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Rural Financial Innovation in China Viewed from Subprime Mortgage Crisis

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Abstract The root causes of subprime crisis are analyzed based on the introduction of the definition and features of subprime mortgage loans; firstly, a loose financial supervision and regulation environment leads to weak risk awareness; secondly, the highly complex financial products enlarge the risk. Taking into account that our rural finance is characterized by vast territory, scattered distribution of population, small economic scale and insufficient mortgage, it is pointed out that rural finance has different development rules and patterns from urban finance. On the basis of introducing that there is an insufficient amount of formal finance in our rural finance and our informal finance is under a long-term suppression, the great significance of financial innovation to rural finance is discussed; firstly, it effectively increases financial supply; secondly, it gradually regulates and develops the informal finance. The enlightenment of subprime crisis to our rural financial innovation is explored; firstly, financial innovation is the driving force of rural financial development; secondly, to strengthen risk awareness is a prerequisite for financial innovation; thirdly, a flexible and effective supervision and regulation system is an effective approach to preventing financial risks.

Key words Subprime mortgage crisis, Financial supervision, Financial risks, Rural financial innovation, China

Currently, the 2008 financial crisis in USA has spread the worry and panic to the whole world. As known to all, the root causes of this financial crisis lie in that the financial innovation is beyond the scope of financial supervision and regulation, diverse and complex financial derivatives make it hard for the investors as well as the supervision and guidance authorities to judge its risks. However, we can not thus totally deny the positive role of financial innovation, financial innovation always goes with financial supervision and guidance. In the *Opinions on Accelerating the Innovation of Rural Financial Products and Service Modes* released by China Banking Regulatory Commission in October 18, 2008, it is proposed to promote the innovation of rural financial products and service modes, which justly affirms the role of financial innovation. Starting from the causes of subprime crisis and according to the characteristics of Chinese rural finance, I try to make an in-depth analysis of the enlightenment the subprime crisis brought to our rural financial innovation.

1 The root causes of subprime crisis

"Subprime mortgage loan" is a mortgage relative to prime mortgage and Alt-A mortgage. Subprime borrowers are mainly those without an income certification and burdened with excessive debts. As subprime mortgage does not have strict requirement for the customers' credit, its interest rate is usually 2% and 3% higher than other general mortgages. The root causes of subprime crisis are mainly the following two points:

1.1 A loose financial supervision and regulation environment leads to weak risk awareness During 2001–2003, after the burst of the IT bubble, the Federal Reserve made a hefty rate cut. In 2001, it continuously cut the Federal funds

target rate for eleven times from 6.5% to 1.75%; the cut of the rate continued in 2002 and 2003, which finally dragged the Federal funds target rate down to the lowest point of 1%. This low interest rate lasted for one year, which did not see another increase until June, 2004. Low interest rate pushes the continuous boom of real estate market, while it also weakens the public risk awareness and feeds their blind optimism. In 2000 U. S. Congress passed the *Commodity Futures Modernization Act*, which discontinues the right of U. S. Commodity Futures Trading Commission to supervise and regulate the financial derivatives^[1]. A loose supervision and regulation environment accelerates the development of financial derivatives, but doesn't attach the same importance to controlling their risks.

1.2 The highly complicated financial products enlarge the risk A significant feature of financial derivatives is that its value is calculated in a complex mathematical formula or by a model. Its price and risk could not be evaluated directly by the investors, instead, it highly depends on the credit and risk rating structures. However, these structures do not take serious attitude toward financial derivatives, which, as a result, fuels the emergence and spread of economic bubble. Moreover, since the value of these derivative products is very sensitive to risk appetite, the profit will explode under better economic situations while it will dramatically shrink at difficult economic situations, which will exacerbate the risk of the financial derivatives themselves^[2].

Generally speaking, the root cause of subprime crisis is that financial supervision and regulation fail to keep up with the pace of financial innovation. Nevertheless, we should not stop eating for fear of choking and thus inhibit the financial innovation. The key of the problem lies in how to enable a reasonable and appropriate development of financial innovation in the context of financial supervision and regulation so as to push the de-

velopment of our rural economy.

