

# Rural Financial Reform in China: Progress Made and the Path Forward

XINGYUAN FENG, GUANGWEN HE AND CHRISTER LJUNGWALL

## Abstract

Significant progress has been made in reforming China's rural financial system. Nevertheless, the current institutions are unable to meet the multi-layered and diversified demands for rural financial services. Establishing a comprehensive and efficient rural credit system to support the dynamic commercial sector of the rural economy, small-scale farming and small and medium-size enterprises is the major challenge in China. This article identifies bottlenecks and suggests policies to develop a well-functioning and sustainable agricultural and rural financial system that would address the diverse needs of the rural and agriculture sectors. To preview the policy recommendations, attention should be given first to legislation and supervision, and then to the corporate governance structure of financial institutions.

*Keywords:* China, rural finance, economic reform

## Introduction

The initial reform of the rural financial system was spurred by the start of the overall reform of China's rural economy in late 1978.<sup>1</sup> This reform led to rapid commercialization and monetization of the rural economy and generated a demand for more effective and diverse formal financial institutions that could better support investments. The overall reform was pushed ahead by both government-led policies and the natural expansion of existing financial institutions during the reform process.

During the 1980s and the first half of the 1990s, government-led policies focused mainly on improving the supply of rural finance and coordinating activities between providers and users of financial services. This led to accelerated diversification of formal and informal sectors. However, financial risks accumulated significantly in both the formal and informal (including semi-formal) financial sectors and financial defaults increased, especially in the midst of the poor economic performance of the township and village enterprises (TVEs) in the 1990s (Feng,

He and Du 2006). In the late 1990s, the State Council took action to crack down on semi-formal and informal financial organizations and activities, which were considered detrimental to the stability of the financial order.<sup>2</sup> Almost all the semi-formal and informal financial organizations disappeared during this government-led campaign.

Despite the efforts of government-led reforms, formal rural finance institutions have been unable to meet the multi-layered and diverse demands for rural financial services and provide support for the stable development of Chinese agriculture. Furthermore, monopolies have prevailed in the formal financial sector. Rural credit cooperatives (and rural commercial banks and rural cooperative banks since 2003) have dominated the rural formal financial sector in terms of their share of the loan and deposit market since the late 1990s. In particular, although China has undertaken complex reforms to develop a market economy, there was no substantial progress with regard to the rural finance management and property rights systems until 2003 (Feng et al. 2006; He 2004). Important challenges thus lie ahead, including promoting the development of rural financial institutions and innovations in rural finance and improving rural financial market mechanisms.

In 2003, the new Party and government leaders assumed office and reversed the course of development. Since the beginning of the 1980s, two tracks of rural financial reform are identifiable. The first track, characterized by the adjustment of the existing structure, started in the early 1980s and accelerated after 2003. Since 2003, the government has launched a series of reforms one after another, including a wide-scale reform of rural credit cooperatives (RCCs), and the transformation of postal saving services into a postal savings bank. The other track is the so-called 'New Deal', characterized by an increase in the number and diversity of rural financial institutions, which was set in motion by Document No. 1 of the Central Committee of the Chinese Communist Party (CCCCP), released in early 2004. This served as a market entry policy for new types of formal and semi-formal financial institutions with the potential to absorb informal finance funds and other private capital, while keeping the repressive policies toward informal finance unchanged (Feng et al. 2006). Since then, China has made significant progress in overall formal rural financial reform. However, the government still tolerates informal financial activities, although they have not been allowed to function on a large scale.

Evidence shows that limited access to financing is an impediment to the development of agriculture as well as the creation of off-farm

employment and thus enlarged opportunities for income generation in rural areas in many developing and transition economies (see Davis 2003; Burgess and Pande 2005; Lipton and Zhang 2007; Demirgüç-Kunt and Levine 2008; Hakenes, Schmidt and Xie 2009). Establishing a comprehensive and efficient rural credit system providing financing for both the dynamic commercial sector of the rural economy (agricultural and non-agricultural) and small-scale farming, which lacks collateral and is isolated from markets, is one of the major challenges for developing economies (Yaron 1992; Zhang and Heufers 2002).

The main objective of this article therefore is to identify bottlenecks and to suggest policies to develop a well-functioning and sustainable agricultural and rural financial system that would address the diverse needs of the rural and agriculture sectors. In this respect, the article focuses on the formal and semi-formal financial sectors.

