Overcoming Institutional Voids during Market Transition: Private Sector Financing in China

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The importance of institutions in fostering economic development and effecting stable governance has long been recognized. Observers have highlighted the role of institutions in maintaining macroeconomic stabilization, promoting growth, managing conflicts, safeguarding social security, and so on.¹ Making institutions “right” has once been a central argument in the so-called East Asian development model, when exceptional economic performance in a number of East Asian countries was attributed to the presence of strong, autonomous, and meritocratic state institutions that “led the market” in advancing economic development.² This model is attractive to developing economies that are striving hard to catch up. The question is where we can locate the source of institutional supply, when many developing nations are characterized by the absence of much-needed institutional arrangements to regulate market exchange, mobilize economic resources, coordinate policy implementations, and administer developmental programmes. Such institutional voids exist not because there is no desire or attempt to create new institutions. Often the reason is because various structural and political factors prevent the establishment of sustainable institutions or render those institutions ineffective. The question thus comes to a full circle: how to make institutions right? Or put differently, how can institutional voids be filled?

In fact, rapid social and economic change often creates institutional voids. This is most evident in post-communist societies where the shift from a command economy to a market economy is achieved within a short period of time. Many of the institutions which regulate economic exchanges have to be created from scratch. Specifically, the transition is often characterized by the absence of “market institutions” to coordinate capital, labour, and product transactions. Regulations and mechanisms for contractual agreements are often weak and ineffective. Furthermore, there is a relative lack of intermediary firms, accounting practices, price system, distribution networks, and other established structures to organize economic exchange. The success or failure of the economic transition depends to a large extent on whether such institutional voids can be filled in one way or another. An exemplary case is China where market reform has brought spectacular and unprecedented growth for more than three decades. How China fills the voids is therefore a key question which may prove invaluable to our understanding of developmental governance.

So far the problem of institutional voids has been analysed in terms of weak state capacity, market failure, or bad governance. The central concern has revolved hitherto around the consequences of state failure as well as the prescriptive remedies to turn governance from bad to good. While acknowledging the insights from existing studies, this paper approaches the problem from a different set of concerns. We notice that institutional voids are sometimes filled by unconventional actors/organizations who, in the process of negotiating rules, resources, and discourses with formal and informal circuits of power, contribute to the emergence of alternative forms of governance. Our main questions are therefore: Under what conditions will an institutional void be filled, and by whom? And why are some voids filled but not others? In other words, while we share similar concerns about the consequences of institutional

¹ Rodrik, 2007.
² Boyd and Ngo, 2005.
redundancy, organizational weakness, and state failure, we take one step further and focus on specific cases in which various forms of organizations, practices, and actors perform coordinating or regulatory functions in an attempt to address institutional inadequacies.

We take up the quest by looking at a widely acknowledged institutional void in China during market reform: the inadequacy of private sector financing, especially for small and medium-sized enterprises. Despite their profit earning ability, these enterprises have difficulty in obtaining bank loans and credit. State-owned banks and other financial institutions have deliberately refrained from lending to these enterprises. Paradoxically, such a shortage in the supply of capital for private sector financing has been accompanied by an abundance of idle capital when many profitable enterprises are unable to invest their earnings. In other words, the banking system and other financial institutions have failed to match the supply of capital to its demand.

Generations of scholars have underlined the key role played by the financial system in structuring growth and development. The early work of Hilferding draws our attention to the relation between large banks and capitalist development. Shonfield further explores the variation in banking systems in accounting for the difference in economic growth between Germany and Britain. More recently, Zysman argues that the way firms are financed affects industrial policies and hence growth. Given the almost consensual view about the importance of a strong and sound financial system in effecting economic development, how can we account for the rapid growth of China in the wake of the weak financial setup?

We argue that in response to the mismatch in private sector financing, some unconventional actors have emerged to fill the institutional void, albeit only partially. These include pawnshops, consignment shops, private consortia, crowdfunding, and so on. While some actors have successfully received formal recognition within the system, the status of others remains dubious. Their emergence is a response to the functional demand for effective financial intermediaries under the market economy, but their subsequent success or failure in becoming an institutionalized practice hinges upon broader political and historical conditions.

The different outcomes underline an important question about institutional creation. Existing scholarship has drawn our attention to institutional entrepreneurship as an exogenous actor that catalyses institutional innovation and creation. Insightful as it is, the literature tends to overlook the broader socio-political conditions which facilitate or constrain such entrepreneurship. By comparing the cases of private sector financing in China, this paper examines the broader politico-institutional conditions that allow institutional entrepreneurs to experiment with new practices to fill institutional voids. The case studies presented here were collected during fieldworks conducted over a period of ten years between 2005 and 2015. Field visits and interviews were undertaken in Shanghai, Kunshan, Wenzhou, Taizhou, Dongguan, and Guangzhou.

**Institutional Voids in Private Sector Financing**

Let us first take a look at the specific case of institutional voids in private sector financing. The unique role of the banking sector in China reflects a common situation faced by post-communist economies. On the eve of market reform, state-owned banks made up the entire financial sector, and they were the sole supplier of credit to the economy. The state’s monopoly over the banking sector has undergone several phases of reform. To begin with, four state-owned banks each with individual specializations and specific

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1 Hilferding, 1910.
2 Shonfield, 1965.
3 Zysman, 1983.
division of labour were created. New public-owned commercial banks, joint-stock commercial banks, and local banks were then introduced. Later on, non-banking financial institutions such as finance companies, trusts, investment companies, and credit cooperatives were added, giving rise to a great variety of financial institutions in present-day China.

Yet the current banking sector remains far from adequate in meeting the needs of China’s growing economy. Despite the emergence of new competitors, state-owned banks have retained their dominance in retail banking. On the one hand, most of the people still prefer to deposit their money in state-owned banks. On the other hand, the bulk of lending is still underwritten by the same group of banks. Through its control and influence over the so-called “policy loans”, the Chinese government channels private savings to selected industrial sectors and enterprises which it considers to be strategic to China’s development.

