Rural Financial Services: Supply

The suppliers of rural financial services in Guizhou include institutions such as RCCs, ABC and ADBC, and postal savings. In recent years, postal savings in Guizhou have accelerated the outflow of funds, many RCCs have had to operate with PBC on-lending, and ADBC has been reducing the amounts of loans. Although ABC outstanding loans exceed outstanding deposits, the increase in loans is less than the increase in deposits, and its loans are mainly for infrastructure. Since 2001, even most poverty reduction loans have been directed to project lending. Without considering government transfer and remittances from migrant workers, Guizhou suffers from a large outflow of funds, from heavy losses by rural financial institutions, and from a government-supported microfinance scheme and poverty reduction on-lending program that have become the major funding sources. In other words, the rural financial system has entered a vicious cycle.

Rural Financial Institutions

Postal Savings Office

Postal savings deposits have expanded rapidly in recent years in Guizhou. From 2000 to 2003, total deposits increased from CNY4.5 billion to more than 8.8 billion, of which deposits below the county level (townships and villages) increased from CNY846 million to around CNY2.2 billion (Table 19). In the PRC as a whole, postal savings below the county level accounts for around 60% of the total. Compared to those in more developed provinces, the network of postal savings offices in Guizhou is relatively small with 548 branches, and the farmers are relatively poorer resulting in around 20% of postal savings below the county level. However, the rate of increase is high with added savings ranging from CNY371 billion to CNY571 billion per year. The added deposits of postal savings are roughly equivalent to added deposits of RCCs.

RCC

With 85 branches and around 2000 outlets, RCCs have more than more than doubled total deposits and loans in Guizhou during the period 2000-2003. Deposits increased from CNY9.17 billion to CNY21.7 billion for a net increase of CNY12.5 billion, and rural loans grew from CNY4.41 billion to CNY9.80 billion for a net increase of CNY5.39 billion. It is also clear that loans to township and village enterprises (TVEs)[6] increased moderately from CNY764 million to CNY1,012 million yielding a net increase of CNY248 million. This shows that TVEs in Guizhou are less developed and have low levels of industrialization. Part (40%) of the increase in loans was from PBC on-lending, which increased from CNY531 million to CNY2.48 billion. The importance of PBC on-lending varied, however, with some districts almost completely dependent on it for funding.

[6] Township and village enterprises are those enterprises established by town or village governments.

The amount of medium- to long-term loans from RCCs was less than 10% of the total at CNY433 million in 2000 and CNY1,072 million in 2003 (Table 20). In fact, Guizhou lacks financial institutions that offer medium- and long-term loans for agriculture and agricultural projects. ADBC provides all grain procurement loans which are short-term, and only ABC and the Construction Bank of China are willing to provide medium- and long-term loans to government-guaranteed state projects.

Table 19. Deposits Outstanding: Postal Savings in Guizhou

(Year-end figures, in CNY10, 000)

Item	2000	2001	2002	2003	September 2004
Number of Branches	548	548	548	548	548
Deposit	452,278	594,141	716,185	887,078	1,007,352
Of Which:					
Below the County Level	84,623	121,741	158,535	215,699	266,055
Increase		37,118	36,794	57,164	50,356

Table 20. Deposits and Loans Outstanding: Rural Credit Cooperatives in Guizhou

(Year-end figures in CNY10, 000)

Item	2000	2001	2002	2003
Number of Branches	85	85	85	85
Number of Outlets			2111	2001
Total Deposits	917,450	1,145,212	1,779,600	2,168,884
Total Loans	711,722	921,851	1,254,961	1,485,934
Short-Term Loans	668,423	862,530	1,163,717	1,378,580
(1) To Rural Households	441,034	579,532	838,891	980,251
(2) To TVEs	76,442	89,360	92,003	101,237
Mid-/Long-Term Loans	43,299	58,912	91,164	107,246
PBC On-Lending	55,130	113,714	240,000	248,068

Table 21.
Loans Outstanding: Agricultural Development Bank of China in Guizhou

(Year-end figures, in CNY10, 000)

Item	2000	2001	2002	2003
Number of Branches	56	56	56	56
Total Loans	663,913	627,113	594,055	585,510
1. Short-Term	657,097	620,837	588,360	580,484
for Procurement	655,935	618,719	584,864	577,001
2. Mid-/Long-Term Loans	6,816	6,276	5,695	5,026

Agricultural Development Bank of China

The total amount of loans outstanding has been decreasing for ADBC although the total number of branches remains at 56. In 2000, the amount outstanding was CNY6.64 billion (Table 21); three years later, this figure decreased by CNY784.3 million to CNY5.855 billion of which medium- and long-term loans accounted for a small but dwindling portion falling from CNY68.2 million in 2000 to CNY50.3 million in 2003.

