

# **The Economic Transition of Wenzhou Before and After the Financial Crisis in 2011: An Institutional View**

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## **Abstract**

Since the Chinese economic reforms in 1978, private firms have played a vital role in the Wenzhou economy and have promoted this city's rapid economic growth. Because banks mainly extended credit to only state enterprises, private companies usually borrowed money from informal sources. The informal finance and private economy in Wenzhou thus flourished together and resulted in what has become known as the "Wenzhou model". After the financial crisis in 2011, however, the Wenzhou economy suffered a deep recession. This paper indicates that the "Wenzhou model" has been changing since 2011 because the three features of the "Wenzhou model", the informal finance, private enterprises, and an inactive role of the local government, were destroyed by the financial crisis.

## 1. Introduction

Wenzhou, one of the fastest-growing cities in China, is historically famous for its entrepreneurs and informal finance. At the beginning of Chinese economic reforms in 1978, the first individual and private enterprise was set up in Wenzhou,<sup>1</sup> and many current Chinese big businesses originated from this city. Furthermore, these private companies usually borrowed money from informal sources because banks mainly extended credit to only state enterprises. The informal finance and private economy in Wenzhou thus flourished together and resulted in what is known as the “Wenzhou model”.

However, economic development in Wenzhou in recent years has lagged behind. A serious financial crisis that started in Wenzhou in 2011 bankrupted several firms, and several factory owners had to escape from bad debts. The three features of the “Wenzhou model” of informal finance, private enterprises, and an inactive role of the local government, were destroyed by the financial crisis and the Wenzhou government was forced to organize a fund to help overstretched businesses. The Wenzhou economy also suffered a deep recession after the onset of the local financial crisis. According to the relevant literature, private firms have played a vital role in the Wenzhou economy and have promoted rapid economic growth for a long time. At the same time, the black-market finance was created by the cash-starved private businessmen since it was difficult for them to borrow money from banks. During this period, since the Wenzhou government neither made policies nor built good infrastructure to support private companies’ operations, it was seen an inactive

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<sup>1</sup> See [http://big5.china.com.cn/news/txt/2006-08/22/content\\_7096140.htm](http://big5.china.com.cn/news/txt/2006-08/22/content_7096140.htm) (8/22/2006).

government.

After the financial crunch, these three characteristics of the “Wenzhou model” collapsed. The purpose of this research project is thus to explore the process of Wenzhou’s economic transition from the perspective of historical institutionalism. By examining the event of the 2011 lending crisis, this paper will show that the “Wenzhou model” has been changing since 2011 because the main economic developmental institutions were dismantled. The 2011 Wenzhou financial crisis was a “critical juncture”, prompting the government of Wenzhou to be more actively involved in economic development and resulting in a shift opportunity to change the private economy-dominated economic model of Wenzhou. The transition is also an important indicator to evaluate whether or not the present-day Chinese local economic developmental models can converge.

To support the argument, the article presents data collected from in-depth interviews with bankers, entrepreneurs across different industries, scholars and local officials in Wenzhou from 2012 to 2013. Some of the entrepreneurs were members of industrial associations and so could examine the roles of business associations in the financial crisis. Pseudonyms such as “W business” are used to replace the names of enterprises to protect respondents who cooperated as informants in the fieldwork.

In the following sections, this paper will review briefly the extant literature on the development of the “Wenzhou model” and related basic concepts of theories. The third section describes economic development of Wenzhou and local governance before 2011. The focus of the fourth section is the context of the financial crisis in 2011, and then illustrates its effect on Wenzhou’s economy. The final section concludes this

article and assesses whether the economic transformation of the “Wenzhou model” will have a significant impact on the Chinese economy.

## 2. Views of “Wenzhou Model” and Theories

### 2.1 Views of “Wenzhou Model”

Many scholars have focused on historical, geographic, and financial reasons in explaining the “Wenzhou model”. Historical views suggest that the rapid development of private businesses and petty commodity production in Wenzhou from 1978 was just the historical continuation of its past as a city with a major trading port since the tenth century.<sup>2</sup> In addition, based on the legacy of a unique local revolutionary history in 1949, many of Wenzhou’s cadres also ran private businesses in order to increase their income and the Wenzhou government received “voluntary donations” from private firms for the development of public infrastructure projects.<sup>3</sup> As a result, Wenzhou’s cadres were more open-minded and willing to protect the private economy.

Geographic reasons are seen as the most important factor to explain the rise of Wenzhou private economy by some Chinese scholars since Wenzhou is located in a mountainous region with scarce resources and isolated from the rest of China.<sup>4</sup> This forced Wenzhou people to have to engage in household production and trade for survival.<sup>5</sup> Second, as traditionally Wenzhou has been regarded as part of the military

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<sup>2</sup> Xiang Wu, (1986). "Lun fazhazhong de Wenzhou nongcun shangpin jingji" ("On the developing of the commodity economy in rural Wenzhou"), *Renmin ribao*, 4 August 1986, p. 5; Enzhen Yuan, (1897). *Wenzhou moshi yu fuyu zhilu (The Wenzhou Model and the Road Towards Affluence)* (Shanghai: Shanghai shehui kexueyuan chubanshe).

<sup>3</sup> Yia-Ling Liu, (1992). “Reform from Below: The Private Economy and Local Politics in the Rural Industrialization of Wenzhou,” *China Quarterly*, No. 130, pp. 293-316.

<sup>4</sup> Renshou Zhang, and Hong Li (1990), *Wenzhou moshi yanjiu (A study of the Wenzhou model)* (Beijing: The China Social Sciences Press).

