Since the 1980s, income disparity has increased significantly in the People’s Republic of China, largely as a result of widening urban–rural income gaps. The urban–rural inequality stems from the dual economic structure between urban and rural areas as well as the insufficient development of nonagricultural industries and township and village enterprises in rural areas. The economic divergence across regions can also be related to the unbalanced development of small and medium enterprises (SMEs). Promoting the development of SMEs in rural areas and economically underdeveloped regions could help reduce urban–rural and regional income inequality. However, a banking structure dominated by the four state-owned commercial banks is not conducive to the development of SMEs and thus not conducive to reducing the present economic disparity.

I. INTRODUCTION

The economy of the People’s Republic of China (PRC) has been growing at about 9.5 percent annually during the last three decades. Rapid growth has brought about a dramatic improvement in the standard of living and a significant reduction in the number of people living in extreme poverty. However, income inequality has widened. The country’s Gini coefficient of per capita income at the national level has reached about 0.45 without adjusting for cost of living (Ravallion and Chen 2007, Li and Zhao 2006). This rising inequality could create social tensions and undermine economic and social stability.

Many decomposition studies find that the rising income inequality between urban and rural areas has been one of the major sources of increase in national inequality. According to the survey done by the Chinese Academy of Social Sciences in 2002, decomposition of the Theil Index demonstrates that the contribution of urban–rural income disparity to overall income disparity has reached more than 40 percent (UNDP and CDRF 2005). Using extrapolated unit-
level household income data covering urban and rural populations of 23 provinces during 1990–2004, Lin et al. (2008) also find that, after adjusting for cost-of-living differences, urban–rural inequality accounted for 12.1 percent of national inequality in 1990, and increased to 30.4 percent in 2004. In addition, the analysis shows that, in 2004, interprovincial income inequality accounted 11.2 percent of national inequality. Many studies have looked at the causes of rising inequality in the PRC, some taking the perspective of the urban–rural dual structure, some looking at the role of regional development strategies, and some focusing on regional differences in the role of nonfarm industries and township and village enterprises (TVEs) (Li and Zhao 1999, Zhu 1994, Wang and Fan 2005).

It is only recently that financial factors’ impacts on income distribution have been discussed. Following the works of, among others, Greenwood and Jovanovic (1990), Galor and Zeira (1993), and Banerjee and Newman (1993), the relationship between financial development and income inequality in the PRC has attracted much attention. Zhang et al. (2003), Wen et al. (2005), Fang (2006), and Zhang and Zhan (2006) carried out in-depth analyses of the impact of the PRC’s financial development on its income distribution. However, few analysts have looked at the relationship between the financial structure of an economy and income inequality. This paper argues that the structure of the PRC’s financial system, through its impact on the development of small and medium enterprises (SMEs), is one of the critical factors contributing to the country’s rising income inequality.

The rest of this paper is organized as follows. Section II examines the relationship between the development of SMEs and income distribution, focusing on the role of TVEs in reducing the urban–rural income gap and narrowing regional economic disparity. Section III describes the structure of the financial system, and discusses why it has affected the development of SMEs and its implications for income distribution. Section IV summarizes key findings and provides policy recommendations for reducing income inequality in the PRC.

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1Based on some studies, the contribution of regional inequality to overall inequality is even higher. For example, using province-level income statistics, Wang and Xu (2006) find that the average contribution of regional inequality is more than 20 percent of overall inequality. Tang et al. (2006), using household survey data collected by the Urban Survey Team of the National Bureau of Statistics of China, estimates that 40 percent of urban income disparity comes from provincial differences. Wang et al. (2006) find that, during 1978–2003, over 50 percent of rural income inequality comes from regional disparity. Thus, the contribution of the regional factor varies among different studies based on different data sources, and the use of province-level data might result in overestimation of the contribution of the regional factor.
II. DEVELOPMENT OF SMEs AND INCOME DISTRIBUTION

The development of SMEs helps improve income distribution for at least two reasons. First, SMEs have lower technological thresholds and are more labor-intensive than large firms, and hence can generate more employment opportunities with the same amount of capital. Second, SMEs also help improve access to markets by dispersed rural households. Better access to markets increases the value-added of farm products, enhances rural incomes, and reduces income disparity between urban and rural areas and among regions.

