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MICRO-FINANCE, POVERTY ALLEVIATION, AND FINANCIAL REFORM IN CHINA*

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Abstract

This paper assesses the potential role of micro-finance for poverty alleviation and financial reform in China in light of China's micro-finance experience to date and ongoing changes in China's economic, institutional, and policy environment. China's micro-finance movement began in 1994 and has experienced mixed success. Some small-scale NGO programs have demonstrated that the poor are capable of repaying loans at relatively high rates of interest and that such programs can achieve financial sustainability. But the uncertain legal status of NGOs, a strict financial regulatory environment, and inadequate financial management capacity prevent program expansion. Changes in credit demand associated with economic restructuring suggest that micro-finance is not well-placed to lead China's poverty alleviation efforts. As an example of innovative institutional design, China's micro-finance could help shape the direction of financial reform and play a future role in a diversified financial system.

1. Introduction

The goal of this paper is to assess the potential role of micro-finance for poverty alleviation and financial reform in China in light of China's micro-finance experience to date and ongoing changes in China's economic, institutional, and policy environment. Micro-finance programs have played a prominent role in the rural financial systems of a number of developing countries (*e.g.*, Bangladesh, Indonesia), and have been lauded for their ability to overcome traditional barriers to lending to the poor. They were first introduced into China in 1994, and since that time have achieved a mixed record of success.

Since economic reforms began, China has been undergoing rapid structural change characterized by rising incomes and fast-paced industrialization and urbanization. Many have been concerned that the rural poor, especially those living in remote areas, have been left out of this process, contributing to growing inequality. In particular, some have warned that poor farmers' access to credit has declined as financial reforms enable funds to flow to richer, rapidly growing urban areas either in response to the attraction of higher returns or due to implicit or explicit government policies biased in favour of urban areas. This creates concern because most of China's poor population continues to reside in rural areas, the recent emergence of urban poverty notwithstanding, and lack of credit has long been viewed

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as an important constraint to development in poor areas. Moreover, in recent years, the positive performance of some micro-finance programs in China has led to optimism that micro-finance models might help lift the poor out of poverty in a way that is financially sustainable and which could spur broader financial reform.

Of course, this train of logic rests on propositions that must be proven rather than assumed. This paper attempts to bring available empirical evidence to bear on these questions. China has moved slowly in reforming its financial system, delaying many liberalizing reforms until late in the transition process. Today China's financial system remains tightly regulated in several key areas, such as interest rates, competition, and inter-bank lending. However, China has committed to opening its financial sector to international competition under the terms of the WTO agreement, and substantial reforms of China's financial system appear likely to occur soon. This makes it a particularly opportune time to reflect on the potential role that micro-finance can play in a reformed financial system.

The paper is organized as follows. We first review the experience of China's micro-finance programs to date in section 2. In section 3, we analyze economic changes occurring in China, especially those affecting the poor, and their implications for the potential for micro-finance programs on the demand side. In section 4, we examine China's financial regulatory environment, the performance of China's rural financial institutions, and the impact of recent reform initiatives, which shape the feasible space for operating micro-finance programs on the supply side. Finally, in section 5, we discuss the role that micro-finance should play in poverty alleviation and financial reform in the future.

2. China's micro-finance movement

Micro-finance models were first introduced to China in 1994 as part of a worldwide proliferation of NGO-led micro-finance programs. The rapid introduction of micro-finance in China reflected the exuberant optimism of the international development community that such programs could not only empower the poor to help themselves but also do so in a way that was financial sustainable. A variety of programs were established in a very short time. Most were executed on a small scale, targeted the poor, followed the Grameen model, and were undertaken in collaboration with international donors. The early performance of NGO micro-finance projects was encouraging, with many programs achieving loan repayment rates of close to 100 per cent.

In recent years, China's NGO micro-finance movement has continued to mature in some ways but overall has not maintained the momentum of its early rapid growth. In fact, the number of rural households participating in NGO micro-finance programs in China has probably declined since the late 1990s. Some of the early programs failed outright, as should have been expected. Some relied on one-time external grants that were not renewed as donors shifted to new priorities (*e.g.*, programs by UNFPA, UNICEF, UNDP, World Bank). Regulatory restrictions preventing micro-finance programs from mobilizing their own deposits severely curtailed possibilities for expansion.[1] Most programs failed to institutionalize commercial banking practices necessary to achieve sustainable growth.

