

# **Rates of Interest, Credit Supply and China's Rural Development**

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## **Abstract**

By analyzing the data on the supply of rural credit, we find that official statistics have overstated the supply of institutional credit in rural China, as the supply of institutional credit as a proportion of rural deposits in China has actually plummeted after 1996. Using the findings from field investigations in China, we argue that the current official lending rate is unsustainable and that state regulation of interest rates and the consequential market distortions have contributed to the ever-growing non-performing loans and financial losses of rural financial institutions, and hence to the declines in the supply of rural credit.

**Key words** : credit supply, interest rate, Asia, China

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## **ABBREVIATIONS**

ABC	Agricultural Bank of China
ADBC	Agricultural Development Bank of China
FPC	Funding the Poor Cooperatives
LDCs	Less Developed Countries
MFIs	Microfinance Institutions
MoA	Ministry of Agriculture
PBOC	People's Bank of China
RCCs	Rural Credit Cooperatives
RCCU	County Union of Rural Credit Cooperatives
RCFs	Rural Credit Foundations
RFIs	Rural Financial Institutions
SMEs	Small and Medium Enterprises
SOEs	State Owned Enterprises
TVEs	Township and village enterprise

## **1. Introduction**

Following the continuous decline in the growth rate of farmers' incomes and the widening income gaps between the rich and the poor and between urban and rural areas since the early 1990s, there has been renewed interest and renewed policy debates about China's agricultural and rural development. The new government inaugurated in March 2003 has vowed to give policy priority to supporting agricultural development and rural incomes and to narrowing the income gap between regions and between the rich and the poor.

The outflows of funds from rural areas channeled through rural financial institutions (RFIs) and the lack of rural credit have been identified as one of the major obstacles to China's rural development (Zhang Xiaoshan 2003).<sup>1</sup> The *Xinhua News Agency* reported recently that large amounts of rural funds have flowed from rural to urban areas, driving an increasing wedge between the demand for and supply of rural credit. The shortage of rural credit has been blamed for the slow pace in rural structural adjustment in developed areas of China, by jeopardizing the taking-up of investment opportunities in high value added agriculture, such as large scale production of vegetables and aquatic products and in agricultural processing and rural off farm production.<sup>2</sup> In the major agricultural producing areas and also within the poor areas, the lack of credit from formal financial institutions has given rise to the rapid growth of rural usuries. In a report submitted to the Monetary Policy Committee of the People's Bank of China (PBOC), China's central bank, Wen Tie-yun (2001) argued that a growing number of the poor in rural China have been trapped in a debt cycle and been forced to provide labor to moneylenders in exchange for interest repayment.

Various policy suggestions have been put forward to the Central Government and the PBOC to raise the supply of rural credit so as to improve rural output and incomes. The Ministry of Agriculture (2002) proposes to raise the amount of agricultural lending by setting the minimum amount of agricultural loans to be disbursed by financial institutions and by increasing the variety and quantity of policy loans for agriculture. It also proposes to extend the loan duration and reduce the lending rate (so as to reduce the costs to borrowers) for rural borrowers in China.<sup>3</sup> These policy suggestions are very similar to the credit policies once implemented in many other less developed countries (LDCs), the so called traditional approach to rural finance, that has been proven unsuccessful in tackling rural poverty and promoting rural development. However, the political pressure for expanding cheap rural loans has been so great that the PBOC introduced the agricultural on-lending program by providing cheap loans to rural credit cooperatives (RCCs) in 1998, and the value of these loans has been growing over time. Moreover, in early 2003, the PBOC further set the annual target for growth of the loan portfolio of RCCs at over 15 per cent, with the agricultural loan portfolio of RCCs to grow by 20 per cent or more (PBOC website).<sup>4</sup>

This paper addresses the concerns about the shortage of rural credit by examining changes in rural deposits and loans of RFIs and the relationship of these changes to the

changes in the structure and real rates of interest in China. The paper argues that the change in the structure and real rates of interest is one of the major forces, perhaps the most important one, behind the outflow of rural loanable funds, following the commercialization of RFIs in China since the early 1990s. The distortions in China's rural financial markets have serious implications for the efficiency of rural financial intermediation, for state budgets, and for the allocation of scarce resources in rural China. Applying the theory of finance and economic development, the paper aims to analyze the impact of market distortions caused by selective credit policies on the allocation of rural credit and on efficiency of financial intermediation in rural China.

The relationship between financial policies and economic development has been a popular topic in the study of development economics.<sup>5</sup> Selective credit policies have been blamed for the misallocation of scarce resources and low efficiency in financial intermediation (Adams, Graham and Von Pischke 1984). However, as far as the authors are aware, there have been no systematic studies about the impact of financial policies and the structure of interest rates on the allocation of resources and on the efficiency of financial intermediation in rural China, although similar studies have been undertaken for many other LDCs (Fry 1995). This study attempts to fill the gap. It has important policy implications given the size and importance of China's rural economy, the large current institutional loan portfolios and the amount of loans disbursed each year by RFIs in China. By the end of 2001, the total loan portfolio of RFIs in China had reached ¥11,200 billion (equivalent to 1,350 billion US dollars), dwarfing that in many other LDCs. The lessons drawn from China are valuable for other economies in the process of economic development and transition. The materials used in this paper are drawn from both official sources and from information collected by the authors in field investigations in China.

The paper is organized as follows: Section 2 documents the evolution of RFIs in China. The changes in rural deposits and loans are examined in Section 3. Using their knowledge and data from field investigations, the authors examine official statistics on the changes in rural deposits and loans and have made a number of adjustments to provide a clearer picture about the changes in the supply of institutional credit in rural China in the last decade. Regulation of interest rates and its impact on the allocation of resources and efficiency of financial intermediation in rural China are discussed in Section 4. Section 5 describes the behavior of RFIs under interest rate and market distortions. Conclusions and policy implications are provided in Section 6.

## **2. Evolution of Rural Financial Institutions and Markets in China**

China's financial reforms launched in 1993 and 1996 have been characterized by drastic changes in RFIs and their lending responsibilities. In terms of rural finance, the reforms aimed to separate policy from commercial banking, to commercialize the operation of the Agricultural Bank of China (ABC) and to make RCCs real credit cooperatives to be controlled by their members. In these ways the reforms sought to improve the efficiency of financial intermediaries and reduce the proportion of non-performing loans. Prior to the reforms, formal finance in rural China was dominated by

the ABC, with the latter responsible for both commercial and policy lending in agriculture and for managing RCCs. In 1994, the Agricultural Development Bank of China (ADBC) was created and was charged with the responsibility of managing policy loans, which at that time included loans for agricultural procurement, storage and processing, and loans for integrated agricultural development and poverty alleviation (ADBC 1994). However, the management of subsidized poverty loans, an important part of agricultural policy lending in China, was returned to the ABC in 1998 following a marked deterioration in poverty loan quality. The comprehensive financial reforms launched in 1996, which separated RCCs from the ABC, set the ABC further on the road to commercialization. The management of RCCs was shifted first to a newly established Inter-ministerial Coordination and Leading Group for Rural Financial Reforms in 1996, and then the leading group joined the PBOC in 1997 (Almanac of China's Finance and Banking 1998). The formal financial sector in rural China is currently made up of the ABC, the ADBC, RCCs and Rural Postal Savings (RPS). Rural Postal Savings are savings-only financial institutions.

