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China's Monetary Reform: The Counterrevolution from the Countryside

by
Carsten A. Holz

Division of Social Science
Hong Kong University of Science and Technology
Clear Water Bay
Kowloon, Hong Kong

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Carsten A. Holz

Social Science Division
Hong Kong University of Science & Technology
Clear Water Bay
Kowloon
Hong Kong
Tel. (852) 2358-2422
Fax (852) 2335-0014 (Attn. C. Holz)
E-mail: socholz@usthk.ust.hk

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Abstract

In the past decade China's financial sector has developed rapidly. What is often ignored is the rise in financial institutions operating outside the formal financial sector. This paper focuses on the rural cooperative funds attached to lower-level tier governments and Party Committees. Their rise is explained in the context of a central-local as well as an intra-central conflict. While rural cooperative funds may pose a threat to local financial as well as nationwide macroeconomic stability, rigorously supervised funds with a clearly defined lending purpose can fulfill an important niche function. Although rural cooperative funds are government-controlled institutions, their hard budget constraint, a little regulated business environment and implicit local government deposit guarantees lead to an improvement in rural financial intermediation that neither the formal financial sector nor a private financial sector could achieve.

Journal of Economic Literature classification: G2, O16 and 17, P34

Keywords (all on China): rural finance, informal finance, financial intermediation, central-local relations, intra-central policy coordination

Introduction

China's rural economy has little access to formal financial sector funding. While township- and village-run enterprises accounted for 14.95% of China's GDP in 1996, only 3.57% of all loans of the formal banking system went to these enterprises. Individual-owned and joint enterprises fare little better.¹ But this does not necessarily imply a lack of external funds. Up to 50% of all enterprise borrowing throughout China may in recent years have been provided by sources outside the formal financial sector (Qin 1993).

In the countryside these sources include, among others, loans between individuals (*minjian daikuan*), loans extended by private banks and government departments, bank loans lent on by state-owned enterprises, as well as off-balance sheet financing from the formal financial sector.² One of the most significant developments since 1994 has been the rapid spread of various forms of "rural cooperative funds" (*nongcun hezuo jijinhui*) in many locations across the country. While rural cooperative funds (RCFs) were originally set up in the late 1980s to manage the financial property of the disbanded communes and production brigades,

¹ See ZGTJNJ 1997, 42 and 622, and ZGXZQYNJ 1997, 121. The formal banking system includes the four state commercial banks and all other nationwide and regional commercial banks, savings deposit agencies of postal offices, housing saving banks, urban and rural credit cooperatives, urban cooperative banks, financial trust and investment agencies, and finance companies. Township- and village-run enterprises together with joint enterprises (owned jointly by several individuals) and individual-owned enterprises, all in the countryside, constitute "township and village enterprises" (TVEs).

² For more details see, for example, Zhu and Hu (1997), Jiang (1996), and Xu and Deng (1994). Hu and Zhang (1998) describe the recent reforms in the rural financial sector.

the RCFs of the early and mid-1990s had their eyes set on much grander development objectives.

The proliferation of RCFs has led to a spate of local survey reports in Chinese newspapers and journals in the mid-1990s.³ The failure of three RCFs in Lanxi Municipality, Zhejiang Province, triggered a severe and much publicized criticism by the State Council (*Renmin ribao* 25 Nov. 1996). But neither the rise and evolution of the RCFs nor the significance of this development are well understood. Why did RCFs evolve and grow as rapidly as they did? With RCFs turning into a prominent financial force in many rural areas, what constraints do they face, and why were these constraints not adequate to prevent RCFs from taking over large swathes of rural finance?

The rise of the RCFs in many localities is in the following explained in the context of a central-local conflict as well as an intra-central conflict. Local economic growth was stunted by a lack of financing when the formal financial sector was re-centralized and fiscal resources dried up in the early 1990s. New sources of financing were created locally through the RCFs established under the protective shield of the Agricultural Ministry despite vocal central bank opposition.

The continued existence if not growth of RCFs has a number of economic implications. RCFs prevent the outflow of rural deposits into urban areas and furthermore serve primarily that part of the local economy neglected by the formal financial sector. On the other hand, their internal structure is weak with few control mechanisms while

³ The English language literature has so far taken little notice of the RCFs. Park, Brandt, and Giles (1997) in their survey of rural financial institutions note the existence of rural cooperative funds and their extent in the surveyed localities as part of the rural financial system. Tsai (1999) investigates the relationship between local government attitudes towards the private economy and the development of different informal financial institutions.

external checks are almost completely absent; this raises questions about their financial health. RCFs furthermore have an impact on the liquidity as well as the profitability (and therefore solvency) of the formal financial sector, and thus influence central bank policies and endanger net worth of the state-owned banks.

Although RCFs resemble the formal financial sector in that they are government-controlled institutions, they also lead a monetary counterrevolution from the countryside in that they pose a major challenge to the rural formal financial sector through their market-oriented banking practices. Operating in a little regulated business environment with a hard budget constraint—while enjoying an implicit local government deposit guarantee—results in a degree of rural financial intermediation that neither the formal financial sector nor a private financial sector could achieve.

The paper draws on nationwide as well as provincial and sub-provincial tier evidence. Findings from interviews in several counties of the three regions of China are supplemented by official statistics, case studies in the Chinese literature, and relevant government documents.⁴ On the provincial and sub-provincial tier disproportionate attention is given to Shaanxi Province, a trial province for the establishment of farmer associations from 1994 to 1997.⁵

⁴ Interviews were conducted throughout 1997 and 1998 in several counties of Shaanxi Province (Western region), Hebei and Henan Province (central region), Jiangsu Province (coastal region) as well as in Beijing.

Central government documents are available from a number of law collections. Local government documents are frequently on display in the RCFs in an attempt to create an image of respectability, at times in competition with other local RCFs.

⁵ See SXNJ 1995, 122.

Characteristics and Extent of Rural Cooperative Funds

The origins of the RCFs date back to the mid-1980s when local governments searched for ways to manage communal funds accumulated in the by then abandoned communes, production brigades, and production teams. Most of these RCFs were closed cooperative funds run on township and village tier, and their task was limited to administering communal funds. The RCFs consisted of no more than a set of accounts; all business was conducted through the formal banking system.⁶

It was only after Deng Xiaoping's tour through South China in spring 1992 that the character of the cooperative funds began to change. RCFs in their modern form as quasi-banks began to grow rapidly in Sichuan Province as early as 1994. Today, RCFs come in a number of variations. RCFs are either

- * defined by the category of borrowers (such as township and village enterprises, or farmers), or
- * united by a particular depositor background (such as membership of a trade union or a supply and marketing cooperative), or
- * set up for the sole benefit of a singular government or Party unit (such as a local finance department).

Most of these cooperative funds carry the qualification "rural" in their name even if they are located in urban districts. "RCF" in the following

⁶ By end-1988 Shaanxi Province had approximately 370 such cooperative funds with total liabilities of 40m yuan, compared to total deposits at state banks and rural credit cooperatives of 21,033m yuan. (*Shaanxi ribao* 89/5/13 and SXTJNJ 1990, 407 and 409)

is used as a generic term to cover cooperative funds with the characteristics outlined in this section.⁷

Characteristics of rural cooperative funds

RCFs share a number of basic characteristics. (For case studies see the Appendix.) RCFs are not financial institutions (*jinrong jigou*) but mutual aid organizations (*huzhuzu*) without profit objective. Since RCFs are not financial institutions, they are not allowed to attract deposits (*cunkuan*), give loans (*daikuan*), and to pay interest (*lilu*). Instead, they offer shares (*rugu*) and borrowing (*jiekuan*), and pay a user fee on the shares (*zhanyongfei*). In practice, these differences are semantic only.

RCFs are run and regulated by the founding government or Party department on county tier, and registered with the county agricultural department. In the early phases the government department typically provides seed capital which later is withdrawn. County-tier governments and Party organs organize mass meetings to promote the RCF and assign depositing tasks to their departments and lower-level tier institutions. RCFs are owned by shareholders comprising collective-owned enterprises, government units and individuals. The particular ownership

⁷ All the funds mentioned are “open” cooperative funds in that they are open to the public. Closed funds, on the other hand, have a limited number of clearly identified members; their existence is frequently not known to the public. One example are cooperative funds run by the “financial guidance station” (*caiwu zhidao zhan*) of the Rural Work Department (*nongcun gongzuo bu*) of the Party. In many localities these funds are not open to the public and go by the name “internal fund circulation work” (*neibu zijin rongtong yewu*). Another example are RCFs run by the administration of economic development zones. An altogether different category of closed funds are the traditional neighborhood funds (*hehui*) with their various accumulation and distribution principles (see, for example, Jiang 1996, Chapter 2). This article in the following focuses on open funds.

configuration varies from province to province (see Table 1) but individuals tend to hold between a quarter to three quarters of all shares. Although shareholders have the authority to at an annual shareholder meeting determine the leadership of the RCF, in practice the RCF is run directly out of the government or Party department to which it is attached. Managers are frequently former, if not current, government or Party employees, while the Board of Directors and the Supervisory Committee (if existent) comprise concurrent government and Party staff.⁸

RCFs offer a choice of at least two types of shares, on the one hand a share which is equal to deposits in all but name and freely redeemable, and on the other hand a “basic” share which supposedly cannot be withdrawn. The distinction carries implications for voting rights at the shareholder meeting and for the return on the share; the deposit-type share carries no voting right and only pays interest (and/or a fixed “dividend”), while the basic share comes with voting rights and pays interest and a profit-dependent dividend.⁹ The return on shares is determined by the superordinate department and tends to be twice as high as on a corresponding bank deposit. This is achieved either through a much higher interest rate (fee) or through a combination of interest rates and dividends. In the latter case interest rates are frequently set 10% above the corresponding bank interest rate (i.e., multiply the bank interest rate by a factor of 1.1). The spread between loan and deposit

⁸ In 1995 51% of the 8236 employees of RCFs in Henan Province concurrently held other positions. (Dui nongcun 1996, p. 2)

⁹ The 33 RCF in Dali County, Shaanxi Province, distinguish between three types of shares: basic shares which carry risk, pay dividends and are usually not to be sold (they accounted for 2.5% of all external funds at end-1996); “fixed shares” which carry risk, pay usage fees (interest) and dividends, and can be redeemed after one year (37.3%); and non-fixed shares which are deposits in all but name (20.1%). (Dali xian 1997)

interest rates is usually low at 1-2% but higher penalty interest rates come into effect once a loan turns overdue.

Loans extended by RCFs are primarily short-term working capital loans (of 3-6 months duration) to members. But it is frequently understood that the loan will be rolled over once due or that overdue loans will not be pursued aggressively. Across provinces, more than half of all lending typically goes to the agricultural sector and another third to township- and village-run enterprises. Farmers receive a large share of the agricultural loans as well as of the residual loans and across different provinces account for between 40 and 96% of all lending. (See Table 1.)

RCFs have extensive branch networks covering several townships and villages where branches are set up according to their economic viability. Branches have virtually no decision-making authority on loans. This authority rests with the head office in the township or county seat and thus often, given the personnel overlap, with the superordinate department. In many localities several RCFs coexist, such as funds run by the county TVE bureau, the county agricultural department, and the supply and marketing network. Final authority on interest rates and on general policies (such as institutional expansion) then is concentrated in one government office, usually in the agricultural department. The profit-dependent dividend may vary from RCF to RCF.

