China's Rural Enterprises in Crisis:

The Role of Inadequate Financial Intermediation

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The slowing down of an important engine of growth

Up to the middle of the 1990s, the rural sector provided the main economic mechanisms to translate China's market reforms and economic opening into higher output growth. The decollectivisation of agriculture made that sector a slightly bigger engine of growth than the state-dominated industrial sector in the 1979-1983 period. Just as the one-time productivity gains from the decollectivisation was nearing exhaustion in 1984, the further easing of restrictions on entry by non-state enterprises into the industrial sector allowed the emergence of a new engine of growth in China's countryside -- the township and villages enterprises (TVEs).

The original policy of allowing diversification in the ownership of industrial enterprises was designed to prevent capitalist enterprises from taking over what Lenin has called the commanding heights of the economy. In theory, non-state enterprises that employed more than 7 non-family employees had to be owned by the local community collectively, and those that had up to 7 non-family employees could be registered as individually-owned.\(^1\) So the term TVE originally applied only to collectively-owned enterprises.

However, over time, with growing differences across localities in the registration requirements of TVEs, in the management of its operations, and in their supervision by local authorities, different species of TVEs appeared. By the end of the 1980s, some regions even differentiated between collective TVEs and non-collective TVEs, making it clear that the term TVE was not an analytic statement that connoted public ownership. Reading the

\(^1\) Marx had stated (casually) that 7 workers was the cutoff between a family workshop and a capitalist enterprise.
literature on TVE ownership can be akin to listening to descriptions of an elephant from the three blind men of Hindustan who had each touched a different part of the beast.

Official statistics have increasingly referred to all rural enterprises as TVEs, and we have adopted this convention in this paper. To prevent possible confusion, we should mention a word on the official nomenclature used for statistical categories. It is common for data on output by ownership type to find the ownership universe encompassed by (1) state-owned (2) collective-owned (with a rural subcategory) (3) individual-owned (with a rural subcategory), and (4) other ownership forms. These terms were coined in the mid-1980s when almost all rural enterprises fell within the rural subcategories of collective-owned and individual-owned. Since 1993, collective TVEs in many areas have implemented insider privatisation to convert themselves into shareholding cooperatives. It appears that the statistical reporting system has continued to put rural enterprises under the two rural subcategories. Many times, however, the official statistics would present data only under the heading of "collective-owned" and "individual-owned." In these situations, we will use the data for these two categories to proxy for their rural components because even today the bulk of output from collective-owned and individual-owned enterprises are from the rural subcategory. The numbers will hence overstate the actual values of the rural enterprises but the trend in the data is most probably correct.

The biggest contributor to growth in China since 1984 has been the industrial sector, which is typical for a developing economy undergoing industrialisation. Table 1 shows that by 1986, rural enterprises could have contributed as much as the state-owned enterprises (SOEs) to the growth rate of total industrial output. Since 1988, the rural enterprises have contributed more every year to the growth of industrial output than the SOEs. However,
recently, this rural engine of growth has shown signs of slowing down. In 1997-1999, it contributed only 5.2 percent points to the growth rate compared to 7.3 percentage points in 1984-1988 and 13.0 percentage points in 1992-1996.\(^2\)

This slowdown in rural industrial growth was the result of a slowdown in the expansion of production capacity. Table 2 reports that there has been a secular decline in the investment of rural enterprises. They invested an annual average of 8.5 percent of GDP in 1984-1988, 7.8 percent in 1992-1996, and 7.5 percent in 1997-1999. What is unusual and should be of concern is that this secular slowdown in rural fixed asset investment runs counter to the overall investment spending in the economy. In the same three periods, the national investment rate has climbed from 30.7 percent of GDP to 35.0 percent and then dropped slightly to 34.8 percent.

This slowdown in rural investment is a country-wide phenomenon. Table 3 compares the average investment of TVES and SOEs across provinces in the 1987-1987 period and the 1998-1999 period. TVEs in the three metropolises with province-level status, and in all the provinces in the coastal, central and northeastern regions invested less in the second period. Omitting Tibet, TVEs invested less in 24 of the 30 provinces, SOEs invested less in 12 provinces, and total investment fell in 7 provinces. The TVEs are clearly slowing down in their growth. Because the rural industrial sector has been an important engine of growth, it is important to understand the causes of its slowdown so that a decision could be made if a response by the government is desired, and if it desired, what form should that response take.

