3 Greasing the wheels of development: rural credit in China

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Banking services, inclusive of savings and credit, play an indispensable role in rural development. They provide farmers with essential capital for investment in children's education, setting up small businesses, and buying new farming equipment. Additionally, they offer resources to ride out personal crises, such as illness of family members and bad harvests. Beginning in 1978, rural credit can be divided into banking for retail consumers and policy banking for state agricultural procurement. Retail banking serves the credit demands of rural households, individual household businesses (*getihu*), and small- and medium-sized enterprises in rural areas, whereas policy banking provides loans to state enterprises specializing in state agricultural procurement. Despite a diverse range of credit demands, the retail sector has been largely monopolized by the Rural Credit Cooperatives (RCCs) (*nongcun xinyongshe*), as well as by the state-owned Agricultural Bank of China (ABC) (*Zhongguo nongye yinhang*) up until the late 1990s. The Agricultural Development Bank of China (ADBC) (*Zhongguo nongye fazhan yinhang*) provides policy loans to state enterprises purchasing grain, cotton, and oil for consumption, for the purposes of national food security. The capital of the ADBC comes from the central bank, instead of from household savings, unlike the retail banks. Since state agricultural procurement is covered elsewhere in this volume, this chapter will focus on retail banking to rural consumers.[1]

The objectives of this chapter are twofold. First, it aims to provide a précis of the rural credit sector and recent institutional changes. Second, by drawing on the author's household survey data, it provides in-depth analyses of the RCCs, the most prevalent rural credit institutions in China. The survey investigates why farmers become RCC members, why they bank with RCCs, their perceptions of loan conditions, and their uses of formal and informal loans. The household survey consisting of 277 respondents was conducted during 2004–06 in seven townships across three provinces—Shandong, Hebei, and Sichuan. Aside from the survey, this chapter also draws upon the author's numerous field interviews with bank officers and local officials throughout rural China.

Savings of rural households were the engine behind the spectacular rural industrialization of the 1980s and early 1990s, which consisted predominantly of collective township and village enterprises. Rural industrialization was the key contributor to economic growth up until the early 1990s. Meanwhile, farmers have always experienced difficulties in obtaining credit. Due to a lack of alternative means of savings, rural credit institutions in China have absorbed the lion's share of rural households' savings. Nevertheless, the bulk of the capital has been channeled to collective and local government-linked enterprises instead of farmers' productive or consumption uses. While this may be partly attributable to farmers' lack of collateral, higher returns on industrial activities, and other economic reasons, this chapter argues that politics and lack of governance play an indispensable role in explaining this prevalent development outcome in China.

The rural credit sector

Rural credit cooperatives

The RCCs are the backbone of official credit in rural China. They collectively account for over 80 percent of rural deposits and loans (Figure 3.1). With respect to agricultural loans, the Agricultural Bank of China, one of the big four state-owned banks, takes up only one-tenth of the total, compared with over 80 percent for the RCCs (Figure 3.1).

The RCCs are the dominant credit institutions in the rural areas, covering about 60 percent of total townships in the country (Ma 2003: 36). The RCCs' networks have been shrinking since the late 1990s due to ongoing central government efforts to save costs incurred in the RCC system. As part of this effort, the central government abolished village RCCs in the 1990s, reducing the number of RCCs from over 40,000 in the late 1990s (about one RCC in every township) to 24,600 in 2005. Some of the state-owned commercial banks and commercial shareholding banks have branches in the peri-urban areas, but not in remote rural areas, since such presence is costly to maintain. The only credible competitor to the RCCs in

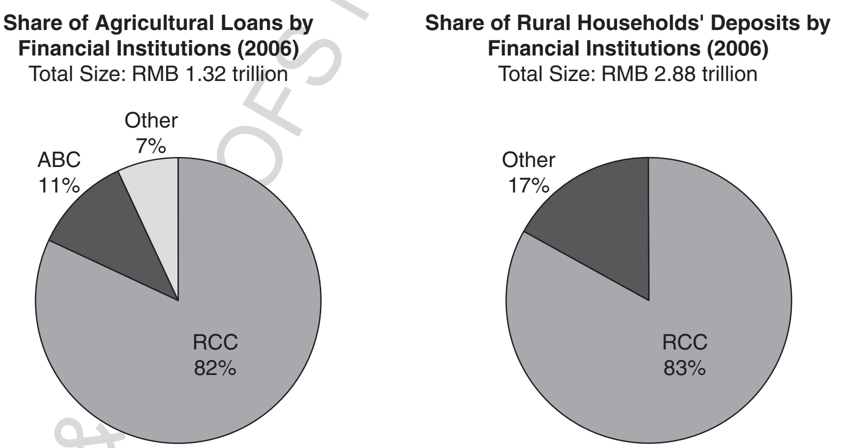

Figure 3.1 Overview of rural financial sector, 2006
Source: *Zhongguo jinrong nianjian 2006* (2007).

Table 3.1 Financial institutions by size of assets, loans, and deposits, 2006

Billion RMB, 2006 year-end	*Assets*	*%*	*Loans*	*%*	*Deposits*[a]	*%*
State-owned Commercial Banks	22969	*52.0*	17999	*51.8*	17547	*56.0*
Shareholding Commercial Banks	7265	*16.5*	5830	*16.8*	5147	*16.4*
Rural Credit Coops & Rural Banks	4484	*10.2*	3382	*9.7*	3886	*12.4*
State-owned Policy Banks	3539	*8.0*	3244	*9.3*	213	*0.7*
City Comm Banks & Urban Credit Coops	2770	*6.3*	2247	*6.5*	2254	*7.2*
Postal Savings Bank	1612	*3.7*	870	*2.5*	1602	*5.1*
Others[b]	1491	*3.4*	1191	*3.4*	667	*2.1*
Total	44130	*100.0*	34764	*100.0*	31316	*100.0*

Source: Author's own calculation from *Zhongguo Jinrong Nianjian 2006* (2007).

Notes
a Deposits are from households and firms.
b Others consist of overseas banks and finance companies.

attracting rural savings is the China Postal Savings Bank, which has networks throughout both urban and rural areas.