While by 1998 some municipal agricultural departments have set up coordinating RCF offices, provincial-level coordination is rare. In the case of the 32 township and village enterprise (TVE) RCFs in Shaanxi Province the provincial TVE bureau only promotes their cause and circulates development guidelines but does not issue instructions on how

to run a RCF; nor does it exercise any supervision. No nationwide uniform regulatory framework on RCFs exists.¹⁰

Extent of rural cooperative funds

At the end of 1994 more than one third of all townships and slightly below one fifth of all villages nationwide had a RCF (or a RCF branch). But the spread of RCFs is not uniform across the country. By the end of 1995, 65% of all municipalities and 56% of all counties in Sichuan Province had established “joint” cooperative funds (*hezuo jijinhui lianhehui*) each coordinating several RCFs. By the end of 1996, 712 townships in Shaanxi Province, accounting for 32% of all townships, had established RCFs. In Henan Province 63% of all counties, 32% of all townships, and 65% of all villages had established one or more RCF by September 1995 (Dui nongcun, 1996). In Xinjiang Province, 44% of all townships and 45% of all villages had some form of RCF by the end of 1996. In other provinces, such as in Hebei Province, RCFs exist but have remained on a smaller scale.¹¹

While some local data on the volume of funds held at RCFs can be pieced together, official nationwide or systematic data is not available.

¹⁰ The Agricultural Ministry handles RCF matters within its Rural Cooperative Economy Guidance Office (*nongcun hezuojingji zhidaosi*) which has established a Rural Economic Administration Station (*nongcun jingji guanli zongzhan*) as a semi-independent administrative facility (*shiye danwei*). The central bank, the People's Bank of China (PBC), covers RCFs in its Rural Cooperative Finance Administrative Bureau (*nongcun hezuojinrong guanli ju*).

¹¹ The nationwide data is from *Nongcun hezuojingji yingying guanli*, no. 10 (Oct. 1995), p. 13. For Sichuan Province see Guo and Yang (1997) on Sichuan Province, for Shaanxi Province ShGov 97/7/21 (SXNJ 1997, p. 101 reports 700 townships with RCFs), for Henan Province Dui nongcun (1996), and for Xinjiang Province *Xinjiang nianjian 1997* (1997, p. 160).

Nationwide deposits at RCFs appear equivalent to about 0.73 to 2.92% of total deposits at financial institutions in China. (See Table 2.) The range reflects the unofficial estimates of economists in the central bank (the lower estimate) and of economists in the Agricultural Ministry (the upper estimate).

Across provinces, deposits at RCFs are equivalent to between half a percent and six percent of deposits in the formal financial sector. The relative size of RCFs has been increasing over the years in all provinces for which RCF data is available. RCFs in Shaanxi Province are insignificant according to all sources, but the claim that the 32 TVE RCFs account for perhaps less than 3% of the number of RCFs in Shaanxi Province while for almost 90% of all deposits at RCFs is not credible. If the average size of a TVE RCF were about the average size of all RCFs in Shaanxi Province, which is likely, and if the TVE RCF deposit data were correct, then deposits at all RCFs in Shaanxi Province would have been equivalent to approximately 5% of all deposits in the formal financial sector around the end of 1996. Within Shaanxi Province, RCFs in Weinan Municipality by the end of 1997 have attracted deposits equivalent to about 27% of deposits in the formal financial system.¹² Overall, published data is more likely to under- than to over-estimate the extent of RCFs given the central-local and intra-central conflicts discussed in the following two sections.

¹² Data on the 1997 increase in deposits in the formal financial system vs. the RCFs confirm the size of the RCF sector in Weinan Municipality. See PBC Weinan Municipality (1998) and Wu (1997).

Table 1. RCF Deposit and Lending Structure

Province	Sichuan	Guangxi	Hunan	Guizhou	Henan	Shaanxi	Yunnan	Yunnan	Xinjiang	Xinjiang
Year	1996	1996	1996	1996	1995	1995	1996	1993	1996	1993
Total deposits at RCFs (m yuan)	21599	1774	7400	250	2257 (cum.)	1470	3093	414.39	936.57	~309
of which in % by:										
by collective				41.4	22.2		35.0	59.6	26.6	54.1
by individuals				24.0	63.0		48.3	19.6		20.9
reserves							3.4	2.3	5.3	8.5
“others”							13.3	18.5	68.1	
as shares (in %)	87.2									
Number of RCFs	5464	848		300	807	923	2058	449	274	408
Average deposits per RCF (m yuan)	3.95	2.09		0.83	2.80	1.59	1.45	0.92	3.42	0.76
Cumulative annual lending* (m y.)	^a 185.41	2070	10600	280	3388	2030	4951		876.86	
agriculture (%)	^a 52.8	46.5	60.38	40.7		54.7	33.0			80.3
farmers (%)				(48.8)	(47.2)	(56.7)	(39.5)		(95.8)	(75.7)
tsh.- and village-run ent. (%)	^{ab} 31.2	^b 31.9		30.4	35.4	23.6	33.3			5.6
other sectors (%)		21.6					33.6			
Source: prov. yearbook (year, page)	1997, 110	1997, 181	1997, 124	1997, 293	1996, 176	1996, 121	1997, 138	1994, 179	1997, 160	1996, 169f

Notes:

* Lending can be categorized according to economic sector (agriculture, industry, services, etc.) or according to borrower (farmers, township- and village-run enterprises, etc.). This distinction is not consequently maintained across the sources.

a: The data is year-end data rather than cumulative.

b: The data covers all township and village enterprises, not only township- and village-run enterprises.

Sources:

Provincial yearbooks and provincial economic yearbooks of the years 1994 through 1997. If a province is not included in the table this implies that none of the four yearbooks carried any evidence on RCFs (with the exception of Tianjin where the data was too sparse to warrant an entry in the table).

Table 2. Extent of Rural Cooperative Funds

Locality	Date	RCFs (#)	Deposits (m yuan) at RCFs [a] banks [b]		a/b (%)
<i>Nationwide</i>					
	end-1990		8-10,000	1,401,260	0.57-0.71
	early 1990s		20,000		
	end-1994	17,800			
	1995		80,000	5,386,220	1.49
	end-1995		~72,700	5,386,220	1.35
	mid-1997		200,000	6,857,120	2.92
	mid-1997		50-70,000	6,857,120	0.73-1.02
<i>Provinces</i>					
Tianjin	end-1993	181	240	58,612	0.41
Sichuan	end-1994	4966	6000	183,800	3.26
	end-1995	5349	14526	250,400	5.80
	end-1996		21599	314,000	6.88
Henan	end-1993	426	476	114,366	0.42
	end-1994	548	569	160,295	0.35
	9/95	74	1828	213,169	0.86
	end-1995	807	2257	270,765	0.83
Hunan	end-1993		676.77	72,151	0.94
	end-1994		1968	98,453	2.00
	end-1995	2750	4000	124,436	3.21
Guangxi	end-1993	588	260	66,534	0.39
	end-1996	848	1774	136,117	1.30
Guizhou	end-1995	70	70	47,821	0.15
	end-1996	300	250	58,626	0.43
Yunnan	end-1993	449	414.39	59,356	0.70
	end-1994	1160	1280	84,115	1.52
	end-1995	1792	2000	118,724	1.68
	end-1996	2136	3093	153,959	2.01
Xinjiang	end-1993	408	128.72	44,068	0.29
	end-1994	1034	442.31	63,444	0.70
	end-1995	190	808.34	83,842	0.96
	end-1996	274	936.57	101,247	0.93
Anhui	end-1996	510	510	142,070	0.36
Shaanxi	end-1988	370	40	21,034	0.19
	end-1993		323	92,382	0.35
	end-1994		764	120,682	0.63
	end-1995	923	1470	156,909	0.94
	end-1996	900	2000	205,399	0.97
	end-1996	1129	286	205,399	0.14
32 TVE RCFs	mid-1997	32	250	205,399	0.12
<i>Shaanxi Province, subprovincial localities</i>					
Xi'an Municipality	mid-1997		~100	61,998	0.16
Weinan Municip.	end-1996	214	1091	8,530	12.79
Weinan Municip.	end-1997	450	2300	8,530	26.96

Notes:

In the case of nationwide data banks consist of state banks and rural credit cooperatives (RCCs); these comprise the PBC, the four state commercial banks, urban cooperative banks, urban credit cooperatives, post office deposits, financial trust and investment companies, finance companies, and financial leasing companies. No definition is available for the provincial and subprovincial tiers.

Sources (for RCF data; for bank data):

Nationwide:

End-1990: Xu and Deng (1994), p. 10, 84 (approx. 1/4 of all townships has at least one RCF); ZGJRNJ 1997, 464.

Early 1990s: unofficial estimate by an economist with the Agricultural Ministry.

End-1994: *Nongcun hezuo jingji jingying guanli* no. 10 (Oct. 1995), p. 13.

1995: unofficial estimate by an economist with the Agricultural Ministry; ZGJRNJ 1997, 464.

End-1995: Guo and Yang (1997); ZGJRNJ 1997, 464.

Mid-1997: unofficial estimate by an economist with the Agricultural Ministry; ZGJRNJ 1997, 464 (end-1996).

Mid-1997: unofficial PBC estimate; ZGJRNJ 1997, 464 (end-1996).

Provinces:

Tianjin, end-1993: *Tianjin nianjian* 1994, 151; ZGJRNJ 1997, 156.

Sichuan, end-1994: *Sichuan nianjian* 1995, 109; ZGJRNJ 1997, 232f, 236.

end-1995: *Sichuan nianjian* 1996, 109; ZGJRNJ 1997, 232f, 236.

end-1996: *Sichuan nianjian* 1997, 110; ZGJRNJ 1997, 232f, 236.

Henan, end-1993: *Henan nianjian* 1994, 112; ZGJRNJ 1997, 210.

end-1994: *Henan nianjian* 1995, 115; ZGJRNJ 1997, 210.

9/95: *Dui nongcun* (1996); ZGJRNJ 1996, 210.

end-1995: *Henan nianjian* 1996, 176; ZGJRNJ 1997, 210.

Hunan, end-1993: *Hunan nianjian* 1994, 219; ZGJRNJ 1997, 216.

end-1994: *Hunan nianjian* 1995, 157; ZGJRNJ 1997, 216.

end-1995: *Hunan nianjian* 1996, 118 (registered RCFs); ZGJRNJ 1997, 216.

Guangxi, end-1993: *Guangxi nianjian* 1994, 343; ZGJRNJ 1994, 224.

end-1996: *Guangxi nianjian* 1997, 191; ZGJRNJ 1997, 229.

Guizhou, end-1995: *Guizhou nianjian* 1997, 297; ZGJRNJ 1997, 239.

end-1996: *Guizhou nianjian* 1997, 293; ZGJRNJ 1997, 239.

Yunnan, end-1993: *Yunnan nianjian* 1994, 179; ZGJRNJ 1997, 241.

end-1994: *Yunnan nianjian* 1995, 185f; ZGJRNJ 1997, 241.

end-1995: *Yunnan nianjian* 1996, 141; ZGJRNJ 1997, 241.

end-1996: *Yunnan nianjian* 1997, 138; ZGJRNJ 1997, 241.

