

NPRS-PRF

Helping Accelerate Poverty Reduction in Asia and the Pacific

RURAL FINANCE REFORMS AND DEVELOPMENT OF MICROFINANCE INSTITUTIONS IN THE PRC

In the last 30 years, the People's Republic of China (PRC) has made remarkable progress in reducing levels of poverty in the country. Since the start of PRC's reform process in 1979, the number of people living below the \$1-per day poverty line has fallen dramatically.

Recent World Bank data suggest that the number living on \$1 a day had fallen to 135 million by the end of 2004. However, since 1999, the rate of poverty reduction has slowed, while levels of inequality have risen. This is particularly evident between urban and rural areas (with the rural being the poorest), and between the east and west of the country (with western provinces being poorest).

The Government of the PRC has increasingly emphasized tackling rural poverty and reducing the inequalities between rural and urban areas and between the east and west of the country over the last 10 years. The provision of credit to support the development of local, rural enterprises has formed a major element of the Government's 5-year plans and is re-emphasized in the current 11th Five-Year Plan. In addition, the Government has been encouraging the development of microfinance institutions (MFIs) with a specific aim of serving poor rural households. Other government institutions are providing subsidized loans to the poorest households, often working through the rural credit cooperatives.

The Rural Finance System in the PRC

The PRC has an estimated 32,000 rural credit cooperatives (RCCs), the main financial system in rural areas. RCCs were mostly established in the early 1950s, with farmers voluntarily holding shares and choosing the leaders of the cooperatives. Increasingly, however, many cooperatives became the local branches of state-owned banks and so lost their advantages to serve farmers. In the past decades, in a bid to sharpen competitiveness in the face of fierce foreign competition, PRC's four state-owned commercial banks—the Agriculture Bank of China (ABC), Bank of China, China Construction Bank, and Industrial and Commercial Bank of China—have withdrawn from most countries and rural areas to refocus on more profitable operations in big cities. As a result, RCCs are the only financial

institutions serving many rural areas. But their capacity needs to be enhanced and a more sustainable and competitive policy environment for rural finance needs to be developed.

Background of the Project

In 2004, the PRC government approached ADB to request support for rural finance reforms and the development of MFIs in Inner Mongolia Autonomous Region (IMAR) and Guizhou Province, both among the poorest areas in the PRC. ADB agreed to fund a technical assistance project, TA 4430, through the Poverty Reduction Cooperation Fund, supported by the United Kingdom for international Development for a total of \$1,000,000 (government counterpart financing equivalent to \$440,000).

TA 4430: Rural Finance Reforms and Development of Microfinance Institutions in the PRC is implemented through two separate components respectively for IMAR and Guizhou Province, each responsive to the particular needs of the concerned regions and timing of reforms. The TA aims to address issues of financial access for the rural poor. Several factors encourage RCC reform and microfinance support in the provinces.

- *Strong government support.* For instance the IMAR and Guizhou governments have placed utmost importance on a successful rural finance reform program.
- *Rapid growth of nonagricultural sectors.* IMAR and Guizhou have registered rapid economic growth in the last 3–4 years, primarily fueled by resource-intensive industries, small and medium-enterprise industries, small and medium-sized enterprises, and tourism.
- *Addressing poverty.* The 2005 ADB study noted that many rural households are without access to RCCs, trapping them in a cycle of poverty and dependence on usury (excessive

interest rates). The IMAR and Guizhou governments recognize the importance of RCCs in providing finance to the rural poor and have committed to establishing a focused microfinance program.

The TA goal was to expand sustainable financial services to the rural poor in underdeveloped areas of Guizhou and IMAR. The two core outputs were to:

- Ensure the adoption of suitable RCC institutional and supervisory frameworks, resulting in institutional restructuring strategies for various types of RCCs and appropriate regulatory and supervision systems for restructured RCCs; and
- Develop a sound policy and institutional framework for MFIs and rural microfinance services, resulting in enhanced awareness of policy makers and the public about the importance and feasibility of microfinance mechanisms and the licensing of institutions.

Implementation began in early 2005 and consisted of a number of stages of inputs:

