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Towards a diversified and inclusive financial market in rural China: A theory-driven approach

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Abstract

Farmers and small and medium sized enterprises have an important position in the Chinese rural economy, but evidence suggests their role is impeded by limited access to formal finance and the general underdevelopment of rural financial markets in China. This paper attends to the matter and discusses means to establish a comprehensive and efficient rural financial system able to provide finance to both the agricultural and non-agricultural sector of the rural economy, which is essential for the realization of the Rural Vitalization Strategy. We review existing rural finance paradigms and propose an alternative paradigm, the Local Knowledge Paradigm based on Hayek's notion of local knowledge. The new paradigm suggests that further diversification of rural financial institutions and the formation of a competitive and inclusive rural financial market are important prerequisites for farmers and small and medium sized enterprises to be able to fully capture the benefits from their economic activities. By employing this new paradigm, we further analyze the structure of China's rural financial system, the demand of China's rural financial services, the development of rural formal, semi-formal and informal finance and some considerations of how to improve China's rural financial market.

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Content

1. Introduction

China's rural financial system has changed dramatically over the last 40 years. Great progress has been made with the financial pluralization in terms of increasing number of financial institutions operating in respective counties or other county-level jurisdictions. This was made possible partly because substantial rural finance reforms were implemented since 1997 and new market entry policies have been launched since mid 2000s for a limited number of new types of formal and semi-formal financial institutions, making it possible for them to absorb capital from the informal finance sector. The formal financial sector has become more robust than before, with the ownership system of rural credit cooperatives (RCCs, nongcun xinyong hezuoshe) got gradually restructured and the new entities that came out of the restructuring became more market-oriented since 2001. Financial institutions within the RCC system are changing entirely to shareholding entities, given the fact that they lost anyhow the characteristics of real credit cooperatives. Furthermore, despite of legal uncertainty, unregistered rural mutual fund societies (nongcun zijin huzhuhui) became flourishing in many rural communities, encouraged by the favorable rural finance policy proclaimed by the CCP. Most of them are real credit cooperatives. Yet, their respective size is very small. At the same time, the rate ceiling for informal lending was changed by the Supreme Court in 2015 to a more tolerate level. And the death penalty against the crime of "fund-raising fraud" was abolished in the 2015 amendments of the Criminal Law. However, all unauthorized financial organizations and activities and frequent informal lending businesses were declared illegal by the government in recent development.

In comparison with the rural financial system of a dozen years' ago, a much better financial ecosystem is developed, which is quite conducive to the financial sector's excising better functions[1]. Despite the above progress China's rural finance reform has made, China's rural financial sector still lags behind the rural socio-economic development, and is unable to meet the changing, multi-layered and diversified demands for financial services in rural areas, not mentioning those demands which emerged with the nation-wide implementation of the recently launched Rural Vitalization Strategy. Farmers and small and medium sized enterprises (SMEs) have an important position in the Chinese economy, but evidence suggest their role is impeded by limited access to formal finance and the general underdevelopment of rural financial markets[2]. That's one reason why informal finance still plays an important role for rural economic agents in China.

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[1]As regard to the role of a financial ecosystem and the importance of the functions of finance, see Bodie et al (2009).

[2]See, for example, Levine (2005) for a discussion on the relationship between financial development and economic growth.

A well-developed financial system is a key to an efficient allocation of social resources (Shaw, 1973; Goldsmith, 1969; Levine, 2005). If financial transaction mechanisms are underdeveloped, this will inevitably harm the development of an economy. And formal, semi-formal and informal finance are integrated parts of such a system. Their healthy and robust development is the key to the overall development of a better rural financial ecosystem.

In this paper, we review existing rural finance paradigms, propose an alternative paradigm based on Hayek's notion of local knowledge (Hayek, 1945 and 1948) which we denote the "Local Knowledge Paradigm" ("LKP" in the following). With respect to the resulting policy implications, this alternative paradigm suggests that further diversification of rural financial institutions and the formation of a competitive and inclusive rural financial sector are important prerequisites in order to fully exploit the potential of markets. Such competitive and inclusive rural financial structures do not exclude special government policy-oriented finance as a complement to better meet the demand for rural financial services.

This paper proceeds as follows: Section 2 reviews the theoretical foundation of rural finance, i.e. existing paradigms. In section 3 we subsequently introduce the new rural finance paradigm. Section 4 discusses the current structure of the rural financial system followed by an analysis of the demand for financial services in rural areas. Section 6 describes the development of rural finance institutions and the informal financial sector and their role in the supply of financial services in rural China,, and in accordance with the LKP highlights the importance of a high degree of diversification of rural financial institutions and downscaling financial services via their branches and Fintech. Hereinafter, section 7 presents the policy implications resulting from our analysis in order to improve the rural financial system in China. Section 8 finally concludes.

2. Existing Rural Finance Paradigms

Rural finance theory is derived more from practices and experiences and, therefore, rural finance paradigms always involve a dual dimension, i.e. they combine theoretical and practical components. Their rejection, modification or acceptance is often subject to an evolutionary process of trial and error (Popper, 2004). Nevertheless, rural finance paradigms play an important role in providing policy guidance for decisions fostering the access to finance in rural areas.

There are two representative rural finance paradigms to date, the *Subsidized Credit Paradigm* and the *Rural Financial Systems Paradigm* (Yaron et al, 1997b). The latter one follows the path of traditional development finance theories, as for example Shaw's theory of financial deepening (Shaw, 1973) and McKinnon's theory of financial liberalization (McKinnon, 1973). Both theories are pointing out the need to eliminate financial repression and to enhance financial market deepening and liberalization in developing countries. In addition, though not being an explicit rural market paradigm, Stiglitz's Incomplete Market Paradigm (Stiglitz and Weiss, 1981; Stiglitz, 1989;

Greenwald et al, 1986; Zhang et al eds., 2002) has important implications for rural financial development. In particular, it lends support to government intervention into incomplete financial markets to do away with inefficiencies in the allocation mechanism.

2.1 The Subsidized Credit Paradigm

The Subsidized Credit Paradigm as a traditional theory dominated discussion on rural finance before the 1980s. It is based on the implicit assumption that farm households, especially the poor, lack adequate saving opportunities. The chronic lack of capital poses a permanent problem to rural areas. This paradigm correctly emphasizes that income uncertainty is high in the agricultural sector but incorrectly concludes that the sector cannot be an interesting target to commercial banks as agricultural profits generally are far too low (Yaron *et al.*, 1997b ; Zhang et eds., 2002). As a matter of fact, however, many agricultural activities are able to generate enough returns to cover the cost of capital.

Based on its underlying assumptions mentioned above, the Subsidized Credit Paradigm concludes that it is necessary to inject capital from outside rural areas and to establish special non-profit financial institutions that assume the task of funds allocation in order to increase agricultural production and alleviate rural poverty. According to this theory, interest rates of loans for agricultural production must be lower than in other industries in order to reduce the structural income gap between the different sectors. This paradigm implies that informal finance with high interest rates makes poor farmers even poorer and hampers agricultural development still further. Under such a framework, the government provides through rural bank branches and credit cooperatives a large number of low-interest policy funds into rural areas, with special subsidized loans targeting the poor.

Nevertheless, the assumptions underlying the Subsidized Credit Paradigm are inaccurate. In fact there is a demand for savings opportunities by rural farm households, including the poor. Experiences from several Asian countries show that most poor people will save if they are offered adequate opportunities and incentives (Adams, 2002). Furthermore, low-interest loan policies do rather poor in promoting agricultural production and in effectuating a pro-poor income redistribution (Yaron et al, 1997a). As the uses of funds for loans are fungible, low-interest loans are unlikely to promote particular agricultural activities. Indeed, often it is not the poor agricultural population in rural areas that emerges as the main beneficiaries of low-interest loans but rather wealthier farmers in need of large amount of credit that may divert away and exploit the interest subsidy of low-interest loans (Vogel, 2000). Many subsidized credits are even channeled to initially commercially profitable projects and thus crowd out conventional commercial finance. The subsidized credits result in adverse selection problems and cause distortion in rural financial markets. The concept of subsidized credits also intensifies the misconception of financial institutions that agriculture is inevitably a low-return industry, further hampering farmers' access to finance and thus further increasing their dependence on government subsidy.

