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CREDIT CO-OPERATIVES AND THEIR ROLE IN POVERTY REDUCTION IN RURAL CHINA

Li Zhao

Rural Development Institute, Chinese Academy of Social Sciences
No. 5 Jianguomennei Avenue, Dongcheng District 100732, Beijing, China
E-mail: zhao-li@cass.org.cn

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Abstract: Financial constraints may contribute to poverty traps. In the underdeveloped capital markets of rural China, many poor farmers in disadvantaged areas are financially constrained and denied access to formal financial services. A few attempts have been made to reform rural credit co-operatives but with limited impact. Recently, the development of rural mutual co-operatives, as one of new-type rural financial institutions, has gained increasing attention among scholars. While scholars predict that it would be difficult for true co-operative financial institutions to establish themselves and develop in China, this study discusses the conditions for the development of rural mutual co-operatives and identifies their institutional advantages in poverty outreach and financial sustainability. The analysis of the study is largely based on the primary data collected from field investigations and case studies. The study reveals that these organizations have played a significant role in promoting financial inclusion and become a sustainable driver for poverty reduction. This observation is in contrast to the widely-believed prediction that it is hardly probable for true credit co-operatives to establish themselves in modern China due to excessive government intervention and China's peculiar political culture and social context. The findings also suggest two conditions be necessary to achieve their potential, namely, the co-operation between credit co-operatives and agricultural co-operatives, and local embeddedness with good social connectedness.

Keywords: Credit co-operative; co-operative financial institution; rural mutual co-operative; poverty reduction; sustainability.

1. Introduction

Vulnerability to poverty is widespread in China, particularly in rural areas. Currently, China is at a critical development phase in its ongoing fight against poverty. According to the country's 13th Five Year Plan for Economic and Social Development, the Chinese government has committed itself to the ambitious goal of eliminating poverty such as defined by the year 2020 according to the poverty line currently in effect. According to the 2010 criterion used currently to set the poverty line applicable in rural China, in 2015, there were still 55.75 million people in China who were poor by this standard.

To many, the fundamental cause of poverty traps is the financial constraints that prohibit the acquisition of those resources to poverty-escaping scale (Turvey and Kong, 2008). Stiglitz (1990) considers capital markets in the rural sector as underdeveloped. Since microfinance programs were firstly introduced into China in 1994, they have achieved a mixed record of success (Park *et al.*, 2003), and not yet produced the significant results as those in other countries like Bangladesh or Indonesia. On the one hand, government-run microfinance programs in China, while larger in scale, do not pursue self-sustainability and thus have been a failure. On the other hand, NGOs-involved public interest microfinance institutions remain confined to small-scale projects and are typically external-funded. They have little prospect of widespread replication or expansion due to their problem of not being recognized as financial institutions (Park *et al.*, 2003). Therefore, Grameen-type lending in China is believed to have limited application (Turvey and Kong, 2008). In comparison with microfinance institutions, in many cases, co-operative financial institutions (CFIs) serve larger numbers of poor people without relying on donor support as the formers do. In fact, existing literature widely supports the notion that CFIs serve many poor people. Even though middle-income clients are also among their membership, such feature nevertheless allows them to reach the poor without necessarily compromising their sustainability (Cuevas and Fisher, 2006).

In China, a few attempts have been made to reform existing CFIs but with very limited impact (Park *et al.*, 2003). Nominally rural credit co-operatives (RCCs) have been regarded as the most important and, for a long time, the only CFIs in China. However, it is widely agreed among scholars that they are co-operatives in name only (Xie, 2003; Gale and Collender, 2006; Ong, 2009).

Recently, new type rural financial institutions have gained increasing attention among scholars. These three new-type rural financial institutions (RFIs) in China refer to village and township banks (VTBs), rural mutual co-operatives (RMCs) and lending companies (LCs), introduced by the China Banking Regulatory Commission (CBRC) in 2007. Since then various financial innovations and practices are burgeoning in rural China. By the end of 2014, a total of 1226 new-type RFIs were registered nationwide, including 1153 VTBs, 49 RMCs and 24 LCs.

