

The Research on the Integration of Rural Formal Finance and Informal Finance of China

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Abstract: Through regarding the integration of the rural formal finance and the informal finance as the full text inherent core, analyzing its historical mission and age-old malpractice in the process of development deeply, such as the financial institutions with single and imperfect function, lagging the financial service mechanism in rural area, imperfect rural financial environment, contradiction between the singleness of rural financial product supply and diversified demands, rural funding is seriously insufficient, regarding establishing the national policy support system, optimizing the environment of the law, optimizing the environment of credit, establishing the informal financial regulatory system, the rural formal financial institutions should play a main role in the process of integration, building the system of finance and insurance to guarantee the healthy development of the financial industry as the key factors to clear handicaps and realize the target to make integration of the formal finance and the informal finance construction become the common practice so as to promote China's economic development.

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Key words: Rural formal finance, Informal finance, System of finance

1. Introduction

Garmaise and Moskowitz (2003) show that “even in the United States, informal networks play an important role in controlling access to finance. Using the commercial real estate market as an example they show that brokers serve an important role in providing clients access to finance and that brokers and banks develop informal networks that have a significant effect on availability of finance.” Meghana Ayyagari (2008) thinks that “even in fast growing economies like China where the formal financial system serves a small portion of the private sector, external finance from the formal financial system is associated with faster growth and higher profit reinvestment rates for those firms that receive it.” Allen and Qian (2005) further suggest that China may be an important counter-example to the law and finance literature's focus on formal systems since the fastest growing Chinese firms rely on alternative financing channels rather than formal external finance.

According to the above documents, the dominant view is that informal financial institutions play a complementary role to the formal financial system by servicing the lower end of the market - informal financing typically consists of small, unsecured, short term loans restricted to rural areas, agricultural contracts, households, individuals or small entrepreneurial ventures. Informal financial institutions rely on relationships and reputation and can more efficiently monitor and enforce repayment from a class of firms than commercial banks and similar formal financial institutions can. According to this view, however, informal financial systems cannot

substitute for formal financial systems because their monitoring and enforcement mechanisms are ill equipped to scale up and meet the needs of the higher end of the market.

2. The current status of rural formal finance and informal finance development

The development of rural economy relies on the rural finance, which, at present, consists mainly of the formal finance supply in China. The formal finance supply includes commercial, policy-based and cooperative financial institutions. The formal finance supply in rural area of China cannot meet the needs of the rapid development of rural economy with severe shortage.

2.1 The current status of rural formal finance development

2.1.1 The financial institutions have single and imperfect function

The rural formal finance system in China includes the Rural Credit Cooperatives (RCC), the Agricultural Bank of China (ABC), the Agricultural Development Bank of China (ADBC), the Postal Savings Bank of China (PSBC), the Agricultural Insurance, the Rural Commercial Bank and Rural Cooperative Bank. The Postal Savings only provides saving service with the single financial service function. Though the system of the Rural Credit Cooperatives has been re-organized systematically for several times since 1950, it still and always performs as the major force of rural finance system in China. In 2002, the rural loan balance of the Rural Credit Cooperatives accounts for 78 percent of that of the financial institutions. The Rural Credit Cooperatives

has been in trouble for a long time due to the control of the Central Bank over the interest rate and funds use, high operation costs and lack of benefit encouragement, etc., according to the statistics, the accumulative historical bad debts of the Rural Credit Cooperatives amount to more than RMB 100 billion Yuan, and its non-performing asset ratio mostly remains 50 percent above, and even over 90 percent in some underdeveloped provinces, which tops the four major state-owned commercial banks to a large extent. So the members there have no rights to determine the business of the Rural Credit Cooperatives, therefore the Rural Credit Cooperatives shall not be considered as a true cooperative. As its capital sources are limited and loan application there requires mortgage and has limited amount with complicated procedures, it is difficult for most of the rural households to gain loans from the formal financial institutions. The contribution of the Rural Credit Cooperatives to rural development remains limit with only 20 percent poor rural households having been contacted.

The Agricultural Bank of China is reestablished in 1978 and it mainly serves agricultural business institutions (e.g. food bureau and supply and marketing cooperative) and township enterprises, which basically have no direct connection with the rural households. The Agricultural Bank of China transforms towards the commercial type with the business goal of maximizing the benefits, and as its share in rural market decreases year by year, the support to the development of rural economy recedes significantly. According to the empirical study of the scholar Zhang Jianhua, in 2000 and 2001, the average efficiency of the Agricultural Bank of China ranked 15 in all commercial banks without regard to non-performing loans; if the non-performing loans are taken into account, then the Agricultural Bank of China ranked out of 20. So we can see the condition of asset quality of the Agricultural Bank of China is not optimistic.