\(^2\) We ignore the slow output growth 1989-1991 period because it was caused by an unusually austere macroeconomic policy and by uncertainty over the future direction of economic policy.
There are many possibilities for why the slowdown in TVE growth has occurred. Perhaps, the slowdown of TVE growth is the result of the general economic slowdown since 1994. Furthermore, export growth has been low in 1998 and 1999. Another possibility is that the TVE slowdown is the natural result of the increasingly porous nature of the household registration. Employers now can set up factories in the cities and still obtain cheap labor from the illegal migrants. A third possibility is that the widespread reports of the arbitrary collection of fees from the farmers by the local officials apply also to the owners of the rural enterprises. The TVE owners are certainly more lucrative targets.

There are many more possible reasons for the parlous state of the TVEs. Only a detailed empirical study can assess the relative contribution of each factor, and this is beyond the scope of this paper. In the rest of this paper, we will focus on how inadequate financial intermediation in the rural areas has discouraged investment.

Motivation for our financial sector focus

We have been led to focus on rural financial intermediation because we have been trying to understand the reason for the recent rise in the saving rate of urban and rural residents. Some observers have interpreted the rise in the saving rate to be a sign of general pessimism by the Chinese public. These observers claim that the urban workers are afraid of losing their jobs as a result of the forthcoming state enterprise reform. With the forthcoming cancellation of free housing, free medical care, and subsidized education, the workers are now saving more for the future. While this line of thinking may apply to urban residents, it is hard to see why it applies to the rural residents. This is because rural residents have little to fear about the loss of jobs in the state-enterprise sector because none of them are employed
there. They do not have to fear losing free housing because they never had free housing.

They do not have to fear losing their pension and other subsidies because they never had it in
the first place.

We suspect that one important factor for why the rural sector has increased its savings
rate is because the most dynamic industrial expansion in China since 1984 occurred in the
rural areas. Since these non-state firms in the rural areas could not borrow from the banks,
the only way they could establish themselves was through self-financing, which required the
wannabe entrepreneurs to save first. In the very first phase of rural industrialization, the
amount of capital that was needed to start a factory workshop was very low. After 16 years
of rapid industrial growth, the Chinese countryside is saturated with labor-intensive
enterprises. Competition is now very fierce. It no longer makes no sense to invest and open
the same type of factory workshop, rural enterprises have to move up to the next stage of
value added production. This new generation of rural enterprises will be much more capital-
intensive, thus requiring a much larger amount of startup investment.

Rural residents have responded to the higher capital requirements by increasing their
saving rates. The rising rural saving rate reflected not pessimism about the future but
optimism about the future. This phenomenon of investment-induced savings is not new.\(^3\) It
had happened earlier in Taiwan. Up until the mid-1980s, all Taiwanese banks were state-
owned. Every Taiwanese loan officer was personally responsible for any loan that went bad,
and so every loan officer minimized lending to small and medium sized enterprises, and lent
readily only to big business groups. During the 1960 to 1985 period, there was a steady rise
in the saving rate in Taiwan.

\(^3\) See Liu and Woo (1994) for theoretical discussion and empirical verification.
We now turn to look at the formal financial system in rural China, and at the sources of investment funds available there.

The financial system in rural China

The Agricultural Bank of China (ABC) was established in 1955 to provide financial services to the rural sector, and channel funds for the grain procurement purchases. Small-scale collectively-owned rural credit cooperatives (RCCs, Nongcun Xindai Hezuoshe) were started in the early 1950s, under the supervision of ABC, to be the primary financial institutions serving the rural areas. Although RCCs are independent accounting units owned by townships, or towns, or villages, or several villages jointly, they are, in practice, grassroots units of the Agricultural Bank of China (ABC). RCCs operate an extensive network of branches, savings deposit offices, and credit stations in market towns and remote areas. The number of RCC units rose from 389,726 in 1981 to 421,582 in 1984, and then fell steadily to 365,492 in 1995. We want to highlight this decline in the number of RCC units after 1984 because this decline means a decrease in the effort to mobilise rural saving, and a decrease in the access of the rural community to investment financing.

