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CAN MICROFINANCE CHANGE THE LIVES OF THE POOR IN CHINA?

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Introduction

In October 2006, the Nobel Peace Prize was awarded to Muhammad Yunus and his Grameen Bank, and as a result microfinance gained huge attention from the world. But in fact much experimentation and research had been carried out. Regarded as a tool for realizing the potential of the poor, microfinance has been giving a great deal of hope to those people who are dedicated to poverty reduction. While the practice of microfinance has expanded globally, debates around the topic have never stopped.

While traditional banking sectors in developing countries tend to cater for rich people, microfinance wants to say “The poor are also creditworthy”. Through innovative financial methods, microfinance allows poor people access to credit. The invention of microfinance is inspiring, especially in the context of efforts to end poverty internationally. The announcement at the 2006 Nobel Peace Prize ceremony may tell us something about microfinance and poverty alleviation: “Lasting peace cannot be achieved unless large population groups find ways in which to break out of poverty. Microcredit is one such means.” (The Norwegian Nobel Committee, Oslo, 2006)

At the same time, microfinance has not been an unequivocal success. Partly due to lack of data and research information, evaluation of the impacts of microfinance on poverty alleviation is quite uncertain. Some arguments from academia are crucial: Are the repayment rates really as high as some institution declared? Can they realize financial sustainability? Have the loans reached the target group? Is the media reporting accurate or misguided?

Microfinance was introduced into China as an innovative tool of poverty alleviation thirteen years ago. But it was pushed under the flash lamp at one night in late 2006. Under the transitional financial and social environment in China, microfinancing had been carried out quietly and cautiously.

The confusions about microfinance in China are evident. Poverty reduction has become a priority for the Chinese government. However, with a vast yet deserted rural financial market and a complicated financial system, China is still swaying between the longing for a potential bright future which microfinance could help bring about, and fear of possible financial instability.

Through combing the theoretical base, main arguments and global practice of microfinance, this paper is aiming to answer these questions: what is the condition of microfinance in China? What are the problems with it? And then, how far could microfinance help tackle poverty there?

The structure of this paper is set as follows:

The paper will take a look at the conception and categorisation of microfinance in first part. Based on that, in the theory section, the paper will review and explore why the conventional financial market does not work well when facing the poor, and focus on the function of a key component in credit: collateral. The second half of the theory review will explain why microfinance can open the door to the poor when they cannot provide collateral. The next part is devoted to the microfinance situation in China which is also the core of this paper. The paper will try to find the main characteristics of microfinance in China due to its special social environment. The paper cannot draw a clear-cut "right and wrong" conclusion at the end, but relevant findings as well as policy recommendations will be displayed in the last part of this research.

Chapter 1 Microfinance- its origins in poverty reduction

1.1 What is microfinance?

It is difficult to give microfinance an accurate theoretical definition, but it has been widely accepted that microfinance emerged from a concern about the poor. The vagueness of definition is not only because there are too many types, modes and exceptions in practice, but also because the different stakeholders' attitudes towards microfinance, its methods and applicability as well as effects, are far from unanimous. And also, along with field experiences, the definition of microfinance has changed and varied much in past decades.

"Microfinance refers to provision of financial services loans, savings, insurance, or transfer services to low-income households."(Morduch, 1999) This is one of the typical definitions of microfinance. These definitions of microfinance are still quite broad. Some of them point out certain features, such as "Microcredit, or its wider term microfinance, the extension of small amounts of collateral-free institutional loans to jointly liable poor group members for their self-employment and income generation, is a Grameen Bank innovation." (CGAP, 2003)[1]

It is not feasible to define what size loan is small, and some original characteristics, such as 'collateral-free', or 'jointly liable poor group members', have not always applied in practice. But amongst microfinance projects all over the world, we are still able to grasp the main features of microfinance- from its purposes, contents or functions:

1) A focus on providing financial services to poor households. Whether microfinance projects or institutions aim at economic profits or social effect, all of them set poor people, individuals or households as their targets. This is also the crucial difference between microfinance and conventional finance.

2) Small loans which are usually rejected by the formal commercial banking system. The poor often cannot meet the requirements of the formal banking sector. The main purpose of microfinance is to bridge this gap.

3) Other services. Microfinance began with microcredit which refers to small loans. However, microfinance has replaced it with a wider coverage nowadays, along with the understanding that "Financial services needed by the poor include working capital loans, consumer credit, savings, pensions, insurance, and money transfer services."(CGAP, 2003)

4) An indirect tool to help the poor. Microfinance has been relevant to poverty-reduction from the beginning, but in contrast to financial relief, it requires

[1] CGAP: Consultative Group to Assist the Poor, hosted by the International Bank for Reconstruction and Development (The World Bank), is a consortium of 33 public and private development agencies working together to expand access to financial services for the poor.

repayment. Credit itself does not create economic potential directly, but it can unleash it, enabling the targeted people to use their human and productive capital more profitably and efficiently to build up their financial base, which could be a good beginning to get rid of poverty.

1.2 Categories of microfinance

Microfinance, or its original form microcredit, can be tracked back to a non-profit and religious organization, Opportunity International, founded in Columbia in 1971. Another early non-profit organization in Massachusetts, USA, which started its small loan financial service quite early, was founded in 1973. And the famous Grameen Bank was built up by Muhammud Yunus in 1976.

Since 1980, microfinance sprouted and then boomed worldwide. All kinds of parts have been widely involved in microfinance practices. From the provider characteristic of microfinance, microfinance providers can be sorted into NGOs, community cooperative financial institutions, credit unions, non-banking finance companies, commercial banks, specialized microfinance institutions and governmental institutions.

