

MICROFINANCE IN CHINA:
BUILDING SUSTAINABLE INSTITUTIONS AND A STRONG INDUSTRY

by

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Chapter 1: Themes and Methods

Section One: Core Themes

The thesis that follows is a narrowly-focused discussion of one specific route for poverty reduction in one nation in our world. That route, however, is inevitably situated in a larger macro-economic and political context, especially within the context of international development and the influence trends in development thought have on specific applications of poverty reduction strategies. The core themes discussed below try to situate this thesis into a larger international development context, particularly within the themes of globalization, local initiative and the appropriate role for donors, and the influence elites hold within bureaucracies.

Globalization

The term “globalization” can be largely classified as the impending irrelevance of national borders and the erosion of national sovereignty. Washington Consensus policies promulgated by the Bretton Woods institutions, including liberalization of trade, finance, and investment, consume the national policies of many developing countries. Furthermore, other international organizations, particularly UN agencies, come in to operate in these countries under the guise of public intervention as a means to solving problems of basic needs and human rights. It is the international financial institutions, however, that have been more powerful, and have significantly influenced the course many developing countries have taken in the past 50 years. High priority is given to commercial interests by these institutions, and so national governments have given way to globalized policy-making. (Khor 2001, 7-16)

The globalization trend creates an intense debate in the development community and elsewhere as academics, policymakers, and citizens try to understand what the implications of such policies are. Some interesting notions of how history will be re-written with the advent of globalization have come about. Francis Fukuyama has asserted that Western liberalism has become the global paradigm within which successful nations operate. Developing countries will eventually embrace this system as well, and so the “end of history” has arrived as all that needs to occur is to continue using this ideology. (Fukuyama 1989) Samuel Huntington takes this one step further, however, in predicting that all future conflict will only come from between culturally-defined civilizational boundaries, especially a backlash against the West, as their

globalization policies, such as financial liberalization, are pushed down the throats of the rest of the world. (Huntington 1993)

Other detractors from globalization focus on a micro-level analysis. Noam Chomsky asserts that globalization is another attempt to colonize developing countries so that they can supply cheap resources and labor. While the West attempts to foster democracy in these developing countries, it is largely organized around an elite with access to information that is not then disseminated to the majority poor of the country. This is all done under the guise of globalization, and the belief that free trade and democracy are good for all. (Chomsky 1991) It has been pointed out by many, however, that globalization policies lead, generally, to increased inequality within and between countries, especially as both poor countries within the international arena and poor people in a national arena are kept from decision-making processes. Khor points out increased inequality and some of the factors that cause it have in fact also slowed investment and deterred growth. (Khor 2001, 17-19) This corresponds to Dani Rodrik's findings that the East Asian tigers had higher levels of equality than other nations before their economic booms began and that a strong correlation exists between equality and economic development. (Rodrik 1994)

Others have pointed out the shifts in power that globalization enforces. "Forms of everyday resistance" is the term Fantu Cheru uses to show that for many poor people, there are ways to combat the negative effects globalization has had on their lives. Many withdraw from the formal sector to the informal, others will join political organizations, and many jumpstart the growth of democracy movements that call for an end to Chomsky's elitist democratic governments. (Cheru 1997) Jessica Matthews predicts a power shift as governments recede and international organizations and multi-national corporations fill the gap in the provision of public services and employment. She sees this movement as having both positive and negative consequences as sometimes the international organization will provide better and more comprehensive services than a national government could, while cautioning that such NGOs can become narrowly-focused, subject to limited donor funds, and fail to build local capacity to independently provide these services. (Matthews 1997)

Within the Chinese context, globalization and the concession to follow Washington Consensus policies have been limited. The Chinese government has fully embraced the idea that export-led growth with increased amounts of foreign investment are crucial to their own

economic development. (Studwell 2002) It has not acquiesced government control over certain policies, however, and the country continues to control its poverty reduction strategies. NGOs and UN agencies are forced to work in tandem with government partners in a situation that both builds the capacity of the local partners and allows the government to keep tabs on the activities these international organizations are implementing. So, while following international experience and slowly, methodically succumbing to its policies (most dramatically with acceptance into the WTO in 2001), China, largely because of its size and potential power, has also been able to keep its hand in traditional government activities that other developing nations affected by globalization have lost control of.

Local Initiative and the Appropriate Role for Donors

As shown above, the policies advocated through globalization create inequalities in the power structure that create animosity between actors. Furthermore, as more and more citizens mobilize in grassroots initiatives (as will be discussed below) to look at, for example, environmental concerns, a fundamental question that must be addressed is: who controls the resources? (Broad and Cavanaugh 1993, 69) How do people gain access to these resources? In looking at local initiatives to gain a sense of how the poor see their own development, donors can perhaps do a better job at promoting successful initiatives rather than funding finite, policy-oriented, narrowly-focused programs.

Both Fantu Cheru and Alan Durning have documented how citizens are forming grassroots organizations that resist national policies and ask for more moral or ethical policies from their national governments. Alan Durning writes that these “local organizations form a sort of ragtag front line in the worldwide struggle to end poverty and environmental destruction.” As Durning points out, though, these groups are organized in response to a crisis or opportunity and their objective is usually self-help, not political change, to create economic growth that does not damage their health or opportunities for future generations. (Durning 1969, 154-159) Furthermore, Cheru writes that these grassroots organizations are popping up as a response to national policies that have been neither transparent nor participatory in their design; people are finding new ways to assert themselves into the development process. (Cheru 1997, 153-155)

There are various examples of this phenomenon. Across South Asia the Gandhi-inspired self-help movement has mobilized thousands of people, largely women, into groups organized around a variety of social causes that address everything from infrastructure to community health

needs. Groups from India to Brazil, where 10 million landless people have begun occupying private estates that have gone unused, are addressing inequalities in land distribution. (Durning 1969, 156,167) Broad and Cavanaugh point out that ecological degradation is being effectively addressed by the poor who are most affected by the situation. For them it is a fight for survival to retain the natural resources that they depend on for life. In this example, the poor are “the initiators of sustainable and equitable alternatives.” (Broad and Cavanaugh, 1993,67) Another option for these every-day resistances has been to withdraw from the formal sector of production and produce only on a subsistence basis or to produce only within the informal sector. In this example, citizens are creating the organizational structures to provide services that government should and does not provide. This avenue could be successful because what Cheru terms the “silent revolution” of dropping out of the formal economy has a potentially disastrous effect on a nation and this threat can ensure that the poor have their voices heard. (Cheru 1997, 1555-163)

Furthermore, people are not pigeonholed into one, static identity from which they will act in any given situation. Rather, we are “multiply-positioned subjects” that are moving toward new ways to identify ourselves that are both in-between and in excess of traditional sources of identity. (Bhabha 1994, 1-18) All the while, people are fighting to be seen, listened to, and become active participants in their own destinies. The power structure inherently created in the new era of globalization has not presented that opportunity for either poor people or poor countries, and development initiatives need to look closer at that disparity.

International development organizations, fueled by developed countries, can play an important role in this idea. The top (international institutions) must be united with the bottom (local initiatives) in order for the revolution to move forward in a constructive manner. (Durning 1969, 168-173) As professionals and donors, the development industry would do well to heed the advice of Robert Chambers and his admonition that poor people’s realities are important and significant to the development process. Chambers warns that donors and professionals will “underperceive” local reality and complexity and tend to look past the local initiatives described above. This results in the embedded error syndrome of development, where mistakes are habitually re-made without the will to explore how local complexity caused the mistake to occur. (Chambers 1997)

Within the context of this work, there is a need to not only ask where China’s poverty reduction strategies fit within the international development trend, but also, how do they fit

within the context of local initiative and local realities? In examining microfinance and how it can be developed into a strong industry, one that is based on client demand, it will be important to know whether or which programs are donor-imposed, government-embraced development projects, as some may well be, or whether they are in answer to local demand for capital, including indigenous informal finance mechanisms.

The Role of Elites within Bureaucracies

In understanding the importance of local initiative, another aspect to explore is the power structure these initiatives, and the people that create them, operate within (and without). Elites represent the members of a society who occupy positions of power and influence. Elites will stay in power as long as they have legitimacy, and members of the society will sometimes be grateful to have someone to make decisions and have more expertise, and thus passively accept the hierarchy that comes with an elite system of power. Bureaucracy can typically refer to the public and civil service, its employees, procedures, and organizational culture. It can also refer to any large organization and its components, procedures, etc. Bureaucracies play an important role in development as they can help, hinder, and in many ways affect project implementation.

Understanding bureaucracy is the first step; knowing how elites enforce that power structure is another layer of complexity that is also important. Vertical political mobilization has been written about as one method of forming power relationships and providing access to resources in developing countries. Joan Nelson writes of three forms of vertical mobilization: traditional leaders, such as village chiefs, patron-client relationships, and urban political machines. These types of vertical mobilization often provide the only political participation available to the poor and as such can sometimes help to mobilize resources for the poor. For the most part, however, they tend to inhibit the ability of the urban poor to mobilize horizontally (i.e., on class or ethnic lines) and fight for change, as most vertical mobilizations are fairly conservative. (Nelson 1979)

Within the overarching political power structure, there are bureaucracies that exist to provide services to people. Michael Lipsky argues that these services are rationed through adjusting the supply or demand of such services. This is done through adjustments in costs such as time spent in accessing the service, psychological costs of using the service, cost of gathering information, as well as through adjustments in queuing procedures or routines required to access the service. While Lipsky would say that these adjustments are largely rational in that they

service a function to an agency, as the bureaucracy is trying to make best use of their own resources when demand outstrips the human resource supply, it is not always clear that his analysis is useful in a developing country context. (Lipsky 1994)

In the development context, however, there is a need to understand how those elites within the bureaucracies will react under a development project which inherently seeks to promote change in a country and potentially within a system. David Hirschmann looks at the role that bureaucracy in developing countries plays, both by looking at the impact bureaucratic elite have on development and the impact development has on those bureaucrats. Key in his analysis is the realization that bureaucratic elites hold sway within the bureaucratic machine and also have an incentive to stay within that machine. Thus, their stake in the system is quite high. To initiate change, it will inherently mean changing the status quo for those elites, so that, unless the change is for the betterment of the elites' position, they will not necessarily be willing to participate. (Hirschmann 1999) The stake that the bureaucrats hold in the system is crucial when implementing a development project.

Understanding this phenomenon is especially prescient in this thesis, as any donor-funded or international NGO-funded microfinance project in China is implemented through a local bureaucracy such as the Poverty Alleviation Office or the local Women's Federation. These elites, who are generally better educated, and live in the township capital, also generally are not full-time employees for the microfinance project. The demands placed on their work from the local government and from the foreign project funder are sometimes at odds, and their own stake in the community and within the bureaucracy affects how the project is implemented.

Section Two: Concentration Themes

Microfinance is but one subset of the development toolkit and with it comes several themes that are important to discuss. Situating the thesis within this larger debate in the microfinance community elicits a discussion of the following three themes: 1) microfinance and poverty alleviation, 2) tradeoffs between financial self-sufficiency and reaching the poorest, and 3) regulatory issues for microfinance.¹

Microfinance and Poverty Alleviation

How well and in what manner access to microfinance alleviates poverty has been a source of debate within the microfinance industry. Both qualitative and quantitative impact assessments have been undertaken, with differing results, and a variety of tools to implement these assessments have been created. For example, USAID commissioned the creation of a toolkit called Assessing the Impact of Microenterprise Services (AIMS) which presents five qualitative tools for institutions to examine the impact of their services. (AIMS 2001) A number of economists have also undertaken more quantitative, econometric studies of impact, with varying conclusions.

Some studies have shown improved livelihoods as a result of participating in these programs. By helping poor households to stabilize and smooth income, reduce risk, and invest in upscaling productive activities, microfinance helps to alleviate their poverty and hopefully bring them above national poverty lines. In a 1996 overview of 32 research and evaluation reports, Sebstad and Chen concluded that there are two main types of beneficiaries in microfinance projects. Richer clients tend to use the credit to deepen available capital thus helping to increase income. Poorer clients will use the credit for capital widening which will reduce risks and vulnerability, but not necessarily improve income. These evaluation reports show various levels of impact on clients in terms of increases in household and enterprise income as well as a variety of other social factors. (Sebstad and Chen 1996)

Jonathan Morduch and Barbara Haley conducted a comparable study of previous impact evaluations and found roughly similar findings. Specifically, they found evidence that microfinance increases income and reduces vulnerability for the poor. They further testified that

¹ For the purposes of this paper, microfinance broadly refers to the provision of small loans and other financial services to poor people who traditionally lack access to formal sector credit.

when the poorest are involved in these programs, impacts are higher for that population. Fewer studies exist with evidence on health, nutritional status, and primary schooling attendance, but Morduch and Haley felt that the existing evidence pointed to positive impact in these areas as a result of participating in microfinance programs. They do point out, however, that this can only occur when additional, *relevant* services are provided to clients, not simply added as an afterthought without regard to local reality. (Morduch and Haley 2001)

In a paper written to show how microfinance programs can be financially self-sufficient while positively impacting the lives of the poorest, Anton Simanowitz showed that participants in both CRECER in Bolivia and SHARE in India had significant changes in terms of income sources as well as consumption smoothing. 76% of SHARE's clients (which total more than 100,000 people) had significantly reduced their poverty and one-third of them are no longer poor. At CRECER, 66% of clients had increased income and 41% of clients had increased asset ownership, particularly in the purchase of animals. (Simanowitz 2002, 22-25)

It has been noted by many, however, that programs that do not specifically and actively target the poorest clients will tend to have mission creep and find that their programs serve an increasing number of non-poor or less-poor clients. This can happen because of the stereotype that the poorest can not repay the loans or the reality that providing smaller loans is more costly than larger loans. Targeting clients needs to be done throughout the program through tools that help to draw in the target group, designing products that are relevant to their needs, and mainstreaming impact assessment techniques into all areas of project implementation in order to monitor the success the program has in affecting clients' lives. (Morduch and Haley 2001, Simanowitz et al., 2000, Cheston and Reed 2000, Navajas, et al. 2000)

Knowing that microfinance can alleviate poverty and that specific targeting measures need to be taken in order for that to happen is important to the microfinance industry in China as it relates to projects with a poverty focus. Both government and donor/NGO funded projects have poverty alleviation missions in China. Understanding how this occurs, plus how to ensure impact, will help them to fulfill their missions.

Financial Self-Sufficiency vs. Reaching the Poorest

One fundamental divide in the microfinance industry is a fierce debate that is only natural for an industry that is trying to marry practical banking practices with "soft" issues of poverty alleviation. The debate concerns possible trade-offs between reaching institutional financial self-

sufficiency (IFS) and working with the poorest people.² The industry generally concedes that self-sufficiency is a goal: Elisabeth Rhyne concurs that everyone in the microfinance industry wants to “provide credit and savings services to thousands or millions of poor people in a sustainable way.” (Rhyne 1998, 6) No matter which side of the debate a person may emphasize, it is generally recognized that reaching financial self-sufficiency is an important goal in the quest to provide financial services to the poor. The Microcredit Summit in 1997 set a nine-year fulfillment campaign of reaching 100 million poorest families with credit by 2005 – and estimate the cost of this endeavor to be about \$21.6 billion. Little more than half of this amount is expected to come from donor funds. (Declaration and Plan of Action 1997) It is obvious that self-sufficient institutions will play a crucial role in reaching this goal as microfinance institutions (MFIs) scale up their operations to reach greater numbers of poor people.

Furthermore, there generally exists the consensus that subsidized credit – the rural farmer credit projects of the 1950s and 1960s – failed because of subsidization. These programs had very low interest rates, which resulted in the absence of savings mobilization, and low repayment rates. Rent-seeking behavior plagued these programs, as loans went to the non-poor elites. (Adams and von Pischke 1992, 1463-1366) The interpretation of this failure, however, is where the divide begins to be evident in the microfinance industry.

Those who sit squarely in the institutional financial self-sufficiency (IFS) camp see in subsidized MFIs of today the same examples from the rural farmer credit programs of old, such as the same rent-seeking and inefficient behavior that was a result of subsidized credit. (Robinson 2001, 7) What others emphasize, however, is that the new microenterprise credit that grew out of the 1980s and 1990s developed technologies that reduced information asymmetries, charged market or near-market interest rates, recognized the fungibility of cash, and offered short-term loans for its predominantly urban, non-farmer borrowers. (Woller et al. 1999, 39)

Corollary to the idea that subsidized credit programs will fail is another argument from the IFS camp, that sustainable programs are the only programs that will reach large numbers of poor people. Those in this camp argue that only sustainable, commercially financed institutions, because they are able to grow into large institutions with millions of borrowers, can meet the full demand for credit around the world for the economically active poor. These are the subset of the

² For the purposes of this paper, poorest will be defined by the Consultative Group to Assist the Poorest (CGAP): the bottom half of those living below the poverty line in any given country.

poor population that can use credit most effectively, as the poorest need a variety of other services before they can effectively use and benefit from access to credit. These services should be provided by government ministries and private charities, not the financial sector. (Robinson 2001, 8-10, 20, 23-28)

Those in the poorest camp recognize the importance of sustainability and its contribution to achieving large scale poverty alleviation. One point of divergence, however, is that sustainability is a means to an end for those in the poorest camp, as it enables an institution to reach large numbers of clients without the risk of losing funding and ending operations. For this reason, it is a desirable goal. Those in both camps understand that economies of scale must be reached in order to effectively attack poverty – those in the poorest camp are equally as committed to sound operational and management practices and institutional efficiency as those in the sustainability camp. There is the fear, however, that as MFIs focus on profitability, the poor in the programs will become marginalized and again be crowded out from the financial system. (Woller et al. 1999, 29-36)

Within the poorest camp is the persistent question: is subsidy all that bad? While recognizing the importance of self-sufficiency to sustain an institution in the long-run, the point is made that most of the innovations in the industry today grew from subsidized MFIs, not the least of which was group lending and village banking. (Woller et al. 1999, 40) Second, subsidized institutions are not necessarily inefficient. Morduch has pointed out that by keeping a hard budget constraint, even subsidized MFIs can maintain efficient practices. (Morduch 2000, 624) Finally, the poorest camp argues that if the end goal of microfinance is improved social welfare, the subsidy dependence level of an institution is logically irrelevant – the only important thing to measure is the impact on social welfare. (Woller et al. 1999, 54)

One major point of debate within the industry is the question: does breadth equal depth? Do larger institutions, because they reach so many more clients (breadth), inherently reach more poorest clients (depth) because of their size than smaller, targeted programs? In a 1995 study, Christen, et al., wrote that, “Achievement of significant scale by [MFIs] means that substantial numbers of the very poor are being served. In short, it is scale, not exclusive focus, that determines whether significant outreach to the poorest will occur.” (Christen et al. 1995) Those who believe in the argument that breadth equals depth are also more likely to support the

commercialization of microfinance to promote upscaling and increased outreach to a wider variety of clientele. (Rhyne 2001, 7)

A more empirical study, led by a team from Ohio State University, found the opposite in Bolivia. There, a small rural program with only 4,900 clients reached more clients from the poorest category than a large urban program with 30,000 clients, showing that breadth did not equal depth. (Navajas et al., 2000, 37) This evidence undermines the argument for commercialized, large programs, especially if the danger persists that these large-scale programs may marginalize the poor and not reach as many as a targeted program might.

The application of this debate to the Chinese situation is clear, where Chinese microfinance has been earmarked as a poverty alleviation tool that must, due to government interference, subsidize its interest rates. Most of the donor and NGO-funded programs, however, understand the importance of self-sufficiency and that their clients can overwhelmingly pay a higher interest rate, especially those involved in off-farm income generating activities. Therefore, the trade-off is not as evident to project implementers in China, yet they must deal with policymakers who force interest rate caps upon them, thus preventing financial self-sufficiency to be reached, and the appearance of a trade-off between the clientele they reach and the financial ratios they can ensure. On the other hand, government programs, with subsidy cushions, reach larger scale than the targeted donor and NGO programs. The debate about which is more crucial towards reducing poverty, breadth or depth, is also wrapped up in whether these tradeoffs exist between sustainability and poor clients.

