Introduction

Enormous changes have taken place in the rural financial system of the People's Republic of China (PRC) following the commercialization of state-owned commercial banks (SOCBs) that began in the mid-1990s and the restructuring of their ownership initiated in 2003. The increasing differences in regional economic structure have led to changes in rural finance supply and demand in different regions of the country. In the more developed coastal areas, demand for credit for nonfarm activities is soaring, leading to the convergence of rural and urban finance. In the central region, noncropping activities such as aquaculture and agricultural processing are becoming more important. As specialized production has become the major source of demand for credit, the trend of specialized rural financial supply has emerged. In the western region, credit is basically used for alleviating poverty and smoothing consumption. This is because of limited investment opportunities due to scarce natural resources, poor market conditions, and uncertain weather and other natural conditions.

Regarding the supply of rural financial services, the SOCBs have gradually withdrawn from rural areas, although the Agricultural Bank of China (ABC) maintains a large but dwindling branch network and manages poverty alleviation loans in many counties and townships. Rural credit cooperatives (RCCs) have become the dominant providers of credit, and in many places, the sole supplier. Meanwhile, because of limited funds for rural credit, agriculture-supporting on-lending[1] from the People's Bank of China (PBC) has become one major funding source in some places.

This report analyzes rural financial services in Guizhou Province which shares many similarities with other western provinces in the PRC. Because it was one of the provinces to undertake an RCC pilot program, RCC reform in Guizhou is ahead of other provinces in many ways. The pilot program will have an enormous impact on the future rural financial framework in Guizhou as well as on the capability of rural financial institutions to provide efficient, sustainable support to agriculture, rural areas, and farmers (*san nong*).[2] These will, in turn, have far-reaching impacts on developing local economies, enhancing the incomes of farmers, and establishing an all-around prosperous society. Moreover, these pilot programs will affect future rural finance reform programs in other, especially poor, provinces as well as the overall progress of financial reform.

The main objectives of this report are to (i) examine the current status of demand for and supply

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[1] The People's Bank of China (PBC) started to provide low interest agticulture-supporting on-lending in 1999 to encourage rural credit cooperatives to provide microfinance loans. The initial interest rate was 2.25% per annum, 0.99 percentage points lower than the base on-lending rate. The rate was adjusted to 3.24% per annum on 1 January 2005, the same as the base on-lending rate. The quota for the on-lending has been increasing over years, and reached CNY128.8 billion by the end of 2004. PBC decided not to increase the quota, but to adjust the geographic location of the on-lending from eastern to central and western, northeast, and grain-production regions. In fact, the total outstanding on-lending has been around CNY90 billion.

[2] *San nong*（三农）literally means three "nong". The word "nong" in Chinese is combined with other words to form phrases such as nongcun (rural villages or rural areas), nongmin (farmers or peasants), nongye (agriculture or agricultural industry).

of rural finance, (ii) identify existing issues and constraints, evaluate ongoing RCC pilot programs and emerging financial innovations, and (iii) explore suitable roadmaps for needed rural financial reforms and innovations. Building on this, the report provides policy recommendations for the development of a rural financial system in the 3- to 5-year term. Some of the views and recommendations are rather general and can be applied to other provinces while others relate to the special features of the Guizhou RCC pilot program.

From the point of view of development economics, poor areas are likely to be stuck in a poverty trap that is a vicious cycle of low levels of economic development, low per capita incomes, low savings rates, low investment levels, and a lack of dynamic for development. To break this cycle, a well functioning financial system capable of channeling internal savings and external funds into productive investment is necessary.

A new paradigm in development finance emerged in the 1980s. In this paradigm, to promote rural development and improve farmers' welfare it is critical to establish an efficient and commercially sustainable financial system and to provide timely, reliable, and convenient financial services for a wide range of economic activities. This requires that public funds for subsidizing interest rates and bailing out rural financial institutions be allocated to improving the profitability of farming (e.g., investment in education and infrastructure) which in turn improves the capacity of farmers to repay loans. This is a more efficient way for alleviating poverty that at the same time improves self-sustainability of rural financial institutions. Four elements are key to establishing such a paradigm and creating an enabling environment for an efficient rural financial market. They are (i) removal of interest rate controls, (ii) establishment of a proper supervisory framework, (iii) improvement of operational procedures and capacity building of institutions and human resources, and (iv) targeted government interventions and timely impact evaluation.

This report is drawn from a rural finance demand and supply survey in Guizhou and is formulated on this paradigm. We have integrated the essence of the speeches by PBC Deputy Governor Wu Xiaoling in her visits to Guizhou. The remainder is organized as follows. Chapter II provides a descriptive analysis of the demand of rural financial services in Guizhou, and Chapter III describes the supply. Chapter IV reviews and evaluates the RCC pilot programs as well as financial innovations. Policy recommendations are summarized in Chapter V. This report reflects only the views of the authors, not of the institutions in which we work.