Agricultural Bank of China

With the acceleration of commercialization in recent years, the operations of ABC have been moving towards big cities and large projects. This is shown in reduced number of outlets, increased lending for medium- and long-term state projects and reduced lending for agriculture and TVEs, in other words, reduced lending to rural areas (Table 22). Even poverty reduction loans have been directed to project loans. Combined with the lending structure of RCCs, we can see that total lending to TVEs is low reflecting the economic structure of Guizhou. With the reduction in ABC lending except for projects financed by state debt, the repayment ratios dropped from 90.26% in 2000 to 76.32% in 2001 and to 78.18% in 2002.[7] In 2003, ABC's repayment ratio of 69.84% in Guizhou was the third lowest among those of all provinces in the country.

In terms of the total rural credit supply from financial institutions, it is a commonly held view that there are large outflows of funds from rural, especially poor, areas. This is not the case in Guizhou where the inflow of funds is far larger than the outflow after accounting for government transfer and remittances of migrant workers. Data from the National Statistics Bureau show that in 2003, total fiscal expenditures in Guizhou were CNY33.24 billion, 2.7 times the total fiscal revenues of CNY12.46 billion that

Table 22. Deposits and Loans Outstanding: Agricultural Bank of China in Guizhou

(Year-end figures in CNY10, 000)

Item	2000	2001	2002	2003
Number of Branches	78	77	84	90
Number of Outlets	598	509	452	394
Total Deposits	2,100,100	2,442,900	3,017,900	3,633,100
Total Loans	3,141,388	3,405,366	3,658,478	4,249,191
Short-Term Loans	1,474,722	1,273,445	1,307,680	1,351,683
(1) Industry	94,625	100,429	168,446	277,960
(2) Agriculture	81,777	70,332	64,153	60,807
(3) TVEs	68,069	66,529	61,891	61,487
Mid- Long-Term Loans	1,562,855	1,999,555	2,278,857	2,591,200
(1) Infrastructure	293,343	420,025	475,153	732,683
(2) Technology Improvements	98,608	138,700	132,719	118,072
(3) Others	1,170,904	1,440,830	1,670,985	1,740,445

[7] Repayment ratio is calculated as the ratio of total amount of payment on time to the total amount of payment due.

year, indicating a net fund inflow of more than CNY200 billion through fiscal transfers. Even if we assume that all fiscal transfers were used at the county level and above, that leaves a huge inflow of funds below the county level. The major channels of the flow include loans from ADBC and on-lending for agriculture from PBC. In terms of flow, loans from ADBC are shrinking, while on-lending from PBC is increasing from CNY0.5 to 1 billion per year. In terms of stock, the total amount of outstanding loans of ADBC stood at CNY5.86 billion in 2003; these are all net inflow because ADBC does not take deposits. In the same year, total on-lending from PBC was CNY2.48 billion, which yields a total inflow of CNY8.34 billion when added to the ADBC figure.

In rural areas, the outflow of funds also has three channels: the gap between deposits and loans in ABC and other SOCBs, in RCCs, and in postal savings. From December 2000 to September 2004, the total amount of postal savings outstanding in the province more than doubled, of which incremental savings below the county level also more than doubled. Even so, total postal savings outstanding below the county level was CNY2.16 billion as of end 2003, and the gap between deposits and loans in RCCs was 6.8 billion given their total amount of outstanding loans of CNY14.8 billion. The gap between deposits and loans in ABC in Guizhou was very small. Without taking into account the gaps between deposits and loans in other SOCBs, the total outflow of funds from postal savings, RCCs and ABC was around CNY9 billion.

