

# EVOLUTION OF RURAL FINANCE IN CHINA: INSTITUTIONAL “LOCK IN” OR GRADUALISM?<sup>1</sup>

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## Abstract

*To mobilize savings and credit with earmarked priority to implement development strategies, financial depression and policy-driven financial institutions dominated the rural financial system in China. The ongoing reforms encourage the entry of private capitals into the rural economy to liberalize the rural financial market. By making a retrospective review on the evolution of the rural financial system in China, we find that there has been negligible progress. The policy-led financial institutions ended up as merely a disbursement window and a costly drain on state budget. Institutional changes were blocked by patching up the existing institutions. Current reform faces challenges for a sustainable and pro-poor financial system.*

**JEL classification:** E44, N25, D72 and Q14

**Keywords:** rural finance, institutions, intervention, gradualism, China.

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## 1. INTRODUCTION

Economists disagree sharply on how they see the contribution of the financial sector to economic growth. Robert Lucas, in his widely cited lecturing paper (Lucas, 1988), claimed financial development as merely being an “over-stressed” determinant of economic growth. Even pro-finance economists disagree on the mechanism by which financial development contributes to economic growth. Levine (2004), in a reviewing paper, demonstrated a strong positive link between the functioning of the financial system and long-run economic growth, despite the existence of countervailing theories and evidence.

Ample evidence in the 1980s, however, presented that the government-oriented “cheap” credit policies, implemented in numerous developing countries, failed to live up to the expectations (Adams, Graham, & Von Pischke, 1984; Yaron, 1994). In the years thereafter the discussion focused on imperfect market and information asymmetries, and development economists started explaining the reasons for the failure of rural credit markets in developing countries and redefining the role of government in the presence of informational problems (Besley, 1994; Braverman & Guasch, 1986, 1989; Hoff & Stiglitz, 1990; Stiglitz, 1990).

Meanwhile, a growing literature has tried to understand the selection of institutional arrangements and economic performance by comparative institutional analyses, rather than using regression across countries (Acemoglu, Johnson, & Robinson, 2005; Bardhan, 1989; Bardhan, 2005; North, 1990; Nugent, 1993). Once an institutional form is selected or placed, the path chosen by the initial adopters may “lock in” the whole system for a long time to come, denying perhaps potentially more appropriate technologies or institutions (Bardhan, 2001, p. 276). The social or economic system finds itself hard to escape from the dysfunctional institutions, although there are multiple options.

The rural financial market in China carries the traditional paradigm that has been found in many developing countries: institutional credit is subsidized; formal credit programs are highly centralized and heavily dependent on governmental budget; “cheap” credits with earmarked utilization are extended to stimulate investments in agricultural production; private lending is strictly regulated and often considered illegal; credit rationing is prevalent and the rural credit market is fragmented (Cheng & Xu, 2004; Jia, Heidhues, & Zeller, 2007).

From 2006 onwards, Chinese policymakers started waging the “New Rural Campaign” to boost the rural economy and ease the tension caused by

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the increased inequality between rural and urban areas. Credit policies, believed to be efficient and guided tools to provide money to investors, gained a great deal of appeal. With an increasing state budget favoring rural economy, subsidized poverty alleviation loans and other agriculture related financial schemes suddenly became sought-after. Given the widely existing failure of government-driven rural credit programs in other developing countries (Adams, Graham, & Von Pischke, 1984; Von Pischke, Adams, & Donald, 1983; Yaron, 1994), questions arise: What can be learnt from the rural financial reforms that have taken place in the past decades in China? Could the ongoing schemes produce expected outcomes, or merely lead to a repetition of the rent-setting and rent-seeking? How is the state playing its role in the rural financial system?

Although a line of research has investigated China's rural financial system from different perspectives (Cheng & Xu, 2004; He, 2001; Park & Ren, 2001), little has been done to explain the institutional inertia and path-dependency along the evolution. The existing evidence is therefore fragmented and anecdotal. This study aims at elaborating the difficulty of China's rural financial system in evolving into full-service finance motivated by commercial imperatives rather than policy-dominated schemes. The paper is organized as follows. It begins with an overall description of the formal financial system and its evolution in rural China. In section 3, informal finance is addressed. The development of microfinance is surveyed in detail in section 4. Conclusions are drawn in section 5.