Below, sections 2 and 3 discuss the main characteristics of the two tracks of rural financial reform. Section 4 analyses the effectiveness of the reform, while section 5 highlights existing problems. Section 6 discusses the direction for further reform in favour of the establishment of an inclusive financial system in rural China.

## **Characteristics of the First Track of Rural Finance Reform**

The first reform of China's rural financial system began in the early 1980s. It was enhanced by the government in 2003 and has since been a gradual process. Perhaps its most significant contribution is that it helped unleash huge innovative and productive forces in the economy. The government-led reform focused its resources on improving the supply of rural financing and on the intermediation between rural financial institutions and those requesting services. Substantively, it concentrated on reforming the system's organizational structure, with its basic elements reflected by five key components, detailed below.

### **Separation of Rural Credit Cooperatives from the Agricultural Bank of China**

One of the first steps to reform was to separate rural credit cooperatives (RCCs) from the Agricultural Bank of China (ABC) in 1996. The purpose was to establish a financial service mechanism closer to farm households and small and medium-sized enterprises (SMEs). In 1979, the agricultural credit business unit was separated from the Central Bank and the ABC was re-established out of this unit, many years after

it was merged into the Central Bank in 1965. In 1984, the State Council approved the reform of the RCCs' management system and proposed that RCCs should conduct their savings and loan business independently, but under the supervision of the ABC. During this period, RCCs in practice became 'grass-roots institutions' under the ABC. In such a system, where the ABC managed RCCs, it was difficult for RCCs to be independent institutions. RCCs had passively been carrying out administrative orders made by the ABC, thus negatively affecting their independence and the efficiency of their operation (Xu et al. 1994). The ABC could not handle the many relationships with RCCs while transforming itself into a commercial bank. As a result, in 1996 the State Council decided that RCCs should discontinue their subordinate relationships with the ABC. Thus, RCCs embarked on a self-development programme and became institutions mainly serving farm households and SMEs (Xu et al. 1994; He 2004).

### **Development of Commercial Finance**

A second step was to separate the commercial banks' policy-oriented financial business (subsidized loans aimed at reaching specific goals of government policies such as poverty alleviation) from their commercial financial business. In practice, this laid the foundation for commercial finance (Xu et al. 1994; He 2004). Prior to 1994, as a major rural financial institution, the ABC engaged in both commercial banking and policy-oriented financial business activity. However, this created constant conflict within the ABC and made it difficult for the bank to coordinate its commercial and policy objectives. Consequently, the Agricultural Development Bank of China (ADBC) was set up in 1994 for the purpose of issuing policy loans. Thus, it laid an institutional foundation for the ABC to function in accordance with the operating mechanisms of a modern commercial bank and it gradually become a market player with independent legal status.

### **Institutional Foundation for Commercial Finance for a Sustainable Rural Economy**

The third step was to deepen the reform of the ABC and construct an institutional basis for commercial finance for sustainable development of the rural economy. The ABC was the most powerful rural financial institution in China and the course of its reform is closely linked with the development and transformation of China's rural economy. The original intention of the ABC's reorganization in 1979 was to support the

production and marketing of agricultural products as well as industrial enterprises at the township and village levels. After the establishment of the ADBC in 1994, policy makers tried to separate policy-oriented financial business from the operations of the ABC and RCCs. After the separation of its policy-oriented financial business and the cessation of its executive subordinate relationship with RCCs, the ABC accelerated the pace of its transformation, converting from a state-owned specialized bank into a state-owned commercial bank, adjusting its business strategy and changing its operational mechanism (Xu et al. 1994; He 2004). To build a foundation for sustainable development, like other state-owned banks, the ABC also implemented specific market-oriented reforms, by first dismantling and merging a number of institutions and, second, by reclaiming the credit decisions of part of township- and even county-level branches. The number of branches under the ABC declined from 67,092 in late 1996 to 28,234 in 2005.<sup>3</sup> However, as a state-owned bank, the ABC still encountered problems, including an unsound governance structure and high principal-agent costs. To this end, the ABC explored shareholding reform. At the National Finance Work Meeting of 19-20 January 2007, the central government made clear the guiding principles for the reform of ABC, including supporting the development of agriculture, rural area and farm households (known as 'san nong'), pushing forward holistic restructuring, commercial operation and seizing opportunities to get listed. This formally opened ABC's shareholding reform. The following clean-up and listing of the ABC in 2010, in turn, has proved conducive to enhancing the overall strength of rural financial services.

