Imperfect Substitutes: The Local Political Economy of Informal Finance and Microfinance in Rural China and India

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Summary. — Banking authorities in both China and India have attempted to limit most forms of informal finance by regulating them, banning them, and allowing certain types of microfinance institutions. The latter policy aims to increase the availability of credit to low-income entrepreneurs and eliminate their reliance on usurious financing. Nonetheless, the intended clients of microfinance continue to draw on informal finance in both rural China and India. This article argues that the persistence of informal finance may be traced to four complementary reasons—the limited supply of formal credit, limits in state capacity to implement its policies, the political and economic segmentation of local markets, and the institutional weaknesses of many microfinance programs.

Key words — Asia, China, India, informal finance, microfinance, rural finance

“[O]fficial reports of the moneylender’s impending demise are much exaggerated.”— Clive Bell on India (1990).

“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 (November 29, 2002).

1. INTRODUCTION

Developmental economists have long noted the complexity of providing effective rural credit delivery in large, agrarian countries such as India and China. 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 macrolevel, 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 microlevel, 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 dimension to the official depiction of

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informal finance: when the poor lack access to conventional sources of credit, they are exploited by loan sharks and other illegal curb market operators. Following 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. Moreover, in some cases, the scale of informal finance actually increases in communities that have been targeted for a greater supply of official credit. This raises the question of why official attempts at limiting informal finance and expanding the accessibility of formal finance may have such unintended consequences. One basic reason for the persistence of informal finance is that the supply of formal finance is limited and insufficient to meet the demand for credit. A second explanation is that official state policies are not being implemented properly. In addition to these economic and state-centric explanations, this article argues that informal finance and formal finance are imperfect substitutes for two additional, complementary reasons: First, because credit markets are segmented by local political and social dynamics; and second, because government-sanctioned microfinance programs are often structured in a manner that fails to serve its intended clientele. This suggests that informal finance is not simply a manifestation of weaknesses in the formal financial system, but also, a product of local political, institutional, and market interactions. The analytical value in recognizing these local interactions lies in their ability to explain why developmental outcomes deviate from state intentions.

The article proceeds as follows: Section 2 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. Section 3 outlines the main expressions of informal finance in China and India and discusses the extent to which they have been subject to state regulation. Section 4 delineates four complementary explanations for why state efforts to substitute informal finance with microfinance have not been successful, and presents two local case studies from India and China, respectively, to illustrate how the combination of credit supply, local political economic conditions, and institutional characteristics of financial intermediaries mediates the dynamics of rural finance.

2. 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. 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.

(a) Formal financial sector

After India’s independence in 1947 and the establishment of the People’s Republic of China 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% of rural households relied on informal finance (Bouman et al., 1989, pp. 12–14). This finding inspired a strong political commitment to establishing formal sector alternatives to the curb, which was popularly viewed as being exploitative and even “evil” (RBI, 1954). Hence, throughout the 1950s and 1960s, the government actively promoted the expansion of cooperatives “to provide a positive institutional alternative to the moneylender himself, something which will compete with him, remove him from the forefront, and put him in his place (RBI, 1954, pp. 481–482)—or more generally, to enhance the availability of agricultural credit and alleviate rural poverty. 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 nonbanking finance companies. Even though the number of bank branches tripled during 1969–79, the government considered rural access to be too low at 37,000 people per rural bank branch; therefore, in 1980 another seven commercial banks were nationalized to extend their outreach in rural areas (AFC, 1988, in Nagarajan & Meyer, 2000, p. 172). 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 17,000–21,000 rural citizens per bank branch. But, the RRBs have proven to be financially unsustainable and inefficient in loan delivery (Bhatt & Thorat, 2001).

Shortly after the founding of the People’s Republic of China, the Chinese communists ordered the closure of all forms of private finance and banned popular forms of curb market financing, including pawnbrokering and “loan sharking” (Hsiao, 1971). 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. Meanwhile, in the early 1980s, the Ministry of Agriculture established a network of Rural Cooperative Foundations (RCFs) to serve farmers, but the People’s Bank of China never considered them formal “financial institutions” and succeeded in shutting them down at the end of the 1990s. Indeed, throughout the reform era central authorities have repeatedly waged national political campaigns to crackdown on the curb. In July 1998, China’s State Council even issued formal “Provisions on the Cancellation of Illegal Financial Institutions and Activities,” which reiterated that illicit financial institutions should be banned (Xinhua, July 22, 1998, cited in Tsai, 2002a, p. 1).

