

People's Republic of China

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Summary

With a population of 1.24 billion, the People's Republic of China offers an enormous market for microfinance. While there are a number of small microfinance projects attempting to apply international lessons, they have minimal outreach in relation to the potential market demand. Far greater outreach is achieved by government microcredit services implemented as part of poverty eradication efforts. These services are heavily subsidized and unsustainable, and are viewed by both government and central bank as a social, rather than a financial sector, program.

The People's Bank of China (PBC, the central bank) sees microfinance as a low priority, given pressing issues of financial sector development and reform. Interest rate controls are a major impediment to sustainable microfinance. However, while complete deregulation of interest rates depends on the resolution of broader issues, PBC could allow progressively greater flexibility in the case of microfinance loans. It could also undertake further "promotional" activities to support microfinance, such as authorizing more pilot projects, research, training, and working with other stakeholders to develop performance and reporting standards, as well as improving the operational effectiveness of rural credit cooperatives.

People's Republic of China

Currency Equivalent

Currency Unit – Yuan (Y)
US\$1 = Y8.3 (at mid-1999)

Abbreviations

ABC	Agricultural Bank of China
ACWF	All China Women's Federation
ADB	Asian Development Bank
AusAID	Australian Agency for International Development
CANGO	China Association for NGO Cooperation
CASS	China Academy of the Social Sciences
CICETE	China International Centre for Economic and Technical Exchange
DID	Développement International Desjardins
GDP	gross domestic product
GNP	gross national product
HDI	Human Development Index
IFAD	International Fund for Agricultural Development
LGOP	Leading Group Office on Poverty Alleviation and Development
MFI	microfinance institution
NBFI	nonbank financial institution
NGO	nongovernment organization
PBC	People's Bank of China
PRC	People's Republic of China
RCC	rural credit cooperative
RCF	rural cooperative foundation
SOE	state-owned enterprise
TVE	township and village enterprise
UNDP	United Nations Development Programme
UNICEF	United Nations Children's Fund

Note

In this report, "\$" refers to US dollars.

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1 Introduction and Background

1.1 Key Demographic and Economic Data

The People's Republic of China (PRC) had a population of 1.227 billion people in 1997 of whom 391 million (or 32 percent) lived in urban areas. The population had grown at an average annual rate of 1.3 percent over the period 1980 to 1997. Over that same period, gross domestic product (GDP) in real terms had grown at 10.2 percent (1980–1990) and 11.6 percent (1990–1997) (World Bank 1999). Gross national product (GNP) per capita grew at 7.7 percent over the period 1975 to 1995, indicating rapid improvements in standard of living. By 1997, GNP per capita was \$860 while GDP per capita in purchasing power parity terms was \$3,130. PRC ranked at 98th among 174 countries for which the United Nations Development Programme's (UNDP) Human Development Index (HDI) was calculated in 1997. It was placed in the medium human development category with an HDI score of 0.701 (UNDP 1999).

GNP per head grew at an annual rate of 7.7 percent over twenty years, to 1995

The World Bank (1999) cites survey evidence recording the incidence of poverty in PRC at 6 percent in 1996 (7.9 percent in rural areas, less than 2 percent in urban) while giving a Gini index score¹ of 41.5. This indicates a relatively uneven distribution of income (by comparison with, for example, India at 29.7 or Bangladesh at 28.3). In terms of distribution of income, PRC is comparable with the Philippines, with a Gini index score of 42.9. Over the period 1990 to 1997, some 69 percent of the male and 76 percent of the female workforce remained in agriculture, while value added in agriculture in 1997 was only 19 percent.

1.2 Poverty in the People's Republic of China

In the past two decades, as the data cited suggest, PRC has undergone a massive economic transformation and corresponding changes in social conditions. Government estimates cited by Kiminami (1999) show the numbers of the poor shrinking rapidly from some 250 million to around 125 million between 1978 and 1985, due principally to the introduction of household responsibility in agriculture, which increased the monetary incentives for private initiative. The number reported had dropped further, to 80 million, by 1992.

Over two decades China has undergone massive economic and social change, with substantial reductions in poverty

From the 1980s, PRC had looked to reduce poverty primarily through economic reform, with sustained and rapid macroeconomic growth. The Government had become aware of a policy inconsistency, between reducing government intervention to encourage markets and employing mass interventions for poverty reduction. Hence, policies for poverty eradication had evolved during the 1980s from a "rescue and alleviation" model to a "developmental" one (China Institute for Reform and Development 1998).

Despite this, in 1993 PRC thought it necessary to launch another mass intervention, the National 8–7 Plan for Alleviation of Poverty (1994–2000). This "8–7

1 The Gini index appears in the literature, for example, World Bank (1999) and UNDP (1999), with a value between 0 and 100. This indicator is essentially the same as the Gini coefficient, with a value between 0 and 1.

Plan” was framed with particular reference to 592 counties identified as poverty stricken, where poverty was to be eliminated by 2000. In its mechanics, the plan is described by the China Institute for Reform and Development as a “strict top-down responsibility system, which compulsorily includes poverty reduction as a concrete and long-term act by governments at various levels ... established on the basis of administrative hierarchy.” This mechanism mobilizes rapidly to implement new policies on a wide front, but the China Institute also noted some “obvious defects,” including “insufficient participation and organisation of the poor population” (China Institute for Reform and Development 1998, 16).

It appears the goal of eliminating poverty altogether was proving elusive even as absolute numbers of the poor declined during the early 1990s. Poverty had become increasingly regionalized, concentrated in remote, mountainous, or otherwise ill-favored areas. Western provinces away from the coast, benefiting least from economic reform and an increasingly open economy, were a particular locus of poverty. As an observer noted:

It is becoming increasingly difficult to address poverty. It is against this background that the Chinese government announced the 8–7 poverty alleviation plan. The Chinese government is determined to mobilise all resources ... to resolve the issue of feeding and clothing 80 million poor people in seven years ... There is rarely such a government action plan with such a definite time framework and such a clear poverty alleviation objective (Guo 1997, 8).

The China Institute for Reform and Development was pessimistic in 1998 about eliminating rural poverty by the end of the target year 2000, even referring to “re-pauperization” due to structural change in some areas. Urban areas also presented new difficulties. In 1993 the urban poor were estimated at 12 million, with an incidence of only 3.6 percent. However, more recent reforms in the state-owned enterprises (SOEs) had led to further millions of workers being laid off, so that the total of urban poor and retrenched workers was then probably more than 20 million people, with an increasing incidence of absolute poverty (China Institute for Reform and Development 1998). The 8–7 Plan has been directed to the rural poor and to the 592 designated poor counties. It does not have an urban focus.

2 Development of Microfinance

Almost all discussions of this subject in PRC itself refer to “microcredit” rather than “microfinance.” Two reasons may be suggested for this. First, the emphasis on credit to the exclusion of savings reveals the top-down thrust of Chinese poverty alleviation programs, in which resources are funneled into the regions. Second, it suggests that lack of access to savings facilities is not seen as a problem, since PRC’s aggregate savings rate is extremely high by international standards.

In this report, the term “microcredit” (as distinct from “microfinance”) will be used to describe government lending programs which have adopted some of the organizational principles of microfinance, mostly taken from the Grameen model, without absorbing its financial principles. Microfinance is defined by the Asian Development Bank (ADB) as “the provision of a broad range of financial services such as deposits, loans, payment services, money transfers, and insurance to poor and low-income households and their microenterprises” (ADB 2000, 1). Any discussion of microfinance in PRC needs to distinguish clearly between two quite separate categories. The first consists of small (mostly foreign assisted) attempts to apply international lessons in microfinance to Chinese conditions. The second concerns the more recent mass delivery of subsidized microcredit to poor households by government, with the aim of abolishing poverty by the end of 2000, under the 8–7 Plan.

As absolute poverty has become less of a mass problem, poverty policy has become more targeted

Industrial restructuring has increased the numbers of urban poor

Small foreign-assisted projects apply international microfinance principles whereas mass government programs provide subsidized microcredit

2.1 External Support for Microfinance

According to Holcombe and Xu (1997), the International Fund for Agricultural Development (IFAD) and the United Nations Development Fund for Women had supported projects in PRC with credit or revolving fund components from the early 1980s. One of the earliest projects with some characteristics of microfinance was supported by the United Nations Children's Fund (UNICEF) and conducted by the All China Women's Federation (ACWF) in Shaanxi Province from 1989. This is particularly interesting because the credit scheme was "an indigenous response to poverty" designed by ACWF. The Women's Federation realized that training women in income-generating skills was pointless if the women lacked capital to put their new skills into practice. Another feature of the Shaanxi scheme was its trialing of six distinct credit models, employing the typical Chinese method of experimentation prior to scaling up.

Microfinance on international principles was stimulated by the official "8-7" poverty alleviation plan, from 1993

Microfinance, as it is understood internationally, can be dated in PRC from the commencement of the 8-7 Plan, albeit with "Chinese characteristics" (Guo 1997). In 1994, the China Academy of the Social Sciences (CASS) commenced a pilot microfinance project in Yixian County, Hebei Province, with international support. This was based consciously on a foreign model (the Grameen Bank) and attempted to apply best practice principles. The scheme was an experiment conducted by CASS without benefit of financial institution status but tolerated by the central bank (People's Bank of China, or PBC) as a research exercise. Its activities have expanded, but the issues of its status and right to engage in financial sector activities remain problematic. As a result, CASS has felt increasing uncertainty in regard to both continuity of foreign support and vulnerability to arbitrary official intervention.

By the end of 1998, the project was operating in three counties in the provinces of Hebei and Henan. Total disbursements amounted to some \$1.76 million to 8,900 borrowers in 1,760 groups. Repayment rates were reported at between 98 percent and 100 percent, and the annual interest rate on loans was 6 percent, nominal. CASS claimed to have achieved operating self-sufficiency (with the longest operating program, in Yixian County, said to be running at 173.6 percent operating self-sufficiency and 85.5 percent financial self-sufficiency at the end of 1998). In Yucheng and Nanzhao counties, CASS claimed financial self-sufficiency ratios of 101.6 percent and 97 percent, respectively (China Academy of the Social Sciences 1999).

