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Building Pro-rural Economic Institutions in China – What Can the Reforms of Rural Credit Cooperatives Achieve?

CHENG Yuk-shing*
Department of Economics
Hong Kong Baptist University

1. Introduction

China has initiated a series of measures to improve the livelihood of Chinese peasants and to build a “new socialist countryside” since 2003. This is a response to the rural crisis that started to emerge in the late 1990s. Due to some structural changes in the economy, farmers were having falling incomes in that period of time. However, they were forced to pay excessive taxes and surcharges. In other cases, land were expropriated without sufficient compensation. Recurring protests, demonstrations and even riots in rural areas were seen.

The crisis was triggered by several government policies introduced in the early or mid 1990s. When the Chinese Communist Party decided to establish a “Socialist Market Economy”, a number of institutional reforms were initiated. In the taxation reforms of 1994, the central government centralized fiscal incomes from provincial government. It could be justified by the need to redistribute income from coastal areas to inland areas. However, the provincial governments, facing the squeeze from above, attempted to extract more revenues from lower-level governments. Grassroots governments, burdened by various unfunded missions, had to collect fees and surcharges to cover the administrative expenses. China’s banking reforms, which aims to strengthen the profit motives of the state banks, led to massive close-down of branches and offices in rural areas. The financial disintermediation in rural China has increased the difficulties of the farmers to improve production. Furthermore, as the city governments started to expand their urban space, an increasing number of farmers have lost their farmland without getting sufficient compensation. This is partly caused by the legal power of the state to expropriate farmland in the name of public interest.

In the wake of rural unrests, the Chinese government started to adopted pro-rural policies in 2003. The new slogan was to “return-feed the agriculture by industry” or

* Correspondence: Department of Economics, Hong Kong Baptist University, Renfrew Road, Kowloon Tong, Kowloon, HONG KONG. Email: ycheng@hkbu.edu.hk; Telephone no.: (852) 3411 7550; Fax no.: (852) 3411 5580.

“support the rural areas by cities”. A large amount of fiscal resources were injected to the rural or the agricultural sector. A series of institutional reforms were gradually implemented. For instance, the mechanism for city government to expropriate land from farmers has been tightened. Attempts were also made to clarify the budgetary responsibility of various levels of local governments, so that the grassroots governments would not be overburdened with excessive duties. A nation-wide reform of the rural credit cooperatives (RCCs) was introduced in 2003-04, aiming to build a new rural financial system.

Alleviating the hardship of peasants by spending more money in the rural areas can generate effects in a short period of time. However, building institutions that have long-last impact on the livelihood of the peasants is much more difficult. Various difficulties were already seen in various areas. This paper aims to analyze the problems in the rural financial system. In what follows, we will first provide an historical account of the development of rural credit cooperatives in China. In doing so, we also discuss other forms of rural finance and explain why a financial disintermediation was resulted after the introduction of a series of policies in the mid 1990s. The reforms of the RCCs in 2003-04 will then be analyzed.¹

2. History of Rural Credit Cooperatives in China

The attempt to establish RCCs as a formal credit supplier in rural China can be dated back to the 1950s. Along with the formation of agriculture production cooperatives, the Chinese government also encouraged the setting up of RCCs to provide loans to agricultural producers. The establishment of RCCs was aimed to protect farmers from the possible exploitations of usury, which had long been a problem in pre-liberation China. By the end of 1956, there were over 103,000 RCCs and nearly 100 million households had joint a RCC as a shareholder. Although the RCCs were collectively-owned by the members, they did not have full autonomy. Even in the early stage of collectivization, the management of the RCCs was appointed by local party organs (Shang, 1989, Chapter 13).

The cooperative elements were further weakened when people’s communes were established in 1958 to serve as the governing body in rural areas. RCCs effectively became an administrative subordinate of people’s communes. Later on, some RCCs

¹ The analysis of the historical development of China’s rural credit cooperatives and the description of the reforms in 2003-04 in this paper draws heavily on my earlier paper, Cheng Yuk-shing, “China’s Reforms of Rural Credit Cooperatives –Progress and Limitations *Chinese Economy*, M.E. Sharpe, July-August 2006 39(4):25-40.

were managed by production brigades, which were under the administration of people's communes. Since then, as almost all the economic activities outside the collectives were suppressed, the need for rural credits also diminished. After the failure of the Great Leap Forward movement, the Chinese government recentralized economic powers from local governments and curtailed the power of people's commune in 1962. The RCCs were then subject to the administration of the state banking system. They were once managed by poor peasants in the radical years of the Cultural Revolution before being administered by People's Bank of China (PBOC) in 1970 (Watson, 2003; Shang, 1989, Chapter 13).

