X Rural Financial Market Development in the People's Republic of China: A Process of Planned Transition

In 1979, the PRC embarked simultaneously on two transitions: (i) from a centrally planned economy to a market-based economy, and (ii) a structural transformation from an agricultural-based to a nonagricultural-based economy. The transitions have not been smooth, but much has been achieved in a short time in the PRC compared with other transition countries. Real GDP per capita grew at an annual rate of almost 9 percent during 1980–1995 compared with 6.5 percent for Thailand and 3.5 percent for India.

The rural real GNP per capita in 1995 was 3.75 times that in 1978 when the transition began (Morduch, Park, and Wang, 1998). Although 70 percent of the population still live in rural areas, rural poverty is reported to have declined from 250 million people in 1978 to 58 million in 1996. The gross value of rural social output, an indicator of overall growth of the rural areas including agriculture, industries, commerce, and construction, grew by 9.3 percent annually in real terms between 1978 and 1991. The gross value of agricultural output increased at a real rate of 5.6 percent per year during the same period.

The structural transformation was accompanied by an increase in demand for a variety of financial services. The increase in incomes raised economic surpluses and the demand for deposit services. The household savings rate during the transition was significant, averaging about 33 to 37 percent of GDP between 1978 and 1995, the highest in the world (World Bank, 1997d). The level of financial deepening indicated by the ratio of money circulated through banks to GDP (M_2/GDP) grew from 79 in 1990 to 106 in 1996 (ADB, 1997e). It became a challenge to channel the impressive levels of domestic savings into productive investments. The financial systems in centrally planned economies were inadequate to allocate resources efficiently between surplus and deficit units. As a result of the economic changes, the stage was set for moving towards a market-based financial system.

OVERVIEW OF THE FINANCIAL SYSTEM

Beginning in 1979, financial sector reforms were implemented along with land and input- and output-market reforms. However, financial sector reforms have progressed slowly compared with reforms in other sectors, and a market-based financial system has yet to fully evolve (Tuan, 1993). Significant changes occurred in the financial sector as it was transformed from a simple monobank-based system in 1979 to one with multiple financial institutions in the 1990s. Four State-owned specialized banks, three policy banks, 14 small commercial banks, and a huge network of urban and rural credit cooperatives characterize the current financial system. Recently, the nonbank financial institutions, consisting of trust and investment companies (TICs) and insurance companies, have been growing at a significant pace.[1] In addition, there are now quasi-State-owned financial institutions called rural credit foundations (RCFs), and microfinance programs initiated by the Government and donors. Capital markets are also rapidly emerging, but strict controls remain regarding participation. A new securities law is expected to be implemented in 1999.

[1] For more information on nonbank financial institutions, see Kumar et al. (1997).

The financial sector transformation in the PRC can be better understood by examining the changes that occurred during four distinct phases: (i) pre-reform phase: before 1979; (ii) reform phase I: 1979–1984; (iii) reform phase II: 1984–1993; and (iv) current reform phase: after 1993. A brief chronology of events under the four phases is provided in Table X.1. The pre-reform period was characterized by a monobank, called the People's Bank of China (PBC), and Rural Credit Cooperatives (RCCs). The PBC was primarily used as a mechanism to mobilize deposits from the public to fund State-owned enterprises. The RCCs were controlled by the PBC and were responsible for deposit mobilization and the provision of loans to rural households and collectives.

The phase I reforms between 1979 and 1983 marked the introduction of a two-tier banking system. The financial system in the PRC was expanded to include four State-owned specialized banks (the Agricultural Bank of China (ABC), the Bank of Industry and Commerce (BOIC), the People's Construction Bank of China (CBOC), the Bank of China (BOC)), and a central bank– the previous People's Bank of China (PBC). These State-owned specialized banks operated within their designated lending areas. During phase II, several nonbank financial institutions, such as trust and investment companies, were allowed to emerge and compete with the State-owned banks. Competition began to emerge among the financial intermediaries.

The phase III reforms commenced in 1994 with the creation of three policy banks to disburse government-directed loans so that the State-owned specialized banks could be converted to commercial banks. The other State-owned commercial banks that existed since 1979 were provided with greater autonomy in lending decisions; the creation of new privately-owned commercial banks was encouraged. A unified interbank market, auctions for treasury bills, and strict asset-liability ratios were established for commercial banks. The reforms also severed the links between banks and nonbank financial institutions, and tightened regulations on stock exchanges; a modern payment system was initiated (World Bank, 1997d).

Table X.1: Chronology of Major Financial Sector Reforms in the PRC

Years	Financial sector	Rural financial sector
Phase I: Pre-reform period, prior to 1979		
Until 1979	Monobank system.	The PBC functioned as central bank and commercial bank. Provided agricultural loans to communes through its branches. RCCs were responsible for loans to households.
Phase II: 1979–1983		
1979	Established four State-owned specialized banks including the ABC.	The ABC finances agricultural sector (but not farm households). RCCs finance rural households and TVEs.
1983	Two-tier banking system created; central bank created out of the PBC; competition allowed among the State-owned specialized banks.	
Phase III: 1984–1993		
1984		Control of RCCS shifted from PBC to ABC. RCCs begin servicing TVEs and households independently.
1985	Financing responsibilities shifted from Government to banks.	Supply of funds to State farms transferred from Ministry of Finance to ABC. TVEs and households in rural areas financed by ABC and RCCs
1987	Competition among all banks and nonbank financial institutions.	Several small commercial banks allowed to lend to all sectors. Nonbank financial institutions allowed to operate.
Phase IV: 1993 to date		
1993	Refinance facilities from PBC restricted.	PBC no longer required to finance budget deficits and to provide loans or refinance the State-owned banks for policy purposes in rural areas.
1993	Comprehensive reforms introduced.	State-owned specialized banks converted into real commercial banks. Diversified financial market established that is regulated and supervised by PBC, and PBC made into a real central bank.

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(Table X.1 Cont.)

Years	Financial sector	Rural financial sector
1994	Establishment of three policy banks.	ADBC established to provide policy loans to priority sectors such as agriculture.
August 1996		Established an interministerial coordination group for rural financial system reform, led by the PBC.
September 1996		Contract responsibility system for ABC. Taxes and targets agreed upon with finance bureau and residual profits retained by ABC.
1998	Competition among specialized banks	All specialized banks allowed to finance all sectors in rural areas. Interbank borrowing and lending allowed.
1998 (proposed)		Merger of RCFs with RCCs or disband RCFs. Increased regulation of RCFs.

Sources: Compilation based on Ruogu (1996); Cheng and Watson (1997); Park, Brandt, and Giles (1997); World Bank (1997d); Morduch, Park, and Wang (1998).

Beginning in 1998, lending quotas for State-owned commercial banks were lifted and banks were authorized to adjust interest rates within a 20-percent band depending on the borrower's creditworthiness. There are plans to consolidate bank branches, including those of the central bank, to maximize staff productivity and to reduce costs of operations and political influence of local governments.