Microfinance and Regulatory Environments

International experience in microfinance has shown that large-scale delivery of a diversity of financial services to the poor lies in a regulated, licensed environment. First, it must be clear that the general reason for financial regulations is to safeguard the financial system and protect savings deposits by applying prudential regulations to institutions; licensing of institutions would then mark where savings are “safe.” (Hannig and Braun 2000) Second, the benefits for microfinance providers in doing this within a regulated framework include the ability to take savings deposits from the public and ostensibly access commercial sources of finance, thus solving capital constraints and allowing substantial outreach. (Ledgerwood 1999, 155-160; Robinson 2001, 263-265)

There has recently emerged the idea that financial regulatory environments, in order to accommodate and encourage the delivery of microfinance to the poor, should use tiered structures of financial windows. The tiering depends on where deposits come from – delineating between public deposit-taking institutions, those that use members' money such as cooperatives, and those that use donor money and offer credit-only, such as many NGOs. These tiered frameworks can regulate either by institution (by creating separate institutional niches for microfinance) or by activity (by allowing existing institutions to expand into the microfinance sector). These are not mutually exclusive options. Arguments for this tiered approach include the ability for institutions to specialize within a market niche and to create linkages between MFIs and the formal sector banking institutions. (van Gruening et al. 1999)

The debate rages, however, about the appropriate timing and phasing of such regulations. Some will argue that putting regulations in place before the market matures will effectively stifle the industry and fail to result in innovative provision of alternative financial services by pigeonholing the sector into regulatory norms. The hassles, paperwork, and bureaucracy involved in many countries, including China, with registering as a formal entity also make regulating microfinance too early quite difficult for immature institutions. Others argue that early regulations will foster the industry to grow into a healthy, mature financial sector and reduce risk. It is difficult to determine how or when to regulate. Christen and Rosenberg assert that the global microfinance industry is rushing towards regulation where it is mostly premature. While they assert that credit-only MFIs do not need to be regulated, they also believe that very small organizations should not be prevented from taking deposits just because the supervisory body does not have the capacity to supervise them effectively. This is driven by a cost-based analysis whereby there is a cost to a central bank for creating a microfinance regulatory environment that involves supervisory costs, staff capacity, and time. This needs to be taken into account when creating these now-popular regulatory frameworks. (Christen and Rosenberg 2000)

There are several triggers that call for a regulatory framework to be put into place. These generally involve four types of risk. First is ownership and governance risk stemming from situations where an odd mix of shareholders (e.g., NGOs, government, donors, private individuals) might not have the skills necessary or when government intrudes on the governance of the MFI. Second is management risk when decentralized branches create an environment where internal control mechanisms are hard to enforce and fraud results. Third is portfolio risk,

or to enforce management of delinquency so that MFIs are held to certain standards to minimize risk to depositors. Fourth is new product risk, so that when new products are implemented the staff have the appropriate skills necessary to implement the product. (Graham 1998)

The key prudential standards that are generally implemented are 1) minimum capital for entry and subsequent capital adequacy requirements; 2) loan loss provisioning and write-off policies; 3) limits on risk in unsecured loans, insider lending, and single loan limits; 4) standards for liquidity risk; 5) compliance for surveillance requirements such as external auditing and on-site inspections. In general, in order for these regulatory mechanisms to work properly, they must correspond to adjustments in property rights, collateral law, and security interests for the entire financial sector, including microfinance. In addition, clear tax laws that adjust for increased loan loss provisioning on unsecured loans need to be in place as well. (Meagher 2002)

Most of all, however, the proper regulatory environment hinges on a clear definition of microfinance and microfinance providers, a definition that currently does not exist in the Chinese context. Thus, the current policy environment that microfinance providers face in China must be examined with an understanding of international experience that shows how best to build strong and sustainable microfinance industries.

Section Three: Research Methodology

Research Question

This paper seeks to address the question of how a sustainable microfinance industry can be created in China given current state attitudes, and what steps will need to be taken to ensure the growth of strong institutions in the future. In exploring this question, I conducted fieldwork in China to explore the current state of microfinance there and to determine where donors, experts, and practitioners foresaw the industry moving in the future. I will address the topic through a discussion of the current financial environment, focusing on the rural areas, where microfinance currently occurs most frequently, government poverty alleviation strategies, and the discussions I had with a series of stakeholders in the field. I will analyze the state of the industry from an institutional point of view as well as suggest avenues for creating both stronger institutions and a more stable sector in the future. I will conclude by discussing the current legal and regulatory environment for microfinance and providing recommendations for change within this framework.

Data for this paper was collected during fieldwork in the summer of 2002 in China, where I was based in Beijing and took research trips to rural villages, visiting six project sites in five provinces. While in China, I was hosted by the Chinese Academy of Social Sciences – Rural Development Institute (CASS-RDI). The Rural Development Institute itself runs a microfinance institution called Funding the Poor Cooperative (FPC), and several researchers attached to the institution helped me further frame my research question and advised my collection of data. Apart from collecting and consulting primary project documentation and secondary analyses or evaluations, there was a four-pronged process in gathering this data. First, I had both formal and informal discussions with a variety of scholars, donors, and policy makers considering the development of the microfinance industry and its larger role within the rural financial system. Second, (and sometimes overlapping with those in the first category), I conducted semi-structured, open-ended interviews with the senior-level managers at the national and local level of ten microfinance projects, each following the same format. A list detailing who was interviewed in these first two categories can be found in Annex 1 on page 99. Third, I held focus group discussions with local-level fieldworkers: mainly loan officers and accountants. Fourth, I held focus group discussions with clients at the six project sites I visited. Annex 2 on page 101 shows where and when I held each focus group discussion.

Surveys

In talking to national and local level managers, I gathered information on the following aspects of each project:

- lending methodology:
 - loan size
 - loan term
 - interest rate
 - how groups were formed
- organizational management:
 - how many staff worked for the project and their responsibilities
 - how staff salaries were paid
 - staff recruitment processes
- local economic context:
 - what types of income-generating activities clients were involved in
 - what other financial resources existed for local citizens.

Furthermore, I held a discussion with project staff concerning the long-term development goals of the organization, what actions they were taking to achieve these goals, and what obstacles or hurdles they foresaw in achieving them. These discussions have become the crux of the research, as looking at the patterns that emerged from these responses helped to identify the current status and state of development in the Chinese microfinance industry.

These surveys were entirely open-ended and followed the same basic format. Probing questions were asked to follow-up and refine the points made by managers. I would occasionally ask a pointed question asking if the respondent had thought about a different aspect or to comment on something someone from another institution had pointed out. I have tried to mark where responses were self-identified or came from one of my own probing questions. It was also important to ask the same questions of national and local level managers as the differences between their answers often pointed to insights about the particular organization or the difficulties in implementing large projects in such a vast and varied country.

Focus Group Discussions

The focus group discussions I led, which only took place during site visits, fell into two categories. First, I held a group discussion with loan officers and other project staff on many of the same topics I discussed in the survey with national and local level managers. The purpose in doing this was to triangulate the data received from the managers – especially in product design

and delivery as well as financial and project management – and to gain a sense of how deep institutional awareness was within the project.

In addition, I led a focus group discussion with five to ten clients, in which I surveyed each for basic information on their history with the institution – what loan cycle they were on, how much money they had borrowed, how they used the money, and demographic data such as age, educational level, and family size. Then, employing a modified version of the AIMS Client Satisfaction Tool,³ I led these clients in a discussion of the institution, by going through each aspect of the project – loan size, loan term, interest rate, group meetings, and savings requirements (or lack thereof) – to determine their satisfaction with each aspect and what suggestions they had to make the project better suit their needs. We also discussed other options for financial services in their area and what convinced them to borrow money from that particular microfinance organization instead of using another option. We would often talk about changes clients saw in their lives as a result of borrowing this money, what benefits they perceived from participating in the project, and how long they intended to continue borrowing. These focus group discussions were mainly used to triangulate the data I received from project staff, particularly in reference to their clients, their level of satisfaction, what type of competition they were facing from other financial institutions, and whether their plans for the institution's future were complementary to how the clients perceived their own future with the institution.

My original research design called for a survey with a mixture of closed and open ended questions to be administered individually to each client. The first trial was a disaster as clients were monosyllabic in their answers, and were often surrounded by not only me, but the entourage of loan officers, branch managers, and headquarters staff that accompanied me. I then decided to employ a focus group discussion format to mitigate the problems posed by that ratio as well as to facilitate more free-flowing discussions where clients could bounce ideas off each other. The AIMS Client Satisfaction Tool offered a complementary format to the data I was trying to gather.

³ “Assessing the Impact of Microenterprise Services” (AIMS) is a group of impact assessment tools developed by USAID and the SEEP Network of microcredit practitioners. The Client Satisfaction Tool, developed by Nancy Horn, asks clients to discuss aspects of the lending technology and assess their level of satisfaction with each aspect, as well as suggest recommendations for change. All of the tools in the AIMS kit can be found at <http://www.mip.org>

From these surveys and focus group discussions, I tried to gain a sense of how the industry saw its current position, in what direction it was trying to head, what experts in the field expected to happen, the strengths and weaknesses of various projects, and what obstacles the projects faced, both at the policy level and at the institutional level, in achieving those goals. All of these topics help to address how to build a sustainable microfinance industry in China.

Institutions Surveyed

I gathered information from and about the following organizations: Association for Rural Development of Poor Areas in Sichuan (ARDPAS), Canadian International Development Agency (CIDA), China Foundation for Poverty Alleviation (CFPA), China Little Flower, Chinese Academy of Social Sciences (CASS), China International Center for Economic and Technical Exchanges (CICETE), Ford Foundation, Habitat for Humanity International, Heifer Project International, KfW, Microfinance Training Center, Oxfam Hong Kong, PACT, People's Bank of China, Project Grace, Salvation Army, World Bank, UNICEF, UNFPA, UNDP, and World Vision. In addition, I interviewed local staff and officials at the following six local project sites which I visited:

1. Funding the Poor Cooperative branch in Yixian County, Hebei Province
2. Funding the Poor Cooperative branch in Nanzhao County, Henan Province
3. UNDP/CICETE/Women's Federation project in Chifeng City, Inner Mongolia Province
4. Oxfam Hong Kong project in Luquan County, Yunnan Province
5. Rural Economic Development Association (REDA) in Malipo County, Yunnan Province
6. China Foundation for Poverty Alleviation (CFPA)/Association for Rural Development of Poor Areas in Sichuan (ARDPAS) project in Langzhong City, Sichuan Province

In total I was able to gather substantial information on eleven different institutions, which form the sample for my analysis. They are, in no particular order:

Limitations

The data that will be presented is limited by time, language, supervision, and nonrandom sampling. First, my time in China was limited; three months is not enough time to be truly acquainted with an entire industry. Knowing that before I started, I prepared the groundwork prior to departure by creating questionnaires, doing background research, and contacting several people to make appointments, and so was able to “hit the ground running,” taking my first site visit seven days after arrival. Second, each site visit was also limited, usually lasting from 2 to 4 days. Hosting visitors, especially foreigners, is a time-consuming and expensive process in China, as social norms create expectations for grand meals and late nights entertaining – all of which takes away from the very important work these people are doing. Therefore, while staying to casually observe the processes at each site would have been ideal for the research, it would have been too disruptive for the institution. I tended to focus my time in conducting semi-structured interviews in order to minimize the time I took from project managers and clients.

Second, I did not employ a translator or a research assistant. For the most part, there was no problem in operating without a translator, as my proficiency in spoken and written Mandarin Chinese is fairly fluent, especially when dealing within the context of microfinance. On occasion, however, I had to depend on people who spoke standard Mandarin Chinese to translate local dialects into Chinese for me, which may bias the data, as I have witnessed the tendency for people to not only translate but also embellish, exaggerate, or re-state someone’s answers. I tried to correct for this as much as possible and never relied solely on one person to translate during a survey or focus group discussion.

Third, each site visit was supervised in some manner. Where applicable, a staff from the national-level headquarters accompanied me. This person’s presence, I am sure, influenced the responses I received. During discussions with local project staff, I usually had a representative from the headquarters staff present at the discussion. At each focus group discussion with clients, I invariably was accompanied by at least one local staff (whose presence I requested, to help me in understanding local dialects and to help transcribe the discussion), and sometimes by headquarters staff and local government officials as well. Despite my attempts to assure the clients that this was for research purposes and to engender a spirit of speaking freely, the presence of these officials may account for the overwhelming number of “satisfied customers” I

encountered. In addition, there is always the inherent bias I bring myself, as a white, American woman posing these questions.

There were other unforeseen obstacles as well. At one project site I was denied the request to lead focus group discussions with active clients and instead was directed to ask questions of a graduated client, then ushered out of the village “for my safety.” At another project site, clients were bussed over an hour to come to the headquarters to visit me, as local management were afraid the overwhelming heat that day (41 degrees Celsius) would make me sick and they would be responsible; the meeting was held in an air conditioned office. These types of conditions will not only color the analysis I can present, but also mean that a series of holes exist in the data I have gathered.

Lastly, the organizations I selected to gather data from are a nonrandom sample based on the “snowballing” method of using my initial contacts at CASS-RDI and other sources to lead to introductions to other projects where I might gather data. The sample is overwhelmingly biased towards the donor-funded or international NGO implemented type of project. In addition, because of time and language constraints, I was unable to randomly sample project staff or clients to talk with at each project site. Before each research trip, I sent selection criteria for focus group participants to try to ensure a representative sample based on gender and length of time participating in the project. When I arrived at each site, the local manager had already determined who I would talk with, and it was difficult to determine how well each manager followed my sampling guidelines, which biases the data I have gathered. Furthermore, with some exception, the fieldwork does not contain a representative sample of local government financed and implemented projects, of which many exist in China.⁴ Furthermore, while I did speak with several academics and donors about the subject, I was unable to interview government officials about the Rural Credit Cooperatives (RCCs) and their initiatives to start microfinance operations.

The discussion will be organized as follows. Chapter two will situate microfinance in a wider development paradigm, both within changing notions of development and as a tool for poverty alleviation. China’s economic and financial environment will be touched on in Chapter

⁴ One exception is Malipo REDA, which is run by a local government-NGO (GONGO, a truly unique Chinese type of institution). It does fit into the donor-funded category as the site was originally developed by UNDP/CICETE and has received additional funding from Grameen Trust. Government poverty alleviation funding is about to enter the project as well. Another is ARDPAS, a local Sichuan organization run largely by government funding – but who is facing serious problems with this funding source, as will be noted further below.

three, which will look at economic policy and reforms from 1949 to the present, the rural financial system, recent government poverty alleviation strategies, and how Chinese microfinance is situated within that context. Chapter four will introduce the organizations surveyed and present a typology for microfinance in China, while Chapter five will introduce the borrowers working with these organizations. Analysis of institutional-level data as well as recommendations as to how strong institutions and a stable industry can be created are presented in Chapter six. Chapter seven covers legal and regulatory frameworks, while Chapter eight sums.

Chapter 2: Microfinance as a Development Tool

Microfinance in a Changing International Development Paradigm

In the 1980s, a series of structural adjustment programs (SAPs) were instituted globally to deal with a building debt crisis and to attempt replication of the newly industrialized countries' (NIC) success. These were basically austerity programs that cut social services, shrank governments, and ignored rural development in an effort to promote the industrial, export-led development the NICs had achieved and earn government revenue to pay back international debts. In those countries that implemented SAPs, there were large subsets of the population without access to any basic services. (Fishlow, et al, 1994) Within this vacuum grew a trend to provide subsidized credit to the rural poor. These small farmer credit programs were run by governments and offered low interest rates. By international financial standards, these programs failed miserably, with low repayment rates and abysmal financial records. The low interest rates and government subsidies provided little incentive to repay. Rent-seeking non-poor individuals generally gained access to these loans, being attracted by low interest rates, no repayment incentives, and the power to subvert the loans to their own uses. This resulted in little credit delivery to the poor. (Adams and von Pischke 1992)

While some have argued that the new era of microfinance is simply a replication of failed subsidized rural credit schemes (Adams and Von Pischke 1992), there are others who see microfinance as a rural finance tool that has solved for the failures in the subsidized credit programs of the past. Because microfinance programs usually charge a cost-recovering interest rate and are generally run outside of government jurisdictions, they are part of a new trend in international development that answers to both the financial liberalization of the Washington Consensus⁵ and the McKinnon model (see below) as well as the micro-level development “with a human face” promoted by those who oppose such models.⁶

To situate microfinance in this way requires an examination of the financial systems approach to microfinance, which largely grew out of the lessons learned from subsidized rural credit. This approach promotes savings as just as important as credit in this process, calls for

⁵ Washington Consensus policies refer to seven general recommendations: stabilize the economy; reduce budget deficit; have stable, realistic exchange rate; liberalize international trade; privatize domestic enterprises; deregulate markets; and liberalize and deregulate financial markets.

⁶ For more about development with a human face, see, e.g., UN Commission on Human Rights (1999).

cost-covering interest rates, and focuses on providing access to financial services. (von Pischke 1998; Robinson 2001) There is some debate about how well microfinance fits into a financial services approach. As Jonathan Morduch points out, many MFIs have yet to achieve full financial self-sufficiency, the founding tenet of the financial systems approach, and many programs target the very poor in rural areas, whom the financial systems approach argues do not need credit. (Morduch 2000) Herein lies the placement of microfinance within the overarching international development paradigm, as programs situate themselves between market-driven macro-economic policies while providing services at the micro-level.

It should be pointed out, however, that the McKinnon model which ultimately justifies liberalization of capital markets, is based on a household-level model. The model looks at the aggregate real demand for money as a function of income, the investment-income ratio, and the real return for holding money. The model recognizes and operates under the assumption of a fragmented economy (thus, in the developing country context) in which households are self-financed.⁷ The model's basic conclusion is that in order for investment and economic growth to occur, there must be incentives for households to hold money, thus the real rate of return for this activity must be raised and thereby justifying increased interest rates. This model recognizes the household's propensity to have indivisible (lumpy) investments in technology, thus the need to save in preparation. Having higher interest rates will also force people to use capital in more efficient, effective ways as it becomes more costly to waste. According to McKinnon, then, high interest rates to de-fragment capital markets enforce macro-economic growth by spurring investment. (McKinnon 1981) Microfinance, with liberalized interest rates (at least, in the international experience), thus not only helps with a household's own investments and income, but also works on a national level to boost the financial sector and the overall economy.

On the micro-level, however, the idea that development should be commenced with a "human face" in mind is also present in the idea of microfinance services and its ability to reduce poverty, as is discussed below.

⁷ This, of course, is a troubling assumption in its simplicity as most households in a developing country context are not self-financed and have access to informal credit and savings markets.

Microfinance and Poverty Alleviation

Microfinance has enjoyed favor among donors for at least a decade as a financially sustainable tool for poverty alleviation. Ostensibly, donor funds will affect more than one client as the loan funds revolve among the populations of poor people in an area or around the world. Microfinance can be used as a development tool alone, in its capacity to increase income generation, or in tandem with other projects to create a multi-sectoral approach to poverty alleviation. Increasingly, microfinance has been taken as a donor development tool in contexts as varied as sub-Saharan African HIV/AIDS projects, Latin American community development projects, and South-east Asian gender projects.

Risk Mitigation

Jennifer Sebstad and Monique Cohen's monograph on risk management is a comprehensive overview of the types of risk clients face as well as the ways in which access to microfinance can be one tool of risk aversion. Risk, defined as the chance of a loss or loss itself, can occur from various sources: structural, which are generally exogenous such as seasonality or inflation; unanticipated crises and emergencies such as illness, violence, or theft; life cycle events including marriage and education; operating an enterprise, especially in management risks with information asymmetries, lack of market knowledge, and an inability to invest in technology; and even in taking a loan where clients risk achieving less than expected returns on their investments and an inability to repay. (Sebstad and Cohen 2001, 31-43)

As Sebstad and Cohen show, poor people have many options in reducing vulnerabilities. These strategies are both ex-ante and ex-post a shock. As they relate to credit and savings, poor people will, ex-ante, save cash – either at home, in formal banks, or through savings and credit associations – or ensure access to multiple sources of credit to draw upon when a shock comes. Ex-post, poor people's loss management techniques include personal financial intermediation strategies. Sebstad and Cohen found that one of the most prevalent ex-post responses to shock for poor households was to borrow, especially from informal sources and from microfinance institutions. (Sebstad and Cohen 2001, 45-70)

Loan funds are used for a variety of investments; microfinance lending institutions increasingly realize the fungibility of these funds and worry less about the division between consumption and investment uses. For the most part, however, Sebstad and Cohen found in their

study that clients largely use funds from these loans to 1) build income and asset bases through investing in or starting new enterprises or to purchase inputs such as land, livestock, or wholesale goods as well as in 2) cash or resource management, such as managing cash flow to meet daily household expenditures, repay existing debt, or to meet short-term consumption needs. These investments in productive functions are ex-ante strategies that smooth income and minimize adverse shock from potential risk. Using these loans to smooth consumption are ex-post strategies of managing risk and loss. (Sebstad and Cohen 2001, 71-86)

Poverty Reduction

How well and in what manner access to microfinance alleviates poverty is a source of debate in the microfinance industry. Both qualitative and quantitative impact assessments have been undertaken, with differing results, and a variety of tools to implement these assessments have been created. For example, USAID commissioned the creation of a toolkit called *Assessing the Impact of Microenterprise Services* (AIMS 2001) which presents five qualitative tools for institutions to use to qualitatively measure the impact of their services.⁸ A number of economists have also undertaken more quantitative, econometric studies of impact, with varying conclusions. Determining program impact is largely complicated by the difficulty in accounting for endogenous program placement and self-selection biases. In the first problem, MFIs choose to locate their programs in places because of a confluence of characteristics, some of them intangible that allow for micro-enterprises to grow well there. It is hard to replicate those characteristics in a control group. In the second problem, participants in microfinance programs self-select into the program because of a bundle of characteristics, many of them intangible that are also hard to replicate in a control group. These characteristics compel them to want to take loans for self-employment ventures, something that not every poor person is willing or able to do. One method of circumventing these problems is to use baseline data and undertake a panel series of surveys with clients over a period of several years. The problem is that few programs establish such baseline data at the start of a program, when so many other issues seem more pressing, and collecting panel data can be tricky when participants also drop out, move away, or become unwilling to participate.