The decollectivization reform after 1978 has transformed the rural economy entirely. Demand for credits from rural household and township and village enterprises surged. To accommodate this change, the Chinese government strengthened the role of RCCs in supplying credit. Following the reestablishment of the Agricultural Bank of China (ABC), the RCCs were placed under its administration. During 1980-82, more RCCs were established to cater for the need of the villages. They were given more autonomy in issuing loans (Watson, 2003). Reforms after 1982 laid out some more fundamental objectives. Firstly, the government aimed to restore the "three characters" of RCCs, namely the mass character in organization, the democratic character in management and the flexible character in operation. Secondly, the RCCs were attached with the responsibility for their profits and losses while having independence in running business. Specifically, the RCCs in principle could decide to whom the money should be lent, provided that they deposited the required reserves in the ABC. To reduce the intervention of the ABCs on RCCs, the government established rural credit cooperative unions (RCCUs) at the county level to coordinate the member RCCs. It was unclear, however, what role the RCCUs should play in practice. It was particularly confusing as it was emphasized that the RCCs should have full autonomy in operation. Nevertheless, by the end of 1984, as many as 1136 counties had established RCC unions. (Shang, 1989, Chapter 13).

Not much real progress was made in achieving these goals during this period. Most of the reforms are reportedly nominal rather than real. For instance, it was commonly agreed that the ABCs continued to intervene in the operation of the RCCs in practice. Furthermore, the constraints on the flow of funds imposed on the RCCs also limited their financial activities. Apart from the required reserves, the RCCs had to surrender a large share of their deposits to the ABCs. The share of the funds that the RCCs could use for lending activities was substantially reduced. Consequently, although the RCCs had become the major channel for the rural residents to deposit their savings, the total amount of loans issued by the RCCs constituted only about 50% of their total deposits. Furthermore, they were instructed to apply an

unreasonable interest rate structure which caused big financial losses. Very often, the lending rates were even lower than the deposit rates. In 1989, over 40% of the RCCs were loss-making (Xu et al, 1994, Chapter 2).

In any case, the first decade of rural reforms saw a rapid financial development in China's countryside. Total deposits in RCCs increased from Rmb 16.6 billion in 1978 to Rmb 214.5 billion in 1990. Total loans supplied by RCCs expanded from Rmb 4.5 billion to Rmb 141.3 billion during the same period of time. Other rural financial institutions also experienced a rapid growth. The ABC, another formal financial institution that served the rural economy, also registered rapid growth in loans, from Rmb 168.8 billion in 1985 to Rmb 377.4 billion in 1990 (see Table 1). Starting from the mid 1980s, the ABC was allowed to diversify its business into non-rural lending and encouraged to engage in profit-making activities. Nevertheless, by the end of the 1980s, over 60% of its loans belonged to policy loans, which were supplied to facilitate policy implementation rather than to ensure profitability. In late 1980s, the ratio of non-performing loans (NPLs) was already 17.5% (Xu et al, 1994, p.31).

Despite the rapid growth of loans provided by the formal financial institutions, the rising demand of credits in rural areas still could not be met. In the mid 1980s, various kinds of informal financial institutions started to emerge. Private lending in the rural society was estimated to Rmb 40-60 billion in the late 1980s. This amounted to 30-40% of the loans of the RCCs. (Xu et al 1994, p.4). Also noteworthy was the development of rural cooperative foundations (RCFs), which were internal financial institutions of rural collectives (Cheng, Findlay and Watson, 2003). In the late 1980s, the central government permitted and encouraged the development of RCFs. The funds gathered by them was estimated to Rmb 8-10 billion in 1990 (Xu et al. 1994, p.4). After the rapid expansion in the early 1990s, the number of village-level and township-level RCFs grew to 24,000 and 21,000 respectively by 1996 and the total loans supplied amounted to Rmb 150 billion (Li, 2004).

In sum, rapid financial development was seen in rural China in the 1980s. However, the soundness of the financial institutions already drew attention from the policy makers. As noted above, the formal institutions, i.e. RCCs and the ABC, had already accumulated large amount of non-performing loans. The informal financial activities, on the other hand, lacked proper supervision. The quality of the loans could not be ensured. Attempts to improve the financial system were thus made in the 1990s.