2 The significance of financial innovation to our rural financial development

Our rural areas are characterized by vast territory, scattered distribution of population, small economic scale and insufficient mortgage, which determines that rural finance has different development rules and pattern from urban finance. For a long time, due to a neglect of the characteristics of rural finance and a lack of financial products matching the rural economy, the large financial institutions could not play its due role in the rural economy.

2.1 The main features of our rural finance

2.1.1 The total supply of formal finance is insufficient. Seen from the whole nation, there is a serious shortage of the supply of formal finance in rural areas. In recent years, due to the requirements of commercialization operation, the outlets of four commercial banks in the county areas are dissolved or merged, some of the rural financial institutions also shift their business focus to the urban areas. By the end of 2007, the number of the financial institution outlets in county areas is 124 000, 9 811 less than in 2004; the four major commercial banks have 13 000 outlets, 6 743 less than in 2004; there are 438 000 financial practitioners, 38 000 less than in 2004. Among them, the Agricultural Bank has 13 100 outlets in the county areas, 3 784 less than in 2004, accounting for 10.6% of the total number of all financial institutions outlets in county areas, which saw a two percentage points drop compared to 2004. The dissolution, merge and transfer of these financial institutions leave a blank in financial services in some rural areas^[3]. By the end of 2007, there are 2 868 counties and towns without any financial institutions, this number accounts for about 7% of the total number of our townships.

2.1.2 The informal finance suffers a long-term suppression. In our rural areas, the informal finance has existed for a long time, its main forms are Rotating Savings and Credit Association, Bidding Association and so on. As there is an insufficient supply of formal finance in a long term, the informal finance plays an important role in activating capital financing and promoting rural economic development. But meanwhile, as informal finance is characterized by small scale, weak anti-risk capacity and non-standard operation, it disrupts financial order and increases economic risks. Therefore, the government strictly controls the development scale of informal finance.

2.2 The great significance of financial innovation to rural finance

2.2.1 Effectively increasing financial supply. The insufficient rural financial supply is resulted from the following reasons: firstly, the small-scale farmers lead to the per unit high information costs in providing financial service; secondly, the farmers lack effective mortgage. Generally, to apply for a loan needs real estate mortgage or income guarantee, which are all beyond the small-scale farmers' capacity. To conduct financial innovation in rural areas is to design various financing means according to the characteristics of rural economy so as to search

a suitable way to develop rural economy. As long as the financial institutions fit the characteristics of rural economy and design appropriate financial products, they could provide the funds to the farmers in need so as to solve the difficulty in applying for a loan and increase the supply of rural finance.

As the practice of new-type rural financial institutions shows, the innovation of the mechanism can fill in the blank of traditional financial services, effectively solve the farmers' difficulty in applying for a loan and better promote the development of rural economy. In December 2006, China Banking Regulatory Commission promulgated *Comments on relaxing and adjusting access policy of the banking financial institutions in rural areas and better supporting the building of new socialist countryside*. By the end of August, 2008, there are already 61 new-type rural financial institutions, seen from the direction of loan investment, the new-type rural financial institutions loan to the farmers 895 000 000 Yuan, accounting for 46.69% of the total amount of loans, and issue the loans of 1 132 000 000 Yuan to the farmers benefiting 22 797 households; the small rural enterprises have a loan balance of 775 000 000 Yuan, which makes up for 40.43% of the total amount, it extends a total amount of 1 017 000 000 Yuan loans to the small enterprises, supporting 4 452 small enterprises^[4].

2.2.2 Gradually regulating and developing the informal finance. The informal finance could have existed for a long time in rural areas is mainly due to its flexible financing means and correspondence to rural reality. Learning from the experience in forming the institutions of informal finance, financial innovation could further regulate the whole financial market. By carrying out financial innovation and providing new-type financial services the farmers will get easy and convenient access to formal financial services. All those doings above not only extend the services scope of formal financial institutions and improve its services quality; but also could regulate and supervise local financial market as well as standardize local informal finance.