The Agricultural Development Bank of China mainly undertakes the policy-based financial business stipulated by the central government and the appropriation of agricultural support funds, and provides credit funds support only for the special enterprise group and has no credit business relation with individual rural households. The business of the Agricultural Development Bank of China cannot meet the fund demand of rural households directly. With the deepening of the reform of grain purchase and sale system in China, the Agricultural Development Bank of China based on such system shows a tendency of commercialization gradually.

Since we recovered the handling of agricultural insurance business in 1980s, the agricultural insurance in China maintains stagnant for a long time. In 2003,

the premium income of agricultural insurance in China amounted to only 460 million Yuan, accounting for approx. 0.5 percent of that of the property insurance in China. The network of postal savings institution covers the most range in rural area, but before the incorporation of the Postal Savings Bank, it provided only saving service rather than loan service, which led to a great amount of rural capital outflow. After the Postal Savings Bank of China was founded, as its business has not developed overall, it cannot adapt to the demand of rural households for microcredit completely.

2.1.2 The financial service mechanism is lagged in the rural area

The rural financial service mechanism lags, and the types of agricultural credit support perform single consisting mainly of microcredit with intermediate business absence. In addition, the way of rural financial service falls behind the time with less-educated personnel in financial institutions and outdated technology and equipment. None of these can keep up with the development of new village construction. The lacking of funds supply to loans of “village, agriculture and farmers” by the current rural financial system mainly shows as that: ① the credit of gross-level financial institutions is limited in amount, and the loan over a certain amount must be approved by the superior; ② the verification conditions of credit are rigorous with complicated loan procedures, and the approved amount of loans will not exceed 60 percent of the mortgage generally; ③ the financing costs of “village, agriculture and farmers” are significantly high, the floating factor of the loan interest rate of “village, agriculture and farmers” presents mostly 50 percent above, which is higher than the floating range of the interest rates of commercial banks in the same term to a large extent.

2.1.3 The rural financial environment is imperfect

1) The functions of the existing rural financial institutions are weakened. First, the function of policy-based financial agricultural support weakens. Second, the agricultural financial support of the commercial banks recedes. Third, the agricultural finance is affected by the history significantly with poor economic benefits and stamina lacking of agricultural support, which limits the function on the width and depth of agricultural support.

2) The capital in rural area keeps flowing into the urban area. First, stimulated by the higher rate of return of transfer, the savings scale of Postal Savings expands rapidly, and a large amount of spare capital flows into the urban area in the form of postal savings and cannot be used back for rural benefits. Second, under the guidance of the thought of seeking quick success and instant benefits, the investment of the

state-owned commercial banks mostly focuses on the urban area, and the branches of institutions of county level reduce sharply. The existing branches hand over the funds to the superior, which makes them the “savings offices” of the superior to a large extent, and intensify the capital shortage in rural area.

3) The link of rural financing credit is weak. The problem of credit crisis is widespread in rural area for a long time, the features presenting in four respects: first, the own funds are accumulated inefficiently with low financing ability and lacking of repayment guarantee. Second, problems on the administration system of rural economic entity produce the randomness of the use and return of loans with high potential risks. Third, affected by the natural disasters, the agricultural production is with high risks as well as low benefits, which leads to the weak economic foundation for the rural households to maintain the loan credit. Forth, debt evasion and nullification occur from time to time due to the low awareness of credit, which increases the ethical risk of rural financing. These damage the rural financing environment and substantially obstruct the capital input on “village, agriculture and farmers” of financial industry.

2.2 The current status of rural informal finance development

The informal finance of our country derives from rural area, especially the costal area, such as Zhejiang, Fujian, Guangdong. The direct reason is that the lag of Chinese finance system reform to economy. The 30-year reform of finance system causes the complete change of Chinese economic structure, such as rapid rising and expanding of non-state-owned economy, rising of private enterprises. However, the remove and merging reform of basic level of state-owned financial institution during the Chinese economic transformation period causes not only the fast shrink to rural financial support, but also most rural capital loss, which leads the vacuo of rural financial service and the injection of informal finance.

Wen Tiejun (1999) surveyed 15 provinces and found that occurrence rate of private lending reached 95 percent; the survey report (2001) pointed that the loan amount of Chinese farmers getting from informal finance market approximates 4 times of loan getting from formal finance: they think the scale of China “underground finance” has reached 900 billion Yuan, which equals to 6.5 percent of China’s GDP. In addition, the survey results of 20 provinces from east, middle and west announced by Central University of Finance and Economics also states that scale index of farm produce getting financing through underground finance channel is 56.78 (including the highest index of the west is 62.43, next, the east is 56.45, and the middle is 55.47), that is to say, the proportion of farmers getting financing through formal finance

channel, such as the Rural Credit Cooperatives, the commercial banks, is less than 45 percent. Obviously, the occurrence rate of informal finance is high and it covers widely, which is the common economic phenomenon in the rural area of east, middle and west region of our country. The rural informal finance in our country includes the following several forms: Free lending; Loan intermediaries; Native bank; The rotating savings and credit associations (ROSCAs).

