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Evolution of Rural Financial Market in China : An Institutional “Lock in” or Gradualism?

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We appreciate comments from Franz Heidhues, Manfred Zeller and Calum Turvey. Disclaimer: The findings, interpretations and conclusions expressed in this paper are entirely those of the authors, and do not represent the views of authors' affiliation. Copyright 2007 by the authors. All rights reserved. Readers may make verbatim copies of this document for non-commercial purposes by any means, provided that this copyright notice appears on all such copies.

ABSTRACT

Historically, China's political attempts to provide access to rural credit has met with mixed results and an institutional structure that often strays from intended policy goals. There has been a close correspondence between financial depression and many policy-driven financial institutions that dominated the rural financial system in China. More recently, ongoing reforms are dedicated towards a gradual liberalization within the system. In this study, we explore the context of agricultural transition and political process as defined by the various interlinkages across the Chinese rural financial system. We find that there has been negligible progress in the evolution of the rural financial market in China. The policy-led financial institutions ended up as merely a disbursement window and a costly drain on state budget. Institutional changes were locked in by patching up the existing institutions.

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

JEL classification: E44, N25, D72 and Q14

1 Introduction

Economists disagree sharply on how they see the contributions of the financial sector to economic growth. Robert Lucas, in his widely cited lecturing paper (Lucas, 1988), claimed financial development as merely an "over-stressed" determinant of economic growth. Even pro-finance economists disagree about 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 theory and evidence.

Ample evidence in the 1980s, however, criticized government-oriented "cheap" credit policies, that were implemented in numerous developing countries and failed to meet expectations (Adams *et al.*, 1984; Yaron, 1994). In the years thereafter the discussion focused on imperfect market and information asymmetries, and development economists started to explain the reasons for the failure of rural credit markets in developing countries and to redefine the role of government in the presence of informational problems (Besley, 1994; Braverman & Guasch, 1986, 1989; Hoff & Stiglitz, 1990; Stiglitz, 1990).

Meanwhile, another strand of research has tried to understand the selection of institutional arrangements and economic performance by comparative institutional analysis, rather than using regression across countries (Acemoglu *et al.*, 2005; Bardhan, 1989; Bardhan, 2005; North, 1990; Nugent, 1993). It is a paradox to some that the thriving East Asian economy has not led to a greater evolution of economic institutions into the more complex organizations that evolved to support growth in Western economies. Instead the institutional framework moved towards more 'collectivist' organizations, control by key individuals, personal obligation bonds and relational contracting (Bardhan, 2005). However, these organizations may not be the most efficient ones and external finance becomes imperative in transforming the mercantile into modern industry to pool risks and mobilize capital in larger scale. Due to such financial market failures,¹ government-mediated coordination has played a critical role in the long-term economic growth and acquisition of financial experience for economic take-off.

¹ There are several key manifestations of market failure in financial markets (Stiglitz, 1994): (a) monitoring, like other forms of information, is a public and is therefore undersupplied; (b) there exist sever (positive and negative) externalities of credit selection and lending within

Nevertheless, 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 later, perhaps potentially more appropriate technologies or institutions (Bardhan, 2001, p276). The social or economic system finds itself hard to escape from the dysfunctional institutions, although there are multiple options. This study is trying to elaborate the difficulty of China's rural financial system to evolve into a full-service finance motivated by commercial imperatives rather than policy-dominated schemes.

The purpose of this paper is to explore the institutional evolution of the various credit providers in rural China in order to elaborate the difficulties incurred by China's rural financial system as it attempts to evolve into a full-service financial system motivated by commercial imperatives rather than policy-dominated schemes. This objective is motivated by new reforms initiated in 2006 under which Chinese policymakers started waging the "New Rural Campaign" to boost the rural economy and ease the tension caused by the increased inequality between rural and urban areas. Credit policies, believed to be efficient and directed towards providing money to investors, have gained a great deal of appeal. With an increasing state budget favoring the rural economy, subsidized poverty alleviation loans and other agriculture related financial schemes are becoming suddenly sought-after. Given the widely existing failure of government-driven rural credit programs in other developing countries (Adams et al., 1984; Von Pischke et al., 1983; Yaron, 1994), questions arise: What can be learnt from the previous rural financial reforms 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 rural financial system?

To answer these questions, this paper aims at trying to explore the evolution of the rural financial market in China and assess the ongoing reforms. Because institutional inertia and path-dependency slow down (somehow even prohibit) economic transition in many developing countries, a thorough understanding of the origin of the current system and the way it evolves facilitates further studies. However, such knowledge is by and large scant and anecdotal.