Well-known NGO micro-finance programs that remain active in China typically began as, and often continue to be, collaborations between international donors and Chinese government, financial, or research institutions. In order of size calculated by the number of current borrowers, these include

1. One domestic micro-finance NGO, the Association for Rural Development and Poverty Alleviation in Sichuan (ARDPAS) established in 1997, was closed in 2001 with a clientele of over 35 000 people because its funds came from budgetary grants from the provincial government. In China, budgetary funds are not allowed to be used for lending.

the following: the China Foundation for Poverty Alleviation (CFPA), which took over two pilot sites begun by a World Bank project and also administers other sites with different financing sources, including a foundation in Hong Kong; the Funding the Poor Cooperatives (FPC), China's earliest micro-finance program administered by researchers at the Chinese Academy of Social Sciences (CASS) along with locally recruited staff working in township poverty alleviation cooperatives (*fupinshe*), with financing from Ford Foundation, Grameen Trust, and the Canada Fund; Sustainable Micro-finance Assistance for the Poor (SMAP), which manages four project sites that began as part of a United Nations Development Program (UNDP) project; and the Qinghai Agricultural Bank Micro-finance Program, involving the Agricultural Bank of China (ABC) and supported by AUSAID. Key features of these programs are described in Table 1. For a longer list of programs established from 1994 to 2000, see Park and Ren (2001). He and Lin (2002) provide more detailed descriptions of the larger of China's past micro-finance programs. Table 1 omits many smaller NGO micro-finance programs that currently operate in China. A few NGOs also have initiated programs in urban China, targeting migrants or laid-off workers.[2]

A few observations about China's NGO micro-finance are worth noting.[3] First, relative to China's rural population or even to her poor population, the number of participants remains miniscule. And as noted earlier, in aggregate the scale of NGO programs has recently contracted rather than expanded. Second, the Grameen model of group lending and poverty targeting remains dominant,[4] even though the nature of many projects make greater flexibility in contract terms desirable. Third, some programs (in particular the FPC projects) have demonstrated that at current scales of operation they can achieve high repayment rates (generally over 95 per cent) at relatively high rates of interest and reach financial and even economic sustainability. As seen in Table 1, the most common loan interest rate is 8 per cent, but when instalment payments begin immediately after the loan is made, the effective interest rate doubles (to 16 per cent). This is much higher than official interest rates. Fourth, the programs appear to be reaching some but not all of the poor (more below). Fifth, the programs have found it challenging to maintain and improve financial vigilance. Some current programs are legacies of earlier development projects, and receive less management support than before. Reporting and information systems remain far behind best practice. In fact, some well know micro-finance project sites recently have been closed because of management failures.[5] NGO managers often treat the programs as development projects or experiments and have little personal stake in the projects' commercial viability or growth.[6] Overall, no NGO programs have evidenced institutional potential for widespread expansion and outreach.

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2. A project by UNDP, AUSAID, and the Tianjin government targets female laid off workers; a project by the Workers' Union (*gonghui*) and UNDP in Jiazuo City in Henan supports workers through loans to employers; and the Women's Federation also has micro-finance initiatives in urban areas. The Ministry of Labor has just begun a small loan program for laid off state-sector workers (China Daily, 2003).

3. Greater detail on most of these points can be found in Park and Ren (2001).

4. Even when there is group lending, joint liability generally is not enforced. Borrowers form groups to discuss projects and meet weekly to make repayment installments witnessed by other borrowers.

5. For example, in 2003 the FPC suspended new lending in Yucheng County, Henan Province, and CFPA dropped a site in Ankang which had been a former World Bank project area, because of fraud committed by local managers.

6. Managers are usually project officers with no financial management experience. For example, researchers at CASS who supervise the FPCs are paid a fixed government salary, have responsibilities to their research institutes, and view their micro-finance work as action-research. This provides little incentive or ability to push for project expansion.

Table 1. Prominent NGO Micro-finance Programs in China

Chinese Organization(s)	International Donors/NGO	Year began	Groups?	Interest rate*	Repayment	Coverage
China Foundation for Poverty Alleviation (CFPA)	World Bank, Huaxia Bank, Kadrooie Charitable Foundation (Hongkong)	1997-2002	yes	7-8%	One year (bi-weekly repayment)	27 937 members (Dec. 2002) in Sichuan, Guizhou, Shanxi, Fujian, and Guizhou
Funding the Poor Cooperative, Chinese Academy of Social Sciences	Ford Foundation, Grameen Trust, Canada Fund, Private donation	1994	yes	8%	One year (weekly repayment)	15 873 members (Sep. 2002), Henan (Nanzhao, Yucheng) and Hebei (Yixian)
Qinghai Agricultural Bank	AUSAID	1996	yes	12%	6-12 months (lump sum and/or installments)	13 000 members (Feb. 2003) in Qinghai (Le Du, Ping An and Huang Zhong county)
Sustainable Micro-finance Assistance for the Poor (SMAP)	United Nations Development Program, Japan government	1996	yes	8%	One year (weekly repayment)	7 865 members (Dec. 2002) in Inner Mongolia, Gansu, Sichuan, and Guizhou

*Effective interest rates are double when repayment is in equal installments over the length of the loan.