Pioneering microfinance projects claim high degrees of self-sufficiency, but comprehensive independent audits are needed

At a fourth site (Danfeng County, Shaanxi Province), CASS was implementing a more recently established project that appears to have become subsumed into the poverty alleviation program of the 8-7 Plan when subsidized loan funds at 3 percent per annum became available. CASS is providing technical assistance to this project. This was substantially larger, both in funding and outreach, having more than 25,000 borrowers in some 5,000 groups, with \$2.8 million disbursed in two years to the end of 1998 under CASS management. CASS claimed a 96 percent repayment rate with 81 percent operating self-sufficiency (China Academy of the Social Sciences 1999).

CASS itself feels the need of a comprehensive independent audit of all its projects. One issue in such an audit might be the extent to which Beijing "headquarters" costs are adequately recognized in sustainability calculations, as well as services and resources provided in the field by the Agricultural Bank of China (ABC) and local governments. Gibbons, an experienced observer, has estimated that CASS would need to charge at least 12.5 percent per annum, nominal, to achieve long-term sustainability (Gibbons 1999).

Whether lending rates of interest are high enough is an important issue

Another observer, Park, comments that "during the past five years, the microfinance movement has taken China by storm." Since 1994:

... a host of international and domestic organisations (often in partnership) have introduced a variety of models ... A number of provincial governments, frustrated by

the disappointing performance of China's subsidised poverty loan program, have also turned to microfinance design features and the national Office of the Leading Group for Economic Development in Poor Areas has given the movement its blessing (Park 1999, 9).

Park lists 17 internationally funded projects, supported by bilateral and multilateral donors and international nongovernment organizations (NGOs), and explains the rapid take-up in these terms:

Because most nongovernment programmes are externally financed, limited in scale, and targeted to the poor, local governments have generally supported new initiatives, even allowing programmes to charge effective interest rates above official rates (p. 9).

UNDP had 13 microfinance projects in August 1999, implemented with the China International Centre for Economic and Technical Exchange (CICETE), in which nominal annual rates of interest (negotiated with CICETE and local authorities) ranged between 6 and 10 percent. This appears to be the range within which almost all externally supported projects fit. Few microfinance programs anywhere could expect to achieve sustainability charging such rates. Counting the projects of other international agencies (IFAD, UNICEF, World Food Program, International Labour Organization, United Nations Fund for Population Activities, World Bank), microfinance programs are supported in 150 counties of 22 provinces (Wang 1999), not counting those of bilateral agencies and international NGOs.

UNDP works with CICETE to select project sites and depends on local governments and semi-government organizations (such as ACWF) to implement the projects (Wang 1999). By contrast, an IFAD program is implemented via the Ministry of Finance and employs rural credit cooperatives (RCCs) to handle the loans. RCCs have PBC permission to price loans at the top of a "band," at up to 50 percent above the official lending rate. A project operated by Développement International Desjardins (DID), a Canadian NGO, is interesting in that it provides only technical assistance, designed to blend Grameen methods with RCCs' operations.

At the time of writing, RCCs can charge around 10 percent per annum, flat, under the "band" arrangement. DID claims that with "fees" this is enough to cover costs and provide a small return to the collaborating institutions. However, official easing of monetary policy in recent years, aimed at stimulating the macroeconomy, has put downward pressure on the lending rates that microfinance institutions are able to negotiate with local authorities. Thus, in mid-1995 the official lending rate on 12-month working capital loans was over 12 percent per annum whereas at the end of 1998 it had fallen to 6.39 percent per annum (People's Bank of China 1999).

There is an Australian Agency for International Development (AusAID) project that also involves a formal financial institution. This project is implemented by the Agricultural Development Bank of China and has a range of lending rates up to 12 percent per annum, nominal. Overall, however, the opportunity to trial cost-recovery interest rates is limited. The central bank appears content to allow such externally supported experiments to continue, but is less willing to countenance any more widespread flexibility in interest rate setting, or any substantial scaling up of successful experiments. The central bank would be concerned with the implications of such flexibility for the broader financial system (discussed in Section 3). Meanwhile, the recent rapid expansion of official subsidized microcredit (discussed in Section 2.2) increasingly limits the potential for large-scale replication of experimental programs that are viable.

There is a range of microfinance models in operation. Park noted 17 projects. Morduch et al. (1997) described 15 projects operating in 1997, of which five were adaptations of the Grameen model and provided group loans, while three others provided individual loans and another four provided revolving funds for groups and individuals. One program provided a loan guarantee for bank loans (Meyer and

Internationally supported microfinance projects have proliferated, often with local partnership

Lending rates are negotiated with local authorities and range between 6 and 10 percent per annum, flat

Rural credit cooperatives have some limited flexibility in setting interest rates

A variety of microfinance models are under trial, including the Grameen model, but the legal status of projects is ambiguous

Nagarajan 1999). Data for total outreach of microfinance programs are hard to find. In 1997, total outreach for donor-funded programs was suggested to be at around 10,000 (Morduch et al. 1997), but the number has been growing rapidly since then. There is a single urban microfinance initiative, in Tianjin, where UNDP has funded a project for women workers laid off by SOEs.

A common difficulty of all such programs is one of identity and entitlement, as noted previously in the case of CASS. They may have identities bestowed by virtue of a memorandum of understanding between CICETE and a donor agency, or by registration with the Ministry of Civil Affairs, but these do not bestow any financial institution status. As a result, under the present regulatory framework they do not have a strict legal entitlement to make loans, still less to accept savings.

2.2 Government Lending for Poverty Alleviation

Government lending schemes for poverty relief date from 1986 when a targeted and subsidized scheme was introduced. Most of this highly subsidized lending was channeled to collectives and to township and village enterprises (TVEs) rather than to individual households. Lending to households was not, in practice, targeted to the poor, nor did it generally reach them. Thus:

Official poverty lending programs date from 1986 and lending rates, at around 3 percent per annum, are heavily subsidized

PRC's subsidised loan program, like similar programs in other developing countries, has been heavily criticised for failing to reach the poor and achieving low rates of repayment. Subsidised rates of 2.88 per cent (compared to official interest rates of 8–10 per cent) have made the loans an attractive target for rich households, enterprises, and local leaders eager to support revenue-generating industrial projects. The loans are considered to have a welfare dimension that encourages delinquency. Average timely repayment rates have been only about 50 per cent (Park 1999, 12).

In 1996, with the year 2000 deadline approaching, authorities changed course by commencing to channel subsidized credit to individual households in the 592 poor counties. This was a substantial shift in social policy. While still conducted within the 8–7 Plan, this new strategy contrasted with the predominant mode of poverty lending, which was directed to collectives and TVEs, and is described as follows:

After initial scepticism toward new microfinance, the Chinese Government did a complete turnaround and since has become an active proponent. Much of the initiative has come from local governments, [and] ... most programs use funds previously allocated to the subsidised loan program (Park 1999, 12).

Only recently has emphasis been given to lending directly to households, rather than to collectives and state enterprises

From the Grameen model of microfinance, officials drew the notions of group organization, group guarantee, and repayment by installments, none of which is present in older-style poverty lending. From its start in 1996, the official microcredit program in Shaanxi reached 60,000 households within the year. In 1997, with the numbers of rural poor still as high as 50 million (or 6.12 percent of the rural population), the central government allocated Y8.5 billion (\$1.025 billion) to subsidized credit programs (up from Y5.5 billion in 1996). This amounted to more than half of all poverty alleviation expenditures, and a small but growing proportion of these funds began to flow towards microcredit.

Grameen principles of organization have influenced the official program under the 8–7 Plan

By August 1998, official microcredit schemes were operating in more than 600 counties in 22 provinces, with the largest programs (in Shaanxi and Yunnan) reaching over 500,000 households. Typical loan size was Y1,000 (\$120) with a maximum of Y2,000, and the annual interest rate was set at the poverty program level of 2.88 percent, nominal. In 1999, with between 30 and 40 million people still classified as poor, the central government's budget for the 8–7 Plan called for expenditures of Y24.8 billion (\$3 billion), of which Y15.3 billion (\$1.84 billion, or 62 percent) was for loan funds (UNDP 1999). Not all such lending could be classified as microcredit, but it appeared that as much as Y6 billion (\$700 million) would be outlaid on microcredit in 1999.

ABC is given responsibility for payments under the program. Funds are mobilized through ABC from the central government, and provincial government budgets are tapped for other costs. Reflecting the fact that activities under the 8–7 Plan are primarily of a social, rather than economic, policy nature, ABC works with the Leading Group Office on Poverty Alleviation and Development (LGOP) in each province. LGOP is responsible for planning and coordination and sets up the delivery mechanism, down to the “joint liability groups” of borrowers at village level. Initial attempts to employ local poverty alleviation associations under the guidance of LGOP as direct financial intermediaries between ABC and final borrowers were not acceptable to PBC. PBC requires the role of such groups to be restricted to social intermediation, including selection of borrowers and collection of repayments, for which they are reimbursed by ABC. This obliges ABC to contract directly with borrowers.

Funds are currently made available to final borrowers at the subsidized rate of 3 percent per annum (originally 2.88 percent). ABC bears the repayment risk, and there is normally no margin for its risk or administration costs. As a result, ABC incurs a significant additional subsidy cost. Despite the involvement of a major state financial institution and the volume of resources involved, the regional branches of PBC do not normally supervise these microcredit programs, regarding them as non-commercial in nature. This is an indication of the extent to which official microcredit is seen by PBC as a social rather than a financial program. It is also an expensive deviation from the path of commercialization laid down for ABC under current financial sector reforms (discussed in more detail later) since it is required to bear part of the cost burden of state social policy.

