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China's Informal Economy: Ethical, Economic, and Empowerment Considerations

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Abstract China's rapid growth has lifted millions out of poverty in the countryside. However, many rural borrowers have been excluded from the formal financial sector, forcing them towards unregulated and potentially exploitative lenders. Rural women struggle for financial security when facing formal sector obstacles and China's patriarchal customs. An analysis grounded on ethical, cultural, and structural perspectives yields recommendations that empower rural women and strengthen China's financial sector.

Introduction

In China, 800 million people have been lifted out of poverty because of the country's staggering growth. China averaged 9.8% annual GDP growth in 2018, spurring the World Bank to characterize it as "the fastest sustained expansion by a major economy in history." Growth has slowed greatly, however, with economists predicting a rate of 5.5% in 2024.[1] This slowing leads to two questions: what is the next growth sector for China, and how can the Chinese financial system work better for those who no longer struggle with poverty?

The answers to both questions lie in China's countryside. Currently, China's rural population is 39.2% of its overall population.[2] Yet, in 2009 urban residents received 2.33 times the earnings of rural residents.[3] Many escaped poverty yet rural real incomes have been falling since 2014, decreasing as much as 20% from 2018 to 2019.[4] While only 0.5% of China's population live under global standards of poverty, how and why is the existing financial system leaving rural Chinese households behind?[5]

One key answer lies in access to capital through banks. The formal financial sector, comprised of large state-owned banks, usually lends to big corporations with high growth potential, little risk, and sizeable accounts. Rural firms and small and medium sized enterprises (SMEs) tend to be the opposite: relatively low growth potential, high risk of default, and small account values. The formal financial sector ignores rural firms for these and other reasons, creating a capital shortage in the

countryside. Because this money is vital to household and business survival, many turn to the informal financial sector instead. Family and friends, loan sharks, pawn shops, and underground banks compose the illegal, unregulated informal financial sector. SMEs account for 60% of GDP, 75% of the workforce, and 90% of new positions created, but as of 2012 they only received less than half of bank loans.[6] Many are lost in the cracks between the formal and informal financial sectors.

There exist a concerning number of ethical problems in both financial sectors, particularly in the case of a vulnerable demographic in China: rural women. These cultural influences hold stronger in the countryside where often local rules have stronger influence than the laws. Rules like land rights being allocated toward male heads of household, men being the locals with more social capital, and assumptions of less credit-worthiness of women, keep women financially dependent on their male relatives. Rural women might also have fewer acceptable forms of collateral for banks because they lack private land rights and carry the burden of a disadvantaged financial situation. As one of the largest financially vulnerable demographic segments in the world, an ethics analysis to assess this particular group's current position is certainly helpful, even necessary, accompanied by a set of recommendations going forward.

Structure and Problems of China's Formal Financial Sector

China's financial system rapidly changes with impenetrable obscurity. Each decade presents new reforms while data collection on their impacts is increasingly difficult. Because the Chinese government intervenes in financial activity more frequently than other governments in major world economies, financial activities are as secret as state activities. The majority of capital movements in China's formal financial sector occur between its many large banks like the "Big Four," and large, state-owned companies.[7] Some of these large banks, like the Agricultural Bank of China and the Agricultural Development Bank of China, were created to help rural firms. Instead, they lend to large corporations. Rural Credit Cooperatives (RCCs) attempt to fill the credit shortage. These networks of savings and loans cooperatives throughout the countryside are managed by local governments but face two plaguing issues.[8] The first is that RRCs actually make a number of loans to their own local government as well as large corporations, particularly those that spread from urban centers into the countryside. This crowds out local borrowing by increasing interest rates. The second is those loans the RRCs actually give to rural firms overwhelmingly become non-performing loans, or those where the clients have defaulted and will not repay them.[9] This bad debt totaled 37% of RRC loans in 2013, impairing RRC's capacity to lend to other rural firms.[10] This structure creates a plethora of issues that underserve rural communities, forcing borrowers into the informal credit markets to survive.