Microfinance project models are extremely varied. Typical and prevailing models include collateral loans from banks, cooperative communities, cooperative banks, community banks, credit unions, village banks, group lending and individual loans.

According to different targets and aims, microfinance has been divided into two types---- Institutionalism microfinance and Welfarism microfinance (Morduch, 1997). The microfinance institutions (MFIs) which take social impacts as their priority are usually called "Welfarism microfinance". The other MFIs which take financial sustainability as their first aim are called "Institutionalism microfinance". But, for some experts, these two types are not clearly divided, because most MFIs hope to realize both social impacts and financial sustainability at the same time. But due to different structures, principles and conditions of subsidy, MFIs tend to emphasize one point or the other.

1.3 Poverty, unmitigated pressure

Poverty alleviation is a long-running war. In February 2006, Secretary-General of UNDP (United Nations Development Programme) released a report saying that "the proportion of poor people living on less than one dollar a day in developing countries declined from 27.9 to 21.3 per cent between 1990 and 2001, a transition of roughly 118 million persons out of extreme poverty."[2] This inspiring result lit up the Millennium Development Goals (MDGs)[3] which target halving extreme poverty at the national level by 2015.

[2] "Review of the first United Nations Decade for the Eradication of Poverty (1997-2006)" , UNDP

[3] The Millennium Development Goals are eight goals that 191 United Nations member states have agreed to try to achieve by the year 2015.

However, the report pointed out that this global picture masked important disparities at the regional level. Global poverty is still under unmitigated pressure. Apart from the success of East Asia and the Pacific and South Asia, all other regions have experienced setbacks since 1990. Some countries are at severe risk of falling short of the MDG. Compared with her peers, China has projected a beam of light on the dim picture of global poverty. As the UNDP report said, “Global poverty reduction has been driven by China, in fact, China has already achieved the poverty reduction target: the number of people living in extreme poverty there fell from 377 million to 212 million between 1990 and 2001, or from 33 per cent to 16.6 per cent of the population.”

However, China makes up about 22 percent of the earth's total population, so the moderate percentage of 16.6% still means a huge absolute number living in poverty. And behind the striking numbers, China has experienced fluctuations in poverty reduction.

For quite a long period in the past, China was bedevilled by poverty for various reasons. Over the past quarter century, China has witnessed the most rapid reduction of income poverty in human history. Since the late1970s, with the implementation of market economic reform, China has really stepped on her track of poverty alleviation. After 1978, the reduction can be grouped into three different periods: [4]

1) Between 1978 and 1985, tremendous progress was made in the reduction of income poverty. The incidence of poverty rapidly declined in China. Accordingly, between 1978 and 1985, the total population living below the national poverty line declined from 260 million to 97 million, and the incidence of poverty declined from 33% to 9.2%. If measured by the international standard, $1 a day per capita in 1985 PPP[5], the incidence of poverty dropped from about 60% in 1978 to less than 40% in 1985.

2) Nevertheless, China's progress in poverty reduction was not sustained during the second half of the 1980s and early 1990s. There were signs that income poverty had increased in 1989 and 1990. The rural poor increased to 103 million in 1989 from 86 million in 1988, and the incidence of poverty rose from 10.4% to 12.3%. Urban poverty rose from 0.2% in 1988 to 0.4% in 1990.

3) After 1992, progress in poverty reduction resumed, although not as rapidly as the period of 1978-85. The number of poor people moving above the poverty line rose to 5 million per year, compared with only 2.5 million in the late 1980s and the early 1990s. By mid 1996, the number of people below the poverty line had fallen to 65 million from 94 million in 1991.

[4] Main data from: Poverty Alleviation In China: Commitment, Policies And Expenditures, By Amei Zhang, 1997 Human Development Report, UNDP

[5] PPP, the Purchasing Power Parity. It is the method of using the long-run equilibrium exchange rate of two currencies to equalize the currencies' purchasing power. These special exchange rates are often used to compare the stands of living of two or more countries.

1.4 Microfinance, knocking at the door of China

Though there could not be one "magic bullet" to conquer poverty all over the world, people were excited when microfinance emerged as a new financial innovation. "Few recent ideas have generated as much hope for alleviating poverty in low-income countries as the idea of microfinance." (Morduch, 2000) Microfinance promises both to combat poverty and to develop the institutional capacity of financial systems through finding ways to cost-effectively lend money to poor households. All at once, different kinds of success stories were being written around the world about how- typically- a person had got a small loan, founded his or her small business and had become financially independent.

The story of the Nobel Prize winning Grameen Bank in Bangladesh is a case in point. In 1974 Grameen Bank (GB) made its first small loan of $27 to a group of 42 families. Now "GB's 1,658 rural branches operate in 57,790 of the total 68,000 villages."(Islam, 2007). Nowadays, the cumulative investment of the GB in 2005 in rural Bangladesh is more than five billion dollars, disbursed among 5.3 million borrowers, 96% of whom are women (Grameen Bank, 2005). And, the GB operations have contributed between 1.1 to 1.5 percent of GDP of Bangladesh (Grameen Bank, 1999). By way of comparison, the small scale industries sector contributes less than 4% and agriculture and fisheries around 3% of GDP, suggesting that the Grameen Bank's contribution is quite substantial (Wright ,2000).