The paper is organized as follows. It begins with an overall description of rural financial system in section 2. Each institution is then explored in details in section 3, in light of the history, the performance and its interlinkage with other institutions in agricultural transformation. In section 4, the ongoing reforms are illustrated. Conclusions are drawn in section 5.

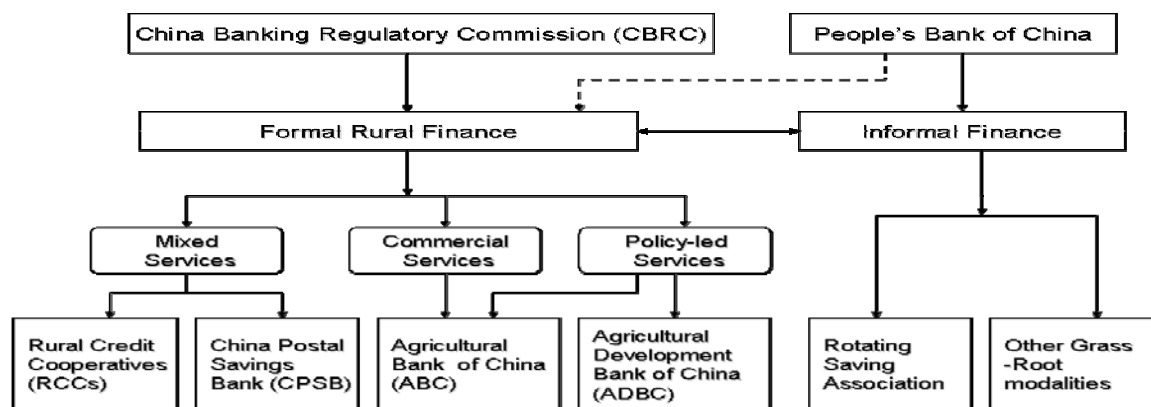
2 The transition of rural financial system in China

The rural financial market in China carries the traditional paradigm that is similar to what has been found in many developing countries: institutional credit is subsidized; formal credit programs are highly centralized and heavily dependent on governmental budget; the "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 *et al.*, 2007)

(and even across) markets; (c) market is incomplete because information is imperfect and costly to obtain (i.e. adverse selection and moral hazard); (d) imperfect competition because the collection and procession of information involve fixed costs; (e) discrepancy between social returns and private returns of projects; (f) imperfect knowledge and capability of investors to process disclosure information and regulations.

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 Rural Credit Cooperatives (RCCs), the Agricultural Bank of China (ABC), the Agriculture & Development Bank of China (ADBC), the China Post and Saving Bank (CPSB) and various informal institutions (see Figure 1).

Figure 1 Rural Financial System in China



Source: Own presentation

The Agricultural Bank of China (ABC) was founded in 1979 to provide financial services for agriculture and rural development. It was in 1994 that government reshuffled the national financial system and a newly established Agricultural Development Bank of China (ADBC) started implementing policy-based loans, mainly about grain procurement purchasing. The RCCs used to play the major role in rural financial system, both in terms of deposit and loan disbursement, especially after ABC's urbanization since 1995. However in an example of how one public institution can be developed to crowd out another, the emergence of the China Post and Saving Bank (CPSB), which used to be called Post Savings (PS), was as a deposit-only institution siphoning the bulk of rural funds decreasing both supply and access. The CPSB under current reforms has been renamed and granted the right to disburse loans in rural areas since March 2007.

The RCC, ABC and ADBC are not independent from each other. Large rents existed in China's transition drive different pressure-groups to lobby the government for their own interests and to discard bad assets to others. For example, the ABC was started in 1979 as a policy-led financial institution to be specialized in agricultural and rural development. The RCCs were affiliated with ABC at that time but (since the mid- 1990s) under the direct supervision of the central Bank (PBOC-website), and most of ABC's non-performing loans, piled in the highly centralized era, were devolved to the RCCs.² The situation was the same between ABC and ADBC in 1999 when policy-oriented loans (e.g. poverty alleviation and infrastructural investments) which were assume by ADBC when it was founded in 1994, were transferred back again to ABC due to ADBC's unpleasant and worrisome performance.

² 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 to carry bad assets for the take-off of the state-owned banks.