3 The enlightenment of subprime crisis to our rural financial innovation

How to balance financial innovation and financial supervision has received great concern from the government and regulators after the subprime crisis. After a reflection on the root causes and influences of subprime crisis, it is decided that neither financial innovation nor financial supervision is dispensable. In our rural finance, financial innovation still needs to learn from the experiences and lessons of subprime crisis.

3.1 Financial innovation is the driving force of the development of rural finance

The subprime crisis gets the investors clearly understand the risks of financial derivative tools, and makes them even more cautious about the constantly emerging financial innovation. Some people even deny and suppress the financial innovation. But undeniably, it is financial innovation that brought American finance a decade of prosperity. Subprime crisis is rooted in crisis control and the supervision of financial activities rather than financial innovation. Whenever it is, financial innovation is still the driving force of fi-

financial industry and even the whole economic development.

Our rural economy is in a critical point of development, rural finance plays an important role in pushing the development of rural economy, since joining the WTO, China's banking industry becomes more and more open, but our rural financial development still faces lots of difficulties. Therefore, we must make the financial innovation accommodate to the new situation of rural economic development so as to cope with the competition with foreign banks after the opening up of banking industry. Financial innovation should not only be the innovation of few financial services and products, instead, it should cover the whole financial service system. We should make a comprehensive arrangement, emancipate our thinking, and gradually build and perfect a modern rural financial service system; we should also keep pace with the times from our thoughts to the design of specific financial products so as to accommodate to the needs of the whole rural economic development.

3.2 To strengthen risk awareness is a prerequisite for financial innovation The subprime crisis is resulted from weak crisis control. The complexity of financial derivatives leaves the investors a blur view of their crisis^[5]; the Credit Rating Agency over-estimates the risk premium, which, however, makes the financial derivative products even more popular among investors, what's more, American regulatory authorities relax the regulation of financial derivatives. The above activities which weaken the financial regulation finally breed the once-in-a-hundred financial crisis.

While conducting the rural financial innovation, we should also strengthen the risk control. Our rural economy is very complex, investment chances and risks coexist. ①China has a vast rural area with a scattered distribution of population and small economic scale, it needs certain information costs to clarify the actual situation of the farmers' production and operation. While for those financial institutions, this information asymmetry will increase the risks of loans. ②There are few mortgages in our rural areas. General farmers have few real estates and lack reliable source of incomes, which gets them no access to loans in traditional financial institutions. In order to solve the farmers' difficulty in applying for a loan, the new-type rural financial institutions provide flexible and convenient services, for example, to apply for a small loan is very simple and easy and needs no guarantee, it is an innovation and complementary for traditional finance, but on the other hand it increases the credit crisis of financial institutions. Therefore, during the financial innovation, we should also strengthen the risk control of financial products, for example, to enhance the investigation on the operation and credit record of the farmers and so on. Never emphasize innovation while neglect the risks.

3.3 A flexible and effective supervision and regulation system is an effective approach to preventing financial risks

As financial innovation advances and new-type financial institutions join the works of rural finance, diverse financial products come one after another. It needs strict as well as flexible regulation on those newly-emerged financial innovative products. A less strict regulation could not control the risk, while a rigid regulation would kill the financial innovation initiatives. I think that we should do from the following aspects: ① Classified regulation is an effective means. For example, currently the new-type rural financial institutions and rural banks should be given a comprehensive prudential supervision like other commercial banks; as for those loan companies, we should mainly play the role of supervision and control as an investor, and enhance the consolidated supervision on the investors; in the rural fund mutual cooperative, we should aim at improving the self-discipline management of the members. ②We should cooperate with local government, industry and associations so as to carry out detailed investigations. Local government and farmers know about the economic situation of the lender, while the industries and associations have a better understanding of local production and operation conditions, the rural financial innovation needs their support so that the crisis could be effectively controlled and the financial service and business scope would be easily extended. ③Industry self-discipline is the basis of financial regulation. The new-type financial institutions should actively explore the ways and channels of crisis control, and guarantee the safety and effectiveness of capital use.

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(From page 43)

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