A. Development of SMEs and the Urban–Rural Income Gap

The wide urban–rural income gap has been a long-standing issue for the PRC. During the prereform period, a development strategy was implemented that favored urban areas and the industry sector (Cai 2003). Under this strategy, prices of industrial products were kept artificially high and those of agricultural products artificially low through centralized allocation of goods and materials, thus creating unfavorable terms of trade for the agriculture sector. Collective farming distorted incentives for peasants, leading to low agricultural productivity. Labor mobility from rural to urban areas was controlled administratively through the *hukou* system, accompanied by a dualistic welfare system favoring urban residents. Investment priorities were biased toward state-owned enterprises in urban areas. Together, these factors resulted in large and persistent income gaps between urban and rural households.

Economic reforms since 1979 have helped bridge the urban–rural divide through greater reliance on market forces in resource allocation. Farmers have gained more control over what they produce. But the income gap between rural and urban areas has remained significant and is likely to persist, partly because of limited income opportunities for rural residents and partly because of the continuation of institutions and policies that helped create the urban–rural divide, such as the *hukou* and associated welfare systems.

Farmers earn income from both farming and off-farming activities. Due to constraints in human capital, land conditions, and production technologies, the ability to increase income from farming has been limited. An effective way to close the urban–rural income gap is to increase rural incomes by creating more off-farm employment opportunities. However, since the *hukou* system has made labor migration costly, the development of local SMEs, especially TVEs, gains increasing importance as they promote the transfer of labor from agricultural to nonagricultural sectors within the same locality.

In rural areas, most TVEs are SMEs. The third national industrial census indicated that, in 1995, over 99 percent of the TVEs were small- or medium-size, and township industrial SMEs accounted for 90 percent of all SMEs in the
country. Promoting the development of nonagricultural industries through TVEs is both necessary and viable. The marginal yield of capital of nonagricultural industries in rural areas far exceeded that in urban industries in the 1990s, and its rate of increase was 4.3 times that of urban industries between 1990 and 2001 (World Bank 2004).

The development of TVEs in the past 30 years has transferred a significant number of rural households from farming to off-farm employment. From 1978 to 2002, the value-added by TVEs grew at an average annual rate of 17.2 percent, and the number of employees in TVEs grew at an average annual rate of 6.7 percent. Farmers, on a per capita basis, received an average of CNY1,100 from TVEs in 2005, accounting for 34 percent of their total per capita income (Zhou and Hu 2006). As Table 1 indicates, off-farm wage incomes surpassed agriculture income and became the most important source of income for rural households in 2005.2

Table 1. Per Capita Annual Net Income of Rural Households by Source, 1990–2005 (CNY)