Dazzling cases such as this made microfinance attractive for countries which are pressed by chronic poverty and inequality. It is understandable that China should be concerned with poverty reduction. Poverty alleviation has not been greatly emphasized as a policy objective in China since the market-oriented economic reform and open-door policy was set out at the end of the 1970s. During the past two decades or so, China has rapidly become one of the most important engines of growth in the world. Data from National Bureau of Statistics of China shows that from 1979 to 2004 the average annual GDP growth rate was 9.6%. Like many other developing countries, some problems appeared in China, along with the rapid yet uneven growth:

1) The gap between the rich and poor. According to research by the Treasury Ministry of China in 2003[6], the Gini Coefficient for the National Income of China has reached 0.46, which has surpassed the international alerting line 0.4. Though a debate arose around whether it reflected the real condition, the research still conveyed that the inequality between rich and poor in China is very serious. Despite the rapid growth rate, there are still huge numbers of people living under poverty line.
2) Social instability. Based on the experiences and lessons from other countries, when Gini Coefficient touches alert line, social instability and economic regression are a

[6] The report was released by Institute of Scientific Research, Treasury Department of China in 2003.

worrying possibility.

3) Economic disparity. Disparity is a marked characteristic of China's development during recent decade. This includes disparity between regions. East coast areas have taken much more advantage of economic reform while most of the central and west provinces are lagging behind. Also disparity exists between different social classes which always tangled with social instability. Urban incomes now average more than three times those of rural incomes in China and are growing much more quickly. Thirdly, economic disparity may arouse political disparity as well.
4) Inequality of development for individuals. Social resources are allocated unevenly in China between different regions, classes and social groups. For example, most urban residents have more opportunities to find a job than rural residents; most children in cities have much better access to education services than the children in rural area. A large number of people do not have the minimum conditions needed for their personal development because of unequal social environment.

All these potential risks push the Chinese government take poverty reduction as a priority, out of concern for social stability and economic sustainability. Moreover, the vast rural areas of China provide a favorable terrain for microfinance because of following:

1) A lack of formal financial services. According to a survey by China Banking Regulatory Commission[7], there are only 2.13 banking outlets on average per town, and only one outlet amongst 50 villages. Apart from rural cooperative financial institutions and post savings institutions, all the commercial banks have withdrawn their branches from rural areas. The banking services in rural areas are totally absent.
2) Aspects of social structure particularly conductive to the success of microfinance. Social structures in China, especially in rural areas are quite traditional and influenced by its long history. People tend to prefer stability of life to mobility. They care a great deal for relationships. And in China, people have the habit of saving and accumulating wealth. Furthermore, with high population density, residents in rural areas tend to be highly sociable. Because of these factors, China may be even better suited to the adoption of tried and tested microfinance models than some other developing countries.
3) Longing for a pathway to get rid of poverty. Rural areas, Rural residents and the Rural economy- termed the "3R"- is the top priority task for China. It has been emphasized each year in No. 1 Document of the Central CCP[8]. If the poverty of the rural areas cannot be tackled properly, it will influence the maintenance of sustainable growth in the future.

[7] The China Banking Regulatory Commission (CBRC) was established on December 24th, 2006.

[8] No. 1 Document of the Central CCP is basically an annual policy guideline for China, which is issued by the CCP at the beginning of each year.

Chapter 2 A theory review

---- How microfinance tackles problems in credit markets

2.1 Credit and collateral

Economic activities have time differentials. Investment is put in today and has a payoff only after a period. That is where credit originates and why it is indispensable for a smoothly running economy. Credit refers to a contractual agreement, in which a borrower receives something of value now, with the agreement to repay the lender at some date in the future.

Credit can benefit both borrower and lender if the borrower has an investment opportunity with a higher expected return of revenue than the cost of providing the loan. The lender provides a borrower with capital in advance, under the expectation that they will pay back, with a price, the interest rate, later. To the lender, the purpose is to have the capital back with a return that covers the cost, expenses and give some profit. The borrower applies for the credit based on belief that he can gain a return higher than the interest rate.

However, lending involves a risk of default. Defaults can be grouped into two types: involuntary default and strategic default. Involuntary default is a result of failure in investment which makes the borrower incapable of repaying. Strategic default refers to a situation where the borrower has the ability to repay the loan, but he does not because he does not find it in his interest to do so. This often happens, especially in contexts where the legal system of loan enforcement is weak.

In order to reduce the risk of default, lenders require collateral. A collateral shifts the risk from the lender to the borrower. If the borrower cannot pay back the loan, collateral would be compensation.

The fear of default creates a tendency to ask for collateral, whenever this is possible. Collateral may take many forms, but fundamentally there are two types: one in which both lender and borrower value the collateral highly, and another in which the borrower values the collateral highly, but the lender does not (Ray, 1998). The first condition has the advantage that it covers a lender against both strategic and involuntary default. The second one occurs when borrowers have collateral, but the mode of collateral they have cannot be valued and accepted by the credit supplier, for example, labour or trust from peers. This covers a lender against strategic but not involuntary default.

Collateral is very important in a conventional financial system. Because they lack acceptable collateral, millions of poor people cannot access the formal banking system.

2.2 Information problems in credit markets

Theoretically, in a free market, when there is demand for a commodity, the supplier could raise the price until they cover their costs. In the context of credit, banks could raise interest rates until they cover risks arising from uncollateralized loans. And also, according to the principle of diminishing marginal returns to capital, enterprises or individuals with relatively little capital should be able to earn higher returns on their investments than enterprises or individuals with large quantities of capital.

Thus, poorer borrowers should be able to pay higher interest rates than richer ones, as money should flow to high return activities. However, in reality this does not happen. The reason for this is *informational asymmetries.*

Informational asymmetries arise because the borrowers have better information on their creditworthiness, risk taking and actions than does the bank. Borrowers are different from one another. Some of them like taking risks, while others are extremely risk-averse. However, banks do not know which group each of their clients belongs to. They also cannot see whether their clients are making effort to repay the loan, or whether they are taking risks that are not in the interest of the bank.