- A team of international consultants and Chinese experts carried out research to look at the demand and supply of credit in the rural areas of IMAR and Guizhou. The aim of this survey and of the work to review the existing structures was to map out a future reform process for both areas and to identify areas for capacity building. A midterm seminar was held between the consultants and representatives from the banking institutions to further develop the proposals for reforms.
- A high-level seminar was then held in mid-2005 to discuss the reform proposals made. It included representatives from the Ministry of Finance, the People's Bank of China (PBC), the regulatory authorities, and experts in the sector. This was followed by a European study tour for representatives from the executing agencies of the two areas and from the proposed pilot areas. The team visited Germany, Holland, and France to look at practices in rural financial institutions.
- ADB supported an international bidding process to select and grant microfinance institution licenses in two pilot areas. This was part of a wider pilot in which the PBC agreed in 2005 to allow the formation of "credit-only" lending companies in one country each of five provinces. The commercial microcredit institutions have now opened for business in IMAR and Guizhou and have already issued considerable loans. They are a new type of service provider in the country and their existence with Government encouragement is a first.
- ADB continues to support the development of a more comprehensive policy framework for rural financial development. In early 2007, a workshop was organized with the participation of the PBC and the China Banking Regulatory Commission, as well as other stakeholders in rural finance, to discuss the need to streamline and consolidate the existing policy framework to cover issues such as lowering the barriers for entry to the rural finance market and supervision and

enforcing regulations. Other key donors in the sector took part in the workshop, including the World Bank. German Technical Cooperation (GTZ) and the Department for International Development.

Project Results

TA 4430 has achieved significant results in a number of areas, including:

- The first detailed assessment of demand for and supply of rural credit in two of the poorest areas in the PRC;
- Support to the establishment of commercial microcredit institutions in IMAR and Guizhou, starting the process of establishing a range of providers in the rural financial sector; and
- Mapping out future reforms to the sector and continuing to provide support to the development of a more comprehensive policy framework.

While it is generally accepted that a high level of unmet demand for credit in rural areas exists and that the poorest have little access to the limited credit available, there has been little detailed research in the PRC to support these conclusions. One of the key initial phases of TA 4430 was to carry out detailed quantitative research on the demand and supply of credit in IMAR and Guizhou. Detailed surveys were carried out in six counties in Guizhou, covering a total of 720 rural households, and in three counties in IMAR, covering over 400 households and 64 micro and small enterprises. The survey results confirmed a number of the generally accepted conclusions that (i) there is a large demand for credit in rural areas and poor people generally have the most difficulties in obtaining credit; and (ii) formal institutions such as RCCs tend to target medium and large enterprises and are unable to meet the growing demand for credit.

At the same time, the detailed survey results provided a range of insights into the scope for the development of rural financial markets, including (i) the need for a range of products; (ii) the importance of remittance support services in some areas with large numbers of migrants; and (iii) the lack of knowledge among rural households about the products and services that are currently available.

As discussed above, one of the major achievements of the project was to support the establishment of commercial microcredit institutions in the IMAR and Guizhou Province. The Government currently dominates in the microfinance sector in the PRC and while hundreds of institutions implement microfinance projects, many are small scale and operate in an uncertain environment. The support given by ADB to the establishment of a new player in the sector is in itself a major achievement. However, much remains to be done.

The microcredit institutions established by the TA are only some among a number of potential players in the sector. While the institutions have been set up in two of the poorest areas of the PRC, their main targets will be small and medium enterprises in these rural areas rather than in providing loans directly to the poorest households. In addition, the capital that these

institutions can draw on to provide credit is limited and further work is required to develop policy to support their growth. However, the implementation of TA 4430 and other pilot work in the PRC is part of a broader vision for rural financial sector. The PBC envisages the development of the establishment of multiple, competitive financial organizations covering various markets.

ADB has recognized that the support provided through TA 4430 is only a small step in a longer-term process. The microcredit institutions established with the support of the project exist in an uncertain policy environment. For example, while the China Banking Regulatory Commission announced a set of principles to facilitate access to finance in rural areas, these principles did not cover microcredit institutions. As discussed above, ADB continues to look for opportunities to take up these issues and to provide support working with others to develop a more comprehensive policy framework for rural financial development. Lessons learned from TA 4430 are also being used in developing loans that are focused on poverty reduction in Yunnan and, possibly Hubei, Province.

Lessons Learned

Two main lessons can be drawn from experience in TA 4430:

- The need for a long-term process of support to reform, doing the groundwork and taking advantage of opportunities to make strategic inputs into the reform process; and
- Reforms might not have an immediate impact on the poor, but are necessary in longer-term reforms to provide services to the poor.

ADB staff continue to look for opportunities to offer technical assistance, working with others in encouraging the key stakeholders to continue to develop the overarching policy framework. ADB has recognized that major reforms, such as those in the rural financial sector of the PRC take time. Taking opportunities as they arise is as important as developing long-term relationships that support the slow process of change.

This case study was written by Social Development Direct (RETA Consultant) under the Regional TA 6270: Facilitating Knowledge Management for Pro-Poor Policies and Projects with inputs from Ying Qian, Project Officer of TA 4430, and Sonomi Tanaka, Senior Social Development Specialist, ADB. The views and assessments contained herein do not necessarily reflect the views of ADB or its Board of Directors or the governments they represent. ADB does not guarantee the accuracy of the data and accepts no responsibility for any consequences of their use.

For any queries, contact:

NPRS-PRF Secretariat
nprs-prf@adb.org