<sup>5</sup> Enzhen Yuan, (1897). *Wenzhou moshi yu fuyu zhilu (The Wenzhou Model and the Road Towards Affluence)* (Shanghai: Shanghai shehui kexueyuan chubanshe);

front against Taiwan if a war should break out, it received little state investment for the infrastructure construction.<sup>6</sup> As a result, a self-sufficient economy formed in Wenzhou.

The third point is that informal finance has played a crucial role in Wenzhou's economic development. The private lending usually developed from the extended family, friends, and neighbors since they enjoyed a high degree of trust and tight social network could reduce problems of asymmetric information.<sup>7</sup> Thus, private entrepreneurs created a back-alley banking system to finance household- and firm-level ventures, which stimulated the private economy.<sup>8</sup>

These perspectives are necessary to understand Wenzhou's economic development but not sufficient. For example, the lack of investment from the Chinese central government is very common in mountainous regions throughout China. So, why could private businesses become a predominant part of Wenzhou economy faster than in other areas? Even with the existence of its historical legacy, why did Wenzhou officials break orders from the higher authorities to maintain the private economy? Furthermore, all explanations do not point to various interactions of institutions but instead to an economic developmental trajectory of a region that was constituted by

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<sup>6</sup> Jinlong Ma, (2001). "Wenzhou moshi de lailongqumai" ("The Context of the "Wenzhou model"), *Decision-Making*, No. 8, pp. 10-12.

<sup>7</sup> Jun Zhang, (1999), "Gai ge hou zhong guo nong cun de fei zheng gui jin rong bu men" (The Informal Financial Sector in Rural China after Reform) in Shu Guang Zhang ed. *Zhong guo zhi du bian qian de an li yan jiu* (Case Studies of Chinese Institutional Change) (China Financial & Economic Publishing House); Jin Chuan Shi, et al. (2004), *zhi du bian qian yu jing ji fa zhan: Wenzhou moshi yan jiu* (Institutional Changes and Economic Development: A Research on the Wenzhou Model) (Zhejiang: Zhejiang University Press).

<sup>8</sup> Kellee S. Tsai (2004), *Back-Alley Banking* (Cornell University Press); Jin Chuan Shi, (2004), "Analysis of the Historical System of the Wenzhou Model: A View from the Perspective of Personalized Transaction and Nonpersonalized Transaction," *Zhejiang Social Sciences*, No. 2 (March, 2004), pp. 16-20.

different mechanisms, including the market, networks, corporations, and the state.<sup>9</sup> Also, there are no studies that have analyzed whether the “Wenzhou model” changed or not after the Wenzhou financial crisis in 2011, with the exception of one which argued that Wenzhou has transformed from the semi-laissez faire market economy to an associational-coordinated market economy because the role of business associations has changed.<sup>10</sup> However, this might be an ostensible effect of business associations in an authoritarian regime.<sup>11</sup>

## 2.2 Theoretical Approaches

In recent research on economic performance many scholars have recognized that economic growth cannot be fully explained by the ability of a society to increase its physical capital, human capital, and improve its technology. Instead, the role of institutions in economic growth has been stressed. According to North, “Institutions are the rules of the game in a society or, more formally, are the humanly devised constraints that shape human interaction.”<sup>12</sup> Institutions conducive to economic development reduce the transaction costs of economic activity, and ensure the enforcement of contracts for trade.

Historical institutionalism uses institutions to find sequences of social, political, economic behavior and change across time, and to explain the difference of policies among countries from the perspective of macro contexts. As actors are shaped by the

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<sup>9</sup> J. Rogers Hollingsworth and Robert Boyer, *Contemporary capitalism: The Embeddedness of Institutions* (Cambridge, U.K.; New York: Cambridge University Press, 1997).

<sup>10</sup> Yia-Ling Liu, (2011). “Coping Strategies and Institutional Divergence in the Economic Transition of Wenzhou and Wuxi,” *Taiwanese Sociology*, No. 22, pp. 59-110.

<sup>11</sup> interview with L business, 2012

<sup>12</sup> Douglass North, *Institutions, Institutional Change and Economic Performance* (Cambridge: Cambridge University Press, 1990).

broader institutional environment, institutions are equally the outcome of particular constellations of actors and their interactions. As a result, historical institutionalists embrace the notion that policy-making and institutional change have a tendency to be path-dependent processes because institutions restrict the choices available to decision makers, and decision makers would incrementally adjust their policies.<sup>13</sup>

There are two types of path dependent patterns: self-reinforcing sequences, and reactive sequences. The path-dependent process of self-reinforcing sequences means that in an increasing returns process, the probability of further steps along the same way increases once a specific trajectory of institutional development is established. It is difficult to reverse the track because the relative benefits of the current activity increase over time.<sup>14</sup> In the case of reactive sequences, according to Mahoney, "Reactive sequences are chains of temporally ordered and causally connected event."<sup>15</sup> Reactive sequences observe a final event as an outcome and then analyze the chain of events as a path leading up to this outcome. In other words, self-reinforcing sequences stress mechanisms of institutional reproduction, while reactive sequences support the possibility of institutional change.

While created, institutions tend to change in subtle and gradual ways over time.<sup>16</sup> However, when an exogenous shock impinges on the existing institutional system, and

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<sup>13</sup> Paul Pierson, "Increasing returns, Path Dependence, and the Study of Politics," *American Political Science Review*, Vol. 94, No. 2 (June 2000), pp. 251-267.

<sup>14</sup> Brian Arthur, *Increasing Returns and Path Dependence in the Economy* (University of Michigan Press, 1994); Paul Pierson, "Increasing returns, Path Dependence, and the Study of Politics," *American Political Science Review*, Vol. 94, No. 2 (June 2000), pp. 251-267.