### **Improved Ownership and Management Systems**

The fourth step was to improve ownership and management systems and to cultivate the market-dominant position of RCCs, as well as building capacity for self-sustainable development. The reform undertaken by RCCs mainly focused on their ownership and management systems. The reform of the ownership system consisted of two distinct phases. The first phase focused on the reorganization and cooperative nature of RCCs. Prior to the new round of pilot reform of the RCCs that started in 2003, several attempts had been made to resume a cooperative system. Nevertheless, experience showed that the objective of resuming a cooperative system was difficult to achieve.<sup>4</sup> The second phase provided a variety of ownership options. A deeper reform initiated by the State Council was launched in 2004.

Governments at all levels applied three ownership types, including shareholding, cooperative and joint-stock cooperative systems, and four organizational forms, including rural commercial banks, rural cooperative banks, RCCs as county-based (municipality-based) unified legal entities, and RCU-led RCCs with both as separate legal individual entities at the county and township level, respectively. Although rural commercial banks as a new form of legal entity are not cooperatives, all the above four forms are still regarded as components of the rural cooperative financial system. The reformers of RCCs insisted on the direction of market-oriented reform with the goal of serving the development of agriculture, rural areas and farm households. It was clearly stipulated by the government and its national regulatory authority that local governments were responsible for the industrial management of RCCs. After the relatively smooth transfer of RCCs' management responsibilities to provincial governments, the governments of all provinces (municipalities or regions) unanimously opted for the formation of a provincial union, and the governments of Beijing and Shanghai set up rural commercial banks, while the Tianjin government established rural cooperative banks as two tiers of legal entities at the municipal and district (county) levels. In June 2008, Chongqing Rural Commercial Bank was opened as a unified legal corporate entity. In 2011, the China Banking Regulation Commission (CBRC) requested that all rural cooperative banks be transformed into rural commercial banks.

The reform of the rural cooperative financial system is still an ongoing issue. Thus, the course of the reform of RCCs is a *de facto* process of gradual improvements to their governance structure and a strengthening of their market position, with the objective of reinforcing rural financial services.

### **Reform of postal financial services**

The fifth step opened up a new channel to supply financial services, the postal savings business. These institutions were initiated in 1986 and were self-managed by the department of postal services until 1990. Two thirds of postal savings resources came from rural areas. Due to its non-credit, deposit-only character, the postal savings business caused a serious outflow of rural funds. In 2003, the deposit and transfer policy of postal savings was changed to the autonomic use of funds by the central bank. In early 2006, upon the approval of the CBRC, the three provinces of Fujian, Shaanxi and Hubei issued micro loans backed by certificates of deposit issued by postal savings businesses,

offering financial intermediation services to urban and rural residents, the majority being farm households. This effort was expanded in late 2006 to include more than ten provinces and municipalities across the country. Since its establishment in early 2007, the Postal Savings Bank of China (PSBC) has gradually been increasing financial services for farm households, self-employed persons and small-business owners (Wang 2009; Feng et al. 2013).

During the reform process, owing to the insufficient supply of formal rural financing, other financial service mechanisms have emerged and expanded, such as micro-credit services through non-governmental organizations, community development funds, rural informal finance organizations as well as informal financial activities. With respect to informal financial activities, the Chinese government has never had any clear policy direction, except the diversion, described above, of some part of informal finance or private capital into the formal financial sector. The CCCCP Document No. 1 of 2006 stressed that informal financing should be 'standardized'.<sup>5</sup> However, the term 'standardized' here can be interpreted in two ways: either to promote or to further restrict its development (Feng et al. 2006; Feng et al. 2013). Informal financing is tolerated during periods of capital shortages in the formal financial system. Nonetheless, during a period of strict macro-control policies, informal financing becomes a chief 'culprit' that 'disrupts' the financial order and 'impedes' an economic 'soft landing' and, hence often becomes a target for government policy (Feng et al. 2006; Feng et al. 2013).

## The Second Track of Rural Financial Reform

A consensus has been reached at the policy level regarding the diversification of rural financial institutions and the construction of a competitive rural financial market system. For a long time, China has been governing rural financing based on the idea of promoting urban financial development, e.g., meeting the needs of rural financing through commercial financial institutions giving primacy to financial stability. However, given the multi-levelled, diversified and highly decentralized financial needs in rural areas, the model used by large, commercial financial institutions is often unable to adapt to the situation in rural areas. Although the basic framework of China's rural financial system has been established, which is mainly characterized by its market orientation, its enforcement has become increasingly complicated and hindered by the 'stability first' mentality and the related financial repression policy of the government.