Some idea of the scale of recent official support for microcredit is provided by ABC (Wei Jiang Bin, personal communication). Between May 1998, when ABC took over the poverty lending program from the Agricultural Development Bank of China, and August 1999, total microcredit lending amounted to around Y2 billion (\$240 million) and benefited some 1.5 million families. ABC claims that some 3 million people were elevated from poverty as a result of this intervention. No estimate of the subsidy cost incurred by ABC is available; however, in view of growing pressures to operate commercially, this must be sufficiently large to give ABC an interest in finding more cost-effective modes of delivery. Park provides a sobering view of this growing government microcredit effort:

The rapid expansion of government microfinance has no precedent internationally, and probably should be cause for as much concern as excitement. Local officials may have interests that compromise their ability to implement lending programmes. In general officials have focussed narrowly on the ability of microfinance to increase repayment rates without grasping basic principles (Park 1999, 12).

Park reports findings of a small survey of a model government program. Loans were going to the rich and (in a program supposedly based on Grameen principles) small groups were non-existent. On-time weekly repayment rates were only 70 percent, compared with 95 percent in the CASS projects. Park predicts that “without correction, such programmes are likely to perform little better than those that they replaced.” He is critical of the failure to trial a wider range of microfinance models, claiming that “allegiance to the [Grameen] model has probably constrained the innovative potential of the microfinance movement in China.”

Some experiments have been conducted by government or semi-government agencies, outside the framework of the official poverty alleviation program. For example, the State Council Leading Group Office for Poverty Alleviation and Development has overseen pilot projects conducted with World Bank support in Sichuan and Shaanxi provinces since 1996 (Human Resources Development Center for West of China 1998–99). This is a modified Grameen replication. PBC has been experimenting with RCC delivery of microcredit in Hebei Province, using the flexibility allowed for RCC lending rates and trialing group organization methods.

Massive increases in official microcredit lending occurred approaching the end-2000 deadline

Microcredit under the 8–7 Plan is a social, not a financial, program

The rapidity of expansion of the official lending program has no precedent elsewhere

PBC is considering the potential of rural credit cooperatives for microfinance

Some Preconditions for a Diverse and Sustainable Microfinance Sector

- Interest rate liberalization
- Acceptance and adaptation by government of international best practice
- Emergence, and official acceptance, of civil society organizations to run MFIs
- Creation of new models of small financial institution

RCCs are widespread rural financial institutions, numbering more than 40,000 currently. They have a substantial deposit base, and while in principle owned by the member households, these cooperatives actually had little autonomy in their management and lending operations so long as they were controlled by ABC. In 1997 the central bank assumed responsibility for their operations. RCCs had typically lent substantially more to collectives and to TVEs than to individuals or households, and were not noted for micro-lending. However, PBC appears to regard RCCs as a key instrument for rural financial reform and the diversification of the rural economy, with a potential also for microfinance (RCCs are discussed in Section 3.3).

Park endorses attempts to channel microfinance services through existing formal financial institutions such as ABC (as done by AusAID) and RCCs (by IFAD, the Canadian International Development Agency, and PBC) and believes PRC should:

... create a rural financial sector with a diversity of institutions that face competition and specialise in meeting the needs of groups with different demand characteristics (ranging from banks to cooperatives to microfinance institutions) (Park 1999, 13).

Such a strategy would require leadership from the center and far greater flexibility on the part of local officials responsible for implementation on the ground, as well as a broader range of experimental programs. There is some pessimism (for example, Gibbons 1999) that once the 2000 deadline has passed, official support for microcredit will “fade away.” While this is probably unlikely, it would certainly be unfortunate if official experimentation were to diminish, or if less tolerance were shown for experiments by external agencies. Models of microfinance developed through experiment will depend, for their ultimate sustainability, on a number of contingencies. These include some or all of the following: interest rate liberalization, government take-up of microfinance programs and their methods, the emergence of civil society organizations to operate microfinance institutions (MFIs) independently (and their acceptance by the State), and the creation of new forms of small financial institution. Such developments will require significant change and long-term commitment.

2.3 Demand for Microfinance

The demand for a service (in this case, microfinance) can be measured only in relation to a price, or schedule of prices (in this case, rates of interest). The issue of interest rates in PRC is a complex one and is discussed later in relation to the broader financial system. Interest rates from state institutions are rigidly controlled and often subsidized; this applies particularly to official microcredit in PRC. Only limited experiments with cost-recovery microfinance loan pricing have been possible to date, and these (as described earlier) are largely restricted to a small number of externally financed programs.

At the current nominal rate for government microfinance programs under the poverty alleviation program (3 percent per annum), the effective demand for microfinance is presumably very high, perhaps even perfectly elastic for all practical

A diversity of financial institutions is needed in the rural sector

“Effective demand” for microfinance is the relevant concept, not “need”

purposes. Continued expansion in the numbers of borrowers in donor-funded programs indicates the existence of effective demand for credit despite the higher interest rates charged (normally 6 to 10 percent per annum, nominal). The highest rate reported for any program is 3 percent per month in the microcredit component of a foreign-supported project in Guizhou Province where, significantly, lending rates are agreed by members of the borrower groups. However, these are short-term production loans, repayable in full after three months. As pointed out by Park (1999), borrowers in this scheme may be willing to pay this rate because payments go back into a "collective pot."

More generally, from Park's discussion of survey evidence, one may infer that the demand for microcredit, under the conditions and in the regions where it is currently available in PRC, would be quite elastic for interest rates above 20 percent (effective) per annum. But there is an important qualification here. A number of observers — for example, Park (1999) and Meyer and Nagarajan (1999) — have commented on the official targeting of microcredit to remote, underpopulated, and ill-favored areas where poverty is judged to be most intractable. The emphasis given in PRC to lending for livestock and agriculture, rather than for off-farm activities, is also noted. If microcredit were targeted to more densely populated areas, with more diversified rural economies, the poor in those areas would probably prove willing and able to pay higher interest rates. This would simply reflect the higher productivity of capital in such areas, where a wider range of economic opportunities exists.

Relative prices also play a part. In an environment of widespread subsidization of other forms of formal credit, the "reservation price" that the poor set for borrowing might well be depressed. On the other hand, experience in other countries suggests that the poor actively borrow from informal moneylenders at rates much higher than those in the formal sector. Surveys of informal moneylending in PRC suggest that borrowing is more likely to be for consumption than for production. It has also been noted that borrowing from moneylenders is more common among non-poor households than among the poor (who are more likely to rely on friends and relatives) (Meyer and Nagarajan 1999). While much informal borrowing seems to occur at interest rates substantially above the levels set for Chinese microcredit programs, the evidence is too fragmentary to suggest what ceiling interest rates the market for microcredit will bear.

With regard to the demand for access to savings services, reference has previously been made to the Chinese people's extremely high propensity to save. Official microcredit schemes do not incorporate savings, and perhaps the assumption is that this is not necessary. However, in an environment of low official deposit rates, households do exhibit sensitivity to relative prices, as evidenced by the success of rural cooperative foundations in winning deposits away from the RCCs and ABC (Cheng 1997). The role of these rural financial institutions is discussed in Section 3.

3 Role of the Central Bank

3.1 Process of Economic Reform and the Role of the Financial Sector

PRC's economic system is in transition from socialism to a market economy. This painful and lengthy transformation involves broader processes of economic reform in which modernization of the financial sector is only one element. And within the financial sector itself, reform of the central bank (PBC) is subject to broader imperatives

Effective demand in PRC is very high when the interest rate is only 3 percent per annum

Effective demand will be higher among the poor in regions of greater economic opportunity

In the transition to a "socialist market economy," modernization of the financial sector is only one part of a much broader process

of reform, which limits the pace and direction of progress. It is therefore necessary to situate the discussion of the role of the central bank with regard to microfinance in the context of these broader reform processes.

Financial sector reform in PRC is difficult to disentangle from the broader processes of economic reform. In the late 1970s PRC commenced a wide-ranging process of economic reform, commencing in the rural sector. The “responsibility” system of private agricultural production led to expanded output, higher personal incomes, and progressive breakdown of the agricultural communes. The substantial increase in rural per capita incomes (which grew more rapidly than urban incomes during the 1980s) was not uniformly distributed. Remote and natural-resource-deficient regions lagged behind; as mentioned earlier, these are now the locus of PRC’s hardcore poverty problems.

Structural transformation of the economy has required new financial institutions and a new role for PBC

Along with transition from central planning to a market economy, PRC also commenced a structural transformation from agriculture to industry and services. Financial sector reforms required to facilitate this process commenced early in the 1980s. New types of nonbank financial institutions (NBFIs) were permitted to operate. These were important in financing a growing non-state sector and included trust and investment companies and urban credit cooperatives. Girardin (1997) comments that NBFIs have, in PRC as elsewhere, proved superior to banks in retailing credit, while the latter were more effective in mobilizing savings. In consequence, the state banks channeled substantial amounts of savings to the new NBFIs to benefit from their comparative advantage, coincidentally avoiding credit ceilings imposed on them by the central government. This situation contributed to excesses of various kinds that continue to bedevil the Chinese financial system.

In the period between the start of the reforms in the late 1970s and 1992, the Chinese economy experienced substantial modernization and greater openness to the international economy. While the financial sector developed a broader range of institutions, financial sector reform lagged behind changes in government and the real economy. Reform in the financial sector gained new impetus in 1992 when the Communist Party accepted the idea that the market system could be reconciled with the ideals of socialism. PRC would establish a “socialist market economy.” This implies:

... an economy in which the market mechanism governs economic interactions but ownership over the most important means of production remains in the hands of the public sector or the collectivity, thus preserving the socialist character of the society (Mehran et al. 1996, 1).

A comprehensive strategy was formulated in 1993 to achieve this transformation, in which financial sector reform was identified as a key element. This was “implicit recognition that the financial sector, if not reformed, could become a bottleneck for further reforms in other parts of the Chinese economy” (Mehran et al. 1996, 1). Among other areas for reform were SOEs and the macroeconomic control system. In regard to the latter, the Third Plenum of the Central Committee noted that this would require:

... [a] central bank whose primary objective is to stabilise currency value, regulate the aggregate money supply, and maintain balance of international payments and that, furthermore, the central bank ... under the leadership of the State Council, should implement monetary policies independently (quoted by Mehran et al. 1996, 2).