<sup>15</sup> James Mahoney, "Path Dependence in Historical Sociology," *Theory and Society*, Vol. 29, No. 4 (2000), pp. 507-48.

<sup>16</sup> James Mahoney, and Kathleen Thelen, "A Theory of Gradual Institutional Change," in James Mahoney and Kathleen Thelen eds., *Explaining Institutional Change: Ambiguity, Agency, and Power* (New York: Cambridge University Press, 2010), pp. 1-37.

severely challenges mechanisms of institutional reproduction, critical junctures open up opportunities to alter the trajectory of institutional development.<sup>17</sup> Building on the theoretical insights of historical institutionalism, this article examines three crucial features of the “Wenzhou model” – informal finance, private enterprises, and an inactive role of the local government—to explain the path of economic transition in Wenzhou.

### **3. Economic Development of Wenzhou and Local Governance before 2011**

As one of the most affluent cities in China, Wenzhou’s economy has been booming since 1980 (Figure 1) and Wenzhou’s businessmen, called “Jews of the Orient,” hold an important position in the Chinese domestic markets. The yearly economic growth rate of Wenzhou usually rises faster than an average rate of China and Zhejiang (Table 1).

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<sup>17</sup> Stephen D. Krasner, “Approaches to the State: Alternative Conceptions and Historical Dynamics,” *Comparative Politics*, Vol. 16, No. 2 (Jan. 1984), pp. 223-246.; Paul Pierson, “Not Just What, but When: Timing and Sequence in Political Processes,” *Studies in American Political Development*, Vol. 14, Issue 1 (April 2000), pp. 72-92.



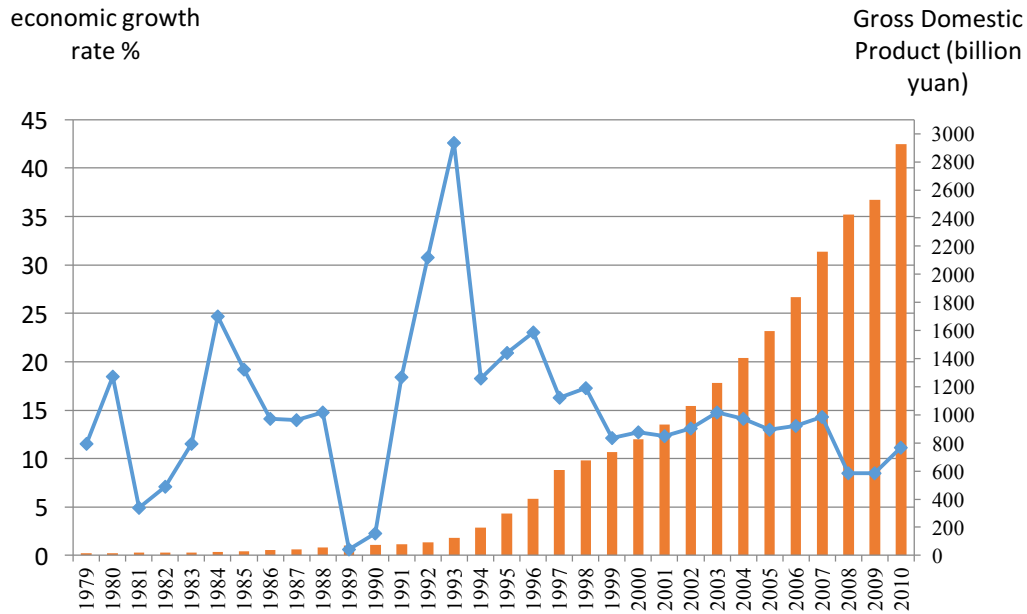


Figure 1: Economic Situation in Wenzhou

Table 1: Yearly Economic Growth Rate

Unit: %

Year	China	Zhejiang	Wenzhou	Year	China	Zhejiang	Wenzhou
1979	7.6	13.6	11.5	1995	10.9	16.8	20.9
1980	7.8	16.4	18.5	1996	10.0	12.7	23.0
1981	5.2	11.5	4.9	1997	9.3	11.1	16.3
1982	9.1	11.4	7.1	1998	7.8	10.2	17.3
1983	10.9	8.0	11.5	1999	7.6	10.0	12.2
1984	15.2	21.7	24.7	2000	8.4	11.0	12.7
1985	13.5	21.7	19.2	2001	8.3	10.6	12.3
1986	8.8	12.1	14.1	2002	9.1	12.6	13.1
1987	11.6	11.8	14.0	2003	10.0	14.7	14.8
1988	11.3	11.2	14.8	2004	10.1	14.5	14.1
1989	4.1	-0.6	0.6	2005	11.3	12.8	13.0
1990	3.8	3.9	2.3	2006	12.7	13.9	13.4
1991	9.2	17.8	18.4	2007	14.2	14.7	14.3
1992	14.2	19.0	30.8	2008	9.6	10.1	8.5
1993	14.0	22.0	42.6	2009	9.2	8.9	8.5

1994	13.1	20.0	18.3	2010	10.4	11.9	11.1
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Source: China Statistical Yearbook, Zhejiang Statistical Yearbook, and Wenzhou Statistical Yearbook.

Despite Wenzhou's remarkable economic performance since the 1980s, in comparison with other municipalities in Zhejiang, its recent decline in GDP growth rate has made Wenzhou's local officials anxious. In 2000 Wenzhou had the highest GDP growth rate among cities in Zhejiang, but this city's growth rate of GDP slipped into the weakest level since 2003, as illustrated in Table 2.