It is important to mention that VTBs and LCs are commercial financial institutions, and only RMCs are meant to be CFIs. Therefore, this paper focuses on RMCs as the only CFIs recognized by the state regulatory agency. While scholars predict that it would be difficult for true CFIs to establish themselves and develop in China due to China’s peculiar political culture and social context, this study is nevertheless interested to see whether the co-operative model can serve as an effective tool to combat poverty and foster financial inclusion in the rural society of China.

The paper is structured as follows. After an introduction on methodology, the next section presents an analysis on the problems of access to formal financial services in rural China and the development of credit co-operatives since reform and opening-up.

Based on findings from the fieldwork, it discusses the conditions for the development of RMCs in China and identifies their institutional advantages in poverty outreach and financial sustainability.

2. Methods

The analysis of the study is largely based on the primary data collected from field investigations and case studies. The cases in the study are located in Zhejiang, a pioneering province in China where the new co-operative movement is most vibrant. Zhejiang has established its local co-operative regulation as the first one in China, even before the appearance of the national law. This may demonstrate that the co-operative development in Zhejiang is advanced compared with that in the other areas in China.

In this study, four pilot organizations were included (hereafter coded as B, H, Y and M). In total three field visits were made, in autumn 2010, summer 2011, and autumn 2016, respectively. The first phase of the study included preliminary conversations with local government officials and pilot interviews with key organizations' founding leaders. This helped the author to identify and gain access to the cases for the whole research process and further follow-ups. During the second and third phases, in-depth interviews and focus group discussions were made with the management teams, big and small members and local officials responsible for RMCs' development. Follow-up questions were asked via telephone when clarification or more information was required.

In total 29 interviews were conducted. The interviews with 17 member informants averaged 40 minutes, whereas the interviews with 12 leader informants and local officials were two to three hours each in length. The interviews with both leader and member informants were open-ended, and followed a protocol that evolved with the research project. Interview questions were developed to understand and assess the cases' missions and principal activities, their operations and the lending technologies that ensure their outreach and sustainability. Besides, secondary sources are also used. The author employed multiple data sources by double-checking some general information with archival data (i.e. documents for project application), if available.

3. Mapping Credit Co-operatives in China

3.1. Problems of China's Rural Financial System

A large range of studies on China's rural finance and financial reform, and microcredit or microfinance, point out the significant challenge in the access to formal financial services by the poor in disadvantaged rural areas (Jia and Guo, 2008; Park *et al.*, 2003; Tam, 1988; Turvey and Kong, 2008). The problems of farmers' difficulties in obtaining capital have to do with the three principal features of rural credit markets: (1) scarce collateral (largely due to a lack of physical assets and poorly-developed property rights); (2) underdeveloped complementary institutions (such as poorly-developed communication system and transaction costs, and the absence of insurance market); and (3) covariant risk (particularly weather fluctuations and changes in commodity prices

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that affect agriculture) and segmented markets. The latter means a lender's loan portfolio is concentrated on one particular group of individuals or in one geographic area thus limiting capital flow across regions or groups (Besley, 1994). Therefore, the incumbent RFIs were not willing to provide loans to household farmers (thus a "market failure"). Consequently, intervention was regarded as important by the Chinese government. The same may hold true concerning poverty reduction programs. However, it was widely believed that such government-initiated programs are hardly probable successful in a long run (therefore a "government failure"). This section briefly examines the problems mentioned above, and particularly, how they have been addressed in the new era, under new reforms, and by new players of financial institutions.

3.2. New Era, Old Problems?

With People's Communes was dismantled in the early 1980s, the RCCs was run by the state as the grassroots level financial administration in the rural sector. Since 1984, when the state decided to revive the RCCs, the RCCs have started to go through several reforms and institutional changes. However, progress has been "slow and insignificant" (Tam, 1988). This is partly because there was no such plan from the state to make banks and their branches to compete with each other (Shen *et al.*, 2010). Briefly speaking, the RCCs' deposit reserve requirements, entire operations and lending interest rates were directly and indirectly controlled by the Agricultural Bank of China (ABC). Therefore, RCCs continued as the rural branch of the state banking system. Before a new period of reforms started, according to Xie (2003), major challenges that RCCs faced included ownership and governance structure (whether being co-operatives or commercial shareholding banks), historical burdens and nonperforming loans (NPLs).