Xinjiang, end-1993: *Xinjiang nianjian* 1994, 169; ZGJRNJ 1997, 258.

end-1994: *Xinjiang nianjian* 1995, 187; ZGJRNJ 1997, 258.

end-1995: *Xinjiang nianjian* 1996, 180; ZGJRNJ 1997, 258.

end-1996: *Xinjiang nianjian* 1997, 160; ZGJRNJ 1997, 258.

Anhui, end-1996: *Nongcun hezuo jingji jingying guanli* #8/1997, 23; ZGJRNJ 1997, 195.

Shaanxi, end-1988: *Shaanxi ribao* 89/5/13; SXTJNJ 1990, 407, 409.

end-1993: *Shaanxi nianjian* 1994, 97; ZGJRNJ 1997, 246f.

end-1994: *Shaanxi nianjian* 1995, 122; ZGJRNJ 1997, 246f.

end-1995: *Shaanxi nianjian* 1996, 121; ZGJRNJ 1997, 246f.

end-1996: *Shaanxi nianjian* 1997, 101; ZGJRNJ 1997, 246f.

end-1996: Fan and Xu (1997); ZGJRNJ 1997, 246f.

32 TVE RCFs, mid-1997: Shaanxi Province TVE Administration Bureau 10 June 1997 (one year after general promotion); ZGJRNJ 1997, 246f (end-1996).

Xi'an Municipality, mid-1997: XATJNJ 1997, 373 (end-1996).

Weinan Municipality, end-1996: Wu 1997; *Shaanxi nianjian* 1997, 349.

end-1997: *Zhongguo renmin yinhang Weinan shi fenhang ketizu* 1998 (235 RCFs + 215 other cooperative funds and financial institutions); *Shaanxi nianjian* 1997, 349.

Central-Local Dichotomy

Why did RCFs in many localities grow so rapidly in recent years? One reason is the increasing scarcity of formal financial sector funding. Following a series of illegal practices at the lower-level tiers of the banking system, the formal financial sector was re-centralized in 1994. All refinancing of financial institutions by the PBC now occurs on the central tier. Commercial bank headquarters and provincial branches since 1994 retain part of the annual increase in credit plan limits for own lending which is then financed through a “second-tier minimum reserve” levied on lower-level tier branches. Decision-making authority on individual loans has likewise been re-centralized.

In practice, these changes frequently imply a lack of lending allowance, a lack of funds, and a lack of decision-making authority at the lowest-level tier bank branches, in particular on the county level with its offices in townships. The data in Table 3 documents the increasing relative scarcity of formal financial sector funds in the countryside beginning in 1994. While nationwide formal financial sector lending increased by 24% in both 1994 and 1995, and by 21% in 1996, Agricultural Bank of China (ABC) lending to TVEs peaked in 1993 at a growth rate far above the nationwide formal financial sector loan growth rate to fall below the nationwide growth rate in 1994 through 1996; the growth rate of lending by rural credit cooperatives (RCCs) to TVEs likewise fell dramatically from its peak in 1994 to below the nationwide average in 1995. Viewed from the point of view of township- and village-run enterprises,¹³ the only type of borrower for which balance sheet data is available, the annual

¹³ Township- and village-run enterprises accounted for 58% of total value-added by TVEs in 1996. (ZGXZQYNJ 1997, p. 129) Balance sheet data for joint enterprises and individual-

growth rate of bank loans (from any formal financial sector institution) dropped sharply from 72% in 1993 to 11% in 1994, 9% in 1995, and 15% in 1996. The share of bank loans in total liabilities and capital fell by 14% in 1995 and by another 2% in 1996.

The scarcity of formal financial sector funding is even more striking once output changes are taken into account. Nationwide, the ratio of GDP to formal financial sector lending has remained remarkably constant between 1.01 and 1.16 in the period from 1990 to 1996, with a small rise from 1.05 in 1993 to 1.15 in 1994 (a 10% deterioration) and to 1.16 in 1995. Township- and village-run enterprises, on the other hand, not only add twice as much value per formal financial sector loan than the nationwide average, but furthermore show a much stronger deterioration in the ratio—by 39%—in 1994, continuing into 1995.¹⁴

The limited exposure of the formal financial sector at the lower-level administrative tiers reflects a fundamental central-local dichotomy. The formal financial sector regulated if not owned by the central government traditionally lends to the state-owned enterprises under an implicit government lending guarantee as well as loan repayment guarantee. On the other hand, neither township nor village government or individuals may establish financial institutions, and the central government does not regulate on TVEs. Formal financial sector institutions when lending to TVEs or households thus are not lending to "members of the same family," and lack the implicit government loan repayment guarantee.

owned enterprises in the countryside are not available; formal financial sector lending to these enterprises is likely to be very small.

¹⁴ The 1994 vs. 1993 comparison is based on gross output value data as value-added data is not available; the relative changes in the gross output value ratio and the value-added ratio in 1995 over 1994, when both time series are available, are almost equal (a 21.6% deterioration vs. a 22.3% deterioration or a 18.6% deterioration if the lacking Shanghai data in 1994 were approximated as outlined in the notes to Table 3). This suggests that relative changes in the ratio of gross output value to formal sector lending prior to 1995 are likely to be a good approximation to the relative changes in a ratio based on value-added.

While the bias of the formal financial sector is starving local enterprises and farmers of development funds, economic development on the other hand continues to be a major issue for local governments and Party Committees. The unusually sluggish growth of TVEs in many provinces in recent years has contributed to a sense of urgency. But localities increasingly lack government funds to promote economic development. The 1994 tax reform massively raised the share of total revenues collected by the center (from 22.02% in 1993 to 55.70% in 1994) which then redistributed the funds to provinces to an extent that the local share of expenditures fell only two percentage points (from 71.74% in 1993 to 69.71% in 1994). (ZGTJNJ 1998, 281)

The county tier was hard hit by the changes in revenue allocation. As Table 4 shows, in six out of ten provinces for which county tier data can be calculated the ratio of the county tier share of total provincial expenditures to the county tier share of total provincial revenues increased significantly in 1994 over 1993, while in three other provinces the ratio decreased, but only slightly. The last provincial-level entity, Tianjin, appears to have conducted a major redistribution of revenues to the county tier.¹⁵ The general increase in the ratio was primarily due to a disproportionate decrease in revenues rather than a disproportionate increase in expenditures (see Table 5). Unless central government redistribution of revenues reached the county tier disproportionately this suggests that the county tier faced very strong pressures in 1994 to find new ways to finance local economic development. This development was partly reversed by 1996 only.

¹⁵ The mean ratio of 1994 is significantly different from the mean ratio of 1993 at the 5% significance level (two-tailed test, excluding Tianjin).

Table 3. Formal Sector Lending to Township- and Village-run Enterprises

	1990	1991	1992	1993	1994	1995	1996	1997
Formal sector financial institutions consolidated balance sheet								
Total loans, annual growth rate (in %)		20.68	23.36	25.15	23.88	23.84	21.00	22.50
Agricultural Bank of China (ABC) balance sheet								
Loans to TVEs, annual growth rate (in %)		7.84	16.87	32.98	21.14	17.81		
Rural credit cooperatives (RCCs) balance sheet								
Loans to TVEs, annual growth rate (in %)		29.92	42.17	37.73	27.74	22.07	17.45	12.92
ABC and RCC consolidated balance sheet								
Loans to TVEs, annual growth rate (in %)		21.15	33.22	36.25	25.74	20.83		
Township- and village-run enterprise balance sheet								
Loans from formal financial sector, annual growth rate (in %)		27.80	35.68	72.38	11.29	9.24	15.20	-5.57
Share of bank loans in total liabilities and capital (in %)					22.08	18.89	18.53	19.46
Growth rate of share of bank loans in total liab. and capit. (in %)						-14.45	-1.86	4.98
Output-lending ratios								
GDP / total loans of formal financial sector	1.0490	1.0131	1.0120	1.0513	1.1458	1.1571	1.1101	
Annual growth rate (in %)		-3.42	-0.11	3.88	8.99	0.99	-4.06	
Township- and village-run ent. gross output value / bank loans	6.3268	6.0803	6.8267	6.8962	9.5774	11.6460		
Annual growth rate (in %)		-3.90	12.28	1.02	38.88	21.60		
Township- and village-run ent. value-added / bank loans					2.1084	2.5848	2.4628	2.5174
Annual growth rate (in %)						22.60	-4.72	2.22

Notes:

Formal sector financial institutions include all state banks (including other commercial banks), urban credit cooperatives, rural credit cooperatives, trust and investment companies and finance companies.

Total lending by ABC and RCCs to all TVEs (in practice primarily township- and village-run enterprises) amounted to 388.511b yuan in 1995, the most recent year for which data is available, while total bank loans received by township- and village-run enterprises from any formal financial sector institution was 379.330b yuan.

All data on township- and village-run enterprises, whether balance sheet or output data, excludes Guangdong Province since no 1994 data is available; value-added data in 1994 for Shanghai is also not available and thus excluded. In 1995 Shanghai contributed 3.32% of nationwide value-added (excluding Guangdong Province); if the share was the same in 1994, then the ratio of township- and village-run enterprise value-added to bank loans in 1994 is 2.18.

1997 data on township- and village-run enterprises is in fact on “collective” TVEs with no definition of this newly introduced term given. Presumably it matches “township- and village-run enterprises” in the earlier statistics. A comparison between 1997 and earlier years is furthermore difficult as privatization of collectively-owned TVEs began to gain momentum in 1997. Poorly performing enterprises with little access to bank loans may have been the first to be privatized.

Data calculated from:

Formal financial sector lending: ZGJRNJ '97, 464; ZGJRNJ '98, 508.

GDP: ZGTJNJ '98, 55.

ABC loans: ZGNCJRTJNJ 1996, 12, 15; ZGNCJRTJNJ 1995, 15, 27, 29; ZGNCJRTJNJ 1993, 43.

RCC loans: ZGNCJRTJNJ 1996, 56; ZGNCJRTJNJ 1995, 77f; ZGNCJRTJNJ 1993, 87; ZGJRNJ '97, 564; ZGJRNJ '98, 621.

Data on township- and village-run enterprises:

Loans: ZGXXZQYNJ 1998, 223, 225; ZGXXZQYNJ 1997, 242, 245; ZGXXZQYNJ 1996, 255f; XZQYCW TJHZZL 1994, numerous pages; ZGXXZQYNJ 1994, 369; ZGXXZQYNJ 1993, 239; ZGXXZQYNJ 1992, 207; ZGXXZQYNJ 1991, 200.

Total assets: ZGXXZQYNJ 1998, 223; ZGXXZQYNJ 1997, 242; ZGXXZQYNJ 1996, 254; XZQYCW TJHZZL 1994, numerous pages

Gross output value: ZGTJNJ 1996, 389; ZGXXZQYNJ 1995, 90; ZGXXZQYNJ 1994, 179; ZGXXZQYNJ 1993, 153; ZGXXZQYNJ 1992, 144; ZGXXZQYNJ 1991, 144.