This system poses a number of problems. The one which concerns us here is the difficulty faced by private enterprises – especially the small and medium-sized ones – in obtaining financial services. This problem plays out in two paradoxical ways. On the one hand, many small and medium private enterprises have difficulty in obtaining bank loans. On the other hand, a substantial number of private enterprises cannot find appropriate outlets to re-invest their earned profits. Studies have found that private enterprises obtained a tiny fraction of all loans approved by state-owned banks. State-owned banks preferred to lend to state-owned enterprises partly because of the pressure from local governments and partly because of their own desire to reduce credit risk. At the same time, some successful enterprises have found few investment opportunities outside the formal banking system. They can only re-invest in their own business or put their money in bank deposits with very low returns. Both problems point to the inadequacy of the existing financial system in meeting the needs of a market economy.

In response to vociferous calls to speed up financial liberalization and to expand the provision of bank loans, the first private bank Minsheng Bank was established in 1996. At the same time, state-owned commercial banks were also asked to extend more loans to the private sector. Yet these moves only led to a marginal improvement, partly because the amount of loans was limited vis-à-vis the strong demand, and partly because most of the loans were extended to large, prestigious, and well-connected enterprises. The majority of small and medium enterprises have been excluded from the formal financial sector. One major reason is that banks are unable to make accurate assessments of credit risk. As a result, they tend to play safe by refusing loan applications from private business.

The absence of adequate financial services during rapid economic growth inevitably led to the emergence of a curb market. One observer cited that more than RMB 200 billion was circulated in the underground money market at the end of the 2000s. Another source reported that, before the global financial crisis, illegal borrowing and lending in the curb market amounted to some RMB 950 billion annually. Although the actual size of the curb market is hard to confirm in the absence of reliable statistics, its magnitude is anything but trivial. The extent of the activity shows that the current banking system is unable to provide sufficient credit for the booming economy. All in all, the shortage of bank credit for private enterprises and limited investment opportunities other than bank deposits and the volatile stock market represent major institutional voids in China’s developmental governance.

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7 Interview, 13 July 2006.  
8 Tsai, 2002.  
9 Interview, 14 July 2006.  
10 Tsai, 2002.  
12 Shanghai Shangbao, 8 March 2006.
The presence of distinct institutional voids creates a functional demand for the development of new practices or the conversion of existing institutional practices to fill those voids. However, such functional demand for arrangements to fill an institutional void is never automatically met. This is because the supply of new institutions is not always readily available. Put differently, institutional voids expose a functional inadequacy, but this in itself is insufficient to ensure remedies. Void-filling is shaped by social and political processes not singularly responding to the functional needs of restoring the effectiveness of the system. As a matter of fact, many voids in developing countries remained unfilled. This failure may be attributed to either one of the two problems or both: the first relates to the failure of public or private actors to create a new practice; and the second relates to the failure to institutionalize a new practice when such a practice clashes with broader cultural values, the politico-legal framework, or interests of the status quo. Let us demonstrate these issues by bringing in some empirical case studies.

**Institutional Conversion under Entrepreneurial Performativity**

Where do new institutions come from? Research in organizational studies has highlighted the role of powerful actors (such as the state, professional associations, and business groups) in institutional innovation and in the establishment of new practices. This is often discussed under the subject of institutional entrepreneurship. Previous studies have underlined a variety of cases where institutional entrepreneurs took over responsibilities of regulatory governance for the purpose of reform and development. For instance, in India some business groups have been the driving force behind infrastructural development in less-developed states. In Indonesia, a private business conglomerate, the Ciputra Group, has taken over some governmental tasks such as the provision and management of public facilities, roads, sewage, town development, and public security.

The emphasis on single-actor institutional entrepreneurship has been criticized for its over-simplification of the institutional process. A useful alternative has been put forward by Lounsbury and Crumley who take into account the multiplicity of actors in producing change through interactive performativity. They argue that individual performances reproduce or alter a given practice through variations in its enactment. Such variations in performativity can be deliberate or unintentional. Regardless of the intention, such variations inevitably invite reactions from other actors and stakeholders. Those feeling threatened by the new practice may work together to marginalize the deviations. Or they may jump on the bandwagon and help mobilize support to institutionalize the innovation.

The idea of performativity provides a useful perspective to analyze institutional entrepreneurship. In the case of China, the private sector’s lack of access to formal channels of finance has created some variations in performativity. For instance, a widely practised strategy among private enterprises to gain better access to bank loans and other policy privileges is to disguise themselves as collective or state-owned enterprises. They do this by enlisting the support of local governments to allow them to register as government-sponsored enterprises – the so-called “wearing a red hat”. This practice is often limited to larger enterprises that are able to offer substantial benefits to local governments in exchange for their special status. Small enterprises or those enterprises not well connected to government officials have to look for other alternatives.

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14 Dieleman, 2011.
16 Ngo, 2018.
One of the most notable and unexpected innovations that has emerged to fill this institutional void is the rise of pawnshops. Pawnshops are commonly perceived to be an ancient financial institution that serves as the poor man’s bank. In her study of informal finance in China, Tsai categorized pawn-brokering as one of the curb market activities. Pawnshops are seen to provide a similar source of back-alley banking for small private businesses and are comparable to interpersonal lending, trade credit, rotating credit associations, and informal financial societies. However, a close examination reveals that this characterization of pawn-brokering as an ancient form of back-alley banking is far from accurate in present-day China. Having once been eliminated after 1949 as exploitative usury business, pawnshops reappeared in the 1980s and have since grown into a distinctive sector. There are now more than 3,000 officially registered pawnshops in China.

In contrast to the image of old-fashioned stores, contemporary pawnshops in China have become highly professional and are well equipped. Instead of serving as the poor man’s bank, pawnshops have targeted private enterprises and relatively well-off consumers as their clients. In the first six months of 2010 alone, the entire pawn sector issued a total of RMB 84.7 billion to its clients, of which RMB 63.9 billion went to 480,000 small private enterprises. Since loans approved by pawnshops are based on collateral rather than credit risk assessment, pawnshops face lower risks than banks and are thus more willing to extend loans to small and medium enterprises. As a result, pawnshops have increasingly become the major source of private sector finance outside the formal banking sector.