This decision of the Central Committee was followed in 1995 by new legislation for the central bank and the commercial banking system (discussed in Section 3.2). The tasks of reform confronting PRC were summarized as requiring reform of government finances, making room for markets to operate, and putting policies in place to support their operation (World Bank 1997).

All these objectives have implications for the financial system. And progress in financial system reform is necessarily limited by progress in reform of other areas.

Economic reform is seen as requiring a more independent central bank with a mandate to assure monetary stability

It's Not That Simple! (Obstacles to Liberalizing Interest Rates)

- Sustainable microfinance requires interest rates high enough to cover costs.
- However, the state-owned banks are carrying heavy nonperforming debt, much of which is owed by SOEs.
- Liberalization and higher interest rates would bankrupt many SOEs, causing them to default on bank debt.
- Loan defaults by SOEs would cripple state banks, so government finances would be destabilized by the need to rescue SOEs and recapitalize state banks.
- This sequence of events would set back both financial sector reform and broader economic reform; MFIs would be only one group among many to suffer.

For example, interest rate liberalization is a precondition for sustainable microfinance. But the Chinese banking system is carrying a heavy burden of nonperforming loans, widely thought to be at least 20 percent of assets, a large proportion of which are due from SOEs or from business entities controlled by SOEs (ADB 1999). To permit interest rates to rise in advance of appropriate reforms in the state enterprise sector would precipitate default on much of this lending and the collapse of SOEs. This in turn would trigger the collapse of banks and other financial institutions already substantially decapitalized by bad loans. In turn, this would have a severe impact on central government budgetary revenues, while involving government in considerable expenditure to resolve the problems of collapsed institutions. The final result of inappropriately timed interest rate liberalization would be to set back financial sector reform, as well as impeding the disentanglement of government from markets and prejudicing the smooth operation of those markets.

3.2 Financial Sector Development and the Central Bank

To see the potential of financial institutions to engage in microfinance, and to understand the policy and institutional barriers to its development, requires some further account of the development of the financial sector over two decades of economic reform. The account which follows draws on a number of sources.²

Before the commencement of the reform period in 1978, PBC served as a "monobank" handling most financial transactions. The allocation of credit by state banking institutions was set by a centrally determined credit plan, itself linked to the overall state plan for physical production. Under this credit plan, PBC fixed both aggregate and sectoral allocations of bank credit, and lending institutions met their obligations by adhering to lending ceilings. Two other specialized banks, the People's Construction Bank of China and the Bank of China, operated as special departments within PBC.

The banking system was re-established between 1978 and 1984 in the early years of economic reform. PBC assumed the primary function of central banking, while continuing to perform certain commercial banking activities. It remained a department of the State Council. The People's Construction Bank and the Bank of China began to operate as independent specialized banks, while the Agricultural

PBC ceased to act as a "monobank" and progressively took on the central banking role

2 Primarily Mehran et al. (1996), but also World Bank (1990, 1996, 1997), Girardin (1997), and ADB (1999).

Rural credit co-operatives emerged to provide small-scale banking services, primarily for collectives and state enterprises

Bank of China was established to perform rural banking functions previously conducted by PBC. Also during this period, a network of some 60,000 RCCs was set up to provide small-scale rural banking services (and particularly to mobilize savings). At this time, as already noted, the first NBFIs began to appear. These were primarily trust and investment companies, many of them designed to facilitate investment in the newly established Special Economic Zones.

A period of diversification and innovation occurred between 1984 and 1988, in which PBC began to operate formally as the country's central bank and to divest its remaining commercial banking activities. A fourth specialized bank, the Industrial and Commercial Bank of China, took over these residual commercial functions. This development "formally ended the transition toward a full-fledged two-tier banking system ... (Mehran et al. 1996, 12).

Also during this period, further financial sector diversification occurred. In 1986 new financial institutions, urban credit cooperatives, were created to serve small individually or collectively owned enterprises and, like RCCs, to mobilize savings. In the late 1980s, a new institution, the rural cooperative foundation (RCF) emerged in rural areas. This is attributed to the fact that "low and regulated deposit rates created poor incentives for rural households to save with RCCs and the [Agricultural Bank of China]" (Meyer and Nagarajan 1999). None of the financial institutions regulated by PBC have succeeded in sourcing so large a proportion of loans and deposits from individuals and households as these small, locally based entities (which were under the control of the Ministry of Agriculture).

Rural credit foundations offered financial services to households and individuals

A number of new "universal" commercial banks were also established to compete with the existing specialized banks, and the specialized banks were permitted to expand lending outside their original sectoral activities. Trust and investment companies also began to proliferate during this period. Often established by banks to circumvent credit quotas, these companies further diversified the range of financial services available.

A period of "rectification" and recentralization of the banking system followed between 1988 and 1991, in which tentative moves to liberalize interest rates were reversed. However, since 1992, a new phase of commercialization and expansion of the banking system has occurred. In 1994 the State Council approved the establishment of three "policy lending" banks (the Agricultural Development Bank of China, the Import Export Credit Bank, and the State Development Bank). These had sectoral responsibilities under the state credit plan. They were created to allow the four state commercial banks mentioned earlier to operate commercially, unimpeded by government lending directions, as part of the progressive relaxation of the credit plan. In 1995 four new financial laws were promulgated, including Acts governing the central bank and the commercial banks. These Acts have been described as "keystones for the further development of the financial system in a market based economy" (Mehran et al. 1996, 18).

Legislation in 1995 set the state "commercial" banks on the path to real commercialization

In 1998 the movement towards market-based allocation of credit proceeded further when the final abolition of the centrally directed credit plan was announced. Throughout the reform period, the aggregate plan had in any case become less effective (and, as already noted, much of the proliferation of NBFIs was due to attempts by financial institutions to evade their credit ceiling responsibilities). From January 1998, the state banks have been supposed to allocate credit based on commercial judgments rather than on central bank and government directives (ADB 1999). However, the influence of various levels of government on lending is still pervasive, the term "policy-oriented commercialized loan" conveying something of the flavor.

The table below describes the structure of the banking system at the end of 1998. The four state commercial banks, including ABC, held 66 percent of deposits

and 69 percent of loans, while the policy banks were responsible for 6 percent of lending. The beginnings of diversification in the system were apparent from the operations of ten "national" commercial banks (one of them the only private bank permitted to operate in PRC so far) and 88 "city" commercial banks. These two classes held only 13 percent of bank assets between them, and there is no suggestion that either has any potential for microfinance at present. Also shown are the urban credit cooperatives (5 percent of assets) and the RCCs (9 percent).

People's Republic of China's Banking System (end 1998)

Type of Financial Institution	Total Assets (Y billion)	Percent Market Share	Total Loans (Y billion)	Percent Market Share	Total Deposits (Y billion)	Percent Market Share
State-Owned Commercial Banks (4)	8,259	66	6,231	69	5,948	66
Policy Banks (3)	569	5	552	6	1	0
National Commercial Banks (10)	1,148	9	584	6	835	9
City Commercial Banks (88)	457	4	220	2	364	4
Urban Credit Cooperatives (3,240)	561	5	401	4	608	7
Rural Credit Cooperatives (41,500)	1,143	9	881	10	1,216	13
Foreign Banks (162)	283	2	223	2	40	0
Total (45,100)	12,420	100	9,092	100	9,012	100

Notes: Policy banks' figures exclude Agricultural Development Bank of China.

Rural cooperative foundations are not included.

Source: Moody's Investors Service (1999), derived from *PBC Quarterly Statistical Bulletin* (1999).

Financial services available in rural areas are now provided, firstly, by regulated financial institutions: ABC (a commercial bank), the Agricultural Development Bank of China (a policy bank), RCCs, RCFs, and mutual association and credit groups. The "mutuals" are minor institutions set up by the Ministry of Civil Affairs to provide loans, mainly for consumption, to poor households. RCFs, under the supervision of the Ministry of Agriculture, are in the process of liquidation or conversion to credit cooperatives (as discussed later). Secondly, financial services are provided by government- and donor-sponsored microfinance programs (with the latter tolerated by PBC rather than regulated by it) and, thirdly, by informal finance. NBFIs, such as the trust and investment companies, finance companies, and leasing and securities companies, are almost entirely urban in their outreach and of minimal relevance to rural communities.

A major factor in financial deepening during two decades of reform has been an extremely high propensity to save (some 40 percent of GDP). In the face of administered deposit rates that are generally low and sometimes negative, this suggests that "financial repression" has limited value in explaining this aspect of the Chinese financial system (Girardin 1997). Financial repression is, however, a continuing and important feature of the system, as the discussion of the role of the central bank in Section 3.5 will indicate.

The Asian Development Bank (ADB 1999, 71–72) summarizes the current state of the financial system:

During the last two decades, the PRC has made considerable progress in establishing the foundation for a modern financial system. Nevertheless, weaknesses persist. The key issues that the government needs to address include introducing prudential

The national propensity to save is extremely high, notwithstanding low, or negative, real rates of interest

Financial Services in Rural Areas

Services are provided by:

- Agricultural Bank of China (ABC), a state commercial bank
- Agricultural Development Bank of China (ADBC), a “policy lending” bank
- rural credit cooperatives (RCCs)
- rural credit foundations (RCFs) (now in liquidation or conversion to new status)
- microfinance programs (either donor-financed, or under the 8–7 Plan, with the latter implemented through ABC)
- informal lenders.

norms and risk management practices to strengthen the financial soundness of the banking system, developing the institutional capacity of the central bank to manage and supervise the financial sector, developing the regulatory framework for nonbank financial institutions, and reforming and developing capital markets.