Value-added: ZGXXZQYNJ 1998, 112; ZGXXZQYNJ 1997, 129; ZGXXZQYNJ 1996, 258; ZGTJNJ '96, 390; XZQYCW TJHZZL 1994, numerous pages.

Table 4. Ratio of County Tier Share in Provincial Expenditures to County Tier Share of Provincial Revenues

	1993	1994	1996	Growth rates (%)	
				94 / 93	96 / 94
Henan	1.12	1.00	0.94	-11.12	-5.46
Xinjiang	1.49	2.15	1.80	44.05	-16.24
Yunnan	1.55	1.41	1.00	-8.73	-29.25
Zhejiang	0.56	1.17	1.82	108.21	55.46
Ningxia	1.26	1.50	1.07	18.99	-28.67
Anhui	1.09	1.70	1.32	56.03	-22.38
Sichuan	0.10		0.79		
Shaanxi	0.98	0.95	0.89	-2.87	-6.84
Jiangxi	0.73	1.35	0.78	83.96	-42.35
Hebei	1.29	2.17	0.78	68.63	-63.85
Tianjin	6.44	0.97	0.98	-84.94	1.21

Sources: Calculated from individual provincial statistical yearbooks. For all excluded provinces the data is not available in their statistical yearbooks.

Table 5. Growth Rates of Local Fiscal Expenditures and Revenues (in %)

	1994 vs. 1993				1996 vs. 1994			
	Expenditures		Revenues		Expenditures		Revenues	
	Prov.	County	Prov.	County	Prov.	Cou.	Prov.	Cou.
Henan	14.82	13.34	-32.94	-25.52	50.51	60.17	73.60	95.42
Xinjiang	12.94	13.42	12.94	-21.26	48.79	77.35	48.79	111.74
Yunnan	1.55	10.09	-62.57	-55.55	32.72	65.64	69.50	198.98
Zhejiang	22.38	12.85	25.65	-44.35	39.65	135.21	39.33	50.95
Ningxia	-0.11	4.31	34.52	18.05	52.36	38.58	-13.13	10.76
Anhui	29.53	24.51	48.87	-8.29	91.60	207.84	77.22	266.82
Sichuan	13.26		-50.93		4.17		55.06	
Shaanxi	13.42	10.84	-32.29	-31.87	42.42	34.20	58.73	60.55
Jiangxi	12.37	12.98	35.02	-26.21	43.27	46.23	-13.06	53.93
Hebei	13.05	2.31	12.00	-39.90	44.18	-13.11	-7.00	55.02
Tianjin	41.07	36.17	-33.10	328.78	56.53	51.59	57.60	50.81
All China	24.78		19.99		37.03		41.97	

Sources: Calculated from individual provincial statistical yearbooks. For all excluded provinces the data is not available in their statistical yearbooks. Nationwide data is from ZGTJNJ (1998, 281).

These developments in 1994 did nothing to alleviate tight budgets on the county tier—county and township tier budgets are frequently described as "daily necessities" (*chifan*) budgets, barely sufficient to cover administrative costs, with little or no discretionary spending. Lacking fiscal funds, increased lending by financial institutions often remained the only channel to support local economic development. With ever less local government influence on re-centralized formal financial sector decisions on lending, RCFs offer an opportunity to raise significant sources of extra funding for township- and village-run enterprises (mainly provided by specialized TVE cooperative funds) as well as for individual-owned enterprises, jointly-owned enterprises and farmers (mainly provided by more general-purpose RCFs).

Tax arrangements likewise encourage the establishment of RCFs. RCFs pay a business tax of 5% on interest income from lending activities to local governments as all other financial institutions do (Wang and Yang 1997, 195). But the 55% income tax of the state commercial banks, calculated for each bank on the national level to include the income of all branches, is submitted to the state tax office (*guojia shuiwuju*) and turns into central government budget revenues. RCFs, on the other hand, pay their income tax to the local (provincial and subprovincial) tax office (*difang shuiwuju*).¹⁶ (State tax office 95/2/10) In practice, local governments in support of their RCFs frequently do not collect income

¹⁶ The maximum income tax rate for RCFs as non-financial institutions is 33%; since the operation of one cooperative fund is relatively small, the reduced tax rate of 27 or 18% may apply. (The income tax rate is 27% if the taxable income is 100,000 yuan or less, and 18% if the taxable income is 30,000 yuan or less. (State tax office 95/5/18))

Wang and Yang (1997), the tax almanac used by local tax authorities in at least Xi'an Municipality includes 34 pages of tax exemptions (pp. 400-434), including an exception for RCCs in poverty areas (RCCs otherwise face an income tax of 33%),

taxes from RCFs but allow them to retain all profit after paying the business tax. RCFs likewise tend to escape the various local government levies on rural enterprises; thus the TVE bureau rarely collects the administrative fee of 0.7% of income from TVE RCFs that it levies on TVEs.

Besides the local government most local actors, in particular enterprises and households have incentives to support local RCFs. Enterprises benefit from a high return on deposits, the availability of loans and the independence from the state commercial banks as extended arms of the central government; state regulations on the use of cash by non-households find no application in RCFs. Households, like enterprises, benefit from a higher return on deposits and the availability of loans.

Of all local actors, the PBC branch is perhaps the one most reluctant to tolerate or even support the RCFs. The establishment of a financial institution requires PBC approval and the RCFs are de facto financial institutions. While the county PBC branch may prefer to maintain good relations with the local government, the direct vertical leadership structure within the PBC ensures a minimal amount of county branch compliance with the instructions of the PBC headquarters and pressure on the county branch to act thus is high. For example, the PBC branch of a poverty county in Shaanxi Province, after prompting by its superior municipal branch, wrote to the county government in late 1996 proposing that "the county government organize the relevant departments to in accordance with the law ban and investigate the illegal financial

but on cooperative funds only states that the Agricultural Ministry is responsible for determining the relevant policies and laws and regulations (p. 423).

institutions in our county.”¹⁷ It was, however, careful to point out that this excluded the “rural cooperative funds” presumably directly under the agricultural department; the TVE cooperative fund was illegal. As in other counties, the local government was highly protective of the only financing source of local economic growth under its control. In the absence of a conclusive central policy the document had no immediate effects.¹⁸

¹⁷ A list of illegal financial institutions was attached. Twenty copies of the document were forwarded to the county Party Committee, the county People’s Congress, the municipal PBC branch, and leading employees of the county PBC branch itself.

¹⁸ In response to the widespread growth of the RCFs, the PBC of the same municipality demonstratively issued golden plaques to all “legal” financial institutions—but not to cooperative funds. The signs are displayed in prominent position above the banks’ front doors and read “X branch is a legal financial institution approved by the PBC. Deposits at this institution enjoy the protection of the laws of the state. [Signed:] PBC branch, Y municipality.” As of 1998 such plaques violate Art. 18 of a PBC regulation on deposit withdrawal (PBC 98/2/23) which prohibits PBC branches from issuing any deposit guarantees.

Intra-Central Conflict

The rapid establishment and growth of RCFs in recent years was accommodated by a lack of agreement between central ministries on how to regulate RCFs. In 1986 Chen Muhua as governor of the PBC reached an agreement with the Agricultural Ministry to accept RCFs as non-financial institutions under the condition that they would not publicly solicit deposits and remain small, local mutual-aid organizations. SC 88/9/17 as the earliest piece of central regulation specifies that the establishment of a RCF requires approval by the PBC and registration with the Civil Affairs Administration; RCFs are to report on their finances to these two institutions annually, and to accept their supervision. While RCFs were explicitly denoted “social organization legal persons” (*shehui tuanti faren*), the question of whether they are financial institutions was not raised. PBC and Civil Affairs Administration were entrusted with the implementation of the SC decree and with enactment of implementing instructions. The Agricultural Ministry was not mentioned in this decree.

Shifting authority over RCFs to the Agricultural Ministry

This arrangement remained unchallenged until the mid-1990s. The Eighth Plenum of the Thirteenth Central Committee in November 1991 confirmed the legitimacy of the RCFs (“the rural cooperative funds shall be continued;” CCPCC 91/11/19) and the SC in its blueprint for financial reform (SC 93/12/25) added a new twist by stating that RCFs are not

financial institutions, cannot collect deposits, and cannot extend loans. But in early 1994 the development of the RCFs was given new impetus when the Chinese Communist Party Central Committee (CCPCC) and the SC decided that “the rural cooperative funds shall be turned into social, mutual cooperative funding organizations (*shehuixing de zijin huzhu hezuo zuzhi*); they do not conduct deposit business but serve agriculture and farmers in the locality.” (CCPCC 1994)

Authority over RCF matters gradually shifted to the Agricultural Ministry. Agricultural Ministry and PBC together restated that RCFs are not financial institutions and assigned responsibility for RCFs to the Agricultural Ministry (AgMin 1994). In 1995 the Agricultural Ministry followed up with a regulation on the registration of the RCFs (AgMin 95/4/19). While the accompanying circular asked that the superordinate department of the RCF strive for PBC support, the regulation states very unambiguously that establishment of a RCF only requires approval by the township government and then registration with the county-level agricultural administration. Supervision over RCFs is exercised by the agricultural departments; no mentioning is made of the PBC which in the previous regulation (AgMin 1994) was still named as exercising supervisory authority.

The change in approval and registration procedures may well reflect earlier, dispersed local developments possibly in violation of the 1988 SC regulations. For example, the Hebei Province Party Committee as early as on 6 July 1992 urged all local governments and departments to “let the rural cooperative funds develop as quickly as possible,” and “localities which have not yet acted are to implement pilot projects and to do all they can so that cooperative funds will be widespread one or two years from now.” This decision in the absence of any such nationwide

policy suggests that RCFs may have begun to grow beyond their originally intended scope of administering formerly collectively owned property almost from the date of their inception, with little regard for proper approval and registration procedures.¹⁹ Financial sector policies never envisaged such developments.

The clarification that the RCF is a mutual aid (or cooperative) organization with as superordinate department the Agricultural Ministry allowed the explosive growth of RCFs. In many localities government and Party Committee began to openly promote the establishment of RCFs. In 1995 the Shaanxi Province Party Committee and the Shaanxi government, for example, requested that by the end of the eighth Five-Year Plan 60% of all townships were to have established RCFs (Xi'anGov 95/4/27).

Legal ambiguities and PBC backlash

The SC in a rural financial reform blueprint (SC 96/8/22) subsequently admonished that RCFs may not collect deposits. If they do, they are to be incorporated into the RCCs. The PBC and the Agricultural Ministry were requested to issue "rural cooperative fund administration regulations" which, however, as of late 1998, have not yet been issued. The Rural Economic Administration Station that handles RCF matters within the Rural Cooperative Economy Guidance Office of the Agricultural Ministry was ordered to stop work and to report to the SC.

¹⁹ Tai (1998) reporting on the establishment of a RCF in Xiaoying Village (Liquan County, Xianyang Municipality, Shaanxi Province) in 1990 does not mention any particular approval procedure. The county urgently needed funds to establish its

While the central government searched for a policy, the growth of the RCFs continued unabated. For example, the Shaanxi Province TVE Bureau in June 1997 encouraged the further growth of the TVE RCFs with as long-term perspective a TVE development fund (Shaanxi Province TVE Administration Bureau 97/6/10).