The decision in August 1998 to close the biggest nonbank investment company, Guangdong International Trust and Investment Corporation, and the refusal of the Government to assume its debts sent strong signals to foreign investors that the Government may not bail out State-owned companies that borrow more than they can repay. The Government has also indicated that there will be a reduction in the number of trust and investment companies from 240 to about 20. While the refusal of the Government to bail out a prominent company reduced the confidence of foreign investors, it also indicated the commitment of the Government to reform the financial system (Anon., 1998e, 1998f).[2] This could lead to some reduction in foreign capital inflows and create a credit crunch if the Government does not boost investor confidence.

The implementation of financial reforms has been cautious, but it has contributed to the creation of many types of financial institutions. Several issues remain unresolved. It is not clear if the regulatory system has been adequately strengthened and staffed with skilled personnel to supervise the diverse institutions effectively. There has been a huge problem with nonperforming loans leading to insolvency of the majority of State-owned banks (Ling, Zhongyi, and von Braun, 1998). Official estimates in 1997 show that 20 percent of their loans were nonperforming, and about 5 to 6 percent were unrecoverable, amounting to about yuan (Y) 1,000 billion ($120.5 billion). The loan loss reserves represented less than one percent of the loans (Song, 1998).[3] Most of the nonperforming loans were policy loans made to State-owned enterprises at subsidized rates. The Government is considering a write-off of over Y180 billion ($21.7 billion) during 1998 to 2000 (Oxford Analytica, 1998). This may create some moral hazard problems in that an expectation may develop that future nonperforming loans will also be forgiven.

APPROACH TO RURAL AND AGRICULTURAL FINANCE

In the 1990s, a slowdown occurred in the income growth of farm households. Regional and rural-urban income disparities

[2] The closure of the Guangdong corporation also revealed the bad-loan problems faced by nonbank financial institutions and the weak regulatory guidelines for them.

[3] A recent World Bank report suggested that a systemic crisis will occur if nonperforming loans exceed 15 percent of total loans (Caprio et al., 1998).

became more pronounced. Farm household incomes per capita grew by only 1.4 percent during 1991 compared to 5.8 percent in urban areas. Income per capita grew more rapidly in rural areas located in the coastal regions compared to rural areas in the interior. Of the total income inequality, rural-urban disparities explained about 60 percent, while regional disparities contributed less than 20 percent (Tuan, 1993). This has caused concern because the majority of the population lives in rural areas and generates surpluses through savings. Rural finance is considered to be an important tool to improve rural incomes, especially agricultural incomes, and to generate surpluses that can be used to finance rural nonfarm enterprises.

Rural financial reforms were a significant part of overall financial sector reforms. The phase I reforms between 1979 and 1983 marked the initiation of the household responsibility system, leading to emergence of about 230 million peasant farms and an enormous demand for financial services (Ling, Zhongyi, and von Braun, 1998; see Box X.1). The ABC was created as a State-owned specialized bank to finance agricultural purchases by the marketing boards. The RCCs, under the direction of the PBC, were made responsible for servicing the rural households. With the phase II reforms, the control of the RCCs shifted from the PBC to the ABC. The ABC and the RCCs, due in part to political reasons, began financing the township and village enterprises (TVEs) that emerged in the 1980s.[4] Cheng and Malcolm (1995) claimed that the phase I reforms facilitated the dismantling of the collectives and increased farm production and incomes, and that phase II reforms coincided with the transition from subsistence farming to commercialized

[4] TVEs are industrial enterprises owned by local governments and citizens and generally produce consumer goods for domestic and foreign markets. The TVEs have so far created about 95 million jobs and their share in GDP rose from 13 percent in 1985 to 31 percent in 1994. Because the local governments can retain the revenues from TVEs, they have been efficiently managed and often the loss makers are closed down. They are usually financed by local financial institutions and some foreign investors (World Bank, 1996b).

production in rural areas. Phase II was characterized by slower growth in agricultural production and incomes, a rapid growth of TVEs engaged in nonfarm production activities, and a shift in labor from agriculture to the nonfarm sector.[5]

The phase III reforms included two major components relevant for the rural PRC: (i) the separation of the Agricultural Development Bank of China (ADBC) from the ABC in 1994 with the ADBC responsible for providing policy loans including loans for the purchase of farm goods, poverty alleviation, and

Box X.1. Household Responsibility System

The household responsibility system, ratified by the Government in early 1981, assigned collectively owned lands to households under a 15-year lease. The profits and production decisions were transferred from the communes to the households. It was estimated that the proportion of households participating in the household responsibility system increased from less than one percent in 1979 to 99 percent in 1984. It is also reported that the system alone contributed to nearly half of the growth in agricultural output between 1978 and 1984. Grain yields increased rapidly in the 1960s with the advent of the green revolution but declined after that until 1979. The average growth of grain yields during 1960–1970 was 5.3 percent, but only 2.9 percent during 1970–1978. However, with the introduction of the household responsibility system, the average growth of grain yields increased to 5.7 percent during 1978-1984 (World Bank, 1997d).

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[5] The share of the labor force in agriculture dropped from 76 percent in 1975 to 69 percent by 1995. The annual growth rates in the agricultural labor force declined from 0.77 percent in 1970–1979 to negative 0.08 percent in 1990–1993. The decline in agricultural labor resulted in a shift of the labor force, not from rural to urban areas, but to the rural nonagricultural sector. This shift is estimated to have contributed to about one percent per year to real GDP growth.

agricultural development; and (ii) the separation of the RCCs from the ABC in 1996 with the RCCs mandated to service rural households and small rural enterprises independently. With the separation of the development portfolio in 1996, the ABC was left to operate as a State-owned commercial bank (Cheng, Findley, and Watson, 1997). The central bank required that the ABC and the RCCs become responsible for their losses without help from the State. Thus, they became cautious in rural lending, and as a result access to loans for rural households and TVEs has declined. Furthermore, low and regulated deposit rates created poor incentives for rural households to save with the RCCs and ABC. This facilitated the emergence in 1988 and 1991 of nonbank institutions such as the rural credit foundations (RCFs).

The rural financial sector is currently composed of formal financial institutions, donor- and government-sponsored microfinance programs, and informal finance. The formal financial institutions include the State-owned specialized bank, the ABC; the policy bank, the ADBC; and the nonbank financial institutions, the RCCs, RCFs, and mutual associations and credit groups (MACGs).

