

# Bloomberg

## China Credit Squeeze Prompts Suicides, Violence

By Bloomberg News - Nov 6, 2011

Hours after a creditor and his gang of tattooed thugs hustled Zhong Maojin into a coffee shop in Wenzhou, he says he wouldn't yield to their demands.

They wanted to take over one of the pharmacies in a chain he'd built by borrowing from private lenders. Instead, he made an offer of traditional retribution in this eastern Chinese city, known for loan sharks who have sometimes meted out violence to bad debtors.

"If you like, you can cut off one of my fingers instead," Zhong, 42, says he told them.

Giving up the store would have made it impossible to pay back another 130 creditors, Zhong said. He'd borrowed 30 million yuan (\$4.7 million) at [interest rates](#) as high as 7 percent a month to expand the business. Many of the lenders were elderly neighbors who'd mortgaged their homes.

At least 90 bosses in similar situations to Zhong have fled the city since April, and two killed themselves, according to Zhou Dewen, head of a small [business association](#) in Wenzhou. One was shoemaker Shen Kuizheng, who jumped to his death from his 22nd-story home on Sept. 21, he said.

Wenzhou's 400,000 businesses are facing financial hardship because of rising costs, soaring black market interest rates and a sudden credit squeeze, Zhou said. Similar problems are happening across China because private enterprises in China rely on underground borrowing rather than banks to operate, he said.

Their predicament prompted [China's](#) premier [Wen Jiabao](#) to visit the city 230 miles (370 kilometers) south of Shanghai on Oct. 4, where he pledged help for troubled businesses. National and local leaders have since announced moves to help small firms, including offering easier access to bank loans, a cap on private-lending interest rates in Wenzhou and a crackdown on loan sharks that use violence.

### 'Huge Pressure'

The measures have done little to help Zhong, he says.

“I am under huge pressure,” he says, sitting in a warehouse with fast-depleting stocks of medicine. “We don’t have enough money.”

The sudden collapse of informal lending networks reveals the fragility of China’s unregulated financing system when credit tightens and creditors lose confidence, said Tao Dong, a Hong Kong-based economist at Credit Suisse Group AG. Money supply has shrunk as the government tightens lending to try and rein in inflation running near a three-year high.

## ‘Tip of Iceberg’

“This is a much bigger problem across the country,” said Tao, who estimates outstanding private loans stand at 4 trillion yuan, or 8 percent of total lending in China. “Wenzhou is just the tip of the iceberg.”

Most of the informal lending has been pumped into real estate developers riding China’s property boom that is showing signs of slowing, said Tao. In Wenzhou, it’s driven up [home prices](#) to among the most expensive in the country.

Chinese media reports of similar difficulties have emerged in the prosperous mining town Ordos in the north and the industrial heartland of Guangdong in the south.

The risks to China’s wider economy include a potential credit freeze triggered by increased mistrust among informal lenders, also referred to as curb lenders, according to an Oct. 11 report by [Wang Tao](#), a Hong Kong-based economist at UBS AG. That could trigger more widespread bankruptcies, she said.

Wenzhou -- a city of 9 million whose private enterprises range from shoemakers in dusty road-side homes to manufacturing plants in new industrial parks -- produces 90 percent of China’s eyeglasses and exported lighters. The city’s wealth is reflected in the Porsches and Land Rovers parked in the streets and the emergence of downtown shopping arcades selling Hugo Boss clothes and Omega watches.

## Embraced Deng’s Reforms

It was the first city to widely embrace private enterprise in the early 1980s under the economic reforms of then leader [Deng Xiaoping](#), developing the most advanced private lending networks in the country. Businesses in Wenzhou used family and hometown networks because bank loans were hard to come by.

The local government helped foster that by taking a lenient approach to private lending, according to Huang Yasheng, an associate professor at the [Massachusetts Institute of Technology’s Sloan School of Management](#). A previous credit squeeze in Wenzhou 25 years ago

affected 200,000 lenders, resulting in 523 [kidnappings](#) and more than 30 deaths, according to a local government website.

As the clacking from a nearby shoe factory drifts through the window of his warehouse on Wenzhou's industrial outskirts, Zhong tells how he relied on money lenders to build Blue Sky Pharmacy into a chain of 27 shops in just three years.

