

UNDP MICROFINANCE
ASSESSMENT REPORT
FOR
China

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A. The potential role and current status of Micro-Finance in China

Overview

It is widely accepted that China is one of the leading countries in both its commitment as well as success in poverty alleviation. In 1978, approximately 250 million Chinese lived below the poverty line (defined largely by calorie intake). This number was dramatically reduced to 125 million in 1985. Since 1985, the pace of the reduction has been far slower. However, successful inroads have still been made with the population living below the poverty line being reduced to 80 million in 1992. Traditionally, the strategies embarked on in the past have been large scale, Government driven efforts often using a combination of highly subsidized credit and new or existing township and village enterprises (TVEs). Many respected Chinese researchers have concluded that these traditional approaches suffered from an inability to become sustainable without heavily subsidized capital. It was also often noted that under these schemes, short-term benefits accrued disproportionately to TVEs and to their (usually state) owners rather than to poor households.

Being a state led and state driven society, the Chinese strategy for poverty eradication relies on an intricate set of bureaucratic arrangements reaching through all levels of Government as well as through the various levels of state-owned companies (centrally, provincially, and county owned). At the core of these institutional arrangements is the Leading Group on Poverty Alleviation, an inter-ministerial body with executive authority reporting to the highest level of Government (the State Council). Created in 1986, the Leading Group currently allocates an annual budget of \$ 1.2 billion (largely through heavily subsidized loans granted by banks). Starting in 1997, it will have double this amount as well as a \$500 million World Bank loan due to become operational in the near future. This funding is provided to target counties officially designated as "poor counties" making them eligible for this support and other efforts. Almost 1/3 (nearly 600) of all counties in China have been designated either by Central or Provincial Governments as "poor".

As in many parts of the world, the state driven approach adopted by China has had serious shortcomings. In particular, the use of heavily subsidized credit has often created short-term improvements that are short-lived and unsustainable. Leading researchers have also observed that many programmes and projects aimed at creating sustainable livelihoods for the poor have been generated through well meaning top-down efforts using Township and Village Enterprises (TVEs) that are unsustainable. Throughout China, numerous initiatives have been undertaken by existing and specially created TVEs fueled by highly subsidized loans which lead to short-term production of a variety of agricultural and non-agricultural products that are either not marketable or are produced at distorted prices which cannot be sustained in the long-term.

More recently the Government has embarked on a different approach to poverty alleviation based on support to economic activities at the household level. This strategy rests on helping households to develop a broader portfolio of economic activities (both agriculture as well as cottage industries and services). The core strategy is the 8 - 7 poverty alleviation plan whereby households would develop specific agriculture (basic grains and cash crops) activities for their own food security as well as off-farm activities. A critical constraint to supporting these grassroots economic activities is that substantial capital (currently \$1.2 billion per annum due to be doubled next year) at subsidized

rates is channelled through enterprises at central, provincial, and county levels. Little experience exists with lending to individual households and what does exist indicates very poor rates of recovery.

Within this complex, state driven and "top down" environment, microfinance (M/F) has been initiated as an experimental activity to test an alternative strategy of making a service available which is based on the choices of poor households rather than on Government directed initiatives. For China, microfinance represents a radically different alternative for credit and savings services than is currently available through the formal and semi-formal financial institutions in rural areas where the vast majority of the poor subsist. The major differences from services currently available are that microfinance: 1) targets a poorer segment of the population than what is currently being reached by the two main institutions operating in rural areas--Rural Credit Foundations (RCFs) and rural Credit Cooperatives¹ (RCCs); 2) clients have freedom to choose how loan capital will be used; 3) all experiments in China use variations of the Grameen Bank 5-person guarantee groups and center (30 - 50 borrowers) meetings; and 4) the interest rates charged in microfinance programmes, while still subsidized at 16% per annum (effective rate)², are far above interest rates charged under most poverty alleviation programmes (often at 0 or 2% per annum).

