

# History, Culture and the Rise of Informal Finance in China

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## Summary

By providing micro-credits to small businesses, informal finance has achieved sustained growth in China in the past few decades. This paper examines the long-term effect of historical financial institutions on the development of contemporary informal finance. Our hypothesis is that, although historical financial institutions had vanished for nearly a century, the culture they embodied, particularly the (Confucian) norms of integrity, kinship solidarity, and acquaintance network, which can help enforce the credit relationship in traditional Chinese society, may survive to this day. In light of the fact that informal financial activities in China operate in an environment of weak legal protection, they may still rely on traditional culture to sustain their growth.

Drawing upon data from 137 counties in north China, our analysis finds that the density of local financial institutions (*qianzhuang* and *diandang*) in the late Qing period (circa 1911) still has a positive impact on the number and total assets of Small Loan Companies, a dominant institution of informal finance today. This result is robust to the inclusion of a variety of

confounding variables and instrumenting historical financial institutions using the frequency of crop failures in the Qing period. Using the density of Confucian temples in each county in the Qing dynasty as the proxy for the strength of Confucianism, we find that the persistent effect of historical financial institutions on today's Small Loan Companies becomes significantly greater in counties that had more Confucian temples, suggesting that Confucian culture is likely to sustain the long-term persistence of historical finance.

While most studies focus on the contemporary institutional and social-economic determinants in explaining the rise of China's informal finance, a unique contribution of ours is to incorporate historical and cultural factors into analysis. This suggests that to-day's informal financial activities are still shaped by historical financial institutions with the Confucian norms embedded.