3.3. New Reforms, Old Problems?

Since the mid-1990s, a competitive banking system was gradually introduced in rural China as the reform and opening-up process accelerated (Oi, 1999; Shen *et al.*, 2010; Watson, 1998). Financial reforms resulted in the transformation of four national banks into state-owned commercial banks that, mainly driven by the rationale of economic efficiency, gradually retreated from the rural areas (particularly the ABC). The reform of rural credit co-operatives had a similar effect. In an attempt to restructure the formal rural financial system, the state separated the RCCs from the ABC in 1996. From then on the Chinese government has taken numerous steps to reform the RCC's banking system in order to recast the RCCs as true CFIs.

However, most observers counted this effort as a failure. RCCs are regarded as "small scale and locally based quasi state banks in rural China" (Xie, 2003), or put simply, "local branches of a state-owned bank" (Ong, 2009). Their ownership was unclear and members did not necessarily have any say in management (Gale and Collender, 2006). Furthermore, because RCCs were often more inclined to fund projects

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with lower risk and higher capital returns, the situation of a lack of lending in rural areas was exacerbated, and poor households were increasingly excluded from credit access. Therefore, they are "hardly meeting the credit demands of the very constituencies they are supposed to serve" (Ong, 2009). According to Turvey and Kong (2008), they were not fully endorsed either the self-help group model or the notion of trust as a form of capital. Thus in China, the very poor are credit-constrained from the microcredit market. Moreover, the study by Huang *et al.* (2006) reveals that, in almost the entire reform era, capital was flowing from agriculture to industry and from rural to urban sector. Therefore, China has been extracting large volumes of capital from low-return sectors to high-return sectors, partly due to a lack of a strong intervention into the sector and of an effective rural lobby. This phenomenon corresponds surprisingly to the situation in the 1930s, when a continuous drain of capital flew from rural districts to the cities (Hsu, 1937).

After 2000, the state has experimented with a series of reforms to introduce various property rights to the RCCs. However, it was not until 2003 that it began a major reform of RCCs. In 2003, the state allowed experimental reforms to be carried out in eight provinces and cities, being expanded further to the nationwide in 2004 (*Guofa* No.15/2003). During the whole process, RCCs have been reorganized, with stronger ones (mostly in economically-developed regions, with a relatively healthy financial status) being restructured as provincial rural commercial banks or rural co-operative banks (RCBs), and most others (mainly in less-developed areas) being merged into county or provincial-level unions. They were given more latitude to offer higher interest rates on deposits to compete with other RFIs and adjust interest rates on loans within a band around rates set by the People's Bank of China (PBC).

However, it was still not clear whether RCCs have been transformed into real co-operative banks in which members have influence over the institutions' management. Since member households very rarely take part in member representative meetings, managers hold an informational advantage that gives them enormous power, resulting in insider control (Ong, 2009). It is widely agreed that RCCs were still subject to China's Communist Party (CCP) and government directives. One survey finds that members' representative meetings are often made up of township and village cadres (village heads, village Party secretaries and township officials), instead of farmer members. As a result, members' representative meeting often becomes a rubber stamp, whereas the real authority lies with the head of the board of directors (Ong, 2006). Board members included representatives of the CCP and government, and board members and managers must have the approval of the CBRC. By evaluating the institutional design of the post-reform RCCs, Ong (2009) shows that the reforms have failed to eliminate the entrenched Party involvement in the financial organizations, which is "fundamentally inconsistent with effective corporate governance structure". They have adopted many trappings of commercial banks, but they were still effectively controlled by the government, and lending decisions often reflect policy initiatives and development

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strategies. Therefore, while rural financial institutions have resembled commercial banks, the rural financial market was not driven by market forces and many barriers to intermediation of funds remained (Gale and Collender, 2006).

With the increased competition and commercialization, traditional financial institutions (including RCCs, RCBs and rural commercial banks) were still unwilling to provide loans in the lack of collateral. Considering sustainability and profitability, they usually preferred to choose as principal clients those farmers who were in the middle class in terms of income. Farmers with lower income had great difficulty in obtaining loans (Turvey and Kong, 2008). Around 2006, the share of microcredit to farmers by the RCCs stagnated around 30 percent, which could, according to Jia and Guo (2008), lead to further marginalization of small-scale farmers.