2.2 The Rural Financial Systems Paradigm

In early 1980s, the Rural Financial Systems Paradigm gradually replaced the Subsidized Credit Paradigm. Being built from exactly opposite theoretical assumptions than its predecessor paradigm, the rural Financial System Paradigm emphasizes the role of financial markets (Yaron *et al.*, 1997b; Zhang et al eds., 2002). According to its logic, there is no need to channel subsidized credits to rural areas as rural farm households have saving ability.[3] Even more, a low interest policy rather will prevent people from depositing in financial institutions and consequently will curb financial development. In addition, it is natural that the interest rate of informal lending is high, as considerably higher opportunity cost come along with informal lending in rural areas.

The Rural Financial Systems Paradigm focuses on the importance of rural financial reform. First, financial institutions in rural areas play an important role in rural finance, especially for the mobilization of savings, which is of utmost importance. Second, interest rates must be determined by the market, and the real deposit rates needs to be positive in order to attract savings and balance demand for and supply of funds. Third, whether or not a rural financial system is successful should be assessed by its financial institutions' performance as well as the degree of autonomy and sustainability of their business operations. Fourth, there is no need to implement a directed loan system for specific target groups. Finally, informal finance has its legitimacy and thus should not be completely eliminated but rather informal structures should be embedded into the overall rural financial system.

The two paradigms presented above have aroused much interest since the 1980s. Although the Subsidized Credit Paradigm is still supported by governments in a large number of developing countries, the Rural Financial Systems Paradigm has become the mainstream view within the international rural finance circle.

2.3 Incomplete Market Paradigm

Stiglitz's *Incomplete Market Paradigm* stresses that some social and non-market factors are needed to foster an efficient financial market. In its basic framework, it understands financial markets as markets characterized by imperfect information. In particular, lenders (financial institutions) do not dispose of full knowledge about borrowers, i.e. there is imperfect information potentially hampering the efficiency of the

[3]For instances, livestocks can be a kind of saving for the poor (Zeller, 1994). There are also rotating savings and credit associations (RoSCAs) in Guizhou which use rice as savings and credit instruments (Feng et al, 2012).

market mechanism and leading to socially undesirable financial market outcomes. According to this paradigm, in order to remedy this type of so called "market failure", there is a need to implement appropriate government intervention schemes in the financial market. Non-market measures such as getting borrowers organized can be adopted as well (Stiglitz and Weiss, 1981; Stiglitz 1989; Zhang and Heufers eds., 2002).

Stiglitz' extensive work on incomplete markets and information asymmetry between lenders and borrowers has had significant influence on finance research. Besides, a related field of study, information economics, has also become an important tool in financial market analysis. Stiglitz concludes that "government intervention" in a market under imperfect information is imperative as it is able to mitigate information asymmetries.

3. The Local Knowledge Paradigm as a New Paradigm

However, government faces also information asymmetry problems and it has no advantage over market players to using local knowledge. Local knowledge refers to dispersed knowledge "which is and remains widely dispersed among individuals" (Hayek, 1973: 15) and "the knowledge of the particular circumstances of time and place" (Hayek, 1948). Furthermore, Stiglitz regards information asymmetry as an obstacle to the attainment of certain market outcome. However, behind information asymmetry is often the local knowledge that can be utilized by market players, especially if new market mechanisms are discovered. Here competition can be utilized as a discovering procedure in Hayekian sense (Hayek, 1968).

In rural financial markets the prevalence of local knowledge means that there exist situations that are characterized by information asymmetry between borrower and formal lender. However, this does not automatically provides a justification for government intervention as a more developed market potentially could do away with these inefficiencies. For Hayek (1973:15), local knowledge or dispersed knowledge is a resource which can be utilized by market actors. One can rightfully utilize and explore market process and market mechanisms to discover and utilize local knowledge (Kirzner 1973/1992), and thus reduce the information asymmetry in rural financial markets. In contrast to the Imperfect Market Paradigm, the LKP emphasizes the concept of local knowledge rooted in Hayek's epistemology. It echoes the above mentioned rural financial market paradigm, but focuses explicitly on how to solve inefficiencies in the market process brought about by imperfect competition and imperfect information by discovering and exploiting local knowledge.

Hayek stressed that competition is a discovery procedure (Hayek, 1968, 1969). In particular, competition is a procedure of discovering information and thus reducing imperfect information and information asymmetry. Competition in rural financial markets can also manifest itself as a discovery procedure. According to Hayek's local knowledge notion, also known as the Market Process Paradigm, competition can help discover knowledge, promote its dissemination, and enhance cooperation (Hayek, 1937, 1945, 1948). Accordingly, agents engaging in peer relational transactions (including spot financial transaction) at a specific time and location can best explore and use local knowledge to reduce information asymmetry.

An effective implementation of the LKP in China implies a fundamental change in both the organizational and operational structure of financial institutions and will ultimately result in a more competent rural financial system. In detail, the changes will spur competition within the rural financial sector by increasing financial institutions' degree of diversification and thus establishing a competitive rural financial order. Policy-steered credit schemes can still play a subsidiary role in specific sectors where an efficient competitive financial market cannot be established. Local knowledge on the other hand will be exploited more comprehensively making it possible to prevent or mitigate problems of information asymmetry and imperfection more effectively. As regard to “non-market measures” as proposed by Stiglitz, such as getting borrowers organized, the LKP recognizes them as a part of normal market process since there is no market without market players’ actions or interactions. One example for getting borrowers organized can be formation of groups and centers in the Grameen Bank Model introduced by Prof. Yunus (2008) in Bangladesh. In respect to “government intervention” as proposed by Stiglitz, the LKP recognizes all the necessary measures for improving the rural financial sector by utilizing by any actors within the state and society the local knowledge available to them. It stresses also on their compliance with the principle of subsidiarity if the actions are to be done by the government.

4. The Structure of China’s Rural Financial system

Rural financial institutions in China are classified as formal, semi-formal, and informal financial institutions. Abiding the definition by Adams and Fitchett, (1992), financial institutions which are regulated by the authorities fall onto the category of formal institutions, those fully beyond their supervision are called informal, and semi-formal institutions are situated between these two categories. Formal financial institutions are generally supervised by financial authorities, such as currently the China Banking and Insurance Regulatory and Administrative Commission (CBIRC), while semi-formal institutions are established upon central or local government approval or licensing and are supervised by the government. Informal finance, on the other hand, is not subject to a regulatory mechanism and is mainly self-governed and controlled by prohibition (or access control) and subsequent cleanup.

With the possible exception of Fintech (such as P2P lending companies), many forms of which are informal financial activities, the informal sector has a much greater extent of local features[4]. This is also compatible with respect to endogeneity of these informal financial institutions or activities. Moreover, the formal financial institutions are

[4]In the following, we will not discuss informal Fintech activities which is a fully different type of informal finance in contrast to other informal financial institutions and activities.

generally of a much larger scale, operate over a greater geographical area, and are more systemized than its counterparts in the informal sector.

It should be noted, however, that technical advances in information technology increases the action radius of informal finance. This is especially the case as regard to FinTech. Table 1 provides an overview of the different types of financial institutions and activities in China.