This preliminary assessment shows that the total inflow of funds in this period was more or less equivalent to the outflow of funds in terms of stock. Considering that SOCBs other than ABC have net outflows of funds, the outflow from all financial institutions should be larger. However, the direction of the flow could reverse after taking into account remittances from migrant workers. It was estimated that total annual remittances from migrant workers in Guizhou were around CNY8 billion, indicating that even with large outflows from financial institutions, the total inflow of funds should be greater than the outflow. Claims of funding shortages in the rural areas of Guizhou are therefore due to the lack of profitable investment opportunities and to inefficient credit allocation mechanisms.

Government-Supported Rural Financial Services

Rural Credit Cooperative Microfinance Loans

PBC initiated microfinance loans in 1999 using on-lending for agriculture to support RCC operations. This section analyzes the sustainability of microfinance loans of RCCs using panel data from 1999 to 2003 that includes deposits, loans, and key financial performance indicators from 48 RCCs in Fenggang, Danzhai, Dafang and Zhijin (data from the other two counties were not available).

Table 23 shows that between 1999 and 2003, the deposits and savings of RCCs increased rapidly while microfinance loans to rural households without collateral increased at an even faster pace. Specifically, growth rates were higher from 1999 to 2002 but declined in 2003. The ratio of microfinance loans to outstanding RCCs loans increased from 22.5% in 1999 to nearly 40% in 2003. That indicates that the proportion of microfinance loans without collateral in poverty-stricken rural areas kept growing. Because of the rapid increase in loans, no provisions for future NPLs were made as it takes a year or more to see whether any NPLs emerge; therefore financial indicators could not correctly reflect real financial performance.

Table 23. Key Performance Indicators of Rural Credit Cooperatives

(Year-end data in CNY10, 000 unless otherwise specified)

	1999	2000	2001	2002	2003
1. Outstanding Loans Rural to Households	221	327.5	371.2	599.7	705.7
Growth Rate (%)		48.3	13.1	61.6	17.7
2. Outstanding Microfinance Loans to Rural Households	50	76.7	138.0	244.9	279.0
Growth Rate (%)		54.5	80.0	77.4	13.9
3. Outstanding Microfinance Loans / Outstanding Loans to Rural Households (%)	22.5	23.4	37.2	40.8	39.5
4.Total Deposits	274	340.6	467.5	644.7	769.4
Growth Rate (%)		24.1	37.3	37.9	19.3
5. Loans to Rural Households / Deposits (%)	80.5	96.2	79.4	93.0	91.7
6. PBC On-Lending	13	45.6	88.7	158.0	176.6
Growth Rate (%)		248.2	94.5	78.1	11.8
7. Nonperforming Loan Ratio (%)	59	61.0	65.9	37.6	34.4
8. Owner's Equity	-14	-11.5	-27.9	-10.8	6.8
9. Annual Net Profits	-96,589	19,708	-33,166	46,433	-120,671

Note: Nonperforming loans are all loans with payments overdue.
Net profits are income after tax minus operational expenditures without considering provisions for nonperforming loans.

RCC microfinance loans without collateral differ from microfinance loans piloted in the PRC under the Grameen model in terms of interest rates, gender of the clients, and repayment schemes. First, the interest rates on RCC microfinance loans were lower than the interest rates charged by RCCs on other loans, which are also much lower than the interest rates charged by other grant-supported microfinance projects. Note that the interest rates of microfinance loans under the Grameen Model, not subject to PBC regulations, are normally between 15-20%, while those of RCC microfinance loans are below 10%. Second, the Grameen model prefers to extend loans to women while the microfinance loans extended by RCCs on a creditworthy basis mainly target heads of households more than 95% of who are males. Third, Grameen ensures high repayment with frequent installments and group guarantees while RCC loans have a single repayment on the due date.

The microfinance loans of RCCs have large coverage, but RCCs have limited staff. In 2003, an average RCC staff of 4 to 5 had to serve 9,272 rural households in areas with 100.4 households per square kilometer (around 400 people). As required by regulatory authorities, RCCs conducted household creditworthiness evaluations using rating committees consisting of RCC staff, village officials, and RCC members; village officials played an important role. However, the fact that evaluations are conducted once every 2 years has undermined their value. Moreover, the evaluations lack a scientific, uniform system.

