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Preface

The Asian Development Bank (ADB) is pleased to make this book on rural finance issues in the People's Republic of China (PRC) available to policy makers, financial institutions, and practitioners. The analysis contained in this volume grew out of ADB-financed technical assistance projects for rural and microfinance that focused on expanding sustainable financial services to the rural poor in underdeveloped areas.

The book is a valuable contribution toward a better understanding of the issues in the PRC rural finance market, particularly the reasons for recent reform measures and key market and institutional changes. The book will hopefully promote further work and innovative approaches toward building a sound rural finance system that allows easy access for the underserved financial segments of market services. There are indeed opportunities for synergy between government and participants in the rural financial market to join forces for poverty reduction.

The book highlights the need for a bottom-up approach in rural financial market development to meet local demand and adapt to local financial risk profiles. It emphasizes that effective supervision of rural financial market participants requires effective communication between government and the market. The book also argues that opening the rural financial market allows innovative approaches and different types of institutions to compete, thereby ensuring better services and higher efficiencies.

The contributions of authors, editors, and the staff of the Financial Sector, Public Management, and Regional Cooperation Division as well as the Department of External Relations were invaluable in producing this knowledge product and are acknowledged with gratitude.

Klaus Gerhaeusser
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Foreword

Nurturing Local Financial Strength in Rural Areas

Existing finance theory and practice has demonstrated that local small and medium-sized financial institutions are the best financial system for small and medium-sized enterprises and farming households. Government agencies in the People's Republic of China (PRC) have proposed policies that would relax market entry criteria and allow the creation of diversified rural financial institutions, enhancing financial support for small and medium-sized enterprises and farmers. These measures will help improve the PRC's financial structure, promote better rural financial services, enable financing of labor-intensive economic activities, and promote harmonious socioeconomic development.

The development of rural finance, in particular, necessitates innovations in perception and institutions. For this reason, I greatly appreciate the effort of the authors of this book to introduce international experience, to examine the evolution and relevant lessons of rural finance in the PRC, and to provide valuable suggestions for improvement. Developing rural finance requires the participation of local small and medium-sized banks, microcredit companies, and cooperative financial institutions as well as the development of formal and informal credit, guaranty mechanisms, and a system of investment and financing.

In recent years, the newly opened rural financial market has provided rural economic entities with diverse financing options and has introduced the concept of small-scale financial institutions. These institutions include village banks, microcredit lending companies, and credit shops. However, such small and localized institutions differ from existing commercial banks and demand innovative supervision.

The key to developing a new rural financial entity lies in nurturing localized rural financial services through a bottom-up approach, which creates the basis for a new rural financial market.

Traditional rural financial institutions, such as the Agricultural Bank of China and rural credit cooperatives, are all local branches of larger financial institutions. The authorities or higher-level branches appoint senior management, set policy or commercial objectives, and help to resolve financial difficulties. This kind of top-down setup usually carries high cost and high risk, limiting the institutions' incentive to meet the financial demands of small and medium-sized enterprises and farming households and limiting financial supply in rural areas.

In the poorer rural areas in the central and western regions of the PRC, moreover, financial institutions either are unsustainable because of policy lending or channel funds out of rural areas for commercial purposes. Since the restructuring of the state-owned commercial banks in the 1990s, large banks have been relieved of policy lending tasks. To increase profit, they now target urban areas and medium-sized and large enterprises and have been withdrawing from rural areas.

Improving financial services for small and medium-sized enterprises and farming households requires investment in local financial services. In this regard, the opening of the rural financial market is more about reinventing incentive systems and promoting local financial institutions than about inviting the return of state-owned commercial banks or restructuring rural credit cooperatives hindered by large volumes of nonperforming loans.

Localized rural financial entities can leverage their information advantage for rapid expansion.

The nurturing of localized rural finance should begin by legalizing informal finance. Non-deposit-taking informal finance providers can be transformed into new rural financial organizations, and deposit-taking informal financial service providers should register as formal financial institutions and be subject to prudential supervision.

Localized financial entities, likely to be cooperatives, should be developed in a bottom-up manner to meet local demands using local money. In this way, new rural financial organizations can better meet diverse local demand through flexible services. This kind of financial entity will blend and grow with the local economy. As their scale increases, they may either be transformed into commercial entities or remain as cooperatives.

The core advantage of small and medium-sized rural financial entities is that they can use "soft information" to ensure lending safety. Soft information is difficult to quantify. It comprises intangible assets rather than legally binding restraints and includes, among other things, interpersonal kinship and trade relationships, borrower work capability, borrower experience and reputation, peer pressure, and competition among related parties. Such information represents an alternative to financial statements, tangible collateral and guaranty, and so forth. The localization of new rural financial entities is a prerequisite for using the soft information inherent in all social and economic activities. More importantly, such soft information carries low cost.

Rural credit shops and microcredit entities may present more vitality for future rural finance development. These entities have close links with existing agricultural organizations such as production cooperatives or specialized farmers' organizations, which helps them to better understand farmers' financial demands, production capabilities, and systems. Such understanding can serve as a replacement for collateral and is the key to identifying suitable borrowers and ensuring loan repayment.

Successful financial models ought to carry distinctive local features, but their innovative and broad institutional arrangements must be capable of replication across regions. If small rural financial entities can develop a profitable credit model, then the credit demands of labor-intensive small enterprises and business can be better met, agricultural productivity can be enhanced, and farmers' income can be increased. This kind of finance model surely will be trusted by farmers and therefore can be widely replicated.

The development of new rural financial institutions also can help attract commercial banks back to rural areas. Relatively large commercial banks can make wholesale loans to small financial entities with sound performance and credit, and such wholesale lending can be commercially viable and profitable. Moreover, by using small financial entities as agents for credit and asset management, commercial banks can recover part of their lost market share. Meanwhile, with their information advantage and support from large commercial banks, small rural financial institutions will develop sustainably.

Effective supervision of localized rural financial entities requires both innovation and effective communication between government and market.

New rural financial institutions will require different supervisory measures than commercial banks, and the objective of supervisory innovation is to balance financial stability with efficiency. The guidelines for microcredit lending companies—issued jointly by the China Banking Regulatory Commission and the People's Bank of China—introduced three revolutionary breakthroughs in rural financial supervision.

First, the guidelines introduced layered supervision, which allows provincial authorities such as the Microcredit Lending Company Supervision Bureau and the Office of Finance to supervise if they agree to be responsible for lending companies' risks. This is a major breakthrough in financial supervision in the PRC and it will promote supervisory diversification, competition, and financial innovation.

Second, the guidelines allow microcredit lending companies to borrow from up to two commercial banks. This not only will present commercial banks with wholesale lending opportunities but also will enable them to participate in rural finance. Moreover, the wholesale banks will join provincial supervisory authorities in overseeing microcredit lending companies, which will help to reinforce market discipline among such companies.

Third, the guidelines allow microcredit lending companies with superior credit records to apply to become deposit-taking village banks. This provides incentives and gives lending companies the ability to transform into local, privately owned banks. Equally important, as the wholesaler to the lending companies and, later, as a shareholder in the village banks, wholesale banks can assist in this transformation. This will support the integration of rural and urban finance.

Other changes also are required. For instance, the capital adequacy ratio requirement for new rural financial entities needs to be upgraded. The major difference between lending companies and credit shops or village banks lies in their respective capital adequacy ratios. The capital adequacy ratio requirement for lending companies is 100%; the ratio for credit shops or village banks depends on credit risk. Following the establishment of an entity, a capital adequacy ratio of 50% or higher can ensure that part of the founders' own money is used for lending. If an entity becomes commercially viable, such a requirement can be relaxed to the level of commercial banks. Higher capital adequacy ratio requirements, combined with timely bankruptcy mechanisms, can effectively mitigate a financial entity's operational risks.

Moreover, small financial entities should be allowed a higher deposit rate ceiling to enhance their competitiveness. Small financial entities carry higher risks, and the depositors in such entities should receive a risk premium. Only when these small entities offer higher deposit interest rates can they compete against other commercial banks in the deposit market.

Finally, government policy lending targets should be met through commercially sustainable means. If the government intends to provide low-cost support for agricultural production, it should provide the relevant small financial entities or banks with fiscal subsidies or reduce lending risks by providing agriculture insurance. Such institutions will survive and be sustainable only when commercial viability is guaranteed.

In all, the ultimate goal in opening the rural financial market is to meet diverse financial demand and to mitigate financial risk by enhancing competition and improving the efficiency of the financial system. We genuinely hope that the opening of the rural financial market will be a harbinger of future financial market opening throughout the PRC.

Justin Yifu Lin
Senior Vice President and Chief Economist
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Abbreviations

ABC	-	Agricultural Bank of China
ADBC	-	Agricultural Development Bank of China
BRI-UD	-	Bank Rakyat Indonesia–Unit Desa
PRC	-	China, People's Republic of
CNY	-	yuan
GAO	-	gross agricultural output
GDP	-	gross domestic product
MFI	-	microfinance institution
NABARD	-	National Bank for Agriculture and Rural Development
PBC	-	People's Bank of China
PKSF	-	Palli Karma-Sahayak Foundation
PSBC	-	Postal Savings Bank of China
RCC	-	rural credit cooperative
RCFs	-	rural cooperative foundations
SSCOP	-	Self-Support Capacity Building Project
UNDP	-	United Nations Development Programme

Introduction

Despite significant progress in the general financial reform of the People's Republic of China (PRC), rural financial reform has been lagging. It has been 16 years since the establishment of the Agricultural Development Bank of China in 1994, 14 years since the separation of the Agricultural Bank of China from the rural credit cooperatives (RCCs) in 1996, and 7 years since the current round of RCC reform began in 2003. Nonetheless, rural financial policies, especially those targeting poverty-stricken areas, are still in the exploration stage.

Many constraints on reform remain to be addressed. For example, urban finance is used to guide rural finance, and informal finance is simply replaced by formal finance. This has led to the domination of RCCs in rural areas and difficulty in enacting rural financial innovation. In addition, the mission of rural finance to sustainably support *sannong*—agriculture and agricultural industry, including rural areas and farmers—remains unclearly defined. Rural financial institutions should support *sannong* in a financially sustainable manner and stop the vicious cycle of placing the heaviest burden of support on the poorest areas, which undermines sustainability. Third, the moral hazard of local government intervention in rural financial institutions must be reduced. Government intervention increases the cost of rural finance and creates the perception that rural finance is not sustainable without government support and direction. These constraints call for changes in perception, an improved financial environment, and innovation.

Ensuring Access to Finance

Economic reform in the PRC is a process of empowering individuals and enterprises and transferring power from government to market. It also is a process of government and market repositioning. The reform that has occurred in rural areas allows tens of millions of farmers to decide what and how much to produce. The reform in distribution enables suppliers and buyers to sell and purchase, as they desire, at mutually accepted prices. The reform of state-owned enterprises links the performance of managers with enterprises' revenues, reflecting the rights and value of entrepreneurs as the soul of enterprises. The opening of the labor market endows the labor force with the freedom to migrate to other places and choose jobs. Farmers, as users of collectively owned land, are granted certain land lease right. Private capital is allowed to enter most industries formerly monopolized by state-owned enterprises, including the civil aviation industry, reflecting respect for the rights of investors.

Until now, however, reform has not touched upon the right of individuals and enterprises to access financing. The only legal financing channel for individuals is through financial institutions dominated by state-owned commercial banks, whereas enterprises can get financing only through bank loans or in the highly regulated capital market. Modern financial theory holds that finance includes both investment and financing. Thus, the financial rights of individuals and enterprises are incomplete if they comprise the right to make investment without access to financing.

The requirements for diversifying financial rights include cultivating the market, establishing a credit mechanism, and breaking the inertia of the traditional government administration system. The protracted state monopoly of the credit market suppresses informal finance, and unsound market mechanisms or the uncertainties of market operation are principal reasons for concentration of financial rights. For instance, financial institutions have maintained previous interest rates even after bank loan interest rate liberalization. The insensitivity of state-owned financial institutions to interest rates is partly to blame for this, but the lack of an effective interest rate discovery mechanism is a more important cause.

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In addition, an incomplete credit information system may result in individuals infringing upon the state's credit. Credit information is a basis for financial activities. For a long time, financial institutions have based their businesses on state or collective credit. Without a fully developed credit information system, uncertainties brought about by the diversification of financial rights may shift credit risks to the state. For instance, troubled securities companies and enterprises are put into state custody.

Finally, the inertia of the traditional system postpones financial diversification. In the command economy, all economic resources, including financial resources, were at the disposal of the state or collective. Given the unique role of finance in resource allocation, financial rights are an extension of the administrative rights of governments. When it comes to economic planning, industrial policies, project approval, and microeconomic adjustment, the combination of financial rights and administrative rights reflects the government's guarantee. This is why, at a time when most economic rights are diversified, financial rights, especially the right to financing, remain centralized in government-controlled financial institutions.

Overly centralized financial rights concentrate economic risks in the state and are very costly. One major characteristic of centralized financial rights is a limit on the right of individuals and enterprises to use their own money, forcing them to entrust this right to state-designated and state-guaranteed financial institutions. Due to pervasive information asymmetry in financial markets, the use of others' money in this way may lead to moral hazards. On the one hand, financial institutions may suffer from moral hazard in selecting clients and monitoring loans. On the other hand, enterprises may be subject to moral hazard when they sacrifice others' interests in the pursuit of profits. Moreover, the centralization of financial rights may spread the credit risks generated by these two types of moral hazard throughout the entire economy.

Financial rights centralization also infringes on the economic rights of individuals and enterprises. Many business opportunities are transient and cannot be turned into earnings without the right to financing. In this sense, the right to invest is not complete without a right to financing. The difficulty of small and medium-sized enterprises in accessing funds reflects the conflict between diversified investment rights and centralized financing rights. The only option for most such enterprises is informal finance. However, informal finance is not protected by law and therefore represents a heavy burden rather than a right for individuals and enterprises. In the current system, informal fund-raising and soliciting deposits from the public are criminal conduct; there is only one step between investment and crime.

Major efforts are needed to guarantee the diversified financial rights of individuals and enterprises, beginning with the repeal of laws and rules that conflict with the establishment of a competitive financial market. For example, Article 176 of the criminal law stipulates that whoever takes deposits from the public illegally or in disguised form or disrupts financial order shall be sentenced to between 3 and 10 years in prison or criminal detention and fined CNY20,000 to CNY500,000, depending on the severity or monetary amount of the offense.

The basis for such laws is that financial resources belong to the state and no individual has the right to dispose of financial assets because limited financial resources must be used to serve the economic good. According to these provisions, deposit agreements between individuals, between enterprises, or between individuals and enterprises are illegal activities. Such lending and borrowing activities are regarded not as legitimate competition for state-owned financial institutions (including RCCs) but as illegal activities, and lending organizations outside of formal finance are illegal financial organizations. Beyond a certain threshold, taking deposits through private channels also is considered a crime. The coarseness of this legislation results in law enforcement authorities randomly cracking down on lending activities outside the system and puts a damper on financial innovation.

The statutes governing usury are unclear. According to provisions of the Supreme People's Court, private lending interest rates can be higher than the bank interest rate, to a certain extent, subject to the discretion of local people's courts and in accordance with the local situation. However, the private lending rate may not exceed four times the bank lending rate in the same category; interest rates exceeding this threshold are not protected by law and are deemed usury. In a market economy, however, the lending rate should be linked with lending risks, and the interest rate on riskier loans should be higher. In a developing country such as the PRC, there are many uncertainties associated with loans, so annual interest rates of 15% to

Major efforts are needed to guarantee the diversified financial rights of individuals and enterprises, beginning with the repeal of laws and rules that conflict with the establishment of a competitive financial market

30% are normal. Artificially limiting the private lending rate to within four times the bank loan rate renders illegal a large number of private lending activities.

In addition to repealing laws that hinder the establishment of a competitive financial market, laws and regulations should encourage such establishment. For example, to facilitate financial innovation, laws should confirm the integrity of individual and enterprise capital property rights, guarantee the legitimate investment rights of individuals and enterprises, and allow nonfinancial enterprises and individuals to lend their proprietary funds to other enterprises and individuals according to lawful agreements.

Second, when amending or drafting laws on taking deposits from the public, disturbing financial order, or usury, attention should be paid to distinguishing financial fraud from investment activities. The primary purpose of financial regulation is to avoid the moral hazards brought about by financial institutions taking deposits from the public, such as sacrificing depositors' interests to maximize profits. Normal lending activities between individuals and enterprises that do not belong to this category should be legalized. The maximum penalty for the crime of illegally taking deposits from the public should be relaxed according to the type, purpose, and potential risk of loans. Anti–financial fraud laws should be instituted, but the crime of illegally disturbing financial order should be eliminated. Laws on market-based interest rates should be drafted, and the threshold interest rate for usury should be increased to eight times the benchmark bank loan interest rate or more.

Normal lending activities between individuals and enterprises that do not belong to this category should be legalized

Third, commercial bank law should be amended and the criteria for the entry of private banks should be relaxed. Lending shops, private lending agencies, and microcredit institutions with a long history of operation, good business records, adequate scale, and the desire to establish banks should be allowed to upgrade into banks according to the requirements for commercial banks, and prudential regulation should be applied. The key to a competitive financial market is to allow competitive financiers and financial institutions to grow into intermediaries of that market. This requires the creation of opportunities for informal financial institutions to grow into formal ones, bringing about meritorious competition in which superior institutions succeed and inferior ones fail.

Current law stipulates that national commercial banks must have no less than CNY1 billion in registered capital, city commercial banks must have no less than CNY100 million, and rural commercial banks must have at least CNY50 million. These high thresholds have resulted in a gap between informal and formal financial institutions, which is not conducive to the market entry and growth of small and medium-sized banks. Consideration should be given to reducing these thresholds and emphasizing the quality rather than the size of financial institutions. Community-based financial institutions are not necessarily big, but they can operate more efficiently than large commercial banks. In the United States, for example, credit cooperatives based on enterprises, schools, large organizations, and communities play an important role among financial institutions. They remain important in several waves of acquisition, primarily because they can take advantage of community information dissemination and contracts enforcement.

Because national banks do not have such advantages, community-based credit cooperatives are irreplaceable.

Fourth, laws regarding microcredit institutions, cooperative finance, and informal finance should be promulgated. In the early stage of reform, microcredit institutions should be prohibited from taking deposits, cooperative financial institutions should have their membership and scale restricted, and the size of informal finance should be controlled. Nonprudential regulation should apply to these three types of institutions.

Fifth, international experience can be used to formulate laws or regulations on community reinvestment in the PRC. For example, the United States' Community Reinvestment Act requires a community-based financial institution to meet the lending needs of the community, predicated on compliance with principles of operational safety and soundness. Other than that, there are no rigid requirements on loan percentages. In Thailand, on the other hand, all community-based financial institutions must use 20% of their deposits in agriculture.

Finally, antimonopoly laws should be enacted to protect fair competition, policy finance laws should be enacted to enhance the effectiveness and transparency of policy finance, and the investment activities of major shareholders in financial institutions should be regulated.

Promoting the Domestic Opening of Financial Markets

The key to opening financial markets to domestic players is to endow enterprises and individuals with lawful financial rights, enabling those most effective in capital utilization to lawfully participate in financing activities. This requires innovation in financial systems and instruments, though decisions about which systems and instruments are the most effective should be left to markets rather than to governments. Legalization of informal finance is part of opening the market to domestic players, because informal finance is the means by which enterprises and individuals allocate credit resources based on market price signals.

Opening to Informal Finance

Informal finance covers lending between individuals and enterprises, lending through moneylenders (brokers), rotating savings and credit associations, pawns, chambers of commerce, underground banks, trade financing, and so forth. In some places, Buddhist temples serve as a platform for financing activity. In the PRC, these financing modes used to be called underground finance or illegal finance; they are now known as informal finance.

The key to opening financial markets to domestic players is to endow enterprises and individuals with lawful financial rights, enabling those most effective in capital utilization to lawfully participate in financing activities

Finance is an extension of trade in goods, and credit from transaction is the foundation of finance. The famous Shanxi Draft Bank was developed based on industrial capital, and other communities have managed to combine industrial capital with financial capital. However, there were no banks or specialized banking regulatory authorities in the PRC during the late 19th and early 20th centuries. In Hong Kong, China, there still is no central bank, although a few financial institutions print Hong Kong dollars. So-called formal financial institutions grow out of successful informal financial institutions, the only difference being whether an institution is accepted by regulatory authorities. The development of formal finance will not and should not restrict the existence and development of informal finance, and the financial rights of individuals and enterprises should be protected, not constrained.

In developed market economies where the criteria for market entry are much lower, there are few informal financial institutions. Formal financial institutions employ some informal finance principles, such as the "church steeple" principle that the borrower is much more important than collateral or the courts. A good financial institution should be able to see its clients and know what they are doing, as from the steeple of a church.

A good financial institution should be able to see its clients and know what they are doing, as from the steeple of a church

The discrimination against informal finance in the PRC stems from the protection of state-owned financial institutions, but such protection actually dumps the baby with the bathwater. At present, existing informal finance is based on individual credit, addresses information asymmetry, guaranties loans through social capital, complements formal finance, and can become an important mechanism for interest rate discovery.

First, informal finance is based on individual credit. An individual's credit record is established through culture; folk custom; geographic, kinship, personal, or business relationships; and other social networks that keep detailed "records" about reputations, business activities, and social relationships. Moneylenders, rotating savings and lending associations, and the like are financial organizations based on credit platforms.

Second, informal finance addresses information asymmetry by using layered information and various low-cost informal information sources. Community-based organizations such as chambers of commerce and guilds, production organizations such as specialized technology associations for farmers or cooperative production associations, intermediaries such as reputed celebrities in local areas, and other organizations with abundant access to information, such as automobile clubs, pigeon-raising clubs, and temples, are used to distinguish borrowers, screen lending projects, and reduce credit risks. For example, some relatively large enterprises can gauge farmers' credit demand and evaluate credit risks through their long-term supply and marketing relationship with farmers. More importantly, lenders can reduce repayment risks by linking loan repayment with proceeds. The lending shops emerging in some areas are established on a natural relationship with production cooperatives. Such practices also can allow the informal financial market to play an important part in interest rate discovery.

Third, informal finance can guarantee loan security by using social capital—forms of informal agreement based on social networks, informal organizations, and social customs—to replace collateral or courts. Social capital represents a kind of virtual collateral or court, and functions similarly. The difference is that most social capital is established by usage, thus offering a much less expensive way to settle lending disputes.

In the early stage of economic development, informal finance can dissolve risks before, during, and after loan issuance, making it a cheaper institutional arrangement than formal finance. For example, before a loan is issued, informal finance can use various information sources to screen borrowers and lending projects, thus preventing reverse selection of riskier borrowers, who are more willing to apply for loans even when the interest rate is high. Such screening can help reduce risk before a loan is made. Moreover, when a loan is provided, the lender can prevent moral hazard on the part of the borrower, because the purpose of the loan is clear. Finally, after a loan is provided, a lender can prevent a borrower's strategic default by using peer pressure, group punishment in which all informal financial organizations respond together to stop lending to the defaulter, or a boycott of the defaulter's business.

Fourth, the relationship between informal and formal finance is both competitive and supplementary. Studies have shown that competition from informal finance exerts a positive effect on the governance structure and the performance of formal financial institutions. On the one hand, competition promotes innovation by formal financial institutions; on the other hand, formal financial institutions can learn from informal finance. International experience also indicates that formal finance can utilize the information advantage of informal finance when lending to start-ups, which can become clients of formal financial institutions after establishing a credit record. In some localities, formal and informal financial institutions even diversify credit risk by issuing joint loans.

Rural Lending Shops

Any institutional innovation, particularly an inductive institutional innovation, needs an enabling environment. Private enterprises in the PRC faced discrimination before booming under relaxed regulation and an improved operational environment. Presently, a friendly policy environment is encouraging the diversification of financial organizations in the PRC, and diversified real economic entities demand increasingly diverse forms of finance and financial innovation.

The new rural financial organizations are both familiar and strange for many farmers. Before the reform of the collectively owned economy in the countryside, production cooperatives, supply and marketing cooperatives, and lending shops (or credit cooperatives) were the three major cooperatives in rural areas. However, the function of these cooperatives was to prepare for the transformation to a collectively owned economy. It has become obvious that, after being stripped of distribution and/or sales and credit, production cooperatives cannot operate independently and efficiently. This is particularly true of RCCs, because such segregation severed the otherwise inherent link between production and capital allocation, artificially creating information barriers between production cooperatives and lending cooperatives and thus making it difficult to match capital allocation with production demand. Emerging production cooperatives (also known as rural special technique associations or the company-plus-farmer model) successfully link production and the market, and rural lending shops represent a model that connects supply, sales, production, and credit.

Private enterprises in the PRC faced discrimination before booming under relaxed regulation and an improved operational environment

Rural lending shops can help address, at low cost, issues that are costly for formal financial institutions such as credit cooperatives. The purpose of merging Baixin Rural Lending Shop and Baixin Farmers' Cooperative in Jilin Province, for example, is to provide funds for the farmers' cooperative. Though the two cooperatives have their own names, they are one entity; the farmers' cooperative provides the lending shop with a platform to raise funds. Members of the farmers' cooperative have detailed knowledge of members' funding needs, integrity, repayment ability, and capital source for loan repayment (e.g., income from sheep sales). Such knowledge helps address information asymmetry and simplifies loan assessment.

In addition, the farmers' cooperative is an institutional arrangement through which borrowers may repay loans. If a member intentionally defaults, the farmers' cooperative may deduct the proceeds of a member's sales to repay the loan or may terminate his or her membership. Because all members live in the same or adjacent communities, peer pressure subjects the defaulting member to sanction in every aspect of production and life. Such punishments prevent borrowers from defaulting, and loans are repaid on time even in the absence of collateral, litigation, government intervention, or other means.

One advantage of informal institutional arrangements is their low cost, which makes it possible to meet even the smallest demand for credit

Initially, lending shops were an informal institutional arrangement that relied mainly on interpersonal trust, local culture, folk customs, and personal acquaintance. Such informal institutional arrangements are difficult to regulate through word and contracts, making them unofficial and informal, as opposed to laws and regulations. One advantage of informal institutional arrangements is their low cost, which makes it possible to meet even the smallest demand for credit. In addition, informal institutional arrangements may be exempt from the regulatory and other types of examinations required in formal institutional arrangements. Of course, informal institutional arrangements also are subject to constraints, such as difficulty in accessing legal and administrative assistance in case of disputes. In this sense, lending shops are similar to private lending organizations.

The risks faced by lending shops are similar to those faced by farmers' cooperatives. Lending shops are generally small, with strong homogeneity, meaning that similar productive or operational risks affect a large number of their members. Baixin Rural Lending Shop, for example, would suffer large numbers of defaults or even go bankrupt in the event of plague or other disease, or if market prices fluctuated, and its self-rescue ability is weak.

Thus, institutional innovations are needed to forestall the risks related to lending shops. In the beginning, government has an important role to play. First, the size of lending shops must be rigorously restricted to ensure that financing occurs only among members. Second, productive and operational risks must be diversified. For example, farmers' cooperatives may cooperate with the government, insurance companies, and disease prevention and quarantine agencies to prevent the spread of plague. Governments can subsidize some insurance premiums and can encourage the insurance sector to create insurance products tailored to local needs. Disease prevention agencies can share partial risks or benefits through holding a stake in the form of technology. Third, a risk fund can be established with interest income and partially subsidized by governments. Finally, a loan guaranty fund can be created to compensate for losses from natural disasters or accidents beyond human control.

In addition to the adoption of institutional innovations to diversify risks, rural financial institutions also should put in place innovations to reduce operational and transaction costs, especially in far-flung and sparsely populated areas. Rural financial organizations may reduce transaction costs by adopting informal financial approaches, creating an all-around operation that covers rural finance, postal savings offices, and farming material sales. They can also learn from international experience in introducing technologies such as mobile phone banking.

Developing a New Rural Financial System

The purpose of reforming and developing rural finance is to provide farmers with equal access to investment, financing, and development opportunities. The ultimate objective of establishing a harmonious society is to enable all citizens of the PRC to share the benefits of rapid economic development. The proposed new socialist countryside is intended to allow vast rural areas and farmers to benefit from development. Thus, rural financial services should engage in and promote industrialization, urbanization, and the building of a new socialist countryside.

Since 1978, farmers have participated in the PRC's economic development and have benefited from rapid growth. In fact, farmers were the first group to benefit from reform. In the early 1980s, the launch of the household contract responsibility system brought benefits to almost every rural household. Later, development priorities gradually shifted from agriculture to nonagriculture sectors. The emergence of township and village enterprises in coastal areas enabled farmers to go from subsistence to prosperity. However, farmers in the central and western parts of the PRC lagged behind. Later, with the opening of the labor market, many farmers migrated from central and western PRC to coastal regions and urban areas. The transformation of farmers to migrant workers provided them with another opportunity to participate in economic development.

Industrialization: From Farmers to Migrant Workers

Even in the command economy, the importance of agriculture made it one of the central government's top priorities. However, farmers failed to reap real benefits. Price controls were created to support industrial development, farmers and agriculture were exploited, and financial resources were mostly monopolized by the state. In addition, farmers were bound to the land and could leave neither their land nor their hometown. A series of institutional arrangements was erected to achieve these objectives.

The emergence of township and village enterprises in coastal areas enabled farmers to go from subsistence to prosperity

After over 2 decades of rapid growth, a solid industrial foundation has created the capacity to support agriculture. However, the industrial support of agriculture is intended not to place farmers back on the land but to improve their lives with limited fiscal subsidies. A more important aspect of such support is to create more jobs for farmers, enabling them to become migrant workers.

Industry can support agriculture either by transferring funds from industry to agriculture or by transferring farmers from agriculture to industry. The experience of township and village enterprises in the central and western PRC in the late 1980s and early 1990s showed that industrialization in these regions resulted in large numbers of nonperforming loans in the finance sector. This mistake should not be repeated. Therefore, farmers must be transferred from agriculture to industry, which means transferring farmers from rural areas in the central and western PRC to coastal regions and urban areas. Estimates show that about 300 million people will have been released from agriculture by 2020. Assuming that one-third of the resulting migrant population concentrates in coastal regions, these regions will attract about 100 million new migrant workers in the next 10 years, enabling the PRC to continue with labor-intensive industries but also posing new challenges.

The change of status from migrant worker to new urban resident can directly improve farmers' welfare

This does not mean that rural areas do not need more investment, but it does mean that the investment should be focused. First, fiscal transfer payments and new investment should focus on providing public services, including basic education, skills training, a minimum standard of living, and assistance for the destitute. The provision of such public services can help some farmers to access jobs and to avoid sliding into poverty because of illness or disaster. Second, farmers engaged in the handicraft industry or in peddling should be exempt from taxes and fees, to encourage capable farmers to start their own businesses. Finally, financial institutions should provide credit to farmers with a certain acreage of farmland or particular animals.

Urbanization: From Rural Migrant Workers to Urban Residents

Transforming farmers into migrant workers is not the ultimate goal, and it is necessary to enable migrant workers to become new citizens or new residents of urban areas. This is urbanization. For a long time, the PRC's urbanization has lagged far behind industrialization. Less than 40% of the PRC's labor force has urban *hukou* (a residential certificate), but 60% of the labor force is engaged in nonagriculture sectors. Inadequate urbanization impedes the transfer of the labor force from agriculture to industry while also constraining the development of consumer and service sectors in migrant workers' places of origin. This is an important cause of tepid consumption.

The change of status from migrant worker to new urban resident can directly improve farmers' welfare. Migrant workers with such status can at least join in the social security network provided by local governments and share in public resources such as education and medical services. The change of status also can fundamentally change the migratory habits of a population on the move, from individual to family-based migration. Such a change will have positive effects on consumption and the development of the service and real estate sectors.

Presently, the PRC's urbanization has three shortcomings. First, the residential system that has been in place for nearly half a century was intended to prevent farmers' free migration and relieve burdens on cities. It is a system that sacrifices farmers' interests to support industrial development in cities. Second, the current land system forbids collateralization and sales of land, which reduces farmers' ability to raise funds and to migrate. Finally, the reforms of the residential and land systems promote the development of urban belts in the coastal regions, concentrating economic activity but preventing concentration of population in urban areas. At present, the Pearl River Delta, the Yangtze River Delta, and the Bohai Rim account for one-third of the national gross domestic product, and with the expansion of urban belts, the proportion will probably increase to around 50% or 60% by 2020. The size is comparable to that of urban belts in the United States and Japan. The development of urban belts makes possible large-scale labor transfer from the agriculture sector to the industrial sector, and from the central and western regions to the coastal regions.

Building a New Countryside: From Traditional to New Farmers

Industrialization and urbanization should become an organic part and an important development phase in establishing a new countryside. Given the PRC's vast territory and the sharp differences in economic development among different regions, the building of a new countryside is bound to start first in more-developed regions. Customarily, we use the word *sannong* to describe countryside-related issues, but such a generalization risks blurring the policy focus. Roughly categorized, the issues of agriculture, rural areas, and farmers occur in three different regions of the PRC, requiring the adoption of individual strategies suited to the characteristics of these regions.

In most coastal regions, the core *sannong* issue is the transformation of rural areas. Most coastal regions have gone through the industrialization phase, so they have a high proportion of nonagricultural labor and well-developed small townships. The building of a new countryside in these areas should focus on urbanization. An appropriate mechanism of land turnover should be created to encourage farmers to voluntarily leave their land and become new urban dwellers. The building of a new countryside has entered this final phase in certain mature regions where farmers not dependent on land represent a certain percentage of the total population.

In the central regions, the core *sannong* issue is about agriculture. Again, the key to building a new countryside is to encourage more farmers to move out of the agriculture sector and become migrant workers or new city dwellers—urbanization. At the same time, land is increasingly concentrated in the hands of skilled farmers, which prevents agricultural production from fluctuating due to the migration of labor and also forces industry to nurture agriculture through subsidized scales of production, increasing agricultural income. This marks the intermediate phase.

Most coastal regions have gone through the industrialization phase, so they have a high proportion of nonagricultural labor and well-developed small townships

In western regions, the issues of *sannong* center on the issues of farmers. To a large extent, subsistence guaranty depends on fiscal transfer. At the same time, the government can use mandatory education and vocational training to help farmers find jobs in nonagriculture sectors. These regions are in the primary stage of the building of a new countryside.

A New Rural Financial System: Satisfying Multilayered Financial Needs

The new type of rural finance is based on industrialization, urbanization, and the building of a new rural countryside. It serves more than just *sannong*, and the financial service providers include both RCCs and a variety of financial institutions.

At present, the opening of the rural financial market in poor areas provides new opportunities for the development of rural finance, and a brand-new era is unfolding. In May 2005, the People's Bank of China launched pilot microfinance lending companies in Guizhou, Inner Mongolia Autonomous Region, Shaanxi, Shanxi, and Sichuan, signaling a key step forward in the opening of rural finance. In December 2006, the China Banking Regulatory Commission issued an opinion on reforming RCCs and encouraging banking financial institutions to increase their presence in rural areas. In addition, permission was granted to form three new types of rural banking financial institutions: village and township banks, community credit cooperatives, and lending companies. Gansu, Hubei, Inner Mongolia Autonomous Region, Jilin, Qinghai, and Sichuan pioneered the pilot programs, and if these turn out to be a success, a series of grassroots financial innovations will promote bottom-up rural financial reform.

The new rural finance may encompass several rural financial innovations and services. The first innovation is in financial services for microenterprises or individual businesses, which encourages entrepreneurship and represents an important means of increasing the employment and income of farmers. To date, such financing needs have been met through informal lending. The emergence of microfinance institutions, lending companies, and village and township banks signifies the partial legalization of informal finance and diversifies the available financing channels.

The first innovation is in financial services for microenterprises or individual businesses, which encourages entrepreneurship and represents an important means of increasing the employment and income of farmers

Second, with rapid economic development and urbanization and the resulting decrease in the farming population comes the opportunity to develop large-scale plantation and animal husbandry enterprises, which may become the most important elements of production. At the same time, prices for agricultural produce have increased in recent years, so such enterprises have good prospects and have become major recipients of rural credit. More importantly, some specialized farmers' associations will become carriers of credit, linking borrowers with lenders. The combination of rural lending shops with specialized production organizations will become a major form of rural finance in the future.

Third, the transformation of farmers into city dwellers and the steady cash flow of migrant workers in urban areas during the process of urbanization will generate a heavy demand for consumer credit. Farmers will need funds for their children's education, for homes, for marriage, and for the purchase of durable consumables. Financial institutions can design relevant financial products to provide farmers with consumer credit. With migrant workers' cash flow as a guaranty, the risks of consumer credit are controllable.

Fourth, *sannong* must be supported in a commercially viable manner, guided by fiscal policies and based on laws such as the Community Reinvestment Law that encourage financial institutions to tap the rural credit market in poor areas. Credit support for *sannong* should be a goal of the government rather than of financial institutions. For example, the government wishes to expand credit coverage for low-income populations and lift them out of poverty. However, due to the high credit risks associated with low-income populations, any financial institution is bound to ask for a relatively high-risk premium in the form of a high interest rate, government-subsidized interest, tax reductions, or other preferential policies. Only in this way can government objectives to support *sannong* be combined with the functions of financial institutions. In fact, not only the Agricultural Bank of China but also other financial institutions and investors should be encouraged to participate in the process of supporting *sannong* at the wholesale or retail levels.

Finally, there is a growing demand for wealth management in rural areas. Farmers' increased income improves their ability to accumulate wealth and increases their need for wealth management. The wealth management market in the PRC will gradually expand from cities to rural areas. Suitable wealth management products can improve farmers' property gains and generate intermediary commissions for financial institutions, representing an important future component of rural finance.

PART I

AN OVERVIEW OF RURAL FINANCE

CHAPTER 1

Rural Financial Reform

History of Rural Finance in the People's Republic of China

Rural financial reform in the People's Republic of China (PRC) has been slow and has lagged behind general economic reform. The reform process has occurred in five phases, beginning with the monobanking system and then moving through the resumption of rural financial institutions, the formation of the rural financial system, explorations of rural financial reform, and finally, a new round of rural financial system reform. The ultimate objective of the new round of reform is to build up a modern rural financial system.

Phase 1. The Monobanking System (1949–1978)

During the period of the planned economy (before 1978), the central government was in charge of resource allocation, including credit allocation. Almost all enterprises, including banks, were state owned, and investment decisions were made by the government's planning department. There was no real market.

The People's Bank of China (PBC), established in the 1940s under the leadership of the Ministry of Finance, was the supervisory authority and the sole practitioner in rural finance. It was established as a central bank but also functioned as a commercial bank. Deposit and lending outlets were set all over the countryside. The agriculture department of the PBC had branches from provincial to township levels.

Launching the Rural Credit Cooperatives

In 1951, the government promulgated a series of regulations on cooperatives and a new type of institution—the rural credit cooperative (RCC)—was launched to offer credit services exclusively to rural households. By 1954, under the slogan "One village, one cooperative," 124,000 RCCs had been established in the country. In 1955, the number reached 159,000. In 1956, the administrative mergers of districts and townships reduced the number of RCCs to 103,000; these covered close to 100 million rural households. By 1957, rural credit cooperatives were firmly established in the country. Subsequently, RCCs gradually deviated from the cooperative system and were put under the management of the PBC until after the Cultural Revolution. Throughout the 1960s and 1970s, RCCs served as implementing agencies for rural credit and savings plans. RCCs and the agriculture department of the PBC thus formed the rural financial system.

Establishing the Agricultural Bank of China

The Agricultural Bank of China (ABC) was established in 1955 with a mission to raise funds from rural areas and to support industrialization and agricultural production. At that time, the ABC was entrusted (by the PBC) with the supervision and management of the RCCs. In 1957, the ABC merged with the PBC. A few years later, the ABC was supervising the distribution of budgetary agriculture funds and central bank lending to rural areas.

Similar to institutions in other sectors, the relationship between the RCCs and the ABC in rural areas is not competitive but is more like the relation between cashiers and accountants. In the planned economy, the industrial system did not need services from commercially oriented financial institutions. Likewise, rural financial institutions were designed to provide the rural credit that would enable production of cheap grains and raw materials for capital-intensive industrial development.

The rise in agricultural output and the emergence of rural industrialization substantially boosted rural household income in the early stages of reform

Phase 2. Resumption of Rural Financial Institutions (1979–1993)

In the late 1970s, the PRC embarked on economic reform. The reform started in the rural areas and significantly increased farmers' production incentives by increasing prices for agricultural products and by instituting the land contract responsibility system.[1] The reform soon expanded to the agro-industrial sectors. Production was deregulated, leading to a non-state-owned type of rural enterprise—township and village enterprises—most of which were collectively owned and proliferated during 1980s. The market opening unleashed suppressed consumption demand, and township and village enterprises flourished because they met the demand well and kept profitability high.

The rise in agricultural output and the emergence of rural industrialization substantially boosted rural household income in the early stages of reform. From 1978 to 1984, the annual growth of per capita rural household income reached 73% (adjusted by the agricultural products purchasing index) and industrial production in rural areas grew by 1,188%, which was much higher than the rate of national industrial production for the same period (227%). Industrial production in rural areas as a percentage of total industrial production increased from 13% in 1980 to 40% in 1990, adjusted for inflation. During this phase, rural financial institutions were reestablished or newly established, and a diversified and competitive rural financial system started to take shape.

Restructuring the Agricultural Bank of China

PBC restructuring represented the core of financial reform. During the planned economy period, the PBC was the sole financing entity, with extensive functions. With economic liberalization, however, the PBC was unable to perform these complex duties well. At the same time, the monobanking system was unable to provide financing for dynamic rural areas. To remedy these problems, four state-owned commercial banks—the ABC, the Bank of China, the China Construction Bank, and the Industrial and Commercial Bank of China—were carved out of the PBC as independent financial institutions serving different economic sectors.

The ABC, dissolved during the Cultural Revolution, resumed operation in 1979 and established branches and subbranches all over the PRC. In particular, the ABC took charge of lending to the agriculture sector and was the only state-owned commercial bank allowed to do business in rural areas. The main function of the ABC was to manage agriculture funding, provide rural credit in a centralized manner, and manage the operation of the RCCs. The ABC was therefore at the core of the rural financial system as it undertook combined functions of fiscal appropriation, commercial lending, and RCC management.

Reforming the Rural Credit Cooperatives

A second reform was the resumption of RCCs as cooperative financial institutions. In 1979, the management of the RCCs was transferred from the PBC to the ABC, and the county branches of the ABC were made responsible for regulating local RCCs. However, the relationship between the two varied by region and over time. For instance, in some regions the RCC and the ABC branches were the same institution, whereas in other regions the RCC and the ABC township branches were independently managed but reported to the same ABC county branch. In many regions, the ABC and the RCC shared the same management team, with only the names distinguishing the two. This kind of relationship resulted in lack of independence and ineffective competition in the commercialization of the rural finance sector.

Beginning in 1983, joint RCCs were formed at the county level to strengthen the independence of the RCC system, and the State Council created county rural credit unions. A two-level legal-person system was gradually established at the county, county-level city, and township levels, and the rural credit unions assumed responsibility for managing, guiding, and funneling funds to the RCCs. In 1984, the State Council requested that the RCCs become the cooperative financial organizations for the majority of rural households and be responsible for their own operations and performance.

Nevertheless, at this stage, the government still entrusted the management of the RCCs to the ABC, which ran the RCCs as banks, effectively making them ABC branches and offices. As a result, RCCs were still characterized as government owned and failed to follow the direction of cooperative finance. In addition, the legal-person status of a township RCC was mostly nominal. Rural credit unions had the right to appoint and dismiss RCC senior management and to approve both loans and expenditures.

Creation of Postal Savings

A third reform was the creation of postal savings, which had been removed from China Post in 1953. In 1986, upon the approval of the State Council, the function of postal savings was resumed. The Postal Savings and Remittance Bureau

Rural credit unions had the right to appoint and dismiss RCC senior management and to approve both loans and expenditures

was set up within the postal system, and the postal management bureaus of various provinces, autonomous regions, and municipalities established corresponding agencies. The Ministry of Posts and Telecommunications and the PBC announced the agreement on launching postal savings and outlined their respective capacities as investor and operator. The agreement first took effect in 12 cities, including Beijing and Tianjin, to explore a legal framework for developing the business all over the PRC.

After China Post resumed the postal savings business, it became an important part of the financial arena, taking deposits but not extending loans. In rural areas, it also facilitated savings and remittance. Initially, the postal savings outlets served as agents of the PBC, and postal savings deposits were redeposited in the PBC at a monthly commission of 0.22%. During the high-inflation period of the 1980s and early 1990s, postal savings played a positive role in absorbing funds and withdrawing cash from circulation. The PBC paid interest on postal savings in addition to its commission. Later, the commission was changed to a savings-interest spread.

Due to the high interest rate and the risk-free nature of deposits with the central bank, postal savings offices were motivated to take deposits from the public

After 1990, postal savings branches collected savings on their own and transferred deposits to the PBC at relatively high interest. The interest rate on deposits of postal savings in the PBC was 4.13%, whereas the interest rate on commercial banks' reserve with the PBC was only 1.89%. Due to the high interest rate and the risk-free nature of deposits with the central bank, postal savings offices were motivated to take deposits from the public. Some of them even paid high interest rates themselves, to attract savings. As a result, postal savings offices expanded rapidly.

However, the high interest rate on postal savings deposits with the central bank resulted in an outflow of rural funds, distorted the interest rate structure, and encouraged irregular operations on the part of the postal savings offices. The shutdown of ABC outlets at the township level and the closure of rural cooperative foundations left RCCs as the principal source of credit in rural areas, but the rapid development of rural postal savings offices took available savings away from RCCs. In extreme cases, farmers in certain townships deposited money with postal savings offices while applying for loans with RCCs, weakening the ability of RCCs to provide loans.

Creation of the Rural Cooperative Foundations

In a fourth reform, rural cooperative foundations came into play. In the late 1980s, Sichuan Province approved the establishment of both rural cooperative foundations and some rural enterprise finance companies. With the development of the family contract responsibility system, rural cooperative foundations started to emerge nationwide in 1984. By the end of 1992, various types of rural cooperative foundation had been established in 37% of townships and 15% of villages all over the country. In the early stage, their funding sources were largely collective funds, and loans mainly targeted local village farmers.

Enhanced productivity provided impetus for the commercialization of previously policy-oriented financial businesses. The rural branches of the ABC and RCCs began developing commercial credit with idle funds. Although credit size and term structure were strictly controlled, the credit target shifted. From 1980 to 1994, ABC and RCC loans to rural industries grew twelvefold, much faster than the growth rate of other loans, and the share of rural industry loans rose from 13.8% to 33.2%.

Phase 3. Formation of the Current Rural Financial System (1993–1996)

The PRC's financial reforms launched in 1993 and 1996 have been characterized by drastic changes in rural financial institutions and their lending responsibilities. In terms of rural finance, the reforms aimed to separate policy operation from commercial operation, to commercialize the operation of the ABC, and to make RCCs into real credit cooperatives controlled by their members. In these ways, the reforms sought to improve the efficiency of financial intermediaries and to reduce the proportion of nonperforming loans. Prior to the reforms, formal finance in rural areas of the PRC was dominated by the ABC, which was responsible both for commercial and policy lending in agriculture and for managing RCCs.

Commercialization of the Agricultural Bank of China

Before 1994, the ABC was a pure policy bank; its primary tasks were to support agricultural production, manage RCCs, and develop the rural economy. In 1994, the ABC separated its commercial operations from its policy functions and began commercializing. In September 1996, the ABC divested itself of the RCCs and changed its development focus from the rural financial market to urban commercial financing at the county level and above.

The Role of Rural Credit Cooperatives

The role of RCCs as the major force in the rural financial system has been enhanced. By the end of 1995, there were 50,000 financially independent RCCs, and RCC loans accounted for more than 60% of total agriculture loans. With the promulgation of the State Council's 1996 Decision on Rural Financial System Reform, a series of reforms was undertaken. These efforts focused on safeguarding rural financial stability, improving services, and managing risks. Major changes have taken place in the rural financial system, which is based on cooperative finance and encompasses both commercial and policy finance.

The Role of the Agricultural Development Bank of China

Prior to the creation of the Agricultural Development Bank of China (ADBC), the ABC and the China Construction Bank took charge of medium- and large-scale infrastructure loans for agriculture, forestry, animal husbandry, and irrigation as well as for technological advancement and other policy operations. The Third Plenum of the Fourteenth Communist Party of China Congress in November 1992 spelled out the overall objectives of the PRC's financial system reform.[2] The following month, in December 1992, the State Council promulgated the Decision on Financial System Reform, charging the ADBC with managing policy loans—which at that time included loans for agriculture procurement, storage, and processing—and loans for integrated agriculture development and poverty alleviation.

Major changes have taken place in the rural financial system, which is based on cooperative finance and encompasses both commercial and policy finance

In line with the spirit of the decision, the ABC transferred to the ADBC CNY186 billion worth of policy lending, to separate policy and commercial operations. However, the management of subsidized poverty loans, an important part of agriculture policy lending in the PRC, was returned to the ABC in 1998, following a marked deterioration in the quality of poverty loans.

Phase 4. Pilot Rural Financial Reform (1996–2002)

In response to problems—especially risks—that emerged in rural financial reform during the 1990s, the authorities stepped up their management efforts. Major policy measures included putting rural finance in order and advancing reform. In line with the basic strategy set by the 1997 Central Financial Working Conference, state-owned commercial banks were required to shrink institutions at (and below) county level, and small and medium-sized financial institutions were to be developed to support local economic development. State-owned commercial banks, including the ABC, therefore gradually streamlined their county and subcounty branches.

The comprehensive financial reforms launched in 1996 pushed the ABC to become profit oriented

Since the mid-1990s, the operational environment of rural financial institutions has undergone significant changes. First, many township-owned and state-owned enterprises at and below county level have been privatized, and private small and medium-sized enterprises have thrived. By 2000, the output share of state-owned enterprises declined to below 30% of total enterprise output. Second, the rural labor market and other factor markets, excepting the capital and land markets, have been largely liberalized. Third, development of information technology has enhanced regulation and consumer discipline. Fourth, the legal environment has improved, with strengthened enforcement and an increased supply of valid collateral. Finally, the development of informal credit and the entry of foreign banks have intensified competition in the finance sector.

Agricultural Development Bank of China and the Agricultural Bank of China

Also since the mid-1990s, a financial system featuring the coexistence of cooperative banks and policy banks has been taking shape in the PRC's rural areas.[3] In 1994, the newly established ADBC took up policy financing functions such as managing the fund supply for acquisition of agricultural products; poverty reduction loans; and lending for comprehensive agriculture development, small-scale rural infrastructure, and technological upgrading.

In August 1996, the State Council promulgated the Decision on Rural Financial System Reform, further clarifying the guiding principles for rural financial system reform to include establishing and improving a rural financial system based on cooperative finance, complemented with commercial and policy finance under a clear division of labor, and further improvement of rural financial services. In line with this decision, the RCCs were spun off from the ABC and reformed on a cooperative pattern.

The comprehensive financial reforms launched in 1996 pushed the ABC to become profit oriented. The management of RCCs was shifted to the newly established Interministerial Coordination and Leading Group for Rural Financial Reforms in 1996, and then the leading group joined the PBC in 1997. In 1998, the ADBC assumed exclusive responsibility for crop procurement loans, and other policy operations were undertaken by the ABC.

Between 1998 and 1999, the State Council decided to shift from the ADBC to the ABC the special lending for comprehensive agriculture development; poverty reduction; enterprises affiliated with crop, cotton, and oil production; and People's Bank of China agriculture loans. Moreover, efforts were made to crack down on illegal and informal financial activities, which included closing down and liquidating rural cooperative foundations across the country. In 1999, the rural cooperative foundations were overhauled to restore rural financial order. The PBC provided funding support to promote RCCs and extend to rural households microcredit and collective-guaranty loans, and pilot RCC reform was initiated in Jiangsu Province in 2000.

Rural Credit Cooperatives since 1996

Since 1996, RCC reform has gone through three stages, with the first stage occurring between 1996 and 1998. Following the 1996 Decision on Rural Financial System Reform, the RCCs were separated from the ABC and began a transformation into cooperative financial institutions with farmers as shareholders and members as management. RCC reform in various regions of the country was implemented under the direction of the State Council, but the result was unsatisfying. RCCs were left with heavy historical burdens, poor asset quality, and high potential risks, and their services fell far short of the needs of rural economic development. Since 1997, the PBC has strengthened supervision and has closed over 10,000 RCCs. Nevertheless, RCCs still face many difficulties.

Stage two (1998–2000) comprised the commercialization and withdrawal of state-owned commercial banks from rural areas and the shutdown of rural cooperative foundations. The operations of the ADBC were confined to acquisition loans for crops, cotton, and oil. RCCs thus became the main force in rural finance.

In 1999, to increase rural households' access to credit, the PBC began to provide loans to RCCs to encourage the issuance of microcredit through agriculture loans. The interest rate was 3.25%, 0.99 percentage points lower than the general PBC lending rate.[4] Meanwhile, RCC reform was pushed ahead under the principles of voluntary share purchasing, democratic management, and member-oriented services, which proved to be beyond the RCCs' capacity. The reform thus failed to achieve the expected results and instead magnified the conflict between the capabilities and the responsibilities of the rural credit cooperatives.

During the third stage (2000–2002), the Pilot on Organizational Systems of Rural Credit Cooperatives provided the legal basis for pilot RCC reform in Jiangsu Province. Jiangsu examined the possibilities of clarifying the equity rights of members, improving operational mechanisms, making township RCCs into branches of county RCCs, establishing rural commercial banks, and creating provincial rural credit unions to manage the RCCs. In addition, the microcredit pilot was implemented nationwide, expanding rural household microfinance to nearly CNY75 billion nationwide by December 2002.

RCCs were left with heavy historical burdens, poor asset quality, and high potential risks, and their services fell far short of the needs of rural economic development

During this stage, reform proceeded amid RCC restructuring. RCCs were gradually restructured into cooperatives owned and managed by farmers and providing services to members. RCCs, now separated from the

ABC, were managed by county rural credit unions and regulated by the PBC.

Phase 5. Rural Financial Reform and Liberalization

In recent years, the PRC has been developing rapidly and rural income has been growing quickly. From 2001 to 2004, total savings in rural areas increased from nearly CNY4 trillion to nearly CNY7 trillion, yielding a CNY1 trillion yearly increase in rural savings. RCC savings accounted for 40% of total rural savings, the ABC accounted for nearly 20%, and other banks represented around 30%. Postal savings accounted for around 10% of total rural savings, with the percentage varying from region to region. The gap between total rural savings and loans widened to about CNY2 trillion in 2004, accounting for half of total rural loans.

The major functions of the RCC union include providing management, coordination, and services to the RCCs in the county

The formal finance sector in rural PRC currently comprises the ABC, the ADBC, RCCs, and rural postal savings.[5] Rural postal savings financial institutions are savings-only. The ABC, RCCs, and postal savings have outlets at the county level and below. RCCs are the main force in rural finance and township RCCs are categorized as independent legal persons and profit centers. Many RCCs have credit and savings stations and agents in the villages. At the county level, RCCs are represented by a union that, with shares from individual RCCs in the county, also is a profit center and a legal person. The township RCCs report to both the RCC union and the county branch of the PBC. The major functions of the RCC union include providing management, coordination, and services to the RCCs in the county.

Since 2000, the ABC has closed many outlets, including 8,601 in the central PRC (a decrease of 39.3%) and 4,635 in the western PRC (a decrease of 31.9%). Under its strategic restructuring, the ABC has focused on commercial financing in counties and cities.

ADBC has outlets in 1,606 counties, though none in the poorest regions, and its function has shifted from comprehensive loans to crop-acquisition loans. With the market-oriented reform of the grain and cotton circulation system, the monopoly of state-owned enterprises in this area has been broken. This has reduced ADBC business in some regions, ending the supply of development financial services and leaving the RCCs as the major player in rural finance, although RCCs can only meet basic financial demand for agricultural production in most regions.

Rural financial institutions' deposits and loans are not entirely rural deposits and loans. As financial institutions based at the township level, however, the operations of RCCs have been restricted to rural areas. Therefore, all RCC deposits and loans can be regarded as rural deposits and lending.[6] ADBC loans, which are used for the procurement, storage, and processing of important farm goods (mainly grain), have been officially defined as rural lending, although the benefits brought about by such policy loans are far from restricted to rural areas.

The PRC's gradual rural financial reform has been demand-oriented. When the rural economy was dominated by township and village enterprises, collective credit dominated. At the time, the ABC and RCCs were instrumental in supporting township and village enterprises. In early 1990s, when township and village enterprise reform began, private enterprises in a few regions witnessed rapid growth and individual credit gradually overtook collective credit in rural areas. To some extent, the commercialization of the ABC, the separation of RCCs from the ABC, the introduction of collateral and various guaranties, and new financial products such as microfinance based on individual creditworthiness and collective guaranty addressed the contradiction between state-owned and collective financial systems and individual credit. Rural finance played a positive role in supporting the development of private enterprises and small-scale industrial and commercial entities.

