

**IMPERFECT SUBSTITUTES: The Local Political Economy  
of Informal Finance and Microfinance in Rural China and India\***

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ABSTRACT

This paper compares the dynamics of informal finance and microfinance in rural China and India, and argues that the political economic context at the local level can explain why many policy interventions by the central state have had unintended consequences—namely, the continuing persistence of informal and illegal finance. Small business owners in both countries lack access to formal sources of credit; therefore, it is not surprising that farmers and petty traders generally rely on informal financing mechanisms, including community-based rotating savings and credit associations, moneylenders, and assorted finance companies. By the same token, central banking authorities in both countries have relied on similar strategies in dealing with such forms of informal finance: regulating them, banning them, and allowing certain types of microfinance institutions. The latter policy is intended to increase the availability of credit to low-income entrepreneurs and eliminate their reliance on apparently usurious and destabilizing financing means. Even though the scope and scale of officially sanctioned microfinance programs in India outstrips those in China, the intended clients of microfinance programs continue to draw on informal finance both countries. While developmental policy makers might interpret this as implying that microfinance institutions are ineffective across the board, this paper proposes instead that microfinance is not a perfect substitute for informal finance because most localities have internal political and economic hierarchies that create market segmentation in the demand and supply of resources, including investment and working capital.

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### **List of Abbreviations**

ABC	Agricultural Bank of China
ADB	Asian Development Bank
AFC	Agricultural Finance Corporation
AIDIS	All-India Debt and Investment Survey
CASS	Chinese Academy of Social Sciences
FPC	Funding the Poor Cooperative
HPF	Hire-Purchase Finance
ICMB	Industrial and Commercial Management Bureau
IFAD	International Fund for Agricultural Development
IRDP	Integrated Rural Development Program
MCA	Ministry of Civil Affairs
MFI	Microfinance Institution
MOA	Ministry of Agriculture
NABARD	National Bank for Agriculture and Rural Development
NBFC	Non-banking Finance Corporation
NBFI	Non-banking Financial Institution
NGO	Non-governmental Organization
PA	Poverty Alleviation
PBC	People's Bank of China
PRC	People's Republic of China
RBI	Reserve Bank of India
RRB	Regional Rural Bank
RCC	Rural Credit Cooperative
RCF	Rural Cooperative Foundation
ROSCA	Rotating Savings and Credit Association
SETC	State Economic and Trade Commission
SHG	Self-help Group

### **Exchange Rates as of 2002**

US\$1	= 48.12 rupees (Rs)
US\$1	= 8.28 renminbi (RMB)

“[O]fficial reports of the moneylender’s impending demise are much exaggerated.”

- Clive Bell on India (1990)<sup>1</sup>

“The fact that these private or underground credit money houses exist and sometimes thrive in the countryside even today has revealed that farmers need them.”

- *People’s Daily* on China (2002)<sup>2</sup>

Developmental economists have long noted the complexity of providing effective rural credit delivery in large, agrarian countries such as India and China.<sup>3</sup> Establishing and maintaining a network of rural financial institutions is expensive, and managing their operations is difficult in the absence of proper training, monitoring, and incentive structures. The operational challenges of rural financial intermediation are compounded by state development strategies that promote industrialization and urbanization at the expense of agricultural production. At the macro-level, the notorious scissors gap between agriculture and industry redistributes savings from rural to urban areas, thereby limiting the relative supply of rural credit. At the micro-level, this means that even well located rural households that have the option of keeping their savings in official financial institutions may lack access to formal sector credit and rely instead on a wide range of informal, curb market mechanisms.

It is in this context that governments throughout the developing world have regarded informal finance as a negative reflection of deficiencies in the formal financial system. In both China and India, the traditional image of the usurious moneylender adds an additional pejorative layer to the official depiction of informal finance: when the poor lack access to conventional

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<sup>1</sup>Clive Bell, “Interactions between Institutional and Informal Credit Agencies in Rural India,” *The World Bank Economic Review* 4, 3 (September 1990), 298.

<sup>2</sup>“Farmers Need Money to Run for Xiaokang,” *People’s Daily Online*, November 29, 2002, at [http://english.peopledaily.com.cn/200211/29/eng20021129\\_107673.shtml#](http://english.peopledaily.com.cn/200211/29/eng20021129_107673.shtml#).

<sup>3</sup>Useful compilation of the debates include F.J.A. Bouman and Otto Hospes, eds., *Financial Landscapes Reconstructed: The Fine Art of Mapping Development* (Boulder, CO: Westview Press, 1994); and Karla Hoff, Avishay Braverman, and Joseph Stiglitz, eds., *The Economics of Rural Organization: Theory, Practice, and Policy* (New York: Oxford University Press for The World Bank, 1993).

sources of credit, they are exploited by loan sharks and other illegal curb market operators. According to this logic, the prescription thus requires increasing state efforts to eliminate informal finance, while enhancing the availability of state-sanctioned financial intermediaries, especially microfinance programs devoted to poverty alleviation. Even with these policy measures, however, small business owners and farmers continue to rely primarily on curb market finance in both China and India. This raises the question of why the state is able to “command” the creation of formal financial institutions, but unable to eliminate less conventional forms of financing. In analyzing the puzzling persistence of informal finance, this paper argues that informal finance and formal finance are imperfect substitutes because credit markets are segmented by local political and social dynamics. This does not mean, however, that informal finance represents the zero-sum victory of society over the state. Informal finance is not purely an “anti-statist” or “societal” phenomenon, but rather, a product of local governmental and market interactions. Theoretically, this finding suggests a need to go beyond the basic state-society dichotomy by distinguishing between central versus local levels of the state, as well as examining intra-societal dynamics when explaining developmental outcomes.

The paper proceeds as follows. The first section reviews the key expressions of formal and semi-formal finance in China and India, and shows how the countries’ strategies in rural financial intermediation compare with one another. Both have relied on directed credit and encouraged the growth of microfinance programs, albeit to differing degrees. The second section outlines the main expressions of informal finance in China and India and discusses the extent to which they have been subject to state regulation. The third section delineates three competing explanations for why state efforts to substitute informal finance with microfinance have not been successful, and argues that local political and social conditions fundamentally

mediate state efforts at policy implementation. It also presents two local case studies from India and China, respectively, to illustrate the causal power of local political economic dynamics in financing rural development.

### **Financing Rural Development in China and India**

To understand the formal institutional context against which curb market activities have flourished, this section highlights major changes in the basic structure of rural finance. At various points in time, both countries have established credit cooperatives, commercial banks, and poverty alleviation microfinance programs in rural areas, but these formal sector institutions have not displaced informal and semi-formal sources of credit.<sup>4</sup>

#### *The Formal Financial Sector*

Following India's independence in 1947 and the establishment of the People's Republic of China (PRC) in 1949, the 1950s represented a relatively optimistic and ambitious phase for both countries in establishing a national system for agricultural finance. Both newly inaugurated regimes shared the developmental goals of promoting growth without exploitation, and creating grassroots-level savings and credit institutions to serve farmers.

Although India inherited a basic network of credit cooperatives from the colonial era, the Reserve Bank of India's (RBI) first decennial All-India Debt and Investment Survey in 1951 found that 93 percent of rural households relied on informal finance.<sup>5</sup> Hence, after the 1955 nationalization of banks, the government actively promoted the expansion of cooperatives to

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<sup>4</sup>By definition, *informal finance* refers to financial flows that occur beyond the scope of a particular country's formal financial system of banks, non-banking financial institutions, and officially sanctioned capital markets. Most countries, however, also have a range of financial intermediaries that are best described as *semi-formal* because central banking authorities do not regard them as part of the formal financial system, but they may be approved by some government agency or entity. In India and China, the definitional boundaries among informal, semi-formal, and formal finance have shifted over the last half-century due to changes in their political, macroeconomic, and regulatory environments.

<sup>5</sup>F.J.A. Bouman, with René Bastiaansen, Han Van Den Bogaard, Henny Gerner, Otto Hospes, and Joost Groot Kormelink, *Small, Short, and Unsecured: Informal Rural Finance in India* (New York: Oxford University Press, 1989), 12-4.

enhance the availability of agricultural credit. In the mid-1970s, India's rural financial system went through another expansionary stage with the establishment of regional rural banks (RRBs) at the district level, farmers' service societies at the village level, and further growth of non-banking finance companies (NBFCs).<sup>6</sup> Even though the number of bank branches tripled between 1969 and 1979, rural access was still considered too low; therefore, in 1980 another seven commercial banks were nationalized for the purpose of extending their reach in rural areas.<sup>7</sup> In quantitative terms, progress has been made on this latter objective: according to the RBI, by 1998 India had a total of 64,547 RRB branches, which was equivalent to 17,000 to 21,000 rural citizens per bank branch.<sup>8</sup>

During the 1950s, China also set up a network of rural credit cooperatives (RCCs), but unlike the cooperatives in India, China's original RCCs acted mainly as fiscal institutions that funneled credit between the state and the people's communes rather than serving as commercial credit-granting institutions. It was not until the commencement of market-oriented reforms in the late 1970s that RCCs started to function more as grassroots banking institutions that served rural households and collective enterprises, and the Agricultural Bank of China (ABC) was re-established to handle larger scale commercial banking activities.<sup>9</sup> Meanwhile, in the early 1980s, the Ministry of Agriculture (MOA) established a network of Rural Cooperative Foundations (RCFs) to serve farmers, but as will be discussed below, they were never considered formal

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<sup>6</sup>RRBs represent a hybrid between cooperatives and commercial bank; they were established specifically to serve impoverished farmers, laborers, and microentrepreneurs in rural areas.

