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Rural finance reform in China

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Abstract

China's current financial structure does not give sufficient support to rural areas, leaving many farmers and rural businesses without the capital they need to develop. Rural finance is the weakest point in the country's entire financial system. Low profits for rural financial institutions, a lack of rural financial products and services and the difficulty many farmers experience in securing loans are the main problems plaguing the rural financial system. Accelerating rural financial reform and making it easier for rural people to access capital are key parts of the country's effort to reform its overall financial system, to resolve "Three Rural Issues (San Nong)"¹ (Agriculture, Countryside, Farmers), and to create "new socialist countryside". The main objectives of this paper are to (i) examine the current status of rural finance's demand and supply and identify existing issues and constraints; (ii) evaluate ongoing rural financial reform and explore suitable roadmaps to develop a well-functioning and sustainable rural finance system, which would address the diverse needs of "new socialist countryside" construction.

Résumé

Les agriculteurs et les entreprises des milieux ruraux chinois qui ne disposent pas d'un soutien suffisant de la part du système financier national n'ont pas accès dans leur grande majorité aux capitaux dont ils ont besoin pour se développer. La finance rurale est actuellement le point le plus faible du système financier de la Chine. Les principaux problèmes concernent les faibles bénéfices dégagés par les institutions financières, le manque de produits financiers et de services dans ces zones et la difficulté que rencontrent ces agriculteurs pour l'obtention de prêts exigeant une garantie. La réforme proposée par le gouvernement vise à faciliter l'accès aux sources de financement pour les paysans et résoudre les trois problèmes ruraux ("San Nong")²—agriculture, campagnes, paysans) en créant "de nouvelles campagnes socialistes". Les principaux objectifs de ce papier sont (i) d'examiner l'état actuel de finance rurale à travers l'offre et la demande dans ce secteur en identifiant les problèmes et les contraintes ; (ii) d'évaluer la réforme financière en cours dans les zones rurales et d'explorer la route conduisant à un système financier rural adéquat et soutenable, qui permettrait de répondre aux divers besoins de la construction des "nouvelles campagnes socialistes".

Keywords: banks, microcredit institutions, agricultural insurance, informal finance

JEL Classification: G21, G22, Q14

¹ San nong literally means three "nong". The word "nong" in Chinese is combined with other words to form phrases such as nongye (agriculture), nongcun (villages or countryside), and nongmin (farmers or peasants).

² "San Nong" signifie littéralement trois "Nong". Le mot "Nong" en chinois est combiné avec d'autres mots pour former des phrases comme nongye (agriculture), nongcun (villages ou campagnes), et nongmin (agriculteurs ou paysans).

1. Introduction

China's rural financial market has long been underdeveloped. For quite some time, the difficulty in borrowing money had severely prevented farmers from making headway in developing their industry. According to a recent national survey for rural households, only 16% of farmers had recourse to formal or informal credit. This was partly due to their weak economic foundation, but also to a lack of collateral³/credit guarantee and to high transaction costs involved in obtaining formal credit. Another factor was the closing of many local branches of major state-owned commercial banks in the late 1990s because of small business volume and high costs, and the failure of new ones to appear. So the emergence of informal financial institutions couldn't be avoided. In the meantime, *Fu Pin* Communities (Poverty Alleviation Communities) gave free economic aid for long time, so that credit culture was not well created. Difficulties to get loans for farmers and difficulties to grant loans for official financial institutions have become a contradiction.

While farmers accounted for 70% of the population, they were responsible for only 15% of the country's total bank loans and deposits (statistics at the end of October 2006). Per capita outstanding loan balance for rural residents was less than 5 000 yuan (640 US\$) at the end of 2005, only 10% of that for urban residents. By the end of 2005, "total deposits" and "total loans" in East represented 60% and 57% of national totals respectively, while those in Centre and in West were only 40% and 43% respectively. The capitals flowed to the East and the cities. (China Daily, 22/01/2007) Serious shortages in credit and other types of financial services in rural areas have become a bottleneck for the development of agriculture as well as the increase of peasants' income, and thus enlarged income disparity between rural and urban populations, especially in Centre and West as well as parts of Northeast.

In the 11th five-year plan, the issues concerning agriculture, rural areas and farmers constitute a top priority of the central government. The government is seeking to promote rural development with the "new socialist countryside" program, which aims at improving agricultural production, people's living conditions and public administration in rural areas with their huge population of about 800 million. It is estimated by National Bureau of Statistics that the country would need 15 trillion yuan (1.92 trillion US\$) to fund its new countryside construction by 2020, most of which would come from financial institutions. So the government presses ahead with rural financial reforms in order to establish an efficient and commercially sustainable rural finance framework, to boost rural development and to narrow the growing urban-rural income gap.

The remainder of this paper is organized as follows. Section 2 reviews the existing literature on the role of rural finance in economic development in developing countries. Section 3 provides a descriptive analysis of supply and demand of rural financial services, and discusses the predicament currently faced by rural finance and contributing factors. Section 4 examines ongoing rural financial reform under the "new socialist countryside" construction. Section 5 underlines market economy's role in the development of a dynamic rural finance sector and puts forward some proposals. Section 6 gives some concluding remarks.

2. Literature Review

³ The land belongs to collectives.

The problem of rural finance is always a pressing issue on the development agenda. Most developing countries abandoned subsidised rural and/or agricultural credit programmes in the 1980s, partly because the programmes had met with little success globally, and partly due to the influence of the financial systems approach adopted as part of the liberalisation of the financial sector (Yaron et al., 1997). During financial liberalisation, the state withdrew from providing rural finance and the microfinance sector expanded (Zeller and Sharma, 1998). However, growing evidence indicates that the financial needs of agriculture-dependent rural communities remain unmet (e.g. Zeller and Sharma, 1998; Murdoch, 2000) and developing efficient, sustainable and accessible rural finance systems continues to present a significant challenge.

This paper examines the issues that need to be considered and addressed in pursuing policies and the ongoing reform to make rural finance more readily available and beneficial to the poor in the case of China. In general, improving access to credit and rural finance systems have a positive impact on household income, technology adoption and food consumption. These in turn have important long-term effects on household productivity and on poverty rates (Mosley, 2001; Zeller and Sharma, 1998; Yaron, McDonald and Piprek, 1997).

2.1 The role of rural financial systems

The Consultative Group to Assist the Poor (CGAP) defines rural finance as “financial services offered and used in rural areas by people of all income levels”, and agricultural finance as “a sub-set of rural finance dedicated to financing agriculture-related activities, such as input supply, production, distribution and wholesaling, and marketing” (Pearce, 2003). Consistent with these definitions and that of Schmidt and Kropp (1987), rural finance is treated in this paper as encompassing all the savings, lending, financing and risk minimising opportunities (formal and informal) and related norms and institutions in rural areas. This definition recognises that rural financial markets are part of the domestic financial system and are therefore affected by government and central bank policies. Rural financial markets tend to be fragmented (Germidis, 1990; Besley, 1994) and consist of formal, semi-formal and informal financial intermediaries. The definition also acknowledges that the rural population requires a range of financial services, including the following:

- *intermediation*, which involves mobilising and transferring savings from surplus to deficit units and provides safe, liquid and convenient savings (deposit) facilities and access to credit facilities tailored to the needs of the rural population (World Bank, 2004);
- *savings facilities*, which allow wealth to be kept in a form that preserves its value and is liquid and readily accessible;
- *credit* for consumption smoothing and investment in agricultural production, marketing, processing and input supplies (Gonzalez-Vega, 2003);
- systems for effecting *payments* and transfer of *remittances* (Orozco, 2003; Sanders, 2003);
- general *insurance* and cover against variability in output (especially as agriculture is largely weather-dependent), price and marketing uncertainty (Skees, 2003; Von Pischke, 2003).

2.2 The importance of rural financial systems to economic development

Financial sector development promotes economic growth and can also reduce poverty (DFID, 2004a and 2004b). Demircuc-Kunt and Levine (2004) conducted a study of 150 countries and

noted that a well-functioning financial system is critical to long-term growth. Empirical evidence from additional studies confirms the strong, positive link between national savings (aggregate income less total expenditure) and economic growth (World Bank, 2004). Correlation between the level of financial savings (savings held in liquid form in the formal financial sector) and growth is even stronger (Fry, 1995). Savings are important as they allow households to maintain precautionary balances against shocks. Households can also build up cash collateral and a track record of saving will allow them easier access to credit (Marr and Onumah, 2004). Most rural communities lack secure and accessible deposit facilities and, consequently, savings are held as cash or assets (e.g. livestock and building materials). Such savings are harder to mobilise and do not increase availability of loanable funds. Rural entrepreneurs therefore find it difficult to access funds and have to rely largely on self-financing when they want to invest.

The need for credit to support development of agriculture-based livelihoods has been stressed, particularly as a justification for the state and donor supported subsidised credit programmes of the 1950s–1970s (World Bank, 2004). However, the rural economy is financially very fragile. Lack of credit is a significant and sometimes binding constraint, limiting investment in productivity-enhancing technology and inputs. Finance is also required for commodity marketing, sometimes through inventory-backed financing, which offers rural producers, traders and processors the opportunity to improve household income through adopting better produce marketing and raw material procurement strategies (Coulter and Onumah, 2002). Liang (2006) finds a negative and linear relationship between rural finance development level (measured by the ratio total rural loans to rural GDP) and income inequality, using Chinese provincial data over the period of 1991–2000 and applying the generalized method of moment techniques. These findings have important policy implications to China’s economic development. To lower China’s rural inequality, further steps have to be taken to strengthen the rural financial system, and effective policy measures should also be taken to accelerate financial development in rural areas.

Access to payment systems offered by financial institutions allows rural producers and traders to participate in modern, efficient commodity trading systems that offer better prices. Financial institutions should ideally provide low-cost and accessible channels for transfer of remittances (e.g. migrant wages), which are crucial to the coping strategies of many rural households (Orozco, 2003).

Rural finance plays a critical role in household strategies to reduce vulnerability. It assists the poor to smooth consumption and to build up assets greater than the value of the liability (Gonzalez-Vega, 2003). This is particularly important for the rural poor, since agricultural incomes and rural health fluctuate widely and could destabilise consumption if households have no savings or credit to fall back on (IFAD, 2003; World Bank, 2004). Furthermore, rural households lack sufficient access to formal insurance, relying instead primarily on informal safety nets. Improved access to insurance could reduce enterprise and household risks, and make investment in the rural economy more attractive, contributing to growth and poverty reduction (Skees, 2003; Von Pischke, 2003).

3. Analysis of financial constraints in rural areas

3.1 Rural Financial Services: Supply

3.1.1 Past rural financial situation

The institutions previously providing rural financial services in China included both official and unofficial financial organizations. The official institutions mainly included Agricultural Bank of China (ABC), Agricultural Development Bank of China (ADBC), Rural Credit Cooperatives (RCCs), and China Post Savings and Remittance Bureau (CPSRB). In addition, such state-owned commercial bank as Industrial and Commercial Bank of China (ICBC) and the life and property insurance companies in Xinjiang and Shanghai provided a few financial services to the peasants. Unofficial financial organizations were generally meant popular organizations, which mainly grant loans between private individuals and in the form of clandestine money shops (presented in 2.3).

Agricultural Bank of China

As a state-owned commercial bank, the ABC was a pillar in rural finance, involved in agriculture-related loans including specialised rural loans (poverty alleviation, grain, cotton and oil businesses), conventional agricultural loans (crop cultivation, forestry, water conservancy, livestock breeding, fishery and agro-food processing), loans for township and village enterprises (TVEs), loans for rural supply and marketing cooperatives, loans for the purchase of agricultural products and for the construction of rural infrastructures. The main targets of service were rural enterprises and there were very few loans for peasants households. The support to rural areas decreased gradually. The total amount of agriculture-related loans fell from 593.7 billion yuan in 1997 to 353.6 billion yuan in 2001, and the proportion in the total loans issued by the ABC decreased from 54% to 30% in the same period.