However, a number of problems emerged during the course of reform. For instance, a great number of nonperforming loans built up during the process of township and village enterprise reform and the transition from collective to individual credit. With the gradual exit of state-owned commercial banks from the rural financial market and the overhaul of rural cooperative foundations, RCCs became monopolies in the rural financial market. A large amount of money departed rural areas through rural financial institutions. RCC reform thus failed to change the foundations of rural financial institutions and particularly failed to address poor RCC governance.

Agricultural Bank of China Development Strategy

The ABC receives the majority of its deposits from rural areas but lends in both rural and urban areas and, since 1996, has gradually shifted its lending operations more exclusively to urban areas. All rural postal savings deposits originate in rural areas and are redeposited with the PBC. Thus, the ABC and rural postal savings have been blamed for channeling funds from rural to urban areas.

Changes in the ABC's development strategy include reducing rural staff and offices, weakening the authority of county subbranches, implementing more-stringent lending requirements, and transferring deposited funds with upper-level entities. First, the ABC has made reductions in rural areas. Initially, the ABC enjoyed the advantage of extensive grassroots operational offices in every county and township. Since 2000, however, the ABC has undertaken a reform similar to that of other state-owned commercial banks, focusing on staff reduction, institutional adjustment, risk-control enhancement, and improvement of internal management. It also has cut operational offices, retreating from rural areas and parts of the rural credit market. According to a 2006 survey of selected counties in 29 provinces, from 2000 to mid-2006, the number of operational ABC offices in Shandong Province declined from 2,173 to 1,228 (a 9% decrease per year) and the number of employees decreased from 31,340 to 14,557 (a 12% decrease per year). In Changchun, 58% of the ABC's operational offices (in rural areas) and savings offices (in urban areas) were dissolved. In Qinghai, the ABC dissolved or merged township operational offices, and no other financial institutions provide credit or lending to farmers or herdsmen.

County subbranches are the lowest management layer, but they have no authority to appoint or remove staff, to budget independently, or to approve loans

Second, the ABC adopted measures to weaken the functions of county subbranches. Thus, due to sharp differences across regions, policy and management decisions made by headquarters usually lag behind or fail to conform to local reality. County subbranches are the lowest management layer, but they have no authority to appoint or remove staff, to budget independently, or to approve loans. For example, lower subbranches and enterprises spend time and effort rating enterprises applying for loans and then submit the results to provincial branches, which conduct examination only on an annual basis. Moreover, according to the president of one county subbranch, it normally takes 1 to 2 months for loan distribution, much longer than loan distribution from urban and rural credit cooperatives. Such an overstretched line of reporting deprives the ABC of good development opportunities.

Third, the ABC raised the threshold of access to loans, focusing on businesses in advantageous industries and enterprises in big cities. ABC's policy is to serve only clients with credit ratings of 2A and above, abandoning clients rated below 2A and subjecting new clients to credit rating by provincial branches. The ABC employs universal criteria for credit ratings, but some enterprises in less-developed regions have difficulty meeting such requirements and therefore cannot get loans. Some high-quality county enterprises do not appear to be viable when compared with peers at the provincial level, and many enterprises are daunted by the standards.

A PBC survey showed that the interest rate on capital deposited with upper-level entities is much higher than the rate provided by other commercial banks

After 2003, the ABC strengthened control over credit aggregation and intensified collective management of credit, resulting in a worsening capital shortage at the county level. The ABC's function in rural areas has shifted from supporting rural development by providing loans to taking deposits, providing settlement and intermediary services, and liquidating nonperforming loans. Operational offices below the county level mainly provide settlement, remittance, and other intermediary services; deposit certificate guaranty loans are the bank's only credit product. At present, grassroots operational offices take deposits but refrain from lending to township enterprises and farmers, except for a few poverty-reduction loans. Thus, the ABC has been transformed from a state-owned commercial bank that mainly targets rural areas to a bank that gradually reduces its presence in the agriculture sector.

Finally, the ABC transfers all collected deposits to upper-level entities and centralizes capital by raising the interest rate on such deposits, resulting in capital outflow from rural areas. A PBC survey showed that the interest rate on capital deposited with upper-level entities is much higher than the rate provided by other commercial banks. For example, in the first half of 2006, the 1-year interest rate on capital deposited with upper-level entities was 3.33%—one-half to one percentage point higher than the interest rate at other commercial banks. This policy encourages county subbranches to deposit their capital rather than lending it, impeding the efficiency of capital utilization in the local area. As a result, the balance sheet of county subbranches is quite unbalanced, with a declining deposit–loan ratio.

Following these major policy shifts, the ABC lost its advantages and now competes with a multitude of financial institutions in large and medium-sized cities. At the same time, certain agriculture loans are more likely to become nonperforming loans. Because it is impossible to get additional loans from the ABC, the bank has become more estranged from its former clients, including enterprises and farmers, and many borrowers are less willing to repay existing loans. This is particularly true of borrowers in certain townships where the ABC has closed down operational offices. As a result, the number of nonperforming loans in county sub-branches has skyrocketed in recent years.

Dominance of the Rural Credit Cooperatives

Competition in the PRC's rural financial markets is constrained by state regulation of the entry and exit of financial institutions. The ABC and the ADBC are government-owned financial institutions. RCCs, though defined as cooperatives, are subject to PBC regulation and management and have a corporate governance structure similar to that of state-owned financial institutions. It is virtually impossible for new financial institutions to enter the market, and there is no defined mechanism for individual loss-making RCCs with negative equity to exit the market.

Despite the creation of the ABC and the transfer of RCC management from the ABC to the PBC, the reforms of 1994 and 1996 failed to make rural financial markets more competitive. On the contrary, the reforms led to the gradual withdrawal of the ABC from rural lending and the collapse of rural cooperative foundations and other informal financial institutions, and the PRC's rural institutional lending markets have become dominated by RCCs. Nonprice competition for rural deposits has become fierce, especially in more-developed areas, as the ABC continues to fight for rural deposits, and the share of deposits held by rural postal savings has grown over time.

Building on the experience of a pilot in Jiangsu Province, the 2002 National Financial Working Conference laid down the basic principles of RCC reform. The conference decided that one-size-fits-all organizational patterns are ineffective, that commercialization should be allowed in qualified regions, that management should not be vertical across the country, that microcredit should be continued, and that provincial governments should participate in risk mitigation.

In June 2003, the State Council launched the pilot RCC reform in eight provinces and cities, including Chongqing, Guizhou, Jiangsu, Jiangxi, Jilin, Shaanxi, Shandong, and Zhejiang. In August 2004, the pilots were expanded to 21 provinces, regions, and cities, including Beijing, Hebei, and Tianjin.

The 2003 pilot RCC reform was designed to solve the supply–demand contradictions between collective financial institutions and individual credit by improving the governance of financial institutions. Two Communist Party of China Central Committee documents, in 2004 and 2005, further defined the guiding macroeconomic policy principles behind rural financial reform, laying the overall foundation for a modern rural financial system in the PRC.

By the end of 2006, the RCC pilot reform was launched in Hainan Province, marking the national coverage of the reform (there are no RCCs in Xizang Autonomous Region[7]). The China Banking Regulatory Commission created rules to allow for the establishment of rural financial institutions such as rural banks and lending companies, opening a new chapter in the PRC's rural financial development. Meanwhile, the pilot of new types of rural financial institutions was gradually expanded to increase competition in the rural financial market.

In June 2003, the State Council launched the pilot RCC reform in eight provinces and cities, including Chongqing, Guizhou, Jiangsu, Jiangxi, Jilin, Shaanxi, Shandong, and Zhejiang

The pilot RCC reform allowed private shareholding for ownership restructuring, which drew on the experience of restructuring township and small and medium-sized state-owned enterprises. Conducted under the leadership of the China Banking Regulatory Commission, the major reform measures included giving provincial governments authority for administering RCCs, issuing special central bank bills and loans to support the reform, and granting subsidies and tax exemption for the period 1994 through 1997.

The reform of postal savings is an important part of the state postal system reform

Unfortunately, the implementation of RCC reform has yet to address the issue of moral hazard. First, RCCs are not subject to bankruptcy and can incur losses in the name of supporting the rural economy. Second, local governments and RCCs might ask for unreasonably high compensation from the central government as a means of resolving historical burdens. Third, by exploiting the overlap of policy and commercial operations, RCCs can request central bank support, again in the name of supporting the rural economy.

Postal Savings Reform

The reform of postal savings is an important part of the state postal system reform. Since 2001, the PBC, the Ministry of Finance, and the Ministry of Posts and Telecommunications have conducted a number of studies and proposed a reform scheme under which different interest rates apply to deposits before and after a cutoff date, and postal savings offices have been encouraged to expand their business scope. In 2003, the National Development and Reform Commission played a leading role in coordinating with relevant ministries and commissions and proposing to the State Council a postal system reform plan that would enable postal savings offices to utilize their funds independently and promote commercial viability of postal savings.

After 1 August 2003, the PBC changed the interest on deposits from postal savings. According to the new method, the interest rate on new deposits with the PBC was the same as that on financial institutions' reserves (1.89% per year), while the previous interest rate (4.13% per year) remains applicable to deposits before August 2003. At the same time, postal savings offices were allowed to utilize new savings at their own discretion.

Under such circumstances, postal savings maintained rapid growth. As of the end of 2002, postal savings outstanding stood at CNY736.9 billion. Two-thirds of these deposits were from rural areas and all were deposited with the central bank. As of August 2006, postal savings outstanding was more than CNY1.5 trillion, an amount exceeded only by the four state-owned commercial banks. The Postal Savings Bank of China (PSBC) also boasts the largest financial network in the nation, connecting urban and rural areas through more than 37,000 outlets, two-thirds of which are in rural areas.

An important part of the central government's postal system reform was to reform the postal savings management system and standardize the operations of financial services provided by postal savings offices. The general reform plan called for a gradual shift from the previous operational model, in which all savings were deposited with the PBC, to independent utilization of savings under the supervision of the PBC and the China Banking Regulatory Commission. Savings deposited before the cutoff date of 1 August 2003 would continue to follow previous policies until 1 August 2005, whereas new savings were utilized at the discretion of postal savings offices. After 1 August 2005, postal savings offices' deposits with the PBC would be transferred out over 5 consecutive years. As of 21 March 2006, three such transfers—totaling CNY62.2 billion—were made without affecting the operation of the postal savings offices.

The second element of reform was the gradual diversification of the use of postal savings funds. With previous savings gradually transferred out of the PBC, the ability of postal savings offices to utilize funds independently has been improving. They have adapted to rural financial reform and have piloted pledged microcredit to reinforce support for agricultural industry, rural areas, and farmers *(sannong)*. In December 2005, the China Banking Regulatory Commission approved microcredit lending to rural residents, using time deposit certificates as pledges, in Fujian, Hubei, and Shaanxi provinces.

As of August 2006, independent fund use outstanding exceeded CNY800 billion, most of which was in bonds or was deposited with banks. The China Development Bank was selected as China Post's partner in the lending business. In June 2006, the two parties signed a comprehensive agreement to cooperate in a variety of areas, such as asset management, fund use, consulting services, human resources, and settlement.

On 31 December 2006, the China Banking Regulatory Commission approved the incorporation of the Postal Savings Bank of China, permitted China Post to become the sole investor in the PSBC, and approved the creation of the fifth-largest commercial bank in the PRC. According to the articles of association, the PSBC operates through the China Post network, must establish an internal control and risk management system in accordance with corporate governance and other requirements for commercial banks, and must operate in line with market principles. Similar to other banks, the institutional arrangement, operations, and senior management are subject to banking supervision focused on the bank's capital adequacy ratio. The PSBC is well positioned to rely on its current network of outlets to improve financial services with retail and intermediary businesses in both urban and rural areas.

After its transformation from China Post, the biggest problem now facing the PSBC is inadequate lending capacity. It was not until August 2003 that postal savings deposits were gradually transferred out of the central bank and new savings were available for utilization at the discretion of the PSBC, which mainly purchased bonds and deposits under negotiated terms. Since 2006, the China Banking Regulatory Commission has allowed China Post to launch pilot programs of microcredit pledged with deposit certificates, interbank deposits, and investment in syndicated loans and bonds issued by international development agencies. As of August 2006, the balance of independently utilized funds exceeded CNY800 billion, but most of the funds were still invested in bonds or deposited with banks.

Market Liberalization and Rural Financial Development

Liberalization of the PRC's rural financial market entered a new stage in 2005, and the most notable reforms are the pilots of microfinance companies and new types of financial institutions. Since the second half of 2005, the PBC has piloted microfinance companies in five provinces and regions,

The PSBC is well positioned to rely on its current network of outlets to improve financial services with retail and intermediary businesses in both urban and rural areas

and in May 2008, the pilot was expanded nationwide (including Guizhou, Inner Mongolia Autonomous Region, Shaanxi, Shanxi, and Sichuan). Presently, nearly 500 microfinance companies have been established. In addition, the China Banking Regulatory Commission relaxed market entry requirements for rural financial institutions and, at the end of 2006, piloted the liberalization of rural financial markets in Gansu, Hubei, Inner Mongolia Autonomous Region, Jilin, Qinghai, and Sichuan. In addition to microcredit institutions that provide lending without taking deposits, other new types of financial institutions include village banks, loan companies, and mutual financial organizations (also called mutual fund associations).

Market opening also has provided a base for the legalization of informal credit

A great number of farmers have gained control over their agricultural production, supply, and sales through the family contract responsibility system, and the liberalization of the rural financial market allows farmers to legally obtain credit. Production, supply, sales, and credit can work together to help farmers gain a competitive edge in the growing market economy.

Market opening also has provided a base for the legalization of informal credit. Some qualified informal creditors could become legal rural financial institutions through registration. Such institutions, as well as loan companies with a 100% capital adequacy ratio, RCCs with relatively low capital adequacy ratios, and other commercial banks, including the ABC, will present a complete spectrum of rural financial institutions, and such diversity of institutions can better meet diverse financial demands. In addition, private capital (including foreign capital) is now, for the first time, allowed to purchase a stake in and control newly established financial institutions. Pilot provinces have experienced an increase in mutual financial organizations self-managed by farmers, private microfinance companies, and village banks representing partnerships between financial institutions and private investors.

Main Issues of the Rural Financial System in the People's Republic of China

The main challenges to the PRC's current rural financial reform stem from the old financial administrative system, which was designed to support agricultural production with cheap money from the ABC (in the form of poverty reduction loans) and RCCs (in the form of small credit loans). Such an institutional design requires a highly centralized financial system, simplified financial institutions, and administrative management similar to that of government agencies.

The PRC's traditional rural financial system is characterized by lack of competition, diverse demand, capital outflows, difficult access to credit, the need for government credit inputs, insider control, and a lack of an enabling operating environment. Monotypic institutions reduce competition in rural financial markets, and demand for diversified financial services cannot be met. Furthermore, government credit supplies cannot reverse the large outflows of funds from rural areas or relieve farmers' difficult access to credit. At the same time, the "reform" of rural financial institutions under senior management that makes decisions without consulting shareholders has separated loan decision making from the interests of rural households.

Lack of Competition

Rural financial reform since 1996 has failed to promote competition in the rural credit market. Instead, the reform caused the ABC to gradually remove its lending business from the rural credit market and close down rural cooperative foundations and other informal financial institutions. In addition, the ADBC has decreased its lending for acquisition of crops, cotton, and edible oil. As a result, RCCs have been forced to play the role of primary credit providers in rural financial markets, giving them a virtual monopoly in the rural credit market and creating the low efficiency that usually accompanies a monopoly. However, a mismatch between RCCs' capacity and their mandate soon emerged. Due to the historical burden of a large volume of accumulated nonperforming loans, the administered interest rate, and inefficient management in some areas, RCCs still suffer huge losses, despite their monopoly status. The losses are especially heavy for RCCs in the central and western regions of the PRC, and such losses make RCCs unsustainable as the only service provider in the rural financial market.

Diverse Demand

One consequence of the lack of competition in rural financial markets is the creation of a monotypic rural financial system that cannot cope with the different demands for services among the eastern, central, and western regions. A system with the RCC as the sole player cannot meet the demands of farmers and enterprises in different regions. With the development of local economies and urbanization, demands for financial services have been evolving. Moreover, different economic structures in different areas produce different demands for financial services. RCCs, with their similar operational structures, lending modes, internal management, and incentive systems, are unable to meet these diverse demands in a timely fashion.

Capital Outflows

Since the mid-1990s, the sluggish and volatile nature of agricultural product prices, the low productivity of small-scale, self-sufficient rural households, and the large number of closures of township enterprises have contributed to the lack of investment opportunities in rural areas. This has forced many farmers to migrate to other provinces. The earnings of these farmers are remitted back to the rural financial institutions in their hometowns but then flow to the eastern and more-developed regions through institutional purchases of Treasury bonds and deposits in upper-level entities. As a result, insufficient funds are available for *sannong*, and rural economic development enters a vicious cycle.

Postal savings enjoys very high redeposit interest rates at the PBC, which translates into a hemorrhage of rural funds into other regions

Rural funds flow out through three channels: state-owned commercial banks, postal savings, and RCCs. State-owned commercial banks have shrunk their branch networks and tightened credit controls, and most county and lower-level offices of the four largest state-owned commercial banks are required to redeposit funds in their upper-level entities. Postal savings enjoys very high redeposit interest rates at the PBC, which translates into a hemorrhage of rural funds into other regions. Finally, many RCCs purchase Treasury bonds, deposit funds in other financial institutions, and lend to urban clients, which translates into additional outflows.

Difficult Access to Credit

Most rural households, especially those running small and medium-sized rural enterprises, have difficulty accessing credit. With commercialization, the ABC has abandoned some branches and merged others. Meanwhile, the mode and means of RCC services cannot meet the demands of rural households or rural economic development. Although RCCs have increased microfinance lending to rural households, loans to small and medium-sized rural enterprises have been shrinking significantly. In addition, because microfinance loans largely depend on PBC agriculture onlending, they feature high transaction costs and loan sizes are small. With the fixed interest ceiling, RCCs can hardly maintain their microfinance operations in the long run. In many central and western provinces, loss-making RCCs are unable or unwilling to lend to rural households, whereas PBC onlending for agriculture is unequal to the demand for credit, forcing farmers to depend on borrowing from relatives, friends, or informal sources. The government's poverty alleviation loans through the ABC can barely accommodate rural households.

Government Credit Inputs

If the old rural financial system supported the PRC's rural economic development, the financial support represented a kind of overdraft and was therefore unsustainable. It is impossible to solve the problem of outflow of rural funds and to ease the difficulties in accessing credit in rural areas with PBC onlending and poverty alleviation loans, both of which are fiscal in nature. The PBC's relending is utterly inadequate in dealing with the vast demand in rural areas. It was difficult for government-sponsored, interest-subsidized poverty reduction loans dispensed through the ABC to truly benefit rural households, and the persistently high nonperforming loan ratio of poverty reduction loans made it difficult to achieve the anticipated poverty reduction.

Key factors widening the gap between urban and rural areas are the relative access to fiscal funds, national and local government investment, and the different returns on investment in various regions. Although support for *sannong* is important, finance cannot serve the function of fiscal policy. In the past, the central and local governments have misconstrued finance, making it shoulder too many fiscal functions. This has resulted in huge losses, shrinking rural financial services, increased outflows of rural funds, and serious moral hazards.

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Insider Control

The advantages of local rural financial institutions lie in their access to local information, which can reduce monitoring costs and information asymmetry. However, under the current system, RCC management assumes little responsibility for RCC performance. In the absence of significant changes in the ownership arrangements and governance structures of rural financial institutions, the reforms remain under the control of an RCC management that benefits from the current system. With weak governance, risk control can only be strengthened by administrative measures—that is, by concentrating decision-making power. At the ABC, this is done by depriving lower-level branches of decision-making power over loans; RCCs concentrate decision-making power regarding lending and treasury functions in the rural credit cooperative unions. Nevertheless, concentrated decision-making power can hardly solve the problem of asymmetric information or encourage a timely response to changes in demand.

Lack of an Enabling Operating Environment

There are insufficient risk-sharing mechanisms for rural loans. Underdeveloped agriculture insurance, the rudimentary futures market for agricultural products, and various legal and policy constraints have prevented rural financial institutions from finding efficient substitutes for collateral and guaranty. At the same time, rural financial institutions have few incentives to resolve collateral-and-guaranty difficulties through financial innovation. The sustainable development of these institutions also is hampered by tax policies and controlled interest rates.

Lessons from Rural Finance Reform

Past reform has not fundamentally changed the basic structure of rural finance in the PRC. First, the government still controls rural finance, and the commercialization of financial institutions has been limited by both lending policy and low interest rates. Second, the market structure has not changed, and RCCs still dominate rural financial markets. Third, the performance of financial institutions has not fundamentally improved. This represents a sharp contrast with the nation's robust economic growth, particularly rural economic growth, in the past 2 decades.

The traditional rural financial system has contributed to rural economic growth, but the "overdraft" of financial resources from rural areas can hardly be sustained. The delay in reform has hampered the ability of rural finance to support the rural economy, and its inefficiency will obstruct rural economic growth. For too long, the rural financial system has been undergoing reform in name, but this reform has centered on improving the external administrative system of RCCs rather than putting in place effective internal incentive and discipline mechanisms. Regardless of nominal changes, therefore, the RCCs have failed to break away from the general characteristics typical of state-owned enterprises in the planned economy, including lack of ownership, soft budgetary discipline, and insider control, resulting in more government involvement and increased distance from farmers. Farmers still must resort to informal financial institutions to meet their financial needs.

The traditional rural financial system has contributed to rural economic growth, but the "overdraft" of financial resources from rural areas can hardly be sustained

It is fair to say that, so far, the PRC has not truly launched market-oriented rural financial reform. The relationship between the government and the market has not been resolved, reform has focused on changing existing institutions rather than on building a modern financial system, there remains a mismatch between the rural financial and nonfinance sectors, and reform has tended toward a one-size-fits-all approach.

First, the ends and the means of the government's rural work were confused, and the relationship between the government and the market was not properly resolved. The objectives of the government's rural work are to solve problems related to *sannong*, to develop the rural economy, and to raise rural household income. Multiple means could be utilized to achieve these objectives, and credit support is one important channel through which rural financial institutions can serve and support the rural economy. However, if rural financial institutions are forced to extend credit support as a major means for the government to achieve its rural targets, then rural financial institutions are constrained in maximizing their profit. This not only harms the independence and efficiency of financial institutions but also provides a basis for direct government interference in the business of financial institutions.

Facing a shortage of fiscal resources, rural financial institutions unduly assumed some fiscal functions to promote rural development, which contributed to serious problems in rural finance. Large losses on the part of rural financial institutions made farmers' access to credit increasingly difficult, and rural capital outflows and inadequate credit became major constraints on rural economic development. In this context, changes to and evolution of the single rural financial pattern previously tailored to a planned economy were inevitable. The rural financial system has actively or responsively evolved to meet the financial needs of *sannong*.

If RCCs do not perform well, rural finance in some regions has no backup

Second, with the exception of commercialized reform of the ABC in the mid-1990s, rural financial reform has been limited to the reform of the RCCs. No effort has been made to build a modern rural financial system. A truly modern rural financial system should have the capacity to accommodate formal and informal finance, direct and indirect finance, and competition among different financial institutions and financing approaches. One key lesson of the PRC's gradual reform is that reform entities need external impetus. In this sense, it may be said that the secret of successful reform lies outside the reform itself.

The reform of the collective rural economy has achieved great breakthroughs, thanks to institutional innovations such as the family contract responsibility system and the reform of large state-owned enterprises. Nevertheless, the reform of the rural financial system has so far been dominated by the monopolistic RCCs. In some regions, informal finance and other innovative financial institutions were labeled as illegal fund-raising or disrupting the financial order, so that informal finance was actually killed. If RCCs do not perform well, rural finance in some regions has no backup.

Third, the mismatch between the rural financial and nonfinance sectors is yet to be resolved. Historically, the PRC's financial system was based on collective credit, or government credit, which was measured by the nature of the enterprises or the administrative level of the government in question. In the early period of specialized banks, assessment of a borrower's repayment ability was based on collective credit, which took the form of implicit guarantees by industrial regulators or the government. As long as enterprises within a particular jurisdiction made profits on the whole, collective credit was sound. Industrial regulators and local governments controlled the majority of economic resources, such as appropriation and pricing of raw materials, enterprise licensing, energy, and transport, and were backed by large fiscal revenues. Thus, the higher the administrative level of a regulator or government, the more resources it controlled and the better was its creditworthiness. Collective credit did not depend on collateral; thus, state-owned or collective enterprises with support from industrial regulators or local governments could easily borrow from banks, which largely explains the protracted and large numbers of nonperforming loans of the PRC's financial institutions.

Beginning in the mid-1990s, however, intensified competition worsened the profit-making capability of local state-owned and collective enterprises, and collective credit was on the brink of collapse. To protect their lending, financial institutions were forced to look for substitutes for collective credit. The commercialized reform of banks, launched in 1994, was intended to replace specialized banks with commercial banks and to make a distinction between policy lending and commercial lending, at least in terms of the form of the reform.

However, the reform represented a revolutionary shift in the credit basis of financial institutions, from collective credit to individual credit—an inevitable process in the transition from a planned economy to a market economy. The basic feature of individual credit is to disregard administrative level or the nature of a borrower's enterprise and to base bank lending on a borrower's repayment ability as measured by a series of indicators, including adequate collateral or guaranty, repayment history, corporate size, information disclosure, and so forth. With the emergence of individual credit, enterprise ownership is no longer a key factor in banks' lending decisions, as long as an individual meets the lending criteria.

Thus, banks gradually shifted from lending only to state-owned and collective enterprises and began to include private enterprises. This promoted broad reform of small and medium-sized state-owned enterprises and collective enterprises, especially township enterprises. However, it will take time to resolve the mismatch between the rural finance sector and the credit system of the nonfinance sector.

Finally, the one-size-fits-all reform approach has been unable to keep up with changing economic and financial needs, given the differences in rural financial demand across the eastern, central, and western regions of the PRC. With the deepening of financial reform, especially since commercialized banking reform was launched in the mid-1990s and shareholder banking reform began in 2003, enormous changes have taken place in the PRC's rural financial system. Growing regional disparity in economic structure has created differences in supply and demand in the rural finance sector. In advanced coastal regions, for example, the growth of nonagriculture industries has increased the need for financial services in extra-agriculture rural sectors and has increased both the need for and the actual integration of rural finance with the entire financial system. In the central region, the share of non-crop-growing sectors, including animal husbandry and agricultural products processing, has been increasing; thus, specialized production accounts for the bulk of financial needs and financial supply has been trending toward specialization. Poverty reduction and streamlining consumption are the main financial needs in the western region, which has relatively few profit-making opportunities, a shortage of natural resources, and large uncertainties related to market and weather conditions.

The major demand for financial services in poverty-stricken rural areas includes the need to make deposits, to remit funds, and to access capital for simple production

Despite differing regional needs, however, each round of rural financial reform since the 1990s has been carried out uniformly across the whole country, giving localities little discretion in adapting implementation to specific local circumstances. As a result, previous reforms have failed to solve practical problems, and a pattern that worked in some regions might be difficult to implement in other regions. Thus, new problems continue to emerge in the process of reform.

The major demand for financial services in poverty-stricken rural areas includes the need to make deposits, to remit funds, and to access capital for simple production. Postal savings agencies and RCCs satisfy these demands well. However, the current financial structure faces great challenges in creating sustainable development that will promote a sound cycle of local economic and financial performance.

CHAPTER 2
Rural Economic Situation

The poverty reduction effort in the People's Republic of China (PRC) serves as an example for the rest of the world, with the number of poor people (relative to average income in the PRC) sharply reduced, from 200 million in 1980 to 25 million in 2005. However, since the mid-1990s, the PRC has witnessed widening disparities between urban and rural areas and among regions. A large number of poor people are concentrated in the midwestern region, especially in its poverty-stricken rural areas. Despite government efforts to ease the economic development bottleneck in these regions through fiscal policy–based poverty alleviation, poverty alleviation credit, and the Great Development of the West, there have been no fundamental changes, and the number of poor people has increased in many midwestern rural areas. This has hindered sustainable economic development and social harmony.

Although fiscal transfer has leaned toward less-developed regions in recent years, a large proportion of public service resources actually have been concentrated in urban areas, and funds and other resources constantly flow into cities and developed regions through a variety of channels. Because of the uneven distribution of public finance investment among urban and rural areas, the flow of funds and labor in the PRC's rural areas, especially in the midwestern region, has resulted in prolonged sluggishness and volatility in agricultural production; extremely low productivity among small-scale, self-sufficient peasants; and massive shutdowns of township and village enterprises. These factors have forced many farmers to leave their homes to seek employment. However, the money they earn and remit home usually is deposited in rural financial institutions, where it then flows back to big cities and developed regions through institutional purchases of government bonds, interbank lending, reserve banking, and deposit with the People's Bank of China.

Many aspects of the PRC's poverty reduction policies call for further study. For instance, if the ratio of nongovernment income (e.g., migrant workers' remittance) to farmers' income has been increasing, then where have those government poverty alleviation subsidies gone, and how effective are such subsidies? Under the current system, it is difficult for local governments to change local industrial structures and improve the economic status quo. In this context, what should be the direction of future poverty alleviation policies and rural financial reform in poverty-stricken areas of the PRC?

General Economic Situation

Our data show a severe economic situation in poverty-stricken areas. The basic features of these areas include an increasing percentage of the population living in poverty, a relatively low gross domestic product (GDP), and a decreasing area of cultivated land per capita. Because a major proportion of income increase has come from nonagriculture income, especially migrant workers' remittance, local economic development is unlikely to lead to increased income for farmers in these regions.

A large proportion of the budget is earmarked for paying the salaries of government functionaries, which has trimmed the local public finance available for medical care and education and has reduced local farmers' access to public services

It seems that local governments can do little to improve local industrial structures significantly. Meanwhile, the fiscal position of poverty-stricken areas with agriculture as their pillar industry does not look rosy either. A large proportion of the budget is earmarked for paying the salaries of government functionaries, which has trimmed the local public finance available for medical care and education and has reduced local farmers' access to public services. Although recent years have seen heavy investment in transport, compulsory education, and clean water projects under the Great Development of the West, some rural financial institutions continue to serve as public finance providers, due to the limited rural social security system and the unsound grassroots fiscal system.

The number of poor in these core poverty-stricken counties has not shown a downward trend; instead, it rose from 22.5% in 1999 to 28.4% in 2003. In the core poor counties in Sichuan Province, the number increased by about 10 percentage points. Similarly, there was an upward trend in the ratio of poverty-stricken townships to the core poverty-stricken counties in Gansu and Yunnan, and the figure remained at around 80% in four other western provinces of Ghizhou, Ningxia Huizu Autonomous Region, Shaanxi, and Sichuan. During the 5-year observation period, the ratio of key poor villages in these places stood at around 50%. From 1999 to 2003, the average per capita GDP increased by around CNY200 per year in the sample counties, rising from CNY1,668 in 1999 to CNY2,391 in 2003. This is about one-quarter of the national average for the same period.

There also is a lack of cultivated land in poverty-stricken areas, especially in the poor southwestern regions, where most of cultivated land is in small parcels located far from farmers' homes. Gansu and Ningxia reported a larger area of cultivated land per capita but suffered from the lowest irrigation rate among the six provinces; only 9.5% of the cultivated land in Ningxia's poverty-stricken counties is irrigated. Poverty-stricken counties in the other four provinces sampled have a relatively small per capita area of cultivated land—the per capita area of cultivated land in Guizhou, for instance, was only 0.72 *mu,* or 0.05 hectare—and from 1999 to 2003 the per capita area of cultivated land in the poverty-stricken counties of all six provinces decreased. In 2003, the figure in the sample counties was 1.8 *mu*, or 0.12 hectare, around half of which was unirrigated land. Land scarcity and inferior quality are important reasons for rural household poverty and farmers' migration to the nonagriculture sectors.

Industrial Structures

Agriculture is the main sector in poverty-stricken areas. Although from 1999 to 2003 the ratio of gross agricultural output (GAO) to GDP decreased, the magnitude of decrease was small and the GAO–GDP ratio of all sample counties stood at over 50%. The industrial sector in these areas is underdeveloped. Of the six provinces studied, Shaanxi had the highest ratio of gross industrial output to GDP, at 47.4%, and Gansu had the lowest ratio, at 27.9%. During the period from 1999 to 2003, the gross industrial output of poverty-stricken counties in Gansu, Guizhou, Ningxia, and Yunnan even observed a downward trend.

Despite the efforts of local governments to increase tax revenue and develop raw materials–based industry, all the provinces except Shaanxi have shown limited results. Local industrial output values are not high, and with the abolishment of the agriculture tax, the ratio of tax revenue to expenditure in poverty-stricken areas will decline further.

In addition, the output value of the service industry in these areas is very low. Many poverty-stricken areas are in mountainous regions with beautiful scenery, and the idea of developing the service industry, especially the tourism industry, has merit. However, this is not in the interest of local governments because the service industry yields little local tax revenue. Currently, industries in poverty-stricken areas are mostly energy intensive and highly polluting, which will affect the development of the service industry and harm the sustainable long-term development of local economies.

Agriculture Loans

Statistics show that the ratio of agriculture to other loans is nearly equivalent to the ratio of the agriculture sector to the overall economy, and our survey data confirmed this. During the 5-year period from 1999 to 2003, the GAO–GDP ratio dropped by 4.8 percentage points in the western provinces, which are major agricultural provinces. This trend was in line with the situation of the country as a whole, where the GAO–GDP ratio decreased by 3.7 percentage points. During the same period, agriculture-related loans represented around 70% of total loans outstanding and increased by 3.7 percentage points—greater than the increase in the GAO–GDP ratio. This showed that, on the one hand, local governments had strengthened their efforts to support agriculture-related loans but that, on the other hand, they still were focused on secondary and tertiary industries for their economic development. The importance of the secondary and tertiary industries was enhanced, whereas agriculture had not been duly developed.

Fiscal Position

Currently, local public finance in the PRC, especially public finance below the county and township levels, is mostly payroll finance, and a considerable number of poverty-stricken areas rely on fiscal subsidies to maintain operations. In these poverty-stricken areas, the expenditure

The importance of the secondary and tertiary industries was enhanced, whereas agriculture had not been duly developed

for existing staff accounts for over 60% of the total fiscal expenditures, and this number is rising. In 2003, the percentage reached 92.9% in Shaanxi. Because local private economies are underdeveloped and employment opportunities are scarce, people have a strong incentive to get government posts.

In the current pattern of resource allocation, the central and provincial governments control most public finance resources whereas the county and township governments are responsible for a large proportion of social security and social development expenditure. Under the current fiscal and investment systems, central and provincial governments mainly invest in large and medium-sized infrastructure projects, and it is difficult to cover vast rural areas. Thus, county and township governments are responsible for the construction of small and medium-sized infrastructure in rural areas, but they have difficulty fulfilling such responsibility due to their limited financial strength.

Many farmers lack basic medical insurance, and many poverty-stricken households are lost in a vicious cycle of poverty and illness

The deteriorating fiscal position of poverty-stricken counties affects the sustainable development of local financial institutions. Because public finance at the township level is used primarily to finance payroll, heavy rural debts affect the operation of rural financial institutions and represent an important factor constraining their sustainability. There is a relatively serious financialization of rural debts in the sample counties, and a large proportion of these debts are owed to rural credit cooperatives (RCCs).

Typical of the situation in rural areas, the core poverty-stricken counties in Guizhou lack not only a sound township fiscal system but also sufficient fiscal resources for education and medical care. In 2000, the per capita spending for public health in urban areas was 3.8 times the spending in rural areas. In 2004, this figure increased to 4.2 times. Many farmers lack basic medical insurance, and many poverty-stricken households are lost in a vicious cycle of poverty and illness. Education and medical treatment accounted for 29.7% of rural household borrowing in 2004, and funds used for such purposes are less likely to be repaid. Moreover, although investment in education is very important to families and to the country as a whole, the short-term, direct benefit from education investment remains low.

Preferential tax treatment and other government subsidies represent the majority of fiscal support for rural finance. For instance, RCCs in eight provinces (expanded to 21 provinces in January 2004) received an exemption from a 3% business tax for the period from January 2003 to January 2005, resulting in a total tax exemption of CNY1.7 billion, and the business tax on RCCs in other provinces was halved. In 2003 and 2004, RCCs in the eight provinces also paid CNY1.6 billion less in income tax. In addition, governments subsidized the RCCs for losses resulting from the interest rate rise on their inflation-linked deposits for the period from 1994 to 1997.

Sources of Farmers' Income Growth

Farmers' per capita net income in the poverty-stricken counties of the six western provinces increased by over CNY200 per year from 1999 to 2003. In poverty-stricken areas of Gansu and Sichuan, the growth of rural households' per capita nonagriculture income exceeded the growth of per capita net income, indicating a decrease in rural households' agriculture income. In Guizhou, Ningxia, and Yunnan, the growth of rural households' per capita nonagriculture income also accounted for over 50% of their increased income.

Both the number of migrant workers from poverty-stricken areas and their income have been increasing. Guizhou posted the greatest increase; income of migrant workers from its poverty-stricken areas nearly tripled during the 5-year study period. Remittance by migrant workers comprised an important part of the local per capita net income, and farmers' income growth in these poverty-stricken areas increasingly relies on rural labor transfer and the employment opportunities created through economic growth in more-developed regions. The income of rural migrant workers has become the most important source of income growth in poverty-stricken areas, indicating that government poverty alleviation policies have an insignificant effect.

CHAPTER 3

Rural Financial Services for the Poor and for Rural Migrants

Local Institutional Outlets

The People's Republic of China (PRC) has established a rural financial system featuring both formal financial institutions, which serve as major providers of financial services in rural areas, and informal financial institutions and nongovernment microcredit organizations, which serve as valuable supplements. Rural financial products comprise loans and microcredit, remittance services, and in a few regions, agriculture insurance. Rural financial product innovation has been springing up. However, the rural financial market still suffers from lack of competition, weak performance, and inability to meet the demands of agriculture and rural economic development.

As of this writing, formal institutions—including the Agricultural Bank of China (ABC), the Agricultural Development Bank of China (ADBC), the Postal Savings Bank of China (PSBC), and rural credit cooperatives (RCCs)—have outlets at and below the county level, though the ABC has substantially withdrawn since 2000. The ADBC has outlets in 1,606 counties, but not in most poverty-stricken regions. Around 20% of poverty-stricken areas have PSBC outlets. A China Banking Regulatory Commission survey found that financial institutions covered most county areas but fewer and fewer townships and villages. This was particularly true in the western regions.[1] By the end of 2005, there were slightly more than 126,000 depository institution outlets at or below the county level, down by 24% from approximately 166,000 in 2000. Of these, 49,000 outlets were in counties, 62,200 were in townships, and 9,368 were in villages. On average, there are 25 outlets per county, 2 outlets per township, and 1 outlet for over 50 villages (Table A.1). About 65% of townships have only PSBC and/or RCC outlets; these two types of financial institutions accounted for 87% of total financial outlets in townships and 90% in villages.

Commercial banks (excepting the ADBC, the PSBC, and RCCs) also have substantially reduced staff at or below the county level. From 2000 to 2005, the number of employees decreased by 14%. By the end of 2005, commercial banks had 31,900 outlets and 431,400 employees at or below the county level, a decrease of 26,200 outlets and 179,000 employees from 2000.

Distribution of financial institution employees is much higher in the eastern region than in the western region. By 2005, there were 1.3 employees per thousand people in the eastern region, as opposed to 0.9 employees per thousand people in the western region. A survey demonstrated that approximately 64% of rural households considered the number of local financial institutions to be proper, whereas around 24% considered it to be on the low side. Moreover, approximately 22% of rural enterprises and 16% of rural households regarded inadequate coverage of local financial institutions to be the major reason for difficult access to credit.

Data showed a small increase in the concentration of the deposit and loan markets in 54 counties from 1999 to 2003

Our survey in six western provinces supported previous studies' conclusions about the concentration of rural finance. The concentration of deposit and loan markets in the sample counties during the observation period was measured using the Herfindahl-Hirschman Index. The higher the index, the higher the market concentration or monopoly, with a score of 1 implying a monopolized market. Data showed a small increase in the concentration of the deposit and loan markets in 54 counties from 1999 to 2003. The concentration of the loan market (around 39%) was slightly higher than that of the deposit market (around 36%) (Table A.2), implying the withdrawal and merger of many financial institutions in the rural financial market and reduced competition in general. Relatively speaking, more financial institutions were scrambling for the rural deposit market, which reduced the level of concentration in this market, but these institutions were not making loans locally. Guizhou was a counterexample; it posted a declining concentration in both deposit and loan markets, with the level of concentration in its loan market declining by nearly 12 percentage points.

The market share of the ABC, postal savings, and the RCCs in the sample counties changed less in the deposit market (Table A.3) than in the loan market (Table A.4). For example, the ABC's share of the loan market dropped by nearly 7 percentage points from 1999 to 2003, whereas RCCs' share of the deposit market increased by just under 5 percentage points during the same period. The share of loans from other state-owned commercial banks was close to 20% in 2003. Although these institutions' share of the deposit market is lower than in 1999, it is much higher than their share of the loan market (12%), meaning that these state-owned commercial banks took funds out of western rural areas.

Due to the rapid expansion of the entire rural deposit market, the total deposit of postal savings in 2003 was over three times that in 1999, but its market share moved up less than 4 percentage points. The deposit market share of postal savings in poverty-stricken areas increased from 7.4% in 1999 to 11.1% in 2003. The expansion was particularly significant in the sample counties in Shaanxi, where the postal savings market share almost doubled, from 10.6% in 1999 to 20.8% in 2003.

Among the 54 counties surveyed, 22% of villages and townships had no RCCs. Fifty percent of villages and townships in

Sichuan had no RCCs. From 1999 to 2004, the absolute number of RCCs decreased by 15% and the number of rural households per RCC increased from around 3,000 to over 3,770. Thus, the workload of each RCC increased by an average of over 20%. Each RCC loan officer had to take care of approximately 1,500 rural households on average; in Guizhou, the figure was 2,278 households. Given a loan coverage rate of about 58%, each loan officer was thus responsible for issuing and managing loans for over 800 households—a difficult task, even without considering the limited transport and infrastructure in poverty-stricken areas. Under such circumstances, it is hard to ask for quality loan issuance and management.

With the reform of the state-owned commercial banks, the ABC has positioned its operation at or above the county level and has been withdrawing or merging its outlets below the county level in many of the core poverty-stricken counties. By the end of 2005, the ABC had merged or closed 8,601 outlets in the central region (about 39% of outlets since 2000) and 4,635 outlets in the western region (about 31% since 2000). As a result, the number of ABC outlets in villages and townships, and the number of ABC employees, has been decreasing, especially after 2000. On average, 85.4% of villages and townships had no ABC office by 2005, and the trend is continuing today.

Agriculture and Poverty Reduction Loans

The central government attaches great importance to the issues of agriculture, farmers, and rural areas *(sannong)*, and in turn, to relevant financial policies. In this regard, the ABC, the ADBC, and the People's Bank of China (PBC) have made tremendous efforts to undertake some fiscal functions, although new, market-oriented approaches are needed to improve financial support for *sannong*. Policy finance includes agriculture loans, poverty alleviation loans, and policy loans.

The strategic adjustment of the ABC, the shifting function of the ADBC, and the decreasing share of ADBC loans in poverty-stricken areas has made rural credit cooperatives the main force in rural finance. However, RCCs are unable to adapt themselves to the diversified demand for rural finance, and in many regions can only meet simple production needs of rural households. High operating costs and transaction risks have led to RCC losses in the western region. Total RCC losses in the 54 sample counties exceeded CNY105 million in 1999 and CNY25 million in 2003 (Table A.5).

The strategic adjustment of the ABC, the shifting function of the ADBC, and the decreasing share of ADBC loans in poverty-stricken areas has made rural credit cooperatives the main force in rural finance

RCC funding sources in 2003 included PBC agriculture loans, deposits, and funds transferred from the provincial RCC, and the average interest rate was less than 3% per annum. The average interest rate on PBC loans was 2.25% from 1999 to 2003, increasing to 3.24% in 2005. In addition, the average RCC interest rate was 7.3%, yielding a spread of 3.5 to 5.5 percentage points. The spread enabled RCCs to provide necessary financial services in poverty-stricken areas, but it could not make up for the operational and transaction costs of RCCs. For example, the average salary of RCC employees increased by 12% per year, from over CNY10,000 in 1999 to over CNY20,000 in 2003, likely the fastest salary increase of any financial institution in the world. Although the actual income of RCC employees was not salary only (the actual income of some might be several times their salary), the salary increases were not affected by RCCs' high nonperforming loan ratios.

With the support of the PBC's agriculture loans, RCC loans in poverty-stricken areas increased significantly from 1999 to 2003, and average loans outstanding more than doubled. In poverty-stricken areas in Ningxia, RCCs loans more than quadrupled from 1999 to 2003, and microcredit loans to rural households accounted for 74.8% of total loans in the province in 2003. In Guizhou and Ningxia, RCCs' share of the loan market more than tripled. Overall, the market share of RCC loans has been increasing, from less than 14% in 1999 to about 25% in 2003, and it continues to rise.

In Guizhou and Ningxia, RCCs' share of the loan market more than tripled

As RCC loans to rural households in the sample counties increased, agriculture loans in these regions by the PBC also increased, from about CNY146 million in 1999 to over CNY8 billion in 2002. However, in 2003, the PBC adjusted the geographic distribution of its agriculture loans. As a result, loans for the sample counties in the six provinces declined to CNY4.4 billion, whereas Ningxia and Yunnan showed an increase of over 50% from the previous year. The PBC's share of the new loans increased from just under 27% in 2000 to nearly 52% in 2002 before dropping back below 30% in 2003. During the same period, the new loans of RCCs in the sample counties increased from CNY6.7 billion to CNY15 billion. Approximately half of the new RCC loans in the sample counties were supported by PBC loans. In Ningxia, this figure reached 67% in 2002 and 124% in 2003, indicating either that the RCCs in the sample counties in Ningxia were unable to absorb the PBC loans or that these loans were used for other projects.

Poverty alleviation funds increased from CNY6.8 billion in 1999 to CNY15.8 billion in 2003. In terms of the funding structure, government bonds projects and fiscal funds for poverty alleviation increased, whereas funding for work relief programs decreased (Table A.6). Although road construction under state bonds projects is conducive to rural development, the work relief program has more direct impact on rural households. Moreover, fiscal funds for poverty alleviation were allocated through different government agencies and the fiscal fund–supported projects were not coordinated with financial policies, further discounting the loans' poverty alleviation effects.

The commercialization of the ABC, its mergers and withdrawals from poverty-stricken areas, and its transfer of loan decision making to upper-level branches did not improve the quality of loans in these areas. On the contrary, its loan interest collection remained at around 50% from 1999 to 2003, with a minor decrease in Ningxia and Sichuan (Table A.7). The situation was less optimistic for the ADBC, whose nonperforming loan ratio increased from 24.9% in 1999 to 29.4% in 2003 (Table A.8).

ABC loans mainly include agriculture loans, poverty alleviation loans, township and village enterprise loans, and loans for the purchasing and processing of grains, cotton, and edible oils. Between 1999 and 2003, there was a slight increase in the total size of ABC loans in the sample counties (Table A.9). The increases were mainly in agriculture loans and poverty alleviation loans, which accounted for approximately 60% of the ABC's loans. However, the ABC's loans for township and village enterprises decreased from 7% in 1999 to 4% in 2003 (Table A.10), and loans for the purchase and processing of grains, cotton, and edible oils decreased from 5% in 1999 to 3% in 2003. This was particularly true in the sample counties in Ningxia and Yunnan, where there was a dramatic decline in township and village enterprise loans, from 6% in 1999 to 2% in 2003. The sample counties in Gansu also saw loans decrease by one-half. This indicates that township and village enterprises in these areas were shrinking and generally too inefficient to meet the ABC loan requirements.

The ABC's short-term agriculture and township and village enterprise loans also have been decreasing, and its loans for rural medium- and long-term state bonds projects are focused on infrastructure such as transport. In terms of loans outstanding, the ABC remains number one, accounting for over 40% of the market. There was a fast decline in the ABC's operation in Guizhou from 2001 to 2004, with RCCs taking most of the market share in the sample counties, yielding increased market concentration. In 2001, the ABC's poverty alleviation loans for rural households began declining relative to the total number of similar loans in the sample counties in Guizhou and Yunnan, and in some areas, the ABC ceased poverty alleviation loans for rural households in favor of project loans (Table A.11). This created unequal competition in the rural financial market.

With the exception of the sample counties in Guizhou, the ABC's medium- and long-term loans rose to over 55% of the total (Table A.12), indicating that new loans in these poverty-stricken areas were mostly directed toward infrastructure projects such as transport and hydropower stations. There was almost no change in the ABC's loans outstanding, but the ratio of deposits to loans was rising (Table A.13), indicating a declining role for state-owned commercial banks in poverty-stricken areas.

In terms of the ABC's corporate loan structure in the sample counties, there was an increase in loans for family businesses but a small decrease in loans for collective and state-owned enterprises (Table A.14). Loans for state-owned enterprises in the sample counties in Guizhou and Yunnan still accounted for over 50% of total loans, reflecting underdeveloped private enterprises in these areas.

Since 2001, the reform of the grain circulation system has trimmed the function of the ADBC to issuing loans for grain purchases and has transformed the monopoly status of the state-owned grains circulation enterprises. Even so, ADBC loans for grain purchasing and selling have decreased notably, and only short-term grain purchase loans are being issued. Many regional ADBC operations have been suspended, tightening the supply of policy finance, such as medium- and long-term loans, in the rural financial market.

Loans for state-owned enterprises in the sample counties in Guizhou and Yunnan still accounted for over 50% of total loans, reflecting underdeveloped private enterprises in these areas

Moreover, although the ADBC is the only policy bank in poverty-stricken areas, it had no outlets in many poverty-stricken counties in 2003 and declined loans in sample counties in Guizhou and Shaanxi. Moreover, its average share of the loan market dropped from 11.3% in 1999 to 9.4% in 2003 (Table A.4). In the sample counties in Ningxia, the ADBC's market share was cut nearly in half, indicating a weakened role for the ADBC as a policy bank in poverty-stricken rural areas.

People's Bank of China Lending to Support the Agriculture Sector

The PBC has provided extensive support to rural financial institutions since 1996, including lending to the ADBC in 1996; writing off CNY345.8 billion worth of non-performing loans, some of which were central bank loans, in 1998 and 1999; and lending to RCCs in 1999 to encourage them to provide farmers with microfinance and group loans.

Microcredit and group loans effectively solved the problem of loan guaranty and expanded the coverage of loans for rural households

After the separation of the RCCs from the ABC in 1996, the RCCs' nonperforming loan rate soared. Massive bankruptcies of township and village enterprises, coupled with problems within the rural cooperative foundations themselves, left the RCCs weakened, making it more difficult for farmers to access credit. To enable RCCs to strengthen their support for *sannong*, the PBC supplemented the RCCs with low-interest loans.[2] In 1999, Jiangsu Province was chosen for a pilot program of rural household microcredit and group loans, for which the PBC provided CNY5 billion worth of interest-free loans. Because rural household microcredit has simple procedures and requests no collateral or guaranty, it has been well received by most farmers and has evolved to become the major means by which RCCs can serve *sannong*.

In 2002, the PBC promulgated the Guidelines on the Management of RCC Microcredit for Rural Households, based on nationwide experience with microcredit loan operations. In 2002, all RCCs began promoting microcredit at full scale. Microcredit and group loans effectively solved the problem of loan guaranty and expanded the coverage of loans for rural households. In 2003, the pilot program was expanded to eight provinces, and CNY38 billion in central bank bills were issued to cover the RCCs' historical burdens. After that, the program was expanded to 21 provinces, and central bank bills issued amounted to CNY168 billion.

By the end of 2003, microcredit operations were being managed by 31,446 RCCs across the country (90% of all RCCs) and 17,195 RCCs had provided group loans. Nearly 53 million rural households had received microcredit or a group loan. However, RCCs in many areas still could meet only the simple production needs of rural households. The high percentage of rural household microcredit in poverty-stricken areas reflected the stagnation of local private enterprises and family businesses.

Microcredit in the sample counties increased from CNY72 million in 1999 to 1.8 billion in 2003, an increase of 150% per year. The RCCs allocated extensive resources to promote this business, and farmers' demand for microcredit was strong. Microcredit also boosted the percentage of RCC rural household loans to over 70%, except in the sample counties in Yunnan, where the ratio dropped from 71.6% in 2002 to 51.8% in 2003. This reflected the underdeveloped industry in poverty-stricken areas and the efforts of the PBC to boost microcredit through agriculture loans.

In 2004, the PBC increased the RCC loan quota by CNY5 billion, which was used to boost productivity in the grain-producing regions. In addition, the PBC adjusted the geographical distribution of the remaining credit line, transferring CNY4 billion in loans from eastern coastal and more-advanced areas to the central, northeastern, and western regions. By the end of 2004, the quota of agriculture loans from the PBC had reached CNY128.8 billion, with total loans outstanding of around CNY100 billion. After that, the PBC decided not to increase quotas but to tilt its policies toward the central, northeastern, western, and grain-producing regions.

Issues with People's Bank of China Lending for Agriculture Support

Although the PBC's agriculture loans have somewhat improved farmers' access to credit in poverty-stricken areas, the ever-increasing number of outstanding loans also creates problems. For example, RCC microfinance loans create systemic risks with the potential to endanger the PBC's agriculture fund. The only characteristic that distinguishes microfinance loans from enterprise loans is the more diverse credit lines of microfinance loans. At present, most RCCs operate at the township level, with only a few at the county level, making it difficult to achieve geographic diversification in the fund.

Another hazard is the nature of the agriculture sector itself. In the absence of agriculture insurance, the sector is very vulnerable to natural disasters. Moreover, some local governments have conducted so-called agricultural restructuring, intervening in farmers' productive activities and requesting that all farmers within their respective jurisdictions produce the same crops. Microfinance loans to these farmers are therefore susceptible to both environmental and market risks.

Third, because microfinance loans feature small sizes, diverse clientele, and high administrative costs, controlled interest rates cannot cover cost and risks. In addition, RCCs prefer loans to enterprises over loans to farmers, because the two types of loans yield different returns, undermining the PBC's efforts to direct a required percentage of microfinance loans to farmers. Finally, the use of unscientific methods to determine microfinance credit lines and credit ratings, as well as overreliance on village or township officers, may add to the risks of microfinance in some localities.

In all, though microfinance loans are moving in the right direction, the microfinance business suffers from high costs and risks. In the absence of a risk compensation mechanism, the PBC is the risk taker of last resort.

Another problem is the lack of proper principles to guide the issuance of agriculture loans, which can result in poorly performing RCCs being financially rewarded and high-performing RCCs being punished. The issuance of agriculture loans is based on whether the RCC is from a large agricultural province or the midwestern region, rather than on its performance in supporting *sannong*. As such, agriculture loans may fail to be used for their designated purposes and cannot provide RCCs with appropriate incentives. Instead, agriculture loans often are allocated to institutions with low efficiency and poor management. In fact, RCCs incurring greater losses need more capital and hence are more eligible for PBC agriculture loans. RCCs in less-developed regions suffer from heavy historical burdens, poor management, a high nonperforming loan ratio, and limited sources of funding. The combination of these factors may endanger the repayment of agriculture loans and put the fund at risk.

RCCs in less-developed regions suffer from heavy historical burdens, poor management, a high nonperforming loan ratio, and limited sources of funding

Management of agriculture loans also is difficult. RCCs keep accounts of PBC lending simply for the sake of bookkeeping, and omissions are common. The issuance, utilization, and collection of the PBC's agriculture loans are not tracked separately but rather are mixed with the agriculture loans from an RCC's self-collected funds. As a result, it is difficult to manage a microfinance fund independently or to guarantee that the fund is used only for designated purposes, and effective regulation is impossible to achieve. For instance, some PBC funds may be used to provide credit to companies or to cover farmers' medical expenses. In addition, because the interest rate on agriculture loans is relatively low and stable, some RCCs apply for PBC agriculture loans while investing most of their surplus funds in corporate and Treasury bonds with higher yields.