Because of informational asymmetries, two problems occur which economists call---- moral hazard and adverse selection. These can make banks close the door to the poor due to high costs, even if they have projects with high returns.

In the lending context, moral hazard "refers to situations where lenders cannot observe either the effort made or action taken by the borrower, or the realization of project returns."(Aghion, Morduch, 2005). In the case of moral hazard, inefficiencies arise when the bank cannot deter borrowers from taking excessive risks that raise the probability of default. The problem is that by defaulting, borrowers avoid facing the full consequences of their actions, if they do not give full collateral.

Stiglitz and Weiss (1981) pioneered adverse selection models in which banks lack good information about the riskiness of the borrowers' projects. Banks cannot distinguish risky borrowers from safe borrowers, so banks must raise interest rates to cover the risky loans. Such high rates in turn drive credit-worthy low risk borrowers out of the credit market.

Both adverse selection and moral hazard are serious constraints faced by banks in low-income societies where people lack collateral. If banks raise interest rates to cover the risks, it may end up exacerbating conditions, because with high risk clientele and projects, banks' default rates may climb and profits fall. "Commercial banks will understandably be reluctant to enter markets where collateral is scarce and transactions costs are high." (Aghion, Morduch, 2005).

Microfinance is seen as a way to break the vicious circle, by reducing transaction costs and overcoming information problems.

2.3 How microfinance tackles lack of collateral and information problems

Most microfinance projects are carried out in rural areas though projects focus on urban residents. The extensive rural areas where financial services are generally scarce are quite different from traditional formal financial markets. Usually the rural credit markets have such characteristics as informational constraints, segmentation, interlinkage, interest rate variation, credit rationing and exclusivity (Ray, 1998). Many of the poor lack collateral acceptable to the large-scale financial institutions. Furthermore, in most poor countries, information on individual credit histories is extremely limited. There is no information database which is the base of credit in developed markets. Lack of institutions and legal framework is another crucial problem.

No information, no collateral, no institutions……policy makers throughout the world have actively tried to tackle these problems and improve access to financial markets in poor regions, but often failed. As Morduch said, 'good intentions repeatedly went awry as stated-owned development banks mismanaged resources and interest rate restrictions prevented banks from operating viably in poor areas.' Against this background, microfinance emerged as an especially promising way to tackle lack of collateral and information problems, opening a door to banking for the poor.

In the mainstream modes of microfinance, we find several mechanisms which aim at tackling the problem of information asymmetries and high contract costs, and minimize default risk at the same time.

1) *Group lending.* Group lending is an "invention" of Grameen Bank, which opened up possibilities for microfinance to borrowers without collateral. There are three main avenues through which group lending works. (a) Self-selection: before the group lending contract is signed, those people who share a similar attitude towards risks and are familiar with each other's credit level would form a group through peer selection. The high-risk borrowers are excluded because no one will want them in the group. "A group has to be formed very carefully by the individuals to weed out bad borrowers who could jeopardize the creditworthiness of the group as a whole…..." (Ray, 1998) (b) Group responsibilities or joint liability: the mechanism of group lending generates group responsibilities or joint liability, which means risks of the loan are shared by members of the group. Letting down other members of group and the accompanying social sanctions are a strong disincentive to default. Also, the other group members can repay even if one defaults, in order to secure the loan, reducing the risk of default. (c) Close relationships: group members are familiar with one another, and it can mitigate adverse selection problems aroused by information asymmetry, as group members can monitor each other's actions and apply social sanctions if necessary.

2) *Dynamic incentives*. In microfinance practice, dynamic incentives have proved to be an effective way of reducing default rates, and have been widely used in group as well as individual lending. There are two main types: firstly, if the borrower repays the loan in time, he can get the same sum. Type two is an "aggressive loan" or "step loan". If the borrower repays the loan in time, the loan he gets next time will be bigger. For a borrower, to get a steady and bigger financial resource is a practical incentive to fulfil the contract.
3) *Frequent repayment, or regular repayment schedule*. Many MFIs use this mechanism which means shortly after the borrowers get their loan, they should begin to repay part of the loan monthly or biweekly. This method has several advantages. Firstly, when a borrower repays a percentage of loan every month, it conveys a signal that the whole loan (or the majority of the loan) is running well, and it helps the lender to know the condition of loan regularly. Secondly, this mechanism actually needs the borrower to own some property as a guarantee of frequent cash income, which also can help the lender reduce the risk of default.
4) *Collateral substitute*. As MFIs' targets are low-income groups, so clients usually cannot supply conventional forms of collateral. However, the poor may be able to supply other forms of collateral. These collateral substitutes can be a 'group communal fund' or 'compulsory savings'. In some microfinance models, MFIs may ask the borrowers to put a percentage of a loan into a saving pool which acts as a collateral substitute to some extent.
5) *Targeting women*. More than 80% clients of Grameen Bank are women. In China, female clients of microfinance projects are almost 48.9% (Cao, 2006). It has been empirically analyzed that women have higher repayment rates and more stability socially. And also, a woman's financial activities may influence the whole family through her role as mother and wife. Targeting women helps to improve repayment rates, and could fulfil the goals of poverty reduction more effectively.

At the same time, microfinance, as it has surpassed its original term- microcredit- has become more extensive in terms of financial services, involving loans, savings, insurance and transfer services. Multi-dimensional microfinance, not restricted to small loans, has proved to be effective in poverty reduction. For instance, micro-insurance focuses on helping poor people deal with fluctuations of their production. Charitable MFIs also provide social services as a supplementary method to enforce the effects of microfinance. Microfinance is no longer limited to the provision of credit.