The characteristics of the development of rural informal finance are:

1) It has the rapid growth

The research group of Central University of Finance and Economics conducted a field sample survey, in 2006, including the 28 provinces, autonomous regions and municipalities directly under the central government in the whole country, except for Tibet, Guizhou, Chongqing and Taiwan, found that the scale of national folk lending, underground lending and illegal lending had exceeded 6000 billion Yuan. In the first quarter of 2008, China’s GDP was 6.15 trillion Yuan, 10.6 percent upper than the former year, and non-observed credit grew 16.96 percent (credit to economic growth elasticity was 1.6). If calculated in accordance with the uniform growth, in the first quarter of 2008, national non-observed credit should be 9.5 trillion Yuan. Under the tight monetary policy, calculating in accordance with such speed, in June 2008, national non-observed credit has exceeded 10 trillion Yuan.

2) The interest rate is high

High interest rates are the typical characteristic of informal finance. Five cents monthly interest turned to be a low interest rate, and 0.15 to 0.2 yuan interest is common. Calculating in accordance with the simple interest method, the annualized rate is as high as 60 percent to 240 percent. Besides, the underground financial organizations never issue medium-and-long-term loans, short-term loans are the only species, generally ranging from 1 to 3 months. This means if you can’t repay, “compound interest”, the compound annual interest will be 80 percent to 720 percent. The high interest rate of the informal loans determines the enterprises can only use these loans for short-term cash flow, and they cannot use them for medium-and-long-term investments and other production and business operation activities.

3) The potential risk is high

The operation mechanism of informal finance is not standard, with very high potential risk. Once released, it is likely to cause confusion of the financial order, and may lead to social unrest. Some informal financial organizations, like Rotating Savings and Credit Association, underground private banks and so on, have weak internal control mechanisms. The endogenous problem of rural informal finance leads to

anarchy. The lack of relevant legislative and regulatory responsibilities distribution, the informal finance, which is in a state of “vacuum”, is generally with a implicit operation. Meanwhile, due to the lack of effective external supervision and restraint mechanisms, it may be used by some unscrupulous elements. They are always trying to encircle money with high interest, not for business operation, but for speculation, and accumulating the solvency risk. And this unproductive and forgivable loan will ultimately lead to collapse of the payment chain, and damage the participants’ interest, finally causing social unrest.

3. Countermeasures for the integration of rural formal finance and informal finance

Through the analysis of the previous chapters, there is a basic conclusion: the integration of rural formal finance and informal finance has the necessity and the feasibility; The integration has two successful cases at home and abroad, and the integration of both achieved a good effect. However, in reality practice which can be acted as example is less, there exist many factors restricting the integration. On these basic conclusions, this chapter summarizes the way how to choose the integration of rural formal finance and informal finance, and considering the restricting factors on the integration policy suggestions are put forward.

3.1 Establishing the national policy support system

Relative to the formal finance, the informal finance has the access to information, the hard constraints and cost comparative advantage. If the government cracks down and clamps down on the informal finance, the informal financial funding markets show that there is no significant effect of these behaviors, and that needs to spend a lot of cost. On the contrary, with a better understanding of informal finance practically, the government provides loose investment environment for its development and introduces laws to strengthen the functions of the allocation of resources in the informal basic role in the financial market, allowing it to exist in a variety of interest rates, a variety of investment and financing channels for free, in order to achieve the normal development of informal finance under the guidance and supervision. In the financial integration the formal finance is dominant, which results the informal finance has become a main object of mobilization. Government and department for financial supervision and regulation should formulate the corresponding encouraging policies, and formal financial institutions can also provide some favorable conditions specifically.

3.2 Optimizing the environment of the law

Although various forms of informal finance exist, the authority should resolutely combat and process the informal finance who disrupts the financial order and

social order. On contrary, for whom speeds up faster and better development of our domestic economy and strengthen financial markets, the way to making informal finance legal can be better to build the system of protecting the property rights of informal finance main body and the legitimate business activities. On the one hand, perfecting the existing laws and regulations for the nature of the informal financial behavior and boundaries, there is a necessity to define clearly. On the other hand, the authority should formulate relevant laws to regulate and protect the informal financial activities. At the same time, standardizing some that do not belong to the category of illegal financial. Through the form of legislation to informal finance, making it legalization and open to give it full play of the complementary role of the formal financial.