The most successful rural financial institutions, such as the Bank Rakyat Indonesia, usually start with loans for nonagriculture activities

Because of low interest rates and a lack of lending criteria, agriculture loans are increasingly likely to generate moral hazards. RCCs in a short capital position rely on central bank lending rather than on taking deposits. In addition, although the 2002 Guidelines on the Management of RCC Microcredit for Rural Households require timely repayment, maturity may be extended from 9 months to 12 months, and cross-year utilization of an agricultural quota by branches is allowed. Thus, the actual term can be as long as 3 years. Because there is a time lag (usually 2 years) between loan issuance and default, many RCCs hide risks and expand loan sizes, which totaled more than CNY100 billion in 2004. If agriculture loans become nonperforming loans in a few years, the PBC may not recover these funds from RCCs that have expended their required reserve and emergency funds. In all, using central bank funds to improve farmers' credit access might hide existing problems in RCCs and bring about a new series of risks.

Furthermore, many borrowers do not have a clear understanding of the purpose of agriculture loans. Some RCCs regard them as policy loans intended to maintain social stability and solidarity, whereas others believe that, in case of default or farmers' late payments, an RCC will have to repay the central bank with its own funds. These misunderstandings have created passivity among RCCs instead of encouraging them toward proactive financial innovation. The various problems associated with central bank lending cannot be fully addressed until such misunderstandings are corrected.

The limited use of agriculture loans is not conducive to the RCCs' commercial viability, their cooperative nature, or their objective of becoming financial institutions serving communities. The most successful rural financial institutions, such as the Bank Rakyat Indonesia, usually start with loans for nonagriculture activities. Only after they develop into mature financial institutions can they provide agriculture loans. Even cooperative financial institutions in developed countries, such as Crédit Agricole in France, must cover cooperative finance losses with profits from other businesses, particularly commercial operations.

Despite the huge volume of PBC funds flowing into rural financial institutions, the outputs are negligible. Due to restrictions on capital sources and systemic loopholes in the rural financial market, rural financial institutions suffer great losses, aggravating the financial risk, and commercial banks are therefore reluctant to enter the rural financial market. Such capital outflow from the countryside is not a phenomenon unique to the PRC; other countries have the same problem.

Development of Poverty Reduction Loans

The poverty reduction credit fund was established in 1986 to support priority poverty-stricken counties and to provide an important force for poverty reduction. Following the establishment of the fund, poverty reduction efforts were intensified. As of 1993, CNY10 billion in loans had been issued.

In 1994, the ADBC was given responsibility for the issuance and management of poverty-reduction loans. However, due to the limited number of ADBC subbranches and the high cost of managing loans, the central government decided that the ABC should take over the issuance and management of poverty reduction loans after May 1998 and should conduct its commercial operations based on principles of lendability and zero default.

In 1994, the 8-7 National Poverty Reduction Program was adopted, signaling a new stage in poverty reduction efforts. To expand production and increase the income of poor farmers in poverty-stricken areas, the central government scaled up the size of the poverty reduction fund to CNY10 billion in 1998 and CNY15 billion in 1999.

In 1999, for the sake of standardization, the State Council decided to fix a unified preferential interest rate for poverty reduction loans. The credit reached CNY18.5 billion in 2001 and 2002. As of the end of 2002, outstanding poverty reduction credit stood at just over CNY90 billion—CNY55 billion more than in 1998, when the ABC resumed management of the loans. Along with the aggregate increase, its proportion among the three types of poverty reduction funds (e.g., fiscal funding, interest-subsidized loans, and work-for-aid) also rose, from 55% in 1986 to 63% in 2002.

In 2001, the PBC, the Ministry of Finance, and the Leading Group Office of the State Council for Poverty Reduction jointly issued the Measures on Management of Poverty Reduction Loans with Discounted Interest Rates, which set new requirements for the management of poverty reduction credit funds. Such funds come mainly from ABC deposits, and the ABC can apply for central bank lending at the normal interest rate. The PBC prescribed that such loans should be issued independently by commercial banks and include project and household loans. The size of the credit fund is subject to recommendations rather than directives.

At this new stage, the poverty reduction credit fund is less policy oriented and more commercial. Nonetheless, poverty reduction loans are policy loans, a fact reflected in the preferential interest rate, which at 2.88% per annum is lower than the benchmark interest rate. The remaining portion of interest is subsidized by the central government and is included in the annual fiscal budget.

The PBC prescribed that such loans should be issued independently by commercial banks and include project and household loans

According to the 8-7 National Poverty Reduction Program, poverty reduction loans with discounted interest rates are designed to help low-income people in poverty-stricken counties increase their income and improve their living conditions. To ensure that the loans are truly used to lift this group of people from poverty, the ABC is required to select borrowers from a list provided by grass-roots poverty reduction offices. The discounted interest payment is subject to confirmation by local financial bureaus and poverty reduction offices. By the end of 2000, outstanding poverty alleviation loans stood at CNY70.5 billion; by 2001, they stood at CNY79.2 billion; and by 2003, they had reached CNY96 billion with interest subsidies of CNY620 million.

Issues with Poverty Reduction Loans

Though poverty reduction loans are designed to benefit farmers and rural regions, the loans suffer from a high nonperforming loan ratio and poor performance. This is due to the contradiction between the goals of policy lending and those of commercial banking, to high capital costs, and to government intervention in loan disbursements.

The discounted interest payment is subject to confirmation by local financial bureaus and poverty reduction offices

Because of the conflict between the objectives of a poverty alleviation loan and those of a commercial bank, ABC loans to rural households have been decreasing since May 1998. Although the ABC is given a subsidy to cover the difference between the interest on poverty alleviation loans and the interest on standard loans, it manages poverty alleviation loans in accordance with commercial standards. Interest-subsidized poverty alleviation loans are mainly provided to support the aquaculture and animal husbandry businesses of poverty-stricken households. These loans are subject to seasonal fluctuation, tight processing schedules, large numbers of transactions, large numbers of borrowers, and small loan sizes, requiring significant institutional and human resources. However, because the ABC has been closing branches, these resources often are not available.

For example, Guizhou Province has 48 state-designated poverty-stricken counties comprising 874 townships, but only 200 townships have ABC outlets, and the average number of loan officers is between three and five. This small number of loan officers is responsible for the distribution and daily management of poverty reduction loans in four to five townships, requiring additional staff from county sub-branches to distribute loans extensively and quickly. The ABC branch in Changshun County, for instance, has 13 loan officers covering 23,000 clients, a nearly impossible situation because it normally takes several days to visit each client in an average village of 100 households.

To ensure that poverty alleviation loans reach rural households, local governments and poverty reduction offices require that 85% of loans be allocated to core poverty-stricken counties and that 85% of the funds go to poverty-stricken households. In addition, the maximum amount per loan is set at CNY50,000; most loans are less than CNY2,000. This small scale, coupled with the large amount of retail lending in geographically scattered poverty-stricken households, has added to already high operating costs. In 2000, for instance, rocky roads shortened the life of a four-wheel-drive vehicle used by the ABC's Libo County branch to develop poverty alleviation loans. The ABC branch in Guizhou Province spent CNY58,500 for every CNY1 million in microcredit loans, CNY39,000 more than the cost of loans to other businesses. In other words, the distribution cost of microcredit loans is nearly 5.9%, 3.9 percentage points higher than the cost of loans to other businesses. In practice, therefore, poverty reduction loans are retail loans with much higher operating costs than wholesale loans. As such, the goals of policy finance contradict the commercial operating principles of the ABC.

Funding is another issue. Funds for poverty alleviation loans are provided by the ABC; the government provides only interest subsidies. Because these loans mainly target deprived counties where the ABC has more loans than deposits and depends on interest spread for profit, these ABC offices must request funds from other ABC organs. The ABC's prevailing intrabank lending rate is 4.32% per annum, whereas the interest rate on poverty alleviation loans is 3%, plus a government subsidy of 5.85% or 5.94% (after the increase in the PBC base rate). This implies that if funds are borrowed from higher-level ABC branches, the county branch will incur a net loss of 5.38% to 5.47% per year for disbursing poverty alleviation loans, even without considering repayment ratio.[3]

Local governments and county poverty reduction offices intervene excessively in the disbursement of poverty alleviation loans, and a large number of household loans have been made in some areas where such loans are not suitable. When making poverty alleviation loans to rural households, the ABC generally uses a client list provided by the local poverty reduction office and has neither the ability nor the means to examine whether borrowers meet the lending criteria or to manage the loans on a daily basis. Some local governments even ask the ABC to support uncompetitive projects featuring antiquated technologies and poor technical proficiency. For instance, by the end of 2000, the ABC had provided CNY1 billion worth of poverty reduction loans to processing enterprises in poverty-stricken counties in Guizhou, but the nonperforming loan ratio exceeded 85%.

In addition, many local government authorities emphasize only the disbursement of poverty alleviation loans but neglect the management and servicing of the loans or the support and education of borrowers. There is a widespread misconception among local government officials and borrowers that poverty alleviation loans are public funds that do not require repayment. Some local governments view poverty alleviation loans as public aid and distribute them freely, at times even to the deceased. In some places, local governments take advantage of the loans and use them to collect various taxes and charges.

Thus, loans are likely to be treated like other types of poverty reduction funds, and this in turn influences borrowers' willingness to repay. In the case of the ABC, the policy nature of poverty reduction loans is reflected only in the Ministry of Finance subsidy covering the difference between interest rates on poverty reduction loans and the market interest rate. Otherwise, loan management accords with commercial principles, ultimately leading to losses on the part of the bank. By the end of 2001, the ABC's cumulative nonperforming poverty alleviation loans reached CNY32.82 billion, equivalent to 41.4% of all poverty alleviation loans.

Some local governments view poverty alleviation loans as public aid and distribute them freely, at times even to the deceased

Since 2001, the ABC has stopped its special evaluation of poverty alleviation loans and has started to combine such evaluation with the evaluation of other types of loans. This has linked employee remuneration to loan performance, strengthened accountability for nonperforming loans, and strengthened the assessment of poverty alleviation loans. In practice, however, because county poverty reduction offices decide on loan borrowers whereas the ABC subbranches and loan officers release and manage loans, the rights and obligations of these two entities are asymmetric. There is little incentive for local ABC offices to process poverty alleviation loans that will incur losses, and this has exposed related problems.

Evaluating Poverty Reduction Loans

Conflicts between policy and commercial goals are bound to emerge. Although the ABC regards poverty reduction loans as commercial loans with certain policy loan features, such loans nonetheless represent a kind of directed lending. Many countries cite market failure as a legitimate reason for directed lending. However, extensive directed lending cannot compensate for market deficiency and may even impede the development of the finance sector as a whole. Therefore, it is critically important to evaluate the effects of such directed lending, the allocation of scarce public capital, and the improvement in poverty reduction loans.

Poverty reduction loans are mainly granted to leading agriculture companies, thereby playing a certain role in driving the economic development of agriculture and increasing farmers' income

Four indicators measure the performance of single batches of poverty reduction loans or individual poverty reduction projects. The first is targeting, which refers to whether the poverty reduction funds go to the designated poverty-stricken areas and people. The second is effectiveness in achieving desired results—including, for example, the extent to which farmers' income increases, how much crop production increases, and how many more people can access potable water. The third is the efficiency of capital utilization; that is, how much is paid to achieve a set target, or the input–output ratio. The fourth measure is whether the poverty reduction effects can be sustained and fund management institutions can become financially self-sufficient. If measured against such criteria, the performance of poverty reduction loans in the PRC is unsatisfactory.

The first challenge of poverty reduction loans is to target the correct group of people and to provide loans to the needy. Poverty reduction loans are mainly granted to leading agriculture companies, thereby playing a certain role in driving the economic development of agriculture and increasing farmers' income. However, because of the high risks associated with agriculture and the inefficient management of such policy loans, poverty reduction loans remain highly risky.

Moreover, although poverty reduction loans are designed to target farming households, the ABC prefers to lend to rural enterprises. The proportion of loans actually granted to farmers is very low, and ABC loans to farmers have been on the decline since May 1998. According to a Poverty Alleviation and Development Office survey in 22 provinces and autonomous regions, the ABC provided CNY17.6 billion worth of poverty reduction loans in 2001. Of this, just under CNY3.8 billion was loaned to farmers, accounting for slightly more than 21% of the total. (The percentage of poor farmers among all farmers who received loans is not known.) For example, poverty reduction loans to 23 poverty-stricken counties in Hunan Province amounted to CNY24 million in 2001, accounting for a mere 3.5% of the total poverty reduction loans in these counties. Chifeng, in Inner Mongolia Autonomous Region, distributed CNY88 million worth of poverty reduction loans, but CNY83 million of this was loaned to leading companies and only CNY5 million—accounting for 5.7% of the total—went to farmers. Meishan, in Sichuan Province, released only CNY6 million of loans to farmers in 2006, accounting for 3% of poverty reduction loans in Meishan. Such a low percentage plays only a limited role in driving the local economy of poverty-stricken regions.

The second measure of poverty reduction loan performance is the loans' effectiveness. Ironically, the low interest rate on poverty reduction loans does not benefit borrowers, because interest payments represent only a small portion of borrowing cost. Our survey showed that the cost of loans includes gifts and kickbacks for loan officers, time and transport expenses incurred when applying for loans, compulsory RCC membership fees, and so forth. It is not rare to invite loan officers to dinner or to provide kickbacks to loan officers or other people in charge. The time-consuming and complicated application procedure scares away many prospective borrowers and sometimes costs borrowers opportunities to produce and invest. Thus, farmers cannot access either market-rate loans or low-interest poverty reduction loans.

Third, the asset quality of the ABC's poverty reduction loans is poor. Between 1998 and 2000, CNY1.3 billion worth of poverty reduction loans came due, but only CNY120 million was repaid, a repayment ratio of merely 9%. By the end of 2001, nonperforming loans outstanding reached CNY32.8 billion, up CNY2.8 billion from the previous year, for a nonperforming loan ratio of 41.4%—an increase of 1.5 percentage points. As of the end of 2002, the total outstanding nonperforming loans of the ABC reached CNY34.4 billion, representing 38% of total poverty reduction loans—10 percentage points higher than the nonperforming loan ratio of other loans. Up to 60% of loans to farmers were nonperforming loans. As of 2006, 85% of poverty reduction loans were sunk and unreceivable.

Even a discount from the Ministry of Finance is insufficient to cover such loan losses. In 2001, the ABC issued a cumulative CNY17 billion worth of poverty reduction loans. In accordance with the 2001 Measures on Management of Poverty Reduction Loans with Discounted Interest Rates, the State Council creates an annual interest discount budget, which it forwards to the Ministry of Finance. The ABC then uses the interest discount budget to determine the size of its poverty reduction loans.

In recent years, the budget has been around CNY520 million to CNY550 million, so loans are projected to be CNY18.5 billion. Normally, however, the ABC's poverty reduction loans are CNY4 billion to CNY5 billion more than the budgeted CNY18.5 billion per annum, and the excess part is subject to the benchmark interest rate. Each year, loan repayment totals more than CNY10 billion. The State Council requires poverty reduction loans to grow yearly and requires loan repayments to be reloaned to leading enterprises and agriculture infrastructure projects at the benchmark interest rate. Normally, the duration of discounted loans is 1 year and no more than 3 years, but other loans can feature 3-year to 5-year terms, and the benchmark interest rate applies to poverty reduction loans after their discount period.

The ABC then uses the interest discount budget to determine the size of its poverty reduction loans

Supposing that all poverty reduction loans are lendable and repayable, nonperforming loan losses must be included with overhead, expenses in securing repayment, and funding costs when calculating the total cost of lending.

The operational cost of poverty reduction microloans is over 10% and, according to the ABC's calculation, the average cost of issuing and managing poverty reduction loans is 7%. Even if the ABC receives interest payment in full and receives a timely interest discount, poverty reduction loans are prone to incur losses.

Such a financial system seems unsustainable, thus failing the fourth performance test for poverty reduction loans. According to the survey in Guizhou Province, for example, outstanding discounted poverty reduction loans stood at CNY7.76 billion as of October 2001, including CNY3.26 billion in nonperforming loans (42% of loans) and a microloan repayment ratio of only 21%. Although the spread between the required interest rate and the interest rate on poverty reduction loans was narrowed from 7.2 percentage points in 1989 to 2.3 percentage points in 2002, the interest differential remains, and the spread between the ABC's floating interest rate and the interest rate on 1-year poverty reduction loans can be as high as 5.6%. Thus, the interest rate on poverty reduction loans can be much lower than the ABC's base interest rate, dampening the ABC's enthusiasm for such loans and resulting in a plummeting loan collection ratio.

Since 2001, for example, the ABC has gradually reduced loans to farmers in favor of directing poverty reduction loans to projects

Such a situation can also disturb the market order. Since 2001, for example, the ABC has gradually reduced loans to farmers in favor of directing poverty reduction loans to projects. But such project loans, particularly when used for infrastructure, are actually commercial loans in the name of poverty reduction. This practice puts the ABC in an unfairly competitive position relative to other state-owned commercial banks and invites accusations that the ABC uses low-cost poverty reduction loans to undertake commercial lending activities. As such, low-rate poverty reduction loans disturb the order of the financial marketplace.

Remittances of Rural Migrants

The PRC's dual economic model has increased agricultural productivity and subsequently created surplus farm labor. It also has increased foreign and domestic investment and job opportunities in the coastal regions while constraining farmland transactions. These factors, in addition to the residential registration system, have led to an increasing number of domestic migrant workers in the PRC. A pattern of temporary migration has helped to generate a huge inflow of money from migrant workers to their families at home. Compared with migrant workers in other countries, migrant workers in the PRC send a higher proportion of their income home.

Remittances from migrant workers have contributed to an improvement in farmers' incomes and welfare and have aided rural poverty reduction by decreasing the consumption of grain and other goods on farms. Returning migrant workers also bring in additional income by using new ideas and skills learned while working in the coastal areas. The income of migrant workers, comprising 20% to 50% of total family income in the receiving households, is crucial to paying for education, family medical expenses, and some other basic consumption expenses.

The quality of remittance services affects rural migrants' contribution to family income and consumption. An improvement in remittance services not only will bring about additional income and welfare gains for migrant workers and their families but also will benefit broader rural communities by increasing the outreach of formal financial services to the poor in the PRC.

Demand for Remittance Services

Migrant workers usually are defined as rural laborers transferred out of their home counties for more than 6 months. So defined, there were 30 million to 40 million migrant workers annually from 1997 to 1999 and an average of 75 million migrant workers annually from 2002 to 2004. In 2005, the State Council's Development Research Center predicted that the PRC must shift at least 10 million rural laborers out of farming each year for approximately 10 years to cope with an ever-increasing surplus labor supply and improvement in agricultural productivity.

Overall demand for remittance services is determined mainly by the number and allocation of migrant workers, their income levels, the proportion of income sent home, and the rates and services offered by the services. Demand for remittance services in the PRC derives primarily from migrant workers working outside their home counties, particularly those outside their home provinces.

Group interviews indicated that migrant workers remit a relatively small amount of money home with each transaction. An average migrant worker remits money three to six times each year, each time in amounts of CNY500 to CNY1,000. Construction workers, who are paid CNY300 to CNY400 per month, with all payment coming in a large sum at the end of a project or the end of the year, tend to remit larger sums. Migrant workers in general reported that they do not like to remit too much money each time, for reasons of security and control over spending at home.

In general, migrant workers in the PRC send money home either through a formal remittance provider or by carrying money home themselves.[4] The survey of 400 migrant workers in Zhejiang found that about half channeled their remittances through postal savings outlets, a quarter carried money home, and a quarter employed commercial banks, usually the ABC. Rural credit cooperatives were used by less than 5% of migrant workers.

These findings were confirmed through focus group discussions in Sichuan and Zhejiang. Of the 15 families interviewed in Anyue, 9 used postal savings outlets, 5 carried money home, and 1 used the ABC. Rural credit cooperatives are not a popular channel for remittance. According to the farmers interviewed, although RCC branches are located in every township of the county, the RCCs' remittance service is slow and inconvenient. Some RCCs do not offer the service, others discourage farmers from using the RCC for remittance, and there is no guarantee on the timing of delivery. Farmers also do not completely trust the RCCs and prefer to deposit large sums of money with banks. Of the 15 migrant workers interviewed in Cixi, Zhejiang, 7 used the ABC, 6 used postal savings outlets, 2 used other state banks, and no migrant workers used RCCs for money transfer.

Demand for remittance services in the PRC derives primarily from migrant workers working outside their home counties, particularly those outside their home provinces

The high proportion of families using postal savings outlets does not necessarily mean that these outlets provide better remittance services. Rather, the only available service providers in most rural areas of Anyue are the postal outlets and the RCCs, and the postal outlets are the better option. ABC offices are located only at the county seat and in large rural townships.

Based on the survey results and market projections, we estimate that formal financial institutions captured about 75% of a CNY223 billion remittance market in 2004. The remaining funds were carried home or delivered through other channels. Of the CNY162.5 billion market captured by formal service providers in the PRC, therefore, market share was around CNY101 billion (62%) for postal savings outlets, CNY52.6 billion (32%) for commercial banks, and CNY8.9 billion (5.5%) for RCCs.

Migrant workers' complaints about service providers in the PRC focused on fees and quality of the service, particularly the service provided by postal savings outlets

The surveys in Sichuan and Zhejiang reveal that migrant workers select their remittance channel based mainly on the availability of the service provider in their home or a nearby township, and on the fees charged. The county seat, where the commercial bank branches are located, is regarded by most migrant workers as too far away from their home villages and thus is not their priority service provider selection.

Delivery speed, quality of service, and safety are secondary determinants. In the end, what matters most to migrant workers and their families are the real costs of remittance, rather than the nominal fees charged by service providers. The real costs of remittance include both nominal fees and additional fees charged by service providers, the forced savings imposed by certain service providers (mainly postal savings outlets in certain areas), complicated procedures in sending and receiving money, and the time and money spent on collecting remittance. In general, such real costs are higher for migrant workers and families originating in poverty-stricken and remote areas of the PRC, and for older migrant workers with low levels of education. Service providers tend to charge additional fees and to provide poor service in poverty-stricken and remote areas where few service providers are available. Logically, therefore, these migrant workers are more likely to carry cash home.

Migrant workers' complaints about service providers in the PRC focused on fees and quality of the service, particularly the service provided by postal savings outlets. Postal savings outlets are the sole service provider in many remote rural areas and provide remittance services for more than 40% of migrant workers. Older migrant workers with low levels of education are more likely to use postal savings outlets because they are more likely to come from areas where only such outlets are present. It also is less complicated to use postal savings outlets than to use a bank, which usually requires one to open a bank account and, in many cases, to apply for a bank card. Many migrant workers' family members do not know how to use a bank card.

The survey also found that only limited bank services are available for migrant workers in the PRC because these workers do not have an official urban residence. The services used by migrant workers have been restricted to remittance, deposits, withdrawal, and the use of debit cards for deposit and withdrawal. Migrant workers with no local residence are not eligible for loans from financial institutions; likewise, they are not eligible for credit cards.

Supply of Remittance Services

The PRC's remittance services market so far has been dominated by formal financial institutions because informal and microfinance institutions are not allowed to provide such services. The major service providers include postal savings outlets, state-owned commercial banks, and rural credit cooperatives. Postal savings outlets are the channel of remittance most frequently used by migrant workers, followed by large commercial banks.

As of this writing, China Post has 57,136 service points across the PRC, 41,196 of which are located in rural areas. In addition, China Post has 34,540 service points for postal savings, usually housed in the post office, 24,000 of which are connected electronically. In 2004, China Post handled 180 million remittance transactions, with a value of CNY213 billion. CNY140 billion (70%) of these remittances went to rural areas. It is estimated that over 90% of remittance to rural areas through postal savings outlets has been from migrant workers. Postal savings outlets offer three major options for money transfers in the PRC: postal money orders, electronic express money transfer, and green card services.

The express service offered by postal savings outlets is more expensive than the one provided by commercial banks in the PRC, which usually charge a low fee for their remittance products and services. The commercial banks' fee structure on money transfers within the PRC has been subject to regulations set by the People's Bank of China and the National Development and Reform Commission. The products and services of commercial banks fall into three broad categories: regular 24-hour money transfer service to a bank customer at a low fee, real-time money transfer to a bank and/or nonbank client at a higher fee, and discounted real-time money transfer to a bank cardholder. The ABC's National Roaming, the China Construction Bank's Fast Remittance, and the Industrial and Commercial Bank of China's Direct Vehicle services are real-time, but more expensive, remittance services.

According to a survey of financial institutions in three cities of Shandong Province, 60% to 70% of all individual electronic money transfers through commercial banks were remitted to recipients who had an account with the bank, 5% to 20% were remitted to individuals who were not bank clients, and 15% to 25% were remitted to a bank cardholder. The proportion of remittance through telegraphic transfer and money order is very small, generally below 10% of all individual money transfers.

Unlike the banks in many other developed economies, commercial banks in the PRC charge bank clients a fee to withdraw money from the same bank in a different location, whether through an ATM or over the counter. The rates are similar to the banks' fees for money transfers. This creates a problem for migrant workers: if a worker opens a bank account at home, he or she incurs a fee to withdraw money at his or her workplace, and vice versa. Some migrant workers, aware of such fees, have opted to open bank accounts at home for depositing and receiving money transfers but do not withdraw money from the account at their workplace. Other migrant workers are unaware of the charges on money withdrawn from a bank branch at a different location.

The proportion of remittance through telegraphic transfer and money order is very small, generally below 10% of all individual money transfers

In principle, the fees for interbank money transfer are the same as the fees for intrabank money transfers, though intrabank transfer can be conducted only among banks that have a formal money transfer agreement. Some small banks do not have such agreements with all the major banks. Some bank branches are not keen to conduct interbank money transfer operations, especially with smaller banks, and such transfers usually take longer.

Recently, commercial banks in the PRC have introduced account-keeping fees for small savings account. For example, the ABC introduced a CNY10 account fee for savings accounts or the issuance of a debit card, and the China Construction Bank in Sichuan introduced an account-keeping fee of CNY10 for accounts with an average daily balance below CNY300.

Issues in Rural Finance

International experience indicates a strong correlation between the scale of rural finance, gross domestic product, and rural per capita income. The higher the per capita income, the greater the benefit derived from nonsubsidized financial services and the larger the transaction volumes, which helps compensate for transaction costs. Rural financial demand in developing countries generally depends on informal financial institutions, including microcredit agencies, pawnshops, and cooperative associations. Surveys by the World Bank and various international institutions suggest that conventional financial institutions offer limited loan coverage for rural households.

Rural credit cooperatives offer relatively wide coverage in the PRC

Rural credit cooperatives offer relatively wide coverage in the PRC. Nonetheless, during the past 3 decades of reform and market liberalization, rural economic growth has been slower than urban growth, resulting in fewer investment opportunities and lower per capita income in rural areas. Interest rate restrictions have prevented financial institutions from fully covering operational costs and transaction risks in such areas. In addition, there is no established favorable environment for the development of informal financial institutions. Given these factors, formal financial institutions cannot meet rural financial demand, especially that of small and medium-sized rural enterprises and farmers in poverty-stricken areas. Many surveys have found that over 50% of the credit demand of small and medium-sized enterprises and farmers is met through informal channels, but informal finance has many problems. Ultimately, the mismatch of financial supply and demand in rural areas has affected rural economic development.

Access to rural financial services for *sannong* is hindered by high operational risks and high transaction costs related to the nature of agricultural production and rural areas, the lack of physical and financial infrastructure in such areas, and rural financial policies. For instance, the small-scale production and low income of rural households requires microcredit, and the management costs of small-scale, seasonal, and risky loans are inherently high. In the absence of agriculture or natural calamity insurance in the PRC, financial institutions are unable to transfer the risks of serious regional natural disasters and therefore must restrain the scale of their lending.

Second, insufficient rural transport, electricity, water, telecommunications, and security infrastructure has affected agricultural profitability, magnified the volatility of rural household incomes, and undermined rural households' ability to repay loans, thus increasing the costs and risks of extending loans and managing savings. The absence of information infrastructure in rural areas also drives up the information costs of rural financial transactions. The information-collecting and information-processing methods used in modern, urban, large-scale lending cannot be applied to grassroots rural lending, especially in lending to households, and centralized lending approval requirements negate the information advantage of local branches, weakening the ability to collect and analyze information.

Third, despite reform efforts, rural and agriculture policies are yet to be improved, and fiscal policy has failed to play its role in rural areas. Public fiscal resources have been directed toward cities, even while the countryside lacks necessary public services. Farmers are forced to borrow to cover medical services and their children's education, and loans of this type add to institutional risk. Moreover, low prices for agricultural products and rising production costs mean farmers' income has not increased, even in the event of a bumper harvest. This has reduced the profitability of agriculture and further weakened the loan repayment capabilities of rural households, again increasing lending risks and costs. As a result, rural financial services suffer from weak growth and rural credit represents only a small portion of total loans. In turn, the small scale of agriculture loans adds to lending costs and further impedes rural financial development, forming a vicious cycle.

In some ways, therefore, rural financial policies have actually restrained rural financial development. For reasons of financial security, authorities have not emphasized variety in rural financial services, resulting in market monopoly and low efficiency. The central government also has interfered with the rural financial market through credit rationing and lending subsidies, crowding out and suppressing competition from private commercial lenders. Because interest rates are not fully liberalized, existing financial institutions are unable to determine lending rates, resulting in high operational risks.

One alternative, informal finance, remains a legally gray area and is therefore impossible to develop. In accordance with relevant rules or official decisions, more than 100 pilot projects sponsored by various institutions (including international institutions) have been put in place over the past 10 years, but these remain at the pilot stage.

In the quasi-monopoly market, monotypic rural financial institutions often blame policy restraints for their own performance weaknesses. Even so, preferential financial policies for rural development have created moral hazards related to the lack of financial discipline, strict monitoring, or education of rural borrowers. Some rural households consider concessionary loans to be subsidies that do not need repayment, and even collude for repayment exemption or waiver. Weak judicial and enforcement systems in the countryside have augmented risks and transaction costs and have dampened commercial creditors' incentive to develop the rural market. Limited eligible collateral in rural areas has restricted loan size and increased borrowing costs, preventing farmers from accessing formal financial institutions, and has increased uncertainty and costs on the part of creditors, limiting lending and precluding rural financial development.

PART II
CURRENT RURAL FINANCIAL POLICY

CHAPTER 4

Capital Flows and Rural Finance

In a market economy, capital flows to regions and sectors with more investment opportunities and higher returns, and this has been true in the People's Republic of China (PRC). Interregional capital flows have varying effects on economic growth, investment opportunities, financing costs, household income, living standards, and the structure and performance of local financial institutions in both the source and destination regions, due to the various channels of flow, different costs, and different incentive mechanisms.

The PRC is experiencing unbalanced regional economic development. Many studies have used growth theories to analyze the trend and causes of regional imbalance, with particular focus on labor, human and material capital accumulation, technology, and the economic system (including management and government policies). Few studies have focused on interregional capital flows and allocation. However, a region's capital allocation mechanism and abundance of capital determine the speed and size of capital accumulation and profoundly affect economic progress in that region.[1]

Economic development is reflected not only in aggregate expansion but also in the restructuring and transformation of sectors and industries, both of which carry phased characteristics. Economic development also is a process of urbanization and industrialization.[2] In the early stage of this process (the elementary stage), outflows of production factors from rural areas are likely to grow along with economic development. In more advanced stages, such outflows will gradually moderate and inflows may occur.[3]

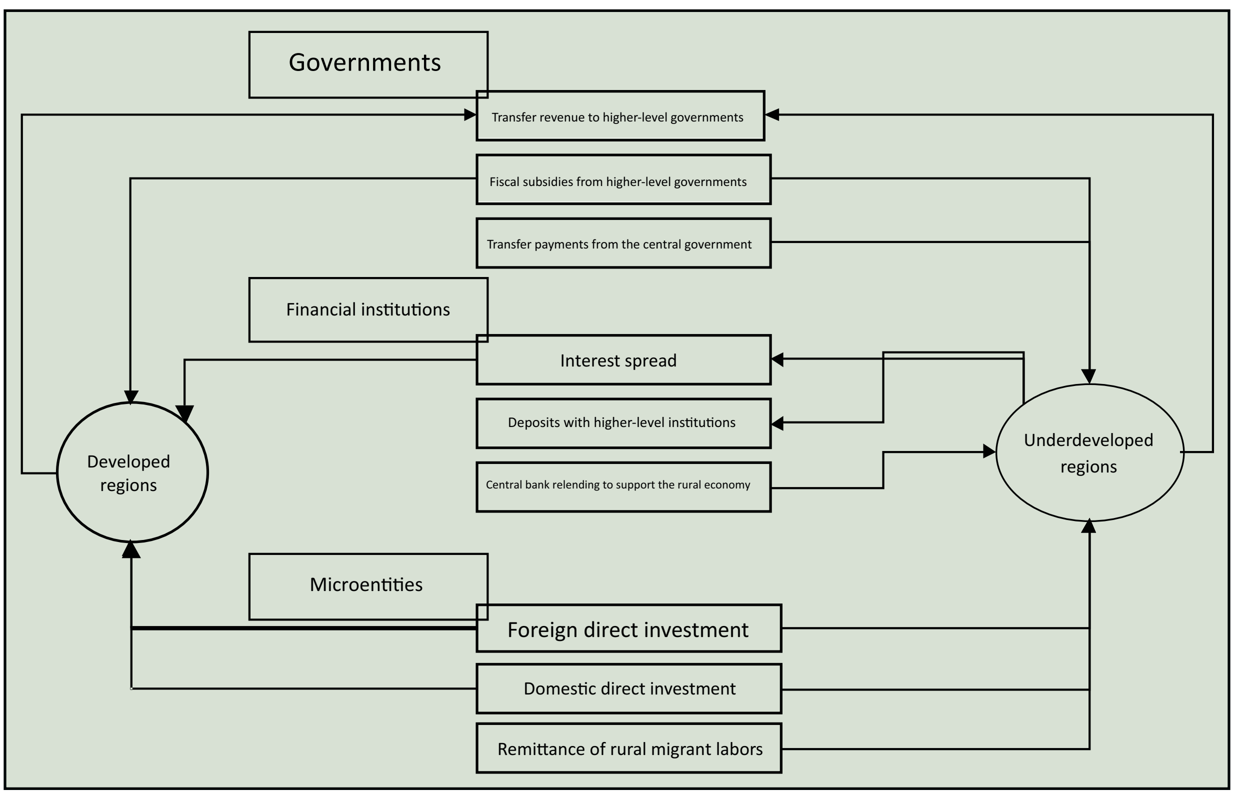
This also holds true for capital flows. In a market economy, return spread determines capital flow across sectors. Return spreads will first widen and then become narrower with the advancement of economic development. In the elementary stage of economic development, industrial sectors are underdeveloped and the capital return is not much different from returns in the agriculture sector; hence, capital outflows from the countryside are relatively moderate. With economic development, industrial structures gradually improve and economy of scale and industry concentration comes into play. Productivity in industrial sectors will increase substantially, leading to a growing gap between the returns of the industrial and agriculture sectors, and capital outflows from the countryside will grow. Subsequently, industrial development will drive growth in agricultural productivity, the return gap will shrink, and capital outflows will gradually ease.[4]

Interregional Capital Flows

A large body of research shows growing disparity in the economic development of the PRC's eastern, central, and western regions.[5] These disparities are reflected both in overall regional economies and in local rural economic development. Disparity in per capita net income in rural areas across provinces has been growing, with the Gini coefficient rising from 0.19 in 1988 to 0.23 in 1995.[6] Research found that the ratios of per capita net income in eastern rural areas to that in central and western areas were 1.79 to 1.13 to 1 in 1990; 1.81 to 1.15 to 1 in 1995; and up to 2 to 1.09 to 1 in 1999, pointing to growing disparities.

Economic growth in different regions of the PRC has shown both conditional and club convergence, with growth in the eastern, central, and western regions converging to different equilibrium levels.[7] To some extent, this underscores the vast difference in development stages among regions. Economic activity in the eastern regions has developed to a relatively advanced level and supports a high level of stable economic growth. The preconditions for such economic equilibrium are optimal sector structures (between industry and agriculture) and a benefi-

Figure 1. Interregional capital flows in the People's Republic of China



Source: Authors.

cent circle among sectors. With economic development, rural capital outflows in the eastern regions are likely to moderate, whereas rural capital outflows in the central and western regions will increase. Such a contrast in capital flow will favor economic growth in the eastern regions, resulting in growing imbalances in the rural economy.

Interregional capital flows in the PRC have three carriers: fiscal authorities, banks, and other microentities (Figure 1). First, the central government makes fiscal transfer payments to poverty-stricken areas. Within a province, county and/or city governments transfer revenues to provincial governments and the latter provide various subsidies to counties. Second, financial institutions allocate funds within and across regions. Third, other microentities, including foreign direct investors, domestic direct investors, and rural migrant worker remittance services invest and remit funds.

We compiled data on capital flows through local governments, financial institutions, and other microentities. The inflows of government funds include fiscal poverty alleviation funds, fiscal revenue, and transfers. In the sample counties of Gansu, Ghizhou, Ningxia Huizu Autonomous Region, Shaanxi, Sichuan, and Yunnan, this kind of funding more than doubled over 5 years, from CNY2.9 billion in 1999 to CNY6.3 billion in 2003. Ningxia posted the highest increase, nearly quadrupling its capital flow. Such inflows came mostly from fiscal transfer payments, which increased from CNY670 million in 1999 to CNY2.6 billion in 2003.

The inflow of funds through financial institutions included Agricultural Bank of China (ABC) and People's Bank of China (PBC) loans, which more than doubled from CNY2.3 billion in 1999 to approximately CNY5 billion in 2003. Sample counties in Ningxia and Sichuan had the highest increase, more than tripling.

Domestic and foreign investment and remittances also nearly doubled, from CNY3.2 billion in 1999 to CNY6.6 billion in 2003. Yunnan posted the highest increase, nearly quadrupling this type of funding, due to international cooperation and the tourism industry. Sample counties in both Gansu and Guizhou also experienced an increase, nearly doubling this type of funding.

When analyzing fund outflows, we focus on financial institutions' deposit-to-lending gap because poverty-stricken areas make few fiscal payments to higher entities. Postal savings fund outflows from the sample counties in the six western provinces increased from CNY1.3 billion in 1999 to CNY3.8 billion in 2003. The deposit-to-lending gap of other financial institutions, such as the ABC, rural credit cooperatives (RCCs), and other commercial banks, differed, but the trend was obvious. In 1999, loans in these sample counties were CNY4.5 billion more than deposits, meaning that each province had fund inflows. However, fund inflows through financial institutions rapidly declined. By 2002, financial institutions in the sample counties in five provinces posted a total net fund outflow of CNY2 billion; only Sichuan had a net inflow, of less than CNY30 million. By 2003, the total net outflows of funds through financial institutions in the sample counties reached CNY3.8 billion, nearly matching the outflow of postal savings funds.

Overall, the inflow of funds to the sample counties was far greater than the outflow

Thus, interregional fund inflows totaled CNY8.4 billion and outflows amounted to CNY3.2 billion in 1999; in 2003, total inflow was CNY15.8 billion and total outflow was CNY7.6 billion. Overall, the inflow of funds to the sample counties was far greater than the outflow. However, total inflows decreased from CNY11.6 billion in 1999 to CNY8.2 billion in 2003, adding to the funding scarcity created by the escalating funding demands of the Great Development of the West.

Capital Flows: Fiscal Authorities

Local fiscal position comprises fiscal revenue, transfer, and spending. Fiscal revenues differ sharply across regions as a result of economic development disparities. During the 5-year period from 2000 to 2004, for example, fiscal revenue in the eastern regions averaged more than CNY900 million, 4.8 times that of the central regions and nearly 7.5 times that of the western regions. The gap widened from 2000 to 2003 and then shrank to some extent in 2004 due to increased central government transfer to the central and western regions. From 2000 to 2004, fiscal revenue growth was similar across regions; all doubled over 5 years. The ratio of fiscal revenue to gross domestic product (GDP) in the western regions averaged 18.5%, much higher than the 7% of the eastern and central regions.

The gap widened from 2000 to 2003 and then shrank to some extent in 2004 due to increased central government transfer to the central and western regions

Revenues surrendered by county governments and subsidies to county governments were higher in the eastern regions than in the central and western regions, but the gap in subsidies was much smaller than the gap in revenues surrendered (Table A.15). In addition, the ratio of revenues surrendered to GDP was similar, whereas there was a substantial difference in the ratio of subsidies to GDP; the ratio in the eastern regions was the lowest and the ratio in the western regions was the highest. The ratio of fiscal capital inflows to GDP stood at 15% and the ratio of fiscal capital outflows to GDP was 1.1% in western regions, indicating that higher-level government entities relied considerably on the western region for fiscal support. The ratio of fiscal revenues and spending to GDP was highest in the western counties and lowest in the eastern counties. Fiscal transfer from higher-level governments has increased markedly, and government disposable revenue has matched spending.

Capital Flows: Financial Institutions

Comparison of deposit–loan ratios, outstanding loan and deposit balances, deposits with higher-level institutions, central bank relending, and postal savings help us to analyze capital inflows and outflows through financial institutions. Rural areas have experienced heavy capital outflows over time. From 1994 to 2004, the cumulative deposit-to-lending gap in rural areas amounted to more than CNY4 trillion (excluding deposits from township and village enterprises). In 2005, rural financial institutions channeled CNY1.87 trillion away from rural areas. By the end of 2005, outstanding postal savings deposits reached CNY883.9 billion, all of which was deposited with the central bank. The trend of capital flows through financial institutions also was reflected in the number of financial institution outlets and the deposit–loan ratio.

The four largest state-owned commercial banks (the ABC, the China Construction Bank, the Industrial and Commercial Bank of China, and the PBC) each maintain four deposit-taking and lending outlets per county in the eastern regions, but deposit-taking outlets outnumbered lending outlets in both the central regions and, especially, the western regions (Table A.16). The central region had an average of 3.7 deposit-taking outlets and 3.6 lending outlets per county, whereas the western region had an average of 3.1 deposit-taking outlets and

2.6 lending outlets per county. This suggests that these banks channel deposits from the west and lend in the east. From 2000 to 2004, the number of outlets did not change in the eastern and central regions but declined slightly in the western regions, suggesting that the four largest banks reduced their financial services in the west.

In addition, the loan–deposit ratios of the four largest banks and the RCCs all were less than 1, suggesting that deposits surpassed lending in rural areas. Discounting factors such as excessive liquidity or minimal lending within the banking system, this means that capital migrated from rural areas to cities. The loan–deposit ratios of the ABC and the RCCs were relatively high and generally equal across the eastern regions and, with a few exceptions, even higher in the central regions, probably for different reasons. In the eastern regions, a good customer base led to a high level of lending. In the western regions, poverty reduction loans and PBC relending to support agriculture, farmers, and rural areas contributed to more lending, and thus to a higher loan–deposit ratio, even given the same amount of deposits.

A comparison of financial institutions' funding sources in different regions illustrates the correlation between deposits, loans, and economic activity. The rate of deposits outstanding is highest in the eastern regions and lowest in the western regions, and central bank loans purposely favor the central and western regions (Table A.17). In particular, beginning in 2002, the average PBC agriculture loan to RCCs was higher per county in the western regions than in the eastern regions in absolute terms. The ratio of PBC loans to GDP was much higher in the western regions than in the eastern and central regions, and the ratio in the eastern regions was the lowest.

Comparison of financial institutions' regional use of funds also points to a high correlation between loans and economic activity. The eastern regions had the most loans outstanding, whereas the western regions had the fewest, and this was closely linked with the regions' level of economic development. In the central and western regions, banks deposited substantial funds with higher-level financial institutions (Table A.18). The deposit–loan ratio was much higher in the central and western regions, where it was around 1 or more, than in the eastern regions, where it averaged about 0.7.

Even in relatively advanced provinces, county financial institutions deposited considerable amounts of funds with higher-level institutions. A survey of 29 counties in Shandong Province showed that, by the end of May 2006, financial institutions in the sample counties had deposited CNY57 billion with higher-level institutions, representing an annual increase of 20.7% from the end of 2000. During the same period, annual loan growth in the sample counties was 17.5%, 2 percentage points lower than the average loan growth of all counties in the province.

The ratio of PBC loans to GDP was much higher in the western regions than in the eastern and central regions, and the ratio in the eastern regions was the lowest

In general, banks in western regions extended fewer loans while depositing more with higher-level branches, and the deposit–loan ratios of the China Construction Bank, the Industrial and Commercial Bank of China, and the PBC were much lower in the western regions than in the eastern regions, though PBC fund transfer has eased funding pressure in the western regions to some extent.

Capital Flows: Microentities

Other microentities include remittance of rural migrant workers, foreign direct investment, and domestic direct investment, all falling into the category of capital inflows. In absolute terms, the average annual remittance by rural migrant workers per county was highest in the eastern regions and lowest in the western regions (Table A.19). However, the ratio of remittance to GDP in the western and central regions was much larger than in the eastern regions: 0.17 in the western regions, 0.11 in the central regions, and 0.04 in the eastern regions.

Foreign direct investment in the eastern regions far exceeded investment in the central and western regions

Foreign direct investment in the eastern regions far exceeded investment in the central and western regions (Table A.20). In 2000, foreign direct investment per county averaged CNY342 million in the eastern regions, just under CNY58 million in central regions (amounting to 17% of the investment in the eastern regions), and even less in the western regions, where investment is below 5% of investment in eastern regions. In 2004, the figure rose to CNY1.2 billion in the eastern regions and more than CNY412 million in the central regions, while remaining at CNY76 million in the western regions. The ratio of foreign direct investment to GDP was much higher in the eastern and central regions than in the western regions, indicating that foreign direct investment was concentrated in the eastern and central regions.

Regional differences in domestic investment also were significant and growing. In 2000, domestic investment in the eastern regions was more than twice the investment in either the central or the western regions (Table A.21). By 2004, the gap had widened; domestic investment in the eastern regions was nearly 3 times the investment in the central regions and more than 10 times the investment in the western regions. However, the ratio of domestic investment to GDP was slightly higher in the central and western regions than in the eastern regions, and was increasing over time.

Ultimately, the remittance of rural migrant workers is more important for the central and western regions than for eastern regions. The western regions lagged behind the central and eastern regions in attracting foreign direct investment and also attracted less domestic investment, though this was in line with the GDP of the western regions.

Issues of Capital Flow

Interregional capital flows in the PRC are characterized by severe and increasing outflows from rural regions, large regional differences in capital outflow, and constrained development of commercial banks in rural areas and the western regions due to regional differences in operational revenue.

By 2000, county banking institutions' deposits amounted to about CNY3.2 trillion, and these institutions' loans outstanding stood at about CNY2.4 trillion. This yielded a gap of CNY843 billion and a loan–deposit ratio of 74.8%, 5.5 percentage points lower than that of all banking institutions during the same period. By 2005, deposits of banking institutions at or below the county level amounted to about CNY6.9 trillion and loans outstanding stood at about CNY3.9 trillion. This CNY3 trillion gap was 3.5 times the gap in 2000. Moreover, the loan–deposit ratio decreased to 56.3%, 12.7 percentage points lower than that of all banking institutions during the same period. During the 5-year period from 2000 to 2005, bank deposits at or below the county level grew by 16% per year, close to the 17.7% growth rate of all banks in the PRC, but bank loans at or below the county level increased by a mere 9.7%, much less than the 15.7% growth rate in total loans across the country.

There are large regional differences in capital outflows, with the heaviest outflow from the central region. At the end of 2005, the loan–deposit ratio was 63.7% in the northeastern regions, 57.4% in the eastern regions, and 56% in the western regions, whereas the ratio in the central regions was only 51.8%, 4.5 percentage points lower than the average.

There also are large per capita operational revenue differences between urban and rural areas and between eastern and western regions, which has constrained the development of commercial banks in rural areas and the western regions. By 2005, bank deposits averaged CNY13 million per bank employee in the PRC as a whole, but deposits averaged only CNY6.5 million per bank employee in rural areas. Rural deposits averaged CNY9.2 million per bank employee in the eastern regions and CNY5.3 million per bank employee in the western regions. Thus, the eastern regions had an average of 22.5 bank outlets per county whereas the western regions had 9.9 outlets per county. In addition, many western counties were dominated by RCCs and therefore lacked effective competition.

Loans and Deposits

Rural financial institutions in the PRC, with their extensive branch networks and deposits insured by the central government, have played an important role in rural savings and lending and hence in the process of rural development. Rural lending by other banks, which have neither networks nor incentives to lend to rural enterprises and households, is negligible, except in a few developed areas where township and village enterprises are particularly strong. Both rural deposits (Table A.22) and rural loans (Table A.23) increased significantly from 1989 to 2005. However, total rural institutional loans as a percentage of deposits fell from 110% in 1989 to around 86% in 2001, an indication of the outward movement of funds that rural financial institutions might have used for rural lending.

The ABC appears to be the most important rural financial institution in the PRC, accounting for about half of both rural institutional loans and rural deposits. There has been a remarkable increase in postal savings deposits, and the percentage of postal savings to total rural institutional deposits rose from 0.6% in 1989 to around 8.6% in 2001. The ABC has allocated a growing proportion of its loans to urban areas, and the year-end loan portfolios (as shown in Table A.23) are very different from the supply of rural credit in the PRC. The ABC's rural loan programs—lending to agriculture and to township and village enterprises—decreased significantly after 1998, when the commercialization of the ABC started to affect its loan composition (Table A.24). The reduction in ABC rural loans has made RCCs the dominant supplier of credit in the rural PRC (Table A.25), although the ratio of annual loan disbursement to loans outstanding declined significantly for both the ABC and the RCCs after 1991 (Table A.26).

Rural deposits averaged CNY9.2 million per bank employee in the eastern regions and CNY5.3 million per bank employee in the western regions

A bulk of rural financial demand is for credit. In recent years, the total amount of agriculture loans has been growing rapidly, from about CNY1.4 trillion in 2001 to about CNY1.9 trillion in 2004, representing an annual growth of more than CNY100 billion. In 2004, agriculture loans, including Agricultural Development Bank of China (ADBC) loans, accounted for 10.5% of total loans and 102.7% of agricultural value-added. These figures were not low when compared with most developing countries. In an agrarian country such as New Zealand, for example, agriculture loans represented 114% of agricultural value-added, which was 17.2% of GDP. In Latin American countries, agriculture loans represented 8% of total loans in 1980, compared to 12% in 1972, and 21% of agricultural value-added in 1980, compared to 27% in 1970.

Most RCC loans have gone to rural households and enterprises, and RCCs in many areas can only meet the demand for simple agricultural production

With robust growth in other industries, the share of rural loans as a proportion of total loans declined. Loans to rural areas increased from CNY3.3 trillion in 2001 to CNY4.7 trillion in 2004, with the share in total loans declining from 29.43% to 26.36%. Since 2001, new loans to rural areas have averaged CNY400 billion per annum; 60% to 70% of these loans were made by RCCs. ABC loans to rural areas have remained largely unchanged, ADBC loans are on the decline, and loans from other banks have increased somewhat, mostly going to the eastern regions.

In recent years, the ADBC has provided only short-term crop procurement loans, and its loans for crop transactions have declined markedly with the deepening reform of the grain and cotton circulation system. This has left a vacuum in the provision of medium- and long-term development loans. The ABC has substantially downsized outlets and has gradually shifted loans to large cities and large projects. Its short-term agriculture loans and township and village enterprise loans have declined, and medium- and long-term loans have targeted transport infrastructure. Most RCC loans have gone to rural households and enterprises, and RCCs in many areas can only meet the demand for simple agricultural production.

Rural Household Credit Demand

According to the China Banking Regulatory Commission, the RCC loan coverage of over 240 million rural households was 30% in 2005, meeting 60% of demand. Generally, rural financial demand in developing countries largely relies on informal financial institutions such as microcredit agencies, pawnshops, and cooperative associations; coverage of formal financial institutions is low. By comparison, the coverage of formal financial institutions in the rural PRC is fairly high.

Rural households fall into four categories: traditional households, households engaged in multiple small-scale businesses, households engaged in large-scale planting and/or aquaculture, and rural migrant workers or self-employed households. The credit demand of traditional rural households can be met in time. Because the production cost of traditional agriculture is relatively low, with investment averaging around CNY250 to CNY400 per mu (equivalent to approximately 0.16 acre), traditional rural households typically require loans of between CNY1,000 and CNY10,000 for basic production, and microcredit businesses can meet the needs of these households. For example, 70% of counties and over 50% of rural households in Inner Mongolia Autonomous Region have obtained credit.

The credit demand of rural households engaged in multiple basic businesses, such as small-scale planting and aquaculture, also can be largely met. Due to limited scale and inputs, credit demand for this kind of household was CNY10,000 to CNY30,000 per year, above the typical CNY5,000 threshold of microcredit. However, households with good credit records usually can obtain such loans through collective guaranty.

The credit demand of households engaged in large-scale planting and/or aquaculture cannot be fully satisfied. Their demand is variable, depending on the size of their land or ponds and the amount of seed, fertilizer, and feed required, and ranges from CNY10,000 or CNY50,000 to several million renminbi. Demand below CNY50,000 can be satisfied through collective guaranty or credit lines, but county rural financial institutions have difficulty meeting demand for loans of more than CNY50,000.

Likewise, the credit demand of rural migrant workers and self-employed households often remains unsatisfied. Their demand for working capital and funds for expanding production is high, but their demand seldom is met.

Rural Enterprise Credit Demand

Demand for rural enterprise funding has been increasing rapidly, but it is increasingly difficult to meet these borrowing needs. Because state-owned commercial banks have shrunk their rural operations, supply-and-demand tensions are acute in rural enterprise lending. Some enterprises experience difficulty accessing credit and must rely on self-funding or informal financing. Only the state-owned grain reserve can borrow from the ADBC for crop acquisition, leaving 60% of other enterprises and the self-employed to rely on other means of finance. For instance, a survey in rural Jilin Province showed that bank loans can meet only about 30% of the financing demand for rural enterprises. Likewise, the funding demands of large enterprises are generally more than several hundred thousand renminbi, which is beyond the capacity of small and medium-sized financial institutions. The Industrial and Commercial Bank of China and the ABC can meet such demand, but their county branches require approval from higher-level branches before doing so.

Rural Government Credit Demand

Finance demand for rural infrastructure has been strong, and such demand must be better met. According to the survey in Jilin Province, 55% of county governments considered it difficult to procure financing for rural road construction and irrigation. Seventy-two percent of respondents named roads as the most needed livelihood facilities, about 30% named irrigation, and just over 29% considered improvement of drinking water for both humans and livestock as the most pressing need. Moreover, 97% of county governments believed that the finance sector should gradually increase lending for infrastructure. A survey on rural credit demand in Zhongmou, Sichuan, in 2006, suggested that more than 60% of the financing demand of primary sectors such as planting and aquaculture could be met, whereas only 30% of the secondary and tertiary sectors such as agricultural products processing and transport could secure needed loans.

A survey by the China Banking Regulatory Commission found that the credit demand of 55% of rural households and

The credit demand of households engaged in large-scale planting and/or aquaculture cannot be fully satisfied

44% of rural enterprises could be fully met, whereas the demand of 45% of rural households and 56% of rural enterprises could not be fully met. Access to credit on the part of rural households and small and medium-sized enterprises is an important driving force behind rural development, and inadequate access to credit will constrain rural development and the integration of urban and rural areas.

The China Banking Regulatory Commission also found that constraints on rural finance include high interest rates, tedious procedures, and complex loan terms. Just under 22% of rural households and about 15% of rural enterprises considered the lending procedure simple, whereas 22% of rural households and 26% of rural enterprises deemed the procedure complex and time consuming, indicating that credit access is a more acute issue to rural enterprises than to rural households. The rural financial market is essentially a seller's market, with nearly 62% of rural enterprises unable to select their financial institution freely.

CHAPTER 5

Interest Rate Policy

Following the continuous decline in the growth rate of farmers' incomes, the widening income gap between the rich and the poor, and growing disparities between urban and rural areas since the early 1990s, there has been renewed interest in and policy debate about agriculture and rural development in the People's Republic of China (PRC). The government inaugurated in March 2003 vowed to give policy priority to supporting agriculture, farmers, and rural areas *(sannong)*, to improving rural incomes, and to narrowing the income gap among regions and between the rich and the poor.

The outflow of funds from rural areas and the lack of rural credit have been identified as major obstacles to the PRC's rural development.[1] Large amounts of rural funds have flowed from rural to urban areas, creating a conflict between the demand for and the supply of rural credit. The shortage of rural credit, in turn, has been blamed for the slow pace of rural development because it jeopardizes investment opportunities in high-value-added agriculture (such as large-scale production of vegetables), in agriculture processing, and in rural off-farm production. Since the PRC's entry into the World Trade Organization, there has been increasing awareness that development in these areas is essential to the nation's rural economic growth and to employment in its wealthier areas, given the extremely small size of farms and the low labor productivity in the traditional agriculture sector.