For the 148 rural households with credit lines and loan certificates in 2003, the average loan size was CNY4, 756 and the maximum was CNY20, 000, far exceeding the typical initial credit line of CNY1, 000 under the Grameen model pilot projects in the PRC. More importantly, the ratio between rural household credit and its expected annual cash income was 107%. With excessively high credit lines and without a loan repayment incentive system, the default rate for microfinance loans without any collateral will inevitably be high.[8] Microfinance loans without collateral began in land and loan markets in rural areas where land ownership was not clearly defined and where formal financial institutions set the interest ceiling on loans. The initial objective of this product was to encourage RCCs to extend microfinance loans to rural households using PBC funds and charging low interest rates. However, if the product is not profitable under the current system, it cannot be sustained commercially.

There are three qualitative requirements for microfinance loans from RCCs in Guizhou: they should go to rural households, the amounts should be small, and they should be based on creditworthiness. These criteria by their very nature can help mitigate risks. From a macro point of view, highly diversified loans can diversify risk and can reduce overall operational risks. Experience in microfinance operations shows that risks still exist. Inaccurate credit ratings for borrowers, neglecting the rural credit system, lax loan management, excessive pursuit of speed in operations, and oversupply of a single microfinance product will lead to large volume of NPLs in circumstances where there is no agricultural insurance. The result would be similar to what happened with loans to TVEs in the mid-1990s. [9]

Our survey shows that the RCC loan officers regard microfinance loans as unworthy because of their small scale and because they carry no collateral or guarantee. In comparison, guaranteed or collateralized loans are more sustainable. Many RCC credit officers think that their microfinance operations incur high operational risks, agricultural risks, and other risks from sources such as natural calamities. The operational costs are relatively high because of the small lending scale and scattered clients. RCCs therefore prefer enterprise loans to microfinance loans because of the interest rate differences between the two. Even though PBC controls RCCs' lending directions and percentages of microfinance loans as requirements for obtaining on-lending for agriculture, these may not sustain microfinance loans.

Many factors discourage microfinance lending by RCCs. It is not cost-effective for RCCs because of (i) its small scale, (ii) the large numbers of transactions, (iii) the large numbers of clients, (iv) difficult transportation conditions in rural areas, (v) manual operations, (vi) the low efficiency of RCCs, and (vii) heavy workloads for RCC staff. Furthermore, RCCs do not have sufficient human resources for microfinance operations as most of them suffer from serious shortages of credit officers. In addition, the technical design of microfinance loans cannot meet the demands for credit and other financial services.

Presently, the effective interest rate of RCCs loans to rural households has reached its ceiling of 10.28%, doubling the base rate of 5.14% per annum. In other words, even if the maximum interest rate is charged, it is still difficult for commercialized financial institutions to recover their costs because of small loan amounts, high risks, and consequently high lending costs. The 100% upward float margin is not large enough for RCCs to recover their costs. Our survey found that the effective interest rate on microfinance loans to rural households has reached 15% per annum through imposing interest penalties, deducting interest in advance, and compulsory shareholding requirements. The only way to transform rural credit loans from a government requirement to a valued RCC product is to improve the design of microfinance credit loans, liberalize interest rates, and make loans to rural households profitable.

[8] In the short run, significant amounts of microfinance loans without collateral can improve loan quality and financial performance indexes.

[9] Many TVEs went bankrupt in mid-1990s under the competition arised from the emergence of private enterprises, the entry of foreign-owned enterprise, the reform of state-owned enterprises. This has left rural financial institutions with huge amount of non-performing loans.

Poverty Alleviation Loans

Poverty alleviation loans counted for more than half of the state's poverty alleviation funds. They were established to support economic development in core poor areas and to lift poor rural residents out of poverty. These policy-oriented loans are managed by government-appointed financial institutions and receive interest subsidies through fiscal transfers. The most recent poverty alleviation loan policy is the "Implementation Regulation of Poverty Alleviation Interest-Subsidized Loan Management" jointly issued by PBC, the Ministry of Finance, and the State Council Leading Group for Poverty Alleviation and Development Office (PADO) in 2001. The regulation specifies the following.

(i) The major funding source is ABC deposits; the remaining can be financed from PBC on-lending.

(ii) Relevant commercial banks (i.e., ABC) shall select projects and disburse loans inaccordance with credit regulations.

(iii) The scale of poverty alleviation loans was changed from government planning to window guidance.[10]

(iv) Poverty alleviation loans include project and household loans.