That being said, a number of studies have shown improved livelihoods as a result of participating in microfinance programs. Some, of course, have shown only increased

⁸ All of the tools in the AIMS kit can be found at <http://www.mip.org>.

indebtedness and further impoverishment. By helping poor households to stabilize and smooth income, reduce risk, and invest in upscaling productive activities, however, microfinance helps to alleviate their poverty and hopefully bring them above national poverty lines. In a 1996 overview of 32 research and evaluation reports, Sebstad and Chen concluded that there are two main types of beneficiaries in microfinance projects. Richer clients tend to use the credit to deepen available capital thus helping to increase income, while poorer clients tend to use the credit for capital widening which will reduce risks and vulnerability, but not necessarily improve income. These evaluation reports show various levels of impact on clients in terms of increases in household and enterprise income as well as a variety of other social factors. (Sebstad and Chen 1996)

In a paper written to show how microfinance programs can be financially self-sufficient while positively impacting the lives of the poorest, Anton Simanowitz showed that participants in both CRECER in Bolivia and SHARE in India had significant changes in terms of income sources as well as consumption smoothing. 76% of SHARE's clients (which total more than 100,000 people) had significantly reduced their poverty and one-third of them are no longer poor. At CRECER, 66% of clients had increased income and 41% of clients had increased asset ownership, particularly in the purchase of animals. (Simanowitz 2002, 22-25)

Understanding that impact on clients varies between institutions points to the subtle differences between programs. The design of loan products, the efficiency and financial strength of the institution, and even the type of staff hired to run the program all affect the ability of the project to positively impact its clients.

Other Impacts

Empowering Women

Many have contested and debated the ability of microfinance programs to empower women. Naila Kabeer, in a survey of empowerment studies in microfinance, found that one reason this issue is so hotly debated is that the definition of empowerment has been nebulous and contradictory between studies. Evidence of disempowerment usually lies in accusations of over-indebting women, increasing their work burdens through increasing the labor they must perform in order to pay back the loan, lack of control over use of loan funds, and not enough access to the market. (Ackerley 1995 and Goetz and Sen Gupta 1994, cited in Kabeer 2001) Proof of

empowerment comes from increased income and consumption standards for women after taking the loans, increased asset holdings due to women's access to loans, the exercise of purchasing power, and increased political and legal awareness. Reduction in domestic violence and other violence against women is also sometimes held up as a result of access to these microcredit loans. (Kabeer 2001, 63-65 and Rahman 1986, Pitt and Khandker 1995, Hashemi, Schuler, and Riley 1996, and Schuler, Hashemi, Riley, and Akhter 1996, all cited in Kabeer 2001). Thus, Kabeer notes, because the debate is stratified by differing definitions of empowerment, she suggested an alternative meaning: empowerment is access to choice, and increasing empowerment means to increase the range of choices available.

As Cheston and Kuhn point out, however, the ability of a microfinance program to empower women lies inherently in the structure, organization, and design of that program. They assert that simply bringing financial services to women is not enough to create an environment for empowerment; rather, the institutional will to affect women helps to create that environment. Specifically, they advocate for the inclusion of business training, an open discussion of social issues, support and advice for balancing different types of work burdens (the productive-reproductive balance), as well as re-structuring the management of the MFI itself to effectively impact women's lives. (Cheston and Kuhn 2002). Mayoux (2001) presents a similar belief, as she outlines three paradigms within microfinance: the financial sustainability paradigm, the poverty alleviation paradigm, and the feminist empowerment paradigm. She asserts that current tenets of best practice being encouraged by donors do not necessarily contribute to women's empowerment; in fact, it is not access to savings and credit that causes this empowerment. Rather, she advocates for a participatory approach that mainstreams strategies for women's empowerment into programs designed under the other two paradigms in order to fully realize the potential for microfinance to empower women and change gender dynamics.

Improved Health and Nutrition; Increased Education

There are some who advocate the use of microfinance as a development tool because of their belief in its ability to not only impact the productive ability of the household but also to impact the health, nutrition, and education of all members of the household, including children. In Sebstad and Chen's overview of 32 impact studies, three of the studies showed a decrease in the proportion of household expenditure allocated to food, indicating a movement beyond basic

survival; however, none of the studies showed significant impact on health and nutrition of the family. Evidence from these impact studies on education was contradictory as some found a positive impact on girl's schooling, others found this impact was only applicable to boys, while others found no significant changes in schooling.

Freedom from Hunger, an American NGO specializing in the provision of microfinance services coupled with education in basic health, nutrition, reproductive health, etc., has extensively studied the impacts these type of programs have on clients. They found that nutritional impacts of the credit and increased income are contingent upon a variety of factors including basic health of the client and household, the state of intrahousehold food allocation decisions, and extant practices in maternal and child health. Thus, a program's nutrition impact depends both on this baseline data and how the program seeks to address these practices. (MkNelly and Dunford 1996) Based on this knowledge, Freedom from Hunger staff have created a project model called *Credit with Education* that seeks to combine those services.

Thus, it must be stressed in each of these situations that the impact microfinance has on clients and their families depends significantly on the institution that is providing those services. Institutions that are strong, efficient, and have a product designed to meet specific target goals and/or clients will be able to better impact its clients. In sum, I quote Christopher Dunford in relaying the ability of microfinance programs to affect clients in a specific way:

I am continually impressed by the will of the people for whom we design and implement microcredit and other development services. It is a tribute to the power of their will to survive and succeed that the poor turn the paltry resources and opportunities we offer into something useful and meaningful in their lives. When successful, what we *will* to offer resonates with the *will* of the poor... There is nothing wrong with lacking a certain will, but we must understand how this will or lack of will actually shapes our perception of the feasibility of a particular proposal and, should we decide to give it a try, the chances for its success. (Dunford 2002, 108)

At the Microcredit Summit +5, a global conference on microfinance held in New York City in November 2002, I witnessed the confluence of such wills. Suddenly, it seemed that microfinance practitioners had realized that, while they lend a helping hand, it is not credit and savings alone that would alleviate the multi-faceted nature of poverty. While understanding the importance that a lack of access to financial services has in keeping poor people trapped in poverty, these practitioners began talking at length and in great detail about what *other* services

should be provided to their clients. This was in recognition of the demand for non-financial services among clients and thus, the long-term sustainability of the program that depends on its ability to meet client demand. This new trend also recognizes that increased impact on the lives of clients depends on the microfinance institution's ability to provide non-financial services. This is an important trend in the industry and will, I believe, change the way these programs impact their clients.

More importantly, these are the types of trends that will impact the Chinese microfinance sector as it grows and encounters international ideas, debates, and best practices. In the past five years, there has been a steady increase in the amount of knowledge Chinese practitioners had about what the rest of the microfinance world is doing. Programs have been sending practitioners abroad to study basic tenets and as these practitioners increasingly attend global conferences such as the Microcredit Summit +5, hopefully these ideas about creating strong institutions that positively impact clients will begin to creep into their own practices. Knowledge of these international trends will itself help to build a strong microfinance industry in China. That industry, however, will forever be situated in the larger Chinese financial and economic context, to which we now turn.

Chapter 3: China's Financial and Economic Environment (as it affects the microfinance context)

China's microfinance industry occurs overwhelmingly within the rural context, thus a brief discussion of the rural reforms that have taken place over the last fifty-plus years as well as the rural financial system will help situate the discussion and bring it into its wider context.

Rural Economic Reforms: The Era of Mao Zedong

When the Chinese Communist Party (CCP) came to power in 1949, the rural landscape had been ravaged by war, famine, occupying armies, and poverty. The rural peasants had backed the CCP and so land reform was one priority in the CCP's plans to clean up the country. In 1949, 90% of the population lived in rural areas and 65% of national income came from the agricultural sector. (Pyle 1997, 24-25; Lippit 1997, 3)

Land reform between 1949 and 1952 relied on the CCP's ability to quickly mobilize the peasants, which allowed for rapid collectivization and land redistribution. During this period private rural enterprises were protected from being nationalized. (Lippit 1997, 3-4). The Chinese instituted a thorough redistribution of land between all classes of peasants and also organized them into co-operatives for production. Their strategy was to emphasize class differentiation, expropriate land from those classified as landlords, and redistribute it among the poor and landless peasants. All land was re-distributed according to class status, which consolidated the CCP's political power in rural areas. (Cheng 1982, 62-66)

This land reform policy precipitated three dilemmas. First, it increased the number of land holders, thereby reducing average farm size, and lessening the ability to accumulate capital. Second, class stratification persisted as traditionally poor peasants continued to borrow money, tools, and draft animals from the traditionally rich peasants. Third, the peasants' rate of consumption increased, thus decreasing the amount of grain and agricultural products taken to market, which created a food shortage in urban areas. (Cheng 1982, 67-68)

After this initial tiptoe towards land reform, in 1958, Mao Zedong asserted his dreams of accelerating progress towards Communism by initiating the Great Leap Forward. The GLF employed a dual approach of mobilizing the rural population into large communes and intensifying industry by utilizing the urban underemployed. (Lippit 1997, 7) In rural areas, peasants were mobilized into communes that averaged 5,000 households per commune. The

basic unit of labor was a production brigade. The state abolished private ownership of land and households ate in communal kitchens. Communes issued payment according to “attitude toward labor, technical skill, and physical strength.” (Cheng 1982, 100) The famous “backyard furnaces” became ubiquitous in urban and rural areas alike and the entire population was engaged in melting down metal household objects to make “steel.” The resulting iron ore was useless in any productive capacity. (Rawski 1980, 51-53). Because of the attention paid to this mobilization the 1958 crop was poorly harvested; furthermore, because zealous cadres, looking to please higher authorities, overreported crop production, state taxes took a large percentage of grain, creating a food shortage. (Becker 1996, 53-55) A famine ensued that was hidden from the world; later estimates of the number of people that died from hunger as a result of these policies range from 23 million to 30 million during the Great Leap Forward. (Lippit 1997, 8; Becker 1996, xi)

The “readjustment” period that ensued tried to stabilize the rural countryside once again. Between 1961 and 1965, economic development planners had four major strategic priorities: 1) balanced growth between industry and agriculture, in recognition that China’s underdevelopment of the agricultural sector would constrain industrial development; 2) a change in investment priorities that put agriculture first, consumer goods second, and capital goods third; 3) institution of a system of self-reliance by trying to stem China’s import dependence, and; 4) renewed efforts to stem population growth as policymakers understood that a large population put pressure on the underdeveloped agricultural sector. (Cheng 1982, 268-269)

The policies that grew out of these strategic priorities introduced a system of household responsibility in the rural areas. This system weakened the large rural communes. Also, material incentives became a part of the wage structure for both rural and urban areas. In the first few years after the Great Leap Forward, economic control was re-centralized and economic planning was based on a better information gathering system. Also during this time, rural enterprises flourished, especially in manufacturing fertilizer and cement, and some private ownership of land in rural areas was allowed. (Lippit 1997, 9; Cheng 1982, 269; Rawski 1980, 57; Pyle 1997, 42)

The quality of life for rural peasants increased somewhat during this time, especially in external linkages: rural telephones increased from 200,000 in 1957 to 492,000 in 1965, and roads in rural areas extended 255,000 kilometers in 1957 and increased to 514,000 kilometers in 1965.

Health facilities improved as the number of hospital beds increased fourfold from 1957 to 1965. Educational opportunities also increased as double the number of primary school aged children entered school in 1965 than in 1957.⁹ (Parish 1985, 6-7)

Rural production teams, which were the organization level below communes, gained increased decision-making authority during the early 1960s, and Party leadership emphasized production of manufactured agricultural inputs (through state investment) such as fertilizer, pesticide, and farm machinery to spur agricultural production. Government policies increased prices for agricultural products, lowered delivery quotas to the state, and re-opened rural markets that had been in use before the Great Leap Forward for products in excess of state quotas. Agricultural output and productivity were heightened after the abandonment of the idea of local self-sufficiency in rural areas; each area was able to specialize production and engage in inter-regional trading to bring in other necessities. (Lardy 1985, 41-43)

In 1966, at the start of the Great Proletarian Cultural Revolution (GPCR), previous policies for rural areas were abandoned and prices were frozen, markets constricted, and interregional flows of commodities restricted, which prevented economies of scale from being reached. Regional and national self-sufficiency again became a major goal, a policy which ignored local conditions in rural areas and prevented specialized production. Mao rejected the idea that scale economies and comparative advantage would catalyze the agricultural sector, instead opting for a grand scheme of self-sufficient rural communes that contributed to a self-sufficient national state. Inter-regional trade declined significantly thus skewing agricultural development of several key products such as soybeans and sugar. Because of this the GPCR marked an overall decline in trade, specialization, and income-earning opportunities for rural peasants. While grain production soared, state purchases of grain stagnated – the market rate in 1976 was lower than it had been in the mid-1950s. (Lardy 1985, 43-46) Rural enterprises continued to flourish, however, especially as a result of this policy of local self-reliance. Most scholars assume that surplus labor existed in the agricultural sector and these small-scale local enterprises used this surplus labor and contributed significantly to development during this period. (Lippit 1997, 11-14)

⁹ The availability of more traditional indicators such as GDP per capita is sketchy during this period of China's history as statisticians were subject to the same standards as farmers and SOE managers: to reach targets set by the government regardless of the verity of the reported numbers. This is a persistent problem even in China today. One popular phrase says, "*guan chu shuzi, shuzi chu guan*" [officials produce numbers, numbers produce officials]. (Studwell 2002, 232)

On the other hand, the cost of agricultural inputs rose, which decreased efficiency. The gross value of agricultural output had an average growth rate of 3.7% between 1966 and 1977, although when rising costs are accounted for, that number decreases to 3.2% (Lardy 1985, 46). These economic statistics do not paint a full picture of rural peasants' lives, however, as increases in educational opportunities and healthcare also changed their quality of life. Efforts were made to improve education for peasants, and the training of barefoot doctors brought basic healthcare and family planning services to rural areas began. (Lippit 1997, 10) The number of barefoot doctors increased from 94,000 in 1965 to 1,559,000 in 1975 and rural deaths declined by 20%. The number of rural hospital beds increased 240 percent and the number of trained doctors and nurses doubled. (Parish 1985, 6-7)

Rural Economic Reforms: Post-Mao

After Mao Zedong's death in 1978, rural reform took a much more aggressive approach, fundamentally reshaping the Chinese economy. One reason why agricultural reforms were more emphasized during this period was because rural peasants, on whose back the CCP had risen to power in 1949, were growing restless with increased poverty and urban biases in government planning. The major objective in early reform policies was to improve rural livelihoods by improving prices and transferring more income generating activities to rural areas. This induced a broad liberalization of rural policy which resulted in three major responses: 1) a return to household farming; 2) a large increase in household savings; and 3) rapid growth in rural enterprises. (Naughton 1996, 138; Pyle 1997, 50)

Curiously, rural reform began in the grassroots. In 1978 and 1979 some areas, particularly in Anhui province, began surreptitiously experimenting with breaking up the commune and returning to traditional forms of family farming. Contracts were extended on a household basis and households retained earned profits. In 1980 the central government took note of the success of these experiments and officially sanctioned the system, which was gradually implemented over several years across the Chinese countryside. (Blecher 1997, 21-22; Pyle 1997, 59-61) By the end of 1982, 90% of rural households were involved in the household responsibility system. Between 1979 and 1984, agricultural output grew exponentially: grain production grew from 283 million metric tons to 407 million metric tons; wheat production more than doubled; rice production grew 150%. The state began to raise the prices of agricultural products (while not raising food prices in urban areas) and reforms in the early 1980s gave rise to

rural free markets, private ownership of agricultural production means, and rural industry. (Pyle 1997, 62-67)

Originally designed to be “handmaidens” to agricultural production, rural industries – especially those located near urban areas – began to diversify into a wide variety of products in the early 1980s. (Mood 1997, 123-124) While the 1979 reforms did not directly address rural industry, by relaxing restrictions, promoting local production of agricultural inputs, and encouraging urban industry to subcontract with rural industries, liberalization of rural industry expanded production significantly. Rural industrial output grew on average 21% annually between 1978 and 1985. There are several reasons for this success. First, rural industry faced a truer factor price ratio than urban state enterprises because wage levels were less subsidized and capital was lent at near-market rates, allowing the industry to respond to truer signals. Taxes were lower for these industries, which were situated near urban areas and thus benefited from urban industrial growth (rural industry did not grow as well in western regions, where spatial dispersion limited growth). A variety of organizational models proliferated in these industries, ranging from private enterprise to collective enterprise. Moreover, these industries had virtually unfettered access to capital because of increased rural household savings and the practice of developmental lending policies. As farmers channeled more and more savings into rural credit cooperatives (RCCs), these institutions began lending more and more to rural industries, particularly township and village enterprises (TVEs). In addition, local governments acted as guarantors to these TVEs, effectively eliminating a hard budget constraint within this access to capital. Household savings accounted for approximately two-thirds of capital formation in the decade starting in the mid-1980s. (Naughton 1996, 148-161; Blecher 1997, 22; Lardy 1998, 9) Because of the success of this sector, rural industry was actively stressed in government policy in 1984. (Naughton 1996, 162) By 1987, in recognition of their immense profitability, TVE exports were emphasized and rural reforms were deepened further to increase reliance on the invisible hand of the market. (Mood 1997, 125-126) Obviously, this enterprise-driven strategy for rural development affects the poverty alleviation strategies promulgated by the government, as will be shown below.

The entire 1980s reform period can be characterized by showcasing income levels: rural income grew 150% in real terms from 1978 to 1985, yet did not increase at all between 1985 and 1989. (Naughton 1996, 253) Moreover, inequalities in income distribution, between urban and

rural areas and between eastern and western China have risen sharply throughout the reform period. (*China HDR*, 7)

After the Tiananmen Square incident in June of 1989, the government quickly turned its tail on reforms and returned to a more rigidly planned economy. This period did not last long, however, as by 1992, Deng Xiaoping began touting and publicly praising private and joint-venture enterprise. This spurred an investment frenzy in urban areas and rural reform again took off. (Studwell 2002, 26-63) Because of this, state-owned enterprises began to significantly “grow out of the plan” as more and more of their production went at market-oriented prices. In rural areas, structural transformation occurred in the labor force as workers increasingly turned away from agriculture and state-owned enterprise and towards private enterprises. (Naughton 1996; Lardy 1998, 25) Moreover, in 2001 China gained entrance to the World Trade Organization (WTO), which means that within three to five years significant changes in the economic and financial environment will take place. Some of the commitments the government made were to reduce statutory tariffs, bring tariff rates for chief agricultural goods to almost zero, gradually eliminate quotas and licenses on some imports, increase trading rights, and opens its telecom, banking, and insurance industries to foreign direct investment. (Lardy 2002, 22)

In sum, rural reforms took China’s rural areas from being based in a collective, commune environment to a household responsibility system that stressed the individual’s capacity to produce for him/herself and participate in an almost (but not quite) market economy. As accession to the WTO draws nearer, and provided China follows through on its promises to the organization, the financial and economic landscape will change even more significantly in the future, especially for farmers who will face foreign competition for their products as well as increased variety in the sources of financing available. This environment, with mounting pressure and attention being placed on entrepreneurial systems, at the direction of the state government, is the backdrop for microfinance in China. Understanding the state control of the macro-economy helps to understand the ability the state has to control the microfinance industry as well.

The Rural Financial System

There are a variety of formal financial institutions available in China’s rural areas. These include sectoral banks, policy banks, commercial banks, cooperatives, savings institutions, non-bank financial institutions, and informal financial institutions. In 1996, China’s State Council

devised a tripartite rural financial system. The three leading financial institutions in China's rural areas are the Agricultural Bank of China (ABC), the Agricultural Development Bank of China (ADBC), and the system of Rural Credit Cooperatives (RCCs).¹⁰ The ABC is a commercial bank with offices in provinces, cities, counties, and large townships. Its lending activities generally deal with larger farming units such as seed companies and marketing co-ops. The second institution, the ADBC, is a policy bank that was established in 1994 as an instrument to separate policy lending from commercial lending; ADBC loans are largely used to implement rural development policy objectives. Its lending activities involve funding projects for storing crops, distributing, marketing, or processing agricultural products, or for large-scale agricultural development projects run by the state government. The third institution is the RCCs. RCCs are the most local institutions; almost every township of rural China has an RCC, which have local administrations, no centrally governed headquarters, and fall under the supervision of the People's Bank of China (PBC). Ninety percent of RCC funding comes from savings deposits, 80 percent of which comes from farmers. RCC loans go largely to township/village enterprises (TVEs), whose loans the government will guarantee. Some middle-income male farmers also have access to RCC credit. (Watson 2002; Du 2002; Zhu, et al. 1997, 17-30)

In 1993, the PBC instructed both the ABC and the RCCs to become commercially-oriented banks that work toward generating profit under market economic principles. Both tend to fund large-scale projects (i.e., not to the household). In addition, the ABC, which once had an extensive branch network throughout the country, has begun to close non-performing branches under increasing pressure to become a self-sufficient institution. (Lardy 1998, 83; Du et al. 2001, 144; Du 2002, 5) By 2001, however, while state mandates called for commercial activity, most banks still operated with soft budget constraints, did not use profitability as a standard for lending decisions, and struggled with poor management, inefficient uses of funds, and repayment problems. In addition, state-owned enterprises and township and village enterprises (TVEs) continued to receive the bulk of bank credit; 83% of bank credit in the mid-1990s was given to state-owned enterprises. (Tsai 2002, 29-31; Lardy 1998, 83)

The Rural Credit Cooperative system is the most extensive network of financial institutions in rural China. Until the 1996 State Council mandate, it had been under the umbrella of the ABC, so that 20-30% of its deposits were given to the ABC, which oversaw its lending

¹⁰ The term "cooperative" is in name only, as these institutions are not member-based financial institutions.

priorities. In 1996, the RCCs officially became independent entities. (Watson 2002)¹¹ In 2001, they disbursed 78% of all agricultural enterprise loans and more than 95% of all personal agricultural loans (Du 2002, 5). RCCs face a conflicting set of goals, however, as the PBC has begun a rhetoric of requiring them to reach economies of scale, turn a profit, achieve greater financial efficiency, compete with other markets, and reduce risk. At the same time, they are supposed to serve a variety of policy goals including meeting the needs of local farmers and the rural economy, sometimes at the expense of earning the best returns on its money. (Watson 2002).