3. The search of a new rural financial system during 1994-2002

In the mid 1990s, the Chinese government decided to launch a series of reforms in rural finance. It was part of the national financial reforms introduced in 1994 with an overall strategy to differentiate the roles of various financial institutions. The new financial system consists of commercial banks, policy banks as well as cooperative financial institutions. The commercial banks have to run their business with an objective to maximize profits. Policy banks are expected to extend loans that serve policy objectives. Their lending activities could be yielding very low or even negative profits. Cooperative financial institutions are designated to serve the interests of the cooperative members. An important step was to commercialize the four existing state-owned specialized banks, the Agricultural Bank of China (ABC), the Industrial and Commercial Bank of China, China Construction Bank and Bank of China. To do so, part of their assets that originally have the nature of policy loans were transferred to the policy banks, China Development Bank, Agricultural Development Bank of China (ADBC) and the Export-Import Bank of China, which were established in 1994 (see Cheng and Cheng, 2003).

Within this general policy framework of national financial reform, more concrete measures were announced in 1996 to reform China's rural financial system.² The first element of the reforms was to restore the cooperative nature of the RCCs. Cooperative finance was considered to be the base of rural finance that supply credits to individual rural households and enterprises. Secondly, the ADBC was charged with the responsibility for supplying policy-related loans, including loans for grain procurement, loans for poverty alleviation and loans for rural infrastructural projects approved by the government. The Chinese government decided to extend its branches so that they could reach most parts of the rural areas. Thirdly, the ABC, as mentioned above, would be transformed into a commercial bank. The rural commercial financial sector would be supplemented by cooperative banks. Fourthly, to reduce the financial risks, the government decided to close down all the RCFs.

In order to restore the cooperative nature of the RCCs, the first step was to delink the RCCs from the administrative control of the Agricultural Bank of China. The latter would no longer be able to intervene in the operation of the RCCs. The new system relied on the formation of RCC unions at the county level to administer and coordinate the activities of the individual RCCs. The central bank, on the other hand, would perform the supervision function. Essentially, this was to set up a supervision system that relies on the vertical control from the central government to the grassroots level. It was decided that major staff originally responsible for managing RCCs in

² The policies were announced in a document called State Council's Decision on Rural Financial System Reforms, downloadable from <http://www.people.com.cn/GB/33831/33836/34152/34158/2539708.html>

the Agricultural Bank should be transferred to the central bank to strengthen the latter's ability to supervise the RCCs.

The reforms also included the restructuring of the ownership and governance structural of the RCCs. To strengthen the cooperative nature of the RCCs, it was suggested that the capital of RCCs should come mainly from rural households, rural collective economic organizations and staff and workers of RCCs. Within a RCC, the highest authority should be the congress of representatives of cooperative members, where the rule of one-person-one-vote (instead of one-share-one-vote) should be followed. Serving the members is the primary objective of the RCCs. Priority should be given to agricultural production in lending activities, with at least 50% of the total loans to be supplied to the members.

During the implementation of these reforms, two additional measures were launched. Firstly, in light of the outbreak of the Asian financial crisis, the Chinese government decided to shift its focus of the financial reforms to the preventions of financial instability (OSSC-MOA, 2005, p.57). It decided to consolidate RCCs as well as other financial institutions. RCCs that had been managed badly or deemed to be unable to survive for external reasons were closed down. As a result, the number of RCCs (counting independent legal entities) decreased from 49,692 in 1996 to 33,020 in 2002 (see Table 1). Similarly, the liquidation of RCFs was also quickened. By 1999, all the RCFs were closed down (Li, 2004).

Secondly, based on the experience of microfinance programs initiated in the early 1990s, the Chinese government decided to provide small loans to the farmers through the RCCs in recent years. Early microfinance programs were mainly initiated by foreign non-governmental organizations and international developments banks to alleviate poverty in backward regions in China. In 1996, the Chinese officials recognized microfinance as an effective way of helping the poor and thus decided to promote its development. In 1999 and 2000, two major policy documents governing the operation of the microfinance activities of RCCs were issued. By June 2003, total amount of lending in the form of microfinance was over Rmb 160 billion, equivalent to 23% of the total agricultural loans (Du, 2005).