The central government and the People's Bank of China (PBC) have outlined various policies intended to raise the supply of rural credit and improve rural output and incomes. In 2002, the Ministry of Agriculture proposed increasing agriculture lending by setting a minimum amount of agriculture loans to be disbursed by financial institutions and by increasing the variety and quantity of policy loans for agriculture. It also proposed to extend loan terms and to reduce loan rates for rural lending as a means of reducing borrowers' costs. These policy suggestions are very similar to the credit policies once implemented in other less-developed nations. For example, the reserve bank in Thailand stipulated that the proportion of agriculture loans to the total loan portfolio for any commercial bank must be greater than 5% and that the proportion of agriculture loans to total deposits must be greater than 11%.

The so-called traditional approach to rural finance has proved unsuccessful in reducing rural poverty and promoting rural development. However, the political pressure to increase inexpensive rural loans has been so great that, in 1999, the PBC introduced the agriculture onlending program, which provided inexpensive loans to rural credit cooperatives (RCCs), and the value of these loans has been growing over time. Moreover, in early 2003, the PBC set the annual target for growth of the RCC loan portfolio at over 15%, with the agriculture loan portion set to grow by 20% or more.

The relationship between financial policies and economic development has been a popular topic in the study of development economics

Understanding the shortage of rural credit begins by examining the changes in rural financial institutions' deposits and loans and the relationship of these changes to changes in the structure and real rates of interest in the PRC. Change in the structure and real rate of interest is one of the major forces—perhaps the most important force—behind the outflow of loanable rural funds that has followed the commercialization of rural financial institutions since the early 1990s. Distortion of the PRC's rural financial market has serious implications for the efficiency of rural financial intermediation, for state budgets, and for the allocation of scarce resources in rural areas. Theories of finance and economic development allow us to analyze the market distortions caused by selective credit policies and their effect on the allocation of rural credit and the efficiency of financial intermediation in rural areas of the PRC.

The relationship between financial policies and economic development has been a popular topic in the study of development economics.[2] Selective credit policies have been blamed for the misallocation of scarce resources and low efficiency in financial intermediation.[3] However, as far as we are aware, there have been no systematic studies of the effect of financial policies and interest rate structure on the allocation of resources or on the efficiency of financial intermediation in rural areas of the PRC, although similar studies have been undertaken for other less-developed countries.[4]

Such information has important policy implications, given the size and importance of the PRC's rural economy, the currently large institutional loan portfolios, and the amounts of the loans disbursed each year by rural financial institutions in the PRC. By the end of 2001, the total loan portfolio of rural financial institutions reached CNY11.2 trillion, dwarfing the portfolios of many other less-developed countries. The lessons drawn from the PRC are valuable for other economies in the process of economic development and transition. The materials used in this chapter comprise both official sources and information collected by the authors during field investigations.

Changes in Rural Deposits and Loans

Annual loan disbursement (credit flow), rather than year-end loans outstanding (stock), determines the supply of institutional credit in rural areas. The declining ratio of annual loan disbursement to loans outstanding reflects an increase in the proportion of nonperforming loans for both the Agricultural Bank of China (ABC) and RCCs over time. Due to increased numbers of nonperforming loans and the resulting decreases in loan collection rates, rural financial institutions have less funding available for loan disbursement.

The supply of rural credit comprises the cumulative rural lending of the ABC and the RCCs (Table A.27). Agricultural Development Bank of China (ADBC) loans are not counted as rural lending because such loans are not provided to rural households or enterprises for productive investment or consumption. The ratio of cumulative disbursement to year-end ABC loans outstanding (Table A.26) reflects ABC loans for agriculture and for township and village enterprises.

The ratio of institutional lending to total institutional deposits in the rural areas has been reduced by more than half in the past decade. The fall was most dramatic from 1996 to 2001—a result of the ABC's reallocation of credit to urban areas, an increase in nonperforming loans at the ABC and the RCCs, and an increase in rural postal savings deposits (Table A.22). For instance, the percentage of ABC loans fell from 17.2% of total deposits in 1996 to 4.9% of total deposits in 2001. Thus, despite the rising demand for rural credit, as indicated by the rapid increase in rural institutional deposits, rural credit remains in short supply and the role of the ABC and the RCCs in channeling rural savings into rural productive investment has declined over the past decade.

In addition, the decline in the proportion of rural credit to deposits has been fairly consistent over time, and the steeper declines in the ABC's agriculture lending since 1997 have been somewhat offset by increased RCC lending. Eighty-four percent of total rural institutional lending in 2001 was provided by RCCs, and the ABC became a relatively insignificant player in financing households and enterprises in rural areas.

An important aspect of the PRC's selective credit policies is the policy loans from rural financial institutions to priority sectors of the economy. Policy loans for rural areas include (but are not limited to) loans for agriculture procurement and storage (provided mainly by the ADBC), poverty loans, and agriculture onlending from the PBC to the RCCs. Other agriculture policy loans include agriculture development loans and loans to grain processing enterprises provided by the ABC. ADBC loans represent about 20% to 25% of total institutional loans. RCC poverty loans and agriculture onlending relative to total ABC and RCC rural loans increased beginning in 1995. By 2001, policy loans made up about 10% of total rural loans provided by the ABC and the RCCs. Clearly, the decrease in the supply of rural institutional credit would be more drastic after 1996 had there not been a marked increase in rural poverty loans.

Market Distortions and Efficiency of Rural Financial Institutions

Since the early 1990s, the PRC has made progress in removing market distortions caused by negative rates of interest. Real deposit and lending rates rose significantly from 1989 to 1998. The increases in real interest rates, reflecting a process of financial deepening, should have contributed to the increases in rural savings deposits, benefitting rural depositors and improving the allocation of resources in the rural areas of the PRC. However, the rapid increase in rural deposits also may have been the result of other factors, including a lack of opportunities for farmers to invest in financial assets such as bonds, shares, or physical capital assets, and the closing down of rural cooperative foundations.

An important aspect of the PRC's selective credit policies is the policy loans from rural financial institutions to priority sectors of the economy

Farmers and rural communities also have benefited from improvements in the structure of interest rates. The difference between the demand deposit and time deposit rates has narrowed consistently, and the term structure of deposit rates has become less tilted over time. Depositors, especially those with demand deposits, have benefited from such a reduction. In addition, the disparity between the base rate and the subsidized rate for poverty loans has declined from 7.2% in 1989 to less than 3% in 2002, and the preferential rate for agriculture procurement loans was removed in 1998. Finally, the rate differential between 1-year lending and 1-year deposit has increased, leaving a higher margin for rural financial institutions.

Lending Rates

In the early 1990s, the central government began relaxing direct state control over interest rates, and rural financial institutions, particularly RCCs, have been at the forefront of interest rate liberalization. The centerpiece of the reform is the introduction of the bands within which financial institutions adjust their lending rates. In 1992, state banks and financial institutions were allowed to float their working capital lending rates around the base rate, with an upper band of 20% and a lower band of 10%. On June 1, 1996, state control over the rates on interbank money markets was removed. Then, in 1998, the interest band for loans to small and medium-sized enterprises was increased from 10% to 20% and the band for RCC lending increased from 40% to 50%. In 1999, all financial institutions and branches operating at and below the county level were allowed to float their lending rate by a maximum of 30%, and the band for loans to small and medium-sized enterprises also was raised, from 20% to 30%. Finally, in 2002, the central government launched pilot programs for interest rate liberalization of RCCs in eight counties. The RCC lending rate band was expanded from 50% to 100% and, for the first time, RCCs in these counties were allowed to float their deposit rates by 20%.

The centerpiece of the reform is the introduction of the bands within which financial institutions adjust their lending rates

However, distortions in the PRC's rural financial market remain. The capped lending rates for institutional finance are far from sufficient to cover operational and funding costs while leaving a margin for the growth of rural financial institutions. Although real rural lending rates have increased over time, they remain low relative to the market rate of interest, represented by rates in the informal financial markets (around 20% to 25% nominal). Institutional rates also have been lower than the effective rates charged by microfinance institutions. The microfinance experiments undertaken by Funding the Poor Cooperatives in Hebei and Henan provinces indicate that, given a nominal fund cost of around 2% per annum, an on-time loan repayment rate of over 95%, and an annual loan loss within 3% of the portfolio, microfinance institutions in these areas must charge an effective rate of approximately 15% to achieve operational viability—that is, to ensure that income covers operational costs, loan losses, and real fund costs (which is usually subsidized and is not the same as the opportunity cost of capital). This is much higher than the maximum lending rate allowed to RCCs. Moreover, microfinance institutions such as Funding the Poor Cooperatives have no historical burdens (legacy nonperforming loans and financial losses) or tax obligations, and loan repayment rates tend to be much higher than that of the average RCC in the PRC.

Based on surveys of RCCs in Anhui, Jiangsu, and Shanxi provinces in 2001 and 2002, we estimate lending rates that will substainably cover the cost of capital, operations, and loan losses for rural financial institutions and the ABC. These cost projections are for above-average RCCs with good management and would apply to ABC branches as well. The opportunity costs of capital (more than 3% per annum) and the historical burdens of RCCs are assumed away.

On average, rural financial institutions in coastal areas need to charge a minimum of 9.5% per annum to survive. A few better-off RCCs in these areas would be able to charge a lower rate if their major customers were large enterprises and they could invest part of their funds in the financial market. An average RCC needs to charge a nominal lending rate of at least 11.5%, whereas rural financial institutions in poor and remote areas of the country need to charge more than 16% to survive. These results are more or less consistent with Funding the Poor Cooperatives' operationally sustainable rate of 15%, considering that its programs are located in poor counties and the scale of its operations is smaller than that of RCCs. The actual required lending rates would be much higher than these projections, assuming that RCCs need to generate profits to pay dividends to their members, to grow, and to cover accumulated financial losses and historical bad loans.

These findings have important implications for the operation of rural financial institutions in the PRC. First, low lending rates have contributed to the growing financial losses of rural financial institutions, given the high operational costs and high risks of rural lending in the PRC. Second, the low lending rates have given rise to a lack of operational funds for rural financial institutions and their staffs, which in turn has contributed to increases in nonperforming loans. For example, in Guizhou Province in 2000 and 2001, RCC staff received almost no subsidies for going to villages to screen loan applicants or to monitor loans, due to the RCCs' financial difficulties. In the remote and mountainous areas of Hunan and Guizhou provinces, RCC staff were forced to use their own motorbikes for work-related travel, and no subsidies were paid on fuel. As a result, RCC staff usually avoided trips to the villages.

Financial losses and the ever-increasing numbers of nonperforming loans have crippled rural financial institutions' ability to provide loan support to rural households and enterprises. Moreover, low lending rates have discouraged rural financial institutions from lending in rural areas, given the higher transaction costs and higher risks of rural lending, and have exacerbated the RCCs' already serious moral hazard problems, a result of unclear ownership structures and poor corporate governance. For instance, RCCs can easily mix losses from nonperforming loans and bad management with those caused by the low lending rates.[5]

Financial losses and the ever-increasing numbers of nonperforming loans have crippled rural financial institutions' ability to provide loan support to rural households and enterprises

Ironically, rural borrowers in the PRC have not necessarily benefited from low lending rates because interest expense comprises only a part of the overall borrowing costs for rural borrowers.[6] Surveys indicated that the borrowing costs for farmers mainly include gifts and kickbacks to loan officials, time spent on traveling and on loan applications, and membership fees for joining an RCC. To ensure loan access, for instance, it is common for loan applicants to invite loan officials to banquets and/or to give kickbacks directly to loan officials or RCC directors. The long and complicated loan application procedures often place the poor at a disadvantage and jeopardize productive investment opportunities when quick credit is required. A PBC survey in Shanxi Province also found that it is common for RCCs to require loan applicants to pay CNY50 to CNY200 to join the RCC before their loans are processed and approved, which adds to farmers' borrowing costs.

The high cost of institutional loans is one of the major reasons that farmers switch to informal sources of finance. Thus, farmers generally would benefit from a more sustainable interest rate, in combination with the provision of financial services and products tailored to their needs, or from an overall reduction in borrowing costs.

Dual Pricing

Institutional rates of interest in the PRC are distorted in other ways. First, creating lending rate bands for rural financial institutions—an important step toward relaxation of direct state control of interest—has its own limitations. The bands have created dual prices for the same loan products offered by different financial institutions. For example, RCCs are able to adjust their lending rate by a maximum of 50%, whereas the ABC can only adjust its base rate by a maximum of 20% to 30%. In conjunction with high operational costs, high risk, and low lending rates, dual interest rates likely helped push the ABC and other state banks away from the rural lending market.

The high cost of institutional loans is one of the major reasons that farmers switch to informal sources of finance

More importantly, rural financial institutions are unable to charge a risk premium for riskier projects, riskier borrowers, or loans disbursed in different regions of the PRC. This inflexibility has efficiency and equity implications. The ABC has effectively closed its lending operations in poor counties, with the exception of making subsidized poverty loans for state-designated poor counties. Loan disbursements from RCCs in these areas have declined as well, owing to a higher proportion of nonperforming loans and the RCCs' accumulated financial losses. The reduced supply of institutional credit has pushed up the interest rates on the informal financial markets and more poor have become trapped in the cycle of debt.

Finally, although the gap between the base lending rate and the rate for poverty loans was reduced from 7.2% per annum in 1989 to 2.3% per annum in 2002, the gap remains. The gap between the poverty rate and the maximum rate that RCC can charge for a 12-month loan is 5.65% per annum. Obviously, the poverty loan rate is far below the sustainable lending rate for rural lending in the PRC, and subsidized rates for poverty loans often give rise to low rates of loan repayment and problems with targeting.[7]

Rate distortions apply not only to borrowers but also to lenders. When special PBC onlending was initiated, the onlending rate to RCCs was 1% lower than the rate available to other financial institutions in the PRC. The gap remained until 2004. The subsidized onlending rate for RCCs, in combination with a 50% band for RCCs' rural lending, helped push other formal financial institutions further away from the rural lending market. Even so, the subsidies provided by the lower onlending rate are insufficient for RCCs to cover their full costs.

Likewise, the rate for rural postal savings redeposit has been much higher than the rate available to other financial institutions—even higher than the base time-deposit rate. The higher rate has fueled large increases in postal savings redeposits and has contributed to the outflow of loanable funds from rural areas. By the end of 2001, agriculture onlending to RCCs (CNY65 billion by the end of 2001) was no match for the outflow of funds channeled through rural postal savings (CNY355 billion).

Barriers to Interest Rate Liberalization

Several factors have contributed to the formation and adjustment of official interest rates since the early 1990s: the belief that positive real deposit rates work to protect depositors; the interest payment burdens of state-owned enterprises, many of which are highly leveraged; government tax revenue and the profits of financial institutions; the state's economic development policies and strategies; and the supply of and demand for loanable funds, as well as loan terms and risks. Thus, interest rate liberalization in the PRC must overcome a variety of barriers. For instance, the low profitability of state-owned enterprises and the vastly different natural and economic conditions and returns on investment under current market conditions have prevented capital from flowing to the poorer areas of the country. Moreover, owing to low agriculture prices and low profitability, there has been political pressure for the central government and the PBC to balance growth by providing a greater number of inexpensive loans in rural areas and in the western and central regions of the PRC.

Institutional Response to Market Distortions

The Agricultural Bank of China

Following the financial reforms of the mid-1990s, the ABC was required to commercialize its operations and to become financially viable, which made the bank more responsive to interest rate signals. The ABC's head office and the provincial divisions not only have rationed credit supply in rural areas but also have transferred funds from relatively poor to wealthier areas. The ABC has rationed the supply of credit by adjusting interest rates, transferring lending authority from local branches, cutting back on local offices and staff, and introducing the life responsibility system.

First, the ABC set a relatively high rate of interest on redeposits from ABC branches in less-developed areas to the provincial ABC and to headquarters, so branches in poor areas benefit financially by redepositing with the ABC rather than increasing their lending. For example, in Inner Mongolia Autonomous Region in 1999, headquarters and the provincial division of the ABC paid an interest rate of about 4.5% for redeposit from the prefecture level, which was close to the rate paid by the PBC for redeposit from rural postal savings.

The ABC has rationed the supply of credit by adjusting interest rates, transferring lending authority from local branches, cutting back on local offices and staff, and introducing the life responsibility system

Second, the ABC moved lending authority from county to provincial branches and set direct targets on the total quantity of loans by county branches in poor and major agricultural areas. In Guizhou, for example, some county branches were allowed to make up to CNY200,000 in commercial loans each year but were only given authority to lend CNY50,000 to any rural enterprise. The lending authority of state-owned commercial banks resides mainly with the provincial divisions; county branches usually have authority only for loans under CNY100,000 and for loans collateralized by borrower deposits, which can be regarded as risk free.

The major losers in the ABC's credit rationing are township and village enterprises and rural households engaging in off-farm production and investment

Third, the ABC cut back on township business offices and staff and mainly transformed the remaining township business offices into savings stations. From 1995 to 2001, the ABC cut its staff by around 13% and its branches and business offices by 34%. Many of these closed branches and business offices were located in rural townships.

Finally, the ABC tightened the credit supply by introducing the life responsibility system, which makes loan officers responsible for loans they disburse. Officers held personally responsible for delinquent loans are less likely to disburse loans.

By reducing its rural lending, the ABC has diversified its portfolio, shifted its lending focus to urban and coastal areas, and developed its off-balance-sheet transactions. According to the president of the ABC, consumer loans—including mortgage loans, automobile loans, and loans for house renovations—have increased substantially since 1997. By the end of 2001, the balance of ABC's consumer loans reached CNY121.7 billion, representing around 9% of the bank's total loan portfolio. However, in 2001, the increases in consumer loans accounted for only 35% of the increases in total loans disbursed by the ABC.[8]

The major losers in the ABC's credit rationing are township and village enterprises and rural households engaging in off-farm production and investment. The slowing growth of township and village enterprises, which has contributed to slower growth in the PRC since 1996, has been closely related to the operation of the rural financial system.[9] The reduction in ABC rural lending has negatively affected the employment opportunities provided by township and village enterprises and large off-farm households. The withdrawal of the ABC from the rural lending market also has reduced the already very limited competition in the PRC's formal rural financial markets.

The costs of the ABC's commercialization could have been reduced if the financial reforms of the mid-1990s had been broader and better coordinated. Direct state control over interest rates could have been relaxed to encourage the ABC to continue its rural lending programs, and competition in the PRC's rural financial markets could have been enhanced by encouraging market entry of new institutions. The costs also could have been reduced if changes had been introduced gradually and had been accompanied by government assistance to rural enterprises and rural off-farm production, especially in poverty-stricken areas.

Rural Credit Cooperatives

Given the current lending rates, RCCs should have reduced rural lending and channeled funds out of rural areas, as the ABC did. Indeed, RCCs in poverty-stricken and remote areas have a strong incentive to do so. However, PBC regulations control RCC funds. First, RCCs are allowed to lend to households and enterprises only within their geographic boundaries. Second, more than 50% of RCC loans must be provided to their members, and over 70% of new loans must be agriculture loans, including loans to individual households or agricultural collectives.

Moreover, the PBC set restrictions on interbank lending by RCCs. RCCs can transfer funds to other RCCs in the same county through the county RCC union, but intercounty transfers must go through the PBC. In order to lend funds to other RCCs or financial institutions, RCCs must demonstrate good capital quality, effective management and internal control, and profitable operations (or declining losses) over the previous 2 years. In addition, interbanking lending must not exceed 2% of all the deposits organized by the RCC in question.

Restrictions on the uses of RCC funds have caused further distortion in the rural financial markets. For instance, territorial restrictions have contributed to increased geographic and industrial risks, resulting in a high proportion of nonperforming loans. Such risks could have been mitigated by the small-scale operation of RCCs and the RCCs' enhanced understanding of their clients. However, moral hazards and the lack of funds have prevented RCCs from obtaining the necessary information about their loan applicants and borrowers. Thus, the low lending rate and restrictions on the use of RCC funds have contributed to the RCCs' low profitability and high proportion of nonperforming loans and have impaired their capacity to provide more credit to rural households and enterprises.

PART III
FINANCIAL MODELS

CHAPTER 6
Cooperative Finance

With the deepening reform of the state-owned commercial banks and the transformation of the rural credit cooperatives (RCCs), a great deal of rural financial institutional funding has gone to townships, cities, and large projects. Cooperative finance can serve local communities and attract rural funds, which helps to remedy the insufficient funding of commercial banks and to meet diversified microfinance demand. Developing a cooperative credit system with local characteristics is a major rural finance challenge in the People's Republic of China (PRC), and relevant international experience and lessons from existing informal domestic finance may provide important parts of the solution.

Cooperative financing has unique advantages, including democratic management and information advantage. Democratic management means that RCC members make the most important decisions and practice their right to supervise RCC management. However, none of the existing cooperative financing organizations has practiced a democratic management system. After true cooperatives are established, democratic management will help protect and better serve members.

In addition, the structure of RCCs confers an information advantage, resolving the difficulties of information collection and analysis in microfinance. The high cost of selecting and monitoring borrowers has kept traditional banks away from the informal microfinance sector, but RCC members can supervise each other, reducing information asymmetry between banks and borrowers and therefore significantly reducing this kind of cost. Moreover, whereas banks suffer from conflicts between shareholders and depositors, RCC members are most concerned about deposit safety and quality of service. RCCs are nonprofit organizations, and depositors are RCC members who are highly motivated to preserve the safety of RCCs' assets. This is opposite to the practice of commercial banks, which are primarily concerned with profit margins.

True RCCs may be useful within the binary structure of the urban and rural economies and in addressing the circumstances under which commercial banks are unable to meet the financial demands of agriculture, farmers, and rural areas *(sannong)*. However, RCCs may not be superior to commercial banks in all cases. In fact, with the coming of economic development, many RCCs share some characteristics with commercial banks such as Crédit Agricole in France. In the long term, RCCs may survive the disappearance of the binary economy, when serving *sannong* is no longer the government's main policy goal. The credit unions in many developed nations serve as examples of this transformation.

Principles of Cooperative Finance and International Experience

Cooperative finance originated in Europe in the 19th century and later emerged in North America. In this kind of organization, all owners (farmers and other small-scale producers) agreed to take limited returns and to retain the rest of their funds with the organization, which would use such funds for the development of local communities. In other words, the ownership used the credit cooperative both as a vehicle for investment and as an agency for credit. The basic characteristics of this type of credit cooperative include membership based on willingness and openness; democratic member control; financial participation of members; operational independence and autonomy; provision of education, training, and information; cooperation among cooperatives; and community service.

The core principle of a credit cooperative is voluntary participation, democratic management, and equal membership

The core principle of a credit cooperative is voluntary participation, democratic management, and equal membership. Like a company that wants to maximize profits of the owners, a credit cooperative wants to provide members with the best service. The community cooperative bank is a financial institution self-managed by its members. This type of nonprofit financial institution is organized through a democratic process and is owned and managed by all members, each of whom has equal rights in electing the director of the cooperative. According to the core principle, development of a credit cooperative is bottom-up and thus requires time. In the preliminary stage, the operation of the credit cooperative is characterized mainly by member deposits. During the slow course of development, volunteers do most of the work.

In many developing countries, the government has tried to circumvent the development process by launching credit cooperatives, promoting them externally, and developing them rapidly. However, without sufficient time to explore, learn, and improve the system, the development of the credit cooperative is constrained, increasing the possibility of failure. In particular, excess government intervention destroys the core principle of cooperative finance and increases moral hazard. The failure of many credit cooperatives has demonstrated that the development of cooperative finance is a step-by-step process in which the core principles of independent operation, voluntary participation, and savings orientation must be observed.

As a credit cooperative develops, individual member shares will shrink. Fewer members will know each other, weakening their supervisory motivation and increasing member difficulties in accessing loans. Free riding will become more frequent. This situation will be aggravated when a cooperative begins to seek external funds—especially when the government tries to use the cooperative as a channel for implementing a rural loan strategy. In such a case, the previous incentive for self-supervision will become a moral hazard. Members and management are likely to try to use external funds to maximize profit for themselves rather than for the cooperative.

Ultimately, the credit cooperative system will face a new challenge: regional and national credit cooperatives must be united into one organization to provide a platform for information sharing, legal consultation, banking, and other services. In this way, a multilevel cooperative finance system will be established and its rapid development will attract government attention.

Rural finance has played an active role in poverty-stricken regions, and one good example is the village bank. In the 1980s, John Hatch and his partners at the Foundation for International Community Assistance initiated village banks to provide microfinance in Latin America. This kind of organization operates in a democratic manner and its main business is to provide loans at market interest rates. (The major difference between a village bank and a community bank is that individual village bank members may have several votes whereas each community bank member has only one vote.) The village bank is a self-sufficient organization of 10 to 50 people who meet weekly or bimonthly. The group provides itself with three basic services: microcredit loans to start or expand businesses, deposit incentives and measures to attract savings, and community support. The members of village banks provide guaranties for each other and adopt integrated democratic principles.

Like other rural financial institutions, village banks tend to serve poor people, especially women. More often than not, the village bank gets an initial loan from a funding organization, deposits these funds into an external account, and then uses the funds to cover operational costs and make member loans. The initial member loan is normally around CNY350 for a term of 4 months. Successive loans are linked to members' deposits, which should equal at least 20% of the loan amount. Member savings are deposited into an internal account and are available for withdrawal at any time. The ultimate goal is to establish an internal account that will enable the complete withdrawal of funds from the external account within 3 years.

A village bank makes use of local information and is supervised by village residents. In addition, the operational goal of the village bank is financial sustainability. To achieve this, the loan rate is set at 4% per month. However, because many village banks are located in remote areas where service is not easily accessible, the average village bank's revenues cover only 70% of its total cost and most still require a considerable subsidy. Such organizations must pay more attention to coverage than to scale.

Lessons of Cooperative Finance in the People's Republic of China

Rural Credit Cooperatives

RCCs in the People's Republic of China have gone through several rounds of transformation. In 1952, there were more than 2,000 RCCs serving farmers. Before the Cultural Revolution, RCCs were the financial institutions of the people's commune and were true collectives; after the Cultural Revolution, the RCCs became a part of the people's commune rather than independent financial institutions. From 1958 to 1979, RCC operation was stagnant, but in the 1980s, the People's Bank of China (PBC) resumed collective ownership of the

RCCs in the People's Republic of China have gone through several rounds of transformation

RCCs. Since then, the RCCs have become a supplementary administrative institution of the Agricultural Bank of China.

RCC reform, which began in 1983, brought about rapid RCC expansion, until membership covered 80% of farmers. The board of directors was established, as were the training system and guidelines for financial safety. However, with the rapid growth and overheating of the economy, local governments forced the RCCs to grant large numbers of loans to township and village enterprises, which ultimately led to massive losses when many of these enterprises went bankrupt.

The history of RCCs shows that excessive government intervention has twisted the nature of the RCC by ignoring the cooperatives' internal governance, blurring the lines between supervision and management, and ignoring RCC autonomy and shareholder rights, ultimately generating serious moral hazards.

In 2003, provincial governments were given management rights, provincial rural credit unions were established, and RCC pilot reform improved governance structure

First, the RCCs' established internal governance was ignored. In 1996, when the State Council commercialized the state-owned commercial banks and separated the RCCs from the Agricultural Bank of China, the central bank implemented many measures to transform rural credit cooperatives into truly cooperative finance institutions. Afterward, external supervision was emphasized while the governance and internal control system was ignored. Shareholders' meetings, the board of directors, and the board of supervisors played no effective role, and senior officers were still appointed by government agencies. Moreover, incentive, supervision, and exit mechanisms were largely missing. In 2003, provincial governments were given management rights, provincial rural credit unions were established, and RCC pilot reform improved governance structure. Even so, RCCs have not been transformed into true cooperatives and still suffer from weak governance and poor sustainability.

Second, the separation of RCC supervision and management was ignored, and some management functions were replaced by government supervision, thus weakening the RCCs' effective management mechanism. In legal terms, supervision and management are closely associated and are referred to as supervision and regulation. In the general sense, supervision and regulation oversee market entry and exit; gather timely information about the supervised organization; undertake discovery and punishment of misconduct according to laws, regulations, and other stipulations; and administer corrective measures. Regulation covers the appointment of personnel and decisions about development strategy. In the PRC, the government also is involved in formulating management objectives and strategy and in appointing an organization's regulators. As a result, there is no clear distinction between supervision and management, but supervision in place of regulation has a long history.

Third, the autonomy of RCCs as legal enterprises was ignored, removing independent management and RCCs' responsibility for their own risks and performance. During the period of planned economy, the central and local governments shared the same goals. However, during the transition from the planned to the market economy, especially after the tax system reform of 1994, the interests of the central and local governments began to diverge. Because the central government is responsible for financial stability, it has to bear all losses resulting from local government intervention in financial institutions. On the other hand, local governments are largely responsible for developing their local economies, and they are highly motivated to intervene in the operations of local financial institutions. It was not uncommon for local governments to direct the lending of finance institutions while ignoring debt evasion, resulting in increased numbers of bad loans.

Since the reform of the state-owned commercial banks and the 2003 amendment of commercial bank law, local governments have reduced their intervention in commercial banking. Nonetheless, intervention in RCC operations still exists in some regions. By influencing the selection of borrowers and the scale of loans, local governments have asked RCCs to provide loans to clients who are unable to repay the loans. This has put many RCCs into a difficult, unsustainable position.

For example, in the 1990s, local governments required RCCs to provide numerous loans to township and village enterprises; many of these loans later became bad loans and brought about heavy RCC losses. Some local governments collected high taxes and fees from RCCs. Moreover, under the weak supervisory system, the management of some RCCs colluded with a few local government officials, which enabled some borrowers to garner illegal profits. All of these problems cost RCCs dearly, and the central government later absorbed these losses.

Finally, the legal status of RCCs as independent financial institutions has been ignored, and the democratic management right of members and shareholders has been weakened. RCCs require voluntary participation, self-assistance, and democratic management. However, from the very beginning, the PRC's rural credit cooperatives were established by government administrative bodies. Although on paper RCCs were owned by members, each member's shares were trivial and scattered, making it very difficult for members to exercise their ownership.

It is even more difficult for members to exercise their democratic management rights because they have almost no say in decision making. For instance, the government and senior RCC management still make all decisions about development goals, business strategy, and operating mechanisms without reference to the RCC members or organizations elected by members. RCCs are effectively government-owned and government-managed organizations. Given this, it is impossible to guarantee the rights of shareholders to make independent decisions about directors, large investments, profit distribution, and so forth.

The RCC director is appointed by the director of the county RCC union, and other senior officials are appointed by higher-level government offices

Moreover, the board of directors, the board of supervisors, and the members' conference lack supervision over senior management. At present, the RCCs' candidate directors are not elected by RCC members but are appointed by higher government authorities before member voting. The RCC director is appointed by the director of the county RCC union, and other senior officials are appointed by higher-level government offices. In the end, the qualification of potential managers is inspected by the PBC and their election is a government appointment; the members' election is only a final endorsement. As a result, these managers are not motivated to answer to the board of directors, the shareholders, or the RCC members. Instead, they are accountable to the officials who appoint them. Managers can allocate funds without bearing in mind the risk to the RCC, and some of them do not even consider asset quality. Ultimately, the interests of RCC members are vulnerable and RCC operations are unsustainable.

Rural Cooperative Foundations

In the mid-1980s, local governments established rural cooperative foundations (RCFs), without PBC supervision. Originally, RCFs were established to manage the funds of the dissolved people's commune and the production group, but they soon developed into a sort of "financial institution" that collected deposits and provided loans. The development of the RCFs reflected the great demand for diversified financial services in rural areas. With the commercialization of banks, formal financial institutions in rural areas have transferred to urban areas a large amount of savings and the local government has little say in the use of funds.

The establishment and registration of RCFs required township government approval, but there were few entry criteria

To promote local economy, local governments naturally wish to establish local financial institutions. A rural cooperative foundation is both a nonprofit organization of mutual assistance and a tool of local government. To differentiate themselves from financial institutions, RCFs sell shares instead of collecting deposits, pay dividends instead of interest, and lend only to members instead of providing loans to the public. For some time, the central government encouraged and approved of this practice.

RCFs originated in 1984 in Heilongjiang and Jiangsu provinces, followed by a 5-year reform period that began in 1987. From 1992 to 1995, RCFs expanded rapidly. According to a 1994 report, there were 17,800 RCFs with deposits totaling CNY80 billion, accounting for 10% of total RCC savings. In some provinces, such as Sichuan, RCFs accounted for nearly 40% of the market share in savings, sometimes even dominating the local savings market. By the end of 1996, 21,000 townships and 24,000 villages had RCFs, with total financing of CNY150 billion.

The RCFs expanded rapidly in the early stages because of their innovative features, including an attractive interest rate, public perception of a government guarantee, and their commercial orientation. Because RCFs were not subject to PBC regulations, they could offer high interest rates and attract large amounts of rural savings. In addition, farmers believed that RCFs were public financial institutions with an implicit government guarantee. Finally, the commercial orientation of the RCFs was not set by the Agricultural Bank of China or the RCCs. To a large extent, RCFs served only those who were not accepted by formal financial institutions. To accomplish this, RCFs applied elements of the credit techniques used by RCCs and microfinance institutions, including linking loans with savings, serving only local members, collecting information via intermediaries, charging high lending rates, and using appropriate guaranty measures and peer pressure to ensure loan repayment.

Unfortunately, weak governance structure and a lack of supervision ruined the RCFs' active and innovative elements. RCFs were controlled by township governments that intended to accumulate rural savings for the development of township and village enterprises, which represented a tremendous conflict of interest. The establishment and registration of RCFs required township government approval, but there were few entry criteria. RCFs were outside of financial laws and regulations, and beyond supervision. According to an auditing report, for instance, loans to township and village enterprises in Hebei Province accounted for 38% of total RCF capital by the end of 1998, and 90% of these loans were directed by local government. Most of these loans could not be repaid. In addition, RCF funds were used for local government infrastructure projects such as highways, schools, and hospitals. In some places, the local government even used RCF funds to cover budget deficits. Lack of owner supervision and commercial orientation eventually created serious risks.

The central government was aware of these problems and was concerned about the future of RCFs. In the mid-1990s, the State Council prohibited RCFs from taking deposits and asked the PBC to intervene. In the late 1990s, the first run on RCFs occurred, because some RCFs were unable to return shareholders' funds. The State Council ordered the closure of all RCFs by the end of 1999 and an audit of all RCF accounts. The audit revealed large numbers of nonperforming loans and serious fund abuse by local governments. The closure of RCFs has increased township government debt, and because RCF savings and loans were in many cases transferred to RCCs, the nonperforming loan rate of RCCs also increased.

Strengths of Rural Credit Cooperative Reform Policies

With central and local government policy support, reform has improved RCC operations, development, and organization; lifted their historical burdens; enhanced asset quality and profitability; and improved management.

First, RCCs have experienced rapid operational development and improved performance. By June 2006, RCCs' total asset reached CNY4.15 trillion, including CNY2.54 trillion in loans, CNY3.97 trillion in liabilities (including CNY3.65 trillion in deposits), and CNY180.9 billion in shareholders' rights (including CNY189.8 billion in paid-up capital). At the time, rural financial institutions' outstanding agriculture loans nationwide totaled CNY1.22 trillion—91.4% of total agriculture loans. While promoting effective services such as group loans and microcredit loans to rural households, RCCs under the guidance of the China Banking Regulatory Commission also introduced syndication loans and community loans to strengthen funding support for rural micro- and small-scale enterprises. These products meet the funding demands of various rural entities and promote the full-scale coordinated development of the rural economy.

Reforms include pilots of shareholding and stock cooperative systems as well as establishment of rural commercial banks, rural cooperative banks, and the county/city–based legal person entities

Second, reform has established rural financial institutions through merger and pilot programs and has improved organizational structure and operational mechanisms. Reforms include pilots of shareholding and stock cooperative systems as well as establishment of rural commercial banks, rural cooperative banks, and the county/city–based legal person entities. By March 2009, 25 rural banks had been established, 172 rural cooperative banks had been approved, and 2,001 county/city–based legal person entities had been approved for establishment.

Third, reform has made progress in resolving historical burdens and containing risks through policy support. At the end of 2005, for instance, inflation-linked fiscal subsidies and discounts totaled CNY6.9 billion, and business and income tax reductions and exemptions reached CNY13.4 billion. In 2006, the reduction and exemption for RCCs was extended for another 3 years, indicating the central government's upgraded support for RCCs. Moreover, by the end of 2007, the central bank had issued to rural credit cooperatives CNY165.4 billion in special central bank notes, accounting for 99% of the quota. The acceptance of special notes was initiated as of the second quarter of 2006, with a cumulative CNY4.6 billion honored. Local governments supported RCCs through fiscal subsidies, asset donations, nonperforming asset swaps, and the like. Through policy support and their own efforts, RCCs have to a certain extent managed to reduce various risks and historical burdens.

Local governments supported RCCs through fiscal subsidies, asset donations, nonperforming asset swaps, and the like

Fourth, reform has resulted in major enhancement of RCC asset quality and profitability. By the end of June 2006, the ratio of RCCs' nonperforming loans to total loans was lowered by 24.6 percentage points from the ratio during the initial period of reform. The capital adequacy ratio was 7.72%, an increase of 16.17 percentage points from its formerly negative number; the capital adequacy ratio of rural cooperative banks, based on the standards for RCCs, reached 12.28%; and the capital adequacy ratio of rural commercial banks, based on the standards for commercial banks, reached 8.7%.

Fifth, RCC reform has transferred operations and risk management to provincial governments, resulting in improved management. By the end of 2005, provincial rural credit unions had been successfully established in 25 provinces, regions, and cities across the country.

The improved financial position of RCCs in recent years is mainly attributable to government policy support. The pilot program called for historical burdens to be shared among the central government, local governments, and RCCs. The central government provided fiscal, tax revenue, and central bank funds, and local governments helped the RCCs recover nonperforming loans, in addition to providing funds, swapping quality assets, and providing subsidies. Overall, these supporting policies have been successfully implemented, although the improvement in the RCCs' financial position has been short-lived due to RCC governance structure and risk-control mechanisms.

Even so, this round of reform has improved the RCCs' financial performance by resolving many historical burdens and putting RCCs on an equal footing with other financial institutions. This enables evaluation of the market value of RCCs. In addition, shareholding reform added investment shares to strengthen the capital base of RCCs. This has enhanced the RCCs' risk management capability, defined shareholders' rights, and laid a foundation for RCCs to take independent civic responsibility. Finally, the establishment of provincial rural credit unions was important in clarifying RCC supervision and management, improving regulation, and enhancing the operations of grassroots RCCs.

The pilot reform of RCCs in eight provinces, which began in the second half of 2003, was a milestone in finance sector reform and an important experiment in amending the serious mismatch between finance sector and nonfinance sector reform over the past 2 decades. It incorporated a lesson from enterprise reform, which is to let local governments and financial institutions, rather than the central government, take the initiative. This innovative approach has significant implications for future rural financial reform and development in the PRC.

Rural Credit Cooperative Reform Policy Issues

Like the progressive reform in other sectors, this round of RCC reform needs improvement. First, decision makers intended to use one successful model during the pilot reform process, neglecting the need for diversification. That is, the success of RCCs means the success of the reform. Second, although RCC pilot reform followed enterprise reform in letting local governments and financial institutions lead the way, it failed to heed the main lesson: first open the market, then establish private firms and introduce foreign funds to increase competition. The key to the successful reform of state-owned enterprises in the PRC, for example, was to maintain control of large enterprises while releasing small ones. Successful township and village enterprise reform was accomplished through systemic restructuring that let managers own relatively large numbers of shares. In contrast, the current ownership of RCCs is overly diverse, with a high cost proxy and low shareholder control over operations and management. This resembles the situation during the early stages of the reform of state-owned and township and village enterprises, which emphasized employee ownership; these enterprises subsequently underwent a second and even a third round of restructuring.

Third, although the RCCs have increased their capital adequacy ratio and many have turned a profit, this has hidden some RCC problems. For instance, the enhanced capital adequacy ratio was garnered mainly by transforming deposits into shares, by compulsory withholding of shares upon loan obtainment, and through government promises of dividends and subsidies. Increasing shares by such means separates equity reform from the governance structure. In addition, high shareholder returns came from the interest of depositors, and in essence, deposits were used to pay dividends. In the end, such loopholes became larger and larger, systemic risks emerged, and the central bank was forced to intervene once again.

Fourth, the lack of an exit mechanism for RCCs means that regulatory authorities must focus on breaches of rules and regulations but not on closure or liquidation. Moreover, provincial rural credit unions can interfere with RCC operations by using management appointment rights. As a result, RCCs are not forced to bear the consequences of any improper operations, and large numbers of nonperforming loans will have to be borne by the state.

The key to the successful reform of state-owned enterprises in the PRC, for example, was to maintain control of large enterprises while releasing small ones

Fifth, RCC market discipline is yet to be established. In the course of this round of RCC reform, the formation of uniform legal persons at the county level and the compulsory membership in the provincial rural credit unions have reinforced the RCCs' monopolistic status in rural financial markets. RCC reform initiated by the government rather than by RCCs themselves is doomed to fail.

Evaluation of Rural Credit Cooperative Reform Policy

The RCC pilot programs of the past 2 decades were important experiments in correcting the serious mismatch between rural realities and finance sector reform and development. The main objectives of the reforms were to encourage financial innovations that suit local economic conditions and to establish a modern rural financial system capable of meeting the financial demands of localities, industries, and households of varying income levels. Different economic and market structures across regions of the PRC have resulted in a variety of demands for financial services. In the eastern regions, demand for rural finance comes mainly from the nonagriculture sector, whereas in the central regions it comes from aquaculture. In the western regions, most financial demand is to protect livelihoods, a need generated by uncertainties in agricultural production. The *sannong* issues also vary from region to region. In the east, the focus is on the issue of integrating rural with urban areas, whereas the central region has more agricultural issues and the western region focuses on farmers.

County RCC unions (the managers) need to expand their capital bases to meet capital adequacy requirements but they do not need to report to their shareholders

One of the keys to successful RCC reform lies in eliminating the RCC monopoly in rural financial markets. Monopolies, a by-product of the planned economy, are by nature rigid in the face of changing demand and must be abolished to establish an efficient and sustainable market with a variety of useful products. Rural credit cooperatives must use different approaches in different provinces, and financial institutions or service providers should be suited to local socioeconomic and geographical conditions.

Therefore, in a sense, one key indicator for evaluating RCC reform is whether the reform introduces competition and establishes a diversified, effective, and sustainable rural financial system. However, RCCs still suffer from moral hazards, high costs, nationalized risk, lack of efficient mechanisms to activate idle capital and attract investors, diverse financial demand in rural areas, and lack of shareholder control over reforms.

In the present system, the relation between RCC managers and shareholders creates moral hazards. County RCC unions (the managers) need to expand their capital bases to meet capital adequacy requirements but they do not need to report to their shareholders. In addition, each provincial RCC union has the right to appoint the director of a county RCC union (one director per county) but is not responsible for the county RCC union's performance. Finally, the shareholders, deprived of their rights as principals, want to pursue high short-term returns with minimal risk.

Although some RCCs have expanded their capital bases and have introduced membership and investment shares, the directors of RCCs and county RCC unions still are appointed by the regulatory authorities. The shareholders do not have the right to appoint senior management, and the shareholders' meeting and the supervisory board remain rubber stamps. The asymmetry between shareholders' rights and responsibilities has created stocks of time deposits with high interest rates, and the main objectives of the shareholders are convenient borrowing and preferential interest rates.

The RCC pilot programs seem to have emphasized the merging and renaming of institutions but have ignored much-needed systemic reforms. When one RCC director was asked to describe the differences before and after reform, for example, he replied that the two-level legal entity system had become a unified legal entity at the county level, and that the regulator had changed from the PBC to the provincial RCC union, changes that are more cosmetic than substantive. The pilot programs have not addressed operational issues such as incentives, supervision, or RCC exit mechanisms. The moral hazard problem has not been resolved and RCCs still use credit support for *sannong* as an excuse for their losses. This deviates from the stated objectives of the pilot programs.

An additional moral hazard is that much of the PBC's lending is used to benefit RCC employees before it benefits *sannong*, but rural financial reform cannot be limited to safeguarding the interests of RCC employees. In many areas of Guizhou, for example, the average annual expense for an RCC employee is CNY60,000 to CNY80,000, higher than the expenses of employees in the eastern region, indicating that preferential policies and PBC onlending have failed to achieve their intended objectives of assisting *sannong*. Without a proper governance structure, RCC development cannot go hand in hand with support for *sannong*.

Ultimately, the RCC model is still the only model in operation, RCCs maintain a monopoly in the market, and their operational environments remain the same. The pilot programs followed a top-down approach that is not in line with the guiding principles advocated by the State Council, and this round of reform is therefore no different from previous ones. The RCC system and staff are the same, there has been no change in mechanisms or human resources, and moral hazards remain unaddressed.

An additional issue is that support for agriculture is costly and unsustainable. RCCs' organizational structure and weak corporate governance have resulted in high average costs per employee, a high nonperforming loan ratio, and low rural household coverage, making RCC operations too costly for poverty-stricken areas. Many nonperforming loans are the result of moral hazards, government intervention, or the risks inherent in agricultural production. Due to lack of information, moreover, it is difficult to discern whether nonperforming loans are the result of operational or human factors. In fact, loans intended to support agriculture have become an excuse for moral hazard. Although RCCs cannot avoid losses caused by natural calamities, loan officers do not take responsibility for rural household loans, and RCCs are not responsible for risks associated with natural disasters. More importantly, no one seems to be concerned about the RCCs' huge number of nonperforming loans. Credit support for *sannong* requires a new approach based on efficiency and market-based support.

The pilot programs followed a top-down approach that is not in line with the guiding principles advocated by the State Council, and this round of reform is therefore no different from previous ones

A third issue is that RCC losses ultimately are borne by the central government and become public debt. The rural areas of Guizhou, for example, suffer from inadequate social security or cooperative medical systems. As a result, many RCC loans are used for medical treatment, which should have been a fiscal expenditure, and losses are inevitable when RCC funds are used as public finance. In addition, the government is under heavy pressure to develop the local economy, but a large portion of government finance goes to civil servants' salaries. Because RCCs are the only financial institutions under its influence, the local government will naturally instruct RCCs to use their funds at the government's discretion. When the local supply of funds is insufficient, PBC onlending becomes the sole funding source and the central government must bear the subsequent nationalized risks.

Fourth, the major problem of many RCCs is not a shortage of funds but a lack of efficient mechanisms to activate idle capital and attract investors. The focus of RCC pilot programs is funding, and all efforts are centered on the special 2-year PBC notes. However, outstanding PBC onlending to RCCs in Guizhou, for example, was CNY2.4 billion at the end of July 2004, whereas funding for the pilot programs was less than CNY800 million. If the vast amount of PBC onlending cannot resolve RCC issues, it is difficult to believe that a PBC contribution of one-third that amount can make much difference.

The uniform approach to establishing county and provincial RCC unions may be convenient for RCC management, but it concentrates risks on the RCC unions and stifles competition

In our field interviews with RCC directors, we asked two questions. First, we asked whether the directors would operate their RCC in the same way if they owned it. We also asked whether the directors believed they could make money as the owner of an RCC. The answers to the first question were all negative; directors would not operate an RCC in the present fashion. On the other hand, directors responded positively to the second question, believing that they could make money as the owner of an RCC. This indicates that, in the view of RCC directors, many RCCs are not short of funds but simply lack effective mechanisms to become sustainable. This round of pilot programs should have prioritized the establishment of an efficient mechanism to attract capital and a sustainable mechanism to retain capital.

A fifth problem is that the arrangement of provincial RCC unions can barely meet diversified rural demand. The uniform approach to establishing county and provincial RCC unions may be convenient for RCC management, but it concentrates risks on the RCC unions and stifles competition. If the central government required provincial governments to shoulder the risks inherent in reforms, a relatively poor province such as Guizhou might be unable to do so.

The provincial RCC union system includes numerous weaknesses. First, the system mixes supervision with regulation. Regulators bear no risk and managers have no one to blame. Second, provincial RCC unions may be suitable for some provinces but not for others. Areas may differ in their level of economic development and their financial demands, and one provincial RCC union policy may not be suitable for all. Third, the provincial RCC union arrangement is likely to inhibit financial innovation because county RCC union operations must follow the directives of the provincial RCC union but some such directives may neglect local financial demands. Moreover, all RCCs have to become members of the provincial RCC union, which constitutes a de facto monopoly and precludes any outside competition. Monopoly is the natural enemy of financial innovation.

A final hindrance to RCC reform is that shareholders currently do not select the reform mechanisms. The pilot program and local innovation are restricted if decisions about the pilot model are delegated to provincial governments. Such a decision-making structure makes it difficult to avoid retracing the path followed during previous reform attempts.

Resolving the issue of who determines a new mechanism requires transforming the role of government. Instead of directing RCC reform models, provincial governments should design a new mechanism that is adaptive, flexible, and self-correcting according to laws and regulations. In other words, the duties of the government are to set the principles that will allow RCCs to operate and innovate on a market basis according to local situations. All types of RCCs and investors should be allowed to make decisions about merging and restructuring. RCCs should decide for themselves whether to join county RCC unions, to be independent, to form another alliance, or even to form a rural commercial bank. Potential investors also should be allowed to form new financial institutions. This will enable effective competition among financial institutions and will enable farmers to find reliable institutions for financial services.

CHAPTER 7

Microfinance

Microfinance—a type of sustainable financing for low-income and vulnerable populations—originated in Bangladesh in the 1970s. It began with small loans made to farmers with no collateral and in the 1980s began to serve small enterprises. Later microfinance has aimed at sustainability and coverage, incorporating diversified models that integrate microfinance into the financial system, and has expanded over the past 30 years to become an effective means of poverty alleviation in many developing countries of Africa, Asia, and Latin America.

The rapid development of microfinance is a reflection of the finance-for-the-poor approach. The impoverished once were regarded as unworthy of credit and were not served by commercial banks because of high operational costs and risks. To remedy this situation, governments in developing countries and international development institutions have supported the creation of specialized policy financial institutions that provide low-interest agriculture and poverty reduction loans. However, most of these institutions have not achieved the desired poverty alleviation due to problems with guiding principles, policy design, and executing agencies as well as a lack of attention to deposit taking.

The emergence of microfinance introduced a market mechanism and overturned the traditional model of government-subsidized loans to impoverished households. Microfinance has demonstrated tremendous advantages over the traditional approach, including a high loan repayment rate—successful microfinance projects boast a repayment rate of over 90%. In addition, 100% of microfinance loans reach rural households and target vulnerable groups such as poor women, supplementing and improving the existing financial service system. As an effective poverty alleviation measure, microfinance projects worldwide are striving to deliver financial services to poor populations that used to be deprived of such services.

There are many microfinance institutions (MFIs). Among them, Bank Rakyat Indonesia–Unit Desa (BRI-UD), BancoSol in Bolivia, and Grameen Bank in Bangladesh are well known. In addition to financial institutions, microfinance agencies include nongovernment organizations, community organizations, government agencies, and international organizations.

The history of financial markets has demonstrated the tremendous market potential of low-income populations and small enterprises. If operational cost and financial risk can be reduced, MFIs can extend services to the poor while maintaining operations and returns. Microfinance can support the start-up of small enterprises and provide them with long-term services. Moreover, deposit services can help the poor to increase their savings, and loan services can help low-income borrowers improve production and incomes. Microfinance mainly targets the poor with work abilities, who will invest in a small business, small-scale trade, or production, smoothing consumption. MFIs may provide long-term agriculture loans to diversify their portfolios, but the proportion of such loans should be small. Moreover, the destitute and handicapped, who lack repayment ability, should receive public aid rather than microfinance loans.

Diversified Microfinance Development Model

Microfinance originated from informal financial service providers, and microfinance projects are linked to banks in two ways. First, small-scale credit projects gradually grow into independent institutions and then into formal financial institutions such as BancoSol or Grameen Bank. Alternately, national commercial banks may introduce microfinance projects, expand services to low- and middle-income clients, and then set up specialized, market-oriented microfinance arms. Some examples of this are the Agricultural Bank of Mongolia, BRI-UD, and the European Bank for Reconstruction and Development. Recently created specialized MFIs have performed well and covered 92 million clients as of 2005.

Microfinance can support the start-up of small enterprises and provide them with long-term services

Diversified microfinance models address different economic development stages in different countries and serve clients with diverse social and cultural backgrounds. Models include the nongovernment organization model, the financial institution model, or some combination of the two; the cooperative or village bank model; or a state-funded model. Despite their different approaches, however, microfinance models share similar targets and offer similar services. The aim is to provide sustainable services to low-income populations and to help alleviate poverty.

Grameen Bank is a good example of the nongoverment organization model. Established in 1976, Grameen Bank was converted into an independent bank with government support in the 1980s. By the end of 2007, Grameen Bank had 2,481 offices and a staff of 12,000. The bank covered 7.41 million members, with a cumulative loan distribution of about CNY45.7 million. The annual loan interest rate was 8.5% to 12%, the loan repayment ratio stood at 99%, and the declared dividend rate stood at 20%.
To shake off the negative image of dependence on subsidy, Grameen Bank stopped receiving government and international funding support in 1998.

To meet increased client demand and to remain competitive, the bank began lending to small and medium-sized enterprises. Grameen Bank emphasizes the development of group-based farmers' organizations, requesting that poor people with similar social and economic status in the same community form loan groups on a voluntary basis. In this way, the poor can help each other to choose projects, monitor project implementation, and assume repayment duties for each other. Building on the loan groups, centers for financial and skills training were established. The centers also offer small short-term loans without collateral; clients are required to make installment payments and to attend center activities regularly. Grameen Bank provides ongoing loans to disciplined farmers who make timely payments.

South Africa's Khula Enterprise Finance, founded in 1996, is a microfinance institution for small and medium-sized enterprises. Khula is a public limited liability company, established and registered with the Government of South Africa, and has its own council. Its initial capital was from a local government and its follow-up capital comes from the Government of South Africa, the Ford Foundation, the United Nations Development Programme (UNDP), and international organizations from Canada and Europe.

Khula, which accounts for 90% of financial institutions' microfinance loans in South Africa, does not lend directly to small enterprises but rather operates through a network of nearly 20 retail financial intermediaries. Retail financial intermediaries issue loans ranging from approximately CNY140 to approximately CNY8,200 at an annual interest rate of 40% to 60%. Retailers must have more than 50 active clients and about 25 clients per loan officer, must be financially independent, must have a loan repayment rate of at least 50%, must be able to borrow and to attract new clients, must reach financial sustainability within 5 years, and must make loans under CNY8,200. Retailers meeting these requirements can obtain CNY68,000 to CNY13.7 million at an annual interest rate of 14%.

Bank Rakyat Indonesia–Unit Desa is an example of the financial institution model. BRI-UD has regional subsidiaries that function as independent operational units to determine loan scale, term, collateral, issuance, and repayment. Each unit has an incentive system, with 10% of annual profits distributed among employees during the following year. BRI-UD uses high interest rates to achieve financial sustainability, and the commercial lending rate of 32% per annum is applied to cover costs. If borrowers repay on time for 6 months, 5% of the principal is returned each month as a bonus. The interest rate on savings varies by amount deposited, with larger deposits paying higher interest. This policy helps BRI-UD to attract idle funds from around 3.3 million farmers in the rural areas of Indonesia, making savings the institution's main funding source. In addition, BRI-UD clearly separates social from commercial functions. For example, it does not involve itself with farmers' training and education.

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A community cooperative bank, or credit union, is a democratic, nonprofit financial cooperative administered by specific groups, institutions, or organizations and owned and run by all community members. Each member is entitled to one vote in selecting the head of the cooperative.

The idea of the village bank was established by the Foundation for International Community Assistance. Village banks are democratically managed and their main product is market-interest-rate loans.

The difference between a village bank and a community cooperative bank is in the voting; village banks allow individual members more than one vote, generally determined by the number of shares held. The village bank is a self-administered group of 10 to 50 members, with group meetings every week or every 2 weeks. The group provides its members with small self-employment loans to establish or enlarge businesses, in addition to savings initiatives and a system to provide mutual support and promote independence. Members of the village bank can vouch for each other and the group employs democratic decision making.

The Palli Karma-Sahayak Foundation (PKSF) is a well-regarded state-run wholesale microfinance institution. It was founded by the Government of Bangladesh to collectively manage donor agency and government funds and to promote MFI sustainability. Established in 1990, the PKSF was registered as a nonprofit shareholding company with CNY1.16 billion in capital raised from domestic and foreign grants and international financial organizations. Its board of directors comprises seven independent social elites; the chairperson and two of the members are recommended by the government. The PKSF provides capacity-building support and wholesale microfinance loans to qualified agencies. By the end of 2003, the PKSF had 189 cooperating agencies and had issued CNY1.13 billion in microfinance loans, covering more than 2 million poor farmers. The PKSF supervises its cooperating agencies through on-site surveys, audits, and review of financial statements, and it helps agencies set up long-term development programs.