After initial scepticism that micro-finance models were appropriate for China, the government in 1997 decided that it would lead rather than follow the micro-finance movement, adopting a Grameen-type approach to disburse loans as part of its longstanding program of subsidized loans for poverty alleviation administered by the Agricultural Bank of China. Following the lead of NGO pilot programs, the government established independent poverty alleviation cooperatives, usually staffed by government workers, to administer group lending with repayments made in instalments. The government programs expanded rapidly to reach over 600 counties in 22 provinces by August 1998, almost immediately dwarfing the NGO micro-finance movement. However, at about that time, financial reform policies required closure of poverty alleviation cooperatives because they were not officially recognized as financial institutions, and administration of poverty loans was fully returned to the Agricultural Bank of China. The rapid expansion of government micro-finance without proper training, incentives, or oversight predictably led to poor implementation of key micro-finance principles (*i.e.*, election of group leaders, weekly meetings, etc.) and to poor repayment performance (Park and Ren, 2001). There is little promise that such programs can perform any better than the individual subsidized loan programs they replaced, which had repayment rates of about 50 per cent. Not surprisingly, low interest rates also made the loans targets of wealthier households, reducing targeting effectiveness (Park and Ren, 2001). Worldwide, there is no successful precedent of which we aware for this type of government-run micro-finance.[7] In the rest of this paper, we focus attention only on NGO micro-finance.

A few of China's NGO micro-finance programs have tried to involve existing rural financial institutions, encouraging them to try new institutional approaches to lending and helping them to improve their financial management capabilities (*e.g.*, AUSAID and local Agricultural Bank branches in Qinghai, Developpement International Desjardins and local RCCs in Hebei).[8] The Qinghai program has emphasized the establishment of strong incentives for village agents and improvement of the banks' capacity for loan management, and is attracting attention from the provincial ABC as a reform model.[9] In many areas, the Agricultural Bank and in some locations RCCs, also have been involved in implementing the government's micro-finance programs, so have had some exposure to micro-finance concepts. In addition, managers of rural financial institutions have become aware of the success of pilot NGO micro-finance models through the media and professional circles. Finally, national-level officials in the People's Bank of China, the Agricultural Bank, and RCC headquarters, have been engaged by the development community in dialogue about the potential of micro-finance institutions, and have even taken study trips to Indonesia and Bangladesh to better understand how micro-finance has been implemented in other countries.[10] While it is hard to point to tangible results of these various activities that transcended local settings, such initiatives potentially can play a key role in the process of institutional learning that could yield much larger impacts when the regulatory environment permits more real experimentation with new methods of rural lending.

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7. BRI in Indonesia was a state-owned bank, not a government administrative agency, and successfully established positive incentives for strict financial management. Later, we discuss the potential for similar reforms of China's rural financial institutions.

8. One of the authors, Sangui Wang, is also engaged in experimental research with RCCs in Sichuan to examine the importance of interest rates and repayment schedules to profitability and loan repayment.

9. Conversation with Enjiang Cheng.

10. Ford Foundation has been a leading agent for promoting this dialogue. Engaging China's formal banking system also was a top priority of the Consultative Group to Assist the Poorest, headquartered at the World Bank.

3. Economic development and credit demand

China's micro-finance movement is predicated on the assumption that lack of credit is a barrier to investment and income growth of poor households. This same assumption long has underlied the government's emphasis on subsidized credit as the centrepiece of its rural poverty alleviation strategy. However, there are reasons to be sceptical of making household credit the top priority in China's poverty alleviation strategy.

Recently, the credit demand of households in poor areas has changed with the rapidly changing structure of economic production. In Table 2, we present summary data on the income composition of rural households in poor areas in 1997 and 2000, using data from the China Rural Poverty Survey, a longitudinal household survey conducted in officially designated poor counties in four poor provinces--Shaanxi, Gansu, Sichuan, and Guizhou. The sample is broken down into three wealth levels—rich, medium, and poor. Table 2 shows that there was a dramatic increase in the share of income from off-farm wage labour (primarily migration), from 24 to 56 per cent, and a reduction in the share of income from traditional agriculture (cropping and livestock), from 60 to 31 per cent. Self-employment income also increased, but not substantially among the poorest households. The importance of wage income increased for all wealth levels, mirroring changes occurring in much of rural China. Part of the increase in rural wage employment is a response to the collapse of agricultural commodity prices in the late 1990s which reduced the return to on-farm labour. However, the increase in the relative importance of wage income has been particularly fast in China's western regions where most of the poor reside. National Statistical Bureau rural survey data show that the wage share of income in Western China increased from 14 to 23 per cent from 1995 to 2000, much faster than the national average.