<sup>7</sup>Agricultural Finance Corporation (AFC), *Agricultural Credit Review: Role and Effectiveness of Lending Institutions, Vol. V* (Bombay: AFC, 1988), cited in Greetha Nagarajan and R.L. Meyer, *Rural Financial Markets in Asia: Paradigms, Policies, and Performance* (Manila: ADB, 2000), 172.

<sup>8</sup>According to a study commissioned by the Asian Development Bank, however, by 1999 India had a total of 140,000 branches of various rural credit facilities, which is equivalent to one formal financial institution per 5,600 rural citizens. See Sanjay Sinha, "India," in Asian Development Bank, *The Role of Central Banks in Microfinance in Asia and the Pacific: Country Studies, Vol. 2* (Manila: Asian Development Bank, 2000), 66.

<sup>9</sup>Note that in 1984, the responsibility for RCCs shifted from the PBC to the ABC. Also, the Agricultural Development Bank was established in December 1993 to handle the policy lending functions of the ABC so that the latter could devote itself to commercial banking activities.

“financial institutions” and were shut down at the end of the 1990s. The elimination of RCFs left over 40,000 RCCs at the township level (with about 280,000 village branches) as the only formally-approved non-banking financial institution (NBFI) devoted to serving rural enterprises and households. Since then, central banking authorities have deliberated over how to improve their performance and injected approximately US\$4 billion in recapitalization funds into the RCC system because RCCs are technically insolvent. As of year-end 2001, RCCs accounted for 12 percent of total savings and 11 percent of loans extended by formal financial institutions,<sup>10</sup> and experiments to convert them into Rural Commercial Banks were underway in Jiangsu, but overarching reforms had not been approved.

### *The Microfinance Solution?*

Given the inability of most formal sector banking institutions to reach rural populations and the popularity of informal sector alternatives, microfinance programs have emerged as a potential solution for bridging the gap between the supply and demand for rural finance. In both India and China, microfinance has taken the form of subsidized loans in government-supported poverty alleviation (PA) programs, and various donor and NGO-lead endeavors. While the actual expressions and overall scale of microfinance differs in the two countries, the relative effectiveness of these two main forms of microfinance is similar. Specifically, subsidized micro-loans in government-supported PA programs tend to have low repayment rates and tend not to reach the intended clientele; and microfinance programs run by NGOs have mixed results depending on how they are structured.

### Directed Subsidized Credit in Public Poverty Alleviation Programs

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<sup>10</sup>“China’s Rural Credit Cooperative Loans Rise,” *People’s Daily*, February 5, 2002; and “Central Bank Pledges More Loans, Flexible Policy for Farmers,” *People’s Daily*, March 12, 2002.

Extending subsidized loans to low-income areas and households has traditionally been the first, and perhaps least effective strategy that governments use in their rural development strategies, and India and China are no exceptions.<sup>11</sup> In India, the Integrated Rural Development Programme (IRDP) was established in 1978 with the mandate of extending microloans through the banking system to impoverished households and now regards itself as the “world’s largest program for providing micro-loans to the poor.”<sup>12</sup> In its first two decades, the IRDP extended Rs250 billion worth of subsidized loans to approximately 55 million families who have an annual income of less than Rs11,000 (US\$305).<sup>13</sup> In addition to the loans, IRDP borrowers also receive a cash subsidy at the time of loan disbursement equivalent to 25 to 50 percent of the project cost.<sup>14</sup> The program has certainly disbursed a high volume of loans, but funds have been misused via the subsidy component, and the program has had a repayment rate of only 25 to 33 percent. Meanwhile, the RRBs and primary agricultural credit societies have not performed any better. The RRBs have been saddled with soft loans to priority sectors, while primary cooperatives have served mainly as tools of political patronage.<sup>15</sup> Basically all of the formal sector institutions involved in microfinance have depended on refinancing and recapitalization by apex institutions on a regular basis.<sup>16</sup>

State-subsidized microfinance in China has had a shorter history than in India, mainly because China started poverty lending about one decade later than India. To be sure, both central and local governments in China have directed subsidized credit to particular sectors or industries,

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<sup>11</sup>The classic critique of subsidized credit is Dale Adams, Doug Graham, and J.D. von Pischke, *Undermining Rural Development with Cheap Credit* (Boulder: Westview, 1984).

<sup>12</sup>Sinha, “India,” 66.

<sup>13</sup>Ibid.

<sup>14</sup>Nagarajan and Meyer, *Rural Financial Markets*, 170.

<sup>15</sup>Especially during the 1980s, nationalized banks had periodic loan *melas*, which entailed extending massive quantities of subsidized loans to targeted sectors of society without regard for their creditworthiness.

<sup>16</sup>Nagarajan and Meyer, *Rural Financial Markets*, 177-179.

but that type of “policy lending” has not occurred in the name of microfinance or poverty alleviation.<sup>17</sup> In 1986, a subsidized lending scheme for poverty relief was introduced, which targeted collective enterprises at the township and village level rather than individual households.<sup>18</sup> While official interest rates on loans ranged between 8 and 10 percent, the poverty alleviation loans charged only 2.88 percent interest. As is the case with most subsidized credit schemes, the loans were distributed to politically important enterprises and higher-income households, and the repayment rates were about 50 percent.<sup>19</sup>

Providing subsidized loans directly to households did not start until a few years into the PRC’s National 8-7 Poverty Alleviation Plan, introduced in 1993. As part of the strategy to raise 80 million people out of poverty in seven years (i.e., from 1994 to 2000), the central government identified 592 poor counties where households would be directly targeted for subsidized poverty loans. In quite a change from the previous mode of distributing subsidized credit to local enterprises, in 1996 many of the counties adopted the Grameen Bank model of group lending whereby groups of five borrowers would mutually guarantee the repayment of their respective micro-loans in multiple installments.<sup>20</sup> These loans ranged from 1,000 to 2,000 RMB (US\$120-240) and they continued to be subsidized at the official PA lending rate of 2.88 percent. Once the decision was made to disburse PA loans directly to households in officially-designated impoverished counties, they were disbursed rapidly, almost quota style:

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<sup>17</sup>When it comes to subsidized loans for state-owned enterprises or collectives that employ a large number of people, the argument could be made that propping them up has local employment and therefore, welfare implications; but in the development field, microfinance refers specifically to loans that are extended to individual (and typically small) business owners rather than larger scale corporations that have larger capital requirements.

<sup>18</sup>Scott Rozelle, Albert Park, Changqing Ren, and Vince Bezinger, “Targeted Poverty Investments and Economic Growth in China,” *World Development* 26, 12 (1998): 2137-2151.

<sup>19</sup>Albert Park, “Banking for the Poor,” *China Brief* II, 2 (May 1999): 9-15.

<sup>20</sup>On the Grameen Bank model, see David Bornstein, *The Price of a Dream: The Story of the Grameen Bank* (Chicago: University of Chicago, 1997); Susan Holcombe, *Managing to Empower: The Grameen Bank Experience of Poverty Alleviation* (London: Zed Books, 1995); and Shanhidur R. Khandker, Baqui Khaliliy, and Zahed Khan, “Grameen Bank: Performance and Sustainability,” World Bank Discussion Paper, no. 306, Washington D.C., 1995.

By August 1998, official microcredit schemes were operating in more than 600 counties in 22 provinces, with the largest programs (in Shaanxi and Yunnan) reaching over 500,000 households...In 1999, with between 30 and 40 million people still classified as poor, the central government's budget for the 8-7 Plan called for expenditures of Y24.8 billion (\$3 billion), of which Y15.3 billion (\$1.84 billion, or 62 percent) was for loans funds.<sup>21</sup>

As in the earlier model of poverty lending, however, repayment rates in these government programs have been low, i.e., less than 60 percent. Even though the ABC (a state commercial bank) took over the poverty lending program from the Agricultural Development Bank (a policy bank) in 1998, the PBC has not been involved in monitoring the microcredit component of the ABC's operations, and the loans are treated more as social grants rather than as commercial loans.<sup>22</sup> In other words, the microcredit component of PA lending has been treated as one-time fixes rather than exhibiting a commitment to sustainable models of microfinance.