However, the rural financial reform program implemented since the mid 1990s did not lead to a healthy and sustainable rural financial system. Each component of the system encountered some problems. Regarding the cooperative finance, although the reforms helped to formalize the governance structure of the RCCs, their balance sheets continued to be fragile. This in part reflected the fact that there was not significant improvement in the management of the RCCs. Indeed, many observers argued that due to its limited capacity, the central bank failed to supervise the RCC system properly. The bad financial performance of the RCCs was also because they

were forced to absorb the NPLs of ABC when ABC went for commercialization. In addition, when the RCFs were liquidated, some of their NPLs were transferred to the RCCs (Ma, 2004). Zhou Xiaochuan (2004), the President of the People's Bank of China, disclosed that the ratio of NPLs was over 50% in late 1990s. At the end of 2001, the ratio of NPLs stood at 44%. Among all RCCs, 46% were loss-making and 58% registered a negative equity. The operation of the RCCs relied heavily on the relending of the central bank, which amounted to Rmb 31.2 billion or 22.37% of the net increase in the loans of RCCs in 2001 (Yu and He, 2003)

The fragility of the balance sheets of the RCCs has constrained the effectiveness of the microfinance experiments. Due to the large debt-equity gap, the RCCs could not provide the loans to farmers without the relending of the central bank. In the end of 2002, the relending for the supporting agricultural development amounted to Rmb 94.6 billion, of which Rmb 77.2 billion were dispatched to RCCs (OSSC-MOA, 2005, p.39). Over-reliance on the relending indicated that RCCs could not run microfinance on a sustainable basis, which is a major merit of the program.

The commercialization of the state banks, together with other factors, led to a contraction of credits in rural areas, which was not expected by the policy makers. As the state-owned banks were required to operate on commercial basis, they closed down a lot of branches and offices to cut down the running costs. These branches and offices were mostly serving directly or indirectly the rural economy. This was reflected in the decrease of some 44,000 of county branches and offices of the four state-owned commercial banks during 1998-2001. The ABC alone reduced its county-level branches and offices from around 60,000 to 44,000 (OSSC-MOA, p.85). This curtailed the availability of rural credits that were essential to the development of the rural economy. Although the total loans of the ABC increased from Rmb 1,367 billion in 1998 to Rmb 1,858 billion in 2002, it reduced its agricultural loans from Rmb 178 billion to Rmb 124 billion during this period of time. Likewise, its lending to rural enterprises declined from the peak of Rmb 190 billion in 1999 to Rmb 154 billion in 2002. This resulted in an outflow of capital from rural to urban areas. Adding to this problem was the increasing importance of the postal savings. The total amount of postal savings expanded from Rmb 128.8 billion in 1996 to Rmb 442.1 billion in 2002. The attractiveness of putting money in rural postal savings came from the relatively high interest rates. Since the postal system could deposit money at the central bank at a preferential rate, it could offer a higher interest rate to attract deposits (OSSC-MOA, p.191). The central bank, receiving deposits from the postal system, only allocate a small share of the funds for rural areas (e.g. through the Agricultural Development Bank). The net effect was a reduction in the supply of credits in rural areas. Furthermore, the RCCs, despite increases in deposits, were

diverting more funds out of the rural areas through deposits and reserves in People's Bank, purchases of bonds etc. The estimated outflow of funds through these channels increased from Rmb 328.0 billion in 1997 to Rmb 447.7 billion in 2002 (OSSC-MOA, p.190).

The operation of policy banks in rural areas also faced difficulties. As mentioned above, the ADBC had been initially responsible for providing loans for agricultural procurement and other policy-related loans. The problem was that a lot of funds designated for grain procurement were used for other purposes by the ADBC. In 1998, the Chinese government decided to adopt a new procurement policy that could protect the interests of the farmers while minimizing the leakage of funds. The government provided funds to state grain procurement units which were asked to procure grains from farmers at a price floor. The grains would then be sold to grain commercial units at a mark-up price. Throughout the process, the flow of funds was tracked carefully to avoid leakage of funds for other uses, a policy called "closed circulation of funds" (zijin fengbi yunxing) by Chinese officials. To better monitor the flow of funds, the government decided to attach with ADBC the sole responsibility to supply the loans related to procurement of major agricultural products. All other policy loans were shifted to the ABC.³ However, as the government liberalized the market for grains and other products after 2001, the loans that needed for policy purpose also decreased drastically. There was even a suggestion that ADBC could be abandoned. By 2004, the ADBC, which was equipped with over 60,000 employees, was trying to lobby the government to allow it to expand its activities (Chang, 2004a).