Subsidized lending under the 8–7 Plan works against financial reform

The assessment of progress is not complete, however, without also noting the effect of the Government’s highly subsidized lending for poverty alleviation. This, as noted, is seen as a social rather than a financial program, but has nonetheless been described as “counterproductive to the objective of creating efficient competitive financial markets” (Meyer and Nagarajan 1999). This was discussed in Section 2.2, which described the 8–7 Plan and showed it to be outside the control of the central bank. As long as it continues in its present form, it makes PBC’s task of building a viable financial system more difficult.

3.3 Rural Financial Institutions with Potential for Microfinance Operations

We complete this review of the development of the financial system in PRC by considering the formal institutions available in rural areas to implement microfinance. ABC is involved with microfinance in various ways, principally as the conduit for official poverty lending, some of which is used for government “microcredit” operations described earlier. It has also been involved in the CASS experiment in Shaanxi Province, as well as cooperating with AusAID in one bilateral microfinance project. ABC incurs considerable expense in subsidizing the operations of the 8–7 Plan, for which it receives no lending margin, and should have an interest in finding ways of discharging this obligation more cheaply.

ABC is not well placed to engage in microfinance on any more sustainable basis. Under current regulations, it suffers from very limited interest rate flexibility, being restricted to pricing small enterprise loans within a band no more than 20 percent above the official rate. Smaller, more locally based institutions might be better equipped, both by reason of greater pricing flexibility and by virtue of experience with individual lending. The two formal rural financial institutions that have commonly been identified as having potential for microfinancing are RCFs and RCCs.

Rural Cooperative Foundations

RCFs were minor but widely distributed rural financial institutions dating from the late 1980s, which drew their deposits from and made their loans to individuals and households to a greater extent than any other financial institution, notwithstanding their relative insignificance in the broader financial system. They were under the

supervision of the Ministry of Agriculture, not PBC. They lacked the status of financial institutions and often charged effective loan rates above the regulated levels. Although not permitted to mobilize deposits directly, RCFs did so by offering a savings product defined as a shareholding, with a minimum term of 12 months. The “dividends” paid by RCFs were often higher than the return on 12-month deposits with the formal rural financial institutions, ABC, and RCCs. Consequently, RCFs tended to draw funds away from these other institutions (Cheng 1997). In 1996, their deposits were estimated at about 11 percent of those held by RCCs (Park 1999).

In a comparative study of RCFs and Grameen Bank replications in several provinces, Cheng found that the latter were at a disadvantage in mobilizing voluntary savings because of the competition of RCFs and other regulated financial institutions.

RCF loan procedures were also often relatively simple and quick, and with no collateral requirement for loans below Y500 (\$60), they were able to serve at least some of the working poor, if not very poor households. However, Cheng commented that RCFs, not being under the direct supervision of PBC, were not obliged to make regulatory deposits with PBC, typically had quite high loan/deposit ratios, and provided insufficient protection for depositors. Cheng concluded that RCFs were not sufficiently regulated, despite the fact that some RCFs achieved higher rates of repayment and better financial returns than the regulated financial institutions with which they were competing.

In view of the performance of the better RCFs, it is not surprising that some observers saw them, among the available institutional models, as the most promising for the introduction of microfinance. This is no longer a possibility since, as the result of a 1998 State Council decision, PBC has taken action to close down RCFs because of failures and abuses in some institutions. Some are to become RCCs and others are in liquidation.

Rural Credit Cooperatives

RCCs were a promotional initiative of the early reform period of the 1980s, designed to facilitate access by rural populations to the financial system and in particular to mobilize savings. They were brought under the provisions of the Commercial Banking Act promulgated in 1995. Originally placed under the supervision of ABC, RCCs were removed from the control of the Agricultural Bank in 1997 and placed under the direct regulation and supervision of PBC. PBC's local branches are engaged in a process of “standardising” their structures and operations and strengthening their balance sheets (Almanac of China's Finance and Banking 1998). Attention is also being given to strengthening the county-level cooperative unions, and the establishment of a national deposit insurance system is being considered (*Financial Times* 1999).

Today there are some 42,000 independent RCCs at township level, 2,400 RCC unions at county level, and some 280,000 village credit outlets. In total, the network employs around a million employees and accounted for 12.7 percent of deposits of all financial institutions and 19.5 percent of all savings deposits in 1998. Credit outstanding from RCCs amounted to almost 10 percent of institutional lending, and some 60 percent of lending to the agricultural sector (*Financial Times* 1999).

3.4 Mandate and Role of the Central Bank

Legislation for PBC (People's Republic of China 1995) was promulgated at a time when the pendulum for central banks around the world was swinging decisively towards autonomy. Chinese authorities were concerned both to provide the central bank with the authority and tools for effective monetary management and to signal to the world financial community their commitment to financial sector modernization.

Rural cooperative foundations drew funds away from other rural financial institutions

The better rural cooperative foundations showed potential as vehicles for microfinance

Rural credit cooperatives are now supervised by PBC and are being strengthened

PBC now has considerable autonomy

However, the State Council, as the highest organ of the State, remains the ultimate decision-making body in PRC.

Thus, the legislation “establishes an agency under the leadership of the State Council, which entrusts this agency with a high level of independence from all other levels of government” (Mehran et al. 1996, 19). The Act forbids lending and overdrafts to government. This, combined with a fair degree of budgetary independence, appears to grant the central bank about as much autonomy (in relation to central government) as can be expected in the present governmental framework.

The Act also increased the autonomy of PBC with respect to local authorities, whose close links with PBC staff in the regions had weakened PBC’s capacity to exert control from the center. A substantial reduction in numbers of PBC branches and staff in the regions and the redrawing of PBC’s regional boundaries have reduced the scope for such interference. PBC’s capacity to implement monetary policy through indirect instruments has accordingly been enhanced.

Following international trends, PBC is primarily concerned with price stability

PBC legislation follows current international trends in taking domestic price stability as its primary objective and explicitly linking this with the goal of promoting economic growth. However, this function, too, is exercised under the leadership of the State Council, which in addition is empowered to nominate the governor and deputy governor of PBC. The monetary instruments defined for PBC in the Act reflect the intent to shift from direct to more indirect methods of monetary management.

The Act (Article 30) gives PBC authority for supervision, thus combining prudential control with responsibility for monetary policy. PBC is required to “exercise supervision over financial institutions and their business operations to maintain the legitimate, stable and sound operation of the financial industry” (People’s Republic of China 1995). This supervisory power extends to all state and other institutions, including the “policy” banks. The Act further empowers PBC to “check and supervise” the deposit and lending rates of financial institutions, thus continuing interest rate controls, but freeing up PBC somewhat to conduct more active interest rate management. PBC has since acted to simplify and rationalize the bewildering array of official interest rates, as well as to permit some flexibility within bands around particular official lending rates.

The central bank now has capacity for more “active” interest rate management

Finally, it is worth noting PBC’s responsibility (Article 4) for “statistics, investigation, analysis and forecasting for the financial industry.” This implies a mandate for research and data collection which can be applied to financial sector development in general and could be directed to microfinance issues in particular, if PBC were to adopt that priority.

3.5 Some Comments on Financial Repression

There are many remaining elements of financial repression in the Chinese financial system, but we have already noted that there are limits to the usefulness of this concept in PRC (in observing how an extremely high propensity to save coexists with very low administered deposit rates). In our studies of other countries of the region, the concept of the “developmental” and “promotional” activities of central banks (in the sense that these terms are used by Chandavarkar)³ has been a useful organising

3 Chandavarkar (1996). Chandavarkar distinguishes between the “developmental” and the “promotional” functions of a central bank, with the former contributing to situations of financial repression and being justified, if at all, only during the very early phases of a financial system’s development. By contrast, the promotional role is described as crucial for financial development. It fills in gaps in the system by means of “supply-leading” initiatives taken by the central bank. This distinction is employed in Volume 1 (Overview) of this publication.

principle. The concept is used for charting the progress of a financial system away from financial repression (a situation marked by PBC's substantial involvement in developmental activities) to financial deepening and the emergence of a diversified set of financial institutions. This progression towards financial sector modernization is facilitated by the active promotional efforts of the central bank, and is helpful for the emergence of sustainable systems of microfinance.

In the case of transitional economies such as PRC's at present, it is simple enough to point to the persistence of elements of financial repression and the ways in which central banks continue to play a developmental role. But in such an economy the idea of a relatively straightforward progression from repression through deepening to modernization and liberalization is an oversimplification. It does not take into account complex political issues, such as PRC's imperative to reform SOEs while disentangling government from markets, and managing all this without the collapse of enterprises and financial institutions.

Many elements of financial repression remain in PRC. Most fundamentally, the state banks are still not completely free to lend on the basis of commercial criteria, and interest rates remain essentially controlled. The full list of central bank functions (Article 4) includes the power to "administer" financial institutions and to "control" financial markets, language that seems more akin to a developmental stance than a promotional one. Some potential for promotional activities, in Chandavarkar's sense, is found in the research and data collection functions of PBC. PBC's overall responsibility for administration and control of financial markets and institutions, already noted, also gives it a capacity to "fill in the gaps" in the financial system. This could be used to support the development of a microfinance sector without reference to higher authority, if PBC were minded to do so.

Many elements of financial repression remain, and removing them is a complex task

4 Central Bank Support for Microfinance Initiatives

4.1 Central Bank Perceptions of Microfinance

From the discussion so far, some generalizations emerge. As far as microcredit within the official poverty alleviation program is concerned, it seems clear that PBC currently regards this primarily as a social rather than a financial sector program. In general, and understandably, microfinance development is a low priority for PBC. While recognizing the importance of interest rate liberalization for the sustainability of microfinance, PBC sees this issue as subordinate to the overarching issues of financial sector and state enterprise reform. Because of irregularities that have occurred, PBC is not sympathetic to the emergence of unregulated financial institutions at the local level (even though this development may be evidence of needs unsatisfied by existing institutions and regulations).⁴ Accordingly, PBC is unwilling to see NGOs or community organizations play any role in financial intermediation. It could perhaps benefit from closer observation of informal financial sector activities in PRC. Research on these could provide useful clues to unsatisfied demand for financial services and hints for satisfying such demands within the regulated institutions.