Self-organizing forces in rural financing, if getting stronger, will provoke a government crackdown. Therefore, it is urgent to open the minds of government officials, adapt regulatory approaches to the new situation, further open up rural financial markets, develop new types of rural financial institutions and introduce market-oriented reform.

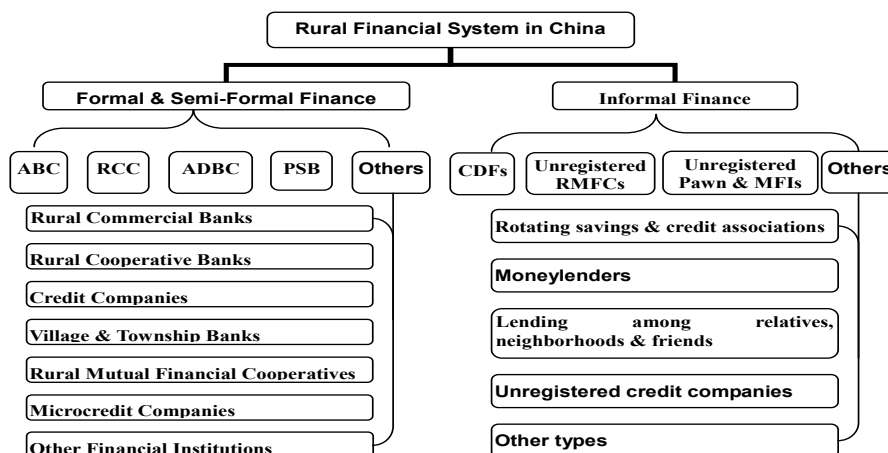
The 'New Deal' was a top-town reform approach in the beginning. Since May 2008, the CBRC has let provincial-level governments take on management responsibilities for the micro-credit companies and the provincial-level governments were made responsible for their related financial stability. With the new deal, informal financing and private funds poured into these new financial organizations. Since some Party documents encouraged the attraction of private and foreign capital to the rural financial sector, many farmers' mutual fund cooperatives emerged, which were not registered or only partially registered with a county government department such as the bureau of civil affairs, or bureau of industry and commerce.

## Effectiveness of Rural Financial Reform

Improvements in the organizational system covering rural financial institutions have developed simultaneously with the rural economy (Wang 2009; Feng et al. 2013). Following the structural changes since the late 1970s, China has gradually formed an organizational structure for formal institutions with RCCs as the foundation, and with the ABC and the ADBC as major components. Other commercial banks and non-banking financial institutions, including a series of governmental regulatory systems, complement these. In addition, there are some financial organizations arising from self-organized innovations within the rural society. As a result, from a macro perspective, a system with a wide range of institutions has essentially taken shape. Figure 1 shows a classification of the components of the rural financial system in China.

Figure 1 classifies the components into formal finance and informal (including semi-informal) finance. According to the definition by Adams and Fitchett (1992), financial institutions that are regulated by the authorities fall into the category of formal institutions; those fully beyond their supervision are called informal; semi-formal institutions are situated between these two categories. Formal financial institutions are generally supervised by financial authorities, such as the CBRC, while semi-formal institutions are established upon central or local government approval or licensing and are supervised by the govern-



**FIGURE 1:** Basic Framework of China's Rural Financial System

Notes : ABC = Agricultural Bank of China, ADBC = Agricultural Development Bank of Bank, CDFs = Community Development Funds, RMFCs = Rural Mutual Financial Cooperatives, RCC = Rural Credit Cooperative, PSB = Postal Savings Bank, MFIs = Microfinance Institutions  
 Source: The authors.

ment. Informal finance, on the other hand, is not subject to a formal regulatory mechanism, is mainly self-governed and is constrained by informal sanction mechanisms such as peer pressure, loss of trust and reputation, and loss of further access to informal loans as a result.

Farm households and SMEs will undoubtedly encounter financing difficulties in modern-oriented commercial credit markets as their economic activities generally are characterized by low credit volumes, limited savings, lack of collateral, greater operational risk, lack of systematic and rigorous financial records, etc. (He 2004; Feng et al 2006; Wang 2009). Some degree of credit rationing is inevitable. Besides the pluralization of financial institutions and activities, further measures are possible to improve financial services for these target groups and to mitigate the problem of credit rationing.