Table 1. Financial institutions in rural China

Formal finance	**Semi-formal finance**	**Informal finance**
Rural branches of the 'Big Four State-owned Commercial Banks'[1]	Credit companies wholly owned by domestic banks	Informal direct borrowing
State Development Bank	Microcredit companies	Informal lending intermediaries
Agricultural Development Bank of China (ADBC)	Registered pawn houses	Informal lenders[4]
Rural credit cooperatives[2]	Registered community development funds	Rotating savings and credit associations
Rural cooperative banks[2]	Registered credit guarantee companies	Unregistered rural mutual fund societies (nongcun zijin huzhu she)
Rural commercial banks[2]	Registered investment companies	Microcredit programs
City commercial banks[3]	Pawn shops	Unregistered microcredit institutions
Postal Savings Bank of China	Registered microfinance institutions	'Underground banks'[5]
Joint-stock commercial banks	Registered rural mutual fund societies (nongcun zijin huzhuhui)	Informal discounting services
Village Banks	Registered Fintech activities and organizations	Informal Fintech activities and organizations
Rural mutual fund associations (nongcun zijin huzhushe)	Others	Trade credits
Branches of securities companies		Others
Branches of insurance companies		

Note: 1. 'Big Four State-owned Commercial Banks' include Bank of China, China Industrial and Commercial Bank, China Construction Bank and Agricultural Bank of China. 2. Rural credit cooperatives, rural cooperative banks and rural commercial banks are regarded as 'financial institutions within RCC system'. The rural cooperative banks and rural commercial banks are an outcome from the restructuring of rural credit cooperatives in many counties or cities since 2001. 3. Most of city commercial banks are the outcome from the restructuring of city credit cooperatives in some cities. 4. Private lenders or "informal lenders" are individuals specialized in private lending businesses. 5. 'Underground banks' involve various types of entities doing private saving and lending

businesses or running foreign exchange conversion businesses without government approval. Their businesses are illegal according to Chinese law and regulations.
Source: The authors.

From the viewpoint of the enforcement mechanism of financial contracts, formal financial institutions rely mainly on formal sanctions such as those provided by laws and regulations, while semi-formal institutions, though subject to the use of laws and regulations first and foremost implement informal sanctions in order to enforce financial contracts. In contrast to formal, semi-formal and informal institutions, informal financial organizations and activities are first subject to informal sanctions such as peer pressures and then formal sanctions.

From the viewpoint of epistemology, formal finance relies on both global and local knowledge, although the sector has problems in fully exploiting the potential of local knowledge. Semi-formal and informal finance, on the other hand, greatly benefit from the extensive use of local knowledge. As mentioned above, large formal financial institutions can enhance their ability to use local knowledge by downscaling financial operations and services. In this aspect, Rural Credit Cooperatives (RCCs), rural commercial banks and rural cooperatative banks, all the three types of which are regarded as ‘financial institutions within the RCC system, can do better than Agricultural Bank of China (ABC) in serving small farm households, since their operations are locally rooted to a greater extent.

Table 2 shows various categories, types and number of rural banking financial institutions. The major players are in the first place RCCs, rural cooperative banks and rural commercial banks in lending business for farm households and rural micro and small enterprises. In general, there is only one RCC, rural cooperative bank or rural commercial bank operating in each county or other county-level jurisdictions.

Table 2. Categories, types and number of rural banking financial institutions in China (by the end of 2016)

Category	Name	Types by Size	Number
Policy-oriented banks	State Development Bank	Big Bank	1
	Agricultural Development Bank of China	Big bank	1
Commercial banks	“Big Four” State-owned Commercial Banks (Rural branches, including those of the Agricultural Bank of China)	Big banks	4
	China Postal Savings Bank of	Big bank	1
	Rural commercial banks	Mostly small and medium banks	1114
	Village banks	Small banks	1443
Financial institutions within the RCC system	Rural cooperative banks	Small and medium financial institutions	40
	Rural credit cooperatives	Small and medium financial institutions	1125
	Rural or town mutual fund associations	Small and medium financial institutions	48
Semi-formal financial institutions	Credit companies	Small semi-formal financial institutions	13
	Microcredit companies	Small semi-formal financial institutions	8673

Source: China Banking Regulatory Commission. Annual Report of the China Banking Regulatory Commission 2016, July 25, 2017; People’s Bank of China. Report of the Statistical Data of Microcredit Companies 2016, January 25, 2017.

5. Demands for rural financial services

5.1 Structure and Diversity of Demand

Demands for financial services in rural areas depend on multiple factors and arise from different needs of farm households, rural enterprises, villages, as well as township and county governments. Living expenses and small agricultural loans constitute the main demand for credit amongst farm households. Studies such as Han (2009) have shown that the average credit needs of farm households are small in volume and geographically widely distributed, have short maturity and exhibit seasonal characteristics. Moreover, credit is used for a wide range of living and production purposes. Farm households which run an agribusiness demand mainly larger loans for specialization and expanding their scale of production. Migrant workers need to have their trip to cities or back to their hometown.

The situation is different with family farms, agricultural cooperatives, and rural micro and small enterprises. They demand credit for starting their businesses, keeping operating, expanding their production, and entering markets. The credit volumes demanded are relatively small in comparison to that required by medium and large enterprises focusing on tapping new markets, or maintaining or expanding their current business. From an epistemological point of view, any form of financial institution which is relatively good at utilizing local knowledge is more capable to meet the demand of these micro and small enterprises for loans: Such financial institutions tend to better utilize the financial tools currently at their disposal and identify and manage clients. With respect to larger enterprises, financial institutions in context of their lending decisions rather rely on global knowledge.

Financial service providers which emphasize the use of local knowledge on the other hand are better able to adapt to the specific needs of farm households and rural micro and small enterprises in their geographical proximity. They limit their business scope to a small range of financial products, especially loan business. Yet, to facilitate the access to rural finance and in order to broaden finance opportunities for rural economic agents, more diversified financial institutions are needed. However, a mere expansion of the number of local financial institutions alone will not do away with the problem of limited access to financial services for farm households and SMEs in rural areas. For these institutions to effectively contribute to an efficient rural financial system, they must downscale their financial services and combine them with complementing mechanisms such as agricultural credit insurance mechanisms, which is an effective mechanism of utilizing local knowledge and solving information asymmetry problems. Table 3 summarizes the diversified financial services demanded by farm households, rural enterprises, local governments, and village organizations.

Table 3. Demand for financial service in rural areas

Users of rural financial services			Main type of loan demands
Farm households	Poor farm households		Living expenses and small loans
	Ordinary farm households	Traditional farming	Living expenses and small loans
		Farm households running agribusinesses	Specialization and expanding scale of production
		Migration work	Financing trip to do migration work
	Family farms	Scaled farming by farm households	Starting, maintainin, specializatio and expanding scale of productio
Agricultural cooperatives	Ordinary farm households and agribusiness enterprises	Traditional farming; running agribusiness	Starting, maintainin, specializatio and expanding scale of productio
Rural enterprises	Micro and small enterprises		Starting, maintaining and expanding business
	Medium to large enterprises		New market entry; maintaining and expanding current production / business
	Leading enterprises	In early stage of development	Expanding specialized technolog intensive production and expanding overall production / business
		In developed stage	Expanding specialized technology-intensive production and expanding overall production / business, maintaining or expanding market share / entry to new markets
Local government	Provincial, county and township governments		Infrastructure, new loans to pay off old loans
Village organization	Villagers’ committee and village economic cooperatives		Infrastructure (roads, schools and village office buildings, etc)

Source: Revision by the authors based on Feng et al (2013: 68).

The launch by the CCP of the Rural Vitalization Strategy in the end of 2017 implies an immense increase in demands on financial services, provides many new opportunities for rural financial institutions, and constitutes big challenges to them as well. The entire rural finance system is to be further developed to meet such challenges and capture gains from such opportunities. In addition, there are tendencies of the population aging, sub-replacement fertility and hollowing-out in many Chinese villages. Furthermore, with the increase of per-capita-income of rural population and farm households, the propensity to consume has been changing. Less young people are willing to work in cropping field. The second generation of the migrant workers tend to save and spend their money in a totally different way and most of them choose to stay in cities. All these factors imply a persistent change in structure of demands on financial services in rural areas.

5.2 Meeting the Financing Demand of Farm Households, Family Farms and Agricultural Cooperatives

Although the overall financial supply situation is improving, the coverage of formal financial institutions in China's rural areas remains limited. In 2017, the China Agricultural University investigated 2093 farm households in 54 villages of 3 provinces, i.e. Shandong, Henan and Guangxi, and obtained 1730 effective sample households. 705 of them (40.75%) had credit demand. Of the 705 households with credit demand, 485 (68.8%) can be satisfied through formal and informal channels. Of the 485 households with credit support, only 165 (34.02%) obtained sufficient credit support from the formal financial institutions. Although 60 households can obtain formal credit support, the amount of their loans cannot meet their financial needs, and they need to be supplemented through informal credit. In addition, 260 farmers are unable to obtain formal credit support and are totally dependent on informal credit (He et al 2008).