#### NGO and Donor-Managed Microfinance Institutions

The involvement of NGOs in running microfinance institutions (MFIs) varies significantly in India versus China. This is due in part to differences in the policy environment for both NGOs and NBFIs. While the government of India has promoted the growth of self-governing NGOs and encouraged domestic development finance institutions to collaborate with them, China's NGOs are sponsored by a particular government unit (making them government-organized NGOs rather than pure NGOs) or established by international donors. To date, India's NGOs have had more extensive reach in microfinance than their counterparts in China, but in both countries, few MFIs are financially sustainable while the market for MFIs remains vast.

In India, microfinance NGOs have generally taken one of the following three forms: i) self-help group (SHG) programs that have linkages with banks, ii) cooperatives, or iii) Grameen

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<sup>21</sup>John D. Conroy, "People's Republic of China," in ADB, ed., *The Role of Central Banks*, 36.

<sup>22</sup>In addition to the primary model of channeling poverty alleviation funds through the ABC for microloans, it is worth pointing out that under the PBC, the RCCs have been involved with microfinance experiments in Hebei Province.

replicators.<sup>23</sup> Organized by NGOs, SHGs consist of 10 to 12 people with similar socioeconomic and demographic characteristics (e.g., low-income women in rural areas). The purpose of the SHGs is to help the members save small amounts of money on a regular basis, to create an internal insurance fund for members to draw on in times of emergencies, to empower the members through collective decision-making, and to extend uncollateralized loans to group members.<sup>24</sup> Since 1992, the National Bank for Agriculture and Rural Development (NABARD) has experimented with creating linkages between SHGs and banks, such that banks lend through NGOs or directly to SHGs.<sup>25</sup> By 1999, over 200 banks were participating in microfinance linkages with 550 NGOs and over 18,500 SGHs; in total, these covered a total of 560,000 families. At present, NABARD is continuing to encourage banks to create linkage relationships with SGHs and hopes to raise 100 million rural people out of poverty via one million SHGs by 2008.

Aside from participating in the SGH-bank linkage model, over 500 NGOs serve as financial intermediaries themselves by brokering funds between banks and low-income borrowers. There are also a handful of cooperatives such as SEWA Bank, the Indian Cooperative Network for Women, Tamil Nadu, and cooperative credit societies associated with the Cooperative Development Foundation that are involved in microfinance. And finally, about ten organizations may be considered Grameen replicators. The largest ones are SHARE, Activists for Social Alternatives Trust, and Rural Development Organization, Manipur.<sup>26</sup>

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<sup>23</sup>This is the classification used in EDA Rural Systems, *India: Micro-finance for the Poor: An Assessment of the Status and Efficacy of Microfinance Institutions and Programmes*, Study prepared for the Asian and Pacific Development Centre, Kuala Lumpur, 1996, cited in Sinha, "India," 70.

<sup>24</sup>Alfred Hannig and Edward Katimbo-Mugwanya, eds., "How To Regulate and Supervise Microfinance? Key Issues in an International Perspective," Proceedings of the High-Level Policy Workshop, Kampala, November 1999, 7.

<sup>25</sup>Nagarajan and Meyer, *Rural Financial Markets*, 170.

<sup>26</sup>Sinha, "India," 70.

Overall, MFIs in India have not been subject to stringent regulations, especially those that are not registered as cooperatives or NFBCs. Given the developmental contribution of MFIs, the RBI has not enforced Section 45S of the RBI Act, which prohibits savings mobilization from the public without RBI permission. Furthermore, financial liberalization since the 1990/1991 economic crisis has loosened interest rate controls on microcredit, which means that there is space for MFIs in India to structure their loans in a financially self-sustainable manner. Whether this occurs, however, depends in large part on changing popular perceptions that low-income borrowers cannot afford commercially viable interest rates.

In contrast to the relative ease with which NGOs may register themselves and act as MFIs in India, China's policy environment is much more restrictive. All NGOs in China must have an official government unit sponsor their application to register as "social organizations" with the Civil Affairs Bureau.<sup>27</sup> As such, China does not have purely *non-governmental* organizations engaged in microfinance even though they may be functionally equivalent to NGOs. For example, the NGO/magazine *Rural Women Knowing All*, was started in 1993 by two journalists employed by the All-China Women's Federation, the state-level mass association representing women. Even though *Rural Women Knowing All* has raised its own source of funds from the Ford Foundation, the Asia Foundation, and Oxfam Hong Kong for providing training and micro-credit services to rural women, the founders are still employed by the Women's Federation and their office space is supplied by them as well.

Similarly, the introduction of the Grameen model of microfinance came about through the individual initiative of researchers at the Rural Development Institute (RDI), Chinese Academy of Social Sciences (CASS) and international donors; but to date, the China's most

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<sup>27</sup>Tony Saich, "Negotiating the State: The Development of Social Organizations in China," *The China Quarterly* 161 (March 2000): 124-41.

successful Grameen replications are managed from an office housed at CASS. After visiting the Grameen Bank headquarters in Dhakah, Bangladesh in 1993, Professor Du Xiaoshan of RDI was inspired to try a replication in China.<sup>28</sup> With funding from Grameen Trust, the Ford Foundation, and the Canada Fund, the CASS researchers established the Funding the Poor Cooperative (FPC) in Yixian, Hebei in 1994. To implement the project they collaborated with the Yixian county-level Poverty Assistance Bureau and the Civil Affairs Office. As of November 2002, there were three FPCs in Yixian, Yucheng (Henan), and Nanzhao (Henan) counties, respectively. Together they had served a total of over 22,500 borrowers; with repayment rates in ranging from 95 to 99 percent, the FPCs are considered the best examples of Grameen-style microfinance in China. A central part of their success has been structuring the loans in a manner that covers their operational costs, i.e., at 16 percent effective interest per annum.<sup>29</sup> Scaling up to extend their reach and experimenting with non-Grameen lending methodologies is their next challenge.<sup>30</sup>

Besides the FPC Grameen replications, quite a number of microfinance programs initiated by international donors have proliferated over the years. They have all implemented their projects with different local governmental partners. For example, the AusAid project in Haidong, Qinghai that started in 1996 collaborates with the ABC and Qinghai MOFTEC; the Heifer Project International has been collaborating with the Sichuan province Animal Husbandry Bureau since 1985; and since 1995, the International Crane Foundation Trickle-Up Program in Guizhou has been implemented with the cooperation of the Guizhou provincial Environmental

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<sup>28</sup>For more detail, see Kellee S. Tsai, *Back-Alley Banking: Private Entrepreneurs in China* (Ithaca: Cornell University Press, 2002), 200-202.

<sup>29</sup>For a comparison of the performance of NGO, joint NGO-government, and purely government run microfinance programs in China, see, Albert Park and Changqing Ren, "Microfinance with Chinese Characteristics," *World Development* 29, 1 (2001): 39-62.

<sup>30</sup>On November 19, 2002, Citibank announced that it was going to donate US\$1.3 million to FPC via Grameen Trust to help the three existing FPCs open more branch offices. "Citibank Donates US\$1.3 Million to Expand Microfinance in China," *Xinhua*, November 19, 2002.

Protection Bureau.<sup>31</sup> With few exceptions, the donor-initiated programs have been structured as projects with a limited lifespan rather than as MFIs aiming for sustainability. Although this may be attributed in part to the official interest rate ceilings on poverty loans, the FPCs have shown that it is possible to build in a higher, sustainable rate of interest in the Grameen model; and that rural borrowers are willing and able to pay those rates. Indeed, a study of NGO MFI clients found that the highest monthly interest rate that they would be willing to pay is 32.6 percent.<sup>32</sup> This is consistent with the popularity of informal financing mechanisms (discussed below) that charge even higher interest rates.

### **The Informal and Semi-Formal Financial Sector**

As suggested already, despite the substantial expansion of rural financial institutions in both countries over the last several decades, informal finance still represents a major source of credit for farmers and petty traders. In China, a study by IFAD estimates that farmers obtain four times more credit from the curb market than from formal financial institutions,<sup>33</sup> and my study of small business owners found that the curb accounted for up to three-quarters of private sector financing during the first two decades of reform.<sup>34</sup> In India, the 1992 AIDIS survey revealed that nearly 40 percent of rural households continue to rely on informal finance—or more technically, “non-institutional credit agencies,” which include agricultural moneylenders, professional moneylenders, traders, relatives and friends, and others.<sup>35</sup> Table 1 outlines the

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<sup>31</sup>For a list of microfinance projects supported by international donors, see *China Brief* 2, 2, May 1999.

