

**FORMAL AND INFORMAL FINANCING
CHANNELS IN CHINA**

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Executive Summary

1. China achieved remarkable growth despite weak legal protection of investors and an undeveloped financial system. The private sector in China would have grown stronger if China has a better developed financial sector or less financial repression.
2. The Chinese financial system is dominated by the largely state-owned banking sector. The four state-owned banks still accounted for 46.6% of total assets and total liabilities in the Chinese banking sector at end 2011. A large share of bank funding thus goes to state-owned enterprises, regardless of their profitability, constraining credit of companies in the private sector.
3. The Chinese stock market and bond market are smaller than those of most other countries. As most shares are controlled by the government and large SOEs, the stock markets in China provide only a small fraction of corporate financing despite their large market capitalization.
4. The corporate bond market is crippled by excessive government regulation and the lack of institutional investors and credit rating agencies to help price the debt accurately.
5. Other (informal) financing channels have thus played a significant role in the growth of the Chinese non-state sector by serving the needs of private entrepreneurs who have been shut out of the formal banking system.
6. The fast growth of the Chinese private sector, especially small and medium enterprises (SMEs), shows that it is alternative financing and governance mechanisms that support China's growth. Many private SMEs do not utilize bank finance, but rely on informal sources.
7. Private sector finances largely come from family and friends. Reputation- and relationship-based implicit contractual agreements have worked effectively,

since there are no formal written contracts between friends/investors and the entrepreneurs in many cases.

8. Informal financing channels also include credit cooperatives, moneylenders, etc. These private lenders are typically illegal since they charge interest rates above state-mandated interest rate ceilings.
9. Besides, informal financial organizations, especially underground lending organizations, do not have mechanisms that guard against financial risks and lack a reserve and deposit insurance system. Therefore, many informal financial organizations are associated with organized crimes.
10. The weak protection and legal uncertainties (unlawful activities) of informal financing for instance led to inefficient allocation and use of financial resources, and ultimately hinders growth. Recent measures announced/implemented seem inadequate in accelerating the development of China's financial market. More and bolder reforms are needed.