According to a 2006 survey organized by the People's Bank of China (in the following PBC survey), only some 10 percent of farm households receive credit from formal financial institutions whereas the figure for farm households having received informal loans is close to 25 percent[5]. According to data from the China Banking Regulatory Commission, of the more than 230 million Chinese households, more than 120 million claimed to be in direct need of credit in 2007. At about 32 percent of total households thereby satisfy their need of credit by accessing rural cooperatives and farmers' mutually guaranteed loans (Hu, 2009). The PBC survey also shows that, in general, the average loan volume that farm households borrow from the formal financial sector is close to 50 percent higher than from the informal financial sector. Table 4 summarizes the origin and size of farm household loans.

[5] A total of 20 040 households was surveyed by The People's Bank in 10 provinces nationwide. Here informal loans include loans from informall and potentially semi-formal ones. However, semi-formal channels were very rare and the corresponding amout would be very limited in 2006.

Table 4. Farm household loans and their size

	Formal and informal sector	**Formal sector**	**Informal sector**
Percentage of farm households having taken loans in all households	30.8%		
Percentage of farm households having taken loans in all households		10.4%	23.8%
Average amount of a loan in RMB	6,606	8,589	4,624

Note: Interest-free borrowings are included in informal loans. “Informal” refers to “informal and semi-formal” if one contrasts “informal” to “formal” only. This applies to the whole book unless “semi-formal” is mentioned explicitly.
Source: People’s Bank’s Survey on the Borrowing Situation of Farm Households, 2009.

According to the PBC survey, regarding the purpose of lending, farm households' credit needs for meeting living expenses accounts for 45 percent of their total loan demand, thus exceeding their credit need for productive (41 percent) and other purposes (11 percent).[6] Loans supply to farm households by formal financial institutions is far from being sufficient, and the extent of credit rationing remains severe.[7] The average loan for a household amounts to 10 906 RMB, with more than 52 percent of all households draw on loans in excess of 5 000 RMB, 20 percent on loans between 10 000-20 000 RMB, while less than 3.5 percent have loan higher than 30 000 RMB. When asked how much money they were willing to borrow under the existing mortgage and guaranty conditions, farm households' answers range around 22 000 RMB on average. Thus, as becomes apparent, the credit need voiced by farm households is far from being satisfied. At the same time, several farm households with effective credit demand find themselves unable to find appropriate credit instruments that suit their needs. Table 5 summarizes the main reasons for farm households willing to take loans that prevented them from applying for credit with formal financial institutions.

Table 5. Farm households’ reason for not applying for a loan

Reasons	**Percentage (%)**
Afraid of failing to repay the loans	10.72
Interest rate and other costs too high	37.1
Afraid of not getting loan application approved	18.54
Other reasons	32.92
Total	100.00

Source: People’s Bank’s Survey on the Borrowing Situation of Farm Households, 2009.

[6] People’s Bank’s Survey on the Borrowing Situation of Farm Households, 2009.
[7] Credit rationing describes the situation when a bank limits the supply of loans, although it has enough funds to loan out, and the supply of loans is less than the effective demand of borrowers.

The main reason why farm households don’t succeed in receiving loans from formal financial institutions essentially is the lack of “guanxi”[8] and having no mortgage or guarantee for getting loans (see Table 6). Another reason is credit rationing in the formal sector. Yet, in using detailed information on farmers' investment projects and exploiting local knowledge of farmers’ credits records, formal financial institutions could do much better in meeting farmers' credit needs. For example, by downscaling its financial products and services, formal financial institutions can refine its credit rating system and enlarge loan coverage. The government furthermore could encourage farm households to establish formal grassroots financial institutions of their own. By fully exploiting internal local knowledge and the information symmetry among farmers, the formal grassroots financial institutions could establish an efficient intermediary providing financial services to farmers.

Table 6. Reason to reject farm households’ loan applications

Reasons	**Percentage (%)**
Having no mortgage or guarantee	23.83
Lack of guanxi	33.36
Too poor	7.73
There were old loans which hadn’t been paid o	7.57
Other reasons	27.51

Source: People’s Bank’s Survey on the Borrowing Situation of Farm Households, 2009.

As Table 7 illustrates, there also is a high but still unexploited loan demand from farm households. The main reasons why many farm households can but do not want to borrow money is that they, in descending order (i) have enough financial resources to meet current production and living demands; (ii) are unfamiliar with borrowing; (iii) have no profitable projects to develop; or (iv) can accumulate enough money by labor.

Table 7. Reason for not demanding loans

Reasons	**Percentage (%)**
Have abundant money to meet current production and living demands	60.5
Don’t have any profitable investment project	12.5
Don’t want to become used to borrow money	14.0
Can earn enough money by working as migran labor	10.1
Others	2.9
Total	100.0

Source: People’s Bank’s Survey on the Borrowing Situation of Farm Households, 2009.

[8]According to Luo (2000:1f), guanxi means broadly “interpersonal linkages with the implication of continued exchange of favors. It includes reciprocal obligations to respond to requests for assistance”.

Most loans (93 percent) farm households receive from peers are interest-free. Among loans bearing interest, high rates are charged in very rare cases. The average interest rate of farmers' borrowing from peers for maturities between six and twelve months was 9.3 percent in 2006, the average interest rate for the one-year maturity was 10.4 percent. In fact, interest rates of loans between farm households on average have been higher than that of loans from formal financial institutions. Table 8 provides information on average annual interest rates charged.

Table 8. Average borrowing and lending interest rates in informal sector in 2006, (%)

Loan term / Interest rate	½ year	½ - 1 year	1–3 years	3 – 5 years	5 years and above
Borrowing	9.2	9.3	8.4	9.4	6.6
Lending	10.1	10.4	10.6	-	-

Source: People's Bank's Survey on the Borrowing Situation of Farm Households, 2009.

Notably, 49 percent of farmers taking loans (including from formal financial institutions) had overdue debts in 2006. The two main reasons for farm households not repaying their debt in time are the lack of enforcement mechanisms and unpredicted family expenses. Moreover, relatives and friends account for more than 83 percent of the creditors for farm households' first loans. These creditors, in turn, collect their receivables mainly when the debtors have the money available (62 percent) or in terms of a one-time payment (32 percent). As a result, the overdue rate appears to be quite high. This figure, although related, is not to be confused with the loan default rate. While the former is the percentage of borrowers who fail to pay their debts in time, the latter captures the ratio of outstanding loans debtors have failed to pay in time to total outstanding loans of a respective financial institution (formal or informal). Moreover, overdue behavior is not synonymous with breaking a contract, taking into consideration that both borrowing and repayment behavior should be monitored against the background of local culture and customs.

In the social network of a close community of the rural area, lending is often a reciprocal social exchange: It is a favor of the lending person granted to the borrowing person who promises to repay; however, the borrower, in her/his requesting a borrowing, she/he often only requests the return of a favor she/he granted beforehand to the lender. Such lending customs are reflected by the fact that most loans are interest-free, most creditors do not have a written receipt, and debtors are able to delay the repayment when they don't dispose of enough money at the time payment is due. Besides, in accordance with Chinese customs, most farm debtors who delay their debt repayment do not deny their obligation but recognize their unlimited liability. While this is different from Chinese formal civil and contract law, this does not mean that the lending parties cannot resort to formal laws.

Hence, though the loan default rate of formal financial institutions (those within the RCC sysem for example) appears to be high, the part of which in regard to small credits for small farm households can partly be interpreted appropriately considering Chinese farmers’ credit culture and customs. Many farmers who defaulted are able to pay the interest, but have limited ability to pay the principal. Loan officers generally just extend these loans' period considering their personal income and the interests of the RCC. In this way, bad loans are disguised as standard loans. As a result, although the loan default rates of farm household debtors appear to be high, they rarely constitute a high volume of bad loans. On the other hand, formal financial institutions are forced to pay attentions to the matter. Education on modern credit culture is needed among farmers and a strict credit discipline is required to eliminate high default rates.