<sup>32</sup>NGO participants said they were willing to pay up to 32.6 percent in annual interest, while participants in government-run PA programs were willing to pay up to 21.4 percent annually and those in mixed NGO-government programs were willing to pay up to 20.2 percent. Park and Ren, “Microfinance with Chinese Characteristics,” 45.

<sup>33</sup>International Fund for Agricultural Development (IFAD), *People’s Republic of China: Thematic Study on Rural Financial Services in China* (Rome, Italy: IFAD, 2001), C11. Available on-line at [http://www.ifad.org/evaluation/public\\_html/eksyst/doc/thematic/pi/cn/cn\\_1.htm#2](http://www.ifad.org/evaluation/public_html/eksyst/doc/thematic/pi/cn/cn_1.htm#2).

<sup>34</sup>Tsai, *Back-Alley Banking*, 36-7.

<sup>35</sup>The survey found that 39.6% of rural households relied on “non-institutional credit agencies.” RBI, AIDIS, “1991-92 – Incidence of Indebtedness of Households, Part I,” *RBI Bulletin*, February 8, 2000, Table 5, available on-line at <http://www.rbi.org.in>.

primary forms of informal and semi-formal finance in both countries and notes the extent to which they are sanctioned or prohibited. In both countries, private transactions involving high interest rates are in violation of banking regulations (interest rate ceilings in China and anti-usury laws in India), as are organizations that mobilize savings without registering with the appropriate authorities. Beyond those two restrictions, however, the legal marginalization of curb market activity has not been consistently defined or enforced. In practice, curb market actors in both China and India have proven to be adaptable despite multiple rounds of disciplinary action by financial regulators.

**Table 1. Legal Condition of Informal Finance in China and India**

<b>Type</b>	<b>China</b>	<b>India</b>
<b>Interpersonal lending</b> – loans extended among friends, relatives, neighbors, or colleagues	<i>minjian jiedai</i> – financial authorities do not interfere with causal, interest-free lending	Interpersonal lending - financial authorities do not interfere with causal, interest-free lending
<b>Trade credit</b> – merchandise credit between wholesalers and retailers	<i>hangye xinyong</i> – neither sanctioned nor prohibited	Trade credit, forward sales
<b>Moneylenders, loan sharks</b> – loans from professional and non-professional money brokers, typically at high interest rates	<i>gaolidai</i> – all high interest lending is illegal	Mahajan and Chettiar bankers - Some are registered as finance companies, trusts, banks, and partnership firms.
<b>Rotating savings and credit organizations (ROSCAs)</b> – indigenously organized savings and credit groups	<i>huzhuhui, hehui, biaohui, chenghui, juhui</i> - permitted in localities where they have not collapse	Chit funds – registered as companies, partnerships, and sole proprietorships
<b>Pawnshops</b> – extends collateralized loans with interest	<i>diandang, dangpu</i> – permitted when operated according to regulations	Pawnshops – legal if licensed
<b>Indigenous banks, money houses, finance companies</b> – mobilize savings and extend collateralized loans	<i>siren qianzhuang</i> , private money houses – regarded as private banks, which are illegal; most operate underground now.	Deal with short-term credit ( <i>hundis</i> ) combined with trade for financing trade – committees have suggested formalizing them but indigenous bankers have resisted this.
<b>Rural cooperative foundation</b>	<i>nongcun hezuo jijinhui</i> – approved by MOA until closure by PBC in 1999	n.a.
<b>Social organizations, mutual benefit funds</b> – registered entities that are supposed to serve lower-income populations	<i>huzhuhui, hezuo chu jijinhui</i> (mutual assistance societies, cooperative savings foundations) – registered with MCA, but not supposed to engage in for-profit financial intermediation	Nidhi companies, mutual benefit societies, permanent funds (mainly in Tamil Nadu) – committees have recommended that they be regulated more stringently

### Grey Areas in China's Curb Market Financing

In China, the extremes of legal versus illegal forms of financing are distinguished by whether or not they are sanctioned by the People's Bank of China (PBC), which hinges on whether they mobilize savings from the general public and offer/charge interest rates above the repressed interest rate ceilings. Interpersonal lending and trade credit, for example, are among the most basic strategies that entrepreneurs use to deal with short-term liquidity requirements. Small business owners frequently borrow money from friends, relatives, and neighboring shopkeepers. Wholesalers may deliver goods to retailers on ten-day or even 30-day credit if they have an established relationship. Such practices are not illegal to the extent that they do not entail interest above the rates of state banks,<sup>36</sup> in contrast to those charged by the proverbial loan shark or private money houses. The latter are clearly illegal by PBC standards because they reflect the higher market cost of capital in a financially repressed environment. Indeed, with the sole exception of Minsheng Bank,<sup>37</sup> private commercial banks are prohibited in China and the PBC has launched multiple "financial rectification campaigns" to shut down private money houses. Nonetheless, they have continued to operate underground, not only in the coastal south where private commerce is better developed, but also northern central provinces such as Henan.<sup>38</sup>

Pawnshops straddle a finer line between being legal and not quite legal and provide a good example of Beijing's regulatory ambivalence in dealing with unconventional financing mechanisms. Their re-emergence during the reform era has been uneven and ambiguously

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<sup>36</sup>They are "legal" to the extent that they have not been banned explicitly.

<sup>37</sup>China Minsheng Banking Corporation was established by the All-China Federation of Industry and Commerce in February 1996. In November 2000, it went public by issuing 350 million A shares on the Shanghai Stock Exchange.

<sup>38</sup>For more detail, see Tsai, *Back-Alley Banking*, Ch. 5.

regulated due to their usurious connotation.<sup>39</sup> By 1956 private pawnshops were effectively eliminated, but after the first one opened up during the reform era in Chengdu in 1987, they developed rapidly and by 1993, there were 3,013 documented pawnshops throughout the country. Most were operated by various branches of government agencies, including state banks, policy departments, tax bureaus, customs bureaus, and finance and insurance companies,<sup>40</sup> though some simply registered as ordinary private businesses with the Industrial and Commercial Management Bureau (ICMB). The official interpretation of the “new” pawnshops was that they differed fundamentally from the traditional exploitative ones. As researchers in the Ministry of Finance explained in a 1993 report,

It should be noted that today’s pawnshops in the country are not entirely what they used to be. Pawnshops in old China took in personal effects at very low prices when the owners were poverty-stricken. However, such businesses today represent a medium for normal commodity circulation... The new-born pawn brokering aims to serve the people and social production.<sup>41</sup>

Despite this more favorable, revisionist evaluation of pawnshops, it became increasingly apparent that many were (illegally) mobilizing savings deposits from the public and offering high rates of interest.<sup>42</sup> As a result, in 1994 the PBC was granted administrative authority over pawnshops and two years later, a PBC-lead crackdown on illicit financial institutions led to the closure of over half of the registered pawnshops, leaving only 1,304 shops with PBC licenses.<sup>43</sup>

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<sup>39</sup>Communist-era references to pawnshops in imperial China condemned them as an expression of class-based exploitation. For example, Xin Jin, *Diandang shi* (History of pawnshops) (Shanghai: Shanghai wenyi chubanshe, 1993).

<sup>40</sup>Li Mingyu, “Diandangye: ‘jinzi zhaopai’ xiexia qianhou” (Pawnshops: future after removing the “gold store sign”), *Hexun caijing* (Homeway Financial News), October 2000.

<sup>41</sup>Zhongguo yinhang Beijing guoji jinrong yanjiusuo (Beijing Institute of International Finance), *Zhongguo de jinrong jigou jiqi zhuyao jingying* (China’s Financial Institutions and their Primary Management) (Beijing: Zhongguo jihua chubanshe, November 1993), 240-43.

<sup>42</sup>For example, pawnshops in Xingtai, Hebei offered annual interest of 40 percent to its depositors in 1991. Ibid. A more recent study found that some pawnshops charge monthly interest rates between 5 to 8 percent (i.e., up to 72 percent interest annually). “Chinese Experts Evaluate China’s Pawnshop Industry,” *China Online* (<http://www.chinaonline.com>), September 9, 1999.

<sup>43</sup>The rectification effort was not entirely effective, however. The PBC issued additional regulations throughout the late 1990s to standardize their operations and reiterate prohibitions against charging/offering high interest rates—again, to limited avail in implementation.

In a further attempt to circumscribe financial malfeasance of pawnshops they were reclassified in 2000 from being “financial institutions” under the PBC’s authority, to “a special kind of industrial and commercial enterprise” regulated by the State Economic and Trade Commission (SETC).<sup>44</sup> In short, over the course of the reform-era, pawnshops have been legally registered in some cases, registered with the incorrect local agency in others, and engaged in practices that are clearly illegal.