The elimination of RCFs left about 44,000 RCCs at the township level (with about 280,000 village branches) as the only formally approved nonbanking financial institution devoted to serving rural enterprises and households. Since then, central banking authorities have deliberated over how to improve their performance (Watson, 2003), and injected approximately US$4 billion in recapitalization funds into the RCC system because RCCs are technically insolvent. As of mid-2003, RCCs accounted for 11.5% of total savings and 10.8% of loans extended by formal financial institutions, and a pilot reform scheme for decentralizing their management was underway in eight provinces (PD, November 30, 2003).

(b) The rise of microfinance

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 nongovernmental organization (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 microloans 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 are more effective in reaching poor clients when loans are structured in a financially sustainable manner and use lending methodologies that are adapted to the particular economic needs of the intended clients.

(i) Directed subsidized credit in public poverty alleviation programs

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 (Adams, Graham, & von Pischke, 1984; cf. Morduch, 2000). The Indian 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 microloans to the poor (Sinha, 2000, p. 66).” In its first two decades, the IRDP
extended Rs. 250 billion (US$12.3 billion) worth of subsidized loans to approximately 55 million families who have an annual income of less than Rs. 11,000 (US$305). Given that 70 million families live below the poverty line in India, it is apparent that the IRDP has had significant outreach. In addition to the loans, IRDP borrowers also receive a cash subsidy at the time of loan disbursement equivalent to 25–50% of the project cost (Nagarajan & Meyer, 2000, p. 170). The program has certainly disbursed a high volume of loans, but funds have been misused via the subsidy component such that cash is diverted to local elites rather than the intended borrowers; as a result, the program has had a repayment rate of only 25–33% (Sinha, 2000, p. 66). 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. Due to the non-commercial orientation of these programs, basically all of the formal sector institutions involved in microfinance have depended on refinancing and recapitalization by apex institutions on a regular basis (Nagarajan & Meyer, 2000, pp. 177–179).

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, but that type of “policy lending” has not occurred in the name of microfinance or poverty alleviation. 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 (Rozelle, Park, Ren, & Bezinger, 1998). While official interest rates on loans ranged between 8% and 10%, the poverty alleviation loans charged only 2.88% annual 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% (Park, 1999).

By 2000, the government had disbursed US$775 million worth of subsidized microloans (Tsien, 2001), and by 2002 nearly US$3.7 billion (or half) of the central governments poverty-relief funds were going toward poverty-relief loans (Xinhua, March 2, 2002). As in the earlier model of poverty lending, however, repayment rates in these government programs have been low, i.e., less than 60%. Even though the Agricultural Bank of China (a state commercial bank) took over the poverty lending program from the Agricultural Development Bank (a policy bank) in 1998, the People’s Bank of China (PBC) has been encouraging RCCs to extend microloans to rural households. As of 2002, the PBC reported that RCCs had extended a total of 78.9 billion RMB (US$9.54 billion) worth of microloans and that 25% of all rural households in the country had received such loans (CIIC, November 5, 2002).
Although RCCs report higher repayment rates than the PA programs, as of year-end 2003, their ratio of nonperforming loans was still quite high at nearly 30% (SIC, January 14, 2004).

(ii) **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 nonbanking financial institutions. 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: self-help group (SHG) programs that have linkages with banks; cooperatives; or Grameen replicators (EDA Rural Systems, 1996). Organized by NGOs, SHGs consist of 10–12 people with similar socioeconomic and demographic characteristics (e.g., low-income women in rural areas). As of 2002, there were one million SHGs with 17 million members (Ashe, 2002, cited in Wilson, 2002, p. 221). 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 (Hannig & Katimbo-Mugwanya, 1999, p. 7). 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. As of March 2003, over 444 banks were participating in microfinance linkages with 717,360 SHGs; in total, the SHG–bank linkage program had served an estimated 7.8 million low-income households (NABARD, 2002, 2003). Ultimately, NABARD hopes to reach one-third of India’s rural population through the establishment of one million bank-linked SHGs by 2008. (Bansal, 2003, p. 24).

Aside from participating in the SHG–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. Finally, about 10 organizations may be considered Grameen replicators. The largest ones are SHARE, Activists for Social Alternatives Trust, and Rural Development Organization, Manipur (Sinha, 2000, p. 70).

Overall, MFIs in India have not been subject to stringent regulations, especially those that are not registered as cooperatives or nonbanking finance companies. 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 1990–91 economic crisis has loosened interest rate controls on microcredit, which offers MFIs in India the space 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 (Saich, 2000). As such, China does not have purely nongovernmental organizations engaged in microfinance even though they may be functionally equivalent to NGOs. The introduction of the Grameen model of microfinance provides a good example of the close relationship between government entities and NGOs in China.