The informal financial sector persists because of failures in the formal financial sector. First, the structure of China's formal financial sector does not incentivize large banks to loan to rural firms. Banks tend to seek low-risk, high-margin projects. High-risk, low-margin projects in the countryside do not achieve the safe level of growth banks and shareholders prioritize.[11] In particular, when faced with high administrative and construction costs of establishing a bank branch in mountainous, difficult terrain, banks have actually fled the countryside. For decades, China's big banks have restricted rural people's access to formal financial institutions by closing at least 30,000 rural branches.[12] Even those who manage to stay in rural areas face high administrative burdens of trekking difficult terrain to collect interest. Revenues barely cover operating costs because many interest payments still default.[13] Financial technology, a potential solution to these issues, is inaccessible to more than 50% of rural residents.[14] While not necessarily a fault of the banks, there seems to be little internal and external motivation to include marginalized rural firms.

Second, a more specific obstacle to rural borrowers is lack of collateral. A major risk for banks is, without land ownership, rural farmers have little savings deposits as security. Borrowers cannot use the land they work as collateral because the government owns all rural land. Additionally, moveable assets like equipment cannot be used as collateral according to Chinese financial law, further restricting options.[15]

Third, the countryside lacks small- or medium-sized banks that could fill the capital shortage presented. The RRCs are stretched to their limits, saddled with great amounts of bad debt and representing the only formal institution focused on lending to SMEs. This resurrects the issue of administrative costs and profits for banks. Although the loan amounts and interest payments are small and the administrative costs are high for large banks, smaller banks with lower revenue goals and areas of interaction could interact more readily with rural communities.

Finally, the financial tools available do not fit the specific needs of an agricultural firm. Although banks take into account low collateral by giving smaller, short-term loans, they insufficiently support the sustained investment necessary in the many months before harvest. In a study done by a Chinese microfinance institution, it finds strict repayment schedules conflict with infrequent income streams.[16] These factors altogether cause rural firms to avoid banks altogether and pursue informal support.

History and Structure of China's Rural Informal Financial System

The informal financial sector is difficult to assess because it is unregulated and the most opaque sector of China's financial system. Few studies have or can characterize

its size. Rural reforms after the Communist revolution and Deng Xiaoping's rule saw informal finance wane throughout the 20th century, going underground after 1998 reforms outlawed non-government-owned finance.[17] Between 2002 and 2013, China's Ministry of Finance routinely seized assets from illegal informal financial institutions, apprehending 100 billion RMB ($70.65 billion) from 500 underground banks.[18] A 2001 study shows rural households receive four times more credit from the informal sector than from banks.[19] And while 72% of households nationally receive informal finance according to a 2003 Ministry of Agriculture study, most of the funds are used for sustenance and production, a mix of business and household expenses.[20]

In an overview of China's informal financial sector, the Brookings Institution defines informal financial institutions as "financial intermediaries that are not registered with any regulatory agencies and therefore are not regulated," indicating activities escaping government purview.[21] These intermediaries tend to be loan sharks, non-state-owned credit cooperatives, pawn brokers, individuals who personally lend in the community, or State-Owned Enterprises (SOEs) which lend excess funds.[22] The majority of financial activities occur as high-interest loans with low collateral requirements that instead rely on relationships and community rapport. Termed *gao li dai,* these loans are larger and longer-term than those from banks since agriculture means riskier and lower yield returns.[23] Businesses also lend to each other through trade credit where goods are given from wholesalers on credit for 10 to 30-day terms.[24]

Lastly, informal financial cooperatives of many shapes and sizes exist. Rotating savings and credit associations (ROSCAs), or *hui,* pool group members contributions and rotate the total to individuals, and sums vary depending on contribution amount, group size, and membership trends. Smaller groups, usually of women, are unregulated because the local government sees them as stable and productive money organizations among locals. Without regulation, however, individuals may steal the pot, causing the group to lose future contributions and trust in the infrastructure. Large *hui* inevitably collapse because with such high amounts and long wait times to circulate to so many members heightens the incentive to steal. With this characteristic, however, local governments usually permit *hui* without regulation.[25] The informal financial sector interacts with households and firms in all shapes and sizes, but this flexibility is not always legal.