While pawnshops are now technically subject to central-level regulations, rotating savings and credit associations (*hui*), have contradictory legal standing in different localities. When *hui* involve relatively small groups of people (five to ten members on average) who pool set monthly contributions and rotate the disbursement of the collective pot of money to each member, they are usually considered a productive form of mutual assistance among ordinary people, typically women. But if a member runs off with the collective pot early in the life of an association, the members who have not had their turn in collecting money are cheated out of their contributions. In the coastal south, a handful of high-profile cases have accumulated where various types of *hui* were exposed as fraudulent schemes organized by con artists.<sup>45</sup> The large-scale cases were not traditional ROSCAs, however, but rather, ponzi schemes that are never sustainable because they generate extremely high returns by exponentially expanding the network of investors. *Hui* collapses make headlines, but they are actually relatively rare.

The ambiguous and shifting legal status of other curb market practices listed in Table 1 share the attribute of being legal according to certain governmental agencies, but not sanctioned by the PBC. The establishment of rural cooperative foundations (RCFs) by the Ministry of

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<sup>44</sup>“China Reclassifies Pawnshops,” *Jingji ribao* (Economic Daily), August 7, 2000. The State Council approved the handover in August 1999, but it was not implemented until one year later.

<sup>45</sup>For more detail, see Kellee S. Tsai, “Banquet Banking: Rotating Savings and Credit Associations in South China,” *The China Quarterly* 161 (March 2000): 143-70.

Agriculture (MOA) in the mid-1980s exemplifies this phenomenon.<sup>46</sup> As noted earlier, the PBC never recognized them as legitimate “financial institutions” because another ministerial bureaucracy created them. Nonetheless, by the early 1990s RCFs had been established in approximately one-third of all townships, and by 1998 there were over 18,000 RCFs with over five million depositors.<sup>47</sup> Since RCFs were not permitted to mobilize deposits or extend loans like formal financial institutions, they used euphemistic terms for comparable transactions; instead of paying interest on deposits, for example, they sold “shares” (*rugu*) and extended “capital use fees” (*zijin zhan feiyong*). Like pawnshops and other forms of informal finance, RCFs had a variety of governance structures and were more central to rural finance in some provinces than others.<sup>48</sup> Their quasi-legal status proved to be short-lived, however. As part of broader national efforts to rectify the financial system, in March 1999, the State Council announced the closure of poorly performing RCFs, and the takeover of better performing RCFs by Rural Credit Cooperatives.<sup>49</sup> These actions triggered farmers’ protests in at least six provinces, including Sichuan, Hubei, Hunan, Henan, Guangxi, and Chongqing.<sup>50</sup>

Apart from RCFs, some *de facto* non-governmental financial institutions have managed to operate above ground and serve private businesses by registering as social organizations, which are administered by the Ministry of Civil Affairs (MCA). These go by a variety of names,

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<sup>46</sup>Cheng Enjiang, Christopher Findlay and Andrew Watson, “‘We’re not Financial Organizations!’: Financial Innovation without Regulation in China’s Rural Cooperative Funds,” *MOCT-MOST: Economic Policy in Transition Economies* 8, 3 (1998): 41-55; Du Zhixiong, “The Dynamics and Impact of the Development of Rural Cooperative Funds (RCFs) in China,” Working Paper No. 98/2, Chinese Economics Research Centre, The University of Adelaide, March 1998.

<sup>47</sup>For a partial provincial breakdown of RCF activity, see Carsten A. Holz, “China’s Monetary Reform: The Counterrevolution from the Countryside,” *Journal of Contemporary China* 20, 27 (May 2001): 189-217.

<sup>48</sup>Cf. Albert Park, Loren Brandt, and John Giles, “Competition Under Credit Rationing: Theory and Evidence from Rural China,” *Journal of Development Economics* (forthcoming).

<sup>49</sup>“Central Bank Official Interviewed on Risk Management in Banking and Finance Sector,” *Zhongguo dangzheng ganbu luntan* (Forum for China’s Party Cadres), No. 2, February 6, 1999, 4-7; reported in BBC Summary of World Broadcasts, March 19, 1999.

<sup>50</sup>“China Closes Credit Coops,” *Associated Press*, March 22, 1999; and “Over 1,000 Investors Protest Closure of Credit Cooperative in Hubei,” *Agence France Presse*, March 23, 1999.

including mutual assistance societies and cooperative savings foundations. The credit societies are supposed to be non-profit organizations that serve impoverished populations. In practice, however, they operate like RCFs or private money houses in the sense that they mobilize savings, extend credit to private entrepreneurs who may be well off, and offer/charge interest rates that are higher than that set by the PBC. These types of social organizations should be distinguished from those that are genuinely oriented towards microfinance poverty alleviation.

#### Attempts at Mainstreaming India's Informal Sector

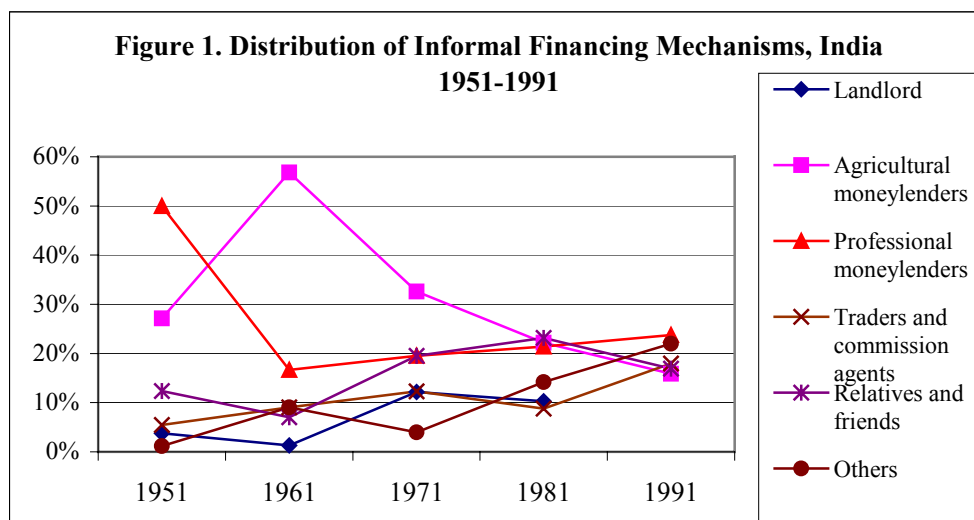
Relative to China, India has a longer history of state-directed credit for poverty alleviation, yet its formal financial sector is more liberalized and its informal financial sector, better documented and more likely to take corporate forms than those of China. These apparent inconsistencies may be attributed to the fact that India's financial policy environment has also fluctuated considerably over the years. Post-independence governments in India have been concerned about the negative effects of informal finance on rural welfare and made repeated efforts to regulate and create institutional alternatives to the curb. Perhaps the biggest contrast from China's situation is that what most would regard as informal financial intermediaries are registered under the Companies Act 1956 or regulated by the RBI. Indeed, the RBI has tracked informal financial activities in official statistics as a means to measure progress in expanding credit access into rural areas. Table 2 lists the official categories of informal finance as defined by RBI and Figure 1 shows their relative share of the curb market over time.

**Table 2. Breakdown of Informal Finance in Rural India over Time**

Type of Non-Institutional Sources	1951	1961	1971	1981	1991
Landlord	3.5%	1.1%	8.6%	4.0%	n.a.
Agricultural moneylenders	25.2	47.0	23.1	8.6	6.3
Professional moneylenders	46.4	13.8	13.8	8.3	9.4
Traders and commission agents	5.1	7.5	8.7	3.4	7.1
Relatives and friends	11.5	5.8	13.8	9.0	6.7
Others	1.1	7.5	2.8	5.5	4.9
Unspecified	n.a.	n.a.	n.a.	n.a.	3.8
<b>Informal Credit as Share of Total Household Debt</b>	<b>92.8%</b>	<b>82.7%</b>	<b>70.8%</b>	<b>38.8%</b>	<b>39.6%*</b>

Source: Reserve Bank of India, All-India Debt and Investment Survey, various years.

\*1991 figures do not add up to 39.6% even though Table 5 of the 1991-92 AIDIS report clearly states that non-institutional agencies account for 39.6% of total rural household debt.