The replication of the Grameen model in China first came about through the individual initiative of researchers at the Rural Development Institute of the Chinese Academy of Social Sciences (CASS) and international donors; but to date, the most successful Grameen replications are managed from an office housed at CASS. With funding from
Grameen Trust, the Ford Foundation, and the Canada Fund, in 1994 a small group of CASS researchers led by Professor Du Xiaoshan established the Funding the Poor Cooperative (FPC) in Yixian, Hebei (Tsai, 2002a, pp. 200–202). To implement the project they collaborated with the Yixian county-level Poverty Assistance Bureau and the Civil Affairs Office. As of March 2003, there were three FPCs in Yixian, Yucheng (Henan), and Nanzhao (Henan) counties, respectively, and together, the three FPCs had served a total of 15,244 borrowers (Du, 2003). With repayment rates ranging from 95% to 99%, 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% effective interest per annum.10 Scaling up to extend their reach and experimenting with non-Grameen lending methodologies is their next challenge.11

Besides the FPC Grameen replications, international donors have initiated over 200 microfinance programs throughout central and western China (Cheng, 2003, p. 123). The donors 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 Agricultural Bank of China and the Qinghai Commission of Foreign Trade and Economic Cooperation; the Heifer Project International has been collaborating with the Sichuan Animal Husbandry Bureau since 1985; and since 1995, the International Crane Foundation has implemented a Trickle-Up Program in Guizhou with the cooperation of the Guizhou provincial Environmental Protection Bureau.12 With few exceptions, the donor-initiated programs have been structured as projects with a limited lifespan rather than as MFIs aiming for sustainability (Cheng, 2003; IFAD, 2001, pp. 20–21; Park & Ren, 2001). 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%.13 This is consistent with the popularity of informal financing mechanisms (discussed below) that charge even higher interest rates.

3. 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 (IFAD, 2001, p. C11), and another 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 (Tsai, 2002a, pp. 36–37). In India, the 1992 AIDIS survey revealed that nearly 40% of rural households continue to rely on informal finance—or more technically, “noninstitutional credit agencies,” which include agricultural moneylenders, professional moneylenders, traders, relatives and friends, and others.14 Table 1 outlines the 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, as are organizations that mobilize savings without registering with the appropriate authorities.15 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.

(a) 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 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 10-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.16 In contrast to those
charged by loan sharks 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, 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 in northern central provinces such as Henan (Tsai, 2002a, Chap. 5).

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 regulated due to their usurious connotation. 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 (Li, 2000), 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 explained in a Ministry of Finance 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

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**Table 1. Legal condition of informal finance in China and India**

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<tr>
<th>Type</th>
<th>China</th>
<th>India</th>
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<td>Interpersonal lending—loans extended among friends, relatives, neighbors, or colleagues</td>
<td><em>minjian jiedai</em>—financial authorities do not interfere with casual, interest-free lending</td>
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<tr>
<td>Trade credit—merchandise credit between wholesalers and retailers</td>
<td><em>hangye xinyong</em>—neither sanctioned nor prohibited</td>
<td>Trade credit, forward sales</td>
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<td>Moneylenders, loan sharks—loans from professional and nonprofessional money brokers, typically at high interest rates</td>
<td><em>gaolidai</em>—all high interest lending is illegal</td>
<td><em>Mahajan and Chettiar bankers</em>—Some are registered as finance companies, trusts, banks, and partnership firms</td>
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<td>Rotating savings and credit organizations (ROSCAs)—indigenously organized savings and credit groups</td>
<td><em>diandang, dangpu</em>—permitted when operated according to regulations</td>
<td>Pawnshops—legal if licensed</td>
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<td>Pawnshops—extend collateralized loans with interest</td>
<td><em>zhuzhu, huihui, biaohui, chenghui, juhui</em>—permitted in localities where they have not collapsed</td>
<td>Deal with short-term credit (<em>hundis</em>) combined with trade for financing trade—committees have made efforts to formalize them</td>
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<td>Indigenous banks, money houses, finance companies—mobilize savings and extend collateralized loans</td>
<td><em>siren qianzhuang, private money houses</em>—regarded as private banks, which are illegal; most operate underground now</td>
<td>Nidhi companies, mutual benefit societies, permanent funds (mainly in Tamil Nadu)—committees have recommended that they be regulated more stringently</td>
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<td>Rural cooperative foundations</td>
<td><em>nongcun hezuo jijinhui</em>—approved by MOA until closure by PBC in 1999</td>
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<td>Social organizations, mutual benefit funds—registered entities that are supposed to serve lower-income populations</td>
<td><em>huzhuhui, hezuo chu jijinhui</em> (mutual assistance societies, cooperative savings foundations)—registered with MCA, but not supposed to engage in for-profit financial intermediation</td>
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2. 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 regulated due to their usurious connotation. 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 (Li, 2000), 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 explained in a Ministry of Finance 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 (Zhongguo yinhang, 1993, pp. 240–243).