The reforms that have occurred in the financial and other sectors since 1979 have shaped the present rural PRC. The growth rate of value added in agriculture per annum was significantly higher during the reform phases than during the pre-reform phase: it was about 8 percent during 1979–1994 compared to 2.8 percent prior to 1979 (Rana and Hamid, 1995). In addition, the rural industries were dominated by TVEs in the 1980s due to restrictions on operation of private industries. Private and individually-owned rural enterprises emerged only in the 1990s. The emergence of private rural enterprises can be attributed to the rise in agricultural prices that increased rural incomes and savings, thus generating capital for nonfarm activities. Also, the availability of labor freed from the communes coupled with the demand for nonagricultural commodities due to increased incomes, created opportunities for starting rural nonfarm enterprises. The Government also encouraged urban industries to subcontract work to rural enterprises. As a result, the share of rural enterprises in industrial output, which accounted for only 22 percent in 1978, increased to 30 percent in 1984 and to 36 percent by 1990 (World Bank, 1997d).

Access to financial services in rural areas, however, has been limited in spite of innovative new rural financial institutions such as the RCFs (Park, Brandt, and Giles, 1997). The ABC and the RCCs that service the rural areas have consistently earned negative profits in the last few years. Rural deposits from farmers and households have been increasingly channeled to finance TVEs and urban enterprises rather than to farmers and nonfarm households in the rural areas (Huang et al., 1998).

THE EVOLUTION AND CURRENT STATUS OF KEY RURAL FINANCIAL INSTITUTIONS

Participants

The ABC, created in 1979, is the oldest and largest of all rural financial institutions in terms of assets, followed by the RCCs (Table X.2). The ABC is now primarily responsible for financing farming activities of State farms and for mobilizing deposits from individuals, collectives, and RCCs. There are currently 20,000 branches of the ABC to mobilize deposits at the township level. In 1994, policy loans were divested from the ABC and moved to the newly created policy bank, the

Table X.2: Gross Assets of Rural Financial Institutions

Institution	1996 ($ Billion)
ABC	180
ADBC	70
RCCs	160

Source: Park, Brandt, and Giles (1998).

ADBC. Since then, the ADBC has been responsible for financing grain purchases by grain cooperatives, and for policy loans directed towards poverty alleviation, agricultural development, and infrastructure development in rural areas.[6] The ADBC utilizes the ABC branches in addition to its own branches that were carved out of ABC for its operations. Most of the loans from the ADBC are financed by the PBC, under its allocation for policy loans.

In addition, there is a wide network of RCCs responsible for servicing rural households and collectives with loans and savings services. These nonbank financial institutions are strictly regulated by the PBC. Currently, there are about 2,400 at the county level, 49,500 at the township levels, and 58,000 branches and 260,000 agents at the village level with an average of 4,000 members per RCC (ADB, 1997e). Although the RCCs are legally owned by their members, the influence of local governments has been significant. Until August 1996, the RCCs were managed by the ABC and functioned almost as resource providers to the ABC, but have since become autonomous.

The MACGs were established by the Ministry of Civil Affairs in about 173,000 villages to provide relief and emergency loans in poor and disaster-prone areas. Several groups also provide consumption loans and a limited volume of production loans up to Y500 for one year to poor households (Ling, Zhongyi, and von Braun, 1998). As of 1993, it was estimated that the MACGs had about Y1.2 billion in outstanding loans in rural areas. However, the MACGs are reported to suffer losses due to negative real interest rates and poor repayment rates (Park, 1998).[7]

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[6] Recently, huge losses due to corruption have been detected in the grain purchase bureaus financed by ADBC. The losses are estimated at 3 percent of the total economic output of the country. The head of the ADBC was removed from office for making loans to the grain stations that were involved in the scandal (Anon., 1999a).

[7] Most loans were perceived as gifts from the Government and were not repaid. These are called *huzu* or *chujihui* in Chinese.

The RCFs expanded in the 1990s to cater to the increased demand for loans and deposit services.[8] They developed voluntarily to manage the collective assets and funds that remained after the disbanding of communes. They are quasi-State-owned financial institutions at the township level under the Ministry of Agriculture and are owned by the collectives and households. The most important source of initial capitalization has been deposits and capital from the collectives. Currently, most RCFs are capitalized by household shares and deposits. The stated goals of the RCFs are to meet the demand for funds by agricultural households and to support the agriculture sector and rural households.

The volumes of loans made by the RCCs, ABC, and ADBC to households, TVEs, and agricultural collectives are reported in Table X.3. Aggregate data for the RFCs were not obtained. The data show that the volume of loans to all sectors has generally increased, especially after 1984. The ABC made more loans than did the RCCs in the early 1980s. Since then, the RCCs have become more important in providing rural loans. The RCCs made an almost equal volume of loans to households and TVEs until the 1990s, when loans to TVEs surpassed those to households, and currently represent twice the volume of loans made to households. In practice, the ABC does not make any household loans in the majority of industrial areas. It has generally serviced agricultural collectives more than the TVEs, except during 1986-1989. In general, the TVEs have obtained more loans from all three institutions than have households and collectives, indicating a bias of the major rural institutions towards TVEs. This bias may be influenced by favorable governmental policies for light industries and linkages with local governments. A case study of investments made in poor

[8] Although the RCFs were allowed to operate as unregulated rural institutions in 1986, their initial growth was slow. They expanded rapidly in the 1990s due in part to the tightening of funds for rural households from RCCs and the ABC. The first RCF was established in 1988 in the province of Sichuan.

counties in Shaanxi Province revealed how loans made during 1984 to 1991 increasingly shifted in favor of TVEs and county enterprises as part of the poverty reduction effort. However, loans made to households seemed to make a larger impact on growth (Rozelle et al., 1998).

Performance of Major Rural Financial Institutions

There are no studies at the national level on the performance of rural financial institutions. Here, we rely on a few cross-section studies conducted in selected provinces in recent years. Park, Brandt, and Giles (1997) studied the RCCs, RCFs, and the ABC in six provinces in 1996 and compared their outreach and performance. The results are summarized in

Table X.3: Loans from RCCs, ABC, and ADBC to Rural PRC in Billion Yuan (1985 prices), 1978–1996

Year	Loans from RCCs to			Loans from ABC to		ADBC loans to agriculture
	Households	Collectives	TVEs	Collectives	TVEs	
1978	1.4	2.8	1.6	10.7	2.5	
1979	1.4	2.8	1.8	12.0	3.8	
1980	1.9	4.1	3.7	12.7	6.3	
1981	2.9	4.1	4.1	13.3	7.2	
1982	5.0	3.9	4.8	14.3	8.3	
1983	8.4	3.2	6.7	15.5	9.0	
1984	19.7	4.2	14.7	19.4	17.2	
1985	19.4	4.1	16.4	19.7	18.8	
1986	24.3	4.2	25.1	23.4	27.2	
1987	30.6	5.7	31.6	26.4	30.8	
1988	27.6	5.9	33.8	25.8	30.3	
1989	26.2	8.5	34.0	25.4	26.5	
1990	32.0	12.0	43.2	36.2	26.7	
1991	37.9	16.0	54.6	43.3	29.9	
1992	43.2	22.8	73.6	50.2	33.1	
1993	44.2	30.1	89.6	45.1	38.9	
1994	44.6	33.1	94.0	38.4	38.8	9.4
1995	48.9	37.3	100.0	42.6	39.8	11.9
1996	52.9	58.6	104.4	49.6	43.8	17.1

Source: Huang, Rozelle, and Nyberg (1998).