To put this in a national perspective, the financial sector is still dominated by the four state-owned commercial banks, which account for about 60 percent of total assets, deposits, and loans nationwide (Table 3.1). The shareholding commercial banks, such as the China Merchant Bank and the Shanghai Pudong Development Bank, collectively take up about 16 percent of total assets. Smaller in scale, the RCCs account for 10 percent of total assets and 12 percent of total deposits nationwide. Despite its rural reach, the Postal Savings Bank's total deposits nationwide are less than half of those of RCCs. (Table 3.1)

Rural savings and rural industrialization

An overwhelming proportion of rural savings had been directed to finance the development of collective township and village enterprises (TVEs). According to a statistical series compiled by the Ministry of Agriculture, which ended in the peak of enterprise development in 1995, TVEs had soaked up the bulk of rural loans (Figure 3.1). The percentage of rural loans allocated to TVEs rose steadily from 38 percent in 1984 to 64 percent in 1993, while the proportion that went to agricultural households during the same time period fell from 51 percent to 26 percent.

While rural industrialization contributes to development such as creating jobs in the countryside and augmenting local government coffers, it has undoubtedly crowded out credit that could have been allocated to farmers and private small- and medium-sized enterprises. The latter is directly detrimental to lifting the standard of living of farmers in China (Figure 3.2).

Agricultural Bank of China

Despite its name, the Agricultural Bank of China (ABC) is relatively detached from agricultural households. The ABC was established by the central

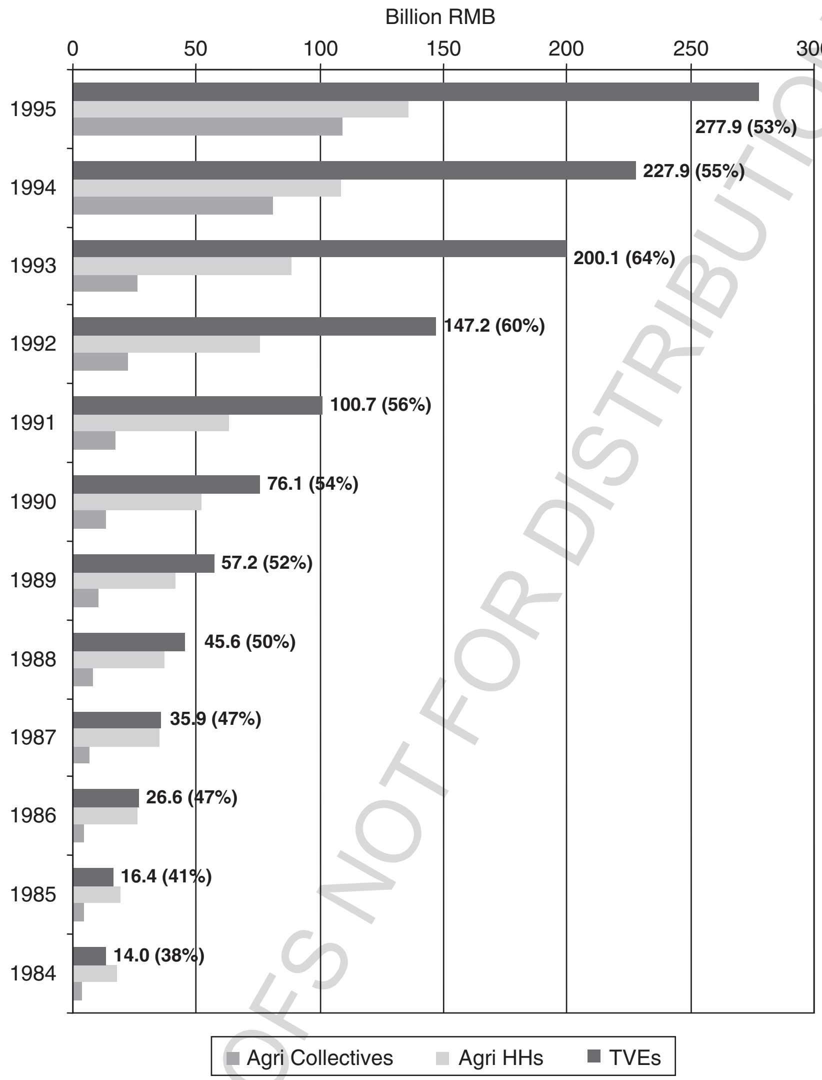

Figure 3.2 Destination of rural loans, 1978–95
Source: *Zhongguo nongcun tongji nianjian* (1997).

government in the 1950s to support agricultural production and to manage the RCCs that pre-dated it. It took over the People's Bank of China's (PBoC) (*Zhongguo renmin yinhang*) rural branches in 1979, and assumed a range of policy and commercial functions, including lending to rural industries, financing state procurement of agricultural products, and managing the RCC system (Interview with a provincial director of the association for rural development of poor areas and manager of a township RCC). During the 1980s, it served mainly to finance the central government's projects in the agricultural sector. Before the establishment of the ADBC in 1994, the ABC was also responsible for financing all of the state's agricultural purchases.

In the late 1990s, the orientation of the ABC shifted further away from the rural areas. In an effort to save costs and to improve profitability, the ABC closed down its grass-roots branches in rural townships and villages in 1999. Currently, branches of the agricultural bank can be found only in county-level cities and some industrialized townships. In 2005, nearly all of the bank's funds came from household savings and deposits by enterprises. The bulk of its lending, however, went to large industrial and commercial enterprises at the county level and above (25.1 percent of total loans), and to local government infrastructure projects (16.7 percent). When the ABC withdrew its rural networks in the late 1990s, it also recentralized loan-making decisions to the county and higher administrative levels. This has meant fewer loans for borrowers in rural townships and villages. Collectively, lending to agriculture, rural enterprises, private enterprises, and individuals accounted for less than 15 percent of the ABC's total loans in 2005, as indicated in Table 3.2.

Since 1998, the ABC has also been responsible for administering China's poverty loan program (*fupin daikuan*). The poverty loan program provides loans at a subsidized interest rate to rural households in poor counties, totaling about RMB 10 billion in 2005. However, the program is widely known to have

Table 3.2 Agricultural Bank of China's deposits and loans, 2005

Deposits	*Amount (billion RMB)*	*%*	*Loans*	*Amount (billion RMB)*	*%*
Deposits by households	2435.8	*61.3*	Loans to industry & commerce	632.6	*25.1*
Deposits by enterprises	1207.8	*30.4*	Loans to construction firms	11.3	*0.4*
Deposits by organizations	144.9	*3.6*	Loans to agriculture	133.9	*5.3*
Agricultural deposits	38.4	*1.0*	Loans to rural enterprises	172.7	*6.9*
Other deposits	143.5	*3.6*	Loans to private enterprises & *getihu*	61.7	*2.5*
			Other short-term loans	256.0	*10.2*
			Medium-term working capital loans	92.2	*3.7*
			Loans to infrastructural projects	419.6	*16.7*
			Loans to technical projects	27.8	*1.1*
			Other long-term loans	709.3	*28.2*
TOTAL DEPOSITS	3970.3	*100.0*	TOTAL LOANS	2517.2	*100.0*

Source: *Zhongguo Nongye Yinhang Tongji Nianjian (2003–2006)*: 6.

extremely low repayment rates and to be fraught with administrative problems. The official repayment rate stands at 50 percent, but some informed sources familiar with the program estimate it to be as low as 20–30 percent (Interviews with a provincial director of the association for rural development of poor areas and manager of a township RCC). As a result, not only has this program achieved little in alleviating rural poverty, but it has also compromised the ABC's commercial orientation.