Agricultural Development Bank of China

The ADBC was a bank created for policy reasons. Its functional position had been adjusted along with the reform of the grain and cotton marketing systems. It had changed from the comprehensive functions in the early days of its establishment to its later single function. When founded in 1994, the range of its main credit business included loans for the procurement and storage of grain, cotton, oil, sugar and meat; loans for the transfer, marketing and wholesale of grain and oil; policy loans for grain, cotton and oil processing enterprises; poverty alleviation loans; loans for small-scale technological improvement involving crop cultivation, forestry, livestock breeding and aquatic products. In 1998, the range of its credit business was reduced to the sole responsibility for the supply and management of funds for the purchase of grain, cotton and oil. In 2005, ADBC granted loans of 342.37 billion yuan, of which 215.07 billion yuan were for the procurement of grain and oil and 59.12 billion yuan for the cotton procurement. The two items together accounted for 80% of the ADBC loans.

Rural Credit Cooperatives

Of the official financial institutions, the RCCs were the main support force to peasants. They also provided loans to the rural collective economy organizations and agro-food processing enterprises. Between 1996 and 2001, the total loans granted to peasants by RCCs were 1 654.8 billion yuan with the average annual amount of 275.8 billion yuan. In 2001, the total loans granted to peasant households by RCCs were 365.7 billion yuan, accounting for 84% of the total agricultural loans provided and more than 95% of loans to peasant households granted by all financial institutions. The balance of agricultural loans from RCCs accounted for 77% of the balance of agricultural loans in all financial institutions at the end of 2001.

Because of policy interference and non-liberalized interest rate, their returns couldn't make up the losses and costs. At the end of 2002, the non-performing loans of RCCs stood at 514.7 billion yuan, accounting for 37% of their total outstanding loans. There were 19 542 RCCs in loss, or 55% of all RCCs.

Without agricultural insurance' protection and credit guarantee system, loans were mainly granted to the richest peasants. About 80% of loans to peasants were granted to those in high income, peasants in middle and low income had difficulty to get loans, especially in developed regions. Because the opportunist cost was high in these regions, RCCs had lots of investment channels. According to a research in one RCCU at city level in Zhejiang province, loans to peasants raised from 29 million yuan in 2003 to 34 million yuan in 2004, the growth rate was 1.47%. But total loans increased from 1 829.4 million yuan to 1921.8 million yuan, the growth rate was 6.24%, higher than the one for loans to peasants. And loans to peasants accounted only for 1.59% and 1.74% respectively.

China Post Savings and Remittance Bureau

China Post began its postal savings services in 1986 with the establishment of the China Post Savings and Remittance Bureau (CPSRB). CPSRB had a single financial service function, providing only a savings service and no loan business. The deposits taken from the public were transferred to the central bank. The difference between its interest income from the central bank and the interest paid to clients, had constituted the major source of profit even as traditional postal services declined. The interests paid by central bank in 2002 were 18 billion yuan, which was the biggest source of profit. The deposits in rural areas remained 30%-45% of total deposits. These capitals flowed out of countryside directly.

Agricultural insurance

Both agriculture and farmers needed insurance to be better protected from risks. And that concerned the stability of the entire economy and livelihood of the people. However, for more than twenty years of development since 1982, agricultural insurance business had shrunk gradually. Only two state-owned commercial insurance companies were engaged in agricultural insurance: the People's Insurance Company of China (PICC) and China United Property Insurance Co., Ltd. Apart from such provinces/municipality as Xinjiang, Shanghai and Yunnan where there was agricultural insurance business on a relatively high scale, the scale of agricultural insurance business in other provinces was rather small. Increasing risks of natural calamities and lack of effective demand inevitably led to narrow business scope and limited scale of agricultural insurance. And this, in turn, discouraged commercial insurance companies from providing agricultural insurance. Premiums from agricultural insurance were a meagre 460 million yuan (US\$55 million) in 2003, accounting for only 0.5% of all property insurance premiums, according to official statistics.

3.1.2 Supply-related constraints on rural finance and contributing factors

Supply-related constraints on rural finance mainly reside in the insufficient network of official financial institutions and in an insufficient supply of funds by these institutions.

i) The structural withdrawal of state-owned commercial banks from the market and the inadequate network of rural financial institutions

From the mid- to late 1990s, the four major state-owned commercial banks started to commercialise their businesses. The impulse to seek benefits, the implementation of international standards, preparations to enter overseas markets and increasing their competitiveness in the face of fierce foreign competition made them draw back from the front line and adopt another developmental strategy of “large banks, large markets and large industries”, with a gradual withdrawal from markets at county-level and below and a reduction in their operational structure at the basic level to focus on more profitable opportunities in the larger cities. Between 1998 and 2001, the state-owned commercial banks shut down 44 000 of their grass-roots offices with a net reduction of 240 000 staff. Relevant data from the annual reports of these banks shows that, between 1998 and 2001, Bank of China (BOC) reduced 2 722 branch offices at the local level. At the same time, it also abolished and merged 246 county branches, so that their number fell by 22% compared with the end of 1997. China Construction Bank (CCB) reduced its county branches by 3 601. From 1998 to 1999, the cumulative net reduction of their operational network was 4 000 establishments. Industrial and Commercial Bank of China (ICBC) abolished and merged 8 700 branch offices. Agricultural Bank of China’s (ABC) network fell from about 60 000 establishments to 44 000. The main task of their rural branches has become to attract rural deposits. A large quantity of deposits drawn from rural areas provided credits to profitable urban businesses. In 2002, it was estimated that capital drained from rural areas by the state-owned commercial banks through the absorption of deposits reached 300 billion yuan.

Although nominally the institutions providing financial services to the countryside included mainly the ABC, the ADBC, the RCCs, CPSRB, and the PICC, those institutions which could in fact supply funds to the countryside were very limited. The ADBC acted as a policy bank and did not provide any loans to ordinary enterprises involved in agriculture or to peasant households. Although the ABC provided loans for agriculture, this was mainly for rural infrastructures and agricultural product processing companies, with very few loans for peasant households. Moreover, after the withdrawal from the rural financial network over recent years by ICBC, CCB and BOC, the ABC has not filled the gap. Therefore, millions of peasant households and tens of thousands of rural enterprises had to apply for loans from RCCs. However, there were only about 40 000 RCCs and they failed to form a financial network. CPSRB provided only a savings service and didn’t issue loans. So there is a lack of financial institutions which can provide credit services and this is one of causes for the insufficiency in the supply of rural funding. Meanwhile, the already limited financial service suppliers usually offer far less diversified products in rural areas than in cities.

Moreover, due to losses in the agricultural insurance activities and inability to obtain policy-related subsidies, the PICC was also forced to contract the scope of its business and to reduce compensations paid to farmers. Thus, through various channels, the policy arrangements described above directly or indirectly reduced the supply of funds to the countryside.

ii) Greater risks, higher costs, lack of collateral

Given the predominance of smallholdings in China’s agricultural sector, banking institutions in rural areas have a large number of business clients who are limited in their production scales and are asset-poor. Farmers are often behind schedule in making mortgage payments and their incomes are uncertain as they are reliant on local weather conditions. In addition, the amount of single loans is small, the terms of repayment are short and the cost of extending loans is high. The interest rates are lower than that for industrial and commercial loans while the opportunity cost for issuing them is higher. These characteristics result in relatively

greater risks and higher costs in providing credits to farmers than to many other businesses. Consequently, banks with a commercial outlook are generally not enthusiastic about providing rural credit services.

Furthermore, Chinese law requires fixed assets to be used as loan collateral. Farmers' "inventory"—such as livestock—is not qualified as collateral and farmers do not own the land they work so can't put it up as collateral either. This places them, as small customers with no guarantee, at the end of the queue for credit.

iii) Outflow of capitals

Since the Asian financial crisis, great changes occurred in the ABC with regard to its market orientation and operational policy. Its conduct on commercial basis became more pronounced. Seeking good results, it strongly reduced operational network and curtailed grassroot level institutions. Also, in view of long capital recovery term, low earnings rate and considerable risks in agriculture, the capital put into circulation by the ABC has been moved from mainly serving agriculture to the development of commerce and industry and from the countryside to the cities. Before the mid-1980s, more than 98% of all loans from the ABC were concentrated on the countryside. Between the mid-1980s to the early 1990s, in order to resolve the "sales difficulty" of agricultural products and to support TVEs, the ABC used 60% of its credit capital every year for the purchase of agricultural products and for the development of TVEs. In the period of 2002-2004, as the business of the ABC expanded towards towns and non-agricultural industry, agricultural loans accounted for below 20% of all loans by the ABC. Therefore, as loans have been withdrawn from the grassroot level, a huge quantity of rural savings has been drained from the countryside. The range of business operations of the ABC was fundamentally no different from other state-owned commercial banks and the leading position which it held for a long time in rural finance had been greatly weakened.

After the withdrawal of SOCBs, the burden of financing agriculture was left mainly to the RCCs. The RCCs operated in a risky sector for credit provision. During the process of several large policy adjustments, the RCCs had accumulated huge amount of bad debts, their losses were very serious and the supply of capital was extremely short. For example, a large number of loans extended to the « collective units » before 1978 had long ago become bad debts. During the development process of TVEs, rural collective organizations have applied for a large number of loans. Bad debts came into being because some TVEs were eliminated by the market or liquidated, shut down or suspended for government policy reasons. When the ABC was separated from the RCCs, it transferred a large number of bad debts to the latter. After the rural cooperative foundation (RCF) was closed down, the state transferred a large number of bad debts to the RCCs. All these debts constitute bad assets for the RCCs. In addition, RCCs were nominally cooperative peasant financial organizations but were actually the extensions of the state-owned banking system in the countryside. They became some kind of interest group independent from peasants, and their operating process was usually controlled by insiders. The "Three Meetings" (meetings of members, meetings of the board of directors and meetings of board of supervisors) were a mere formality, management was chaotic, operations poor and losses serious. By the end of 2000, the RCCs book value of bad assets throughout the country had reached 517.3 billion yuan, accounting for 49.9% of all loan balances. The accumulative losses stood at 108.3 billion yuan, accounting for approximately 10% of the total assets of the RCCs. A huge amount of policy and operational losses severely weakened the capacity of the RCCs to provide loans. In order to cover the RCCs' shortage of loan

capital, the PBC adopted a re-loan policy but the scale of the funds was far from being able to meet demand.

The RCCs couldn't adapt to the requirements of rural economic development. About a third of them were seriously indebted, another third were in precarious shape, and those reporting profits didn't, in the main, lend to farmers or small borrowers. For the RCCs which have a surplus of capital, proceeding from a consideration of self-financed sustainable development, there is a serious tendency towards commercialisation in operation. This leads to a major flow of capital to cities and non-agricultural sectors which genuinely need loans from the RCCs. At the same time, the RCCs also cause much capital to flow from the countryside every year through such means as the payment of reserves against deposits, the transfer of deposits to the Central Bank, the purchase of government and financial bonds and investment in real estate projects. Since the 1990s, the average annual transfer of funds by the RCCs has been approximately 200 billion yuan.

In addition, interest rates were liberalised for banks in 2004, but the RCCs can still only lend at up to 130% of the benchmark rate set by the PBC. This ceiling imposed because of the lingering belief that charging commercial interest rates to rural people amounts to usury, makes it hard for the RCCs to achieve financial sustainability. Most RCCs lend at 9-10% interest, and this is simply not profitable.

Large part of rural capital was channelled out of rural areas by CPSRB. After the state-owned commercial banks cut back their networks of rural deposit operations, the CPSRB network spread all over the cities and countryside, was provided with an enormous area for the absorption of savings. Rural financial resources began to be concentrated in CPSRB and the RCCs. The policy regulated that the CPSRB could only deal in savings operations, but not in loans issuing operations. Therefore, a large amount of capital was transferred out of countryside by intermediary of PBC.

Table 1 – Rural Financial Institutions vs. Urban Finance Institutions in China

Rural Area	Urban Area
- Rural Credit Cooperatives	- State Commercial Banks (ICBC, ABC, BOC, CCB)
- State Commercial Banks (Agricultural Bank of China)	- Joint Stock Commercial Banks
- Policy Banks (Agricultural Development Bank of China)	- City Commercial Banks
- CPSRB/Postal Savings Banks of China	- CPSRB/Postal Savings Banks of China
- Microcredit institutions	- Policy Banks
- Buyer & Supplier	- Foreign Banks
- Informal Arrangements (ROSCA)	- Informal Moneylender

3.2 Rural Financial Services: Demand

Currently, there is an insufficient effective demand by peasant households for services offered by official financial institutions. On the one hand, there is insufficient natural demand which is mainly determined by the low degree of rural commercialisation, high farmer self-consumption of grain, oil, meat and vegetables and a limited degree of monetisation which have reduced the commercial demand by peasant households for funds. On the other hand, stimulation of demand is insufficient.