As regard to the financing of family farms and agricultural cooperatives, various surveys (Li et al, 2015; Du et al, 2019) show difficulties persist for most of most of them. Only a small part of them don’t have difficulty, because they have enterprises and use some profits to purchase the use right for a piece of land and run their family farms or nominal agricultural cooperatives. Since most of farm households and agricultural cooperatives just have the using right for the land at their hand, banks or RCCs normally don’t accept it as a pledge for a loan. It is difficult for banks or RCCs to transfer the pledge to a third party since land using right is strictly regulated in rural area. Informal loans are easily available for most of the family farms or agricultural cooperatives. Many of them got loans, only because some the owners of the family farms or some members of the agricultural cooperatives used own houses (with full title) as mortgage.

5.3 Meeting the Financing Demand of SMEs in Rural Areas

A number of studies such as Feng et al (2006; 2015), Han ed. (2009) and (Li 2004) have shown that lack of credit is a major constraint for SMEs in rural areas. Further factors restricting the development of enterprises are weak external demand, frequent change of macroeconomic policies, unfair competition, exchange rate fluctuation, weak technologies, a high tax burden, lack of information, adverse government intervention, among others (Feng et al 2015). Both formal and informal loans are important for SMEs.

According to the Report on the "Small and Micro Enterprise Index" (with survey data of 2013) released by ChinaPnR Ltd. and Southwest University of Business and Economics in 2014, only 44.7% of money the surveyed rural small and micro enterprises with loan demand have borrowed bank loans (including loans from rural credit cooperatives), their average amount of bank loans per enterprise is 57 900 RMB, and that of informal loans per enterprise 70 200 RMB (including zero-interest informal lending). Data show that the average annual interest rate of their interest-bearing borrowings from the informal financial sector is 18.8%, which is double of the annual bank lending rate (9.4%) (Li, 2014).

Han’s survey data reveals that 37 percent of rural enterprises borrow from rural credit cooperatives while 10 percent access credit from the Agricultural Bank of China. The proportion of loans to rural SMEs from formal financial institutions accounted for 52 percent. Accordingly, informal lending accounted for 48 percent of total credit.

Regardless whether we consider formal or informal finance, credit rationing of rural enterprises is widespread, and new lending supply is far from sufficient to meet the demand of SMEs. According to Han (2009), there are three major problems rural enterprises are facing in applying for loans: First, the proportion of companies that have access to credit supplied by banks or RCCs is small and their credit lines are is too small. Second, the collateral requirements stipulated by formal institutions make it difficult for small enterprises to borrow. Third, because informal channels in rural areas mainly consist of friends and families, specialized informal lenders and other individual loan providers, the scale of informal finance is limited. Key factors in formal financial institutions' lending decisions are the availability of sufficient collateral, a satisfactory scale and performance, as well as good past credit records Feng (2006). Table 9 provides additional information on factors rural enterprises consider as constraints to their development.

Table 9. Factors constraining the development of rural enterprises (%)

Lack of funds	Backward technology	Insufficient market space	Insufficient access to information	Government intervention	Heavy tax burden	Unskilled labor	Other
64.2	30.7	39.6	14.5	10.1	23.5	15.2	4.4

Source: People’s Bank’s Survey on small and medium sized enterprises, 2009.

Note: The sum can be greater than 100 as a result of questionnaire design. 8.3 percent are enterprises which annual sales exceed 30 million RMB.

6. Development of Rural Formal, Semi-formal and Informal Finance

6.1 Development of Formal Finance

General remarks

The above analysis shows that informal and semi-formal finance covers a higher percentage of farm households than the formal finance does. However, it’s no doubt that the formal finance plays a major role in financing the overall economic development in rural China. Many farm households are excluded by formal financial institutions in their delivery of financial services.

The government introduced various rural finance reforms since 1997. It requested the large state-owned banks to withdraw their branches under county-level. It launched a large-scale restructuring of the RCCs in 2003. RCCs were transformed into RCCAs with a single legal-person status at county-level (They are then in principle still regarded as RCCs in name), rural cooperative banks and rural commercial banks. It also introduced a “new entry” policy in 2006. Three new types of financial institutions were grant entry to rural financial markets: village banks, rural mutual fund associations and microcredit companies. With rural financial reforms as such, the rural financial institutions were pluralized to some degree. Financial institutions in the RCC system operate in a basis which is much more sounder than before. To some degree, financial services delivered by rural financial institutions have been getting better than before as well.

The number of formal financial institutions in most of counties of China is now quite large. However, it doesn’t solve the problems with relatively severe financial exclusion in rural China. Rather, existing banking financial institutions tend to focus on competing with each other on lending to larger companies and government projects. In this regard, no matter how many more financial institutions are established or introduced, it is limited to reach the excluded groups or SMEs in rural area.

Rural commercial bank, rural cooperative banks or RCCs dominate in the loan businesses for farm households in their respective county (Table 10). They are among the very few financial institutions that really take care of disbursing loan for agricultural, farm households’ and rural development. Village banks are another play in this business. However, their respective size is too small. State-owned commercial banks (including ABC), and national-level shareholding commercial banks, and city banks are present within Chinese counties, but focusing on lending to larger industrial and commercial companies, and government projects. Although rural commercial banks, rural cooperative banks and RCCs are requested by the government to service primarily the agricultural, farm households’ and rural development and small and micro enterprises, most of them do keep a significant portion of their businesses in these government-designated fields. They are local based and have advantages in utilizing local knowledge about these clients in comparison to other formal financial institutions. However, they prefer to lend to larger companies and government projects, just like other aforementioned other financial institutions. One common reason is that the cost for servicing these clients per loan is almost the same or even higher (if the lender has to go to a remote village to assess the credibility of the client), but the benefit is not larger, but often smaller. This is actually a static viewpoint. All the different formal financial institutions focus on reaching and keeping the existing larger clients. But if rural commercial banks, rural cooperative banks or RCCS do a sound baseline assessment of client credibility and continue the assessment in an iterative way, by using personal input plus Fintech, adopting arm-length principle and relational banking, they can build a reliable client base to capture their profit opportunities. Take the example of the Rural Commercial Bank of Cangnan county, Zhejiang province, which started with credit rating in all-around manner of farm households in 2006. According to incomplete statistics, the bank has accumulated nearly 380,000 credit-granted households, with loans amounting to more than 40 billion yuan and reached a credit coverage of nearly 65%. It supports nearly 130,000 households, with agricultural loans amounting to 18.7 billion yuan, which indirectly drives the production and employment of nearly 530,000 households, and helped them to achieve an annual increase of their income of more than 5 billion yuan[9]. Not only are large commercial banks, especially the state-owned commercial banks, not interested in serving farm households and SMEs in rural area, they also “pump out” the savings they mobilized out of there. Worth mentioning is the Postal Savings Bank which has a huge number of outlets (it shares often the site of post offices which is provided by the government) which constitutes the only challenger to rural commercial banks, rural cooperative banks or RCCs in taking deposits from towns or townships, but centralized its decisions on lending in rural area. The Postal Savings Bank still is lack of personal in lending business, which implies it has difficulty to utilize local knowledge for such business. All the large commercial banks have advantages to take deposits at a relatively low cost since their credibility is better than smaller banks. Although all banks, no matter large or small, are required to join the compulsory deposit insurance scheme. However, the level of insurance is low and doesn’t provide households, companies and local governments with an incentive to deposit with them. The RCC system doesn’t have its own additional deposit insurance scheme, direct or indirect. This leads the RCC system to a disadvantageous position in the competition with other banking financial institutions since their cost of taking deposits is higher.

During recent years, governments request the large state-owned banks to establish financial inclusion units and the Agricultural Bank of China to establish Rural and Agricultural Business Unit. Since these banks mobilize deposits at a lower cost in rural area, they are able to respond to the government’s request to do more financial inclusion by lending to farm households and SMEs in rural area at a lower interest rate. Although showing such a corporate social responsibility seems to be a welcomed move toward more financial inclusion, this tends to be an unfair competition between them and the RCC system.