Microfinance development is a low priority for PBC

4 People's Bank of China (1999). This document notes that in 1998 "PBC ... launched comprehensive efforts to clean up financial institutions established illegally and financial services conducted by nonfinancial institutions. In particular, foundations that took deposits and provided loans services in various names were cleaned up."

4.2 Activities of the Central Bank Affecting Microfinance

Because of local-level abuses, PBC has acted to close down RCFs, as already noted. RCFs were thought by some observers to offer the best chance for grafting microfinance onto an existing institutional form, but since they will not be available for this purpose, we should consider the potential of the larger RCCs, and how PBC has been dealing with them. According to a State Council Decision on Rural Financial System Reform in 1997, RCCs are expected to facilitate rural, especially agricultural, development by combining both policy and commercial objectives.

Supporting the Rural Credit Cooperatives

Following the State Council decision, PBC is required to offer support to RCCs in a number of ways, including “policy lending.” PBC loans have been directed to funding RCCs in poverty-stricken areas, which have been unable to mobilize sufficient savings locally to meet the need for agricultural credit. These resources, totaling Y15 billion (\$1.8 billion) are separate from poverty alleviation funding under the 8–7 Plan. This is a major “developmental” intervention.

With the closure of the rural cooperative foundations, PBC is now attending to the rural credit cooperatives

Governor Dai Xianglong’s speech in April 1999 to the Working Conference on the Rural Credit Cooperatives appeared to envisage an important continuing role for RCCs. He also defined tasks for PBC in supporting and guiding their development as rural financial institutions serving farming households directly. Governor Dai urged RCCs to increase lending to individuals and households, and to “deliver the loan to the door-step,” to “simplify the loan procedure for farmers,” and to trial the method of “united guarantee by the farmers’ families” (*Financial Times* 1999). The last of these is the group guarantee. Together with an exhortation for RCCs to stimulate consumption through lending, this is a call for considerable change in the culture and operations of the cooperatives. While only the use of group guarantees is directly related to microfinance, taken together these reforms would greatly facilitate its introduction into the operations of RCCs.

Experiments with RCCs

Speaking of financial sector reform, Mehran et al. (1996, 8) note:

From the onset of the reform process, one of the preferred ... techniques of the Chinese authorities has been to undertake the reforms first on an experimental basis in some localities and then adopt them on a national scale after they had proved successful at the local level.

Financial “experiments” are a preferred technique

So far as efforts to establish microfinance on international principles are concerned, PBC has been prepared to turn a blind eye to externally supported experiments involving NGOs, although limiting their scale and quarantining them from the rural financial system more generally. On the other hand, it is more sympathetic to microfinance experiments in regulated institutions (conducting one of its own, with RCCs as the intermediaries, in Hebei Province). This has involved use of group guarantees, higher limits for non-collateralised loans, and simplified loan approval procedures, all discussed in Section 5.

However, RCCs are only a small element in the totality of PRC’s banking system, and that system is facing overwhelming difficulties. Not all observers are confident that RCCs will survive the reform and restructuring that will be necessary to assure the long-term viability of the system as a whole. RCCs as a group are known to be carrying a heavy burden of nonperforming loans, and individual institutions may be treated differently on the basis of performance. That may enable the well-performing units to continue, but there are other scenarios. RCCs could be returned to the status of farmer cooperatives, become small communal banks, or form part of

a network serving ABC. Disappearance of the RCC model altogether would be unfortunate for microfinance. Given that RCFs are disappearing, and the commercial banks appear unable to take on microfinance activities, only RCCs among formal institutions appear to have any chance of meeting the challenge.

Policy Dialogue, Coordination, and Training

UNDP has convened an advisory board on poverty alleviation in Beijing, which discusses policy for microfinance in the broader context of poverty alleviation. The board considers issues such as interest rates, and the respective roles of regulated financial institutions and civil society organizations in microfinance. It has considered how dialogue on interest rate policies between donors and the central bank might be fostered, and discussed the need to clarify the legal status of MFIs. The central bank is a member, along with other Chinese agencies, including ABC, ministries, and CICETE. The international community is represented by UN agencies, the World Bank, ADB, some bilateral agencies, and international NGOs. However, the Ministry of Civil Affairs, which registers and regulates community organizations, is not a member, nor are any of the Chinese MFIs (although provision exists to invite them to meetings where appropriate). Despite this, it is a potentially useful forum at which a number of major actors are represented, even if not always at senior level. PBC's participation sends a positive signal.

Another supportive action by PBC is its acceptance of membership of the Council of the newly created China Microfinance Training Center. Established in association with CASS, the China Academy of Social Sciences, the Center is supported by the Consultative Group to Assist the Poorest (CGAP) and the Ford Foundation. It will enable the extension into China itself of CGAP's regional training activities, and will build a cadre of microfinance training and consulting expertise within China. With training commencing from 2000, the Center offers the opportunity for information exchange and policy dialogue, and will facilitate provision of foreign technical assistance to China (<www.microfinance-center.org>).

Consultation on policy issues is valuable, and more stakeholders should be included

5 Regulation and Supervision of Banks

5.1 Current State of the Financial System

ADB's assessment (1999) of the current state of the Chinese financial system was quoted earlier in this report. Among pressing needs in the banking sector were the introduction of prudential norms and risk management practices, and strengthening PBC's own capacity to manage and supervise the banks and NBFIs. The banks with which this account of microfinance has been concerned are the commercial banks, principally ABC. The regulatory provision that definitively rules out any microfinance activity on the part of ABC is the control of its interest rates (quite apart from factors such as its institutional culture and limited involvement with individual lending). At the end of 1998, its deposit rates were 1.44 and 3.78 percent, for demand and 12-month deposits respectively (People's Bank of China 1999). Its 12-month working capital loans carried an annual interest rate of 6.39 percent, with flexibility to raise this for small enterprise lending by no more than 20 percent (that is, to around 7.7 percent per annum).

The rural and urban credit cooperatives are sometimes described as NBFIs, but since they come under the provisions of the Commercial Banking Law, 1995, it is

The banking system has pressing problems and ABC is ill-equipped for microfinance

NBFIs are largely urban and are currently of no relevance to microfinance

probably better to regard them as “near-banks.” NBFIs such as trust and investment companies, as well as finance, leasing, and securities companies appear to have no relevance or potential for microfinance at present.

Reference has previously been made to the magnitude of nonperforming loans on the balance sheets of Chinese banks. Reported figures do not reflect the quality of assets, due to poorly designed and improperly applied loan classification rules. In an effort to deal with this situation, PBC commenced the introduction of a new five-category classification system in 1998. This is derived from United States practice, and began with experiments at a number of selected banks. The central bank expected the system to be applied by commercial banks throughout the country by the end of 1999. In addition, it is working to improve systems for loan loss provisioning and bad debt write-offs. None of this is particularly relevant to microfinance, given the judgment of this study that ABC is not in a position to conduct or support microfinancing. But it is relevant insofar as it shows the magnitude of other problems confronting the central bank, which take priority over the issues affecting microfinance.

5.2 Rural Credit Cooperatives

PBC is developing the regulatory regime for rural credit cooperatives and requiring compliance

However, issues relating to regulation and supervision of rural credit cooperatives are relevant. PBC has restructured its operations to allow the consolidation of all supervision functions for each type of financial institution. This led to the creation of a separate department within PBC for the supervision of cooperative finance institutions (the Department of Cooperative Finance), which is responsible for RCCs. PBC began to develop its supervision and management capacity for RCCs following the separation of the system from ABC in 1997. Regulations for the management of RCCs, from September 1997, set the minimum “registered capital” of an RCC at Y1 million (\$120,000). They provide for the investment of share capital by members, of whom there must be at least 500 (including organizations with legal identity), none of whom may hold more than 2 percent of registered capital. The approved business activities of an RCC include taking deposits (including personal deposits), granting loans, and acting in an agency role for “other banks” (People’s Bank of China 1997).

RCCs are subject to PBC reserve deposit requirements, must make at least 50 percent of loans to members, and must give priority to agriculture. They must maintain an 8 percent capital adequacy ratio, a loan/deposit ratio not higher than 75 percent, and observe minimum liquidity and single borrower limits. Provisions for doubtful debts are mandated, and audit requirements set. PBC has continued to develop a framework of regulations for RCCs, although there is no suggestion yet that RCCs will be obliged to adopt the five-category system of loan classification. Governor Dai Xianglong stated in April 1999 that 60 percent of RCCs had satisfied the current regulations in full (*Financial Times* 1999). Prior to this, there had been a shakeout in the sector, due to closures and amalgamations.

PBC is allowing greater operational flexibility for RCCs but interest rate flexibility is more limited

PBC seems prepared to allow greater flexibility in the operations of RCCs. An example is seen in the group guarantee for non-collateralised loans, which PBC has been trialing in its pilot project in Hebei Province. Further, although previously all financial institutions had been unable to lend more than Y500 (\$60) to individuals without collateral, this threshold was increased for RCC lending in a regulation introduced late in 1998. RCCs are also offering a new loan product, the “small scale credit loan.” The simplification of loan approvals is being assisted by issuing a “borrower card” to individuals, with preset limits for collateral-free loans, based on individual credit ratings. The introduction of group guarantees would take this process a step further, and a new regulation authorizing their use is expected. The Department of Cooperative Finance of PBC is interested in cooperating with external agencies in microcredit delivered via the RCC system.

As discussed earlier, RCCs have more flexibility than any other financial institution to increase lending rates within a band above official levels. PBC has been acting to broaden the band for both RCCs and commercial banks. As the result of the most recent relaxation late in 1998, RCCs may set rates up to 50 percent higher, compared with commercial banks such as ABC, which may price small enterprise loans at no more than 20 percent above the norm. This concession reflects some acknowledgment by PBC of the risks and costs associated with particular classes of institution and loan. Microcredit loans under the IFAD/Ministry of Finance project and under PBC's own experimental project in Hebei, are testing whether sustainability can be achieved within the limits set by the 50 percent band. This currently allows lending at between 10 and 11 percent per annum, flat (or around twice that rate on a diminishing balance basis) compared with the current official lending rate for 12-month working capital loans, which is 7.7 percent per annum.