Firstly, as the provision of consumer credit services by official institutions is lagging, demand by peasant households for such credit is weak. Currently, it is difficult to activate the rural market in this respect, partly due to low peasants' income. However, when peasant build houses, buy durable consumer goods, educate their children, or hold weddings or funerals, it is generally very difficult for them to obtain loans from official institutions. This forces peasants to transfer their demand for consumer credit to unofficial financial institutions and, as a result, the demand for funds from official financial institutions is reduced.

Secondly, risks in agriculture and the low degree of rural marketisation have reduced investment demand by peasant households. As natural disasters frequently occur in China and farm produce is perishable, the natural risks in agricultural production operations are high. But agricultural insurance is backward. At the same time, because of the low degree of market development, the risks and costs for obtaining information and technology, as well as market transaction costs, are high for peasant households. Due to such risks and a lack of policy tools to overcome them, the majority of peasant households can choose only to operate within traditional agriculture instead of entering into other businesses. This restricts their investment channels and reduces their borrowing demand to official financial institutions.

Thirdly, loans from official financial institutions are difficult to access which inhibits investment demand of peasant households. Investment loans from official financial institutions such as RCCs and ABC are difficult to access for peasant households, mainly because of a lack of collateral (e.g. land use rights can not be mortgaged)/credit guarantee and complex formalities. It's especially difficult for impoverished peasant families or peasants living in backward areas, as well as for households with middle or high incomes who want to expand their scale of production or to adjust their agricultural setup. Since ABC has been transformed into a state-owned commercial bank, fewer and fewer loans have been extended to peasant households. The RCCs, the main official financial institutions issuing loans to peasant households, find it difficult to meet the requirements of the majority of those wanting loans. This is due to the tedious formalities of loan procedures, serious problems with the "official businessman" style of working, backward ideas concerning operations and understaffing. This has resulted in the repeated recurrence of difficulties with loans. A lack of innovation and insufficient supply in the institutions has seriously constrained the demand by peasant households for funds from official financial institutions.

Table 2 – Characteristics of financial demands in rural areas

Financial demands in different regions	East	non agricultural sectors
	Centre	crop-cultivating and livestock-breeding
	West	consumption needs
Characteristics of demand entities	Rural households	small-scale production, dispersed housing, lack of collateral (land can't be mortgaged)
	Rural enterprises	majority in early growth, small-scale operation, non-normalised management, low transparency
Agricultural sector' characteristics		seasonal and long- cycle production, low profitability, influenced by nature

3.3 Informal finance

Because of functional defects of official rural financial organizations, it is difficult to meet the demand for capital by peasant households which is growing day by day. By contrast, unofficial financial organizations have advantages such as freedom of investment orientation,

flexible time limits for loans and simple procedures. This provides the unofficial financial organizations with enormous room for survival and opportunities for development in the countryside. According to a research, 72.8% of loans are obtained through informal channels, of which 93.2% are granted between peasants, while only 27.2% come from financial institutions. Presently, there are many unofficial financial institutions in China's rural financial market such as ROSCA (Rotating Savings and Credit Association), private loans, and cooperative mutual foundations. The existence of this popular finance reflects the imbalance of rural financial institutions and the financial dualism. With the difficulty in satisfying rural financial demand through official financial arrangements, unofficial arrangements play a positive role in such matters as expanding production, invigorating rural financial market, increasing financial efficiency and, in particular, encouraging private economy's development.

However, there are many problems with the functioning of popular financial organizations and with their funding activities. Firstly, interest rates on deposits and loans are generally rather high so that production and operational costs for peasant households rise while their competitiveness falls. Secondly, there are considerable financial risks. Organisational conduct is not standardised. There are good and bad among popular financial organizations. Some are run in a chaotic fashion and take huge risks, which is very disadvantageous for maintaining normal financial order and this has affected the stability of the financial market and rural society. Thirdly, popular financial organizations generally develop on a small-scale activity which is either clandestine or semi-overt and the government can't provide effective supervision on them.

3.3.1 Informal finance's role for rural finance

The research group of Central University of Finance and Economics led by Professor Mr. LI Jian Jun had investigated in rural areas⁴ of 15 provinces⁵. Informal finance existing index is 32.22, i.e. there is roughly one-third existence probability of informal finance in rural areas. Informal finance existing index is 37.74 in West, 35.45 in East, and 23.35 in Centre. In Fujian, the informal finance existing index is the highest, reaching at 61.63, and the lowest in Jiangsu with only 12.5.

Informal finance size index in rural areas of 15 provinces is 56.78, i.e. less than 50% of credits for peasants come from formal financial institutions, such as banks, rural credit cooperatives, etc. Informal finance size index is the highest in East (62.43), the lowest in Centre (55.47). In less developed regions, the share of formal credits is relatively low.

⁴ The research group send out 2 656 questionnaires, among which 2 227 were valid. They were filled by 1 597 farmers, 366 rural officers and 264 officers in rural financial institutions.

⁵ 15 provinces in survey:

East (6) – Fujian, Guangdong, Hebei, Zhejiang, Hainan, Jiangsu;

Centre (5) – Shanxi, Hubei, Hunan, Heilongjiang, Henan;

West (4) – Yunnan, Guizhou, Shaanxi, Gansu.

Table 3 – Informal finance existing index in rural areas of 15 provinces

(1) Are there informal financial institutions in your village/county?	Coefficient	Choice %	Total	East	Centre	West
A. Yes	100	0.2545	25.44	40.99	20.10	24.30
B. It is said yes.	66.7	0.1471	9.81	5.94	8.97	17.14
C. I don't know.	33.3	0.1781	5.93	6.55	4.94	9.12
D. No	0	0.4203	0	0	0	0
Informal finance existing index 1		1	41.18	53.48	34.02	50.56
(2) In which institution do you deposit?	Coefficient	Choice %	Total	East	Centre	West
A. formal financial institutions	0	0.7127	0	0	0	0
B. informal financial institutions	100	0.1777	17.77	15.05	8.35	13.25
C. lending to others	50	0.1096	5.48	2.37	4.32	11.67
Informal finance existing index 2		1	23.25	17.42	12.67	24.92
Informal finance existing index			32.22	35.45	23.35	37.74

Notes: 1) Coefficients are defined by the research group;

2) Choice %: percentage of enterprises in sample which have chosen such response;

3) Total=Coefficient*Choice %;

4) Informal finance existing index=(Informal finance existing index 1+Informal finance existing index 2)/2

Source: China's underground finance survey (LI Jian Jun, 2006), China's underground finance size and its influence on macro-economy study (LI Jian Jun, 2005)

Table 4 – Informal finance size index in rural areas of 15 provinces

Order by region		Order by province	
Province	Index	Province	Index
15 provinces in country	56.78	15 provinces in country	56.78
6 provinces in East	56.45	4 provinces in West	62.43
Fujian	66.44	6 provinces in East	56.45
Hebei	55.37	5 provinces in Centre	55.47
Jiangsu	52.08	Yunan	68.70
Guangdong	49.04	Fujian	66.44
Zhejiang	36.31	Shanxi	63.77
Hainan	29.17	Shaanxi	61.18
5 provinces in Centre	55.47	Hunan	58.92
Shanxi	63.77	Guizhou	58.71
Hunan	58.92	Hebei	55.37
Hubei	53.70	Hubei	53.70
Heilongjiang	51.82	Jiangsu	52.08
Henan	35.25	Gansu	51.92
4 provinces in West	62.43	Heilongjiang	51.82
Yunnan	68.70	Guangdong	49.04
Shaanxi	61.18	Zhejiang	36.31
Guizhou	58.71	Henan	35.25
Gansu	51.92	Hainan	29.17

Source: China's underground finance survey (LI Jian Jun, 2006), China's underground finance size and its influence on macro-economy study (LI Jian Jun, 2005)

Informal finance effect index in rural regions of 15 provinces is 21.07. Informal finance has relatively big influence in Centre and in West (with index 24.56 and 31.02 respectively), and almost no effect in East (2.85). In previous years (before 1999), informal finance institutions in Centre and in West were mainly quasi-legal ROSCAs, the interest rates were higher than official interest rates, and the assessment for debtors was less strict. It was easier for peasants to obtain credits from ROSCAs, and these informal financial institutions helped development of rural economy.

Table 5a – Informal finance effect index for rural areas of 15 provinces

Informal finance's influence for development of rural economy	coefficient	Choice %	Total	East	Centre	West
A. Upsetting order of rural economy and finance, negative effect	-100	0.2841	-28.41	-38.38	-26.32	-24.10
B. Supplementing formal finance, favourable effect	100	0.4948	49.48	41.23	50.88	55.12
C. No effect	0	0.2211	0	0	0	0
Informal finance effect index		1	21.07	2.85	24.56	31.02

Notes: 1) Coefficients are defined by the research group;

2) Choice %: percentage of enterprises in sample which have chosen such response;

*3) Total=coefficient*Choice %*

Source: China's underground finance survey (LI Jian Jun, 2006), China's underground finance size and its influence on macro-economy study (LI Jian Jun, 2005)

Informal finance has negative effect in 5 provinces, and favourable effect in 10 provinces. Informal finance effect index is the highest in Hunan (58.66) and the lowest in Heilongjiang (-13.54). This reflects that informal finance isn't balanced and disparate in regions.

Table 5b – Informal finance effect index for rural areas of 15 provinces

Province	Informal finance effect index
Heilongjiang	-13.54
Fujian	-11.68
Guangdong	-5.77
Henan	-1.00
Shanxi	-0.63
Zhejiang	4.55
Hubei	6.12
Hebei	8.56
Gansu	9.09
Shaanxi	24.42
Guizhou	32.58
Hainan	33.33
Yunnan	37.78
Jiangsu	41.67
Hunan	58.66

Source: China's underground finance survey (LI Jian Jun, 2006), China's underground finance size and its influence on macro-economy study (LI Jian Jun, 2005)

Informal finance has complex effect on development of rural economy. On the one hand, informal finance eases peasants' access to credits, stimulates their investments and favours agricultural production; on the other hand, agriculture sector is fragile, it is restrained by natural conditions, peasants' refunding capability can't be ensured. High interest rates in informal financial institutions accelerate poverty of less developed regions and are harmful for peasants and rural economy. According to this survey, informal finance has relatively big positive effect in less developed regions in Centre and in West. Peasants obtain capitals through informal channels, and this helps their agricultural production. But "looking for profit" tendency is not suitable for supporting fragile rural economy.

3.3.2 ROSCA (*he hui*)

Rotating Savings and Credit Associations (ROSCAs) are called *hehui* in China. Different forms of ROSCAs can be found in different regions. The structure of ROSCA is always simple. In fact, with few exceptions (e.g. the members have access to the fund in turns (*lun hui*) or by chance (*yao hui*)), most are in the form of Bidding ROSCAs (*biao hui*). ROSCAs are clearly community based with most members living in the same village and rarely from elsewhere⁶. The sequences of the funds to be used among the registered members of the ROSCAs are determined through bidding the interest rates at certain fixed period of time. The aim of the villagers in establishing the ROSCAs, or becoming a member, is generally to finance family emergencies in their daily lives. The percentage of villagers, who try to raise funds through this means for production capital or for other types of commercial capital, is relatively low⁷.

The Bidding ROSCA refers to a rural private finance cooperative which allows registered members to rotate their access to the collective fund through a bidding system. The higher the interest offered as a bid, the sooner the member gets the fund. The founder of the ROSCA is called "the head of the association" (*hui shou*), and the rest of the members are called "the feet of the association" (*hui jiao*). Only the head has the right to have first access to the fund without having to pay interest. This helps him to gain time and opportunity to solve other problems that were caused by a shortage of cash. This is his biggest benefit as the head of an association, and this is the reason why the villagers are enthusiastic about organising ROSCAs and acting as the head. It does not matter who organises the ROSCA and acts as the head, the key is that there are at least ten members who want to take part and pay up regularly and on time. The villager who wants to set up the ROSCA will need to have some basic resources—such as his/her reputation and credibility in the village, family influence, a wide enough circle of friends and family members, etc. These elements restrict the number of ROSCAs and heads.