Although the average number of financial institutions in each county is large, this doesn’t mean the existence of an excessive financial pluralization. Contrarily, financial pluralization is far from being realized. With the restructuring of the RCC system, there are almost no real credit cooperatives not only within the system. Also within the entire formal financial sector, there are only 48 rural mutual fund associations in pure credit cooperative nature, but their respective size is very small. In informal sector, rural mutual fund societies (or simply “mutual funds”) are scattering in a part of Chinese villages, especially in remote rural area. But both of their size and capital are very limited. Real credit cooperatives are not-for-profit mutal-help organizations and have differentiated ways of utilizing local knowledge at grassroots level. The ones in larger size can be a competitive force in rural financial market, while the ones in smaller size

[9]Rural Commercial Bank of Cangnan County: Pushing Forward High-quality Local Economic Development, China News Net, January 18, 2019, https://baijiahao.baidu.com/s?id=1622968836095857454&wfr=spider&for=pc, retrieved on September 7, 2019.

can be “self-entertaining” actors within their respective location. The lack of real credit cooperatives is a huge gap and defect in current rural financial system.

Table 10 Size and Performance of Main Rural Financial Institutions

	Number of banking financial institutions as legal person entities	Number of branches/ offices	Balance of loans related to Agricultural, farm households’ and rural development (100 million RMB)	Rate of non-performing loan (%)	Total assets (100 million RMB)	Equity (100 million RMB)	Post-tax profits (100 million RMB)	Number of employees
Agricultural Bank of China	1[1]	23682[1]	27600	3.02	195701[1]	13216[1]	1841[1]	496698[1]
Postal Savings Bank of China	1[1]	40000[1]	9174	0.87[2]	82700[1]	44219	398	171551[3]
Rural commercial banks	1114	49307	53096	2.9	202680	15167	1785	558172
Rural cooperative banks	40	1381	1767	3.3	4359	363	38	13561
Rural credit cooperatives	1125	28285	27039	8	79496	4698	519	297083
Village banks	1443	4716	5550	2	12000			81521
Total	3724	147371	124226		1300125			1618586

Note: 1. These indicators of the bank’s size and business performance refer to the whole China, including the urban and rural area. 2. This figure is the rate of non-performing loan of the balance of all loans, not only including the loan for agricultural, farm households’ and rural development. 3. Basic Information of Listed Company, September 30, 2016, http://stockpage.10jqka.com.cn/HK1658/.
Source: China Banking Regulatory Commission: Annual Report 2016, 2017; Agricultural Bank of China: Annual Report 2016, 2017; Postal Savings Bank of China: Annual Report 2016, 2017.

The Agricultural Bank of China

The development of rural financial institutions started from the scratch with the founding of the People’s Republic of China and went along a zigzag path since then. Both the Agricultural Bank of China and the rural credit cooperatives have been major rural financial institutions. The predecessor of the Agricultural Bank was called the Agricultural Cooperative Bank of China, which was founded in August 1951.The

Agricultural Bank received its current name in 1955. From 1951 to 1965, the bank was established and then merged into the People's Bank of China for 3 times.
During the "Cultural Revolution" from 1966 to 1976, the People's Bank served as the only bank in China. It contained various specialized branches to take care of fund supply according to a central plan to corresponding sectors such as agriculture, industry and commerce, construction, and international transactions.
On February 23,1979, it was established for the fourth time, as a state-owned national bank specialized in agricultural lending. In 1993, the bank was changed into a state-owned commercial bank, known as one of the "Big Four" banks in China. From 1997 to 2006, the bank withdrew from many county-level jurisdictions or sub-county-level jurisdictions according to the decision of the 1997 Annual Finance Work Meeting of the Central Committee of the CCP. In September 1997, the bank started to experiment its rural financial service delivery in Jilin, Anhui and other 6 provinces to follow the decision of the Third All-china Finance Work Meeting held in January 2007. According to this decision, the Agricultural Bank of China is to orient itself to servicing the agricultural, farm households' and rural development. In July 2010, the bank got listed in Shanghai and Hong Kong. Table 10 shows the size and performance of ABC in rural financial sector of China.

The RCC System

The first rural credit cooperatives (RCCs) since the founding of the New China were established also in 1951, running basically in accordance with cooperative principles, with members being mainly farmers who paid membership-shares. However, their activities were seriously affected by their external governance structure: They were centrally administered by the People's Bank of China till 1958, then were merged into credit departments (xinyong bu) of the People's Communes with grassroot branches of state owned banks and these credit departments in 1958. In 1959 the rural credit cooperatives were separated from the credit departments and managed by production brigades. In 1962, they began to be administered by the People's Bank of China again. From 1966 to 1974, the operation of rural credit cooperatives was chaotic and heavily affected by the "Cultural Revolution". They were even managed by "poor and lower-middle peasants". From June 1974 to 1977, they were encouraged to operate more autonomously. However, they were managed by the People's Bank as a grassroot branches of that bank in rural area in 1978 according to the 1977 State Council decision "Several Provisions on Rectifying and Strengthening Banking Work". They were at that time fully run by government. They were managed by the Agricultural Bank of China since that bank was separated from the People's Bank in 1979 and increased their self-operation since then.
Only in August 1984, rural credit cooperatives started to rehabilitate their three characters of being organized by the mass, democratically managed and flexibly operated in accordance with the State Council's approval of the Agricultural Bank's path-breaking "Report on the Reform of Management System for Rural Credit Cooperatives". One of the most important breakthrough was that rural credit

cooperative associations were established at the county-level. With the introduction of the associations, the degree of the autonomy of rural credit cooperatives increased. In 1989, rural credit cooperatives were further standardized and consolidated in direction of autonomous business decisions and operations. In August 1996, the inter-ministerial coordination group for rural financial system reform of the State Council issued the “Notice of the Implementation plan of the separation of rural credit cooperatives from the Agricultural Bank of China, and officially declared the rural credit cooperatives to be decoupled from the Agricultural Bank of China. All rural credit cooperatives and their county-level associations have been gradually decoupled from the Agricultural Bank of China then after. In June of 1997, the People’s Bank established the Administrative Bureau for Supervising Rural Cooperative Finance. It was responsible for leading the new round of RCC reform in direction of enhancing its cooperative system, self-management and self-discipling. At the same time, the bureau took the function of supervising the RCCs.

In 1999, first provincial level business associations of rural credit cooperatives (xinyong hezuo xiehui) were established in Heilongjiang, Shaanxi, Sichuan, Zhejiang and Fujian, which took over the function of the sectoral management of RCCs. Also the Rural Credit Cooperative Association of the Ningxia Hui-Nationality Autonomous Region, the first provincial level rural credit cooperative association, was established in the same year. On August 10, 2007, Hainan Rural Credit Cooperative Association was established as the last provincial level association, which symbolized the completion of the reform of establishing provincial level associations across China.

The experiments with the ownership structure reform of RCCs started in 2000. In the same year, all the 1746 rural credit cooperatives were merged with their county-level associations as unified entities in a single legal person status in their respective county-level jurisdictions. In 2001, first rural commercial banks were transformed from RCCAs and founded in Zhangjiagang, Changshu and Jiangying city. In the same year, Yinzhou Rural Credit Association started with its experiment with transforming itself into a rural cooperative bank. This first rural cooperative bank opened its business on April 8, 2003. On June 27, 2003, the State Council launched a full-fledged reform of RCCs, while poor performing RCCs were to be consolidated or even liquidated, others were to be transformed into rural credit cooperative associations as unified entities in single legal person status within respective counties, rural cooperative banks and rural commercial banks. During the reform, part of losses made by RCCs were covered by the central government and local governments.

On November 9, 2010, the China Banking Regulatory Commission released “Guiding Opinions of the China Banking Regulatory Commission on Accelerating Equity Reform of Rural Cooperative Financial Institutions”. According to this document, the rural cooperative financial institutions should formulate a plan for equity reform, speed up the transformation of qualification shares, and abolish them before the end of 2015. In the future, only rural commercial banks will be established. Rural credit cooperative associations and rural cooperative banks which meet the qualification of becoming rural commercial banks should be converted into such banks directly. If the conditions are not met, their qualification shares should be converted into investment shares as soon as possible and they should be transformed into rural credit associations (nongcun xinyong she) under the shareholding system. This document shows no cooperative elements will be retained after the equity reform of rural credit cooperate associations and rural cooperative banks.