The Government has allowed a number of microfinance experiments as part of its ambitious efforts to eradicate poverty by the year 2000 and has signaled a willingness to consider a broader range of experimentation than has been considered heretofore. The recent first workshop on microfinance allowed for a stronger recognition on the part of Government and, in particular, the lead agency responsible for PA efforts, that further experimentation above current levels would be welcome. The head of the lead agency made clear in his address to the workshop that there needed to be a scale of impact and variation to the different types of areas that would allow for meaningful funding and aggressive expansion based on proven successes.

Microfinance activity in China is at the very early stages of experimentation. Less than 3,000 clients are covered at present between some 8 units in various phases of implementation by: 1) the Rural Development Institute/Grameen Trust and the Ford Foundation and 2) UNDP/CICETE with RDI technical support. The two oldest units under implementation (Yixien-Hebei/Yuchang-Henan) have 2 years of experience and approximately 700-800 clients each and have been implemented by

¹ Rural Credit Foundations are currently not regulated by the Peoples Bank and are under the Ministry Of Agriculture. RCFs were initiated 13 years ago largely with capital from County Governments and their enterprises. Currently the MoA claims that there over 100 million households being services by the locally managed and owned institutions. There are some 150,000 RCFs throughout China with total assets (loans) of RMB 72.3 billion. Rural Credit Cooperatives date back to the early 1950's but were assimilated by the Agriculture Bank of China and only recently have they been begun to be separated out as a separate set of institutions. The total assets and savings of these institutions are far greater than RCFs (+US \$ 70 billion in assets as well as savings).

² Current estimates are that to be fully sustainable microfinance programmes require an interest rate of 30% per annum as inflation is running between 12 - 15% per annum and overheads as well as provision for losses would require a total rate of 30%.

RDI. UNDP funded units only began implementation in the first quarter of 1996 and while the first few hundred clients appear to be operating well, it is too early to develop any conclusions of these experiences. (However, a recent review of the oldest units revealed troubling patterns and performance. In particular the decentralized way in which these units are being implemented by RDI has led to a lack of discipline and practices at variance with international best practices³. Interviews with project staff working on UNDP/CICETE units revealed similar concerns and lack of on-going, reliable technical support.)

In short, M/F is at an embryonic stage in China and much more needs to be learned about how to make this activity sustainable in the state dominated environment further constrained by a strong commitment to subsidized rates of interest. At the same time, despite the substantial constraints and the limited experience gained to date, the Mission is in full agreement with those who are optimistic about the prospects for M/F in China for three reasons. Firstly, initial experience in terms of the viability of the "product" in the context of China are highly encouraging; secondly, microfinance has proved itself in a broad range of contexts and there is no reason to believe that China (provided the basic constraint of interest rates can be dealt with) will be an exception; thirdly, and most importantly, a range of international and Chinese observers/practitioners are in agreement that the Government is beginning to display a real commitment to giving M/F a full opportunity to test itself in China.

The scope and scale of the market for M/F in China is obvious. Given the history of the ability to rapidly disseminate and implement (both good and bad) initiatives in the country, it is more than conceivable that China could have several million clients benefitting from M/F services in 10 years or less. If microfinance is given the necessary space to evolve and is proven successful, the consequences can be far reaching not only in providing financial services for the poor and poorest segments of the population on a sustainable basis, but also in helping to devise alternative approaches where the poor are given a real role in defining strategies to support their needs.

Microfinance and Financial Sector Reform

China is in the first phase of a lengthy and gradual process of reform of its financial sector. Four basic laws were enacted in 1995 which, according to Annual Report of the Central (Peoples) Bank, should be deemed historic. In centrally planned economies, the financial sector is often used more as an instrument of planning, disbursement, and control rather than as a means to intermediate capital efficiently. The laws enacted in 1995 further the complex process of separating and

³ In particular: 1) disbursing second loans prior to full repayment of first loans (international experience has been to keep a firm discipline on not disbursing subsequent (and larger) loans until full payment of previous loans has been a key incentive); 2) using accounting staff to form groups and disburse funds (due to the necessity to carry cash in order to bring the services to the poor this function is normally kept totally independent from group formation and recovery); 3) women have often become conduits for activities undertaken by men (while this occurs in other countries the frequency observed in one unit could mean that this practice is prevalent in some units); 4) lack of standard operating procedures or common accounting systems making performance comparisons extremely difficult.

segregating central "policy" functions from basic banking functions. For efforts in microfinance, what is important to consider is the reform of the rural financial sector.