Table 2. China Rural Poverty Survey Household Income Composition in 1997 and 2000, by Wealth Level

	Unit	Cropping		Livestock		Wages		Self-employment		Total income	
		1997	2000	1997	2000	1997	2000	1997	2000	1997	2000
High wealth	Yuan	1985	1 607	528	133	1 238	3 877	1 083	1 139	4 833	6 755
	%	45.40	22.45	9.87	1.90	23.58	59.93	21.15	15.72	100.00	100.00
Medium wealth	Yuan	2 010	1459	250	150	791	1967	247	617	3 299	4 193
	%	59.55	34.30	9.15	3.16	25.02	50.53	6.28	12.01	100.00	100.00
Low wealth	Yuan	1 058	1 258	50	-26	475	1 342	385	235	1 967	2 809
	%	54.61	42.43	2.07	-1.14	23.58	50.99	19.73	7.72	100.00	100
All	Yuan	1 683	1425	275	72	833	2 339	570	632	3 361	4 468
	%	51.45	29.33	8.20	1.48	24.02	56.02	16.32	13.17	100.00	100.00

Note: Wealth groups in 1997 divided evenly into thirds and wealth groups in 2000 use the same wealth level cut-offs defined in 1997 real yuan. See Table 4 for sample sizes.

Although official statistics suggesting the virtual elimination of absolute poverty in China undoubtedly understate the extent of poverty and overstate the speed of poverty reduction (Park and Wang, 2001), it is important to recognize that in most poor regions, incomes have risen significantly over the past decade, albeit inconsistently. As households engaged in traditional agriculture become richer, they generally able to borrow more but choose to borrow less, relying on their own savings or cash income to finance fertilizer and other input purchases. Thus, credit demand for traditional agriculture tends to decline as households become wealthier, except when substantial capital investments are made to realize scale economies or grow new input-intensive crops. Such shifts in cropping are less likely in China's poor areas, where most of the land is sloped and of poor quality.

Overall, economic trends in poor areas suggest that credit is becoming less of a critical constraint for China's poorest households than in the past. China is in the midst of rapid structural transformation in which labour is being shifted from agriculture to non-agriculture and from rural to urban areas. The most promising strategy for poverty alleviation is to make this process inclusive of labour from poor areas, suggesting that priority be given to improving educational attainment and lowering the costs of job search, such as by filling information gaps to enable the poor to find jobs in more distant locales. Although some have suggested that migration requires initial funds to pay for transportation and search costs, wage income from migration also provides cash to the household, which is likely to reduce credit demand.

In many other countries, micro-finance loans are used to support self-employment activities in densely populated areas, which often require capital investments and/or working capital. However, China's poor are located in remote, mountainous villages with low population density, high transport costs, and no sizable urban demand centres to support extensive self-employment activity. Farmers participating in micro-finance programs in China have most often used loans for cropping or livestock. If the poor could engage in self-employment activities as migrants in urban areas, they might be much larger demanders of credit. However, managers of local rural financial institutions have poor information to evaluate such projects. Rural migrants in cities also have little hope to obtain credit from urban financial institutions given their inability to provide collateral, lack of established reputations in urban communities, and high flight risk.

Evidence on the use of household loans in poor areas confirms some of the points just made (Table 3). Comparing the composition of loan demand in 1997 and 2000, we find that the percentage of loans used for production rather than consumption declines substantially for the low wealth group, from 44 to 30 per cent. Borrowing for fertilizer and livestock both fall considerably, while that for self-employment increases. The table also suggests another important trend in credit demand—the growing need for consumption loans in response to rapidly rising costs of schooling, health care, and home construction. The table also reinforces the earlier finding that it is the wealthier households in poor areas that are the ones with growing demand for loans for self-employment. Other rural surveys reported recently in the Chinese literature find that the self-employed and specialized households are large demanders of credit (Xia and Deng, 2001; Zhejiang Rural Survey Team, 2002), the composition of household credit demand has become highly diversified (Gong, 2002), TVE lending has declined (He, Feng, and He, 2002; Shang, 2003), and households are more likely to engage in informal lending than formal lending (Zhejiang Rural Survey Team, 2002).