RFIs in China are nationwide institutions. The ABC and the ADBC, with their head-offices in Beijing, have branches at the provincial, prefectural and county levels. The ABC county branches have business offices operating at the township level. The RCCs however, are based at the township level. Township RCCs are, by law, independent legal entities and profit centers. Many RCCs have credit and savings stations and agents in the villages. At the county level, RCCs are represented by the RCC County Union (RCCU), and the latter, with shares from individual RCCs in the county, is also a profit center and a legal entity. The township RCCs report to both the RCCU and the county branch of the PBOC. The major functions of the RCCU include the provision of management, coordination and services to the RCCs in the county.<sup>6</sup> Rural Postal Savings are also located at the township and county level, as a part of the Post Offices in rural China.

The deposits and loans of RFIs should not be defined entirely as rural deposits and loans. As a financial institution based at the township level, RCCs' operations have been restricted to rural areas.<sup>7</sup> Therefore, all the deposits and loans of RCCs can be regarded as rural deposits and lending. The loans of the ADBC, used for the procurement, storage and processing of important farm goods, mainly grain, have been defined officially as rural lending, although the benefits brought about by such policy loans are far from restricted to rural areas (Cheng 1997). The loans from the ADBC for agricultural procurements have been used for paying farm producers. The ABC, with the majority of its deposits from rural areas, has been lending in both rural and urban areas. Since 1996, the bank has gradually shifted its lending operations to urban areas. All the deposits of the Rural Postal Savings are from rural areas and are re-deposited with the PBOC. The ABC and Rural Postal Savings, with their deposits mainly from rural areas, have been blamed for channeling funds from rural to urban areas.

Informal finance in rural China consists mainly of borrowing and lending among relatives and friends with a low rate of interest or interest free; moneylenders, and informal financial mechanisms organized by rural households, such as revolving savings and credit associations; as well as informal financial institutions. Officially, RFIs in

China do not include informal financial institutions, as these institutions are neither regulated nor supervised by the PBOC and the deposits with these institutions are not protected by the state. In this paper hereafter, RFIs refer to formal RFIs only. The informal financial institutions in China include rural credit foundations (RCFs) and other financial institutions organized by local governments, as well donor-funded microfinance institutions (MFIs). The RCFs emerged in the middle 1985, with strong support from local governments in China (Cheng, Findlay and Watson 1997). Donor funded MFIs emerged in 1993-1994 and became the only viable informal financial institutions in rural China, following the collapse of RCFs and other locally supported RFIs in 1999 and 2000.

Competition in China's rural financial markets is constrained by state regulation of the entry and exit of financial institutions. The ABC and the ADBC are government owned financial institutions and the RCCs, albeit defined as cooperatives, are subject to PBOC regulation and management and have a corporate governance similar to state owned financial institutions. Entry by new financial institutions is virtually impossible.<sup>8</sup> Moreover, there is no defined mechanism for individual loss-making RCCs with negative equities to exit the market.<sup>9</sup> Apparently, restrictions on competition and exit have contributed to moral hazard problems for RFIs in China.

The reforms in 1994 and 1996 failed to make rural financial markets more competitive, although the ADBC was created and the management of RCCs was shifted from the ABC to PBOC. On the contrary, China's rural institutional lending markets have become dominated by RCCs, as the reforms led to the gradual withdrawal of the ABC from rural lending and the collapse of RCFs and other informal financial institutions. These are the major competitors for RCCs in rural financial markets. Non-price competition for rural deposits has become fierce, especially in more developed areas, as the ABC stays on fighting for rural deposits and the share of rural deposits held by Rural Postal Savings has grown over time.

### **3. Flows of Rural Funds Through Formal Financial Institutions**

RFIs in China, with their extensive branch network and their deposits insured by the Central Government, have played an important role in rural savings and lending and hence in the process of rural development.<sup>10</sup> It is shown in Tables 1 and 2 that both rural institutional deposits and loans have increased significantly in the last decade.<sup>11</sup> The ratio of total rural institutional loans to deposits, however, fell from 110 per cent in 1989 to around 86 per cent in 2001, an indication of the outward movement of rural loanable funds in China.<sup>12</sup> The ABC appears to be the most important rural financial institution, as it provided about half of both the rural institutional loans and deposits in China. There has been a remarkable increase in deposits with Rural Postal Savings and the ratio of postal savings to total rural institutional deposits rose from 0.6 per cent in 1989 to around 8.6 per cent in 2001.

The observations above need to be qualified by the fact that the ABC has allocated a growing proportion of its loans to urban areas and the year-end loan portfolios

as shown in Table 2 are very different from the supply of rural credit in China. The ABC lending to agriculture and to TVEs, its rural loan programs, fell significantly since 1998, when the commercialization of the ABC started to impact on its loan composition (Table 3). The decline in the ABC's rural loans has made RCCs the dominant supplier of credit in rural China. It is illustrated in Table 4 that the ratio of annual loan disbursement to the loans outstanding for both the ABC and RCCs declined significantly after 1991. In Table 4, annual loan disbursement refers to the total amount of loans disbursed by the relevant financial institutions. It is the annual loan disbursement (credit flows) rather than year-end loans outstanding (stock) that determines the supply of institutional credit in rural areas. The decline in the ratio of the annual loan disbursement to loans outstanding reflects an increase in the proportion of non-performing loans for both the ABC and RCCs over time. Following increases in the proportion of non-performing loans and hence in loan collection rate, RFIs have less funds available for loan disbursement. To construct a clearer picture of the changes in the supply of credit in rural China, we replace Table 2 with Table 5 where the supply of rural credit is represented by the cumulative rural lending of the ABC and RCCs. It is assumed in Table 5 that the loans by the ADBC should not be counted as rural lending based on the fact that ADBC loans are not provided to rural households and enterprises for productive investment or consumption. Moreover, the coefficients of cumulative disbursement to year-end loans outstanding as calculated in Table 4 for the entire ABC loans are applicable for the ABC loans to agriculture and TVEs.

