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Pilot Project on Financial Reforms in Wenzhou

Introduction

On March 28th 2012, the Chinese State Council announced that the coastal city of Wenzhou, Zhejiang province, would become a pilot zone for the implementation of far-reaching financial reforms.

The project can be seen as an attempt to iron long-standing problems out of the local economy, which has been experiencing significant problems since the beginning of 2011. Following the government's tightening of its monetary policy to curb the soaring inflation, it has gotten increasingly difficult for companies to receive credits, as government-controlled banks generally prefer lending to state-owned companies. Although this new reality has affected the whole of China's economy, its implications have been particularly harsh in Wenzhou, a city with the reputation of being the centre of China's private economy with over 400'000 private companies.

The situation was further aggravated as many SMEs turned to private lenders to keep business running. At its height, private loans in Wenzhou are estimated to have reached 800 billion to one trillion Yuan. The problem was that these underground credits were characterized through short maturities and high interest rates, sometimes as high as 90%. As a result, non-performing loans surged, causing a local credit crunch, which led to many cases of bankruptcy in the city. Reports from the end of 2011 spoke of one-fifth of Wenzhou's SMEs having stopped operating and of many business owners fleeing or even committing suicide.

The central government reacted last October by announcing emergency measures, including a rescue fund over one billion Yuan for companies with problems to pay interest rates and a five billion Yuan financial support for local banks. Simultaneously the local government wanted to implement reforms with the goal of giving residents more investment freedom and thus supporting the local private economy; but the plans were not approved by Beijing. Now however, it seems like the central government has changed its mind, giving Wenzhou allowance for similar plans.

The Reform

The reform consists of 12 measures, of which the most important are listed below:

- Allowing private investors to invest into local banks, establish loan companies and rural community banks.

- Guiding private capital into venture capital and private capital funds.

- Developing local capital markets and opening these for SMEs.

- Allowing private direct investment to be made overseas.

Wenzhou's local government mainly has two intentions with the reform. By legalizing and standardizing private lending it can better control it, thereby protecting firms from exorbitant interest rates and cracking down on crime, related to the city's underground credit system. Furthermore the policy change is helping many SMEs to solve their liquidity problems by allowing a large amount of new capital to be invested into the local private economy.

The reason for the central government's approval of these measures was not only to support troubled private companies in Wenzhou, but by turning the city into a pilot zone of private financing activities, it can also test the impacts of such reforms on a small scale before possibly implementing them in more regions or country-wide. As the Chinese economy is cooling, Beijing is very much interested in measures, which can help to boost the economy.

Two core aspects are tested in the project, both representing landmark reforms within the country's financial system. First of all the state banks' credit lending monopoly is being cracked. By opening more channels for private capital to flow into the economy and thereby simplifying private enterprises' fundraising, Beijing hopes to create a new growth cycle based on non-state sector investment. The result should be an economy less dependent on public spending, which is considered key for sustaining GDP growth.

The national and international calls for liberalizing China's credit system have grown louder recently, as the country has to prepare for times with lower foreign demand and has to focus increasingly on domestic-based growth. One obstacle in achieving this has so far been the reluctance of state banks to sufficiently support the private economy with liquidity, as discussed before; A disturbing fact considering the staggering financial figures of the "big four" state-owned banks. Alone China's largest credit lender, ICBC, has earned an incredible 33 billion dollars in 2011, making it one of the most profitable companies worldwide.

The second remarkable aspect of the pilot reform is the government's intention to further liberalize cross-border capital flows. The *Chinese Foreign Exchange Administration* lifted the amount foreign institutions can invest in stocks, bonds and bank deposits from 30 billion dollars to 80 billion dollars. With this measure, new foreign direct investment is ought to be attracted, increasing business opportunities of promising young enterprises.

The new free market mechanisms however also allow Chinese citizens direct overseas investments, enabling them to grasp global opportunities and achieve higher investment-profitability. Wenzhou's previous reform plan, which had been denied by Beijing as mentioned before, spoke of 200 million USD annually and 10 million USD per time a person could invest overseas. Details concerning the maximum amount for the recent reform have not been published yet by officials.

That the legalization of private overseas investments is part of the reform can be seen as another reason why Wenzhou in particular has been chosen for the pilot project: With a tradition of emigration, the city's entrepreneurs have close international ties, laying a solid foundation for personal cross-border direct investment.

An additional advantage of allowing individuals to directly invest overseas is the ease of investment pressure on the Chinese property market. Thus the reform could turn out to be an effective mean against soaring housing prices – an issue becoming increasingly important for the government as a real estate bubble poses a significant economical danger and has potential for social unrest.

Outlook

The success of the measures introduced in Wenzhou will determine whether a country-wide reform will follow this local experiment. However Shanghai and Tianjin have already asked for approval to be turned into similar pilot zones. In the near future, Wenzhou (and if granted Shanghai and Tianjin) could then channel capital from all over China to be invested overseas. This de-facto possibility for the whole country for private direct overseas investment would consequently make it more probable for the measures to be extended to the whole country in the long term.

Furthermore a China-wide liberalization of cross-border capital flows would be another important step in implementing China's "Going Global" strategy, with the goal of ensuring sustainable economical growth by striking a balance between capital inflows and outflows. Until now, China stuck to the principal of "lenient entry, stringent exit" and imposed stricter investment restrictions on domestic residents than on non-residents.

Prime Minister Wen Jiabao explained the intention of the reform as simply finding out how the country's finance system can be adapted to the development of its economy and society. However one can discern a more meaningful aspect of the policy change in Wenzhou: Once more it is a clear signal of the government's willingness to test and implement further free market mechanisms in China's economy whenever it is necessary to ensure sustained growth.

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