A doctor from a mountain village, Zhong borrowed money to pay medical bills he ran up caring for his wife who died at 23 of liver disease. After he remarried, to a woman with debts of her own from running a money-lending business, he opened up a pharmacy in Wenzhou to try to pay back their combined debt.

## Network of Lenders

The couple took on more debt to fund their expansion, Zhong said. He couldn't get money from the banks, he said, so he first borrowed from elderly neighbors from his home county.

Small and medium-sized businesses account for 80 percent of jobs in China, according to the country's industry ministry. Yet they're largely unable to get loans from banks, which prefer collateral to [cash-flow](#), according to an Oct. 17 report by Sydney-based investment bank Macquarie Group Ltd.

By tapping into his hometown network, Zhong was the final link in a long chain of debt.

"For usual lending, Bank A lends to a customer and sees the cash flows," said Tao, the Credit Suisse economist. "With informal lending, it goes from A to B to C, all the way to XYZ. Once it's beyond C, you have no idea where this money went to."

In Zhong's case, the trail of debt can be traced to rows of four-story cement housing not far from the Wenzhou airport 40 minutes outside of town by car. Men play pool beside the ground-floor storefronts near a darkened mahjong parlor.

## Cottage Industry

The residents turned money lending into a cottage industry, according to interviews with six of them. They built a lattice of interlocked credit, often borrowing from banks and other private lenders to arbitrage interest rates. Taking out bank loans at 1 percent a month, many lent out their cash for 2 percent or higher a month. They pocketed the difference to supplement meager income from odd jobs.

Sitting on a small stool, gray-haired Jin Xiaoyu fills a wooden box with the electrical clamps she makes to earn 10 yuan a day. Her left eye is the milky-white color of a cataract and she says she has difficulty seeing.

She lent Zhong 50,000 yuan and charged 1,000 yuan a month in interest, she said.

“I worry that I cannot get the money back,” Jin says. “I hope the government will help him out.”

Some used their housing as collateral. Among them was Wu Suihua, who borrowed against her five-story home, she says.

## Taking Home Loans

“We don’t have much income,” said Wu. Her home is one building away from a Blue Sky pharmacy which opened a few months ago, selling ginseng and other traditional Chinese herbal remedies as well as Western medicines.

The collateralization of homes means Zhong’s problems may stretch back to the banks. One-third to a half of money used for private lending originally comes from banks, said Lu Ting, an economist with Bank of America Corp.’s brokerage unit.

Tightening cash flow for businesses continues to raise the risk of bank loans going bad, according to a statement from Wenzhou’s Financial Office given to Bloomberg News on Oct. 21. The current non-performing loan rate in Wenzhou is controllable and below the national average, it added.

The informal lending network worked until the summer of 2010 when some of Zhong’s villagers were unable to get new loans from the banks as government tightening kicked in, he said.

## Rising Costs

Wenzhou’s businesses were already facing tougher times because of declining exports to [Europe](#) and the U.S. and rising labor costs, [Chen Yuyu](#), associate professor at the Guanghua School of Management at [Peking University](#), said. Minimum wages in Zhejiang province, where Wenzhou is located, have risen 19 percent in 2011 from last year, according to London-based Standard Chartered Plc.

Zhong needed cash to keep paying his suppliers, rent and employees. Scanning the local paper one day, he saw an ad for loans without collateral. He dialed the number and arranged to borrow 600,000 yuan for one month, from what Zhong called a “gaolidai,” a Chinese term for a loan shark. He borrowed again and started to just pay interest and roll over the principal, he said. Rates rose to 7 percent a month.

Black market rates have doubled this year, far exceeding the return of companies in Wenzhou that typically have wafer-thin profit margins, according to Ren Xianfang, a Beijing-based economist with IHS Global Insight Ltd.

## High Interest Rates

Curb lenders demand annual interest of between 20 percent and 40 percent or higher, many times the official lending rate of 6.56 percent a year, UBS's Wang said. The rate rose as China's new bank loans decreased, down to a 21-month low of 470 billion yuan in September.