Table 2: Rankings of Municipal GDP Growth Rates in Zhejiang Province: 2001-2010

排名	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010
1	Lishui	Taizhou	Jiaxing	Zhoushan	Zhoushan	Zhoushan	Zhoushan	Zhoushan	Quzhou	Jiaxing
2	<b>Wenzhou</b>	Jiaxing	Ningbo	Jiaxing	Huzhou	Quzhou	Quzhou	Quzhou	Zhoushan	Quzhou
3	Jiaxing	Shaoxing	Jinhua	Jinhua	Quzhou	Taizhou	Lishui	Lishui	Lishui	Taizhou
4	Hangzhou	Lishui	Zhoushan	Ningbo	Taizhou	Hangzhou	Ningbo	Hangzhou	Huzhou	Lishui
5	Ningbo	Ningbo	Hangzhou	Huzhou	Lishui	Huzhou	Jinhua	Huzhou	Hangzhou	Jinhua
6	Taizhou	<b>Wenzhou</b>	Huzhou	Shaoxing	Shaoxing	Jiaxing	Hangzhou	Jiaxing	Jiaxing	Ningbo
7	Zhoushan	Hangzhou	Shaoxing	Quzhou	Jiaxing	Jinhua	Jiaxing	Jinhua	Shaoxing	Huzhou
8	Huzhou	Jinhua	Taizhou	Hangzhou	Hangzhou	Lishui	Taizhou	Ningbo	Jinhua	Hangzhou
9	Shaoxing	Quzhou	<b>Wenzhou</b>	Lishui	<b>Wenzhou</b>	Ningbo	Huzhou	Taizhou	Ningbo	Zhoushan
10	Quzhou	Zhoushan	Quzhou	<b>Wenzhou</b>	Jinhua	<b>Wenzhou</b>	<b>Wenzhou</b>	Shaoxing	<b>Wenzhou</b>	<b>Wenzhou</b>
11	Jinhua	Huzhou	Lishui	Taizhou	Ningbo	Shaoxing	Shaoxing	<b>Wenzhou</b>	Taizhou	Shaoxing

Another reason of anxiety for Wenzhou officials has been capital outflows, enterprise relocation elsewhere, and industrial inaction. Many small-and medium-sized enterprises needed extra land to accommodate production expansion, but

instead faced land shortages and skyrocketing prices.<sup>18</sup> Because of rising production costs and short supply of land, many local companies lacking of assistance from local government move out of Wenzhou to seek higher returns.

To rescue the economic recession, in 2004, Wang Jianman, the Wenzhou Municipal Party Committee Secretary, stated: “Without an export-oriented economy, we cannot survive, become wealthy, and achieve high productivity and a high speed of economic development”. The “opening up office” (*kai fang ban*) was established, and investment was regarded as the “No. 1 Project” of the city. The government held a dialogue with the Fortune 500 Forum to assist local enterprises in cooperating with large multinational, inter-provincial companies.<sup>19</sup> During his time as the leader of Wenzhou, Wang Jianman established the following prescriptions for Wenzhou’s economy: investment attraction, the development of the heavy chemical industry, and the construction of a deep-water port. Prior to his leadership, the Wenzhou government was not interested in investment attraction.

According to the development direction raised by Wang Jianman, under the pressure of economic weakness, the government of Wenzhou began attempting to change the past style of inaction of the local government. With the guidance of the government, the policy of “emptying the cage and removing the bird” was implemented to guide the structural adjustment of the local economy and change the manner of growth of the local economy to achieve the goal of investment attraction. In addition to giving preferential policies, the amount of foreign investment attracted

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<sup>18</sup> See <http://www.people.com.cn/GB/jingji/1045/2296402.html> (1/14/2004).

<sup>19</sup> “Wang Jianman, Zhejiang Wenzhou Municipal Party Committee Secretary: New Policies on Investment Attraction”, Sina.com, January 9, 2006, <http://news.sina.com.cn/c/2006-01-09/17568816626.shtml>.

was even included in the assessment indicators of officials in Wenzhou.

However, although the goal of investment attraction was achieved, the actual results it brought did not meet expectations. Wenzhou was originally sufficient in the amount of private capital and had many small and medium enterprises. There has been excessive competition in general private areas, and local companies had time to stay afloat and had to explore opportunities outside of Wenzhou. Therefore, companies did not come to Wenzhou even with the government attracting investment. In addition, the cost of land in Wenzhou is very high, and the marginal benefit of investment is very low. Thus, it is difficult to attract enterprises to enter Wenzhou due to the lack of profit. After the publication of favorable policies for foreign capital, many Wenzhou businessmen even registered abroad and returned to invest to enjoy the favorable policies for foreign capital.<sup>20</sup> In other words, the market competition in Wenzhou is fierce, and private funds are sufficient. What the city needs is investment opportunities. The local government attempted to guide economic development but could not effectively perform industrial upgrading. Blindly introducing foreign investment alone only offered an opportunity to flexible Wenzhou businessmen to earn government concessions but was unable to substantially improve industrial and economic development in Wenzhou.

#### **4. The Development of Wenzhou Financial Crisis in 2011**

Wenzhou has abundant private capital, and underground financing has always been highly developed. For a long period of time, mutual beneficial “associations” (*hui*)

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<sup>20</sup> Interview with a professor at Zhejiang University on July 10, 2012. Interview with the Deputy Director of the Policy Research Office of Wenzhou Municipal Party Committee on July 19, 2012.

have been very popular. In the 1970s and 1980s, “associations” were the most typical method of private financing in Wenzhou. With the continuous expansion of “associations” and their ever-changing types and forms, an increasing number of people made profits from them or committed fraud, which made the risk of “association bankruptcy” increasingly high. However, even if the risk of bankruptcy existed, “associations” of various natures remained very popular in Wenzhou. Because of the lack of support for the private economy from the existing financial system, small and medium enterprises in Wenzhou are mostly dependent on financing outside of the system and financing through mutual funds in the forms of civil united societies, rotating savings, etc.