Local government influence is pervasive in the allocation of poverty loans. The loans are officially approved by local poverty alleviation offices (*fupinban*), which are under the direction of local governments, with the ABC merely doling out the money. Borrowers pay the subsidized interest rate of 2.88 percent per annum and the bank is compensated for the difference between market and subsidized rates by the central treasury. The poverty alleviation offices, like all other local administrative units, are led by local party leaders (though they also report vertically to higher levels in the ABC); loans are often directed to local government projects, such as infrastructure development.

Further, owing to the ABC's increased commercial orientation, it is not in favor of lending to poor individual households (the intended recipients) as such loans are comparatively costly to service. For instance, one Sichuan county in which I conducted field research in 2005 is officially designated 'poor by national standard' (*guojiaji pinkunxian*). Yet, the local ABC has been handing out all the county's poverty loans, totaling RMB 100 million annually, to a power plant in which the county government has a stake. The power plant may stimulate the development of local industrial enterprises and augment local government's tax revenues. But it brings limited direct benefit to poor households, which is the explicit objective of the poverty alleviation program.[2]

China Postal Savings Bank

Postal Savings (*Zhongguo youzheng chuxu yinhang*), a subsidiary of China Post until 2007, has approximately 36,000 branches nationwide, including an extensive network in the countryside rivaling that of the RCCs. However, Postal Savings could not issue loans until it became the China Postal Savings Bank in 2007. As a result, the RCCs were effectively left to monopolize the rural loan market until then. Nonetheless, thanks to its nationwide networks, the remittance service of the Postal Savings has been a key channel for migrant workers in the cities to remit funds to the villages.[3] Until 2007, its main sources of income were interest-rate differentials for deposits parked at the Central Bank and the modest fees collected from its remittance service.[4]

The Postal Savings Bank has rolled out a micro-loan program intended to reach a vast number of small borrowers by allowing them to use time deposits as collateral. As of April 2007, the micro-loan program has gone on trial in 13 provinces (China Financial Stability Report 2007; Economist Intelligence Unit 2007). The bank's widespread nationwide network makes it a potentially successful channel for improving credit access for poor households and small businesses.

Recent rural financial market liberalization

Liberalization of the rural financial market in the mid-2000s is premised on the belief that existing financial institutions have limited coverage in rural areas and the sector suffers from shortages of capital supply and limited competition (China Banking Regulatory Commission 2006).

New types of rural financial institutions introduced in late 2006 are township and village banks (*cunzhen yinhang*), microcredit companies (*xiaoer daikuan gongsi*), and community-based cooperative credit organizations. Their introduction was a regulatory break from the long-standing pattern of government control of the rural financial sector that has allowed its RCCs to have a monopoly for an extended period of time.

Of the three, township and village banks have attracted the most enthusiasm from private domestic banks and foreign banks.[5] The London-based HSBC became the first international investor to open a wholly owned subsidiary in a rural county in Hubei province in December 2007, offering deposit services to local residents and businesses and providing loans to agricultural companies (China.com 2007; Ku 2007). Some domestic regional banks, such as city commercial banks, have also acquired township-and-village-bank licenses that enable them to conduct business in rural areas that would otherwise be beyond their territorial boundaries. The new microcredit companies conduct lending, but unlike the rural banks, they are not allowed to accept deposits.[6] Nonetheless, equity participation in these companies is not exclusive to banks. Market deregulation has opened up the possibility for informal lenders and underground private money houses to operate legally by acquiring licenses to become formal credit companies. Finally, the reforms have also allowed for self-help organizations administered and managed by farmers, but there has been lackluster enthusiasm for these new institutions. Overall, as of March 2008, 25 township and village banks and 4 microcredit companies have reportedly been officially approved (Zhang and Zhang 2008).[7] Even though the rural financial sector liberalization is an encouraging sign of change, it is too early to assess whether it will make a substantial contribution to development.

Informal credit institutions

The heterogeneity in the levels of industrialization and income in rural China implies incredibly diverse credit demands. Such demands can range from obtaining a loan of half a million RMB as working capital, to a loan of RMB 10,000 to start up a small neighborhood shop, and to getting a few hundred RMB to pay for the funeral or wedding of a family member. Accordingly, the size of the informal rural credit sector differs from one locale to another depending on the extent to which the formal institutions are able to meet local clients' needs.

Some informal lenders are more institutionalized than others. The degree of such institutionalization depends on the extent of information asymmetry between the two parties, and particularly on how well the lender knows the borrower's risk profile. It tends to be less institutionalized when credit transactions take place within communities sharing some common characteristics, such as living in the same village or sharing a lineage. The tightly knit nature of the relationships not only helps to provide the lender with information about the borrower, it also offers "peer pressure" and "peer monitoring" to ensure prompt repayments. Because peer pressure offers an alternative means of ensuring loan payments, it negates the need for collateral, which is the way formal institutions hedge against potential defaults (Stiglitz 1990). Examples of this type of non-collateralized informal credit are interest-free (or with low interest rates) interpersonal lending among relatives, friends or neighbors, or trade credit given by wholesalers to vendors.

Another example of non-collateralized informal credit in China are credit associations (*hui*) consisting of a group of people involved in savings and lending. There are three major types of credit associations in rural China: rotating associations (*lunhui*), in which loans are given by rotation among group members; bidding associations (*biaohui*), in which loans are determined by a bidding process; and escalating associations (*taihui, paihui*) and pyramidal investment schemes, which are strictly illegal in China (Tsai 2002: 39).

When an informal lender does not know the borrower's likelihood to repay, lending tends to be more institutionalized and operate in ways similar to those of the formal institutions, except for the lack of a bank license. Examples are money-lenders or middlemen (*yinbei*) who broker savers and borrowers at high interest rates, and underground private money houses (*dixia qianzhuang*) operating like banks. Borrowers face a varying degree of interest rates, some as high as four times the central bank's base lending rate (Shen and Zhong 2006).[8]

Existing studies on informal finance draw no firm conclusion on its regional patterns and uses. In *Back-Alley Banking*, Kellee Tsai argues that diversity of informal finance is positively correlated with local government's support of the private sector.[9] Studies also suggest that in places where private economy is vibrant, such as Fujian province and Wenzhou in Zhejiang province, individuals borrow to finance business start-ups and for working capital purposes. By contrast, in more remote and less developed regions individuals borrow to finance a range of production and consumption needs, such as purchasing fertilizer or poultry, or paying for education or healthcare expenses (see the household survey section in this chapter for more analysis).