After taking into account sampling and non-sampling errors in the decennial surveys, the main trend is that informal credit has certainly declined as a percentage of total debt, and both professional and agricultural moneylenders have reduced their share of the curb market over time. The decline of the moneylender in official statistics reflects in part state efforts to register and regulate professional moneylenders during the 1950s. Some went underground to avoid

regulation and others were probably re-classified as agricultural moneylenders or traders.<sup>51</sup> In this regard, note that the first three official categories of informal lenders—landlords, agricultural moneylenders, and professional moneylenders—are not necessarily distinct from one another in depending on the locality. But generally speaking, landlord lenders extend credit to tenants; agricultural moneylenders primarily deal with agricultural laborers and small farmers; and professional moneylenders service a wider range of customers and may register themselves as companies, partnerships, and trusts.<sup>52</sup>

Those in the fourth official category of “traders and commission agents” are also known as indigenous bankers. In contrast to professional moneylenders who lend their own money, indigenous bankers broker funds between banks and their clients, who tend to be traders rather than farmers.<sup>53</sup> The Shroffs of Western India, for example, provide a short-term credit instrument called a *darshani hundi* to traders who need to travel great distances to purchase inventory and transfer funds.<sup>54</sup> In addition to serving as financial intermediaries, indigenous bankers are also businesspeople themselves.<sup>55</sup> Besides trading, they may operate commission agencies or hire-purchase finance (HPF) companies, which are basically leasing companies that finance automobiles and other goods over a set period of time for clients who do not have

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<sup>51</sup>For more detail on the sampling and non-sampling errors, see Bell, “Interactions between Institutional and Informal Credit Agencies.”

<sup>52</sup>Prabhu Ghate, et al., *Informal Finance: Some Findings From Asia* (Manila: Asian Development Bank, Oxford University Press, 1992), 45.

<sup>53</sup>Heiko Schrader, “Moneylenders and Merchant Bankers in India and Indonesia,” in Bouman and Hospes, ed., *Financial Landscapes Reconstructed*, 341-355.

<sup>54</sup>Ghate et al., *Informal Finance*, 198-200.

<sup>55</sup>In pre-colonial and colonial India, Multanis, Gujarati Shroffs, Marwaris, Nattukottai Chettiars, and Kallindaikurichy Brahmins represented the most prominent indigenous bankers. During the late colonial period, many invested in industry and commerce. Cf. A.K. Bagchi, *Private Investment in India: 1900-1939* (Cambridge: Cambridge University Press, 1972), cited in Schrader.

sufficient cash to pay for such capital goods up front.<sup>56</sup> Even though formal sector HPFs exist, one study found that informal HPFs finance a much higher volume of vehicles than official auto finance corporations—probably because lower-income populations find the informal HPFs more accessible.<sup>57</sup>

Forms of informal finance in the other category also includes indigenous bankers who are not registered as traders or commission agents; unregistered finance corporations; nonprofessional moneylenders (other than those identified as friends and relatives); various types of leasing, investment, and housing finance companies; ROSCAs (chit funds) and Nihdi societies. Unlike the ROSCAs in China, which are completely informal, a number of chit funds in India are registered as companies, partnerships, and sole proprietorships under the All-India Chit Funds Act 1982 or the state acts.<sup>58</sup> The state's rationale for regulating them is to increase the security of the members' contributions and to reduce the incidence of defaults. As such, organizers are required to have licenses and make security deposits with the Register of Chit Funds; the cost of collecting the pot (i.e., *de facto* interest rate) is capped at 30 percent of the size of the pot; and chit funds are limited to a maximum of 60 months.<sup>59</sup> As will be discussed below, these regulations have not had their intended effect, however. Rather than increasing the stability of chit funds in general, many organizers have gone underground and taken their members (who seek higher returns) with them.

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<sup>56</sup> C.P.S. Nayar, "Strengths of Informal Financial Institutions: Examples from India," in Dale W. Adams and Delbert A. Fitchett, eds., *Informal Finance in Low-Income Countries* (Boulder: Westview Press, 1992), 199-200.

<sup>57</sup> A. Das-Gupta, C.P.S. Nayar, and Associates, "Urban Informal Credit Markets in India," Unpublished report, New Delhi: National Institute of Public Finance and Policy, 1989, cited in *Ibid.*

<sup>58</sup> For more detail on chit funds, see S. Rutherford and S.S. Arora, *City Savers* (New Delhi: Department for International Development, 1997), cited in Sinha, "India," 66, nt. 4.

<sup>59</sup> Ghate et al., *Informal Finance*, Box 15.1, 197.

In addition to chit funds, Nidhi companies or mutual benefit societies are also an important part of the non-banking world of financial intermediation, especially in south India. Incorporated under the Companies Act 1956, Nidhis mobilize savings from their members and extend loans that are collateralized with jewelry and real estate.<sup>60</sup> When non-members wish to make a deposit or borrow from a Nidhi, they take a share of the Nidhi. Over the years, the state has made repeated efforts to regulate these mutual benefit societies; and most recently, an Expert Group on Nidhis constituted by the Department of Company Affairs recommended a host of additional regulations to professionalize their operations.<sup>61</sup>

### **The Puzzling Persistence of Informal Finance**

State authorities in both China and India have clearly recognized the importance of formal financial institutions in rural areas, including the expansion of microfinance programs for poverty alleviation purposes. Financial regulators have also made repeated efforts to eliminate and/or regulate of curb market activity. Why, then, does informal finance persist on such a substantial scale in both countries? Three potential explanations may be derived from the perspective of supply-leading economics, state-society relations, and the local political economy of markets. While evidence could be mustered to support all three theories, examining the local political economy of markets carries the most explanatory leverage.

#### *Economics: A Matter of Supply and Demand*

Based on the logic of supply and demand in economics, one possible reason that informal continues to play such an important role in rural China and India may simply be because the amount of credit demanded by rural households exceeds that supplied by formal financial sector

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<sup>60</sup>Nayar, "Strengths of Informal Financial Institutions," 197-99.

<sup>61</sup>Press Information Bureau, Government of India, "Expert Group on Nidhis Recommends Continuation of Regulatory Measures," March 22, 2002. Available on-line at <http://pib.nic.in/archieve/lreng/lyr2002/rmar2002/22032002/r220320022.html>

in rural areas. Therefore, in order to reduce the rural population's reliance on the curb, official sources of credit should be increased. This is known as the supply-leading approach to finance and development.<sup>62</sup> As shown in Table 2, according to official statistics the relative dominance of the curb market in rural India has indeed declined over time with the expansion of formal credit institutions. Clive Bell has convincingly shown, however, that the RBI surveys underestimate the true scale of informal finance and that the volume of business handled by moneylenders has actually grown over time.<sup>63</sup> In other words, increasing the availability of bank loans and microcredit has not correspondingly displaced informal sources of credit.

In rural China, the closure of RCFs eliminated an important source of semi-formal financial intermediation, but we can still heuristically test the supply-leading hypothesis by considering the impact of the government's large-scale poverty lending programs. Specifically, if people were turning to informal finance only because more institutionalized sources were unavailable to them, then we would expect clients of microfinance programs to rely on subsidized poverty loans rather than high-interest loans from the curb. Yet this turns out not to be the case. In their surveys of MFI clients, Albert Park and Ren Changqing discovered that,

[O]ver 50% of households in program areas had outstanding loans from other sources, and that this percentage was similar for both members and nonmembers. The most common source by amount was Rural Credit Cooperatives (55% for members, 46% for nonmembers), followed by informal sources.<sup>64</sup>

In other words, microfinance is not going only to households that lack access to formal credit in China.

Applying the supply-leading hypothesis to India and China poses more questions than it answers. Why is business getting better for India's moneylenders amidst the expansion in formal

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<sup>62</sup>Hugh T. Patrick, "Financial Development and Economic Growth in Developing Countries," *Economic and Cultural Change* 14, 2 (1966): 174-89. Cf. Anand Chandavarkar, "Of Finance and Development: Neglected and Unsettled Questions," *World Development* 20 (January 1992): 133-142.

<sup>63</sup>Bell, "Interactions between Institutional and Informal Credit Agencies in Rural India," 306.

<sup>64</sup>Park and Ren, "Microfinance with Chinese Characteristics," 46.

sector institutions and MFIs? If MFI clients already have access to RCC loans, then why are they receiving MFI loans in the first place? Examining the issue from the perspective of state-society relations may help to explain this disjuncture between the intended and actual recipients of targeted and microcredit.

*State-Society Relations: A Matter of State Capacity*

A second possible reason why increasing the official supply of credit has not translated into a matching decline in informal financial activity may be because official state policies are not being implemented properly. This may occur in three main ways. First, state actors may not be distributing targeted credit properly due to insufficient knowledge of how to identify the intended clients of subsidized credit and MFI programs, or how to structure the services in a manner that meets the needs of the target group. Second, state actors may be intentionally diverting credit from the intended recipients. And third, non-state actors may be interfering with the proper disbursement of formal and MFI credit. Taken together, all three types of implementation failure may be interpreted as reflecting weaknesses in state capacity.