Table X.4. The study found a greater bias towards TVEs and collectives in the loan portfolios of the ABC than in the portfolios of RCCs and RCFs. Indeed, the RCF loans were more strongly oriented towards rural households than were those by RCCs and the ABC. Due to their low level of capitalization, most RCFs were not allowed to make fixed capital loans to TVEs until 1997. It is unclear whether the focus on households will change as a result of their current eligibility to make fixed capital loans to TVEs.

Table X.4: Performance of the ABC, RCCs, and RCFs as of 1995 (Based on a survey of six provinces, mean values reported)

Items	ABC	RCCs	RCFs
Share of households in total loan portfolio	10	43	45
Share of TVEs and collectives in total loan portfolio	30	35	24
Value of outstanding loans per borrower (yuan)	243	189	67
Overall loan-to-deposit ratio	0.15	0.18	0.20
Interest rate spreads (%)	na	7	7
Repayment rate from TVEs and collectives (%)	81	67	76
Repayment rate from households (%)	82	80	82
Share of interest costs in total costs	80	75	65
Share of office expenses in total costs	11	10	14
Loans to gross value of output of industries and agriculture	18	12	1
Profitability (ratio of profits before taxes to total funds)	0.4	1.2	4.7

Source: Park, Brandt, and Giles (1997).

In general, the loan-to-deposit ratio was the highest in RCFs followed by RCCs and the ABC. RCF loans were small, averaging about Y67, compared to Y243 and Y189 from the ABC and RCCs, respectively. This may be because of the smaller proportion of loans to TVEs and collectives from RCFs than from the ABC and RCCs. Another study by Cheng, Findley, and Watson (1997) also reported that the RCF loans were small, usually less than Y50,000, were lent for short terms, usually 3 to 6 months, and were only to meet agricultural working capital requirements. Given the annual GDP per capita of Y5,568 in

1996, the RCFs appear to reach the poor with small loans.[9] However, anecdotal evidence suggests that RCFs tend to be located in industrial towns rather than in poor rural areas.

The study by Park, Brandt, and Giles (1997) also showed that the RCFs charged the highest nominal annual interest rates, about 20 percent, followed by the RCCs at 18 percent and the ABC at 15 percent. The interest rate spread was about 7 percent for both the RCFs and the RCCs. The nominal interest rates for RCFs varied by location, indicating flexibility in adjusting interest rates according to local market conditions, in contrast to the RCCs and the ABC, which are regulated by the PBC.

The repayment rates for TVE loans, calculated as a percentage of loans paid on time to loans outstanding, were 81 percent for the ABC, 67 percent for RCCs, and 76 percent for RCFs, while for households they were 82, 80, and 82 percent, respectively. However, there was a large regional variation in the repayment performance for RCFs compared to that for RCCs and the ABC. The spreads reported above obviously cannot compensate for these low recovery rates. Therefore, interest rate controls and low recovery rates affect the viability of the institutions.

RCFs were observed to be more profitable than the ABC and RCCs. The average profitability, measured as a share of before-tax profits to total funds, was 4.7 percent in 1995 compared with 0.4 percent reported by the ABC and 1.2 percent by RCCs. However, given the low recovery rates compared with the spreads reported above, the profits reported by RCFs appear to be inflated. Differences in accounting procedures might explain some differences. It is important to follow common accounting procedures such that data provided by these institutions are comparable and accurately reflect their health.

Fifteen of the 54 RCCs reported negative before-tax profits in 1995 compared to three out of 37 in 1988. The profitability of the ABC has also declined significantly since 1988, falling from 6 percent in 1988 to 0.4 percent in 1995. Indeed, the competition

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[9] \$1 = Y8.26 in 1997.

from RCFs has reduced the profitability of RCCs due to falling volumes. In townships with RCFs, the rate of growth of funds in RCCs was only 2.1 percent compared with 17.9 percent in those townships without an RCF. As a result, the profitability of RCCs in the absence of nearby RCFs was estimated at about 1.8 percent while it was almost zero when RCFs were present. It was found that RCCs lack client orientation and uniform policies and procedures for loan screening, and there has been a high volume of nonperforming loans, as well as inadequate management information systems and risk management. The Asian Development Bank is currently providing technical assistance to selected RCCs on a pilot basis to restructure them and help them become financially viable client-oriented institutions (ADB, 1997e).

The research by Park, Brandt, and Giles (1997) also showed that the majority of RCF loans required more collateral from both households and TVEs than did the ABC and RCCs. Generally, more prosperous households used third-party guarantors while poorer households were required to offer a combination of collateral and third-party guarantors for RCF loans. Some RCFs that experimented with making loans without collateral or guarantors registered the lowest repayment rates. Within the RCF loan portfolio, contracts were more strictly enforced for households than for collectives and TVEs. Overall, the average frequency of enforcement actions through law suits and collateral foreclosure was lower for RCFs than for RCCs, indicating the importance of collateral in recovering loans.

RCFs were observed to be the most innovative among the formal, rural financial institutions (Cheng, Findley, and Watson, 1997). For example, they used village agents at the beginning of their operations and paid commissions according to the amount of deposits mobilized and loans collected. Later, agents were not used for households that had established a credit record. RCFs consider the size of operation, reputation of the managers of TVEs/collectives, and asset quality in determining loan size. For loans above a certain limit, the managers of the TVEs need to use their enterprise's assets and their personal assets as collateral, such that they have a stake in the loan. In some areas, RCFs also insist that all members of the household sign loan contracts in which family assets are pledged as collateral.

Although the RCFs have been efficient, the ratio of volume of loans to gross value of output of agriculture and industries in the region was the highest for the ABC (18 percent) followed by RCCs (12 percent), and the lowest for RCFs (1 percent). This indicates the relatively small volume of loans made by the RCFs compared with the ABC and RCCs.

Ling, Zhongyi, and von Braun (1998), based on a survey in 1993 of 1,920 rural households from 12 provinces, found that despite the presence of banks, loans from informal lenders were the major source of funds for over half the borrowers. Bank loans were also smaller than the loans from informal lenders, especially for poor households. Asset-poor households were invariably excluded from formal markets.

As shown above, the increase in rural financial institutions has not generally improved access to loans by rural households. The bulk of institutional loans are made to TVEs, and the next largest share goes to agricultural collectives. Where farm households can access loans for agricultural production purposes, they are unable to obtain loans for nonagricultural purposes even though nonfarm activities are more productive than agriculture.[10] Neither can households access loans for nonfarm activities from informal lenders (Cheng and Malcolm, 1995).