3 Rural financial institutions in China

3.1 RCCs

The RCCs have the longest history and play an overriding role in the rural financial system in China. The RCCs underwent four main transitions, along with the decollectivization and market reforms in rural China. The first can be backdated 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 been standing for merely a literal meaning. Though the People's Commune collapsed after the three-year famine and was substituted by the "Production Team", a smaller unit, the cooperatives were still one of the components in the collectivized establishment. Industrial development was the main driving force in that period. Bulk of input factors, natural resources, labor force and capital were accumulated to advance the 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), the RCCs were under the control of provincial governments and played a critical role in developing the 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.

At the third stage, RCCs became independent from the ABC in 1997 and were placed under the supervision of the PBOC, which exerted rigorous influence on RCCs' operation, especially the loan business. Besides financial depression, the PBOC introduced the 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 on the regulations or directives from the Central Bank, they were more inclined to fund projects that had lower risks and higher capital return. The RCCs faced such a quandary. 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 PBOC and the RCC County Union (RCCU). A variety of ownership arrangements are 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 mid- 1990s because of ABC's urbanization. The decline in ABC's rural deposits and loans devolved RCCs the dominant suppliers of credit in rural China. Nonetheless, the figure is flagging since 1996 due to the sizable increase in the share of the Postal Savings. Large amounts of rural deposits have been siphoned out of rural areas.

Table 1 Deposits of RFIs in China¹

Year	ABC ²		ABC Agri. Deposit ³		RCCs		PS ⁴		Total Rural Deposits ⁵
	(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	264.0	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	567.0	73.3	33.9	4.4	774.0	
1995	694.0	n/a	n/a	717.0	92.9	54.7	7.1	771.7	
1996	910.7	n/a	n/a	879.0	92.2	74.0	7.8	953.0	
1997	1132.0	26.4	2.2	1062.0	90.3	88.0	7.5	1176.4	
1998	1333.0	30.0	2.2	1219.0	89.8	108.0	8.0	1357.0	
1999	1549.0	34.2	2.3	1336.0	89.3	126.0	8.4	1496.2	
2000	1752.0	37.2	2.2	1513.0	88.3	163.0	9.5	1713.2	
2001	2025.0	37.7	1.9	1726.0	87.8	202.0	10.3	1965.7	
2002	2410.7	42.4	1.9	1987.5	87.1	251.0	11.0	2280.9	
2003	2900.5	41.8	1.5	2371.0	87.2	307.0	11.3	2719.8	
2004	3417.3	44.1	1.4	2728.9	86.6	377.0	12.0	3150.0	

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.

Neither do RCCs 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.³ 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 in the neighborhood of 0.7. Rural savings collected by the RCCs are not efficiently used.

3.2 ABC

ABC was founded in 1979 as a state owned financial institution which disburses loans for agricultural utilization. In the late 1990, Chinese government decided to forge four full-fledged

³The exceptional rise in the figure in 1995 and 1996 is caused by the unavailable data of ABC.

state-owned commercial banks with international competitiveness. ABC, as one of the four, withdrew from rural areas and focused primarily in 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.

As shown in Table 1, agricultural deposits of the ABC plummeted after its commercialization in favor of urban businesses.⁴ In the same vein, as shown in Table 2, we observe a similar decrease in the percentage of rural loans of the ABC, though there was an increase from 1999 to 2001 during which the ABC reassumed policy-based loans (for poverty alleviation and supporting parastatal grain agencies) which had been supported by the ADBC since it was established in 1994.

Table 2 Loan Portfolio of RFIs in China¹

Year	Total Rural Portfolio ² (Bi. Yuan)	ABC (Bi.Yuan)	ABC Rural Loans ³		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.

⁴ 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.

3.3 ADBC

The ADBC is a creature of a compromise between a decollectivized grain system and government-driven scheme with credit orientation in securing grain and cotton purchasing. Therefore, a brief historical review of the liberalization of grain markets would promote a better understanding in ADBC's past, status quo, and future.

To cope with the increasing food demand from the rapidly growing population and the industrial expansion, from 1950s to the late 1970s, a highly collective farming system and a state monopolized procurement system of grain, cotton, and other major farm products were adopted by the Chinese government. It was until the mid- 1980s that the sweeping market reforms were started.

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

Year	Total	L/D ¹		ACLD ² (bln Yuan)			ACLD/OLs ³		
		ABC ⁴	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.