3.4. New Players, Old Problems?

In December 2006, the CBRC changed market-entry requirements for rural banking aiming to further improve financial services' quality, to increase competition and financial supply in rural areas, and to encourage private capital to enter into the field. Consequently, three new-type RFIs were granted permission for the establishment, RMCs being one of the three (together with VTBs and LCs). Since October 2007, the pilot experiments in 6 provinces were further expanded to a total of 31 provinces, autonomous regions and municipalities. By the end of 2011, a total of 786 new-type RFIs were established nationwide, 473 of them being located in the western and central regions, and 313 located in the eastern region. They have cumulatively taken up 36.9 billion Yuan, with outstanding balance of loans standing at 131.6 billion Yuan. Among the total loans, 42.3 billion Yuan (32.8%) was disbursed to rural households and 62.0 billion Yuan (47.1%) to rural small businesses, together accounting for 80 percent of all loans.

Since 2012, the state banking regulatory has suspended the approval of RMCs. At the time of this writing, there were still 49 rural fund mutual co-operatives approved by the CBRC. However, there are hundreds of thousands unofficial organizations that are spontaneously established yet without licensing while carrying out financial activities. Despite the cautious approval, the authorities continued releasing policies to encourage rural financial innovations and promote the development of credit co-operation, as demonstrated by the central government's Number One Documents since 2014. Besides, local authorities in various provinces have also indicated great interest in the development of RMCs.

4. Discussion

4.1. Development Conditions for Credit Co-operatives in China

To fulfill the goal of eliminating poverty according to the 13th Five Year Plan, a decrease in more than 10 million of the poor population by each year should be witnessed between 2016 and 2020. For those 55.75 million people defined as being impoverished, the Chinese government has regarded industrial development as an important approach which has the potential to lift 30 million out of poverty during this period. Agricultural co-operatives have served as a key driving force of industrial development.

Based on field observations, the study finds that the development of RMCs is to a great extent concomitant with and inspired by that of agricultural co-operatives in China. With the Law of the People's Republic of China on Farmers' Specialized Co-operatives (FSCs) came into force in 2007, a new co-operative movement has been witnessed and regarded as engendering the most dynamic organizations in rural China (Zhao, 2017). Meanwhile, the development of RMCs also entered into a new era, becoming “formalized” as specified by the Interim Provisions on the Administration of Rural Mutual Co-operatives released in the same year.

Most agricultural co-operatives under investigation have operated in a capital-constrained environment. Although the state encourages commercial financial institutions to provide financial services to the FSCs by diversified means, as specified in the Law on FSCs, the reality is quite the contrary. Empirical findings reveal that, different from the situation in the West, debt capital does not appear to be a widely-used traditional financing source: agricultural co-operatives in China have difficulty even in borrowing short-term debt, not to mention borrowing long-term loans. Also specialized/non-traditional external sources of capital such as those provided by co-operative banks do not suffice (Zhao, 2014). Co-operative banks in rural areas that have been transformed from formerly RCCs can still fail to meet the co-operatives’ demand for credit, not to mention the other commercial banks. It is partly because the co-operative itself does not have much fixed capital assets that can be used as collateral. Although according to the central government’s Number One Document and other documents related, many tangible assets can be used as collateral, such as farming machines, agricultural greenhouses and warehouses, in reality, many banks are actually not willing to accept them as collateral. Therefore, it is not only due to the fact that lending agencies are uncomfortable with the co-operatives’ “unorthodox” ownership structure (Zhao and Develtere, 2010), but also because co-operatives in China are regarded to have little capital assets on their own which can be used as collateral. Short-term loans or micro-credits that most co-operatives under investigation have successfully gained are actually in the name of the directors or of the other large shareholders. In other words, personal assets or creditworthiness from the core members are popularly used as collateral for the co-operatives in order to gain loans from commercial banks.