With economic development, enterprises’ demand for funds increased, and the old way of depending on friends and family for financing could not meet enterprises’ needs for funds. Consequently, security companies, pawn shops, and underground financial institutions emerged at the right moment. According to the questionnaire of the Wenzhou Central Branch of the People’s Bank of China on private lending, the scale of private lending in Wenzhou in 2010 was approximately RMB 80 billion yuan, and the financing agencies engaged in the lending were mainly high-interest loan security companies, pawn companies, etc.<sup>21</sup> The wildly soaring interest rates and the large number of investments by companies resulted in the exposure of private lending in Wenzhou to high risk. Once a company has a cash flow problem, the problem will not only lead to economic disputes but also most likely cause breaks in the capital chain

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<sup>21</sup> Please refer to “Wenzhou city is filled with high-interests loans and people are crazy about buying and building houses”, **Tencent Finance**, December 18, 2010, <http://finance.qq.com/a/20101218/001727.htm>

and then spread to the entire underground finance system.

The 2011 Wenzhou financial crisis was due to the breaking of the capital chains of enterprises. Since April 2011, the number of bankrupt companies and fleeing factory owners in Wenzhou has risen. These cases involved in many banks, firms and vast sums of money. From April to September 2011, more than 80 entrepreneurs had run away from Wenzhou because of bad debts<sup>22</sup> and a report by Credit Lyonnais Securities Asia suggested that the total private loans in Wenzhou could be as high as 8,000 billion yuan to 10,000 billion yuan, and that an estimated 10% to 15% of this amount would become bad debts.<sup>23</sup>

In September 2011, the chairman of the Xintai Corporation abandoned his homes and firms and absconded due to the credit crunch. This not only was a terrible shock to Wenzhou industrial areas but also drew the central government's attention since the Xintai Corporation is the biggest manufacture of glasses in Wenzhou. In addition, this company owns the first "Chinese well-known trademark" for its product "Porpoise Eyewear," which is the best-selling brand of glasses in Chinese domestic markets.<sup>24</sup>

Because of the mutual guarantees of companies, private lending involved a number of security companies and banks; the bankruptcies of enterprises attracted tremendous public attention, ultimately attracting the concern of the Chinese State Council. In order to allay fears of the worried citizens and businessmen, China's prime minister Wen Jiabao when visiting Wenzhou in October 2011, commanded the

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<sup>22</sup> *Fears surface over Chinese debt amid lending practices.* BBC News, October 6, 2011, from <http://www.bbc.co.uk/news/mobile/business-15194663>.

<sup>23</sup> Huang, Siyuan and Qian Niu Wei (2011). *Photo: Wenzhou private lending up to 150 billion this year, bad debts or family involved in Jiucheng.* from <http://www.instant-news.us/news-108827.html>.

<sup>24</sup> See <http://www.china-center.com/>.

Wenzhou government to help its economy recover as soon as possible and directed banks to ease credit to businesses. Wenzhou was required to stabilize the economic and financial situation within a month and to calm down the “running away trend” of business owners. On October 12, 2011, the Chinese State Council promulgated the “National Nine Suggestions” (*Guo Jiu Tiao*), giving policy support to small and micro enterprises in aspects related to financing and taxation.

After the CPC Central Committee clearly instructed Wenzhou to stabilize the economic situation as soon as possible, the Wenzhou municipal government established a local financial supervision center in November 2011 and immediately drafted an “Overall Plan on the Comprehensive Financial Reform Pilot Zone in Wenzhou”, which was reported to the Chinese State Council through the Zhejiang provincial government. In March 2012, the Chinese State Council decided to establish a comprehensive financial reform pilot zone in Wenzhou and formulated 12 major tasks. At that point, the financial crisis triggered by the “running away” of business owners finally came to an end.

## **5. The Effect of the Wenzhou Financial Crisis in 2011**

### **(1) Effects on private enterprises**

Because the consolidated interest rate of private lending in Wenzhou has been high, most private capital funds were poured into the private lending market because it is profitable. In addition, after the 2008 global financial tsunami, the Chinese government adopted a loose monetary policy; thus, a high amount of money was in the market. To implement the policies of upper management, banks even took the initiative to require companies to apply for loans. Many interviewees expressed this

point:

After the global financial crisis in 2008, the government invested RMB four trillion yuan to revitalize the economy. There were sufficient funds in the market, and housing prices doubled, with the total amount of loans in Wenzhou presenting more than 30% of the growth. Businessmen in Wenzhou believed that the financial crisis was a good thing. An important assessment indicator of bank executives was the banks' ability to achieve the national policy goals. Therefore, when the loose monetary policy was implemented, the expansion plan in the second half of 2008 and early 2009 enabled banks to have a high amount of money, and they called enterprises every day to ask them to borrow money.<sup>25</sup>

If companies applying for bank loans were unable to provide sufficient collateral, in addition to the mutual guarantee of a number of companies, the banks also "introduced" the enterprise to a security company to be secured by the company for loans. Some security companies, pawn shops, and other financial intermediaries obtained loans from the banks and then lent money to companies.<sup>26</sup> Regarding these financing manners, in the former case, the bank required the security company to have money deposited in the bank, which means that the bank had established a firewall for itself. Thus, if there was a problem, this approach ensured that the bank could recover the loan and would not be affected.<sup>27</sup> In the latter case, although it solved the

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<sup>25</sup> Interview with a professor at Zhejiang University on July 10, 2012; interview with a professor at the Wenzhou Party School on July 14, 2012; interview with a professor at the Wenzhou Party School on July 15, 2012; interview with the vice president of the Wenzhou City Social Science Association on July 21, 2012.