It is shown in Table 5 that, first, as a proportion of total institutional deposits, institutional lending in rural China has more than halved in the last decade, and the fall has been more dramatic since 1996, thanks to the re-allocation of credit by the ABC to urban areas (the ratio of the ABC loans fell from 17.2 per cent in 1996 to 4.9 per cent in 2001), an increase in non-performing loans with the ABC and RCCs, as well as an increase in savings deposits organized by Rural Postal Savings (Table 1). This confirms the observation that, in terms of the rising demand for rural credit as indicated by the rapid increase in rural institutional deposits, there has been a shortage in the supply of rural credit. In other words, the role of the ABC and RCCs as financial intermediaries in channeling rural savings into rural productive investment has declined in the last decade. Second, the decline in the proportion of rural credit to deposits had been fairly consistent over time and the steeper declines in the ABC's agricultural lending since 1997 had been offset to some extent by the increased lending from RCCs. Of the total rural institutional lending in 2001, 84 per cent was provided by RCCs, which made the ABC a relatively insignificant player in financing households and enterprises in rural China.

The conclusions drawn from Table 5 need to be interpreted with caution. The loan rescheduling and refinancing, a widespread problem for RFIs in China, have not been taken into consideration, as the information on refinancing and rescheduling is not readily available. Refinancing and rescheduling of loans affect both loans outstanding and loan disbursements, as part of the normal loans that have been refinanced should have been re-categorized as non-performing loans or have been written-off. The declines in the ratio of rural institutional credit to deposits would be more drastic, if loan refinancing and rescheduling had been taken into account. It is also important to note that the aggregate



rural lending figures in Table 5 conceal the regional variations and flows of loanable funds from poorer to richer areas, a topic deserving further study.

An important aspect of China's selective credit policies is the provision of policy loans by RFIs to priority sectors of the economy. The policy loans for rural China include, but are not limited to, the loans for agricultural procurement and storage (mainly by the ADBC), poverty loans and agricultural on-lending from the PBOC to RCCs.<sup>13</sup> The ratio of ADBC loans to total institutional loans in rural China had been around one quarter to one fifth (Table 2). Of the total rural loans provided by the ABC and RCCs, the proportions of the poverty loans and agricultural on-lending by the RCCs, had increased since 1995. By 2001, policy loans made up about 10 per cent of the total rural loans provided by the ABC and RCCs in China (Table 6). Clearly, the decline in the supply of rural institutional credit would be more drastic after 1996, if there had not be a marked increase in rural poverty loans.

#### **4. Market Distortions and Efficiency of Rural Financial Institutions**

Since the early 1990s, China has made progress in removing market distortions caused by negative rates of interest. From 1989 to 1998, the real deposits and lending rates rose significantly (Table 7). The increases in real interest rates, reflecting a process of financial deepening (McKinnon 1973; Shaw 1973), should have contributed to the increases in rural savings deposits and hence benefited rural depositors, and improved the allocation of resources in rural China.<sup>14</sup> Moreover, farmers and rural communities have also benefited from improvements in the structure of interest rates. The difference between the rates for demand deposits and time deposits have narrowed consistently and the term structure of deposit rates has become less tilted over time. The depositors, especially those with demand deposits, have benefited from such a reduction (Fry 1995). In terms of lending rates, the disparity between the base rate and subsidized rate for poverty loans has declined from 7.2 per cent in 1989 to less than 3 per cent in 2002 and the preferential rate for loans for agricultural procurements was removed in 1998. Finally, the rate differential between one-year lending and one-year deposit has increased, leaving a higher margin for RFIs.

The positive changes above have been brought about by state control over runaway inflation, and to a less extent, by deliberate government policies. The Central Government initiated the process of relaxation of state direct control over interest rates in the early 1990s and RFIs, and particularly RCCs, have been at the forefront of interest rate liberalization. The centerpiece of the reform is the introduction of the bands for financial institutions to adjust their lending rates. In 1992, state banks and financial institutions were allowed to float their lending rates around the base rate for working capital loans, with an upper band of 20 per cent and a low band of 10 per cent. On 1 June 1996, the state control over the rates on the inter-bank money markets was removed (Dai Xianglong 1997, p. 58). Then in 1998, the interest band for the loans to SMEs was increased from 10 to 20 per cent and the band for RCCs lending increased from 40 to 50 per cent.<sup>15</sup> In 1999, all the financial institutions and their branches operating at, and

below, the county levels were allowed to float their lending rate by a maximum of 30 per cent, and the band for loans to SMEs was also raised from 20 to 30 per cent. Finally, in 2002, the government launched the pilot programs for interest rate liberalization of RCCs in eight counties of China, where the band for the lending rate of RCCs was expanded from 50 to 100 per cent and, for the first time, the RCCs in these counties were allowed to float their deposit rate by 20 per cent. By April 2003, the pilot had been replicated in 92 counties of China.

However, the distortions in China's rural financial market remain and the capped lending rates for institutional finance are far from sufficient to cover the operational and funding costs while leaving a margin for the growth of RFIs. The real rural lending rates, although increased over time, have been low compared with the market rate of interest represented by rates in the informal financial markets (around 20-25 per cent nominal). The institutional rates have also been lower than the effective rates charged by microfinance institutions (MFIs) in China. The microfinance experiments in Henan and Hebei of Central China undertaken by Funding the Poor Cooperatives (FPC) indicate that, with the fund cost at around 2 per cent per annum (nominal) and over 95 per cent of on-time loan repayment (annual loan loss within 3 percent of the portfolio), MFIs in these areas need to charge an effective rate of about 15 per cent to achieve operational viability.<sup>16</sup> This is much higher than the maximum lending rate RCCs can charge (currently at 7.97 per cent per annum). Moreover, MFIs in China, such as FPC, have no historical burdens (historical non-performing loans and financial losses), no tax obligations and the loan repayment rates of FPC are much higher than the average RCCs in China. Projections by the authors for the sustainable lending rate by RFIs are shown in Table 8.<sup>17</sup> These projections are based on the surveys of RCCs undertaken by the authors in Shanxi, Anhui and Jiangsu provinces in 2001 and 2002. It is important to note that the cost projections as shown in Table 8 are for the above average RCCs, with good management, in the respective areas of China. The opportunity cost of capital (which would be higher than 3 per cent per annum) and historical burdens of RCCs are assumed away. The projections will be applicable for the ABC branches as well. It is shown in Table 8 that, on average, RFIs in coastal areas need to charge a minimal 8.8 per cent per annum to survive.<sup>18</sup> Most RCCs in China would be in the medium range, and need to charge at least a nominal lending rate of around 11.5 per cent; while RFIs in poor and more remote areas of the country would be in the high range, and need to charge over 16 per cent to survive.<sup>19</sup> The lending rates required would be much higher than these projections, assuming that RCCs need to generate profits for dividends to their members and for growth, and to cover accumulated financial losses and historical bad loans. More financial projections and detailed analyses with more samples are required to calculate the sustainable rates of interest for RFIs in different regions of China.