Consequently, in order to alleviate the problem of capital constraints and loan shortage that co-operatives and farmers face, the Number One document of 2009 emphasized to encourage FSCs to carry out credit mutual-aid. In the same year, an opinion concerning supporting financial services to FSCs (*Yinjianfa* No.13/2009) has been issued, fostering pilot program to establishing RMCs on the basis of FSCs through

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a resource mix structure. In 2013, the central government has allowed an enlarged policy space, permitting farmers' co-operatives to carry out financial services and credit co-operation inside the organizations.

Empirical study shows that, facing great difficulties in obtaining credit, the members in agricultural co-operatives under investigation were inclined to collaborate for credit co-operation. Except the case M in which members in up to three local agricultural co-operatives came together, the other cases were established on the basis of one such co-operative for each. On average 62% of agricultural co-operatives' members participated in credit co-operation. This was financially viable for credit co-operation since its sustainable operation was able to be ensured by way of providing capital in production and investment. Such phenomenon appears to set a new opportunity for the development of RMCs as true CFIs in China.

4.2. Poverty Outreach and Financial Sustainability

For CFIs, balancing social and economic dimensions is considered as a major challenge. Therefore, two aspects are regarded as highly important, namely, poverty outreach and financial sustainability. In many cases, these two aspects are hardly achieved at the same time, and there seems to be a conflict between these two objectives.

For RMCs under investigation in China, on the one hand, from the perspective of social dimensions, they explicitly aim to address the problem of capital constraints and loan shortage in the community where they are located. One interviewee (code number H2-303) noted that, before the existence of the RMC, he always had the problem with the high interest rate of rural informal loan, or faced the difficulty in providing physical collateral required by formal financial institutions (i.e. RCCs). When he heard from his co-operative that the registration of a RMC was under plan, he immediately indicated his willingness to join and provided a minimum share of 2,000 Yuan. On the first day of the case H's operation, he then successfully borrowed 120 thousand Yuan, all within 10 minutes.

Besides, case studies reveal that RMCs have provided effective services to farmer members by offering flexibility, streamlining service procedures, and shortening the loan application approval process. In this regard, most RCCs were unable to compete by granting loans to ordinary farmers within two or three days. Moreover, most RMCs set a loan interest rate lower than that applied for RCCs (and possibly by other financial institutions and VTBs). Such emphasis on service rather than profit is dissimilar with the principles held by commercial banks.

Furthermore, a participatory governance feature is also observed in the field. Different from RCCs, the leaders of RMCs have not been appointed from above, but elected by the members. For the case M, 45 member representatives were elected by the members from three agricultural co-operatives. Besides, the founding leader (code number Y3-102) of the case Y noted that, facing the difficulty to have a common agreement on determining an election date among members, a ballot box was used and moved from one member to another during the election. Meanwhile, the cases have operated on the basis of "one member one vote". In some cases, big shareholders or directors have enjoyed extra votes, but there is a ceiling. For example, in the case H, every member has one basic vote, and those having more than 5% of total shares enjoy extra votes. The ceiling of total extra votes is 20% of the total basic votes. Besides, the organizational charter allows each member to have no more than 2 extra votes, and the total number of members having extra votes shall not exceed 10. In this case, comparing with the total amount of basic votes (*i.e.* 335), the total amount of extra votes (*i.e.* 6) is insignificant in the organization, thus ensuring a democratic participatory feature.

On the other hand, from the perspective of economic dimensions, RMCs provide financial and credit services (deposit, loan and settlement business) to their members. Different from other poverty-alleviation projects, they enjoy a high degree of autonomy. This is because share capital from the members serves as RMCs' most important financial sources, therefore enabling the organizations to remain member-controlled.

Moreover, they distribute part of their earnings to their members based on both patronage and shares. In the cases B and M, alongside 50% dividends based on shares, there are two types of patronage dividends, namely, dividends based on deposit (35% of dividends) and loan (15% of dividends) accounts, respectively. These policies are conducive to members' economic participation.