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. 19 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 closed over half of the registered pawnshops, leaving only 1,304 shops with PBC licenses. 20 In a further attempt to circumscribe the 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 (JJRB, 2000). 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) remain unregulated in most localities. When hui involve relatively small groups of people (5–10 members on average) who pool set monthly contributions and rotate the disbursal of the collective pot of money to each member, local governments usually consider them 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 (Tsai, 2000). 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. As such, it is only in a small handful of localities that hui have been banned by local governments.

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 Agriculture in the mid-1980s exemplifies this phenomenon (Cheng, Findlay, & Watson, 1998; Du, 1998). 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 (Holz, 2001). 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 (Park, Brandt, & Giles, 2003). 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. These actions triggered farmers’ protests in at least six provinces, including Sichuan, Hubei, Hunan, Henan, Guangxi, and Chongqing (AP, March 22, 1999; AFP, March 23, 1999). Apart from RCFs, some de facto nongovernmental 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. These go by a variety of names, including mutual assistance societies and cooperative savings foundations. The credit societies are supposed to be nonprofit 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 use 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 toward poverty alleviation via microfinance.
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. Indeed, what most observers would regard as informal financial intermediaries are registered under the Companies Act, 1956 or regulated by the RBI. For example, moneylenders acts at the state level regulate nonborrowing lenders, while borrowing lenders (or intermediaries) are also subject to various types of regulation. Furthermore, 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.) The extent of curb market regulation and tracking in India stands in contrast to the situation in China where many types of informal financing activities are simply banned.

After taking into account sampling and nonsampling 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

Table 2. Breakdown of informal finance in rural India over time

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<td>Landlords</td>
<td>3.5%</td>
<td>1.1%</td>
<td>8.6%</td>
<td>4.0%</td>
<td>n.a.</td>
</tr>
<tr>
<td>Agricultural moneylenders</td>
<td>25.2</td>
<td>47.0</td>
<td>23.1</td>
<td>8.6</td>
<td>6.3</td>
</tr>
<tr>
<td>Professional moneylenders</td>
<td>46.4</td>
<td>13.8</td>
<td>13.8</td>
<td>8.3</td>
<td>9.4</td>
</tr>
<tr>
<td>Traders and commission agents</td>
<td>5.1</td>
<td>7.5</td>
<td>8.7</td>
<td>3.4</td>
<td>7.1</td>
</tr>
<tr>
<td>Relatives and friends</td>
<td>11.5</td>
<td>5.8</td>
<td>13.8</td>
<td>9.0</td>
<td>6.7</td>
</tr>
<tr>
<td>Others</td>
<td>1.1</td>
<td>7.5</td>
<td>2.8</td>
<td>5.5</td>
<td>4.9</td>
</tr>
<tr>
<td>Unspecified</td>
<td>n.a.</td>
<td>n.a.</td>
<td>n.a.</td>
<td>n.a.</td>
<td>3.8</td>
</tr>
<tr>
<td>Informal credit as share of total household debt</td>
<td>92.8%</td>
<td>82.7%</td>
<td>70.8%</td>
<td>38.8%</td>
<td>39.6%</td>
</tr>
</tbody>
</table>

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.

Figure 1. Distribution of informal financing mechanisms, India 1951–91.
market over time. The decline of the money-
lender 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 (Bell, 1990). 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 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 (Ghate et al., 1992, p. 45).

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 (Schrader, 1994).
The Shroffs of Western India, for example,
provide a short-term credit instrument called
darshani hundi to traders who need to travel
great distances to purchase inventory and
transfer funds (Ghate et al., 1992, pp. 198–200).
In addition to serving as financial intermedi-
aries, indigenous bankers are also business-
people themselves. 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 fixed term for clients who
lack sufficient cash to purchase capital goods
up front (Nayar, 1992, pp. 199–200). Even
though formal sector HPF’s 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 (Das-Gupta & Nayar Associ-
ates, 1989).

Forms of informal finance in the other cate-
gory also include indigenous bankers who are
not registered as traders or commission agents;
unregistered finance corporations; nonprofes-
sional moneylenders (other than those identi-
fied as friends and relatives); various types of
leasing, investment, and housing finance com-
panies; ROSCAs (chit funds) and Nihdi socie-
ties. 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 (Ruth-
erford & Arora, 1997). 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., the de facto
interest rate) is capped at 30% of the size of the
pot; and chit funds are limited to a maximum
of 60 months (Ghate et al., 1992, p. 197). 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.