Table 3. China Rural Poverty Survey Household Credit Use in 1997 and 2000, by Wealth Level (per cent of total new loan value)

	High wealth		Medium wealth		Low wealth		All	
	1997	2000	1997	2000	1997	2000	1997	2000
Production	20.93	56.01	37.79	35.30	43.53	30.47	30.99	45.93
Of which:								
Fertilizer	2.26	0.95	16.44	4.00	16.13	9.77	9.51	3.66
Other inputs	1.06	18.44	10.76	0.71	10.19	3.09	5.93	11.40
Livestock	6.89	0.43	3.62	4.70	5.53	3.78	5.65	2.04
Fixed capital	5.23	10.57	5.17	2.93	0.00	2.85	3.98	7.27
Self-employ	5.49	25.62	1.80	22.95	11.67	10.98	5.92	21.56
Consumption	16.45	13.31	22.03	34.32	26.79	40.24	20.46	23.78
Of which:								
Daily expend	1.56	0.61	7.11	2.71	9.51	2.79	4.99	1.53
Weddings, funerals, etc.	4.11	2.18	1.58	5.04	0.72	9.37	2.60	4.46
Education	5.91	7.74	7.43	6.32	3.36	15.55	5.73	9.37
Health	4.87	2.78	5.91	20.25	13.20	12.53	7.13	8.42
Housing	39.08	18.58	15.44	15.20	5.75	11.37	24.58	16.20
Repay other loans	9.23	5.63	16.15	10.74	5.59	6.37	10.30	6.76
Other	14.32	6.47	8.59	4.44	18.35	11.55	13.67	7.33

Note: Wealth groups in 1997 divided evenly into thirds and wealth groups in 2000 use the same wealth level cut-offs defined in 1997 real yuan. See Table 4 for sample sizes.

The calculation of demand for micro-finance credit must also take into account the ability of the poor to obtain credit from existing formal financial institutions. Park and Wang (2002) found that in 1997 a surprisingly large number of poor households were already able to obtain loans from Rural Credit Cooperatives or other financial institutions, and Park and Ren (2001) found that half of the micro-finance recipients in several pilot programs also borrowed money from other sources. This probably results from the institutional weaknesses rather than strengths of the RCCs. Local RCCs in China are independent accounting units that have difficulty intermediating funds through higher level financial institutions to other regions. They also are encouraged to support local agriculture and to make loans. Poor areas often lack rural enterprises that might compete for available funds. These factors likely increased the access that poor households had to formal loans.

Since the late 1990s, there have been numerous anecdotal accounts of RCCs sharply curtailing or even suspending household lending in poor villages, as financial reforms sought to reduce the non-performing loans in the financial system. Collateral requirements were increased; in some villages savings accounts of equal value to the loan principle became the only acceptable form of collateral, putting loans out of the reach of many of the poor. However, the CRPS data for 1997 and 2000 do not show a significant change in the percentage of rural households who said they could obtain formal loans if they desired (about 50 per cent in both years), and in both years most of those reporting an inability to get loans also report not wanting a loan. Nevertheless, the data do reveal that actual borrowing from formal financial institutions fell quite sharply, from 38 per cent to 19 per cent of households (see Table 4, this includes households that borrow only formal loans or borrow both formal and informal loans). This pattern was especially pronounced for the low wealth group. This change could reflect a fall in formal credit demand associated with rising incomes due to greater savings and supply of informal loans, or to higher perceived costs of formal borrowing given greater collateral requirements and stricter bank enforcement. Farmers in areas where RCCs provided new "trust" loans (described below) since 2002 have reported an improved ability to obtain loans (Wang, 2003). According to one study, 53 per cent of households in Guizhou were deemed eligible for "trust" loans (*Guizhou Daily*, 2003).

Table 4. Household Credit Market Participation in 1997 and 2000 by Wealth Level, China Rural Poverty Survey (per cent of households)

	N° of observations		N° of loans		Formal loans only		Informal loans only		Both formal and informal loans	
	1997	2000	1997	2000	1997	2000	1997	2000	1997	2000
High wealth	92	192	50.00	54.69	14.13	9.90	26.09	29.69	9.78	5.73
Medium wealth	93	150	35.48	48.00	19.35	15.33	26.88	29.33	18.28	7.33
Low wealth	93	240	20.43	41.67	29.03	10.83	25.81	38.75	24.73	8.75
All	278	582	35.25	47.59	20.86	11.68	26.26	33.33	17.63	7.39

Note: Wealth groups in 1997 divided evenly into thirds and wealth groups in 2000 use the same wealth level cut-offs defined in 1997 real yuan.