This lack of access to loans for household activities may reduce the productivity of farm credit. For example, Feder et al. (1990a, 1990b) showed that supplying additional formal agricultural credit would increase agricultural output of credit-constrained households only if access to agricultural inputs and loans for nonfarm activities were not constrained. The supply

[10] A recent study pointed out that the wages in nonagricultural activities in rural areas are seven times higher than in agricultural activities; the marginal returns from farming were found to be three times lower than from rural offfarm enterprises (World Bank, 1997d, p. 45).

of formal production credit to credit-constrained farm households did not significantly affect farm output, but was associated with increased overall output from both farm and nonfarm activities. This result confirms that formal loans targeted towards production activities are fungible because production credit has apparently been diverted to consumption and nonfarm investment. As a result, expanding the supply of formal credit has had less of an output effect on the agriculture sector per se.

DEPOSIT MOBILIZATION

It was reported that personal savings in banks amounted to Y5.43 trillion ($ 655.8 billion) in January 1999, a 16 percent increase from January 1998. These deposits accounted for 68 percent of GDP, the highest in the world. The savings rate has been increasing despite the cuts in deposit rates from 9 to 4 percent per annum due to lack of alternative investments and less optimism in the economy. It was observed that people now spend less but save more (Anon., 1999c).

Data on deposits mobilized by RCCs and the ABC are provided in Table X.5. No comparable data are available for RCFs. Since the mid-1980s, deposits have generally been increasing at a significant pace in both institutions. The RCCs have been more successful in mobilizing deposits than has the ABC. Household deposits account for a substantial portion of the deposits collected by both institutions. The increased incomes that have accrued to households since the 1980s due to favorable prices and the household responsibility system contributed to the increased surpluses available for savings. In 1996, individual farm household deposits accounted for over 85 percent of total savings mobilized by the ABC and RCCs.

Information in Tables X.3 and X.5 shows that total deposits mobilized by both RCCs and the ABC generally outpaced the total volume of loans made by them in rural areas. However, sectoral differences were noted. The loans from the ABC to

Table X.5: Deposits Mobilized by RCCs and the ABC from Rural PRC
(Y Billion, 1985 prices)

Year	Savings in RCCs from			Savings in ABC from		
	Households	Collectives	TVEs	Households	Collectives	TVEs
1978	7.1	12.0	2.6	1.0	4.1	0.6
1979	9.9	12.4	2.8	1.8	4.8	1.0
1980	13.9	12.5	3.5	2.6	7.3	1.3
1981	19.6	13.1	3.4	3.4	6.4	1.6
1982	25.9	13.7	3.8	4.1	6.9	1.8
1983	35.8	10.3	7.0	4.9	6.8	1.9
1984	47.7	9.8	8.8	7.1	7.8	3.9
1985	56.5	7.2	7.2	9.9	7.0	3.1
1986	72.3	7.9	8.7	15.3	8.8	4.3
1987	88.4	7.9	9.2	23.2	9.4	4.8
1988	84.8	7.3	9.5	26.9	8.0	4.6
1989	88.9	5.8	7.9	32.1	7.0	3.5
1990	113.6	6.6	9.2	44.9	8.3	4.1
1991	138.9	8.1	11.5	54.9	9.7	5.2
1992	163.1	12.2	17.2	64.5	10.8	7.5
1993	179.5	12.4	18.2	71.0	8.8	13.7
1994	198.6	11.6	17.8	78.5	8.0	13.0
1995	222.9	11.4	17.4	88.1	7.8	11.9
1996	260.1	12.7	19.2	102.9	7.7	12.7

Source: Huang, Rozelle, and Nyberg (1998).

TVEs and collectives were four and seven times larger, respectively, than the deposits collected from them. Similarly, loans from RCCs to TVEs and collectives were more than four and five times, respectively, the amount of deposits mobilized from them. In contrast, loans to farm households from RCCs represented only one fifth of the savings they mobilized. These results indicate that deposits by the rural household sector invariably finance rural nonfarm activities and collectives.

About three quarters of the total savings mobilized in rural areas are lent out in rural areas, indicating no major siphoning of resources from rural to urban areas. Indeed, it appears that the ABC has transferred resources from urban to rural areas in recent years (Huang, Rozelle, and Nyberg, 1998).

RCFs are now emerging as competitors to RCCs and the ABC, especially in deposit mobilization. Cheng, Findley, and Watson (1997) estimate that the total deposits in RCFs were around Y100 billion by 1996 compared to Y880 billion in RCCs. The RCFs have been innovative in using local connections to mobilize deposits and introduce new financial products.

MICROFINANCE

The PRC's microfinance movement started in 1994 as a mechanism to alleviate poverty, with the establishment of several Grameen-type institutions. There are currently several types of microfinance institutions operated by international donors and, since 1997, by the Government.

Morduch et al. (1997) reported the presence of at least 15 international donors providing microfinancial services in the 1990s. Five of the programs are variations of the Grameen model and provide group loans, three provide individual loans, four provide revolving funds for groups and individuals, and one provides a loan guarantee for bank loans. Anecdotal evidence suggests that the total outreach of all these programs is only 10,000 clients.

The Government microfinance programs are essentially subsidized loan programs intended for poverty alleviation. These programs cover about 87 counties in eight provinces. Thus far, about 80,000 households formed into about 14,300 small and 2,400 large groups are covered. Most of these Government initiatives are variants of the Grameen model (Morduch, Park, and Wang, 1997).

Park, Ren, and Wu (1998) compared three microfinance programs: (i) initiated and implemented by the Government, (ii) initiated by both donors and the Government, and (iii) initiated and implemented by donors. They also randomly sampled 449 households in 18 villages serviced by the three programs. By sampling design, 305 of the 449 households surveyed were microfinance program members and 144 were nonmembers. The results showed that the government-implemented microfinance programs are fairly young and perform poorly compared to donor-initiated microfinance organizations (MFOs). The results also revealed diversity in program design and attitudes of microfinance clients towards their programs. Client willingness to pay ranged from 2 to 3 percent per month, and the average interest charged by MFOs was around 2.3 percent per month. The interest rates on government programs averaged about 0.24 percent per month or 2.9 percent per annum (about 4 percent less than the regulated PBC rates for such loans). However, it is estimated to cost about 4 percent per month to provide microfinance services for agricultural purposes in the poor areas. Therefore, none of the three programs is currently sustainable.