An important innovation that enables pawnshops to fill institutional voids in private sector financing is the broadening of the types of collateral. This can be illustrated by the practice of Oriental Pawn, the biggest pawnshop in Shanghai. Oriental Pawn deals with an incredibly wide variety of collateral such as residential housing, commercial housing (including offices, warehouses, and factories), automobiles (including passenger cars and trucks), construction materials (such as steel, cement, copper, aluminium), stocks (including shares and bonds), and consumer durables (such as jewellery, mobile phones, cameras, musical instruments, computers, electrical appliances, clothing, porcelain, lighters, painting, antiques, etc.). Some other pawnshops accept machinery and even letters of credit as collateral. The expansion of types of collateral greatly facilitates private enterprises in obtaining operational finance for their businesses.

Other innovations in services also help the expansion of pawn activities. Many large pawnshops such as Oriental Pawn (Shanghai), Hualian Pawn (Shanghai), and Min Sheng Pawnbroking (Beijing) have become chain operators. Clients can pawn, redeem, and draw money at different branches across the whole country. E-commerce is also widely used in transactions. Oriental Pawn has even cooperated with eBay to auction seized collaterals on the Web. The ease of transaction is also emphasized by pawnshops. In contrast to the long process of loan application and risk assessment by banks, pawnshops offer speedy services to enterprises. The slogan of Oriental Pawn is: “RMB 500,000 loans on the spot” (50万当天放款 wushi wan dangtian fangkuan).

The transformation of traditional pawnshops into a new player in private sector financing rightly underlines the importance of institutional entrepreneurship. In this case, such institutional entrepreneurship is not performed by a single actor. The first pawnshops appearing in the 1980s were actually set up by state agencies related to the financial sector. They included state-owned banks, tax bureaux, and state-owned finance and insurance companies. These agencies were at the forefront of private sector transactions,
and they caught the first glimpse of the functional demand of small private enterprises for short-term finance. These early birds made innovative alterations to the century-old practice of pawnbroking, and achieved unexpected results.

The well-received alterations in pawnbroking attracted newcomers to join the business. By the mid-1990s there were more than 3,000 pawnshops operating throughout the country. In response to the increasing number of pawnshops, the Chinese government decided to regulate the trade. In 1996, the People’s Bank of China was given the administrative responsibility of supervising pawnshop registration and operation. The Bank implemented a licensing system and forced half of the existing pawnshops to close down. The remaining 1,304 pawnshops were categorized as financial institutions. In 2000, pawnshops were reclassified as industrial and commercial enterprises, and were put under the supervision of the Ministry of Foreign Trade and Economic Cooperation. Subsequently the Ministry of Commerce took over the supervision of pawnshops in 2005. Since then, the registration and operation of pawnshops have followed stipulations laid down by the Company Law. At the same time, a Regulation on the Administration of Pawn was promulgated to regulate the activities of pawnshops. With the formalization of pawnbroking as a legitimate commercial undertaking, the number of pawnshops increased rapidly, and it exceeded 3,000 by the end of the 2000s.

**The Creation of New Practices**

If the re-emergence of pawnshops in China represents an example of institutional conversion through entrepreneurial performativity, the rise of investment capital consortia can be considered an exemplary case of institutional creation. As mentioned earlier, the absence of formal investment outlets has resulted in a large quantity of idle capital looking for venture opportunities, mostly in the curb market. The emergence of investment consortia is a functional response to this demand. The most notable consortium can be found in the city of Wenzhou, and it has earned the reputation “Wenzhou financial groups” (温州财团Wenzhou caituan). In contrast to pawnshops, however, these consortia do not receive formal sanction from the state and are not officially recognized as a legitimate form of institutional finance. They remain informal in nature and their activities are sometimes frowned upon by other economic actors.

Before we compare the fate of investment consortia with that of pawnshops, let us first look at their operations. The former emerged in the early 2000s as a spin-off from trade associations. For a substantial period of time, trade associations have been active in Wenzhou. These associations serve as focal points of information exchange and networking for members that are mostly small and medium-sized enterprises. Some of these associations have played an important role in helping members to expand into new markets and to explore investment opportunities outside Wenzhou.23 On this associational basis, some enterprises started to pull fellow members of the same association together to form informal investment consortia.

A notable forerunner is the Aokang Group that was established in 1988 and has grown to become a major shoemaker with over 2,000 chain stores throughout the country. In 2003, Aokang invited eight other shoemakers from Wenzhou to take part in an expansionist project. The consortia collected RMB 1 billion and set up a shoe manufacturing district with a total land area of 2,600 mu (approx. 428 acres) within the city of Chongqing in Western China. The project proved very successful. Aokang went on to diversify its operations using the same strategy and set up Kanghua Biological Products in Chengdu and Aokang Shopping Street in Huanggang. Subsequently in 2004, together with eight other major private enterprises in Wenzhou, it established the first private investment group in China: Sinorich Consortium (Holdings) Co. Ltd.24

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23 Handke, 2008.
24 Interview, 13 July 2006.
Sinorich had a registered capital of RMB 50 million, but the directors claimed that it had over RMB 100 billion in operating capital. The other shareholders hailed from a diversity of business groups including Sunlead Group (machine tools, property development, and chemicals), CNYH (electrical appliances and machine tools), and Yuanyang Glasses (spectacles). Each of the nine shareholding companies contributed RMB 6.2 million to the investment fund. The rest of the capital came from banks, other enterprises, and individual investors. The nine shareholding companies took turns to manage the consortium, while decisions were usually made by majority vote within the board of directors.25

Shortly after the establishment of Sinorich, another consortium followed in their footsteps. Zhongchi was formed by seven private enterprises in the small town of Liushi. Unlike Sinorich’s shareholders, Zhongchi’s were relatively small enterprises active at the local township level. The registered capital was RMB 100 million, with an operating capital of about RMB 10 billion. The consortium singled out a number of areas in its investment priority, including infrastructural projects, property development, logistics, trade, and high-tech industries. The establishment of Sinorich and Zhongchi aroused much public attention in China. Their activities created a demonstration effect for many private enterprises that were seeking investment outlets for their profits and savings.

