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Wenzhou's economy

It once was lost

WENZHO

A city renowned for its business acumen battles to recover from a financial crisis

DEBT in China can be life-threatening. Walking around the factory floor of his father's company, a manufacturer of small electrical parts, Fan Lele looks relaxed these days. Five years ago, he could not come near it. After a few investments went bad, he found himself 10m yuan (\$1.5m) in arrears to his creditors, many of whom were former friends. Mr Fan feared they might hurt or even kill him, so he went into hiding for months, skipping from city to city. Eventually, his father dug deep to pay them off. He secured Mr Fan's safe return and managed, barely, to keep his company afloat.

In this eastern city, home to some of China's boldest risk-takers, such tales are almost banal. Virtually everyone in business in Wenzhou, which is to say almost everyone in Wenzhou, has a horror story about the financial crisis that struck in mid-2011. Dozens of investors, big and small, fled their debts. The most desperate jumped off buildings. Large, unlicensed underground banks collapsed, as did hundreds of firms. By official (very conservative) reckoning property prices fell some 25% over the next few years (see chart).

These days, Wenzhou is quietly getting back to work. Housing prices have started to rise again. The city's economic growth topped 8% last year, the fastest since 2011. But with bad loans still clogging its bank system, many of the city's scars remain unhealed. Wenzhou is an outlier at the wild end of the Chinese economy. Yet its trajectory—from painful downturn to halting re-

covery—may suggest what lies ahead for the most debt-laden parts of the country.

Wenzhou has long stood apart from the rest of China. It is a port city in Zhejiang province, separated from the interior by mountains, with a dialect unintelligible to most outsiders. The legacy of foreign missionaries in the 19th century is evident in a large Christian community (Wenzhou is sometimes called the "Jerusalem of the East"). When China began to open up to private commerce in the 1980s, Wenzhou was one of the first to seize the new opportunities. Its people became renowned for their aggressive brand of capitalism, and also their golden touch.

Families pooled their cash and organised informal lending societies, backed by the trust born of their tight-knit community. With that capital, they started small fac-

tories. By the late 1990s Wenzhou had become a manufacturing centre for a dizzying array of small products: from cigarette lighters to valves. As Wenzhounese fanned out around the country for business, their money followed. Whenever asset prices spiked, whether for holiday homes on the southern island of Hainan or coal mines in the industrial north, Chinese media pointed to speculators from Wenzhou as the cause. These accounts often contained a kernel of truth.

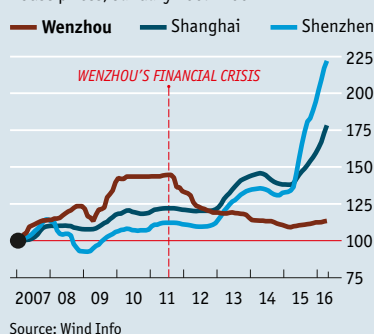
Then came 2011. China had propelled its economy through the global financial crisis by flooding it with cash. Regulators were starting to rein in the excesses. Across the nation, lending to small businesses slowed; property prices and the stock-market dipped. Companies in Wenzhou, which had been counting on a steady flow of financing to fund their bets on stocks and property, were in trouble. The dense networks of trust that had helped propel Wenzhou to wealth turned into liabilities. By the end of 2011 at least 40 small-business owners had reneged on their debts and fled the city, police said at the time. Mr Fan was one of them.

Five years on, Wenzhou is still trying to clean up the mess. In 2012, to much fanfare, the central government designated the city as a "special financial zone". The idea was to bring transparency to underground banking. It set up a "registration centre" at which lenders were urged to declare their loans so that it would be easier to monitor them. By April, about 32 billion yuan in loans had been registered at the centre—a good start, but less than 5% of official bank lending in Wenzhou. It is likely that many underground loans are still hidden.

The city also gave private businesses the right to establish lending companies, trying to steer them into the formal financial system. These have fared poorly. One businessman says he and his partners are closing up shop after less than two years. ►►

The taming of Wenzhou

House prices, January 2007=100



▶ He estimates that about 20% of their 200m yuan in loans has already gone bad. "The government said it was reform," he sighs. "But we wonder if they were just lying to us, getting companies to take our loans to pay back state banks."

There has been progress in other areas, however. One is bankruptcy, a legal process that has been slow to catch on in China (hence bitter disputes when firms go bust). The central government introduced a new law in 2007 allowing the restructuring of troubled companies, using methods similar to Chapter 11 proceedings in America. Businesses in other parts of China, fearing a stigma, have been reluctant to use it. Courts have lacked expertise to administer it. But Wenzhou has got over its inhibitions. With less than 1% of China's GDP, it has accounted for nearly a tenth of bankruptcy cases nationwide over the past three years. It established one of China's first courts dedicated to handling such cases. "Other cities hear 'bankruptcy' and get scared. Here, we are tasting how sweet it can be," says Zhou Guang, who heads the Wenzhou Lawyers' Association.