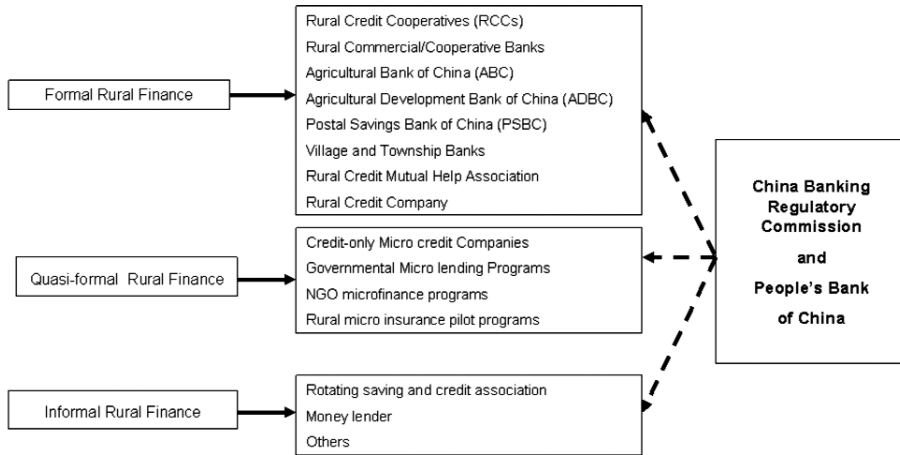
## 2. FORMAL FINANCIAL STRUCTURE IN RURAL CHINA

Compared with the burgeoning and commercialized urban financial system, financial depression and policy-led credit programs overwhelm the rural financial system in China. The current system consists of the formal finance, quasi-formal rural finance, and informal finance (see Figure 1).

### *2.1 Transition of formal financial institutions*

The main formal financial institutions, RCC, ABC and ADBC, are not independent from each other. The ABC was initiated in 1979 as a policy-led financial institution to be specialized in agricultural and rural development. The RCCs were affiliated to ABC at that moment. Nonetheless, since the middle of the 1990s, the RCCs had been under the direct supervision of the central Bank (PBOC-website), and most of ABC's non-performing loans,

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**Figure 1. Rural Financial System in China**

Source: own presentation

piled in the highly centralized area, were devolved to the RCCs<sup>4</sup>. The situation was the same between ABC and ADBC in 1999; policy-oriented loans (e.g. poverty alleviation and infrastructural investments) taken on by ADBC when it was founded in 1994, were transferred back again to ABC due to ADBC's unpleasant and worrisome performance.

### RCCs

RCCs have the longest history and play an overriding role in the rural financial system in China. RCCs underwent four main transitions, along with the decollectivization and market reforms in rural China. The first dates back to the collectivization in 1958 when the RCCs were incorporated into the People's Commune to mobilize capital for large-scale projects. From then on, "cooperative" has had merely a literal meaning. Though the People's Commune collapsed after a three-year famine and was substituted by the "Production Team", a smaller unit, the cooperatives were still one of the compo-

<sup>4</sup> Another big portion of ABC's non-performing loans were stripped off to the Assets Management Company (AMC), which is a state-owned financial unit carrying bad assets to launch state-owned banks.

nents in the collectivized establishment. Industrial development was the main driving force in that period. Bulks of input factors, natural resources, labor force and capital were accumulated to advance industrialization.

The second transition took place after the introduction of the Household Responsibility System (HRS) in 1978. Agricultural production increased remarkably at that time. Degraded as one part of the Agricultural Bank of China (ABC), RCCs were under the control of provincial governments and played a critical role in developing Township & Village Enterprises (TVEs). In 1997, the central government decided to get RCCs back under the direct supervision of the People's Bank of China (the central bank) because of the increased ratio of bad assets.

In the third stage, RCCs became independent from the ABC since 1997 and were placed under the supervision of the central bank, which exerted a rigorous influence on RCCs, especially in the loan business. Besides a financial depression, the central bank introduced agriculture-earmarked on-lending programs by providing cheap loans to RCCs in 1998, with a growth rate of 20 percent for agricultural loan portfolios (Cheng & Xu, 2004). Though RCCs were afraid to infringe the regulation of the Central Bank, they were more inclined to fund projects that had lower risks and higher capital return. RCCs faced a dilemma. During that period, the shortage of institutional lending in rural China was exacerbated. Meanwhile, a variety of informal financial institutions sprang up. However, informal finance was banned by the central government because of its illegal operations and accompanied financial unrest.

At the fourth stage, the poor services of RCCs, together with the depressed prices of agricultural products and the long-lasting downturn of rural households' income, forced the central government to further the reform on RCCs. It is for these reasons that the State Council enacted the "Pilot Plan to Deepen the Reform of Rural Credit Cooperatives" in 2003 in order to clarify the ownership of RCCs and to re-place them under the direct supervision of provincial governments instead of the hitherto existing joint involvement of the central bank and the RCC County Union (RCCU). A variety of ownership arrangements were recommended to allow regional difference in terms of local economic and social environment.