Such TVE funds were legitimized in the PRC TVE Law passed in late 1996 (NPC 96/10/29). The law allows county-tier and higher-level tier governments to establish TVE development funds. While sources of funding comprise government funds, part of the increase in local TVE taxes, and retained profits, they also include other funds provided by rural collective organizations, TVEs, and farmers (Art. 21). The funds are to be used primarily to support TVEs but the categories are broad enough to encompass other uses (Art. 22). Although no development funds have so far been set up, present TVE cooperative funds easily match these requirements and could simply be renamed if need be.²⁰ This pits the PRC TVE Law directly against the PRC PBC Law and the PRC Commercial Bank Law which require PBC approval for all financial institutions.²¹

In mid-1997 the PBC was finally given green light to go ahead and “clean up” the RCFs. In Shaanxi Province the provincial government on 21 July 1997 approved the suggestions of the provincial PBC branch and Agricultural Bureau on “cleaning up” the RCFs between August and

“dragon head” enterprises so it started a RCF open to the public based on the principle “voluntarily purchase shares, freely withdraw shares.”

²⁰ Jiangsu Province, which does not have TVE RCF, is presently considering the establishment of such a TVE development fund on the provincial tier.

²¹ Art. 31 of the PRC PBC Law (NPC 95/3/18) requires PBC approval for the establishment, transformation, and termination of all financial institutions. According to Art. 11 of the PRC Commercial Bank Law (NPC 95/5/10) “without PBC approval no unit or person may collect deposits from the public or conduct other commercial banking business.”

December 1997. On 5 October 1997 the Shaanxi provincial government approved a further “adjustment of the financial order” as suggested by the PBC. This led to a flurry of circulars by government departments on all tiers (such as by the Shaanxi Province TVE Administration Bureau on 29 November 1997) as well as to actual changes in RCF practices. Some RCFs temporarily halted all lending in late 1997 until the investigations were completed.

The most visible result is a slowdown in the rapid expansion of RCFs achieved through an enforced reduction in deposit rates offered by RCFs. While the Shaanxi Province government had requested that the “usage fees” paid on deposits be comparable to the interest rates of the banking system, in practice the former still exceed the latter, but far less so than before.²² The payment of dividends continues without limitations for members (permanent shareholders). Lending now is limited to members but this can be circumvented through low membership shareholding requirements. PBC and agricultural departments in Shaanxi Province also requested a clear internal administrative structure with shareholder meeting, Board of Directors and Supervisory Board, while local government and Party leaders are prohibited from holding leadership positions in the RCFs (ShGov 97/7/21).

²² In one particular county in Shaanxi province, RCFs in April 1998 offered “usage fees” of 8.28 to 9% per annum on “1-year shares” (without dividend payments) while the state-determined interest rate in the financial system on one-year fixed-term deposits was 5.22%.

AgMin and PBC 1994, Art. 7 required RCF “usage fees” to be no higher than the corresponding bank interest rates. The RCFs can evade the spirit of this regulation by paying bank interest rates plus dividends on deposits. Interest rate caps on loans can easily be flouted through handling fees, compensating balances and repayment scheduling.

Illegal financial institutions?

Decisive new policies were expected from the Fifteenth Party Congress in September 1997 but did not emerge. On 14 October 1998 the Third Plenum of the Fifteenth CCPCC in a major decision on agricultural development avoided placing any clear-cut constraints on RCF development and only stated that “various types of economic entities organized by farmers in shareholding form are a new product of reform and shall be actively supported, receive correct guidance, and be gradually perfected.”

But at the same time, the PBC was pushing for RCFs to be dealt with as illegal financial institutions. The SC as early as on 13 July 1998 issued a regulatory framework banning illegal financial institutions and illegal financial activities. While this regulatory framework did not specify which type of quasi-financial institution is illegal, the PBC (with approval of the SC) was quick to issue a circular on 11 August 1998 identifying individual categories of institutions and behavior to be deemed illegal. This circular for the first time explicitly lists individual types of funds as illegal, and issues instructions on how to deal with them.

The circular requests that cooperative funds (*jijinhui*), mutual aid funds (*huzhuzu*), savings funds (*chujinhui*), funds service departments (*zijin fuwu bu*), share service departments (*gujin fuwu bu*), clearing centers (*jiesuan zhongxin*) and investment companies (*touzi gongsi*), all run by governments and their departments, be cleaned up and reorganized. If any financial activities such as acceptance of deposits from the public or lending are undertaken, these have to stop by the end of June 1999. The circular reconfirms the 1988 SC decision (without

referring to it) that cooperative funds require PBC approval and must be registered with the Civil Affairs Administration. All illegal activities and institutions are to be examined in a first step by the end of 1998 and then rectified in a second step by the end of March 1999; the PBC finally is to have checked on the rectification by the end of June 1999.²³

However, the circular does not resolve the conflict between PBC and Agricultural Ministry. In a short sentence the RCFs—as well as “intermediate institutions” of the finance departments—are explicitly excluded from the reorganization campaign. While the PBC thus managed to start a major campaign against various types of funds run by local governments in an attempt to bridge the central-local chasm, the vast majority of cooperative funds are excluded.

The contradiction between PBC and Agricultural Ministry implies that RCFs in the near future will continue to operate as before.²⁴ But the PBC circular, although presenting a three-stage reorganization schedule to be completed by mid-1999, also gives a separate deadline of end-2000 for the whole campaign, one and a half years after completion of the three-stage rectification. This not only suggests that the PBC is well aware of the uphill struggle it is about to embark on and that the success of the three-stage rectification measures is far from guaranteed even with

²³ The Shaanxi Province government has taken up the issue on 9 October 1998 with the establishment of a leading group. Municipalities (and prefectures) are required to likewise establish leading groups. Results of the reorganization are to be reported to the provincial government by end-May 1999. Reports in the media on any financial matter including on various types of local funds require prior PBC approval.

²⁴ The differences in the position of the PBC and the Agricultural Ministry carry over to the publications associated with each of the two institutions. For example, publications associated with the PBC, such as the newspaper *Jinrong shibao*, the nationwide journal *Jinrong cankao* or the local journal *Shaanxi jinrong* offer consistently negative survey reports and comments on the RCFs. Publications associated with the agricultural departments, on the other hand, such as the nationwide journal *Nongcun hezuo jingji guanli* or the local journal *Nongcun jingji* strike a much more positive note about the development of the RCFs.

the limited number of targets,²⁵ but it also raises the possibility that the campaign may enter a new phase after the first three stages. This new phase may then include RCFs, especially if the first phase has brought to light wide-spread irregularities and activities endangering the stability of the financial system.²⁶

²⁵ The national supply and marketing cooperative in early 1999, for example, did not at all require the cooperative funds run by the local supply and marketing cooperatives to be disbanded. All it is concerned about is that funds be no longer "publicly" collected. (*Jinrong shibao* 13 Jan. 1999)

²⁶ A major difficulty in closing cooperative funds is the fact that the central bank has no authority over these institutions. Closure of illegal financial institutions requires action by public security organs acting in accordance with the criminal code; public security, on the other hand, may not be qualified to determine what constitutes an illegal financial institution. The PBC thus needs to first identify the particular institution to be closed and then report to public security for action. See *Xinbao* (Hong Kong Economic Journal) 21 Nov. 1998 for the legal intricacies. In practice, local public security organs may well drag their feet especially if so encouraged by the local government.

Economic Implications of RCFs

The development of RCFs has a number of economic implications. RCFs change the extent and quality of financial intermediation in a locality. The financial health of RCFs affects local economic and social stability. RCFs finally have a number of macroeconomic implications.

5

Financial intermediation

The development of RCFs is likely to increase the degree of financial intermediation in a locality because RCFs offer a larger amount of loans to the locality per local deposits than formal financial sector institutions. The volume of RCF loans is equal to 60-90% of deposits, with the remainder being held as reserves either in cash or with the formal financial sector. 100% of this lending occurs within the locality. The formal financial sector, on the other hand, retains much fewer funds in the locality. Table 6 attempts to pin down the extent of leakages in the formal financial sector out of rural into urban areas by focusing on the two formal financial sector institutions in the countryside, the ABC and RCCs.

Rural credit cooperatives in 1996 made loans equivalent to 72% of deposits. But only a small share of these loans definitely remained in the locality; these are the "TVE loans" which in 1996 were equivalent to 43% of total deposits only. This share has furthermore fallen significantly from its peak in 1993 at 50%, suggesting that the outflow of funds from rural to urban areas through the RCC network has increased

since 1994 when the formal financial sector was re-centralized. Most of the "agricultural loans" are likely to serve agricultural procurement (for transfer of agricultural resources to urban households and state-owned industry). "Other loans" may in part go to individuals but also include loans to state-owned enterprises. Overall, of total deposits collected almost exclusively in the countryside, RCCs re-lend perhaps no more than 50% in the countryside.

The Agricultural Bank of China in 1995, the latest year for which detailed data is available, had a loan-to-deposit ratio of 0.95. Definitely extended in the countryside were again the TVE loans which were equivalent to 16% of total deposits only, far down from a peak of 28% in 1992 and 27% in 1993, again suggesting an increasing transfer of funds out of the countryside. The largest share of ABC loans still goes to state-owned enterprises either to finance industry and commerce (primarily related to agricultural procurement) or to fund capital construction and technological updating and innovation.²⁷ "Agricultural loans" and "other loans" may include some loans to individuals in the countryside, but the ABC is unlikely to bother with small loans to households.²⁸ Even if all agricultural loans and all other loans were viewed as having been extended in the countryside, their share together with TVE loans in total

²⁷ This share dropped significantly in 1994 as much lending related to agricultural procurement was shifted to the Agricultural Development Bank of China (ADBC). Along with these loans, PBC refinancing of the ABC (rather than deposits at the ABC) moved to the ADBC, causing the sharp drop in the ratio of (now reduced) loans to (unchanged) deposits.

The ratio of total ABC loans to total deposits at the ABC is still relatively high as RCCs up to and including 1996 deposited all minimum and excess reserves with the ABC. These reserves are not included in the "total deposits" at the ABC. Since the separation of ABC and RCCs these reserves are held with the PBC; the data discussed here is not affected by this re-organization.

²⁸ According to *Jinrong shibao* of 11 January 1999, 80% of all loans to agricultural households (*nonghu*) and 70% of all loans to TVEs are extended by RCCs.

deposits would still not exceed 43%, by far less than the share achieved by RCFs.

These figures confirm the outflow of funds from the countryside as well as the significant relative increase in this outflow since 1993. One shortcoming of the data is the fact that even in the early 1990s some deposits at the ABC may have been urban rather than rural. An alternative then is to use (an estimate of) deposits by rural households with any formal financial sector institution even though such a measure does not include deposits by rural enterprises.²⁹ Lending in the countryside also falls far short of this new deposit measure, and the increased leakage of funds from rural to urban areas since 1993 is again confirmed. Lacking exact data on the extent of RCFs, it is not clear whether the positive effect of RCF development on local financial intermediation outweighs the increase in formal financial sector leakage. But any depositing with RCFs rather than the formal financial sector improves the degree of local financial intermediation.