The findings above have important implications for the operation of RFIs in China. First, low lending rates have contributed to the growing financial losses of RFIs in China, given the high operational costs and high risks for rural lending in China.<sup>20</sup> Second, the low lending rates have given rise to the lack of operational funds for RFIs and their staff, which has in turn contributed to increases in non-performing loans. The authors found in the Guizhou Province in 2000 and 2001 that RCC staff received basically no subsidies for going to the villages to screen loan applicants and monitor loan usage because of the

financial difficulties.<sup>21</sup> The financial losses and ever increasing non-performing loans have crippled the ability of RFIs to provide loan support to rural households and enterprises. Moreover, low lending rates have discouraged RFIs from lending in rural areas, given the higher transaction costs and higher risks for rural lending, a point discussed in more detail in Section 5. The low lending rates have also exacerbated the already serious moral hazard problems of RCCs caused by unclear ownership structures and poor corporate governance, as RCCs can easily mix up their non-performing loans and financial losses caused by bad management with those caused by the low lending rates.<sup>22</sup>

Ironically, as happened in other LDCs, rural borrowers in China have not necessarily benefited from low lending rates because interest expense constitutes only a part of the overall borrowing costs for rural borrowers (Adams and Nehman 1979). The authors found in the surveys in rural China that the borrowing costs for farmers are mainly in the form of gifts and kickbacks to loan officials, the time spent on traveling and on loan applications, and the membership fees for joining RCCs. It is not uncommon for loan applicants to invite loan officials to banquets for loan access and/or give kickbacks directly to loan officials or directors of RCCs.<sup>23</sup> The long and complicated loan application procedures have often disadvantaged the poor and jeopardized productive investment opportunities when quick credit is required. A survey organized by the PBOC in Shanxi Province also found that as a means to raise more capital for RCCs, it is common for RCCs to require loan applicants to pay ¥ 50-200 to join RCCs before their loans are processed and approved, which adds to the borrowing costs for farmers. The high borrowing cost for institutional loans is one of the major causes for farmers to switch to informal sources of finance. The farmers in general will benefit from a more sustainable lending rate of interest in combination with the provision of the financial services and products tailored to their needs, or overall lower borrowing costs.

In addition to the overall low lending rates, the institutional rates of interest in China are distorted in other ways as well. First, the band for the adjustment of lending rates by RFIs, an important step towards relaxation of state direct control of interest, does have its own limitations. The institutionally based bands have created dual prices for the same loan products offered by different financial institutions. For example, RCCs are able to adjust their lending rate by a maximum of 50 per cent, whereas the ABC can adjust the base rate by a maximum 20-30 per cent only. The dual interest rates would have helped to push the ABC and other state banks away from the rural lending market (see Table 5), an issue deserving further investigation.<sup>24</sup> More importantly, RFIs in China are unable to charge a risk premium for riskier projects and riskier borrowers and for loans disbursed in different regions of China.<sup>25</sup> This inflexibility has efficiency and equity implications. With higher transaction costs and higher risks, the ABC has basically closed its lending operations in the poor counties, except the subsidized poverty loans for state designated poor counties. The loan disbursements from RCCs in these areas have declined as well, owing to a higher proportion of non-performing loans and accumulated financial losses for RCCs in these areas. The reduction in the supply of institutional credit has pushed the interest rates up on the informal financial markets and more poor have become trapped in the debt cycle. Finally, although the gap between the base lending rate and the rate for poverty loans has been reduced from 7.2 per cent in 1989 to 2.3 per cent

per annum in 2002, the gap remains. The gap between the poverty rate and the maximum rate that can be charged by RCCs (for a 12 month loan) is 5.65 per cent per annum. Obviously, the poverty loan rate is far below the sustainable lending rate for rural lending in China. As is widely known, the subsidized rates for poverty loans often give rise to low loan repayments and problems with targeting (Adams, Graham and Von Pischke 1984).

The rates are distorted not only to the borrowers, but to the lenders as well. It is shown in Table 9 that since 1998 the on-lending rate to RCC has been one per cent lower than that to other financial institutions in China.<sup>26</sup> The subsidized on-lending rate for RCCs, in combination with a 50 per cent band for RCCs' rural lending, has helped push other formal financial institutions further away from the rural lending market. However, the subsidies provided by the lower on-lending rate are insufficient for RCCs to cover their full costs (Table 8). Second, the rate for redeposit from Rural Postal Savings has been much higher than the rate applied to other financial institutions and even higher than the base time deposit rate. The higher rate paid to Rural Postal Savings has fuelled the large increases in their deposits and contributed to the outflow of loanable funds from rural areas (Tables 1 and 5). The agricultural on-lending to RCCs (¥ 65 billion by the end of 2001) was no match to the outflow of funds channeled through Rural Postal Savings (¥ 355 billion end of 2001).

Barriers exist to interest rate liberalization in China. According to Dai Xianglong (1997, pp. 136-8), the then governor of the PBOC, the following factors have contributed to the formation and adjustments of official interest rates in China since the early 1990s: the belief that positive real deposit rates have worked to protect depositors; the interest payment burdens of SOEs, as many large and medium SOEs had a high leverage; taxation incomes and profits of financial institutions; state economic development policies and strategies; and supply and demand for loanable funds and loan terms and risks. Dai further argued that the conditions were not ready yet for interest rate liberalization in China because of the low profitability of SOEs and the barriers to the flows of capital in China (Da Xianglong 1997, pp. 140-41).<sup>27</sup> Here, Governor Dai clearly singled out the constraints of loss-making SOEs on China's financial reforms. Moreover, owing to the low agricultural prices and low profitability, there has been political pressure for the Central Government and the PBOC to provide more cheap loans in rural areas and to the western and central regions of China for balanced growth.

## **5. Institutional Response to Market Distortions in China**

### *The ABC, growth of rural enterprises and off farm production*

Following the financial reforms in the middle 1990s, the ABC was required to commercialize its operations and become financially viable, which made the bank more responsive to the interest rate signals. Our field investigations show that the head-office and the provincial division of the ABC have not only rationed credit supply in rural areas

but also transferred its funds from relatively poor to rich areas. The ABC rationed the supply of credit by:

- a) Setting a relatively high rate of interest for re-deposit from ABC branches in the less developed areas to the provincial ABC and the headquarter, so the branches in poor areas can benefit financially by re-depositing with the ABC above, instead of increasing their lending.<sup>28</sup>
- b) Moving up lending authority from the county branches to the provincial Division ABC and setting direct targets on the total quantity of loans by county branches in the poor and major agricultural areas. It was found in Guizhou that some county Branches were allowed to lend up to ¥ 200,000 commercial loans each year, with a lending authority of ¥ 50,000 for each loan to rural enterprises.<sup>29</sup>
- c) Cutting back on township business offices and staff and make the remaining township business offices mainly savings stations. From 1995 to 2001, the ABC cut its staff by around 13 per cent and its number of branches and business offices by 34 per cent (Table 10). Many of the branches and business offices axed were those located in rural townships.
- d) Introducing the life responsibility system to loan officials for delinquent loans.