In both cases of Sinorich and Zhongchi, the constituent enterprises maintained their independence and kept their own core businesses. The consortia acted like an alliance which combined investment capital to share profits and risks. Although the consortia attracted individual investors and banks to contribute to their investment funds, they were registered as commercial undertakings rather than financial establishments. The existing law forbade them to accept public savings. Because of that, unlike investment companies in the West, these Chinese consortia behaved more like an informal network of investors. Most of the participating and contributing investors came from closed personal networks. Some enterprises belonged to several consortia at the same time. Investment decisions were not taken by professional fund managers. Personal trust remained an indispensable element in their operations.26

The activities of the Wenzhou consortia have attracted nationwide attention in the last decade. The sharp rise in housing market prices in major cities has been attributed to Wenzhou's first wave of massive investment in real estate, which earned the Wenzhou consortia the reputation of speculative capital investors. Yet not all of their investment activities were speculative in nature. In the mid-2000s, many consortia turned to coal mining. In the coal capital of Shanxi Province, more than RMB 3 billion was invested in 300 coal mines with a combined output of 20 million tons of coal. Most of the investments went to small-scale mines with an annual production capacity of less than 60,000 tons. Wenzhou consortia upgraded the production and security standards of coal mines in the hope of turning the mines into long-term investment projects. Unfortunately, the Chinese government decided to close down pits with a production capacity of less than 90,000 tons within 10 years.27 Because of that, the Wenzhou consortia pulled out from coal mining and were once again seen as short-term market speculators.

Another prominent project initiated by the Wenzhou consortia was the takeover of state enterprises in Beijing. In 2006 an informal consortium visited Beijing to explore the possibility of taking over state-owned enterprises. The consortium was headed by the Wenzhou Small and Medium Enterprise Association, and comprised some 60 enterprises including Sinorich and Zhongchi. It was reported that the consortium was good for a total investment fund of RMB 10 billion.28 The delegation visited more than 180 state-owned enterprises, high-tech companies, and financial projects. A team of nine lawyers were included in the delegation to offer legal advice on enterprise restructuring. The visit was supported by the city

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26 Interview, 20 July 2006.
government of Beijing and the State-owned Assets Supervision and Administration Commission of the State Council. The project signified tacit endorsement of the activities of private investment consortia by state bureaux for the first time.

In retrospect, the formation of private investment consortia originated from entrepreneurial response to an institutional void in the market, namely the absence of investment outlets for private enterprises – especially small and medium-sized companies. The emergence of investment consortia as a form of organization derived from incremental experimentation. Before Sinorich was set up as a registered undertaking, loose networks of investment capital from Wenzhou enterprises were already in place for a substantial period of time. In fact, as early as 1985, businessmen in Wenzhou already proposed the setting up of a private bank. The initiative was supported by the local government but was blocked by the People's Bank of China. This merely drove private sector financing underground, the magnitude of which grew over the years. One official report estimated that some RMB 277.7 billion were involved in Wenzhou's curb market in 2004. Another report gave the estimation of over RMB 600 billion in 2009 in Wenzhou alone. The formation of consortia was a step further in channelling investment capital to other regions and projects outside of Wenzhou.

**Decentralized Experimentation and Institutional Innovation**

Lounsbury and Crumley recognized the enabling as well as constraining effects of the broader cultural context in fashioning institutional entrepreneurship. They argue that a more complete account of institutional entrepreneurship should not only give due emphasis to the agency of a variety of actors, but should also consider the relation of such agency to wider systems of meanings, cultural categories, and social conventions. This point is echoed by other observers who highlight the importance of habit, custom, and discourse. These wider systems of beliefs and conventions set limits on performativity by defining the roles for strategic actors as well as providing meaning to their activities.

In the case of China, we can easily locate the broader institutional context within which institutional entrepreneurship develops. One of the most distinctive features of the market reform in China is the prevalence of the so-called decentralized experimentation. Some of the most important institutional innovations including the agricultural responsibility system, shareholding reforms of state-owned enterprises, special development zones, business incubators, and so on are the result of such experimentation. In this process, the central government encourages local authorities to try out new ways of problem-solving. Very often these new practices involved bold attempts to venture into grey areas, to circumvent existing regulations, or to undertake controversial schemes. These new practices are usually justified under the policy slogan of “pilot trial and test” (先行先试xianxing xianshi). The results of local experimentations are fed back into national policy formulation.

Heilmann argues that this constitutes a point-to-surface approach in policy-making strategy, which is initiated from numerous points of individual experimentation and driven by local initiatives with the explicit or tacit backing of higher authorities. Successful experimentations which are congruent with current state priorities are labelled as model experiences which are then disseminated and popularized through extensive media coverage, study tours, conferences, and so forth. The results are then revised

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31 E.g. Biggart and Beamish, 2003; Philips et al., 2004.
32 Heilmann, 2008.
further and incorporated into general national policies. In Heilmann’s words, such a sophisticated indigenous
policymaking methodology represents an entrenched legitimacy of decentralized experimentation that
goes beyond the sporadic and unconnected local experiments usually found in other authoritarian polities.33

This tradition of local experimentation provides a positive governing environment that allows institutional
entrepreneurship to emerge. New practices will not be blocked right away. Many will be given the chance
to take shape and develop, until they threaten other vested interests or challenge central policies (this
will be further discussed below). In the cases of pawnshops and investment consortia, both have benefited
from this tradition.

The rise of investment consortia in Wenzhou can be linked to several elements which are closely related
to the tradition of local experimentation. First and foremost is the autonomy of private enterprises and
their attitude towards self-help and risk-taking. Private enterprises in the city of Wenzhou have a strong
reputation of being innovative and unafraid to take risks. Most of the enterprises in Wenzhou are small
and medium in size. They have developed a norm of relying on their own networks, skills, and resources
in seeking new economic opportunities rather than relying on governmental support.