The Rural Credit Foundations (RCFs) were private deposit-taking institutions that in the 1990s provided stiff competition for RCCs in attracting deposits in rural areas. For example, in Yongchuan City, RCCs garnered 635 million *yuan* worth of deposits and the RCF followed very closely behind with 582 million *yuan* of deposits. This far out-weighed the deposits taken by other financial institutions in the area, including the ABC. The PBC declared RCFs illegal in 1998, however, as they were plagued by poor financial management and large operating losses, and thus posed a threat to financial stability. Their activities were absorbed by the RCCs. (Watson 2002, 11) Some rationale for why microfinance institutions in China are guarded so tightly against accepting savings deposits lies in the failure of the RCFs; there is government fear that MFIs could become the second wave of RCFs.

Watson (2002) points out that an extensive network of deposit-taking institutions exist in rural areas, as farmers have access not only to RCCs and the ABC but also to post-office savings and other non-bank financial institutions such as savings and insurance companies. There is contradictory evidence, however, about whether or not the formal rural financial system is meeting the needs of the poor. First, there definitely exists a demand for financial services among the rural poor. According to a Chinese Academy of Social Sciences survey of 616 rural households, 421 of whom were microfinance borrowers, 43.8% of respondents had borrowed from financial mediums other than the microfinance institution available in the area. Of the total number of respondents, 29.5% of them had borrowed at some time from the local RCC. In another survey done in Sanliba County, Inner Mongolia province, an estimate of the entire county's seasonal lending needs was 3 million *yuan* (US\$ 366,000), only 1 million *yuan* (US\$

¹¹ Watson (2002) provides the historical background for RCCs as well as an outline of the challenges faced in the separation from the ABCs.

122,000) of which could be provided by regulated, formal financial institutions. (Du et al 2002, 144-148). Park and Ren found in their study, however, that among the rural households surveyed, people overwhelmingly felt like they had access to RCC loans if they needed it. Over 50% of their respondents had outstanding loans from other sources. (Park and Ren, 2000). The rural women I surveyed, however, had a quite different response when I asked about access to loans from sources such as the RCC or the ABC. The majority felt that there was no possibility that such institutions would ever lend to people of their income level and gender. This corresponds to similar anecdotal evidence gathered by Tsai (2002). In addition, Brandt, et al., (2001) showed an increasing tendency in rural finance for funds from poorer areas to be siphoned off and distributed in richer areas with more investment opportunities, pointing to a trend for farmers in poor rural areas to have less access to financial services.

Government Poverty Alleviation Strategies

The political will to reduce poverty is clearly evident in China. In the 1970s, China's poor population reached over 250 million. Over the last three decades, through rapid economic development as well as concerted government effort to work on this problem, that number has dropped; the UN estimates it currently stands around 50 million. The World Bank, on the other hand, estimates that there are approximately 100 million rural poor, mostly in western provinces and mountainous regions. (*China Human Development Report 1997*, 2; World Bank 2001, 40) In the new era of reform, the government has continued to emphasize poverty reduction activities. To some extent, these have been mainstreamed, as government agencies as diverse as the Ministries of Civil Affairs, Education, Public Health, and Finance all incorporate offices for poverty alleviation activities. In 1986 the State Council created the Leading Group Office for Poverty Reduction (LGPR) to coordinate those activities. Most nationally designated poor provinces, counties, and townships have established their own, local LPGRs as well as Poverty Alleviation Offices (PAOs) to handle poverty alleviation work. (World Bank 2001, 40) In China poverty alleviation work has used a system of geographic targeting whereby the government has designated certain townships and counties as "nationally-designated poor areas." They receive special funding to undertake the poverty alleviation activities of the government, and thus gaining recognition under this category has produced some political jockeying and allowed for some areas to stay on the list longer than was perhaps necessary. (Park, et al., 2001) Recently, however, the government has pledged better targeting practices and has created a dual-

track system of poverty measurement that includes one traditional poverty line based on income and a second more progressive line that looks at comprehensive indicators based on eight criteria: grain income, cash income, housing conditions, access to electricity, access to water, transport and road access, and health and education. While geographic targeting will still be in effect, more emphasis will be placed on targeting poorer villages (rather than townships or counties, thus lessening targeting errors), and more poverty alleviation funding is to be targeted at those areas that count as poor under the newer poverty measurement. China has also designated a second-tier income-based poverty indicator to demarcate the population that has moved above subsistence but is still vulnerable to risk, which will also receive more poverty alleviation funding. Approximately 90 million people live within the two income-based poverty lines. (Weldon 2001)

Regardless of the direction funding is allocated, the LPGR has identified a three-pronged strategy for the use of poverty alleviation funds: 1) subsidized loans; 2) public works program, or Food for Work; and 3) budgetary grants for education, local budgets and tax incentives. The largest portion of funding is given to the subsidized loan portion. (Park, et al., 2001; World Bank 2001) From 1986 to 1999, 68.45 billion *yuan* of this budget has gone towards subsidized lending for poverty reduction, 55% of total funding. (World Bank 2001, 43) These subsidized loans have had a varied history, however. In 1989, most loans were directed toward small and medium enterprises, especially the emerging TVEs, as it was thought they would significantly boost rural economies. By the mid-1990s, however, this was not proving to be true and the LPGR launched the National Plan for Poverty Reduction (the 8-7 Plan)¹² which emphasized a variety of activities targeted towards the household, including increasing access to off-farm income generating activities, emphasis on primary education and basic health-care, and institutional goals of less leakage to the non-poor, better financial management, and greater recovery of loan funds. At a 1996 State Council sponsored National Poverty Reduction Conference, a “poverty reduction responsibility system” was established that held local leaders in poor provinces and counties accountable for poverty alleviation. In 1997, emphasis shifted to providing assistance directly to poor households (*fupin daohu*). (World Bank 2001, 41-48) At the

¹² The 8-7 Plan refers to the strategy’s goal, which was to lift the remaining 80 million poor out of poverty over the following 7 years, by the year 2001.

same time, the LGPR made microfinance an official poverty alleviation tool and guidelines were set for effective management of these projects. (Du 2001; Du, et al. 2001, 161)

In 1997, 80 counties used subsidized loan funding of a little more than 100 million *yuan* for microfinance activities. By 1998, this had increased to 200 counties and 800 million *yuan*. Most of the government microfinance programs follow an adaptation of the Grameen Bank model (i.e., employing group solidarity loans). Originally, local Poverty Alleviation Offices (PAOs) were charged with organizing the project as well as disbursing and collecting loans. High arrears in these projects led to the decision to have ABCs financially manage the project and disburse the loans, while the PAO would be responsible for organizing groups and collecting repayments. (World Bank 2001, 49). The largest government microfinance programs are run in Shaanxi (north-central China), Guizhou, Yunnan, and Sichuan (all in southwestern China). The government support given to these projects allows them to upscale quickly, but interest rates are subsidized and held at 2.88% annually, 10% below PBC-set commercial rates. (Du, et al. 2001, 161, 194; Park and Ren 2000; Tsai 2002, 237)

Thus, it seems the trend in government-led poverty alleviation has focused recently on decentralized responsibility, more comprehensive poverty indicators, and the majority of funding moving towards subsidized credit. These strategies fall in line with trends in economic development as well, as TVE funding from poverty alleviation sources in the 1980s coincided with the break-up of the rural commune but before the government had begun to substantially relinquish control of the economy; TVEs represent the middle ground between the two. In the 1990s, market-based private initiative was focused on (especially after Deng's 1992 Southern Tour) and poverty alleviation strategies moved to a focus on the household.

Government implementation of microfinance schemes has generally been warned against within international microfinance best practice advocated by donors and NGOs, however, and China is one example of why this is not the best way to implement strong microfinance programs. First, getting the loans directly to poor households, as advocated in the poverty alleviation strategy, is difficult with these funds. ABCs do not have enough rural branches, nor is their staff large enough or specialized enough to handle these operations. In addition, with the push for the ABC to generate profit, the high transaction costs associated with lending to the poor do not provide incentive for them to implement the project well, especially when interest rates are capped at 2.88%. These government programs have been unable to achieve financial self-

sufficiency and depend on subsidies to operate. This affects the long-term sustainability of the program, as subsidies are not permanent and without them, it will no longer operate. In addition, these projects have much lower repayment rates than other microfinance projects in China. (Du, et al. 2001, 143, 195-196).

There is also evidence that the funding for these projects has been siphoned away to other uses. Tsai quoted an official investigation that found between 1997 and 1999, local officials had diverted away 20.4% of funds earmarked for microfinance (approximately US\$519 million) to finance other local projects (Tsai 2002, 238). Local governments also resist funding microfinance, as former projects which funded TVEs afforded significant tax revenue for local governments. The idea that the poor are unable to repay loans also persists. In government programs repayment has averaged around 54% and there is a high rate of overdue loans. In addition, these government microfinance projects require complicated loan processing procedures, loan collateral, and guarantees that the poor generally can not access. Subsequent loans are not tied to strong repayment records, further decreasing the incentive to repay. (World Bank 2001, 48) It seems, then, that the government's microfinance program smacks of the subsidized rural credit schemes of yesteryear which Adams and von Pischke (1992) warned about. The creation of a sustainable microfinance industry faces some formidable foes in Chinese conventional wisdom about poverty and in competing for funds with larger-scale TVEs that garner local government support due to tax revenues. Thus, if poverty alleviation strategies may follow trends in economic development, it may not be until China fully embraces a market economy that sustainable microfinance for the poor will also be embraced.

Non-governmental Microfinance

Non-governmental microfinance projects began in China during the 1980s, when organizations such as the International Fund for Agricultural Development (IFAD), United Nations Population Fund (UNFPA), and Heifer Project International experimented with microfinance technologies in China. These organizations employed a variety of methodologies for fulfillment of different objectives, including women's empowerment and local economic development. Many lessons were learned: lending to groups was more effective than lending to enterprises; lending to the economically-active poor led to higher repayment rates; microfinance can be a project to eventually hand over to local government management; non-financial services

are important to provide alongside microfinance. Most of these projects did not take place in the poorer areas of the country. (Du et al. 2001, 149-154)

One of the first programs to employ microfinance in a poverty alleviation capacity was the Funding the Poor Cooperative run by the Chinese Academy of Social Sciences-Rural Development Institute (CASS-RDI), which began disbursing loans in 1994. Initial experiments run by researchers at CASS-RDI showed that group lending and mutual guarantees are plausible lending methodologies in China, and as a result a variety of local governments and international non-government organizations have introduced microfinance projects for poverty alleviation into rural areas. Much has been documented about the history and status of certain projects. (Chen 2000; Cheng 1996; Du, et al. 2001; Horschke 1999; Park and Ren 2000; UNICEF 2000; Zhu, et al. 1997) Most microfinance programs, with group lending methodologies and mutual guarantees, report repayment rates upward of 90 percent, with most near 100 percent. (Park and Ren, 2000) Analysis of my survey work below will outline the current status of such projects.

Important to note, however, is that without a legal status for these types of financial institutions, most donors' and NGO's microfinance initiatives are based in projects that exist with limited government sanctioning. This means their projects start with memoranda of understanding signed with the PBC and state/local governments that will outline what the project will entail, but each project memoranda will have a finite end. NGO microfinance projects are held to PBC-set interest rates, without the benefit of government subsidies. They also are unable to mobilize savings from the public.¹³ This environment is a startling contrast to the main reason why microfinance has been a development darling: its ability to be rooted in sustainable, long-term institutions. Most projects implemented in China started in the late 1990s and were for five-year terms, which means that many of these projects now face serious questions about next steps. Thus emerges the primary question of this research: How can sustainable microfinances institutions be fostered in China and how can that process be facilitated given current state attitudes?

Rural Credit Cooperatives and Microfinance

In 2001, the People's Bank of China (PBC) launched a campaign to encourage RCCs to implement microfinance. This microfinance is not meant as a poverty alleviation tool but rather as a method to increase the provision of financial services in rural areas. Rural finance experts in

¹³ More details on China's current policy environment can be found in Chapter 7.

China applaud this new effort as they believe it will afford the chance for RCCs to correct internal management problems and become more profit-oriented institutions. The scale of this initiative is already large. According to a 27 March 2002 article in the *Jinrong Shibao* [Financial Times], the number of RCCs offering microfinance products at the end of 2001 was 32,000, approximately 70% of all RCCs. About 25% of rural peasants had received this type of loan, and in 10 provinces with primarily agricultural economies, that ratio stood at more than 40%. (Du 2002) A statistical report released by the People's Bank of China in June reported that about 49% of the RCC network had organized microfinance using group lending, covering 9.54 million households. The speed and scale with which the RCCs have approached microfinance is surprising and RCCs are bound to be an important player in the microfinance industry in the future. (Qiu 2002)

Several donors have become aware of the possibilities for using the extensive RCC network to administer microfinance. The Ford Foundation in China is currently funding research on three different models of integrating microfinance services into RCC operations and will publish its findings at the end of the year (Interview with the author, 12 June 2002). In addition, Devellopement International Desjardin, a Canadian NGO specializing in credit unions, has funded the integration of these services in Hebei province, with much success. RCCs in Hebei have largely embraced the provision of microfinance services into their daily operations. This project has used Grameen Bank methodologies such as group lending and trained the RCC staff in how to employ them to achieve better financial success. The RCCs in Luanping County, where the project was first launched, had a rate of 43% non-performing loans and 11.9% bad loans; in contrast, the microfinance component has achieved a 98.5% repayment rate. The project has also received permission to charge higher interest rates (11.4%, 1.4 times the RCC lending rate of 8%) to cover the higher cost of providing microfinance services. (Zuo 2001)

The startling fact that RCCs organized 9.54 million households into microlending groups within a year after microfinance operations began is an indicator of the significant place they will hold in providing microfinance services in rural areas. A few questions remain about the provision of these services. First, the type of client that RCCs traditionally reach are not the rural poor, but rather, the rural middle-income. Second, RCCs traditionally have lent to men instead of women. Third, implementing microfinance using group guarantees and installment repayments requires a certain amount of staff knowledge and capacity that it is not clear RCCs

have attained before rushing into this model. Fourth, RCCs are doing this lending as a state directive, not as a recognition of a new and untapped market niche. These four points are troubling in that they point to microfinance not for poverty alleviation and not for market reasons, but rather as state-directed policy lending they do not have the capacity to fulfill. The sustainability of such an initiative is questionable. Involvement of donors and the Microfinance Training Center in technical assistance, as has already started, will be crucial in making this a long-term initiative that will hopefully begin to also respond to market demand for these services.

Informal Finance

Briefly, nestled within this dialogue of formal financial options, it should be noted that a surprisingly large curb market for informal finance does exist in China. Kellee Tsai has documented this contemporary phenomenon and the options range from the legal: interpersonal lending, trade credit, rotating credit associations, or pawnshops; to the quasi-legal: shareholding cooperative enterprises, “red hat” enterprises, mutual assistant associations; to the illegal: professional brokers and money lenders, private money houses, and pyramidal investment schemes. In addition, local interpretations of financial regulations and how local governments approach regulation of private sector operations allows for some forms of finance, such as rotating credit associations, to be legal in one locality while illegal in another. In Tsai’s survey, 70% of the entrepreneurs she interviewed had participated in some form of informal finance. In addition, Tsai feels that banking reforms, no matter how well implemented, will not necessarily affect the informal financial sector, as they are hardly intertwined and do not serve the same set of clients. (Tsai 2002, 1-52)

Informal finance is often lumped under the category of microfinance and it is important to understand the role it plays within the microfinance industry. Many people use informal mechanisms of savings or relying on relatives and friends to provide credit in times of need. Clients that I surveyed admitted using relatives and friends to cover very small amounts over short periods of time, or in large amounts for big investments such as building a new house. Many said they preferred borrowing from the MFI because of the ease and convenience involved, as well as the lessened social stigma, so had stopped relying on credit from family and friends after joining. Understanding client demand will help MFIs to create more demand-led products and thus build stronger institutions.

Furthermore, lessons from the curb market point to the reservation interest rates among the rural poor and help to tear down the notion that subsidies are required. For example, in the Caohai nature reserve microfinance project in Guizhou, village banks set their own interest rates for a fund that they manage themselves. Some villages have set rates as high as 60%. In surveys undertaken by CASS-RDI, reservation interest rates among the rural poor stood at 24%. (Du et al., 2001) If informal finance mechanisms are flourishing and reservation interest rates match international best practice standards for microfinance sustainability, the market for a strong and sustainable microfinance sector in China exists.

Chapter 4: Introduction to Organizations surveyed

The following is an overview of eleven institutions about which I have gathered basic information. These institutions, in no particular order, are:

1. Funding the Poor Cooperative
2. United Nations Development Program
3. United Nations Children's Fund
4. United Nations Population Fund
5. Association for the Rural Development of Poor Areas in Sichuan
6. Heifer Project International
7. World Vision
8. Canada-China Women's Income Generating Project
9. Malipo Rural Economic Development Association
10. Oxfam Hong Kong
11. China Foundation for Poverty Alleviation

The following is an introduction to each of these projects¹⁴:

Funding the Poor Cooperative

In 1994, the Chinese Academy of Social Sciences – Rural Development Institute (CASS-RDI), with the blessings of the State Council, implemented a research action project in microfinance, dubbed Funding the Poor Cooperative (FPC). This project, one of the first experiments in microfinance in China, originally started in four project sites: Yixian County, Hebei; Nanzhao County, Henan; Yucheng County, Henan; and Shangluo Prefecture, Danfeng County, Shaanxi. Today, the first three project sites are still in operation. (Du et al., 2001, 252) FPC's headquarters are housed at the Chinese Academy of Social Sciences and 4 of the 7 headquarters staff are employees of CASS. All other staff, including local managers, loan officers, accountants, and administrative staff are all independently hired and paid from the interest earned on lending activities. FPC receives grants from bilateral donors, international foundations, and personal donations.

As of 30 June 2002, these three sites combined served 14,884 active clients and cumulatively had lent to 29,035 clients. FPC employs a relatively strict adherence to the

¹⁴ These introductions will discuss, among other things, the staffing of these organizations. Here, I should distinguish between two methods of "hiring" staff within this context. First, many of these projects are in some capacity affiliated with the government and so, some government staff work on the project. These staff were already government employees when assigned to the position. Second, other staff are hired from outside the government and undergo a recruiting/hiring process involving interviews and minimum criteria. These are referred to as independently hired staff; they do not carry government employee status and all the benefits that entails.

Grameen Bank-style lending method, with one-year loan terms, weekly repayments, monthly or bi-weekly center meetings, and a first loan size of 1000 *yuan* (approximately US\$ 121).¹⁵ Loan sizes can increase to 1500 *yuan* in the second year and 2000 *yuan* in the third, after which loan sizes remain capped at 2000 *yuan*. FPC offers an 8% interest rate (yearly). FPC is currently looking at other loan products, particularly the seasonal variety. In the traditional style of the Grameen Bank (GB), 5% of the loan is taken at disbursement to serve as a savings fund; 2 *yuan* (US\$0.25) is also saved at each weekly repayment.

United Nations Development Program

The United Nations Development Program (UNDP) has implemented microfinance projects in China since 1997, through the agency China International Center for Economic and Technical Exchanges (CICETE).¹⁶ In 1997, UNDP brought microfinance services to 48 different counties around the country as pilot projects to determine whether this methodology could work as a poverty alleviation tool in China. In 2001 UNDP and CICETE chose four of these pilot sites to continue receiving funding, under the project title “Sustainable Microfinance to Alleviate Poverty” (SMAP). The other sites are continuing to operate and are looking for alternative funding. Each of the original 48 project sites are implemented in tandem with a local government office, usually the Women’s Federation or Poverty Alleviation Office; local managers are government staff while loan officers are independently hired and paid through interest earned. The UNDP/CICETE projects employ 310 loan officers, who serve an average of 171 clients per loan officer. Funding for these projects comes from UNDP; some project sites have also accessed funding from other sources such as international foundations, NGOs, and government financing.

Installment periods in the UNDP/CICETE project sites are two weeks to one month with a one year loan term. Group lending, with group guarantees and monthly center meetings, is also employed. Some project sites have experimented with seasonal loans of five months’ duration, though most have stopped that practice after initial trials showed high rates of arrears. The number of active clients in all 48 sites is 53,140, while cumulative clients stand at 127,578 (as of

¹⁵ Microfinance practitioners in China are very familiar with the term, “GB model” that they use to implement their projects. In China, this largely refers to the use of group guarantees, installment repayments, center meetings, and sometimes group funds. It does not necessarily refer to other features people may think of when the term Grameen model is used, nor have any Chinese projects started to look at the Grameen Bank-II model that was recently announced.

¹⁶ These projects will be referred to as “UNDP/CICETE projects” throughout this document.