By reducing its rural lending, the ABC has diversified its portfolios and shifted its lending focus into urban and coastal areas and developed its off balance sheet transactions. According to the President of the ABC, the consumer loans of the ABC, including mortgage loan, automobile loans and loans for house renovations, has increased substantially since 1997. By the end of 2001, the balance of its consumer loans reached ¥121.7 billion, around 9 per cent of its total loan portfolio. However, in 2001, the increases in consumer loans accounted for 35 per cent of the increases in total loans disbursed by the ABC (Almanac of China's Banking and Finance 2002, p. 30).

The major losers of the ABC credit rationing and switching are rural enterprises (TVEs) and those rural households engaging in off-farm production and investment. Woo (2003) argued that the slow-down of TVE growth, which has contributed to a post-1996 slower growth phase in China, has been closely related to the operation of the rural financial system. The reduction in rural lending by the ABC has impacted negatively on rural employment and incomes, through TVEs and employment opportunities provided by TVEs and large off-farm households. The withdrawal of the ABC from the rural lending market has also reduced already very limited competition in China's rural formal financial markets. The costs of the ABC commercialization could be reduced if the financial reforms in the mid 1990s had been broader and better coordinated. State direct control over interest rates and entry by new institutions could have been relaxed to encourage the ABC to continue its rural lending programs and to enhance competition in China's rural financial markets. The costs could also have been lower, if the changes had

been introduced gradually, accompanied by government assistances to rural enterprises and rural off farm production, especially to those in poor areas of China.

#### *Rural credit cooperatives*

Under the current lending rates, like the ABC, RCCs should also have reduced their rural lending and channeled their funds out of rural areas. The RCCs in the poor and more remote areas have a stronger incentive to do so. The PBOC however has regulations in place to control RCC funds. First, RCCs are allowed to lend to households and enterprises within their geographic boundaries only (in their townships); over 50 per cent of the RCC loans must be provided to their members, and of the newly increased loans, over 70 per cent has to be used for agricultural loans, including loans to individual households and agricultural collectives. Next, the PBOC set further restrictions on inter-bank lending by RCCs. RCCs can transfer funds to other RCCs in the same county through RCCU and inter-county transfers must go through the PBOC (Park 1998). The RCCs that meet the following criteria are allowed to lend their funds to other RCCs and financial institutions: with good capital quality, management and internal control and having operated profitably, or having financial losses declined for the last two years. The inter-banking lending must not exceed two per cent of all the deposits organized by the RCC in question.

The restrictions on the uses of RCCs funds have the effect of causing further distortions on rural financial markets. The territorial restrictions have contributed to the higher risk operation of RCCs in terms of both the geographic and industrial risks, characterized by a high proportion of non-performing loans. Such risks could have been mitigated by the small-scale operation of RCCs and the insight information of RCCs on their clients. However, the moral hazard problems and the lack of funds have prevented RCCs from obtaining necessary information on their loan applicants and borrowers. Therefore, the low lending rate and the restrictions on the uses of RCC funds have contributed to the low profitability and high proportion of non-performing loans of RCCs and impaired the capacity of RCCs to provide more credit to rural households and enterprises.

## **6. Summary and Conclusions**

Official statistics on the supply of rural credit, represented by the increases in the year-end overall loan portfolios of RFIs, have overstated the actual supply of institutional credit in rural China. A more reliable measurement of the rural credit supply is the annual loan disbursements to rural households and TVEs provided by RFIs. Since 1996, as a proportion of rural deposits, the supply of rural credit in China has plummeted, thanks to the re-allocation of credit by the ABC to urban areas, an increase in non-performing loans with both the ABC and RCCs, as well as an increase in savings deposits organized by Rural Postal Services. The fall in rural credit would be more drastic, if there had not been a marked increase in the supply of policy loans and if loan refinancing and rescheduling by RFIs were taken into account. The fall in the ratio of rural loans to deposits has

contributed to a shortage in the supply of rural credit, following the continuous growth in rural GDP and subsequent increase in the demand for rural credit. The ABC's withdrawal from the rural lending market has made RCCs the dominant supplier of institutional credit in rural China and reduced the already very limited competition in China's rural lending market.

The state regulation over interest rates, and subsequent market distortions, have contributed to the ever-growing non-performing loans and financial losses of RFIs, and hence to the decline in the supply of rural credit and to a reduction in the competition in rural lending market. Rural off-farm production and employment, particularly off-farm production undertaken by rural enterprises, has been the hardest hit by the reduction of ABC lending in rural areas. A decline in the supply of rural credit in poor areas has pushed the rates of interest higher on the informal markets and trapped more poor in the debt cycle. The ever-increasing financial losses of RCCs have serious implications for the state budget and for China's financial security. The low lending rate has, however, not necessarily benefited the small borrowers, as the latter are often forced to pay high non-interest borrowing costs for their loan access.

The problems caused by the shortage of rural credit cannot be resolved simply by increasing agricultural on-lending and other policy loans to RFIs, or by ordering financial institutions to allocate a higher proportion of their loans to rural areas. Fundamental changes should be introduced to the determination of interest rates in rural China. Institutional lending rates should be raised to cover the operational and fund costs, and loan losses based on international standards for financial accounting of RFIs, and at the same time, the non-interest borrowing costs should be cut to reduce the overall borrowing costs. Moreover, RFIs should be able to charge a premium for riskier projects and borrowers. For the poor and remote areas of China where transaction costs are higher and returns on productive investment are usually lower, the Government should focus on policy measures that can reduce the credit risks and transaction costs for RFIs. To address credit risks, the Government should enhance the repayment capacities of the rural communities and farmers by increasing its investment in rural education, health and rural infrastructure, and by improving agricultural extension services and introducing new seeds and new technologies to agriculture. Money could be better used by shifting government subsidies on poverty loans and loans for agricultural supports to direct government investment in rural areas. The government can also reduce credit risks for RFIs by introducing micro insurance in the area of agricultural insurance and medical insurance for farmers and farming communities. There are two ways for the central and local government to reduce the transactional costs for the poor, remote and mountainous communities in China: by encouraging voluntary resettlement and by allowing and encouraging the establishment of community based real savings and credit cooperatives, under proper state regulation and supervision, in these areas.

Liberalization of interest rates alone will not solve the problems. Successful market liberalization does depend on other conditions, mainly macroeconomic stability, adequate prudential supervision and regulation of the banks (Fry 1995, p. 464). Simply raising interest rate may result in adverse selection and moral hazard problems, thereby exacerbating the non-performing loans of RFIs (Hoff and Stiglitz 1993). More careful

research is required to quantify the returns on investment and repayment capacities of rural enterprises and households in different regions of China. Following the improvements in bank supervision and monitoring, the restrictions on new entry into rural financial markets should be gradually relaxed to create more competition in China's rural financial markets.