After this new round of the RCC system reform since 2003, the financial situation of then RCCs or their successors improved significantly. But all of them became profit-oriented, far away from complying with the cooperative principles. Also with the withdrawal of the ABC from many county-level jurisdictions since 1997, RCCs, rural commercial banks, and rural cooperative banks became monopolies or quasi-monopolies in agricultural lending business in the formal financial sector of rural area.

The Postal Savings Bank

While RCCs (or RCCAs), rural commercial banks, and rural cooperative banks became monopolies or quasi-monopolies in agricultural lending in their respective counties or other county-level jurisdictions, their only major challenger in absorbing deposits is the Postal Saving's Bank of China. This is because the bank enjoys a high density of its service outlets. By the end of 2017, the Postal Savings Bank has nearly 4 million service outlets, 143 000 rural deposit withdrawal services and nearly 120 self-help automats across China[10]. It absorbed a balance of personal deposits amounting to 6200 billion RMB and disbursed personal loans amounting to 1580 billion RMB by the end of 2016 across China[11]. The balance of loans for agricultural, farm households and rural development was 917.4 billion RMB at the same point of time. A large part of deposits were taken from the rural area so that the bank was criticized as the "water pump" which has "pumped" financial funds out of the rural area[12]. The Postal Savings Bank was established in 2007. It was originated from the former postal savings services, which was a part of the General Post Office of China. Around three fourth of the outlets of the postal savings bank are not separated from the China Post Group Co.[13], the successor of the General Post Office of China in managing postal and postal savings business operations, which implies heavy subsidy to the postal savings units from the China Post Group Co.

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[10]The Postal Savings Bank of China (2018). Social Responsibilities Reort (Environment, Society and Governance).

[11]China Postal Savings Bank: Annual Report 2016, 2017.

[12]Li Linruan: "The Phenomenon of the Postal Savings Bank's Acting as a 'Water Pump, and It is Questioned How to Return Benefits to Rural Area'", Jinrong Jie, available at http://bank.jrj.com.cn/2014/05/12153817192967.shtml, retrieved on May 18, 2018.

[13]Li Linruan, ibid.

Upon the request of the then China Banking Regulatory Commission, the Postal Savings Bank established a special Devision of Financial Business for Serving Agricultural, Farm Households' and Rural Development.

Policy Oriented Banks

The Agricultural Development Bank of China is the only policy-oriented bank promoting the agricultural development in China. It was founded in November 1994. It is responsible for providing credit support for the national purchase, sale and storage of grain and cotton. By 2013, its new business development model was formed: it is mainly to provide credit support for the national purchase, sale and storage of grain and cotton; at the same time, its main business is to be accompanied by two other business fields: its support for the agricultural modernization and agribusiness development and for the construction of agricultural and rural infrastructure. Currently, its has branches at provincial, prefecture and county level across China.

Another policy oriented national bank is the State Development Bank which focuses on financial support for the implementation of long- and mid-term development strategies of China. It provides local government investment and financing vehicle companies with a total credit line under the condition that local government-designated representative institutions provide explicit or implicit guarantees for the repayment[14]. Such companies provide further the borrowed fund to relatively large development projects of local governments The loans have normally relatively long term.

New Financial Institutions

At the same time, informal lending was pervasive since the financial supply of the formal banking sector to farm households has been limited. This shortage of fund supply from the formal financial sector is reflected by high interest rates in informal sector, which can reach for instances easily 18% or more on annual base in counties of Zhejiang province if one household is in urgent need of fund. The larger the shortage is, the higher is the interest rate of informal lending.

It is a consensus among policy-makers and researchers in rural finance that financial pluralization is needed in rural China. The People's Bank of China started in 2005 with the introduction of small financial institutions serving agricultural, farm households' and rural development, formal and semi-formal, which was also regarded as a new channel to absorb funds from the informal financial sector and divert them into the formal and semi-formal financial sector. 7 microcredit companies (xiaoe daikuan gongsi) were established as a new type of semi-formal financial institution in five provinces in 2005. In 2006, the CBRC started with the experiments of introducing three new types of financial institutions, i.e. village banks (cunzhen yinhang), credit companies (daikuan) and rural mutual fund associations (nongcun zijin huzhushe). In May 2008, the PBC

[14]According to the Budget Law, local government guarantees are illegal. However, local governments provide implicit guarantees through their companies or institutions.

and CRRC jointly launched “Guiding Opinions on the Experiments with Microcredit Companies”, which accelerated the development of this type of new financial institutions.
By the end of 2016, there were 8673 microcredit companies, 1443 village banks, rural (or town) mutual fund associations, and 13 credit companies (Table 2). In general, with the introduction of these financial institutions, the structure of the banking sector got diversified and thus improved. Because of high threshold for the entry of credit companies and rural mutual fund associations (RMFAs)[15], their number were limited. Microcredit companies are lending-only financial institutions, and they not allowed to take deposit, which led to high cost of capital and high lending rate. Accordingly, their business focus is not on the goal of serving primarily for agricultural, farm households’ and rural development which was set by the government, but on lending to companies which have difficulties with the access to formal finance. Village banks focus on small loans for farm households and agricultural development. However, the main initiators should be commercial banks. And their establishment is subject to the approval of the CBRC. This approval system hinders the growth of their number.

6.2 Development of Informal and Semi-formal Finance

Informal Lending and Fundraising

There is a long history of informal lending, especially direct lending among farm households. Beside direct lending as a kind of unorganized lending, there is informal lending in organized form.
In the 1980s, “illegal fund-raising” or usury were regarded as a “crime of speculation”. If they were severe serious enough, the “criminals” were subject to death sentences. For example, in 1986, Zheng Lefen, an female organizer of RoSCAs in Yueqing county of Wenzhou city was sentenced to death because of such a “crime of speculation”. This name of crime was no more suitable with the time of development of commodity economy. Only in 1997, the name of “crime of speculation” was abolished.
In the end of 1990s, the central government issued a set of regulations to ban “illegal fund-raising”. Also the 1997 amendments of the Criminal Law include the crimes of “fund-raising fraud” and “illegal taking of deposit from the public” which are the two main crimes in the category of “illegal fund-raising” in rural China. And the 2015 amendments of the Criminal Law made a “Great Step Forward” in that they abolished the death penalty relating to the crime of “fund-raising fraud”, which means that there is now no death punishment for “illegal fund-raising”.
The Supreme Court made on August 13, 1991 a judicial explanation that interest of informal lending at an interest rate of maximal 4 times of similar lending rate of the

[15]The establishment of RMFAs should be approved directly by the CBRC. However, it seems to distrust this form of banking financial institution.

bank is protected while the excessive part is not protected. On August 6, 2015, the ceiling of interest rate for the protected interests of informal lending was fixed as 24% on annual basis, while the rate over 36% is not protected. The space between the two rates is so called that of “natural debt”: if the borrower pays voluntarily, the court will not ban; if she/he requests the return of the paid interest, the court will not support.
It is more essential that according to the Chinese law, no individual or organization is allowed to run financial business without approval by the PBC and the establishment of financial institutions must be approved by the PBC[16]. On April 16, 2018, the new China Bank and Insurance Regulatory and Administrative Committee (CBIRC) even jointly issued “Notice on Regulating Informal Lending Activities and Maintaining Economic and Financial Order” with the Ministry of Public Security, the State Administration of Market Supervision and the People's Bank of China that any unit or individual may not establish an agency engaged in the loan business or to issue loans as a regular business activity.
Although government policies are quite suppressive toward some special types of informal financial activities which involve or lead to “illegal fund-raising” or usury, or threaten the stability of the so called “financial order”, a large part of informal finance will be further accepted or tolerated and go on playing an important role in financing rural and agricultural development.