The Mission was able to meet with officials from: the Peoples Bank of China, the Rural Credit Foundations, the Rural Credit Cooperatives, and the Agriculture Development Bank, many of whom were aware of the incipient work in microfinance and some of whom attended the workshop. The Mission did not have the time or mandate to go into the complexities of financial sector reform in China, but the rationalization of institutional structures is apparent by the recent establishment of the Agriculture Development Bank and the Rural Credit Cooperative Societies as separate entities from the Agricultural Bank of China.

The key purposes in meeting with these officials were to describe the possible experiment (described in Part Three) that UNDP/CICETE would undertake in microfinance and to check for reactions and possible areas for collaboration. From these discussions, it is clear that if microfinance can make a credible case, there would be greater receptivity now to mainstreaming these experiences in these vast structures than a short time ago. Any serious effort in developing microfinance requires an on-going dialogue with these institutions, which are in a process of significant reform and change. This could also provide much incentive for picking up successful experiences that could be developed by UNDP/CICETE and other collaborators.

Reflections on the First International Workshop on Microfinance

Given the embryonic nature of microfinance in China, what was striking about the workshop was the level of participation it received on the part of Government and others. An initial estimate of some 60 participants was far below the actual attendance which approached 200 for the event. The organization by the Rural Development Institute was excellent and the unusual approach of taking a substantial part of the workshop (some 70 individuals) to Henan Province to view an experimental branch via a 14-hour train ride added to the depth and ability to exchange information and ideas among participants. From all the Mission could gather, the UNDP/CGAP/Ford Foundation supported event was successful in establishing microfinance as a credible activity in China.

The keynote address by the Head of the Leading Group, Gao Hongbin, was clear in giving microfinance a chance to prove itself. However, the address also made clear that there would be skepticism until real tangible results were achieved. Informal discussions with this influential leader at the banquet that evening further convinced the Mission that the Leading Group is results oriented and pragmatic. The closing speech by an influential deputy in the Leading Group (and with key responsibilities in Agriculture), Mr. Yang Zhong, revealed that the microfinance experiment had been taken note of at the level of the Premier himself, who was supportive of the effort.

While a broad range of issues was discussed in the 3-day workshop both by international experts (J.D. Von Pischke, Marguerite Robinson, and Prof. Latifee of Grameen Trust) and local experts/practitioners, interest rates occupied a special place on the agenda and became a recurrent theme. Government officials heard from a variety of points of view and speakers, the need for sustainable interest rates and the consequences of subsidized interest rates. One particular important

presentation was by a senior member of RDI, the most experienced agency in China in this area, who posited that an appropriate interest rate in the context of China was 30% per annum. Current interest rates in poverty lending vary from some 2% per annum to 12% (UNDP efforts are at the highest effective rate--16%). Given an inflation rate of 12 - 15% per annum the 30% per annum suggested by the RDI official would be consistent with international best practice.

The field visit to Henan province (Yuchang County) further continued this dialogue with local Government officials. The Mission would note that the County Government appeared open to the use of higher rates of interest.

Mandate for Experimentation

In response to the workshop especially, the Government has signaled a willingness to accept a defined experiment to see whether M/F can be a useful tool in China. The Mission believes that the recognized license to experiment includes the critical parameter of interest rates and that the efforts of UNDP and others can proceed on this basis, provided recommendations contained in the next parts of this report are carried out. In addition to the critical parameter of interest rates, many other parameters also need to be explored as part of the experimentation being accepted, among them: governance, institutional arrangements, staffing, and frequency of meetings, disbursements, and savings.

B. The Status of Microfinance in China: Observations from Field Visits in Henan and Hebei Provinces

In Henan (Yuchang County):

The Mission observed two center meetings and visited approximately 15 households under the RDI/Grameen Trust supported replication project. In addition, a visit was set up to another initiative which loosely uses the "GB" model as a collection mechanism for a lending programme directed at vegetable production in the County. This later effort involved a recently created TVE specialized in the marketing of vegetables.