Table 1 shows a sharp increase in the share of RCCs' rural deposits in the middle of the 1990s because of ABC's urbanization. The decline in ABC's rural deposits and loans passed to RCCs the dominant suppliers of credit in rural China. Nonetheless, the figure has diminished since 1996 due to the considerable increase in the share of Postal Savings. Large amounts of rural deposits have been siphoned out of rural areas.

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**Table 1. Deposits of RFIs in China<sup>1</sup>**

Year	ABC <sup>2</sup>	ABC Agri. Deposit <sup>3</sup>		RCCs		PS <sup>4</sup>		Total Rural Deposits <sup>5</sup> (Bi. Yuan)
	(Bi. Yuan)	(Bi.Yuan)	(%)	(Bi.Yuan)	(%)	(Bi.Yuan)	(%)	
1985	91.2	47.5						47.5
1986	122.4	58.8						58.8
1987	148.7	65.7						65.7
1988	171.4	67.2						67.2
1989	205.5	72.3	29.9	166.9	69.1	2.5	1.0	241.7
1990	264	85.4	28.0	214.5	70.4	4.6	1.5	304.5
1991	331.9	102.8	26.9	270.3	70.8	8.8	2.3	381.9
1992	413.1	118.3	24.7	347.8	72.7	12.5	2.6	478.6
1993	518.4	149.2	24.9	429.1	71.5	21.5	3.6	599.8
1994	697.2	173.1	22.4	567	73.3	33.9	4.4	774
1995	694	n/a	n/a	717	92.9	54.7	7.1	771.7
1996	910.7	n/a	n/a	879	92.2	74	7.8	953
1997	1132	26.4	2.2	1062	90.3	88	7.5	1176.4
1998	1333	30	2.2	1219	89.8	108	8.0	1357
1999	1549	34.2	2.3	1336	89.3	126	8.4	1496.2
2000	1752	37.2	2.2	1513	88.3	163	9.5	1713.2
2001	2025	37.7	1.9	1726	87.8	202	10.3	1965.7
2002	2410.7	42.4	1.9	1987.5	87.1	251	11.0	2280.9
2003	2900.5	41.8	1.5	2371	87.2	307	11.3	2719.8
2004	3417.3	44.1	1.4	2728.9	86.6	377	12.0	3150

Source: Almanac of China's Finance and Banking (1986-2005).

*Notes:*

1) The figures in this table are outstanding of deposits at year-end. 2) Include the deposits in urban areas. 3) Due to data unavailability, rural deposits of ABC are missing. Agri. deposits are used instead. Underestimation is unavoidably rendered. In contrast, Cheng and Xu (2004) substituted the total deposits of ABC for the rural deposits, exaggerating the ABC's rural deposits because of its soaring saving business in urban area. Neither Cheng and Xu's work nor this study provides a precise estimation on ABC's rural deposits due to data unavailability. More precise studies are wanting. 4) The deposits of PS are defined as deposits in rural areas. 5) Total rural deposits consist of rural deposits of ABC, RCCs and rural PS.

RCCs do not loan the rural deposits fully. As shown in Table 2, the share of RCCs' rural loans decreased gradually, both in terms of the loan outstanding and the annual cumulative loan disbursement<sup>5</sup>. In Table 3, the ratio of loan outstanding to deposits at year end decreases. A decline in the ratio of total rural institutional loans to deposits indicates that the rural loanable funds are either channeled outside rural China or are left unused. After a temporary increase in the early 1990s, the ratio has been stagnating around 0.7. Rural savings collected by the RCCs are not efficiently used.

In Table 3, we observe a downward ratio of annual cumulative loan disbursement to outstanding loan, indicating rising non-performing loans. It should be noted that, besides the poor management, nonperforming loans which were stripped off from ABC to the RCCs contribute to the piled arrears of RCCs.

### **ABC**

ABC was founded in 1979 as a state owned financial institution disbursing loans for agricultural utilization. In the late 1990s, Chinese government decided to forge four full-fledged state-owned commercial banks competitive internationally. ABC, as one of the four, withdrew from rural areas and focused primarily on urban areas. Consequently, the number of branches below the county level was reduced because of the high ratios of loan defaults, especially in those branches with agricultural loan activities. The ongoing rural reforms may bring forth changes in the system. Given the importance of agriculture and enlarged inequality between rural and urban economy, finance is highlighted in the present rural reform as an effective tool to address the depressed rural economy. ABC is re-oriented back to agriculture, an issue that will be dealt with in the Section 2.2.

As shown in Table 1, agricultural deposits of ABC plummeted after its commercialization in favor of urban businesses<sup>6</sup>. Similarly, as shown in Table 2, we observe a similar decrease in the percentage of rural loans of ABC, though there was an increase from 1999 to 2001 during which ABC re-assumed policy-based loans (for poverty alleviation and supporting parastatal grain agencies) which had been supported by ADBC since its establishment in 1994.

