CHINA'S RURAL FINANCE IN THE 21ST CENTURY: A DEVELOPMENTAL AGENDA AND THE MARKET PITFALLS

FENG Hui

EAI Background Brief No. 1227

Date of Publication: 9 March 2017

Executive Summary

1. Agriculture, farmers and rural areas (*sannong*, or 三农) retain their importance in China's economic prosperity and social stability despite agriculture's diminishing share in total output.

2. Although rural finance remains the bloodline of rural and agricultural development, it is widely regarded as the weakest link in China's financial system in an overall robust economy.

3. Since 1996, capital in the Chinese financial system has shifted from shortage to abundance. This development has provided a strategic opportunity and a technical possibility for the Chinese government to undertake institutional reforms in rural finance in order for it to play a more supportive and developmental role for the rural economy.

4. Given the political consensus at the top on transforming the nature of rural finance from extraction to development, the government has increasingly realised the urgency to build a system of rural finance that can stimulate jobs and growth in the new century.

5. The resultant rural financial reforms in the new century have been wide ranging, targeting policy, cooperative and commercial forms of lending.

6. In practice, however, a market-oriented approach has triumphed in the reforms due to the weak capacity of the government in delivering subsidised lending and the distorted institutional structure of cooperative finance in China.

7. As a result, market-oriented reforms have largely failed to achieve its original vision of allocating financial resources to facilitate rural development. Despite the political commitment at the top, the emerging financial market showed little interest in playing a supportive role and continued to divert rural financial resources to the urban, industrial sectors.

8. A profit-driven market system alone hence cannot fulfil the political imperative of nurturing rural development given the higher costs associated with rural lending due to the nature of agriculture, historical issues of rural underdevelopment, and the gap in investment yields between urban and rural operations.

9. The future challenges, therefore, will be the establishment of a rural financial system that caters for various levels of demand for finance in the rural area, a system that is capable of vertically integrating policy, cooperative and commercial lending.