All in all, China's rural financial reforms since the mid 1990s did not give birth to a healthy financial system. The RCCs continued to be perplexed by institutional problems while the commercialization reform of the state banking system ended with an ABC that had to take up policy loans. Thus, there were calls on more fundamental changes of the system (see Xie (2001) for a discussion of various reflections of the previous reforms).

4. Reform experiments in 2003-4

After years of discussions, new reform initiatives were seen in June 2003. The Chinese government designated eight provincial units (Jilin, Shandong, Zhejiang, Guizhou, Jiangxi, Shaanxi, Chongqing and Jiangsu) as the first batch of experimental regions for the reforms of RCCs. A policy document called "Plan for Deepening the Reform of Rural Credit Cooperatives" (hereafter the Plan) was issued to explain in detail the measures to be implemented.⁴ In November 2004, the reforms were

³ The policy changes described here have been discussed in detail by Chang (2004a).

⁴ The document is downloadable from <http://www.gxi.gov.cn/feature/gxzw-zfwj/guywj/200463165829.htm>.

extended to another 21 provinces. Among the provincial-level administrative units, only Xizang and Hainan were excluded in the reform. There was no RCC in the former while the problems in the RCCs in the latter were so serious that the central government decided to deal with it separately.⁵ Despite the wide adoption of the reforms, the Chinese government continued to call them experiments, indicating the possibility that the reforms could be modified in light of the realized impact of the initial changes.⁶

In the new reform program, it was reiterated that the general goal of the reforms was to transform the RCCs into local or community financial institutions that serve the needs of farmers, agriculture and rural economy. Comprehensive measures were designed to tackle the major problems of the RCCs. The program mainly consists of three elements. At the micro-level, the aim is to build up a governance structure with a new operation mechanism. The ownership of the RCCs would be clarified by establishing legal entities at appropriate administrative levels. The new approach opens up a variety of ownership forms which do not necessarily preserve the cooperative nature of the RCCs. There is no need for different regions to adopt a unified model of reform. Another important element is to strengthen the role of the provincial government in administering the RCCs. The provincial governments will also be responsible for choosing the appropriate reform model for the RCCs in its jurisdiction. The third element was to inject funding into the RCCs to help them shed off the financial burdens that had been built up in the past. If the RCCs were trapped in financial difficulties, it is impossible for them to carry out the ownership reforms. The new strategy of cleaning up the NPLs is so often dubbed “spending money to buy a new mechanism” (*huaqian mai jizhi*). In what follows, we shall discuss the specific measures announced in the Plan.

Clarifying the property rights

The Plan mandates that RCCs should be transformed into legal entities with clear ownership and governance structure. The Plan indicates that a shareholding system should be established wherever possible. Those that do not meet the conditions for establishing the shareholding system should follow the principles of the shareholding system to establish shareholding cooperatives. For regions where cooperatives should be maintained at the current stage, improvements should still be made to the cooperative system. More precisely, in regions where RCCs have a high level of commercialization and capitalization, shareholding banks can be established. In

⁵ See the report in *The 21st Century Business Herald*, August 30, 2004, p.20.

⁶ See the report in *International Finance Post* (*guoji jinrong bao*), December 24, 2004, p.4.

densely-populated regions producing cotton and grain, legal person entities should be unified at the county level (originally with RCCs and county-level RCC Unions as separate legal persons). For other regions, the practice of having different RCCs and county-level RCC Unions as separate legal entities can be maintained, but the management has to be improved.⁷

Enlarging the role of provincial governments

According to the Plan, the central government decides to change the administrative structure of the RCCs. After RCCs were detached from the ABCs in 1996, they were administered by the People's Bank of China. However, the People's Bank of China was also responsible for supervision all financial institutions. The first problem is that it did not have the capacity to monitor the activities of the RCCs. The second problem is the lack of check and balance when one single institution is responsible for both the administrative and the supervision roles. In the Plan, provincial governments are designated to be responsible for the administration of the RCCs. Accordingly, the China Banking Regulatory Commission (CBRC), which was established in March 2003 to take up the role of financial supervision from the central bank, will be responsible for supervising the RCCs.