To this end, the government and the financial sector have conducted pilot reforms in a wide range of areas (Feng et al. 2013): 1) providing subsidized credit to farm households and SMEs, such as discount loans for poverty reduction;<sup>9</sup> 2) developing a credit guarantee system and strengthening credit financing capabilities by farm households and SMEs; 3) establishing financial services closer to farm households and SMEs, emphasizing regional and community-based characteristics; and 4) advocating credit business innovations conducted by formal financial institutions enabling them to offer micro-credit loans to farm households and micro- and small enterprises.

A system offering on-going, policy-specific financial services to rural areas has been gradually taking shape. China's rural economic development is highly uneven and commercial credit failures are evident in many areas. Thus, it is essential to establish a policy-oriented finance mechanism to make up for commercial credit failures in these areas. Therefore, the practical significance of the decision to establish the ADBC in 1994 is enormous. The ADBC has long played a major function as a 'food bank', with a narrow business scope and sufficient strength to support agriculture. It has continuously adjusted its activities to support agricultural and rural infrastructure, environmental protection and social development, comprehensive agricultural development and operations in economies of scale, rural poverty alleviation and the development of the central and western regions, while continuing to innovate in commercial loan products. Policies allowing only policy-specific loans have been reversed, resulting in a rich variety of loan products. ADBC has focused on innovation through the integration and expansion of existing loan products and has made pilot agriculture and small business loans (He 2004; Feng et al. 2013). Risk transfer and sharing mechanisms are also being developed; a consensus has been reached to support the development of agricultural insurance and diversification of insurance business entities has been promoted. In addition, a government-funded agricultural insurance test has been undertaken, speeding up its legislative process.

## Existing Problems in Rural Financial Markets

China's rural financial system is still insufficient to meet demand. There are structural and functional defects in the system. The former is reflected in the imbalance in both spatial and organizational structures of rural financing. Furthermore, the strategic rationale for reform, e.g., that changes made in urban areas should spill over to rural areas, is insufficient.

Rural financial markets have comparatively high concentration levels, diversification is limited and there is a lack of competition in financial services. The development of deposit and loan markets within counties in less-developed areas is non-symmetrical since state-owned banks mainly monopolize the deposit market while the major share of the loan market is occupied by RCCs and, hence mechanisms for competition in rural financial markets are basically non-existent (Wang 2009; Feng and He 2010). The result is a lack of diversity of formal financial institutions and limited competition among them. Parallel to banking financial institutions, non-banking financial institutions are largely

underdeveloped. Because rural capital markets lag far behind, it is difficult for farm households and rural micro- and small enterprises to access financial services other than those offered by banks. Meanwhile, indirect financing has an absolute advantage in the financing structure of rural financial markets (Wang 2009).

The imbalance in the number of institutions in combination with an outflow of capital gives rise to a situation where there is no mechanism to make rural financial resources stay in rural areas or for urban financial resources to flow to rural areas. State-owned commercial banks are still an important channel for the outflow of rural funds (Feng et al. 2006; Wang 2009). In the rural areas of more central and western regions of the country, RCCs have become the only formal financial institutions to provide financial services for farm households and rural micro-enterprises. Their monopolistic operations, however, do not encourage RCCs to increase efficiency. Even though the reform of postal savings has achieved outstanding results, the PSBC still has a limited number of credit businesses in rural areas. The apparent mismatch between supply and demand of rural finance is an underlying reason why the effective satisfaction rate of rural farm households' and SMEs' demand for financial services is quite low (He 2004; Feng et al. 2006). The economic compensation mechanism for rural and agricultural risk is another underdeveloped area (Li et al. 2008).