The legality of the informal financial sector ranges considerably. Private commercial banks are illegal in China, so money houses of comparable size operate outright illegally.[26] All other aspects of the informal sector depend on the People's Bank of China (PBC) for their prohibition status. This standing is broken down into two further parts: whether public savings are invested and whether interest rates surpass regulated interest rate ceilings.[27] *Gao li dai* are illegal because interest rates easily exceed government-set ceilings.[28] Many private lenders reportedly charge three to 12

times the annual market interest rate of 5.31%.[29] Trade credit and individual lending are neither prohibited nor encouraged by the PBC. Without legality or regulation, each of these informal channels contribute a unique aspect to China's financial system.

The structure of the rural land system must be considered because it influences household and rural wealth. Dr. Sally Sargeson of the Australian National University explains those who own and administer rural land have been separate from those who use and manage the land since Deng Xiaoping's 1979 reforms. A local government entity like the Village Shareholding Corporation or the township owns all the land, varying according to the region. That entity then contracts mostly to families to farm small plots of land charging them a percentage of the raw good or the profits.[30] Even with this, Chinese farmers cannot own their land. The first disadvantage here is that as urbanization spreads into the countryside, farmers on valuable land cannot sell the land in order to accumulate wealth. Family firms may sell or lease out their land rights, but they miss out on this opportunity for financial security urban residents are afforded.[31] The second disadvantage is that family firms cannot use this land as collateral to acquire loans. This is the only non-moveable asset of great value according to a bank. These conditions force rural borrowers to use alternative assets to obtain financing.

What mostly sets apart the informal financial sector from the formal one is the emphasis on relationships. Because many rural borrowers lack the collateral and accounts that attract the formal sector, they rely on relationships and community rapport to receive the loans they need. Dr. Guibin Zhang shared four characteristics of rural entrepreneurs that govern informal financial transactions: political connections, regional origin, level of education, and business experience.[32] While these characteristics steer formal finance to some degree as well, these are the only determinants of conduct within unregulated financial transactions.

Zhang investigated these qualities and found a strong correlation between them and choices leaning towards formal finance. The first was that those with stronger political connections are more likely to seek formal finance. He and others found that growth of business in command economies depends heavily on political connections for legal shepherding local market development.[33] The second was that locals were more likely to find formal finance than migrants. Sargeson also found that local men in particular have more social capital in villages than men from other villages and the women that marry into local families.[34] Zhang's third correlation was that borrowers with higher levels of education are more likely to seek formal finance. Supported by existing literature, he found that higher levels of education correlated with easier acquisition of formal capital maintenance of loan contracts. The final idea was greater business duration led to acquiring formal capital more easily. Increased creditworthiness and community rapport have been shown to facilitate borrowers

acquiring formal capital once the business has grown.[35] Many social factors direct interactions in the informal financial sector in the absence of regulation and formal relationships.

Women in the Financial Sector

Chinese political and economic reforms the past 40 years have whipsawed women from praising equal labor force participation for women in the 1950s to stripping away their financial and legal security. Most notably, the One-Child Policy (1979-2015) shifted the culture towards aggressive preferences for men throughout society. During and after this misplaced and immoral policy, many families skew work, inheritances, and life investments favoring male children. Chinese women's rights activist Xie Lihua describes her subservience to her brother: "My sister and I knew that all the good food went to him -- when he was done, then we could eat."[36] Especially in the countryside, male children are prized for their physical ability to work the land. Even today, Xi Jinping's government upholds these patriarchal views. Although gender discrimination in hiring is illegal, public and private enterprises often write contract clauses demanding women not to get pregnant for two years. Otherwise, they would be fired. A 2019 poll in China finds that many think women's career advancement faces obstacles. 85% of respondents believe women having children harms their career development with 37% saying advancement opportunities are likely fewer for working mothers.[37] This culture around women poses difficulties to women's financial success.