RCFs also help stem the outflow of funds from regions with low economic returns, independent of the rural-urban dichotomy. In the early 1990s, funds were flowing through the banking system from interior provinces to coastal provinces which enjoyed a higher expected rate of return, leaving interior provinces short of funds to finance even regular production.³⁰ Special government funds to TVEs in the central and Western region frequently disappeared as distributors or recipients of these funds lent them to enterprises in the coastal regions. While much of the interbank money market with its transfers to coastal regions was shut down in 1994, the establishment of RCFs under local government and

²⁹ Such rural enterprise deposits should be small as for the case of the ABC and RCC household deposits accounted for 78% of all deposits in 1995 (see Table 6).

Party control further reduces capital mobility and thus secures funding for potentially less efficient local enterprises.

RCF development finally implies a change in the composition of the borrower pool in the countryside. RCFs target not only township- and village-run enterprises but as the data in Table 1 attests also, and often primarily, individual entrepreneurs or farmers, a borrower group almost utterly neglected by the formal financial sector. Even though the cost of extending small loans and the risks involved may be high, member support is a primary objective of RCFs. RCFs are furthermore better suited than the formal financial sector to lend to individual households due to their relatively low operating costs. RCFs are routinely subsidized by the local government which may pay for half the employees (who concurrently hold positions in the government), provide offices and renounce its claim to RCF income taxes; RCF remuneration of non-government employees is minimal and does not carry any of the housing and social insurance benefits that employees in the formal financial sector enjoy.

³⁰ See, for example, *Shaanxi zhengbao* no. 16 (August 1993), p. 7.

Table 6. Rural Deposits and Loans

	1990	1991	1992	1993	1994	1995	1996
Rural credit cooperatives (RCCs)							
Total loans / total deposits	0.6588	0.6676	0.7056	0.7602	0.7336	0.7216	0.7153
Agricultural loans / total deposits	0.3542	0.3459	0.3425	0.1839	0.1674	0.1759	0.1938
TVE loans / total deposits	0.3805	0.3930	0.4514	0.4991	0.4735	0.4486	0.4256
Other loans / total deposits	0.0326	0.0418	0.0619	0.2303	0.2241	0.2108	0.2006
Agricultural Bank of China (ABC)							
Total loans / total deposits	1.9647	1.8664	1.7425	1.7084	1.0654	0.9454	
Industrial, commercial, and investment loans / total deposits	1.3978	1.3359	1.2290	1.0625	0.5652	0.5063	
TVE loans / total deposits	0.2257	0.2032	0.1856	0.2016	0.1810	0.1593	
Agricultural loans / total deposits	0.2930	0.2835	0.2699	0.2232	0.1690	0.1616	
Other loans / total deposits	0.0482	0.0438	0.0580	0.2212	0.1501	0.1182	
RCCs and ABC							
TVE loans / total deposits	0.2790	0.2729	0.2837	0.3144	0.2962	0.2753	
TVE and other loans / total deposits	0.3165	0.3125	0.3380	0.5200	0.4672	0.4260	
TVE and agric. and other loans / total deposits	0.6154	0.6025	0.6145	0.7062	0.6221	0.5827	
Household deposits							
Estimate of deposits by rural households as share of total household deposits	0.6909	0.6866	0.6740	0.6530	0.6196	0.6083	0.6036
Estimate of deposits by rural households / ABC and RCC household deposits	1.2097	1.2292	1.1981	1.2206	1.2283	1.2786	
ABC and RCC household deposits as share of total ABC and RCC deposits	0.7510	0.7544	0.7315	0.7506	0.7714	0.7801	
TVE loans by ABC and RCCs / estimate of deposits by rural household	0.2306	0.2220	0.2368	0.2576	0.2412	0.2153	
TVE, agric. and other loans by ABC and RCCs/ estimate of dep. by rural households	0.5087	0.4901	0.5129	0.5786	0.5065	0.4557	

Notes:

ABC data for 1994 and 1995 is not perfectly compatible with earlier data as most policy lending (together with PBC refinancing) was shifted to the Agricultural Development Bank of China in mid-1994.

Data calculated from:

RCCs: ZGNCJRTJNJ 1996, 58, 60; ZGJRNJ 1997, 563. ABC: ZGNCJRTJNJ 1996, 16, 19.

For details on the derivation of the estimate of rural household deposits from official, nationwide survey data please contact the author.

Risk assessment by RCFs may be more accurate than by the formal financial sector, and monitoring and contract enforcement likewise superior. Directors of RCFs are likely to know their borrowers well due to their frequently concurrent position in the government office co-operating with if not supervising the borrower. In one RCF in Shaanxi Province, enterprise personnel has been co-opted as RCF staff, in which case the RCF resembles an enterprise-internal finance department with direct access to household funds. In another RCF, government department retirees on behalf of the RCF pay almost daily, informal visits to the borrower to ensure proper use of the loan. Loan repayment can be enforced not only through the courts but perhaps more easily through the administrative government channels.³¹

RCF financial intermediation comes at a cost, namely high interest rates for the borrower, which in turn may restrict the volume of borrowing and thus local economic growth. However, the obvious counter-side of high interest rates are high returns on deposits for other members of the RCF as long as the spread remains small.³² Furthermore, interest rates in the formal financial sector appear to be in practice vastly inflated above the official interest rate through various fees, kick-backs, short maturity with higher penalty interest rates taking effect once a loan is overdue, etc. The level of RCF lending rates may thus be no novelty, with availability of loans for formerly ineligible borrowers a clear improvement.

³¹ One TVE RCF in Shaanxi Province with approximately 150 loans outstanding in mid-1998 was taking one borrower to court. This was the first case since the establishment of the TVE RCF in 1994 that it has taken a borrower to court.

³² A low spread is ensured by the non-profit motive (all profits are paid out as dividends after statutory increases in reserves). The data requirements to prove the low spread are insurmountable. While RCF lending rates are usually fixed by the local government and publicly known, the average return on deposits would have to be calculated a posteriori as a combination of fixed return on deposits, and fixed return plus dividends on member shares.

A second potential shortcoming of RCF lending is a particular lending bias. Formal financial sector institutions may be observing central government lending preferences biased against the private and rural collective-owned economy, but they also reflect cost considerations regarding loan evaluation and monitoring. RCF lending decisions, on the other hand, may follow lending priorities determined by local governments; lending decisions could be biased towards those borrowers who are closely linked to government departments. RCF funds may furthermore be claimed by local governments and their departments for government projects independent of the economic viability of these projects—in the medium to long run, the leadership responsible will be transferred elsewhere. One, perhaps exceptional example are the RCFs in Nanchong Municipality, Sichuan Province, where up to 20% of total loans outstanding at the end of May 1998 had gone to government projects such as road building, with 37% of these loans experiencing repayment difficulties.³³

³³ See Deng (1998). A different report on Gaoping District within this municipality complains that Party and government leaders make RCFs not only extend loans for government projects but also pay for various entertainment events and government consumption of cars and other goods. (Xiang and Ceng 1998) But lending to government projects may occur only in a small number of RCFs and even then on a quite limited scale. Government influence on lending decisions in general may not be pervasive; the provincial-level lending structure shows that the largest share of funds lent usually goes to individual households (see Table 1).

RCF stability

RCFs have a substantial volume of overdue loans which may reach up to 50% of all loans.³⁴ Perhaps RCF lending is on purpose too short-term (usually below six months) in order to ensure frequent monitoring as well as RCF liquidity. All loans supposedly require collateral or guarantees. This suggests that the qualification of a loan as overdue allows few conclusions on whether it is recoverable or not. Nevertheless, perhaps up to 20% of all loans are unlikely to be ever repaid.³⁵

Any accumulation of dubious loans is facilitated by the often poor quality of decision-making and the frequent lack of internal control mechanisms within the RCF. The Agricultural Ministry only requires the employment of “suitable” professional personnel; head and/or manager (*zhuren* and/or *jingli*), accountant, and cashier may not concurrently hold other positions (AgMin 95/4/19, Art. 7). In an earlier regulation, PBC and the Agricultural Ministry required that the member’s congress (*daibiao dahui*) of the RCF elect a Board of Directors (*lishihui*) and a Board of Supervisors (*jianshihui*), with the Board of Directors choosing a head responsible for the day-to-day work (AgMin and PBC 1994, Art. 9).

³⁴ Only one RCF interviewed was willing to provide information on the extent of overdue loans: they accounted for 2/3 of all loans and 55% of the total lending volume. Deng (1998) in an article on RCF problems reports an average of 20% overdue and non-performing loans in all RCFs in Nanchong Municipality, Sichuan Province, at end-May 1998. Xiang and Ceng (1998) document the rapid growth of the overdue and non-performing loan rate in Gaoping District of this Nanchong Municipality with 8% end-1995, 12% end-1996, and 27.8% end-October 1997. Yu (1997) for 90 RCFs in the 12 counties of Ganzhou Municipality (Jiangxi Province) which had established RCFs (out of 18 counties) gives the share of overdue loans as 40.97% at end-1996. In individual RCFs the extent of overdue loans can be quite small, such as in the Shuidongjiang Township RCF in Shaodong County, Hunan Province, at 2.66% end-April 1997.

³⁵ This is an estimate of an official at the Agricultural Ministry; the Agricultural Ministry is not known for criticizing RCFs.

But in practice decision-making and control mechanisms vary dramatically. Few RCF directors have any banking experience and on larger loans the final decision-making authority in the RCFs tends to almost exclusively rest with government officials holding concurrent positions in the RCF. The Board of Directors and other leading personnel is usually handpicked by the township Party committee and government, approved by the county tier superordinate department, and then "democratically elected" by the shareholders.³⁶ Few localities insist that township Party and government personnel may not hold any position in the RCF, most take the view that the RCF leadership needs to be identical with the leadership of the Rural Economic Administration Station of the agricultural departments.³⁷

In one extreme case in Shaanxi Province a full-time manager is responsible for the day-to-day work and the approval of small loans. But the head of the RCF approves medium-sized loans; he is the chairman of a Board of Trustees (*dongshihui*), has no banking experience and concurrently holds a government position. Large loans need to be approved by the Board of Trustees in total. In this particular arrangement a Supervisory Board does not exist, nor is there an external audit. In a different RCF in Shaanxi Province, Board of Directors, Board of Trustees, and Supervisory Board have all been established. The full-time Board of Directors is responsible for the day-to-day management, and the part-time Board of Trustees for important decisions as well as recurrent supervision. The chairman of the Board of Directors is a retired banker. The county government auditing bureau carries out an annual external audit.

³⁶ See, for example, Dali xian (1997) and Yang Longsheng (1997).

³⁷ See Chen and Liu (1997) on the first position and Yang Zonglian (1997) on the second position.