<sup>26</sup> Interview with a professor at the Wenzhou Party School on July 15, 2012.

<sup>27</sup> Interview with a professor at the Wenzhou Party School on July 14, 2012; interview with a professor at the Wenzhou Party School on July 15, 2012.



problem posed by small and medium enterprises when they wanted to apply for loans but could not provide a mortgage, third-party security had to be involved, and in this manner, the high costs of credit financing of small and medium enterprises within the system were reduced. However, the mode of operation of this dual intermediary changed. Banks went from loaning money directly to enterprises to loaning to security companies, with the security companies then loaning money to enterprises. This approach raised the financing costs of enterprises. When enterprises have higher capital costs, the means of business operations of the company change to short-term operations, and the company tends to engage in high-risk and high-return investments.<sup>28</sup> Once enterprises experience these business operations or investment problems, funding problems occur in enterprises and security companies and other intermediaries.

With the changes in the national policy, the Chinese government began to tighten the monetary policy in 2010, implementing real estate regulations, and companies began to experience a tight funding situation. Many enterprises had cash flow problems because they could not repay their loans, and security companies were also affected. An interviewee noted this point:

If an enterprise did not have sufficient funds to repay the loan, the bank would advise the enterprise to borrow money from a security company (for example, borrowing money for one week) and would also help the enterprise to complete all of the formalities. After one week, the bank would make the loan to the enterprise so that the enterprise could repay the money. However, when the bank tightened the

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<sup>28</sup> Interview with a professor at the Wenzhou Party School on July 15, 2012.

control of funds, after the enterprise borrowed money from the security company, the bank refused to lend money to the enterprise. Subsequently, the enterprise could not repay the money to the security company. Ultimately, the enterprise went bankrupt, and the security company shut down.<sup>29</sup>

In summary, due to the close mutual guarantee relationships among the enterprises in Wenzhou or the guarantee chain relationships between companies and security companies, once one of the enterprises had funding problems, the entire system collapsed, as in a domino effect, capable of hitting small and medium enterprise in Wenzhou hard. Second, the breaking of capital chains, bankruptcies, and the running away of business owners also caused serious damage to the private credit environment in Wenzhou. The close interpersonal networks in Wenzhou in the past held up the private lending market and the development of private small and medium enterprises. After the occurrence of the 2011 Wenzhou financial crisis, not only did private lending in Wenzhou dramatically decrease but the entire private credit system in Wenzhou fell. The credit environment was extremely bad.<sup>30</sup> An interviewee said that “before the financial crisis, Wenzhou enterprises made some calls, and one or two hours later, one to two hundred million (RMB) could be transferred; now, transferring one or two million yuan (RMB) in an afternoon is unlikely”.<sup>31</sup> In other words, in the past, there were two markets in Wenzhou, the formal financial market and the underground financial market; after the financial crisis, the underground financial market on which private enterprises relied was disrupted, and companies were unable

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<sup>29</sup> Interview with a professor at the Wenzhou Party School on July 14, 2012.

<sup>30</sup> Interview with the general manager of a small loan company in Wenzhou on September 26, 2013

<sup>31</sup> Interview with the chairman of a funds management company in Wenzhou on September 16, 2013.

to obtain loans from the formal financial market, resulting in more difficult conditions for the development of small and medium enterprises.

## (2) Responses of the local government of Wenzhou

### **2.1 The Role of Wenzhou Local Government before 2011**

In the process of the rapid economic development from the 1980s to 2010, private-sector firms dominated Wenzhou's economy as early as 1985<sup>32</sup> when the local government was seen as playing an inactive role. For example, the Wenzhou government did not take any measures to deal with market failure in the fierce competition which caused firms to produce plenty of fake commodities due to reducing costs. In comparison with other local governments in China, the local authority in Wenzhou either provided little public service such as good public transportation and critical infrastructure or mandated local firms to pay for public projects. Local business preference policies to attract and encourage investment such as tax relief were not made by the Wenzhou government. All these indicate that the Wenzhou government is a "small government" without intervening in economies.

### **2.2 The Role of Wenzhou Local Government after 2011**

After the occurrence of the 2011 Wenzhou financial crisis, to calm the situation, the local government of Wenzhou adjusted, changed the land use restrictions and changed the nature of lands for enterprises encountering funding issues and facing bankruptcy, changing lands that originally could only be used to build factories to allow the building of residences to help enterprises through the crisis. Second, the local

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<sup>32</sup> Yia-Ling Liu, (1992). "Reform from Below: The Private Economy and Local Politics in the Rural Industrialization of Wenzhou," *China Quarterly*, No. 130, pp. 293-316.

government of Wenzhou established relief funds for lending use; that is, when an enterprise loan was due but the account receivable had not yet been received, the government set aside funds from the relief funds to allow the enterprise to repay the loan first. Simultaneously, the local government of Wenzhou also asked banks to extend the loan terms for enterprises, allowing them to borrow first before repayment and relaxing audit criteria for assets mortgaged to the bank by enterprises.<sup>33</sup> One interviewee said the following:

After the 2011 financial crisis, the Municipal Party Committee, 25 national financial institutions in Wenzhou, and the Wenzhou Bank sent 25 working groups to supervise banks so that the banks would not blindly recover loans because if the banks recovered loans and stopped issuing new loans, the funds of enterprises and the circulating funds of security companies would be jeopardized. The municipal government even once permitted security companies to conduct business related to loans again after loan repayment, which security companies were originally not allowed to do. During the early period of crisis management (the end of 2011), the banks were required to sign undertakings for loan renewal if the enterprise repaid the loan. When the loan of an enterprise was due, it would look for security companies for turnover, and the bank would continue to provide loan funds to it.<sup>34</sup>

Apart from the hard hit to small and medium enterprises in Wenzhou by the private lending crisis, the economic growth rate of Wenzhou ranked almost last in the Zhejiang Province rankings, which also exerted pressure on the Wenzhou city

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<sup>33</sup> Interview with a professor at the Wenzhou Party School on July 15, 2012.