The following was observed:

1. The Center Meetings followed the standards observable in Bangladesh and elsewhere. However, borrower understanding of details (amount in savings, etc.) was not as impressive.
2. In a majority of households visited, the economic activities financed were conducted by the men (or sons). The women appeared to be conduits for the loans. This may not necessarily be a problem, but it is a factor that should be monitored, as most programmes do focus on financing the activities initiated and operated by the women themselves.
3. An important innovation has been introduced in Yuchang in the recruitment of Center Chiefs as project staff. This is an interesting means of recruiting women which, provided they are not involved with credit operations in their home villages, could work well. However, this should be carefully observed. The Mission would note that in one village where 2 women had been recruited in this fashion, it was expected that Center Chiefs were a natural means of obtaining stable employment at RMB 200 per month.
4. Significant departures from the basic methodology were observed. For example, a number of households were receiving second loans prior to full repayment of first loans after borrowers persuaded project staff that this practice was advisable. This particular experiment undermines one of the most important foundations of microfinance: subsequent larger loans based on successful repayments.
5. In a majority of cases the assets and income of the households visited would qualify them substantially above the officially and project determined ceiling for consideration in the programme. In programmes where a sustainable interest rate is employed, this factor is less of a problem. In China, however, the implied transfer payment is reaching the wrong beneficiary. The Mission took pains to explain to local authorities that targeted programmes often suffer this form of leakage. Due to the attractive interest rates, the incentive for non-targeted households to join were high.
6. The Vegetable Marketing TVE usage of the basic Grameen (GB) model as a collection mechanism appears to have worked well for the County Enterprise in question. However, the

enterprise has minimal funding, serves as a conduit to subsidized loans (from Leading Group sources), has no business plan or demonstrable understanding of the market, and appears (as in numerous cases of this kind) to be headed for failure after a short-lived success.

Observations from Heibei (Yixien County):

Established in late 1994, Yixien is the first and oldest of the RDI/Grameen Trust promoted Branches. It has close to 800 clients operating in 19 centers. Several basic problems were observed that show that the original disciplines critical for project success were either not properly instilled or, more likely, have dissipated due to a lack of supervision. This experience raises fundamental questions about attempting microfinance in China as the role of local Government is a complicating factor that needs to be contended with in a pragmatic fashion.

Principal problems observed in Yixien:

1. The Mission visited on a Tuesday and was told there were no Center meetings on this day. Given the number of staff and number of centers reporting (19) it is highly unlikely that no center was scheduled to meet. It appeared (unconfirmed by interviews) that center meetings are not being held in the manner intended (weekly), an observation that others from RDI have expressed to UNDP colleagues.
2. In asking about the functions of staff, the Mission was surprised to find that the accountant was also organizing groups and responsible for center meetings. This situation subverts the basic control of a project of this nature which requires staff to handle substantial amounts of funds. The division of responsibilities between the central accounting function and the grassroots banking functions need to be completely separate.
3. The transparency and financial accountability of these types of programmes is based on source documents that are jointly filled out and signed by staff and borrowers (receipts, contracts, pass books etc.). These documents govern the accuracy of the reporting and, ultimately, the legitimacy and credibility with clients. They are usually prepared in full view of all participating borrowers. A book for registering center disbursement and repayment schedules signed by project staff and center chief was noted where the date of signatures was substantially at variance with the date of center meetings (often by 1 month). Either for reasons of convenience or, more likely, as borrowers are not conducting weekly meetings, the basic purpose of this important document has been subverted.
4. The basic accounting ledgers for the project had not been updated since December 1995 for reasons that were neither clear or persuasive to the Mission or Chinese counterparts.

Conclusions from Field Visits

It should be noted in a majority of household visits, borrowers were asked whether they could afford higher payments required for sustainable interest rates (30% per annum) by proposing

specific adjustment to weekly payments of RMB 2 - 5 per week per 1,000. In no case were borrowers (who had already obtained loans with fixed terms) objecting to these increments.