Often poor internal control mechanisms are supplemented by extraordinarily weak external supervision. Local government departments that wish to maintain their control over RCF lending decisions insist that RCFs remain non-financial institutions outside the sphere of influence of the PBC.³⁸ While the Agricultural Ministry and the PBC specified in 1994 that the PBC supervises the RCF's business and together with the agricultural departments handles illegal deposit and loan business (AgMin and PBC 1994, Art. 1), the Agricultural Ministry in a regulation in 1995 only mentions the local agricultural departments as supervisory institutions (AgMin 95/4/19, Art. 15). The county agricultural department conducts an annual inspection of the implementation of the statutes and administrative system, this year's business, including profit and losses and profit distribution, and this year's work in general. The RCF neither reports to the PBC nor receives direct PBC supervision.³⁹

Across localities auditing procedures vary vastly. Shaanxi Province has RCFs which conduct no special audit but may report their accounts to the agricultural departments at year-end. In Jimo Municipality, Shandong Province, the joint RCF conducts three complete audits per year and maintains audit files on each RCF (Zhou 1997). In Xiangfan Municipality, Hubei Province, a municipal RCF office attached to the municipal agricultural department conducts an annual audit, sends inspectors to all RCFs once every quarter, and initiates unannounced

³⁸ Yang Zonglian (1997) takes a particularly ardent view against any audit by external institutions except the agricultural departments.

³⁹ In at least one municipality in Shaanxi Province an unspecified degree of consultation takes place between the agricultural departments on municipal tier and the municipal PBC branch. This appears to be an exception. Secondary literature on higher-level tier coordination reports exclusively on the establishment of county tier and municipal tier RCF offices within the agricultural departments. (See, for example, Chen and Liu (1997) or Pang, Zhang and Li (1997).

examinations (Chen and Liu 1997). Auditing practice thus varies from internal financial reports only to frequent external audits. However, no audit is ever made by any institution that is not also directly or indirectly involved in the running of the RCF, questioning the quality of any audit.

The accumulation of dubious loans poses a significant long-term solvency problem with implications in the short run. A bad loan problem in a RCF can easily trigger irresolvable liquidity problems once depositors lose confidence in the RCF, well knowing that RCFs are not state-guaranteed financial institutions. In contrast to the formal financial sector, where any short-term liquidity problems are bridged by the PBC as lender of last resort, the RCF is left to its own means to resolve bank runs. Consequently, RCFs maintain 10% to 40% of their assets as deposits at state commercial banks.⁴⁰ RCFs, like state commercial banks, also require depositors to give advance notice in the case of large cash withdrawals. These precautionary measures are sufficient for everyday business. They are, however, insufficient in the case of extraordinary events.

For example, in one particular RCF the manager succeeded in evading all controls and to lend up to a third of the RCF's assets to a friend with the loans subsequently not being repaid on time. The county government and Party Committee had to refrain from taking legal or disciplinary action against the manager for the sole purpose of not publicizing the event. The RCF would not have been able to withstand a bank run and

⁴⁰ Reserve practices vary from locality to locality and are specified either as maximum lending ratios or as explicit reserve ratios. Thus RCFs in the municipal-level Suizhou City, Hubei Province, may not lend out more than 60% of the funds collected (Pang, Zhang and Li 1997). RCFs in county-level Taixing City of Taizhou Municipality, Jiangsu Province, maintains a 15% reserve (and a 80% lending limit); 5% reserves are kept as cash in the RCFs or as current deposits at banks and RCCs, 5% are invested in time deposits at banks and RCCs, and 5% are maintained by the municipal joint RCF for quick adjustment purposes (Jiang and Wu 1997).

the county government would not have had the financial prowess to guarantee all loans. A similar instance of misuse of funds in Sichuan Province in 1996 triggered immediate bank runs and required PBC cooperation to be resolved. (*Renmin ribao* 1996/11/25) In 1997 bank runs on RCFs in Langfang Municipality, Hebei Province, induced the municipal PBC to ensure that RCF reserves with the formal financial sector would be withdrawable at all times.⁴¹

Macroeconomic implications of RCF expansion and financial health

While the PBC is denied any significant role in the supervision of RCFs, bank runs on RCFs impact on PBC operations. RCF failures so far have always triggered PBC-led support and rectification measures as local government finances are insufficient to guarantee RCF deposits.⁴² This raises the issue of moral hazard. RCFs use their competitive advantage over the formal financial sector to gain market share and to advance local economic growth which benefits the local government; but should the RCF fail the PBC is called upon and forced to step in by the sheer magnitude of impending local social disorder. RCFs thus may enjoy the best of two worlds: supervision-free, high-interest rate banking and a safety net in case of failure. Local government departments have incentives to push RCF development to the limit as the costs of failure falls incommensurably on the PBC.

⁴¹ See *Hebei Economic Yearbook 1998* (Beijing: Zhongguo tongji chubanshe, 1998), p. 60. The report does not state the cause of the bank runs on the RCFs; perhaps the formal financial sector was unable to repay RCF deposits in the first place?

⁴² Although the PBC has publicly refused to refinance illiquid RCFs, in emergencies it may well have extended help indirectly through formal financial sector institutions.

But RCFs also affect PBC operations under normal circumstances. RCF deposits are unreported and therefore not included in money supply measures. If formal financial sector money supply growth is 10% per year but RCFs gain a market share of 5% of actual (formal and informal financial sector) deposits in the course of one year, then—assuming the absence of an informal financial sector before—money supply growth is in fact 15.5% rather than 10%. Money supply growth rates as published by the central bank thus may well be several percentage points off the actual money supply growth rates. Such a divergence could have a substantial effect on any central bank fine-tuning of monetary policy.

RCF development also affects the central bank as well as the central government indirectly via the formal financial sector. RCF growth implies that these funds are not being deposited with the formal financial sector and that, in addition, past deposits with the formal financial sector may be switched to RCFs. Enterprises which know that they are unlikely to obtain a loan from the formal financial sector in the future but that they can rely on RCF funding, may stop paying interest on their formal financial sector loans if not repayment of the principal altogether. The formal financial sector is left with an increasing share of overdue loans and falling profitability. The PBC as lender of last resort is forced to bridge any liquidity problems in the formal financial sector, while the central government will in the final instance have to pay for the formal financial sector's bad loans.

Conclusions

If the rise of the RCFs is in fact accompanied by costs accruing primarily at the PBC and the central government, why did the SC not prevent the RCFs from taking over a significant share of rural finance? The conventional answer is that RCFs, quietly established over the past years, have already grown too large to be dissolved. But why then are they not folded into the RCCs which at present are already under reorganization by the PBC? If RCFs were merged into RCCs, local governments would have no incentives to pressure their township- and village-run enterprises as well as other RCF borrowers into repayment of their RCF loans. Folding RCCs into RCFs, on the other hand, is likely to meet with resistance by local governments which view RCCs as centrally run institutions and have no incentive to take over responsibility for the RCCs' accumulated bad loans.

Retaining RCFs as separate non-financial institutions has advantages. Efficiently run RCFs provide rural enterprises neglected by the formal financial sector with loans at little above formal financial sector interest rates, thereby preventing the spread of less acceptable forms of informal finance charging usury rates. The central government may also realize that it will never be able to prevent local government meddling in local financial intermediation; RCFs offer at least a semi-regulated environment for such activities.⁴³ RCFs furthermore grant the type of small-volume, high-risk and high interest loans that the formal financial

⁴³ The development of the RCFs so far is part of the increasing division of the financial sector according to ownership of the real economy. In the past decade provincial development banks and investment companies as well as municipal (urban commercial) banks were set up to support the respective tier's state-owned enterprises

sector is unable to provide; their lending to rural enterprises and farmers is fully in line with the central government's desire to accelerate rural economic growth.

Are well-managed, local RCFs ushering in a monetary counterrevolution from the countryside? In contrast to the evolution of the household contracting system in agriculture in the early 1980s, RCFs are not privately run businesses changing the organizational landscape of financial intermediation in the countryside. However, RCFs constitute a counterrevolution from the countryside in that the times when the formal financial sector could easily siphon off cheap rural deposits into urban industrial and state-owned development have come to an end. Furthermore, the development of sound RCFs puts pressure on the formal financial sector to make available loans to traditionally neglected borrower groups and on the PBC to further liberalize interest rates.

One response of the PBC—apart from closing down some types of RCFs as illegal financial institutions—has been to require that RCFs offer deposit interest rates no higher than those of the formal financial sector; this is meant to stop the rapid growth of RCFs. But if the interest rate limit is not breached outright, dividend payments in addition to interest rates raise the de facto return on deposits (shares). If actual returns are market-driven, RCFs will simply continue to grow as long as those borrowers who do not have access to formal financial sector funds are willing to pay the higher RCF interest rates. The pressure for liberalization in the formal financial sector thus continues.

The attachment of RCFs to local governments and the RCF's government-influenced lending patterns are *prima facie* ironic given that the formal financial sector increasingly enjoys lending autonomy. The

and economic development. The only novelty in the case of the RCFs is that they

formal financial sector is abandoning the mandatory credit plan, while the RCFs perpetuate direct government interference in lending decisions. But the formal financial sector still lends in accordance with state policies and the—now indicative—credit plan. Liquidity problems are resolved through the PBC while the central government implicitly guarantees their solvency. Local governments and Party committees, on the other hand, have no recourse to PBC or central government should their RCFs fail. With local government budgets by far insufficient to bail out a RCF in severe trouble, lending decisions must take into account the economic viability of a project. The absence of a lender of last resort for RCFs thus is an incentive for sound banking.

Research by Sicular (1996) on agricultural procurement suggests that the distinction "state" vs. "non-state" agents is no longer meaningful and should be replaced by a distinction between officially designated procurement agents vs. other, non-designated commercial agents. In the case of rural finance, a similar argument runs to the effect that what matters are the degree of regulation and the prevalence of a hard budget constraint. RCFs can successfully fulfill their niche function and serve a clientele largely excluded from formal financial sector lending because of the absence of restrictive regulations of the type that apply in the formal financial sector, while the hard budget constraint of RCFs creates incentives for fundamentally market-oriented lending decisions.

But financial intermediation differs significantly from agricultural procurement in that individual household depositors have long-term stakes in the financial institution. The depositor thus would like to ascertain the RCF's financial health. RCFs then have a significant advantage over private sector competitors: where private sector financial

remain outside the central government's formal financial sector regulatory scope.

institutions could face difficulty in gaining depositor trust in the early years of their existence, the attachment of RCFs to local government departments drastically lowers monitoring costs for individual depositors by providing an implicit deposit insurance guarantee. Although it may appear paradoxical given the usual belief in the need for wide-spread privatization during economic reform, government ownership or government management of RCFs could be superior to dispersed private sector solutions.