31 Dec 2001). Interest rates vary between counties, depending on local governments. The project site I visited at Chifeng, Inner Mongolia (a SMAP site) charged an 8% nominal (14-15% effective) rate. Most project sites employ the Grameen Bank-style forced savings mechanism of 5% of the loan taken at disbursement and small savings deposits required at each installment repayment. No demand deposits are offered.

In addition, UNDP operates an urban microfinance program in Tianjin, just south of Beijing, that works with laid-off female employees from state owned enterprises.

United Nations Children's Fund

In 1996, the United Nations Children's Fund (UNICEF) began a five year program in microfinance called Social Development Program for Poor Areas, which was extended to 2003 at the end of the project cycle. Another project involving microfinance, called Local Planning and Action for Children, began in 2001. These two projects cover 47 counties in at least 13 provinces. The project is implemented through local government offices such as the Women's Federation and all local project staff are government employees.

These projects also employ a group methodology and work exclusively with women. Maximum first loan size is set at 1000 *yuan* (approximately US\$ 121) and loans are available for anywhere from 3 to 14 months. Subsequent loans can increase to 1500 *yuan* and then 2000 *yuan*. Installment periods are based on the length of loan term. Interest rate is 0.8% monthly or 9.6% yearly, flat rate. A portion of the interest rate is allotted to a Social Development Fund that clients decide how to spend within their own communities. The projects combined currently reach approximately 55,500 clients. Outside of the microlending activities, the project also provides training in maternal and child health.

United Nations Population Fund

The United Nations Population Fund (UNFPA) signed project documents to begin microfinance activities in 1998 and first loans were disbursed in 2001; the project cycle will end in 2002. The project is a collaborative effort between UNFPA, the International Fund for Agricultural Development (IFAD), and China's Ministry of Foreign Trade and Economic Cooperation (MOFTEC). These projects operate in 15 counties in 13 provinces. Original project design used the Rural Credit Cooperatives (RCCs) to disburse and collect loans; after loan disbursements began they decided to move the lending operations to the county project

office. County project office staff are government employees while loan officers are independently hired. UNFPA is the sole funder of these projects.

Loan terms are for one year and the maximum first loan size is 1250 *yuan* (US\$ 152). Under the former lending model that employed the RCCs, loans were on an individual basis; the new project design uses group lending and group liability guarantees. The interest rate is 13.77% yearly, but 5% of that interest is returned to the client upon timely repayment, making the rate 8.77% yearly. This office also provides training in reproductive health. As of the end of 2001, the project has reached 7,000 beneficiaries.¹⁷

Association for Rural Development of Poor Areas in Sichuan

The Association for Rural Development of Poor Areas in Sichuan (ARDPAS) began in 1996 and is a non-governmental organization that grew out of Sichuan's Poverty Alleviation Office. ARDPAS operates lending activities in 21 counties in Sichuan province, mainly through county-level poverty alleviation offices. ARDPAS headquarter staff and local management staff are all government employees while loan officers are independently hired. ARDPAS has received funding from the national Ministry of Finance, the Zhejiang Province Ministry of Finance, and loans from the Agricultural Bank of China.

The program also employs the group guarantee system, with a 10 day installment period and a one-year loan term. The interest rate is .5% monthly or 6% yearly. Some local project sites have adapted these terms to their local conditions and adjusted the installment periods or interest rates. The number of active clients in 2001 was 56,652 (down from 72,841 due to funding problems that will be highlighted below) and the repayment rate in 2000 was 91.8%. ARDPAS also offers savings mechanisms to its clients, which are a good source of equity for the program. Each loan officer is responsible for, on average, 200 clients.

Through email correspondence, I recently learned that the Sichuan provincial government has ordered ARDPAS to cease operations.¹⁸ The program experienced trouble with their funding in the last year when it was declared that funding received from the national Ministry of Finance could not be used for on-lending. Unfortunately, the bulk of ARDPAS's capital came from this

¹⁷ UNFPA project staff note that employing microfinance activities to implement reproductive health projects in China is not their ideal tool. Their decision to use microfinance was based on government persuasion; their hesitation to do so lies in UNFPA's lack of expertise in this area. They are currently negotiating terms with MOFTEC and local governments to end the microfinance component of their activities.

¹⁸ Email communication received from Pan Zhufeng, ARDPAS Program Officer, 18 November 2002.

source. An auditor from the State Auditing Board visited the program and told them to stop on-lending in 2001 and so, the program decided to not start any new loans with this funding. Other sources of funding continued to be on-lent to clients. It is unclear how this order to cease operations will be carried out but it does obviously point to all sources of funding, not just those from the national Ministry of Finance.

Heifer Project International

The Heifer Project International (HPI) office in China opened in 1984 and the first disbursement occurred in 1985. HPI uses the Heifer Project model of “passing on the gift” whereby HPI project offices provide animals such as rabbits or goats; recipients then on-lend the offspring of that animal to another recipient. In project areas that have been in operation for some time, HPI has also moved to cash lending. Currently there are 37 project sites in over 60 counties in 13 provinces around China. HPI headquarters staff are all independent employees of HPI and local county project offices are generally run in conjunction with local Animal Husbandry Bureaus. HPI also runs three regional offices within China, none of which are attached to government bureaus.

As of 31 December 2001, HPI has worked with over 32,000 beneficiaries and lent a total of 3.3 million animals. For cash loans, HPI does not employ a group liability guarantee and loan terms can be anywhere from one to five years. Some project sites do charge interest – never any more than the local bank interest, and usually around 6% yearly – while some areas do not charge any interest, depending on the attitude of local government. HPI projects do not mobilize savings.

World Vision

World Vision (WV) began offering microfinance services in 1997 and currently operates in six counties in Yunnan Province, in southwestern China. One of these project sites is a brand-new program in urban microfinance that began lending activities in late July 2002, in Kunming, the capital of Yunnan. World Vision employs a group lending model under a revolving loan fund system. Loans are given in-kind during initial lending cycles in the form of crop seeds. As clients repay the cost of those seeds, the community loan fund grows and the project can eventually begin lending that money in cash.

One WV project site has begun to offer cash loans which employ a lump sum repayment with a 9 to 12 month loan term. Average loan sizes for agricultural loans are 30-200 *yuan* (US\$ 3.66 to US\$ 24.39) and for animal husbandry uses range from 300-500 *yuan* (US\$ 36.59 to US\$ 60.98). No savings mechanisms are offered and interest rates are determined by the participants, usually hovering around 4% yearly. Repayment rates average 88%.

After a careful evaluation of their projects, World Vision will cease using the revolving loan funds and begin piloting a Village Banking model by the beginning of 2003.¹⁹

Canada-China Women's Income Generating Project

The Canada-China Women's Income Generating Project (CC97), funded by the Canadian International Development Agency (CIDA) and the Xinjiang Department of Foreign Trade and Economic Cooperation (DOFTEC), began in 1997. CIDA and DOFTEC ceased funding the project at the end of 2001. Over 7 million *yuan* have been invested to this point and this money will continue to be used for project costs. It operates in 3 counties in northwestern Xinjiang province.²⁰

The project uses a Village Bank-type lending methodology, where funds are disbursed to a village center, of which anyone can be a member. Members must save in a personal savings account in order to get a loan and interest is charged in the form of a Community Development Fund charge that goes into a share account that filters into the village center's lending pool. The target is for lending funds to eventually be repaid to the county project office so that it may then open new village centers. Loan terms are for six months and the maximum first loan size is 600 *yuan* (US\$ 73.17). Original project design set the interest rate at 20% flat, but county project offices subsequently adjusted that rate to between 7 and 10%. There is a group guarantee for the loans. As of May 2002 there were 3,126 active clients in the project and a cumulative total of 4,443 clients had been served since 1997.

Malipo Rural Economic Development Association

Malipo County is located in southeastern Yunnan province, on the Chinese border with Vietnam. In 1998, the government created the Malipo Rural Economic Development

¹⁹ [Email correspondence with Jonathan Su, WV program officer, 12 October 2002].

²⁰ Data on CC97 comes entirely from the evaluation completed post-project by a team hired by CIDA. Du Xiaoshan, executive director of FPC and deputy director of CASS-RDI worked on this team. He shared his project document with me and we had several conversations about the project. I did not speak to any CC97 staff and CIDA staff in Beijing were unavailable for comment.

Association (REDA) as a non-governmental organization whose purpose is to create sustainable rural economic development to alleviate poverty.²¹ Malipo REDA administers all the microfinance funding given to Malipo County, namely from UNDP, Grameen Trust, IFAD, the World Food Program, and the government's Poverty Alleviation Office through the Agricultural Bank of China.²² Lending operations are in 3 townships in Malipo County. All loan officers are independent while management and accounting staff, both at the township and county level, have government employee status.

Each project site employs an adapted Grameen Bank (GB) methodology using group guarantees, a one year loan term, and a 12 day installment period. Loan sizes for the project range from 100 to 1500 *yuan* (US\$ 12.19 to US\$ 182.93) with a 6% annual interest rate. 70% of the clients are women and the project has reached a 51% financial self-sufficiency level. As of 30 June 2002, the project has 4,191 active clients and has cumulatively served 14,404 clients since lending began in 1996. Savings is offered in the traditional GB-style of 5% taken at loan disbursement and a portion saved at each installment repayment.

Oxfam Hong Kong

Oxfam Hong Kong has been in Yunnan province since 1992 and works in five counties in that province (as well as in a variety of other provinces around China). Microfinance activities fall under the category of participatory integrated development projects initiated by Oxfam. Microfinance is not offered unless during needs assessments, the village identifies a lack of credit as a problem they can not solve themselves. At the county level, Oxfam teams with government officials, usually from the Poverty Alleviation Office, but township level workers are all community members who work on a voluntary basis. Originally microfinance activities employed the help of the Rural Credit Cooperatives, but because of the inconvenience this caused the peasants in travel time to reach a credit station and the enforcement of lump sum yearly repayments, Oxfam switched to a community development fund (CDF) system.

Under this system, Oxfam employs a group guarantee and anyone in the village is eligible for a loan. Loan terms are for one year with an installment period of three months and a maximum loan size of 1000 *yuan* (US\$ 121). Interest rates are decided by the communities

²¹ This is indicative of Chinese GONGO's, or government-organized non-government organizations, an apparent contradiction in terms, but one which GONGO staff members cling fiercely to.

²² Malipo was one of the original 48 UNDP/CICETE pilot project sites; it has not been chosen as one of the 4 SMAP sites that will continue to receive funding and technical assistance in the future.

themselves and are fed back into the community development funds. Surpluses from these funds can be used for a variety of activities decided upon by the village, from water and electricity needs, to providing no-interest loans to more destitute families in the village. No savings mechanisms are provided through the project.

China Foundation for Poverty Alleviation

The China Foundation for Poverty Alleviation (CFPA) is a Chinese non-governmental organization founded in 1997. Among other activities, CFPA receives funding from the World Bank, international NGOs such as Mercy Corps, and provincial Poverty Alleviation Offices to implement microfinance activities. Their work is in 9 counties in 7 provinces. While some project sites employ government staff, usually through the local Poverty Alleviation Office, CFPA's project design calls for project implementation eventually to be carried out independently from the government, including by only employing independently hired staff.

The project follows an adapted Grameen Bank methodology with group guarantees. Loan terms are generally for one year with either a biweekly or monthly installment period. Group funds – 5% at the time of loan disbursement – are taken, but no other savings mechanisms are offered. Interest rates do not go above 7% annually and repayment rates average at 95%. The maximum first loan size is 1000 *yuan* (US\$ 121). Since beginning operations in 1997, CFPA has served a cumulative number of 44,552 clients (as of 31 May 2002).

Project Typology

Within the context of microfinance in China, and given the history the industry has had operating within a project-based paradigm, a typology of the different types of institutions possible emerges. Roughly, Chinese microfinance occurs within the following six categories (See Figure 2 on page 55):

1. Independent Institution
2. Bilateral or Multilateral Donor-funded and
 - a. local government managed – through PAO, WF, etc.
 - b. run through the local RCC
3. International NGO-funded and managed (and implemented through local government)
4. Chinese NGO-run / more hands-off donor and government funding
5. Rural Credit Cooperative microfinance
6. Government Poverty alleviation funding

Those that fall under the “Independent Institution” moniker would be characterized by relative independence from other government arms, so that the institution stands on its own by fundraising, managing, and implementing the project without either a donor or a government agency doing the work. These institutions are generally intent on achieving financial self-sufficiency in order to sustainably provide their financial services within a permanent institution. It is not necessary that these institutions be “grassroots,” but it is likely that they will be started or heavily influenced by local or national development professionals. Project types two and three are similar in that they are implemented by an international organization – either donor or NGO – and have generally been implemented in China through a local government agency such as the PAO or WF, largely because government regulations insist that international organizations work with a domestic government partner. Project type four, run by a Chinese NGO, are those organizations that probably receive funding from international donors or NGOs, but the implementation of the project is through collaboration with a national, Chinese NGO and a local partner, or, in some cases, only through a local partner. The funding agency tends to be hands-off and not directly implementing the project, as in project types two and three, where the funding agency also is involved with implementation. Microfinance in rural credit cooperatives, as discussed above, is a new phenomenon as RCCs are just beginning to implement microfinance services using a variety of methods. Government poverty alleviation funding refers to the system of subsidized credit outline above.

Table 1 on page 57 shows to what project type each surveyed project belongs. Of the projects in my survey, only one, FPC, would be an independent institution (despite its top-level affiliation with CASS, FPC is largely independently owned and operated). Four institutions fall under project type three, as they are funded by bilateral or multilateral donors and implemented by local government bureaus such as the Poverty Alleviation Office or the Women’s Federation. Of those that are bilateral or multilateral donor-funded and implemented by the local RCC (project type 2-b), only UNDP continues to run some project sites using this model (the rest have switched to using local government bureaus to implement the project). Three institutions can be classified as project type three, funded and managed by international NGOs, with local implementation done through government. Three other institutions are project type four run by Chinese NGOs, with “hands-off” external funding, sometimes by bilateral donors or international NGOs.

Figure 2: Venn Diagram of Project Typology²³

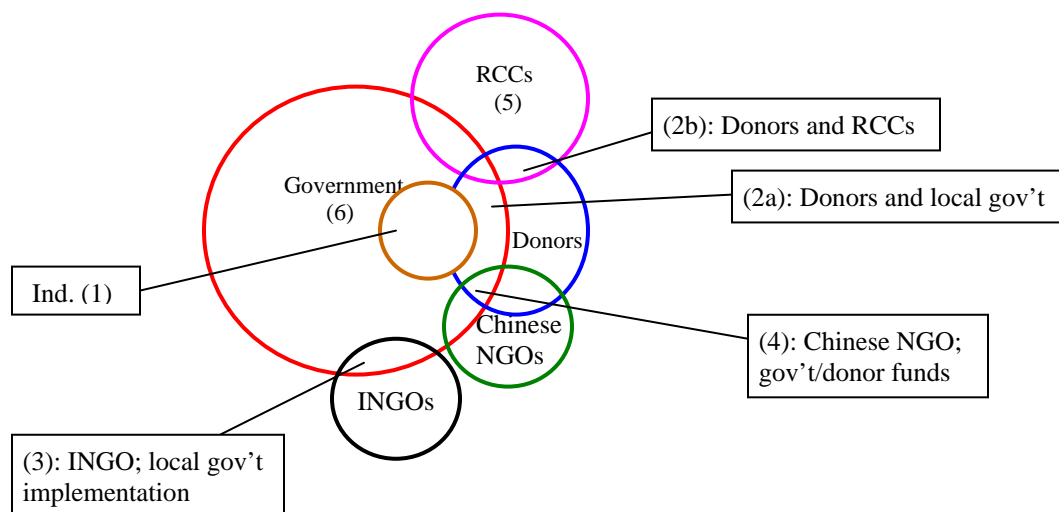


Figure 1 above diagrams the players in the Chinese microfinance sector. The “government” circle is the largest because of the amount of funding, resources, and influence they have provided to the microfinance sector. This circle alludes not only to poverty alleviation funding, but also the resources it provides to all other actors in the industry. It overlaps in some way with all of these projects either through funding, provision of staff resources, or, in the case of RCCs, a soft budget constraint and a mandate to do microfinance. Furthermore, the regulatory environment engendered by the government influences everyone of these projects, so that each circle must touch the government in some way. The circle for independent institutions is placed on top of the government and donor circles to represent the funding and influence received from both sources, but does not overlap due to the lack of involvement of both donors and government in the daily operations of the project. Type 4, Chinese NGOs which benefit from both donor and government funding, are found in the overlap between all three of these circles. The other overlaps should be fairly self-explanatory as they correspond to each project type and the differing stakeholders in funding, staffing, and influence.

²³ Inspiration to create a Venn Diagram for this typology came from a discussion with Sarah Tsien, Head of Mission, PlaNet China.

Project Trends

Please refer to Table 1, below. Of the ten projects listed above that provided relevant statistics, they operate in 207 different project sites (at the county or township level), with a mean of 20 sites per project and a range of 3 to 47. Nine of the projects started between 1996 and 1998. Seven of the projects identified themselves as using an adaptation of the Grameen Bank lending model. Ten of the projects use a group guarantee when lending so that members will guarantee each others' loans, being responsible for those members that default. The average percentage of women clients among the eleven projects is 71.35%; four project sites (belonging to four different projects) had 100% women clients.

Ten of the eleven surveyed projects use government employees to manage the local project sites; seven of the projects employed loan officers who were independent hired and paid their salaries from interest earned. Seven projects had an installment period between one and four weeks, one project employed exclusively lump sum repayments, and two had larger installments ranging from three months to one year. Five projects only offered one year loans, the others ranged from also offering a seasonal loan to offering a range of financing options from 3 to 12 month loan terms. Maximum first loan sizes hover around 1000 yuan (US\$ 125). Five of the eleven projects had some form of savings requirements (and sometimes voluntary savings as well). Data on interest rates for each project can be found in Table 1; they generally hover between 6% and 10% yearly, reflecting government restrictions on interest rates. International standards for microfinance interest rates generally fall between 18% and 35%. Average repayment rates among the five project and 11 project sites reporting is 91.62%. Three project sites reported a 100% repayment rate; only one of these had been in operation for over a year.

Table 1: General Project Design of Surveyed Projects

Project	Project Type	# of Project Sites	In operation since	Lending Methodology	Outstanding Loans (RMB)	No. of Active Clients	No. of Cumulative Clients	Installment Period	Loan term	Loan Sizes (RMB)	Savings?	Interest Rate
FPC	1	3	1994	adapted GB	13,214,173	14,884	29,035	one week	1 year	1000-1500-2000	yes	8%
UNDP/CICETE	2a/2b	48	1997	adapted GB	55,230,838	53140 (2001)	127,578	two weeks to one month	Varies; usually 12 months	Varies; usually 1000-1500-2000	yes	Varies
UNICEF	2a	47	1996 and 2000	adapted GB	20,538,323 (1999)	N.A.	55,500	depends on loan term	3; 3-6; 6-12 months	1000 - 1500 - 2000	yes	9.6% flat
UNFPA	started as 2b, became 2a	15	1998 (2001)	start: RCC; now adapted GB	N.A.	N.A.	7000	varies; mostly biweekly repayments	3-6-9-12 month options	max 1st year = 1250	no	13.775% (5% returned to client upon timely repay)
ARDPAS	4	21	1996	adapted GB	USD 2,164,500 (2001)	56652 (2001)	N.A.	10 days	one year	Max 1 st year = 1000	yes	6%
Heifer Project International	3	37	1985	"pass on the gift"; some cash loans	N.A.	N.A.	31,552	varies; once a year for longer loan terms	1-5 years	In-kind loans; Cash loans vary	no	varies; none surpass market
World Vision	3	6	1996	Revolving loan fund: in-kind and later in cash	576,057	N.A.	3927	mostly lump sum	varies: ave 9-12 mos	In-kind loans; Cash loans range from 30-500	no	determined by participants ; ave = 4%

Project	Project Type	# of Project Sites	In operation since	Lending Methodology	Outstanding Loans (RMB)	No. of Active Clients	No. of Cumulative Clients	Installment Period	Loan term	Loan Sizes (RMB)	Savings?	Interest Rate
CC97	2a	3	1997	Village Bank	N.A.	3126	4443	SI	6 months	600 - 1000 - 1500 - 2000	yes	7 to 10%
Malipo REDA	4	3	1996	adapted GB	2,742,274	4191	14,404	12 days	1 year	100-1500	yes	6% APR
Oxfam Hong Kong	3	N.A.	N.A.	orig used RCC, now uses participatory CDF/RLF	N.A.	N.A.	N.A.	usually 3 months	usually one year	N.A.	no	decided by CPO
China Foundation for Poverty Alleviation	4	9	1997	adapted GB	N.A.	N.A.	44,552	biweekly or monthly	one year	Between 1000 and 3000	no	no higher than 7%

Source: Project documents gathered during fieldwork

Chapter 5: The Borrowers

I was able to hold six focus group discussions with the clients of three projects: China Foundation for Poverty Alleviation, Funding the Poor Cooperative (at both Yixian and Nanzhao project sites), and UNDP/CICETE’s Chifeng site.²⁴ Site visits to Oxfam and Malipo were not conducive to holding focus group discussions, thus, the analysis presented below has a selection bias based on that context. In addition, I was unable to randomly select the borrowers that would participate in the discussion at any project site. All participating borrowers were chosen by local project managers. I requested the managers to provide a representational sample based on length of time in the project and gender. These discussions usually coincided with a regularly scheduled center meeting so as to minimize delaying the clients’ return to productive activities.