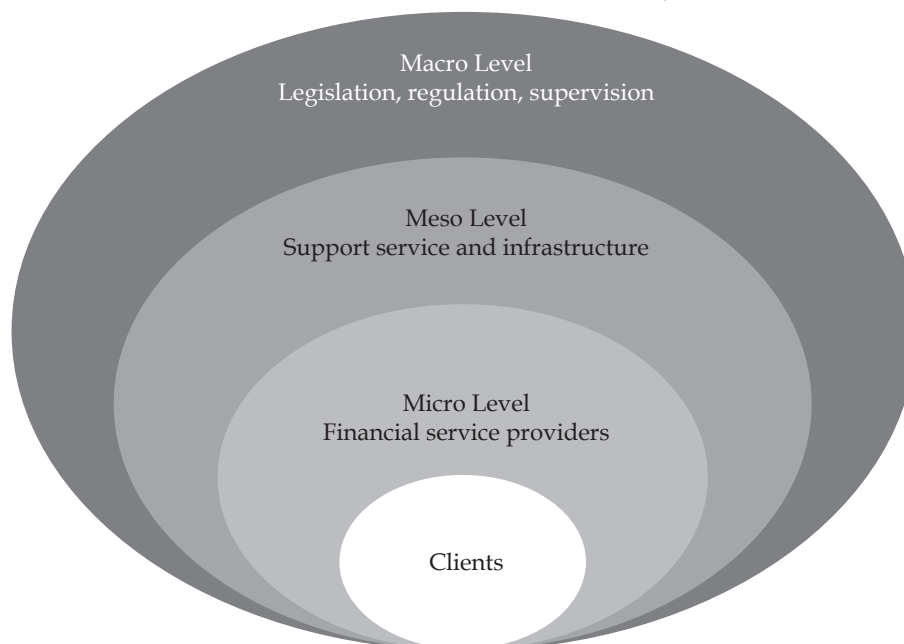
Finally, legislative reforms lag behind and rural financial services remain undiversified and insufficient to develop a rural financial market synchronized with agricultural product markets (Wang 2009; Feng and He 2010). Informal finance prevails but lacks legal norms and protection (Feng et al. 2006; Feng et al. 2013). The legislative process of agricultural insurance is very slow and legal protection related to agricultural insurance is weak (Li et al. 2008).

## **Towards an Inclusive Rural Financial System**

Deeper rural financial reform must ultimately be based on four key components, whether the aim is to eliminate structural or functional imbalances in the rural financial system (Hayek 1945, 1948; Shaw 1973; Li et al 2008). First, it must be conducive to overcoming information symmetry; second, it must help surmount the financing plight of farm households and SMEs due to lack of collateral; third, it must increase accessibility to financial resources for farm households; and fourth, it must improve financial efficiency by way of market-oriented models.

Although informal financing has a certain advantage in the acquisition of information, this advantage is limited to a relatively fixed number of customers within a small area, and the requirements for geography, popularity and kinship-based relationships are comparatively harsh (Feng et al. 2006). With more diversified transactions, this advantage would be lost. Formal financial institutions possess a fully functioning platform and information-sharing systems. Thus, with the increase in transaction volume, the information-sharing advantage of formal finance will become more prominent and the marginal cost of information will continue to decline (Liu 2006). Therefore, the rural financial sector can attract both wealthy and grass-roots customers, and formal and informal institutions could potentially coexist. At the same time, the problems of rural finance are more concerned with issues of structural and systems arrangements (Wang 2009; Feng and He 2010). Accordingly, the improvement of rural financial systems should be a focus of deeper rural financial reform. For low- and middle-income groups in rural areas to have access to financial services and to increase the supply of rural finance, it is essential to build an inclusive financial system and to foster a competitive rural financial market (Helms 2006; United Nations 2006; Li et al. 2008; Wang 2009). Such an inclusive financial system is one that serves all clients—not just the relatively well-off. This means reaching out to poor and low-income clients and providing them with affordable financial services tailored to their needs in rural areas (Helms 2006; United Nations 2006; Chen and Jiao 2009). Changes in the rural financial system as well as elimination of imbalances should be considered at three levels – micro, meso and macro – where the clients are at the centre as demanders of financial services. Figure 2 illustrates the composition of an inclusive financial system, which is a framework developed by CGAP and the World Bank (Helms 2006).

The first level, the micro level (financial institutions) refers to financial institutions providing retail financial services for farm households and micro- and small enterprises on a competitive basis, including non-governmental micro-credit organizations, private and state-owned commercial banks, postal savings banks, credit cooperatives, member-based community financial organizations as well as other non-banking finance institutions. At the same time, non-finance institutions are often important financial services providers. The diversification of financial institutions can promote the formation of a competitive mechanism. In China, since the government generally enforces strict control over

**FIGURE 2:** Composition of an inclusive financial system

Source: Helms (2006).

the establishment of new financial institutions with the objective of maintaining financial stability, the pluralization of financial institutions is still too restricted by government. The top-down approach of strict administrative discretion in approving or rejecting the establishment of new banking institutions is a hindrance to the self-organization of the rural financial system, which is needed to meet diverse demands for rural financial services.