However, interest rate flexibility allowed by PBC is still quite limited, even if the allowance is greater than for other institutions. This conservative approach is criticized as preventing institutions from lending to the private sector generally, and to small and medium enterprises in particular. This criticism applies even more to microcredit lending by regulated institutions, which would find it difficult to recover the higher transaction costs involved through appropriate pricing of loans.

6 Regulation and Supervision of Nonbank MFIs

6.1 Status of NGOs

The Chinese state has reservations about civil society organizations which emerge outside official structures of governance, and in particular those that appear to duplicate the functions of some officially approved agency. Despite this, some 200,000 organizations were registered in 1998 (Forney 1998). The situation for "social organisations" has been somewhat clarified and simplified by regulations issued by the Ministry for Civil Affairs in 1998, which provide for the registration of "nonprofits," "foundations," or "social organisations," but "NGO" is an expression which still carries negative connotations. Whatever they are called, there is a burgeoning of such civil society institutions to which the new regulations, supplemented by a "Charities Law" in mid-1999, are a response.

The regulations bestow a legal identity on approved organizations, and the right to pursue approved objectives. Such organizations must be decentralized, registered at the county level, and their organization at higher administrative levels is not encouraged. There are exceptions, as in the field of environmental action, where the Government appreciates the potential for community action to support government policy. Another is in connection with aid programs, where an approved NGO (the Chinese Association for NGO Cooperation) exists to facilitate cooperation with international NGOs. But, in general, the interest of the Government is in control of civil society organizations, whereas NGOs feel the need for enabling regulations, access to capacity-building resources, and the development of standards of professionalism and governance. So far as microfinance is concerned, the regulatory framework is particularly underdeveloped. Any financial intermediation conducted by unregulated institutions, as in the case of all MFIs, is in fact illegal.

There is some evidence of an appreciation of the potential for NGOs to contribute to solving social problems. CICETE, the government agency responsible

Government has regulated NGOs in response to a burgeoning of civil society institutions

NGOs feel the need of enabling regulation and capacity building

Supporters see the need for civil society organizations to join the anti-poverty fight

for management of United Nations system projects in PRC, has set up the China Association for NGO Cooperation (CANGO) as an “umbrella” organization for Chinese NGOs implementing such projects, which include microfinance. While this is no doubt a response to United Nations operating requirements, there are other voices calling for an autonomous NGO contribution to poverty alleviation. The China Institute for Reform and Development, quoted earlier in relation to the “top-down” nature of the 8–7 Plan, has urged that “governments of all levels should encourage individuals and nongovernment organizations to establish spontaneous poverty-supporting organizations to take part in [the] anti-poverty movement” (China Institute for Reform and Development 1998, 28). This suggestion from a semi-government thinktank appears to be well ahead of official thinking on the role of civil society.

6.2 Central Bank and MFIs

Microcredit under government programs for poverty alleviation is viewed as a social welfare activity rather than a financial activity by the central bank, and even though a major financial institution (ABC) is involved, PBC does not normally supervise this activity. For that reason, this discussion is limited to the externally supported MFIs which are implementing international models of microfinance on a pilot basis, and which have the character of financial institutions in that they strive for sustainability. These MFIs have no legal status as financial institutions, although their lending and deposit-taking activities certainly bring them within the purview of PBC. PBC has opted to tolerate these activities so far, so long as they remain quantitatively insignificant, but what they do has no legal sanction. Their rates of interest and other aspects of their operations are negotiated with authorities, including local governments, but this does not amount to a regulatory framework.

MFIs have no status as financial institutions but their activities are tolerated by PBC

There are no second tier institutions serving MFIs in PRC, nor any apparatus of self-regulation. So far as NGOs are concerned, reference has been made to CANGO. This organization was registered as an NGO with the Ministry of Civil Affairs in 1993, at the initiative of CICETE. CANGO’s mission statement refers to “strengthening cooperation in development among PRC’s NGOs and international NGOs,” but there is no reference to a membership of national NGOs (China Association for NGO Cooperation n.d.). In fact, it seems not so much an umbrella body for Chinese NGOs as an intermediary that facilitates the operations of international NGOs in the provinces, linking them with community organizations and local authorities. Among its activities have been microcredit training programs conducted in connection with UNDP-funded projects. CANGO may have some potential as a center for training and dissemination of best practice in microfinance, allowing it to play an informal regulatory role for NGOs. However, the new China Microfinance Training Center is likely to emerge as an important training center, and a division of labor between the two entities would be necessary.

Any elaborate design for regulation and supervision of MFIs would be premature

Under the conditions in which microfinance is practiced in PRC at present, discussion of elaborate designs for regulation and supervision seems premature. Much attention has been given in this report to various “prior conditions” which must be satisfied before microfinance can take root in any autonomous fashion, including issues of legal status of MFIs and the interest rate regime. In the meantime, communication among various stakeholders and network building are desirable, pending the time when more elaborate structures may be required.

7 Conclusions and Recommendations

7.1 Conclusions

Microfinance is being introduced to the People's Republic of China (PRC) in the midst of transition to a "socialist market economy." The broader financial system is itself moving towards modernization and liberalization, while the central bank, which has quite recently acquired a degree of independence, is gradually developing and using the tools for indirect monetary management. Central government decisions provide the directions of economic and social policy (most notably, for our purposes, in initiatives such as the 8-7 Plan for poverty alleviation), in which the central bank plays a relatively minor role.

The central bank sees microfinance as a low priority, understandably in view of the magnitude of the broader problems of financial sector development and reform with which it is confronted. It is not sympathetic to the emergence of unregulated financial institutions at the local level and is disinclined to see nongovernment organizations (NGOs) or community organizations play any role in financial intermediation. However, it has extended toleration to experimental microfinance projects conducted with external assistance, and is conducting an experiment with a regulated institution itself. It has also introduced regulations favorable to the introduction of microfinance in one category of financial institution and it participates in the meetings of an advisory board on poverty alleviation convened by the United Nations Development Programme (UNDP) in Beijing, with microfinance as its primary concern. Its acceptance of a place on the Council of the new China Microfinance Training Center is another positive act.

Efforts to introduce microfinance in PRC have so far taken two distinct forms. The first (which is quantitatively of limited importance) commonly has external support and attempts to draw upon international experience to develop microfinance institutions that are sustainable and target the poor. They have been permitted to operate on a limited pilot basis in regions identified by the Chinese government as having priority in national poverty alleviation efforts. They attempt to work with community organizations as surrogates for the NGOs commonly found in other countries.

The second stream of microfinance (which is a mass program) is better described as "microcredit" since there is no attempt to integrate savings into the model. It is typified by the top-down provision of credit, funded by government under the 8-7 Plan for poverty alleviation. The credit, which is subsidized, is delivered by the Agricultural Bank of China (ABC), the state rural commercial bank. The activity is conducted in 592 "poor" counties identified by government as the locus of national poverty alleviation efforts. There is no suggestion of creating a sustainable financial activity or institution; repayment rates are reported to be low, and there is said to be "systemic deviation" in the choice of borrowers. Provision of credit under the 8-7 Plan is a social rather than a financial activity.

Among many problems confronting attempts to introduce sustainable microfinance in PRC, the control of interest rates by the central bank is of primary importance. Deposit and lending rates for regulated financial institutions are laid down by the People's Bank of China (PBC), and these would also apply to any microfinance transactions conducted by such institutions. Institutions are allowed some flexibility by the central bank in pricing loans. Commercial banks may price loans to small enterprise within a band, up to 20 percent above the official rate. Rural credit cooperatives (RCCs) may price within a band up to 50 percent above the same official rate (that is, to between 10 and 11 percent per annum, nominal). This represents some acknowledgment of the need to price loans in accordance with risk, but is

Microfinance has little weight in the overall process of financial reform

PBC has nonetheless been supportive of microfinance

Mass microcredit is a social welfare activity, conducted at central government direction

PBC has little room to move on the central problem of interest rates

criticized as being too cautious. It probably biases lending against the private sector in general, and small and medium business in particular, while making microcredit very difficult for the regulated institutions to sustain.

The central bank is constrained in its capacity to effect financial sector reform, including the freeing of interest rates, by higher priorities. High levels of nonperforming loans held by the state banks, primarily due from state-owned enterprises (SOEs), prevent an early resolution of this difficulty. Premature freeing of interest rates would precipitate loan defaults and the liquidation of SOEs, followed by the collapse of state banks and a severe setback to financial sector reform. PBC will proceed cautiously with liberalization of interest rates, at a pace dictated by its capacity to unwind the problems of the state banks and SOEs. The needs of microfinance will not influence this timetable.

For microfinance institutions attempting to replicate foreign models, a primary difficulty is their legal identity and institutional status. While local-level entities associated with an externally funded microfinance project may register with the Ministry of Civil Affairs, their conduct of financial business is viewed by PBC as being, in principle, illegal and therefore liable to sanction by it. PBC has been prepared so far to turn a blind eye to their operations, but the lack of legal recognition and an appropriate regulatory environment is a contradiction at the heart of the microfinance enterprise in PRC.

Lack of legal status and a supportive regulatory environment hold MFIs back

A number of Chinese academics, consultants, and practitioners have developed an understanding of microfinance principles and practice, and have developed professional links with the broader international microfinance community. The China Academy of the Social Sciences (CASS) in Beijing has pioneered the introduction of microfinance and publishes a journal devoted to the subject. It is difficult to judge how much information exchange occurs between Chinese practitioners and scholars of microfinance but in such a large country, professional communication is a problem. The new China Microfinance Training Center, closely associated with CASS, could act as a multiplier for professional dialogue and information exchange on microfinance.