<sup>34</sup> Interview with the Deputy Director of the Policy Research Office of Wenzhou Municipal Party Committee on July 19, 2012.

government. In February 2011, the Wenzhou Municipal Party Committee Secretary, Chen Derong, noted that the main reason why development in Wenzhou lagged behind was lack of investment. To promote the restructuring and development of Wenzhou, government-led investment must be strengthened and “large, excellent, high, and new” projects should be gathered at a large platform. He also raised the annual investment target rate of 50% and required a large investment to promote large construction and great development.<sup>35</sup>

In 2010, the Wenzhou government reorganized 9 state-owned business groups to take responsibility for investment in 9 industries including airports, ports and transportation. Figure 2 shows that from 2000 to 2010, the average growth rate of fixed assets investment in Wenzhou was 34.1%, which is lower than the average rate of China and Zhejiang,<sup>36</sup> but in 2011 and 2012, the amount of fixed assets investment was over 1,500 million and 2,100 million yuan. Investment-driven from the government, the amount of fixed assets investment in Wenzhou increased rapidly from 2011 to 2012 when these investments from the 9 state-owned business groups were focused on infrastructure. The 9 state-owned business groups borrowed capital from banks that resulted in the financial exclusion to make individuals, households or businesses unable to access necessary financial services.

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<sup>35</sup> “Speech by the Deputy Mayor and the Municipal Party Committee Secretary, Chen Derong, on the General Assembly Meeting of third level cadres of the city”, **Wenzhou Water Conservancy Website**, February 23, 2011, <http://www.wzsl.gov.cn/system/2011/02/23/010760795.shtml>.

<sup>36</sup> See <http://www.daluom.com/read.php?tid-30401.html>.

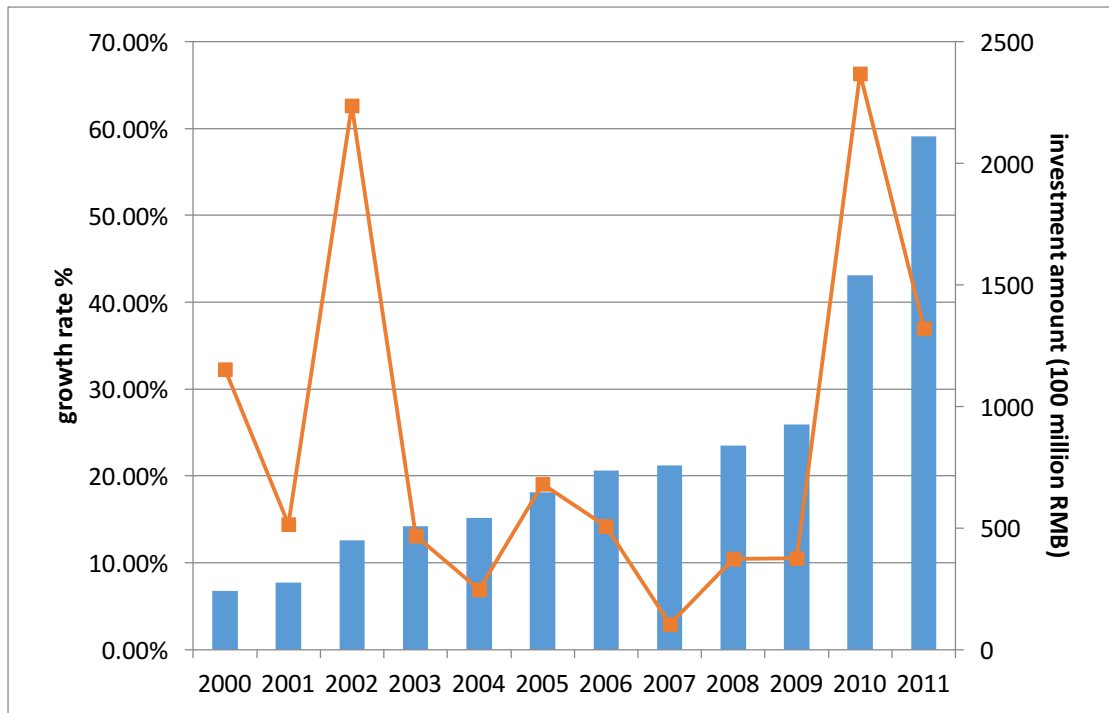


Figure 2: Fixed Assets Investment in Wenzhou

In addition, starting from 2011, the Wenzhou city government began the mass demolition of illegal construction, performed the demolition of villages within the city, and enacted the “illegal must be removed, the buildings in the six situation must be removed” policy, thereby cleaning up the city and also increasing the supply of land. Since the implementation of the “large investment” strategy, to achieve the annual investment target rate of 50%, every year, there must be five acres of land supply. However, according to the survey, from 1999 to 2009, there were nearly 10 acres of land “that were transformed but did not supply”. To complete the investment target, the Wenzhou city government required cadres at all levels to clean up the land and improve the land supply rate.<sup>37</sup> Wenzhou’s cityscape was indeed greatly improved

