

Gold in China's Rural Hills

by Lynette Ong

IF YOU ARE wondering where to park your investments as global financial markets tumble, rural credit in China may offer a silver lining. But, it's important to make the right pick from a basket of good and bad eggs.

The rural financial market in China serves the financial needs of 750 million farmers and a growing number of vibrant small- and medium-sized enterprises in a vast area covering 2,800 counties, 40,000 townships, and at least 400,000 villages. While it is traditionally not on the radar of profit-seeking investors, the recent market liberalization introduced by the central government is changing that. Competition is being introduced to the 35,000 rural credit cooperatives (RCCs) that monopolize the sector around the country, even though most of them operate inefficiently and carry huge nonperforming assets.

As of July 2008, 30 township and village banks (*cunzhen yinhang*) were being set up in various rural locales, and the number is expected to double by the end of 2008. These rural banks have full banking licens-

es—they can issue loans, take deposits, and go the whole nine yards in terms of offering financial services, though rural China may not be ready yet for sophisticated products. Nonetheless, this represents a great change in the attitude of China's central banking officials who have traditionally been obsessed with where farmers keep their hard-earned savings—an issue inherently connected with political stability in the countryside. Chinese history is filled with cases of peasant revolts when poor farmers lost their nest eggs. After being in China for a decade or more, many NGOs or NGO-operated microfinance programs are still not allowed to accept savings from farmers, which means they have to obtain their funding from charitable sources.

These newly established township and village banks face almost no ceiling on lend-

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ing rates, which is another breakthrough from a major problem that besets rural lenders in China. Like the commercial banks in the big cities, the township and village banks are allowed to float the lending rates up to four times that of the central bank's base rate. This gives them wider profit margins compared to the market incumbents, the RCCs, which still face a ceiling rate of 2.3 times.

The London-based HSBC made footprints in a rural district in Hubei Province in December 2007. Apparently, it intends to open another rural bank in Chongqing in western China in the near future. Media reports indicate that Citibank, Standard Chartered and the Bank of East Asia, among others, are also in the process of acquiring rural banking licenses. Domestic regional banks, such as the Nanchong City Commercial Bank and the Harbin City Commercial Banks, have also made their presence known in the rural credit sector.

Primarily owing to political reasons, the rural-credit market was off-limits to domestic and foreign interests until 2007, despite the fact that the existing financial institutions are ineffective in meeting the market demand. The Agricultural Bank of China withdrew its networks from rural China in the late 1990s in an effort to reduce operation costs and improve its profitability. Its bank branches are now only found in county-level cities and some highly industrialized townships. This means that the RCCs have a monopoly on the vast majority of rural China, particularly townships and villages where most farmers reside. The RCCs are the sole financial institutions providing services to hundreds of thousands of SMEs and millions of farmers whose credit needs range from borrowing 100,000 yuan (around \$14,000) to expand their business, to borrowing just a few thousand yuan to invest in cattle, to getting a couple of hundred yuan to pay for a relative's funeral or wedding. The prob-

lem is not simply massive inefficiency and all the excesses of a monopoly, but also a lack of variety of institutions to meet the diverse range of credit demands.

Yet, those who think there is no profitable opportunity in rural credit should look to the Postal Savings in China for inspiration. Until the recent institutional changes, the Postal Savings that has an extensive national network offered only deposit and remittance services. The latter is a much-appreciated service for the hundreds of thousands of migrant workers in the cities who use it to remit funds to the villages. The modest fees that the Postal Savings collects from its remittance service (and some earlier subsidized interest income from the Central Bank) were sufficient to make it so profitable that it had crosssubsidized its loss-making parent company, China Post, for many years. Two years ago, the central government transformed it into the China Postal Savings Bank, a full-fledged bank that can lend microloans to its clients.

When referring to "rural credit," it is critical to recognize what "rural" really means. Rural China is often associated with the impoverished and bucolic backwater of the country, which can be a misperception. Here are some interesting facts from of the country's richest counties (which are cities two administrative levels below the provincial capitals): the per capita income in the 100 richest counties was 21,000 yuan in 2003, which was three times that of an average county, and more than double the national per capita income. These rapidly growing counties are far from "rural": industrial production accounts for 55% of the GDP in these areas, while the agricultural sector contributes merely 12%. Hence, rural China is a vast area that covers some rapidly industrialized small cities and towns, as well as the pastoral countryside.

Lately, the Chinese press is littered with news that many private firms are on the verge of collapse due to a severe credit

crunch. The credit crisis faced by these private enterprises is not only cyclical in nature, but also caused by some fundamental structural issues. Traditionally, the government established banks to provide credit to the state-owned enterprises; private enterprises were systematically discriminated against. The fact that private ownership was not legally recognized until the early 2000s also did not help private entrepreneurs to secure bank financing. Moreover, because banks in China, particularly those located in rural areas, lack effective techniques of assessing borrowers' risk profiles, they either refuse to lend to private borrowers, or they employ political connections (*guanxi*) as a means to mitigate default risks. Until recently, bank officials could get fired if the loans to private enterprises they have approved turned sour; but the same could not be said for loans to the SOEs. It is no surprise then that most loans end up being allocated to politically connected firms. Local government-related enterprises and projects tend to get the bulk of bank financing in the rural areas.