In tandem with this entrepreneurial autonomy, local officials in Wenzhou are commonly believed to be
tolerant towards daring experimentations. Compared with officials in other regions, Wenzhou officials
are more prepared to accept new practices, to bend the rules, and to work with informal arrangements.
Part of this official entrepreneurship derives from the absence of large-scale state-owned enterprises
and strategic industries in Wenzhou, because of which there are no strong vested interests to constrain
local officials and force them to maintain the status quo.34 Officials are therefore more receptive to new
practices and institutional innovations.

The other reason for tolerance on the part of officials relates to a more general factor. During the period
of market reform, performance contracts are signed by leading cadres at different levels of government.
Under the so-called cadre responsibility system, performance of individual cadre is assessed annually with
respect to specific measurable policy targets set down by higher-level authorities.35 Among the various
performance targets, the rate of economic growth is one of the most important criteria. In other words,
local governments are obliged to seek rapid economic growth. This is mostly done through industrial
expansion, capital investment, and land development. During the process, many local officials tolerate
practices that bring about economic growth despite the possibility that these practices might belong to
the grey area. The formation of investment consortia fits squarely into the category. It is a new practice
which is not strictly prohibited by law. At the same time, investment projects initiated by consortia can
certainly boost the local economy as well as increase tax receipts. It is nonetheless a sensitive issue that
borders on the area of finance, an area which is under strict state regulation.

Finally, the general receptiveness to local experimentation in the Wenzhou area also contributes to the
rise of investment consortia as a new form of market practice. Wenzhou was the first region where rapid
economic development was fuelled mainly by small and medium private enterprises. Compared to other
regions, Wenzhou was far ahead in terms of marketization and development of its private sector. The
impressive performance resulting from a highly liberalized market economy has won Wenzhou fame; its
success has been dubbed the “Wenzhou model” (温州模式Wenzhou moshi) of development.36 The success
of the Wenzhou model in turn reinforces the confidence of local officials in encouraging new practices,
and it gives private enterprises the confidence to venture into new business opportunities.

33 Ibid: 1.
34 Parris, 1993.
35 Edin, 2005.
36 Liu, 1992.
In a similar vein, the tradition of local experimentation has proved to be conducive to the transformation of pawnshops into an institutional substitute for banks that provide loans to small and medium enterprises. When the first pawnshops re-emerged in 1987, it was not clear which state institutions were responsible for their registration and supervision. Different provincial and city governments therefore dealt with pawnshops in their own ways. Some provinces treated them like financial institutions and even allowed them to accept deposits and extend loans without collateral. Other provinces were more restrictive and confined them to pawnbroking. Not surprisingly, Wenzhou was among the provinces which allowed pawnshops to take on banking services.

Thereafter, pawnshops underwent various experimentations. In addition to accepting deposits and extending credit, some pawnshops were also involved in money laundering and the exchange of illegal goods. Because of that, the People’s Bank of China introduced a licensing system for pawnshops in 1993. After a few years of trial and error, the People’s Bank announced the Temporary Guidelines on the Administration of Pawnbroking in 1996. As a result of the licensing system and the guidelines, some 1,700 pawnshops were forced to close down, and another 50 were obliged to undergo re-organization. Yet, stringent state regulation from the top did not last for too long. As mentioned earlier, the People’s Bank handed over its regulatory power over pawnshops to the State Economic and Trade Commission in 2000, and subsequently to the Ministry of Commerce. Pawnshops were re-classified as commercial enterprises rather than financial undertakings. This gave pawnshops more flexibility in their operations because commercial undertakings are subjected to less strict regulations than financial establishments. Furthermore, since the State Economic and Trade Commission (and later on the Ministry of Commerce) devolved much of its administrative responsibilities to its local offices, the actual supervision of pawnshops was left to the coordination of local governments.

THE INSTITUTIONALIZATION OF NEW PRACTICES AND INNOVATIONS

The major difference between the cases of pawnshops and investment consortia in terms of void-filling is that the former has been successfully institutionalized while the status of the latter remains dubious. The reason for such difference lies again with the broader context. We have mentioned the enabling and constraining effects of the broader structural context. Such a context goes further than simply fashioning institutional entrepreneurship. The likelihood of a new practice being fully institutionalized as a regular setup rather than an ad hoc solution also depends on its “mesh and clash” with the prevailing socio-political structure. In other words, the existing socio-political structure, which represents a specific configuration of power relations among vested interests, serves as a gatekeeper in shaping the way institutional voids are filled and determining the mechanisms involved as well as the manner in which this is done.

From our comparison of the two cases, we can observe a number of ways in which the broader socio-political structure plays a role. First and foremost, linkages with existing state institutions are an important condition. In China, the party-state occupies a dominant position even after the implementation of market reform. Newly formed establishments with close links to the party-state have a better chance of survival. This explains why some private companies disguise themselves as “red-hat” enterprises. In the case of pawnshops, it has been reported that over 60 per cent of the early pawnshops were set up by state-owned financial institutions such as state-owned commercial banks and credit cooperatives. Even the so-called privately owned pawnshops have a lot of governmental connections. A good example is Jin Bao Pawnshop,

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[12] Ibid.
[13] Ibid.
the first pawnshop established in Beijing in 1992. It was founded by Yan Kewen after his retirement from
the position of vice general manager of the Beijing branch of the People’s Insurance Company of China, the
latter being a major state-owned conglomerate. The launch of Jin Bao had the blessing of the Department
of Commerce in the Beijing Municipal Government.40