The provincial government can decide in what way the RCCs should be administered. They can set up a provincial union of RCCs or any other organization to take up the job if they find it appropriate. No restrictions are imposed on their choice. However, the responsibility of administering the RCCs should not be further transferred to lower level governments.

Fund injection and concessionary policies

Regarding the poor financial situations of the RCCs, the central government decided to take four measures. First, the losses due to the deposits with inflation-linked interest rates during 1994-1997 would be covered by government budgetary. Second, the income taxes of the RCCs in the western region will be exempted for three years, starting from the beginning of 2003. Third, to clean up the NPLs, the RCCs are allowed to exchange the NPLs for the capital provided by the relending or special bills issued by the central bank. The amount of fund to be provided will be equal to 50% of the actual amount of debt-equity gap (i.e. asset losses minus owner's equity minus reserves for bad debts) of the RCCs (counting on

⁷Note that very concrete criteria were specified for what regions could carry out each of the first two kinds of reforms.

legal person entities) at the end of 2002. Provincial governments will be responsible for aggregating the necessary amount of capital and to decide which form of the two they would like to get the funding from the central bank. Fourth, the RCCs are allowed to adopt more flexible interest rates for their lending activities. In regions where informal financial activities are thriving, the lending rates can be set in the range of 1 to 2 times of the basic rate. For small loans to rural households, the lending rates in principle should not be higher than the basic rate. However, in cases of high repayment risk, the lending rate can be as high as 1.2 times of the basic rate. For loans in regions inflicted by natural disasters, the lending rate can be adjusted downwards.

Along with the injection of funding, the Plan attempts to build in a mechanism to give incentives for the provincial governments to make progress in reform. This is to be done in two steps. First, only those RCCs that fulfill certain initial conditions are eligible to apply for the exchange of NPLs for the relending or the bills of the central bank. These requirements screen out the RCCs that were too bad to make improvements. Second, only those that make certain progress in reforms can finally capitalize the gain from the central government's fund injection. Specifically, the initial conditions for different kinds of reform ownership reforms is that the financial institutions, after exchanging 50% of the NPLs for the bills of the central bank, must have a capital adequacy ratio of above zero (i.e. non-negative) for counties where RCCs and county-level RCCUs have separate legal entities, over 2% for counties with unified legal entity and over 8% for rural commercial banks and rural cooperative banks.⁸ In order to cash the bills of the central bank within a time limit (normally two years), the RCCs have to meet two conditions: (1) the capital adequacy ratio must be (i) over 2% for counties where RCCs and county-level RCCUs have separate legal entities, (ii) over 4% for counties with unified legal entity, and (iii) over 8% for rural commercial banks and rural cooperative banks; and (2) the NPL ratio must be reduced to less than half of the level at the end of 2002.⁹

To meet the initial conditions, many local provincial governments have to either mobilize investment or inject funding using their own money. Likewise, to meet the required conditions for cashing the bills of the central bank, the provincial governments have to make further effort. Since the total debt-equity gap of the RCCs amounted to Rmb 330 billion, the total funding to be injected by the central

⁸ "Q&A about Reforms of Rural Credit Cooperatives (10)." *Financial Times* (Beijing) October 28, 2004, p.10.

⁹ "Q&A about Reforms of Rural Credit Cooperatives (12)." *Financial Times* (Beijing) November 11, 2004, p.10.

bank could be as much as Rmb 165 billion. As some of the poor regions could enjoyed some more concessions, it was estimated that the total funding needed would be Rmb 168.8 billion, of which Rmb 167.9 would be special bills and Rmb 0.83 billion special relending from the central bank. By the mid 2005, the 29 provinces included in the two batches of experimental regions had obtained Rmb 98.5 billion of central bank bills.¹⁰

5. What can the RCC reforms achieve

There are two apparent objectives of the recent RCC reforms. The first objective is to clear the financial burdens of the RCCs that have been historically accumulated. The second one is to establish a system of RCCs that could serve the rural areas. This system should be operated in a new fashion that can guarantee its financial viability.