In practice, ABC has few choices for making household loans as it normally selects clients from the project pool made from lists provided by local PADOs. By the end of 2000, outstanding poverty alleviation loans stood at CNY70.5 billion; by 2001, at CNY79.2 billion; and by 2003, at CNY96 billion with interest subsidies of CNY620 million.

Of the 592 poverty-stricken counties recognized by the central government, 48 (8.1%) are in Guizhou. Because of the conflict between the objectives of a poverty alleviation loan and those of a commercial bank, the loans from ABC to rural households have been decreasing since May 1998. Although ABC is given a subsidy by the central government to cover the difference between interest on poverty alleviation loans and standard loans, it manages the poverty alleviation loans in accordance with commercial standards. With the commercialization of SOCBs, the operational focus of ABC has shifted from rural areas, counties, and towns to cities. In the process, it has closed and merged some small, loss-making offices with small transaction volumes and weak management in an effort to streamline its organizational structure and to reduce staff to cut costs and increase efficiency. Offices in poverty-stricken areas are most likely to be closed and their staff dismissed. Fewer offices and employees will make it more difficult for ABC to continue offering poverty alleviation loans, especially microfinance loans to poverty-stricken households. From 1995 to 2001, ABC cut more than 13% of staff and 34% of branches, most of which were in rural areas.

Interest-subsidized poverty alleviation loans are mainly provided to support the aquaculture businesses of poor households. These loans are subject to strong seasonal sensitivity, tight processing schedules, large numbers of transactions, large numbers of borrowers, and small loan sizes requiring sufficient institutional and human resources. For instance, of the 874 townships in the 48 poverty-stricken counties in Guizhou, fewer than 200 have ABC offices, and each office has only two or three credit officers who have to disburse poverty alleviation loans and manage daily operations in four to five townships. Day-to-day loan management is totally neglected when the county RCC staff are called to help gather rural households during the poverty

[10] Suggestions of the authority to the institutions under supervision; they are not compulsory.

alleviation loan disbursement period. The ABC branch in Changshun County has 13 loan officers covering 23,000 clients, which is nearly impossible because it normally takes several days to visit each client in an average village of 100 households.

To ensure that poverty alleviation loans reach rural households, local governments and PADOs required that 85% of these loans be allocated to core poor counties and that 85% of their funds go to poor households. In addition, the maximum amount per loan is set at CNY50,000, with most below CNY2,000. This small scale coupled with the large amount of retail lending in geographically scattered poor households has added to already high operating costs. In 2000, the rocky roads shortened the life of a four-wheel drive vehicle used for developing poverty alleviation loans by ABC's Libo County branch. For the Guizhou branch of ABC, the costs for processing CNY1 million worth of poverty alleviation loans was CNY58, 500 which was CNY39,000, or nearly 60% higher than that of other types of loans. In other words, the cost of disbursing poverty alleviation loans was 5.85% or 3.9 percentage points higher than that for other products. Taking into account the costs of funding, management, and repayment, the operating costs of poverty alleviation loans exceed 10%, even without considering NPLs. ABC gauged that average costs of processing and managing poverty alleviation loans is 7% of the loan amount. Even if interest is paid in full and the interest subsidy is received on time, this business is still a loss-making one.

Funding is another issue. Funds for poverty alleviation loans are provided by ABC; the government provides only interest subsidies. Because these loans mainly target deprived counties where ABC has more loans than deposits, these ABC offices have to request funds from other ABC organs. The prevailing inter-bank lending rate within ABC is 4.32% per annum, while the interest rate on poverty alleviation loans is 3%, plus the government subsidy of 5.85 or 5.94% (after the increase in the PBC base rate). This implies that if funds are borrowed from higher-level ABC branches, the county branch will incur a net loss of 5.38-5.47%[11] per year for disbursing poverty alleviation loans even without considering expenses for processing, management, and repayment. Currently, ABC's management system for poverty alleviation loans is the same as that for regular loans, and the evaluation system for the branches and their managements is also the same. This naturally leads to low incentives for local ABC offices to process poverty alleviation loans.

Local governments have intervened excessively in disbursing poverty alleviation loans, and a large number of household loans have been made in some areas where those loans are not suitable. For making poverty alleviation loans to rural households, ABC generally uses the client list provided by the local PADO. It has neither the ability nor the means to examine whether borrowers meet the lending criteria or to manage the loans on a daily basis.