<table>
<thead>
<tr>
<th></th>
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<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Net Income</td>
<td>686.31</td>
<td>1,577.74</td>
<td>2,253.42</td>
<td>3,254.93</td>
</tr>
<tr>
<td>Income from wages and salaries</td>
<td>138.80</td>
<td>353.70</td>
<td>702.30</td>
<td>1,174.53</td>
</tr>
<tr>
<td>Income from household operations</td>
<td>518.55</td>
<td>1,125.79</td>
<td>1,427.27</td>
<td>1,844.53</td>
</tr>
<tr>
<td>Agriculture</td>
<td>344.59</td>
<td>799.44</td>
<td>833.93</td>
<td>1,097.71</td>
</tr>
<tr>
<td>Forestry</td>
<td>7.53</td>
<td>13.52</td>
<td>22.44</td>
<td>45.77</td>
</tr>
<tr>
<td>Herding</td>
<td>96.81</td>
<td>127.81</td>
<td>207.35</td>
<td>283.60</td>
</tr>
<tr>
<td>Fishing</td>
<td>7.11</td>
<td>15.69</td>
<td>26.95</td>
<td>42.52</td>
</tr>
<tr>
<td>Industrial</td>
<td>9.15</td>
<td>13.63</td>
<td>52.67</td>
<td>61.13</td>
</tr>
<tr>
<td>Construction</td>
<td>12.18</td>
<td>34.53</td>
<td>46.73</td>
<td>47.12</td>
</tr>
<tr>
<td>Traffic, transportation, post, telecommunications</td>
<td>13.45</td>
<td>27.76</td>
<td>63.63</td>
<td>84.19</td>
</tr>
<tr>
<td>Wholesale, retail, and catering</td>
<td>12.69</td>
<td>34.26</td>
<td>78.54</td>
<td>108.55</td>
</tr>
<tr>
<td>Social services</td>
<td>6.55</td>
<td>17.18</td>
<td>28.09</td>
<td>32.61</td>
</tr>
<tr>
<td>Culture and education</td>
<td>6.86</td>
<td></td>
<td>10.13</td>
<td></td>
</tr>
<tr>
<td>Others</td>
<td>8.49</td>
<td>41.97</td>
<td>60.08</td>
<td>31.19</td>
</tr>
<tr>
<td>Income from properties and transfers</td>
<td>28.96</td>
<td>98.25</td>
<td>123.85</td>
<td>235.87</td>
</tr>
</tbody>
</table>


B. Imbalances in SME Development and Regional Disparity

The 2005 Report on the Development of Vibrant SMEs in China (NDRC 2006) noted that SMEs accounted for 99.3 percent of all enterprises, contributed 55.6 percent of gross domestic product and 46.2 percent of tax revenues; produced 62.3 percent of exports; and created 75.0 percent of urban employment. The report also shows that 72.4 percent of all these enterprises in 2004

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2Wage incomes mainly come from working in local enterprises or doing temporary work in another place.
FINANCIAL STRUCTURE, DEVELOPMENT OF SMALL AND MEDIUM ENTERPRISES, AND INCOME DISTRIBUTION IN THE PEOPLE’S REPUBLIC OF CHINA 141

(numbering 16,958) were in the eastern region, 16.2 percent in the central region, and 11.5 percent in the western region. The number of enterprises in the eastern region was 2.7 times those in the central and western region (NDRC 2006).\(^3\) The correlation between SME development and economic growth across regions and provinces is high. Provinces with faster SME development, such as Guangdong, Jiangsu, Shandong, and Zhejiang, recorded higher economic growth. In 2002, among the state-owned SMEs or nonstate-owned industrial SMEs above a given designated size,\(^4\) about 68 percent are located in the eastern region, creating 78.1 percent of the gross industrial output value (Lv and Sun 2005).

Lv and Sun (2005) analyzed the factors affecting the divergence in provincial economic growth using provincial cross-section data from 1985 to 2002. Their findings indicate that SMEs significantly affected provincial economic growth, helped generate a competitive and efficient market, and enhanced economic growth. Moreover, regional disparities in SME development were a main cause of regional disparities in economic development and income. Lv and Cai (2005) compared the contribution to gross regional industrial output value of state-owned SMEs and nonstate-owned industrial SMEs in the three regions in 1990, 1995, 2001, and 2002. They find that, in all three regions, SMEs contribute more than 50 percent of gross industrial output value, while in the eastern region, this contribution is even greater at 60 percent. Lv and Cai also compared the contributions to regional disparities in gross industrial output value by different types of enterprises.\(^5\) They found that, although varying in degree depending on regions and time periods, SMEs, especially small enterprises, are a key source of the disparity in industrial growth among the three regions, and that on average they contribute more than 40 percent of total disparities in gross industrial output value. Therefore, one way to mitigate the gaps in regional economic growth and income distribution is to narrow the disparity in the development of the SME sector.