There are signs that the Chinese government has made significant progress in achieving the first objective. Shortly after the reforms started, the financial performance of the RCCs showed big improvement. The capital-adequacy ratio, one of most important indicators of financial fragility, increased by 10.94 percentage points within two years to reach 2.49% at the end of 2004. Moreover, total profits of RCCs amounted to Rmb 10.462 billion in 2004, the first time being positive in the past decade. In the first half of 2005, total profits of Rmb 9.336 billion were registered.¹¹ These improvements reflected that the transitional arrangements to improve the balance sheets of the RCCs have worked in an expected way. As explained above, the special central bank bills can be cashed only if the RCCs can raise the capital adequacy ratio to a satisfactory level. The provincial governments thus have tried their best to accomplish this task. Many regions have tried to achieve the target by increasing the amount of paid-in capital. They have done so mainly by mobilizing, and sometimes forcing, the staff and workers of RCCs to become shareholders. One prominent case was the reforms in Jilin. At the end of 2002, RCCs in Jilin had a total amount of capital of Rmb 330 million. However, its debt-equity gap amounted to Rmb 10.2 billion, that is 30 times of the capital. By the end of June 2004, the amount of paid-in capital was expanded to Rmb 6.63 billion, representing an increase of 20 times since the end of 2002. Most of the money has come from the staff and the peasant clients of the RCCs. The staff and workers of RCCs were willing to buy the newly issued shares of their RCCs because they knew that the RCCs would be able to get some matching fund from the central government, which would help the RCCs to survive. Some workers were not willing to buy the

¹⁰ *The 21st Century Business Herald*, July 21, 2005, pp.17-18.

¹¹ *Economic Daily* (Beijing), July 16, 2005, p.5.

shares, but they eventually had to do so because their RCCs assigned a mandatory purchasing quota for every worker. The farmers bought shares of RCCs because they could obtain credits only if they do so. Consequently, the capital adequacy ratio rose to 5.45% from -52.9% (Chang, 2004b).

However, the second task is not an easy one. There are hundreds of millions of rural households and millions of small and medium-sized enterprises scattering in large rural areas with poor transportation and communication infrastructure. Moreover, each of the rural households and enterprises only demand for a small amount of loans. High unit costs will be incurred to any institutions that supply credits to them. Still, the rural households and small enterprises usually do not have collateral for their loans to overcome the problem of asymmetric information prevalent in the financial market. Such a high-risk business could attract usury. Any good rural financial institutions must be able to overcome the problem of asymmetric information about the borrowers.¹²

Under the reform program, there are three major destinies of the existing RCCs, namely, shareholding banks, cooperative banks and RCCs which would be under the administrations of County RCCUs. Shareholding banks, which have already appeared in some rich areas (e.g. Jiangsu), will definitely be profit maximizing. It is not likely that they would really be “pro-rural”. That is not a problem, as they are expected located in rich areas where rural-urban difference is not big (alternatively, the level of rural-urban integration is high). The rural areas will be expected to be urbanized not long in the future.

The major problem lies in the areas where RCCs are not qualified to be transformed into shareholding banks. They belong to relatively poor areas. A pro-rural lending policy means that they have to forgo some more profitable non-rural lending opportunities. Whether they can be financially viable is still a question. In these areas, the normal township-level RCCs were merged into a single legal entity of county RCCUs. This transformation runs the risk of further bureaucratization of the system, which is a major cause of the failure of RCC in guaranteeing the quality of the loans in the past. If the control of the RCCs move further up, the agency cost of the system may increase while the problem of asymmetric information could be worsen.

The bureaucratization problem could be extended further to the province level. One of the policy intentions is to shift the responsibility of administering the RCCs to the provincial government. The progress in the reforms thus far could not be made without the involvement of the provincial government. However, the enhanced role

¹² For instance, the Grameen Bank found by Muhammad Yunus has several mechanisms to ensure repayment rate of the borrowers. For instance, the joint liability of group lending ensure that there are peer screening *ex ante* and peer monitoring *ex post*.

of the local government in administering the RCCs is also the most important source of risks that the reform could turn sour. The dilemma is that when the provincial government has to bear the responsibility, it would be unlikely to allow the RCCs to be truly autonomous in operation. One worry that has often been raised by Chinese researchers is the possibility that RCCs would gradually become the financial arms of the local governments, without any ability to refuse the supply of funds to the investment projects supported by the local government. Under such a system, the quality of loans could not be maintained and thus the instability of the system cannot be avoided.