In addition to chit funds, Nidhi companies or
mutual benefit societies are also an important
part of the nonbanking 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 (Nayar, 1992, pp. 197–
199). When nonmembers wish to make a
deposit or borrow from a Nidhi, they take a
share of the Nihdi. Over the years, the state has
made repeated efforts to regulate these mutual
benefit societies; and an Expert Group on
Nidhis constituted by the Department of
Company Affairs has recommended a host of
additional regulations to professionalize their
operations (PIB, 2002).

4. THE PERSISTENCE OF INFORMAL
FINANCE

State authorities in both China and India
have clearly recognized the importance of for-
mal financial institutions in rural areas,
including the expansion of microfinance pro-
grams for poverty alleviation purposes. Finan-
cial regulators have also made repeated efforts
to eliminate and/or regulate of curb market
activity. Why, then, has informal finance per-
sisted and even expanded in both countries?
Four complementary explanations may be
derived from the perspective of supply-leading
economics, state–society relations, the local
political economy of markets, and the institu-
tional characteristics of lending programs. As
will be shown, the first two hypotheses capture
macrolevel dynamics, while the second two have explanatory leverage at lower levels of analysis. Specifically, the economic hypothesis concerns the gap between the overall supply and demand for formal credit, and the state-society hypothesis concerns limits in state capacity to reach the intended recipients of subsidized loans and microcredit. Both the local political economy and institutional design perspectives then explain why certain groups of people do or do not receive credit at the ground level. The rationale for each explanation is discussed in more detail below.

(a) Neoclassical economics: a matter of supply and demand

Based on the logic of supply and demand in neo-classical economics, one reason that informal finance 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 the formal financial sector in rural areas. Therefore, 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 (cf. Chandavarkar, 1992; Patrick, 1966). Table 2 shows that according to official statistics, the relative dominance of the curb market in rural India has declined over time with the expansion of formal credit institutions. Bell (1990) draws on two independent World Bank surveys to demonstrate, however, that the decennial RBI surveys underestimate the true scale of informal finance. This leads him to conclude:

Although the moneylender did lose ground relative to [formal financial] institutions over the period from 1951 to 1981, he remained a very important source of finance to rural households, and the expansion of aggregate debt was almost surely so great as to imply that his volume of business grew.

In other words, despite significant increases in the supply of bank loans and microcredit (over US$15 billion), rural households continue to draw on informal sources of credit. A more recent study of credit rationing in rural India confirms that this is due to the combination of limited access to formal credit and continuing high demand for such credit (Swain, 2002).

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 ceteris paribus we would expect clients of microfinance programs to rely on subsidized poverty loans rather than high-interest loans from the curb. 23 Yet this turns out not to be the case. In their surveys of MFI clients, Park and Ren (2001) discovered,

Over 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. Thus it does not appear that microfinance participants lack access to other credit sources, whether formal or informal (p. 46).

Their study also found that the overall level of indebtedness is higher among microfinance clients, and that only one-quarter of them would have engaged in income-generating activities of the same scale in the absence of these loans. This suggests that although government-sponsored microloans are not going only to rural households that lack access to formal credit, “microfinance lending relieves credit constraints at the margin” (Park & Ren, 2001, p. 46).

Applying the supply-leading hypothesis to India and China explains in part the on-going popularity of informal finance among rural households, but it also raises a number of questions. Why is business getting better for India’s moneylenders amid the expansion in formal 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 helps to explain this disjuncture between the intended and actual recipients of targeted and microcredit.

(b) State–society relations: a matter of state capacity

A second reason why increasing the official supply of credit has not translated into a matching decline in informal financial activity is 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. Second, state actors may intentionally divert credit from the intended recipients. Third, nonstate actors may interfere with the proper disbursement of formal and MFI credit. Taken together, all three types of implementation failure could be interpreted as reflecting weaknesses in state capacity (Evans, Reuss-meyer, & Skocpol, 1985).

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 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 is disbursed, rather than on the identity and needs 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 of 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 (Adams et al., 1984). 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 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 noncropping activities (Park & Ren, 2001). The next section shows that the underlying reason for this second type of implementation failure is due to local market segmentation along political and social lines.

Aside from the top-down weaknesses in state capacity discussed above, nonstate actors may also be responsible for distortions in policy implementation (Migdal, Kohli, & Shue, 1994). In this case, nonstate 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. After all, informal finance persists even in advanced industrialized countries with sophisticated financial systems.

The second main expression of noncompliance by societal actors may come from borrowers themselves. One could argue that lower-income farmers and rural traders boycott formal and semi-formal financial institutions to undermine their legitimacy (Selden & Perry, 2000). 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” (Yaron, Benjamin, & Piprek, 1997, p. 102). The low repayment rates in China’s subsidized PA programs suggest that similar dynamics are in operation.