III. FINANCIAL STRUCTURE, SME DEVELOPMENT, AND INCOME DISTRIBUTION

The development of SMEs depends on a number of factors including human capital, production technologies, management skills, protection of property rights, business environment, and access to credit. In the PRC, access to

\(^3\) Vibrant SMEs are those that demonstrate abilities to utilize resources and take advantage of opportunities to expand over a relatively long time frame (over 5 years).

\(^4\) According to statistical standards of the PRC, enterprises above the designated size refer to those with annual sales revenue above CNY5 million.

\(^5\) Lv and Cai (2005) decomposed the disparity in gross industrial output value among regions into large, medium, and small industrial enterprise components, and estimated the share of these components in total disparity.
credit has been a bottleneck for SME development (Jiang 2001, Lin and Guan 2001, Ma et al. 2004, and Tian and Xu 2007).

In his pioneering work on financial structure and economic development, Goldsmith (1969) defined financial structure as the relative importance of various financial instruments and institutions, their business models, and the degree of concentration of financial subsidiaries. At an aggregate level, financial structure can be looked at from a number of angles, such as the relative importance of banks, securities firms, insurance companies, and trust funds as funding sources; the relative size of different financial instruments and assets; the relative scale of domestic and international financial businesses and assets; and the relative status of formal and informal financial sectors. In the PRC, the formal financial sector was repressed for a long time. As a result, the informal financial sector has played an active role in promoting economic development (Liu, Xu, and Yu 2003).

Structures of financial markets and of the banking sector are two frequently watched indicators. The former is usually measured using the weight of the banking industry in the financial system, dividing financial systems into banks-based and markets-based ones. The latter focuses on the competitive level of the banking industry. Given the PRC’s banks-based financial system and banks’ dominant role in financing SMEs, the following discussions focus mainly on the impact of the banks-based financial system on the financing of SMEs and the implications for income distribution.

A. Current Financial Structure in the PRC

In the pre-reform period, financial institutions acted only as a cashier for the fiscal authorities. Since the early 1980s, the financial system has developed rapidly, and a relatively comprehensive financial system has emerged. Broadly speaking, the characteristics of the financial system today can be summarized as follows (Que 2004):

(i) **Diverse range of financial institutions.** In the last 20 years, a modern financial system consisting of banks, credit cooperatives, securities firms, insurance companies, and trust funds has taken shape (Luo 2003, Liu et al. 2005, CSRC 2005).

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4In addition to the aggregate perspective, micro level factors, such as the asset structure, business portfolio, and earnings structure of a financial institution may also be considered (Zhang 2002).

7In a transitional economy such as that of the PRC, it is important to pay attention to the ownership structure of the financial sector, or the relative scale of state-owned, collective-owned, and private-owned financial institutions.
(ii) **Limited direct financing.** The role of direct financing (stocks, government bonds, and corporate bonds) is still limited in total financing, but it has been increasing rapidly in recent years. In 2000, the ratio of direct financing to total financing reached 31.8 percent in terms of new issuance, compared to 23.6 percent in terms of outstanding value (Figure 1).

![Figure 1. Direct Financing as a Share of Total Financing](image)


(iii) **Unbalanced growth.** Growth of major direct financing instruments has been unbalanced. In terms of outstanding balance, the share of government debt was 58 percent in 1994 and remained at 50 percent in 2001. However, the share of stocks increased from 24.5 to 46.5 percent, and that of corporate bonds declined from 17.3 to about 3 percent over the same period (Figure 2).
Dominance of state-owned commercial banks in the banking sector. Four state-owned commercial banks play a dominant role in the banking sector.\(^8\) Table 2 shows that, in 1995, these four banks together accounted for 77.3 percent of total deposits, 77.3 percent of loans, and 91.6 percent of banking assets. Although these shares have been declining, by 2004, they still accounted for 59.6, 59.2, and 57.7 percent, respectively.