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<sup>5</sup> The exceptional rise in the figure in 1995 and 1996 is caused by the unavailable data of ABC.

<sup>6</sup> But note that this figure underestimates the deposits of the ABC in *rural* areas because only agricultural deposits are used. Other savings, for example, those of the TVEs, are not included due to unavailable data.

**Table 2. Loan Portfolio of RFIs in China<sup>1</sup>**

Year	Total Rural Portfolio <sup>2</sup> (Bi. Yuan)	ABC (Bi. Yuan)	Rural Loans <sup>3</sup>		RCCs		ADBC	
			(Bi. Yuan)	(%)	(Bi. Yuan)	(%)	(Bi. Yuan)	(%)
1985	41.0	168.8	41.0					
1986	56.8	199.8	56.8					
1987	68.9	232.3	68.9					
1988	80.1	263.2	80.1					
1989	197.9	305.8	88.4	44.7	109.5	55.3		
1990	243.5	377.4	102.5	42.1	141.0	57.9		
1991	303.9	457.8	123.0	40.5	180.9	59.5		
1992	388.4	546.8	143.0	36.8	245.4	63.2		
1993	503.4	652.9	177.2	35.2	326.2	64.8		
1994	953.8	591.2	181.5	19.0	415.9	43.6	365.0	37.4
1995	991.8	655.0	n/a	n/a	523.0	52.7	469.0	47.3
1996	1261.2	856.7	n/a	n/a	636.0	50.4	625.0	49.6
1997	1771.6	981.0	174.9	9.9	733.0	41.4	864.0	48.8
1998	1752.6	1367.0	209.1	11.9	834.0	47.6	709.0	40.5
1999	2563.2	1553.0	912.7	35.6	923.0	36.0	727.0	28.4
2000	2583.4	1450.0	794.3	30.7	1049.0	40.6	740.0	28.6
2001	2757.4	1605.0	817.2	29.6	1197.0	43.4	743.0	27.0
2002	2572.1	1857.9	441.7	17.2	1393.8	54.2	736.6	28.6
2003	2845.0	2211.8	456.9	16.1	1697.9	59.7	690.2	24.3
2004	3106.4	2514.6	463.6	14.9	1923.8	61.9	719.0	23.1

Source: Almanac of China's Finance and Banking (1986-2005); ADBC internal report.

*Notes:*

1. The figures in this table are outstanding of loans at year-end.
2. The total loan portfolio includes outstanding of loans of ABC, RCCs and ADBC.
3. The rural loans consist of loans to agricultural households for both production and consumption, loans to TVEs and other agriculture-related loans. Data in 1995 and 1996 are not reported, presumably because of the delegation of policy-based loans to ADBC.



**Table 3. Ratios of Rural loans to Deposits and Indicators of Performance**

Year	L/D <sup>1</sup>			ACLD <sup>2</sup> (bln Yuan)			ACLD/OLs <sup>3</sup>		
	Total	ABC <sup>4</sup>	RCCs	ABC	RCCs	ADBC	ABC	RCC	ADBC
1985	1.85	0.45							
1986	1.63	0.46							
1987	1.56	0.46							
1988	1.54	0.47							
1989	1.11	0.43	0.66						
1990	1.07	0.39	0.66						
1991	1.05	0.37	0.67	654.2	259.3		1.43	1.43	
1992	1.02	0.35	0.71	718.9	342.9		1.31	1.40	
1993	1.01	0.34	0.76	748.3	434.4		1.15	1.33	
1994	1.06	0.26	0.73	509.1	627.8		0.86	1.51	
1995	1.12	n/a	0.73	699.0	606.4	421.01	1.07	1.16	0.90
1996	1.14	n/a	0.72	1036.5	794.1	598.68	1.21	1.25	0.96
1997	1.13	0.15	0.69	1106.9	880.2	758.70	1.13	1.20	0.88
1998	1.09	0.16	0.68	1048.1	796.2	517.92	0.77	0.95	0.73
1999	1.06	0.59	0.69	1000.4	872.1	391.51	0.64	0.94	0.54
2000	0.94	0.45	0.69	961.2	952.7	588.52	0.66	0.91	0.80
2001	0.90	0.40	0.69	1195.4	1153.9	333.80	0.74	0.96	0.45
2002	0.86	0.18	0.70	1392.6	1425.0	180.02	0.75	1.02	0.24
2003	0.82	0.16	0.72	1936.0	1910.0	170.49	0.88	1.12	0.25
2004	0.79	0.14	0.70	2082.7	2283.5	245.95	0.83	1.19	0.34

Source: Almanac of China's Finance and Banking (1986-2005); ADBC internal report.