The group provides its members with small self-employment loans to establish or enlarge businesses, in addition to savings initiatives and a system to provide mutual support and promote independence

Lessons of Microfinance

Commercially viable MFIs require sustainable projects and a useful degree of coverage of the project's target clientele. Sustainability means that project earnings can cover operational costs, funding costs, loan losses, inflation-related asset value reductions, and project expansion. Moreover, only services that meet the needs of clients can be considered sustainable, and sustainability can only be achieved through financial innovation. That is, a mechanism is needed to reduce financial risk and operating cost, to ensure high loan repayment rates, and to cover costs and risks through loan interest.

Successful MFIs adopt various financial innovations to sustain expansion of the financial market for the poor. Many MFIs reduce loan risk through a set of risk management instruments, including loan amounts as low as CNY340; short loan terms of around 3 to 12 months; increased loan quotas for those with a record of timely repayment; security deposits proportional to the amount of the loan; periodic group meetings; delinquency penalties, such as fees or refusal of a higher credit line; borrower education; and risk-based interest rates. Loan evaluation considers factors such as the applicant's assets and credit rating and the projected cash flow of the proposed project. Loans may be issued to individuals, groups, village agents, or subsidiary credit institutions. Financial products are usually flexible enough to meet the needs of both borrowers and depositors.

The main constraint on poor clients' access to credit from financial institutions is a lack of collateral such as land or houses. Microfinance loans deal with these issues in a nontraditional way. MFIs rely on alternatives to collateral, the most common of which is social guaranty. This practice is widely used for group guaranty loans, in which the group assumes the repayment responsibilities of group members. Groups normally comprise five to eight members who supervise and guaranty loans for each other. The gradual increase of loan quotas is another substitute for collateral. Timely repayment is encouraged through the promise of a larger loan during the next loan period. In addition, microfinance loans aimed at low-income clients often adopt direct guaranty or a combination of direct and group guaranty. Some MFIs also accept movable assets as collateral.

MFIs employ several supervisory models, including supervision by bank regulatory authorities, stand-alone institutions, industry associations, apex institutions, or rating agencies; or management by organizers. There still is no common understanding about whether supervision is needed, at which stage MFIs should be supervised, or how to supervise them. In fact, no bank supervision institution in any country has enough staff, funds, and skill to supervise all MFIs, and some even have no interest in carrying out such supervision. It is generally believed that if MFIs do not absorb deposits, they cannot cause systemic risks and do not need prudential supervision.

Authorities should not establish a supervisory mechanism that might fail to function due to lack of resources, skill, or political or other will. In particular, when MFIs have both financial and social missions, there often is a conflict between the two that prevents supervisors from setting appropriate standards or taking prompt corrective action. Due to concerns about systemic risk, some countries have set up basic criteria requiring a certain period of profitable operation and a proven ability to meet future commercial funding costs before nongovernment MFIs can make use of commercial funds to carry out microfinance loans.

Development and Innovation of Microfinance in the People's Republic of China

In 1993, the Institute of Rural Development of the Chinese Academy of Social Sciences introduced the Grameen Bank model to the PRC and initiated poverty alleviation cooperatives in Danfeng County, Shaanxi; Yi County, Hebei; and Yucheng and Nanzhao counties, Henan. In 1995, the United Nations Development Programme (UNDP) and the International Economic Technology Exchange Center in the PRC began developing poverty alleviation microfinance projects in 48 counties across 17 provinces. Later, UNDP established urban microfinance projects targeting laid-off employees in Tianjin and several cities in Henan Province.

It is generally believed that if MFIs do not absorb deposits, they cannot cause systemic risks and do not need prudential supervision

Early microfinance participants in the PRC included multilateral donor agencies under the supervision of the European Union, the International Fund for Agricultural Development, the United Nations, and the World Bank; bilateral institutions such as the Australian Agency for International Development, the Canadian International Development Agency, and the Holland Development Fund; and international and domestic nongovernment organizations such as the poverty alleviation funds and county poverty alleviation cooperatives set up by the Chinese Academy of Social Sciences, which also receive international and domestic donor support.

The most important donor agencies are the Australian Agency for International Development, the International Fund for Agricultural Development, UNDP, and the United Nations Population Fund. Moreover, International Fund for Agricultural Development projects in the PRC usually are regarded as agriculture development projects because they are implemented by county government agencies, which are responsible for loan repayment. Loans are issued and repaid through county, village, and rural autonomous agencies, and they feature low interest rates and long terms, which differs from microfinance in general.

Loan conditions include joining groups, attending center meetings, and participating in group guaranty

Over more than 10 years, the main nongovernment microfinance institutions in the PRC have included those sponsored by UNDP and managed by the Communication Center of the Ministry of Commerce; the poverty alleviation associations and poverty alleviation funds; and the Rural Development Association, Sichuan Province. Most microfinance projects in the PRC are sponsored by international institutions such as UNDP and the United Nations Children's Fund (UNICEF) rather than by domestic agencies.

Most microfinance institutions in the PRC are located in the southwestern regions (52%), followed by the northeastern regions (25.4%), the central regions (10.4%), and the northern regions (6%). Such distribution reflects the MFIs' poverty reduction objectives and projects. The MFIs' supporting institutions, whether registered as communities or as affiliations, are nonprofit. In general, financial and institutional sustainability targets are clarified after the transformation of projects into institutions.

Microfinance projects and institutions in the PRC mainly target poverty alleviation and assistance for women and children. More than 80% of projects are in poor counties, with many in the mountainous areas. In a survey of 44 counties, 21 projects were located in the poorest townships, 16 were located in less-developed townships, and 7 were in townships of average development. This implies that almost all projects were for poverty reduction rather than for development, and it is unknown how long such projects will last.

The small loan amounts also reflect an emphasis on poverty alleviation. In the early stages, 42 of the 44 project counties required that borrowers be poor. By 2005, the number of counties without such requirements had increased to eight, and among these, six counties clearly stipulated that borrowers should not be poor. With the exception of a few counties, most projects required that borrowers be employable.

Well-run nongovernment microfinance institutions in the PRC generally adopt a similar approach to loan conditions, loan issuance, deposit requirements, loan terms and amounts, and interest rates. The basic borrowing unit is the group and community center, with around five people voluntarily forming one group and five to six groups located in one center. Group leaders and center heads are elected by vote. Loan conditions include joining groups, attending center meetings, and participating in group guaranty. No collateral or other guaranty is required.

Loan issuance is provided first to two members, then to two other group members (2 weeks later), and finally to the group leaders. Half of the loan interest is deducted when the loan is issued. When receiving a loan, farmers put 5% of the principal into the group fund. In addition, borrowers deposit CNY1 every week. After the loan is repaid, group funds can be returned.

The loan term usually is 1 year, with repayment made every week or every 2 weeks. The ceiling of the first loan is CNY1,000. After repayment of the first loan, borrowers can borrow up to CNY1,500 or CNY2,000. The nominal interest rate is 8%, although the actual interest rate can be around 16%.

These approaches differ somewhat from those of Grameen Bank in Bangladesh. For example, Grameen Bank provides only group loans whereas microfinance institutions in the PRC provide loans to individual farmers in the group. In addition, Grameen Bank does not return group funds to members whereas PRC microfinance institutions do so after the loan is paid off. Finally, Grameen Bank holds center meetings once a week whereas meetings are held once every 10 days or even every 2 weeks in some PRC projects, and some projects hold no center meeting at all.

Group guaranty plays a major role in credit risk controls and poverty alleviation targets, because the group members' mutual guaranty forms an internal control mechanism. An additional control is the incentive mechanism, which enables continuous loan provision and applications. If all members repay their loans on time, they receive a larger credit quota. Compulsory deposit in the group fund enables MFIs to deduct funds if a borrower cannot repay the loan. Installments also can offer an efficient method of risk management. The main role of the center meeting is to ensure transparent loan issuance and repayment, so that borrowers and loan officers can effectively monitor the loan process.

International Microfinance Donor Agencies

Microfinance in the PRC is supported and promoted by international donor agencies, especially multilateral and bilateral institutions, which employ various approaches and instruments. Donor agency supports include institutional setup and project upgrading, such as microfinance projects, nongovernment MFI projects, village and community funds, and commercial microcredit companies. Agencies also provide support in the form of MFI transformation, decentralization of financial products and services, and market and service expansion. Supporting instruments include low-interest loans, provision of loan capital, equity investment, and technical support.

Agencies also provide support in the form of MFI transformation, decentralization of financial products and services, and market and service expansion

In addition, some international donor agencies are preparing to support the PRC's new microfinance institutions and projects in new ways and with different instruments. In 2005, the PBC began to promote commercially oriented pilot microcredit companies in five provinces. These have garnered equity and technical support from the International Finance Corporation and KfW Bankengruppe as well as technical support from Germany's GTZ. The Asian Development Bank supported the preparation of bidding documents and invitations in Guizhou Province and Inner Mongolia Autonomous Region. KfW Bankengruppe provided low-interest loans and technical assistance to support the transformation of nongovernment MFIs in Chifeng, Inner Mongolia Autonomous Region. UNDP also is considering support for the transformation of microfinance institutions in Chifeng City, Inner Mongolia Autonomous Region, and in Xingren County, Guizhou Province.

Donor focus is shifting from poverty alleviation and social targets to sustainability. As a result, donors are more focused on microcredit companies than on nongovernment MFIs, and on grassroots services and financial products. The means of support also have changed—from funding and refinancing to equity investment or simple technical assistance. Donors such as the Asian Development Bank, GTZ, the International Finance Corporation, KfW Bankengruppe, and the World Bank have become the main sponsoring institutions. In terms of microcredit for poverty alleviation, the focus is on community funds. For example, the World Bank recently sponsored village projects initiated by the Ministry of Finance and the Poverty Reduction Office. Finally, commercialization has led to diversified microcredit products such as microinsurance and microremittance. Various supporting measures, including MFI credit ratings, credit scoring, and computer systems, also have augmented market diversification.

International donor agencies—especially multilateral and bilateral aid institutions—often cannot decide on project locations or partner agencies

International donor contributions to microfinance in the PRC depend greatly on external factors such as the political environment. Compared with other countries, the environment in the PRC includes more constraints, such as the vague legal status of MFIs, limitations on their scope of services, and restrictions on interest rates and products. International donor agencies—especially multilateral and bilateral aid institutions—often cannot decide on project locations or partner agencies. For example, they must implement projects with local governments but governments may have different objectives. In the 1980s and early 1990s, the concept popular in the PRC was that poverty alleviation microcredit must carry a low interest rate—at least lower than the RCCs' interest rate. This approach, combined with a lack of techniques and technical staff, has negatively affected the sustainability of microcredit institutions.

International donor agencies and microcredit projects and institutions, especially those aimed at both poverty alleviation and sustainability, have contributed significantly to microfinance development in the PRC. They have assisted in the creation of nongovernment MFIs, transforming projects into institutions independent of local government, which has formed the basis for future development. The actual interest rate on poverty alleviation microcredit has been raised from between 3% and 5% to between 16% and 17%, transforming the traditional concept of microcredit interest rates. The projects have pioneered poverty alleviation microcredit, proving that farmers and other poor clients can repay loans and that with proper management, credit, projects, and institutional design, MFIs can be sustained in even the most poverty-stricken regions. Projects also have integrated microfinance with social development goals, such as enhancing women's status, improving farmers' health, training farmers, and promoting agricultural technologies. Finally, international donor assistance has provided experiences and lessons applicable to PBC pilots in five provinces and to other commercially oriented microcredit projects.

Reasons for the Slow Development of Microfinance

As of this writing, there are around 300 nongovernment microfinance institutions and projects in the PRC. Larger institutions and projects have covered about 5,000 households whereas smaller ones cover fewer than 1,000 households. Of the 300 MFIs and projects, fewer than 20% can operate properly and few are financially sustainable. Many MFIs face serious challenges caused by shrinking equity. Without additional external funding and fundamental reform of the microfinance institutions themselves, most of the existing nongovernment MFIs would face difficulties and would perhaps close down within 3 to 4 years.

There are many reasons for the slow development of nongovernment MFIs, beginning with the lack of an enabling policy environment for microcredit in the PRC. All countries with well-developed microfinance have long-term programs that include clear legal status for MFIs, which allows these institutions to expand even into deposit taking, and a supervisory framework of nonprudential supervision or registration (for MFIs that do not take deposits) and prudential regulation (for MFIs that do). In addition, these governments support MFIs with credits such as a wholesale fund.

In the PRC, by contrast, the legal status of microfinance institutions remains unclear. Nongovernment MFIs are registered as social groups or non-enterprises, legally unable to provide loans or engage in other financial activities or to transform themselves into microcredit companies or financial institutions. Only the poverty alleviation associations and the UNDP pilot program have obtained approval from the PBC and the Poverty Reduction Office. Although more than 15 years have passed since the initial pilots, nongovernment MFIs remain pilot programs without explicit evaluation standards. Moreover, the requirement that MFIs' lending rate remain within four times of the benchmark interest rate has impeded the commercialization of MFI lending.

A second constraint on MFI development lies in their structure and staffing. Other countries have some successful nongovernment MFIs, such as the Association for Social Advancement in Bangladesh, and not all nongovernment MFIs need to be transformed into commercial microcredit or microcredit banks. In contrast, of the 67 PRC microfinance projects and institutions surveyed, 41 are independent institutions. Among the independent institutions, only 31 are civil entities, independent of local governments; the others are project offices, which are difficult to sustain.

Only the poverty alleviation associations and the UNDP pilot program have obtained approval from the PBC and the Poverty Reduction Office

However, even the independent nongovernment MFIs are vastly different from MFIs in other countries. Most of the microfinance institutions in the PRC are dependent on local governments—mainly county and district government agencies such as the Agricultural Department, the General Office, the Poverty Reduction Office, or the Women's Union—because nongovernment organizations are required to be affiliated with a local government department or have some other affiliation. More importantly, the management staff of county and district nongovernment organizations must be civil servants in local government, appointed and paid by local government agencies. Such employees generally are unwilling to give up such posts for microcredit positions, and in the case of a microcredit institution failure, managerial staff can simply go back to their original government agency. In addition, the council directors often are local government magistrates, leaders of the Women's Union, or other government officers, even though the council is the nominal decision maker for the MFI. Thus, MFI leadership answers to governments rather than to the institution. Under such circumstances, it is impossible to set up an incentive mechanism for managerial staff, which is critical to the development of MFIs.

The dependence of MFIs on local government is closely related to the ownership of the microcredit funds. In the PRC, the major funding source for nongovernment MFIs has been international grants to the government or to the local poor, but local governments can control MFIs by controlling their managerial staff, their councils, and their funding.

The difficulties of nongovernment MFIs also are related to issues with formal finance in the PRC

Nongovernment MFIs also rely on government because most are not sustainable. Salaries and expenditures mostly depend on government funding, and MFI performance is linked to local government agencies, though their goals are not necessarily the same. Changes in government officials and management can affect MFIs, and local government agencies sometimes interfere with MFI loans.

Third, development of nongovernment MFIs is hindered because MFI loans mainly follow the Grameen Bank model, without considering local and institutional differences. The PRC is not Bangladesh. The geography, economic development, religion, and culture of its various regions are drastically different, and one model cannot suit them all. In addition, many pilot MFIs and projects do not take financial sustainability into account, and after the institution or project is designed, little further change is made.

Under the village bank model, offices are set up in counties, branches are set up in townships, and credit officers are located in villages. This three-level operational approach increases the loan cost of MFIs relative to their funding scale, which weakens their financial sustainability. In addition, microfinance institutions in the PRC transform group loans into group-guarantied individual loans, but this does not transfer costs from MFIs to borrowers and is therefore unsuccessful. Lowering the salaries of credit officer could reduce costs but would also reduce incentive.

Fourth, microfinance is growing slowly because the main sources of nongovernment funding for poverty alleviation are donations, especially international donations. Donor organizations, in turn, determine MFI management, operations, models, and projects. Since the mid-1990s, donor agencies have aimed mainly at poverty alleviation and social development and have spread projects across the poorest regions without considering sustainability. Furthermore, most projects have no subsequent capital arrangements and find it difficult to obtain additional investment in case of financial difficulty.

The difficulties of nongovernment MFIs also are related to issues with formal finance in the PRC. Existing rural financial institutions are difficult to sustain because loan interest rates cannot cover funding costs, operational expenditures, bad loans, and development. The low interest rate on poverty alleviation loans in poor regions and on RCC microcredit also affects the survival and sustainability of MFIs. Meanwhile, supervisory agencies are unwilling to open rural financial markets due to the lack of exit mechanisms.

Finally, the microfinance industry suffers from a lack of intermediaries. At present, the PRC has no rating agencies to increase MFI transparency, no microfinance consulting or training companies, and no registered microfinance industry associations or wholesale institutions such as the Palli Karma-Sahayak Foundation in Bangladesh. The lack of MFI intermediaries is closely related to the lack of explicit legal status for microcredit and the lack of sustainable retail MFIs.

Managers, credit officers, and other non-government MFI staff have made great efforts to develop microfinance in the PRC. Many constraints are beyond their control and they, too, are victims of unsound MFIs and projects. Indeed, many staff members and credit officers have lost other opportunities because they went to work in the microfinance industry. When we reconsider microfinance in the PRC, therefore, we should not repeat the same mistakes.

A New Phase of Microfinance Development

In recent years, the central government has gradually realized that opening the rural financial market is the key to rural finance. Because financial institutions lend mostly to large cities, enterprises, and projects, there has been less financial service for agriculture, farmers, and rural areas *(sannong)*. Microfinance can play an important role in increasing credit access for farmers and rural enterprises. All three of the central government's number one circulars from 2004 to 2006 emphasized the program for deepening rural finance reform and supporting microcredit, and central government support has opened a new phase of microfinance in the PRC. During this phase, the guiding principle is to shift the focus away from poverty alleviation and social development and to focus on the integration of poverty alleviation with development of microenterprises and sustainable MFIs.

The new phase has several milestones, the most important of which is support from the central government and promotion by the PBC. The second milestone is the attention of relevant ministries and international donors to extending the financial products and services of existing financial institutions, especially urban commercial banks, to microenterprises, mini-enterprises, and the low-income population. The third milestone is the emphasis on rural and community funds, mainly the village funds, and on integrating financial services with other services to poor farmers. The fourth milestone was the China Banking Regulatory Commission's December 2006 Provisional Regulation on Lending Companies and Provisional Regulation on Village Banks, which approved pilot lending companies and village banks in four provinces and cities. Although no implementation rules were put in place, these measures are important for clarifying the legal status of MFIs and enabling their development in the PRC.

The new phase has several milestones, the most important of which is support from the central government and promotion by the PBC

Since 2004, the PBC has actively promoted pilot non-deposit-taking microcredit companies. Wu Xiaoling, the PBC's former deputy governor, pointed out that the PRC has a large amount of private funds waiting to enter the financial market. Microcredit companies fit both the demands of private funders and the requirements of prudent regulators.

Yi Gang, the PBC's deputy governor, acknowledged that commercial MFIs are an integral part of the rural financial framework because this type of institution represents an innovation in the social objectives and commercial sustainability requirements of rural financial institutions.

This is a prudent time to open the PRC's rural financial market to private capital. With the support of the China Banking Regulatory Commission and the PBC, such pilots started in five provinces and autonomous regions: Erdos, Inner Mongolia Autonomous Region; Guangyuan, Sichuan; Hu County, Shaanxi; Pingyao County, Shanxi; and Tongren District, Guizhou. In May 2008, the pilot program was expanded nationwide, and by the end of 2008, there were close to 500 microcredit companies. The GTZ and other international organizations actively support these pilots with technical assistance, policy consultation, and capacity building. The International Finance Corporation, KfW Bankengruppe, and other donor agencies also actively seek investors, helping international MFIs join the PRC's microcredit pilots.

Microcredit pilots have drawn on the lessons of nongovernment microcredit and other projects. In contrast to nongovernment MFIs, commercially sustainable microcredit companies have explicit investors and owners, which creates a solid basis for sound governance and prevents moral hazard. As a result, such microcredit companies are in a better position to mitigate any local government interference.

Although the microcredit companies are fairly new, some issues are noteworthy. First, the loan amounts are relatively large because some microcredit companies are not interested in microenterprises or farmers. Second, most microcredit companies adopt traditional instruments and measures, such as collateralized and guarantied loans, with few credit loans. These restrictions have kept their services from microenterprises and the poor, who have no eligible collateral and are unable to provide a guaranty. Third, microcredit company staffs are drawn mainly from formal or informal financial institutions and have little experience with loans to microenterprises or low-income farmers. Finally, microcredit companies have limited transparency and lack information management systems. These issues are inevitable in the initial stage of microcredit company development, but they call for the attention of supervisors and founders so that they can be resolved during the pilot period.

To encourage existing financial institutions to deliver services and products to microenterprises, low-income farmers, and rural residents, the China Banking Regulatory Commission has encouraged commercial bank lending to small and medium-sized enterprises. In addition, the relevant ministries have paid great attention to the development of rural and community funds, including village funds. For example, the Ministry of Finance has conducted pilots in 100 villages and has coordinated with the Poverty Reduction Office to conduct a new round of pilots using World Bank funding. The difficulty is in figuring out how to establish an independent community fund outside of the existing administrative system, because the funds come through government channels. The key to the smooth operation of the village funds is whether farmers are willing to deposit their money, not the amount of money coming from the government. Urgent issues also include the organization of the village funds and the need for registration and supervision.

CHAPTER 8

Informal Finance

Informal finance refers to all for-profit financing activities that are not lawfully provided by financial institutions. Such transactions may occur among individuals, between individuals and enterprises, or among enterprises. Informal finance is widely distributed in developing countries and regions in Africa, Asia, and Latin America as well as in a number of developed countries, especially in immigrant areas. Informal finance arrangements take many forms, but all are integrated with local economies and communities.

Informal financial institutions in developing countries typically include private lenders (including usurers), pawnbrokers, and borrowing and lending among relatives and friends. There also are rotating savings and credit associations, or mutual aid unions, which require that members regularly submit funds, labor, or various kinds of production or assets. Funds gathered in this way are used for special purposes such as tax payments, investment, or holiday expenses. Underground or indigenous banks are for-profit banking institutions that accept deposits and make loans without government authorization. Finally, trade credit is a kind of financing by which loans are made to enterprises that are unable to provide sufficient guaranties to obtain loans from formal financial institutions.

The borrower in informal finance is usually an agricultural products processing enterprise with strong seasonal demands. Such enterprises usually need small loans to purchase agricultural goods during the purchasing season, especially during the autumn, but have difficulty meeting rural credit cooperative (RCC) loan requirements and are considered high risk by formal financial institutions. Informal finance can help these borrowers and thus represents an important supplement to formal finance. At the same time, informal finance can support profitable projects, the success of which can help rural households to become quality clients of RCCs.

In some places, informal finance has even become a major player in rural finance. For example, India has experience in combining formal and informal finance. An average of 10 to 20 rural households form self-organized groups that engage in lending activities through accounts with formal financial institutions. Financial institutions provide loans to the groups according to their credit record, and disbursements are based on a positive incentive principle: the initial amount is small but increases with timely repayments.

In most cases, informal finance is an informal agreement subject to human relationships, conventions, and customs within a region or an organization. Such agreements are not recognized or protected by laws, yet the low information cost, sharp market orientation, and unique systemic arrangements channel funds and enhance efficiency. Regardless of the kind of informal finance operation, loan costs are lower than formal financial institutional costs, and informal finance has information advantages and lower collateral requirements. Informal finance can identify the effective financial demand of rural households, employing informal information gained through local networks. In addition, informal finance can discover substitutes for collateral, including a wide array of social relationships, business ties, and other informal connections, to ensure timely loan repayment.

Informal finance can identify the effective financial demand of rural households, employing informal information gained through local networks

Despite these strengths, however, informal finance is normally not recognized by the traditional financial management system. Some financial institutions treat informal finance providers as competitors and brand them as usurers. In fact, the scarcer the RCC funds and the higher the nonperforming loan ratios in a given area, the more insistent are the efforts to discourage informal financiers.

Informal Finance in the People's Republic of China

Informal finance in China dates back to the 11th century, and informal financial institutions appeared during the Ming Dynasty. Informal finance after 1949 decreased but never ceased entirely. After 1978, the tremendous increase in funding demands boosted informal finance, and by the mid-1980s several regions had experienced serious crises in their informal financial markets.[1] In the 1990s, financial system reform revived informal finance, but 1998 regulations sent informal finance underground.[2]

The characteristics of modern informal finance in the People's Republic of China (PRC) vary by region. In developed regions, it can be a commercial financing organization whereas in less-developed regions it is more of a cooperative. Regardless, informal finance in the PRC presently occupies a legal gray area and its development is restricted. Moreover, because it is not regulated by laws and regulations, its scale can only be surmised through surveys. According to a 2002 report by the International Fund for Agricultural Development, for instance, the rate of informal borrowing among farmers in the PRC was over four times the rate of formal borrowing, and thus carried far more importance for the farmers.[3] Similarly, in 2004, the rural survey team of the National Bureau of Statistics found that most rural households had difficulty obtaining loans from banks and RCCs. From 2000 to 2003, the average farmer's bank loan was CNY65 per year, representing about 25% of their total annual borrowing, whereas the average borrowed from informal sources was CNY190 per year, accounting for the remaining 75% of total annual borrowing.

A Ministry of Agriculture survey of over 20,000 rural households in 31 provinces, cities, and autonomous regions confirmed that rural households in the eastern, central, and western regions of the PRC borrowed more through informal sources than through banks or RCCs. In 2003, the rate of informal borrowing was as high as 72% nationwide, and the main purposes of borrowing were for daily subsistence (48%) and production (38%).

In the beginning of 2005, the Central University of Finance and Economics conducted a nationwide survey of 20 provinces, 82 cities and counties, 206 villages, 110 small and medium-sized enterprises, and 1,203 family businesses. The survey revealed that around one-third of financing for small and medium-sized enterprises in the PRC came from informal financial sources and less than 50% of rural household loans came from formal financial institutions such as banks or RCCs. Loans from informal financial sources accounted for over 55% of total borrowing and amounted to CNY741 billion to CNY816 billion. Moreover, the underdeveloped regions relied more heavily on informal lending sources.[4]

According to the People's Bank of China, informal lending in 2004 amounted to CNY950 billion—approximately 7% of the gross domestic product—and represented about 6% of total loans.[5] The average annual interest rate on informal lending was about 12% but differed significantly from region to region and in different periods. In the more advanced Zhejiang Province, for example, interest rates were sometimes as high as 2% per month, and this has remained stable in recent years.

According to a 2005 report by the All-China Federation of Industry and Commerce, 90.5% of nongovernment enterprise funding came through self-financing. Bank loans accounted for 4% of funding, financing from nonfinancial institutions accounted for 2.6%, and other financing channels accounted for 2.9%. This indicates that nongovernment enterprises, especially small and medium-sized enterprises, rely on informal finance.

Informal Finance in Poverty-Stricken Areas

Informal finance has an information advantage both in screening a borrower's repayment ability and in monitoring a loan. Whether for geographic, occupational, or kinship reasons, all parties in informal credit markets can keep in frequent touch, or the lender can easily obtain information about the borrower. This enables the lender to gauge the possibility of loan repayment and to take timely action if needed.

The average annual interest rate on informal lending was about 12% but differed significantly from region to region and in different periods

Moreover, informal finance's collateral arrangements are suited to local conditions, and items unacceptable as collateral in formal financial markets can be used in informal financial markets. For instance, real estate cannot be used as collateral in formal markets, due to regulations, high management and disposal costs, or the low actual value of the real estate to formal financial institutions. However, parties in informal financial markets are able to circumvent the regulations and minimum value requirements of financial institutions. In addition, frequent contact between the borrowing and lending parties keeps the cost of collateral management and disposal relatively low.

In addition to their credit relationship, informal borrowers and lenders share relationships in other markets, such as the commodity market, and both parties may access information about transactions in these other markets before signing a credit contract. Such external relationships not only provide the lender with information about the borrower's credentials and repayment ability but also serve as a de facto guaranty. It adds to the borrower's cost of breaching contract, enabling the lender to maintain some control over the borrower and strengthening the borrower's motivation to use the loan correctly and fulfill the repayment obligations.

There also is a kind of social guaranty mechanism in informal markets. The borrowing and lending parties in informal financial markets have not only a credit relationship but also social connections. These social connections represent an intangible resource that can provide material and other benefits to the parties involved. Moreover, once these connections are linked with the repayment behavior of the borrower, they will become an intangible guaranty. If the borrower repays his loan in full in a timely fashion, these social connections will be maintained; otherwise, these connections will be destroyed, a loss which may offset any benefit of default. The existence of the social guaranty mechanism gives the lender additional possible sanctions, thus constraining the behavior of the borrower.

Informal Financial Institutions

The operation of informal financial institutions is simple. Contracts are straightforward and practical, without many requirements for the participants. Informal financial institutions are small and flexible, and their various localized innovations reduce transaction costs. Although the organization and operation of informal financial institutions can be time consuming, the opportunity cost in poverty-stricken regions also is relatively low, further reducing transaction cost.

The existence of the social guaranty mechanism gives the lender additional possible sanctions, thus constraining the behavior of the borrower

Despite these advantages, informal financial institutions remain constrained by information and transaction costs, and this has confined their scale and scope. First, there is an inverse relationship between the information advantage of informal finance and its scope of activity. If informal finance wants to realize its information advantage, it must limit its activity and its borrowing and lending must target a limited group of people. Expanding the scope of financial activity weakens the information advantage, which in turn requires informal financial institutions to employ more standardized management techniques and operation mechanisms and better-trained managers and staff, which means higher costs. Because some informal financial activities are restricted or banned, the operational risks also are high.

Comparison of Formal and Informal Finance

The state-owned financial system is an expensive form of financial organization and a luxurious arrangement in the early stage of economic development. The state financial system deprives individuals and nonfinancial institutions of fund ownership and blocks their channels of direct financing; money used by the enterprise does not belong to the enterprise. In addition, state financial institutions have no control over enterprise behavior, to ensure they make good use of loans, or over potential moral hazards—the fundamental causes of many nonperforming loans.

The core of formal finance is impersonal borrowing and lending. Without an effective market system, formal finance must rely on expensive systems and tools, such as government support and collateral, to ensure the quality of loans. In comparison, informal finance is relationship based. It utilizes geopolitics and informal arrangements, such as cultural and commercial relations, as well as peer pressure to prevent borrowers from defaulting. This social capital represents a precious financial resource in the course of economic development. The exclusive formal financial system, on the other hand, wastes these financial resources and represents a very expensive financial arrangement for small and medium-sized enterprises and individuals.

Rural Finance Options in Poverty-Stricken Areas

Small rural household operations are the foundation of poverty-stricken areas, and their financial demands usually are characterized by scattered inhabitancy, low income, seasonality, small deposits, heavy environmental and market risks, and lack of necessary guaranty and collateral. These factors represent high risk for rural financial services. The long terms, high risk, and low profit of agricultural investment are contradictory to the safety, liquidity, and profitability requirements of commercial funds. The environmental dependence of agriculture also leads to relatively great regional risks for rural finance, and the unique features of the rural economy creates much higher transaction costs than is present in urban finance.

A number of regional risks also are not in line with standardized commercial credit service requirements. Large for-profit formal financial institutions usually are unwilling to provide credit to rural enterprises with small operational scale, lack of information transparency, and insufficient collateral. The characteristics of rural areas, especially poverty-stricken rural areas, require organizational forms conducive to reduced transaction cost and risk.

Grassroots informal finance fits the diverse requirements of rural finance. It will not crowd out the formal financial market but instead will enhance competition by providing financial products. Moreover, some microlevel arrangements and innovations of informal finance can benefit the reform of the PRC's current financial system.

First, the growth of informal financial markets is rational. Treating informal financial organizations as illegal ignores the bountiful financial resources of rural traditions and financial intermediaries, and regarding expensive formal financial systems as superior to passive and inexpensive informal financial organizations has resulted in lopsided supply and demand. Examining the effect of the planned economy on the finance sector and discussing the reasons for inefficiency in rural finance will pave the way for legalized informal finance in the PRC, thus enabling complementarity and competition between formal and informal finance and establishing a complete spectrum of financial institutions.

The characteristics of rural areas, especially poverty-stricken rural areas, require organizational forms conducive to reduced transaction cost and risk

Second, the competition of financial organizations will promote rural financial reform. Economic reform in the PRC has shown that the key to successful reform lies outside of the reform itself. The rural family contract responsibility system originated with farmers. The success of state-owned enterprise reform resulted from competition among township and village enterprises, and township and village enterprise reform was an inevitable result of the rapid development of private enterprises. It is likely that competition from informal financial organizations will play the same role in rural financial reform.

Finally, understanding the microscale basis and mechanisms of informal financial organizations, especially the practice and innovation of informal financial organizations in resolving information asymmetry and moral hazard, may prove useful for rural financial reform.

Because the credit activity of the informal finance sector is relatively simple, informal and formal financial institutions can substitute for and compete with each other. The relation between the two is not merely competitive; in fact, because each type of finance has its own comparative advantage, the two can partially complement each other. Formal financial institutions have financial strength, comprehensive organizational systems, well-trained managerial staff, and rigorous internal control procedures. Therefore, they have an advantage in providing large amounts of long-term loans. On the other hand, informal finance, characterized by flexibility, promptness, convenience, small size, and information advantage, is more adept at providing residents with sundry and small loans. Given their respective comparative advantages, it is possible for each to serve different types of customers in the credit market and to form a reasonable division of labor. In addition, if formal and informal financial institutions can be integrated, it will be possible to bring informal finance further into play.

PART IV

SURVEYS, PILOT STUDIES, AND POLICY RECOMMENDATIONS

CHAPTER 9

Surveys and Pilot Projects

Poverty Reduction Loans

Loans by the Poverty Reduction Office

To increase the role of discounted credit funds and improve efficiency, the Poverty Reduction Office of the State Council conducted pilot programs in 33 counties, beginning in 2004. In the pilot programs, the Ministry of Finance allocates part of the central government's discounted credit fund to local governments, which then give the funds directly to borrowers or to loan-issuing financial institutions to subsidize interest on loans to poor borrowers. Local government also provides borrowers with support services.

Loan-issuing financial institutions, which are selected through an open bidding process, extend loans to farmers at normal commercial lending rates, based on market supply and demand, and retain the right to select candidate borrowers from a list provided by county poverty reduction offices. The Ministry of Finance provides an interest subsidy for 1 year (interest subsidy on loans of less than 1 year is calculated according to actual maturity). Poverty reduction loans are distributed only to eligible poor farmers approved in village poverty reduction plans, and the issuance and utilization of these loans are regularly publicized and are subject to villagers' supervision.

Risk compensation is based on principles of openness and fairness, and loan-issuing financial institutions are selected through market-oriented approaches. Financial institutions have the right to select candidate borrowers independently, but loans to farmers must account for a certain portion of the institutions' total poverty reduction loans. In addition, the preferential interest rate for poverty reduction loans has been brought in line with commercial lending rates, and loan maturity is set at the discretion of loan-issuing financial institutions, according to the actual production cycle.

The pilot program offers two options for fiscal interest discount. The first option is direct subsidies to loan-issuing financial institutions. In other words, financial institutions issue poverty reduction loans to borrowers after deducting the subsidized interest rate from the normal commercial lending rate. Finance bureaus allocate subsidies to financial institutions following joint approval by the bureau and the county poverty reduction offices. Because the financial institutions assume risks independently, they are better able to balance compensation with risks. This can create additional incentives for financial institutions and can make poverty reduction loans viable and sustainable.

Eligibility criteria and subsidy amounts are announced in borrowers' home villages and townships, to enhance policy transparency and engage the public in supervision

The other alternative is direct subsidies to poor borrowers, after poverty reduction offices and bureaus of finance verify the issuance of loans to poor borrowers at the normal commercial lending rate. However, the loan principal comes from the financial institutions themselves, and the institutions have no incentive to issue poverty reduction loans if they cannot break even.

Each county in the pilot program determines which discount method is appropriate for them, but poverty reduction loans to the pilot projects remain the responsibility of the Agricultural Bank of China (ABC). Eligibility criteria and subsidy amounts are announced in borrowers' home villages and townships, to enhance policy transparency and engage the public in supervision.

Funding for the pilot programs increased from CNY16.5 million in 2004 to CNY100 million in 2005, and the interest discount increased from 4% to 5% per annum. Program coverage in the central and western People's Republic of China (PRC) expanded from 33 counties in 11 provinces in 2004 to 200 counties in 21 provinces in 2005. After evaluating the program in 2006, the Ministry of Finance increased loans to farmers to CNY296 million and expanded the program to 592 priority counties. The pilot program raised the ratio of loans to farmers and mobilized the rural credit cooperatives (RCCs).

Jiangsu Model

In 1998, Jiangsu Province began a pilot program to gradually transfer to RCCs the responsibility for distributing poverty reduction loans, and the handover was completed in 2001. In 16 high-priority, poverty-stricken counties, county poverty reduction offices provide RCCs with a list of prospective borrowers. The RCCs then choose their prospective clients from among this list of law-abiding farmers who are capable of working, have good creditworthiness, and have suitable proposed productive activities.

The bureau of finance in Jiangsu Province provides guarantied funds totaling CNY63 million and deposits these funds in RCCs. The RCCs then issue poverty reduction microloans equal to up to twice the amount of the guarantied funds. The government-guarantied funds are intended to offer an interest discount, to reward successful RCCs, and to mitigate losses, but use of such funds must meet specific requirements. First, poverty reduction loans are subject to the benchmark interest rate, but farmers who repay on time are eligible for an interest discount of 50%. Second, local governments require the collection ratio of poverty reduction loans to reach 50%. If the local ratio exceeds

50%, RCCs and county poverty reduction offices split the remainder equally. Finally, if the loan collection ratio is less than 90%, RCCs and the guaranty fund each cover 50% of the losses. The provincial bureau of finance conducts an annual audit of the guaranty fund and supplements the fund if it is found to be insufficient. After such measures were put in place, 16 counties in northern Jiangsu Province issued microloans of nearly CNY88 million, with a collection ratio of 99.7%. Governments, poor farmers, and RCCs are all satisfied with the results.

Jiangsu's experience shows that such a guaranty system can ensure poor farmers' access to poverty reduction loans, can help distribute financial institutions' risks, and can provide incentives to provide loans. Jiangsu's practice also reveals that market-oriented approaches can magnify the functions of government fiscal support.

Rural Remittance

In December 2004, we conducted a survey of migrant workers in Hangzhou, Zhejiang Province. The participants, 72% of whom were male, included 400 migrant workers, mostly from the central and the western regions; only 10% were from the eastern regions. The largest group in the sample (28%) was from Henan Province, the most populated central province, followed by Sichuan and Guizhou provinces.

The use of financial services by migrant workers in Zhejiang is related to their educational level, which is highly correlated with income. The migrant workers interviewed in Cixi had a higher-than-average level of education. All had mobile phones, two regularly sent and received e-mails, and six had used internet services, whereas no one in the other three groups had used internet services.

Among those interviewed in Cixi, 1 had a credit card and 14 out of 15 had bank cards—1 had four cards, 2 had three cards, and 5 had two cards. Twelve of the cards were issued by the ABC, seven were issued by the Bank of China, and five were issued by postal savings outlets. Cards issued by banks other than the ABC were provided by employers in cooperation with a bank and were used for paying wages directly onto the cards. Migrant workers remitted money home by transferring their wages to the ABC or a postal savings outlet.

Migrant workers in the PRC generally send a relatively high proportion of their incomes home, and remittance incomes are crucial for family consumption. According to the groups interviewed, each migrant worker in Zhejiang remits an average of CNY3,000 to CNY4,000 home, representing 35% to 40% of his or her total income. The major determinants of the amount of remittance include a worker's income, whether the worker's family is living with him or her, and the family's need for money at home. For example, a migrant worker will send home around 20% of his or her income if he or she is single and/or his or her partner and children are with him or her, although under such circumstances some migrant workers will simply bring the money with them when visiting their home village, rather than using remittance services. A worker will send home 20% to 35% of his or her income if the children are left at the

The major determinants of the amount of remittance include a worker's income, whether the worker's family is living with him or her, and the family's need for money at home

home village, and 60% to 70% of his or her income if both partner and children are left at the home village. The money remitted home comprises 40% to 80% of the family income. Major uses of remittance income include educational expenses, household consumption, house building, and weddings.

The group interviews also revealed that migrant workers remit a relatively small amount of money home with each remittance—CNY500 to CNY1,000. The amount was higher among construction workers, with the most remitted at the end of construction. Migrant workers in Zhejiang were paid monthly, except for workers in the construction industry, who were paid a living allowance of CNY300 to CNY400 per month and a lump payment at the end of the project or when the worker returned home. Interviewees indicated they do not like to remit too much money at one time, usually remitting less than CNY1,000, for reasons of security and to maintain control over spending at home. Three to six times each year, therefore, an average migrant worker will remit CNY500 to CNY1,000. Remittance occurs at the time of major festivals, such as the Spring Festival (usually in February) or the Mid-Autumn Festival (September or October), or when there are pressing family needs, such as school fees, a birthday, or building a house. Migrant workers with a partner and children at home sent money more regularly, every 2 or 3 months.

Bank services for migrant workers are limited to remittance, deposit and withdrawal, and issuance of debit cards for deposit and withdrawal

Bank services for migrant workers are limited to remittance, deposit and withdrawal, and issuance of debit cards for deposit and withdrawal. Migrant workers without a local residence are ineligible for loans from financial institutions, and migrant workers generally are ineligible for credit cards. The single migrant worker from Cixi with a credit card received it because her friend worked for a bank.

The major determinants in selecting remittance channels are the availability of the service at the worker's home township and the cost of remittance. Migrant workers tend to select a service provider located near their home. If an ABC business office is located in a nearby township, for example, the recipient can travel to get the money because bus transport is inexpensive. The county seat, where the commercial bank branches are located, is regarded by most migrant workers as too far away from their home villages and thus is not their priority selection. Delivery speed, quality of service, and safety are secondary determinants.

The ABC charged 0.5% for card-to-card services. Other commercial banks charge 1% of remittance, with a surcharge of 30% for express service, which is inconsistent with standard bank charges. Money can be received within 1 day if channeled through a state-owned commercial bank; however, transfer takes 5 to 7 days if remitted through a postal savings outlet.

The field investigation revealed that bank branch service personnel and tellers usually do not advise potential customers about all available remittance products and their fees. Instead, they tend to quote the clients a fee, usually for real-time services at the high end of the scale, according to the quantity of money to be transferred and the transfer destination. The various remittance products and fees also are not posted or available on request. As a result, most migrant workers have little idea about the standard rates for electronic transfers.

Moreover, the additional fees charged for express money transfer vary from one place to another, although the People's Bank of China (PBC) and the National Development and Reform Commission have set them at a 30% surcharge over the regular fee. Electronic transfer service does not guarantee that the money will be received within 24 hours; therefore, clients pay an extra fee for 24-hour service. The varying times required for express service—ranging from instant to 2, 4, or 24 hours—and the complex fee structure are designed to encourage both bank staff and clients to use the express services. However, charges can be around 1% of the total remittance, which can be costly for clients.

All four state-owned commercial banks are present in the three counties of Zhejiang; three are present in Wangcheng and Xiangtang, Hunan; two are present in Lixian, Hunan; three are present in Renshou and Anyue, Sichuan; and two are present in Shimei County, Sichuan. The ABC is found in all of these counties.

The state-owned commercial banks are well represented in rural townships in the coastal areas of the PRC, but in general only the ABC has business offices in the central and western counties, and that presence is limited to less than one-quarter of the townships. No commercial bank has offices in the poor and remote townships, leaving RCCs and postal savings outlets as the only institutions available for remittance services. The four largest state-owned commercial banks (the ABC, the China Construction Bank, the Industrial and Commercial Bank of China, and the PBC) all are present in rural townships of the three counties of Zhejiang Province, though the PBC has no office in Ninghai. In Hunan Province, only the ABC is present in 6 of the 32 townships of Lixian and 2 of the 19 townships of Wangcheng, and only the Industrial and Commercial Bank of China is present in 2 of the 22 townships of Xiangtang. In Sichuan Province, the ABC is present in 13 of the 110 townships of Renshou and 10 of the 69 townships of Anyue, and no commercial bank branches are present in any rural townships of Shimei.

The small, remote townships of the western provinces contain almost no formal financial institutions at the township level. In Renshou, Sichuan Province, 96 of the 110 townships do not have RCCs, and 35 townships have no RCC or postal savings outlet. In Shimei County, 4 out of 12 townships have no RCC and 9 have no postal savings outlet. In other words, four townships in the county have no formal financial institutions or services of any kind. There are no nongovernment microfinance institutions in any of the sample counties.

Cooperative Finance

Ganzi: Perspectives on Unwithdrawable and Unsustainable Rural Credit Cooperatives

In many poor areas, there is only one RCC, and the absence of this RCC would create a financial vacuum. On the other hand, the operation of many of these RCCs is unsustainable. To examine rural financial reform in ethnic minority areas, a local PBC branch conducted an in-depth study of some so-called unwithdrawable and unsustainable RCCs in Sichuan's Ganzi Ethnic Minority Autonomous Prefecture in 2006.

No commercial bank has offices in the poor and remote townships, leaving RCCs and postal savings outlets as the only institutions available for remittance services

By 2005, the RCCs in Ganzi Prefecture suffered from insufficient capital, insolvency, and continuous losses. Their operations were in distress, and a number of village RCCs had no business for several years. In Litang County, for instance, six grassroots RCCs had become dormant, with no employees and no business, only the signage. Most RCCs were unsustainable; more business only meant heavier losses. To meet deposit payments and operating costs, many RCCs operated on debt such as interbank lending and agriculture loans.

The internal control system in these grassroots RCCs could not function with limited managerial, risk management, and development capability. RCCs' loss of credit had deteriorated the local financial environment. RCCs' accounting books were a mess and asset records were unclear. Some grassroots RCCs kept "pocket books," in which they issued only IOUs for receiving deposits and making loans, and some even had no entry records. False entries and fake expenditures were used to line employees' pockets, and unauthorized loans to relatives or to fake names produced huge numbers of nonperforming loans. Moreover, the excessively low salary of employees resulted in frequent illegal activity by some RCC staff.

The internal control system in these grassroots RCCs could not function with limited managerial, risk management, and development capability

The incentive system of the RCCs in Ganzi Prefecture had separated income from performance, and thus most employees had no incentive to raise deposits or manage loans. In addition, these RCCs were unable to provide social security such as medical insurance, and were nearly CNY10 million in arrears on pension payments. Employees were pessimistic about their future and morale was low.

The lack of economies of scale also constrained RCC development. In 2005, the agriculture sector in Ganzi Prefecture amounted to CNY1.1 billion, placing it last among the 21 cities and prefectures in Sichuan Province. The prefecture's population was 900,000, and 84% lived in rural areas. The per capita net income of farmers and herdsmen was CNY1,309, which was 45% of the provincial average and 40% of the national average. The ratio of urban to rural per capita income was 5.3 to 1, the lowest among the 30 ethnic minority autonomous prefectures in the country and the 21 cities and prefectures in the province. The Engel coefficient was 60.5%. Of the farmers and herdsmen in the prefecture, 340,000 (45%) lived in absolute poverty, with a per capita net income of below CNY668. In addition, 160,000 farmers and herdsmen (20%) lived in relative poverty, with a per capita net income of CNY668 to CNY924.

Constrained by the rural economy and low income, RCC deposits outstanding in the prefecture totaled CNY57.8 million at the end of 2005. This yielded an average deposit of CNY1.3 million per RCC employee. Twelve counties had less than CNY1 million in deposits per employee, and seven had less than CNY500,000. In addition, 73 legal person RCCs (65% of the total) had less than CNY1 million in deposits, and 51 RCCs (46%) had deposits of less than CNY500,000. The county rural credit union with the least deposits had only CNY3.2 million, or CNY167,400 per employee. The legal person RCC with the least deposits had less than CNY150,000. Five counties in the prefecture had less than CNY5 million in loans.

Our survey showed that, of various RCC deposits, 75.73% were savings deposits and 19.43% were agriculture deposits.

Corporate deposits outstanding were only CNY15.61 million. The deposits of village and township RCCs came mainly from savings, but they could raise few deposits. In fact, only half of the RCC deposits came from the county or township. The deposits of two counties with many county and township outlets—Kangding and Luding—accounted for 52.61% of the total in the prefecture. Excluding deposits raised by rural credit unions within the county or township, the deposits of farmers and herdsmen totaled only around CNY250 million—less than CNY350 per farmer.

RCC services also are lagging. At the time of the survey, only 13 RCC outlets in the prefecture had an electronic transfer business and 26 outlets were piloting computerized bookkeeping. The RCCs had no bank card business and their settlement and cash supply were dependent on the ABC. The lack of competitiveness, weak financial strength, and high risk have added to public concern and increased RCCs' difficulty in attracting deposits.

At the same time, the operational cost of the RCCs is excessively high. The prefecture is 153,700 square kilometers, accounting for one-third of the province and equivalent in size to Shandong Province. With a population density of 5.8 people per square kilometer, the prefecture has 18 counties, 325 villages and townships, and 2,345 administrative villages under its jurisdiction. The RCCs had fewer than 500 employees and 133 outlets, for an average of 3.8 employees per RCC. On average, one RCC provided rural financial service for approximately 6,000 people in 1,153 households, or 16 administrative villages in three townships covering 1,000 square kilometers. Of the RCCs in the prefecture, 79 (60.8% of the total) had fewer than four employees; 32 had two employees and 12 had one employee. No RCC had more than 10 employees. County rural credit unions generally have only three to five managerial staff.

The herdsmen live scattered across the prefecture, with inadequate transport and communication facilities. Highways are inaccessible in 42 townships and 1,307 villages, and telephone service is not available in 80 townships, adding to the difficulties of rural financial service.

High cost is another problem facing the RCCs in the prefecture. In 2005, operating expenses were as high as CNY21 million, or CNY45,900 per employee. Of the operating expenses, more than CNY13 million was used to maintain the operation of 133 outlets, with the depreciation of fixed assets reaching CNY6.8 million. RCC revenues totaled CNY27 million, while interest expense and the expense from transactions with financial institutions totaled CNY15.7 million. Employee salaries and benefits amounted to CNY8.7 million.

The RCCs in Ganzi Prefecture were established under the organizational framework of one RCC per township, paralleling the administrative structure

The RCCs in Ganzi Prefecture were established under the organizational framework of one RCC per township, paralleling the administrative structure. More than 90% of these RCCs are not commercially sustainable, although they still must fulfill their financial service obligations. Because 70% of RCCs in Ganzi have fewer than four employees, and some are one-person offices, they lack the basic requirements for a legal person governance structure.

In addition, it is difficult to establish and improve RCCs' governance structure and incentive mechanisms. Almost all RCC equity is in membership shares, but because the members know little about finance, they are more concerned with preemptive rights to loans than with the RCCs' operation and management. This has preempted external control.

Finally, supervision is ineffective. Many RCCs cannot maintain even a basic dual-person system, let alone an effective internal control system. One county rural credit union had three to five staff to administer an average of six RCCs, making it difficult to conduct inspections. Only 2 of the 18 counties had China Banking Regulatory Commission offices, making it difficult to effectively supervise the rural credit unions.

Practices in Ganzi showed that RCCs carry high operational costs and risks and are unfit for poverty-stricken areas. It also shows that in small, underdeveloped areas, the market, rather than the government, should decide the types of financial service suppliers.

Baixin Rural Lending Shop: New Pilot Cooperatives

The Yushutai Township Baixin Rural Lending Shop of Lishu County, Siping City, Jilin Province, was established in July 2004 with registered capital of CNY60,000 and more than 10 founding households. In 2 years, Baixin Rural Lending Shop developed a charter that specified membership, dividend distribution, lending rates, and the management of the lending shop. In 2006, this lending shop was included in the China Banking Regulatory Commission's 36 rural finance pilots across six provinces and autonomous regions. As the pioneer of lending shops in the PRC, Baixin Rural Lending Shop was restructured in accordance with provisional regulations issued by the China Banking Regulatory Commission.

The primary issue in the Baixin Rural Lending Shop's restructuring was the shortage of registered capital

The primary issue in the Baixin Rural Lending Shop's restructuring was the shortage of registered capital. According to the provisional regulations, it needed registered, paid in capital of less than CNY100,000. In addition, the chairperson of the board of directors and the manager of the lending shop must have at least a high school or technical school education and should have passed relevant qualification examinations before taking office. Baixin Rural Lending Shop had no offices or security measures, as required; the office was located in the home of the chairperson.

Baixin Rural Lending Shop needed fiscal support to raise CNY100,000, but those funds merely covered office space, security facilities, registration, and salary for accountants and cashiers, leaving nothing to help members. At the time, Baixin Rural Lending Shop only provided loans for members. The provisional regulations have since expanded the business scope of lending shops to include deposit taking, loan provision, settlement services, and other agent services in accordance with relevant regulations.

Before rural collectivization, the three largest cooperatives in the rural PRC were credit cooperatives, production cooperatives, and supply and sales cooperatives. However, the classification of these three cooperatives was meant as preparation for a collective economy. Production cooperatives cannot operate effectively without supply and sales and credit cooperatives. From the perspective of credit cooperatives, the separation of production and fund allocation created artificial information barriers between production and credit cooperatives and hindered the integration of fund allocation and demand with production.

The emerging production cooperatives (rural technical associations or those formed by a company and farmers) support household-based production using supply and sales as a connection. This has proven to be a successful model in linking small farmers with the market. However, due to financial controls, these emerging production cooperatives can only combine supply sales and production, keeping credit cooperatives at arm's length. Baixin Rural Lending Shop provided a model for integration of supply, sales, production, and credit.

A rural lending shop is an inexpensive arrangement; it can provide a low-cost resolution to issues that formal financial institutions can only handle at high cost. The motivation to merge Baixin Rural Lending Shop with the Baixin Farmers' Cooperative was to raise funds. Although the two cooperatives have different names, they are essentially one body. The farmers' cooperative provides a financing platform for the lending shop. On one hand, members of the farmers' cooperative know the funding demands and purpose of each member, are clear about the moral and repayment capacity of borrowers, and even know the source of repayment (e.g., livestock sales). This resolves the issue of information asymmetry in loan disbursement and the difficulties encountered by formal financial institutions.

On the other hand, the farmers' cooperative is an arrangement for loan repayment. If a member intentionally delays loan repayment, the farmers' cooperative can repay the loan by deducting funds from the sales income of that member. The member also can be deprived of membership in the cooperative. Because all cooperative members live in the same or in neighboring communities, peer pressure helps ensure that members repay their loans; failure to do so will lead to sanctions in daily life and production. These informal penalty mechanisms ensure timely repayment without collateral, lawsuits, government intervention, or other mechanisms.

In the beginning, the lending shop was an informal system. It mainly depends on trust, local culture, customs, and long-term relationships among people. These informal systems can hardly be regulated by words or contracts; therefore, they are unofficial and informal compared with regulations and laws. The advantage of the informal system is the low loan cost, which results from reduced supervision and examination requirements and enables the meeting of even the smallest credit demand. However, the lending shop system also has constraints. In cases of disputes, for example, it is difficult to obtain legal and official support. In this sense, lending shops are similar to informal lending agencies.

More institutional innovations are required to manage the risks of rural lending shops, and the government plays a very important role in the initial stage

The risks of lending shops are closely related to the operation of the farmers' cooperative. Cooperative funds are generally small, and the members share similar risks in production or business. In the case of Baixin Rural Lending Shop, for example, widespread disease or a large fluctuation in market prices will cause extensive loan delinquency, even bankruptcy.

More institutional innovations are required to manage the risks of rural lending shops, and the government plays a very important role in the initial stage. Apart from the reform in supervision, risk-reduction measures have been adopted in many places. First, the size of the lending shop is strictly controlled to confine financing among members. Second, the risk of production and operation is diversified. Lending shops can cooperate with government agencies, insurance companies, and epidemic prevention bodies to prevent risks such as widespread disease. The government may subsidize premiums so that insurance companies can provide adequate insurance products; epidemic prevention bodies can bear part of the risk through technical shareholding. Third, a risk prevention fund can be established and drawn from loan interest, and the government may match subsidies. Finally, a loan guaranty fund can be set up to compensate for losses caused by natural disasters or accidents.

Village Cooperative Funds

In 2006, the Ministry of Finance, together with the Poverty Reduction Office of the State Council, developed the pilot program of cooperative funds in 14 provinces, autonomous regions, and cities. The aim was to manage poverty alleviation funds, resolve poor farmers' funding shortage, and boost the self-development capacity of poor villages and households. The pilot was designed to use some poverty alleviation funds to establish cooperative funds in poor villages, enabling village residents to purchase shares of the cooperative fund and borrow for production purposes.