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Appendix: Characteristics of Selected RCFs

	Case 1	Case 2
Official name	XXX County TVE Cooperative Fund	XXX County TVE Cooperative Fund
Location	Shaanxi Province	Shaanxi Province
Superordinate dept.	County TVE Bureau	County TVE Bureau
Date of establishment	10 May 1994	2 August 1996
Registration	<ul style="list-style-type: none"> * 12 May 1994 approved by county government; * approved by provincial TVE bureau; * June 1994 registered as social organization legal person at the local Civil Affairs Administration 	<ul style="list-style-type: none"> * 6 May 1996 approved by provincial TVE bureau; * approved by county government and Party
Capital structure	mid-1997: Municipal Finance Office 1m yuan, legal persons 800,000 yuan; individuals 800,000 yuan	
Branch network and employees	<ul style="list-style-type: none"> * Headquarters with office in county, branches in 25 out of 44 townships; * Approx. 80 employees, one employee in each branch has been seconded (and is paid for) by the township economic committee; the salary is in part linked to handling fee income in that branch 	10 offices with 160 branches
Management structure	<ul style="list-style-type: none"> * Head of county TVE bureau trade union is manager * Head of county TVE bureau is chairman of the board of trustees (<i>dongshihui</i>)—there exists no board of directors (<i>lishihui</i>) * Deputy-chairmen of board of trustees: deputy-head of county TVE bureau, deputy head of county finance bureau * Other members of board of trustees: one person from county TVE bureau, one person from county finance bureau, one enterprise director 	<ul style="list-style-type: none"> * Board of directors (<i>lishihui</i>): chairman with 30 years of experience in rural finance; 3 deputy-chairmen and 2 members with prior experience as enterprise accountants * Board of trustees (<i>dongshihui</i>; part-time officials of cooperative fund): enterprise director as chairman, 2 members (cadres)
Supervisory board	None	<ul style="list-style-type: none"> * Chairman: deputy-head of county TVE bureau; member: agricultural cadre * Meets once/month * County auditing bureau conducted external audit in 1997
Shareholder meeting	Meets once per year to decide on profit distribution and to select board of trustees	
Deposits	<ul style="list-style-type: none"> * Deposits and shares (maximum number of shares per individual: 3 at 1000 yuan; minimum number of shares per legal person: 30,000 yuan) * Total volume approx. 30m yuan (1997 and April 1998) 	<ul style="list-style-type: none"> * No distinction between deposits and shares; maturity matters * March 1997: 18.56m yuan; April 1998: approx. 50m yuan * In 1996 and 1997 absolute deposit growth at state banks in this county was only 1/3 of absolute deposit growth at this cooperative fund [not independently verifiable]

Government support in collecting deposits	<ul style="list-style-type: none"> * Municipal finance office uses TVE support funds as capital contribution at 0.6% annual fee * At early stages, county government and Party organized mass meetings; government departments and townships were given deposit tasks (county government also issued encouraging documents in March 1995 and April 1996) 	<ul style="list-style-type: none"> * Provision of start-up capital, later withdrawn; propaganda support
Return on deposits and shares	<ul style="list-style-type: none"> * 10% above corresponding interest rate at state commercial banks minus handling fee (0.4 yuan per current account transaction, 1.6 yuan per 1000 yuan time deposit) * Total yield on individual-owned shares in 1996 (dividend plus 1.1 times bank interest rate): 22.74% [for comparison, bank interest rates on all maturities were below 10% in 1996] * Dividend on legal person shares (no interest element) in 1996: 15% 	<ul style="list-style-type: none"> * 1997: approx. 15-20% * April 1998: interest rate on one-year deposits 8.28% (vs. bank rate of 5.22%) * Shares also carry dividend * Interest rates are determined by county agricultural department
Loans	<ul style="list-style-type: none"> * Loans should have 3 characteristics: small in volume (less than 200,000 yuan), used as working capital, short-term (to be repaid within 3-6 months); loans are supposed to be backed with collateral or by guarantors * Volume: 60-70% of deposits (30-40% of deposits are held at all local banks and earn a "financial unit interest rate" higher than bank interest rates on deposits by households or enterprises) * Number of loans outstanding (June 1997): 141 * Maximum maturity 1 year, usually less than 6 months * Customers are mainly township-run enterprises, some village-run enterprises, few individuals * Number of overdue loans (June 1997): 94; volume of overdue loans: 55% of total loans outstanding 	<ul style="list-style-type: none"> * Lending structure (March 1997): county TVEs 4.2m yuan; farmers 8.78m yuan; 6m yuan reserves kept mainly at the Industrial and Commercial Bank of China branch * Number of customers: several hundred
Loan approval structure	<ul style="list-style-type: none"> * Formal structure * <50,000 yuan: manager; * 50,000-<100,000 yuan: chairman of board of trustees; * 100,000-<200,000 yuan: "leadership group"; * 200,000 yuan up: board of trustees; * Heads of township economic committees in practice direct some small-scale, short-term lending without official approval 	<ul style="list-style-type: none"> * Branch manager maximally 500 yuan; office manager maximally 3000 yuan; all larger loans must be approved by the board of directors
Interest rates on loans	<ul style="list-style-type: none"> * Shareholders 14.42% per month, non-shareholders 16.08% per month (June 1997); vs. bank 9.5% per month but not available 	Not published and not available
Transfer payments	Through any bank	Through any bank
Reporting duties	None	To county TVE bureau
Relationship to PBC	None	None
Others	Using rural credit cooperative deposit/ withdrawal forms	Using own deposit/ withdrawal forms
Source of information	Interviews in 1997 and 1998, cooperative fund documents	Interviews in 1997 and 1998, cooperative fund documents

	Case 3	Case 4	Case 5
Official name	XXX County Urban District Rural Cooperative Fund	XXX Municipality XXX District Rural Cooperative Fund	XXX Municipality Rural Cooperative Fund
Location	Shaanxi Province	Shaanxi Province	Hebei Province
Superordinate dept.	County Agricultural Department	District government (finance department)	Municipal Party Committee Rural Work Department and Municipal Agriculture and Forestry Office
Date of establishment	24 July 1994	1992	Early 1996
Registration			13 November 1996 with Municipal Agriculture and Forestry Office
Capital structure	400,000 yuan by county government	Start-up capital was supposed to be provided by district finance dept. but then never needed	
Branch network and employees	20 branches with approx. 200 employees, some seconded from government organs	10 branches with approx. 100 employees primarily seconded from district finance department; also some outside hiring (such as from out-of-province PBC)	Office with 2 branches; employees are from Municipal Party Committee Rural Work Department
Management structure	Board of directors appointed by shareholder meeting for three years	* Manager and deputy-manager seconded from district finance department * Board of directors consists of district finance dept. personnel on part-time basis	One manager from Municipal Party Committee Rural Work Department
Supervisory board	Exists	Board of directors has policy and supervisory tasks	
Shareholder meeting	Selects Board of Directors and Supervisory Board; one shareholder one vote	Twice per year	
Deposits	<p>* Basic share costs 20 yuan; membership is acquired by holding 5 shares, this allows participation in shareholder meeting; basic share carries interest and dividend, supposedly not returnable</p> <p>* "Fixed share" (maturity exceeds 1 year) carries interest for non-members and interest and dividend for members</p> <p>* Volume at main office (20 Dec. 1997): 25m yuan by 600 shareholders and depositors</p> <p>* Volume at all offices/ branches (end-1997): 120m yuan by 20,000 shareholders and depositors [for comparison, all local state bank branches have 400m yuan of deposits, all county rural and urban credit cooperatives 200m yuan; not independently verifiable]</p>	* 230m yuan as of mid-1997	(There are 34 rural cooperative funds in this municipality with total deposits of 6000m yuan.)
Government support in collecting deposits		District government mobilized employees	

Return on deposits and shares	April 1998: 8.28% per year plus dividend for members	One percentage point above state bank deposit rate	<ul style="list-style-type: none"> * Deposits below 1000 yuan: approx. 2%age points above bank deposits (depending on maturity) * Deposits above 1000 yuan (mid-1997): <ul style="list-style-type: none"> 1-year: 13.2% (vs. 7.47% at state banks); 2-year: 16.8% (vs. 7.92%); 3-year: 20.4% (vs. 8.28%) * Among others, loans for local government capital construction projects * Safety deposit held at Industrial and Commercial Bank of China
Loans	<ul style="list-style-type: none"> * Preferential availability for members as short-term working capital * Lending structure: 8m yuan for ten large undertakings of county Party Committee and government; loans to more than 1000 farmers; 20% of assets are held as safety deposit at Agricultural Bank of China as mandated by the county PBC branch 	<ul style="list-style-type: none"> * Focus on short-term working capital loans of less than 1 year maturity backed with security and/or guarantors; no limitations on individual borrower (includes support for district-run enterprises) 	
Loan approval structure			
Interest rates on loans			<ul style="list-style-type: none"> * Mid 97: 15-18%^{ee} per month
Transfer payments	Through Industrial and Commercial Bank of China		Through Industrial and Commercial Bank of China
Reporting duties		To district finance department	
Relationship with PBC	<ul style="list-style-type: none"> * County PBC branch requires 20% of assets to be held at Agricultural Bank of China as safety deposit * PBC supervises municipal cooperative fund administration office in agricultural office 	<ul style="list-style-type: none"> * PBC may request short-term lending by rural cooperative fund to state commercial bank 	None
Others	<ul style="list-style-type: none"> * Denying any government influence on lending while administration of rural cooperative fund is located within the county government building 	<ul style="list-style-type: none"> * Agricultural Bank of China provides training for employees of rural cooperative fund * Provincial Party head personally encouraged the growth of this cooperative fund in 1997 	
Source of information	Interviews in 1997 and 1998, cooperative fund documents	Interview in 1997	Interview in 1997

Derivation of estimate of rural household deposits

As the official “rural household deposits” are in effect nothing but household deposits at RCCs, urban (*chengzhen* or *shizhen*) vs. rural (*nongcun*) household deposits were constructed in the following way. First, annual increases in deposits (“depositing”) by urban vs. rural households were constructed from urban as well rural survey data on household income and household expenditures. Second, 1990 total household deposits as given by official sources was split into urban vs. rural according to the relative size of urban vs. rural depositing in 1990. 1991 and later years’ urban vs. rural household deposits were constructed by taking the previous years’ deposits and attributing the official increase in total household deposits to urban vs. rural households in accordance with their current year depositing shares.

Since urban and rural surveys differ significantly in the items surveyed, the first step in turn required a number of calculations. In the case urban households, living expenditures (*xiaofeixing zhichu*) were subtracted from income for living expenditures (*shenghuofei shouru*). Income for living expenditures is total income minus all kinds of taxes and various other items such as presents. It presumably is net of business expenditures by privately- (and individual-) -run enterprises. In the case of rural households, annual expenditures were subtracted from total income. Annual expenditures include household business expenses, living expenditures, “other nonproductive expenditures” and an unspecified residual (which presumably includes taxes). Depositing thus derived is almost equal to depositing derived as net income (*chun shouru*), i.e., income net of taxes and business expenditures but inclusive of all kinds of subsidies, minus living expenditures and other nonproductive expenditures. The first measure of depositing was then used. Depositing per capita thus derived for urban as well as for rural households was then multiplied by the number of persons living in urban vs. rural areas according to the population statistics.

Total depositing by all urban and rural citizens is equivalent to slightly below one half of the annual increase in official total household deposits across all years; reasons for the divergence may include inexact surveys, inexact construction of depositing here given the insufficient definitions of terms offered, and other factors such as borrowing by households—which is not included in any of the income items available—leading to deposits also outside the survey categories. As long as such flows occur in equal proportion relative to the income measures used here in both urban and rural areas they have no impact on the estimates used here. The approximations here are only constructed to obtain urban vs. rural depositing shares; these shares were then applied to official total household deposits (or increases thereof). Another complication is that urban areas include township-towns (*zhen*); the relevant rural share in the context here should thus be larger than estimated.

Sources for household deposits: ZGJRNJ 1997, 467; ZGTJNJ 1998, 105, 326, 344; ZGTJNJ 1997, 293; ZGTJNJ 1996, 282; ZGTJNJ 1995, 262, 278; ZGTJNJ 1993, 286, 311.