The first type of implementation failure is rooted in the conditions under which formal credit is disbursed. In both India and China, conventional commercial banks do not have institutional experience in lending to rural clients who may lack an established credit history and collateral or guarantor. Therefore, the typical state response has been to require that national banks allocate a certain portion of their lending portfolios to lower-income rural households. Quota-style lending often does not achieve its substantive objectives, however, because the emphasis is placed on ensuring that a certain number of loans are disbursed, rather than on the identity of the borrower.

When quota-style lending is accompanied by subsidized interest rates—which has been the case in both India and China’s PA loans—the prospects for reaching the intended clientele are further diminished. Instead of reaching lower-income households, subsidized loans usually end up in the hands of local elites who do not feel obligated to repay the loans. This common phenomenon relates to the second implementation failure, whereby state agents knowingly distribute credit to sectors of the population that are not necessarily excluded from the formal financial system. In India it is well known that a number of government interventions in rural finance have been motivated by short-term political objectives that coincide with the electoral cycle. While China’s political context differs significantly from India’s, targeted credit and PA loans are similarly subject to political patronage at the local level. Compared with participants in the FPCs and mixed NGO-government programs, borrowers in the microcredit projects run by local governments tend to be much wealthier and engaged in non-cropping activities.<sup>65</sup>

Aside from the top-down weaknesses in state capacity discussed above, non-state actors may also be responsible for distortions in policy implementation. In this case, non-state actors would include private economic actors such as financial entrepreneurs and politically important constituents of society. First, the argument could be made that the curb market thrives because informal financiers are determined to evade banking regulations. In other words, no matter how much formal credit is available in rural areas and no matter how stringent the penalties are for violating state laws, a certain strata of financial entrepreneurs will always endeavor to subvert state policies. The second main expression of non-compliance by societal actors may come from borrowers themselves. It is conceivable that lower-income farmers and rural traders boycott

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<sup>65</sup>Ibid.

formal and semi-formal financial institutions to undermine their legitimacy.<sup>66</sup> Thus far, however, there is no evidence for this in India and China. Instead, it is more typically the privileged slice of the population that has interfered with the implementation of PA lending policies. In India, local politicians may extend subsidized credit to the upper tier of society, but after elections, loan recovery has also proven to be difficult because “the credit agencies’ bureaucracy is reluctant to touch the influential rural elite who wield much formal and informal influence and considerable power.”<sup>67</sup> The low repayment rates in the China’s subsidized PA programs suggest that similar dynamics are in operation.<sup>68</sup>

Analyzing the persistence of informal finance through the state-society lens takes us one step closer to explaining why state financial policies have had unintended outcomes. However, conceptualizing the curb market as an inverse function of state weakness and societal strength suffers similar problems as the supply-leading hypothesis. Just as increasing the supply of government-sanctioned credit does not crowd out informal credit, strengthening state capacities in rural financial intermediation does not necessarily come at the expense of non-state actors such as moneylenders and wealthier households. In both China and India, intra-state actors are just as likely as non-state actors to distort policy implementation.

### *Segmented Markets: A Matter of Local Political Economy*

Ultimately, viewing rural credit markets as being more finely differentiated than a dichotomous trade-off between state and society carries more explanatory strength in explicating

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<sup>66</sup>For other forms of societal resistance, see Mark Selden and Elizabeth Perry, eds., *Chinese Society: Conflict, Change, and Resistance* (London: Routledge, 2000).

<sup>67</sup>Agricultural Credit Review Committee Report (1989), cited in Jacob Yaron, McDonald P. Benjamin, Jr., and Gerda L. Piprek, *Rural Finance: Issues, Design, and Best Practices*, Environmentally and Socially Sustainable Development Studies and Monographs Series 13 (Washington D.C.: The World Bank, 1997), 102.

<sup>68</sup>In fact, this phenomenon is hardly specific to India or China. For additional examples from around the world, see Adams, Graham, and Von Pischke, eds., *Undermining Rural Development*; and Maria Otero and Elisabeth Rhyne, eds., *The New World of Microenterprise Finance* (West Hartford, CT: Kumarian Press, 1994).

the persistence of curb market finance. Rather than assuming the perfect fungibility of credit (whether it be formal, semi-formal, or informal), this explanation starts from the premise that credit markets are segmented even at the grassroots level. This means that no single type of credit can meet the needs of various potential borrowers, and no single type of credit is accessible to everyone. While the concept of segmented markets typically refers to the variation in preferences among consumers in different economic strata, in the case of rural credit, segmentation occurs along political and social lines as well. Far from being a pure market where prices (interest rates) reflect the relative supply and demand of different types of financing, formal and semi-formal sector credit for PA purposes often faces state-mandated interest rate ceilings and is subsidized. That is to say, even during periods of credit scarcity, the cost of directed bank credit may be extremely low. By definition directed credit cannot go to the highest economic bidder; instead, it is disbursed by credit officers. And as with any government-allocated good or resource, the distribution of subsidized credit and PA loans is political. Therefore, when PA loans do not reach the target population, more often than not, examining local political hierarchies may reveal where the soft loans were distributed.

Meanwhile, the cost of accessing informal credit also varies depending on the structure of local political and social networks. Interest-free lending only occurs among tight knit groups of people, typically close friends or relatives. Members of ROSCAs usually know one another, or at a minimum, know the organizer or one other member. The higher rates of interest charged by professional moneylenders reflect in part the higher level of risk associated with lending to clients with unconventional forms of collateral (if any). Even then, however, accessing most forms of informal finance requires some form of introduction. Local curb markets are also segmented, though not always in expected ways. The following two cases from India and China

illustrate more concretely how local social, political, and economic dynamics mediate the use of formal and informal finance.

Tribal, Caste, and Occupational Segmentation in a North Indian Village

In a diachronic study of a South Rajasthan village that J. Howard M. Jones calls Chandrapur, we can compare the nature of the local credit market before and after a village bank was introduced.<sup>69</sup> As of 1989, Chandrapur Village had a population of over 1,000 people in 200 households, within which were three main social groups engaged in different economic activities: Hindu households engaged in caste-based non-agricultural activities, Jain households prevailed in commercial and financial services, Jogis relied on income from working as migrants in Gujarat and Bombay, the Bhil population lived in the hinterland. Before a village bank was introduced at the end of 1983, Chandrapur residents relied solely on informal sources of credit. The records of a Jain shopkeeper (called B.Jain) who also provided pawnbroking services revealed that even six years after the village bank was established, B. Jain's lending volume had increased by over 100 percent—from Rs.53,351 in 1982-83 to Rs.110,818 in 1988-89—and the annual number of loans had increased from 290 to 335, but the interest rate had remained at 3 percent throughout the same period. Meanwhile, the total number of pawnshops in the village increased from 15 in 1983 to 24 in 1989. Most remarkably, however, Jones found that the volume of loans extended by pawnbrokers vastly outstripped that of the village bank:

For Chandrapur, as a whole, a tentative estimate of pawnbroking loan volume is made by multiplying Rs.110,818 (B.Jain's loan volume) by the proportions of loan volume indicated by this shopkeeper for the other 23 lenders in the village. Adding the figure to his own loan volume produces a total of Rs.2,292,850 for all 24 pawnbrokers in the village: five times the loan volume advanced by the bank during 1988-89.

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<sup>69</sup>This case draws completely from J. Howard M. Jones, "A Changing Financial Landscape in India: Macro-Level and Micro-Level Perspectives," in Bouman and Hospes, eds., *Financial Landscapes Reconstructed*, Ch. 18.

A similar extrapolation from the 335 loans advanced by B. Jain, results in a total of 6,799 loans for all 24 pawnbroking businesses: 75 times the number of loans advanced by the bank in 1988-89, six years after it was established.<sup>70</sup>

In addition to the expansion in pawnbroking, mutual finance groups emerged during the same phase; by 1991, 50 households in the village were participating in these savings and credit groups.<sup>71</sup>

It is conceivable that the overall demand for credit in Chandrapur simply increased dramatically over those years such that a single village bank could never have fulfilled the demand. But instead of evidence for the supply-leading hypothesis, it turns out that the local credit market was/is highly segmented along tribal and occupational lines. While the Chandrapur village bank was supposed to service a total of 17 villages, Chandrapur village residents received over half (54 percent) of its loans. Furthermore, even though the Bhil are Scheduled Tribe members and represent a specific target group of the bank, over half (52 percent) of these bank loans were extended to Jain borrowers. (It is also worth noting that in 1989, 52 percent of the bank's loan portfolio was in arrears, and 30 percent was past due for over three years, i.e, in default.) Meanwhile, only 23 percent of the number of pawnbroking loans extended by B. Jain went to local villagers, while 75 percent of the loans went to Bhil customers in tribal settlements. In a similar reversal of official intentions, the Jogis who are on the Scheduled Caste Lists are also supposed to receive targeted credit had not received any bank loans; instead, they relied on pawnbroking loans from Jain shops. By 1989, Jain households themselves did not use the services of pawnshops because "to take such a loan would involve loss of prestige with fellow Jains."<sup>72</sup>

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<sup>70</sup>Ibid, 18-4.