The behavior of the provincial governments in the reform process seems to justify this worry. Some researchers have already observed that there had been no significant changes in the governance structure of the RCCs in the experimental regions.¹³ Rather, the provincial governments have attempted to consolidate decision power to their own hands. The eight provinces designated as the first batch of experimental regions all have chosen to set up a RCCU at the provincial level. As noted by Shen (2004), in each province, the county-level RCCUs are shareholders of the provincial RCCU, but the latter in fact has the power to administer the former. For instance, the directors of the county-level RCCUs are appointed by the provincial RCCU. Under this power structure, the provincial RCCUs could easily become a vehicle for the provincial government to obtain cheap credits. Shen (2004) even warned that the provincial RCCUs are now involved in a large scale of loans that could lead to moral hazard problems because they might be “too big to fail”.

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¹³ See, for example, the interview of Han Jun, Head of Rural Economic Research Department at Development Research Centre of State Council in *Financial Times* (Beijing) November 16, 2004, p.10.

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Table 1 Development of China's Rural Credit Cooperatives (RCCs)

(Rmb 100 million)

	Rural credit cooperatives					All financial institutions ^(b)		Agricultural Bank of China	
	No. of RCCs ^(a)	No. of Staff and workers ^(a)	Total deposits	Total loans	Of which: Agricultural loans	Total Deposits	Total loans	Total Deposits	Total loans
1978			166.0	45.1	33.0	1,155.0	1,890.4		
1979			215.9	47.5	33.3	1,361.6	2,082.5		
1980			272.3	81.6	50.5	1,708.2	2,488.1		
1981	55,044	290,335	319.8	96.4	60.9	2,092.9	2,951.6		
1982	55,209	299,312	389.9	121.2	78.9	2,457.1	3,291.0		
1983	55,953	320,577	487.4	163.7	103.6	2,907.2	2,737.3		
1984	58,255	349,754	624.9	354.5	219.5	3,880.5	5,089.3		
1985	58,603	370,345	724.9	400.0	235.6	4,579.5	6,271.9	912.4	1,687.7
1986	59,194	401,799	962.3	568.5	302.6	5,814.0	8,116.5	1,211.8	1,996.1
1987	60,872	433,866	1,225.2	771.4	412.1	7,183.4	9,766.3	1,487.3	2,319.3
1988	60,897	471,910	1,399.8	908.6	452.5	8,237.7	11,425.0	1,713.7	2,632.2
1989	58,970	484,537	1,669.5	1,669.5	520.5	10,786.2	14,360.1	2,055.5	3,058.2
1990	58,200	517,083	2,144.9	1,413.0	652.3	14,012.6	17,680.7	2,640.6	3,774.3
1991	57,885	539,226	2,709.3	1,808.6	801.3	18,079.0	21,337.8	3,319.0	4,578.0
1992	52,763	563,163	3,478.5	2,452.8	982.1	23,468.0	26,322.9	4,131.0	5,468.0
1993	50,865	594,017	4,297.0	3,144.0	1,143.0	29,627.0	32,943.1	5,184.0	6,529.0
1994	50,745	614,501	5,681.2	4,168.6	808.4	40,472.5	40,810.1	6,971.5	5,912.3
1995	50,219	634,245	7,172.9	5,175.8	1,094.9	53,862.2	50,538.0	6,939.4	6,560.5
1996	49,692	648,613	8,793.6	6,289.8	1,486.6	68,571.2	61,152.8	9,106.5	8,566.4
1997	47,214	360,842	10,555.8	7,273.2	1,843.6	82,390.3	74,914.1	11,322.4	9,809.6
1998	41,719	339,346	12,191.5	8,340.2	2,659.3	95,697.9	86,524.1	13,325.3	13,666.1
1999	39,604	328,893	13,358.1	9,225.6	3,039.6	108,778.9	93,734.3	15,492.8	15,550.6
2000	37,624	328,211	15,129.4	10,489.3	3,588.0	123,804.4	99,371.1	17,515.9	14,497.2
2001	37,270	308,562	17,263.5	11,971.2	4,417.6	143,617.2	112,314.7	20,244.5	16,045.9
2002	33,020	307,387	19,875.5	13,937.7	5,579.3	170,917.4	131,293.9	24,106.9	18,579.0
2003	31,448	334,957	23,710.2	16,978.7	7,056.4	208,055.6	158,996.2	29,004.7	22,118.4

Notes: (a) Figures of the no. of RCCs and no. of staff and workers for 1981-1985 are obtained from Shang Ming (ed.), *Contemporary China's Financial Undertaking*, Beijing: China Social Science Press, 1989, p.465

(b) Figures of the total deposits and total loans for 1978-88 are the sum of all state banks and RCCs. Other financial institutions are not counted.