The Mission was unable to examine the Management systems in Yuchang (Henan) as it did in Yixien. Thus no comparison is possible on these functions. However, both visits--the first with borrowers and the second with staff-- do note a common slippage in the original systems and procedures designed for the effort. The Yixien observations are particularly troubling as the fundamental disciplines to guarantee the quality and, above all, financial transparency, were lacking. Microfinance without transparency and accountability will have very limited prospects in the challenging environment of China.

One of the critical problems noted from the above and confirmed for other pilots supported by RDI/GT, as well as UNDP, is the lack of a common simplified and effective standard operating procedures and accounting and management information systems. This is a critical sine qua non to establish a credible and manageable set of experimental pilots which will test different methods and practices in microfinance. A central and unique feature in microfinance is "taking banking to the client", which involves numerous staff collecting and disbursing relatively large amounts of funds. International experience shows that lack of appropriate systems and controls is a common cause of poor performance or failure.

Experimentation cannot be done in an ad hoc manner. It requires disciplines that allow for real learning. Classic science experiments require a "controlled environment" in order to guarantee the process of scientific testing and observation. In microfinance, accounting and management information systems play the same role in guaranteeing the feedback and understanding of what is going on in the field. A basic common language governing procedures and information which lead to transparent performance indicators is a necessary starting point.

At this stage of microfinance development in China, the lack of common accounting/information systems can be considered to be the critical constraint that needs to be dealt with before real and credible experimentation can begin. Once this basic foundation is laid, the numerous other elements required, in particular training and capacity building can be dealt with.

C. Exploring the role of the UNDP in establishing Microfinance as a Credible Instrument for Poverty Alleviation in China.

Poverty Alleviation for the Next Cycle

For the next cycle the Government has entrusted UNDP with an important role in poverty alleviation efforts. Some 30 counties designated for PA efforts by Government will be targeted. Building on experience gained during the last cycle, a number of programme documents have already been designed and reflect a tailored approach in which each county will receive a range of support based on local needs and resources. Over \$ 22 million in financial resources will be involved in these efforts which will cover a myriad of activities in poverty alleviation. At present, the strategy is to devise these programmes on a province (and county by county) basis to ensure activities appropriate to the need and resource base of the various communities. All efforts rely on a participatory approach with local communities.

A broad and complex range of activities are envisioned in the projects developed so far (Gansu, Hunan, Sichuan, Tibet). Components covering activities such as health, education, water, income generation, and several other areas are all provided for. While activities vary from province to province and county to county it is envisioned that there will be a microfinance "branch" established in each county. To date the microfinance components have been costed at some \$ 50,000 to \$150,000 per county for revolving funds. The microfinance components in general represent no more than 15% of financial resources allocated to each Province PA project.

The present approach is to heavily integrate microfinance into the broad range of expected activities envisioned. In discussions with UNDP and, especially, Government staff, M/F emerged as almost a "cure all" as it was expected to deliver well beyond any proven capability. In the Mission's opinion, a very real risk exists that microfinance could become too much of a panacea in the process of project implementation and the disciplines confused with far "softer" forms of development support.

UNDP China experience in microfinance is still in its early stages, with activities being initiated only in early 1996 and the largest number of clients (Yilong County) less than 500. Although UNDP experience is very positive so far, the lack of a proven or standard information system makes any assessment very premature. Interviews with field-based staff, UNDP Beijing, Consultants, and a detailed review of documentation combined with the observations from Henan and Hebei (from which UNDP efforts have been derived and adapted) allow for the following conclusions:

1. Microfinance represents a distinctly different type of intervention to other activities due to the need for discipline and accountability to ensure the creation of sustainable financial services. Experience around the world is conclusive that if this service is mixed with other complex efforts (water catchment systems, health, education, TVE development, irrigation, etc.), clients are

apt to consider the lending component more as a welfare/Government programme than as a disciplined effort to establish sustainable services.