Table 2. Market Concentration of the PRC’s Four State-Owned Commercial Banks

<table>
<thead>
<tr>
<th>Year</th>
<th>Percent of Total Deposits</th>
<th>Percent of Total Loans</th>
<th>Percent of Total Assets</th>
</tr>
</thead>
<tbody>
<tr>
<td>1995</td>
<td>77.3</td>
<td>77.3</td>
<td>91.6</td>
</tr>
<tr>
<td>1996</td>
<td>82.0</td>
<td>81.0</td>
<td>89.9</td>
</tr>
<tr>
<td>1997</td>
<td>73.8</td>
<td>70.6</td>
<td>89.0</td>
</tr>
<tr>
<td>1998</td>
<td>79.7</td>
<td>72.6</td>
<td>88.2</td>
</tr>
<tr>
<td>1999</td>
<td>63.7</td>
<td>61.3</td>
<td>88.7</td>
</tr>
<tr>
<td>2000</td>
<td>70.7</td>
<td>64.8</td>
<td>84.0</td>
</tr>
<tr>
<td>2001</td>
<td>67.8</td>
<td>62.8</td>
<td>82.6</td>
</tr>
<tr>
<td>2002</td>
<td>65.6</td>
<td>62.0</td>
<td>62.9</td>
</tr>
<tr>
<td>2003</td>
<td>63.6</td>
<td>60.8</td>
<td>61.5</td>
</tr>
<tr>
<td>2004</td>
<td>59.6</td>
<td>59.2</td>
<td>57.7</td>
</tr>
</tbody>
</table>

Source: Jiang and Xu (2007).

\(^8\)The four state-owned banks are Industrial and Commercial Bank of China, Agriculture Bank of China, Bank of China, China Construction Bank.
Importance of informal finance. The informal financial sector has played an important role in some regions. Since the beginning of the reforms, the private sector has flourished, but it has been confronted with constraints in access to formal finance and has had to turn to the informal financial sector. Because most informal financing activities operate underground, it is difficult to estimate their overall scale. A field survey in Taizhou and Wenzhou prefectures of Zhejiang province indicates that informal finance accounted for 30 percent of the total financing; in some townships, the share of informal finance even exceeded that of formal finance (Yu et al. 2006).

B. Potential Impact of Financial Structure on the Financing of SMEs and Income Distribution

Different types of financial institutions vary in their abilities and the mechanisms they use to collect and process information, screen potential clients, and tailor supply to demand. Thus, different financial institutions choose their specific client groups. Consequently, the character of a financial structure has implications for income distribution.

The relationship between investors and enterprises in direct financing is, generally speaking, an unstable one. Stocks and bonds are characterized by high liquidity, involving frequent trading. Without transparent information disclosure mechanisms and an effective legal system, investors could be exposed to significant risks. Problems of adverse selection and moral hazard due to asymmetric information could lead to direct financing becoming unavailable. For direct financing to be available, high levels of information disclosure on the part of enterprises are needed.

However, SMEs are generally characterized by poor transparency of information (because of less stringent bookkeeping, etc.). This limits their ability to raise funds through direct financing. In contrast, the relationship between banks and enterprises tends to be stable and long-term. Besides extending loans to enterprises, banks also provide other services like savings, remittance, etc., which enable them to collect and accumulate information through long-term lending and other financial transactions, thereby reducing the information asymmetry between them and their clients. In short, compared with direct financing, indirect financing (credit banking) imposes relatively lower requirements for information disclosure by enterprises, allowing SMEs to obtain loans and promoting their development, in a way that direct financing does not do.