In a Bidding ROSCA, the winning bidder at any bidding interval is the member willing to pay the highest rate of interest for the use of the funds of the ROSCA. The change of the interest rate during the running of a ROSCA is a key feature. Generally speaking, the interest is calculated on a monthly basis. The interest offered at each bidding interval varies: it is

⁶ There are three categories of members in ROSCA: residents of the village, those related to one another (some of them are relatives of the villagers who live in the same village and some others from other villages), co-workers or friends who live nearby.

⁷ Most of ROSCAs are set up to solve family needs when situations arise that are urgent and cannot be put off (medical treatment for a family member or tuition and other expenses for sending a child to school), and for important family matters (building a new house, paying for a marriage, and for higher education fees). Some are for business capital or setting up a factory.

affected by interest rates set by the People's Bank of China and by local economic conditions, and it is closely linked to how urgently the "foot" members need the capital. Amongst the factors, the last one was the most direct and important, and this is the "charm" of a Bidding ROSCA: the "foot" members who need the money urgently are normally willing to pay higher interest for the capital in order to get the money as soon as possible (*dehui*); and those who can set money aside can gain interest from their capital. Interest rates of the ROSCA are higher than those of official financial institutions. The closer the relationship, the lower the interest rate for using the capital becomes, and the stronger is the co-operative spirit. The ROSCA having the lowest interest rate is formed by relatives in the same family. This arrangement combines economic interest and social and cultural factors. Thus, it is a highly competitive financial system.

Risk is a key factor for any financial institution. For a private financial organization such as a ROSCA, risk is even more important because if any member breaches the agreement, the ROSCA can't survive. The welfare of all members will be directly affected and the aims will not be realised. For this reason, every member of the ROSCA is fully aware of the importance of risk control and management. For the head, he/she faces even more serious responsibilities. If any one of the members in ROSCA fails to make his/her payment on time, the head will pay it out of his/her own pocket in order to maintain the ROSCA. In order to prevent this from happening, the head must carefully select his/her members. Accordingly, during the running of the ROSCA (normally 2-3 years), he/she monitors the situation very closely to reduce any risk. If "foot" members do not take the initiative to pay their share, he/she will often visit them and urge them to pay up, either directly or indirectly.

The average financing of each big ROSCA (normally over a two-month period) is 14 000 yuan, compared with 1 000-6 000 yuan for small ROSCAs. The average for both big and small ROSCAs is 6 000 yuan.

The duration for most ROSCAs is longer than one year, so some people took part in two or more ROSCA at the same time.

4. Ongoing rural finance system reform in "New Socialist Countryside" Construction

At the beginning of 2006, the central government issued the Central Government Number One Document for support to rural development and building a "new socialist countryside". Rural financial sector's development becomes an important concern. The government speeds up the establishment of a wide-reaching multi-level, sustainable financial system in rural areas, which have been underserved by the existing financial system.

By the end of 2007, the total assets of rural financial banks amounted to RMB 14.7 trillion (27.6% of total banking assets), debts RMB 14.2 trillion (28.4% of total banking debts), deposits RMB 11.9 trillion (29.5% of total banking deposits), loans RMB 7.9 trillion (27.6% of total banking loan). The total loan outstanding related to agriculture has reached RMB 6.09 trillion, of which direct agricultural loan amounted to RMB 1.57 trillion. The proportion of household that have access to banking loan reached 33%, from which more than 300 million farmers benefited.

4.1 Agricultural Bank of China

The government is accelerating the shareholding reform of the ABC, following the successful listing of the other three big state-owned commercial banks. The bank will follow the restructuring steps of the other three big commercial banks: government capital investment, dealing with non-performing loans, establishing shareholding companies, introducing strategic investors and seeking opportunities for listing. The ABC's shareholding reform should be carried out in a steady manner that would serve the financial demand of rural areas.

Until now, the bank has completed internal and external auditing, set up an accounting supervision and control center, and started the personnel resources reform scheme to pave the way for the shareholding reform. By the end of 2007, the bank's total assets were valued at 6.05 trillion yuan. With its balance sheet at the end of 2007 showing a bad loan ratio at 23.50% and non-performing loans topping 818 billion yuan, due to its huge unprofitable lending in the rural sector, the bank's restructuring is rather complicated and needs a relatively longer time than the other three to complete. Central Huijin Investment Co., Ltd., a unit of the country's Sovereign Wealth Fund with 200 billion U.S. dollars, will inject into the bank U.S. dollars equal to 130 billion yuan (19.01 billion U.S. dollars) at the end of 2008. A total of 817.97 billion yuan of bad loans would be put into a fund, jointly managed by the Ministry of Finance and ABC, which was estimated to take five years to dispose the non-performing assets. The NPL ratio was expected to be lowered to 4.1% after the reform, and the capital-adequacy ratio would reach 8%, which would meet the China Banking Regulatory Commission's requirement. It is expected to finish financial restructuring in preparation for public listing in 2009. The bank should become a modern commercial lender known for its adequate capital, sound governance, strict internal control, safe operation, quality service, good profitability and strong global competitiveness.

The ABC will continue to strengthen its role as a major financial service provider for farmers and county-level businesses. Although the ABC has the heaviest burden among its peers, it also has unique advantage. ABC had accumulative and obvious competitiveness in rural banking as it never stopped its rural expansion in the past few years. The ABC has 36 000 outlets scattered across the country (about 18% of the Mainland's bank branches or 60% of its outlets), mostly in villages in the inland and western provinces and even in the most far-flung areas, far more than the other three State-owned lenders. And 98% of the outlets are electronically connected. The bank vowed to continue to explore sustainable and stable business models and facilitate banking service for farmers. By the end of 2007, agriculture-related loans amounted to 1.21 trillion yuan, or 34.75% of total loans. These loans are mainly granted to agricultural lending enterprises, urbanization construction, products' circulation system construction, rural SMEs, infrastructure construction, special resources' exploitation, peasants for production and consumption.

4.2 Agricultural Development Bank of China

In July 2006, approved by CBRC, the credit business of ADABC for the leading enterprises in agricultural industrialization has been extended to cover agriculture, forestry, animal husbandry, sideline production, fishery, processing, technology, and the credit business of the bank has gone beyond the areas of grains, cotton and edible oil, creating favourable conditions for ADABC to support the building of new countryside in a wider scope.

ADABC was active to explore the appropriate approaches to support the flagship agricultural industrialization enterprises not involved in grains, cotton and edible oil. It formulated the

policies and approaches of business development and created new models of business management according to the characteristics of new business. In management of loans, it advocated the idea of fostering clients and established a project base for leading enterprises not involved in grains, cotton and edible oil. It established a business cooperation relationship with related government departments, strengthened the analysis of related industries, organized professional training sessions, and selected a number of projects which had a strong representation of the industry, a good economic benefit and a big social influence, hence a good beginning of the business. By the end of 2006, the aggregate loans supplied for 61 leading industrialization enterprises not involved in grains, cotton and edible oil had amounted to 1.78 billion yuan. Of the total loan, 160 million yuan was invested in horticulture, 430 million yuan in fruits, 140 million yuan in tea, 140 million yuan in traditional Chinese medical herbs, and 910 million yuan in forestry.

In 2006, ADBC launched experiment of credit business for small-size agricultural enterprises in the four provinces (municipalities) of Shandong, Chongqing, Jiangxi and Fujian. This is an important attempt made by ADBC to provide more support for building new countryside, broaden the scope of business and alleviate the financing difficulties of small agricultural enterprises. Thanks to the efforts made by the headquarter and the pilot branches, the business piloting of loans for small agricultural enterprises achieved a complete success, a set of business management models that suited with small agricultural enterprises and ADBC were developed, and a professional team of loan management for small agricultural enterprises was established. By the end of 2006, the four pilot branch banks in Shandong, Chongqing, Jiangxi and Fujian had supplied a total of 1.01 billion yuan to 160 small agricultural enterprises, involving more than a dozen industries such as fruits, vegetables, flowers, tea leaves, livestock and poultry, aquatic products, timbers, forest products, silkworms and traditional Chinese medical herbs. These undertakings involved activated more than 1.6 million *mu* of land used for growing crops and raising animals, and more than half a million farming households, with each household increasing income of about 4,000 yuan, creating jobs for 28,000 people, and realizing an economic benefit worth 2.5 billion yuan.

In 2007, ADBC carried out in earnest the government's policies and measures regarding purchasing and reserve of grains and cotton, broadened the scope of credit support for agriculture, and increased the volume of lending business. The whole year saw a provision of 275.2 billion yuan for purchase of grain and cotton and a supply of 41.5 billion yuan for reserve of grain and cotton; an accumulated amount of 25.4 billion yuan for special reserve of chemical fertilizers, sugar, meat and edible oil; a provision of 12.5 billion yuan in lending to support pig-raising and dairy industries; a supply of 44.6 billion yuan by means of credit to support rural infrastructure construction projects; an extension of 105.1 billion yuan to support the development of leading agribusiness enterprises, processing enterprises and agricultural technology; and a total of 8.3 billion yuan to support the development of small-sized agri-businesses. By the end of the year, the balance of various loans was 1.0224 trillion yuan, 138 billion yuan more than the beginning of the year, 40.7 billion yuan more than the same period of the previous year.

4.3 China Development Bank

China Development Bank enters “new socialist countryside” construction program according to Central Government Number One Document (2006).

The uneven development across China during the past 30 years has left the rural farmers, the vast majority of the Chinese population, with little of the economic success. Many of these farmers have become migrant workers in the cities across China. The government has undertaken a number of initiatives to improve the living standards of the farmers. One of the initiatives is to promote urbanization at county level. The improvement of living standards for farmers is partially dependant on the success of urbanization. Leveraging its experience in financing city infrastructures, CDB inject funds into pilot urbanization regions to support the construction of rural infrastructures and public facilities. In addition, it targeted local business players to assist them with funding for the purchase of new equipment and technical know-how, and to create more job opportunities. As of the end of 2007, the Bank's outstanding loans to support new rural construction and county level development reached RMB 310.6 billion. 80% of the loans were provided to infrastructure construction including rural road networks, power networks, and drinking water systems. A further 14% of the loans were provided to support industrialization in rural areas, commodity distribution, and county-level projects to assist the development of SMEs. Lending for other community initiatives including rural education, rural medical and health care, the training and development of migrant rural workers, accounted for the remaining 6% of the Bank's loans in this category.

4.4 Rural credit financial institutions

4.4.1 Shareholding reform

In 2003, the State Council initiated pilot reforms of the Rural Credit Cooperatives (RCCs), allowing them to reform their property right schemes according to regional conditions. Originally covering eight provinces⁸, the program was quickly expanded to most other provinces during 2004⁹ and 2005¹⁰. The overall goal of the program is to improve corporate governance and operations through "ownership transformation", and to shift more responsibility for RCC governance and financial liabilities to provincial and county governments. The program also involves the consolidation of individual township level RCCs under the guidance of the provincial government.

Due to the imbalanced development in regional economy and the co-existing of different economic structures and ownership patterns, there are great differentials among RCCs, which determine that their future development destines to diversity. Generally, in the most economically advanced regions, where sufficient economic strength exists and the ability of industry to give support to agriculture is more powerful, the RCCs are merged into single legal entities (rural commercial banks or rural cooperative banks); in central and western areas, where the conditions for economic and social development are rather poor and the provision of more government support is needed so that the credit co-operative system can be gradually developed and perfected, the RCCs are merged into county level RCC Unions (RCCUs). In addition, provincial level RCC Unions are being established in most provinces, in part to ensure oversight of all individual RCCs, but also to offer services to RCCs that would enable, for example, achievement of economies of scale. In general, reform of RCCs should be adapted to the demands of diversified economic development through the diversification of their organisational structure, thereby giving more effective guidance to rural economic development and agricultural structural adjustment and realising the effective allocation of rural credit resources (Annex 3). By the end of June 2008, there have been 19

⁸ Jilin, Shandong, Jiangxi, Zhejiang, Jiangsu, Shaanxi, Guizhou, Chongqing.