<sup>71</sup>Ibid, 18-8.

<sup>72</sup>Ibid, 18-7.

In addition to inter-tribal and caste differentiation, informal credit markets are also segmented along occupational and gender lines. This is reflected in the participation of savings and credit groups: of the 126 people participating in mutual finance, 125 are men; and the groups are organized by professional occupation such that the Jains form the Government Employees' group, the Blacksmith Caste form the School Staff group, and relatively few (8 percent) Bhil cultivators participate in mutual finance.

#### Segmentation within a Single Surname Village in South China

While it may seem intuitive that a multi-tribal village would have a segmented economic structure and therefore credit markets, the case of a single-surname village in the southern coastal province of Zhejiang shows that strong internal forms of differentiation are not uncommon even in a village where everyone could be considered a relative of some sort. Lin Village is comparable in size to Chandrapur Village, but unlike the latter it appears homogenous: 95 percent of the households share the surname Lin and the village temple, which traces the Lin lineage back to the late Qing dynasty.<sup>73</sup> Despite this shared ancestry, access to various forms of credit is segmented along political, sectoral, and gender lines in Lin Village.

The political fault lines in the village are based on the three branches of Lins that originally settled in the village. The first branch was very active during the Communist Revolution and ended up with the most Communist Party members. The third branch was the most prosperous one before the Revolution and was thus subjected to considerable political persecution throughout the Mao era. For example, during the Great Leap Forward, adult members of the wealthiest household were sent to re-education through labor (prison) camps and

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<sup>73</sup>“Lin Village” is a pseudonym. This case is based on the author’s fieldwork in Wenzhou, Zhejiang province in January 2000, and October to November 2001.

their spacious traditional courtyard home was turned into the communal mess hall.<sup>74</sup> The privileged position of the first branch has carried over into the reform era. Even though major decisions are supposed to be made by the democratically elected Village Committee, households from the first branch dominate village governance and the allocation of key resources, including access to land and credit. As such, members in the third branch have a difficult time contracting land for their businesses and accessing official sources of credit.

It is important to point out, however, that the political hierarchies in Lin Village have not translated neatly into economic stratification. During the Mao era, the third branch certainly suffered more than most, but in the reform era, the second and third branches have found ways to operate private businesses without going through official channels. Given the paucity of arable land,<sup>75</sup> virtually every household in Lin Village operates a small factory. Interestingly, a member of the third Lin branch owns the largest of these factories with over 30 employees—yet he has never borrowed from formal sources of credit. Owner Lin explained, “It’s not worth it to me to apply for a loan from a state bank or rural credit cooperative because the credit officers are dirty and rip me off given my family background. If I applied for a 100,000 RMB (US\$12,000) loan, I would only receive 60,000 RMB because the credit officer would pocket the other 40,000 RMB. Meanwhile, I would still be expected to pay interest on 100,000 RMB.” Owner Lin explained that households from the first Lin branch were more likely to borrow from state banks or RCCs because their relatives work there. Lacking such official connections, Owner Lin nonetheless managed to invest 700,000 RMB in his motorcycle parts factory by using 100,000 RMB of his own savings, borrowing 200,000 RMB interest free from his four older siblings, and

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<sup>74</sup>During my visit in 2001, faded slogans from that period could still be seen from the wooden beams. The thought-reformed family was permitted to return to their home in 1963, but as might be expected, during the Cultural Revolution much of the intricate artwork along the entryway, roof, windows, doors, and walls were destroyed or damaged.

<sup>75</sup>Lin Village is all mountains and water as the locals put it.

borrowing 400,000 RMB at 24 percent annual interest through moneylenders (*yinbei*). The latter loans were guaranteed by his sisters who have good credit among moneylenders in the textile sector. As of 2001, Owner Lin still had the largest factory in town even though his family's local political status remains low.

Before Owner Lin's motorcycle part factory was established in 1998, there were larger collectively-owned factories in the village and each of them raised their funds in different ways. For example, at the outset of reform, there was an iron factory, which relied mainly on RCC loans; later on, in the early 1980s, a plastics factory was set up by about 25 households who pooled their savings for four years and registered it as a collective enterprise. (This is called the "wearing a red hat" strategy because the plastics factory was really privately owned—registering it as a collective gave it preferential land use and tax treatment.) Meanwhile, clusters of smaller household factories producing sugar, lime, paint, autoparts, and textiles tend to raise their start-up and working capital in sectorally distinctive ways, except in cases where extended families are involved in more than one sector.

Gender represents the third major dimension along which credit markets are segmented in Lin Village. In contrast to the male-dominated savings and credit groups in Chandrapur, the ROSCAs in Lin Village (called *chenghui* or *hui*) are only managed by women. A handful of middle-aged women run ROSCAs full time, but most *hui* organizers have other income-generating activities as well. The organizer with the largest volume of *hui* in Lin Village, for example, is a doctor who operates the village clinic from the courtyard home of the third Lin branch. At any given point in time, she runs up to five *hui* in the range of 200,000 RMB each (i.e., 20 members contributing 10,000 RMB each meeting), and the interest rates run up to 36

percent annually. Villagers find Doctor Lin to be a trustworthy organizer because as the village doctor, she knows everyone and is unlikely to flee town with their money.<sup>76</sup>

The manner in which credit markets in Lin Village are segmented is only one example of how single-surname villages may be internally differentiated.<sup>77</sup> Indeed, regardless of the particular distribution of surnames at the village-level, many other patterns of local segmentation may be identified in rural China depending on the structure of the economy, the nature of geographical constraints or resources, the extent of external vs. internal migration, and the developmental orientation of the local government.<sup>78</sup>

## Conclusion

The persistence of informal finance in rural China and India is less puzzling when we take into account the local political, economic, and social dynamics that lead to segmented credit markets. Both the supply-leading and state capacity hypotheses make intuitive sense, but they have explanatory limits empirically. To reiterate, merely increasing the availability of official credit may not reach the targeted population because it still needs to be disbursed in some manner. Credit officers and poverty alleviation cadres charged with the task of extending loans to rural households may face local pressures and incentives for credit distribution that deviate from the original intentions of state authorities. This is especially the case when it comes to subsidized microfinance programs because microloans are readily treated as political patronage. Meanwhile, curb market operators at the grassroots level often have a comparative advantage in

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<sup>76</sup>For more detail on why women are relatively advantaged in organizing *hui*, see Tsai, “Banquet Banking.”

<sup>77</sup>Cf. Lily Lee Tsai, “Cadres, Temple and Lineage Institutions,” *The China Journal* 48 (July 2002) : 1-27.

<sup>78</sup>On the varieties of developmental paths and property rights arrangements, see Jean Oi and Andrew Walder, eds., *Property Rights and Economic Reform in China* (Stanford: Stanford University Press, 1999); Jonathan Unger, *The Transformation of Rural China* (Armonk: M.E. Sharpe, 2002); Susan Whiting, *Power and Wealth in Rural China: The Political Economy of Institutional Change* (New York: Cambridge University Press, 2001); and Wu Jieh-min, “Local Property Rights Regime in Socialist Reform: A Case Study of China’s Informal Privatization,” Ph.D. dissertation, Columbia University, New York, May 1998.

serving rural households because they possess better knowledge about local market actors and conditions.

This is not to say, however, that informal finance trumps formal finance in either economic or normative terms, but rather, that top-down efforts at rural financial intermediation are not likely to achieve their objectives if they are not structured in a sustainable manner. It is no wonder that subsidized PA programs have low repayment rates when the loans are presented as developmental side-payments. MFIs that charge sustainable interest rates, on the other hand, tend to have higher repayment rates; and while reliable estimates of repayment rates in the curb are not available, it is probably safe to say that most informal financiers face hard budget constraints. While the constant threat of bankruptcy looms over the curb, the potential promise of additional subsidies fuels targeted microcredit. That is why informal finance and microfinance are imperfect substitutes. Rather than crowding out informal finance, the infusion of public and donor funds into microfinance adds another discrete source of credit in local markets. As seen in the Chandahar case, the establishment of a village bank enabled pawnbrokers to expand their role as financial intermediaries to local populations in the Scheduled Tribe and Caste Lists. Meanwhile, the Lin Village case demonstrated that from the perspective of borrowers with lower political status, formal sector credit is actually more expensive to them than the curb. Informal and formal sources of finance are not necessarily in competition with one another because they serve different segments of local society.

Analytically, if we accept that local-level political and economic dynamics fundamentally mediate developmental outcomes, then it makes sense to transcend the conventional state-society dichotomy by disaggregating both state and society. Just as local state agents may subvert central state objectives, different segments of society may be at odds with one another.