Chapter 3 Microfinance in China

3.1 History of microfinance in China

The history of microfinance in China is quite short. Microfinance, in the form of small loans to the poor, was first used by international organizations as a means to achieve other goals. However, microfinance has rapidly been taken up as a tool to achieve poverty reduction in itself. The process was accelerated when the Chinese government adopted poverty reduction as one of its priority goals, especially with emphasis on poor villages and households since the mid 1990s. There have been four periods in the progress of microfinance.

Period 1 (1993 - 1996) The experimental stage

In the beginning, microfinance was introduced into China as an instrument and special credit technique of poverty reduction. The earliest microfinance project in China was North Grassland and Stockbreeding Development Project, implemented by IFAD (International Fund for Agricultural Development) in 1981. But before 1993, microfinance in China was just a part of the aid to toolkit of international agencies (Wu Guobao, 2001). The first real microfinance institution appeared at the end of 1993. It was carried out by the Rural Development Institute (RDI) of China Academy of Social Science (CASS) in Yixian County of Hebei Province, supported by the Ford Foundation and Grameen Trust. This "Yixian Funding the Poor Cooperative (FPC)" was the first special MFI which was operated by a non-government institute in China. This marked the threshold of microfinance in China.

In this period, microfinance projects were mainly funded and supported technically by international grants and soft loans from government. Operated by NGOs or semi-NGOs, these projects basically replicated the Grameen Bank's model and mainly used the 'Group Lending' mode, with a small proportion using 'Village Bank' or 'Individual Lending'.

Period 2 (1996---- 2000) Government participation

To fulfil the MDGs (Millennium Development Goals) in China, a government-led 'Strategic Microcredit Poverty Reduction Project' has come onto stage since 1996. Projects under this initiative were implemented by governmental institutions along with the Agriculture Bank of China and the Agriculture Development Bank of China. Based on the experience of NGOs, these governmental projects also mainly use the Group Lending mode of the Grameen Bank with some innovation. These projects were funded by national financial capital and provided poverty reduction loans with a preferential interest rate.

Boosted by government, these projects expanded rapidly in some poor provinces like Shanxi, Sichuan, Yunan, Hebei, Guangxi and Guizhou. And many governmental institutions such as the Poverty Reduction Office system, the civil administration system, the social security system, Women Unions and the Handicapped Association got involved in it. Most of these projects began in rural areas, but microcredit to laid-off workers in urban areas also started at this stage. However, the rapid growth of microcredit propelled by government in this period left a huge risk of bad debt for the future.

Period 3 (2000---- 2005) Rapid expansion

In this period, the '3R Strategy' (Rural industry, Rural areas and Rural residents) was brought forward by the Chinese government and emphasized as the most important task. To tackle the problem that rural residents cannot obtain loans, rural cooperative financial institutions, including Rural Credit Unions, rural commercial banks and rural cooperative banks, began to provide 'Microcredit Loans' and 'Group Inner-guaranteed Loans' with funding from the People's Bank of China[9]. This indicated that the formal rural financial institutions have entered into microfinance formally on a large scale, and the goal of microfinance has extended from poverty reduction to provision of financial services to rural households and micro companies. The scale of microcredit boomed dramatically in several years.

It is noteworthy that the microcredit issued by rural cooperative financial institutions in this period was different from the previous mode and Grameen Bank mode. One innovation was the Credit Certificate system. A Credit Certificate was held individually by the household. All the credit history is recorded on the certificate, and a borrower can apply for a loan whenever he or she needs. The balance of loan is controlled, but if the loan can be repaid on time, the balance of loan will be enlarged gradually. After 1999, based on the success of Credit Certificate system, there emerged the Credit Village and Credit County management system. Different villages may have different credit evaluation levels, according to which the MFIs can manage their loans with consideration of local conditions.

Period 4 (2005 -) Attempts to commercialize microfinance

In July 2005, the China Banking Regulatory Commission issued a document, 'Banking Guidelines for the Expansion of Microfinance', advancing six mechanisms to encourage commercial banks to expand loans to micro-companies. Thus microfinance entered into a new stage in China, which is labeled as 'exploring commercial microfinance'.

Most of the commercial banks, which are regulated by CBRC, began to attach importance to small loans and the small business market, and set up special departments to explore the microcredit market. At the same time, two commercial

[9] People's Bank of China (PBC), is the central bank of China, with the power to control monetary policy and regulate financial institutions in mainland.

microfinance institutions invested by private capital appeared in pilot areas. These two microfinance institutions are private corporations, which are permitted to make loans yet not to absorb public savings.

A new signal of this period is that China People's Bank and China Banking Regulatory Commission began to push the development of microfinance through policy, thus commercial capital and formal financial banks launched into microfinance in force. The current financial authorities seem to envisage a new path that microfinance could balance between 'social aims and commercial goals' and realize both extensive coverage of the poor and financial sustainability of MFIs in future.

3.2 What is going on now with microfinance in China

1. Achievements of microfinance

Microfinance provided by Rural Credit Cooperatives has formed the majority of microfinance by financial institutions. From October 1997 under instruction from the People's Bank of China (PBC), the Rural Credit Cooperatives started to implement microfinance programmes to increase the access of the poor to credit. According to the PBC report, by the end of 2002, about 30,710 RCCs (or 92.6% of all the RCCs) have had microfinance programmes, and reached about 59.86 million rural households (Jiao, 2006).

An important part of microfinance given by financial institutions as the poverty loans provided by the Agriculture Bank of China (ABC). The ABC was chosen to be the executive agency for the "National Poverty Loan Program" according to "An Announcement on Helping the Poor Areas" issued by the Communist Party and State Council. At the end of August 2002, the poverty portfolio reached RMB 93.2 billion, of which 32 per cent was disbursed as microfinance to poor households (Jiao, 2006).