The second level, the meso level (support services and infrastructure) refers to an institutional foundation ensuring the healthy functioning of competition including completing a rating system for financial institutions, an audit and supervision mechanism, a payment system, a liquidity protection mechanism and an information disclosure mechanism, and creating mechanisms conducive to enabling these retail finance institutions to enter into domestic and international monetary and capital markets, such as the mechanisms of investment funds issuance, bond issuance and asset securitization (Helms 2006). In China, for example, there is no deposit insurance system.<sup>10</sup> Savings in state-owned commercial banks are implicitly 'insured' by the government. In such a situation, non-state financial institutions are finding themselves at a disadvantage in their competition for market shares. Building a sound deposit insurance system can offer institutional protection for

the operation of a rural financial system with diversified development. In addition, the low level of information disclosure needs to be improved in China.

Establishing agricultural insurance and rural safeguard mechanisms is usually an incentive for those supplying and requesting funds. Rural financial reform in China should be considered from a systematic point of view so that rural financial reform and overall financial reform should be integrated and collectively pushed ahead within a larger framework rather than being considered separately. The development of insurance, social security and other non-banking institutions needs comprehensive consideration in China.

The third level, the macro level (legislation, regulation and supervision) refers to cultivating a good policy environment and requiring the government to play an appropriate role (Helms 2006). The government usually supports farm households and small and micro-businesses through a number of micro-credit projects in China. However, it must be built on the basis of improving market efficiency, while being conducive to strengthening the market status of entities engaging in micro-activities. The premise for a financial system to achieve its functions as an inclusive financial system is to follow market-oriented operations, e.g., to absorb the remaining funds at market deposit rates and to allocate funds at market lending rates in accordance with the supply and demand of funds. As a result, there is an urgent need for liberalized interest rates. However, the Chinese government still has administrative discretion in deciding on baseline deposit rates and lending rates. Since it also keeps the difference between the lending rate and savings rate, the performance of banks is not directly based on performance-oriented competition. To construct an inclusive financial system in China, it is necessary to improve the measures and mechanisms of regulation and supervision and to ensure their independence and effectiveness. It is also necessary for the government to be involved in fostering a favourable financial environment. RCCs' success with micro-credit for farm households in some areas has shown that a healthy credit culture and financial environment cultivated with the participation of local governments can lay the foundation for healthy and sustainable survival of small-scale banking finance institutions.

To construct an inclusive system of financial institutions offering retail financial services to farm households and micro- and small enterprises on a competitive basis requires advances on a variety of fronts simultaneously. The main front has at least two aspects: the first

is to integrate financial stock resources in counties and to allow existing financial institutions to play a role; the second is to improve the incremental allocation structure of financial resources in the counties. The integration of stock resources and the improvement of incremental allocation will reinforce each other. Whether it is stock integration or incremental improvement, it should be based on the characteristics of rural financial needs. The dual track rural finance reform as described above is still characterized by strong financial repression in China, where government discretion dominates to enforce the primacy of financial stability while financial autonomy of financial institutions is still limited in rural areas. The formal financial system arrangement gives priority to state-owned, large-scale institutions, which is difficult to adapt to small-scale financing needs. Rural financial institutions suitable for the credit needs of farm households and rural micro- and small enterprises should be local, regionally focused and grass-roots. Building a rural financial organizational system based on these features is a superior way to resolve the current mismatch in supply and demand in rural finance markets in China.

The first step is to integrate the resources of RCCs at the county level to improve the governance structure and to maintain and preserve the independent corporate status of county-level RCC unions (RCCUs). Second, it is necessary to transform the branches of state-owned banks within counties into independent legal entities and then allow them to become local, regional and micro-lending commercial banks with state-owned banks as their holding companies. This would completely change the situation where state-owned commercial banks pump away rural capital. It would also be possible to push commercial banks into rural financial markets through legislation, or to promote commercial banks to conduct business innovation and downscale their customer groups in order to increase the financial supply by commercial banks in the counties. At the same time, policy-oriented finance mechanisms should be strengthened based on the principles of subsidiarity and additionality. Policy-oriented finance not only includes policy-oriented credit, but also policy-oriented insurance and policy-oriented security mechanisms. In addition, it also includes fiscal assistance and subsidies. Meanwhile, the market-based operating principles of policy-oriented finance should be upheld in China.