To realize government's predominant control over the economy, a fully state owned agency-system was used to procure, store, transport, process and sell grain during the 1980s. Owing to the institutional reforms on incentive structure and decollectivization, grain production soared in the 1980s. Agricultural households, however, experienced a long-lasting negative deflated price of farm produce and thereby a depressed real income (Jia, 2007; Lin,

1998; Rozelle *et al.*, 2000). To avoid possible political unrest, ration prices remained largely unchanged until the late 1980s.⁵

The soaring output committed the government to increase the budget because the government was obliged to buy all grain at the above quota price after a farmer had fulfilled his/her basic quota obligation. Government's consequent practice to reduce the financial burden, however, depressed farming incentives and outputs until the sharp increase in the procurement prices in 1989. Justin Yifu Lin elaborates nicely on the reasons for the failure in the grain market reform (Lin, 1998, p 534):

The main problem in China's grain policy in the 1980s arose from the procurement practice and sale prices. The adjustment in sale price lagged far behind the adjustment in procurement prices. Under this situation, an increase in procurement price meant an increase in the government's subsidy. Because of the gap between the government-set procurement price and the market price, the government was confronted with a dilemma . . . [between] its unbearable financial burden . . . [and] peasant's incentive to produce grain and to fulfill the quota obligations. Since individual households had been given more autonomy in production decisions and the government's enforcement measures had been weakened as a result of the household responsibility system reform, how to stimulate grain production became a difficult issue.

Sweeping liberalization in grain markets was initiated in the early 1990s. It was in 1993 that both the procurement price in rural areas and sale prices in urban areas were decontrolled. Nonetheless, the liberalization results in striking fluctuation in farm produce and concomitant political unease. In response, there was a backfire to reassume administrative control over the grain markets (Rozelle *et al.*, 2000). Increasingly, the state was aware of the importance to establish a national grain reserve system to signal its commitment to 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 the ABC to the ADBC (including already piled arrears in the 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

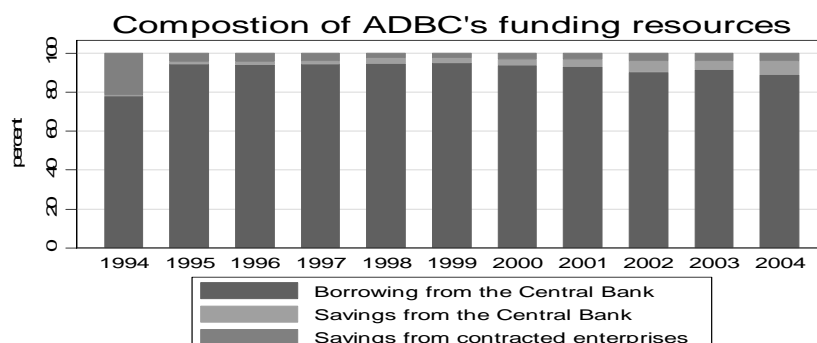
Table 3, ADBC's ratio of annual cumulative loan disbursement to outstanding loans plummeted from 0.9 in 1995 to 0.54 in 1999. The failure in transforming the ADBC into a full-fledged policy-led bank with agriculture orientation, together with the stagnated grain production, forced the government to transfer all the other loans (poverty alleviation and concessional loans to parastatal grain agencies) back to the ABC in March 1998. The ADBC then exclusively focused on loans for procurement purchasing and its share of rural loans decreased (see Table 2).

As shown in Figure 2, the ADBC depends primarily on the borrowing from the central bank; savings from the contracted enterprises and other banks account for only small fraction. To hedge against arbitrage, the interest rate of re-borrowing from the central government is higher

⁵ There exist inconsistent opinions on China's grain market reform. While Justin Yifu Lin (1998) claims that a series of markets-oriented reforms were undertaken at the end of 1984 in both urban and rural sectors, Rozelle, Albert, Huang and Jin (2000) argue, though government permitted free market commodity trade as part of a dual-track pricing strategy, substantial liberalization of grain markets were never taken until the early 1990s.

than the market rate. ADBC's expenditure on borrowing from the central government is subsidized by the fiscal budget though.

Figure 2 Fund Resource of ADBC



Source: ADBC internal report

3.4 China Postal and Saving Bank

Founded in 1986, Postal Savings (now called China Postal Savings Bank) were savings-only financial institutions that absorbed a vast amount of rural funds. In Table 1, we observe a buoyant expansion of PS' share in rural deposits. Because the interest on these savings was higher than that of the RCCs, the bulk of rural funds were channeled via PS to urban areas. Being blamed for resulting in a shortage of funds in agriculture, the interest on savings of Postal Savings was reduced in 2004.