The PRC’s market for direct financing as opposed to indirect financing is as yet not well developed. With regard to equity financing, for example, even though some SMEs could now obtain financing through the Shenzhen Stock
Exchange, their market share has been fairly small. Up to October 2007, among more than 42 million SMEs, only 174 were listed on the Shenzhen Stock Exchange, with a total circulation market value of CNY300 billion, less than 6 percent of the banks’ outstanding balance of loans to SMEs.\textsuperscript{9} This would be far from sufficient to satisfy the enterprises’ financing needs. In addition, strict regulations on raising funds by enterprises themselves have made it difficult for private SMEs to issue commercial bonds. Therefore, the role of direct financing in SME financing has actually been rather limited, and the banking system has dominated formal financing to SMEs.

The relative scale of informal finance in the financial system also has implications for SME financing and income distribution (Guo and Liu 2002; Liu, Xu, and Yu 2003; Feng 2004). The Shanghai Branch of People’s Bank of China carried out a survey of SME financing in Fujian and Zhejiang provinces up to the end of September 2002. Of the 300 SMEs surveyed, about 11 percent had raised funds from their staff, and about 8 percent had raised funds from private moneylenders. A survey in Sichuan province by the International Finance Corporation found that, of more than 600 surveyed SMEs, an average of 45 percent of the funding for investment of fixed assets came from trade credit among business partners and private lending from friends and relatives, and that an average of 38 percent of SMEs’ working capital came from trade credit and private lending (Ying 2004). Informal finance, by effectively mobilizing local funding, mitigates capital outflow from rural and less-developed areas, and promotes local SME development and employment, in turn reducing income disparities.

While the overall banks-based character of the financial structure favors SME development, its banking sector has been highly concentrated and dominated by large state-owned banks, which is unfavorable for SME development. Such a banking sector structure could reduce SMEs’ ability to obtain funding and thus affect the development of SMEs and income distribution, for several reasons.

(i) Asymmetric information. Because SMEs usually do not have audited financial statements that are in keeping with strict accounting regulations, there could exist serious asymmetric information between banks and SMEs, entailing potential moral hazard and adverse selection problems and increasing the risk of default on loans (Yu et al. 2006). This lack of hard information can

\textsuperscript{9} The listed SMEs are, of course, themselves the “large” ones within the category of SMEs.
sometimes be compensated for with soft information. However, large banks often have multiple layers of organization, and the cost for generating soft information in such an environment can be high. Moreover, employee mobility in large banks is often high, while soft information often takes time to accumulate, and in any case tends to reside with specific individual employees (Lin and Li 2001).

(ii) **Mismatch of size.** For larger banks, lending to SMEs tends to be more expensive than lending to large enterprises because loans to SMEs, which are usually small, carry relatively higher transactions cost. On the other hand, larger banks have the capacity to extend larger loans. On the demand side, large enterprises also tend to prefer raising funds from one or two large banks in order to reduce transactions costs, rather than from many small banks. Small banks, in contrast, because of their limited lending capacity, would be unable to extend large loans, but are able to lend to SMEs. Therefore, the limited lending capacity of small banks might match well with the relatively low financing demand of SMEs, and consequently the current banking structure dominated by large banks could be unfavorable for SME financing.

(iii) **Flow of funds across regions.** A large financial institution often has numerous branches. In principle, all these branches could be important providers of funding in their localities. However, because of information asymmetry and size mismatch problems, big banks usually find urban areas and the economically developed regions more attractive for lending. With their large networks of branches across the country, large banks could relatively more easily move funds from one locality to another, compared with a network of independent local banks. Consequently, funds often tend to flow more easily from economically backward to more developed regions, and from rural to urban areas through large banks than through small banks. Therefore, a banking sector dominated by big banks could well hamper SMEs’ access to credit in poorer localities, thus worsening the regional as well as urban–rural economic gaps and income disparity.

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10 Soft information refers to information on the character and trustworthiness of an SME owner based on direct contact over time with the institution’s loan officer; payment and receipt history of the SME gathered from the past provision of loans, deposits, or other services to the SME by the institution; or future prospects of the SME garnered from past communications with SME’s suppliers, customers, or neighboring businesses. In contrast, hard information is usually based on an enterprise’s accounting statements, formal financial reports, etc. (Berger and Udell 2004).
(iv) **Efficiency loss due to monopoly.** A higher level of market concentration could reduce SMEs’ ability to bargain for a lower cost of borrowing. Financial institutions with strong market power could force SMEs to pay very high interest rates for any borrowing they obtain.