Microfinance

Based on a variation of the Grameen Bank model popularized by the Nobel Prize winner Mohammed Yunus, microfinance was first launched in China in 1994. Owing to a host of political, regulatory, and locale-specific factors, the momentum of the microfinance programs tapered off at the end of the 1990s after a few years of strong growth. The essence of the Grameen model is to provide commercially sustainable financial services to the poor, or sometimes specifically targeted at women. Based on a set of innovative practices, microfinance utilizes various mechanisms, such as group guarantees, dynamic incentives, and regular repayment schedules, to reduce information asymmetry and to mitigate default risks. Microfinance marks a fundamental departure from the poverty alleviation loans with subsidized interest rates popular throughout the developing world during the 1960s and 1970s. While subsidized loan programs are based on the premise that the poor can ill afford credit at commercial rates, microfinance proponents argue that subsidized rates create excess credit demand, causing loans to be rationed to just the rich and powerful (Morduch 1999).

Some encouraging performance from the early programs run by non-governmental organizations (NGOs) notwithstanding, microfinance efforts in China hit a brick wall when it came to expansion and wider implementation. This was due in no small part to the political environment in China. One of the pioneering programs was Funding the Poor Cooperatives (*fupinshe*), an externally funded scheme administered by researchers at the Chinese Academy of Social Sciences (CASS), with collaboration from township poverty alleviation offices. The success of earlier programs inspired a flurry of NGO-administered microfinance schemes similarly funded by grants from international aid agencies or philanthropic organizations.[10] But all NGOs in China must be registered with the Ministry of Civil Affairs (*minzhengbu*), and must have a sponsoring government unit (*guakao danwei*) supervising the organizations' activities (Saich 2001: 170–5). Therefore, NGOs in China are *not*—strictly speaking—non-governmental organizations since they cannot set their own independent agendas. They also face the threat of being closed down due to their dubious legal status.

Further, the Communist Party and government apparatus, which deeply penetrates rural society, plays a prominent role in the success or failure of any development initiative. Smooth implementation of these so-called "non-governmental" grass-roots programs from loan disbursement to collection requires cooperation from township and village officials.[11] The programs' lack of legal status as financial institutions means they cannot take deposits, which makes them dependent on external funding. Some China-specific characteristics also make the physical environment less conducive for the Grameen model of microfinance.[12]

Government-driven microfinance programs have had rather limited success. The central government launched its own microfinance program in 1997 as part of the long-standing poverty alleviation loans administered by the ABC. The government-run program, which provides subsidized loans, was established on the same premise as the previous poverty alleviation loans, that is, that the poor can ill afford market interest rates. Initially implemented by local poverty alleviation offices (*fupinban*), the government program was rolled out in over 600 counties across 22 provinces by August 2008 (Park, Ren, and Wang 2003). Notwithstanding that, the loans have tended to go to wealthier households, and the repayment rates are very low, estimated at around 50 percent officially (Park and Ren 2001). This is unsurprising given the findings from other developing countries that subsidized credit tends to benefit the rich and powerful households, while leaving the poor behind (Adams, Graham, and von Pischke 1984).

Rural credit cooperatives

The RCCs were initially grass-roots cooperatives organized by peasants in the 1940s with the initial aim of protecting the peasantry against widespread usury. Prior to the establishment of the people's communes in 1957, the RCCs exhibited the basic characteristics of a "cooperative" (as opposed to a state-controlled) system: member households contributed to the capital base, elected the personnel who ran the organizations, and had access to loans as a service provided by the organizations (Zhang 2002). The communes (which later became the townships of today) gained control over the RCCs with the collectivization movement of the late 1950s. As a result, peasants effectively lost control over the cooperatives, as decisions regarding credit allocations were made by the communes. The RCCs had thereby effectively become the financing arm of the communes.

The central government put the RCCs under the auspices of the state-owned ABC, starting in 1979. For one and a half decades, the credit cooperatives functioned as grass-roots branches of the ABC and their employees were managed as part of the bank's bureaucracy. Management by the state-owned bank compromised some key interests of the credit cooperatives.[13] Subordination to the ABC also meant the credit cooperatives had limited control over their capital, as the state bank directed their loans to designated borrowers, such as township and village enterprises (Tam 1988).

The RCCs' relationship with the ABC was formally severed in 1996, as part of the central government's move to restructure the rural financial system. The RCCs were managed—albeit indirectly—by the central bank between 1996 and 2003. The central government set up more credit unions at the county level to manage the grass-roots credit cooperatives. County credit unions, in turn, were managed by the central bank's rural credit cooperative management offices, which were part of the bank's bureaus at the provincial and prefecture levels.[14] During this period, the PBoC took on the dual role of managing (through the control of county credit unions) *and* supervising the RCCs (as part of its role as the banking sector supervisor).[15]

In the late 1990s, it became abundantly clear to the central policymakers that without an injection of capital the RCC system was simply unsustainable. According to the central bank's statistics, the overall non-performing loan rate reached a peak of 50 percent in 1999. The RCCs were not only bleeding financial losses, their collective liabilities exceeded assets by RMB 330 billion. As Table 3.3 shows, both RCC's capital adequacy ratio and net equity were negative, which meant their liabilities were so enormous that they were eating into shareholders' equity. Further, official estimates indicate that more than half of the RCCs nationwide (55 percent or 19,542 credit cooperatives) were technically bankrupt. By "technically bankrupt," I mean their asset value is smaller than the sum of their liabilities and equity, which implies that they would have closed for business if they had operated under market conditions.

The problem is that for the central government, shutting down the RCCs is very much out of the question. As a prominent former central banker, and a chief

Table 3.3 Financial indicators of RCCs nationwide, 2002

	Billion RMB
Financial Losses	5.8
Non-Performing Loans	514.7
Net Equity	−330.0
Financial Loss Coverage*	*33.5%*
Non-Performing Loan Rate	*37.0%*
Capital Adequacy Ratio	*−8.5%*

Source: CBRC (2003).

Note
* Number of RCCs suffering financial losses/total number of RCCs.

architect of the RCC reform, has explained, this is because the RCCs are the major holders of rural households' savings and major providers of rural households' credit (Xie 2003: 438). As a result, closing down the RCCs would deprive rural residents of their only source of formal credit service and expose many of them to abject poverty.