*Notes:*

1. L/D: Outstanding of loans divided by outstanding of deposits (OPs).
2. ACLD stands for annual cumulative loan disbursement.
3. OLs stand for outstanding of loans.
4. Rural loans divided by total deposits, rather than rural deposits due to data unavailability.

### **ADBC**

ADBC was born out of a compromise between a decollectivized grain system and a government-driven scheme with credit orientation in securing grain and cotton purchasing. During the 1980s, to realize government's control over the economy, a fully state owned agency-system was used to procure, store, transport, process and sell grain. The sweeping liberalization in the early 1990s in grain markets resulted in a striking fluctuation in farm produce and corresponding political unease. In response, there was a back-fire to reassume administrative control over grain markets (Rozelle, Park, Huang, & Jin, 2000). Increasingly, the state was aware of the importance to establish a national grain reserve system to signal its commitment to the market-based mechanism that stabilizes prices. *The ADBC was founded, in such context, to facilitate parastatal enterprises in purchasing procurement in a commercial way.*

At the very early stage, nearly all agriculture-related loans were packed from ABC to ADBC (including already piled arrears in ABC). Despite ADBC's procurement purchasing loans were stated to be circulated within a special account, appropriation and rent-seeking were not rare. The fungibility of credit made supervision very costly. Non-performing loans were piled up. As shown in Table 3, ADBC's ratio of annual cumulative loan disbursement to outstanding loans plummeted from 0.9 in 1995 to 0.54 in 1999. Failure in transforming ADBC into a full-fledged policy-led bank with agricultural orientation, together with stagnated grain production, forced the government to transfer all other loans (poverty alleviation and concessional loans to parastatal grain agencies) back to ABC in March 1998. ADBC then exclusively focused on loans for procurement purchasing and its share of rural loans decreased (see Table 2).

### **Postal Savings (PS)**

Founded in 1986, Postal Savings (now called China Postal Savings Bank) were buoyant savings-only financial institutions and absorbed vast rural funds to urban economy (Table 1). The existence of Postal Savings is understandable. It is widely accepted that funds move from a place with lower marginal value to a place with higher marginal return. As a consequence, if it was not PS, some other financial institutions would have assumed the role and channeled out the rural funds. But still, a fact that cannot be denied is that rural financial institutions, especially RCCs, were weakened due to the scarcity of savings, trapped in the vicious circle of capital formation (Heidhues & Buchenrieder, 1999).

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## 2.2 Ongoing reforms

Since 2000, both academia and the state advocated the lift of access barriers to rural financial markets and for the establishment of a competitive rural financial market. Consequently, entry barriers to the rural financial market are being relaxed; current financial institutions are being renewed or restructured and new financial resources are being directed into rural economy.

### 2.2.1 Ease the market access

To establish a sustainable competitive rural financial market, the market entry and quit mechanism is imperative. In December 2006, the China Banking Regulatory Commission (CBRC) released a policy paper to ease market access for financial institutions in less developed rural areas (first piloted in six provinces). The policy allows for banking capital, as well as industrial and private capital both from home and abroad, to be invested in, even to purchase and reorganize the current banking institutions in rural areas, especially the RCCs. The policy aims to lower the registered capital threshold for county banks, township and village banks, and farmer's credit mutual-help associations. In addition, the quantity and proportional restriction for rural financial institutions to set up branches in rural areas are lifted up. Furthermore, the new policy revises the authorization rights for newly established legal entities or branches to enhance the flexibility and simplicity of governance in rural financial institutions.

At the end of 2007, 31 new emerging rural financial institutions (19 township and village banks, 4 microcredit companies and 8 rural credit mutual-help associations) started to provide financial services in rural areas (Sun, 2008), indicating perhaps that there are currently significant incentives to operate efficiently and profitably within rural financial markets in China. The total assets of the above institutions amounted to RMB 14.7 trillion, 27.6% of total banking assets, and the total Debts amounted to RMB 14.2 trillion, 28.4% of total banking debts. The total deposits amounted to RMB 11.9 trillion, 29.5% of the total banking deposits, and Loans RMB 7.9 trillion, 27.6% of the total banking loan. The total loan outstanding related to agriculture has reached RMB 6.09 trillion, of which direct agricultural loan amounted to RMB 1.57 trillion, and the proportion of households that have access to banking loan reached 33%, from which more than 300 million farmers benefited (Cai, 2008).