Table 4 outlines the changes in the operations of RCCS in the reform era. It shows three turning points that coincide with other changes in China’s economy. In 1978, RCCs lent only 27 percent of the deposits they collected in the rural area to finance rural economic activities. The first turning point was 1984 when the legal barriers against non-agricultural economic activities undertaken by farm households, and the establishment of rural credit stations. The number of RCC units is the number of RCCs plus the number of branches, saving deposit offices and credit stations. The number of RCCs (i.e. institutions with independent accounting systems) went up from 55,044 in 1981 to 60,897 in 1988, and then down to 50,219 in 1995. In 1995, RCCs accounted for 13 percent of deposits in all financial institutions, and 10 percent of all the loans made.
enterprises were lowered, and the RCCs were allowed to make more loans in the rural areas. RCCs’ loans to rural areas jumped from 34 percent of RCC deposits in 1983 to 57 percent in 1984. The proportion of RCC deposits going to rural loans increased every year in the 1984-1988 period, reaching 65 percent in 1988. 1984 was also a turning for the SOE sector, it received its first significant dose of operational autonomy.

The second turning point was 1989 when the incremental dismantling of discrimination against rural lending was suspended. It marked the beginning of a period of tight credit, re-introduction of some administrative curbs on investment spending, and uncertainty as to future state policies on economic reform and trade opening. The loan-deposit ratio of RCCs stayed at about 66 percent in the 1989-91 period. The third turning point was 1992 when economic deregulation accelerated after Deng Xiaoping’s inspection tour of southern China (nanxun) in early 1992, and enabled the loan-deposit ratio to continue increasing.

These three turning points produced distinctive economic responses. The suspension of reform in 1989 saw average annual investment (fixed capital formation) declined from 30 percent of GDP in 1984-88 to 25 percent in 1989-91, and the re-starting of economic deregulation saw the RCCs’ loan-deposit ratio jumped to 71 percent in 1992 and investment to rise to 34 percent of GDP in 1992-97. We will use the three distinct periods identified here to organize the discussion in the subsequent sections.

It would be right to say that until the mid-1980s, the RCCs, by relending the bulk of their deposits to ABC, serve primarily as tributaries by which rural savings were channeled to finance economic activities in the urban areas. RCCs still divert a significant proportion of their deposits to finance activities outside of the rural area, 27 percent of their deposits in
The general fact is that non-SOEs face great difficulties in raising funds. The financial system is dominated by the state banks, and the state banks lent primarily to the SOEs. The access to bank loans by non-SOEs get particularly bad during periods of tight credit. In 1989, ceilings were imposed on loans to rural enterprises; and working capital credit from banks to private enterprises severely curtailed. (Banks gave virtually no fixed capital credit to private enterprises before then.) The result was that the number of private enterprises dropped from 225,000 in mid-1988 to 98,000 in early 1991.

Private and small collective enterprises have always paid the higher interest rates in the informal credit markets. A 1992 field investigation reported that a fast-growing private electronic company\(^5\) paid an interest rate of 2.5 percent each month on its working capital; and its original start-up capital came from the savings of the partners and informal loans from friends. These informal credit markets, popularly referred to as “folk finance” (\textit{minjian rongzhi}), appeared to have increased greatly in scope in recent years.

Given the heavy reliance by rural enterprises on non-formal investment financing, a new informal financial instrument called employee bond (\textit{jizi}) has emerged as a significant source of funds. An employee bond is purchased by the new employee when she joins the enterprise, and it carries an interest rate at least equal to that of a time deposit with the same maturity. Many non-SOEs also issue a hybrid equity-bond instrument which, in addition to paying a fixed base rate, also pays a bonus rate -- the size of which is contingent on the profitability of the enterprise. In many cases, especially with rural collectives, tax exemption turned out to be an important source of investment financing. Since many counties, towns and villages are on tax-contracts with their upper levels that specify a fixed

\(^5\) Bao An county factory, September 28, 1992, Case A27 of author’s fieldwork.
amount, they typically start exempting taxes once their tax quotas were reached provided that the extra retained funds would be invested. ⁶

Sources of investment funding for rural enterprises

Table 5 tracks the financing of investments undertaken by enterprises of different ownership type. Part A focuses on where enterprises of each type of ownership obtained their investment funds by calculating the percent of investment that is funded by each financing source. Part B emphasizes the destination of the funds from each financing source by calculating the share of funds from each source received by enterprises of each ownership type. The definitions of the funding sources are as follows:

(a) State Budget: This source finances primarily projects specified in the state investment plan. The funds come from (1) direct budget appropriations, and (2) policy loans from state banks (that are, many times, backed by government deposits). The Chinese economic reforms have drastically reduced the scope of the state investment plan, and hence reduced “state budget” as a source of investment funding.

(b) Domestic Loans: Until the early 1990s, domestic loans were largely loans from the state banks that were backed by the banks’ own funds and non-government deposits. Domestic loans also include investment loans from local governments, and from finance companies.