Regionally, there is some evidence that effective financial intermediation in poor areas has declined relative to rich areas, but this is not because funds are leaving poor areas. An analysis of fund flow in four provinces (Sichuan, Shanxi, Zhejiang, and Jiangsu) found no change in net fund outflow from poor versus rich areas from 1994 to 1997 when a number of financial reforms were implemented (Brandt *et al.*, 2003). The main reason for the relative decline in lending in poor areas was the faster increase in nonperforming loans in poor areas, which crowded out available funds for new lending. Paradoxically, weak financial institutions on the one hand may increase demand for alternative credit such as micro-finance, but on the other hand may make it more difficult for financial institutions themselves to learn from micro-finance programs and adopt innovative reforms.

Considering the rural economy as a whole, China's entry into the WTO is increasing pressure for restructuring. Increased imports of agricultural commodities adversely affect some rural producers, requiring that they shift to activities in which China has comparative advantage (*e.g.*, production of fruit, vegetables, flowers, livestock, selected cash crop crops). At the same time, labour is increasingly leaving the land to work in the non-agricultural sector. Acceleration of these processes will maximize productivity growth and the welfare of rural labour, with many potential benefits for the poor.

Rural finance has an important role to play in facilitating such structural change. Specifically, promoting greater economies of scale in agriculture, which can help raise marginal labour productivity and close widening urban-rural gaps, will require more capital intensive production, as will the shift to production of new, higher-value crops (Johnson, 2000 and 2001). Thus, to support the rural sector as a whole, rural financial institutions will need to support not just the poor, but also larger scale producers and successful entrepreneurs of all types, especially those expanding activities sectors of comparative advantage (many in the non-agricultural sector). There has recently been much concern over the difficulty that TVEs have had in gaining access to credit. To some extent, this has been a product of poor TVE performance, low rates of repayment, and greater attention to loan repayment by rural banks. Still, it will be important for banks to lend to rural enterprises with good projects, especially those in the private sector that were often previously excluded from credit access, and who are potential employers of the poor. If micro-finance can contribute to rural financial reform in a way that promotes faster structural change emphasizing rapid growth of labour-intensive production and services, it is possible that more of the poor could benefit than through narrower programs directly targeting the poorest of the poor.

4. Rural financial reform

In China, by far the most important financial institution providing credit to rural households is the Rural Credit Cooperatives (RCCs). Other formal financial institutions involved in rural lending include the Agricultural Bank of China (ABC) and the Agricultural Development Bank of China (ADBC). The ABC has lent mainly to rural enterprises and trading and retail organizations operating in rural areas, with limited and declining lending to households. As noted earlier, the ABC also administers the government's official subsidized poverty loans. The ADBC manages government policy lending, primarily to finance state procurement of agricultural products, especially grain and cotton. At year-end 2001, RCCs and the ABC controlled 14.1 and 12.0 per cent of all deposits in financial institutions in China, and total outstanding loans of the RCCs, the ABC, and the ADBC were 1.2 trillion yuan, 1.6 trillion yuan, and 0.7 trillion yuan, respectively. The share of total outstanding loans allocated to agriculture (of which rural household lending is a part) was 36.9 per cent for RCCs and 7.8 per cent for the ABC (Xie, 2002). There also exist informal financial institutions, and as in most countries, informal lending among relatives and friends is common (often at zero interest).[11]

Because they are the most likely formal financial institution to develop micro-finance components, we focus on RCCs, which are located in virtually every township in China, often with branches at the village level. Just like other financial institutions in China, RCCs have accumulated large amounts of nonperforming loans. Surveys of RCCs in Zhejiang, Jiangsu, Sichuan, and Shanxi found that nonperforming loans reached 27.4 per cent of outstanding loans in 1997 (Brandt *et al.*, 2003). These shares were much higher in poorer regions. Other data on RCC performance reveal that overdue loans reached as high as 68.5 per cent of outstanding loans in Sichuan (in 2000) and 75.0 per cent in Shanxi (in 1999), before falling to less than 50 per cent by year-end 2002 (Brandt, Park, and Wang, 2003). The recent improvement may reflect attempts by the PBC to write off bad loans through one-time capital injections, and to improved governance within RCCs. Still, as noted in the paper in this volume by Han Jun, by the end of 2002, bad loans accounted for 37 percent of the outstanding loans of RCCs nationwide.