A profile of the sampled programs is provided in Table X.6. In contrast to microfinance programs in other Asian countries, these programs have provided more loans to agriculture-related activities than to small businesses. Although all programs use the group lending methodology, group cohesion varies across the programs. In governmental programs, group leaders are often appointed and there is less participation of center members in loan processing and at the center meetings. Members have a poorer understanding of the responsibilities of the group members, such as joint liability and attendance at the center meetings. The self-reported repayment rates for the nongovernmental organization (NGO) programs range from 71 to 100 percent, while it is less than 60 percent for the governmental programs. More clients in the governmental programs experience difficulty in paying loans on time than in the NGO programs, implying their inability to generate sufficient income. Nonetheless, part of the reason for the lower repayment rate experienced by the governmental programs may have resulted from a lower expectation amongst their clients of continued access to loans, an incentive for prompt repayment, than from NGO programs.

Many programs had a compulsory savings component. NGOs are currently prevented by the central bank from mobilization of voluntary savings. While some programs return the savings to the members after all group members repaid their loans, some do not return savings until the member leaves the program. Several programs provide complementary services

Table X.6: Profile of Microfinance Programs : Results of a Survey

	Program sponsor		
	NGO	NGO and Government	Government
I. Purpose of loans (percentage of female members reporting)			
1. Agriculture and livestock related activities	89.0	97.0	86.0
2. Small business	2.0	2.20	2.0
3. Other purposes	9.0	0.80	12.0
II. Group cohesion			
Percentage of members who know all other members	98	92	85
Formed group with members since village leader arranged it (percentage of members reporting)	3	24	78
Regular meetings held by the center (percentage reporting)	89	67	42
In the past 10 meetings, how many times were you absent? (average of all responses)	1.6	1.7	2.6
III. Repayment status			
Are you responsible for repaying loans of other members who do not repay on time? (percentage of members reporting yes)	94	77	44
Percentage of members who had at least one late repayment	4.7	32.5	75.8
Percentage of members who did not repay their weekly dues on time	2	5.3	36
If you pay all installments on time, will you get another loan? (percentage reporting yes)	95	47	23
In fact you paid loans. Did you get another loan? (percentage reporting yes)	61	28	

Sources: Morduch et al. (1997); Park, Ren, and Wu (1998).

such as linkages with the input and output markets in addition to credit (Morduch et al., 1997).

The microfinance programs are still in their infancy. They are limited in the following ways: (i) a lack of long involvement of NGOs in developmental activities; (ii) firm government involvement through subsidized microfinance lending; (iii) a large proportion of the population that may demand microfinance in sparsely populated mountainous areas where microfinance best practices, such as group lending technologies, may be costly to implement; and (iv) a large demand for crop-based activities that may not permit frequent loan repayments as recommended by the best practices. Therefore, microfinance programs that are successful in countries such as Bangladesh and Indonesia may not be as appropriate for the PRC, and the Government's use of subsidized lending rates does not conform with microfinance best practices. In addition, unlike Bangladesh, these programs tend to provide agricultural loans. It is a puzzle why programs in the PRC prefer agriculture to nonfarm activities when nonfarm activities, for which microfinance is well suited, are largely unserved by the formal financial system.

INFORMAL FINANCE

No longitudinal data exist to examine changes in the share of informal finance in total household borrowings and in interest rates due to the expansion of the formal financial systems. Anecdotal evidence suggests that informal finance has functioned for the past two decades parallel to the formal financial institutions in rural PRC and meets the demand for consumption loans. Informal finance appears to flourish in places where the concentration of formal finance is high (Ling, Zhongyi, and von Braun, 1998).

Fragmentary information based on cross-section studies conducted since the 1980s provides insights regarding changes in the composition of informal lenders. Feder et al. (1989) noted that informal finance had transcended from rudimentary transactions to commercialized ones during the 1970s and 1980s. Although the most common sources of informal credit were friends and relatives, there had been an emergence of commercial informal lenders such as middlemen who link traders and farmers. These middlemen were found to be socially unrelated to the borrowers and nonresidents of the borrowers' village. They appear to link the credit to farm output. In addition, informal rotating savings and credit associations (called *hui* in Chinese) were also popular.

A 1992 national survey reported that two thirds of farm loans in poor areas are obtained from informal lenders (Ling, Zhongyi, and von Braun, 1996). A survey by West (1990) showed that in 1987 about 62 percent of the poor borrower households reported borrowing exclusively from informal sources. Another study indicated that the share of informal loans in total household borrowing increased slightly with the poverty status of the households. Households in the lowest income quartile reported borrowing more than 53 percent of their loans from informal sources compared to 46 percent by households in the highest income quartile (Park and Wang, 1998).[11] It has also been observed that while nonpoor households borrow more from moneylenders than from friends and relatives, the opposite is the case for poor households (IFPRI, 1998).

The importance of informal finance has remained the same in wealthy areas over the past two decades. The ratio of informal to total debt outstanding ranged from 95 to 50 percent in two of the wealthy, major grain-producing counties. About 20 to 45 percent of the households reported loans from informal lenders in the two counties (Feder et al., 1990a, 1990b). The results were confirmed by the latest study conducted in 1997 by Park, Brandt, and Giles (1997). However, Park and Wang (1998), in a survey of six provinces, found that while informal

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[11] These are preliminary results based on a survey of 500 households in counties defined as poor according to national poverty statistics.

loans were larger in number, they accounted for only half the value of formal loans, indicating the small size of informal loans.

A larger proportion of informal loans has an explicit nominal interest rate now than a decade ago. For instance, based on a survey in 1996 of 184 villages in six provinces, Park, Brandt, and Giles (1997) found that the number of villages reporting explicit nominal interest rates from informal lenders increased from 42 in 1988 to 82 in 1995 (almost a 70 percent increase). The informal annual nominal interest rates were much higher than the 15 to 20 percent rate charged by the formal institutions. Feder et al. (1989) cited studies that reported loans from friends and relatives with rates up to 3 percent per month; lenders who were not friends and relatives charged about 5 percent per month; loans arranged by middlemen cost between 10 and 30 percent per month. High interest rates were related to low levels of technological development and access to markets, and the lack of collateral assets.

Feder et al. (1989) reported that the majority of informal loans were short term, although several could be for an indefinite maturity through rollovers, depending upon the borrower's ability to pay. Nonetheless, these loans were of longer duration than formal loans. The informal loans were primarily provided by friends and relatives who were more willing to provide loans for a one-time activity that can be reciprocated, rather than finance an on-going activity that may require continuous support. There were several instances in their sample that reported informal loans with medium-term maturity, and they outnumbered the medium-term loans from the formal lenders. Several informal loans from commercial lenders were secured by collateral although some households reported using third-party guarantors. Most loans from friends and relatives were based on reciprocity.

In general, formal and informal credit markets were observed to be highly segmented and did not substitute for one another. West (1990) reported that loans used for weddings, housing construction, and other consumption activities were financed by informal sources, while loans used for working capital in farming, fixed investments in farming, animal husbandry, and fisheries were financed by formal sources. The farmers faced difficulty in diverting loans obtained for construction and social activities to production activities because they could be easily detected. However, formal loans could still be diverted for day-to-day consumption activities and therefore were fungible while the informal credits were not. This indicated that households constrained in their access to formal sources may have been limited in their ability to finance production activities. Anecdotal evidence suggests that informal sources are still not yet fully commercialized to finance farm and nonfarm production activities as occurs in other Asian countries such as India and the Philippines.