Compared with local RCCs, the newly established township and village banks have an advantage thanks to flexible interest rates, loan terms and a streamlined approval process. For example, the village and township bank is able to provide credit support to farmer's specialized cooperatives and agri-

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cultural products agents. They are allowed to differentiate loan cycle and interest rate according to various customers. These new emerging rural financial institutions, however, have not yet led to substantial competition in rural areas and it remains to be seen whether these new institutions will provide the necessary capital for agricultural investment, especially in poor areas where the advantages to economic growth are readily apparent. Apparently, the new policy excludes NGOs from being the initiators or shareholders of microfinance.

### *2.2.2 Establishing and restructuring the rural financial institutions*

#### *Postal Savings Bank of China*

The Postal Savings Bank of China (PSBC), the former Postal Savings and a supported organization by China Postal Group, was licensed and launched in March 2007. PSBC is the fifth-largest state-owned bank in China, with a registered capital worth 20 billion Yuan (US\$ 2.57 billion), and 60 percent of the total outlets and branches in rural areas. PSBC is presently initiating pilot programs of rural group lending, farmers' micro credit, and micro-entrepreneur loans. Relying on the postal network, PSBC has the potential to enrich product variety, to expand marketing channels, and to improve service in rural China. By the end of 2007, the branches of PSBC exceeded 37,000 and the deposit balance reached RMB 1.7 trillion, with the loan outstanding of RMB 113.4 billion and total assets exceeding RMB 900 billion.

#### *Rural commercial/cooperative banks*

In 2003, the banking regulator allowed qualified RCCs to transform into rural commercial banks or rural cooperative banks. At the end of 2006, there had been 80 rural cooperative banks and 13 rural commercial banks in China (Anonymous, 2007. China Banking Regulatory Commission). Nonetheless, these banks, though titled as cooperatives, are by nature shareholding systems and mainly disburse loans to the enterprises instead of small farmers.

#### *Rural credit-only micro credit companies*

To promote the gradual reform of rural finance projected by the state, seven pilot credit-only microcredit companies owned by private sectors in five pilot provinces<sup>7</sup> were set up at county level in 2005 and 2006. These companies do not collect public deposits but deliver small credits with a lib-

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<sup>7</sup> In order to change the monopolization of existing rural formal financial institutions, the POBC launched a microcredit pilot program in the Shaanxi Province, Shanxi Province, Sichuan Province, Guizhou Province and the Inner Mongolia Autonomous Region, in an attempt to explore the possibility of rural financial innovation both diversified and commercially sustainable.

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eralizing interest rate by using their own financing. This rural financial innovation provides a channel for private capital entering the rural financial market, and is alleged to enlarge the rural financial supply to some extent and to promote better competition in the rural financial sector.

### *2.2.3 Channeling new financial resources into rural areas*

#### *Foreign capital invested village bank in China*

Several foreign financial institutions submitted their applications to set up rural financial institutions in rural China. HSBC is the first international institution to enter China's rural financial market. On December 13<sup>th</sup>, 2007, HSBC opened the Suizhou village and township bank (VTB) in Hubei. At the initial stage, the HSBC's VTB focuses on agriculture-related service enterprises, especially exporters. The less developed rural market in China sees HSBC as an emerging business chance.

#### *ABC's Return to Rural Areas*

In early 2007 the central government redirected ABC back to serve agriculture and rural development under the "commercial operation rule" in eight pilot provinces (Fujian, Hunan, Jilin, Sichuan, Guangxi, Gansu, etc.). The policy initiative for ABC is to provide full services to farm management, SMEs and even consumption loans. By establishing village and township banks (VTBs) in Hubei and Inner Mongolia, ABC intends to resume its lost branching network in rural areas. It is an open question in which way the redirected formal players will not be trapped in the previous predicament.

## **3. INFORMAL FINANCE IN RURAL CHINA**

The fact that scarcity of capital restrains rural economic development is highly recognized. Given the highly regulated and depressed rural formal financial system in China, informal finance has been active since the early 1990s; the co-existence of rural formal and informal finance forms the financial 'dual structure' and proves the rural financial depression in China<sup>8</sup>. In the early 1990s, Chinese government centralized its fiscal revenue to realize dominating economic and political control on the local government. As a result, the local government promoted rural cooperative foundations (RCFs) to

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<sup>8</sup> A large number of potential borrowers have to seek for credit support from informal sources due to fussy loan approval procedures and high transaction costs related to credit application from formal financial institutions.

finance local township and village enterprises (TVEs). RCFs promptly bridged the vast gap between demand and supply of rural formal finance and took the role of rural informal finance. However, due to institutional disadvantages (such as intrinsic deformity of property rights, distorted organizational behaviors, dependence of bureaucratic system, high-risk running and so forth (Zhang, 2002), RCFs were abolished nationwide when the new-round rural financial reform was launched at the end of 1990s.