Laws have only marginally helped women financially protect themselves. Unless the woman's name is on the deed, divorce settlements allocate applicable property assets to the man according to a 2011 law.[38] In rural areas, some villages had women signed on only 17% of land contracts while many villages had none.[39] Division of responsibilities in the countryside especially leaves women dependent on the men in the family and financially vulnerable. While men help tend the farms and migrate to urban areas for their paid work, women usually tend the home and the farm. This work does not allow them any personal funds, much less savings for emergencies or wealth accumulation.

Rural women are hit particularly hard by impediments to financial security through the local legal system and customs. Women are often *de facto* heads of household and family firm managers since generally men migrate to urban centers for work.[40] These positions potentially grant women individual, household, and community power. These women not only work the land themselves, but they also spend more time in the communities building business relationships and tracking the finances and needs of the firm. Although it makes sense to grant women land rights and contracts directly, it is the custom for the man's name to be used in every official

capacity.[41] Even customs of finance in rural China also disadvantage women. Households able to maintain bank accounts put them under the man's name, leaving the woman penniless.[42] Even in formal finance, RRCs loan based on creditworthiness. Men are customarily legally heads of households, so loans are granted directly to them.[43]

Even with these obstacles, women still receive financing through their active role in ROSCAs. A 2000 study by Prof. Kellee Tsai found that in five countryside centers for informal finance, women were consistently the majority of ROSCA participants, reaching rates as high as 90%.[44] Besides the obstacles described earlier, increased participation of women in ROSCAs could have occurred because women face higher rates of illiteracy or face discrimination from banks. Whatever the explanation for the gender difference, there is a clear gap: 70% of survey respondents with banking experience were men.[45] Another explanation for the increased involvement of women is that they pursue financing that can be used for household expenses as they usually take up household maintenance responsibilities.[46] Tsai also found that women could issue more credible commitments to not steal the pot, so they became trusted continued and new members in ROSCAs.[47] Rural Chinese women play an important financial role in their communities and each other's' lives.

Global studies on gender and microfinance discovered that women spend loans differently, usually creating better household and community outcomes. A 2005 study on Bangladesh microfinance summarized literature that claims women have higher loan repayment rates, either because of fewer credit alternatives or lower mobility. Numerous studies in Bangladesh found loans towards women increased women's household bargaining power, leading to greater allocations towards nutrition and human capital.[48] When extrapolated, these conclusions suggest even more reasons why rural women are key players in China's financial sector.

Ethics Analysis

The system of formal and informal finance in China presents a slew of ethical issues. Within the informal financial system, loan sharks can exploit the desperation of rural households. These unregulated lenders also use unorthodox methods of pressuring their debtors, from leaving dead animals on doorsteps to kidnapping and beating debtors until repayment.[49] It is said that many rural business owners pursue these illegal options due to ignorance of the lenders' reputations or tactics, but more often these firms would rather risk anything instead of losing their businesses.[50]

Usury like that which occurs in the informal sector violates commutative justice, the justice relevant to business transactions between parties, when one group

targets, exploits, and profits from the other's vulnerability. While there is not gender dis-aggregated data on this, women likely face even greater risks in the informal financial sector. Commutative justice could be achieved if both the formal and informal financial sectors include and support women's development. If the formal financial sector included rural women with female- or rural-specific financial tools, then women are protected by interest rate caps and the legal system. Still, the other problems of insufficient collateral and cultural conceptions of women exist, making them vulnerable in the interaction.