(c) Foreign Investment: Funds from (1) bonds and shares sold to foreigners (including Chinese from Taiwan, Hong Kong, and Macao) - who may hold the controlling shares – and (2) loans from international organisations that are managed or guaranteed by the government.

(d) Self-Raised Funds: These funds come mostly from (1) retained earnings, (2) bonds/shares sold to workers within the enterprises, and (3) the supervising agencies of the SOEs.

(e) Other Funds: This is more than a residual category. It also encompasses funds that are raised in the formal and informal bond and stock markets. In our usage, there are only two formal bond and equity markets in China because only those in Shenzhen and Shanghai have

⁶ In the author’s 1992 fieldtrip, one Chongqing firm raised Y3 million from jizi to acquire its Y14 million of fixed assets, while a Chengdu firm raised Y1.5 million from jizi for the required fixed asset investment of Y8 million; case A39 and A34 respectively. One big Chengdu company was given tax concessions worth Y3.5 million a year to allow it to accumulate funds to double its present output; case A35.
legal recognition. So we call all the other bond and equity markets (quite numerous but less
developed in the poorer regions) “informal financial markets”.

Table 5 suggests two immediate policy issues for promoting the growth of the TVE sector. The first policy issue is that even though the SOE share of domestic loans has declined, SOEs continue to have disproportionate access to domestic loans and hence are retarding the growth of TVEs.

The second policy issue is that despite the drop in SOE share of total domestic loans, the rural sector’s share did not go up. The rural sector’s share averaged 18 percent in both the 1985-88 and 1992-95 periods. The loan share “released” by the SOEs went entirely to help finance the investments of the foreign-owned firms. The absolute amount of resources transferred by domestic loans to rural enterprises showed little change over time, 1.1 percent of GDP in 1985-88 and 1.3 percent in 1992-95, a paltry increase of 0.2 percentage point.

Regional contrast in the financing of investments by rural collectives

The only dataset that is consistent over time on the sources of investment financing for rural enterprises in different provinces is from the Township-Village Enterprises Yearbook (TVEY) published by the Ministry of Agriculture, and we face several difficulties in using it. The first difficulty is that the TVEY dataset covers only the component of the TVE sector that is registered as collectively-owned, i.e. only rural COEs.

The second difficulty is that the classification scheme for the sources of funds in TVEY is also different from the classification scheme in the China Statistical Yearbook (CSY), with the former being more detailed. From our analysis of the data and from our

7 The 1989 TVEY does not contain the investment financing information for 1998, so there’s a gap in the dataset.
conversations with the statistical authorities, it appears that the approximate correspondence between the two classification schemes is as follows:

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<th>China Statistical Yearbook</th>
<th>Township-Village Enterprise Yearbook</th>
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<td>State Budget</td>
<td>State Budget</td>
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<td>Domestic Loans</td>
<td>Bank and Credit Union Loans</td>
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<td>Foreign Investment</td>
<td>Foreign Funds</td>
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<tr>
<td>Self-Raised Funds</td>
<td>Funds from Supervising Agency + Bonds Sold to Employees + Other Internal Funds</td>
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<tr>
<td>Other Funds</td>
<td>Other Sources + Other Funds Raised Outside of the Firm</td>
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The third difficulty we face in using the investment data in TVEY is that, in some years, their values differ significantly problem with the investment data from the CSY. If the data in both sources are correct, then the data on investments by rural COEs in TVEY should always be smaller than the data investment by all (rural and urban) COEs in CSY. Such is not the case however. The TVEY data on investment by rural COEs data is smaller than the CSY data on investment by all COEs in the 1987-91 period, but larger in the 1992-96 period. The former is 66 percent of the latter in 1987, and 112 percent in 1996.

The larger investment figures in TVEY in the first-half of the 1990s could be due to exaggerations by local officials to make themselves look good. The exaggeration of TVE output is a well-documented phenomenon. For example, the 1996 CSY revised significantly downward the 1991-1994 gross industrial output from COEs and IOEs reported in the 1995 CSY, which were compatible with figures in TVEY. After the data revision, CSY reported 1993-95 gross industrial output from COEs and IOEs that were smaller than in TVEY. So it is likely that the TVEY investment data are also exaggerated. The implication is that we should not draw any conclusions based on the levels of investment reported in TVEY (e.g. investment as percent of GDP). To the extent that the degree of exaggeration in values are
roughly uniform across provinces, and across funding sources, then some ratios of these numbers could provide some useful information.  