(v) **Mismatch of property rights.** In the PRC, state-owned banks are favored in the financial market, while most SMEs are private. This could lead to a mismatch of property rights between banks and borrowing enterprises (Jiang 1998), in that state-owned banks could face political risks when lending to SMEs, particularly when such lending results in bad debt, and banks could be blamed for the loss of state assets, making them reluctant to lend to SMEs (Jiang 1998).

C. **Banking Industry Structure, SME Development, and Income Distribution: Evidence**

In this section, we consider the evidence in support of our hypotheses that the PRC’s banking industry structure is not conducive to the development of SMEs and thus contributes to urban–rural inequality. However, as systematic data that would enable us to rigorously test these hypotheses could not currently be obtained, we present only the limited anecdotal evidence that we have been able to gather.

1. **Banking Industry Structure, Development of TVEs, and Rural Income Inequality**

Since the mid-1990s, as the market became increasingly more buyer-oriented and the government and enterprises became more separated, TVEs have become increasingly dependent on banks to finance their growth. When the Southeast Asia financial crisis hit, the environment for the development of TVEs was undergoing some important transformations.

Constraints on the development of TVEs related to the structure of the banking industry began to emerge in the early 1990s. Chief among these are the following:

(i) **As commercial banks began to improve the risk management of their assets, loan-granting authority began to be moved away from lower to higher levels of authority. As this happened, information transparency (and the related asymmetric information problem) between banks and enterprises worsened, and approval procedures for loans lengthened, increasing the costs of loan applications and approvals.**
This process resulted in an increased outflow of funds from rural to urban areas, and within rural areas from less developed to more developed areas.

The size and property rights mismatch problems between TVEs and state-owned banks, described above, became more prominent (Jiang 2000 and 2001), making the financing environment even worse for TVEs. Thus, the share of TVEs to total new loans decreased from 11.3 percent in 1995 to 7.1 percent in 1997 (Jiang 2001). After the Southeast Asian financial crisis, the financing environment for TVEs—and SMEs in general—further worsened, reducing the share of loans taken by TVEs to a new low of about 4.0 percent (Figure 3).

Figure 3. Share of Loans by TVEs (percent)

The value-added of TVEs had consistently maintained rapid growth from 1978 to 1996, with an average annual growth rate of about 28 percent. However, affected by the changes and unfavorable structural characteristics of the banking system, and the problems of TVEs themselves like unclear property rights, the development of TVEs slowed down beginning in the mid-1990s, as is evident in Figure 4. Since 1998, the annual growth rate of TVEs’ value-added diminished to 7 percent, the lowest level since 1979. Throughout the mid-1990s and late-1990s, the development of TVEs stagnated and the share of TVEs in the national economy stayed at about 27 percent.
As mentioned above, TVEs constitute the majority of rural off-farming industries and one of the most important sources of farmers’ income. Hence, the stagnant growth of the TVE sector directly resulted to a sluggish increase in wage incomes in rural areas. As demonstrated in Figure 5, the growth rate of farmers’ income from wages and salaries fell during 1996 to 2004, which led to only a moderate growth of farmers’ total income, while at the same time the growth rate of urban households’ incomes increased at a much higher rate, which in turn widened the urban–rural income disparity (Figure 5).
2. Banking Industry Structure, Flow of Funds, and Regional Development Gap

Before the early 1990s, commercial banks adopted a deposit-based lending policy balanced across regions. Consequently, regional branches of state-owned banks wielded control over the use of funds, which are usually invested in local businesses (Yang and Li 2004). Moreover, the market for interbank borrowing had not yet been established. Insufficient flow of funds across regions inhibited the optimal distribution of financial resources. On the other hand, the use of local funds for the development of one’s own region also moderated the regional development gap.