Additionally, there are problems of distributive justice. Firstly, lack of government regulation creates a system where poor individuals are harmed by the role of the community or the government in wealth distribution. Few societies can avoid this criticism, but it is especially appropriate in the case of rural women in China. One example of this is how China's rapid urbanization of the countryside exacerbates the gender asset gap as property and firm values increase.[51] The legal institutions and customs that have denied women financial protections and opportunities for economic independence enforce their difficult position. Chinese culture prioritizes the family unit over the individual, making women's financial independence even more difficult to demand. According to this, the ideal distribution of assets prioritizes that between households and communities rather than among the individuals among them. But laws penalizing women for divorce and customs of men's names on official documents excludes women as individuals from the right to financial security that men are afforded. A compromise that accommodates the values of community and acknowledges the hardships rural women face could closer achieve distributive justice in the informal financial sector.

Cultural Relativism in Global Women's Empowerment

A common concern in moral philosophy is cultural relativism. Often Western academics allegedly judge other cultures in a "response-to-the-West" perspective, meaning they see Western values and practices as standards to evaluate all others by. Many then suggest cultures cannot be compared because there are no objective criteria for rights, beliefs, or traditions. More clearly, cultural relativism suggests right and wrong, what is preferred and what is objectionable, all vary depending on the time and place.[52] A popular example is how Westerners think the practice of head coverings for Muslim women is oppressive, seeing it as patriarchal covering of women's bodies. In Dr. Abu-Lughod's book *Do Muslim Women Need Saving?*, she suggests that instead of listening to Muslim women about their problems, Westerners assume "a mission to rescue them from their cultures."[53] Without accounting for the validity of other cultures' practices, people risk subordinating cultures other than their own to the point of cultural imperialism.

On the other hand, philosopher James Rachels argues against cultural relativism by claiming it unsound as well as impractical. The structure of the cultural relativism argument states that if cultures disagree about a practice, then there is no universal standard for it. This rightly responds to supremacist tendencies of prioritizing one, often Western, culture over others. Rachels, however, points out this claim is unsound. Assuming that some cultures disagree based on opinion and tradition, this does not necessarily claim anything about the reality. He explains that "it attempts to derive a substantive conclusion about a subject from the mere fact that people disagree about it," likening it to disagreements about the shape of the Earth. He emphasizes that the conclusion that there is no universal standard may still be true, but that using this premise causes the argument to be fallacious. Practically, cultural relativism limits valid condemnations of atrocities like female genital mutilation, the Holocaust, or apartheid.[54]

One such concern is how a culture regards women. Rachels explains that most people think Western society has progressed since the 18th Century because women have been granted more protected freedoms and rights. Under cultural relativism, however, it would be inappropriate to compare today's society with that of centuries ago because it was wholly different.

A similar application to the situation of rural women in China's financial sector is apt. Many suggest that parts of Confucianism, like all other traditions, oppresses women, but a more nuanced understanding allows for some complexity. In Confucianism, the two genders rely on each other's inherent characteristics although women possess inherently weaker or subordinate traits. Some Eastern philosophers, like the notable 20th Century scholar Lin Yutang, claim that describing women's place in Confucian society as "subordinate" inappropriately applies Western values to an Eastern culture.[55] Lin and other philosophers support this argument by suggesting men's power in society was mirrored by women's power within the home. Instead of taking away women's power, Confucianism just prescribed a different way of organizing it.[56] Current Confucians like Jiang Qing support women's roles in the home as reflective of their "natural and social attributes" of care, kindness, and nurturing.[57] Lastly, numerous historians and philosophers remind us that Chinese women are not and have not been homogeneously victimized throughout history. Professor Chenyang Li reviews the many female rulers and educated gentry-women that demonstrate a multifaceted role Confucianism plays for women in China.[58] He characterizes the past and future for women in Confucianism astutely: "While Confucianism's oppression of women was quite severe—indeed undeniably severe—it must have left some room for women's moral cultivation and even social participation. Such room, however limited, may be expanded as the times change."[59]

Recalling Rachels's refutation of cultural relativism, is there a universal standard for women's treatment and resources? In the case of Chinese women in Confucianism, two statements must be made clear. Firstly, customs of women remaining home are not themselves oppressive. These rightfully fall under the realm of cultural relativism, meaning Western, liberal criticism of this tradition may be inappropriate and ignorant of its own history of gender roles.