In her second year with FPC, Ms. Wang, pictured below with her two daughters, took a 2000 *yuan* (US\$ 250) loan this year. In the past, she ran a butcher shop that eventually closed when she ran out of money. After this, the family fell on hard times, until FPC opened a branch in Yunyang and she was able to take a loan to open the shop again. When asked about the biggest change in her life since starting to borrow with FPC was, she remarked, “My children – two daughters and a son – had to stop attending school when I closed the shop. Now, with the profits I earn (about 20 to 50 *yuan* [US\$2.50 to US\$6.25] a day), I can send them to school; my son even attends a private school.”

Nonetheless, I was able to get a picture of what the average microfinance borrower in these projects looks like. The average percentage of women clients among the eleven projects is 71.35% and four projects lend exclusively to women. Most borrowers are female, because many projects with international funding adhere to a best practice belief that females have higher repayment rates. Most of the borrowers I interviewed had not graduated from elementary school, although most had been in school for at least a few years. Some of the women borrowers had husbands who worked as migrant laborers in bigger cities for approximately six months of the

Pictured here is Ms. Liu, who is working on her third loan from UNDP/CICETE’s project in Chifeng, which was in the amount of 2000 *yuan* (USD 250). Since taking the loans, she has opened a small shop located in the village center that sells clothing, shoes, and other daily necessities. She enjoys participating in the program and helping women to “leave the house to go to market, improve the technical abilities of their families, and improve family and social status.”

year and used the loan money to build an activity to sustain them until their husbands came home with larger sums of money.

For the most part, I found that the borrowers have a diversified income generating

²⁴ See Annex 2 for a list of all focus group discussions held.

scheme. Borrowers have freedom to choose how they will use the loan. Many of the loans are used for animal husbandry – for raising pigs, chickens, geese, cows, or goats. In one project area, many of the women had fruit orchards while in another many grew shiitake mushrooms. The chosen income-generating activity largely depended on local conditions. Other borrowers occasionally used the money for more traditional crops such as rice, wheat, and corn, although these crops are mainly grown for subsistence purposes in rural areas as low prices for commodity goods do not garner much profit. Many borrowers ran small convenience stores, using the loan money to purchase wholesale goods. One woman owned a butcher shop and another a motorcycle repair shop. Some borrowers bought Chinese tractors (three-wheeled vehicles, *sanlun che*) or motorcycles which they rent out for a profit. Often, people will invest the loan in two different activities: one, such as buying chickens to sell eggs, that has a quick profit turnover rate so they can begin paying back the loan right away, and another, such as starting a shop or buying a vehicle, that generates more profit over the long term.

Most of the borrowers, especially women, had not taken any loans from other sources in the past. Many laughed at me when I asked if they had taken a loan from the local RCC, saying things such as, “They would never lend to someone like me!” This was generally because the RCC only lends to men and traditionally to middle-income farmers, at higher sums of money for longer loan terms. Most borrowers admitted they would like to change some aspect of the lending technology being used at their microfinance program, especially the ability to borrow larger sums of money as their businesses grew. Many women who had been with the program for a longer period of time and had built up their businesses would rather not guarantee the loans of the group and would rather have individual loans. On the other hand, most of them recognized this as a strong point in the program, understanding that it allowed them the opportunity to get a loan in the first place, when before no one would have lent money to them. Most longer-term borrowers felt they still had not “graduated” to a more formal financial institution such as the RCC because traditional lending policies persisted in preventing poor

This man and his father together borrowed 1000 yuan (about US\$125), and this is their first year with FPC. They bought a cow, then sold it, and on the profit bought this three-wheel car that his son drives for a local factory. He earns about 30 yuan a day (\$3.80) using this money. They also were able to buy a second cow, which the father takes care of and will sell it for profit when it is grown. They also have a small farm.

women from accessing these loans. Most borrowers exhibited a strong sense of loyalty to the project, although it is possible this sense was a show for the foreign researcher.

One area that met with more resistance was center meetings and the training involved. Many felt that the training did not necessarily correspond to their own demands, especially when technical assistance lessons were given for activities in which they do not engage. Moreover, many were acutely aware of the amount of time these meetings took away from income earning activities. Both men and women project participants had this complaint, although to put this into a larger gendered argument, some women, for example in UNICEF's project, claimed that the biggest drawback to participating in the project was a "lack of time to rest." (UNICEF 2000) This harkens to the failure of these programs to effectively address gendered divisions of labor and the productive-reproductive balance. By increasing the time spent on income-generating activities and not releasing the pressure of reproductive work such as housework or childcare, women will lose important leisure and resting time. Thus, if the trainings offered do not meet the opportunity cost of the time spent doing that activity, it becomes very tiresome for the women to participate.

For the most part, participation in these projects is voluntary. Generally, when the microfinance project decides to provide services in a certain township or village, the branch manager or loan officer will travel to the project site (this is usually after a lengthy decision-making process, as scarce resources mean decisions about where to upscale must be made carefully) and hold a general meeting for anyone in the area that wants to attend. At that meeting, the project representative will explain the basic tenets of the project such as how groups are formed, what a group guarantee entails, the repayment schedule, and the eligibility criteria. Afterwards, interested borrowers will come forward to submit initial applications and the screening process will begin (which generally varies from project to project and loan officer to loan officer). After groups are formed, more intensive training in the lending technology is given. Most projects admit that initial response to these meetings is hesitant, but after some community members have started borrowing, others will come forward to join or form groups when they understand the benefits of participating in the program. Some clients will recruit their neighbors as well.

Highlighting who the borrowers are in the Chinese context helps to understand the market niche filled by these programs. Knowing clients more intimately, listening to the risks

and vulnerabilities they face in everyday life, knowing their coping strategies, and understanding their needs will help a program to create demand-driven products that help to draw clients in. As they meet market demand, their program will grow and a strong microfinance institution can be built. From a policy standpoint, understanding the market niche filled by the industry as a whole is important to create an enabling environment for microfinance institutions to understand and meet client demand.

Chapter 6: Building Sustainable Institutions

Framework for Analysis

Below I will present the results of the surveys conducted with project directors, managers, loan officers, and others, all of whom represented the institutions. This data was gathered in order to understand the current situation of microfinance as it relates to creating sustainable institutions and what steps will be needed to foster such institutions in the future. Under a rubric created in best practice methodology, general indicators of strong, sustainable microfinance institutions are the following: 1) providing appropriate services to a relevant target group; 2) positively impacting clients; and 3) being strong financially sound, and stable. (Ledgerwood 1999, 94) In detailing the goals and strengths, weakness/hurdles, and action plans for the surveyed institutions, it becomes clear how well China's microfinance industry is meeting these criteria of strength and sustainability.

Institutional Goals

Through the course of the research, I asked each institution to identify what their long-term development goals included. This was an open-ended question where I let each institution come forward with their own responses. Occasionally, I would also asked a pointed question about a certain topic to see if they had thought about other options as well; these responses are also recorded below. The individual goals are listed in descending order of importance (ranked by number of responses received by an individual institution, i.e., if several people at one institution mentioned a goal, it would count once) in Table 2 on page 65. Several goals will be elaborated on further, as follows.

1. Institutionalization

The goal that received the largest number of responses is that of institutionalization, a tricky response that implies a variety of meanings. For the most part, however, respondents referred to the institution's wish to become independent from the government arm that implements the project, employ independently hired staff without government status at all levels, and build a stable organization that operates self-sufficiently. This goal implies moving from project-based implementation to being institution-based. Six project leaders at the headquarters level and five project implementers at the local level identified this as a goal, for a total of eight projects of the eleven surveyed.

Those whose national level headquarters identified institutionalization as a main goal have generally begun substantial planning in that respect. For example, UNDP/CICETE has spent considerable resources in preparing their project sites for this eventual goal, by bringing in consultants, both international and domestic, to work on business planning, market research, and product design, who then train project staff how to perform these tasks independently.

There are a variety of challenges in achieving this goal, both on the operational level and the policy level, that will be discussed below. It is significant that in this important transition period, twice as many institutions identified this goal as any other and some have shown thoughtful progress towards achieving it. It can be understood from this response that the future of the microfinance industry does in fact lie in the institutionalization of projects for the creation of stable, sound organizations.

2. Institutional Financial Self-Sufficiency

Perhaps better listed as a corollary to the above goal, there were four projects that identified institutional financial self-sufficiency (or, financial sustainability: covering project costs through project earnings) as a long-term development goal. Three of the four identifying financial self-sufficiency had also mentioned institutionalization as a goal. Self-sufficiency is a goal of most MFIs around the world yet is difficult to attain. Only 60 of the 140 institutions that report to *The MicroBanking Bulletin* have reached this benchmark; there are over 2000 MFIs worldwide. (MicroBanking Bulletin; Daley-Harris 2002) This goal is further problematized by the financially repressive environment in China, where interest rate ceilings and the inability to mobilize savings leave institutions dependent on donor funding. Yet, as will be shown below, many institutions identified a lack of capital as a major constraint in achieving their goals. Some institutions have received special permission to charge slightly higher interest rates, but those permissions are not secure, and national policies to allow market interest rates to prevail are crucial in achieving this goal. As can be seen in Table 1 above, Chinese projects have not approached international standards of sustainable microfinance interest rates as rates in Chinese microfinance projects hover between 6% and 10% yearly. International standards for sustainable microfinance interest rates fall between 18% and 35%.

3. Capacity Building

Capacity building was identified by four institutions as a major aim of their project's initiative. Three institutions thought their microfinance projects should be building the capacity

of local people to build micro-enterprises and participate in a financial institution. Two institutions mentioned capacity building of local government as a key goal in their project, especially because working with local governments to show them how to do such development projects can help those local governments to continue implementing the project in the future, thus building project sustainability. UNICEF, in particular, developed their project in fulfillment of China's Platform for Action for achieving Millennium Development goals. This Platform for Action calls for local government capacity building in planning and implementing poverty alleviation projects; UNICEF's objective in developing this project, outside of using the group methodology to deliver health training to mothers, was to develop local capacity in project management.

Table 2: Institutional Goals

Goal	# of responses
Institutionalization	8
Institutional Financial Self- Sufficiency (IFS)	4
Capacity Building	4
Solving capital restraints, providing access to financial services	2
Upscale operations	2
Raise women's status	2
Increase staff quality	2
Standardize operational system	2
Community Involvement	1
Maximize use of Capital	1

Table 2 outlines the institutional goals identified in the survey. Besides the popular responses mentioned above, a few other responses deserve special mention.

Upscaling

Two projects mentioned upscaling – creating bigger projects with more clients – as a main goal of the institution. FPC, whose goals were somewhat anomalous to other institutions because of its status as already having achieved institutionalization, listed upscaling only as a secondary goal to raising the quality of its staff (see below). FPC's managing director did not want to create a bigger institution until he had built a better institution.

Increasing staff quality

This was a very important long-term development goal for two institutions, including FPC, both of whom self-identified this goal as the main thrust of their planning over the next few

years and have begun pursuit of that objective by arranging in-house training sessions, changing staff incentive systems, applying stringent criteria to staff hiring practices, including the restriction of hiring relatives, and using outside consultants to help guide this process.

Standardize operations

The same two institutions that identified increasing staff quality as a goal also identified standardizing operations as an important long-term development goal. Each of these projects began with a diverse group of project sites experimenting with what operations work best, and now upper-level management would like to take the lessons learned from these sites to standardize operations across all project sites. Both of these projects have created operations manuals that they are in the process of implementing in a uniform fashion.

Thus, it can be seen in the goals listed above that the Chinese microfinance industry has the intention to move towards creating strong, sustainable institutions. Secondary goals of achieving institutional financial self-sufficiency, capacity building, and solving capital restraints point to a consensus on important complements to achieving the primary goal of institutionalization, and ones that will help to build those strong criteria. The lack of emphasis on positively impacting clients is troubling. Raising women's status is the only response that could be characterized as dealing with impact indicators – and the trend in China assumes that credit automatically positively impacts poor clientele. Looking at the strengths identified by institutions, below, will help to show what tools they have at their disposal to create this industry.

Institutional Strengths

Each project manager talked with me about the various strengths each project had that would help it to achieve its long-term development goals. These range from strengths in internal management to lending methodology. Responses are detailed in Table 3 on page 67. There are a few responses that deserve mention before moving to a thematic discussion of institutional strengths.

Other non-financial services/integrated development services

Nine institutions listed their ability to provide services above and beyond credit and savings as a key strength. These services include business development services, basic health training, market information and technical assistance, reproductive health training, gender awareness, animal husbandry, and agricultural extension services. In addition, as the rural credit cooperatives begin to experiment with providing microfinance, the client bases of RCCs and

microfinance projects begin to overlap, and many projects felt that provision of these services was key in their ability to maintain and grow their clientele, while remaining competitive with the subsidized rates offered by the RCCs.

Table 3: Institutional Strengths

Institutional Strength	# of responses
Provision of non-financial services	9
Government support of project	6
Well-trained, experienced staff	6
Community ownership and involvement	5
Ability to recognize faults and fix them	5
Strong Internal Control System	5
Potential or Achievement of Financial Self-Sufficiency	3
Suitable Lending Methodology	3
Experience with foreign donors	3
Low operating costs	2
Strong leadership	2
Good “impact”	2
Large outreach	2
Large potential market	2
Satisfied Clients	2
Standardized Operations	1
High repayment rates	1
Good staff incentive and promotion system	1
Strong reputation	1

Government Support of the Project

As projects usually work with local government bureaus, and all projects need government approval to operate, six institutions listed strong government support of their project as an important strength. This is an important factor to have, especially in local areas, because local government offices help to determine the market each project faces. A former FPC project site in Shangluo, Shaanxi Province was closed after the local government opened their own government forms of microfinance and undercut FPC’s project by offering lower interest rates. Another FPC site in Nanzhao County, Henan Province is facing problems as the local government has begun to levy heavy taxes on their operations. Given the local level of legal interpretation in China, having local government support of a project is an important stepping stone to achieving a facsimile of financial liberalization.

Community ownership and involvement in the project

Microfinance can sometimes be seen as a donor-imposed development tool, yet five projects felt that their operations engendered community involvement in the project implementation. This is especially true at Oxfam Hong Kong's projects, which use extensive participatory processes to determine what development projects will be undertaken at each site. Microfinance is not employed unless the villagers themselves identify credit as a lacking resource they are unable to provide for themselves, and then loan terms, interest rates, and administration of the money are largely left to the villagers themselves to implement. A similar system is employed at CC97 in Xinjiang Province.

Ability to recognize faults and effectively counteract them

This category is somewhat subjective and in many cases I have identified myself which institutions have the ability to do this well through examples they provided me. Five institutions show this ability. Most outstanding is FPC, which because of its academic affiliation, is often used as a microfinance "guinea pig." Upper level project staff often pilot-test new initiatives using recognized social science methods to determine the efficacy of new loan products, different clientele, or types of training offered. Other organizations, through looking at the history of their development initiatives, have shown a clear ability to understand when aspects of the project are not working well enough to achieve their goals and adjust project design accordingly, through thoughtful and careful analysis of the local context.

The primary strength identified was the provision of non-financial services to clients, which shows that the industry is grasping an understanding of how to impact clients positively, as discussed earlier, in which coupling microfinance with non-financial services produced a stronger impact on clients. Their initial intent in bringing up this strength, however, was largely in its ability to make their projects competitive against other financial options, showing the beginning of a market-oriented approach to these financial services, even from an NGO/government community. Listing the government support of the project as the second most important strength emphasizes the importance of the state, still, in China's financial and development arenas and the willingness projects must show to work within that system.

A more useful analysis of these responses groups them thematically, as is shown in Table 4, below.

Table 4: Institutional Strengths by Theme

Theme/Strength	No. of responses
Theme: Financial/Business Management	16
Ability to recognize faults and fix them	
Strong internal control system	
Potential or achievement of financial self-sufficiency	
Low operating costs	
Standardized operations	
Theme: External Linkages	15
Government support of project	
Community ownership/involvement	
Experience with foreign donors	
Strong reputation	
Theme: Product Delivery	14
Provision of non-financial services	
Suitable lending methodology	
Satisfied clients	
Theme: Staffing	9
Well-trained, experienced staff	
Strong leadership	
Good staff incentive and promotion system	
Theme: Indicators	7
Good “impact”	
Large outreach	
Large potential market	
High repayment rates	

The high incidence of responses under the theme “financial/business management,” such as internal control systems, low operating costs, and standardized operations is important to the creation of a sustainable institution and a strong, stable industry. The idea that external linkages are so vitally important to these institutions is curious and points to an obviously donor-dependent industry operating under a controlling state that affects how these institutions operate on a daily basis. The third theme, product delivery, shows attention to creating demand-driven services and the potential for these institutions to operate under market-driven principles, should the environment become conducive. Understanding the weakness, hurdles, and obstacles these projects will face is important in creating a conducive environment for growth and sustainability. Particularly important is knowing how managers themselves perceive their situation, as is explored below.

Institutional Weaknesses, Hurdles, and Obstacles

When discussing institutional development with survey respondents, it became important to discuss what each institution saw as the stumbling blocks on the way to achieving their goals: institutional weaknesses as well as hurdles and obstacles the institution would have to face. Some institutions were able to discuss this at great length; it was obvious that these institutions had articulated and internalized a goal and knew that to achieve it, they would need to face and solve some problems. Other institutions were unable to provide thoughtful answers to this question. There are several reasons for this. First, one institution, with the longest history of work in China, already had a strong institutional system in place that was working for their purposes, and so there were fewer weaknesses in the system as there had been time to solve such kinks. Second, some institutions lacked management staff that had enough cross-institutional experience to realize their project was facing some difficulty. They had little to compare to and not enough training to understand the ways in which they might develop or do things differently. Third, some managers viewed me as a possible source of funding and publicity for their organization, despite my admonitions to the contrary, and thus did not feel comfortable candidly discussing this area. What follows is a discussion of the responses reflecting on this question. Table 5, on the next page, outlines the individual responses to these questions.

A few of these responses are singled out for explanation.

Lack of capital

The most frequent response to the question of what hurdles each project faces is a lack of capital. Eight different institutions mentioned this as an obstacle to growing as larger institutions, maintaining a sense of security among clients and staff, and entering into the formal financial system. It is interesting that both large and small projects identified this problem; there is a wide variance in scale between respondents. The most hard-luck story among them, though, is ARDPAS, an institution whose funding has recently been declared “illegal” and has been ordered to stop on-lending activities, as was mentioned above. While they are searching for other funding opportunities and petitioning the government to continue to be allowed to use the Ministry of Finance money, lack of capital is a truly evident obstacle in the long-term survival of ARDPAS. The 44 UNDP/CICETE project sites not chosen to continue receiving funding from UNDP are also experiencing the crunch of capital as many lack the financial stability to continue on-lending without new capital injections.

Table 5: Institutional Weaknesses

Institutional Weaknesses/Hurdles	# of responses
Lack of Capital	8
Using government staff to implement project	7
Unsatisfied customers	6
Failure to effectively implement financial management system	6
No legal status	6
Problem reaching self-sufficiency	5
Poorly trained staff	5
Regulatory Environment	5
High Project Costs	4
Lack of Standardized Operation Procedures	4
Lack of monitoring and evaluation systems	4
Low or decreasing repayment rates	4
Hard to find and keep good staff	4
No savings mobilizations	3
Ambiguities about capital ownership	3
Problems with MIS	2
Small scale	2
RCC competition	2
Drop-out Rates	1
Inability to operate without donor funding	1
Unclear loan-loss provisioning/write-off policies	1
Lack of repayment incentives	1
Inability for clients to use money effectively	1
Lack of poverty targeting	1

Use of government staff to implement the project

Seven different projects identified the use of local government staff to implement the project as an impediment to achieving their developmental goals. Respondents identified three different reasons why this posed a problem. First, several institutions concluded that this system caused staff instability. As government employees, management staff can be taken in and out of the project at any time. One project site I visited had had three managers in the last 16 months. Another project had had 15 staff trained in Bangladesh to use the Grameen Bank methodology. None of those staff are still assigned to the project nor are they continuing to work in microfinance. Second, the Chinese government employees tend to engender a work attitude that is fairly different from a profit-driven institution. One provincial manager noted to me that if he was not doing this job, the other government staff they could assign to the job would “sit around,

drink tea, read the newspaper, and smoke cigarettes.” China’s system of banquet-driven programs and policies tend to lack transparency, standardization, and long-term development impact. Third, one local manager asserted that there is a conflict when working with the government. The goal of the microfinance project may be, as was the case in this project, to become an independent and sustainable institution, which may take time and involve setbacks. The local government, however, wants to simply impress the donor by completing the assigned task well and on-time – and the explicit scope of work does not necessarily include the creation of an independent institution. This conflict manifests itself in the government staff implementing the project, who are torn between the two sets of bosses that employ them.

Unsatisfied customers

This category was largely gleaned from talking with clients and examining drop-out rates. Six institutions are not dealing completely with their clients’ demands. This became evident during focus group discussions in which clients expressed displeasure in the lending technology, namely loan sizes, loan terms, training sessions offered, or the use of weekly or monthly center meetings. Other projects saw high dropout rates or significantly declining repayment rates. In order to create independent institutions, these projects will need to build a demand-led organization that caters to its clients needs. The rural financial system will not remain monotonic forever and each institution will need to attract a sufficient client base to remain a healthy institution.