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**Table 1. Changes in the total quantity and composition of rural deposits in China, 1989-2001 (billion ¥ at current prices)**

<i>Year</i>	<i>Total rural deposits<sup>1</sup></i>	<i>ABC</i>	<i>% total</i>	<i>RCCs</i>	<i>% total</i>	<i>Postal savings<sup>2</sup></i>	<i>% total</i>
1989	375	205.5	54.9	166.9	44.6	2.1	0.6
1990	483	264	54.6	214.5	44.4	4.6	1.0
1991	611	331.5	54.3	270.3	44.3	8.8	1.4
1992	674	313.8	46.6	347.8	51.6	12.5	1.9
1993	901	450.1	50.0	429.1	47.6	21.5	2.4
1994	1118	517.4	46.3	567	50.7	33.9	3.0
1995	1466	694	47.3	717	48.9	54.7	3.7
1996	1848	895	48.4	879	47.6	74	4.0
1997	2282	1132	49.6	1062	46.5	88	3.9
1998	2660	1333	50.1	1219	45.8	108	4.1
1999	3011	1549	51.4	1336	44.4	126	4.2
2000	3428	1752	51.1	1513	44.1	163	4.8
2001	4106	2025	49.3	1726	42.0	355	8.6

*Sources:* Statistical Yearbooks of China's Banking and Finance; People's Bank of China 1990-2002.

*Notes:* Chinese Yuan is pegged to US dollars at 1 US\$ = 8.3 ¥.

1. Total deposits organized by all the RFIs in China, consisting of deposits of the ABC, RCCs and Rural Postal Savings.

2. Savings organized by Rural Postal Savings. The figures in the table are year-end figures.

**Table 2. Changes in total quantity and composition of loans in rural China, 1990-2001 (billion ¥ at current prices)**

<i>Year</i>	<i>Total rural loans<sup>1</sup></i>	<i>ABC</i>	<i>%<sup>2</sup></i>	<i>ADBC</i>	<i>%<sup>2</sup></i>	<i>RCCs</i>	<i>%<sup>2</sup></i>	<i>Loans/deposits<sup>3</sup> (%)</i>
1989	415	305.8	73.6			109.5	26.4	110.9
1990	518	377.4	72.8			141	27.2	107.3
1991	639	457.8	71.7			180.8	28.3	104.6
1992	792	546.8	69.0			245.4	31.0	117.5
1993	983	656.5	66.8			326.2	33.2	109.1
1994	968	552.5	57.1			415.9	42.9	86.8
1995	1647	655	39.8	469	28.5	523	31.8	112.4
1996	2032	771	37.9	625	30.8	636	31.3	110.0
1997	2578	981	38.1	864	33.5	733	28.4	113.0
1998	2910	1367	47.0	709	24.4	834	28.7	109.4
1999	3203	1553	48.5	727	22.7	923	28.8	106.4
2000	3239	1450	44.8	740	22.8	1049	32.4	94.5
2001	3545	1605	45.3	743	21.0	1197	33.8	86.3

*Sources:* Statistical Yearbooks of China's Banking and Finance; People's Bank of China.

*Notes:* 1. Total loan portfolio by all the RFIs in China.

2. Percentage of the total rural institutional loans.

3. The ratio of total rural institutional loans to institutional deposits; for the total rural institutional deposits, see the 2<sup>nd</sup> column of Table 1. The figures in this table are loans outstanding at year-end. The figures in the table are year-end figures.

**Table 3. Changes in portfolio composition of ABC and RCCs in China, 1989-2001**  
(billion ¥ at current prices)

<i>Year</i>	<i>ABC total<sup>1</sup></i>	<i>Agri.<sup>2</sup></i>	<i>%<sup>3</sup></i>	<i>TVEs</i>	<i>%<sup>3</sup></i>	<i>RCCs total*</i>	<i>Agri.<sup>2</sup></i>	<i>%<sup>4</sup></i>	<i>TVEs</i>	<i>%<sup>4</sup></i>
1989	306	46.4	15.2	39.3	12.9	109.5	52.3	47.8	57.2	52.2
1990	377	56.3	14.9	43.4	11.5	141.3	65.2	46.2	76.1	53.8
1991	458	69.5	15.2	49.8	10.9	180.9	80.1	44.3	100.7	55.7
1992	547	84.7	15.5	58.3	10.7	245.4	98.2	40.0	129.4	52.7
1993	657	85.8	13.1	77.5	11.8	326.2	65.7	20.1	178.3	54.7
1994	552	87.7	15.9	93.8	17.0	415.9	80.5	19.4	227.7	54.7
1995	655	95.5	14.6	95.9	14.6	523.4	109.5	20.9	277.9	53.1
1996	771	120.2	15.6	115.8	15.0	636.5	148.7	23.4	326.4	51.3
1997	981	153.2	15.6	151.9	15.5	732.6	177.4	24.2	346.8	47.3
1998	1367	178.0	13.0	174.9	12.8	834.0	265.9	31.9	376.1	45.1
1999	1553	174.3	11.2	190.0	12.2	922.6	304.0	32.9	418.7	45.4
2000	1450	128.8	8.9	141.3	9.7	1048.9	358.8	34.2	456.9	43.6
2001	1605	125.5	7.8	145.0	9.0	1197.1	441.8	36.9	484.3	40.5

Sources: Statistical Yearbooks of China's banking and Finance; People's Bank of China.

Notes: 1. Total loan portfolios.

2. Agri. Loans: portfolio of the loan balance for agricultural uses, mainly loans to rural households for both farm and off farm production and consumption. The other uses of loans include loans to industrial and commercial individual households, etc., to agricultural institutions and rural buying and selling cooperatives. The ABC also lent urban enterprises and provided consumer finance in urban areas.

3. Percentage of the total loan portfolio of the ABC.

4. Percentage of the total loan portfolio of RCCs. The figures in the table are year-end figures.

**Table 4. Portfolio balance and accumulative loans of the ABC and RCCs, 1989-2001**  
(billion ¥ at current prices)

<i>Year</i>	<i>ABC</i>			<i>RCCs</i>		
	<i>PB<sup>1</sup></i>	<i>AD<sup>2</sup></i>	<i>AD/PB %</i>	<i>PB<sup>1</sup></i>	<i>AD<sup>2</sup></i>	<i>AD/PB %</i>
1989	306			109.5		
1990	377			141.3		
1991	458	654.2	142.9	180.9	259.3	143.4
1992	547	716.2	131.0	245.4	342.9	139.7
1993	657	743.7	113.3	326.2	434.4	133.2
1994	552	744.2	134.7	415.9	525.7	126.4
1995	655	796.7	121.6	523.4	606.4	115.8
1996	771	1036.5	134.4	636.5	794.1	124.8
1997	981	1106.9	112.8	732.6	880.2	120.1
1998	1367	1048.1	76.7	834.0	796.2	95.5
1999	1553	1000.4	64.4	922.6	872.1	94.5
2000	1450	961.2	66.3	1048.9	952.7	90.8
2001	1605	1195.4	74.5	1198.7	1153.9	96.3

Sources: Statistical Yearbooks of China's banking and Finance; People's Bank of China.

