



# The link between credit markets and self-employment choice among households in rural China



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## ABSTRACT

Our paper examines how credit markets operate through wealth to influence households' entrepreneurial choices. Our results show that policy-led bank branch withdrawal in rural China has a significant negative impact on credit availability to rural households, though unexpectedly the effect is felt more strongly in informal than formal credit markets. Furthermore, we observe that self-employment is impeded by reductions in wealth associated with credit contraction. Policies which provide more and better formal financial services to rural households are predicted to increase the flow of credit, through both formal and informal channels, thereby supporting accumulation, diversification, and economic growth.

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## 1. Introduction

Among the many factors to which China's remarkable economic growth can be attributed, industrially oriented rural entrepreneurship is key. According to De Brauw, Huang, Rozelle, Zhang, and Zhang (2002), the fraction of self-employed in China's rural labor force grew from 4% to 16% between 1981 and 2000. Moreover, China's rural entrepreneurs are credited with promoting the development and modernization of China's rural economy (Mohapatra, Rozelle, & Goodhue, 2007). Specifically, Mohapatra et al. find that the rise of self-employment in rural China is of a type characterized by high capital intensity, which enhances the productivity of labor and implies a promise of rising wages and income.

Recognizing the importance of household entrepreneurial activities for economic growth, our research examines the supporting role of credit markets. Owing to the presence of binding liquidity constraints, availability of credit is a critical factor in explaining entrepreneurial outcomes in rich and poor societies, alike. However, what is often overlooked is the dual role that financial institutions play in contributing to enterprise establishment and growth. As deposit-takers they enable the accumulation of capital, while as credit-suppliers they help to direct capital to its most efficient use. Exploiting an episode of policy-led withdrawal of bank branches in rural China, we use panel data on rural households from 1995 to 2002 to estimate

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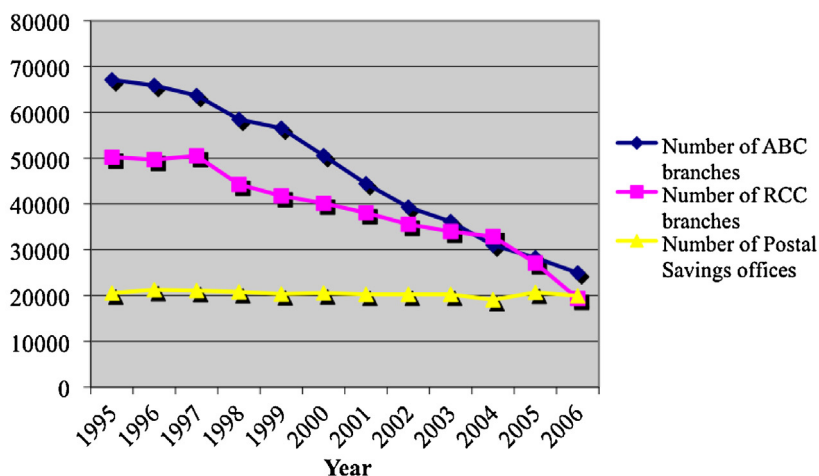
two regression models. The paper follows in the tradition of recent literature (Burgess & Pande, 2005; Dupas & Robinson, 2009; Jayachandran, 2006; Menon & van der Meulen Rodgers, 2011; Rosenzweig, 2001) that emphasizes the savings and insurance role that financial institutions play in facilitating new investment. Like other authors mentioned here, we assess the impact of changes in the number of bank branches on important economic outcomes. In our case, the dependent variables measure household borrowing and household participation in entrepreneurial activities. We contribute to the literature by shedding light on how banks facilitate rural household entrepreneurship in a developing country setting. Documenting this link between financial institutions and rural entrepreneurship can inform policy aimed at supporting a vibrant and diversified rural economy.

In the rest of the paper, we proceed to describe the predominant financial institutions in rural China, their roles in the rural economy, and the specific policies that prompted branch withdrawal (Section 2), followed by a synthesis of the literature relating to wealth, entrepreneurship, and the means by which financial institutions can help household overcome liquidity constraints (Section 3), and finally a presentation of the empirical analysis, the results, and their implications for policy (Section 4).

## 2. Financial institutions and bank policy in rural China

The key formal financial organizations operating in rural China during our sample period include the Agricultural Development Bank of China (ADBC), the Agricultural Bank of China (ABC), the Rural Credit Cooperatives (RCC), and Post Office Savings. All of these operate under the jurisdiction of the People's Bank of China (PBC), and each has its own specialized functions and strategies for serving the rural economy. The ADBC is a policy lending institution having minimal interaction with rural households. Both the ABC and the RCC provide routine banking services—accepting savings deposits and extending credit, though the ABC is heavily oriented toward enterprises while the RCC is officially charged with providing services to rural households. Post Office Savings accepts deposits of savings but, until very recently, offered no lending services.

Deng Xiaoping's 1992 southern tour is often noted as an important turning point in the speeding up of China's economic reforms, and indeed, important changes in the financial sector, including the rural financial market, commenced from the early 1990s. The ADBC was established in 1994 as a policy bank in order to more narrowly focus the scope of the ABC's operations within the realm of commercial banking mainly serving rural areas (Cheng & Cheng, 2003). The RCC operated within the structure of the ABC, initially, but gained independence in 1997 with a mandate to restore its focus on providing services to households and meeting local needs (Watson, 2003). In 1998 the ABC, along with three other large state-owned commercial banks, was targeted for a large-scale bank branch withdrawal policy, aimed at increasing operational efficiency and performance (PBC, 1998). Specific instructions were to (1) withdraw or merge with other branches all branches holding less than 500,000 *yuan* in savings deposit, per employee, (2) withdraw or merge with other branches some branches holding between 500,000 and 1,000,000 *yuan* in savings deposits, per employee, and (3) to merge with other branches some of the branches holding between 1,000,000 and 1,500,000 *yuan* in savings deposits, per employee (People's Bank of China, 1998). The criteria for determining whether a branch should be closed or merged could be adjusted upwards in more economically developed regions. In fact our data (Fig. 1) show evidence of a decline in branch numbers continuously throughout the sample period, suggesting that the policy may have gone into effect before its official announcement, although the drop off appears steeper from 1998 forward.



Source: China Financial Yearbook Compiling Department, *China Financial Yearbook (Zhongguo Jinrong Nianjian)*, various years.

Fig. 1. ABC and RCC branch withdrawal.

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