With this point in mind, Table 6 is constructed to contrast the financing of investments by rural collectives in the coastal provinces and in the middle provinces in the 1987-95 period in two ways (a) the group’s share of funds from each source, i.e. the group’s share of the national total of each type of fund, and (b) the proportion of each group’s total investment that is funded by each of the funding sources. Since the use of the group average can mis-state the situation of a particular member of the group, we have also included the data for Shandong and Sichuan. Shandong is the most populated coastal province, and Sichuan is the most populated middle province. Since Shandong is the poorest of the coastal provinces, and Sichuan has a per capita income that is lower than the average per capita income of the central provinces, our discussion will be more sensitive to the financing situation in the poorer provinces within each provincial grouping.

The detailed data (available from author) show a highly unequal distribution of investment funds. Up to 1994, rural collectives in the five coastal provinces raised more funds from each financing source than rural enterprises in the eight central provinces. During the 1987-96 period, the coastal provinces attracted 47 to 60 percent of the national total of investment funds going to rural collectives while the central rural collectives attracted 16 to 28 percent. The disparity is even greater when we compare the poorer provinces within each provincial grouping. In 1996, rural collectives in Shandong accounted for 17 percent of

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8 The difference in magnitude between the TVEY data and the CSY data could also be due to many other reasons, e.g. possible differences in definition, changes in definitions over time in one source but not the other. We do know that the two sources generated their estimates from different samples – the TVEY relied on annual reports submitted to the TVE Bureau in the Ministry of Agriculture, and the CSY relied on a survey conducted by the Rural Socio-Economic Survey Organisation in the State Statistical Bureau.

9 Sichuan is also the most populated province in China.
the investment by all rural collectives, while rural collectives in Sichuan accounted for just 4 percent.

The data also show that state-directed investment funds did not seek to ameliorate this disproportional flow of funds to the coastal rural collectives. Until 1995, the state budget had always invested much more in the coastal rural collectives (over 40 percent) than in the central rural collectives (under 30 percent). The disbursement of investment funds by the supervising agencies is even more skewed than the state budget allocations, and the volume of funds from the supervising agencies is two to three and half times higher than that from the state budget.

We think that the unequal outcome is largely due to incomplete economic reforms, unequal regional policies, and natural geography, which together rendered the rate of return to capital higher in the coastal provinces than in the central provinces. The gradual dismantling of the central credit allocation plan started in the second half of the 1980s, and the permitted degree of financial market liberalization differed across provinces. The official toleration of informal financial markets occurred earliest, and is greatest, in the coastal provinces, and hence the informal financial markets in the coastal provinces have become the most developed in China. Because the interest rate in the liberalised financial markets are higher than the regulated interest rates of the state banking system, funds have flowed to the coastal provinces from the provinces which lag in financial deregulation and financial development.

The central government has extended special development incentives to many regions in the coastal provinces. These coastal regions are exempted from many economic regulations (e.g. those governing foreign investments), and from several type of taxes (e.g.
import duties). The central government also allocates more funds (via the budget and state banks) for infrastructure investment in the coastal provinces. In short, throughout the 1980s and the beginning of the 1990s, central government actions raised the rate-of-return on capital in the coastal provinces relative to the rate-of-return on capital in the central provinces by deregulating and favoring the coastal provinces more than the central provinces.

Finally, natural geography has also contributed to the higher rate of return to capital in the coastal provinces. The inadequate transportation network in China naturally meant that the economic opening of China inevitably allowed the coastal provinces not only to be the first to be integrated into the international division of labor, but also to be the only provinces (for a considerable period of time) to be integrated into the international economy.\(^{10}\)

Conclusion

The two most important issues in improving the financing of rural enterprises are: the financial system is over-regulated, and the RCC-ABC system lacks the organisational flexibility and incentive to focus on efficient local financial intermediation.

The **deregulation of the financial sector** must be accompanied by the introduction of adequate banking supervision and of prudential standards that comply with international norms. Deregulation involves at the minimum (1) allowing the establishment of privately-owned financial institutions; (2) freeing deposit and loan rates; (3) imposing identical supervisory oversight and prudential standards on state-owned, and private-owned banks;

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\(^{10}\) See Demurger, Sachs, Woo, Bao, Chang and Mellinger (forthcoming) for estimates on the relative effects of preferential policies and geographical location.
and (4) instructing the state banks to process loan applications equally without regard to ownership forms of the enterprises.\textsuperscript{11}