Funds were required to be repaid and revolved and to be used for the development of poor households' production

The pilot project had four main objectives. First, the project was intended to help poor villages to develop a cooperative fund to leverage poverty alleviation funds and innovate a poverty alleviation model. Second, the project explored effective means of integrating the cooperative fund with rural production, technology, and sales, boosting the integration of all production factors in poor villages while effectively reducing the funding shortage of poor rural households, leading to enhanced production and competitiveness of poor villages. Third, the pilot aimed to improve the self-management, self-organizing, and development abilities of poor people in managing the cooperative fund; to nurture special cooperative organizations and modern farmers; and to enhance rural development in poor areas.

To join the project, pilot villages were required to implement a village poverty alleviation plan and to have available resources, leading industries, strong leaders, and virtuous customs and traditions. Funding for the cooperatives came from central government poverty alleviation funds, paid-in shares from farmers in poor villages, and other sources.

The management of the cooperative capital was regulated. Village meetings were convened, and a management committee of impartial, decent, and conscientious members was elected. The responsibilities of the management committee were to formulate the management procedures of the cooperative fund; to implement those procedures; and to approve, disperse, and collect loans. The management committee was guided, supervised, and inspected by upper-level poverty alleviation and fiscal authorities and was overseen by all the villagers.

The pilot funds were used for the mutual support of the village. Funds were required to be repaid and revolved and to be used for the development of poor households' production. Loans were not to be issued outside of the villages, to be sent to underground money shops, to be used by the management committee, or to be divided privately.

Ultimately, all the poverty alleviation and fiscal authorities of the pilot provinces, autonomous regions, and cities were required to cooperate closely and to strive for a better pilot, and diversification of the pilot was encouraged. Currently, the pilot has been fully implemented in all the pilot provinces, districts, and cities, and response by officials and poor people has been positive.

Guizhou Province: Demand for and Supply of Rural Finance

In July 2004, the PBC organized a field survey on the demand for and supply of rural financial services in six counties of Guizhou Province. The main purpose of the survey was to understand the behavior of rural households and rural financial institutions. Such knowledge is critical for the design of future RCC pilot programs in the province and is useful for future improvement of the rural financial system as a whole. The surveys targeted rural financial institutions and households. County PBC branches surveyed the ABC, the Agricultural Development Bank of China (ADBC), and the RCCs; local county statistical bureaus surveyed the households.

Guizhou Province shares many similarities with other western provinces in the PRC. However, because it was one of the provinces to undertake an RCC pilot program, RCC reform in Guizhou is in many ways ahead of that of other provinces. The pilot program will have an enormous effect on the future rural financial framework in Guizhou as well as on the ability of rural financial institutions to provide efficient, sustainable support for agriculture, farmers, and rural areas *(sannong)*. This, in turn, will assist in developing local economies, enhancing the incomes of farmers, and establishing a prosperous society. Moreover, these pilot programs will affect future rural finance reform in other provinces, especially poor provinces, and will advance overall financial reform in the PRC.

Demographic Information

Guizhou Province is one of the poorest in the PRC, and 81% of the population lives in rural areas. The average annual income per rural resident was CNY1,490 in 2002, the lowest in the country. One-third of fiscal expenditures result from central government transfer.

A sample of 1,032 households was selected from six counties in the province. Two of the six counties in the sample, Fenggang and Meitan, are located in Zunyi Prefecture, which is well off. Danzhai and Taijiang counties, in the Qiandongnan Miao and Dong Autonomous Prefecture, are of average income. The remaining two counties, Dafang and Zhijin, are located in Bijie, the poorest prefecture in Guizhou. Participants were selected randomly and a random distribution of households was assumed within each county.

The households have the following features. First, the average family size is relatively small (4.1 people per household), which is contrary to many people's perceptions that poor rural households in the PRC comprise large families. Second, off-farm employment and income are becoming more important for rural households in Guizhou; over one-third of rural labors are engaged in off-farm production. More importantly, 45% of off-farm laborers have worked as migrant workers in other provinces, and over 40% work at

Participants were selected randomly and a random distribution of households was assumed within each county

home. This suggests a considerable lack of employment opportunities in the counties and large cities of Guizhou and is rather different from the rural labor transfer that occurs in more-developed areas of the PRC, where there has been a much higher proportion of migration from rural to urban areas within a province.

Third, the heads of households are predominately male (94.7%), indicating the lower social and economic status of women. Moreover, the level of education among household heads is very low; about 10% of the survey participants were illiterate and another 35% had only a primary school education. In other words, about half of heads of households had received fewer than 6 years of formal education. In addition, some went to school around 20 years ago or more, when educational quality is considered to have been low.

Older houses mean poorer housing conditions, an important indicator of poverty in the province

In rural areas of the PRC, family houses are usually the most important asset because families do not own the land. Many in Guizhou still live in very old houses, over 20% of which were built 25 years ago or more, and some of which were built during the Qing Dynasty. The average cost of building a house in the sample area after 2000 was CNY17,320. Older houses mean poorer housing conditions, an important indicator of poverty in the province.

We classified household assets as physical and financial, productive and nonproductive. On average, financial assets (cash and deposits) accounted for about 40% of the sample population's nonhouse assets and physical assets accounted for the remainder. Assuming an average family house is worth CNY5,000, an average rural household in the province holds about one-third of its assets in the form of financial assets. This ratio is not low, given household income and wealth. Of total financial assets, about one-third is held in cash and two-thirds in bank deposits. Interestingly, rural households hold a high proportion of their physical assets (nearly 50%) in animals. Many households have used animals (mainly pigs, cattle, and poultry) as stores of wealth; whenever needed, animals can be converted into cash at a relatively low cost. This also implies that there are few suitable financial instruments for rural households.

Relative to rural households' assets, income levels are not low. In 2002, the average net income per household was CNY6,709, of which CNY5,842 was held in cash. It is possible that much of this income growth is from migrant workers and off-farm activities—each accounted for more than 20% of net cash income—whereas farming activities generated only one-third of net cash income. Income growth from migrant workers and off-farm activities is quite recent, and it takes time for cash earnings to be transformed into physical assets.

There is limited growth potential for rural household savings deposits. For those without any savings, about half had no extra cash because their incomes cover only basic living expenses, and over 20% used their incomes for important items of consumption and investment. Another 15% of wealth was held in the form of livestock rather than bank or RCC deposits.

Only a few households complained that the deposit interest rates were low or that the services were too far from home. Even so, distance to providers is an important factor in financial services for rural households in remote, mountainous areas. This has become a significant issue because the ABC has been closing loss-making branches and offices in poor rural areas. Likewise, RCCs are closing some branches in poor and remote areas of the country or withdrawing their power to authorize loans. The average distance from rural households to an RCC is 6 to 30 kilometers; the average distance to a postal savings office is 10 to 54 kilometers. These distances are not great, but it may take up to an hour to cover in mountainous areas, even longer if they must be covered on foot. For example, many villages in Danzhai County do not have access to roads. RCCs there must cover large areas with limited staffing, which hinders service provision and increases operational costs.

Rural Financial Services: Demand

Rural households' demand for credit arises from farm and off-farm production and investment. The major household farm expense is the purchase of fertilizer, followed by seeds, pesticides, and plastic film. Accordingly, credit purchasing and borrowing are more often used to buy fertilizer than other farming supplies, and approximately 20% of households may need to borrow to buy fertilizer. We also asked members of rural households what they would do with an extra CNY10,000. After deposits, the next three priorities were children's education, housing, and farm production (Table A.28).

Rural Financial Services: Supply

The six counties surveyed mostly depend on outside funding through four channels: fiscal transfers, PBC agriculture onlending, loans from the ADBC, and remittances from migrant workers (Table A.29). Fiscal transfers are around one to five times fiscal revenue and make up for expenditure shortfalls. PBC onlending normally represents 20% to 30% of outstanding RCC loans. The outstanding loans of the ADBC are decreasing, illustrating its dwindling role as a policy bank in less-developed areas such as Guizhou. Remittances from migrant workers accounted for around 33% to 60% of the outstanding deposits of RCCs, several times the amount of deposit increases. In fact, remittances have been the major source of income growth for rural households in poor areas.

In recent years, postal savings in Guizhou has accelerated the outflow of funds, many RCC operations have had to rely on PBC onlending, and the ADBC has been reducing the amount of its loans. Although the ABC's outstanding loans exceed outstanding deposits, the increase in loans is less than the increase in deposits and its loans are made mainly for infrastructure. Since 2001, even most poverty reduction loans have been directed to project lending. Without considering government transfer and remittances from migrant workers, therefore, Guizhou suffers from a large outflow of funds, heavy losses on the part of rural financial institutions, and government-supported microfinance and poverty reduction onlending programs that have become the major sources of funding. In other words, the rural financial system has entered a vicious cycle.

Households borrowed most from their relatives, friends, and neighbors (64.1% in terms of frequency and 45.7% in terms of total value). Rural credit cooperatives were the second most important source of funds (31.2% in terms of frequency and 41.5% in terms of total value), whereas state-owned commercial banks were the least active lenders (less than 5% in frequency and less than 13% in value).

Postal savings deposits in Guizhou have increased rapidly in recent years

Rural Financial Institutions

Postal Savings Outlets

Postal savings deposits in Guizhou have increased rapidly in recent years. Total deposits increased from CNY4.5 billion in 2000 to more than CNY8.8 billion in 2003. Deposits from townships and villages increased from CNY846 million to around CNY2.2 billion. In the PRC as a whole, postal savings accounts for around 60% of total deposits below the county level. With 548 branches, the network of postal savings outlets in Guizhou is relatively small compared to the network in more-developed provinces, and the farmers have a lower relative income, resulting in a postal savings rate of around 20% below the county level. However, the rate of increase is high, with added savings ranging from CNY371 billion to CNY571 billion per year. The increase in postal savings deposits is roughly equivalent to the increase in RCC deposits.

Rural Credit Cooperatives

Most loans provided by donor-supported microfinance institutions in the PRC average around CNY1,000 to CNY2,000. By contrast, of the 245 recorded RCC loans to farmers after 2001, the average loan size was above CNY6,000. Most RCC loans required collateral and guaranty, which mostly were provided by relatives and friends. Moreover, loan rescheduling was common. Fewer than 50% of the loans were paid on time, which is consistent with the survey of RCCs in the province.

Although the average loan size for RCCs in Guizhou is not small, many sample households needed even larger loans of extended tenure. Unfortunately, RCCs cannot meet the demands of households with large aquaculture businesses. At the same time, many poor households have small funding demands but the transaction costs for small loans are high. This suggests that RCCs cannot meet diverse rural finance demands. These households, which should be the target clients of RCC microfinance loans, also demand simplified loan application procedures.

Most RCC loans required collateral and guaranty, which mostly were provided by relatives and friends

With 85 RCC branches and around 2,000 outlets, RCC deposits and loans in Guizhou have more than doubled during the period 2000 to 2003. Deposits increased from CNY9.2 billion to CNY21.7 billion, for a net increase of CNY12.5 billion, and rural loans grew from CNY4.4 billion to CNY9.8 billion, for a net increase of CNY5.4 billion (Table A.30). Loans to township and village enterprises increased moderately, from CNY764 million to about CNY1 billion, yielding a net increase of more than CNY236 million, indicating that township and village enterprises in Guizhou are less developed and have low levels of industrialization. Forty percent of the increase in loans was funded by PBC onlending, which increased from CNY531 million to CNY2.5 billion. Although the importance of PBC onlending varied, some districts were almost completely dependent on it for funding.

Medium-term and long-term RCC loans represented less than 10% of total loans, at CNY433 million in 2000 and nearly CNY1.1 billion in 2003. In fact, Guizhou lacks financial institutions that offer medium-term and long-term loans for agriculture and agriculture projects. The ADBC provides all grain procurement loans, which are short-term, and only the ABC and the China Construction Bank are willing to provide medium-term and long-term loans for government-guarantied state projects.

Agricultural Development Bank of China

The ADBC's total amount of loans outstanding has been decreasing, although the total number of branches remains steady at 56. In 2000, loans outstanding totaled CNY6.6 billion; 3 years later, this figure had decreased to around CNY5.9 billion. Medium-term and long-term loans accounted for a small but dwindling portion of this number, falling from CNY68.2 million in 2000 to CNY50.3 million in 2003.

Agricultural Bank of China

With the acceleration of commercialization in recent years, the ABC's operations have been moving toward big cities and focusing on large projects. This is evident in the reduced number of outlets, increased lending for medium-term and long-term state projects, and reduced lending for agriculture and township and village enterprises in rural areas (Table A.31). Even poverty reduction funds have been directed to project loans. This, in addition to the lending structure of the RCCs, results in low total lending to township and village enterprises and is reflected in the economic structure of Guizhou. With the reduction in ABC lending (except for projects financed by state debt), the repayment ratio (calculated as the ratio of total amount of payment on time to the total amount of payment due) dropped from 90.26% in 2000 to 78.18% in 2002. In 2003, the ABC's repayment ratio of 69.84% in Guizhou was the third lowest among all provinces in the PRC.

In general, there are large outflows of funds from rural areas, especially poverty-stricken rural areas. However, this is not the case in Guizhou, where the inflow of funds is far larger than the outflow, after accounting for government transfer and migrant worker remittances. There are three typical channels for such outflow: the gap between deposits and loans by the ABC and other state-owned commercial banks, flow through RCCs, and flow through postal savings outlets. The size of ABC loans, for instance, has become smaller in all counties except Taijiang, where a matching fund for an expressway drastically increased the amount. Moreover, new loans totaled less than new deposits, meaning that the new deposits were not used for loans during the observation period, resulting in a net outflow of funds. It is impossible to break down the ABC data by urban and rural areas, and some ABC loans are for urban infrastructure projects.

Data from the National Statistics Bureau show that, in 2003, total fiscal expenditures in Guizhou were CNY33.2 billion, 2.7 times the total fiscal revenues of CNY12.5 billion that year, indicating a net fund inflow of nearly CNY21 billion through fiscal transfers. Even if all fiscal transfers were used at or above the county level, that leaves a huge inflow of funds below the county level. The major channels of flow include loans from the ADBC and agriculture onlending from the PBC. In terms of flow, loans from the ADBC are decreasing, whereas PBC onlending is increasing. The total amount of outstanding ADBC loans stood at CNY5.9 billion in 2003; this is all net inflow, because the ADBC does not take deposits. In the same year, total PBC onlending was CNY2.5 billion, which yields a total inflow of CNY8.4 billion when added to the ADBC figure.

The major channels of flow include loans from the ADBC and agriculture onlending from the PBC

In Fenggang and Meitan of the more-developed Zunyi District, the growth of RCC deposits was three times the growth of postal savings deposits; in Dafang and Zhijin in the poorest Bijie District, however, RCC deposits decreased.

Government-supported loans were unable to meet expected targets and only RCCs showed increased lending, indicating that new demand for funds in these counties was met mostly by RCCs. Migrant worker remittances are the main reason for farmers' increased income and for the increase in deposits in RCCs and postal savings outlets. Although the inflow of funds through government transfers and remittances far exceeded the outflow, the demand for credit still could not be met. Rural finance in Guizhou needs an efficient credit mechanism more urgently than it needs additional funds.

Outflows through postal savings outlets vary; the more-developed counties have higher increases in both absolute amounts and rates. Postal savings offices do not make loans, so deposits are simply net outflow. From December 2000 to September 2004, the total amount of postal savings outstanding more than doubled in the province, as did incremental savings below the county level. Even so, total postal savings outstanding below the county level was CNY2.2 billion as of the end of 2003, and the gap between RCC deposits and loans was 6.8 billion, given total outstanding loans of CNY14.8 billion.

Without taking into account the gaps between deposits and loans in other state-owned commercial banks, the total outflow of funds from the ABC, RCCs, and postal savings outlets was around CNY9 billion. Thus, the total inflow of funds in this period was more or less equivalent to the outflow of funds. Considering that state-owned commercial banks other than the ABC have net outflows of funds, the outflow from all financial institutions should be larger. However, the direction of the flow could reverse after taking into account migrant worker remittances. Remittances from migrant workers to Guizhou were estimated at around CNY8 billion per annum, indicating that the total inflow of funds should be greater than the outflow, even with large outflows from financial institutions. Funding shortages in the rural areas of Guizhou, therefore, result from a lack of profitable investment opportunities and from inefficient credit allocation mechanisms.

The PBC initiated microfinance loans in 1999, supporting RCC operations through onlending for agriculture

Government-Supported Rural Financial Services

Rural Credit Cooperative Microfinance Loans

The PBC initiated microfinance loans in 1999, supporting RCC operations through onlending for agriculture. Between 1999 and 2003, the deposits and savings of RCCs in Guizhou increased rapidly, and microfinance loans to rural households without collateral increased at an even faster pace. The ratio of microfinance loans to outstanding RCC loans increased from 22.5% in 1999 to nearly 40% in 2003. Because it takes a year or longer for nonperforming loans to emerge, no provisions were made for future nonperforming loans; thus, financial indicators do not accurately reflect actual financial performance.

RCC microfinance loans without collateral differ from microfinance loans piloted in the PRC under the Grameen model in terms of interest rates, client gender, and repayment mechanisms. First, the interest rates on RCC microfinance loans are lower than the interest rates charged by RCCs on other loans, which are also much lower than the interest rates charged by other grant-supported microfinance projects. The interest rate on microfinance loans under the Grameen model, which is not subject to PBC regulations, is normally 15% to 20% whereas the interest rate on

RCC microfinance loans is below 10%. Second, the Grameen model prefers to extend loans to women whereas RCC microfinance loans, extended on the basis of creditworthiness, mainly target heads of households, more than 95% of whom are men. Finally, the Grameen model ensures high repayment with frequent installments and group guaranties, whereas RCC loans require a single repayment on the due date.

Among the 148 credit lines and loan certificates in 2003, the average loan size was CNY4,756 and the maximum loan was CNY20,000, far exceeding the typical initial credit line of CNY1,000 under the Grameen model pilot projects. More importantly, the ratio between rural household credit and its expected annual cash income was 107%. With excessively high credit lines and without a loan repayment incentive system, the default rate for microfinance loans without any collateral will inevitably be high.

There are three qualitative requirements for RCC microfinance loans in Guizhou: loans should go to rural households, the amounts should be small, and loan qualification should be based on creditworthiness. By their very nature, these criteria can help mitigate risks. Nonetheless, experience in microfinance operations shows that risks still exist. Inaccurate credit ratings for borrowers, neglect of the rural credit system, lax loan management, excessive pursuit of speed in operations, and oversupply of a single microfinance product will lead to a large volume of nonperforming loans in circumstances where there is no agriculture insurance.

Our survey showed that the RCC loan officers regard microfinance loans as unworthy because of their small scale and because they carry no collateral or guaranty. Even though PBC directs RCC lending and sets a percentage of microfinance loans as a requirement for providing agriculture onlending, microfinance loans are unlikely to be commercially sustainable. In comparison, guarantied or collateralized loans are perceived to be more sustainable. Many RCC credit officers think that their microfinance operations incur high operational risks because of the small scale of lending and the geographic distribution of clients, in addition to risks related to the agriculture sector as a whole.

Moreover, because of the interest rate difference between enterprise and microfinance loans, RCCs prefer to make enterprise loans. As of this writing, the effective interest rate on RCC loans to rural households has reached its ceiling of 10.28%, doubling the base rate of 5.14% per annum. In other words, even if the maximum interest rate is charged, it is still difficult for commercial financial institutions to recover their costs, though our survey also found that the effective interest rate on microfinance loans to rural households has reached 15% per annum through the imposition of interest penalties, advance deduction of interest, and compulsory shareholding requirements.

Poverty Alleviation Loans

More than half of the PRC's poverty alleviation funds were used for poverty alleviation loans during the survey period, and processing CNY1 million worth of poverty alleviation loans cost the ABC's Guizhou branch CNY58,500, which was CNY39,000 (nearly 60%) higher than the cost of other types of loans. In other words, the cost of

Many RCC credit officers think that their microfinance operations incur high operational risks because of the small scale of lending and the geographic distribution of clients, in addition to risks related to the agriculture sector as a whole

disbursing poverty alleviation loans was 5.85%, or 3.9 percentage points higher than the cost for other products. The ABC has estimated that the average cost of processing and managing poverty alleviation loans is 7% of the loan amount. Thus, even if interest is paid in full and the interest subsidy is received on time, this business is unsustainable.

By the end of 2000, over 85% of ABC loans to processing enterprises in impoverished counties in Guizhou were nonperforming. Outstanding interest-subsidized poverty alleviation loans in Guizhou totaled CNY7.76 billion by October 2001, and CNY3.26 billion (42%) of these loans were nonperforming. The repayment ratio of household loans was a mere 21%. Since 2001, therefore, the ABC has focused on using poverty alleviation funds to make commercial loans for infrastructure construction. Of the nearly CNY10 billion allocated for poverty alleviation loans in Guizhou, for instance, the ABC has extended only CNY400 million to rural households. Some local governments and other state-owned commercial banks have expressed serious concerns about this.

Evaluation of the Rural Credit Cooperative Pilot Program

The eight-province RCC pilot program initiated in the latter half of 2003 is a milestone in the financial reform of the PRC. Compared with previous reforms, the pilot program has sufficient funding for robust mechanisms and gives power to the provincial governments. The government is paying to eliminate the RCCs' historical burdens and is delegating to provincial governments the power to implement reforms. This bottom-up approach marks a fundamental change from the top-down approach of previous finance sector reforms. The objective is to reform the RCCs while searching for financial innovations, and to provide credit support to rural areas while ensuring financial sustainability.

The Ministry of Finance approved CNY38.67 million in interest subsidies to RCCs, which paid interest on indexed deposits for the period 1994 to 1997

Guizhou Province is one of the eight pilot provinces. By the end of 2002, total RCC assets in Guizhou reached CNY24.1 billion, including outstanding loans of CNY12.6 billion, total liabilities of CNY24.1 billion, and CNY14.4 billion in outstanding deposits. In addition, cumulative aggregate loss reached CNY910 million, with a loss of CNY4 million in 2002. Nonperforming loans totaled CNY3.5 billion, accounting for 27.8% of total loans outstanding. Of all nonperforming loans outstanding, CNY2.8 billion (80.23%) were idle (loans overdue for more than 6 months) and CNY150 million (4.29%) were bad loans. With an overall capital adequacy ratio of –0.9%, 969 RCCs (17.2%) had negative equity.

In this round of reform, the central bank granted Guizhou CNY719 million in central bank notes. According to central government regulations, the RCCs' business tax rate was only 3% and they were exempt from income taxes as of 1 January 2003. The Ministry of Finance approved CNY38.67 million in interest subsidies to RCCs, which paid interest on indexed deposits for the period 1994 to 1997.

Under the pilot program, 84 county RCC unions in Guizhou (39 of them insolvent) were consolidated into new legal entities in accordance with the State Council's 2003 Program on Deepening Pilot RCC Reform. Three RCC unions—Yunye District Credit Cooperative Union in suburban Guiyang, Huaxi District Credit Cooperative Union in the outskirts of Guiyang, and Meitan

County RCC union of Zhunyi City (a national commodity grain production base)—were selected to pilot rural cooperative banks. By the end of June 2004, member shareholders' paid-in capital from all RCCs in the province reached CNY1.12 billion—an increase of CNY754 million over 2002. The capital adequacy ratio was 3%, up from –0.9% (excluding PBC notes) before the structural reform.

Even under tight budget constraints, all levels of government in Guizhou strengthened their support for RCCs, employing a number of measures. For instance, the provincial finance department allocated CNY8 million per year from 2003 to 2007 to support RCC development and risk management. Such funds have been established in 20 counties, cities, and districts, and also provide land, buildings, and budgetary support to supplement RCC capital. Governments in some areas also subsidize RCC business, real estate, and tenure taxes, and stamp duties.

In addition, the provincial government entrusted qualified RCCs with the management of microfinance poverty alleviation loans formerly managed by the ABC. To implement State Council provisions and provincial government measures, the provincial RCC union and agriculture and finance departments issued a circular authorizing RCCs to handle agriculture tax exemptions for farmers in addition to reductions and direct subsidies for hybrid fine rice production.

To strengthen the RCCs' deposit base, most counties have deposited agriculture-related funds, education funds, off-budget government agency funds, and special central government agriculture funds into RCCs. Moreover, in coordination with relevant government authorities, such as the Industry and Commerce Administration Bureau, RCCs are exempt from certain fees or charges.

The provincial RCC union was established on 30 December 2003, and its affiliates were set up and began operations upon approval by the provincial government. This signified the completion of the initial phase of RCC administrative reform in Guizhou. Rural cooperative banks have been chartered in three counties or cities, and RCC unions in the other 84 counties have merged into county cooperative unions, one for each county. The total paid-in capital of the provincial RCC unions reached CNY972 million, with CNY327 million in new capital added in 2004 through fund-raising and share issuance.

One key component of this round of the RCC pilot program is the transfer of administration to the provincial government. However, because the provincial RCC union is inclined to protect its own interests, the hidden danger is that it will emphasize its own operations while neglecting RCC sector management. Thus, action must be taken to minimize the role of the provincial RCC union and to limit its management responsibilities while improving RCCs at the grassroots level. The key to resolving conflicts between respecting shareholders' rights and strengthening self-regulation is the power of senior management: the shareholder should extend a helping hand, not a controlling hand.

One key component of this round of the RCC pilot program is the transfer of administration to the provincial government

In line with central government policies, the provincial authorities emphasized that rural financial institutions must provide better services for *sannong*, regardless of ownership and organizational structure. The provincial government also guided the provincial RCC union in drafting and implementing over 40 sector-specific rules and regulatory documents, defining the government's risk prevention and mitigation responsibilities at all levels. Government authorities are required to take effective legal, economic, and administrative measures to recover nonperforming loans and to punish debt evasion and abrogation. Through the government's efforts, the RCCs collected up to CNY350 million worth of nonperforming loans by the end of June 2004.

Finally, the pilot program normalized the relationship among city and county governments and the RCCs. RCC administration has been vested in the provincial government, which must motivate city and county governments to support RCCs, without delegating power to them. To accomplish this, the provincial government has clearly defined the duties of the county and city governments, which include taking practical measures to support the RCCs, create a credit culture, and prevent and mitigate risks in a timely fashion; avoiding intervention in RCC operations and human resource management; and avoiding the use of RCCs for direct lending. This will support development of RCCs within their respective administrative areas and effectively prevent excessive intervention.

Financial Innovations

Some Guizhou RCCs have experimented with low-cost financial innovations, which may be important for the success of RCC reform. One such innovation is the establishment of a market-based risk disposal system, which enables risk sharing among various stakeholders. For example, aquaculture businesses in Guizhou have huge market potential, thanks to the province's unique natural conditions, distinctive seasons, and low pollution levels. Turning these potential benefits into material gains for rural households requires a supportive credit environment. However, huge risks beyond the scope of credit, such as natural calamities, disease, and the adoption of new technology, need to be addressed. Under the fixed interest rate regime, such risks are beyond RCCs' means. Without a proper risk-sharing mechanism, an RCC can only avoid risks through credit rationing, which means that even farmers with profitable projects are unable to obtain credit and may miss opportunities.

Under this win-win arrangement, farmers' incomes have increased and RCCs have cultivated a high-quality customer base

In some areas in Guizhou (for example, in Danzhai County), the risk-sharing mechanism established by local governments, insurance companies, rural households, and financial institutions has contributed to the reduction of excessive agriculture loan risk. This also has reduced the risks of RCC loans, which has enabled their relatively low interest rates to cover their costs. More importantly, this mechanism has facilitated agricultural specialization and has helped form a reliable credit clientele. Under this win-win arrangement, farmers' incomes have increased and RCCs have cultivated a high-quality customer base.

The operation of the mechanism is simple. First, local governments allocate part of their budget or poverty alleviation funds to subsidize rural households' insurance premiums. Next, insurance companies introduce special agriculture insurance products. RCCs can then lend to insured borrowers without collateral or by using the insured products, such as livestock, as collateral.

Local institutional resources such as farmers' professional associations and production cooperatives also can increase lending quality and improve client relationships.

In the days of the collective economy, RCCs made loans backed by the goodwill of the village or by collectively owned enterprises. The adoption of the family contract responsibility system, with remuneration linked to outputs, has forced RCCs to deal with individual households based on their own creditworthiness. This has increased credit risk and the cost of collecting credit information. With some farmers leaving their land and with increased agricultural specialization, scattered farmers have begun to organize themselves, and it will be important for RCCs to deal with a variety of farmers' organizations in order to gather useful, accurate information about farmers.

Some RCCs in Guizhou already have coordinated with local farmers' professional associations or production cooperatives and have successfully used this information to improve loan quality. For example, in some townships in Meitan County, RCCs have taken advantage of the presence of local aquaculture businesses to sign feed procurement and sales contracts with suppliers on behalf of farmers. This links rural household loans directly with feed supply, ensuring that the loans are put to good use and enabling the collection of valuable information.

At the same time, RCCs have established lending risk funds that use wholesale and retail price differences to enable sharing of credit risks. RCCs also have established a risk-sharing mechanism with local quarantine authorities. In some places, RCCs, local quarantine authorities, and village officials have established an accountability mechanism. Under this mechanism, if livestock die of disease, the local quarantine authority will bear 50% of the loss, village officials will bear 10%, and rural households will bear the remainder.

A third innovation, group guaranty and microfinance lending, can help resolve issues of credit rationing caused by asymmetric information and can expand credit coverage. The bottleneck in rural finance is the asymmetry between RCCs' returns and their costs and risks. If the costs and risks of RCC loans can be reduced by group guaranties or credit ratings, the RCC model can become commercially sustainable even with a relatively low interest rate. Of course, feasibility depends on local tradition, culture, and individual relationships. In Fenggang County, for instance, group guaranties among hog farmers have been frequent because of the close cooperation among farmers, quarantine authorities, and RCCs.

Fourth, some RCCs are working to create collateral substitutes. Lack of effective collateral is the prime obstacle preventing rural households from obtaining loans. Property such as land and houses cannot be used for collateral, and agricultural production is seasonal. Both of these factors have increased RCCs' risks when lending to rural households, exacerbating the households' difficulties in accessing credit. Moreover, group guaranties and microfinance are applicable only to rural households with small credit demands.

To overcome such difficulties, some RCCs have begun to introduce effective collateral substitutes such as bills of lading, harvest rights, and livestock. Though these are not legally recognized, they can serve as collateral. Other RCCs gather information on clients through direct involvement in the production and sales activities of local quarantine stations and leading enterprises, which is another substitute for collateral. It is possible that, when contractually directed farming emerges in the future, agriculture orders can serve as

Lack of effective collateral is the prime obstacle preventing rural households from obtaining loans

a form of collateral. Furthermore, loans can be made against the credit rating of individual guarantors. It should be noted that, due to the lack of a legal basis, the development of these types of operation is limited.

Fifth, government interest-subsidized loans can mitigate rural households' credit risks. In Guizhou, some local governments have introduced a variety of special interest-subsidized loans for raw silk production, hog farming, tea production, and the like. Some local governments cover 50% of the loan interest; others discount the interest rate to the level of ordinary RCC loans, which makes the effective interest rate for rural households 2.4% per month. These special interest-subsidized loans have reduced rural household defaults without affecting resource distribution and have turned the implicit demand of rural households into effective demand.

Rural finance in the PRC has tremendous potential if it can grasp the opportunities inherent in the rapid economic development

Finally, RCCs can innovate in targeting moderately poor rural households. Rural households require both commercial funding and social welfare funding. Commercial demand may be met by formal or informal financial service providers; social welfare demand may be met by government agencies. Some local governments, such as the government of Taijiang County, have realized that they should provide loan support mainly to moderately poor rural households that are capable of repaying the funds. These households will then be able to help relieve destitute farmers by offering employment opportunities. This, in turn, can partially reduce the pressure on RCCs to provide loans to the agriculture sector.

Prospects for Cooperative Finance in the People's Republic of China

With the opening of rural financial market in the PRC, various forms of rural financial institution will emerge, and cooperative finance is one of the options. Various farmers' technical associations can effectively resolve the conflict between scattered small production and the concentrated big market, without affecting the incentive system based on household operation. At present, farmers' technical associations have integrated the advantages of production cooperatives with those of supply and sales cooperatives, and the growth of cooperative finance will further boost the development of these technical associations.

Urbanization will proceed in the PRC over the next 20 to 30 years. In the process, the rural population will decrease but agriculture will expand, creating potential for cooperative finance. More importantly, with continuous currency appreciation, the price of agricultural products will increase together with farmers' income and demand for rural financial services. This will go hand in hand with rapid expansion of the rural consumer credit market. Meanwhile, the vast distances, scattered population, high cost of information collection, and shortage of collateral in rural areas will reduce the competitive advantage of commercial finance and solidify the monopoly status of cooperative finance in many areas. Rural finance in the PRC has tremendous potential if it can grasp the opportunities inherent in the rapid economic development.

Cooperative finance distinguishes itself in many ways. First, it has a community background and clear boundaries, resulting in information advantage and peer pressure, which is one of the key reasons behind its existence. This community background helps to keep funds in and for the rural areas. Second, cooperative finance stresses the principle of equality, one basic element of its corporate governance. An effectively organized cooperative financial institution does not need prudential supervision. Third, cooperative financial institutions are nonprofit, with only a mission to provide financing for members. This enables cooperative financial institutions to attract deposits with higher interest rates and issue loans at lower interest rates.

Microfinance

Guangxi Learns from Grameen Bank

The pilot microcredit program in Guangxi Zhuang Autonomous Region started in August 1997 by the Guangxi Women's Federation. In February 1998, the Government of Guangxi issued the Provisions on the Microcredit Poverty Reduction Program in Guangxi Zhuang Autonomous Region, which specifies three principles of microcredit: joint guaranty, freedom in forming groups, and installation repayment. In addition, microcredit borrowers are strictly separated from commercial loan borrowers to exclude applicants not conforming to the three basic principles.

In recent years, Guangxi has followed the Grameen Bank model, which includes a risk-sharing joint guaranty system featuring mutual assistance, monitoring, and guaranty among groups of 5 to 10 households. The model also features a center conference system in which three to five groups form a center and communicate with one another through conferences. Such conferences are designed to fully demonstrate the leadership role of center and group heads and to train members in managerial and productive skills.

Finally, repayment requirements cater to Guangxi's reality of vast mountainous territory and scattered households. Instead of requiring repayment installments at an interval of every week or every 10 days as in other provinces and autonomous regions, installments in Guangxi are due once a month, with repayment in 10 installments, beginning in the third month from the date of loan issuance. This change maintains the push for repayment, keeps the pressure on farmers to work hard, and reduces the time that farmers spend in loan repayment.

Award and Subsidy Fund

In 2005, the China Banking Regulatory Commission, the Ministry of Finance, the PBC, and the Poverty Reduction Office of the State Council conducted a pilot program to promote microloans to farmers through an award and subsidy fund in eight counties of Guizhou, Jiangxi, and Shaanxi provinces, and in Chongqing. The program uses part of the central government's poverty reduction fund to subsidize interest and loss or as an award. The purpose of the pilot program is to invent a new operational mechanism to evaluate loans to poor farmers; to explore the possibility of setting aside an award and subsidy fund, creating a precedent for operating loans to farmers nationwide; to accommodate the interests of the poor population; and to create sustainable and financially viable loan-issuing financial institutions. The pilot program is based on voluntary participation, and financial institutions are selected through open tendering, bidding by invitation, and bid negotiation.

The program uses part of the central government's poverty reduction fund to subsidize interest and loss or as an award

Loan-issuing financial institutions raise credit funds for the pilot program and determine the lending rate in accordance with relevant regulations, with the ceiling not exceeding 80% of the PBC-regulated rate of loans of the same maturity and the same type. Loan maturity is subject to the actual production cycle but is no longer than 1 year. Candidate borrowers must be poor, law-abiding, employable, creditworthy farmers; better-off self-employed people, model farmers, and farmers capable of generating above-average income are excluded. Farmers who repay on time can enjoy a 50% interest subsidy.

The award and subsidy fund comprises poverty reduction funds transferred from the central government to provincial governments. If the loan collection ratio is above 90%, principal and interest loss will be fully covered by the award and subsidy fund. When the collection ratio is less than 90% and it is proved that loans are uncollectible, loan losses are split equally between the loan-issuing financial institutions and the award and subsidy fund, after approval from provincial poverty reduction offices and bureaus of finance. Performance assessment is conducted at the county level, using a loan collection ratio of 92% as the benchmark. Principal on loans in excess of the 92% loan collection ratio is awarded and split between loan-issuing financial institutions, which receive 60%, and poverty reduction offices, which receive 40%. The entire award fund is used for operational expenses and staff bonuses. Eligibility criteria, methods, and subsidy amounts determined by pilot counties are announced in target townships and villages.

Eligibility criteria, methods, and subsidy amounts determined by pilot counties are announced in target townships and villages

The pilot program proves that an award and subsidy fund can guide financial capital to support poor farmers in their productive activities, and displays the leveraging capability of the fiscal poverty reduction fund. In 2006, the pilot program was expanded to eight provinces.

Dezhou: Microcredit and Postal Savings Offices

We surveyed pledged microcredit businesses operated through four postal savings offices in Decheng, Leling, Pingyuan, and Wucheng, Dezhou. As of October 2006, 105 loans had been issued, amounting to nearly CNY2.7 million.

In Leling County, the average credit line was between CNY10,000 and CNY50,000; the largest loan was CNY100,000 and the smallest was CNY1,000. Most loans were bridge loans for the self-employed. Out of 16 loans, 10 were used for inventory turnover, accounting for 63.6% of the total. One transaction was for a vehicle purchase, two were for house purchases, and two were for animal feed purchases. The lending rate and maturities were relatively fixed. In 2006, pledged microcredit had only two maturities—6 months at 5.58% and 1 year at 6.12%.

In general, the microcredit lending procedure is more convenient than at commercial banks. When applying for microcredit pledged with a deposit certificate, the applicant can contact the savings section of the post office, which will investigate the applicant's eligibility and sign a contract with the applicant. Then the savings section submits the application materials to provincial and municipal savings management bureaus. Upon approval, borrowers can go to a deposit certificate–issuing institution to terminate the payment of accrued interest on deposits used as a pledge. After that, borrowers can receive loans. If the deposit certificate of a third party is pledged, a statement of the third party's willingness to provide the pledge should be provided. Generally, loans can be granted on the day of application, if borrowers meet lending criteria.

Post offices at the county level and below in Leling conduct postal savings and handle mail. Staff members include one office head, two clerks in charge of savings, two mail carriers, and two clerks in charge of postal business. Savings clerks also can perform postal services. Post offices above the county level conduct postal savings and postal business while county post offices undertake the mailing business. Postal savings outlets are managed by the savings and transfer section of the county post office.

There were 26 postal savings outlets in Leling County in 2006. Twenty of the outlets, in rural areas, cover all townships and residential areas in the county. There are 109 people employed in the postal savings business, including 90 clerks and 19 staff members in the savings and transfer section. Seventeen are college graduates, accounting for 16% of the total; 40 have a secondary school education or less, accounting for 37% of the total. Generally, therefore, the staff's educational background is quite weak.

The survey also showed that 74% of staff members are temporary workers. Out of 26 office heads, only 9 were formal employees; the remaining 17 were contract employees. All clerks were temporary workers. From 2001 to 2006, all office heads remained in office but were rotated geographically. At the time of the survey, over 90% of the clerks had been hired within the previous 2 years, so the turnover was high.

The postal savings business in Leling County has been developing steadily since 2001, and time deposit accounts for 60% of total savings, guaranteeing a stable source of capital. Intermediary services include agency fee collection, agency insurance business, and agency salary payment, with commissions steadily increasing. The postal savings card business has made great headway, with 33,735 debit cards issued. The development of intermediary businesses and the increased issuance of cards further promote the development of the postal savings business.

Taking into account the professional qualifications of the staff and management of postal savings outlets, the Postal Savings Bank of China (PSBC), established in 2007 on the foundation of these outlets, is not equipped to undertake a microcredit business. First, the vast area to be served contrasts with a shortage of personnel. Because most outlets are understaffed, most staff members are employed on a temporary basis, and staff also must provide postal services, supervisory mechanisms cannot be fully implemented, resulting in risk. The current number of employees cannot satisfy business development needs if outlets are conducting microcredit business.

Post offices above the county level conduct postal savings and postal business while county post offices undertake the mailing business

Second, most staff members are not professionals and cannot adapt to business development needs. When the PSBC began its lending operation, the staff did not receive any formal or systematic financial training. Most current staff have only limited knowledge about savings, the credit business, or bank accounting. They cannot adapt to the development needs of a microcredit business in such a short period.

Third, presently, there is no internal control system on microcredit. The internal control system of postal savings is limited to overseeing postal savings and transfer, cash and safety management, and the like. In addition, if no interest subsidy is provided, the PSBC will have to earn profits from its pledged microcredit business and intermediary services. Postal savings began as an exclusively savings business and has no history of credit provision or fund management, meaning that staff will have a great deal to learn to conduct a microcredit business.

Microfinance Case Studies

We surveyed three microfinance projects in Sichuan Province in 2005 to get a sense of nationwide pilots. The main focus of the survey was microfinance project operation and interest rate structure, both of which are key to project sustainability. The factors determining the interest rate include operational cost, fund supply and demand, risk, and projects' sustainability requirements. In practice, there are two rate systems: the low-rate system with a government subsidy, and the high-rate commercialized system to cover at least project operational cost. The estimated effective annual rate of the United Nations Development Programme (UNDP) project in Tongjiang, Sichuan, was 15.09%. The rate of the Caohai Village Fund was 24% to 60%, compared to the 20% to 40% rates of the Bank Rakyat Indonesia–Unit Desa.

The project adopted the operational principles and methods of Bangladesh's Grameen Bank, employing the farmers' center as the central administrative unit of organization

Case 1: Operational Model in Tongjiang County, Bazhong

The Farmers Self-Support Capacity Building Project (SSCOP), an independent civil society legal person project managed by the China Foundation for Poverty Alleviation and the Foreign Capital Project Management Center of Sichuan Province, is a World Bank subproject in Tongjiang County, under the Qinba Poverty Reduction Project. Project implementation began in April 2000, and by the end of 2004, it had provided CNY27.94 million in loans to 18,824 farming households. SSCOP funding came from the World Bank, with the central government assuming responsibility for repayment and then onlending the funds to the county Farmers Self-Support Capacity Service Center through the county finance bureau.

SSCOP service centers in each project village and township supervise several township and village mentors, issue and collect loans, organize meetings and trainings, and so forth. The project adopted the operational principles and methods of Bangladesh's Grameen Bank, employing the farmers' center as the central administrative unit of organization. One center usually comprises 30 to 40 farmers who meet at the center every month. The service center examines and approves farmers' loan applications through the center meetings, and provides farmers with technical training and project management, support services, and market information.

The SSCOP focuses on the repayment capacity of farmers and targets middle-income and low-income farmers with family annual incomes above CNY5,000. The loans are mainly for aquaculture, processing, transport, and small businesses. A participatory approach was adopted in identifying clients, with bottom-up farmers' autonomous organizations selecting potential borrowers. The project only grants loans with a 1-year term. When applying for a loan, borrowers are required to deduct 50% of the interest to cover management costs and service fees, and loans are repaid in installments. The remaining 50% of interest is paid off with the final repayment. In 2005, the nominal interest rate was 7% per annum, although the effective interest rate was about 15%.

The SSCOP was in the red. By the end of 2004, the project had a cumulative loss of CNY619,200 and its earnings covered only 72% of its cost.

Case 2: Economic Promotion Association, Guangna Branch, Bazhong

The Guangna branch of the Poor Village Economic Development Promotion Association in Sichuan Province began to provide loans in July 2004. By the end of May 2005, its cumulative loans are estimated to have totaled CNY870,000, made to approximately 750 farming households.

The relationship between the Guangna branch and the Poor Village Economic Development Promotion Association is similar to the relation between a loan retailer and a wholesaler. The association provides a wholesale loan to the branch at a certain interest rate and the branch grants microcredit to farmers at a higher rate, with the rate gap representing its own earnings. The branch's loan application, issuance, and repayment procedures are similar to those of the SSCOP. The branch submits loan applications to the Poor Village Economic Development Promotion Association, which approves the applications and then transfers a lump-sum fund to the branch. The branch then releases the funds to farmers, monitors monthly repayments, and returns the funds to the association when the loan is repaid.

The branch targets middle-income and low-income farmers, paying attention not only to the profitability of the supporting projects but also to whether the farmer has a house, vehicle, or livestock as a secondary repayment source. Branch loans are made mainly for individual rural industrial and commercial production; relatively few loans are made for aquaculture.

Groups and centers identify potential clients. The term is normally 1 year, with repayment and interest rate arrangements similar to those of the SSCOP. The effective interest rate per year is about 15%, and the loan amounts are normally CNY1,000 per household for the first year, CNY2,000 for the second year, CNY3,000 for the third year, and CNY4,000 for the fourth year, with a CNY5,000 ceiling.

In 2005, Guangna branch was making ends meet.

Case 3: Association for Rural Development Operational Mode in Yilong County

In June 1995, UNDP assisted the Yilong Poverty Alleviation and Sustainable Development Project in Sichuan Province in setting up the Association for Rural Development in Yilong. Project setup was completed in 1998, but the ownership of the project funds was unclear. From 1996 to 2005, the association issued CNY28.27 million in loans, with loans outstanding of CNY4.25 million, representing 68.7% of available funds. Within 10 years of project implementation, the project had covered 100 villages in nine townships,

Branch loans are made mainly for individual rural industrial and commercial production; relatively few loans are made for aquaculture

yielding a coverage ratio of around 12%. Later, the association closed some outlets; five branches remained in 2005.

In 2005, the association had a total fund of CNY6.19 million, including CNY3.93 million in debt from the UNDP revolving fund, the Madame Saider Trust Fund, and the Grameen Bank Trust Fund, and equity of CNY2.26 million from the United Nations Population Fund and donations from the Germany Philanthropy and the Ministry of Commerce.

The microcredit project is implemented mainly through township branches. The loans target poor households headed by women, individual industrial and commercial business operators, service industries, agricultural production, and small-scale household processing. The ceiling for individual industrial and commercial loans is CNY10,000, combining credit and collateral loans. The ceiling for agriculture loans is CNY3,000 and is based on credit rather than collateral. In 2005, the interest rate, which is keyed to the PBC base lending rate, was 8% per annum, yielding a real interest rate of 10% to 14%. The interest on loans repaid in less than 3 months is calculated as 3 months; loans repaid between 3 months and 6 months are calculated as 1 year, with interest payment made in installments. Interest is repaid along with the principal repayment.

The differences result from innovative mechanisms and this, in turn, promotes rural financial innovation

In 2004, the average repayment rate for new loans was 98.3%, with a loan risk ratio of 0.83%. By the end of September 2005, the loan repayment rate stood at 96.8% and the delay ratio of new loans was only 1.6%, yielding a risk ratio of 3.99%. If the risk ratio exceeds 5%, the association will stop lending and put all its efforts into recovering nonperforming loans.

The expenditures and operating costs of each branch include salaries, interest on capital, office expenses, and loan loss provision. The costs of the county association also include funding costs, management fees, and training fees. Since September 2004, each branch association has made ends meet; however, the county association is still in the red because of funding costs and training and management expenditures.

These case studies demonstrate that microcredit as an innovation introduced by nongovernment organizations is different from traditional credit provision in terms of management, funding, market position, client identification, loan products, loan issuance and repayment, risk control, and returns. The differences result from innovative mechanisms and this, in turn, promotes rural financial innovation. The PRC has done substantial work in exploring microcredit operations, accumulating experience and laying the foundation for future development.

On the other hand, although microcredit has over 10 years of history in the PRC, there have been no solutions to some fundamental issues. These issues include choosing the appropriate type of microfinance institutions and their ownership, identifying long-term funding sources, ensuring sustainability, and establishing low-cost, high-efficiency rural financing services that fit local demands.

Informal Finance

Guizhou and Shaanxi

Comparison of the financing structure of Guizhou in the southwestern PRC with that of Shaanxi in the northwest will assist our understanding of informal finance in poverty-stricken areas. Among the sample rural households in Guizhou, rural families tended to borrow the most from their relatives, friends, and neighbors, which accounted for 64.1% of total borrowing. Borrowing from RCCs accounted for 31.2% of the total, and borrowing from state-owned commercial banks accounted for 4.7%.

According to a survey of approximately 400 rural households in Shaanxi Province, 20% of rural households obtained RCC loans, 54% had no borrowing, and others indicated they would borrow money from informal channels such as relatives or friends. Of the rural households with loans, 43% prefer to borrow funds from RCCs and 40% would consider borrowing from relatives or friends; in the latter case, interest usually is not charged. In addition, 17% of rural households obtained loans from informal sources that charged interest.

Thus, the main competition for RCCs in Shaanxi was interest-free loans among relatives and friends, and the RCCs maintained monopolistic market power in rural commercial credit markets because commercial informal lending was still underdeveloped. Unlike informal finance, which attends to creditworthiness and future cash flow and carries unlimited liability, RCCs pay more attention to both the quantity and the quality of collateral.

Combining Formal with Informal Finance

The complementary relationship between formal and informal finance can be realized through conscious cooperation. In Argentina, for instance, local banks and automobile dealers employ the information advantage of rotating savings and credit associations to develop automobile loans and expand automobile sales. Without formal financial institutions, it is impossible for informal financial institutions to raise sufficient funds. On the other hand, without informal financial institutions, formal financial institutions are unwilling to engage in this type of business, due to the risks involved, and an automobile loan market of this kind would shrink.

Another example is India's National Bank for Agriculture and Rural Development (NABARD), which in 1991 began to integrate the small credit operations of self-help groups with formal financial businesses. Through its employees and partners, NABARD conducts the social mobilization and group-based training of rural self-help groups of 15 to 20 women. At first, savings and loan activities are conducted within the self-help groups. After approval by NABARD, loans to the self-help group are issued either directly or through grassroots commercial banks. NABARD also provides capacity building and staff training for partners that offer social and financial intermediary services, as well as onlending for grassroots commercial banks that offer small loans. During the 2002–2003 fiscal year, NABARD provided a total of CNY1.1 billion in new loans to 26,000 newly established rural self-help groups. By March 2003, NABARD had provided loans for 11.6 million poor households in India, covering about 20% of the poor households of the country.

The complementary relationship between formal and informal finance can be realized through conscious cooperation

The practice in Taipei,China also can serve as a reference. Major forms of informal finance in Taipei,China include trade financing with long-term contract arrangements and commodity transactions, usually between those familiar with each other; private enterprises, such as rotating savings and credit associations formed by relatives and friends; underground banks charging high interest; and employee deposits of enterprise working capital, which are essentially loans of individual employees to an enterprise. Although the Government of Taipei,China does not recognize informal finance, these forms of financial transactions are not isolated. There are standardized practices among participants, and their effective implementation has reduced problems in customer selection, transactions, and incentive mechanisms. Thus, the relationship between formal and informal finance in Taipei,China is complementary rather than competitive. Taipei,China's experience is a useful reference for countries where underdeveloped formal finance hinders economic development.

South Africa's practice of encouraging competition and complementary activities between commercial banks and informal finance also is noteworthy. A number of large commercial banks in South Africa have initiated a savings business designed for *stokvels*—a kind of informal savings and loan project—and have opened a bank account for every *stokvel*. Several designated group members are authorized to sign on the account and to issue loans based on accumulated deposits. This practice has benefited both customers and the bank; *stokvel* members' money is safer and enjoys higher returns, and the bank's ability to make loans to *stokvel* members increases a bank's profit.

The complementary relationship between formal and informal finance does not require conscious cooperation. Because they lack relevant information, formal financial institutions are unwilling to lend funds to "ineligible" enterprises and individuals; instead, they lend at relatively low interest to big enterprises with sufficient collateral. However, a qualified enterprise eligible for participation in the formal financial market can onlend its funds to the informal financial market, even in cases where formal financial institutions are unwilling to make loans. In addition, big enterprises can charge a higher interest rate because the lender has business connections with the borrower and therefore understands the credentials and repayment ability of the borrower.

This example demonstrates the complementary relationship between the two markets. The informal financial market provides higher returns, without which a loan will not be made. On the other hand, without formal financial market, big enterprises will not have sufficient idle funds to invest in the informal financial market. Formal financial institutions also may adhere to a lending quota that encourages them to locate quality enterprises and exploit the higher returns of the informal financial market.

Some information intermediaries, such as chambers of commerce, also may connect formal and informal financial institutions. The experience of the Leqing Chamber of Commerce in Tongxiang, Zhejiang, is a good example. This chamber of commerce currently has 160 dues-paying members, 50 to 60 of which are enterprises. The members of the chamber are required to submit membership fees before becoming eligible. The chamber of commerce, in turn, has set up a guaranty fund of CNY1 million at a local bank. The guaranty has a leverage ratio of 10, meaning that it can help the members access to up to CNY10 million in loanable funds. In addition, a joint guaranty group of three people is formed among volunteer members, creating a joint guaranty of CNY500,000. As the ultimate guarantor, the chamber charges a 1% guaranty service fee. This practice has produced satisfying results, bringing enterprises into the formal financial market and somewhat reducing informal lending.

CHAPTER 10

Policy Recommendations

General Policy Considerations

The Role of Government and Market

Building a moderately prosperous society in a comprehensive manner requires coordinated urban and rural economic and social development, growth of agriculture and the rural economy, and a boost in rural household income. In recent years, county economies have suffered from inadequate financial services, especially those targeted at agriculture, farmers, and rural areas *(sannong)*, which has restrained the strategic adjustment of rural economic structures.

Finance plays a crucial role in the modern economy; thus, the new socialist countryside cannot be developed without support from the rural finance sector. However, some factors in the current rural financial system are constraining rural economic development. Major tasks in current rural financial reform, and an important element in building a harmonious society, include giving financial institutions an effective role in resource allocation, promoting county economic development, and guiding rural economic and agricultural restructuring.

The Government of the People's Republic of China (PRC) attaches high importance to rural financial reform, and some progress has been made since the State Council initiated the 2003 Program on Deepening Pilot RCC Reform. Pilot reform has been extended to rural areas across the PRC. The postal savings interest rate mechanism has been reformed, contributing to a drop in rural capital outflows, and the Postal Savings Bank of China (PSBC) has begun operations. The Agricultural Development Bank of China (ADBC) has actively expanded funding sources by issuing policy bonds, conducting interbank borrowing, attracting corporate deposits, and conducting negotiable deposits with postal savings outlets. The ADBC also has launched new lending businesses, serving flagship enterprises in agricultural industrialization, cotton and oil seed, technological advancement, and agricultural technologies. Breakthrough has been made in the pilot agriculture insurance scheme, with three specialized agriculture insurance companies established in Heilongjiang, Jilin, and Shanghai, and a pilot scheme of commercial insurance companies offering agriculture insurance on their own, jointly with the government, or on behalf of the government has been established in Hunan, Jiangsu, Liaoning, Sichuan, and Xinjiang Uygur Autonomous Region. Additional liberalization of the rural financial market also has moved steadily forward.

Communist Party of China Central Committee Document No. 1 made it clear that there should be increased efforts to foster microfinance institutions (MFIs) launched by natural persons, legal persons, or juridical associations and that relevant government agencies should work on administrative rules with a sense of urgency. To this end, the People's Bank of China (PBC) has actively advocated a pilot program to establish microfinance companies that offer lending without taking deposits. To date, this program has been implemented in five provinces and regions, including Guizhou, Inner Mongolia Autonomous Region, Shaanxi, Shanxi, and Sichuan, with the active support of provincial governments.

The great challenge now is to discover how rural finance should adapt to serve the rural economy, prevent risks, and realize sound, rapid, and sustainable development

In early 2007, the China Banking Regulatory Commission enacted rules to develop multiple types of rural financial institutions. Subsequently, the PRC's rural financial reform has entered a new stage of urbanization and industrialization that, in turn, promotes agriculture. Building a new socialist countryside is an important task during the period of the Tenth Five-Year Plan, and thus the government will increase fiscal spending in rural areas. The great challenge now is to discover how rural finance should adapt to serve the rural economy, prevent risks, and realize sound, rapid, and sustainable development.

The key to an improved rural financial system is to properly deal with the relationship between government and market. First, the coverage of public spending in rural areas should be increased and the market environment should be strengthened to lay the foundation for sustainable development of rural finance. In poverty-stricken regions, central and local governments should increase spending on infrastructure, including transport, communications, water conservation, education, and sanitation. The rural social security system should be improved to create conditions for commercialized rural financial institutions. Fiscalization of financial services and the use of rural credit cooperative (RCC) funds as fiscal relief funds should be avoided.

Meanwhile, local fiscal institutions must be improved; this is a key to improving the rural financial system and a precondition for preventing local government interference in rural finance. In addition, local governments should create a sound operational and credit environment for rural financial institutions by nurturing creditworthy townships, villages, and households and cracking down on debt default. Doing so can promote a sound pool of rural funds and prevent large outflows of rural capital.

