Social networks facilitate informal finance in the People's Republic of China

In Chinese culture, as in most other cultures, whom you know is often more important than what you know, and social networks of relatives, friends, or local links are recognized as important to cultivate for help in job hunting, career promotion, or gathering and disseminating information.

In developed economies, it's called "networking," or informal exchanges of business cards and ideas with like-minded people in social settings.

In the Peoples Republic of China, and among the Chinese diaspora, it's called "*guanxi*"—whom to call when something needs to be done, in an exchange of favors or potential influence—and it has long played a crucial role in facilitating informal credit activities.

This has been particularly true during the PRC's transition from a planned- to a market-oriented economy, circumventing law-based protection in the context of a market system.

The commercialization of state-owned banks in the PRC led to the closure of tens of thousands of rural branches, cutting off people's access to financial services, which made access to formal credit difficult for rural and low-income households, as well as small and medium-sized enterprises.

Informal financial markets emerged to provide an alternative source of lending.

As the market economy and formal financial institutions expand in the PRC, the role of *guanxi* comes under scrutiny, because it's not bound by laws and regulations.

The strength of a social network can be measured as a ratio of gift expenses for important events such as wedding, funeral or birthday ceremonies to an anticipated financial outcome, because the offering of gifts is a key factor in the PRC to maintain a network of relationships.

The first element in the analysis is that information, particularly private information, quickly circulates within a tight-knit social network, and default on an informal loan, or misbehavior, is almost immediately known by the group.

Conversely, a household with a strong social network and good reputation wanting to borrow money can easily identify a source of funding.

In the absence of formal credit scores, the social reputation of potential borrowers is key.

Empirical data, taken from the 2011 China Household Finance Survey, confirm that social networks steer both informal lending and informal borrowing by making private information on creditworthiness easily available at a low cost.

A second element is that social ties act as implicit collateral in the absence of tangible assets.

Kinship networks provide full or partial insurance against risks to the lender and compensate for unexpected financial losses, reducing risk.

In the PRC, given the weakness of the formal insurance markets, people set aside money as a reserve against future uncertainty and unavoidable expenditure such as a health crisis or a business downturn, or for retirement, or for a child's education, which involves not only buying a house within a good school district but also subsequent access to good regional tertiary education facilities.

This puts a brake on consumption.

Empirical data show that social networks can offer full or partial insurance against unpredicted events and income shocks, so the need for such a precautionary reserve can be reduced for a household with strong social ties.

Further analysis suggests individuals tend to have a higher degree of perceived risk when they become older and are less willing to lend or borrow.

Social networks are becoming more important for urban households than rural households, because during the economic transition from traditional agricultural to industrialized societies, social ties are weakened amid large-scale urbanization and migration, and *guanxi* needs regular cultivation.

The PRC's economic transition was born from a unique political and social structure. Because of their historical networks, long-established interest groups are well-positioned to take advantage of the economic transformation.

They tend to benefit from the development of new formal institutions through rent-seeking, which is important in the new institutional context.

The development of the formal financial market complements social networks in promoting financial activities, as interest groups use their reinforced power to further participate in the informal financial markets.

This episode was based on research by Shijun Chai, a lecturer at Xinyang Normal University; Yang Chen, a lecturer at Xi'an Jiaotong-Liverpool University in Suzhou; and Dezhu Ye, a professor at Jinan University in Guangzhou, all in the People's Republic of China; and Bihong Huang, a research fellow at ADBI.

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