In both externally funded and government programs, the knowledge and attitudes of local government officials are crucial factors influencing outcomes. Locally hired staff of donor projects is another group whose performance depends on a grasp of best practice principles. There seem to be limited formal facilities for training in-country, although the China Association for NGO Cooperation (CANGO) has been involved in providing microfinance training.

The 8-7 Plan and the microcredit lending associated with it are timebound, with the specific target of eliminating residual poverty in the 592 "poor" counties by the end of 2000. It is unclear whether the Government will persist with this approach to poverty alleviation after that date. It is in any case a source of financial sector distortion, and has undercut genuine attempts at microfinance in some cases. It has been generally unhelpful to the understanding and development of sustainable microfinance practices in PRC.

Whatever its value for eliminating poverty, the 8-7 Plan has been unhelpful to genuine microfinance

Credit under the 8-7 Plan has been directed to the poor in the geographic areas where microcredit as an intervention, for reasons of isolation, climate, and resource endowment, is likely to be least effective. It has been directed to lending for agriculture and livestock to a much greater extent than in other countries, and not to the off-farm activities which should form part of a diversified rural economy. The targeting of poverty by region rather than by household underlies this situation. This is not an argument for discontinuing poverty alleviation activities directed to the poor counties, but it is intended to cast doubt on the efficacy of microcredit, considered as a central intervention, in such counties.

The economic environment for microfinance is probably more favorable in "non-poor" counties, while there are many poor people in those counties who would

benefit from microfinance. Local officials of “non-poor” counties, who do not have access to poverty alleviation resources under the 8–7 Plan, could be much more receptive to the requirements of sustainable microfinance, including the need for higher interest rates. If microcredit is to continue to be directed to the “poor” counties, it should be incorporated as a subsidiary element into a broader package of interventions designed to overcome, as far as possible, the human, environmental, and infrastructural deficiencies which constrain the productivity of microcapital in such areas.

Among regulated financial institutions in PRC, only rural credit cooperatives (RCCs) appear to have some potential to conduct microfinance. Rural cooperative foundations (RCFs), which had been identified by some as the most suitable vehicle, are being abolished. ABC has limited interest rate flexibility, is preoccupied with the need to achieve commercial standards of operation, and is thought not to have the right institutional culture for microfinance.

RCCs appear the most promising option for the expansion of microfinance in the formal financial system as at present constituted, but that is more by default than by positive recommendation. They have the merit of greater flexibility in loan pricing, and are currently undergoing reform supervised by the central bank. They are also able, as the result of recent central bank regulations, to lend more freely without collateral and with benefit of simplified approval procedures, and may soon be able to accept group guarantees in lieu of collateral. If properly applied, micro-lending practices may well improve the financial performance of RCCs, as well as expanding their outreach to the poor.

PBC sees an important role for RCCs in a reformed system of rural finance, including the development of consumer lending to stimulate aggregate demand and to encourage a more diversified productive base in the countryside. However, RCCs are only a small element in a financial system facing massive difficulties. Not all observers are confident they will survive the restructuring and reform ahead. There is in any case a need to have a range of nonbank financial institutions (NBFIs) involved in microfinance, rather than pinning all hopes on a single institutional model.

Microfinance would probably fare better in “non-poor” counties where there are still many poor people

Rural credit cooperatives are the most promising option for providing micro-finance services

7.2 Recommendations

- (1) While broad interest rate liberalization depends on considerations of much greater weight than the needs of microfinance, PBC could allow progressively greater flexibility in interest rate setting in financial institutions such as the rural credit cooperatives.**

PBC will continue the process of interest rate liberalization by addressing related problems in the state-owned enterprise and banking sectors, which must be resolved beforehand. In the meantime, the progressive introduction of greater flexibility in interest rate setting within institutions at the periphery of the financial system, such as RCCs, will be a development favorable for microfinance. Further widening of the “band” will secure this goal.

Wherever possible, PBC should allow some flexibility in setting interest rates

- (2) PBC should continue to tolerate microfinance experiments, and should authorize some expansion in the numbers and scale of such pilot projects. It could encourage greater diversity in their methods of operation, as well as some trials in “non-poor” counties.**

The central bank’s permissive policy with respect to microfinance experiments, such as those funded by external agencies or as initiated by Chinese entities such as CASS, should continue. A statement authorizing some further expansion in the numbers of such projects, and clarifying the permitted degree of scaling up, would reduce uncertainty. Projects should be permitted to reach a scale at which sustainability is feasible. PBC should also encourage such experiments in “non-poor” counties, in addition to the designated “poor” counties, and mandate the

Experiments can be instructive

introduction of a wider range of financial products and models of delivery, as well as permitting higher interest rates, where local government officials are willing to authorize these.

A supportive policy and regulatory environment is essential

- (3) Under Chinese conditions, the early introduction of a supportive policy and regulatory environment is essential for microfinance to flourish. PBC should contribute to the development of such a supportive environment in cooperation with other relevant agencies.**

In some other countries a thriving microfinance sector emerged in an environment of limited regulation and benign neglect. However, the development of performance standards and the creation by authorities including PBC of a supportive policy and regulatory environment would be a prior condition, under Chinese conditions, for the gradual emergence of local initiatives in microfinance.

- (4) PBC should research microfinance operations in PRC in the light of international best practice, with a view to informing itself better about the experience of microfinance in PRC as well as defining minimum performance standards for microfinance institutions (MFIs). This is preferable to its authorizing any particular model or models of microfinance for application in PRC.**

Over time, PBC should conduct research on the variety of microfinance experience in PRC and relate this to international best practice, with a view to informing itself better about the subject, and to developing policies and a regulatory environment supportive of the autonomous expansion of sustainable microfinance. Rather than authorizing a model or models for application in PRC, PBC should define minimum performance standards for MFIs, thus encouraging innovation and adaptation to a wide range of economic and social conditions.

- (5) The central bank should expand its own experimental microfinance projects with rural credit cooperatives, including into “non-poor” counties as well as in the designated “poor” counties.**

PBC should expand its own experiments in microfinance within the rural credit cooperative system, in “non-poor” as well as “poor” counties. It should consider the requirements, including capacity building and human resource development, for the “roll-out” of its pilot project on a larger scale, and consider how these might be met.

- (6) PBC should consult with other stakeholders, including practitioners, to develop appropriate policies, regulations, and standards for MFIs. Standards should evolve in complexity as the microfinance industry itself evolves, and should be tied to incentives for compliance. However, the case of deposit taking calls for a more prescriptive approach.**

PBC should be sensitive to the need for standards to evolve in complexity and rigor only as rapidly as the microfinance sector itself develops, and to make allowance for differing degrees of maturity among MFIs at any particular time. The Philippines experience in setting standards may be instructive in this regard (see McGuire et al. 1998). Further, PBC should tie standards to incentives for compliance, rather than using them to disallow lending activities that fall outside the guidelines. The case of deposit taking requires a more prescriptive approach, however. Such a process of drafting appropriate policies, regulations, and standards would require consultation with other stakeholders, including practitioners, and PBC should develop procedures for such consultation.

- (7) PBC should develop constructive relationships with voluntary agencies operating MFIs, and should clarify their right to offer loans and mobilize savings under appropriate conditions.**

The question of the broader status of NGOs within Chinese society is one that is, strictly speaking, outside the province of PBC. However, constructive working

Research to define principles is better than taking a model off the shelf

PBC should consult with all stakeholders

relationships between PBC and the voluntary sector, as for example in the processes described earlier, would provide examples of the potential for community organizations to contribute to the solution of social problems. These might have some broader demonstration effect. It would be appropriate for PBC to issue a statement specifying that nonbank MFIs can engage in microfinance by making loans, and can mobilize savings subject to particular conditions and to meeting performance standards. A diversification of the range of institutions engaged in microfinance and in the variety of models employed would be a healthy development.

(8) PBC should sponsor the development of training capacity for microfinance in PRC.

The central bank should stimulate the development of training capacity for microfinance by contracting services from agencies such as the China Microfinance Training Center and CANGO, as part of the necessary process of human resource development just described.

(9) If appropriate, PBC should bid for some lending under official poverty alleviation programs to be channeled via RCCs in future.

Should microcredit lending under the 8–7 Plan (or some successor program) be continued after 2000 in some suitably revised form, PBC should consider whether its experience with microfinance lending via RCCs justifies a bid for some poverty alleviation resources to be channeled via the cooperatives, in addition to ABC. This could be designed as a localized experiment, and might provide an instructive comparison with the more conventional poverty alleviation lending. Experiments with other institutional forms would also be desirable.

Some official poverty lending could be channeled via RCCs to see how they perform

(10) PBC's efforts to raise the operational effectiveness of RCCs could include the introduction of some microfinance practices as well as a greater degree of interest rate flexibility and the financing of off-farm activities and consumer lending.

The central bank should continue its efforts to raise the operational effectiveness of RCCs (referred to earlier). It should consider how far the application of some microfinance principles (such as group guarantee, payment by installment, linkage of savings with credit) is capable of increasing the effectiveness of RCCs in general for low income and near-poor clients, as well as the poor. Armed with a wider band for lending rates, RCCs could gain greater experience in pricing loans for risk. This might be done by giving more emphasis to financing off-farm activities and to the development of consumer financing (as mandated by Governor Dai). Such experience would be beneficial in preparing the way for the wider application of sustainable methods of microfinance.

Applying best practice principles of microfinance could help RCCs to lift their game

(11) PBC should consider moving to more decentralized management of RCCs in time. This would be more conducive to creativity and differentiation in the services offered.

Concerning RCCs, a conflict may arise between the roles of PBC as their supervisor/regulator and as their effective "manager." PBC assumed control of the credit cooperatives from ABC as part of a broader process of financial system reorganization and restructuring. In time it may be possible for the central bank to adopt a more decentralized mode of management, which, in conjunction with continued supervision and regulation by it, would be more conducive to creativity and differentiation in the services provided by RCCs, including microfinance.

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