In one case held up by the city as a model, Haihe, a drug firm with a history going back to 1670, was salvaged after going bust. Its previous owners had run up unsustainable debts punting on property. Its creditors took control and eventually sold it to investors. The lenders only managed to recover a small portion of what they were owed but, crucially from Wenzhou's perspective, Haihe is back in business. It now has plans to expand.

State-run banks also appear to be healthier. They say that nearly 5% of their loans were bad in early 2014; at the end of last year, 3.8% were. That is still more than double the national average and probably an understatement, since banks regularly hide their bad loans. Part of the clean-up also reflects an asset shift rather than a real solution: Wenzhou is the first city in China to create its own "bad bank" to take over failed loans. But these caveats aside, the city is justifiably proud. It is just about the only city in China where banks have reported an improvement in lending quality over the past two years.

Even the city's underground lenders—at least those still in business—have learned lessons. Yan Yipan has transformed his law firm into an intermediary that connects borrowers and creditors, helping to structure legally binding deals between them. From a stylish wood-clad tea room in his office, he says that the city offers a glimpse of what awaits the rest of the country as growth slows and debt-laden companies sputter. "Wenzhou was the first to fall into trouble but it is also the first to get back up again," he says. "When the economy was going well, no one thought there could ever be problems. Now we are much more rational."

Yet the prevailing mood is gloomier than before the crisis. At Mr Fan's company, Tietong, the concern is not loan sharks but rather the problems of small businesses anywhere in China. A manufacturer of metal wiring for light switches, Tietong is squeezed between rising wage costs and falling demand amid an industrial slowdown. To survive, it has been trying to break into new markets. It has recognised that its products are not good enough for rich countries, so it is focusing on developing ones—only to find that its prices are often too high for them. That is a common experience in Wenzhou, where the economy is dominated by small businesses like Mr Fan's.

Wenzhou's identity as a relatively independent, easy-going city has also started to fade. In the past two years, officials in Zhejiang have been waging their biggest crack-down on open displays of Christian belief in years. This has involved the demolition of several churches and the removal of

hundreds of rooftop crosses from others, with Wenzhou a main target. At some churches, Christians have protested and scuffled with police. The chill has extended to the city's business atmosphere: provincial and central officials now watch Wenzhou more closely. That may be reasonable, given the turmoil of 2011, but it is a change nonetheless.

There has also been a loss of trust between people themselves. Zhang Xiaoyan, an adviser to the local government, says the "spiritual damage" from the crisis is worse than the material damage. "It used to be that Wenzhouese would lend to each other with no questions asked and not even so much as an IOU. It was like a blood bond. This is no more," she says. In place of the trust-based system, the city is trying to foster a modern economy based on contracts and credit records. If successful, Wenzhou may well emerge more resilient, though nothing like its former rum-bustious self. ■

China-United States relations

Aerial chicken

BEIJING

A rocky patch could get rockier

BARACK OBAMA'S "pivot" to Asia has been his most important foreign-policy shift. But the continent is causing him more pain than gain, at least to judge by the final cabinet-level meeting of his presidency between China and America. The gathering, called the Strategic and Economic Dialogue, was held in Beijing on June 6th and 7th. It showed that some progress is being made by the mutually suspicious powers. But it has been only tentative. Remaining problems are intractable and dangerous.

In one friendly-sounding gesture, China pledged to cut excess steel production, which has been depressing global prices and upsetting steelmakers in America and elsewhere. But the country had already said it would reduce capacity by 100m-150m tonnes by 2020. China admits this will not eliminate the glut.

China also agreed to enforce sanctions that were imposed on North Korea by the UN in March. That would please America, which believes China is half-hearted about stepping up pressure on the North to stop making nuclear bombs. But the two countries showed little sign of agreeing on what to do next. America wants more pressure, China more talks.

Tension at the meeting was inevitable. An international tribunal is preparing to rule soon on rival claims by the Philippines (an American ally) and China in the South China Sea. China will be furious if, as is expected, the ruling favours



What the hell ADIZ?

the Philippines. It says it will not abide by the verdict, and is reported to be planning to declare an Air Defence Identification Zone (ADIZ) in the South China Sea. This would require planes to identify themselves, or face a military response.

On his way to Beijing, America's secretary of state John Kerry (pictured, with President Xi Jinping) warned against the ADIZ idea. During his talks, in a reminder of the risks involved, Chinese fighter jets buzzed an American spy plane in the ADIZ that China already has in the East China Sea. The Pentagon called the interception "unsafe". That would also apply to the relationship more generally.