The Chinese Communist Party's Central Committee meeting in 2008 heightened the general awareness of the lack of legal recognition for collective ownership, and how it has impeded rural borrowers' access to credit. Most factories or offices of rural enterprises are built on land that was previously used for farming and is collectively owned. This means that enterprises or borrowers cannot use the rural land, which is often their most valuable asset, as collateral. Unfortunately, the Central Committee fell short of transferring the land ownership rights to farmers or allowing them to collateralize farmland as widely expected, and instead merely reaffirmed the existing practices of the subcontracting and transferring of land-use rights.

Innovation is essential to overcoming the systematic hurdles that private borrowers face in the rural credit sector. Foreign

expertise may prove to be relevant and useful in this area. Currently, rural banks use a combination of strategies to mitigate risks, including requiring deposit guarantee, guarantors and imposing higher lending rates on perceived higher-risk borrowers. But none of these strategies are ideal, as they tend to favor the more established borrowers or those with social connections.

Before the central government's 160 billion yuan bailout in 2003, most of the 35,000 RCCs nationwide were plagued by mountains of nonperforming loans. The average NPL rate (as a percentage of total loans) was officially estimated to be as high as 50% in the late 1990s. The actual rate is likely to have been much higher. RCC reforms were part of efforts by the administration of President Hu Jintao and Premier Wen Jiabao to pay attention to the increasing urban-rural divide and the plights of farmers. A few reform measures were introduced, such as setting up credit unions at the provincial level to manage the grass-root credit cooperatives; providing subsidized wholesale loans to the RCCs to encourage them to lend to agricultural projects; and introducing various corporate-governance rules that have mostly resulted in changes in form rather than in substance. The Central Bank also paid 160 billion yuan to bail out the credit cooperatives with negative net worth, which are those with excess liabilities over asset value. (The provincial governments were supposed to match the Central Bank's contribution, but there is little evidence that the money has come forward.) The bailout reflects a key political consideration of the central government.

Under market conditions, any financial institution that has negative net worth is technically bankrupt, and should be closed down because any further loss will eat into the owners' equity. Yet, the RCCs must continue operating, as shutting them down will deny millions of enterprises and farmers access to their only formal channel to cred-

it. However, the central policy makers recognized that such measures could yield only limited improvements if the credit cooperatives continue to monopolize the sector. This is essentially their rationale for opening up the sector to competition.

Currently, the township and village bank licenses approved by local banking regulatory commissions allow banks to conduct business only in designated counties. This means a bank granted a license to operate in one county is not permitted to set up branches in a neighboring county. Though this currently entails significant fixed costs for the investors, one should not rule out further market relaxation given the speed of liberalization in recent years. Despite the restriction, rural banking licenses are attractive to domestic regional banks, such as the city commercial banks, eager to expand their presence beyond the geographical boundaries within which they have been restricted. By acquiring a township banking license in rural Sichuan Province, for example, the Nanchong City Commercial Bank is able to venture beyond the boundary of the city.

Microcredit companies are another type of financial institution that the central government has introduced in the recent reform. Yet microcredit companies have attracted only limited interest thus far; new set-ups can be found only in inland provinces such as Sichuan, Gansu and Inner Mongolia. The major constraint faced by these companies is—unlike the full-licensed township and village banks—they are not allowed to take deposits, thus they must source their capital elsewhere. But, the investors in the credit companies need not be financial institutions; any private individual or enterprise can become an owner.

Foreign donors or investors need to recognize that an imported model—that is not modified to suit local circumstances—is unlikely to work. China is not new to microfinance, which to varying extent is based on the Grameen Bank model in Bangladesh. But these NGO-run microfinance programs in China face many hurdles. For instance, unlike Bangladesh, most of the rural poor in China live in remote mountainous areas that are harder to reach and organize into small groups. Consequently, such programs in China face higher transaction costs than those that have been successfully implemented in other developing nations.

The rural credit sector has long been recognized by the central government as the “weakest link” in the country’s financial industry. However, no single central agency has taken charge of industry reform until recently.

The China Banking Regulatory Commission (CBRC), an offshoot of the Central Bank, has been put in charge of creating a modern rural financial sector for the New Socialist Countryside. Rumor has it that the new banking regulatory commission is eager to outshine its predecessor, and some degree of bureaucratic infighting among the ministries is not uncommon or necessarily unhealthy. The eager-to-perform CBRC is expected to further liberalize the rural credit sector in the near future.

The rural credit sector in China may be primitive by international standards, but the regional economies it serves are a hodgepodge of rapidly industrializing, peri-urban counties and subsistent agricultural areas. Rural banking can be profitable in China, but it’s important to identify the right locales. And, investors should be prepared to pay some tuition fees upfront to learn the local rules of the game. ■

Rural banking can be profitable in China but investors may need to pay some tuition fees to learn the game rules.