The existence of Postal Savings is understandable. It is an iron rule that funds move from the place with lower marginal value to the place with higher marginal return. In consequence, if it was not PS, some other financial institutions would have assumed the role and channeled out the rural funds. But still, one fact that can not be ignored 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).

4 Ongoing reforms

Since 2000, both academia and the state have called for the lifting barriers on access to rural financial markets. From 2004 to 2007, each year's No. 1 document, elaborating on the biggest economic concern of the state, encourages the establishment of a competitive rural financial market. Consequently, gradual relaxations of the access barrier to the rural financial market were launched by the banking regulatory sector in China since the late 2003. In the following, some pilot financial programs and the ongoing reforms are introduced.

4.1 China Postal Savings Bank (CPSB)

The China Postal Savings Bank, with the former Postal Savings and a blessed organization by China Postal Group, was licensed and launched in March 2007. CPSB is the fifth-largest state-owned bank in China, with registered capital worth 20 billion yuan (US\$ 2.57 billion), savings of 1.6 trillion yuan (US\$ 205.65 billion), and 60 percent of the total outlets and branches in the rural areas. The CPSB is presently initiating pilot programs of rural group lending, farmers micro credit, and micro-entrepreneur loans.

4.2 Rural commercial/cooperative banks

The banking regulator gave permission to transform qualified RCCs 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 in the nature of share holding system and mainly disburse loans to the enterprises instead of small farmers.

4.3 Rural credit-only micro credit company

To promote the gradual reform of rural finance projected by the state, seven pilot credit-only microcredit companies owned by private sectors were set up at the county level in 2005 and 2006. The companies do not collect public deposits but deliver small credits with a liberalizing 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 pave the way promoting better competition in rural financial sector.

4.4 CBRC's new policy for market access

On December 22nd, 2006, China Banking Regulatory Commission (CBRC) released a policy paper to ease the market access for financial institutions in less developed rural areas. Six pilot provinces were selected. The policy allows banking capital, as well as industrial and private capital from both home and abroad, to be invested in. They are allowed to purchase and reorganize the current banking institutions in rural areas, especially the RCCs. The policy lowers the registered capital threshold of 3 million Chinese yuan (US\$ 384,615) for county banks, 1 million yuan (US\$ 128,200) for township and village banks, and 300,000 yuan (US\$38,462) for township mutual-help associations, as well as 100,000 yuan (US\$12,820) for village mutual-help associations. In addition, the policy lifts the minimum shareholding percentage for domestic investors in village banks and rural capital mutual-help associations to 20 percent for financial institutions, and 10 percent maximum for individuals.

The regulatory commission's new policy aims to establish a diversified and competitive rural financial market in China. Policymakers envisage the following in the future: first, more funds are attracted to countryside and more financial institution outlets are opened in rural areas; second, some farmers' mutual-help associations are formed to improve the local credit outreach; third, a number of informal grassroots financial organizations are "formalized" to deliver financial services with a legal status; fourth, the corporate governance structure of rural financial institutions is becoming flexible and simple, and more qualified senior executives and directors are selected to take charge of the institutions.

4.5 Three types of new emerging rural financial institutions

At the end of March 2007, ten new emerging rural financial institutions (6 township and village banks, 2 credit-only microcredit companies and 2 farmers' mutual-help associations) started to provide financial services in rural areas,⁶ indicating perhaps that there are currently significant incentives to operate efficiently and profitably within rural financial markets in China. Compared with the local RCCs, the newly established township and village banks have an advantage with flexible interest rates, loan terms and a streamlined approval process. 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

⁶ See <http://finance.aweb.com.cn/2007/3/21/225200703210955690.html>

necessary capital for agricultural investment, especially in poor areas where the advantages to economic growth are readily apparent.

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 the individuals or institutions is not fully compatible with the proposed objectives. Consequently, the policy-led financial institutions in rural China end up as mere a disbursement window, rather than balanced and full-service financial institutions. Far from motivated by commercial imperatives, the concessional funds with capped interest rate and earmarked utilization in agriculture piled large number of bad assets. The involved 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 had to rescue the system by either bail-out or takeover of 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, too heavily focused 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 disseminating 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 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 excessively 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 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. Very difficult can the pursuit of self-interest tend 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, p20), the "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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