In some places, the government even requires ABC to provide loans to projects with outdated techniques, low levels of technology, and limited competitiveness. By the end of 2000, over 85% of ABC loans to processing enterprises in impoverished counties in Guizhou were nonperforming. In addition, many local governments emphasize only the disbursement of poverty alleviation loans but neglect the management and servicing of the loans and support and education of borrowers. There is a widespread misconception among local officials and borrowers that poverty alleviation loans are public funds that do not need to be repaid. Some local governments view poverty alleviation loans as public aids and distribute them freely, at times even to the deceased. In some places, the local governments take advantage of the loans and use them to collect various taxes and charges.

[11] Loan processing and managing costs (7%) plus fund opportunity costs (4.32%) minus government subsidy rates (5.85% - 3% = 2.85%, or 5.94%-3%=2.94%).

All these problems have, to various extents, undermined the incentive of local ABC branches to process poverty alleviation loans. By the end of 2001, the cumulated nonperforming poverty alleviation loans of ABC reached CNY32.82 billion, equivalent to 41.4% of the total. Our data also show that the value of outstanding interest-subsidized poverty alleviation loans in Guizhou was CNY7.76 billion by October 2001, of which CNY3.26 billion, or 42%, were nonperforming. For household loans, the repayment ratio (number of loans / number of loans paid in time) was a mere 21%. Since 2001, ABC has stopped its special evaluation of poverty alleviation loans and has started to combine it with the evaluation of other types of loans. This has linked employee remuneration to loan performance, strengthened the accountability for NPLs, and strengthened the assessment of poverty alleviation loans. This has also seriously affected ABC branch incentives for processing poverty alleviation loans and has exposed related problems.

Since 2001, ABC has instead made commercial loans for infrastructure construction using poverty alleviation funds. Of ABC's close to CNY10 billion for poverty alleviation loans in Guizhou, only CNY400 million have been extended to rural households. Some local governments and other SOCBs have expressed serious concerns about this.

Issues in Rural Financial Markets

The major obstacle to rural finance reform originates in the traditional financial system in the PRC which is designed to use cheap credit to support agricultural production through ABC and RCCs. Such a system consists of highly centralized institutions with structures similar to government agencies. Because of these monotypic institutions, rural financial markets lack competition, and demands for diversified financial services cannot be met. Furthermore, government credit supplies cannot reverse large outflows of funds from rural areas or relieve the difficult access to credit of farmers. At the same time, the "reform" of rural financial institutions under senior management that makes decisions without even consulting shareholders has diverted loan decision making from the interests of rural households.

Lack of Competition in Rural Financial Markets

Rural finance reforms since 1996 have failed to enhance competition in rural credit markets; on the contrary, ABC has been withdrawing from poor rural areas, and other competitors of RCCs such as agriculture credit foundations and informal finance providers have been closed by the government. This has strengthened RCC's monopoly in rural credit markets which naturally inhibits efficiency. With the dwindling number of ABC branches in townships, the narrowing of the scope of operations of ADBC for loans for procurement of grain, cotton and edible oil, and the abolishing of rural credit foundations, RCCs have been forced to play the role of primary credit providers in rural financial markets. However, the conflict between such duties and the capability to perform was soon revealed. Because of the large volume of accumulated NPLs, the controlled interest rate regime, and the low operational efficiency in certain regions, RCCs still suffer huge losses despite their status as monopolies. The losses are especially heavy for RCCs in the central and western regions of the PRC which makes them unsustainable as the only service provider in the rural financial market in the long run.

Monotypic Institutions are Unable to Meet Diversified Demand

One consequence of the lack of competition in rural financial markets is that the monotypic rural financial system cannot cope with the differences in services demand among the eastern, central, and western regions. A system with the RCC as the sole player cannot meet the demands from farmers and enterprises in different regions. With the development of local economies and urbanization, demands for financial services have been evolving. Moreover, different economic structures in different areas have also produced different demands for financial services. However, with their similar operational structures, lending modes, internal management and incentive systems, RCCs are unable to meet these demands in a timely fashion.