To date rural informal finance in China exists in the modality of non-interest credit, money shop, ROSCA, pawn-broking, private funding pool and so on<sup>9</sup>. The small-scale peasant economy naturally and chronically combined with private credit and the vacuum of rural formal finance provoked the rapid movement of rural informal finance (Wen, 2001). The increasing income level along with the rural economic development in China led to an abundant supply of rural informal finance, and at the same time the rural people lacked in security investment (such as treasure bonds stocks and funds). As a result, private capital holders, driven by the interest income, became the suppliers or intermediaries of rural informal finance. Apparently, rural informal finance takes the role of transformation from capital to investment, and thus affects rural formal finance.

Rural informal finance is playing a positive role in agricultural growth, rural development and farmer's income generation in China. Guo (2004) estimated the total volume of rural informal finance and found that it increased from 223.8 billion Yuan in 1997 to 275.0 billion Yuan in 2002, as shown in Table 4. In some cases, rural informal finance gives demonstration effect to its formal counterparts, such as, how to improve its information collection mechanism, how to use the liberalized interest rate, how to continuously develop and refine its micro-lending operation and stabilize its customers. Moreover, policy makers in China should consider how to revise the existing laws and regulations that impede the development of rural informal finance. Therefore, the regulatory authority should positively agree with the existence of informal finance, encourage its development and formalize it into the financial regulation system. Second, for the rural informal financial institutions that have reached a certain scale with the functional management system, an authorized license system is useful. Third, the illegal acts in rural informal institutions should be strictly confined or abolished. Last, the concepts of legal, contractual and guaranteed informal financial activities should be widely propagandized and emphasized among the rural population.

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<sup>9</sup> Because pawn broking in China is legal, in order to evade the regulation, many informal financial institutions develop informal credit thanks to pawn broking.

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**Table 4. Estimate on Rural Informal Finance in China**

Items	1997	1998	1999	2000	2001	2002
1. Total amount of fixed assets investment in private sector	3429.4	3744.4	4195.7	4709.4	5429.6	6280.3
2. Loans in private sector from formal finance	386.7	471.6	579.1	654.6	918.0	1058.8
3. Balance between fixed assets investment and loans from formal finance in privates sector (1-2)	3042.7	3272.8	3616.6	4054.8	4511.6	5221.5
4. Informal external finance in private sector						
(1) Narrow Caliber	167.35	180.00	198.91	223.01	248.14	287.18
(2) Broad Caliber	791.10	850.93	940.32	1054.25	1173.02	1357.59
5. Volume estimate on informal external finance in rural private sector						
(1) Narrow Caliber	117.14	126.00	139.24	156.11	173.70	201.03
(2) Broad Caliber	553.77	595.65	658.22	737.97	821.11	950.31
6. Informal finance per farmer household (yuan)	936.07	1042.98	1091.2	1020	1048.69	1000
7. Farmer Households' informal finance 6×180 million	1684.93	1877.36	1964.16	1836	1887.64	1800
8. Volume Estimate on Rural Informal Finance						
(1) Narrow Caliber 5.1+7	1802.07	2003.37	2103.40	1992.11	2061.34	2001.03
(2) Broad Caliber 5.2+7	2238.70	2473.01	2622.38	2573.97	2708.75	2750.31

Source: Pei Guo, 2004 "Volume Estimated on Rural Informal Finance in China", China Rural Survey, No. 2.

Note: a) Unit: RMB 100 million Yuan

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#### 4. MICROFINANCE INSTITUTIONS (MFIS) IN CHINA

Microfinance in China is dominated by internationally sponsored and government-driven programs. During 1998-2002, these two parts accounted for 83 percent of microcredit in China (Zhang, 2004), and the figures leveled off<sup>10</sup>. The development of microfinance in China experienced primarily four stages (Jiao & Yang, 2006). During 1993-1996, blessed by international funding, several microcredit pilot programs were experimented and the performance of these programs was reviewed by Park and Ren (2001). During 1996-2000, in pursuing the Millennium Development Goals (MDG), microcredit was borrowed by government to deliver anti-poverty finance (Sun, 2003). When entering into the 21st century, public finance was heavily oriented towards agricultural transformation and rural development due to China's depressed rural economy and exacerbated livelihood of rural population (Jia & Fock, 2007). In this context, rural financial institutions – primarily RCCs and Rural Commercial/Cooperative Bank – started microcredit programs by adopting micro loan certificates and group lending. Increasingly, the original initiative of anti-poverty was bypassed and the use of micro-credit expanded sharply into rural industry; unfortunately, the targeted smallholder farmers were left behind. Recognizing the limitation of public finance and the inactive involvement of private capital into China's rural economy, from 2006 onward, the Chinese government started to lower entry barrier to encourage private capitals' entering into the rural microfinancial market. In the context of the recession of world economy in 2008, financial support to Chinese small & medium enterprises (SMEs) emerges on the top of the development agenda.