The above financial reforms will stop the disproportionate flow of credit to the SOE sector, and free up the funds for the more productive projects in the non-state sector; and allow the appearance of new small-scale local financial institutions that will mobilise local savings to finance local TVE investments. Folk finance (minjian rongzhi) was definitely the source of the development of TVEs in Wenzhou city in Zhejiang Province. Liu (1992) reported that:

"Ninety-five per cent of the total capital needed by the local private sector has been supplied by "underground" private financial organizations, such as money clubs, specialized financial households and money shops ..."\textsuperscript{12}

In the face of strong rural industrial growth in China up 1996, many informal rural financial institutions have sprouted to meet the financing needs of the rural industries. Since these illegal rural financial institutions lived under the constant threat of closure, and so they have tended to focus only on the short run and take more risks. It is therefore not surprising that these risky rural financial institutions often failed. Whenever they failed, the government had to bail them out in order to maintain political stability. The government has therefore been clamping down even harder on these illegal financial intermediaries, because the government does want to choose between the risk of bailing them out or the risk of

\textsuperscript{11} The Export and Import Bank of China has recently decided “to gradually expand its financial services to collectively-owned firms and joint-stock companies” and to continue making “the large- and medium-sized State-owned firms .. as its major clients” (China Daily, “Bank loans to non-State enterprise,” January 22, 1998). This decision is a step in the right direction, but it is a very inadequate one because of the continued discrimination against private enterprises – which makes a mockery of the heading of the article.

\textsuperscript{12} The power of market forces (when tolerated by the local authorities) to induce financial institutional innovations is an old story. Taiwan's small and medium private enterprises exhibited dynamic growth in the 1960-1985 period even though they were heavily discriminated against by the (wholly state-owned) banking system because informal financial markets (curb markets) appeared to cater to their needs, Shea and Yang (1994).
having social instability. The government's increasing strict enforcement of the ban on private financial intermediation is exactly opposite to what ought to be done. The efficient solution is to allow private financial intermediaries in the rural area, and bring them under proper prudential supervision.

The **reorganisation of the RCC-ABC system** can usefully draw upon the wealth of international experiences with various schemes in developing countries to direct investment credit to the rural areas. In particular, we wish to draw attention to the successful Indonesian experience of establishing a self-sustaining and profitable banking system (the **Unit Desa** system) in the countryside to provide a starting point for the discussing how to accelerate financial development in rural China. Indonesia is very similar to China in key economic and institutional features. Like China, Indonesia is a geographically vast, and heavily populated economy, and its rural financial system is dominated by branches of a state bank (Bank Rakyat Indonesia, BRI) which has been designated to serve the rural areas.\(^{13}\)

The Indonesian experience with the **Unit Desa** system suggests that the reorganisation of the RCC-ABC system be guided by five principles:

1. a large-scale subsidised credit program for the rural areas cannot be sustained because it is both too expensive and too inefficient;
2. the government must provide seed money to enable technical training, start the credit unit’s lending activities, and cover the losses for the first few years;
3. the rural credit unit must be given the incentive to maximise profits in a prudent manner, which means that each credit unit be given a large degree of operational

\(^{13}\) See Patten and Rosengard (1990), Woo (1995), and Yaron, McDonald and Piprek (1997) for details of the Indonesian case.
autonomy in return for being financially accountable to the supervising branch of ABC;

4. rural loan rates are generally higher than in the urban areas because they reflect the higher costs of making many small loans, and the absence of collateral to cover losses; and

5. no rural bank should be given privileges that allow it to monopolise the local market because the rural poor are many times unaware of their eligibility for loans, and only a bank that is facing competition will attempt to reach these groups with advertisement campaigns, and with mobile teams.\(^\text{14}\)

We want to end by re-emphasizing that the proposed ABC credit unit system could work satisfactorily only with competition from other rural financial institutions. Wenzhou’s experience with investment financing in the 1980s leaves no doubt about the beneficial effects of vigorous competition from folk finance on state-owned financial institutions:

“In order to compete with [the new folk finance institutions]... , as early as 1980 a local collective credit union, without informing the superior authority, abandoned for the first time the fixed interest rate and adopted a floating interest rate which fluctuated in accordance with market demand but remained within the upper limit set by the state. Despite the dubious legality of the floating interest rate, the local state bank branches and all the credit unions in Wenzhou had already adopted it before the central state officially ratified it in 1984.” Liu (1992).

\(^{14}\) Without competition, a bank may even actually reduce its presence in the rural areas like the 13 percent reduction in the number of RCC units in the 1984-95 period – echoing the textbook monopolist who maximises profit by restricting supply.
References