Second, policy finance coverage should be expanded in rural areas. The nation should consolidate funding to the countryside and should distinguish indispensable fiscal spending from fiscal spending for compensation purposes. Such action will create a sound market environment. Fiscal authorities at various administrative levels can fund road construction in rural areas. The central and local governments can provide funding for significant construction projects and research on fundamental subjects.

Some other projects that usually have high social benefits but low economic benefits include projects related to agriculture development, technology, and infrastructure. Because these projects have large funding demands, long project periods, slow investment recovery, and high risks, commercial banks are reluctant to step in, and such projects are forced to rely on policy finance. Thus, in addition to regular fiscal spending, the central and local governments should set aside a portion of spending for compensatory expenditures, such as providing interest subsidies and loan loss compensation to institutions engaged in policy finance. A small amount of public subsidy could guide funds into agriculture and the rural economy, meet the funding needs of economic restructuring, and fund infrastructure and environmental projects.

Third, rural financial services must adapt to changes in rural households' productive patterns. An increasing number of farmers are leaving the countryside to find jobs in the manufacturing and service sectors of coastal provinces, producing large capital flows between rural laborers and their families. In contrast to migrant laborers in other countries, rural migrant laborers in the PRC remit the bulk of their income back home. Such remittances contribute to an increase in rural household income and welfare and alleviate poverty because farmers are less dependent on crops and other agricultural production. In addition to the extra income, migrant workers benefit from new ideas and skills learned by working in coastal regions.

Remittance of rural laborers accounted for 20% to 50% of their total household incomes, helping them meet tuition, medical, and daily expenses. Such contributions depend to a large extent on the quality of remittance services. An efficient remittance service can help migrant laborers send money back home in a safe and timely manner, increasing their welfare by saving them time and effort in remittance, and better serving the urgent production and consumption needs of their family members back at home. Efficient remittance service also encourages rural migrant laborers to send more money back home and encourages their family members to use relevant financial services, thus attracting new users of financial products and services.

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Fourth, rural finance must adapt to rural industrial restructuring. Rural industrial institutions have changed with the adjustment and upgrading of rural industrial structures, including the emergence of a great number of crop-growing, livestock-rearing, and combined agricultural production entities. Flagship agricultural industrialization enterprises and specialized agriculture associations connect rural households with the market. The government should bring rural financial institutions into full play, rely on market means to solve development financing problems, guide farmers toward decreasing blind production, and help thousands of rural households hedge market risk by promoting agriculture based on orders, documentary insurance, and agriculture commodity futures.

Fifth, building a new socialist countryside requires an efficient and competitive rural financial system based on improved market exit mechanisms, faster implementation of deposit insurance, and the steady opening of the rural financial market. Regulation and supervision of dispersed RCCs is very challenging, and information is not always reliable. It is imperative to develop and improve the corporate governance of rural financial institutions and to increase transparency so that an effective regulatory mechanism can provide positive incentives and prompt corrective measures.

Given specific circumstances in the PRC, a timely and effective market exit mechanism also is required. The key to such a mechanism is to protect and compensate small and medium-sized depositors; thus, deposit insurance must be put into place promptly. In addition, a sound rural financial system should be very dynamic, rather than a rigid combination of institutions, allowing the entry of new financial institutions and the exit of problem financial institutions. Because only diversified financial institutions can meet rural financial needs, rural financial reform requires the creation of a truly competitive rural financial system.

Regulation and supervision of dispersed RCCs is very challenging, and information is not always reliable

When liberalizing the rural financial market, regulators should take prompt corrective measures in line with the development of rural financial institutions, strengthen supervision, build a deposit insurance system, and ensure safe and effective market operation. Rural financial reform is a systematic project covering a wide range of areas, and improving the rural financial system requires improving the operational mechanism of policy finance, guiding funds flowing back to rural areas, and steadily liberalizing the rural financial market. Careful study and multipronged efforts are required to create a sustainable rural financial system that features financial institutions with complementary functions and distinct positions, sound risk control, better services, and commercialized operations assisted by fiscal subsidies.

An efficient rural financial system serves the rural economy by keeping funds within the rural area for the benefit of *sannong*. Therefore, this round of rural financial reform should uphold the principles of rural financial market liberalization, encouraging innovation and relying on the market to determine the best financial institutions based on fair competition. The pursuit of such goals distinguishes this round of reform from previous rounds.

Market-Based Rural Finance Reform

After years of study and debate about the objective of rural financial reform, consensus has gradually emerged that the goal is to develop market-oriented and commercially sustainable financial institutions and financial service providers and to offer sufficient and reasonably priced financial services for *sannong*. This overall objective applies to rural areas across the PRC, though the specific targets and the methods of reaching those targets should vary according to the economic and market structures of different regions.

At present, there exist acute problems with county financial services in remote and border areas, in minority regions, and in poverty-stricken areas. First, policy financial institutions are based in cities and have limited functions and coverage. For example, the ADBC serves mainly as a cashier for market crop enterprises in poor areas and performs few tasks related to agricultural product acquisition.

Second, state-owned commercial bank branches and postal savings outlets actually serve as channels of capital outflow. The Agricultural Bank of China (ABC) already has closed many branches below the county level and channels large deposits to other regions.

Third, with their limited capital and functions, the RCCs are very vulnerable and difficult to expand. As legal entities that should be responsible for their own performance and risks, RCCs confront an adverse environment in poverty-stricken areas. They must continue to fulfill policy functions and maintain social stability even in the face of persistent losses, and most of them are already insolvent due to legal constraints, transaction costs, clearing and settlement conditions, and coverage.

Fourth, in the near term, the functions and effects of informal credit in povery-stricken areas are irreplaceable. Policy finance outlets play a limited role, due to their function and business limitations. Commercial financial institutions have narrowed their business scope to deposit taking and remittance for capital transfer, owing to profit considerations and stringent credit authorization conditions. Postal saving outlets are channels of capital outflow, and although RCCs play an important role in offering lending, they remain in a difficult situation.

The government uses various subsidies and interest rate policies, such as poverty reduction loans and interest rate controls, to meet the capital needs of poverty-stricken rural areas and to promote financial services, but this practice has proved a failure because of high cost and because the bulk of capital does not go to farmers. Meanwhile, in areas such as education, medical services, and social security, the government has not played its role or has played an inadequate role. This has forced financial institutions to take up some fiscal functions and has led to severe moral hazard, low efficiency in capital utilization, and adverse effects on the commercial sustainability of the financial institutions themselves.

In underdeveloped rural areas, scattered small-scale business, low productive efficiency, low accumulation and investment rates, and high information and management costs all limit the scope of large-scale commercial financial institutions and provide a natural setting for small-scale informal finance. A rural financial system that can adapt to and promote social and economic developments in poverty-stricken rural areas must be based on specific circumstances in these areas. The benefits of informal mutual finance should be recognized, and efforts should be made to promote its legal operation so that it may contribute to economic development in these areas.

Most rural financial reform over the past decade has followed a uniform, top-down pattern, with little regard to specific regional circumstances

Most rural financial reform over the past decade has followed a uniform, top-down pattern, with little regard to specific regional circumstances. Fortunately, even in the face of many restrictions, some financial innovations have emerged, including government-sponsored rural insurance, local agriculture technology associations, or partnerships between corporations and farmers. Such innovations are distinctively local and have performed soundly, but mechanisms and measures to evaluate and extend them are not yet in place.

Operating financial institutions in high-risk, high-cost, poverty-stricken rural areas requires ensuring their commercial sustainability. Thus, profit-oriented financial institutions in these regions must offer services to institutions and individuals at risk-matching prices. The government can encourage this by improving the legal and regulatory operating environment for rural financial institutions. In addition, policy should allow coexistence and competition among multiple types of financial institutions and should promote market interest rate reform.

To promote rural financial development and meet rural financial demand, the government and market must work to reduce the risks and costs of rural financial services. In this regard, the functions of government include establishing an enabling environment, reducing operational risks, and channeling funds to rural areas. Given an enabling environment, financial institutions and other financial service providers will be able to strengthen corporate governance and instrument innovation, reduce operational costs and nonperforming loans, improve efficiency, and increase returns.

The role of government is particularly important in poverty-stricken areas and direct government action to reduce poverty is a priority

The role of government is particularly important in poverty-stricken areas and direct government action to reduce poverty is a priority. To accomplish this, government should assess poverty and its causes in these areas and identify the scope of the market in addition to fiscal and other government functions. The government must take comprehensive and systematic action to develop the financial market, social security, employment, and public aid and to enhance infrastructure and increase human capital investment. This will create an enabling, competitive environment among rural financial service providers, augment sector efficiency, enhance product quality, and promote innovation. Concerted effort on the part of government and the market will help to meet growing rural financial demand, promote coordinated development between poor and developed areas, and advance a harmonious socialist society.

Rural Finance in Poverty-Stricken Areas

Because the PRC's present rural financial system was formed during the period of the planned economy, a large proportion of financial service in rural areas is neither market oriented nor sustainable. Interest rates have not been liberalized, and low interest rates may generate false demand. In addition, part of the supply of rural financial services is policy based. This includes ADBC policy loans, microcredit supported by the central bank's agriculture loans, and excessively low fees on remittances. These services are not commercial products and would be unsustainable without government subsidy.

Despite the economic and financial reform of the past 2 decades, the rural financial system has maintained its original structure with minor changes. Under this structure, rural finance remains the major tool by which governments support rural economic development (through low interest rates and fund support). The less-developed regions depend more on this tool, which features a higher degree of financial fiscalization. In many poverty-stricken rural areas, for example, credit from rural financial institutions is commonly used to pay for medical treatment, education, or the salaries of village cadres. Moreover, the high degree of financial control has reduced market competition and the financial institutions' elasticity and motivation to innovate. Thus, the commercialization of financial institutions has reduced loan availability in poverty-stricken areas.[1]

The shortage of rural credit cannot be resolved simply by increasing agriculture onlending and other policy loans to rural financial institutions or by ordering financial institutions to allocate a higher proportion of loans to rural areas. Rather, the process of determining interest rates in rural areas of the PRC must be fundamentally changed. Institutional lending rates should be increased to cover operational costs and loan losses and should be based on international financial accounting standards for rural financial institutions. At the same time, the noninterest costs of borrowing should be cut to reduce overall borrowing costs, and rural financial institutions should be allowed to charge a premium for riskier projects and borrowers.

In the poor and remote areas of the PRC, where transaction costs are higher and returns on productive investment are usually lower, the government should focus on policy measures to reduce the credit risks and transaction costs of rural financial institutions. The government can enhance the repayment capacity of rural communities and farmers by increasing investment in education, health, and infrastructure in rural areas, and by improving agriculture extension services and introducing new agriculture technologies. Government money would be more effective if it were invested directly in rural areas rather than being used to subsidize poverty and agriculture loans. The government also can reduce rural financial institutions' risk by introducing agriculture and medical microinsurance for farmers and farming communities.

Finally, there are two ways for the central and local governments to reduce transaction costs in poverty-stricken, remote, and mountainous communities in the PRC: by encouraging voluntary resettlement and by allowing and encouraging the establishment of community-based real savings and credit cooperatives, under proper state regulation and supervision.

Interest rate liberalization alone will not resolve the problems in rural finance. Successful market liberalization also depends on other conditions, mainly macroeconomic stability, adequate prudential supervision, and bank regulation.[2] Simply raising the interest rate may result in adverse selection problems and moral hazard, increasing rural financial institutions' nonperforming loan rate.[3] Careful research is required to quantify returns on investment and the repayment capacity of rural enterprises and households in different regions of the PRC. Following improvements in bank supervision and monitoring, the restrictions on new entry into rural financial markets should be gradually relaxed to create more competition in the PRC's rural financial markets.

Poverty Reduction Loans

Traditional opinion holds that government can play a positive role in the rural financial market and favors direct interference such as mandating interest rates on loans and deposits and establishing state-owned rural financial institutions that prioritize agriculture. However, this approach neglects the growth of nonagricultural enterprises in rural areas and the resulting opportunity to diversify risks. Rather than increasing farmers' income or eliminating poverty, therefore, this approach aggregates poverty.

Government money would be more effective if it were invested directly in rural areas rather than being used to subsidize poverty and agriculture loans

Since the 1980s, many countries have adopted a new understanding of rural finance that prioritizes income growth and poverty reduction and emphasizes market efficiency in the belief that government interference should be limited and market oriented. This new understanding does not deviate from traditional goals, but it utilizes more market-oriented, efficient methods of achieving them.

Poverty reduction loans are guidance funds intended to increase social welfare by providing loans to priority sectors and to those who normally cannot access loans. Typically, countries subsidize agriculture loans through government financing arrangements, including discount instruments, loan quotas, and the agriculture financing system. The intention may be to promote rural welfare, guarantee food safety, popularize modern technologies, or compensate for deficient economic and financial policies in favor of urban development. Such a financing system features a managed interest rate, subsidies to borrowers, and directed credit plans. However, practices in many countries have shown that the agriculture credit model rarely succeeds in improving income. Directed loans are inexpensive, thanks to low interest rates, and mask obvious problems such as a rural credit crunch, but they are prone to disappearance when fiscal departments terminate capital support or to remain in place even after they are no longer needed.

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During the past decades, various countries and international development agencies have made huge investments in developing rural financial markets, but the rural population in most developing countries still cannot access loans through normal channels. Traditional methods lean toward loan issuance but neglect loan quality and banks are treated as loan dispensers rather than as commercial financial institutions. Moreover, subsidized loans create excessive demand for credit, but better-off, privileged customers intercept many of the limited number of loans. In addition, directed loans focus on financing primary agricultural activities but neglect nonagricultural economic activities, even though the latter usually create higher returns, resulting in a high number of nonperforming loans.

Directed loans are not in alignment with commercial viability indicators, such as sufficient asset return and effective loan collection. The agriculture credit model usually aggravates the problems of already poorly performing financial institutions in rural areas. Problematic financial institutions pay little attention to loan collection, client needs, or financial sustainability. As a result, such financial institutions usually need a government bailout, but bailout consumes scarce public funds that should be used to provide future relief, and financial discipline is further weakened. Ultimately, poorly performing financial institutions in rural areas will rely on government relief indefinitely.

The problems of rural financial institutions also might adversely affect overall economic stability. In the 1980s, for instance, agriculture credit subsidy accounted for 2% of the gross domestic product (GDP) in Brazil and Mexico, and many countries were ignorant of the fiscal cost of maintaining inexpensive directed agriculture credit projects. One study of 18 countries showed that direct agriculture credit subsidies accounted for 2% of the countries' GDP from 1960 to 1984 but that negative transfer brought about by indirect intervention consumed 15% of their GDP.[4]

Traditional financial indicators are insufficient to evaluate directed loans because directed loans and the subsequent return on assets and equity rely on the cost of borrowed funds. If the value of loan subsidies is not properly understood, traditional indicators become meaningless or even misleading. First, there is a gap between expense and income as it is reflected on the loan's income statement and financial institution's income statement. Second, traditional accounting methods cannot reflect or accurately record various directed loan subsidies, and because the size of subsidies is a determining factor in determining return on assets and return on equity, the return on asset and return on equity ratios are dependent rather than independent variables.[5]

International experience indicates that governments can create a favorable environment for financial intermediaries by formulating and implementing effective macroeconomic and monetary policies; by setting up full-fledged management, supervisory, judicial, and law enforcement systems; and by putting in place efficient institutional arrangements, such as encouraging private sector loans to the agriculture sector and the rural population. Direct intervention should be avoided.

Ultimately, the PRC must establish a diversified and sustainable rural financial system. Until then, poverty reduction loans, even if used as an interim poverty reduction method, should be market oriented and reinforced through institutional arrangements to ensure that loan-issuing financial institutions have incentive schemes in place, that poor farmers get benefits, and that the cost is acceptable to fiscal agencies at various levels. Achieving this goal requires a competitive market. Financial institutions should be selected through market mechanisms, and the use of interest subsidy funds should be revised. Some subsidy funds should be used to set up a poverty reduction guaranty fund to compensate loan-issuing financial institutions for their risks. The remainder can be used to directly subsidize farmers.

Rural Remittance

Migrant and Nongovernment Organizations

To improve remittance services for migrant workers in the PRC, it is important to provide consumers with information about the major products, services, and fees available from different service providers. This information should be updated frequently and service providers should be required to fully disclose information about products and charges. Government programs, nongovernment organizations, and associations working with migrants can disseminate this information through various outlets. Some of the information should be illustrated, given that more than one-third of migrant workers have fewer than 7 years of formal education and 15% have fewer than 4 years of formal schooling.

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Workers also need to be informed about using bank services, applying for and using bank card, and locating information about remittance services and charges. A toll-free hotline can be set up for making inquiries or complaints, and the PBC's current number for reporting card losses should be made public. Such an educational campaign should focus on migrant workers from remote and poverty-stricken areas. Possible agencies for promoting such consumer education include nongovernment organizations working with migrant workers, or the All-China Women's Federation.

Policy Makers and Regulators

Given the problems with existing service providers, it is important to enhance competition among remittance services in rural areas of the PRC particularly in the western provinces. Market competition can be enhanced by encouraging state-owned commercial banks, particularly the ABC, to remain in the large rural townships. Improving the payment and settlement system for RCCs and other small banks also will provide alternate channels of remittance. Lending-only microcredit institutions and other microfinance institutions can be linked directly to the payment and settlement system of the PBC, or indirectly via other commercial banks, to provide remittance services. Other possible alliances between state-owned commercial banks and MFIs will create competition for the Postal Savings Bank of China (PSBC) in remote rural areas, and international service providers such as MoneyGram, Western Union, and others may be linked with domestic providers of remittance services.

Financial Service Providers

As the service provider with the largest market share in the PRC's domestic remittance market, it is important for the PSBC to improve its services across the country. In addition to improving access to information about services and fees, the PSBC also should study remittance fees in sending and receiving offices and provide more incentives for receiving offices in the remote rural areas. A permit for the PSBC to provide other financial services also could increase financial competition in rural areas.

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Increasing the commercial banks' share of the remittance market will benefit both banks and migrant workers. Commercial banks with broad branch coverage are encouraged to consider using this capability for remittance services. Funds could be remitted via ATMs or point-of-sale devices, and more card-based products, including credit cards, will reduce workers' remittance costs. Migrant workers and their families should be able to use mobile phones, text messaging, and the internet to make inquiries about their bank card balances and about their remittance transactions.

An increase in remittance market share could benefit commercial banks not only by generating remittance income but also by increasing deposits and by facilitating consumer loans or other profitable services. Remittance service providers should be encouraged to explore opportunities for cross-selling other financial products, such as savings accounts, loans, insurance, and mortgages. Commercial banks and RCCs should use remittance income, or a record of remittance income, as loan guarantees for remitters and payees. Migrant workers might be allowed to to use remittance to buy insurance for family members, and workers with stable incomes should be able to take out mortgages in their home counties and townships.

More remittance partnerships should be formed between RCC township offices and other commercial banks, particularly the ABC. Following the establishment of the provincial RCC federation in many provinces, the RCCs should be in a stronger position to negotiate with commercial banks. Commercial banks also should be reminded not to withdraw from the rural markets, given the close bond between migrant workers and their families in the villages, and the potential for developing new financial products and services.

Cooperative Finance

The key to sustainable financial institutions is low transaction and operating costs. For example, while RCCs in Ganzi were making huge losses, local loans by Buddhist temples were performing quite well. To save costs, financial services in rural areas might be combined with postal and telecommunications services, or with the sale of agriculture materials and other commodities. In addition, international experience indicates that the government should encourage investment in telecommunications networks so that farmers and herdsmen can access financial services electronically. In remote agricultural areas, the Indian model can be introduced to establish informal self-help groups, which then establish business relationships with RCCs. In short, rural financial institutions in poverty-stricken areas must adapt themselves to the local economic, social, religious, cultural, and geographic situation. Furthermore, to reduce the risks of rural household loans, it is necessary to develop agriculture insurance and futures and to bring public finance into play.

In addition to reform, the sustainable development of financial institutions requires an enabling environment. The construction of the new socialist countryside will expand public finance in rural areas to include the establishment and improvement of a rural social security system suitable to local economic development, the strengthening of rural financial infrastructure, and the upgrading of public finance in support of agriculture and other fields. These measures will create a sustainable foundation for rural financial institutions and will reinforce the role of the government. Careful attention should be given to the separation of fiscal and financial services, to the role of government in RCC operations, and to the effective supervision of RCCs.

Serving *sannong* is a government priority, and of all agriculture supports, funding support is one of the easiest and most welcomed by farmers. Funding for *sannong* may take the form of fiscal transfer, PBC credit transfer, or loans from rural financial institutions, but fiscal and financial service functions must remain separate. Fiscal transfer can be used to meet poor families' nonproductive needs whereas loans from the PBC and financial institutions should be used for productive purposes and must include repayment capacity. Fiscal transfer is a government function whereas financial services are actions of enterprises.

Unfortunately, RCCs often have been used to provide not only financial services but also fiscal services, including public aid. RCCs are told to provide finance for infrastructure development and agriculture technology promotion. This happens often in areas with severe fiscal situations, and local governments simply transfer to financial institutions the function of fiscal support. For instance, the PBC provides loans to RCCs for agriculture lending and microfinance, but some areas require that 85% of this type of lending go to the agriculture sector. Thus, 85% goes to farming households, and a large portion of such lending supports poor households' basic living, medical, or education expenses, which are

Fiscal transfer is a government function whereas financial services are actions of enterprises

more properly supported through public aid from the fiscal budget. Moreover, because agricultural production is subject to high risks and because lending to poor households for nonproduction purposes will not generate returns to be used for repayment, the financial sustainability of RCCs is compromised. This, in turn, dampens RCCs' ability to support *sannong* and forces the government to continue providing fiscal subsidies.

The asymmetry in responsibilities and rights of the central and local governments adds to the moral hazard of rural financial institutions. Local governments, especially those with budget difficulties, tend to direct RCC lending toward local economic growth, particularly because commercial bank operation in rural areas is often scarce. Local governments benefit from the intervention of RCC operations but transfer the cost to the RCCs, and ultimately, to the central government.

The dual identity of the provincial RCC union prevents it from acting as a real supervisor or closing RCCs for violating regulations

A systemic framework should be established to enable local government to utilize its advantages, provide preferential policies, and create a sound environment for RCC operation. Meanwhile, local governments ought to provide a certain amount of emergency support when local RCCs encounter payment risks. Local government also can use its administrative authority and resources to help RCCs resolve nonperforming loans.

The Government of the PRC typically has been involved in the operation of enterprises, and the government has always supervised the RCCs. The RCCs have been variously managed by the ABC, the China Banking Regulatory Commission, the PBC, and the People's Commune. Currently, provincial governments supervise the RCC sector through the provincial RCC unions, which subjects RCC operations and personnel policy to government influence. The dual identity of the provincial RCC union prevents it from acting as a real supervisor or closing RCCs for violating regulations.

In the pilot program begun in 2003, the provincial RCC union transferred only part of its functions to county RCC unions, and it still supervises the county unions through management. The China Banking Regulatory Commission has insufficient staff and capacity to monitor and supervise the large number of RCCs, and the situation is more severe for commission offices in remote areas. For historical reasons, many commission staff overseeing RCCs are former RCC staff themselves, which may affect their judgment, and both the China Banking Regulatory Commission and the provincial RCC union charges supervision and management fees, adding to RCCs' financial burdens.

Efficiency is one of the most important criteria for any rural financial model, whether the model is cooperative, commercial, or informal. For example, if the government insists on the so-called cooperative system and requires RCCs to make all loans locally, as much as two-thirds of the loan amount may end up as nonperforming loans. On the other hand, if the government requires that only 50% of RCC loans be allocated locally, then the RCCs may be able to sustain themselves commercially. If commercial operation is allowed, 50% of the deposits from rural areas can be used locally, support for *sannong* will be much stronger, and local governments can be freed from responsibility for nonperforming loans. The guiding principles of rural finance reform, therefore, should be to open the rural financial market and encourage various forms of financial institutions to compete on an equitable basis. This would mark a major difference between this round of reform and the previous rounds.

Rural financial markets in Guizhou Province, for instance, have tremendous potential. First, the province has a large number of migrant workers, and their remittances are an inexhaustible source of funds for financial institutions. Second, with appropriate mechanisms, reforms in the near future can enable retention of part or all postal savings deposits. Third, Guizhou has become an integral part of the national economic system over the past 20 years. If it can take the initiative, the province will be able to create and capitalize on opportunities.

Financial institutions have tremendous potential for innovation. Various credit guaranty and risk-sharing arrangements, such as microfinance and group guaranties, will greatly enhance credit quality. Financial institutions can be profitable if the financial markets are opened, if fair competition is allowed, and if underperforming institutions are given an exit mechanism. The withdrawal of state-owned commercial banks from rural areas has provided a large opportunity for the development of grassroots financial institutions, and the PBC is adjusting onlending to the central and western regions. Finally, some RCCs and local governments are cooperating to reduce credit risks and some RCCs are making efforts to meet the credit demands of specialized agriculture, because the income of households engaged in agriculture industrialization is much higher than the income of other rural households.

New mechanisms must be designed to curb the present outflow of human and financial resources from poverty-stricken areas. Such mechanisms should enable RCCs to make profits on loans to rural households and to achieve economies of scale while also satisfying local demand for financial services. It is not desirable to sustain RCCs without satisfying local needs; this only creates a vicious cycle of poor economic development, low per capita income, low savings rates, low investment levels, and a lack of incentive for development.

Financial institutions in poverty-stricken areas require preferential policy and capital support, but more importantly, they need efficient mechanisms. Rural financial reform requires a large, systemic effort; concentrating only on RCC reform cannot succeed. One such reform, for example, is to introduce market-based interest rates that will induce flows of funds to poverty-stricken areas. With large numbers of clients spread over extensive areas, small loan sizes, and high transaction costs and risks, rural financial institutions can survive only with an adequate interest spread. Liberalization of interest rates on loans is one prerequisite for sustainable rural financial institutions and for the flow of funds into rural areas. When rural households must choose between low interest rates and loan accessibility, they prefer access.

New mechanisms must be designed to curb the present outflow of human and financial resources from poverty-stricken areas

Given RCCs' monopoly status in the current rural financial market, interest rate liberalization on loans may enable RCCs to transfer their low efficiency to farmers. In addition, liberalizing interest rates on deposits may cause fierce competition among financial institutions, if those with high risks increase their rates to hide operational losses. Nevertheless, liberalizing interest rates is a necessity, and it must be done in tandem with the opening of markets. Suppliers will not enter the market without adequate interest rates, and competition among market players will decrease rates only if interest rates are sufficient to cover costs and risk. This is what happened in Bolivia, for example. When interest rates were first liberalized, the rates climbed rapidly, but they soon were pushed down to a reasonable level by competition in the microfinance market. This competitive equilibrium of interest rates cannot be achieved in the PRC, where many counties have only one RCC.

Along with interest rate liberalization, rural financial reform must introduce new types of financial institutions and explore new forms of financial organization. The PRC should consider regulated and commercially oriented MFIs (engaging in lending only and initially prohibited from taking deposits), village-based cooperative associations, privately owned banks, and informal finance providers. Options for organizing RCCs should not be restricted to the types stipulated in the State Council's 2003 Program on Deepening Pilot RCC Reform. The key to the success of an RCC is its suitability to the local market and its ability to create financial innovations. Community-based financial institutions with good governance structures will help serve the local economy, including *sannong*. Therefore, each area should be permitted to develop new forms of financial institution and to let the markets decide the winners.

Community-based financial institutions with good governance structures will help serve the local economy, including *sannong*

In the near term, possibilities for promoting competition in rural financial markets (in addition to reform of existing RCCs) include pilot testing of regulated microfinance and cooperative finance and the legalization of informal finance. In the early stages, provincial pilots of regulated microfinance agencies that do not accept deposits might be considered. Such institutions can avoid the potential moral hazard of taking public deposits without prudential financial supervision. This differs from accepting deposits backed by implicit state guarantees against loan losses, which can lead to moral hazard. Such institutions can initially use their own funds and funds donated by international organizations. At a later stage, funds from wholesale institutions such as the Postal Savings Bank of China can serve as a major revenue source. Ultimately, the development of regulated MFIs not only can introduce competition in the rural financial market but also can play an important role in legalizing informal finance.

Reform also should implement market-based RCC pilot programs. According to the theory of financial hierarchy, financial institutions have various advantages and disadvantages, and the market should select the survivors. In the PRC, cooperative finance is not truly cooperative because it has to address policy, but neither cooperative nor commercial finance can be sustained if government intervenes. The government should not preemptively prohibit any form of financial institution; the market and investors should have the final say. To achieve this, policy makers must decide whether it is possible to allow some RCCs to remain independent of a county RCC union, whether it is possible to allow two RCC unions in one county, and whether it is possible to allow some county RCC unions to stay out of a provincial RCC union.

Establishment of interregional RCCs also should be allowed. Intervention in RCC operations mostly comes from local governments, especially county and township governments. Establishing interregional RCCs would avoid the current overlap of administrative and business regions. One RCC could cover several townships and, if needed, an RCC union could cover a number of counties. The number of townships and counties covered by each local RCC or RCC union may not be large, but there should be no fewer than three. It is highly possible for two county and township governments to collaborate in seeking rent from RCCs, for instance, but the possibilities for collusion are much lower if three or more townships and counties are involved. This is in line with the PBC's strategy of establishing interprovincial regional centers to prevent local government interference.

Moreover, profitable RCCs should be allowed discretion about whether to join an RCC union or to remain independent. Under the present pilot program, RCCs have no choice but to join the RCC union system, which prevents any external competition. This has essentially led to monopolies, the natural enemy of innovation. Allowing profitable RCCs to decide on this question will enable a competitive environment, resolve the problem of exit mechanisms, and subject RCCs to market discipline.

Reform should seek to create an enabling environment for the sustainable development of RCCs. Most areas in Guizhou, for instance, are underdeveloped. Although reforms and the central government policies that support them have helped to enhance agriculture support, RCCs in the province still face a particular set of difficulties due to weak agriculture infrastructure and a large, poverty-stricken population. Other difficulties include heavy historical burdens and the lack of exit mechanisms.

By the end of 2003, the cumulative losses of all RCCs in Guizhou Province had reached CNY1.45 billion. About 50% of the amount, or CNY719 million, was covered by central government funds; the rest must be covered by RCCs and local governments. In addition, policy and system changes and political interventions resulted in about CNY2 billion worth of nonperforming loans. For instance, when RCC management was transferred from the ABC in 1999, a large volume of nonperforming loans also was transferred. The RCCs also suffered huge losses when the central government forced the closure of five types of small enterprises and when the central bank required indexed loans as a guard against inflation.

It is impossible to resolve all of the RCCs' historical problems in the short term, and RCC development must therefore follow a progressive, long-term course. Many RCCs are unable to make ends meet but cannot be closed, and they are unable to resolve these issues by themselves. Among 959 grassroots RCCs in Guizhou, 514 have deposits of less than CNY2 million per RCC employee and 234 have deposits of less than CNY1 million per RCC employee. Most of these RCCs are in remote areas and must cover extensive service areas despite difficult transport conditions and poor operating environments. Although current policies permit mergers and closures, such action would create a vacuum in financial services for *sannong* that is unimaginable for both the farmers and the government. Party committees and governments at all levels have made great efforts to boost RCC development in Guizhou and to smooth the implementation of pilot programs. However, the provincial government cannot solve the fundamental problems faced by RCCs.

RCCs in the western regions differ from their eastern counterparts in size, nonperforming loan rates, operating environment, and sustainability

RCCs in the western regions differ from their eastern counterparts in size, nonperforming loan rates, operating environment, and sustainability. Although pilot program policy takes into account local economic, geographic, and social conditions, actual implementation shows that RCCs in the western regions have not benefited much. In addition, with the exception of some insignificant preferential tax rates and policy fund selections, most support policies are uniform.

In the end, the resolution of RCC issues in Guizhou depends on development of the local economy and the deepening of reform efforts, particularly the transformation of operating mechanisms and the improvement of RCC institutional capacity. In the short term, however, the central government must introduce additional supporting policies and measures. These can include, among other things, prolonging the corporate income tax exemption period, suspending business taxes, and establishing an RCC development fund to build an electronic network and train employees. Other elements of an enabling environment include agriculture insurance and an agriculture futures market, innovation in rural financial institutions, and collateral and guaranty substitutes for rural households and small and medium-sized enterprises.

The central government also can encourage reform by creating an environment that will attract external funds to poverty-stricken areas. This requires improved infrastructure, education, and health care. Regulations are needed to enable RCCs to conduct commercial operations, to penalize debt evasion, and to establish standards for the creditworthiness of households, villages, and townships. For example, if the repayment rate of a village as a whole is more than 95%, the village can be qualified as a creditworthy village, eligible for lower interest rates on PBC-supported microfinance loans. Or an RCC may choose to let the village rate the households of the village, which will enable those households to get loans more easily. In practice, RCC lending limits are determined by the limit of their own deposits and by PBC onlending, and only a good credit environment can attract more external funds.

The establishment of a risk-sharing fund also can help maintain order in financial markets by enabling financial institutions to assess market-based interest rates in a safe manner

In addition, instead of using poverty alleviation funds for interest-subsidized loans, the government should distribute subsidies directly to households or create a risk-sharing fund to mitigate some RCC financial risks. This would leverage fiscal funds and strengthen financial and risk awareness in rural households. Many rural households regard interest-subsidized poverty loans as aid that does not need to be repaid, and this has distorted the market. Financial awareness can only be strengthened when the poverty alleviation loan is renamed, when there are no preferential interest rates, and when premiums are based on creditworthiness. Rural households will acquire risk awareness when families with high credit ratings are able to borrow at low interest rates whereas families with poor ratings pay more and have little bargaining power. This does not mean that subsidies will be completely abolished; direct fiscal subsidies still can be provided to destitute rural households. The only difference is that support comes in the form of government fiscal aid rather than loans from financial institutions.

The establishment of a risk-sharing fund also can help maintain order in financial markets by enabling financial institutions to assess market-based interest rates in a safe manner. This will prevent potentially destructive competition among financial institutions that use interest-subsidized funds to invest in commercial projects. For example, ABC branches in some areas have used poverty alleviation loans to compete with other commercial banks on small hydropower and road construction projects, thus distorting the markets. In the future, therefore, interest-subsidized loans should be abolished and loans should carry only normal interest rates aligned with risk and creditworthiness. Such measures will help keep the financial markets in order. Moreover, preferential tax rates can reduce the operating costs of financial institutions and encourage them to set up more outlets in poverty-stricken areas.

As has been noted, rural areas suffer from large fund outflows. Many state-owned financial institutions take deposits without making loans in these areas, and postal savings outlets have extracted large volumes of funds from rural areas by redepositing those funds in the PBC. Such outflows over a long period inevitably hamper the growth of the rural economy. The PRC should learn from international experience and promulgate laws and regulations on community reinvestment. For instance, community reinvestment law in the United States requires financial institutions to meet the credit demands of their communities if those demands are based on sound and prudential criteria, though no compulsory ratio is specified. Thailand requires all financial institutions to lend to the agriculture sector 20% of all deposits.

More research is needed to determine the appropriate community reinvestment model for the PRC, and more time is needed to formulate regulations or directives. Nevertheless, in the near future, postal savings can be pumped back into rural areas, and rural financial inputs through the Agricultural Development Bank of China (ADBC) can be increased. In the absense of an open rural financial market, however, keeping postal savings where it originates will only strengthen the monopoly status of RCCs and will present a significant moral dilemma.

In addition, in the absence of a deposit insurance system, the inflow of postal savings to rural areas through RCCs still presents an asymmetric risk: the borrower is the provincial RCC union but the actual user is the county RCC union. Therefore, liberalization of the rural financial markets must be integrated with a market-based mechanism to attract additional postal savings back to rural areas. Moreover, internal ADBC control mechanisms should be improved and operational transparency should be enhanced so that the operational scope of ADBC can be expanded according to its capability.

More research is needed to determine the appropriate community reinvestment model for the PRC, and more time is needed to formulate regulations or directives

Sustainable reform also will require separation of regulation from management and the implementation of minimum regulatory requirements. The current financial supervision system in the PRC is an integral part of the traditional government administration system, and administrative intervention or micromanagement is the main means of supervision. Financial supervisors uphold market entry criteria through administrative approval, especially for private financial institutions, and thus direct the lending of financial institutions. Their supervisory goal is to reduce nonperforming loans, not to safeguard the soundness of the financial system, and they apply uniform supervisory standards to all financial institutions. These practices, combined with limited supervisory capacity, have limited the diversification of financial institutions.

Therefore, the success of RCC pilot programs also depends on the reform of the means and focus of supervision. First, a firewall should be erected between regulation and management. This can prevent both excessive supervision and moral hazard in RCC operations. Second, minimum regulatory requirements should be implemented, although a rigid supervisory framework may suffocate financial innovations, particularly in transitional economies. The main objective of supervisory authorities is to prevent financial risks while avoiding rigidity in supervision. Minimum regulatory requirements can ensure basic financial safety while leaving room for financial innovation.

An effective supervisory mechanism should comprise a positive incentive mechanism that enables prompt corrective actions

Supervision of RCCs is relatively difficult because RCCs normally are geographically scattered, making information collection more expensive. To ensure effective supervision, it is imperative to strengthen the governance structures of rural financial institutions and to improve their operational transparency. An effective supervisory mechanism should comprise a positive incentive mechanism that enables prompt corrective actions. Under such a system, the regulator should have authority to take actions such as restricting a financial institution's business scope and dividend distribution if the institution's capital adequacy ratio, leverage ratio, or other performance indicators are beyond certain predetermined thresholds. These actions may prevent managers from taking more operational risks or engaging in other activities that endanger shareholder interests. If performance indicators reach a second predetermined threshold, the regulator may request an acquisition or merger of the financial institution to maximize its value and protect the interest of shareholders. If performance continues to deteriorate, the regulator should have the authority to close the institution while its assets still are at least equivalent to its liabilities.

It also is necessary to establish a timely and effective exit mechanism under which small and medium-sized depositors can be properly protected and compensated in case of institutional failure. Therefore, the PRC should establish a deposit insurance system as soon as possible. While opening rural financial markets, regulators should take measures to strengthen regulations in accordance with the development of rural financial institutions. Meanwhile, a deposit insurance system can help ensure the effective operation of the rural financial markets.

The results of any reform will vary according to region and the external environment; this is particularly true of finance sector reform. An evaluation system can alleviate risks in reform, summarize experience, and improve future reforms. Among other things, the evaluation of RCC reform should address the sustainability of RCCs, the compatibility of the rural financial system with the local economy, and the post-reform capacity for financial innovation.

Microfinance

Microcredit is an important means of poverty reduction. It can improve financial services for low-income populations and microenterprises and promote the low-end financial market. Sustainable microcredit can contribute to sustainable poverty alleviation by helping more poor people and small enterprises act on their investment opportunities. This will create more employment opportunities, increase incomes, improve income distribution among different regions, and promote the establishment of a harmonious socialist society.

Microfinance development in the PRC calls for a holistic development plan. Currently, the most important requirement is innovation, not imitation. The PRC needs innovative institutions, microcredit loans and other financial instruments, microcredit service systems, and related policies. Material progress in financial sustainability requires supporting and improving existing nongovernment MFIs. More private capital must be legally invested in financial services for low-income populations, small enterprises, and microenterprises, to create more employment opportunities. In addition, more commercial banks, especially urban commercial banks and RCCs, must decentralize their financial services and actively develop financially sustainable microfinance products and services.

Nongovernment Microfinance Institutions

Existing nongovernment MFIs targeting poverty alleviation should first rescue themselves by improving corporate governance and management, upgrading information management systems, and increasing the transparency of financial statements, loans, and business development. In addition, MFIs should continue to improve their microcredit products and services to adapt to changing circumstances. Nongovernment MFIs also need to promote themselves to the public and to donor agencies, thereby mobilizing more resources to serve the poor.

At present, it is unlikely that nongovernment MFIs can be transformed into completely independent institutions, mainly because of unclear fund ownership. These institutions actually are controlled by local governments—their staff is government staff and the board is unable to play its role. Though local government can be integral to improved supervision of nongovernment MFIs, it should provide more support and less interference and should facilitate the institutions' independent operation. Moreover, local governments should assist these institutions in clarifying their fund ownership.

Microfinance development in the PRC calls for a holistic development plan

The associations, networks, and other intermediaries of nongovernment MFIs targeting poverty alleviation also can play a bigger role. They can help MFIs develop information management systems, achieve accounting transparency, promote microfinance loans and other financial products, contact domestic and international donor agencies, and obtain funding and other support. Moreover, they can help government agencies and donors establish a wholesale fund for MFIs and strive for legal status for MFIs. The central government might consider changing the legal status of nongovernment MFIs targeting poverty alleviation so that they can provide loans and other financial services to the poor and to microenterprises.

Pilot Microcredit Companies

Commercialized microcredit companies are important for the sustainable development of microcredit in the PRC. Establishing and developing commercialized microcredit companies can increase loans and other financial services to low-income populations and enterprises, promote competition in rural financial markets, facilitate the reform of RCCs and commercial banks, and pave the way for entry of private funds into the financial market.

According to circulars issued by the central government, one important need of microcredit companies is to fend off financial risk. Rural cooperative foundations have demonstrated the need to prevent deposit-taking or implicit deposit-taking and illegal fund-raising. Presently, there is no systemic risk if microcredit companies do not raise public funds or take deposits. Therefore, non-deposit-taking microcredit companies may require only a supervisory authority and uniform reporting requirements for monitoring purposes. Companies involved in illegal fund-raising and deposit taking should be banned to maintain financial stability, safeguard the interests of other microcredit companies, and ensure the success of microcredit pilot programs. In addition to strengthening supervision, supporting microcredit companies with wholesale and subsequent funding also helps to prevent illegal fund-raising and deposit taking. Well-run microcredit companies should be given access to wholesale funding with which to provide credit services to microenterprises, small enterprises, and low-income populations.

Microcredit companies also can be encouraged to target some urban enterprises and microenterprises as well as diverse industries to mitigate financial risks

Microenterprises, small enterprises, and some medium-sized enterprises have difficulty accessing loans because private funds are profit driven and may be myopic at times, and because the government's macroeconomic management polices may lead to tight credit, which turns some institutions away from microcredit. This can be remedied by providing necessary technical assistance and training, helping microcredit companies realize that there is profit potential in issuing microloans to *sannong* and microenterprises. Microcredit companies also can be encouraged to target some urban enterprises and microenterprises as well as diverse industries to mitigate financial risks. Finally, helping well-run microcredit companies access additional funds through wholesale fund and onlending will encourage microcredit and agriculture loans and can serve as an example for MFIs.

Microcredit companies also should be required to meet certain expectations. For example, support of *sannong* and microenterprises and the fulfillment of certain conditions might make them eligible to provide other financial products and services, including deposit taking. Ultimately, they might be transformed into banks for the poor, serving mainly low-income borrowers, microenterprises, and small enterprises.

Restricting a pilot project to a single county does not encourage sustainable development of microcredit. Instead, this may push privately owned microcredit companies to provide only large loans. Moreover, the one-province, one-county, one-pilot model does not encourage competition and comparison among different institutions, preventing the gathering of valuable lessons from the pilots. Thus, pilot projects should be expanded to larger geographic areas.

The other noteworthy issue is MFI financing. At the early stage of development, equity investment is the main form of MFI financing. With the development of microfinance, commercial loans and other financing instruments can be adopted as complements to equity financing, and eventually deposits might become an important source of funding. This, however, requires interest rate liberalization and prudential regulation of deposit-taking MFIs.

At present, there are two main kinds of investors in commercial microcredit institutions: commercially oriented local investors, who treat microfinance as a profitable opportunity, and international investors specializing in microfinance. These may be donors, foundations, or social investment funds of the type that played an important role in the development of microfinance in the former Soviet Union and other Eastern European countries. So far, these two kinds of investors have invested a total of nearly CNY7 billion in microcredit, and they are looking for new investment opportunities.

To help MFIs access bank loans, the government may consider requiring commercial banks to dedicate a certain level of their loan portfolios to MFI financing. This has been done in Brazil, India, Nepal, Thailand, and the United States. Nevertheless, if MFIs show poor profitability, such requirements cannot help either. In any case, refinancing should be based on efficiency, and ratings can be used to enhance MFIs' financial transparency.

Shifting Financial Products and Services to Rural Areas

Moving the financial products and services of existing financial institutions may be a shortcut to creating large-scale, sustainable microcredit in rural areas. At present, urban commercial banks, especially those with a sound governance and management structure, should focus on cities. The key is to provide incentives for urban commercial banks to conduct microcredit operations.

Postal savings outlets should improve their institutional capacity and governance structure and should be encouraged to experiment with financial innovation. The Postal Savings Bank of China should promote microcredit products and develop collateralized guaranty and credit services for the low-income population and microenterprises. The question is whether postal savings outlets can be transformed into a financial institution capable of issuing microcredit loans.

During the process of shifting products and services to rural areas, attention should be paid to avoiding past mistakes in the PRC and other developing countries. Encouraging low-interest subsidized loans to farmers often has failed to reach targeted clients, creating unsustainable MFIs.

Non-Deposit-Taking Microcredit Companies and a Supervisory Legal System

The following policy recommendations are based on international experience and the principles guiding the development of microcredit companies in the PBC. Briefly stated, microcredit companies are non-deposit-taking and microcredit lending–only nonbanking financial institutions, the supervision of which is intended mainly to prevent illegal deposit taking. Microcredit companies should engage in market-based commercial operations, increase their presence in the rural financial market, and improve microcredit coverage.

New Microcredit Companies and the Market

Microcredit companies do not take deposits but only grant loans and may target either rural or urban areas. Their most suitable legal form is the limited liability company, which can ensure clear

The key is to provide incentives for urban commercial banks to conduct microcredit operations

ownership and sound governance. Microcredit techniques are effective poverty alleviation tools for farmers and microenterprises, and experience shows that if microcredit procedures are simple and speedy, and the loans can be repeated, the poor are willing and able to pay a market interest rate.

The main funding source of microcredit companies should be direct investment, including donations. To attract more donor agencies and private investors, 100% foreign ownership should be allowed. The other capital source is third-party debt (except that of microcredit companies and their borrowers). Government and PBC funds, including postal savings funds, can be onlent through professional wholesale financial institutions; meanwhile, direct lending to microcredit companies should be avoided.

Supervisory and Microfinance-Supporting Institutions

Although microcredit companies are lending-only nonbank financial institutions, registration and supervision still are required to prevent illegal deposit taking and fund-raising and to ensure that the institutions are meeting their social objectives and management standards. New institutions comprising representatives from the China Banking Regulatory Commission and the PBC can conduct such registration and supervision.

Similarly, microfinance-supporting institutions can play an important role in the development of the microfinance industry. The key to developing the microfinance market is training, and institutions should be set up to provide standardized external training. At the same time, MFIs should be encouraged to set up networks. Formal microcredit associations should be established only when there are a substantial number of sustainable MFIs, and wholesale funds should be provided by banks instead of by microfinance associations. There should be further discussion about the establishment of new wholesale banks, the possibility of using existing banks to provide wholesale funds for microcredit companies, and the possibility of establishing microfinance guaranty agencies.

The main funding source of microcredit companies should be direct investment, including donations

There are two possible ways to establish a microfinance supervisory agency. The first is to let the present supervisory authority assume the duty. Although the China Banking Regulatory Commission supervises commercial banks, it is not clear whether it is suitable for supervising microcredit companies. Moreover, deposit-taking financial institutions that need prudential supervision should be treated differently from MFIs. The second option is to establish a new supervisory agency for microcredit companies. For instance, the Government of South Africa created the Microfinance Supervision Bureau, and its board of directors includes representatives from the government, clients, and credit agencies.

The legal framework of microcredit companies is one of the key microcredit issues in the PRC, and a certain number of supporting institutions should play a large role in the whole strategy. The most important supporting institutions include training institutions, microfinance associations (established after microfinance reaches a certain stage of development), wholesale banks targeting microcredit, credit bureaus, rating agencies, and consulting firms providing service for business development.

There are three important kinds of microcredit-supporting agencies. First, training agencies with well-trained staff are a precondition for improving microfinance industry in any country. Such agencies can realize economies of scale through dense and low-cost courses, on-site surveys, and software development. In addition, they can undertake to certify the qualifications of microcredit companies' managerial staff as part of the process of microcredit development.

Second, microcredit associations can play several roles. Under existing conditions, their main roles are to regulate the conduct of microcredit companies, promote successful microcredit companies, and collect and analyze loan coverage ratios and other member financial information. At the same time, microcredit associations can study the supply and demand of the microcredit market, contact the main equity investors within the industry, including government, and lobby relevant individuals and organizations. Such associations have performed well in Benin, Bolivia, Ethiopia, and Uganda. To prevent conflicts of interest, wholesale institutions should not play roles in associations.

Finally, wholesale institutions can direct funds into microcredit. Banks are the best candidates for such fund direction because they not only can channel funds to microcredit companies but also can fend off local government intervention. Meanwhile, they can help microcredit companies create procedures to access donations. The PSBC should not use postal savings funds to provide microcredit loans directly; instead, wholesale funds should be established to provide MFIs with performance-based funding, although the establishment of such wholesale institutions is excessive when there are relatively few MFIs.

Policy Environment

The PRC must establish a new nonprudential supervision mechanism and must partially liberalize the lending rate (to eight times the PBC's base rate). The new laws should be consistent with existing laws and regulations but should clarify whether microcredit is a financial product as specified in the commercial banking laws. If so, existing regulations should be amended or explanatory notes should be issued to account for microcredit companies. Such laws need not contain detailed specifications for microcredit supervision but they do need to elucidate supervisory means. Detailed implementation regulations must include entry criteria and details about MFI operations and existing mechanisms.

At present, the PRC is more concerned with the nonprudential than the prudential supervision of microcredit companies. The main goal of reform is to encourage microcredit companies to provide loans to low-income populations at market interest rates while protecting clients' interests. Only registered microcredit companies should be allowed to charge higher lending rates, and this will push MFIs to register as formal microcredit companies. Market-rate lending by unregistered microcredit companies should be banned, a practice which has shown good results in South Africa. Microcredit loans are not subsidized or subject to

Banks are the best candidates for such fund direction because they not only can channel funds to microcredit companies but also can fend off local government intervention

outside intervention, and RCCs with low-cost funding and the potential for moral hazard should not charge the liberalized lending rate. Commercial banks and RCCs should be allowed to conduct market-based microcredit operations only when microcredit companies are in fair shape and external conditions are mature.

Risks and Other Issues

Traditional microfinance is not suitable for long-term agriculture loans or serving the poorest populations. Though it is an effective instrument for microenterprises and poor farmers, it is not a panacea. Long-term agriculture loans support policy lending, insurance, and rural infrastructure construction, and support for the destitute should follow the same rationale. Destitute people need aid that is not affected by high interest rates, rather than credit, and microfinance does not need much public attention or public funding. Microcredit is usually used for short-term loans with high returns, and international experience proves that competition and economies of scale will reduce the interest rate. However, the development of long-term agriculture loans requires a comprehensive agriculture-supporting system, not simply low-interest microcredit. Microcredit companies can be allowed to grant agriculture loans, but this is not the main business of microcredit companies.

A proper operating model should be led by a powerful government agency with the close cooperation of financial supervisory authorities, relevant ministries, operational institutions, and donors, which will enable the clarification of regulatory frameworks and market entry criteria

Interest rate liberalization for microcredit companies will promote microcredit but will also create a large spread between banks' low deposit rate and microcredit companies' lending rate. Therefore, MFIs will have a strong incentive to take illegal deposits. The promulgation of bylaws, random audits, free hotlines, information dissemination, and the like can be employed to prevent this. One effective mechanism is to cancel all loan contracts if a microcredit company is found to be taking deposits, which would eliminate the incentive of MFIs to take illegal deposits.

Order and Steps in Opening the Market

After 16 years of uncoordinated microcredit pilot projects, the PRC needs a guided and ordered market opening, which requires coordination among all government agencies, clear midterm policy targets, and a legal framework to ensure investor confidence in microcredit companies. A proper operating model should be led by a powerful government agency with the close cooperation of financial supervisory authorities, relevant ministries, operational institutions, and donors, which will enable the clarification of regulatory frameworks and market entry criteria. Moreover, priority should be given to the formation of necessary microcredit-supporting institutions, especially training agencies, which may take a relatively long time.

To obtain firsthand information and necessary experience, initial pilots should include minimal restrictions. Microcredit pilots can be created in several provinces, including at least one province each from the eastern, middle, and western regions. In the past, hundreds of pilots have been supported, but given limited funding and thus limited scale, they have been unsuccessful. Small-scale pilots also can lead to the misperception that the central government does not strongly support the microcredit industry, which discourages international donor agencies. Only relatively large-scale pilots can keep the cost of a new supervisory framework relatively low. Moreover, large-scale pilots must adhere to a market orientation and microcredit companies should not be artificially selected. All applicants that meet the registration requirements should be allowed to become microcredit companies.

Pilots must include time-limited evaluation indicators and systems. Nongovernment microcredit company pilots have been underway for more than 10 years, yet no conclusions have been drawn because there were no clear targets and no common evaluation indicators. Taking a cue from international best practices, the PRC should form clear evaluation standards, regulate intermediaries, and establish a corresponding evaluation system in a timely manner. Only then can pilot programs be evaluated fairly and expanded properly.

Moreover, microcredit companies must be integrated into the financial system and the transformation of microcredit companies into banking institutions should adhere to some basic principles. Before taking deposits, for instance, microcredit companies should have a clear ownership structure, a proper match between ownership and rights, and private capital participation, bearing in mind that only industries and institutions with competitive returns attract private capital. Moreover, regulatory agencies can establish a microcredit registration system and information can be shared among microcredit companies. This will enable lower-income borrowers to enter the credit system and establish a credit record, which will help microcredit companies manage risks and nurture credit awareness among borrowers.

Postal Service Bank of China's Microcredit Project

Since the transformation from China Post to the PSBC, the biggest problem facing the PSBC has been inadequate lending capacity. A key issue is the safety of the microcredit funds, which requires sound institutional arrangements and expertise in microcredit. Therefore, the first step in any microcredit pilot is staff training. Moreover, success requires strong leaders with a full understanding of the significance of microcredit programs, and pilot counties should evaluate potential leaders' understanding of microcredit and primary implementation plans. Ultimately, the experience gained from pilot programs should be popularized in other areas.

The PSBC could make wholesale loans to the ABC, the RCCs, or through the money market

Regulatory authorities should allow the PSBC to expand the scope of its capital utilization, gradually and according to its risk-control capacity, while maintaining appropriate restrictions on the selection of fund recipients. The PSBC also should put in place a risk-prevention mechanism to strengthen internal control.

Feasibility of the Postal Savings Bank of China as a Wholesale Lender

There are many ways by which the PSBC may transform itself from a pure savings bank into a bank with a comprehensive business line. One option is to become a wholesale lending institution. This option is not without risks, and the key is the selection of loan recipients. The PSBC could make wholesale loans to the ABC, the RCCs, or through the money market. For instance, as the ABC's funding source shifts from central bank lending to market financing, the PSBC might provide a certain percentage of these fund at an interest rate determined by the bond interest rate. Because there is excess liquidity at the current stage, however, it is unlikely that the PSBC can make a profit by lending to the ABC at such a rate. To succeed in RCC lending, the PSBC must effectively control risks and determine an appropriate lending rate by rating the performance of RCCs in different regions. Finally, the PSBC might offer wholesale loans through the money market, though the demand for capital is often temporary, unstable, and prone to trigger capital outflow from rural areas.

The PSBC will face substantial risk in the wholesale loan business until there is a stock of healthy small and medium-sized financial institutions and competent rating agencies

PSBC wholesale lending to nongovernment organizations registered as microfinance institutions also is a possibility. To date, there are around 300 MFIs in the PRC, with the large ones covering 5,000 households and the small ones covering about 1,000 households. Fewer than one-fifth of these MFIs break even, and only a small fraction achieve operational sustainability in which interest and other income covers operational costs, even excluding nonperforming loan losses and accounting for the subsidized cost of assets. The number of MFIs that can achieve financial sustainability is even more marginal. Without external capital support or radical reform, therefore, most nongovernment MFIs and projects will be in serious trouble or even face bankruptcy within the next 3 to 4 years.

Unfortunately, because intermediaries are less developed, it is difficult for the PSBC to assess the performance of nongovernment MFIs in order to lend money to them. The PRC has no rating agencies evaluating and publicizing the performance of MFIs, nor do any companies specialize in offering consulting or training to MFIs. Moreover, no registered MFI associations or agencies lend funds to MFIs on a wholesale basis.