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, i.e., why state-subsidized credit and microfinance have not gone to their intended recipients. But 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 automatically crowd out informal credit, strengthening state capacities in rural financial intermediation does not necessarily come at the expense of nonstate actors such as money-lenders and wealthier households if local agents and institutions face competing political
incentives. In both China and India, intrastate actors (such as local officials and bureaucrats charged with loan disbursement) are just as likely as nonstate actors to distort policy implementation.

(c) Segmented markets: a matter of institutional design and local political economy

Ultimately, rural credit markets are more finely differentiated than a dichotomous trade-off between state and society. 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 (Hoff & Stiglitz, 1990).

The concept of segmented markets typically refers to the variation in preferences among consumers in different economic strata, e.g., in terms of loans for consumption versus productive purposes, and the conditions of credit access such as collateral, third party guarantees, and savings requirements. In other words, various forms of credit are not functionally equivalent to the borrower. Both the institutional design and lending methodology of different forms of credit influence the relative attractiveness of, for example, government-subsidized loans versus unsubsidized microfinance loans from NGOs versus high-interest loans from the curb. All of them have different restrictions in terms of loan size, amount, repayment terms, preferred clientele, etc. Hence, a borrower might take out a high-interest loan from a moneymender rather than a low-interest one from a government program because the former entails lower transaction costs or because the latter requires that the loan be used for productive purposes.

In addition to supply-side differences in the institutional types of rural credit, market segmentation also occurs along political and social lines, which further distorts the way local credit markets function in practice. 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. Moreover, 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 and social hierarchies may reveal where the soft loans were distributed.

Similarly, 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 moneymenders 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 both formal and informal finance.

(i) Tribal, caste, and occupational segmentation in a North Indian village

In a diachronic study of a South Rajasthan village that Jones (1994, Chap. 18) calls Chandrapur, we can compare the nature of the local credit market before and after a village bank was introduced. As of 1989, Chandrapur Village had a population of over 1,000 people in 200 households, within which were four main social groups engaged in different economic activities: Hindu households engaged in caste-based nonagricultural activities, Jain households prevailed in commercial and financial services, Jogis relied on income from working as migrants in Gujarat and Bombay, and 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 provided pawnbrokering services revealed that even six years after the village bank was established, B. Jain’s lending volume had increased by over 100% in nominal terms—from Rs. 53,351 (US$5,455) in 1982–83 to Rs. 110,818 (US$6,756) in 1988–89—and the annual
number of loans had increased from 290 to 335, but the interest rate had remained at 3% per month throughout the same period. 26 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.

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 (Jones, 1994, pp. 18–24).

In addition to the expansion in pawnbrokering, mutual finance groups emerged during the same phase. By 1991, 50 out of the 200 households in the village were participating in these savings and credit groups, and by 1992, the loan volume of mutual finance groups was comparable to that of pawnshops and exceeded that of the village bank (Jones, 1994, pp. 18–8, 18–9). Why did a substantial expansion in curb market activities follow the introduction of the village bank?

Each of the explanations outlined above offers insight into the question. First, from an economic perspective, one could infer 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. Indeed, during 1988–89 the village bank accounted for only 90 out of the total of 425 loans extended in the village (Jones, 1994, pp. 18–23). 27

Second, irrespective of credit supply, the village bank itself was poorly managed and failed to carry out its intended mandate. Specifically, the Chandrapur village bank was supposed to service a total of 17 different villages, yet Chandrapur village residents alone received over half (54%) of its loans. Furthermore, even though the Bhil are Scheduled Tribe members and represent a specific target group of the bank, over half (52%) of these bank loans were extended to Jain borrowers who are relatively well off. It is also worth noting that in 1989, 52% of the bank’s loan portfolio was in arrears, and 30% was past due for over three years, i.e., in default. By way of contrast, during the same period 70% of the loans extended by B. Jain’s pawnshop were repaid in full.

Third, the local credit market was highly segmented on both the supply and demand sides. On the supply side, the lending methodology varied considerably among different sources of credit. The village bank did not offer the types of services demanded by certain groups in the community. In contrast, the popularity of pawnbrokering and mutual finance groups may be attributed to their flexibility relative to restrictions associated with loans from the village bank. Villagers turned to the pawnshops to meet seasonal needs such as productive household consumption (e.g., housing construction, education, migration), agricultural cultivation, and ceremonial expenditures. At the other end of the income spectrum, members of mutual finance groups used them to engage in money lending rather than consumption or productive investment purposes.