Government Credit Inputs are Unable to Reverse Outflows of Rural Funds or to Increase Farmers' Access to Credit

Since the mid-1990s, the sluggish and volatile nature of agricultural product prices, the low productivity of small-scale, self-sufficient rural households, and the large number of closures of township enterprises have contributed to the lack of investment opportunities in rural areas. This has forced many farmers to migrate to other provinces. The earnings of these farmers are remitted back to the rural financial institutions in their hometowns but then flow to the eastern and more developed regions through purchases of Treasury bonds by these institutions and deposits in their upper-level organs. The end result is that the agricultural sector, rural areas, and farming households cannot obtain sufficient funds, and rural economic development enters a viscous cycle.

Rural funds flow out through three channels: SOCBs, postal savings, and RCCs. SOCBs have shrunk their branch networks and tightened credit controls. Most county and lower-level offices of the four SOCBs are required to redeposit funds in their upper level organs. Postal savings enjoys very high redeposit interest rates at PBC which translates into a hemorrhage of rural funds into other areas. In addition, many RCCs purchase Treasury bonds, deposit funds in other financial institutions, and lend to urban clients, all of which mean additional outflows.

Most rural households, especially rural SMEs, have difficulties accessing credit. With commercialization, ABC has abandoned some branches and merged others. The mode and means of RCC services cannot meet the demands of rural households and rural economic development. Although RCCs have increased microfinance lending to rural households, loans to rural SMEs have been shrinking significantly. In addition, because microfinance loans largely depend on PBC on-lending for agriculture, they carry high transaction costs and small loan sizes. With the fixed interest ceiling, RCCs can hardly sustain their microfinance operations in the long run. In many central and western provinces, loss-making RCCs are unable and unwilling to lend to rural households, while PBC on-lending for agriculture is too small compared with the demand for credit, forcing farmers to depend on borrowing from relatives, friends, or informal sources. The government's poverty alleviation loans through ABC can hardly accommodate rural households, while their persistently high NPL ratio has undermined poverty reduction objectives.

It is impossible to solve the problem of outflow of rural funds and to ease the difficulties in accessing credit in rural areas with PBC on-lending and poverty alleviation loans, both of which are fiscal in nature. Key factors widening the gap between urban and rural areas are their access to fiscal funds, investments from national and local governments, and the different returns on investment in various regions. Although support for *san nong* is important, the function of finance cannot replace the function of fiscal policy. In the past, the central and local governments have misconstrued finance, making it shoulder too many fiscal functions. This has resulted in huge losses, shrinking rural financial services, increasing outflows of rural funds, and serious moral problems.

Reformed Rural Financial Institutions under Insider Control have Increasingly Alienated their Lending Policies from the Interests of Farmers

The advantages of local rural financial institutions lie in their access to local information that can lower costs of monitoring clients and reduce asymmetry in information. However, with no significant changes in ownership arrangements and governance structures of rural financial institutions, the reforms remain under the control of RCC management that benefits from the current system.[12] With weak governance, risk control can only be strengthened by administrative measures, i.e., through concentrating decision-making power. This is done in ABC by depriving lower-level branches of decision-making power for loans and in RCCs through concentrating decision-making power for lending and treasury functions to rural credit cooperative unions (RCCUs). Nevertheless, concentrated decision-making power can hardly solve the problems of asymmetric information and timely responses to changes in demand.

Past reform has not fundamentally changed the basic rural finance structure in the PRC. First, the government still controls rural finance. The commercialization of financial institutions has been limited by both lending policy and low interest rates. Second, the market structure has not changed as RCCs still dominate rural financial markets. Third, the performance of financial institutions has not fundamentally improved. This represents a sharp contrast with the robust economic growth, particularly rural economic growth, of the past two decades.

Comprehensive rural finance reform has become imperative. The traditional rural financial system has contributed to rural economic growth, but financial resource “overdrafts” from rural areas can hardly be sustained. The delay in reform has hampered the ability of rural finance to support the rural economy, and its inefficiency will obstruct rural economic growth.

Lack of an enabling operation environment for development of rural financial institutions

There are insufficient risk sharing mechanisms for rural loans. The waning agriculture insurance, preliminary futures market for agricultural products, and various legal and policy constraints have prevented rural financial institutions from efficient substitutes for collateral and guarantee. At the same time, rural financial institutions have few incentives to resolve the difficulties in collateral and guarantee through financial innovation. Moreover, the sustainable development of these institutions is also hampered by the “cookie-cutter” tax policies, and the constroled interest rates.

[12] Under the current system, RCC management assumes little responsibility for RCC performance.