More importantly, because the RCCs hold the bulk of rural savings (totaling about RMB 1.6 trillion at 2002 year-end), any sign that they might be financially unsound would set off massive panic and social unrest in the countryside. This risk of social instability is buttressed by the peasant-savers' perception that their savings at the credit cooperatives are being guaranteed by the central government. Granted, the central government is under no formal obligation to do anything should the RCCs fail. However, it has strong incentives to keep the RCC system from collapsing. Indeed, the RCCs have remained in business, despite having negative net assets, while many other unstable financial institutions were unceremoniously cleared away by the central government after the Asian Financial Crisis in the late 1990s.[16]

The PBoC introduced the micro-loan (*xiao'e daikuan*) scheme in 1999 to simultaneously improve rural households' access to RCC loans and enhance RCCs' profitability. Under this scheme, the central bank provides wholesale loans with subsidized interest rates to the RCCs in poor areas, in order to alleviate fund shortages that constrain their lending capacity. The subsidy, in turn, allows RCCs to raise lending rates to farmers by up to two to three times the subsidized rate, thereby helping to improve the RCCs' profitability. Between 1999 and 2006, the central bank provided a total of RMB 128.8 billion of highly subsidized loans to RCCs, more than 90 percent of which were disbursed to those located in the western and central regions (People's Bank of China 2006). An essential feature of the micro-loan scheme is that household borrowers need not have collateral or any guarantor once they are awarded "credit passes" with good ratings by the RCCs. This has worked to the farmer-borrowers' advantage because a primary impediment to their credit access is lack of collateral, as the collectively owned land on which farmers' houses (their most valuable assets) are built is not legally admissible as collateral.[17]

Despite the high proportion of rural household loans, repayment is still a serious issue, because the way microloans work in practice differs from their supposed functioning. Credit ratings are supposed to be given on the basis of borrowers' creditworthiness, the consideration of which includes their age, asset value, income levels, and job types. Nevertheless, because a few credit officers in a township RCC typically have to deal with a few thousand borrowers, they lack the resource capacity to accurately assess the creditworthiness of all potential borrowers. As a result, one universal credit rating is often given to all borrowers in a village, giving rise to the title of "a creditworthy village" (*xinyongcun*). Obviously, such a sweeping classification often fails to capture the diverse risk profiles of all villagers. Further, owing to the fact that RCC officers lack intimate knowledge of the repayment capacity of every villager, they often have to rely on information given by township and village heads or cadres. This provides opportunities for rent-seeking behavior or consideration of factors unrelated to a borrower's ability to repay. For instance, local leaders can talk up their relatives or cronies so as to get credit officers to lend to them (Xie *et al*. 2005). In no small part, the enormous expansion in loan size from subsidized agricultural loans has contributed to a recent reduction in non-performing loan rates and therefore to an increase in the profitability of the RCCs. RCCs' official non-performing loan rates fell to 17.5 percent in 2005 from a peak of 50 percent in the late 1990s.

In 2003, the central policymakers agreed that there should not be a "one-size-fits-all" model (*yidaoqie*) of RCCs and introduced two major changes to the system (Xie 2003). The first change was the transfer of RCC management rights from the PBoC to the provincial governments, with the intention of making regional governments financially responsible for the credit cooperatives in their jurisdictions (Xie, Zhong, and Shen 2006). The provincial RCC unions are administrative organizations (*xingzheng jiguan*) that do not take deposits or issue loans. They represent the respective provincial governments in managing the credit cooperatives in their territories. Their functions are similar to those of the pre-reform county unions, except that their control on the local credit cooperatives is more intrusive and pervasive. The prerogatives of the provincial unions range from personnel appointments, appraisals and dismissals, the setting of province-wide remuneration systems, veto rights on large loans, and approval rights of major expenditures, to auditing and service provisions, such as province-wide management and support of IT systems, and personnel training (Interview with deputy director of a provincial RCC union). Second, the PBoC's supervisory function (over all banking institutions nationwide, not only RCCs) was transferred in 2003 to the newly set up China Banking Regulatory Commission (CBRC).

Additionally, subject to certain conditions, the RCCs could choose to adopt one of three institutional models: the rural commercial banking model, the rural cooperative banking model, or the existing rural credit cooperative model. The RCCs located in highly industrialized locales with better financial performance could become rural commercial banks. These are allowed to conduct businesses like any urban commercial bank, and are similarly bound by few policy requirements. Rural cooperative banks are a hybrid between rural commercial banks and the existing credit cooperatives. While they can raise equity by bringing in individual and enterprise investors, they are required to allocate a certain proportion of their loan portfolios to agricultural projects. A majority of the RCCs nationwide, particularly those in the central and western regions, opted to become rural cooperative banks, while only a handful in the industrialized province of Jiangsu became rural commercial banks. Except for some RCCs in poor western areas that retained the original RCC model, the independent legal entity status of township RCCs was abolished to the effect that they became part of the county union cost centers.

Furthermore, the central bank also provided two other forms of financial assistance—the RMB 168 billion debt-for-bonds swaps and RMB 830 million earmarked loans—to assist RCCs further in disposing of bad assets and writing off historical losses. However, although the subsidies were contingent upon improvement in the RCCs' corporate governance, actual change in this was rather cosmetic.[18]

Household survey analysis

The household survey respondents were drawn from seven townships across three provinces with diverse economic conditions—Shandong, Sichuan, and Hebei. Typically, two villages were chosen randomly from one township. There are great variations in wealth level of the survey respondents: the median wealth ranges from RMB 128,080 in Shandong, and RMB 60,930 in Hebei, to RMB 25,370 in Sichuan.[19] The survey provides in-depth analysis of the rural credit market, specifically, the reasons for becoming RCC members and clients, utilizations of formal and informal loans, and perceptions of RCC loan conditions.

In terms of occupation, 70 percent of the sample respondents were farmers, 10 percent were microentrepreneurs (*getihu*), 8 percent were migrant laborers, and 4 percent were collective enterprise workers.[20] A substantial majority of the respondents were either primary (43.3 percent) or junior secondary (38.6 percent) educated, while 9.4 percent had no education, 7.2 percent had senior secondary education, and 1.4 percent had tertiary education.

Forty percent of the respondents were RCC members, and 60 percent were not. When asked why they had become members, 80 percent responded that membership was required to obtain loans from the credit cooperatives (see Figure 3.3).

Why do farmers bank with the RCCs? The results indicate a lack of alternative saving instruments available in the localities, the perception of RCC savings as being guaranteed by the central government, and the RCCs' widespread networks are the primary reasons (see Figure 3.4).