⁹ 21 provinces/municipalities, Hainan and Tibet excluded.

¹⁰ Hainan. There is no RCC in Tibet.

rural commercial banks, 131 rural cooperative banks and 1 894 city/county-level institutions as the unique legal entity.

The PBC issued special credits or special bills to replace the non-performing loans of RCCs. The pilot RCCs can choose themselves. In case of special credits, the PBC granted credits to provincial governments. The amount is 50% of difference between their liabilities and assets at the end of 2002. The interest rate is 50% of reserve rate in PBC. The duration is 3, 5, 8-year term. In case of special bills, the amount is 50% of difference between their liabilities and assets at the end of 2002. The duration is 2-year term. These special PBC bills pay interest but cannot be sold or borrowed against, but can be repaid before maturity. Beneficiary RCCs are then to raise additional capital and take steps to improve governance. If, after two years, the RCC has met certain criteria¹¹, the PBC will redeem the bills. Going forward, beneficiary RCCs are to comply with the same regulatory standards as do commercial banks. Being the result of in-depth reform on RCCs with better assets superiority in developed regions, rural commercial banks have developed well. At present, the non-performing loan ratio and capital adequacy ratio can basically meet the supervisory standard. Up to the end of June 2007, PBC and CBRC had put 166.1 billion yuan into RCCs through special bills and special loans and completed funding support program. And the PBC had repaid special bills amounting 120.6 billion yuan to 1 771 counties/cities up to the end of June 2008. NPL ratio is 8.4%, decreasing 28 points compared to 2002. Capital adequacy ratio is 12.0%, 8.6% and 14.6% respectively for RCCs, rural commercial banks and rural cooperative banks.

The first pilot RCCs in eight provinces and the second pilot RCCs in West and in Centre are exempted from income tax for three years (for 2003-2005 and 2004-2006 respectively). In June 2006, Ministry of Finance and State Administration of Taxation decided to prolong tax cut period for these pilot RCCs (until 2008 and 2009 respectively). The rural commercial banks can't enjoy this tax advantage. But they can always have a business tax rate of 3%, 2 percent lower than the one for other commercial banks (policy effective from 2004). The money economized from this tax advantage should be used in writing off bad assets and in increasing provision, but not in distributing dividends.

The pilot RCCs introduce market principles in their interest rates so that interest on deposits could go up by 30% of benchmark rate (at most 50%) while interest on loans could go up by 70% (at most 100%).

The RCCs' earning abilities enhanced. Since 2004, the RCCs have turned around from loss making to profit making, with sustained growth (Table 6).

Table 6 – Profits of the RCCs

Book Profits (RMB billion)/Year	2003	2004	2005	2006	2007
Rural commercial banks	0.09	0.81	2.94	4.09	4.28
Rural cooperative banks	-	-	3.01	5.37	5.45
Rural credit cooperatives	-0.55	9.66	12.03	18.62	19.34

Note: 2003-2006: pre-tax book profits; 2007: after-tax book profits

Source: CBRC

¹¹ Capital adequacy ratio should reach 2% for RCCs and Rural Credit Cooperative Union at county/city level, 4% for RCCs with a unique legal entity, 8% for rural commercial bank and rural cooperative bank. In addition, NPL ratio (calculated by old method) should decrease 50%, compared to the one at the end of 2002.

4.4.2 Support to rural economy

The reserve against deposits rate in RCCs is lower than that for other commercial banks¹², which economizes 80 billion yuan of capitals that can be used to *Sannong*.

RCCs play a leading role in offering financial services for rural economy. By the end of June 2008, the balance of loans granted by RCCs was 12% of total credits by financial institutions (increasing 1.6 points compared to 2002), and agricultural-related loans were 47% of total loans granted by them (increasing 7 points compared to 2002) (PBC monetary policy report, Quarter 2, 2008).

4.5 Postal Savings Bank of China

In August 2003, the CPSRB was granted authority to place its deposits at its discretion (subject to certain investment restrictions), and simultaneously the PBC reduced substantially the interest rate paid on new CPSRB deposits. The balance of CPSRB's funds at the PBC are to be run-off in five years by August 2008¹³. CPSRB now invests its funds in government and financial bonds (the latter issued by the CDB and some state-owned commercial banks) and in the interbank market, and lends some to RCCs and UCCs.

To encourage the postal savings funds to flow back to the countryside, CBRC initiated a pilot program in March 2006 in three provinces—Hubei, Fujian and Shaanxi, which involves granting small loans fully secured by deposits held by CPSRB. In September 2006, second round of pilot units were chosen in ten provinces/municipalities—Beijing, Tianjin, Shandong, Anhui, Zhejiang, Guangdong, Guangxi, Henan, Chongqing and Sichuan. This is the first step in building the lending capacity of CPSRB, and a precursor to the establishment of a Postal Savings Bank.

Efforts to set up the postal savings bank have never ceased since 1997, when it was first proposed by the PBC. The State Council finally approved the establishment of the postal savings bank in July 2005, when it decided that China Post will be split into three parts: a post regulatory body, a postal service company and a postal savings bank. In June 2006, CBRC gave green light for the establishment of China Postal Savings Bank. This marks the beginning of a concrete implementation phase for the establishment of new bank.

Approval from CBRC to start its lending business was still pending¹⁴, the Bureau has started preparatory work because of its lack of experience in the area. To avoid being saddled with bad assets, and to strengthen its resistance to risks and corporate governance, it is seeking to cooperate with other financial institutions. In mi-June 2006, the Bureau signed a full-scale cooperation agreement with the CDB, a policy bank that provides long-term financing for key projects in the infrastructure and other pillar industries. Cooperation covers asset management, capital utilization, professional counsel, personnel and financial settlements. If approved, they will offer a variety of loans including syndicated, joint and commission loans and jointly manage trust assets. The Bureau will also actively undertake the sale and issuance of the CDB's bonds and asset-backed securities. The agreement is viewed as a win-win situation; the Bureau gains valuable experience from working with CDB, which in turn has the opportunity to break into the rural market. Rural areas would also benefit from the flow of

¹² 7.5% for RCCs, 8.5% for other banks (effective from August 15, 2006).

¹³ 10% for the 1st year, 15% for the 2nd year, 20% for the 3rd year, 25% for the 4th year, and 30% for the 5th year.

¹⁴ CBRC give its approval in February 2007 for all CPSRB nationwide.

deposits that could be used for development. The agreement also provides for the possible training of Bureau personnel at CDB. With this and other similar cooperation agreements and partnerships, the Bureau (Postal Savings Bank of China later), will be able to gradually move towards operating its own lending business.

The Postal Savings Bank of China (PSBC) completed registration on March 6, 2007 with total registered capital of 20 billion yuan (2.56 billion US\$). It formally opened on March 20, 2007. With its distribution network, lack of legacy lending problems (no “historical burden”), and sizeable core deposit base, the new bank has a natural advantage over its competitors in basic financial services like granting microcredit, especially for rural households and companies and to become a significant positive factor in rural financial sector development. In the future, the postal savings bank will take full use of its network advantage to improve its financial service functions in urban and rural areas. It will focus on retail customers and intermediary businesses and provide basic financial services to all residents. It will also form sound, complementary relations with other commercial banks to support the construction of a “new socialist countryside” and the balanced development of urban and rural economies.

Since it was kicked off in 1986, the postal savings service has developed into an important financial force in China. By the end of May 2008, it had notched up savings deposits of 1.8 trillion yuan, only below that of “big four”. Postal savings have accumulated almost 1.18 trillion yuan of savings deposits under its independent use. Post offices boasted more than 60 000 outlets nationwide, with two-thirds of them located in counties and areas below county level (in some remote areas, postal savings even become the only financial service people have access to), and 480 million account holders. Individual postal savings bank books numbered 280 million.

4.6 Microcredit institutions (Township and Village banks, Rural Loan Companies, Rural Mutual Cooperatives, etc)

A Nobel Peace Prize winning concept of lending small, unsecured amounts to the poor has renewed interest in the establishment of a micro-credit bank in China. Grameen Bank¹⁵ created by Muhammad Yunus in Bangladesh, has offered tiny loans of more than 5.7 billion US\$ to 6.6 millions of poor Bangladeshis to help them get out of poverty and become self-employed in the past 30 years, 97% of whom are women. Nearly 60% of debtors and their families have got out of poverty level. “It’s not charity. It’s business that can earn money and also help lift the poor out of penury”, according to him. In 1993, this model has been introduced into domestic credit markets and operated as FPC (*Fu Pin* Community-Poverty Alleviation Community). About 300 pioneering institutions, mostly domestic or overseas non-government organizations, have experimented with microcredit for more than 10 years. But China should only borrow from Grameen Bank’s model instead of importing its practice as a whole unquestioningly, as there are major differences in two countries’ specific circumstances.

A pilot commercialized micro-credit organization program was launched in five provinces¹⁶ in November 2005 under the guidance of the PBC, aimed at creating competition for the RCCs and formalizing heretofore informal lending business. Like the RCC reform program, this pilot envisions a substantial role for local authorities and private investors. These

¹⁵ This bank demand no collateral or guarantor, but mutual guarantee by five-persons group, or to purchase bank’s shares, and a percentage of credit amount as risk provision in order to prevent credit risk. The credit refunding ratio attains 99.02%.

¹⁶ Shanxi, Guizhou, Sichuan, Shaanxi, Nei Mongol.

companies are not allowed to take savings deposits, but only to lend from their own equity, raised from private investors. The shareholders of the micro-credit company and the institutions that provide funds should bear relevant risks from funds operation. The minimum equity threshold was set at around RMB 100 million—much less than China’s regulations require for establishing commercial banks or cooperative financial institutions (RMB 1 billion and RMB 150-200 million respectively). The first two private microcredit companies were established in January 2006 in Pingyao, Shanxi Province. Now there are seven companies in business by the end of 2007. They may charge as much as four times the benchmark rate, which means that it is easier for them to sustain their business and stay afloat.

In response to such problems as low financial institution network coverage, insufficient capital supply and inadequate competition among financial institutions in rural areas, CBRC issued “Proposals on Adjusting and Relaxing Market-Entry Policies for Banking Institutions in Rural Areas¹⁷ to Support the Construction of the New Socialist Countryside” on December 22, 2006, which lowered the entry requirements of new rural financial institutions to increase farmers’ access to microfinance. These measures encourage private investments in rural banks and set low registered capital thresholds: RMB 3 million for establishing county/city level banks, and RMB 1 million for establishing banks at township/town level. The proposals also allow credit cooperatives to be set up at township/town level with registered capital of RMB 300 000, and at administrative village level with registered capital of RMB 100 000. The lending subsidiaries wholly invested by commercial banks and rural cooperative banks should have RMB 500 000 of registered capital. Concerning for risk management, CBRC requires that established banks must hold at least a 20% of stake in the new village banks, and each private investor is limited to a maximum stake of 10%. Moreover, village banks have to maintain an above eight percent capital adequacy ratio and above 100 percent bad loan coverage ratio. The new rules encourage rural banks to do all types of banking services, and sell policy-financial products through commercial network. Especially in the old, remote and poverty-stricken regions, policy banks may cooperate with commercial banks to develop financial businesses. What is missing in the new rules is the loan pricing ceiling of village banks. The government liberalised risk-based pricing in 2004 by removing the lending rate upper-limit that commercial banks can charge, but has kept the lending rate ceiling of credit cooperatives at 2.3 times of benchmark rate. Since the new village banks are much smaller than credit cooperatives, so at least the credit cooperatives’ lending rate ceiling will be applicable for village banks. Given the current 5.85 percent benchmark rate in China, village banks should not be able to charge more than 13.5 percent interest: this is even lower than what commercial banks normally charge on the credit card revolving balances.

CBRC publicized the Provisional Rules of Management for Village Banks, rural loan companies and rural mutual cooperatives respectively on January 22, 2007 to facilitate banks’ entry to the rural market and improve their financial services. In February 2007, CBRC announced that the new rules would be piloted in 33 counties of six pilot provinces (Sichuan, Jilin, Gansu, Qinghai, Hubei and Inner Mongolia Autonomous Region).