Non-financial microfinance institutions, including NGOs and governmental or semi-governmental organizations, are also active, though the amount of their programmes is relatively small. At the end of 2002, the total allocation of non-financial microfinance institutions is RMB167.4 million, of which NGOs took up 78.39 per cent, and governmental and semi-governmental organizations held the remaining 21.61 per cent (Jiao, 2006).

2. Contribution to poor households

As a poverty reduction tool, the most important impact of microfinance is increased opportunities and capabilities to improve living standards for the poor. According to Wu Guobao's research in 2001, the main contribution of microfinance to its target people have been as follows:
1) Increased opportunities to get credit and training. A survey by experts investigated

ten microfinance projects covering 425 rural households between 1998 and 2001. It indicated that microcredit increased the households' opportunities to get credit (Wu Guobao, 2001). Eight of these ten projects also provided technical training along with credit. Eighty-two per cent of the surveyed households believed that this training had a positive influence on their use of the loan, especially on training of how to use new seed and new agriculture technique.

2) Accumulation of household production assets. A study compared household assets before and after a microfinance project. It showed that average household production assets increased by 46% from RMB 1985 yuan to RMB 2901 yuan. Amongst the assets, 62% of the new property was purchased by microfinance capital. And almost all the increased investment of livestock was the result of microfinance. The level of development in microfinance project villages is much more positive than control villages without a microfinance project (Wu Guobao, 2001).
3) More employment opportunities. This result was especially evident in microfinance projects in urban areas. Most of the borrowers funded by microfinance projects invested in developing micro industrial or commercial companies. However, it is still unclear how many of these companies could survive when the microfinance loan stops. In rural areas, amongst households funded by microfinance, the percentage of working in other places increased which created more chances to gain income.
4) Risk reduction. The poor are always vulnerable to natural or economic accidents. According to studies by Hossain (1988) and Morduch (1999), one of the most important contributions of microfinance is smoothing consumption, which can keep the living standard comparatively steady. Amongst the borrowers who use microfinance to develop small business, as microfinance did increase their ability to stand risks and smooth their daily living expenses (Wu Guobao, 2001).
5) Female empowerment. Many microfinance projects take female empowerment as an important principle, and women are usually given priority loans. Research indicates that women's access to social relations, control over money and information increased when they received microfinance. But it was also mentioned that along with the increasing opportunities and income for women, labour burdens and psychological pressures also increased.

3. High default rate and financial sustainability

From the international microfinance experience, there is a substitution relationship to some extent between financial sustainability and serving the poorest. Researchers argue that taking financial sustainability as a priority may exclude the poor. Meanwhile, if microfinance only focuses on covering the poor without considering cost and return, microfinance will not be able to live on without subsidy. The dilemma resulted in an incessant debate around microfinance worldwide, as well as a high default rate in microfinance institutions in China.

For most of the microfinance practitioners around the world, securing social goals and financial sustainability simultaneously seems too perfect a picture to realize. For example, BRI (Bank Rakyat Indonesia's village units) in Indonesia is considered one of the best MFI models in the world in terms of financial sustainability. However, the average income of its borrowers is above the poverty line in Indonesia, which means its target has excluded most of the poorest people. On the contrary, Grameen Bank in Bangladesh is often viewed as the best example of serving the poorest, while it is reported that it was not until 1996 that Grameen Bank seemed close to breaking even after 20 years' struggle.

A worldwide survey shows the revenues of microfinance programmes which target the poorest borrowers could only cover 70% of the full costs (MicroBanking Bulletin, 1998). This means that most MFIs which take social effect as main goal have difficulties covering costs and breaking even, let alone making profits.

Financial sustainability is also a crucial problem for microfinance in China. The asset quality of Rural Credit Cooperatives, the major microfinance supplier in rural area, is deteriorating these years. Zhou Xiaochuan, the president of People's Bank of China, pointed out in 2004 that "During the years after Asian financial crisis, bad debt of RCCs has ever reached the zenith of 50 per cent."(Liu Xitao, 2004) The Agricultural Bank of China, another big microfinance supplier almost has the same problem. ABC statistics showed that, at the end of 2002, bad debt from poverty reduction loans reached 38%. And in July 2004, amongst the RMB 38.1 billion poverty reduction loans, bad debt had climbed to 70%. In Jiangxi province from 1998 to 2000, total poverty reduction loans were about RMB1.3 billion, and repayments were was just RMB 0.12 billion with a repayment rate of 9% (Liu Fuhe, Su Guoxiao, 2005).

The position in non-financial institutions is better but far from satisfactory. A report from the PBC in 2004 says overdue loans of non-financial MFIs have reached 27.25%, and it is increasing year by year. The percentage of overdue loans in governmental MFIs is higher than that in NGOs. The default rate of individual loans is higher than that of group loans, but "group loans default is going up rapidly as well." (Jiao Jinpu, 2006)

3.3 Main characteristics of microfinance in China

Due to a special political, economic and social environment, microfinance in China is different from microfinance practices in other countries. Government, formal financial institutions and NGOs, these three factors have moulded the main characteristics of microfinance in China.

1) "Movement mode": an effective yet uncertain way

There is no other country which has pushed microfinance so rapidly and extensively in a short period as China. This is due to a strong government role in China. In many fields including microfinance, the government, as a referee of the whole game, often takes part in the competition itself. This is partly because the Chinese government has not transformed completely from an all-controlling role in a planned economy to a service and managing role in a market economy. Under top-down and bureaucratic control, it is more like the way of a political movement to carry out an economic activity. These activities can be expanded rapidly, while the results may be distortional and unpredictable.