3.3 Optimizing the environment of credit

As a result of limited professional ability of the informal financial institutions in rural area, the rural loan, interest rate and the term of use vary for that matter, the rural loan deals with the systematic risk. The informal financial activity should pay more attention to the good faith principle. So setting up and improving the credit reporting system to ensure the informal financial stability and healthy development is more important than formal finance. We should give feedback customer of a bad credit record in time to ensure financial transactions related to the interests of the parties. Financial regulators can establish credit files for the rural informal financial institutions and school credit systems. According to the source of funding, the cost of financing, capital scale, organization reputation as well as the scope of the operation and information, developing the informal financial institutions that have the potential, at the same time for the operation of the informal financial institutions supervision and management, thus reducing the formal financial institutions and its integration of transaction costs and reduce transaction risk.

3.4 Establishing the informal financial regulatory system

Public interest theory believes that the market is fragile, and drift will lead to injustice and low efficiency. Informal finance born in private economy and small and medium-sized enterprises more than other financial institutions often has the poor ability to repaying the loan, which makes the market prospects uncertain nature, so it needs financial regulation. Otherwise, if the lender due to the lack of moral or poorly run, could easily lead to financial risk; Because of lack of regulation, and also the informal financial illegal fund-raising and fraud phenomenon emerge in endlessly, and thus brings damage to both borrowers and lenders, even threatening the entire financial

system of effective operation as well as security and stability. So, It is the guarantee of healthy maintenance and development to build the establishment of regulatory principles, regulatory agencies, regulatory means, content and supervision of the result analysis and assessment, and complete supervision system, in the process of the formal finance and informal financial integration.

3.5 The rural formal financial institutions should play a main role in the process of integration

Based on previous analysis, at the beginning of the rural economy, economy is backward areas, so the policy finance must account for the main body status. In the stage, to the further development of rural formal financial exclusion seriously, integrated finance plays a huge role. With the development of economy, the commercial finance has incomparable advantages. But no matter where area and no matter when the time is, the phenomenon of coexistence of three financial forms accordingly exists, and there are different forms of informal finance. Just at each stage of formal financial institutions and their form and proportion of informal financial institutions are different. At the same time, in each stage of formal finance and informal finance, a variety of financial innovation will appear. From the point of the development of agricultural development bank, the policy of financial development is relatively single and slow. Expanding its business scope further, raise and broaden the financing channels to promote the reform of management system. Secondly, increasing the financial input, and pay attention to the low level of rural infrastructure and income farmers' support. In the early stages of the rural economic development, our country is relatively backward in the midwest region, so policy finance should play a bigger role. The policy banks, commercial banks and other financial institutions play a role of main channel in the process of integration of both.

3.6 Building the system of finance and insurance to guarantee the healthy development of the financial industry

The financial industry is a special high risk business. If a financial intermediary crisis occurred because of poor management and failure, considering information asymmetry, savers may occur due to concerns about their assets loss and a run on the institution, which spreads to other more intermediary institutions, leading to the collapse, which affects the stability of the financial system. Especially at present our country rural informal financial situation is multifarious, they generally lack of risk guarantee mechanism itself, also does not have the formal financial institutions legal reserve system and the bad debt reserve canonical credit activities, the establishment of the financial insurance system can

reduce the possibility of failure, namely the establishment of a deposit insurance system can reduce the happening of the risk. With the development of agriculture in our country, many services for small and medium-sized private financial institutions will be born. Due to the small and medium-sized financial institutions to deal with the risk ability is weaker than formal financial institutions. The insurance system is conducive to the healthy development of small and medium-sized financial institutions and the establishment of an orderly financial order. It is the characteristics of our country rural financial institutions operating to make regulatory functions outstanding and strengthen the rural financial institutions of serious problems that include the disposal ability. There are some disposal methods, such as paying deposit, undertaking to buy, not going out of business assistance and transfer of deposit insurance.

Conclusions

This journal carries out the historical review and present station analysis of integration of the formal finance and the informal finance development, analyses its existing problems and reasons and investigates the development state of foreign integration of the formal finance and the informal finance. There are the problems such as the financial institutions with single and imperfect function, lagged financial service mechanism in rural area, imperfect rural financial environment, contradiction between the singleness of rural financial product supply and diversified demands, rural financial institutions are the pumper of rural economic development, overall credit scale decreases and the rural funding is seriously insufficient. It brings out its countermeasure of establishing the national policy support system, optimizing the environment of the law, optimizing the environment of credit, establishing the informal financial regulatory system, the rural formal financial institutions should play a main role in the process of integration and building the system of finance and insurance to guarantee the healthy development of the financial industry.

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