CURRENT POTENTIAL AND CONSTRAINTS FOR RURAL FINANCE

The landscape of the financial sector has changed in the PRC since 1979 with the introduction of different types of institutions. There is a strong deposit base due to a well-established savings discipline, and continuous reforms that increase incomes. The huge volumes of deposits have been a significant source of funds for rural financial institutions, leading to some degree of financial independence from the Government. Overall, the presence of several formal institutions has increased competition in rural areas, at least for deposits. But ceilings on deposit rates impede a strong drive by the institutions to mobilize public deposits, to become subsidy free, and to innovate with flexible savings instruments. It is now important to assess whether the current increasing trend in deposits will continue, decline, or stabilize at the current rate, and whether the financial institutions will develop mechanisms to cater effectively to the demand for deposit services in the future. Few studies focus on the demand for deposit instruments in rural areas.

Although competition is encouraged, political intervention continues to influence the portfolio mix of the banks, and interest rate controls still exist. As a result, access to loans for rural households, although they contribute significantly to the capital of the financial institutions through deposits, is very low. The financial institutions are also biased against financing nonfarm enterprises of rural households. With meager informal lending for nonfarm enterprises, many rural households may be unable to access external finance for nonfarm activities. The ongoing structural transformation will alter the rural sector. Small farm households may predominate in the future and will need to diversify into nonfarm activities to augment incomes (Box X.2). But a liquidity-constrained nonfarm sector may not grow as required to contribute to economic growth.

Other issues remain to be addressed regarding the future structure of rural areas. For instance, there may be an increase in the intensification of farming and a greater demand for long-term loans. It will be important to understand the future demand for various types of financial services by small diversified farms so that appropriate institutions and instruments can be developed. The sparse information available constrains our ability to speculate about the future demand for and the supply of services. There is a clear need to assess the future demand for various services and the capacity of institutions to meet that demand.

With limited information about the negative profits recorded by ABC and the RCCs in recent years, there is uncertainty about their viability and their ability to provide more services in the future. It is not clear whether competition from RCFs and their prudent practices, and focused lending for farms and rural households will initiate changes within the ABC and RCCs that will modify their portfolio mix and make them profitable. Political interventions may hamper the efficient allocation of resources within the ABC and RCCs. The recent political effort to lobby for limits on the expansion of RCFs and the suggestion to merge them with RCCs create great uncertainty regarding the commitment of the Government to encourage competition in rural banking.

Although RCFs are innovative and have contributed to a diversified financial sector in rural areas, several concerns remain. Being unregulated may lead them to imprudent

Box X.2 Evolution of Farming Structure in the PRC

The current farming structure in the PRC evolved from small individual farms that existed prior to 1949 to cooperatives and collectives that existed until 1979. The evolution of the farming structure is provided in Table X.7.

The agrarian reforms during 1919 to 1949 resulted in abolition of the feudal system and distribution of land to actual tillers, creating small private farms. The average farm size was about 0.85 ha. Beginning in the 1950s, there were shifts from individual farm households to mutual aid groups and elementary agricultural producers' associations where about 20 to 30 farm households pooled their land and resources. The average farm size of such associations was about 20 ha. The individual farm households became semi-independent owners in such associations.

However, beginning in 1953 with the socialist regime, the associations were converted into cooperatives and collective ownership of land was introduced. The average number of farm households that formed a cooperative was about 150 to 200 with an average farm size of 160 ha. These advanced cooperatives were then converted to people's communes in 1958 with an average of 4,600 farm households and 3,800 ha of arable land per commune. The commune owned the land and the livestock that belonged to the farm households and made the production decisions. However, input purchase and output sales were arranged by the local and provincial governments.

The scenario changed with the introduction of reforms in 1979. The communes were replaced by the household responsibility system wherein farm households were assigned limited ownership of land previously owned by communes. The average farm size per farm household in 1986 was estimated to be around 0.6 ha, smaller than it was in 1950. Beginning in the late 1980s there were frequent appeals for enlargement of the farms since the small farm structure was shown to suffer from diseconomies for scale and fragmentation due to inheritances. Therefore, some tenurial arrangements such

(continued next page)

Box X.2 (continued)

as renting, formation of voluntary collectives, and cooperatives were allowed. As a result, the farm size in the early 1990s ranged between 0.85 ha per household and 20 ha per voluntary collective. However, fewer than 10 percent of farmers who obtained land under the household responsibility system preferred to sell it so that enlargement could occur. Based on the trend, it was expected that the predominance of small farms will continue for a long time even if not profitable, but there will be a coexistence of various types of tenurial arrangements and diversification of small farm households into nonfarm activities (Ruofeng and Jiyuan, 1992).

Table IX.7: Evolution of Farming in the PRC, 1914–1988

Years	Type of farming	Average number of households per farm	Average farm size (ha)
1914–1949	Individual small farms	1	0.85
1950–1953	Elementary cooperatives	20–30	20
1953–1958	Advanced cooperatives	150–200	160
1958–1979	Communes	4,600	3,800
1979–1985	Individual farms under household responsibility system		
1986 and onwards	Single family farms; cooperative farms; collective farms; specialized farms	1; 10	0.8 to 20

Source: Compiled from Ruofeng and Jiang (1991).

behavior. For instance, Cheng, Findley, and Watson (1997) reported that the capital adequacy ratio in several RCFs is less than 12 percent and the loan-to-deposit ratio is over 90 percent, although PBC regulations require the latter to be less than 70 percent. While banks are required to maintain a reserve of up to 13 percent of deposits, the RCFs maintain no reserves. The provisions for loan losses are only about 0.8 percent of total loans made even though delinquency rates are high. In addition, the Government does not insure deposits mobilized by RCFs, and they tend to operate in fairly small areas with limited scope for risk diversification. The RCFs may have a significant positive impact on the rural sector, but without some regulation they may engage in unhealthy competition that could weaken the entire rural financial system.

Although the financial and economic crisis in Asia has not affected the country directly, there are indirect effects through declining exports that have caused a huge build up of inventory, which cannot be absorbed by the domestic markets. There is a serious challenge to increase domestic demand to keep the economy growing and generate surpluses for investments. There has also been a decline in the inflow of foreign capital due to uncertainties in the region (Song, 1998), and the banking system is not strong enough to support investment. Therefore, it is important now to exploit the vast potential for deposit mobilization in rural areas to finance investments. The challenge lies in effectively transferring domestic resources into productive investments. The weaknesses of the banking system will impede this process.