When asked what they thought RCC loan conditions were, nearly 70 percent of respondents thought "ability to repay" was one of the RCC loan conditions, but 40 percent thought "*guanxi*" (relationships) were important too (multiple responses were allowed), as shown in Figure 3.5. From an economic perspective, much like interest rates, personal connections can be a screening mechanism for credit officers to rationalize funds when excess demand exists, but it should be noted that this is a *non-market* mechanism at the *discretion* of loan officers. This interpretation is

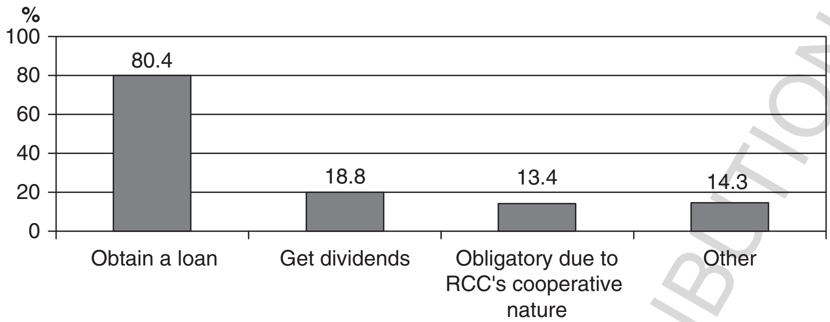

Figure 3.3 Why did you become an RCC member?
Source: Author's survey.
Notes: Valid responses: 112. Multiple responses allowed.

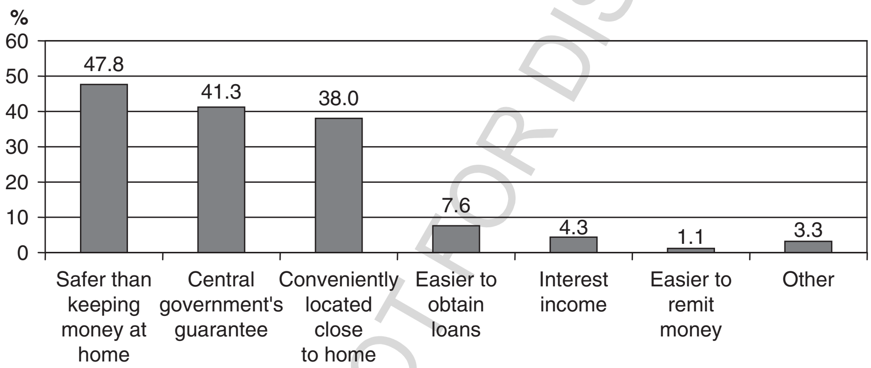

Figure 3.4 Why does your household have RCC savings accounts?
Source: Author's survey.
Notes: Valid responses: 92. Multiple responses allowed.

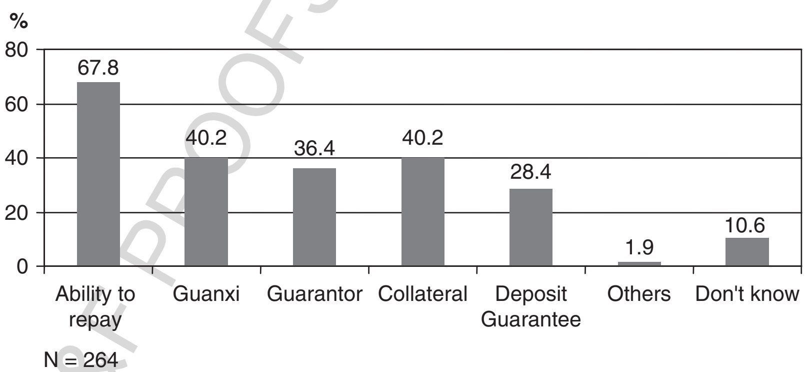

Figure 3.5 What do you think are RCC loan conditions?
Source: Author's survey.

consistent with anecdotal evidence from my in-depth interviews with household borrowers, that in order to secure loans they had to treat RCC managers and officers to banquets, obtain letters of recommendation from village heads, or ask the village elders to give them a good recommendation.

The major uses of formal or RCC loans were cropping, seed capital for private businesses, and children's education. However, this masks the diverging uses of loans across locales. Respondents in richer areas borrowed in order to start their own businesses. Those in middle-income locales borrowed for a range of purposes, reflecting the uses in the overall sample. It is noteworthy that a majority of respondents in poor locales (two townships in Sichuan) borrowed in order to pay taxes, as indicated in Figure 3.6. (The survey was conducted in the mid-2000s just before the agriculture and agricultural-related taxes were phased out; see Göbel's chapter in this volume.) Household interviewees in the poor subsample informed me that cadres who came to collect taxes and fees often brought RCC officers along with them, and instructed the households to borrow from the credit institutions if they could not afford the payments. This highlights the menacing governance problem in the RCCs and flagrant siphoning of loans by local officials. In addition, it also implies that local government interference in credit allocations has "crowded out" loans to households for other essential uses.

Uses of informal loans differ rather significantly from those of formal loans. The top three uses of informal loans (mostly interest-free from relatives and friends) were education, housing construction, and medical expenses (see Figure 3.7). Given that these activities do not generate immediate monetary returns, this suggests two things: one, borrowers had turned to the informal market rather than the formal market because they did not have to pay interest on informal loans; and two, the RCCs may have refused lending for these purposes because of their lack of immediate financial returns. This suggests that formal credit and informal credit are only substitutes to a limited extent because they serve different purposes. Additionally, it is noteworthy that cropping was the single most important use of informal loans among those in the poor locales, underlining the fact that the formal credit institutions are unable to meet the basic credit demands of households in the economically deprived areas. However, the reason is unclear: it could be because the RCCs had deemed some borrowers in these poor regions to be uncreditworthy, or the households had preferred to borrow interest-free loans due to low returns on cropping in the locales.