Early microfinance pilot programs in China were successful (Park & Ren, 2001). Nevertheless, the thrust of the government-driven microfinance program undermined the inherent incentive and the accountability of the local government confounded the performance of microfinance. The current liberalization of the rural financial market, for certain, will encourage competition towards efficiency-improvement. Nevertheless, a great number of smallholder farmers face prohibitive costs to access agricultural technology, market information, and extension service. From 2002 onward, although RCCs actually took the lead in disbursing credit to smallholder farmers, the share of microcredit to farmers has stagnated around 30 percent (Table 5). All these

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<sup>10</sup> From 2001 onward, RCCs and the Rural Commercial/Cooperative Bank started to carry government-driven microcredit programs. Unfortunately, data availability restrains us from drawing quantitative evidence.

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**Table 5. Microcredit Disbursed by RCCs in China**

Year	2002	2003	2004	2005	2006
Microcredit	74.57	111.86	167.84	157.85	167.77
Farmers' Credit	323.77	402.15	473.12	498.97	566.69
ratio	23.0%	27.8%	35.5%	31.6%	29.6%

Source: Almanac of China's Finance and Banking, 2003, 2005 and 2007.

Note: Unit is billion Yuan

factors, when put together, lead to further marginalization. For future sustainable development, there is a pressing need to identify pro-poor microfinance in order to achieve in the synergistic triangle of financial sustainability, outreach and poverty (Zeller & Meyer, 2002).

## 5. CONCLUSION

The government-led rural financial institutions in China channel sizable funds out of rural areas, as well as re-direct cheap credit back to rural sectors with earmarked priority to implement rural development strategies. Primarily in the form of direct intervention, the incentive mechanism for individuals or institutions is not fully compatible with the proposed objectives. Consequently, policy-led financial institutions in rural China end up as a mere disbursement window, rather than balanced and full-service financial institutions. Far from being motivated by commercial imperatives, the concessional funds with capped interest rate and earmarked utilization in agriculture piled a large number of bad assets. This inappropriate intervention also creates moral hazard, encouraging bank insiders to take risky projects or appropriate credit in their interests because they believe that the government will bail out at the end (and such belief has been verified in the evolution). In the end, the cornered government has to rescue the system by either bailing-out or taking over a newly established institution.

The ongoing reforms projected by policymakers promote competition among different institutional lenders and thus potentially improve the financial services in rural areas. Nonetheless, the interventions focus too heavily on liberalizing the system and encouraging the entering of private capital without truly realizing the mechanisms by which financial development contributes to economic growth (inter alia, mobilizing information and dis-

seminating technological progress), without thoughtful regulations and interventions to redress financial market failure (rather than to supplant markets by the states). The up-down reforms are little more than a repetition of rent-setting and rent-seeking with exclusion of a majority rural households.

In the critical leap between the mercantile economy and the industrial economy the ability of the state to act as a catalyst and a coordinator in the financial market can sometimes be important (Bardhan, 2005). Gradualism, taken when the political acceptance of full and immediate reforms implies costly compensations, allows for better rent extraction from some groups and for reaching allocative efficiency gradually (Dewatripont & Roland, 1992). However, the rent-seeking opportunities created by gradualist reform give rise to new distortions and an institutional "lock-in". Institutional change is not likely to be merely a matter of Pareto-improving innovations and adaptations. Instead, inefficient institutions are often adopted. The pursuit of self-interest rarely tends to promote the evolution of efficient institutions because of the involvement of state, non-voluntary interactions (externalities), inertia and complexity of institutions (Matthews, 1986). To sum up, while the rationale for liberalizing financial markets is based "neither on a sound economic understanding of how these markets work nor on the potential scope from government intervention" (Stiglitz, 1994, p. 20), "gradualism" reestablishes new distortions over regions and sectors, and therefore locks in new institutional arrangements which have high allocative efficiency. The transition proceeds on the "edge of a razor", a term borrowed from Alwyn Young (2000).

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### Résumé

Pour l'offre de services d'épargne et de crédit avec l'objectif de promouvoir le développement, la dépression financière et des institutions financières dominées par la politique ont dominé le système financier rural en Chine. La réforme courante encourage l'entrée de capitaux privés dans l'économie rurale pour la libéralisation des marchés financiers. À travers une revue rétrospective de l'évolution des systèmes financiers en Chine, on trouve un progrès négligeable. Les institutions dominées par la politique ont été surtout une fenêtre de déboursement et une absorption de coûts pour le budget étatique. Les changements institutionnels ont été bloqués par le rapiécage les institutions existantes. Les réformes récentes constituent un défi pour un système financier soutenable et en faveur des pauvres.