RCC managers face a number of challenges. First, interest rates have been regulated and set at artificially low levels. This is a particular problem for lending to the poor since the cost of such lending is higher and so generally requires higher returns for banks to be willing to lend. Inter-bank transfers also have been prohibited, other than deposits and loans to RCC county associations. Until reforms in 2003, there has been no mechanism for intermediation of funds across counties. Internal interest rates for bank deposits and the limited volume of interbank lending also are regulated, and so do not effectively support efficient financial intermediation across regions. Second is the problem of governance. RCCs are supervised by local PBCs, who appoint managers. There are no owners with the ability and appropriate incentives to maintain the value of the bank's capital. Instead, managers, who often hold their position for just a few years, respond to contractual incentives that emphasize high rates of loan repayment, deposit mobilization, and profitability. Without a strong accompanying monitoring system, these imperfections in the governance system can easily lead to fraudulent strategies such as rolling over bad loans, or evergreening, which on paper meet the manager's short-term objectives while undermining the real value of the bank's portfolio. Third, RCCs live in an

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11. Rural Credit Foundations, quasi-formal financial institutions charging effective interest rates above regulated rates and formerly found in many rural areas, were abolished in 1999. Other informal sources include rotating savings and credit associations (ROSCAs, or *hui*). Moneylenders are not very common. Alternative credit sources are less common in remote rural areas.

imperfect institutional environment in which it can be difficult or costly to seize collateral through the courts, and information systems remain relatively primitive, making it difficult to obtain information on credit ratings or project quality. One response of higher level financial institutions to such institutional imperfections has been to centralize lending approval authority despite the lost local information available to branch managers (Park and Shen, 2003). This runs counter to the micro-finance goal of decentralized management and incentives. Fourth, the PBC, except in special cases, generally has been unwilling to sanction innovative changes in financial instruments, staffing, or ways of doing business, reducing the ability of managers to respond to local needs in creative and profitable ways. Finally, there is a severe shortage of experience and expertise in commercial financial management practices at all levels of the financial system, requiring training and changes in business culture that will occur only very slowly.

Despite these difficulties, there is evidence of improvement. Governance in rural financial institutions, as measured by pay incentives to managers and collateral requirements, has improved over time especially in richer areas and areas with greater repayment problems (Brandt *et al.*, 2003). At the beginning of 2002, experiments in interest rate liberalization began in 8 counties nationwide (Xie, 2002).[12] To their credit, officials in China's PBC as well as a number of national and local government officials, have recognized the importance of lessons learned from micro-finance and appear open to experimenting with changes.

Several other policy reforms can be viewed as attempts to improve incentives and regulatory oversight, and to support innovations that might improve RCC capacity to lend effectively. In July 1999, a new form of household lending by RCCs was announced by the Peoples Bank of China. "Trust" loans (*nonghu xiaoe xinyong daikuan*) are loans in which households are assigned maximum credit limits based on evaluations of each household's credit-worthiness, and then are allowed to borrow freely up to the credit limit without condition (*i.e.,* no collateral or guarantors required). The program began in 10 experimental counties in 2000, and a conference was convened by the PBC in December 2001 in Beijing to assess the results. After favourable reviews, the program was promoted nationally beginning in 2002 and expanded rapidly. In many areas, "trust" loans have already become the most important type of lending to rural households.

In January 2000, local RCCs were also given permission to provide households with joint liability loans (*nonghu lianbao daikuan*) in which group members mutually guaranteed repayment of individual loans, similar to Grameen-type loans. By the end of 2002, RCCs had 25.3 billion yuan in outstanding joint liability loans, and 74.6 billion yuan in outstanding "trust" loans.

In 2003, the PBC announced a new reform plan for RCCs which endorsed three different models of RCC institutional reform for eastern, central, and western China, respectively: 1) establishment of rural commercial banks, or Jiangsu model, based on successful experiments with such reform in counties in Jiangsu (Cheng and Chu, 2003); 2) establishment of county-level RCC associations (*xianji lianshi*) as independent accounting units; and 3) maintenance of township or local RCC associations. The RCCs would be monitored by the newly established financial regulatory commission (*yinjianhui*). Main goals of this reform were to rationalize lending across regions and diversify risk across individual RCCs.