Poor implementation of financial management mechanisms

Six projects have not been able to effectively implement a strong system of financial management. Some institutions felt this weakness existed either because too many actors are involved in this process, as with donor/government alliances, or because the funds had been turned over to the villagers, such as Oxfam’s participatory development systems. In one project, I asserted that this is a weakness of the project’s after it took the accounting staff 30 minutes to answer my question, “What is the amount of outstanding loans in this project?” (after I had explained what the term outstanding loans means). This same project was unable to produce any financial statements for me to see, despite the fact that their donors were requesting them. This sort of shoddy financial management will affect the business as it grows and its ability to be a strong and healthy financial organization. In addition, four other institutions mentioned a lack of

standardized operating procedures as an impediment and most were currently working towards the establishment or implementation of operations manuals.

Lack of monitoring and evaluation systems

Monitoring and evaluation, especially at the local level, were a problem for four institutions. One project believed that distance was a major predicament to implementing monitoring and evaluation systems, as the project sites were in remote areas and were hard to access. Thus, monitoring and evaluation from the provincial office was an arduous task as it involved several days of rough travel to visit a site. This is a consistent problem with microfinance services in China, where the poorest are also the most difficult to physically reach. This calls into question the feasibility of providing sound financial services to these populations, especially using certain group lending models that require stricter monitoring and evaluation systems.

The weaknesses or hurdles identified by the institutions can also be grouped thematically, as is summarized in Table 6, below.

Table 6: Institutional Weaknesses by Theme

Theme/Weakness	No. of Responses
Theme: Project Implementation and Procedures	34
Unsatisfied Customers	
Poor Financial Management Systems	
Problems reaching Financial Self-Sufficiency	
Poorly trained staff	
Lack of standardized operating procedures	
Lack of monitoring and evaluation systems	
Problems with MIS	
Unclear loan-loss provisioning/write-off policies	
Lack of repayment incentives	
Theme: Capital and Financial Efficiency	16
Lack of capital	
High project costs	
Ambiguities about capital ownership	
Inability to operate without donor funding	
Theme: Regulatory Obstacles	14
Lack of legal status	
Overall regulatory environment	
Inability to mobilize savings	
Theme: Staffing	11
Use of government staff	
Inability to keep good staff	

As can be seen in Tables 5 and 6, many projects have been able to identify the weaknesses and hurdles they face. This is an important step in being able to create stronger institutions. The most important individual weakness, lack of capital, points to the nascent industry in China and the lack of investment opportunities. This is also hindered by regulatory obstacles, which were the third most prevalent theme in this survey. Solving this capital constraint will, of course, help in institutionalizing, but the reliance on donor funding (especially when most projects do mean donor funding when mentioning “capital” because of the lack of access to commercial funding) is troubling as this reliance does not help to create sustainability. Instead it allows institutions to operate inefficiently, to sometimes concentrate on donor demand instead of client demand, and as was mentioned above, create ambiguities about capital ownership that can lead to the negation of repayment incentives.

Table 8 on page 85 provides a brief sketch of financial indicators for these projects; even those with high levels of operational or financial self-sufficiency still rely on donor funding. On the other hand, these projects recognize that using government staff in implementing the project is a weakness. This is important for two reasons. First, government “culture” and the role that bureaucratic elites play in implementing the project affect the project’s ability to provide appropriate services as the voices of the poorer clientele are often squeezed out when local government officials are involved. (See, e.g., Chambers 1997) For example, in a mid-project impact assessment for UNICEF’s microfinance program, it was found that more non-poor than poor clients were participating in their project and that, furthermore, relatives and friends of the project implementers (government staff) were receiving loans. Some project staff said they felt that the non-poor should participate to demonstrate to the poor clientele how to use the project. Yet, many of the poor self-selected out of the program, saying it was “not for them.” This points to a problem when elites are so ingrained in project implementation. Second, using government staff implies a hidden subsidy for these programs; achieving financial self-sufficiency would entail moving to independently-hired staff.

Project implementation and procedures is the most important theme, which points to the knowledge that appropriate services are not being efficiently provided to a target group. Financial management systems, operating procedures, monitoring and evaluation systems, management information systems, loan-loss provisioning, and repayment incentives all need to be tightened in the microfinance industry. Without strong management procedures such as these, it will be impossible to foster healthy institutions. Institutional knowledge that this weakness exists is promising in that it is an important first step in trying to fix the problem in order to create a sustainable, strong industry.

The theme of capital and financial efficiency points to knowledge that strong financial bases are important in creating such institutions. A lack of capital, as was mentioned above, is coupled with high project costs and ambiguity over capital ownership. Three institutions identified this ambiguity as an obstacle. These three projects have operations particularly intertwined with local government bureaus, and it is unclear to the stakeholders who exactly owns the capital. Some believe it is the local government; others believe it is the villagers. In all cases, the project needs to own the capital, to help further engender a repayment culture, to avoid

the misuse of the money by local governments (as is seen in poverty alleviation funding), and to make the most efficient use of the funds.

The third theme, that of legal and regulatory obstacles, is surprising in its low levels of response. Five projects mentioned their lack of legal status as a problem to deal with in reaching those goals. This is a problem for several reasons. First, some loan officers were very concerned about this because they felt that their job security was at stake when their employer was an ill-defined organization from a legal point of view. This will affect the project's ability to attract and keep good staff. Second, this also affects the ability to attract funding to upscale, as it is riskier to invest in a project without secure legal status. Third, this means that there are local variations in the way microfinance projects are treated by local government and thus implemented. Were legal status to be involved, projects would not have troubles with, for example, differential tax policies, as mentioned above.

Five institutions identified the general regulatory environment as an obstacle in their pathway. As shown above, most institutions say there are problems with legal status, ability to mobilize savings, and enforce contracts, yet understand also that they have little power to lobby for change in that system. One institution's attitude was particularly enlightening, however, when the management said that the most effective thing they could do was to continue operating in a sound financial manner and as they grew, attract more and more government and media attention. As their project and the needs it faced became more evident, that media attention would be one way to influence China's politicians to enact change in the financial regulatory environment. The regulatory obstacles, however, are generally out of the hands of the institutions and will be dealt with in Chapter seven. How institutions look to solving these other problems is examined below.

Action Plans for Achieving Goals

Another discussion held with project managers concerned how each institution planned to achieve their goals, i.e., what steps they were considering taking in order to move towards the goal. These plans for action are grouped in four themes: 1) project management, 2) staffing, 3) project implementation, 4) regulatory environment. Please refer to Table 7 on the next page.

Table 7: Action Plans by Theme

Theme/Action	No. of Responses
Theme: Project Management	25:
Improve portfolio quality	5
Create independent institution for project implementation	4
Create strong governance/monitoring structure for the project	3
Improve financial management	2
Create business plan	2
Standardize operations	2
Fundraise	1
Downscale	1
Partner with RCC	1
Increase reporting standards	1
Improve MIS	1
Upscale	1
Create client satisfaction/impact assessment	1
Theme: Staffing	17:
Create staff incentive system based on portfolio quality	4
Train staff in financial management	3
Train staff in standard operating procedures	3
Capitalize on staff experience	2
Train staff in fundraising	1
Pay staff salaries from interest	1
Make all staff full-time employees	1
Increase information sharing among staff	1
Increase English language capabilities	1
Theme: Product Delivery	9:
Change lending methodology	4
Offer savings mechanisms	2
Improve non-financial services	2
Charge market interest rate	1
Theme: Regulatory Environment	3:
Get legal status	2
Get legal ownership of loan fund	1

A correlation exists between the actions being planned by these projects to achieve their goals and the weaknesses described above. Thematically, the number one weakness was in project implementation, and here, project management is the most active area for change. This shows that the managers of these particular projects understand and believe that either they can

not change a repressive regulatory environment or that the project management is the most important part of the project that they can control, thus their best action will be to create a strong institution. One manager felt this in particular, as he believed that by creating a healthy institution he could show to policymakers the potential this industry has in China, thereby influencing policy.

Knowing these action plans helps to illustrate that, within the criteria for creating strong institutions mentioned above, projects are looking internally to do so. They are not necessarily, however, focusing on creating appropriate services for their clients. Changes in product delivery are only the third most important themes mentioned (although changes in lending methodology was a fairly popular choice), and the high incidence of unsatisfied customers among these projects, as outlined in institutional weaknesses above, shows waning interest from clients in these programs. While management mechanisms will be important, it is the services these institutions provide that will make them competitive in a market-like environment such as China's, especially as RCCs begin to provide these services as well. Yet, a glance at Table 1 on page 57 shows that seven of the surveyed projects use an adaptation of the GB model, ten projects use group guarantees, seven projects had installment periods between one and four weeks. A majority only offer one type of loan product, with a term of one year. Financial innovation among these projects has been weak as they cling to standard microfinance models. The institutions that begin to understand the importance of product and management flexibility will be working from a vantage point if and when a competitive microfinance environment matures.

Analysis

Microfinance, as an international development tool, has since its beginnings in the 1970s, built some "best practice" norms that apply to the creation of strong, healthy institutions. As was shown in the above analysis, the main goal of these microfinance programs in China is to create such strong institutions. In 1999, Joanna Ledgerwood produced *The Microfinance Handbook* which synthesizes the norms of international best practice. According to Ledgerwood, attributes of a good institution are 1) the provision of appropriate services to the relevant target group; 2) positively impacting clients; and 3) being strong, stable, and financially sound. (Ledgerwood 1999, 94). These attributes are discussed in the Chinese context below.

Provide services to the relevant target group

Components of the loan technology such as loan size, collateral requirements, loan application procedures, and incentives to ensure repayment should be attractive and fit the demand of the *target client*. Therefore, if the microfinance industry in China is aiming to reach a rural, largely female, and poor clientele who traditionally has not had access to financial services in the past, the credit technologies and financing mechanisms they offer should correspond to that group. Ledgerwood emphasizes two criteria: first, the scope of services both in number and scale should fit client demand. Second, appropriate prices should be given to these services, including low transaction costs for clients, a high degree of deposit liquidity, and rapid availability of loans.

In this survey, the biggest strength listed was the provision of non-financial services by these projects. They recognized this as a competitive edge over the RCC version of microfinance, reflecting that their comparative advantage lied in the range of demand-driven services they provided. The programs surveyed need to be careful, however, in assuming that all non-financial services such as technical assistance and training are welcomed by clients and are truly “demand-driven.” During focus group discussions with clients, there were a variety of reactions to this component of each program. Some clients felt center meetings were helpful in sharing market information or learning new skills. Others balked at the waste of time involved in attending these meetings and believed most of the training provided was irrelevant. This is especially true when diverse groups of clients with a variety of income-generating activities and different experiences meet for training: finding suitable topics for all borrowers is difficult. Furthermore, there does not exist a cultural context for tools such as market research to understand client demand that might produce more suitable services, because Communist ideology, not efficient market mechanisms, still pervades the local governments implementing these projects.

Fewer programs have institutionalized non-financial services outside of the technical assistance or business development services realm. One that has been particularly successful in doing this is UNICEF’s projects which strive to provide education in maternal and child health care, production skills, and literacy as well as promote education for children, community participation, and gender awareness. Participants show increased levels of education, better knowledge of health issues including HIV/AIDS prevention, and perceived improvements in

their community standing against a comparable control group. (UNICEF 2000) Other programs have failed to make this routine within their product delivery – for example, at one FPC site, I was told they once had a doctor come to give free examinations to the clients, a service that was met with much delight by the women. That type of service was rare and certainly not institutionalized across all FPC sites. The point in providing these non-financial services, however, is to provide a well-rounded attack against poverty. For microfinance programs with a stated goal of poverty reduction, then the biggest impact, as was shown in chapter two, has been in programs that provide this range of services instead of relying purely on credit and savings services. While some may argue that provision of non-financial services leads to unsustainable projects, institutions as diverse as BRAC in Bangladesh, CRECER in Bolivia, and FOCCAS-Uganda have shown that these services can be integrated in a sustainable manner through a variety of models, including partnering with other local service providers instead of bearing the cost of this service provision entirely by the project. (Dunford 2002)

Furthermore, only three projects identified a suitable lending methodology as an institutional strength helping them to achieve their goals. Six projects had “unsatisfied customers” as a weakness. The third most important theme identified for action planning was changes in product delivery. This inability to recognize suitable lending methodologies and weak commitment to changes in product delivery points to a current inability to provide appropriate services and a potential for change in the future. Furthermore, analyzing Table 1 on page 57 and comparing loan terms, sizes, and installment periods across programs reveals the homogeneity of loan products offered to clients. A few projects have offered flexibility in loan terms, but most program managers admit that for simplicity’s sake, the loan officers in these programs tend to steer their clients towards 6 or 12 month terms. It is unlikely that single loan products are suitable given the heterogeneity in age, gender, geographic, and educational levels of clients in the target group. Such variation points to diverse loan usage. I would never use a car loan to finance my education, so why should a microfinance client have to use a one size fits all product?

When it comes to Ledgerwood’s second criteria, appropriate prices and availability, an interesting balance is struck in China. First, most of the projects tie availability of subsequent loans to repayment of previous loans. Turnover time between loans is fairly short, a common characteristic especially among group lending methodologies. Transaction costs for these loans,

however – particularly for those projects who employ group lending techniques with frequent meeting requirements – are high for the borrowers, especially when factoring in the opportunity cost of clients' time in attending these meetings. That transaction cost should be balanced by the reward received for attending the meeting (e.g., access to credit and, ostensibly, training). As was shown in Chapter 5, however, not all borrowers are satisfied with the content of these meetings because of the inapplicability of the trainings and the amount of time they take to attend, thus increasing their transaction costs for the loan. Moreover, few savings mechanisms are offered, and where they are, access to that savings is often tied to timely and successful loan repayment, thus suggesting very low deposit liquidity. China's national financial regulatory system, however, prevents more attractive methods of savings mobilization from being an optional service for microfinance programs to provide.

Thus, while China's fledgling microfinance industry is starting to understand the importance of providing services to target clients and make moves towards becoming demand-led institutions, it will require institutional will and effort on the part of the institution to internally change their mechanisms. In addition, the external regulatory environment acts as a hindrance to truly providing a complete range of financial intermediary services. As institutions struggle under interest rate caps or the inability to mobilize savings, there is a constant awareness that the lack of legal status for microfinance translates to institutional instability; the fate of ARDPAS, recently shut down by the government, could be theirs as well. This undoubtedly affects any program's ability to think and plan for long-term sustainability of the institution.

Positive Impact on Clients

The institutions should have some "identifiable positive" impact on the lives of the customers. (Ledgerwood 1999, 94) This is especially relevant for those institutions who claim their mission is poverty alleviation, as is true for many of the donor and NGO funded programs in China, as well as for the independent institution FPC. As was noted earlier, the RCCs mission in providing microfinance services is not necessarily poverty alleviation but instead to deepen financial services in rural areas, and so impact assessments would not necessarily be as stringent a qualifier for these institutions.

There is not a strong history of institutional impact assessments in China. International best practice advocates that impact assessments be worked into the daily routines of microfinance institutions so that loan officers are continually collecting baseline data and other

evidence about the impact participation in the microfinance program has on the client. FPC has recently teamed with ImpAct, a research consortium in the United Kingdom, to create such a system. The other projects I visited did not have a strong tradition in this sense. The original microfinance project carried out by UNICEF, the Social Development Program for Poor Areas, did employ an impact assessment near the end of the project cycle in order to determine how the next project cycle should be designed. The original mission of the project was to improve capacity building for local governments as well as impact maternal and child health; the impact assessment showed positive impact in the areas of maternal and child health, especially in the use of safe water, iodized salt, proper diarrhea cures, and knowledge of HIV/AIDS prevention techniques. The impact assessment did point out, however, that many of the participants in the program belonged to the category non-poor, showing an inclusion error in the program. Capacity building was lacking as many staff continued to be hindered by government intervention, their inability to use MIS, and a lack of financial and accounting knowledge. This impact assessment was empirically well-done in that it tested several key hypotheses; it did show how clients were impacted by the program. The problem in this assessment, as in many impact assessment done as an afterthought, was its control group, which was chosen by government officials. This could have caused a significant bias in the data collected. When impact assessments are institutionalized, baseline data is compared with data collected through the project cycle, eliminating these control group selection biases.

Be strong, financially sound, and stable

Stability in this context is financial, i.e., an institution that is not running out of cash and is not in danger of insolvency. In addition, a strong institution can maintain or expand scale in order to continue meeting client demand as their income generating activities grow. Larger institutions tend to have lower costs per client, which rationalizes growth. In addition, financial sustainability can be measured by subsidy dependency levels, not necessarily in absolute terms, but looking over time at the institution's commitment to work towards covering costs. The pundits of international best practice understand that most institutions are not self-sufficient, especially during the first few years after start-up, but progress towards that end should be made. The most stringent guidelines say that self-sufficiency can be reached within the first five years. Organization stability is a less quantitative indicator but can be measured in

terms of stable organizational and ownership structures. Mission drift would be one example of instability in the structure of the organization. (Ledgerwood 1999, 94)

Table 8 on page 85 highlights the financial data I was able to gather on each institution. I have also listed the 4 SMAP projects of UNDP/CICETE separately from their composite data for comparison. The eleven projects surveyed are all subsidy dependent. Most do not have adequate levels of institutional financial self-sufficiency, reflecting the level of dependence on grants and soft loans for their survival. Some have better rates of operational self-sufficiency, which measures how well an MFI can cover its costs through operating revenues. Financial self-sufficiency, on the other hand, uses an adjusted operating revenue to reflect how well an organization would be able to cover its costs if it were unsubsidized, thus it is an important measure for understanding the long-term stability of the organization. (SEEP 2002)

The second most repeated goal among institutions was achieving institutional financial self-sufficiency, while the first goal, institutionalization, involves the creation of stable and strong institutions. Some of China's microfinance projects are on a track towards institutionalization, if in spirit only. They still face obstacles. Many of these organizations encounter high staff turnover, however, particularly because of the government status of their employees, which means projects will have real problems in gathering the institutional will to make this goal a reality. One project site has begun the process of institutionalization by creating a new charter, board of directors, and long-term business plans, all in collaboration and consultation with their primary donor agency. In this process, when the time came to move the managers from government employee status to independent hire status, the two senior managers refused to do so, threatening to quit the organization. A compromise had to be worked out so that these managers would retain the benefits promised them under government employment. This illustrates the dangers each project will face when they try to move experienced staff out of the comfort and safety of government employment to the risky position of heading a potentially unstable institution. This is why a top-down push for institutionalization from the donor community will not be effective in the Chinese context.

In my opinion, only three of the six organizations where I had site visits will be able to harness the institutional will to make institutionalization a reality.²⁵ These organizations – FPC,

²⁵ It would be unfair to pass such stringent judgement on projects that I have not visited to see project implementation first hand.

CFPA, and the Chifeng site of UNDP/CICETE – are characterized by a committed staff who understand the importance of moving in that direction and the dangers inherent in maintaining government status. The leaders of these institutions have been able to instill a sense of purpose and drive towards achieving a long-term goal which is crucial in the institutional culture in order to break fully away from the government arm.

Few institutions paid serious attention to the regulatory environment in answering the survey. Responses concerning the regulatory environment showed up in the middle of the list of hurdles institutions face in achieving their goals. One reason for this might be a feeling of futility among managers who operate within a government system just beginning to implement a rule of law; the ability to influence government action is minimal. Those organizations who I believe have the institutional will to achieve the goal of institutionalization also exhibited a more complete understanding of the limits placed on their progress by China's repressive regulatory environment. It will be necessary to change this regulatory framework in order for complete institutionalization to occur. Thus, I turn now to this regulatory environment, the effect it currently has on the industry, and recommendations for the future.

Table 8: Financial Analysis

Project	Funding Sources	Outstanding Loans (RMB)	Loan Size (RMB)	Interest Rate	Repayment Rate	% FSS	% OSS	No. of LO's	Loan Port/LO (RMB)	Clients /LO
FPC	GT, GF-USA, AusAID, Ford, personal donations	13,214,173	1000-1500-2000	8%	98% (not including Yucheng branch) ²⁶	Yucheng ²⁷ : 12.16% Yixian: 41%	Yucheng: 17.40% Yixian: 44% ²⁸	N.A.	N.A.	N.A.
UNDP/CICETE	UNDP, UNFPA, GTZ, JICA, etc.	55,230,838 (end of 2001)	Usually 1000-1500-2000	Varies	79.18%	N.A.	53.37%	310	163,641	171
(SMAP) ²⁹	UNDP, UNFPA, GTZ, JICA, etc.	10,152,426 (end of 2001)	Usually 1000-1500-2000	Varies	77.75%	N.A.	81.86%	51	201,169	208
UNICEF	UNICEF	20,538,232 (1999)	1000 - 1500 - 2000	9.6% flat	N.A.	N.A.	N.A.	200	40,000	40
UNFPA	UNFPA/MOFTEC	N.A.	max 1st year = 1250, can increase subsequently	13.775% (5% returned to client)	N.A.	N.A.	N.A.	N.A.	N.A.	N.A.

²⁶ The Yucheng branch at FPC has been experiencing a serious problem with defaults and bad-loans. There are currently only about 800 active clients in this branch and a portfolio at risk of 219,010 RMB in yearly loans and 930,830 in seasonal loans. Over 6,400 clients have dropped out of the program since inception. This problem is being addressed by the management of FPC and a recent change in management as well as standardized operating procedures should help to resolve the problem.

²⁷ FPC's financial statements are only at the branch level.