The first three village banks were inaugurated on March 1, 2007: Huimin village bank in Yilong county of Sichuan province, Chengxin village bank in Dongfeng county and Rongfeng village bank in Panshi city of Jilin province. There are the smallest banks in China. No guarantee or mortgage is required for the farmers to get a loan. The lenders simply consult village officials and peasants-turned-businessmen concerning the applicants’ credit standing

¹⁷ Rural areas at county/city level or below in Centre, in West and in Hainan Province, and poverty-stricken counties defined by the central government or by provincial government in other provinces.

and repayment capacity. In Huimin village bank, farmers can get loans of up to 20,000 yuan without guarantee, while small enterprises or farmers engaged in special areas can obtain loans of up to 100,000 yuan with a collateral/guarantee. The interest rate for loans is between 8 and 10 percent, slightly higher by two to four percent than the current interest rate in urban markets because of higher costs and more risks. But the rate is much lower than the average 12 to 15 percent charged by unlicensed lenders—well-off farmers and local businessmen who are often the only creditors when impoverished villagers can't prove their creditworthiness with rural cooperative banks. The interest rates for deposits are the same as the official rate set by the PBC, which is 0.72 percent for on-call deposits and 2.52 percent for 12-month time deposit. In Rongfeng village bank, loans need be guaranteed by five rural households, and these five rural households can guarantee for each other. Or this bank can ask the grain-procurement enterprises in upper reaches and the seed & fertilizer-supply enterprises in lower reaches to grant guarantee for rural households. These two forms of guarantee need not collateral.

The Huimin Loan Company also opened in Ma'an Town, in Yilong County of Sichuan Province on March 1, 2007. A lender wholly owned by Nanchong Commercial Bank, it has 500,000 yuan of registered capital. The company provides only a loans service.

The first rural mutual cooperative “Baixin” in Yanjia Village of Jilin Province was established on March 9, 2007 with registered capitals of 101 800 yuan. The members pay at least 100 yuan as organization fee, they can obtain loans of ten times organization fee paid at most.

There are now 30 micro-credit institutions of new types. Microcredit business plays a positive role in increasing peasants' revenue and production. The establishment of rural financial institutions of new types and their development meets a huge demand for banking services from individuals and small businesses in the countryside, especially in less developed areas and insufficient competition regions. They will mushroom to help fill up the gap.

Table 7 – Resources and uses of capitals in different banks

Bank	Resources of capitals	Uses of capitals (lending clients)
Agricultural Bank of China	deposits	Geography : Yangtze River delta, Pearl River Delta, Baohai Rim and capitals in other provinces Industries: telecommunication, energy, petrochemical, transport, etc. Agricultural loans (55% in total loans) Lending to small enterprises Consumer loans (77% of which are housing loans)
Agricultural Development Bank of China	PBC relending (43%) Financial bonds (35%) Deposits (22%)	Traditional business: The procurement and storage of grain and oil, others (sugar, meat, chemical fertilizer, etc.) In the future: farming, forestry, animal husbandry, fishery, processing, city/town construction Technology, etc.
China Development Bank	Financial bonds in RMB and US\$	State infrastructures' construction and pillar industries Industry restructuring and promoting harmonious development of different regions Rural infrastructures' construction and agricultural resources' exploitation SMEs
Rural Commercial Banks	deposits	Loans to agriculture (leading enterprises, economic institutions, professional cooperatives), rural areas (infrastructure construction and industrial zone development), rural households and peasants (consumer and production loans)
Rural Cooperative Banks	deposits	Loans to farmers and rural households (production, consumer, education, alleviation loans), sole industrial & commercial

		proprietorships (<i>getihu</i> enterprises), private enterprises
Rural Credit Cooperatives	deposits	Loans to farmers and rural households
Postal Savings Bank of China	deposits	Microcredit to urban and rural households
Township and Village Banks	deposits	Farmers and small enterprises
Rural Loan Companies	Deposits of parent companies	Farmers and small enterprises
Rural Mutual Cooperatives	deposits	Farmers and small enterprises members
Microcredit companies	Capitals of shareholders	Farmers and sole industrial & commercial proprietorships (<i>getihu</i> enterprises)

Source: Annual Reports of banks (2006), CBRC.

4.7 Agricultural insurance

Agricultural insurance has been long underdeveloped, as insurers are often reluctant to underwrite such policies because of risks and small chance of profitability, though the rural population of 800 million underlines market potential. However, agricultural insurance as a “rock” of the rural economy can stabilize the rural economy and help farmers through natural disasters. The government is making more efforts to promote the coverage of agricultural insurance and make it available for the overall agriculture sector and rural households.

4.7.1 Rural microinsurance

With the features of small premium and low amount insured, the rural small-sum insurance can be regarded as an important part of rural small-sum finance. At present, small-sum insurance has won world’s attention widely. The experience of small-sum insurance in such developing countries as India and the Philippines has proven that in the rural areas which are short of social security system, the small-sum insurance is an effective way to provide the basic security to rural poor people, and it has strong vitality. Compared with the other developing countries, micro insurance in China is still in a fledgling phase. The promotion of rural small-sum insurance will be beneficial to the big population of Chinese peasants.

In order to improve China’s insurance coverage and running micro insurance successfully, there are four key factors: government support, market need, wide distribution channels and creative products.

➤ Government support

The increasing expansion of agriculture in China required more agricultural infrastructure and investment, while risks might follow. As a low-profit insurance product, government support can really boost micro insurance’s development. The government could be involved in two ways: subsidizing the farmers and supporting the insurers. At present, the income for a majority of farmers is very low, and they could not or were not willing to pay the premium for insurance, hence the government must join in and subsidize the farmers. On the other hand, China is a country vulnerable to natural disasters. Its agricultural industry is very fragile, which means that the loss ratio could be very high. In cases of extremes, insurance companies might not be able to sustain the astronomical compensation. Therefore, the government should subsidize the insurance companies to keep them going.

Subsidy and fiscal allowances by local governments stimulate the growing enthusiasm of Chinese farmers for insurance. The Shanghai municipal government, for instance, pays 33 percent of the crop insurance premiums for farmers, while Meishan city government (in Sichuan province) offers a 66 percent of premiums as a subsidy for dairy herd insurance.

Farmers in Suzhou (in Zhejiang province) only need to pay 38 percent of the premium for rice insurance, while those in Xinjiang are spared 12 percent of the premium for cotton insurance.

In 2007, the central government funds a budget of 2.15 billion yuan for the first time to carry out a pilot of subsidies to agricultural insurance premium. Among them, the 5 major food crop insurance in 6 provinces are given a budget of 1 billion yuan, 1.15 billion yuan given to sow insurance. The agricultural insurance premium income reached 5 billion yuan, an increase of 6 times the premium income in 2006 (846 million yuan), which realises a breakthrough in premium income, coverage region and protection scope in the development history of China's agricultural insurance.

➤ **Market need**

Despite some progress in the fledging sector, the country's current micro-insurance products are not fully matching the demand of farmers. However, China's micro insurance market has a huge potential. It is estimated that there are at least 200 million to 400 million potential clients in the country who can overcome poverty and protect themselves against all kinds of risks under the insurance umbrella.

➤ **Wide distribution channels**

Distribution channels are generally believed to be the keystone of developing micro insurance. In fact, in recent years, more and more insurance companies have paid attention to the rural market called "Wealth at the Bottom of the Pyramid". For example, China Life, the first one getting the approval has already entered the market in rural areas long ago, and now started to be rewarded. By the end of July 2008, China Life's county business has reached RMB 110.1 billion yuan with an increase of 51% compared with 2007, and it accounts for 55% of China Life's total premium and half of China Life's total business. China Life is even positioning the rural small-sum insurance as the inherent requirements for the rapid development of their company. China Life plans to increase the number of networks in rural areas to 19,000 and develop 500,000 sales staff there by 2010, aiming to cover most of the rural areas in China. Apart from China Life, Pacific Insurance pilots micro-life insurance products in rural areas in four provinces. Taikang Life Insurance has tested a 50 yuan premium for 50,000 yuan of accidental injury insurance coverage in 19 counties of seven provinces. Some branches of the Chinese People's Insurance offer the comprehensive insurance in the rural areas which is equivalent to the small-sum insurance. Many other insurance companies are actively preparing to enter the rural market.

Besides local insurance companies, multinational companies are also showing growing interest in this sector. In 2004, French insurer Groupama set up a property insurance subordinate in Chengdu and Chongqing, two key cities in the nation's west. Zurich Financial Services Group is also one of the few international insurers that have embarked on research for entry into China's micro insurance market. They are expected to help China improve insurance protection for its agricultural industry and farmers, especially in the underdeveloped western areas. They will play their role in promoting agricultural insurance in China and developing the central and western areas.

➤ **Creative products**

For the small-sum insurance products, CIRC pointed out that the pilot must always be carried out in the order of “first security, then investment; first short term, then long term” so as to provide peasants with the correct awareness for insurance. It is believed that although with lower income, the peasants are of highly loyal customers, and the international experience for small-sum insurance has proven that large scale can create high efficiency. The income of Chinese peasants is gradually rising. Therefore it can be presumed that the customers of current small-sum insurance will be of the high-end ones in the future.

In recent years, especially in 2007, many insurance products have been invented to specifically target different sectors in China’s rural areas, such as planting, livestock breeding, farmers’ houses, farm machinery, farmers’ household property, as well as micro-medical insurance and insurance against micro-loans, a practice adopted in rural areas to provide more financial products there.

There are already a range of similar micro-insurance products available on the market, though not group-based, as insurance companies come up with new products to grasp opportunities in the vast rural areas. For example, a micro-life insurance product developed by China Life Insurance, the country’s largest life insurer, offers an eight-time refund on an annual premium of 100 yuan for farmers to guard against fatal accident. Such products are more affordable for farmers, if compared with regular products that would ask for an annual premium of several thousand yuan or more. The per capita net income of farmers reached 4,140 yuan in 2007, however, it still fell short of more than 10,000 yuan on average for urbanites. China Life Insurance covered 1.2 million farmers with such life insurance in 2007.

Through innovation in the various aspects, the small-sum insurance has displayed the features such as appropriate security, low premium and simple procedure for the claim and settlement, etc., which can effectively meet the needs for security in the rural insurance market. Therefore, these products will play an example and leading role for the rural small-sum insurance coming afterwards, and will actively push forward the rural small-sum insurance in China.

Moreover, innovative products are the biggest advantage of multinationals. Micro insurance is neither life insurance nor property insurance. It should be a package of insurance with lower fees. Packaged insurance products seem more convenient for buyers, but there are problems selling them in China. Given the prevailing policy, property insurance and life insurance are best operated separately.

4.7.2 Bancassurance

The commercial banks cooperate with insurance companies and shift their eyes to the rural market with huge potential due to the intense competition in the city insurance market.

- **Agricultural Bank of China**

In 2006, ABC increased its cooperation with insurance companies in product development and sales system designs. Insurance agency business was rapidly developed. In 2006, ABC cooperated with ten insurance companies and grossed RMB 62.517 billion in insurance premiums. Using “Yin Bao Tung” (Bancassurance One-Stop Shop) system, ABC insurance agency has 80 products on-line and grossed RMB 11.524 billion in premiums in 2006.

In July 2007, PICC signed a comprehensive agreement with ABC with a view to develop rural finance and insurance businesses. According to the terms of the agreement, both sides will cooperate in designing a bancassurance platform, striving to improve county-level and regional economic development. They will strive to create a new multi-leveled, and sustainable rural finance and insurance system to develop and widen cooperation in bancassurance products and services, to further innovate bancassurance operating models, to increase coverage scope and deepen penetration of insurance in rural areas.

In November 2007, ABC started in full force selling China Life's microinsurance product: "New Simplified Personal Insurance". This product was dubbed as "the number one insurance policy in serving the construction of new rural sectors". In consideration of farmers' needs, ability to pay, spending habits, China Life has designed this new product with microinsurance characteristics in mind, that is, low premiums, suitable protection, return of premiums at the end of policy terms, and easy to apply. It is believed that this policy would satisfy the needs of China's rural market.