In a market-oriented environment, the flow of funds across regions depends on regional return on investment. In the state-owned commercial banks, the employees, funds, and businesses of local branches are mostly managed by higher-level branches. Local branches in the central and western regions have less control on the use of their own surplus funds. In this case, to ensure security of the funds, depositing the funds in a higher-level branch was the only choice for local branches (Yang and Li 2004), which leads to outflow of capital from less developed to relatively more developed regions, widening the regional gap in economic development.

The lending-deposit ratio reflects how much of a locale’s deposits is translated into loans to that specific area. Yang and Li (2004) found that, from 1997 to 2003, the overall lending-deposit ratio in the PRC decreased from 86.6 to 76.4 percent, while in the eastern PRC it only decreased from 76.5 to 73.2 percent. Moreover, Beijing, Shanghai, Zhejiang, and other economically prosperous cities enjoyed an increase. The large reduction in the lending-deposit ratio reflects serious outflows of funds from the central and western regions.

Liu et al. (2004) studied the relationship between regional disparity and outflow of rural funds from 69 rural credit cooperatives and financial institutions in Jiangsu, Shandong, and Shanxi. They found that in the economically developed regions in the eastern PRC (Jiangsu and Shandong), townships with higher per capita income levels experienced a lower rate of funds outflow, whereas in the economically backward regions in the central-western PRC (Shanxi), townships with higher per capita income levels experienced a higher rate of funds outflow. Their interpretation of this result is that since the return on investments is relatively low in the central and western PRC, additional deposits resulting from increased per capita income tend to flow out to other regions.

The flow of funds across regions led to the regional imbalance of SME financing. According to the 2005 Report on the Development of Vibrant SMEs in China (NDRC 2006), SMEs in the eastern PRC were more satisfied with their financing channels than those in the central PRC, and SMEs in the central PRC were more satisfied than those in the western PRC (Figure 6).
Using data on financing abilities of SMEs in Hubei, Jiangsu, and Zhejiang, Yu and Liu (2006) found that regional factors significantly affect an SME’s ability to obtain bank loans, after controlling for other factors. SMEs in the eastern PRC are more likely to obtain loans than those in the central PRC. Liu, Du, and Zheng (2003) and Liu (2004) found similar results. As discussed above, in view of the dependence of SMEs on bank financing and the important role of SMEs in regional economic development, this outflow of capital—especially serious from certain regions, and in part caused by the particular structure of the banking system—could have caused the regional gap in economic development to widen.

Figure 6. SMEs’ Satisfaction Level with the Financing Environment

As the foregoing discussion reveals, the PRC’s banking structure is generally not conducive to the development of SMEs and may have contributed to urban–rural and regional income inequalities and disparities in economic development.

V. CONCLUSION

The insufficient development of rural SMEs and the regional divergence in SME development are important causes of urban–rural income inequality in the PRC. This paper discussed the influence of a banking structure dominated by the four state-owned commercial banks on the ability of SMEs to obtain bank loans. We believe that a big banks-oriented financial structure could indeed further increase the imbalance in urban–rural and regional development.
The following policies are recommended. First, actively develop small- and medium-size financial institutions like small regional banks, including microfinance institutions; encourage financial market competition; and allow disadvantaged groups to participate in the financial markets. Second, implement the Community Reinvestment Act, balance better the distribution of financial resources, and ensure adequate flows of funds toward rural areas and the western and central regions of the PRC. Third, improve the infrastructure of financial markets, especially of the credit system, and establish laws and regulations for financing SMEs, making policies supportive of SMEs. Finally, encourage the development of informal financial institutions that are particularly useful to SMEs.

REFERENCES


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11 The Act aims to encourage depository institutions to help meet the financial needs of the communities in which they operate, particularly in rural areas and remote areas, and to provide favorable financial services for low- and moderate-income households, women, and other socially vulnerable groups.


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