Zhong thought his problems would be solved in August after two friends agreed to act as guarantees and he finally secured a loan from the local branch of Fuzhou-based Industrial Bank Co. It was for 15 million yuan at 1 percent a month, divided into two tranches. One of the guarantors put up his downtown apartment as collateral in exchange for 60,000 yuan a month from Zhong, he said.

There was a snag. By now, Zhong said he owed the "gaolidai" 4 million yuan. The first tranche of the bank loan mostly went to paying that debt. The lender said Oct. 20 he was no longer in the business when reached by phone, declining to comment any further.

The Industrial Bank's Wenzhou branch wouldn't comment on Zhong's case.

## Warehouse Mobbed

When word of Zhong's shortfall spread, angry creditors converged on his warehouse demanding their money back, Zhong and villagers said. Zhong says he struggled to calm them down as they started tossing cups on the floor and grabbing boxes of medicines.

In September, the alarm spread across Wenzhou after newspapers reported businessmen had fled or killed themselves because they couldn't pay debts.

"Everyone was nervous and insecure," said the mustachioed Zhong, sockless in leather shoes, standing near a darkened conference room with a bust of Chairman Mao. "Panic was everywhere. Blue Sky is famous now -- for owing debt. No one is going to lend me money."

## Lobster Dinner

Zhong's problems are shared by many other business owners. A few weeks ago, a group of about 20 gathered in one of the marbled private rooms to feast on lobster and steak at Hai Yan Lou, a Cantonese restaurant across the street from the local offices of China's banking regulator.

The mood was grim. They talked about the recent suicide of shoe factory owner Shen because he couldn't repay debts, and the disappearance of another boss who owed them money, according to Yang Xi, the owner of a company that makes dyes for shoes and textiles, who was there.

Each man present downed a bottle of Moutai, an expensive brand of Chinese liquor made from sorghum, because they feared they may never be able to afford the luxury again, she said.

By October, the deteriorating situation in Wenzhou prompted the visit by the premier, which triggered a raft of initiatives to help private businesses.

“After Premier Wen’s visit, I sent [text messages](#) to friends all over the world that Wenzhou will be rescued,” Yang said.

## Emergency Fund

China’s banking regulator said later it would let banks [sell bonds](#) to raise money for loans to small enterprises and tolerate higher rates of non-performing loans among other measures to encourage bank lending.

In Wenzhou, the local government set up an emergency 1 billion yuan fund. Its anti-loan shark campaign led to the Oct. 27 arrest of a couple suspected of illegally raising 1.3 billion yuan, according to the [China Daily](#).

A few businessmen who had fled Wenzhou have returned since Wen’s visit, according to Zhou of the small business association. Others have been tracked down and arrested, according to the official Xinhua News Agency.

Analysts are trying to ascertain how effective the measures are and how widespread the fallout from Wenzhou will be across China. The city is now the country’s biggest source of private capital, marshaling about 800 billion yuan, equivalent to 2 percent of China’s total economic output, according to Ren of IHS Global. Money from Wenzhou is invested in everything from real estate in Dubai to coal mines in Shanxi province, in China’s northwest.

After a research trip to Wenzhou, Bank of America’s Lu said in an Oct. 25 report that the chances of a nationwide liquidity squeeze were low.

## Broader Problems

Others see Wenzhou as symptomatic of broader problems, such as an over-reliance on investment to grow the economy that steers money toward state-owned companies, said Michael Pettis, the Beijing-based chief strategist at Guosen Securities Co.

“You can solve Wenzhou, but you’re simply transferring the problem someplace else,” he said.

Zhong, the pharmacist, says he’s filed a report to the local government hoping to benefit from the bailout plan.

He spends his days and nights in the warehouse of his crumbling dream. He's sold off his BMW and lives in a company dormitory. His wife sleeps in one of their stores and they've sent their daughter to live at school.

Zhong recounted his night at the coffee shop.

Alerted to the incident by Zhong's wife, a more sympathetic creditor came by demanding his release, saying the pharmacist owed him even more money. The ruse worked, Zhong said. His offer for a finger was declined.

He says he'll probably still lose his business. He's negotiating to transfer it to his 130 creditors. They would keep him on as a paid manager.

"My wife and I will probably have nothing left," he said.

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