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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. [1] 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. [2]

(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