As one type of CFIs, RMCs bear a significant level of default risks, which may endanger their sustainability. Therefore, managing default risks becomes the key to ensure a RMC's sustainability. Generally speaking, default risks consist of two forms: involuntary and voluntary ones. The former one is related to the capability to repay (Stiglitz and Weiss, 1981), whereas the latter refers to the willingness to repay (Besley and Coate, 1995). Following the logics by Stiglitz (1990), one can regard a RMC as a local moneylender, who, albeit being a formal financial institution, is operating at a local level, where borrowers, depositors and working staff of a RMC know each other well. Therefore, RMCs are presumed to have one significant advantage over RCCs and other formal institutions, i.e. they have more detailed knowledge about borrowers. They tend to have a strong connection with borrowers and depositors. They have better information about individuals' efforts and/or abilities to repay.

To illustrate, take the case H as example in which more than 92% of members come from one town. In order to manage both voluntary and involuntary default risks, the case organization created a loan investigation commission, consisting of all members from board of directors and board of supervisors. For a loan with an amount of more than 120,000 Yuan, the approval by the investigation commission is needed. Although it was not necessary for borrowers to provide physical collateral, they need to have a guarantor. Besides, members of the investigation commission are allowed to become guarantors.

When a loan application comes, the commission first pays a visit to the borrower's family to investigate how the loan is planned to be used or invested. This helps reduce the involuntary default risks. Afterwards the commission also visits the guarantor's family to see if he is creditworthy and capable to be. If the borrower would be unwilling to repay, the guarantor should bear the joint responsibility. So, the voluntary default risks could also be controlled.

Moreover, for a loan amount below 120,000 Yuan and below 60,000 Yuan, the director and the manager have the right to approve, respectively (interviewee code number H1-202). Since the RMC's director is also the director of the agricultural co-operative based upon which the case organization was established, he has much detailed knowledge of the members and therefore can monitor the borrowers effectively, making sure that the loans are used productively and thus lowering the default rate. Furthermore, the manager and two working staff who live in the local community have also played an important screening and monitoring role in the process of providing lending services for the applicants.

Finally, there is also a social penalty function available within the organization, i.e. those in default would be deprived of the opportunity for loan applications in the future. This can be an effective incentive device, as Stiglitz and Weiss (1983) emphasized in an earlier study. Due to a lack of good alternatives to gain access to financial services, the borrowers tend to keep a stable relationship with the organization. This also increases their incentives to repay. At the time of the study, most member borrowers have repaid their loans, even in advance. No default or arrears were reported. It is supposed that such feature also enables to harness social collateral. Although in this case, group lending is not referred to, the fact that they have high connectedness with each other in the local social life other than lending activities nevertheless constitutes a powerful incentive device which may be regarded as social collateral.

5. Conclusion

Credit co-operatives in China, albeit still primitive as they may seem as compared to international experiences, are becoming more prominent in rural areas. Due to limited impacts of government initiatives and commercial institutions on satisfying credit demands from the rural poor, credit co-operatives have certain institutional advantages. This study makes clear that the advantages of RMCs are originated by the fact that they are characterized as truly member-based, not-for-profit organizations. Therefore, they intend to place service ahead of profit, which meets poor farmers' pressing needs in credit in spite of scarce collateral. Moreover, they enjoy a basic autonomy and independence from the government, which informs internal motivation for a good management and sustainable development. Furthermore, they emphasize a participatory feature in decision-making process, which makes members feel that these organizations belong to themselves. All these advantages show that they can play a significant role in promoting financial inclusion and poverty alleviation in a more competitive

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environment in the process of commercialization of the rural economy in China.

These credit co-operatives have thus the potential to combine social and economic dimensions of poverty outreach and financial sustainability, which makes them a sustainable driver of poverty reduction. However, the unsuccessful experiments of RCCs' reform during different periods demonstrate that there are certain conditions that are necessary to achieve such combination. Through empirical observations, at least two conditions turn out to be important. One is the co-operation between credit co-operatives and agricultural co-operatives. The fact that agricultural co-operatives have mushroomed in an unprecedented fashion appears to set a new opportunity for developing both economic and social aspects of RMCs in China. However, this condition should be combined with a second one, namely local embeddedness with good social connectedness, a feature that is able to harness social collateral. This can help the institutions separate out high-risk and low-risk borrowers and monitor contract enforcement more effectively, thus ensuring to lower and control both involuntary and voluntary default risks.

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