Among these recent changes, improved governance, liberalization of interest rates, and the creation of new mechanisms to facilitate better inter-regional financial intermediation all are critical for developing an effective commercial banking system. But the reforms need to go much further. In

12. In experimental counties, local RCCs can adjust deposit and lending rates by 30 and 70 per cent around official rates, compared to zero and 50 per cent in other counties.

particular, it will be essential to strengthen prudential financial regulation (still in a stage of infancy in China) and design a governance and ownership system which credibly pressures managers to maximize banks' capital value. Allowing more open competition can also increase competitive pressure on local RCCs to improve their performance (Park, Brandt, and Giles, 2003). The reforms establishing new lending instruments (trust loans and joint liability loans) are unlikely to lead to noticeable improvements without a foundation of more fundamental reforms that allow bank managers the discretion and authority to tailor loans and savings instruments to meet the needs of local borrowers. On the positive side, they do reflect a willingness of China's rural financial institutions to experiment boldly with new ways of lending, which at least partly reflects the influence of China's micro-finance experience.

The message for micro-finance is similar. China's financial (and legal) reforms have yet to create an institutional space in which micro-finance can operate, thrive, and expand, and so expansion of micro-finance will almost definitely have to await substantial further progress in creating a truly commercial financial system. In the meantime, however, micro-finance programs can help push the boundaries of existing practice and accelerate meaningful reform by setting an example of possibility and by actively engaging China's formal financial institutions.

5. Micro-finance in China: challenges and policy recommendations

After all of this discussion, what can we say about the appropriate role of micro-finance in China's future poverty alleviation and financial reform strategies? Despite nearly a decade of experience, thus far micro-finance in China remains confined to small-scale projects and experiments, typically funded externally, that have little prospect of widespread replication or expansion. Government-run micro-finance, while larger in scale, has been a failure. A few attempts have been made to reform existing rural financial institutions such as the ABC and RCC to adopt micro-finance practices, but with very limited impact.

The stagnation of the micro-finance movement as a whole is mainly the product of an inhospitable legal and regulatory environment. It remains difficult to establish independent NGOs in China because NGOs enjoy uncertain legal status and must have a supervising government unit and be registered with the Ministry of Civil Affairs. NGO's involved in micro-finance have the additional problem of not being recognized as financial institutions, which prevents them from mobilizing deposits, which is critical for expansion and for developing a commercial banking culture. While small-scale micro-finance NGOs are often permitted to evade interest-rate regulations, the same has not been true for the RCC system as a whole. This, along with a host of incentive problems and limits to managerial authority, effectively preclude RCC managers from having the necessary motivation and freedom to experiment profitably with micro-finance design features. Thus, micro-finance will only play a large role in the rural financial system after many key system reforms are put into place, which may take some time.

Given the space to operate and expand, there is no reason that multiple micro-finance models cannot coexist in China. Given economic changes occurring in China's poor areas, we do not recommend that rural micro-finance programs be viewed as the key weapon in the fight against poverty, although in some localities targeted micro-finance can undoubtedly help some of the poor. There may be greater promise for micro-finance organizations to reach excluded groups by providing loans to self-employed migrants or laid-off workers in urban areas, although this brings with it additional challenges.[13] Meeting the growing demand for consumption loans also merits greater attention.

In the right institutional environment, micro-finance principles will have much greater influence if they can help existing rural financial institutions (RCCs) to profitably provide flexible saving and borrowing instruments to a broad range of rural residents, especially private entrepreneurs. This, too, will help many poor, by raising the return to saving and enabling the ambitious to embark on new projects. A diversity of financial institutions will best serve the increasingly diverse needs of different types of borrowers living in diverse regions across China.

How can micro-finance promote broader rural financial reform? First, by changing conventional wisdoms that handicap institutional innovation. Already, micro-finance programs have clearly demonstrated that many of the poor are capable of repaying loans at relatively high rates of interest, contrary to most Chinese rural banking experience before micro-finance. This should invite financial institutions to think hard about exploiting these potential markets when they can do so profitably. Second, the programs have shown that innovations such as group lending can reduce transaction costs and better harness local information in monitoring loans in poor areas. Third, the micro-finance programs have highlighted the importance of developing appropriate financial management systems if the vision of decentralized, innovative, accountable financial institutions is to be realized. In some cases, the programs have directly helped financial institutions to improve their own capacity. Many of China's major economic reforms began with experiments and models, and China's current micro-finance programs should see this as their mission even if the scale of their operations remains limited. In the longer run, it will be important for China's micro-finance NGOs to lay the groundwork for expansion, by ensuring independence of NGO decision-making, by hiring professional financial managers to head their organizations, and by further strengthening their financial management capacity. The micro-finance community in China should also place high priority on engaging China's existing rural financial institutions to support reforms that will improve their ability to provide financial intermediation to a diversity of borrowers in both poor and non-poor areas.

13. In urban settings, more alternative sources of credit may be available, undermining dynamic incentives, and both bank and peer monitoring may be less effective because borrowers are more mobile and less socially connected.

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