

Executive Summary

In recent years, the extensive losses of rural financial institutions and farmers' increasing difficulties in getting loans have inspired people to reflect on the following questions. What are the real effects of government-subsidized microfinance loans provided by rural credit cooperatives (RCCs) and the poverty alleviation loans of the Agricultural Bank of China (ABC)? What is the coverage of RCC microfinance loans? Have such loans met the demands for credit of rural households? What is really needed in rural finance, an ample supply of funds or a good funding mechanism? Can the rural financial system meet the demands of the Chinese rural economy in transition? Is the current supervisory framework for RCCs effective?

In July 2004, with technical assistance funding from the Asian Development Bank (ADB), a large-scale field survey was conducted in six counties in Guizhou Province—two relatively well off, two average, and two very poor. The survey targeted ABC, the Agricultural Development Bank of China (ADBC), RCCs, and rural households. The survey of ABC, ADBC, and RCCs was done by the county branches of the People's Bank of China (PBC), and the survey of rural households (about one thousand) was done by the rural survey teams of county statistical bureaus. The main objective of the surveys was to examine the demand for financial services from rural households, the extent to which their demands have been met, and the uses of financial supplies of rural financial institutions. Understanding all of these is critical in designing reform programs for RCCs and rural finance.

Some conclusions can be drawn from the initial

analysis of the survey data. First, poverty-stricken areas are in need of funds but are in even greater need of efficient financial mechanisms. The earnings of many farmers working in other provinces are remitted to the rural financial institutions in their hometowns, but those funds flow back to the eastern and more developed regions through the purchase of Treasury bonds and deposits in upper-level organs by these institutions. The survey indicates that it is not sustainable for RCCs to use PBC on-lending¹ for agriculture to provide microfinance loans because of the lack of institutional guarantees and because ABC's poverty alleviation funds have disrupted financial market order. For many RCCs, funds are not the problem; rather, the lack of an efficient credit allocation mechanism is. An efficient mechanism will enable RCCs to make good use of idle money and will attract investors. Therefore, current reforms should first establish an efficient mechanism to attract funds and should then use a sustainable mechanism to keep the funds in the province.

Second, poverty-stricken areas should explore new ways that rural financial institutions can fit into local circumstances. A large portion of rural household borrowing in Guizhou is from friends, neighbors, and relatives. RCC performance indexes such as expenses per employee, nonperforming loan ratios, and rural household coverage demonstrate that the current RCC model is very expensive and is too costly for impoverished areas. A less expensive form of financial organization more suitable for deprived areas should be explored.

¹ Funds that are lent to financial institutions and are then to be used explicitly for new loans.

In fact, with commercialization, ABC has closed some loss-making branches, and RCCs have closed branches in remote, poor areas in Guizhou or withdrawn their power to authorize loans. Many villages are not far away from RCCs and postal savings offices,² but it takes hours to travel in mountainous areas. Some householders have to walk a long way to get financial services. It is the limited coverage of the formal rural financial institutions—the RCCs—that gives rise to usury in some remote areas. Sole reliance on formal financial institutions for services not only means high cost but also means a great deal of inconvenience for farmers in many areas.

Third, the single RCC model cannot meet diversified rural finance demands. On one hand, RCCs do not have sufficient funds to meet the credit demands of households with large-scale aquaculture businesses. On the other hand, RCCs are short of staff to cover poor households scattered in widespread areas that are large in number but have small demands thus resulting in high transaction costs for RCCs.

Fourth, public finance has to play its proper role in poor areas to enable rural finance to operate in a normal manner. Guizhou does not have a sound rural social security system or a reliable rural cooperative health system, so many RCC loans are used for medical care that should have been covered by public finance. In such circumstances, RCCs are bound to make losses. The rural household survey shows that children's education, agricultural production, and house construction are the most frequent uses of funds, and that the extension of credit is closely linked with the ability to pay debts. Although short-term returns on education are meager, it is essential for households to invest in education for the good of the country. Therefore, the government should invest more in primary education in poor areas and should provide public goods such as a rural social security system. These will help to sustain rural financial systems in

deprived areas.

Fifth, in RCC reform, a top-down approach should be combined with a bottom-up approach. Guizhou's practices have illustrated that many low-cost financial innovations exist; the key is how current RCC pilot programs can draw on them.

Analysis of the Guizhou survey leads to the following policy recommendations.

- Reform of rural finance cannot succeed with only isolated RCC reforms. The country's economic development calls for diversified rural financial institutions and systems.
- At the heart of rural finance reform is breaking the monopoly of the RCCs on the rural financial market, establishing a competitive, efficient market; and then implementing an appropriate supervisory framework. It is the market that will determine the organizational form of financial institutions.
- So far in the current pilot programs, RCCs have, with financial support from PBC, got rid of their historical burdens and have become financially healthy. To prevent RCCs from falling back to financial difficulties in future operations, their governance structure should be improved. For this, the following measures are suggested: (i) separate fiscal aids from commercial credit, (ii) open up rural financial markets, (iii) establish a deposit insurance system, (iv) take prompt corrective actions when the need rises, and (v) adopt a market-based interest rate regime.

² Postal savings offices are subsidiaries of the post office that accept deposits. They make no loans; they redepot the funds with the People's Bank of China.