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China Aims to Curb Underground Loans;

It raises benchmark interest rates for the first time in nine years in part to spur use of state-run banks.

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SHANGHAI

Zhang Xin, a garrulous man with long curly hair, works out of a tiny office in a drab building that he calls a "big toilet." No matter; people flock to see him.

That's because the 34-year-old is a middleman in China's growing black market for loans, and business is so brisk he can barely keep up.

"I wish I could help everyone coming to me," he said.

As the government has curbed bank lending in the last year to cool China's sizzling economy, many private businesses have turned to people like Zhang to lead them to an array of groups and companies that are using back channels to feed billions of dollars into land deals, steel plants and other ventures.

The rise of these underground money houses helps explain why China's economy hasn't slowed down much at all. And it was a major factor in Beijing's surprise move Thursday to raise the nation's benchmark interest rates for the first time in nine years.

Many analysts noted that the primary aim of the quarter-point increase was to show the world that China was willing to use market forces -- instead of command-and-control tactics -- to help engineer a slower and more sustainable economic growth rate.

But there was clearly another goal as well: to discourage underground lending by giving citizens a higher rate for their deposits in state-run banks.

Indeed, evidence has been mounting that Beijing's top-down policies were being undermined by a burgeoning informal banking system.

Both industrial production and fixed investment in land, buildings and equipment rebounded at the end of the summer -- at least partly stimulated by underground loans. Meanwhile, government data show that there has been a sharp decline in the growth of bank deposits in China.

Analysts said **many more individuals** and businesses **have been shunning banks,** almost all of them government-owned, and the paltry interest they've paid on deposits. Instead, their money has gone into alternative channels offering higher returns.

Tao Dong, an economist at investment bank Credit Suisse First Boston in Hong Kong, estimated that as much as $17 billion had been poured into black-market financing in the last two months.

At the same time, businesses in search of loans have been tapping funds coming from overseas companies as well as from speculators in Hong Kong, Taiwan and elsewhere who are betting on China's hot real estate market and currency rising.

It's unlikely that Thursday's rate hike of 0.27 percentage point will put a big dent in China's informal banking market. The benchmark interest rate on one-year deposits at banks will still pay only 2.025%. Meanwhile, the one-year lending rate went from 5.31% to 5.58%.

However, if the People's Bank of China continues to push up rates, as analysts believe it will, it could slow the underground activity -- and more important for Beijing, give it a little more control over the economy.

"It will tend to quell domestic investment, hence domestic production," said Tony Hughes, who covers China out of Australia for Economy.com. At the same time, he said, it wasn't clear that the rate hike, even if the first in a series, would tamp down inflation.

Beijing officials, for their part, haven't said much publicly about the black lending market. On Thursday, China's central bank said the rate increase was needed "to address recent conflicts and problems, and to further consolidate the results achieved."

Underground lending has grown in cities dominated by private enterprises, such as Wenzhou in Zhejiang Province, where many businesses have long dismissed banks in favor of loans from individuals or organized groups. But more recently, the practice has spread throughout China as the country has moved from communism to a market economy and many more people have formed smaller firms.

It's no secret that China's banks prefer to lend money to large state-owned companies, which are well-connected politically. Businesspeople say that favoritism has become all the more glaring in the wake of Beijing putting restrictions on how much money banks could loan.

The interest rate hike was thus welcomed by many businesses that have been shut out by state-owned banks.

"The government should have done this a long time ago," said Wang Shiyu, vice president of China Feitian Industrial Co. in Shanghai. "It's much better and [more] proper than administrative behavior, which was like knife chops."

Wang said that his company, which manufactures semiconductors and pharmaceuticals, was abruptly cut off by the state bank late last year.

Still, he said Feitian had refrained from borrowing from informal banking sources. The main reason: Those loans come with an interest rate as high as 20%, whereas state-owned banks charge as little as 4.8% for a one-year loan.

While companies like Feitian scrounge for financing, many others are racing ahead with their projects.

In Shanghai, scores of construction cranes dot the city of 17 million, and analysts believe the city's real estate market is inflated. Morgan Stanley economist Andy Xie has long warned that inevitable interest rate hikes will boost mortgages and lead to a bust.

After slowing somewhat earlier in the year, Shanghai home prices have rebounded recently, with the average price per square foot in September rising 8% from August.

Some of the construction may never have happened without black market financing, according to brokers and bankers.

Zhang, the loan middleman, said he was aware of one deal in which a large state-owned company in Shanghai had lent $22 million to a land developer based in the nearby city of Hangzhou at an interest rate of more than 12%.

The Shanghai company, which he declined to name, had borrowed the money from a bank at a rate of 5%.

"It's been quite common for them to do this," he said.