Conclusions

This chapter has presented ample evidence pointing to the fact that a whole range of rural credit institutions that are intended to serve farmers' credit demands have failed miserably in their missions. The list includes the RCCs, the ABC-administered poverty alleviation loans, and various microloan and microfinance schemes. In no small part, this is attributable to local officials' ability to interfere in the loan allocation process and governance problems in these credit institutions. This is in spite of the corporate restructuring and the central government's massive

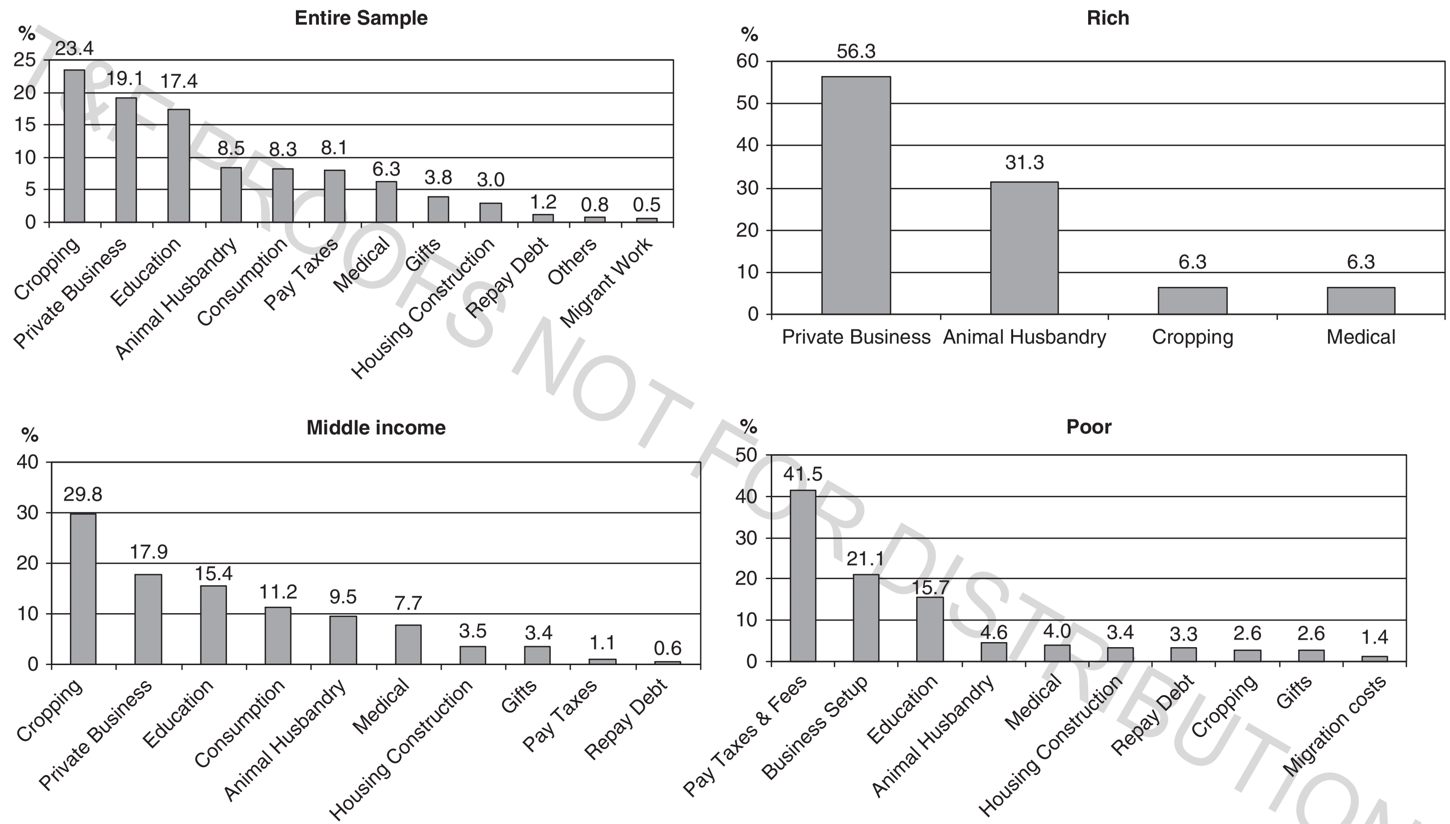

Figure 3.6 RCC loan uses by localities
Source: Author's survey.