In comparison, most investment consortia owe their existence to private initiatives. Some consortia
have realized that their vulnerability was the result of their failure to get governmental bodies on board.
At one point Sinorich collaborated with the Wenzhou Construction Bank and the Wenzhou Agricultural
Bank, and signed strategic cooperation agreements with them. Yet compared with the pawnshops,
consortia obviously wield less political clout. In fact, the central government has been sceptical about the
activities of the consortia from the beginning. The existence of huge amounts of funds outside the formal
financial sector – in other words outside official control – presented a potential threat to the system. The
central government was worried that speculative activities by investment consortia could upset national
economic policies. Local governments outside Wenzhou were ambivalent towards investment consortia:
on the one hand, investment consortia might bring in investment projects to boost their local economy;
on the other hand, they could also generate social instability by jacking up market prices. Because of
that, despite the high profile of some consortia, there has been limited support from the government for
such activities and even less enthusiasm for the institutionalization of private consortium as a legitimate
form of investment banking.41

Notwithstanding official scepticism, there have been attempts by Sinorich and Zhongchi to institutionalize
the new practice. Both consortia have created a formal organizational structure to manage investment
funds. They also succeeded in registering as a legal entity. However, they were not allowed to provide
financial services to a wider public, nor were they entitled to receive public contributions. Yet without
the possibilities of attracting public contributions, the significance of setting up a formal consortium is
rather limited.

Another condition for successful institutionalization is the penetration of new practices into the existing
socio-economic structure. This refers to the extent to which new practices can hook up with existing
societal interests and institutional players. The sooner they establish a symbiotic relationship with other
institutions and interests, the greater the chance of success that such practices will have in becoming a
permanent setup. This is most obvious in the case of pawnshops. Many of them have established strategic
partnerships with other business sectors. In fact, given the wide varieties of collateral, it is essential for
pawnshops to form alliances with other government departments and business enterprises in order to
manage different types of collateral. Take the Oriental Pawn for example, it has a number of strategic
partners listed as its major shareholders. They include Shanghai International Commodity Auction Co.
(the largest auction house in China), SFZH Shanghai Housing Purchase and Exchange Co. (one of the largest
property agents in China), and Shanghai STEO Exhibition Co. Such a partnership enables Oriental Pawn to
handle its collateral professionally and efficiently. Others have established partnerships with securities
companies to manage securities and stocks. In addition, many pawnshops maintain close relationships
with relevant government departments to facilitate their dealings with real estate and land rights.

Equally important is the strategy of the new establishments to construct their social existence. Here
we see a lot of effort taken by the pawnshops to define pawnbroking as a professional practice and to
construct pawnbroking as a distinctive business sector. Many large pawnshops have actively taken part in
the provision of social services or have engaged in trade association activities.42 They have set up national
and local trade associations to promote exchange and to boost the professional standard of pawnbroking. As

40 Interview, 2 June 2010.
41 Interview, 20 June 2009.
42 Interview, 5 August 2012.
a result, there are provincial pawn associations in nearly every province of China. A National Commission of Professional Pawnbroking has been established to protect the interests of the sector. Furthermore, the Internet has been fully exploited to help create a social identity for pawnbroking. A number of nationwide websites have been created to disseminate information about pawnbroking regulations, to publicize the profile of pawnshops, and to provide updates on the development of the trade and related information about different types of collateral. Besides trade-related activities, some pawnshops also strive to gain high-profile positions. For example, the general manager of Oriental Pawn, Wang Fuming, was an elected member of the People’s Congress. Oriental Pawn also cooperates with local universities to run regular training courses for those interested in joining the pawnbroking business.

In comparison, investment consortia have been slow in integrating with other societal institutions. The lack of government blessing forced many consortia to retain an informal setup. And since many consortia remain in loosely organized networks, there has been no regulation to control their activities. Many consortia thus work in a grey area between the open and curb markets. The informality and the lack of government recognition in turn create a vicious circle. In the absence of formal organization and rules, most consortia fail to develop professional management and to formulate long-term investment strategies. As such, they rely on ad hoc decisions in response to short-term market opportunities. This explains why Sinorich did not stick to its ostensible goal of investing in infrastructural projects and in the restructuring and merger of state-owned enterprises, but instead moved from real estate purchase to investment in coal mines and then to speculation in art works – which reinforces the common perception that equates investment consortia with speculative investments. In return, governments at different levels have become increasingly reluctant to grant official recognition, and have tried to keep an arm’s length from such activities.

Finally, the avoidance of direct conflict of interests with existing stakeholders will lower the resistance of the status quo in the institutionalization of new practices. This can be illustrated in the case of pawnshops. In the Temporary Guidelines issued by the People’s Bank, pawnshops were only allowed to provide loans to small private enterprises and private individuals. In addition, they were not allowed to accept intangible collateral such as stocks. These regulations prevented pawnshops from competing directly with banks that considered large state-owned enterprises as their main clients. Paradoxically, such regulations also reduced the hostility of banks towards pawnshops. From the point of view of the powerful banking institutions, loans for small private enterprises were nothing more than a kind of left-over business, and could thus be left safely to pawnshops. This regulation was relaxed in 2001 when the State Economic and Trade Commission took over the supervisory power. Since then pawnshops do not have to confine themselves to a certain group of clients. In practice, however, the number of pawnshops in a particular city is still subjected to regulation with respect to the number of private enterprises in that city. Pawnshops can now accept intangible collateral such as real estate deeds and stocks; while banks are still not allowed to accept stocks and shares as collateral. In other words, a certain division of labour is maintained between conventional banks and pawnshops.

**State Sanction of Void-Filling Initiatives**

This is far from the end of the story. The successful institutionalization of pawnshops as a quasi-financial institution partially eased the problem of private sector financing. In contrast, investment consortia responded to the problem of private investment much less successfully. Yet, besides the state-licensed banks, the formal financial sector is still short of a functional intermediary that directly channels private
savings into investments, especially with respect to small-scale savings and investments. In fact, it has been a long-standing state policy that only financial institutions officially sanctioned by the state are allowed to handle borrowing and lending directly. The incomplete void-filling exercise thus creates further incentives for other groups of institutional entrepreneurs to seize business opportunities.