<sup>37</sup> “Wenzhou cleaned up 41,000 acres of land ‘that was transformed but did not supply’ and cleared away the largest system barriers”, Xinhua News, May 4, 2011, [http://big5.xinhuanet.com/gate/big5/news.xinhuanet.com/2011-05/04/c\\_121376786.htm](http://big5.xinhuanet.com/gate/big5/news.xinhuanet.com/2011-05/04/c_121376786.htm).

after this rectification; however, the demolition also had a serious impact on the survival of small and medium enterprises. Most small and medium enterprises in Wenzhou were developed from family workshops, and a large number of family-owned enterprises existed across the city and suburbs in Wenzhou, placing factories and businesses next to houses. After the start of demolition, many small and medium enterprises and family-owned factories were demolished and shut down. Due to the high cost of land in Wenzhou, these enterprises were unable to purchase land to build new plants, which ultimately led to the result that these small and medium enterprises could not survive.<sup>38</sup>

These policies suggest that after the lending crisis in 2011, the Wenzhou government has become aggressive in economic development to foster economic growth. By restructuring state-owned companies to raise capital and dominate many public infrastructure projects, the local authority has been intervening in markets and this has resulted in the transformation of the “Wenzhou model”.

### (3) Institutional change opportunity

Recalling the economic development of Wenzhou, before the reform and opening up, the city had a unique history of “local self-liberation”, which created opportunities for the development of the private economy, forming the unique system heritage of Wenzhou. Since the reform and opening up, Wenzhou has followed the path of rapid private economic development and inaction by the local government. This result demonstrates the path of a self-reinforcing mechanism, i.e., private enterprises and private financing in Wenzhou flourished together, strengthening the anticipated

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<sup>38</sup> Interview with a professor at the Wenzhou Party School on September 27, 2013.

direction and path of system remanufacturing. However, after 2003, because the economic growth rate of the city ranked last among all prefecture-level cities in Zhejiang Province, the municipal government in Wenzhou implemented policies of investment attraction, petrochemical industry development, etc. The local government went all over China to attract investment; hence, the management style of inaction of the past changed, but the self-reinforcing mechanism in the path was not destroyed. Private capital in Wenzhou was abundant, but the city lacked investment opportunities. Thus, the policies of the local government only offered another opportunity to private enterprises in Wenzhou to earn preferential benefits but did not have an impact on the existing development path of Wenzhou.

However, after the 2011 Wenzhou private financial crisis, many companies had cash flow gaps due to the mutual guarantee of companies, causing a large number of enterprises to face bankruptcy. This crisis created an opportunity of system change. The private financial markets and private lending in Wenzhou were hit hard due to this private financial turmoil, the demolition projects of the local government also harmed the survival of small and medium enterprises, and the self-reinforcing mechanism of the original path was thus destroyed. Simultaneously, under the dual pressures of the financial crisis and economic backwardness, the government in Wenzhou intended to guide the various development and construction projects of Wenzhou through the establishment of state-owned group companies and improve economic growth by investment through the local financing platform and bank loans. Private enterprises in Wenzhou that had already been facing operational difficulties faced further troubles over enterprise survival due to the lack of support from the private financial market



and formal financing because of the financial crowding-out effect.

When facing external crises, the old system would not be easily replaced. The crisis would first erode the replication mechanism in the system and weaken the power for the continuous existence of the system. The 2011 Wenzhou private financial tsunami impacted the original development path of Wenzhou and damaged the system remanufacturing mechanism of the strengthened path, causing a system crisis. The subsequent actions of the local government simultaneously injected new condition factors in the existing development path and further destroyed the old self-reinforcing mechanism. In other words, the 2011 Wenzhou financial crisis was a crucial juncture that brought a shift opportunity to Wenzhou to change its path of development. However, whether it can actually break the path dependence, collapse the rigidity of resistance to change in the system and lead to changes in Wenzhou's model of development depends on whether the condition factors can further damage the remanufacturing mechanism of the old system.

## **6. Conclusion**

In this paper, we explained changes in the development path of Wenzhou after the occurrence of the 2011 Wenzhou private financial crisis based on path dependence theory in historical institutionalism. As a pioneer in China's market economy development, Wenzhou has always been famous for its private economic development. The economy has grown rapidly since the reform and opening up, and Wenzhou businessmen and Wenzhou enterprises are world-renowned. This coastal city, which lacks natural resources and the injection of capital from the central government, has received a considerable amount of attention from the public. In 30

years of economic development, the weak local government, the vitality and vigorous development of small and medium enterprises, and the development of private financing constituted the important characteristics of the Wenzhou model. However, the economic recession in Wenzhou in recent years has called into question whether the Wenzhou model is sustainably developed.

The unique system heritage of Wenzhou created conditions for private economic development. Once formed, inertia in the system after entering into a path occurred, causing changes to be resisted, which constitutes the current development path of the Wenzhou model. However, with the emergence of crisis, it is possible to erode the existing self-reinforcing mechanism. This paper shows that the three main features of the “Wenzhou model” have been dismantled in the aftermath of the 2011 lending crisis which resulted in the economic transition in Wenzhou.

After the 2011 Wenzhou financial crisis, a large number of small and medium enterprises in Wenzhou went bankrupt, private lending was damaged, and the city government of Wenzhou strongly pushed government-owned group companies to invest in construction in an attempt to lead economic growth in Wenzhou through government infrastructure investment. The reproduction mechanism in the old path of the development of Wenzhou, namely, private economy and private financing, was damaged. The measures taken by the Wenzhou city government to revitalize the weak economy further weakened the self-reinforcing mechanism in the original path of Wenzhou. The implication is that for the Wenzhou model, the 2011 Wenzhou financial crisis was a crucial juncture that created the possibility for change in the development path of Wenzhou. However, whether it can actually break the dependence on the path

remains to be seen.

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