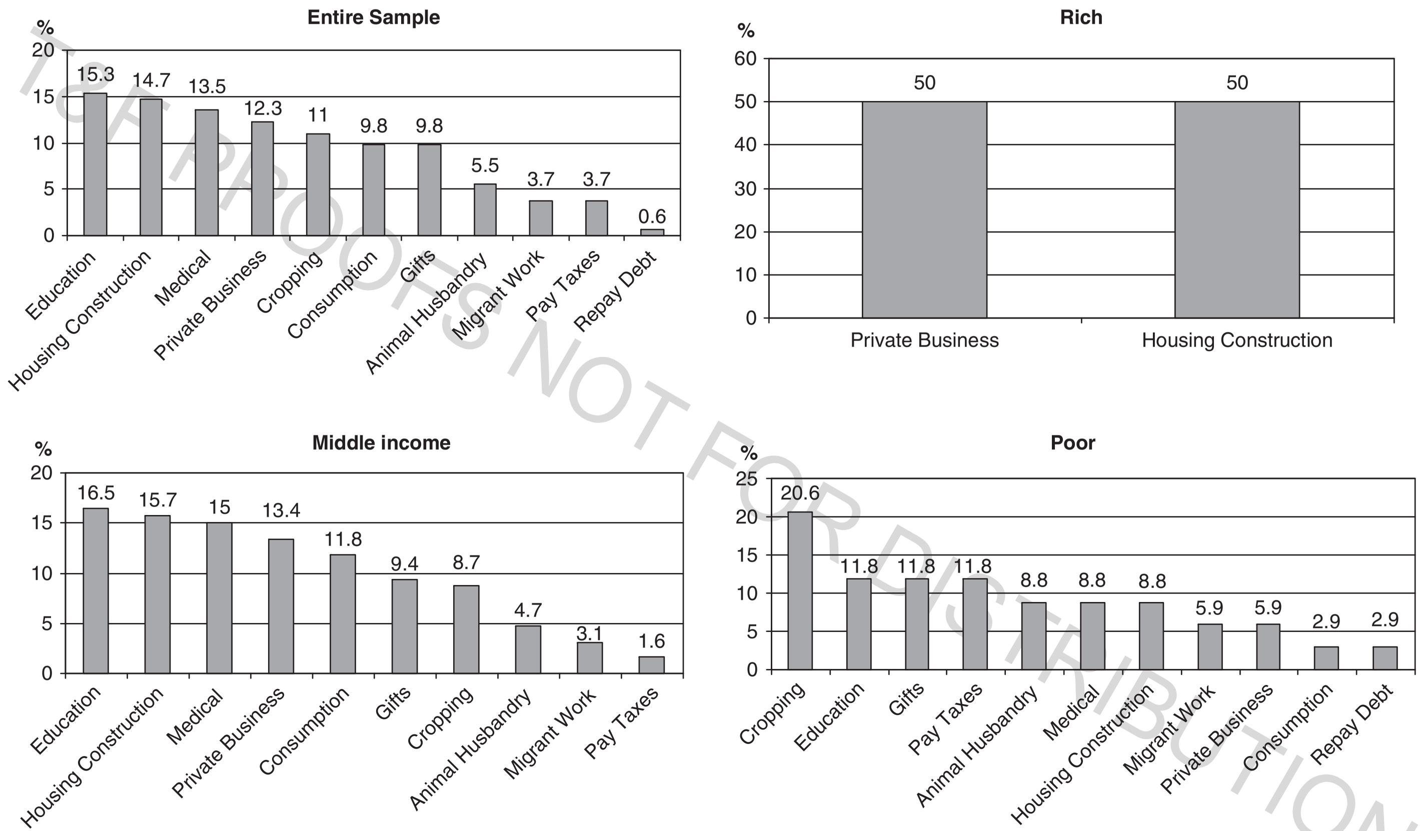

Figure 3.7 Informal loan uses by localities
Source: Author's survey.

efforts in recapitalizing the credit entities that were saddled with mountains of bad debts resulting mostly from lending to local government-related enterprises and projects.

This highlights the need for further governance reforms of credit institutions and areas for future scholarly research. A thorny issue in Chinese corporate governance is the existence of Chinese Communist Party institutions, namely party committees, in banking corporations. The implication is that the internal party secretary who heads the institution is held accountable by territorial party leaders. Local party secretaries strive for economic growth because their political performance is assessed on the basis of local GDP growth and industrial development. It will require more than the installation of a board of supervisors or independent directors to sever effectively the nexus between politics and finance in China. Fundamental changes to corporate governance and establishment of the rule of law will be needed.

Notes

1 For details on finance for the cotton industry, see Alpermann (2010): chapter 8.
2 When asked why the poverty loans were going to the power plant instead of poor households, the intended recipients of the scheme, the director of the poverty alleviation office justified this by arguing that when completed, the power plant would contribute tax revenue to the local government coffers (Interview with the county poverty alleviation office).
3 RCCs cannot remit funds from one city to another because they are county-based financial institutions with independent computer and accounting systems.
4 However, the profits were so lucrative that the Postal Savings had been able to cross-subsidize its parent company, the China Post, before becoming an independent banking entity in 2007.
5 The minimum registered capital requirement for a county-based bank is 3 million *yuan*, while that for a township-based bank is 1 million *yuan*.
6 In addition to the microcredit companies approved by the CBRC, the central bank can also issue licenses for microcredit companies whose business functions are similar to the CBRC-approved ones. They are called “microcredit” companies for the small amount of lending conducted, not for following the practices of the Grameen model popularized by Muhammad Yunus.
7 In addition to those approved by the CBRC, there were reportedly seven microcredit companies approved by the PBoC at the end of 2006, operating in five provinces.
8 When the lender does not know the likelihood of repayment, interest rate can be used as a screening mechanism. A borrower with a risky project is likely to be willing to take out a high-interest loan, while one with a low-risk or low-return investment is more likely to stick with a low-interest loan (see Stiglitz and Weiss 1981).
9 In places where the local government is helpful towards private enterprises, such as in Wenzhou, there is a variety of informal financing. Conversely, when the local government has an unwelcoming attitude towards the private sector, such as in Henan province, informal finance tends to be less diverse.
10 For a full list of programs, see Park and Ren (2001: 40).
11 All programs must be approved by local authorities. Additionally, organizations that do not have the necessary manpower in the program sites may require assistance from local officials. When borrowers fail to repay loans, persuasion or influence by village elders may be useful to induce desirable behavior.
12 Unlike the poor in Bangladesh and India who concentrate in urban or peri-urban areas, a large proportion of the rural poor in China live in remote mountainous regions that rely

on farming as a means of living. Because farmers incur high costs to attend group meetings, dropouts are common, and group loans and joint liability loans do not work as well in China. Since agriculture has a longer gestation period compared with urban petty trading, and different agricultural activities, such as cropping and raising livestock, have diverse production cycles, farmers in China often require something other than the standard repayment terms the programs offer.

13 First, the RCCs were required to place 20–30 percent of their savings deposits with the ABC as reserve. These became the single largest source of capital for the state-owned bank, accounting for nearly half of its total deposits in the early 1980s. Further, while RCCs were paid about 4 percent interest for the reserve they left at the ABC, they had to pay around 9 percent interest on farmers' deposits. The negative interest margins were a major source of structural losses for the RCCs (Tam 1988; Watson 2003).

14 In August 1996, the central government established the Inter-Ministry Coordination Group for Rural Finance Reform at the State Council, with its head office located at the headquarters of the PBoC in Beijing. In addition, the local leading groups for rural financial reform (*nongcun jinrong tizhi gaige lingdao xiaozu*) were established at the provinces and prefectures, and they subsequently became the rural credit cooperative management offices (*nongcun xinyongshe guanli bangongshi*) that were put in charge of managing the county credit unions. The local leading groups reported to the heads of the PBoC's local branches (Interview No. 77).

15 There were various conflicts of interest between the central bank's role as the manager of credit cooperatives and its supervisory role. For further details, see Xie (2001).

16 In the late 1990s, the central bank shut down many trust and investment companies and informal credit institutions that violated rules of financial prudence. These financial institutions included the Hainan Development Bank, China New Tech Venture Investment Corporation, Guangdong International Trust and Investment Corporation, Guangdong International Lease Company, and the Rural Cooperative Foundations.

17 This microloan scheme differs in substance from the Grameen Bank-pioneered microfinance because it lacks group guarantee, market interest rates, focus on women clients, and regular repayments, which are the essential features of the Grameen model.

18 Major changes include establishment of a board of supervisors and a bank governor's office, but they have yielded limited impact because of the entrenched party institutions within the RCCs. For further analysis, see Ong (2009).

19 Wealth level is estimated based on the respondents' house value, cash savings, and possessions such as livestock and motorcycles. These are used in lieu of cash income to measure their net worth because cash income is highly skewed and polarized.

20 These were the respondents' actual occupations at those times, rather than being based on their household registration (*hukou*). Almost all rural residents are "farmers" according to their household registrations, though a large number of them, particularly those in peri-urban townships, may generate most of their income from private business activities rather than from farms. Despite my best effort to ensure the respondents had provided accurate occupations, the proportion of "farmers" may still be overestimated, given the respondents' tendency to think of themselves as "farmers" (*nongmin*). Microentrepreneurs are peddlers who run mom-and-pop shops or food stalls. "Migrant laborers" in the survey definition refer to those who had spent more than six months working in other counties or provinces.

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