A third step is to continue to expand and relax rural financial market access, including a focus on private and small-sized institutions, to promote the diversification of financial institutions and identify means

to formalize informal financial institutions. Rural private lending has played a positive role in activating rural financial markets by expanding financial resources for production. However, informal finance also hides certain financial risks and has no legal status, thus lacking necessary protection. The 'New Deal' of the CBRC and PBC in 2008, without doubt, provides an opportunity for private capital.

## Conclusion

China has made significant progress in reforming the rural financial system in recent years. Nevertheless, current rural financial institutions are unable to meet the multi-layered and diverse demands for rural financial services. Problems exist in meeting the increasing demand for credit in the countryside and providing support for the stable development of Chinese agriculture and SMEs. With regard to reform of property rights and the organizational form of financial institutions, little progress has been achieved compared to reforms in other domains. Access to financial markets is still limited. Although financial institutions are diversified, their system of property rights and their organizational structure continue to use a public ownership model, meaning that the entire operation of finance is not adjusted to market-oriented economic growth. Therefore, in the process of promoting pluralistic rural financial institutions in China, attention should be given first to legislation and supervision to safeguard a normal financial order and then to improve corporate governance so as to renew their modes of operation. The development of financial institutions should not be emphasized unilaterally. Direct financing and capital markets should be developed and there should be organic integration and coordinated development of the capital and insurance markets. Attention should be given to the complementary and coordinated development of financial reforms and reforms in other areas so that an inclusive financial system can be attained in rural China.

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*Xingyuan Feng is Vice Director of the Unirule Institute of Economics and Professor at the Rural Development Institute of the Chinese Academy of Social Sciences, Beijing, China. His main research fields include local and rural governance, rural finance and rural government finance. E-mail address: fengxy@cass.org.cn. Guangwen He is Professor and Director of Faculty of Finance at the College of Economics and Management, China Agricultural University. His research fields include rural finance, development finance and microfinance.*



*Christer Ljungwall is Associate Professor in Chinese Economics at the Copenhagen Business School. His research fields include development economics and quantitative analysis of economic growth.*

## NOTES

- 1 With the dissolution of more than 26,000 people's communes, over 200 million farm households received more independence in conducting economic activities. The rural financial system was to serve this large new group and, hence, a more demand-oriented reform became inevitable. See Ma, Zhang and Li (2009).
- 2 In 1997, the State Council ordered the liquidation of all rural cooperative funds across China, whether they were operating at a profit or loss. On 13 July 1998, the State Council released 'Methods of Abolishing Illegal Financial Institutions and Illegal Financial Activities', Decree No. 247.
- 3 Z. Zhang, 'The Reform of the Agricultural Bank of China: Persistent Difficulties Emerged'. *Financial Times*, 16 August 2006.
- 4 Primitive RCCs were established within each township or town, often consisting of thousands of members. Being so large, it was difficult to follow the basic principles of cooperatives. From this followed a lack of democratic participation in the election, decision-making, management, and supervision processes. Problems of 'inside control' by the management, 'outside control' by the government, or a commercial orientation are inevitable with such size. See Feng et al. (2006).
- 5 The Central Committee of the Chinese Communist Party and the State Council, 'Several Opinions on the New Socialist Countryside Construction', 31 December 2005.
- 6 People's Bank of China, and China Banking Regulatory Commission 2008, 'Notice on Relevant Policies Relating to Village and Township Banks, Credit Companies, Rural Mutual Financial Cooperatives and Microcredit Companies', Document No. Yinfa-2008-137, May 8.
- 7 Data on micro-credit companies was released by the PBC while data on the other three types of financial institutions was provided by the CBRC.
- 8 See online statistics of the PBC, available from: <http://www.pbc.gov.cn/publish/html/kuangjia.htm?id=2012s01.htm>.
- 9 The Chinese experience with subsidized credit is similar to international experiences and its effectiveness is questionable. The funds allocated as interest subsidies for poverty alleviation loans are limited in size. Some poverty alleviation loans are used by village cadres and by investors for commercial projects. The principle of subsidiary is not fully complied with. Furthermore, it is more important for farmers to have access to loans, rather than enjoy subsidized loans (Feng et al. 2006).
- 10 A deposit insurance scheme is currently under development by the People's Bank of China.

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