At the same time, Chandrapur’s local credit market was also highly segmented along tribal and occupational lines. For example, the Jogis who are on the Scheduled Caste lists were supposed to receive targeted credit from the village bank, but due to their life cycle and consumption needs (e.g., weddings and funerals), they ended up relying on pawnbroking loans from Jain shops. Meanwhile, only 23% of the number of pawnbroking loans extended by B. Jain went to local villagers, while 75% of the loans went to Bhil customers who focused on agricultural cultivation in tribal settlements. 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 (Jones, 1994, pp. 18–27).” Instead, Jains not only enjoyed privileged access to loans from the village bank, but also dominated the ownership of pawnbrokering businesses and accounted for one-third of the participants in mutual finance groups, which were geared toward enhancing the volume of their informal lending activities.

In addition to intertribal 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 occupa-
tion such that the Jains form the Government Employees' group, the Blacksmith Caste form the School Staff group, and relatively few (8%) Bhil cultivators participate in mutual finance. These multiple dimensions of segmentation help to explain why the scale of informal finance actually increased after the introduction of the village bank: not only did the village bank deviate from its mission, but ironically, the fact that most of the bank’s loans went to local curb market financiers (Jains) enabled them to expand the provision of informal financial services to other groups in the village.

(ii) Segmentation within a single surname village in South China

While it may seem intuitive that a multiracial 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% of the households share the surname Lin and the village temple, which traces the Lin lineage back to the late Qing dynasty. 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 their spacious traditional courtyard home was turned into the communal mess hall. 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. Although members of the second branch are neither politically privileged nor persecuted, they also have disadvantaged access to various production inputs relative to the first branch.

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, 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 (US$7,200) because the credit officer would pocket the other 40,000 RMB (US$4,800). 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 (US$84,000) in his motorcycle parts factory by using 100,000 RMB (US$12,000) of his own savings, borrowing 200,000 RMB (US$24,000) interest free from his four older siblings, and borrowing 400,000 RMB ($48,000) at 24% 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 remained low.

Before Owner Lin’s motorcycle parts 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 because it was run by managers from the first branch of Lins. Later on, in the early 1980s, about 25 households in the second branch set up a plastics factory by pooling 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. Given the rapid industrial transformation of Lin Village in the first two decades of reform, it is unlikely that the local RCC and county-level Agricultural Bank could have kept up with the grassroots demand for investment and working capital. As such, the expansion in informal financing during the reform era is not surprising. It is noteworthy, however, that the businesses that have received formal sector loans, i.e., those run by the first branch, have not performed as well as those financed by the curb. This may be attributed at least in part to the tendency of local political elites to view the loans as grants rather than serious business obligations.

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. In China’s southern coastal provinces, women dominate hui participation because they have better developed social networks with one another, because they are more likely to remain in town year round (as opposed to men who may engage in seasonal migration), and because men are more likely to have other financing options (Tsai, 2000). In Lin Village, 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 (US$24,000) each (i.e., 20 members contributing 10,000 RMB/US$1,200 each meeting), and the interest rates run up to 36% 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.

The manner in which credit markets in Lin Village are segmented is only one example of how single-surname villages may be internally differentiated (Tsai, 2002b). 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 versus internal migration, and the often path dependent developmental orientation of the local government (Unger, 2002; Walder & Oi, 1999; Whiting, 2001; Wu, 1998).

Finally, despite the shared popularity of informal finance, the financial landscape in Lin Village differs significantly from that of Chandrapur. While the introduction of formal finance to the latter had the unintended effect of expanding the volume of the curb, in Lin Village the formal financial institutions have always been captured by local political elites who are not especially adept at business (cf. Adams et al., 1984; Otero & Rhyne, 1994). The vast majority of commercially successful operations in Lin Village have relied on informal financing mechanisms that do not involve the first branch of Lins. This is typical of China’s private sector as a whole. As of year-end 2003, less than 1% of all loans extended by state banks were going to private entrepreneurs (PBC, 2004). Hence, even though there is political and economic segmentation at the local level, the expansion of informal finance in China is largely attributable to the limited supply of formal credit to the nonstate sector.

5. CONCLUSION

The enduring popularity of informal finance in rural China and India may be traced to a number of complementary factors: First, formal financial institutions and microfinance programs are often unable to meet the demand for grassroots credit. But, merely increasing the availability of official credit may not reach the targeted population because it still needs to be disbursed in some manner. Even if the supply of official credit were sufficient, credit officers and poverty alleviation cadres charged with the task of extending loans to rural households often 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. Mean-
while, curb market operators at the grassroots level generally have a comparative advantage in 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 and implemented properly. 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 Scheduled 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. Recognizing the complexity of grassroots segmentation ultimately has implications for the local distribution of both governmental and nongovernmental sources of finance. Commercial bank credit, subsidized loans, microfinance facilities, and curb market financing all entail a mix of social, political, and economic incentives that are contingent on local context. Only when microfinance programs are structured according to local needs and aimed at cost recovery will microfinance hold greater potential for displacing usurious forms of informal finance.