Secondly, assumptions about all women's character and discrimination against women who pursue traditionally male roles stemming from these traditions are oppressive and deserve moral scrutiny. They face many cultural barriers due to Confucian practices. While Confucianism praises interrelatedness and harmony, there are "powerful pressures on women to conform to expectations about care, while weakening their rights to security and support."[60] The notable Confucian Dong Zongshu explained that yang was always superior to yin, a metaphor for the relationship between men and women: "The husband is yang even if he is from a humble family, and the wife is yin even if she is from a noble family."[61] Confucianism both prioritizes harmony, loyalty, and community alongside the suppression of women. As covered earlier, women are overlooked as primary financial managers even though they could manage money more efficiently. As amplified through the financial sector, women are left financially dependent on their male family members. If there were a universal standard for treatment of women, it must include the culture's perspective of women as independent, autonomous, and capable human beings so they can take care of themselves in the case that community and harmony do not suffice. All cultures could be criticized on this account, but given this financial and ethics analysis, it is particularly appropriate for rural women in China.

Recommendations for the Financial System

New policies could solve a few different types of problems present. A simple, effective solution to including informal financial sector participants in the formal financial sector is to fix some of the problems described earlier. More nuanced solutions could directly empower rural women, strengthen China's whole financial system, and progress the Chinese economy.

One overall recommendation is to include rural women into all aspects of the financial system. As Sargeson explained, women are often the managers knowledgeable of the farm's needs and potential. Banks could more easily collect interest, track the loans, and ensure well-used loans if they loan directly to female managers.[62] This reduces the risk that banks associate with migrant male workers and increases the efficiency of capital use. It is possible that the loans would still be managed by the man of the household after it is allocated. Given this, however, initially

providing it in the woman's name allows the opportunity for empowerment, signals the bank's changing culture, and shifts the community's culture towards embracing women in positions of financial power. This, lastly, could bear out results of previous studies showing improved social outcomes when women are allocated credit.

Different tools and attitude in the countryside may be the inclusion of rural borrowers into the financial sector. One lesson learned from the challenges banks face spreading into the countryside is that they should use existing customs and networks to do their work. In one way, this means reducing collateral requirements in place of individual reputation and community trust. Another way rural borrowers could be included is offering specific tools for their needs. Used already by the Ewenke Baoshang Village & Township Bank (EBVTB), three new tools have different collateral requirements, larger loan amounts, and accommodating repayment methods—all requests from rural borrowers of large banks. To overcome traditional obstacles to collateral, EBVTB accepts "pasture operation certificates" and land rights contracts that certify borrowers work the plots. Payments on principle are allowed irregularly, and those on interest could be monthly or quarterly to accommodate inflexible income. Given these, the loan amounts are correspondingly large so borrowers do not need to piece together amounts elsewhere.[63] The administrative and infrastructural burdens banks face in the countryside could partially be solved by still building on what currently exists. Because administrative costs are so high for such small loans,[64] it would pay to establish a small branch in the countryside that employs former informal money lenders.[65] Whatever simple accommodations banks make, rural borrowers must be met halfway.

These reforms also require the financial sector to alter its views. Overall, banks must accept two precepts. Firstly, the formal financial sector could learn from the importance of relationships and trust in business. The Confucian legacy of interrelatedness helps the informal financial sector overcome information asymmetries and lack of legal protections.[66] With this in mind, banks could approach the informal sector with empathy and trust, then extending leniency towards the rural poor. The second, albeit more difficult, precept to accept is that social good will sometimes be prioritized over profits. Instead of continuing the past trend of lending to big corporations for profits and security, accepting higher risks and lower profits could have larger significance to rural Chinese women. As the gender and Asian studies economist Dr. Alain Blanchard has stated, "Economic growth is not the same thing as economic development; examples from many countries show that economic growth does not always 'trickle down' to disadvantaged and minority groups."[67] Overall growth has lifted millions of rural individuals from poverty, but greater development is needed for those still on the line.

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