The tightly controlled banking system made it difficult for microfinance to grow spontaneously in China at an early stage. There were two main attitudes towards microfinance experiments. One was to hope microfinance could be a new means of poverty reduction. The other was a hostile and sceptical attitude towards the new approach growing beyond the reach of government.

This ambivalence existed until 1997 when the government began to take an active part in microcredit itself. Once some pilots had seen some success, experiments of microfinance funded and managed directly by governmental institutions spread rapidly across China's vast rural areas. Microcredit "as an important and potent tool of poverty reduction" was recognized and regulated by documents and regulations from the State Department and the CCP.

At every turning point of microfinance development, these can always been found a decisive document, conference or regulation issued by authorities. For example, the volume of the subsidized poverty loans has increased rapidly, from RMB 2.3 billion in 1986 to RMB 18.5 billion in 2002. At the end of August 2002, the poverty loan portfolio reached RMB 93.2 billion, of which RMB 30 billion, or 32% of the total loan portfolio, was disbursed as microcredit to individual poor households (Jiao, 2006). This enormous programme benefited millions of poor residents in rural areas, yet unfortunately also produced massive bad loans for the bank, due to lack of a systematic management and a clear conception toward microfinance.

Also, the rapid growth of microfinance in recent years owes much to the priority given by "Number One Document" several years in a row. "Number One Document" is a crucial annual policy guideline of the Chinese Communist Party which is issued at the beginning of each year. "Number One Document of 2004" advised "keep on expanding microcredit in rural areas……, absorbing social capital and foreign capital, and endeavour to establish financial institutions serving rural residents". In "Number One Document of 2005", the government indicated clearly that "in the rural area where has conditions, try to explore establishing microfinance institutions initiated by individuals or enterprises." Furthermore, "Number One Document of 2006" said "make great efforts to foster microfinance institutions initiated by individuals, enterprises or juridical association. Allow private capital and foreign capital to hold share. " Three guidelines in a row gave a strong signal of the government's determination to expand microfinance. Practitioners, academics and institutions in microfinance were quick to read differences between the lines to grasp the policy trend.

To a large degree, the rapid expansion of microfinance in China has mainly been pushed by the government. Compared with NGOs MFIs, governmental microfinance has its advantages. It can: 1) organize and mobilize resources rapidly on a large scale and in a short term; 2) supply non-financial services which the poor need; 3) link household economy with a regional economy by organizing microfinance with the local main industry which can reduce inefficiency of loan use; 4) absorb the poorest people into projects through the help of governmental staff, which usually is difficult in a pure market economy.

But, like two sides of the coin, after more than four years' practice, the problems of governmental microfinance have also been exposed.

The most serious problem is that an administrative relation replaces a credit relation. Since poverty reduction is an important reference point for local governmental officials, there is a high incentive for them to expand the poverty reduction plan quickly. To increase microfinance scale rapidly, many practitioners ignore some crucial principles of microfinance which is likely to create problems. It is quite common that the receivers as well as some governmental staff consider poverty reduction loans as an aid to the poor instead of a credit loan, which leads to a high default rate of governmental microfinance later.

Secondly, governmental microfinance aims at rapid expansion and quantity instead of quality of loans. Because local governments tend to pursue coverage and amount of microfinance, some fundamental principles and procedures are abandoned, and rules which have been validated by international practice are weakened. Thus the faster governmental microfinance develops, the bigger are the potential risks accumulated in the process.

Along with the market reform and transition period of entry into WTO ended in 2006, China's financial system has evolved gradually from a centrally planned, closed economy towards an open market economy. However, the financial market, including microfinance, is still a government-dominated market. Based on a policy-oriented mechanism and an inefficient banking sector, this system attaches a level of uncertainty to the path of microfinance in future.

2) Dominance of formal financial institution

In most countries, microfinance's target groups are those who cannot access formal financial institutions. And MFIs usually are institutions which are separate from formal banks. But in China, after microfinance became propelled by the government, formal financial institutions began to play a dominant role in it.

China has a large but underdeveloped banking system. The banking system is mainly dominated by four very large state-owned commercial banks: the Industrial Commercial Bank of China, the Bank of China, the Construction Bank of China, the Agricultural Bank of China, which are firmly controlled by the People's Bank of China and China Banking Regulation Commission (CBRC). There are also some commercial banks which have appeared in recent decades, while only holding a small market share compared with the four giants. In rural areas which has been almost abandoned by the four state-owned commercial banks, the Rural Credit Cooperatives (RCC) provide fundamental financial services to rural residents. The RCC is a nominal cooperative bank, monitored by the central bank.

Table 1 Statistics of microfinance in China (unit: RMB)

Type	Governmental MFIs	NGO MFIs	Poverty Reduction Preferential Loan	Microcredit from Rural Credit Union	Small loans from Commercial Banks
Total sum	0.6 billion	1.1 billion	38.1 billion	226.3 billion	2,680 billion

The figures in **Table 1** (Jiao, 2006) give us an interesting picture of microfinance in China. It can see that the financial institutions are playing the leading role in China's microfinance, accompanied by active participation by non-financial institutions. The total sum of microfinance in China is enormous. But it contains various components. All these parts were tangled with one another during the development of MFIs. Many microfinance programmes in China are closely linked to government policies and government institutions, and some programmes implemented by NGOs have close relationships with local governments.

In Table 1, there is a clear contrast between formal financial institutions and non-financial institutions. As mentioned in the history of microfinance above, the official financial institutions entered into microfinance formally on a large scale in 2000. Since then, microfinance has boomed in China. And the figures of microfinance swelled suddenly due to the dominant formal financial institutions network.