Beginning in the late 2000s, a new form of practice emerged that overlaps the businesses undertaken by pawnbroking and investment consortia: consignment shops (寄售行 jishouhang). These shops mushroomed by the hundreds, and soon outnumbered pawnshops in many cities. With the official recognition of pawnshops, the licensing of pawn brokering has been brought under official regulation. There are strict requirements for the paid-up capital, with a minimum of RMB 3 million for ordinary pawnshops and up to RMB 10 million for pawnshops that accept stocks and shares as collateral. Investors who are unable to meet the requirements turn to alternatives offered by consignment shops which require neither a minimum paid-up capital nor a special licence. In principle, consignment shops sell (used) items on behalf of clients and receive a service fee after the transaction. By law they are not allowed to engage in pawnbroking or to sell gold/platinum, automobile, real property, and stocks and shares. In practice, almost all of them offer pawnbroking. Many also raise private funds and offer high-interest lending.45 In essence, the practice of consignment is an open disguise for illegal private banking targeted at individuals and small and medium enterprises.

The rise of consignment shops represents to a certain extent another void-filling exercise through institutional conversion. However, unlike pawnshops and investment consortia, the practice of consignment shops is ad hoc and they are led by rent-seeking motives in response to the opportunities present in private sector financing. Many consignment shops tread in the grey area of illegal finance – they take advantage of the ambivalence between the formal economy and the curb market. They have not attempted to formalize the practice of consignment, and they realize that there is little likelihood of obtaining any state sanction for their business.

Ironically, the activities of consignment shops have been tolerated by local state authorities despite the widespread recognition of their illicit nature. This is due to the government officials’ tacit acknowledgement of the prevailing institutional void in private sector financing.46 To a large extent, institutional void has been sustained by state policies that allow financial operations to be solely handled by banks. Any non-bank undertakings that engage in borrowing and lending can only operate illicitly, which is what consignment shops are doing. However, such an illicit practice meets certain needs but at the same time it creates new problems. Consignment shops charge high interest rates for their loans. The lucrative usury business has attracted a large number of private investors to channel their idle capital into lending. The bubble did not take long to burst. Borrowing against a high interest rate by private enterprises through consignment shops eventually triggered off a credit crunch in 2011. Driven by their inability to repay their debt, an alarming number of private enterprise owners in Wenzhou abandoned their business and took to their heels – which created a chain reaction that made many consignment shops and loan sharks recall loans or to go bust, leading to more closures and eventually a credit crunch. This alarmed Beijing. For fear of triggering off a nation-wide financial crisis, the then Premier Wen Jiabao visited Wenzhou in August 2011 to find ways of containing the crisis and, more importantly, to explore viable alternatives to fill long-existing voids in private sector financing.

In 2012, the State Council finally approved a pilot scheme to undertake comprehensive financial reform, to be started in Wenzhou. In line with the strategy of decentralized experimentation, the pilot scheme encourages the creation of a number of innovative establishments, including capital management companies, small loans corporations, and private lending registration centres. These establishments offer

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45 Interview, 10 November 2014.
46 Interview, 11 November 2014.
different possibilities to meet the functional needs of private sector financing, without contravening state restrictions on borrowing from and lending to banking institutions. Eight years after the establishment of the investment consortium Sinorich, the first state-sanctioned private investment company – the ICT Folk Capital Management Corporation – was founded in Wenzhou in February 2012. The paid-up capital was RMB 100 million, which came mainly from shareholders. This was followed shortly by two others: Dong Tie and Huafon. Under the pilot scheme, these companies are forbidden to engage in external fundraising, to accept public deposits, or to give out loans. Their purpose is to manage the excess capital of their shareholders by investing in selected projects. In retrospect, the once frowned upon initiatives of Sinorich and Zhongchi finally gained official recognition – the practice is now being institutionalized.

In response to the practice of pawnbroking as a disguise for lending to small enterprises, companies offering small loans are now encouraged by the state authorities. In 2012, the biggest company offering small loans was set up in Chongqing. Xinhui was formed by a number of state-owned enterprises including Chongqing Import and Export Insurance Co. and Chongqing Textile Holding (Group) Co. It has a paid-up capital of RMB 200 million. The targets of lending are the suppliers and subcontractors of Chongqing Textile Holding, including 3000–4000 small enterprises in sectors such as textile, beer, cleansing utilities, and construction materials.

A further innovation is the formalization of financial brokers in borrowing and lending. The first such initiative was undertaken by the Wenzhou Private Lending Registration Service Centre, set up in 2012. Unlike banks which accept deposits and offer loans at their own risk, the registration centre serves merely as a broker between lenders and borrowers. Under the pilot scheme, registration centres are not allowed to handle capital directly. They merely provide broker services by putting potential lenders and borrowers in contact with one another, and charge one to two per cent service fee for every transaction. Those who lend their money through the service centre are not allowed to charge more than four times the current bank interest rate. In the first month of its operation, the Wenzhou Centre had registered over RMB 300 million available for lending, and requests to borrow amounted to RMB 960 million.

Meanwhile, with the rapid spread of the Internet and e-commerce, a new financial broking platform has gained increasing popularity: crowdfunding. Crowdfunding has a long history in the West. It is a practice to raise money from a large number of people or from the general public to support a project or venture. When it was introduced into China in the mid-2010s, its potential void-filling function was more than apparent in channelling individual investments to financing projects initiated by small and medium private enterprises.

The most important player in this new financial instrument is the Internet platform, which serves as the broker between individual investors and the initiators of projects. The platform is responsible for screening appropriate projects, collecting funds from individuals, forwarding funds to the selected projects, and ensuring the payment of dividends by the enterprises to the investors. By 2015, more than 50 platforms have been in operation, another 20 have already closed down. One of the most organized platforms is the one operated by JD Finance. The platform was set up in 2014. During the inaugural year, the platform succeeded in raising RMB 10 million for an air-purifier project. In less than two years’ time, it has already raised a total of RMB 2.5 billion. One of the largest single projects funded under the platform is an electric scooter project, which received RMB 72 million.

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48 Chongqing Shangbao, 29 August 2012.
The initial success prompted JD Finance to rapidly expand its business and services related to crowdfunding. In addition to managing the digital platform, JD Finance offers training, financial management services, insurance plans, procurement and logistics services, and so on to project initiators. In essence, the company turns itself into a multi-function business that combines financial brokering, e-commerce, portfolio management, and business services.