Microfinance Institutions and Programs

Beside the microfinance of formal financial institutions, there are many microfinance institutions or programs in informal or semi-formal financial sector. Microcredit companies are the government-introduced new type of financial institutions which can be regarded as semiformal financial institutions. Some P2P lending companies can be regarded either semi-formal or informal financial institutions. Microfinance institutions or programs are important in providing small farm households, especially poor households with microcredit or some other financial services. They are often initiated by international organizations, non-governmental organizations, and some government departments, and sometimes by some individuals or companies, or by their members themselves. It’s no doubt that they made contributions to the target groups’ income generation. However, the total size of the fund has been limited. And only a small part of them were financially sustainable, and very few of them were institutionally sustainable.
To mention are various types of rural mutual fund societies (noncun zijin huzhuhui). They were often established by farm households or cooperatives. They were not approved by the CBRC and were thus different from the rural mutual fund associations approved by the CBRC. However, the development of mutual fund societies were encouraged by the government. They were often not registered anywhere at all, or

[16]People’s Bank of China, Notice of the people's Bank of China on the failure of enterprises or individuals to handle financial transactions, No. Yinfa[1992]285, November 14, 1992.

internally registered with some government department such as local bureaus of civil affairs, or with local federations of industry of commerce. Most of them operate as mutual lending cooperatives, while the rest runs as guarantee funds. These rural mutual fund societies and the rural mutual fund associations are real credit cooperatives. In some poor regions, rural mutual fund societies also receive funds from the government. They are required by the government to ensure the access of the poor members to loans. According to incomplete statistics, there were 19397 rural mutual fund societies within poverty villages in 2013 (Zhao, 2015) and 2159 rural mutual fund societies run by farmers' cooperatives by the end of March 2014 (Office of the State Council Leadership Group of . In sum, these various types of rural mutual fund societies are worth paying attentions to. Again, the total amount of their funds is still limited.

7. Improving financial market mechanisms

The multilayered demand for financial services on the part of farm households and SMEs requires further development of all types of rural financial institutions. The government's rural finance policies are in general favorable, but further opening up the access to rural financial market is needed. Also sole pluralization of rural financial institutions is not sufficient. Financial institutions have to provide differentiated financial services tailored to the financial demand in their respective market segments. In this respect, the LKP can provide a theoretical basis that helps them reach their goals, and the government provide for an environment apt for the development of sound and diversified rural financial markets. Specific suggestions for improving rural financial market mechanisms include further diversification of rural finance, and the shaping of a competitive rural financial order and the building of an inclusive financial system:

Diversification of rural finance: First, rural financial diversification will enable more financial institutions to use own capability and skills to identify and use local knowledge available to them and meet the demand on rural financial services in their way. Second, the diversification of rural financial institutions will introduce financial supply-side competition in the rural financial market and, thus, break the quasi-monopoly position of RCCs, rural cooperative banks or rural commercial banks in lending to farm households. Competition will foster efficiency and spur financial innovation, as well as it will lead to the expansion of the supply of financial services and the introduction of risk-based pricing. Third, further diversification is necessary in order to exploit further local knowledge and to tailor the supply of financial services to actual demand. Currently, rural financial institutions are more diversified than before. But financial services they delivered were similar and credit rationing is pervasive. More self-organized financial institutions are needed, which are close to the demand side and can simply come out of the demand side. More innovative financial institutions are needed, which are innovative in designing new products to activate financial demand that is potential and frozen because of lack of some sideline conditions. For instances, only after the transfer of some knowledge on some market opportunity and even some skills of production, a poor farm household can discover its demand on some microcredit. Innovative financial institutions can even create new demands on financial services.

Shaping a competitive rural financial order: A competitive rural financial order implies a rural financial pluralization under a fair and open competition order. Under such an order, commercial finance and cooperative finance should play a major role while the government, with its policy-oriented finance, plays a supportive role in accordance with the principle of subsidiarity. Also a competitive rural financial order implies a high degree of financial autonomy of the market players, and an open or low-threshold market entry in rural area. A competitive financial market is a corresponding market form under a competitive rural financial order. It can best explore and use the scattered local knowledge, utilize a variety of market mechanisms, and improve the financial services for farmers and rural SME's.

Building up an inclusive financial system: An inclusive financial system implies two dimensions: first, individuals and organizations have access to financial products and services that meet their demands and are delivered in a responsible and sustainable way; second, poor or low-income groups, many agricultural cooperatives and family farms, and SMEs, which are often excluded by banking financial institutions can enjoy this at affordable cost. Many things should be done at three levels:

Macro level: A proper framework of legislation, regulation and supervision for an inclusive financial system should be established and maintained (Helms 2006). A very positive development is that the State Council released at the end of 2015 "Plan for Promoting the Inclusive Financial Development (2016-2020)". However, currently, a very rigor and centralized approval system for introducing new financial institutions is present, which is not conducive to the building of a real inclusive financial system. Part of financial institutions should and can be introduced in a decentralized way. Provincial offices of the new CBISAC can take more responsibility to approve the establishment of new financial institutions as far as they will operate mainly within the province where they will get registered. Also the term "approval" should be understood as the acceptance of the application on the establishment of a new financial institution as soon as a pre-announced set of prerequisites are met by the applicants.

Meso level: The delivery of support services for inclusive finance should be ensured and a basic financial infrastructure should be built up (Helms 2006). For instances, the credit rating system should be upgraded. Currently, defaults in repayment of loans from formal financial institutions and a small part of related information are included in the PBC's credit rating system. A large part of related information scatter among government departments and even a part concentrated in some internet platform companies such as Taobao and Jingdong. Information on guarantees, informal lending and P2P lending are not included in the rating system. A full-fledged credit rating system is to be established.

Micro level: There should be a multitude of financial service providers, especially retail financial service providers in rural area. The latter ones offer services directly to poor and low-income clients (Helms 2006). First, commercial banks need to substantially improve the supply of financial services to poor and low-income groups by downscaling their branches and services. Second, the current rule of “One RCC, rural cooperative bank, or rural commercial bank operates within one county” should be abolished. RCCs, rural cooperative banks and rural commercial banks can be allowed to operate mainly within their own prefecture-level cities within which they are registered. They can be allowed to operate within the whole province as far as they operate mainly within their own prefecture-level cities within which they are registered. Some rural commercial banks which have operated efficiently should be encouraged and facilitated to take over loss-making rural commercial banks, rural cooperative banks or RCCs in other regions. Third, since the rural credit cooperatives, rural commercial banks and rural cooperative banks became all commercialized, there is also a need for the development of new real credit cooperatives. Fourth, all different kinds of financial institutions or activities, no matter commercial and cooperative, and no matter formal, semi-formal and informal, as far as they are based on taking corporate or individual liability, should be introduced so that they can provide micro-credit, micro-insurance, and other supplementary financial products and services. Various credit guarantee companies or funds are also important to play a role in easing lending to farm households and small and micro companies by granting credit guarantee. Financial institutions should be encouraged to downscale services based on doing real credit ratings for the clients. A bank can benefit a lot from sound credit ratings, as shown in the case of the Rural Commercial Bank of Cangnan county, Zhejiang province, which reflects exactly the case for the LKP. Fifth, policy-oriented banks should can do more in retailing or wholesaling funds to other financial institutions. The KfW, an influential policy bank in Germany is a good example for doing retailing business solely with the Hausbank, i.e. the commercial, cooperative or savings bank which keeps relational banking business for their clients (especially family farms, agricultural cooperatives and SMEs) and provides them with a set of financial services, so that these clients are indirectly cofinanced by it. In this way, these Hausbank’s business was not crowded out by a policy-oriented bank. Sixth, well performing microcredit institutions, microcredit companies, and internet platform based financial service providers can be licensed as banking financial institutions.

8. Concluding remarks

This introduction shows existing rural finance paradigms, our proposed LKP, the structure of China’s rural financial system, demand of China’s rural financial services, development of rural formal, semi-formal and informal finance and some consideration of how to improve China’s rural financial market. We wish this paper can make the reader aware of the importance of the LKP in rural finance, and its implication for the necessity of further transformation of China’s rural financial system toward a more diversified and inclusive one.

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