● **Post Savings Bank of China**

PSBC stresses the development of various financial products. In 1999, all sub-branches in 31 provinces and cities had signed part-time agency agreements with insurance companies. Up to Dec. 2007, there were 25,000 Post Savings sites in the country selling insurance for various insurance companies. They are: China Life, Ping An Life, China Pacific Life, Tai Kang Life, New China Life, Tai Ping Life. Given numerous networks and clients nationwide, there are 25 million households who bought insurance from Post Savings Bank which accounted for 20% of all bancassurance sold in China in 2007.

4.8 Agricultural products' futures market and payment system

There are two agricultural commodity exchange in China: Zhengzhou Commodity Exchange (ZCE), established on October 12, 1990, wheat (including strong gluten wheat and hard white winter wheat), cotton, white sugar, pure terephthalic acid, rapeseed oil and green bean futures contracts are traded on ZCE; Dalian Commodity Exchange (DCE), founded on February 28, 1993, the listed futures products are soybean, soybean meal, soybean oil, corn, and malting barley. The trading volume and value of agricultural products futures have increased continuously in five years. The price in futures market has become an important reference for the determination of price in current market. It plays a positive role in avoiding price risk, natural disasters' risk, preserving and increasing agricultural products' value, and promoting agricultural production. In addition, weather derivatives imitated from American market should be introduced.

"Banking card service" pilot program has been initiated at the end of 2006 in 12 provinces/municipality by commercial banks for peasants who have left their villages and work in cities. According to the statistics, the number of peasant-workers has exceeded 100 millions, and the number increases 4-5 million per year. Peasant-workers account for 57.6% of active population in secondary industry, 80% in construction. The annual net income for them is 350-400 billion yuan. So it's important to facilitate the carrying money for them and resolve the funds security problem.

5. Prospects and Recommendations

5.1 “Rural Market Economy” & increasing peasants’ income— indispensable condition for creating a rural dynamic financial market

Rural economy determines rural finance, and rural finance influences rural economy.

In China, conventional banks have no interest in household credit in rural areas because of high repayment risks and operational costs. Thus, rural productivity has been hampered by a lack of access to reliable and affordable credit to purchase inputs and to invest in small, off-farm, income generating activities. How to attract capitals to come back to the countryside? Lowering the entry threshold of banking sector and creating new financial institutions in rural areas are not enough. Whether peasants can afford interests, whether financial institutions can gain, remain the key questions for the development of rural finance. If banks can't make a profit, they will retreat as before. Finance is based on economy. In order to have a financial break-through, it should create market economy and increase peasants' income. It should create farming-breeding-processing, production-supply-sale, commerce-industry-agriculture integrated operation. A unified market for farm produces and labour should be created. Only in this condition, farmers can obtain credits more easily for expanding production and increasing their profits. It's "win-win" for farmers and banks.

The problem at the kernel in *Sannong* issues is that of peasants' income. Peasants' income increases slowly. The income gap is still widening between the urban and rural areas, so is the cleft between the regions and among the rural population. The peasants can't get the benefit of economic expansion.

At the initial stage of China's opening-up and reform, the grain output was only about 300 million tons a year. It exceeded 500 million tons in 1996 and levelled off for several years and 1998 saw it hit the record high (512 million tons). Since then, China's agriculture entered into a new stage featuring a balanced gross output and surplus stock in years of good harvest. The upsurge of farm produce output and the slow growth in consuming farm produce by urban residents keep grain prices low. The price curve plummeted to the bottom-line. In addition, China's entry in the WTO is set to accentuate the downward pressure on peasants' income as the gates are opened for overseas agricultural produces from more efficient producer countries. The agricultural productivity is of low efficiency and staple farm produces¹⁸ has poor competitiveness in the global market. The staple farm produces are sold at unreasonably low price for years. Peasants get low profits in deduction of the cost and in turn they had less initiative to invest in grain growth. Much land is left uncultivated in some areas.

Another important reason lies in the surplus of rural population and excessive rural labour force. 70% of population and 50% of active population depend on agriculture which produces less than 20% of GDP. So agricultural development can never stimulate fast growth of income among 800 million peasants. A good way to ensure a long and sustainable growth in peasants' income is to reduce population in rural areas, i.e. encouraging the rural labour force to shift to non-agricultural industries (in secondary and tertiary industry, in cities and in towns). It can bring about several benefits. The outflow of labour force can leave more land to those staying in rural areas to till so that they can expand their operation on land and their farm produces can be more commercialized. The labour force transferred from rural areas will be changed from suppliers of farm produces to consumers, thus boosting the demand for farm produces

¹⁸ Such as wheat, corn, cotton, vegetable oil, sugar, sheep's wool, milk.

and pushing up the prices. The combination of the two forces will keep the peasants' income rise fast. According to Green Book of Rural Economy published by Chinese Academy of Social Sciences (2008), per capita annual net income of rural households reached 4 140 yuan in 2007, of which wages income was 1 596 yuan (the contributing rate to income increase was 40%), while household business income was 2 155 yuan (the contributing rate to income increase was 45%).

At the same time, the government has adopted a series of agriculture-friendly policies to boost rural economy and increase farmers' income, including direct subsidies for grain growers and more subsidies for farmers to buy crop strains, agricultural machinery and tools. And in order to lighten their burden, China's 2600-year-old agricultural tax was rescinded on January 1, 2006. Furthermore, the government should work to improve education, health and cultural undertakings in rural areas so that residents can enjoy more social welfare benefits. Tuitions for nine-year compulsory education in rural areas have been exempted in 2006 and 2007. The central government and local governments at various levels will allocate a total of 218.9 billion yuan (27.36 billion US\$) to subsidize compulsory education in rural areas in five consecutive years (from 2006).

Generally speaking, acceleration of agricultural and rural economic restructuring, industrialization of agricultural operations, modernization of traditional agriculture, standardization of agricultural production, and urbanization are important to narrow the urban-rural residents' income and to resolve *Sannong* issues in order to promote more balanced development and build a harmonious society.

The goal of rural finance is to increase peasants' income and ameliorate their living conditions. It should create necessary conditions so that they could leave their home and work in cities and in industry/service. Credit capitals should be invested into urbanization, rural infrastructures and TVEs, and also to business skills training for peasants. For example, channelling investment to small-sized infrastructure projects in rural areas, including roads construction, water and power supply, which are featured with small investment, short construction period and quick return and generous social and economic benefits. They can create many job opportunities to the rural labour force which is cheap, thus adding to peasants' income sources. Furthermore, it can improve the living conditions, help boost consumption, and absorb the excessive production capability in rural areas.

5.2 Diversified and complete rural financial system

The government is trying to recycle funds back to rural areas so as to promote the modernization of the agricultural industry and urbanization of countryside. Economic development in China is not balanced judged from many aspects. Multi-layered economic development level and complicated economic structure require multi-level financial institutions to provide relevant services. Accordingly, various financial institutions should divide the credit market according to "cost-efficiency" principle and comparative advantages to precisely choose their target markets and development strategies. Financial product innovation should be encouraged so as to provide peasant households or other business entities with different financial instruments including loans, credit guarantee, securities finance, insurance, leasing, and settlement of payments in order to adapt to the diversified need for rural finance.

◇ **Commercial finance, cooperative finance, policy finance, other finance**

Complete rural financial system including commercial finance, cooperative finance, policy finance and other finance should be created. Farmers can maintain simple production through policy finance and other finance, primary enlarged production through cooperative finance, and advanced enlarged production through commercial finance with competition.

There is a widening gap between the east, west and central region. The rural population in the east is largely enjoying a better living and production condition, and the market economy is almost established. The rural areas in the west are still in small-scale farming. The rural areas in the centre have the biggest rural population, limited natural resources, most serious poverty and the fastest ecological deterioration. So it should have more policy finance in West, by contrast more commercial finance in East.

❖ **Collateral and Credit Guarantee System**

Residential houses, collectively owned land, and courtyards can't be mortgaged, so farmers have difficulty to get loans, in particular loans for breeding and planting industries. While full-fledged private land ownership rights are not likely in the near future, farmers should be able to use long-term land use rights as collateral. Movables, bills of storage, rights can also be used to mortgage. Once the mortgage problem is solved, productive enterprises will develop rapidly.

Credit guarantee system should be created in rural areas so as to help rural banks cope with the hardship at the initial stage of development. Relevant protective policies such as government credit guarantee for farmers and credit guarantee among farmers themselves should be allowed. The leading company can also be allowed to create a credit guarantee institution in order to provide guarantee to peasants related. Moreover, due to great risk of agricultural investment, farmers can buy agricultural insurance when they demand credits.

❖ **Interest rate**

The successful microcredit institutions in foreign countries have an interest rate much higher than the one in commercial banks. For instance, in Indonesia, the microcredit's interest rate is above 28% while 18% in commercial banks; in India, 20%-40% vs. 12%-15%; in Bangladesh, 20%-35% vs. 10%-13%. So generally, the microcredit's interest rate is above 10 percent higher than the one in commercial banks. However in China, the microcredit's interest rate is slightly higher than the one in commercial banks. So it should increase the floating range of interest rate so that it could close up to the market one. In the one hand, government finance can be mitigated. In the other hand, the microcredit can be granted to the poor who need really the money, but not the rich who want to get loans with lower interest rate ("rent-seeking" phenomenon).

According to Jennifer Isern, a micro-finance expert at the World Bank's Consultative Group to Assist the Poor (CGAP), reductions in interest rates are achieved through a competitive market. For example, in Bolivia, micro-credit interest rate decreased to 20% from a high level of 70-80% due to competition. Only when micro-credit companies do not benefit from government subsidies do they have the incentive to lower costs, develop themselves and expand the scale of service to poor people.

Transparency is critical. Transparency not only makes supervision easier, it helps donors, investors and loan applicants make sober judgments about the risks and returns.

❖ **Agricultural insurance**

Agriculture serves as the foundation of the national economy and faces special difficulties in its production process, some other countries have supported the development of agricultural insurance in order to protect farmers' interest. Subsidies to agricultural insurance are legitimate according to the World Trade Organization's "green box policies" and they've become an important means by which developed countries support and protect their agricultural industries. Hence, to promote agricultural insurance in accordance with WTO rules is a matter of urgency for China's agricultural development.

Firstly, the State should take all necessary measures to increase farmers' income to transform their potential demand into effective demand for agricultural insurance. Meanwhile, the government should also encourage concentration of farming activities to realize economy of scale and enhance farmers' dependence on agricultural insurance.

Secondly, it should not follow a single model for agricultural insurance development but should build up a tailor-made and multi-level system with wide coverage. Each region may choose its own model to expand agricultural insurance coverage according to its fiscal strength and natural conditions. Some local governments, for example, have been working together with insurance companies to develop agricultural insurance that combines fiscal and policy support with commercial operations.

Thirdly, the State should improve legislation to provide a sound legal environment for the development of this insurance. In comparison with commercial insurances, agricultural insurance is so risky that the government should invest a lot in the initial phase of its development. It is suggested that the State should lay down the laws and regulations on agricultural insurance as soon as possible to ensure constant government support for this undertaking.

Fourthly, the government should make more efforts to raise farmer's insurance awareness and foster grassroots insurance professionals. It takes time for hundreds of millions of farmers across the country to understand the nature, role and advantage of agricultural insurance. The government should try to organize farmers on a voluntary basis to participate in agricultural insurance. Grassroots insurance professionals should master not only theories about agricultural insurance but also related knowledge about agricultural management, agro-technique and prevention of natural calamities. The government should make full use of advanced foreign experience to foster a group of qualified local insurance professionals.

Finally, the function of agricultural insurance companies should be improved to reduce concerned insurance risks. Because of the unique position of agricultural insurance companies in risk management, they could and should provide services like consultation and supervision on policy holders' disaster prevention and reduction. This is particularly useful for small-sized farming economies. In addition, establishment of agricultural insurance companies in rural areas can be combined into that of a comprehensive agricultural service system to multiply functions and cut down operational cost. A sound evaluation system is the prerequisite for making reasonable compensation. Since the country has not developed a unified index yet,

agricultural insurance companies can try to set up a relatively scientific evaluation system suited to local conditions to minimize insurance risks.