The PSBC might engage in wholesale loans to microcredit companies initiated by the PBC, which has actively advocated microcredit and has promoted the establishment of lending-only microcredit companies. Pilot microcredit companies build on nongovernment MFIs and other projects, though this initiative has only just begun and few companies have been founded. When providing wholesale loans to such institutions, therefore, the PSBC must exercise careful risk control. The PSBC also may consider making wholesale loans to village banks.

Because the rural financial market must be opened up gradually, it will take some time to establish a large number of sustainable rural financial institutions. The PSBC will face substantial risk in the wholesale loan business until there is a stock of healthy small and medium-sized financial institutions and competent rating agencies.

Feasibility of Direct Postal Savings Bank of China Microloans

At present, the two outstanding problems in the rural financial market are monopoly and the outflow of large quantities of rural capital. In recent years, the major channel of capital outflow has been postal savings offices at the county level and below. PSBC microcredit loans in rural areas not only would be conducive to the creation of a competitive rural financial market but also would help address the issue of capital outflow and make loans accessible to individual farmers and microenterprises.

The PSBC has unique and huge potential advantages that could help it become a major player in the direct lending business in rural areas of the PRC, especially in providing microloans to microenterprises, individual farmers, and households. These advantages include a massive database of savings accounts from which historical savings trends can be traced. A broad postal information system and wide service coverage give the PSBC a good public image and strong reputation, and mail carriers can access potential microcredit clients at a very low cost. In addition, the PSBC has a broad-based sales network, an effective operational platform, and an interconnected information management system.

The PSBC must effectively utilize such comparative advantages to create a commercially viable and financially sustainable institution capable of successfully providing direct loans. Through full use of historical savings account information, daily access to tens of thousands of rural residents, a thorough understanding of conditions in rural areas, and other advantages, the PSBC can tailor loan products to client demand.

At the same time, the PSBC has some disadvantages. First, the PSBC's clients include salaried workers, retirees, students, journalists, frequent travelers, and small enterprise owners. Of these, however, only small enterprise owners can become microloan clients. Second, the PSBC's information management and accounting systems are centralized in provincial centers, but client information in these systems is not interoperable and information management needs improvement. Finally, there is a shortage of credit officers and managers, and proper risk-control mechanisms are not in place.

Selection of Postal Savings Bank of China Business Models

The transformation of the PSBC will be an arduous task, and a long-term development plan is needed. Most importantly, the PSBC should fully capitalize on its networking advantage. The PSBC has been providing savings services through 35,000 outlets and payment and remittance services through 48,000 outlets. It has a market share of 10% of residential savings and 25% of agency insurance sales by banks. Nearly 25% of pension payments and 10% of salary payments are made through the PSBC's remittance system.

In the short term, the PSBC can diversify risks and improve efficiency by diversifying its products. One possible option is to become a wholesale lender. The key issues in this approach include the selection of appropriate borrowers and the purchase of bonds, which may lead to fund outflow. The second option is to disburse loans directly through postal savings offices, which will have a positive long-term effect on rural finance. This option carries the lowest risk, but in order to accomplish it, the PSBC must upgrade its training and improve its client management system. Moreover, the PSBC should establish a risk-control mechanism and develop products based on local conditions. Such tasks cannot be achieved quickly, and thus long-term plans are needed.

CHAPTER 11

Opening the Rural Financial Market and Piloting New Rural Financial Institutions

It has been over a decade since the promulgation of the State Council's 1996 Decision on Rural Financial System Reform. The reform of rural finance has included the separation of commercial banking from policy banking since 1996 and a new round of pilot rural credit cooperative (RCC) programs, beginning in 2003. In that time, the objective of rural financial reform has become better defined: to create a modern, commercially viable rural financial system that meets the needs of agriculture, rural areas, and farmers *(sannong)* as well as small and medium-sized enterprises.

Rural financial reform is a systemic program, and it cannot succeed if it depends only on RCC reform. Rather, achieving commercial sustainability and effectively satisfying rural financial demand requires diversification. Market competition is necessary not only to improve the governance structure of RCCs but also to enable effective supervision. Moreover, diversified rural financial demand requires various types of rural financial institution, which makes it urgent to open the rural financial market.

The guiding principles of rural finance reform were established in several central government documents. The pilot microcredit companies guided by the People's Bank of China (PBC) in 2005 and the 2007 China Banking Regulatory Commission regulations governing the opening of the rural financial market were new initiatives. Recently, the China Banking Regulatory Commission announced the nationwide expansion of the pilot programs. However, although the opening of the rural financial market can enhance the efficiency of financial institutions, it also can increase the possibility of their failure. The People's Republic of China (PRC) learned bitter lessons from the performance of rural cooperative foundations, and the potential risks of new types of rural financial institutions cannot be underestimated. The opening of the rural financial market is inevitable, but further research is needed to discover the best way to establish a market that is efficient, competitive, and sustainable.

Important Issues in Opening the Rural Financial Market

Opening the rural financial market is an important part of opening the finance sector to the domestic market, and it is just as important as the opening of the banking sector after 2001. Establishing an efficient and competitive rural financial market requires the creation of sound governance structures, separation of policy objectives from reform methods, integration of informal finance, clarification of the relationship between new and existing institutions, development of nondepository lending institutions, and diverse methods of reform.

Formal financial institutions carry strong fund capacity, sophisticated organizational structure, highly qualified professionals, and strict internal control procedures

First, opening the rural financial market requires sound governance. Rural financial operations feature high cost, lack of collateral, and high risks, and therefore differ from urban finance. Innovation is required to create sustainable rural financial institutions, and a sound governance structure is the basis of capacity for innovation. At present, the weak governance of rural financial institutions is the most fundamental reason for their losses. The senior managers of newly established village and township banks are not on the payroll of these banks; instead, they receive their salary from the parent banks, and thus the new banks represent de facto branches of their parent banks. The decoupling of performance from salary apparently fails to provide senior management with sufficient incentive to maintain good governance.

Second, reform efforts must refrain from mixing policy objectives with the means of achieving those objectives. The government's objectives are to address the issues of *sannong* and to increase farmers' incomes, and there are various ways to obtain these objectives, one of which is to provide credit to farmers. However, requiring rural financial institutions to issue credit to farmers as the major means of obtaining policy objectives would constrain rural financial institutions' ability to maximize profits, would impair their independence and efficiency, and would provide an excuse for local governments to intervene directly in their operations.

Third, the rural financial system should integrate existing informal financial systems. To some extent, formal and informal finance can substitute for and supplement each other, given their respective comparative advantages. Formal financial institutions carry strong fund capacity, sophisticated organizational structure, highly qualified professionals, and strict internal control procedures. They have advantages in issuing large and long-term loans. Informal financial institutions, on the other hand, benefit from their simple procedures, flexibility, convenience, small scale, and information access and therefore are better positioned to provide short-term and small loans. The two types of financial institutions have different target clients and a reasonable division of labor. Thus, it is important to develop informal finance to meet diverse rural demands.

The advantages of informal finance are many. One advantage is in information access, which is reflected in the ability of informal finance to assess borrowers' capacity to manage and repay loans. Due to geographic, occupational, and kinship connections, lenders and borrowers in the informal credit market can maintain frequent contact. This enables lenders to measure the probability of timely loan repayment and to take action accordingly.

Such localized guaranty arrangements also reduce the constraints on farmers and small and medium-sized enterprises. Many guaranties considered unacceptable in the formal financial market, such as real estate and livestock, can be accepted as collateral in the informal financial market. Moreover, in addition to their creditor-debtor relationship, lenders and borrowers conduct business together in other markets, such as the commodities market, a relationship which in turn can be included in lending agreements. Such relationships serve as an additional guaranty that borrowers will correctly utilize the loans and repay them on time, because delinquency may damage relationships and incur losses that offset the benefits of default.

Another advantage of informal finance is low transaction cost. The operations are simple, contracts are practical, and participant qualification requirements are low. Although the organization and operation of informal financial institutions consumes time and energy, the opportunity cost in less developed regions is low, which further reduces transaction cost. In addition, informal financial institutions are small and apt to innovate based on actual situations, which also reduces transaction cost.

We should note that these advantages are relative and that the efficacy of informal finance is limited to small-scale operations, leading to disadvantages in economies of scale. For instance, there is a trade-off between the information advantage of informal finance and its activities. In order to access unique information, informal financial services must be limited to a certain scope and to a few people. The expansion of financial activities weakens information advantage, requires more standardized management techniques and operational mechanisms, and thus requires more qualified managers and staff, all of which pushes up cost. Moreover, because some informal financial activities are legally restricted or prohibited, operators must take regulatory risks into account. Finally, certain informal financial activities and forms are particularly adaptable to some cultures and hence are more popular in some communities than in others.

It is unwise to formalize informal finance. Rural lending shops, as a type of informal finance, used to be limited to members of a village or to production and distribution cooperative organizations, and credit risks were reduced through information advantage. Under the current system, however, market risks cannot be reduced and the operational and supervision cost of formal financial institutions is bound to outstrip the capabilities of grassroots finance. Internationally, therefore, small formal financial institutions such as rural lending shops are rare. On the other hand, there are quite a few successful international examples of cooperation between formal and informal finance. For instance, India's National Bank for Agriculture and Rural Development established a microfinance model that combines self-help groups with formal finance.

Rural lending shops, as a type of informal finance, used to be limited to members of a village or to production and distribution cooperative organizations, and credit risks were reduced through information advantage

Fourth, an efficient and effective rural financial market requires clarification of the relationship between new and existing institutions. Since 2003, the reformed RCCs have been cooperatives in legal form and operational approach but are oriented toward government policy. County RCCs are managed by provincial rural credit unions, and although RCC general managers decide on capital replenishment and investment, they are appointed by their administrative organs without shareholder input. Shareholder and supervisory board meetings have become rubber stamps. Due to asymmetry between the rights and obligations of shareholders, shares have become time deposits and the primary goal of shareholders is to obtain convenient borrowing and preferential interest rates. Microlevel RCC mechanisms such as incentives, supervision, and market exit are much ignored. RCCs use their credit support of *sannong* as an excuse, and moral hazard issues are not addressed.

One trend in the reform of RCCs is to allow some shareholders to own controlling shares and to centralize responsibilities, rights, and interests during management selection

It is impossible to resolve rural financial service issues simply by establishing new types of rural financial institutions without attending to the reform of RCCs. The ongoing RCC reform fails to draw on the experience gained from enterprise reform. The success of state-owned enterprise reform is due to the close oversight of large state-owned enterprises and the subjecting of smaller ones to market competition; the success of township enterprises is due to reform of the ownership structure, which allows management to own a relative majority of shares. RCCs' ownership structure, on the other hand, is overly diversified and features high agency cost, weak shareholder rights, and ineffective control of management. This is similar to state-owned and township enterprises during the early stage of their reform, when employee ownership was excessively emphasized. This situation ultimately required a second or even a third round of reform.

One trend in the reform of RCCs is to allow some shareholders to own controlling shares and to centralize responsibilities, rights, and interests during management selection. Preventing big shareholders from hollowing out RCCs, however, requires legislative oversight. In all, opening the rural financial market and restructuring RCCs with private capital are critical for both rural financial reform and RCC reform.

A fifth requirement for an efficient and effective rural financial market is the development of nondepository lending institutions. The PRC has many depository rural financial institutions, including the RCCs, the Postal Savings Bank of China, the Agricultural Bank of China, and other state-owned commercial banks. At present, the Agricultural Bank of China, the Postal Savings Bank of China, and the RCCs have outlets at the county level or below. However, lending institutions are not enough. Regulations on lenders should be promulgated, with emphasis given to nondepository lending institutions.

International experience clearly shows that equity financing is the major channel through which nondepository institutions can be provided with sufficient funding during the early development of microfinance institutions. As microfinance institutions grow, commercial lending and other debt financing instruments can supplement equity financing. To help microfinance institutions access bank loans, commercial banks can be required to dedicate a certain percentage of their lending to refinancing microfinance institutions. However, this method does not work in the case of a weak microfinance institution. Refinancing should be based on efficiency, and credit ratings can be used to enhance the transparency of institutions' performance.

Ultimately, an efficient and competitive rural financial market depends on diverse reform methods. Until now, rural financial reform has employed monopolistic approaches and structures. Such an approach enables reforms to proceed with ease, but this convenience comes with a cost. For instance, in the absence of competition it is difficult to evaluate the advantages and disadvantages of various forms of financial institution. The PRC is a country with sharp regional differences, and without competition we cannot be sure which institutional form is suitable to any specific region—though domination by RCCs or village banks certainly is not an optimal arrangement.

Additional Requirements

The overall objective of rural financial reform is to fundamentally change the way finance supports economic development and to establish an independent, modern rural financial system aligned with the needs of the market economy and able to grow with the rural economy. The new system should encourage the coexistence of various forms of financial institution, including informal and formal finance and privately owned and state-owned financial institutions of all sizes. The market should enable fair competition among financial institutions, and the market, rather than government or supervisory authorities, should decide which forms of financial institutions are suitable for which areas. Orderly financial regulation should enable various financial institutions to display their respective advantages and institutional innovations. Financial intermediaries should serve financial institutions and diversify risks, and a competitive regulatory system should provide national and local supervision.

It is important to establish a layered supervisory system. Following the reform of state-owned enterprises, regulatory authorities have become national supervisors covering all types of financial institutions in all regions. Centralized supervision is conducive to financial regulation and is convenient when implementing the macroeconomic and financial policies of the central government, but it is difficult to adapt such supervision to the varying financial supply and demand across regions. This is particularly true when financial reform is still in process and financial innovations are still emerging. Centralized financial supervision does not lend itself to bottom-up financial innovations, and information asymmetry drives up the cost of supervision.

Regulatory authorities prefer to distribute supervisory functions by setting up intermediary layers, such as provincial RCC unions, and by constraining the scope of small and medium-sized financial institutions. However, this undermines the establishment of a comprehensive, competitive financial market. In addition, the primary objective of financial supervision is to forestall systemic financial risks, but monopolized supervision may concentrate the risks arising from certain regions or certain financial institutions.

The market should enable fair competition among financial institutions, and the market, rather than government or supervisory authorities, should decide which forms of financial institutions are suitable for which areas

It is necessary to explore a new supervisory approach, dividing supervision among central and provincial authorities to establish a diversified and multilayered financial system. Layered supervision is conducive to competition among different supervisors and thus creates a relatively favorable supervisory environment. Financial innovations suitable for local development also will diversify financial risks and reduce systemic risks. For example, state supervisory authorities might focus on large banks that operate nationwide whereas small and medium-sized banks might be subject to provincial level supervisors who can tailor regulations to local conditions. This approach takes into account regional differences while mobilizing the incentives and creativity of local governments and maintaining economies of scale. Ultimately, this will create a benign environment for the development of small and medium-sized financial institutions.

Financial innovations suitable for local development also will diversify financial risks and reduce systemic risks

Moreover, it is important to distinguish supervision from management. The approval system for the establishment of financial institutions should be replaced by a registration system, and market exit mechanisms should be reinforced. Investors should be allowed to select appropriate forms of financial institutions, whether this comprises informal, cooperative, nondepository microcredit organizations or small and medium-sized banks. Moreover, different financial institutions should be subject to different supervisory requirements to avoid financial risk and to create equilibrium between supervision and diverse financial institutions.

The current financial supervisory system is part of the traditional government system, in which the major means of supervision is administrative intervention. Financial regulatory authorities set artificially high criteria for the market entry of private financial institutions, consider nonperforming loan reduction rather than financial security to be the supervisory objective, direct loans in the name of supervision, and apply uniform rather than differentiated criteria to different financial institutions. This supervisory capacity and approach largely affects the diversification of financial institutions, and the success of rural financial pilot programs therefore depends on supervisory reform.

To prevent moral hazard in RCC operations while also discouraging excessive supervision, there must be a clear line between supervision and market participation and a firewall between supervision and management. However, only minimal regulation should be implemented; overly strict legislation may stymie financial innovation, particularly in transitional economies. Thus, the main objective of regulatory authorities should be to reduce financial risks but to refrain from being too heavy-handed. Financial innovation must be given room to prosper.

Finally, it is important to set up a market exit mechanism. Given the difficulties of regulating scattered rural financial institutions and ascertaining the authenticity of information, effective supervision is only feasible with an improved governance structure and operational transparency among rural financial institutions, and an effective regulatory mechanism must be compatible with incentives. For instance, when an RCC's capital adequacy ratio or other performance indicator exceeds a specified threshold, supervisory authorities should take prompt corrective action to restrict business development and dividend payout, thereby constraining the institution. If performance deteriorates, supervisory authorities should call for acquisition or close down problem institutions while they are still solvent. Such authority requires an effective market exit mechanism, and the key to such a mechanism is the protection and compensation of small depositors, which also necessitates a deposit insurance system.

Cost-Effective Approach

Diversified financial organizations should be allowed to compete fairly, with the market selecting the fittest. Experience has shown that government-led cooperative finance is not cooperative in essence and is required to undertake the additional policy task of supporting *sannong*. Although cooperative finance grudgingly provides credit for the agriculture sector, the cost is high, and the key issue is who will pay the bill.

In this round of financial reform, reformers have two choices: to implement truly cooperative finance or to give up cooperative finance entirely and resort to "less expensive" financial arrangements. Either way, the market and investors should select arrangements suitable to their local needs and RCCs should be allowed to operate across jurisdictions. Because local governments, especially county or township governments, presently intervene in RCC operations, administrative jurisdiction should be amended to allow one grassroots RCC to serve several townships and one county RCC union to cover a number of counties, if necessary. This, in fact, is an extension of the strategy that the PBC uses when it breaks from provincial boundaries and divides the country into several areas covered by central branches.

RCCs also should be given autonomy to choose whether to join RCC unions. The current reform scheme requires mandatory association membership, removing competition from outside the system and forming a de facto monopoly, which is the natural enemy of innovation. Giving RCCs the right to decide on RCC union membership can nurture a competitive environment, address the issue of market exit, and help impose market discipline.

Opening the rural financial market is difficult but represents an irreversible trend. However, although some regions and departments have made efforts to establish new types of rural financial institutions, problems remain and potential risks cannot be underestimated. More study is required to determine how to establish an effective, competitive, and sustainable rural financial market.

What is clear is that rural finance in the PRC requires long-term planning. At the current stage, sound governance and performance of any national rural financial institution (e.g., the Agricultural Bank of China, the Agricultural Development Bank of China, or the RCCs), coupled with competition from smaller, diversified formal and informal financial institutions, will lead to benign competition in the rural financial market. We suggest that future pilot programs adhere to the principle that new rural financial institutions must be bottom-up organizations initiated by farmers and capable of delivering financial services to *sannong* at minimal cost.

APPENDIX

Table A.1: Number of Banking Outlets, by Region, 2005

	Northeastern region	Eastern region	Central region	Western region	Average
Per county	38.95	32.94	25.32	18.96	25.04
Per township	2.70	2.85	2.47	1.58	2.40
Per village	0.01	0.14	0.02	0.02	0.05

Source: China Banking Regulatory Commission.

Table A.2: Credit Market Concentration in Sample Counties, 1999–2003 (%)

Year	Yunnan	Guizhou	Sichuan	Shaanxi	Gansu	Ningxia	Average
Loans							
1999	41.31	45.63	42.62	31.12	31.86	35.70	38.04
2000	49.91	41.75	42.61	33.38	34.02	45.94	41.27
2001	49.17	39.40	46.02	35.87	34.13	42.69	41.21
2002	48.65	36.26	44.70	36.98	34.08	38.43	39.85
2003	45.81	34.09	44.01	40.78	34.79	35.06	39.09
Deposits							
1999	36.09	35.13	40.76	29.99	31.88	31.15	34.17
2000	45.65	35.93	39.73	29.46	31.70	30.53	35.50
2001	43.67	35.58	41.65	30.03	32.88	30.95	35.79
2002	43.51	35.41	39.62	29.93	34.21	30.20	35.48
2003	43.22	34.38	40.74	33.25	34.29	29.18	35.84

Source: Authors' calculation.

Table A.3: Rural Deposits in Sample Counties, 1999–2003

Year	Yunnan	Guizhou	Sichuan	Shaanxi	Gansu	Ningxia	Total
Agricultural Bank of China deposits outstanding (CNY billion)							
1999	0.88	0.68	1.04	0.93	1.03	0.55	5.11
2000	1.12	0.89	1.22	1.02	1.29	0.65	6.19
2001	1.20	1.06	1.37	1.11	1.42	0.77	6.95
2002	1.39	1.25	1.53	1.38	1.69	0.91	8.15
2003	1.62	1.60	1.69	1.79	2.01	1.08	9.80
Agricultural Bank of China market share (%)							
1999	45.4	36.9	42.2	26.8	32.0	32.0	35.9
2000	55.2	42.1	43.1	26.5	32.8	31.3	38.5
2001	53.9	40.7	44.8	27.1	35.7	32.0	39.0
2002	54.4	40.8	44.3	29.6	35.5	30.6	39.2
2003	53.8	38.5	45.9	32.4	36.3	29.9	39.5
Rural credit cooperative deposits outstanding (CNY billion)							
1999	0.45	0.41	1.44	1.25	0.93	0.35	4.83
2000	0.57	0.47	1.58	2.09	0.92	0.42	6.06
2001	0.65	0.62	1.94	1.71	1.33	0.55	6.79
2002	0.73	0.81	2.13	1.93	1.61	0.66	7.87
2003	0.88	0.95	2.59	2.37	1.95	0.92	9.64
Rural credit cooperative market share (%)							
1999	20.0	18.4	41.2	28.4	22.9	16.3	24.5
2000	23.2	18.4	38.4	31.7	25.4	21.2	26.4
2001	23.2	19.8	37.5	32.6	25.8	22.9	27.0
2002	23.8	21.8	36.4	32.8	28.9	23.5	27.9
2003	24.6	21.8	36.5	36.3	29.6	26.3	29.2
Postal savings deposits outstanding (CNY billion)							
1999	0.12	0.14	0.19	0.39	0.23	0.18	1.25
2000	0.13	0.18	0.29	0.63	0.32	0.23	1.77
2001	0.19	0.22	0.39	0.90	0.46	0.25	2.42
2002	0.21	0.26	0.51	1.22	0.56	0.30	3.06
2003	0.24	0.34	0.61	1.51	0.71	0.43	3.83
Postal savings market share (%)							
1999	5.8	6.0	7.6	10.6	7.1	7.4	7.4
2000	5.9	6.0	9.3	14.3	8.9	9.3	8.9
2001	7.4	6.4	9.5	17.4	11.0	9.0	10.1
2002	8.2	6.1	10.4	19.4	11.0	9.2	10.7
2003	7.4	6.2	10.4	20.8	11.7	9.9	11.1

Note: Total market comprises these institutions as well as other state-owned commercial banks and insurance companies.
Source: China Banking Regulatory Commission's local offices.

Table A.4: Rural Loans in Sample Counties, 1999–2003

Year	Yunnan	Guizhou	Sichuan	Shaanxi	Gansu	Ningxia	Total
Agricultural Bank of China loans outstanding (CNY billion)							
1999	1.10	2.10	1.74	1.61	1.68	1.14	9.37
2000	1.19	1.86	1.73	1.59	1.57	1.42	9.36
2001	1.26	1.73	1.81	1.64	1.59	1.42	9.45
2002	1.40	1.63	1.88	1.72	1.67	1.45	9.74
2003	1.63	1.56	1.50	1.99	2.01	1.51	10.21
Agricultural Bank of China market share (%)							
1999	58.5	61.8	44.6	44.0	46.1	48.4	50.6
2000	65.0	59.3	46.0	44.4	45.8	60.6	53.5
2001	63.5	54.0	47.4	43.8	43.5	56.2	51.4
2002	61.9	48.9	45.5	42.5	39.9	48.8	47.9
2003	58.7	37.6	42.0	42.7	39.6	41.7	43.7
Rural credit cooperative loans outstanding (CNY billion)							
1999	0.36	0.34	1.00	0.89	0.72	0.22	3.53
2000	0.45	0.44	1.13	1.03	0.90	0.24	4.20
2001	0.57	0.59	1.44	1.28	1.13	0.42	5.42
2002	0.52	0.84	1.79	1.61	1.41	0.72	6.89
2003	0.66	0.96	2.12	2.01	1.68	0.97	8.39
Rural credit cooperative market share (%)							
1999	13.8	12.2	31.2	21.4	17.0	12.3	18.0
2000	17.1	14.1	34.1	27.3	21.9	12.2	21.1
2001	19.3	18.4	37.7	32.4	26.2	19.7	25.6
2002	21.7	25.4	39.1	37.3	31.2	27.3	30.3
2003	24.2	34.9	43.0	41.7	34.5	31.3	34.9
Agricultural Development Bank of China loans outstanding (CNY billion)							
1999	0.15	0.37	0.29	0.45	0.60	0.34	2.20
2000	0.15	0.37	0.62	0.48	0.63	0.41	2.66
2001	0.15	0.36	0.64	0.45	0.63	0.36	2.60
2002	0.15	0.33	0.66	0.67	0.70	0.35	2.86
2003	0.18	0.30	0.70	0.43	0.71	0.50	2.81
Agricultural Development Bank of China market share (%)							
1999	6.5	11.8	9.9	11.7	14.4	13.7	11.3
2000	7.2	11.7	10.6	12.8	15.5	10.3	11.4
2001	6.1	11.2	9.9	11.2	15.5	9.1	10.5
2002	6.1	9.8	9.4	9.4	14.8	6.9	9.4
2003	6.3	10.6	9.1	8.5	14.3	7.6	9.4

Note: Total market comprises these institutions as well as other state-owned commercial banks and insurance companies.
Source: China Banking Regulatory Commission's local offices.

Table A.5: Rural Credit Cooperatives' Nonperforming Loans, Bad Debt, and Losses in Sample Counties, 1999–2003

Year	Yunnan	Guizhou	Sichuan	Shaanxi	Gansu	Ningxia	Average
			Ratio of nonperforming loans				
1999	0.276	0.533	0.385	0.373	0.402	0.363	0.389
2000	0.262	0.481	0.487	0.438	0.410	0.471	0.425
2001	0.229	0.465	0.437	0.407	0.416	0.417	0.395
2002	0.247	0.269	0.323	0.329	0.476	0.305	0.325
2003	0.309	0.254	0.333	0.262	0.397	0.329	0.314
			Ratio of bad debt				
1999	0.049	0.033	0.043	0.063	0.038	0.046	0.045
2000	0.058	0.038	0.033	0.043	0.040	0.043	0.043
2001	0.063	0.036	0.037	0.039	0.033	0.082	0.048
2002	0.091	0.056	0.061	0.044	0.030	0.096	0.063
2003	0.078	0.060	0.056	0.052	0.034	0.070	0.058
			Loss (CNY million)				**Total**
1999	(7.66)	(8.00)	(53.14)	(27.54)	(4.43)	(4.66)	(105.42)
2000	(7.82)	(6.50)	(24.06)	(17.22)	(4.32)	(1.30)	(61.22)
2001	(3.37)	(9.97)	(16.48)	(3.55)	0.74	(8.18)	(40.81)
2002	(2.48)	(7.64)	(4.81)	13.05	3.04	0.54	1.71
2003	(5.76)	(48.78)	1.61	22.45	3.73	1.45	(25.30)

( ) = negative.

Source: China Banking Regulatory Commission's local offices.

Table A.6: Fiscal Funds for Poverty Alleviation in Sample Counties, 1999–2003

Year	Yunnan	Guizhou	Sichuan	Shaanxi	Gansu	Ningxia	Average
			Ratio of work-for-relief subsidies				
1999	0.248	0.533	0.340	0.376	0.579	0.274	0.391
2000	0.222	0.401	0.246	0.302	0.455	0.248	0.312
2001	0.154	0.254	0.172	0.271	0.286	0.135	0.212
2002	0.149	0.185	0.210	0.353	0.242	0.093	0.205
2003	0.111	0.163	0.176	0.322	0.236	0.081	0.182
			Ratio of government bonds				
1999	0.243	0.117	0.154	0.205	0.125	0.166	0.168
2000	0.079	0.163	0.162	0.272	0.267	0.305	0.208
2001	0.248	0.293	0.251	0.231	0.301	0.403	0.288
2002	0.394	0.423	0.238	0.225	0.324	0.591	0.366
2003	0.354	0.392	0.258	0.311	0.335	0.558	0.368
			Ratio of fiscal poverty alleviation				
1999	0.508	0.310	0.440	0.419	0.179	0.249	0.351
2000	0.698	0.413	0.478	0.426	0.219	0.188	0.404
2001	0.595	0.444	0.470	0.459	0.368	0.390	0.454
2002	0.448	0.387	0.490	0.389	0.365	0.256	0.389
2003	0.534	0.434	0.500	0.336	0.383	0.322	0.418

Source: China Banking Regulatory Commission's local offices.

Table A.7: Interest Collected in Sample Counties by the Agricultural Bank of China, 1999–2003 (%)

Year	Yunnan	Guizhou	Sichuan	Shaanxi	Gansu	Ningxia	Average
1999	63.8	45.5	65.0	63.6	33.7	44.3	52.7
2000	70.8	46.3	69.2	59.4	35.1	44.4	54.2
2001	74.4	46.7	67.4	62.1	33.3	43.5	54.6
2002	73.7	49.3	59.4	62.9	32.5	46.5	54.1
2003	74.5	50.1	60.4	64.2	33.7	44.0	54.5

Source: China Banking Regulatory Commission's local offices.

Table A.8: Agricultural Development Bank of China Nonperforming Loans in Sample Counties, 1999–2003 (%)

Year	Yunnan	Guizhou	Sichuan	Shaanxi	Gansu	Ningxia	Average
1999	24.8	19.7	20.3	28.9	36.2	19.6	24.9
2000	30.5	23.6	32.4	34.5	43.9	17.5	30.4
2001	32.1	28.9	44.6	32.7	36.2	20.9	32.6
2002	34.1	34.5	32.0	31.7	33.4	18.4	30.7
2003	27.1	46.5	29.9	28.2	29.0	16.0	29.4

Source: China Banking Regulatory Commission's local offices.

Table A.9: Agricultural Bank of China Loans Outstanding in Sample Counties, 1999–2003 (CNY billion)

Year	Yunnan	Guizhou	Sichuan	Shaanxi	Gansu	Ningxia	Total
1999	1.10	2.10	1.74	1.61	1.68	1.14	9.37
2000	1.19	1.86	1.73	1.59	1.57	1.42	9.36
2001	1.26	1.73	1.81	1.64	1.59	1.42	9.45
2002	1.40	1.63	1.88	1.72	1.67	1.45	9.75
2003	1.63	1.56	1.50	1.99	2.00	1.51	10.19

Source: China Banking Regulatory Commission's local offices.

Table A.10: Agricultural Bank of China Loans in Sample Counties, 1999–2003

Year	Yunnan	Guizhou	Sichuan	Shaanxi	Gansu	Ningxia	Average
Ratio of agriculture loans							
1999	0.24	0.22	0.12	0.13	0.54	0.17	0.24
2000	0.23	0.21	0.08	0.14	0.52	0.18	0.23
2001	0.23	0.22	0.10	0.12	0.58	0.18	0.24
2002	0.22	0.21	0.11	0.12	0.57	0.16	0.23
2003	0.25	0.27	0.11	0.24	0.64	0.16	0.28
Ratio of poverty alleviation loans							
1999	0.21	0.48	0.27	0.39	0.12	0.34	0.30
2000	0.26	0.49	0.30	0.50	0.15	0.39	0.35
2001	0.28	0.57	0.30	0.49	0.15	0.40	0.37
2002	0.28	0.57	0.30	0.48	0.16	0.38	0.36
2003	0.27	0.32	0.32	0.38	0.14	0.37	0.30
Ratio of township and village enterprise loans							
1999	0.06	0.06	0.07	0.06	0.11	0.06	0.07
2000	0.05	0.05	0.05	0.05	0.08	0.04	0.05
2001	0.04	0.05	0.05	0.05	0.06	0.03	0.05
2002	0.02	0.05	0.04	0.05	0.05	0.02	0.04
2003	0.02	0.04	0.05	0.07	0.05	0.02	0.04

Source: China Banking Regulatory Commission's local offices.

Table A.11: Agricultural Bank of China's Poverty Alleviation Loans in Sample Counties, 2001–2004

Year	Yunnan	Guizhou	Sichuan	Shaanxi	Gansu	Ningxia	Average
Ratio of rural household loans							
2001	0.160	0.344	0.238	0.574	0.600	0.422	0.390
2002	0.143	0.241	0.255	0.610	0.651	0.443	0.390
2003	0.131	0.164	0.291	0.616	0.649	0.454	0.384
2004	0.129	0.219	0.317	0.631	0.652	0.472	0.403
Ratio of enterprise and project loans							
2001	0.740	0.649	0.762	0.362	0.396	0.575	0.581
2002	0.757	0.752	0.745	0.326	0.344	0.553	0.580
2003	0.763	0.777	0.709	0.318	0.345	0.543	0.576
2004	0.833	0.656	0.683	0.327	0.348	0.517	0.561

Source: China Banking Regulatory Commission's local offices.

Table A.12: Ratio of Medium- and Long-Term Loans to Total Agricultural Bank of China Loans in Sample Counties, 1999–2003

Year	Yunnan	Guizhou	Sichuan	Shaanxi	Gansu	Ningxia	Average
1999	0.499	0.638	0.504	0.366	0.417	0.467	0.490
2000	0.583	0.628	0.492	0.433	0.525	0.547	0.534
2001	0.639	0.543	0.527	0.458	0.520	0.511	0.529
2002	0.669	0.582	0.486	0.484	0.524	0.510	0.538
2003	0.695	0.487	0.572	0.557	0.513	0.483	0.551

Source: China Banking Regulatory Commission's local offices and authors' calculation.

Table A.13: Agricultural Bank of China Deposit–Loan Ratio in Sample Counties, 1999–2003

Year	Yunnan	Guizhou	Sichuan	Shaanxi	Gansu	Ningxia	Average
1999	1.17	2.75	1.01	0.94	1.24	1.71	1.47
2000	1.03	1.81	1.27	0.92	1.09	1.88	1.33
2001	0.92	1.43	1.21	0.95	1.00	1.60	1.19
2002	0.92	1.16	1.09	0.97	0.90	1.52	1.09
2003	0.95	0.92	0.71	1.07	0.84	1.46	0.99

Source: China Banking Regulatory Commission's local offices and authors' calculation.

Table A.14: Agricultural Bank of China Enterprise Loans in Sample Counties, 1996–2003 (%)

Year	Yunnan	Guizhou	Sichuan	Shaanxi	Gansu	Ningxia	Average
Private enterprises							
1996	9.1	15.2	8.5	18.1	55.1	36.2	23.7
1997	13.3	13.5	8.3	19.0	28.3	35.8	19.7
1998	14.0	15.1	12.1	19.2	29.2	38.9	21.4
1999	14.8	20.4	15.0	21.6	32.5	39.6	24.0
2000	17.3	21.6	16.9	21.8	35.8	38.1	25.2
2001	18.4	24.3	17.7	22.6	38.3	38.0	26.5
2002	20.8	24.2	19.7	23.5	42.0	37.6	27.9
2003	26.3	18.6	24.2	25.3	41.6	38.2	29.0
Collective enterprises							
1996	23.0	28.9	34.6	21.3	22.8	37.5	28.0
1997	19.9	29.0	35.9	28.4	23.0	36.8	28.8
1998	25.7	29.0	35.9	27.3	22.9	37.1	29.6
1999	26.2	28.0	35.1	27.0	21.9	34.0	28.7
2000	24.0	28.6	33.4	25.9	22.8	30.5	27.5
2001	22.5	26.7	34.7	25.8	22.1	30.1	27.0
2002	19.3	25.7	35.2	22.3	22.0	30.4	25.8
2003	17.9	25.3	34.1	22.7	22.0	30.2	25.4
State-owned enterprises							
1996	63.3	56.0	56.9	52.4	67.0	26.3	53.6
1997	62.1	57.5	55.9	43.8	36.8	28.0	47.3
1998	60.4	56.1	52.0	45.3	35.3	24.9	45.7
1999	59.1	51.6	49.9	43.4	32.5	26.5	43.8
2000	58.8	49.8	49.7	44.2	30.2	31.4	44.0
2001	58.7	49.0	47.6	43.5	28.6	31.9	43.2
2002	60.0	50.1	45.1	45.0	24.8	32.0	42.8
2003	55.9	56.1	41.8	44.2	25.6	31.6	42.5

Source: China Banking Regulatory Commission's local offices.

Table A.15: County Revenues Surrendered and Subsidies, 2000–2004

Region	2000	2001	2002	2003	2004	Average
Revenues surrendered by county governments to higher governments (CNY million)						
Eastern	294.14	342.25	439.32	724.58	490.26	457.84
Central	25.85	24.82	35.65	42.32	48.53	35.19
Western	59.76	65.40	79.01	93.20	82.74	76.08
Subsidies to county governments by higher governments (CNY million)						
Eastern	188.65	146.04	217.76	285.64	325.65	233.59
Central	59.64	92.96	120.92	135.70	160.82	114.01
Western	83.96	120.29	174.60	254.10	243.53	176.27
Ratio of revenues surrendered to gross domestic product						
Eastern	0.032	0.030	0.033	0.042	0.028	0.033
Central	0.022	0.021	0.035	0.034	0.030	0.028
Western	0.076	0.024	0.032	0.037	0.032	0.040
Ratio of subsidies to gross domestic product						
Eastern	0.024	0.017	0.023	0.023	0.024	0.022
Central	0.067	0.091	0.121	0.125	0.132	0.107
Western	0.314	0.135	0.156	0.177	0.173	0.191

Source: Department of Finance, various provinces.

Table A.16: Number of State-Owned Commercial Bank Outlets per County, by Region, 2000–2004

Region	Type	2000	2001	2002	2003	2004	Average
Eastern	Deposit-taking outlets	4.0	4.0	3.9	4.0	4.0	4.0
	Lending outlets	4.0	4.0	4.0	4.0	4.0	4.0
Central	Deposit-taking outlets	3.7	3.7	3.8	3.7	3.7	3.7
	Lending outlets	3.6	3.6	3.6	3.6	3.6	3.6
Western	Deposit-taking outlets	3.3	3.2	3.1	3.1	2.9	3.1
	Lending outlets	2.8	2.6	2.6	2.6	2.4	2.6

Source: People's Bank of China.

Table A.17: People's Bank of China Agriculture Loans per County, by Region, 2000–2004

Region	2000	2001	2002	2003	2004	Average
People's Bank of China agriculture loans per county (CNY million)						
Eastern	30.64	28.59	43.14	48.43	59.06	42.57
Central	17.38	21.61	35.54	46.06	46.27	35.19
Western	7.00	31.15	52.09	56.04	58.17	42.85
Ratio of People's Bank of China agriculture loans to deposits						
Eastern	0.027	0.030	0.037	0.061	0.065	0.045
Central	0.068	0.068	0.088	0.114	0.087	0.087
Western	0.064	0.240	0.296	0.256	0.178	0.213

Source: People's Bank of China.

Table A.18: Funds Deposited with Higher Financial Institutions, by Region, 2004

Region	Agricultural Bank of China	Industrial and Commercial Bank of China	China Construction Bank	Bank of China	Rural credit cooperatives
Funds deposited with higher financial institutions (CNY million)					
Eastern	414.04	462.86	552.28	608.89	510.33
Central	74.07	162.20	109.39	151.12	124.35
Western	142.66	184.31	255.76	307.77	222.76
Ratio of deposited funds to loans outstanding					
Eastern	0.746	0.646	0.603	0.699	0.673
Central	1.085	1.098	1.218	1.225	1.157
Western	1.095	1.160	0.819	0.809	0.960

Source: China Banking Regulatory Commission.

Table A.19: Rural Migrant Workers' Annual Remittance per County, by Region, 2000–2004

Region	2000	2001	2002	2003	2004	Average
Annual remittance (CNY million)						
Eastern	339.75	423.41	419.99	485.67	538.69	441.50
Central	257.86	282.69	451.04	348.09	427.85	356.89
Western	42.92	81.74	55.89	130.27	75.72	77.31
Ratio of remittance to gross domestic product						
Eastern	0.049	0.046	0.042	0.042	0.041	0.044
Central	0.104	0.111	0.129	0.115	0.106	0.113
Western	0.317	0.177	0.086	0.189	0.091	0.172

Source: China Banking Regulatory Commission.

Table A.20: Foreign Direct Investment per County, by Region, 2000–2004

Region	2000	2001	2002	2003	2004	Average
Foreign direct investment (CNY million)						
Eastern	342.21	358.57	594.24	1,004.64	1,209.12	701.76
Central	57.89	76.24	122.25	202.89	412.23	186.17
Western	14.50	8.33	11.87	22.00	76.00	24.94
Ratio of foreign direct investment to gross domestic product						
Eastern	0.035	0.025	0.035	0.048	0.052	0.039
Central	0.017	0.010	0.010	0.017	0.047	0.019
Western	0.022	0.028	0.046	0.055	0.079	0.048

Source: CEIC and authors' calculation.

Table A.21: Domestic Direct Investment per County, by Region, 2000–2004

Region	2000	2001	2002	2003	2004	Average
Domestic direct investment per county (CNY million)						
Eastern	414.81	555.02	859.11	1,269.78	2,317.27	1,096.76
Central	203.27	301.90	400.37	647.40	798.21	490.61
Western	161.17	143.06	246.84	132.66	227.70	182.36
Ratio of domestic direct investment to gross domestic product						
Eastern	0.065	0.067	0.089	0.118	0.164	0.101
Central	0.089	0.119	0.140	0.173	0.174	0.142
Western	0.138	0.118	0.167	0.131	0.178	0.146

Source: CEIC and authors' calculation.

Table A.22: Rural Deposits, 1989–2005 (CNY billion)

Year	Agricultural Bank of China	% of total	Rural credit cooperatives	% of total	Postal savings	% of total	Total rural deposits[a]
1989	206	54.9	167	44.6	2	0.6	375
1990	264	54.6	215	44.4	5	1.0	483
1991	332	54.3	270	44.3	9	1.4	611
1992	314	46.6	348	51.6	13	1.9	674
1993	450	50.0	429	47.6	22	2.4	901
1994	517	46.3	567	50.7	34	3.0	1,118
1995	694	47.3	717	48.9	55	3.7	1,466
1996	895	48.4	879	47.6	74	4.0	1,848
1997	1,132	49.6	1,062	46.5	88	3.9	2,282
1998	1,333	50.1	1,219	45.8	108	4.1	2,660
1999	1,549	51.4	1,336	44.4	126	4.2	3,011
2000	1,752	51.1	1,513	44.1	163	4.8	3,428
2001	2,025	49.3	1,726	42.0	355	8.6	4,106
2002	2,480	52.6	1,988	42.1	2,512	5.3	4,718
2003	2,998	52.8	2,371	41.8	3,066	5.4	5,675
2004	3,492	47.8	2,729	37.4	1,079	14.8	7,299
2005	4,037	49.5	2,761	33.8	1,360	16.7	8,157

[a] Excluding rural deposits by the Agricultural Development Bank of China, which are insignificant.

Source: People's Bank of China. 2006. *Statistical Yearbook of China's Banking and Finance.* Beijing: China Finance Publishing House.

Table A.23: Amount and Composition of Rural Loans, 1989–2005 (CNY billion)

Year	Agricultural Bank of China	% of total	Agricultural Development Bank of China	% of total	Rural credit cooperatives	% of total	Total rural loans
1989	305.8	73.6	—	—	109.5	26.4	415
1990	377.4	72.8	—	—	141	27.2	518
1991	457.8	71.7	—	—	180.8	28.3	639
1992	546.8	69.0	—	—	245.4	31.0	792
1993	656.5	66.8	—	—	326.2	33.2	983
1994	552.5	57.1	—	—	415.9	42.9	968
1995	655	39.8	469	28.5	523	31.8	1,647
1996	771	37.9	625	30.8	636	31.3	2,032
1997	981	38.1	864	33.5	733	28.4	2,578
1998	1,367	47.0	709	24.4	834	28.7	2,910
1999	1,553	48.5	727	22.7	923	28.8	3,203
2000	1,450	44.8	740	22.8	1,049	32.4	3,239
2001	1,605	45.3	743	21.0	1,197	33.8	3,545
2002	1,858	46.6	737	18.5	1,394	34.9	3,989
2003	2,212	48.1	690	15.0	1,698	36.9	4,600
2004	2,590	49.5	719	13.7	1,924	36.8	5,233
2005	2,829	51.6	787	14.4	1,868	34.1	5,484

— = data not available.

Source: People's Bank of China. 2006. *Statistical Yearbook of China's Banking and Finance.* Beijing: China Finance Publishing House.

Table A.24: Agricultural Bank of China Loans, 1989–2005 (CNY billion)

Year	Agriculture loans[a]	% of loan portfolio	Township and village enterprise loans	% of loan portfolio	Total loan portfolio
1989	46.4	15.2	39.3	12.9	306
1990	56.3	14.9	43.4	11.5	377
1991	69.5	15.2	49.8	10.9	458
1992	84.7	15.5	58.3	10.7	547
1993	85.8	13.1	77.5	11.8	657
1994	87.7	15.9	93.8	17.0	552
1995	95.5	14.6	95.9	14.6	655
1996	120.2	15.6	115.8	15.0	771
1997	153.2	15.6	151.9	15.5	981
1998	178.0	13.0	174.9	12.8	1,367
1999	174.3	11.2	190.0	12.2	1,553
2000	128.8	8.9	141.3	9.7	1,450
2001	125.5	7.8	145.0	9.0	1,605
2002	441.7	23.1	—	—	1,913
2003	456.9	20.1	—	—	2,268
2004	574.6	22.2	—	—	2,590
2005	450.9	15.9	—	—	2,829

— = data not available.

[a] Agriculture loans mainly comprise loans to rural households for farm or off-farm production and consumption. Other uses of agriculture loans include loans to agricultural institutions and to rural buying-and-selling cooperatives.

Source: People's Bank of China. 2006. *Statistical Yearbook of China's Banking and Finance.* Beijing: China Finance Publishing House.

Table A.25: Rural Credit Cooperative Loans, 1989–2005 (CNY billion)

Year	Agriculture loans[a]	% of loan portfolio	Township and village enterprise loans	% of loan portfolio	Total loan portfolio
1989	52.3	47.8	57.2	52.2	109.5
1990	65.2	46.2	76.1	53.8	141.3
1991	80.1	44.3	100.7	55.7	180.9
1992	98.2	40.0	129.4	52.7	245.4
1993	65.7	20.1	178.3	54.7	326.2
1994	80.5	19.4	227.7	54.7	415.9
1995	109.5	20.9	277.9	53.1	523.4
1996	148.7	23.4	326.4	51.3	636.5
1997	177.4	24.2	346.8	47.3	732.6
1998	265.9	31.9	376.1	45.1	834.0
1999	304.0	32.9	418.7	45.4	922.6
2000	358.8	34.2	456.9	43.6	1,048.9
2001	441.8	36.9	484.3	40.5	1,197.1
2002	557.9	40.0	514.1	36.9	1,393.8
2003	705.6	41.6	569.6	33.5	1,697.9
2004	845.6	44.0	598.9	31.1	1,923.8
2005	933.1	50.0	455.5	24.4	1,868.0

[a] Agriculture loans mainly comprise loans to rural households for farm or off-farm production and consumption. Other uses of agriculture loans include loans to agricultural institutions and to rural buying-and-selling cooperatives.

Source: People's Bank of China. 2006. *Statistical Yearbook of China's Banking and Finance*. Beijing: China Finance Publishing House.

Table A.26: Portfolio Balance and Cumulative Loans of the Agricultural Bank of China and Rural Credit Cooperatives, 1989–2001 (CNY billion)

	Agricultural Bank of China			Rural credit cooperatives		
Year	PB[a]	AD[b]	AD/PB (%)	PB[a]	AD[b]	AD/PB (%)
1989	306	—	—	109.5	—	—
1990	377	—	—	141.3	—	—
1991	458	654.2	142.9	180.9	259.3	143.4
1992	547	716.2	131.0	245.4	342.9	139.7
1993	657	743.7	113.3	326.2	434.4	133.2
1994	552	744.2	134.7	415.9	525.7	126.4
1995	655	796.7	121.6	523.4	606.4	115.8
1996	771	1,036.5	134.4	636.5	794.1	124.8
1997	981	1,106.9	112.8	732.6	880.2	120.1
1998	1,367	1,048.1	76.7	834.0	796.2	95.5
1999	1,553	1,000.4	64.4	922.6	872.1	94.5
2000	1,450	961.2	66.3	1,048.9	952.7	90.8
2001	1,605	1,195.4	74.5	1,198.7	1,153.9	96.3
2002	1,968	1,392.6	70.8	1,393.8	1,425.1	102.2
2003	2,212	1,936.0	87.5	1,697.9	1,909.6	112.4
2004	2,590	2,082.7	80.4	1,923.8	2,283.5	118.7
2005	2,829	2,507.4	88.6	1,868.0	2,434.0	130.3

— = data not available.

[a] Portfolio balance at the end of the year.

[b] Annual cumulative loan disbursement.

Source: People's Bank of China. 2006. *Statistical Yearbook of China's Banking and Finance*. Beijing: China Finance Publishing House.

Table A.27: Rural Deposits and Loans, 1991–2001 (CNY billion)

Year	Total rural deposits	Agricultural Bank of China disbursements[a]	% of total deposits	Rural credit cooperative disbursements	% of total deposits	Cumulative loan–deposit ratio (%)[b]
1991	611	170.6	27.9	259.4	42.5	70.4
1992	674	187.3	27.8	342.8	50.9	78.6
1993	901	184.9	20.5	434.4	48.2	68.8
1994	1,118	244.5	21.9	525.8	47.0	68.9
1995	1,466	232.8	15.9	606.1	41.4	57.2
1996	1,848	317.2	17.2	794.3	43.0	60.1
1997	2,282	344.1	15.1	879.9	38.6	53.6
1998	2,660	270.7	10.2	796.5	29.9	40.1
1999	3,011	234.6	7.8	871.8	29.0	36.7
2000	3,428	179.0	5.2	952.4	27.8	33.0
2001	4,106	201.5	4.9	1,087.0	26.5	31.4

[a] Includes agriculture loans and loans to township and village enterprises, including poverty loans.

[b] Includes both Agricultural Bank of China and rural credit cooperative disbursements and deposits.

Source: People's Bank of China. 2006. *Statistical Yearbook of China's Banking and Finance*. Beijing: China Finance Publishing House.

Table A.28: Demand for Credit Among Sample Population (N = 833)

Item	Respondents ranking as highest priority	% of respondents
Deposits	255	30.6
Education	120	14.4
House	116	13.9
Farm production	78	9.4
Off-farm production	60	7.2
Weddings and funerals	55	6.6
Debt repayment	37	4.4
Food	32	3.8
Cash	25	3.0
Medical	14	1.7
Vehicle	12	1.4
Daily necessities	12	1.4
Borrowing for profit	0	0.0
Other	17	2.0

Source: Authors' calculation.

Table A.29: Fund Inflows in Sample Counties, 2003 (CNY million)

	Dafang	Danzhai	Fenggang	Meitan	Taijiang	Zhijin	Total
Fiscal revenue	150	21	40	82	22	150	464
Fiscal expenditure	296	70	150	196	100	325	1,137
People's Bank of China onlending	43	19	30	6	18	32	148
Migrant worker remittances[a]	171	27	90	152	30	136	606
Agricultural Development Bank of China loans	63	17	114	69	15	52	330

[a] Estimated remittances through postal savings outlets.
Source: Bureau of Finance, various counties; People's Bank of China, various provinces.

Table A.30: Rural Credit Cooperative Deposits and Loans Outstanding in Guizhou, 2000–2003 (CNY billion)

	2000	2001	2002	2003
Total deposits	9.2	11.5	17.8	21.7
Total loans	7.1	9.2	12.5	14.9
Short-term loans to rural households	4.4	5.8	8.4	9.8
Short-term loans to township and village enterprises	0.8	0.9	0.9	1.0
Total short-term loans	6.7	8.6	11.6	13.8
Total medium- and long-term loans	0.4	0.6	0.9	1.1
People's Bank of China onlending	0.6	1.1	2.4	2.5

Source: China Banking Regulatory Commission's Guizhou office.

Table A.31: Agricultural Bank of China Deposits and Loans Outstanding in Guizhou, 2000–2003 (CNY billion)

	2000	2001	2002	2003
Total deposits	21.0	24.4	30.2	36.3
Total loans	31.4	34.1	36.6	42.5
Short-term loans to industry	0.9	1.0	1.7	2.8
Short-term loans to agriculture	0.8	0.7	0.6	0.6
Short-term loans to township and village enterprises	0.7	0.7	0.6	0.6
Total short-term loans	14.7	12.7	13.1	13.5
Medium- and long-term loans for infrastructure	2.9	4.2	4.8	7.3
Medium- and long-term loans for technology improvements	1.0	1.4	1.3	1.2
Other medium- and long-term loans	11.7	14.4	16.7	17.4
Total medium- and long-term loans	15.6	20.0	22.8	25.9

Source: Agricultural Bank of China, Guizhou Branch.

Notes

Chapter 1. Rural Financial Reform

1. Under the land contract responsibility system, farming households lease production tools, including land, from villages or townships. The agreement is a 30-year term contract with zero leasing cost. Farming households determine what to produce after fulfilling the tasks assigned by the village or township.
2. The stated objectives of financial system reform were to establish a central banking system for independent monetary policy implementation; to establish a financial system with separate policy and commercial finance operations, in coexistence with state-owned commercial banks and various types of financial institutions; and to establish an open financial market featuring orderly competition and strict management.
3. Although cooperative finance in the PRC is not truly cooperative, this book uses the official term, for convenience.
4. The quota of PBC loans to support the rural economy increased each year and reached approximately CNY129 billion in 2004. Thereafter, the PBC decided not to increase the quota but to allow for regional adjustment and bias toward the central, western, and northeastern regions and crop-producing areas. Outstanding PBC loans of this type presently stand at over CNY80 billion.
5. Officially, informal financial institutions in the PRC are not counted as rural financial institutions because they are neither regulated nor supervised by the PBC and because deposits with these institutions are not protected by the state.
6. The county RCC union usually has its own business office, offering deposit and lending services to urban residents at the county seat. RCC deposits from urban residents, and lending in the urban areas of the county seat, represent an insignificant portion of overall RCC deposits. Moreover, the county seat itself should be regarded as a rural area.
7. Also known as Tibet Autonomous Region.

Chapter 3. Rural Financial Services for the Poor and for Rural Migrants

1. The northeastern region comprises Heilongjiang, Jilin, and Liaoning; the eastern region comprises Beijing, Fujian, Guangdong, Hainan, Hebei, Jiangsu, Shandong, Shanghai, Tianjin, and Zhejiang; the central region comprises Anhui, Henan, Hubei, Hunan, Jiangxi, and Shanxi; and the western region comprises Chongqing, Gansu, Guangxi, Guizhou, Inner Mongolia Autonomous Region, Ningxia, Qinghai, Shaanxi, Sichuan, Xinjiang Uygur Autonomous Region, and Yunnan.
2. The initial annual interest rate on agricultural loans was set at 2.25%, 0.99 percentage points lower than the benchmark deposit interest rate. On 1 January 2005, the interest rate was adjusted to 3.24%, the same as the benchmark deposit rate.
3. Calculated as fund opportunity cost (4.32%) plus loan processing and management costs (7%), minus the government subsidy rate (5.85% or 5.94%).
4. Although international and national media have reported many cases of illegal providers of currency exchange and international remittance services, our investigations so far have not found informal providers of remittance services for migrant workers inside the PRC.

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3. Economic development stage, a core concept of our analysis, refers to a certain period in the course of economic development, during which economic development demonstrates a stable and consistent trend in aggregation and structure and differs significantly from other periods.
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5. See Cai Fang and Du Yang, "China's Regional Economic Growth: On the Great West Development Strategy," *Journal of Economic Research* 10 (2000); Lin Yifu, Cai Fang, and Li Zhou, "Regional Differences in the Transitional Chinese Economy," *Journal of Economic Research* 6 (1998); Shen Kunrong and Ma Jun, "Club Conversion of China's Economic Growth," *Journal of Economic Research* 1 (2002).
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7. See Cai Fang and Du Yang, "China's Regional Economic Growth: On the Great West Development Strategy," *Journal of Economic Research* 10 (2000); Shen Kunrong and Ma Jun, "Club Conversion of China's Economic Growth," *Journal of Economic Research* 1 (2002). Absolute convergence means that, in the absence of differences in technology, savings rate, population growth, or capital depreciation, per capita capital and output of different countries tend to reach the same stable level, or converge. Conditional convergence means that, if countries share similar characteristics except for technology, they will converge at different, stable levels. If a number of countries or regions converge at the same level, they can be identified as clubs; this is usually called club convergence. See R. Barro and X. Sala-I-Martin, *Economic Growth* (New York: McGraw-Hill, 1995).

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