Other platforms soon followed suit, covering a wide range of initiatives and services. Not all of them can be classified as assuming the role of financial brokering between individual investors and private enterprises. Some platforms such as Baidu is basically stock brokering disguised as crowdfunding. Similarly, Taobao focuses mainly on selling newly developed products under the name of crowdfunding. Eventually, the China Securities Regulatory Commission issued a notice in 2015, equating crowdfunding to private-equity fund, and officially put crowdfunding activities and platforms under its regulatory supervision.

In the end, whether all these initiatives can be institutionalized and whether they can successfully fill the voids in private sector financing remain to be seen. In retrospect, the experience of private sector financing in China is a process where unconventional actors take advantage of the opportunities emerging from institutional void by either converting old practices innovatively to suit new circumstances or creating entirely new practices. These entrepreneurial actors are able to exploit the regulatory loopholes and are not afraid to venture into grey areas. In the course of their practices, they adjust their strategies and negotiate constantly with the state and other power holders with respect to the limit of permissibility. From the state’s point of view, some of the illicit practices are tolerated not only because they remedy existing institutional inefficacies but also because they can be used as unofficial experiments for filling voids. In other words, despite the illicit nature of some of the unconventional practices tried out by private initiatives, they become the source of institutional innovations sanctioned by the state. This may be one of the factors underlining China’s extraordinary success in economic growth despite rampant corruption and rent seeking, bureaucratic inefficiency, regulatory lapse, and institutional fragmentation.

**Conclusion**

The case studies about private sector financing demonstrate the dynamics of institutional innovation in China. As a transitional economy, China is far from getting all its institutions “right”. Instead, there is no shortage of malfunctional practices, obsolete regulations, contradictory requirements, and institutional voids. Yet the adaptive capacity of the state and society sets China apart from the conventional developing nations. This adaptive capacity is most observable in the entrepreneurial responses from both state and societal actors to exploit grey areas in order to overcome institutional constraints and to fill institutional voids. In the case of private sector financing, we see a succession of creative efforts to remedy a malfunctioning aspect of the financial system, leading to such innovative creations as pawnshops, investment consortia, consignment shops, capital management corporations, private lending registration services, and crowdfunding. The source of institutional entrepreneurship derives not solely from the private sector, but also from central and local state actors, often in collaboration/conspiracy with private stakeholders.

Many studies have already pointed out that the tradition of decentralized experimentation in China has contributed to the development of institutional entrepreneurship. Yet most studies of institutional innovation tend to highlight the source of institutional entrepreneurship without giving sufficient attention to the institutionalization of such innovations. We argue that while the existence of an institutional void

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creates a functional demand for new practices to fill that void, the emergence of such new practices is never automatic. And even if new practices do arise, they may not be formally institutionalized. A comparative analysis of our cases suggests that it is useful to distinguish between the creation of new institutional practices and the institutionalization of those practices.

In our comparison of the different types of private sector financing in China, we find that the broader socio-political structures play a gatekeeping role in institutional selection. The successful institutionalization of a new practice depends very much upon its relationship with the state apparatus, the penetrative reach of the new practice into the prevailing socio-economic structure and its relationship with broader social and economic groups, the resistance from vested interests, and the success or failure of the new practice in constructing its own social existence.
References


Dans les pays en développement, l’absence de dispositifs institutionnels indispensables pour réguler les échanges marchands, mobiliser les ressources économiques, coordonner la mise en œuvre des politiques et administrer les programmes de développement est récurrente. Le développement économique dépend en grande partie de la manière dont ces vides institutionnels peuvent être comblés d’une manière ou d’une autre. A partir du cas exemplaire de la Chine, cet article analyse comment des acteurs et des organismes non conventionnels combinent ces vides institutionnels et participent à l’émergence de modes de gouvernement alternatifs en négociant les règles ainsi que l’allocation des ressources, et en ajustant leurs discours avec des circuits de pouvoir formels et informels. En se penchant sur la question du financement du secteur privé, il étudie une série d’initiatives visant à remédier aux défaillances du système financier et générant des solutions innovatrices telles que des monts-de-piété, des consortiums informels d’investissement, des dépôts-ventes, des sociétés de gestion de capitaux, ou du crowdfunding. Le secteur privé, mais également des acteurs étatiques à l’échelle centrale et locale sont à l’origine de cet entrepreneuriat institutionnel. Cet article soutient que les solutions retenues dépendront des structures sociopolitiques dans lesquelles elles s’insèrent : une nouvelle pratique sera ou non institutionnalisée selon qu’elle entrera ou non en résonance avec ce contexte.

Overcoming Institutional Voids during Market Transition: Private Sector Financing in China

Abstract

Developing nations are characterized by the absence of much-needed institutional arrangements to regulate market exchange, mobilize economic resources, coordinate policy implementations, and administer developmental programmes. Successful economic development depends to a large extent on whether such institutional voids can be filled in one way or another. Using China as an exemplary case, this paper looks at how institutional voids are filled by unconventional actors/organizations who, in the process of negotiating rules, resources, and discourses with formal and informal circuits of power, contribute to the emergence of alternative forms of governance. By focusing on the case of private sector financing, the paper documents a succession of creative efforts to remedy a malfunctioning aspect of the financial system, leading to such innovative creations as pawnshops, informal investment consortia, consignment shops, capital management corporations, or crowdfunding. The source of institutional entrepreneurship derives not solely from the private sector, but also from central and local state actors. Furthermore, the paper argues that the broader socio-political structures play a gatekeeping role in institutional selection. The successful institutionalization of a new practice depends very much on its clash and mesh with the broader socio-political structures.

Mots clés

Chine ; consortiums informels d’investissement ; dépôts-ventes ; entrepreneuriat institutionnel ; financement du secteur privé ; monts-de-piété ; performativité ; vides institutionnels.

Keywords

China; consignment shops; informal investment consortia; institutional entrepreneurship; institutional voids; pawnshops; performativity; private sector financing.