❖ **Informal finance**

Informal finance exists since long time ago. And the emergence of informal lending is of growing importance for small-scale farmers and small businesses in rural areas that lack collateral and are virtually excluded from the formal financial sector. If private funds participate in lending activities in accordance with relevant rules on interest rate, informal financing is unlikely to damage social economic order rather it could be a beneficial supplement to formal financing and even a barometer of social financial demands. Judged from past experiences, problems in informal finance stemmed from illegal public financing activities without permission. A good policy to prevent social and financial disorder should focus on establishing a governing mechanism that guides its healthy development while imposing harsh punishment on irregularities. The government is considering “lender rules” to regulate informal financial institutions, especially for usury.

6. Conclusion

China is a developing agricultural country with a population of 1.3 billion. The “three rural issues” (namely agriculture, countryside and peasants) is one of the most essential issues for the government. The government has always been attaching great importance to the development of “three rural issues” and the reform of rural finance. Ever since China’s opening-up, the government has been taking constant efforts in rural finance reform, improving the service system in rural areas and strengthening the supervision to rural finance institutions through a series of strategic arrangements and policy measures.

Apart from the shareholder reform in main financial institutions, the government loosened restrictions on investment caps, localities and venture capital financing channels for banking and non-banking financial institutions to merge with, acquire or strategically invest in small and medium-sized rural financial institutions. It resorted to what called the “new-type” rural financial institutions to ease the chronic capital shortage in rural China that has aggravated the imbalance between the rural economy and the rest of the economy. Moreover, the government also hoped to activate the stagnant rural financial market by bringing in overseas investors. HSBC opened its first county branch in southwest Chengdu, becoming the first foreign bank to enter China’s rural financial market. Some other leading foreign banks, such as Citibank and Standard Charter, have also shown their interest in the rural financial market.

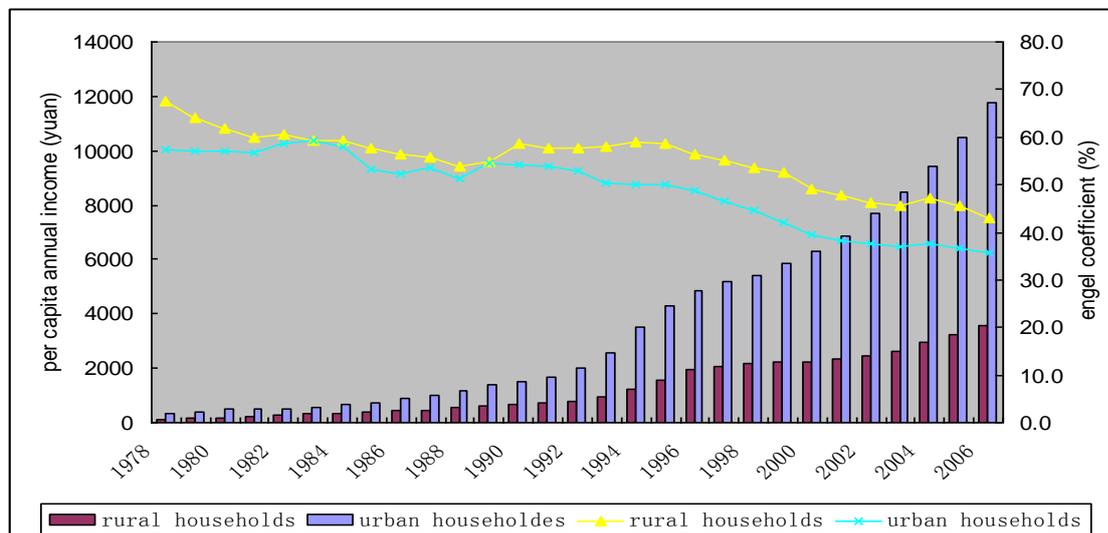
It should strengthen the institutional system of rural finance.

- The matter of collaterals. It should expand the scope of qualified collaterals and study the feasibility of new types of collaterals such as orders, bills of lading and account receivable to tackle the issues of the absence of collaterals and increase accessibility for loan in rural areas.
- The problem of insurance. It should accelerate the building up of a rural insurance system and expand the scope and amount of the subsidies for commercial agricultural insurance.
- The issue of interest rates. It should continue the reform on the liberalization of interest rate system, allowing financial institutions to set their own rates in line with the credit condition of their clients and prospective income.

Finally, a better rural finance policy supporting environment should be constructed on discount policy for agriculture loans, favourable tax policies and monetary policies.

ANNEX 1 - Per Capita Annual Income and Engle Coefficient of Urban and Rural Households

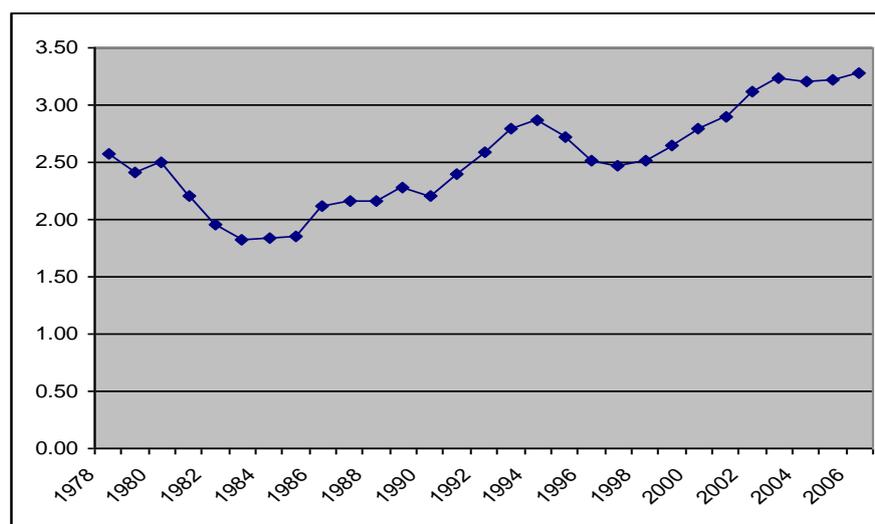
Figure 1 - Per Capita Annual Income and Engle Coefficient of Urban and Rural Households



Note: Engel's coefficient—the proportion of expense on food to the consumption expense. According to the FAO's criteria that an Engle Coefficient above 59 percent denoted poverty, 50-59 percent means enough food and clothing, 40-50 percent stands for well-off, while people living with 30-40 percent Engle Coefficient are rich and those below 30 percent are the richest.

Source: China Statistical Yearbook, various editions.

Figure 2 – Ratio of per capita annual disposable income of urban households to per capita annual net income of rural households



Source: China Statistical Yearbook, various editions.

ANNEX 2 – Per Capita Annual Net Income of Rural Households & their basic conditions in Eastern, Central Western and Northeastern Region

Table 8 - Per Capita Annual Net Income of Rural Households

Item	1990	1995	2000	2004	2005	2006
Net Income	686.31	1577.74	2253.42	2936.4	3254.93	3587.04
By Source						
Wages Income	138.8	353.7	702.3	998.46	1174.53	1374.80
Net Income from Household Business	518.55	1125.79	1427.27	1745.79	1844.53	1930.96
Farming	344.59	799.44	833.93	1056.5	1097.71	1159.56
Forestry	7.53	13.52	22.44	34.13	45.77	54.97
Animal Husbandry	96.81	127.81	207.35	271.08	283.6	265.58
Fishery	7.11	15.69	26.95	36.34	42.52	41.19
Industry	9.15	13.63	52.67	58.65	61.13	68.49
Construction	12.18	34.53	46.73	49.56	47.12	53.18
Transport, Post and Telecommunication Services	13.45	27.76	63.63	72.9	84.19	88.21
Wholesale and Retail Trade and Catering Services	12.69	34.26	78.54	94.07	108.55	118.15
Social Services	6.55	17.18	28.09	31.26	32.61	35.14
Culture, Education and Health Care			6.86	8.35	10.13	12.50
Others	8.49	41.97	60.08	32.94	31.19	33.99
Transfer Income and Property Income	28.96	98.25	123.85	192.15	235.87	281.28

Source: China Statistical Yearbook (2007)

Table 9 - Basic Conditions of Rural Households in Eastern, Central Western and Northeastern Region (2006)

Item	Eastern Region	Central Region	Western Region	Northeastern Region
Per Capita Annual Net Income (yuan)	5188.23	3283.16	2588.37	3744.88
Wages Income	2484.49	1256.47	795.92	902.63
Household Business Income	2251.77	1869.54	1588.76	2435.23
Property Income	188.41	43.35	56.92	156.58
Transfer Income	263.55	113.80	146.77	250.44
Living Expenditure (yuan)	3806.23	2559.88	2192.08	2781.14
Food	1542.15	1151.37	1019.44	1043.43
Clothing	218.79	153.34	125.95	210.37
Residence	672.99	392.37	347.49	482.24
Household Facilities, Articles and Services	178.34	116.27	95.41	96.93
Transport, Post and Telecommunications	428.87	237.82	204.17	297.11
Cultural, Educational and Recreational Articles and Services	430.88	284.67	206.74	322.23
Medicines and Medical Services	245.29	163.45	152.18	258.89
Other Commodities and Services	88.93	60.59	40.73	69.94

Source: China Statistical Yearbook (2007)

ANNEX 3 - RCCs' ownership reform

- ❖ In regions where cities and villages have a great unification, the RCCs are big scale, there is little demand of support for rural economy, and the management is commercialised, we can create rural commercial banks or rural cooperative banks.

Condition for creating rural commercial banks

- Strong management capability;
- The total assets are more than 1 billion yuan;
- NPL ratio is less than 15%;
- The registered capitals are no less than 50 million yuan;
- Adequacy capital ratio reaches 8%.

Condition for creating rural cooperative banks

- There are at least 1 000 sponsors;
- NPL ratio is less than 15%
- The registered capitals are no less than 20 million yuan;
- Core capital adequacy ratio reaches 4%.

- ❖ In populous cities/counties, or counties/cities as the commercial bases of grain, cotton, we can create only one legal entity based on RCCs and RCCU at county/city level.

Condition for creating only one legal person based on RCCs and RCCU at county/city level

- The assets are equal to the liabilities for all of RCCs in this region;
- The RCCs are voluntary;
- The RCCU at county/city level has relatively strong management capability;
- The registered capitals are no less than 10 million yuan (They can be adjusted with CBRC's authorization);
- Adequacy capital ratio reaches the criteria.

- ❖ In other regions, we can maintain a system of 2 levels, i.e. RCCs and RCCUs at county/city level

- ❖ RCCs which have a big risk will be restructured and/or amalgamated. The RCCs whose assets are less than liabilities, and which are located in cities or suburbs of cities, and which have little demand of support for rural economy, will be revoked, according to "norms of revocation of financial organisms" (effective from 15/12/2001).

The reform of RCCs in poor and distant regions is the most difficult, it's the major point in this reform.

Abbreviations and Acronyms

AAIC	Shanghai Anxin Agricultural Insurance Co. Ltd
ABC	Agricultural Bank of China
ADBC	Agricultural Development Bank of China
BOC	Bank of China
CBRC	China Banking Regulatory Commission
CCB	China Construction Bank
CDB	China Development Bank
CIRC	China Insurance Regulatory Commission
CPSRB	China Post Savings and Remittance Bureau
DCE	Dalian Commodity Exchange
FAO	Food and Agriculture Organization
FPC	<i>Fu Pin</i> Community (Poverty Alleviation Community)
ICBC	Industrial and Commercial Bank of China
NBS	National Bureau of Statistics
NPL	non performing loan
PBC	the People's Bank of China
PICC P&C	the People's Insurance Company of China Holding Company, Property and Casualty Company Limited
PSBC	Postal Savings Bank of China
RCCs	Rural Credit Cooperatives
RCCU	Rural Credit Cooperative Union
RLCs	Rural Loan Companies
RMCs	Rural Mutual Cooperatives
ROSCA	Rotating Savings and Credit Association
SMEs	small and medium sized enterprises
SOCB	State-Owned Commercial Bank
TVBs	Township and Village Banks
TVEs	township and village enterprises
UCC	Urban Credit Cooperative
WTO	World Trade Organization
ZCE	Zhengzhou Commodity Exchange

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