Notes: 1. PB = portfolio balance at the end of the year.

2. AD = annual cumulative loan disbursement.

**Table 5. Changes in rural deposit savings and loans since 1991, 1991-2001**  
(billion ¥ at current prices)

<i>Year</i>	<i>Total rural deposits<sup>1</sup></i>	<i>ABC annual disbursement<sup>2</sup></i>	<i>%<sup>3</sup></i>	<i>RCCs annual disbursement<sup>4</sup></i>	<i>%<sup>3</sup></i>	<i>%ABC&amp;RCC disbursement<sup>5</sup></i>
1991	611	170.6	27.9	259.4	42.5	70.4
1992	674	187.3	27.8	342.8	50.9	78.6
1993	901	184.9	20.5	434.4	48.2	68.8
1994	1118	244.5	21.9	525.8	47.0	68.9
1995	1466	232.8	15.9	606.1	41.4	57.2
1996	1848	317.2	17.2	794.3	43.0	60.1
1997	2282	344.1	15.1	879.9	38.6	53.6
1998	2660	270.7	10.2	796.5	29.9	40.1
1999	3011	234.6	7.8	871.8	29.0	36.7
2000	3428	179	5.2	952.4	27.8	33.0
2001	4106	201.5	4.9	1087	26.5	31.4

*Sources:* Calculated from Statistical Yearbooks of China's banking and Finance; People's Bank of China.

*Notes:* 1. Total deposits savings by RFIs in China.

2. Accumulative ABC loans to Agriculture and TVEs, including the poverty loans. The figures are calculated by multiply the end loan balances by the coefficients in Table 4.

3. Percentage of total rural deposits.

4. Annual RCC loan disbursement.

5. Percentage of ABC and RCC annual loan disbursement to total rural deposits. For the year 2001, it is assumed the coefficient is the same as 2000, as the 2001 figure for RCC accumulative loans are not available.

**Table 6. Changes in policy loans in rural China, 1995-2001**  
(billion ¥ at current prices, year-end)

<i>Year</i>	<i>Total rural loans<sup>1</sup></i>	<i>Poverty loans<sup>2</sup></i>	<i>% total</i>	<i>RCC on-lending<sup>3</sup></i>	<i>% total</i>
1995	714.8	18.6	2.6		
1996	872.5	24.3	2.8		
1997	1037.7	33.1	3.2		
1998	1186.9	43.2	3.6		
1999	1286.9	57.5	4.5	15.6	1.2
2000	1319	70.5	5.3	50.6	3.8
2001	1467.6	79.2	5.4	70.6	4.8

*Sources:* Statistical Yearbooks of China's banking and Finance; People's Bank of China, 1996-2002, Almanac of ADBC, 1996 and 1997.

*Notes:* 1. Total rural loans refer to all the loans outstanding by the RCCs and the agricultural and TVE loans outstanding by the ABC.

2. Subsidized poverty loans provided by the ADBC from 1995-97, and by the ABC since 1998.

3. RCC on-lending is the agricultural on lending provided by the PBVOC to RCCs at subsidized rate of interest.

**Table 7. Changes in the real institutional rates of interest, 1989-2002 (per cent)**

	89.2.1	90.8.21	91.4.21	93.7.11	95.7.1	97.7.23	98.7.1	99.6.10	02.2.21
Deposits									
a). Demand	-12.7	0.1	-1.1	-8.9	-11.2	0.9	4.1	4.1	2.0
b). 6 month	-7.5	4.3	2.4	-3.7	-8.2	3.3	6.7	5.3	3.2
c). 12 month	-5.5	6.4	4.5	-2.0	-6.4	4.8	7.6	5.4	3.3
d). 3 years	-4.0	7.8	5.2	-0.8	-5.7	5.4	7.8	5.9	3.9
e). 5 years	-2.4	9.2	5.9	0.6	-5.1	5.8	8.0	6.1	4.1
f) = e-a	10.2	9.2	7.0	9.5	6.1	4.9	3.9	1.9	2.1
Loans									
g). 6 months	-5.5	6.4	5.1	-3.7	-4.1	6.8	9.4	8.8	6.4
h). 12 months	-5.5	7.1	5.6	-2.0	-2.4	7.8	9.8	9.1	6.7
i). Agricultural procurement	-5.5	6.1	4.7	-2.8	-3.2	6.9			
j). Subsidized poverty loans	-12.7	0.8	0.0	-9.1	-10.4	2.1	5.6	6.2	4.4
k) = h-c	0	0.7	1.1	0	4	3	2.2	3.7	3.4
l) =h-I	0.0	1.1	0.9	0.8	0.8	0.9			
m) = h-j	7.2	6.3	5.6	7.2	8.0	5.7	4.2	2.9	2.3
Inflation (p)	17.8	2.1	2.9	13.2	14.8	0.8	-2.6	-3	-1.3

Sources: The PBOC, Almanac of China's Finance and Banking, 1990-2002

Notes: Real rates of interest are calculated using the formula:  $r = (i-p) / (1+p)$ , where  $r$  = real interest rates,  $i$  = nominal rate of interest,  $p$  = annual increase in general retail prices.

**Table 8. Projection on costs and sustainable lending rate of RFIs (nominal rate) (as % of the average loan portfolio per annum in 2001)**

Item	Coastal areas	Major agr. area	Poor areas
Fund cost <sup>1</sup>	2	2.5	3
Operational costs <sup>2</sup>	2.8	3	5
Loan losses <sup>3</sup>	4	6	8
Minimum Lending rate	8.8	11.5	16

Notes: The figures in the table are based on the assumption that: (a) There are no historical non-performing loans and other burdens, (b) No profit generated; (c) Opportunity cost of capital investment assumed away. As a matter of fact, capital base of many RCCs have already been erased.

1. Average deposit rate of interest plus the costs for organizing savings.

2. The operational costs include the capital depreciations allowed and business taxes paid.

3. The projected loan losses based on the proportion and aging of non-performing loans. In the table, the RCCs from coastal areas account for 15-20 per cent, those from the major agricultural areas account for 55-65 per cent and those from the poor areas account for 20-25 per cent of all the RCCs in China. The official maximum lending rate for RCCs is 7.97 per cent per annum since 2002.