FUTURE DIRECTIONS

The Government has been strongly committed to phased financial sector reforms and has not reversed its policies. The phased reforms effectively created a diverse set of institutions, primarily government-owned, to serve the rural sector. However, these institutions are not viable and access to their services appears limited. There is a need for many reforms, but there is little information for use in examining the full implications of past reforms and the current status of rural financial institutions in order to identify specific problems and offer solutions. An important priority for the Government, therefore, should be to open a dialogue with the financial intermediaries to assess the effects of rural financial sector policies implemented thus far. Donors may contribute to the process by helping with independent audits of the ABC, the ADBC, RCCs and RCFs, to examine their constraints and performance, and to evaluate their potential to service the changing rural sector. This information would help identify which institutions need to be restructured, strengthened, or closed. There is also need to conduct surveys to collect microlevel information from rural households and enterprises to assess the current sources of finance in rural areas, the unmet demand for financial services, and the willingness to pay for these services. The survey results would help pinpoint where new instruments are needed to meet demand.

The country has been able to avoid the financial and economic crisis that has affected other East and Southeast Asian countries because (i) the inflow of foreign capital has been used predominantly to finance long-term direct investments rather than short-term loans, (ii) the currency is nonconvertible for capital account transactions, and (iii) the country has a huge current account surplus and foreign exchange reserves. But the PRC is not completely immune to a financial crisis because it has problems similar to the affected economies. There are instances of insider trading within the banking sector, huge volumes of nonperforming loans, a large proportion of bank portfolios composed of loans to inefficient State firms, and indications of overinvestment in real estate (Oxford Analytica, 1998).[12] These problems imply fundamental weaknesses in the financial system that could lead to a systemic crisis if not addressed through fundamental financial reforms to deal with foreign capital inflows, reduce arrears, and prevent insider trading. Reforms to increase the transparency of operations would also need to address the above problems.

[12] It has been reported that Chinese banks have heavily invested in real estate, although market values have declined since 1995. There are millions of square feet of luxury villas, town houses, and office spaces financed by banks in Beijing, Shanghai, and Shenzhen that were found to be unoccupied in 1998 (Oxford Analytica, 1998).

Creating the Policy Environment

Reforms are required to allow the State banks to lend and mobilize deposits largely based on commercial criteria. The interest rates for loans and deposits need to reflect the cost of funds adjusted for inflation and the opportunity costs of capital. State policies artificially control interest rates and hence affect demand such that it is difficult to evaluate the opportunity cost of bank funds used for lending. There is no rationale explaining why State banks have been allowed to deviate up to a maximum of only 20 percent from the fixed lending rates. Donors should promote and contribute to a policy dialogue on interest rates between financial intermediaries and the Government. Experience in other transition countries has shown that rapid increases in interest rates create distress borrowing and financial crises, since it is difficult to raise interest rates on loss-making State firms. A gradual approach to interest rate liberalization combined with reforms to increase competition, and policies that exclude insolvent banks and enterprises from borrowing may help move the system towards market-based interest rates (World Bank, 1996b). Policies should encourage competition and avoid subsidies that undermine it. Moreover, the enterprise reforms need to be expanded and accelerated, with a complete evaluation of State-owned enterprises to identify which ones should be closed or privatized.

The future impact on the PRC of the current financial and economic crisis in Asia is unclear. The weak currencies of other countries in the region put pressure on the PRC to devalue its currency to compete for export markets. This creates a situation of great uncertainty regarding future exchange and inflation rates, which will influence future interest rates. It will be important to stabilize the exchange and inflation rates if devaluation occurs. The current policy to regulate capital inflows and limit currency convertibility may be appropriate given the limitations of the financial sector. The correct sequencing may be first to reform the enterprise sector to complete financial reforms, then open the capital account.

The current governmental approach to alleviate poverty through highly subsidized microfinance lending is counterproductive to the objective of creating efficient competitive financial markets. In other developing countries, this approach has created a dependency syndrome and impeded other market-based initiatives. The Government should focus its scarce resources on improving the environment such that market-based initiatives can successfully introduce new financial products and innovative financial technologies. If the Government must be involved in direct services, it should follow the best practices developed elsewhere. The policy bias towards light industries should be reduced to give nonfarm enterprises better opportunities to emerge.

Creating and Strengthening the Financial Infrastructure

There is evidence of decline in investor confidence due to the recent failure and closure of the Guangdong International Trust and Investment Corporation. It is important for the Government to restore confidence by issuing transparent investment guidelines and regulations for investment companies to discourage investments in risky activities. The entire system of prudential regulation and supervision needs to be evaluated. For example, do good guidelines exist for loan loss provisioning by rural financial institutions, and are they respecting the guidelines? A system of appropriate guidelines and methods to insure compliance is part of the necessary infrastructure for financial institutions. However, the most well designed system cannot be successful if the supervisory personnel are not capable of and efficient in monitoring the financial institutions. Training programs for skill development may be as necessary as the regulatory system itself. There may be a role for donor projects in both developing the systems and training the staff.

Access to good and timely information is the lifeblood of financial institutions. There is no information on the internal methods used by rural financial institutions to collect and analyze information as part of their technology to screen and select clients, and determine loan sizes and terms. These methods need reviewing to evaluate the extent to which they may be responsible for the low loan recovery rates. Alternatively, this analysis might reveal that problems of property rights and the legal system are the chief causes. The second potential problem concerns access to external information. A financial institution must efficiently access information about a potential client's past credit history and the nature of any claims outstanding against property offered as collateral. No information is available on how such information is currently collected, stored, and exchanged in the PRC, or the potential need to create public institutions such as real estate registries or credit bureaus. Third, the regulatory authorities, donors, and investors must be assured that established accounting procedures are followed by financial institutions such that their accounts reflect the true situation. The information available does not inspire confidence that this area of information generation is accurate or efficient.

Institutional Development

Experience to date in transition economies indicates that institution building is a difficult process that requires a long-term commitment from donors and government (World Bank, 1996b). It is not clear that the PRC has yet developed the institutions needed for the future. The decision to create policy banks may allow the State banks to function more like commercial banks. But specialized policy banks may meet the same fate as agricultural development banks in other countries. They suffer from limited portfolio diversification due to restrictions on their portfolio mix, inflexibility in interest rates due to political interventions, and disincentives to mobilize deposits due to access to cheap funds from the government. In the PRC, the transfer of bad loans from the ABC to the ADBC may simply erode the latter's profits and require it to be recapitalized in the future. This bad debt problem needs to be resolved, and the ADBC needs to be allowed to compete for household deposits with RCFs and RCCs by offering market rates and flexible products.

A cost-benefit assessment should be conducted regarding the potential prudential regulation and supervision of nonbank institutions such as RCFs. This assessment should determine whether RCFs should be left unregulated, merged with RCCs, or closed. They meet a demand and have been innovative, but there are possible losses to depositors to be considered in whatever course of action is taken.