2. A corollary to the above point is that under an integrated approach, local management of M/F activities tends to be subsumed and even confused with broader project efforts. Staff involved with M/F should have a different approach and discipline than those supporting technical training, broad organization work for health, literacy, and income generation activities. For these reasons a separate and centralized discipline is required to guarantee quality control and the reliability of information.

3. It is important that expectations surrounding microfinance be kept in line with capability and proven performance. Present attitudes could easily lead to optimistic disbursement and poor performance.

Potential Scale of UNDP/CICETE Microfinance Activities

As per the statements of Senior Government officials, they are willing to allow microfinance to be considered. However, they will need to be convinced by credible results. Scale and geographic distribution are perhaps the most important variables in determining a "credible experiment". UNDP's planned efforts to initiate M/F activities in 30 counties places it at the forefront of bringing critical mass and geographic coverage to experiments in this area. A conservative estimate would be to design M/F efforts in each county to reach 2,000 clients by the third year of implementation. Given a staggered implementation of 10 units per year should to a total client base of 30 - 40,000.

The present strategy for implementing m/f activities in the UNDP funded poverty alleviation programme has significant risks and misses significant opportunities for establishing sustainable microfinance services for the poor in China. The ad hoc nature, lack of centralized controls and monitoring combined with the complex local environment allow for UNDP/CICETE efforts to follow the same pattern as the RDI implemented branches visited. At the same time, the combined scope and scale of M/F activities allow for a critical mass of activity that can justify a more ambitious approach. This will allow much greater support and back up to these fledgling efforts, which could easily dissipate without the proper framework for guidance and control.

A rough estimate is that under current arrangement of the \$ 22 million already approved for PA activities in the next cycle, some \$ 4 to 5 million would be dedicated to microfinance. The following proposal can easily be carried out within this financial envelope and include the substantial improvement that the institutional arrangements can become financially self-sustaining over time.

Non-microfinance Income Generation

A final point worth noting is that a review of the PA activities to date do not adequately cover the issue of entrepreneurship. New enterprises initiated by individual entrepreneurs with investments of \$1,000 or more are not covered by microfinance, and could be a critical source of income generation. In addition, ways in which the county owned TVE's could be reformed and restructured to support private entrepreneurship and greater employment is strongly recommended.

D. Concluding Summary

If present and planned experiments are successful, microfinance⁴ has vast potential in China. The recent recognition of the microfinance experiments being conducted in China from Senior officials offers an opportunity to work in collaboration with central, provincial, and local governments for sustainable financial services for the poor. Government's interest in microfinance stems in its utility as a tool to eliminate poverty.

The on-going restructuring of the financial sector (especially the rural sector) also presents remarkable opportunities as the Government seeks to rationalize and improve the performance to be significantly affected by sustained, well-defined, and transparent successes in microfinance units serving 2,000 and more clients. However, to influence institutions which claim outreach to well over 100 million households, defining success for microfinance has much to do with the complex issue of scale.

Microfinance is in an embryonic phase in China. It has been applied over the past 2 years as a new financial instrument with 2 sets of initiatives: 1) efforts of Grameen Trust and the Ford Foundation with implementation being supervised by the Rural Development Institute and 2) UNDP funded (with RDI training support) and CICETE implemented efforts.

The oldest, funded largely by Grameen Trust, consists of 4 branches in various stages of development. The Mission visited the original branches in the provinces of Heibei and Henan (see Part One). Total client base appears to be below 2,000. UNDP efforts date only to the first quarter of 1995 and, while positive results have been noted, lack of well established reporting systems make analysis of these experiences extremely premature. Some 4 branches are in various phases of implementation and are in need of immediate support.

Chinese policy on poverty alleviation is driven by strategies devised to use heavily subsidized capital. There is a growing disenchantment at the highest levels of Government with the lack of impact, inefficiencies, and distortions created by this approach, as well as an increased awareness that the direct beneficiaries of these schemes are not the poor. Within this complex environment new space has been opened to examine the potential of microfinance in China.

⁴ meaning small loan and savings services for the poor in the range of \$2 - 500 per client account (largest concentration is usually \$ 50 -250).