According to formal financial institutions, microfinance, which they are engaged in, includes three types: 1) Normal loans to small businesses just with a smaller size, usually the borrower cannot provide conventional collateral; 2) Poverty reduction preferential loans issued by government, implemented exclusively by Agricultural Bank of China. 3) Experimental microfinance carried out by formal financial institutions, which aim at poor people and exactly comply with the conception accepted internationally.

A report from CBRC says small loans to small companies in formal banking institutions reached RMB 2,680 billion at the end of 2005, with a growth of RMB 205.7 billion in that year. However, the total sum of non-financial MFIs, including Governmental and NGO MFIs, is just RMB 1.7 billion.

Compared with other MFIs, formal financial institutions have advantages in carrying out microfinance projects. 1) They can use the savings which they absorbed from the public as a resource of microfinance, thus the capital is steady. 2) They have a wide financial service network as well as experienced staff, so the management cost is comparatively low. 3) Despite lack of credit records of rural residents, formal financial institutions have more authority and reputation with the public which could reduce transaction expenses accordingly. 4) They have more capabilities to provide other financial services such as savings and insurance besides microcredit.

Formal financial institutions have not any barriers in law and policy which is the principal advantage. However, as the mainstay of the financial system, they are heavily influenced by government and have to encounter internal problems when carrying out microfinance in a market economy. For example, in the past two decades, central government has changed or adjusted policies towards rural financial markets several times, including contracting outlets of formal financial institutions dramatically since 1996. Outlet shrinkage weakened the service capability and degraded the quality of microfinance service. Furthermore, formal financial institutions, especially the Rural Credit Cooperatives, are burdened with a heavy bad debt.

The main debate around this part of microfinance focuses on whether it is aiming at and reaching the poor. Most microfinance provided by formal banks in China does not conform with the international accepted norm, which is essentially a normal loan but on a smaller scale. According to the PBC, these small loans belong to microfinance and have a dominant percentage in statistics. The huge total sum, if his part was subtracted, would shrink dramatically. Certainly the small loans to small businesses are essential to keep economy vibrant, and also contribute to improving the living standards. It has overshadowed the microfinance aiming at the poor and the poorest, however.

3) Marking time- NGOs live in a legal vacuum

The first real microfinance project was implemented by a NGO in 1993. NGOs were the first to engage in microfinance in China. They set a very good model for governmental MFIs and formal institutional microfinance later. After more than two decades, the status of NGO MFIs in China is still vague. Policy and legal environments as well as internal problems hinder its further development.

Although all the NGO MFIs have registered with the civil administration department according to law, and some of them have even got certificates from the central bank to carry out microfinance, none of the NGO MFIs are financial institutions in a strict sense and they are not have qualified to gain financing as normal economic entities.

The current policy prohibits NGOs from absorbing public savings. And the central bank also bans the commercial banks supplying capital to those MFIs which were registered as 'Social Incorporations'. Most NGOs have no property or estate to get mortgage loans from financial markets. All these make NGO MFIs unable to get a steady capital supply. Seeking for grants and donations is almost the only way to get capital. Once the grants are due and cannot be renewed, most NGO MFIs will have to shut down. The surviving NGO MFIs will find it difficult to enlarge their scale. This posiition may influence the borrowers' confidence as well. At the same time, microfinance programmes tend to charge higher-than-average interest rates to cover costs and make the projects self-sustaining as in international experience elsewhere, but heavy restrictions on interest rates make that difficult for NGO MFIs in China.

Generally NGO microfinance has encountered heavy policy restrictions in China, and its living space is still extremely limited. After the formal financial institutions joined in, compared with the large quantity of loans from these institutions, NGO MFIs seemed even more silent. According to a report from Financial Market Department of PBC, till the end of 2002, there are total 108 non-financial MFIs (projects) in China, including 76 NGO MFIs and 32 governmental MFIs. And 61% NGO MFIs are funded or aided by international capital. The total sum of NGO microfinance is about RMB 1.1 billion. Compared with the total microfinance RMB 2,946 in China, it is almost negligible.

Chapter 4 Conclusions

Based on the history and main characteristics of microfinance in China, it can be seen that microfinance in China has not had an inspiring record of achievement, and is far from becoming the dynamic and important emerging industry it has in some other developing countries.

Due to the specific political, social and economic environment, the make-up of microfinance in China is extremely mixed. Formal financial institutions are dominant in this area, which is different from international cases. A confusion between small business loans and real microfinance is prevalent, which may increase the risk of departing from the original target of serving the poor.

The government should be cautious about hoping to realize social goals and financial sustainability simultaneously. There are some relatively successful cases in the world, but it should not be considered as the only criteria of success of MFIs. Since the "movement mode" can be costly, the government should consider the specific conditions in China before using a certain mode as its main model.

It is possible for China to break the existing mould for microfinance and follow a unique path, due to its special political and economic regime. There is no evidence that we can find a mature model of microfinance and simply replicate it. In addition, as one of the instruments against poverty, microfinance cannot replace other investments in infrastructure, social security and education. Therefore, in this largest developing country, microfinance itself is not enough to pull millions of the poor out of poverty.

A suitable legal system of microfinance should be built and enhanced soon. Since China's transition period of entry into WTO ended at the end of 2006, the legal environment for MFIs has to be improved to meet the requirements of an open and equal financial market.

The future trend of microfinance in China will be characterized of its diversity. Potential demands create the diversity of supply: organizations, products and methods. The challenge here is how the formal financial institutions, non-banking financial entities, cooperative organizations and NGOs can play their roles accordingly and complement one another. And none of these roles can work well without a sound policy framework.

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