**Table 9. Rates of interest between financial institutions and the Central Bank, 1998-2002 (% nominal rate)**

<i>Items</i>	<i>98.7.1</i>	<i>98.12.7</i>	<i>99.6.10</i>	<i>02.2.21</i>
On lending to Financial Institutions (1 year)	5.67	5.13	3.78	3.24
Agricultural on Lending to RCCs (1 year)	4.68	4.14	2.79	2.25
Reserves and other deposits at PBOC	3.51	3.24	2.07	1.89
Redeposit from Postal Savings	6.6429	5.922	4.6008	4.347
Base Deposit Rate (1 year)	4.77	3.78	2.25	1.98

*Source:* People's Bank of China.

**Table 10. Changes in ABC staff and number of institutions since 1995**

	<i>No. formal staff (year end)</i>	<i>No. total units &amp; branches</i>	<i>Of which: business offices</i>	<i>saving stations</i>
1995	564,731	67,092	33,697	26,960
1996	538,780	65,870	n.a.	n.a.
1997	536,846	63,676	33,096	25,350
1998	524,484	58,466	28,442	21,973
1999	527,740	56,539	28,090	20,741
2000	509,572	50,546	n.a.	n.a.
2001	490,999	44,417	n.a.	n.a.

*Sources:* China Financial Statistics, 1997-99, pp. 122-3; Almanac of China's Finance and Banking, 2002, p. 640, 1997, p. 597; Almanac of China's Rural Finance, 1996, pp.105-06.

*Note:* Business offices are mainly located at the township level in rural China.

## Endnotes

- 1 According to the *China Economic Observer* (25 April 2002), funds have been channeled out of the rural sector through rural financial institutions (RFIs).
- 2 See Xinhua News Agency, 27 April 2002. There has been increasing awareness that the development of high value added agriculture and off-farm production is essential to China's rural economic growth and employment in China's rich areas following China's WTO entry, given the extremely small size of farms and low labor productivity in China's traditional agriculture sector.
- 3 The ministry used the agricultural credit policies in Thailand to support its proposal. According to the ministry, the reserve bank in Thailand stipulated that the proportion of agricultural loans to the total loan portfolio for any commercial banks had to be higher than 5 per cent, and the ratio of agricultural loans to total deposits had to be higher than 11 per cent.
- 4 PBOC website address is: [www.pbc.gov.cn](http://www.pbc.gov.cn)
- 5 For studies of financial deepening and economic development, see McKinnon (1973) and Shaw (1973), and for financial restrictions, see Fry (1995), and for the theory on financial restraints, see Hellmann, Murdock and Stiglitz (1997).
- 6 For the functions of RCCUs in China, see Zhang Hua (1998, p.24).
- 7 The RCCU at the county level usually has its own business office, offering deposit and lending services to the urban residents at the county seat. The RCCs' deposits from the urban residents and the lending in the urban areas of the county seat can be regarded as insignificant compared the overall deposits of RCCs. Moreover, the county seat should also be regarded as rural areas.
- 8 Having emerged in the middle 1980s, RCFs, with billions of yuan in deposits, were not financial institutions and by law, were not allowed to organize deposits from the public.
- 9 Since the rural economic reforms, there have been no bankruptcy cases for rural financial institutions, including any of the township level RCCs that are legal entities and profit centers. The only exception to this is the RCCs and urban credit cooperatives in Enping City of the Guangdong Province.
- 10 The lending by other banks in rural China is negligible, as other banks have neither networks nor incentives to lend to rural enterprises and households except in a few developed areas of China where TVEs are particularly strong.
- 11 The deposits of the ADBC, which are insignificant, are not included in Table 1.
- 12 Rural loanable funds in this paper are defined as the funds controlled by RFIs, but which could be used for rural lending.
- 13 Other policy loans for agriculture include the agricultural development loans and loans to grain processing enterprises provided by the ABC.
- 14 The rapid increase in rural deposits following a slow-down in the growth of rural incomes (Xian Zhude 2001) could have been caused by other factors, in addition to the increases in real deposit rate. These factors include the lack of opportunities for farmers to invest in other financial assets (bonds and shares) and in physical capital assets and close-down of RCFs.
- 15 See PBOC Document 446, 1998.
- 16 See CGAP evaluation report, 2000. Operational sustainability here refers to the incomes of MFIs cover the operational costs, loan loss provisions and real fund costs (usually subsidized, not opportunity cost of capital).
- 17 Sustainable lending rates here refer to the rates that cover the cost of capital, operational costs and loan losses only, these could better be described as a survival rates.

18 This applies to average well managed RCCs in coastal areas of China. A few better-off RCCs in these areas would be able to charge a lower rate, if their major customers were large enterprises and they can invest part of their funds on the financial markets.

19 The results in Table 8 are more or less agreeable with the operationally sustainable rate for FPC (15 per cent), considering FPC's programs are located in poor counties and the scale of FPC's operation is smaller than RCCs.

20 Some may argue that if this is the case then why do the ABC and many RCCs in China still enjoy a reported accounting profit. For most of them, their accounting profits will be turned into financial losses if the international standard of accounting is used. In the Chinese accounting system for RFIs, e.g. for RCCs, the provisions for bad loans are generally set at 1-1.5 per cent of the loans outstanding, regardless of the actual proportions of non-performing loans and aging of non-performing loans.

21 In the remote and mountainous areas of Guizhou and Hunan, RCC staff had to use their own motor-bikes for work related travels and there were no subsidies paid on the fuel or subsidies for going to villages. As a result, RCC staff usually avoided trips to the villages.

22 For a description of the moral hazard problem faced by RCCs, see Xie Ping (2001).

23 As reported by Xinhua News Agency, a farmer in the Henan Province spent ¥ 1,000 paying the banquets for the loan official for a ¥10,000 loan. Finally the farmer got ¥ 4,900 loans only, ¥ 5000 for forced savings at the RCC and ¥ 100 was deducted as member's share (Xinhua News website, 27 April 2002).

24 Other contributors, perhaps more important ones, to the withdrawal of state banks from rural areas, are the high operational costs, high risk of rural lending and overall low lending rates regulated by the state.

25 It is important to note that the Band for interest adjustment is different from a risk premium. As argued in the text, the band is institutionally based. With low lending rates, RFIs usually charge the maximum rate they are able to charge, in that case, the band does become the maximum lending rate.

26 The special on-lending to RCCs was initiated in 1998.

27 For barriers to the flows of capital, Governor Dai here refers to the vast different natural and economic conditions and returns on investment which have prevented capital from flowing into the poorer areas of the country, under market conditions.

28 It was found in Inner Mongolia in 1999 that the headquarters and the provincial division of the ABC paid a redeposit rate of about 4.5 per cent for the redeposit from the prefecture level ABC, which was close to the rate paid by the PBOC for redeposit from Rural Postal Savings (see Table 9).

29 This field finding is confirmed by Wang Xiaoyan (2000). According to Wang, 'The lending authority of state owned commercial banks are mainly with the provincial Divisions, the county branches usually have authority for loans under 100,000 ¥, collateral against deposits provided by borrowers (such loans can be regarded as risk free).