NOTES

1. Useful compilation of the debates include Bouman and Hospes (1994) and Hoff, Braverman, and Stiglitz (1993).

2. By definition, informal finance refers to financial flows that occur beyond the scope of a particular country’s formal financial system of banks, nonbanking 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 due to changes in their political, macroeconomic, and regulatory environments. Furthermore, each of the categories encompasses a wide range of different financing mechanisms. In this article, formal finance comprises not only conventional banking and financial institutions, but also officially sanctioned microfinance programs, which include both subsidized and unsubsidized programs, as well as state-sponsored and NGO-led programs. Informal and semi-formal finance will generally be discussed together because both fall beyond the scope of standard commercial and developmental/policy-oriented financial institutions. As the article discusses, many forms of informal finance are subject to regulation in India, while most forms of informal finance are simply banned in China.

3. RRBs represent a hybrid between cooperatives and commercial banks; they were established specifically to serve impoverished farmers, laborers, and microentrepreneurs in rural areas.

4. 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 (Sinha, 2000, p. 66).
5. 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.

6. During 1978–98, one US dollar ranged from Rs. 8.2 to 41.3. The conversion for Rs. 250 billion is based on an annual average rate of 20.3 over that period. The figure includes repeat assistance to the same families.

7. 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.

8. When it comes to subsidized loans for state-owned enterprises or collectives that employ large numbers 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, small business owners rather than larger scale corporations that have larger capital requirements.

9. Note that the participating “banks” include commercial banks, RRBs, and cooperatives. For additional information about SHGs and what is known as the “new microfinance,” see Bansal (2003), Satish (2001), and Wilson (2002).

10. For a comparison of the performance of NGO, joint NGO-government, and purely government-run microfinance programs in China, see Park and Ren (2001).

11. Citibank has committed US$1.3 million to FPC via Grameen Trust for expansion. Xinhua (November 19, 2002).

12. For a list of microfinance projects supported by international donors, see China Development Brief (1999).

13. NGO participants said they were willing to pay up to 32.6% in annual interest, while participants in government-run PA programs were willing to pay up to 21.4% annually and those in mixed NGO-government programs were willing to pay up to 20.2% (Park & Ren, 2001, p. 45).

14. The survey found 39.6% of rural households relied on “noninstitutional credit agencies.” RBI (2000), Table 5.

15. Note that “high” interest rates are defined as rates that exceed the interest rate ceilings in China and the anti-usury laws in India. These limits are in the range of 10–12%/year for China and 24%/year for India.

16. They are “legal” to the extent that they have not been banned explicitly.

17. 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.

18. Communist-era references to pawnshops in imperial China condemned them as an expression of class-based exploitation. For example, Xin (1993).

19. For example, pawnshops in Xingtai, Hebei offered annual interest of 40% to its depositors in 1991 (Xin, 1993). A more recent study found that some pawnshops charge monthly interest rates between 5% and 8% (i.e., up to 72% interest annually), which is how they are able to offer depositors such high rates of return. China Online (September 9, 1999).

20. 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.

21. Many nonborrowing and borrowing lenders probably do not comply with the various acts. Moreover, informal moneylenders fall beyond the scope of regulation. I thank one of the anonymous reviewers for pointing this out.

22. In pre-colonial and colonial India, Multanis, Gujarati Shroffs, Marwaris, Nattukottai Chettiaras, and Kallindakurichy Brahmins represented the most prominent indigenous bankers. During the late colonial period, many invested in industry and commerce (cf. Bagchi, 1972).

23. Of course, formal and informal sector loans do not have similar lending methodologies (in terms of size, length, repayment schedule, collateral requirements, etc.). But this section of the article only focuses on the actual financial cost of formal versus informal credit to examine the issues of access to and demand for credit, ceteris paribus.
24. This phenomenon is not specific to India or China (Adams et al., 1984; Otero & Rhyne, 1994).

25. The local case study from India—“Chandrapur Village” in South Rajasthan—was included in a larger project on microfinance in general. The local case study from China—“Lin Village” in Wenzhou, Zhejiang—was part of a project on informal finance and rural industrialization in Wenzhou.

26. The U.S$ equivalent of the Indian Rupee went from Rs. 9.8 per 1 U.S$ in 1982–83 to Rs. 15.1 in 1988–89.

27. Note, however, that the village bank accounted for 80% of the total loan volume.

28. “Lin Village” is a pseudonym. This case is based on fieldwork in Wenzhou, Zhejiang province, 2000–01.

29. 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, and walls was destroyed or damaged.

30. Lin Village is “all mountains and water,” as the locals put it.

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