failing to regulate the financial market. Due to space and resource limitations for this research, the authors offer some observations on the role of the Chinese state. The Chinese state is fully aware of the gravity of the problem; for example, Document no. 59 (2015) issued by the State Council acknowledges that the problem of illegal fundraising is worsening and could potentially affect social stability. It also admits that private and small businesses have difficulties in obtaining loans and that informal finance must be regulated further. Nevertheless, all the State Council could offer are some general guidelines for local government officials to follow; there are no specific policies and tactics that could effectively improve the situation. Regulations by other departments of the Chinese state do not appear to be effective either. The People’s Supreme Court published a policy allowing the interest rate for non-state borrowing or lending to be higher than that of a similar type of financial product offered by state banks, as long as it is “no more than four times” the state bank interest rate.\textsuperscript{45} By setting up this rule, however, the Supreme Court effectively recognised the legality of most informal financial schemes, making the legality of informal finance a purely technical issue when the most important issue was to institutionalise informal finance in China.

It seems that the Chinese state has been caught in a vicious cycle: the informal financial market will soon end up in chaos if state policies turn liberal, while more restrictive policies will suffocate a crucial source of financial credit supply for private enterprises. This brings up more fundamental questions: Does the Chinese state want to provide private enterprises with easy access

\textsuperscript{43} For details of the survey and results, see <http://www.ipsos-na.com/news-polls/pressrelease.aspx?id=6359> [26 September 2016].

\textsuperscript{44} A relatively new Chinese term, “tu hao”, was invented to refer to the new rich who show off their wealth conspicuously as a symbol of success and status.

to bank loans? Perhaps even more fundamentally, will the Chinese state ease its control over its financial market? On the one hand, it is understandable that state banks in China would not, and perhaps cannot, increase considerably the supply of financial credit to private businesses. On the other, it is practically unrealistic to expect state banks to increase the interest rates for savings to such a high level that ordinary people would rather put their money in banks than in informal financial schemes—the state needs to keep the rates low in order to stimulate the economy while the banks have every motivation to keep the rates low as well. What people can expect the Chinese state to do is to set up effective legal and administrative procedures for formalising the existing informal financial schemes so that they can be effectively regulated.

Besides the responsibilities that the central government should take, local governments must also take their own share of responsibility; as such, local government officials are expected to implement the national policies and have direct contact with business owners and savers. Clearly, there are many questions to answer in this regard: Why did some officials offer symbolic or substantive support to scandalous firms by visiting the owners’ businesses? Why did some local governments allow private business owners to set up fundraising offices in their jurisdictions? And why were some government agents personally involved in informal financial schemes? As illustrated and discussed earlier, many informal financial schemes would not have survived without the involvement and even protection of some local officials. They may not have colluded with the business owners to deceive local residents, but they provided their support, either substantive or symbolic, or simply turned a blind eye to something not completely legitimate. It would not be in the best interest of local authorities to exercise their full authority to stop private business owners from collecting money informally.

<H1>CONCLUDING REMARKS</H1>

China’s rapid economic growth has created a highly active financial market with massive demand for and enormous supply of financial credits. However, such rapid growth comes at a price: the accumulation of material wealth has far outpaced the construction and implementation of an effective institutional framework. The Chinese state has only gradually recognised the significance of the private sector and remains reluctant to offer financial support equally to private and state-owned enterprises. With the financial system almost entirely concentrated on the state sector, the Chinese state has not been able to manage the demand and supply of credit effectively, thus leaving a large institutional space to informal, unprotected and potentially illegal financial transactions. The financial system therefore became highly reactive rather than proactive when informal financial
schemes collapsed. Regardless of the introduction of competition among state banks, their newly gained flexibility cannot catch up with the rates offered by informal, let alone illegal, schemes.

On the other hand, being anxious to maximise the earnings from their savings in order to achieve a long list of material desires, many ordinary Chinese investors believe in their luck rather than stay away from the potential risk of losing their money. Many ordinary people remain inexperienced with the capitalist system and to economic speculation, with some having the naive expectation that a 20 to 30 per cent annual interest rate could be sustainable. This suggests that China is still in the throes of early capitalism and its financial institutions are still not fully developed. If the desire of China’s people to enrich themselves remains popular and strong, informal and illegal finance will not disappear in the near future, although it may put on a new face, and will subsequently continue to cause financial damage to people’s lives and to local economies. How to make official routes for investment more attractive and how to stop dangerous informal financing offers from evolving into a national financial disaster are two questions too important to be left unanswered. Given the damage they could cause to people’s lives, to the trust people have in financial institutions, business and government agents, and to social stability, informal finance is more than simply a financial and legal problem; it is a problem of enormous social and political significance. And given China’s increasing influence in the global economy and finance, the breakdown of informal financial schemes in China could create ripples beyond its own shores.

Regardless of the rise of defaulted informal financial schemes and the damage caused by them, informal economic institutions and transactions will not disappear; instead, they will continue to play an indispensable role in China’s economic reform and development. As they have also been a driving force of economic growth, it is unimaginable for an economy as large and complicated as China’s to operate entirely on the basis of formal and state-controlled institutions. The key argument in this article is that informal institutions, particularly informal financial institutions since the launch of economic reforms in China, have some inherent limitations—i.e. the use of interpersonal relationships as collaterals; trust built on unconfirmed evidence; and a lack of monitoring and supervising procedures. The Chinese government has made some efforts to improve fiscal responsibility and accountability through financial and budget reforms since 1999. Nevertheless, the success of such reforms seems to have been somewhat limited, and little has been done to establish an institutional environment for reinforcing responsibility in informal financial relations. If this article receives serious attention from social scientists, China specialists and policymakers

apropos the potential risks and damage induced by informal financing schemes, this research has been worthwhile.

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