²⁸ These FSS and OSS numbers are for June 2002 only; an annual average number would be more accurate as these fluctuate with seasons. In Yixian in May, for example, these numbers stood at 77% and 102%, respectively.

²⁹ These are the four project sites chosen to continue receiving UNDP funding. They have stronger financial records than the other projects, so it is significant to highlight them separately. Their numbers are also included in the UNDP/CICETE numbers.

Project	Funding Sources	Outstanding Loans (RMB)	Loan Size (RMB)	Interest Rate	Repayment Rate	% FSS	% OSS	No. of LO's	Loan Port/LO (RMB)	Clients /LO
ARDPAS ³⁰	Nat'l Finance Ministry, Zhejiang Fin Min, savings (not on-lent), ABC loans	USD 2,164,500	Max 1 st loan = 1000	6%	91.80%	95%	102%	209	USD 13,356	133
Heifer Project International	HPI	N.A.	In kind loans; cash loans vary	varies; none surpass market	N.A.	N.A.	N.A.	N.A.	N.A.	N.A.
World Vision	World Vision	576,057	In kind loans; cash loans from 30-500	determined by participants; ave = 4%	88%	N.A.	9%	17	57,114	219
CC97	CIDA; MOFTEC/ Xinjiang DOFTEC	N.A.	600 - 1000 - 1500 - 2000	Between 7% and 10%	N.A.	N.A.	21.96%	N.A.	233,820	89
Malipo REDA	UNDP, WFP, IFAD, GT, PAO/ABC	2,742,274	100-1500	6% APR	90%	51.48%		7 (UNDP)	202,638	210
Oxfam Hong Kong	Oxfam HK	N.A.	N.A.	decided by CPO	N.A.	N.A.	N.A.	N.A.	N.A.	N.A.
China Foundation for Poverty Alleviation	World Bank, provincial PAO's, ABC, Mercy Corps, other NGOs	N.A.	Between 1000 and 3000	no higher than 7%	95%	N.A.	51%	102	270,000	276

³⁰ These numbers are as of end 2001. Obviously, given recent news, these are no longer applicable as ARDPAS pulls back its entire lending operations.

Chapter 7: Building Strong Industry

In order to achieve the goals mentioned above and achieve a sound financial base, the legal and regulatory environment is currently not appropriate to foster microfinance for the poor in China. Here, I will explore the current policy environment and make recommendations about potential policy changes within the framework of current industry thought on appropriate regulatory environments.

***Appropriate Regulatory Environments: Best Practice Thought*³¹**

International experience in microfinance has shown that large-scale delivery of a diversity of financial services to the poor lies in a regulated, licensed environment. First, the general reason for financial regulations is to safeguard the financial system and protect savings deposits by applying prudential regulations to institutions; licensing of institutions would then mark where savings are “safe.” Second, the benefits for microfinance providers in operating within a regulated environment include the ability to take savings deposits from the public and ostensibly access commercial sources of finance, thus solving capital constraints and allowing substantial outreach.

The idea that financial regulatory environments, in order to accommodate and encourage the delivery of microfinance to the poor, should create tiered structures of financial windows has recently been the predominant framework. These windows depend on where deposits come from – delineating between public deposit-taking institutions, those that use members’ money such as cooperatives, and those that use donor money and offer credit-only, such as many NGOs. (van Gruening et al. 1999) These tiered frameworks can regulate either by institution (by creating separate institutional niches for microfinance) or by activity (by allowing existing institutions to expand into the microfinance sector). These are not mutually exclusive options. Arguments for this tiered approach include the ability for institutions to specialize within a market niche and to create linkages between MFIs and the formal sector banking institutions.

The debate rages, however, about the appropriate timing and phasing of such regulations. Some argue that creating regulations before the market has developed and mature institutions

³¹ Analysis in this chapter draws on Christen and Rosenberg (2000), Ledgerwood (1999), van Gruening et al. (1999), and Graham (1998), as well as a seminar on microfinance regulatory frameworks in Africa held at The World Bank on 25 November 2002.

exist will effectively stifle the industry and fail to result in innovative provision of alternative financial services by pigeonholing the sector into regulatory norms. In addition, the hassles, paperwork, and bureaucracy involved in many countries, including China, with registering as a formal entity are cited as reasons for not regulating early in industrial development.³² Others argue that early regulations will foster the industry's growth into a healthy, mature financial sector and reduce risk for clients. It is difficult to determine how or when to regulate. For the Chinese context, however, an over-regulated financial sector that does not include microfinance already exists, while NGO and donor microfinance operates outside the sector. RCC microfinance, on the other hand, has been sanctioned by the regulatory environment, but the government mandate to do so suggests that it is not in response to market demands that RCCs began providing this service, a troubling aspect in their provision, especially when conflicting mandates from the PBC alternate between hard budget constraints and policy lending such as microfinance. Another important issue in considering changes to a regulatory environment include the capacity of a supervisory agency (usually the central bank) to effectively regulate more/different institutions and the cost involved in doing so. In order to begin regulating the microfinance sector, however, international experts call for the elimination of interest rate ceilings and government programs of subsidized credit. Obviously, given that both exist for Chinese microfinance programs, this is the starting point for changes in China's regulatory framework as well.

There are several triggers that call for a regulatory framework to be put into place. These generally involve four types of risk; existence of this type of risk indicates the need for regulations to mitigate. First is ownership and governance risk stemming from situations where an odd mix of shareholders (e.g., NGOs, government, donors, private individuals) might not have the skills necessary or when government elites intrude on the governance of the MFI. Second is management risk when decentralized branches create an environment where internal control mechanisms are hard to enforce and fraud results (such as was experienced in FPC's Yucheng branch and at ARDPAS in Sichuan province). Third is portfolio risk, or to enforce

³² Joe Studwell notes that minimum capital requirements for private businesses are some of the highest in the world: US\$36,000 for retail trade and US\$60,000 for manufacturing or wholesale trade. All of this money must be paid in full to the bank before business operations can begin. Furthermore, licensing requirements call for a clear definition of the scope and location of business; any deviation from this definition is then illegal. Harvard University conducted a survey of start-up bureaucracy in 75 developing nations; China ranked 51st overall for delay and 43rd for cost. (Studwell 2002, 229)

management of delinquency so that MFIs are held to certain standards to minimize risk to depositors. Fourth is new product risk, so that when new products are implemented the staff have the appropriate skills necessary to implement the product. (Graham 1998) This fourth risk has been mentioned by the manager of at least one project in China as the reason for his hesitancy to jump on the ‘savings bandwagon’ as he realized his staff were not trained properly to begin accepting deposits.

The key prudential standards that are generally implemented are 1) minimum capital for entry and subsequent capital adequacy requirements; 2) loan loss provisioning and write-off policies; 3) limits on risk in unsecured loans, insider lending, and single loan limits; 4) standards for liquidity risk; 5) compliance for surveillance requirements such as external auditing and on-site inspections. In general, in order for these regulatory mechanisms to work properly, they must correspond to adjustments in property rights, collateral law, and security interests for the entire financial sector, including microfinance. In addition, clear tax laws that adjust for increased loan loss provisioning on unsecured loans need to be in place as well.

Most of all, however, the proper regulatory environment hinges on a clear definition of microfinance and microfinance providers. Thus, the current policy environment that microfinance providers face in China must be examined employing international experience that shows how best to build strong and sustainable microfinance industries while being mindful of the Chinese context.

China’s Current Policy Environment³³

China’s financial regulatory framework can be construed as a classic case of a repressive environment. In 1999 the State Council “endorsed” microfinance, yet failed to delegate supervisory status to the Central Bank or detail which institutions should be providing microfinance. Thus, the perspective is murky from the outset, as no one seems to have a hold on who is supposed to do what. Interest rates are set by the PBC, generally at a subsidized rate. Microfinance institutions are usually held to these interest rate caps as well, without the benefit of government subsidy (as they generally do not access government-funded poverty alleviation funds). Interest rates are allowed to float around a specific rate, but that float is minimal, usually

³³ Information for this section was gathered during conversations during the summer of 2002 with the following: Daniel Wang Dexiang, UNDP Programme Specialist, Beijing; Bai Chengyu and Liu Wenpu, CICETE; Andrew Watson, Ford Foundation Beijing; Ren Changqing of the Microfinance Training Center; and Du Xiaoshan and Sun Ruomei of the Chinese Academy of Social Sciences Rural Development Institute.

around 10%. The belief in setting interest rate caps centers around two common misconceptions held by policymakers in China. First, there is a belief that because the capital for these projects generally comes from foreign sources, it does not need to be repaid. Second, it is also believed that because it is used for poverty alleviation purposes, the interest rate should not be high. It will be hard to combat these beliefs in order to create the first standard for prudential regulation, that of no interest rate ceilings or government subsidized credit.

Microfinance programs, as mentioned above, have project status generally formed through a memoranda of understanding between the donor and the local government. There is not a clear legal status for these institutions, especially prescient as many of them forge ahead to try to institutionalize. These programs are usually not able to mobilize savings, except within organizations that are purely funded by foreign donors, which largely employ the GB model of forced savings through a group fund with small amounts of weekly savings. These savings can not be used as on-lending capital, and because it does not entail a large sum of money it does not fall under the supervision of the PBC.

Thus, while institutions identify a lack of capital as a primary hurdle in their own institutional growth, the current regulatory environment does not allow savings mobilization, a form of capital formation, to happen. This would suggest that a revision within the current regulatory framework is in order; however, it depends on what camp you sit in whether that regulatory framework should be one of prudential regulations or one that simply eases the current repressive environment while not placing further regulations into the mix. A consideration of staff capacity, both within the PBC and within the institutions, is necessary to determine whether regulations can be supervised, in the first case, and savings can be adequately implemented, in the second.

This repressive environment is a central source of the hurdles many institutions identified above. For example, the lack of a legal status creates questions about the long term sustainability of the institution. This is manifested in two ways. First, the institution itself faces uncertainty as it does not know when the policy tide may turn against these types of programs and the government will shut them down. Political movements have historically been cyclical in China and other alternative sources of financing have born the brunt of these government shifts, such as the rural credit foundations. The situation of ARDPAS is a prime example of the impact shifting policies can have. Second, staff of the institution face the risk that their employers are not stable

institutions. As institutions move towards independence and ask employees to leave their government status behind, this becomes difficult, as they are asking employees to work for an institution whose legal status is questionable and might be shut down at any point.

One bright point, however, is the government support of these projects. A large portion of the staffing costs is absorbed by the government, who provides the salaries for staff of the projects. This cuts costs for the project, so the higher interest rate is not necessarily required for the institution to be sustainable. In addition, despite some of the repressive nature described above, it should be noted that these programs are still operating, some of them after their initially established project phase has ended, and so government support, and in some cases complacency, has helped to foster the development of this industry. Thus, it seems that despite international best practice belief in distancing microfinance from government interference, while valid in the ways that this involvement can affect product delivery and choice of clients, may not be a rational choice for China in its current context.

Recommendations for an Appropriate Regulatory Environment

In making recommendations about what type of regulatory environment will foster the development of a strong and sustainable microfinance industry, it is important to distinguish between what an ideal regulatory environment might look like and what a possible regulatory environment under the current state system would be more likely to occur, with the knowledge that this quest for a sustainable industry can only occur under the current state system. What follows are cursory recommendations based on knowledge of current international recommendation for microfinance, what other experts are predicting about China, and my own observations; I will leave it to the experts to discuss specifics of such an environment.

Ideal Environment

First and foremost, the elimination of interest rate caps will be crucial in the development of China's financial system, including the microfinance sector. A market-enforced interest rate would be an interesting phenomenon in China. Recent field studies have shown that within the microfinance market, considerable demand for financial services exists even under high interest rates. The informal finance mechanisms documented by Kellee Tsai (2002) imply this; she asserts that this curb market will survive government regulation because demand is so high. Ren Changqing found that the reservation interest rates in poor areas hovers around 24%; in the

Caohai microfinance project, an innovative study in combining microfinance and sustainable development, clients set their own interest rates and manage the funds: rates there have gone as high as 60%. (Du et al. 2001)

Second, an ideal regulatory environment would create a new financial ‘window’ that would provide legal status to microfinance providers, i.e., the NGO-MFIs that currently do not have legal status. Under this new window for financial services, because of the current size of the industry, which is fairly small, it would be best to gradually phase in licensing and prudential requirements, while allowing deposit-taking to occur. While these institutions continue to have net debtors it is not necessarily crucial to have such prudential requirements as minimum capital adequacy levels and risk-weighting of assets. When this new legal status confers the ability to take deposits on these institutions, the institutions must then be transparent about the lack of prudential regulations governing and safeguarding depositor’s money. Furthermore, it will be important to allow existing financial institutions to downscale into microfinance if they see fit, by providing regulations that address the activity of microfinance, and through clear definitions of what this means.

Third, if RCCs are truly to downscale into microfinance, it must not be because of a state mandate to do so but rather through recognition of market demand accompanied by prudential regulations specific to microfinance activities that then foster incentives for RCCs to conduct this type of business. In a true market environment this would include entry and exit mechanisms, and in this context, where approximately 40,000 RCCs already exist across the country, exit mechanisms for poorly performing institutions might be even more crucial. Furthermore, given the history of cronyism and policy lending, limits on insider and connected business would be important to fostering market incentives. The RCC system, as well as the entire financial system, would benefit from rigorous supervision and reporting requirements. The current precarious state of China’s financial system, as pointed out by Nick Lardy, is in serious need of attention. The microfinance sector can only grow in a healthy manner if the entire financial system has an overhaul.

Possible Environment

Given that in the history of the PRC there has been a tight watch over the formal financial system (which is not to say that informal mechanisms have not existed, as Kellee Tsai’s work

clearly shows they have), this complete overhaul will be unlikely, at least not in a sudden, rigorous manner that might upset the provision of financial services to the state sector and millions of rural farmers and entrepreneurs. China has recently joined the WTO, however, and in the next five years the financial market is supposed to be liberalized considerably, and so it is possible that interest rate caps might be eliminated under these entry requirements. The belief that poverty alleviation loans should have lower interest rates, however, will be another stumbling block. Perhaps, as RCCs forge into the microfinance sector, they can prove that smaller loans do not require such low interest rates in order to be affordable to the poor, and as microfinance providers such as the Caohai project succeed and grow, it can be shown that the reservation interest rates of the poor are much higher than believed by government officials.

Historically, the state has propped up the financial system in such a manner that it is unlikely that the PBC would grant legal status to an entirely new type of financial institution such as the NGO-MFI without regulating that institution. The state has attempted to create a measure of trust in the financial system among depositors and so allowing institutions to accept deposits without proper licensing is unlikely within the current state system.

Research is currently underway, however, that might help to change this idea. The UNDP has funded a PBC research project to create policy proposals appropriate to fostering microfinance. This research project will take approximately two years and will include a serious study of China's current microfinance sector, study tours abroad to understand how other countries have handled regulating their microfinance sectors, and creating policy prescriptions based on knowledge about these two arenas. This is an important and exciting step, made more so by the fact that it was the PBC that stepped forward to ask for this funding, showing their newly emerging commitment to the microfinance sector. This commitment, this political will, will be crucial in helping to foster a strong microfinance industry.

Some at the UNDP have speculated that what will potentially come from this research is, in fact, legal status for a new type of financial institution. This institution could be licensed as a bank, a new type of non-bank financial institution, or separately as a charitable agency, as has been done in some countries for NGO-MFIs. That decision will feed directly into how interest rates will or will not be capped as well as limitations on deposit-taking. Furthermore, at least one microfinance expert has advocated for the creation of an apex institution, much like Palli-Karma Sahayak Foundation (PKSF) in Bangladesh, supported by, yet autonomous from, the

PBC and the Ministry of Finance that would help in supervision of MFIs, provide technical assistance to help them graduate into financial institutions, and mobilize resources and fundraise for them. It is unlikely that the type of vision needed within government leadership needed to create such an institution exists; moreover, financial sector advisors in international financial institutions caution strongly against this situation in any environment.

The most important thing that needs to happen, however, is a clear legal definition for what microfinance is, who can be doing it, and who supervises those activities. It is possible that this definition will need to bifurcate between RCC microfinance and NGO and donor microfinance because of the poverty alleviation thrust of these MFIs that is absent in RCCs. That should not be the case, however, as many microfinance providers with poverty alleviation thrusts have managed to stand up to rigorous financial standards, and subjecting them to the same standards will allow the exit of non-performing MFIs. This will be the crucial first step in creating an environment that will foster a sustainable microfinance industry.

Chapter 8: Conclusion

This paper explored how a sustainable microfinance industry can be created in China given current state attitudes, and what steps will need to be taken to ensure the growth of strong institutions in the future. This requires several steps, including realizing the Chinese context, understanding the current status of institutions, and realistic recommendations for the policy environment.

First, an understanding of the Chinese context as it pertains to the financial and economic sector, Chinese poverty alleviation strategies, and the relations between donors and programs shows that the microfinance industry is influenced by all of these factors. Emerging market reforms have oriented government poverty alleviation strategies towards individual private enterprise and the allocation of credit. The government has realized the links between **microfinance and poverty alleviation** and endorsed it as an important part of China's poverty reduction strategy. State control of the economy, however, shows a resistance to the overarching trends of **globalization**, as the government continues to control interest rates within the financial sector and keep its hand in directing the economy.

Second, the current status of institutions is a state of transition. The institutions in this survey are donor-funded and the majority are implemented by local government agencies. The project documents stipulated project cycles that are now ending and the major goal of the industry is institutionalization, to build strong programs based in independent institutions that can reach sustainability. Many of these programs are top-down initiatives and so donors have not necessarily recognized **local initiatives** towards development and incorporated those ideas into their development microfinance projects. Therefore, they struggle with creating demand-driven institutions that meet market demand for financial services. In addition, the **elites within government bureaucracies** increase inefficiencies and subvert market specialization of these programs because of their mandate to use government staff in implementation.

The current policy environment for microfinance in China is plagued by the idea that trade-offs exist between **financial self-sufficiency and reaching the poorest**, where policymakers believe that if programs serve poorest clients, they can not charge sustainable interest rates. Interest rate caps are just one of the problems in the regulatory environment.

International experience in microfinance regulations provide a strong framework for analysis and show that policymakers in China needs to create clear definitions for microfinance, institutions, and supervisors before proceeding to instill prudential regulatory frameworks.

Therefore, to foster a strong microfinance sector requires two strategic priorities: institutional will and political will. The first, institutional will, is a commitment among donors and project implementers to make stronger institutions. This means financial innovation to build products that fill market niches and meet client demand. This will require also building staff capacity to handle new innovations, and moving to a system of independently hired staff and strong staff incentive and promotion systems to promote a sense of ownership over the project and a stake in making it successful. The second, political will, requires policymakers to understand the role microfinance will play in strengthening the financial sector, by providing another strong financial window, and in moving forward market reforms in China by promoting private enterprise. This will require re-thinking the regulatory environment, clearly stating the roles of all stakeholders in the sector. Removing interest rate caps and allowing savings mobilization, when capacity exists to supervise, will help the institutions become stronger in their financial bases, thus strengthening the entire country's financial and economic base.

Creating both the institutional will and the political will also requires an acceptance of the role that Chinese state intervention plays in the development of the microfinance industry. International best practice in microfinance points to minimal government intervention as key, yet this situation is not possible in the current Chinese context. There are obvious ways in which this intervention hinders the industry: through repressive regulations and through government implementation of programs where bureaucrats sometimes cause mission creep. Strong political will needs to be fostered, perhaps by the institutions themselves, and more likely through increased international interaction by policymakers on this topic. This will help Chinese policymakers to understand the detrimental role they play in hindering the development of the Chinese microfinance industry. When this is realized, the institutional will to create a sustainable industry will have a realistic environment in which to achieve that goal.

Abbreviations

ABC	Agricultural Bank of China
ADBC	Agricultural Development Bank of China
AIMS	Assessing the Impact of Microenterprise Services
ARDPAS	Association for the Rural Development of Poor Areas in Sichuan
CASS	Chinese Academy of Social Sciences
CC97	Canada-China Women's Income Generating Project
CDF	Community Development Fund
CFPA	China Foundation for Poverty Alleviation
CICETE	China International Center for Economic and Technical Exchanges
CIDA	Canadian International Development Agency
CPO	County Project Office
FPC	Funding the Poor Cooperative
FSS	Financial self-sufficiency
GB	Grameen Bank
HPI	Heifer Project International
IFS	Institutional financial self-sufficiency
IFAD	International Fund for Agricultural Development
LGPR	Leading Group Office for Poverty Reduction
MFI	Microfinance institution
MOFTEC	Ministry of Foreign Trade and Economic Cooperation
OSS	Operational self-sufficiency
PAO	Poverty Alleviation Office
PBC	People's Bank of China
PRC	People's Republic of China
RCC	Rural Credit Cooperative
RDI	Rural Development Institute
REDA	Rural Economic Development Association (Malipo, Yunnan)
RLF	Revolving Loan Fund

SMAP	Sustainable Microfinance to Alleviate Poverty
SOE	State-owned enterprise
TVE	Township and village enterprise
UNDP	United Nations Development Program
UNFPA	United Nations Population Fund
UNICEF	United Nations Children's Fund
USAID	United States Agency for International Development
WF	Women's Federation

Annex 1: Individual Surveys

The following lists all individual interviews conducted during the course of this research, alphabetically by last name of the person interviewed.

Normand Arsenault, Consultant, Emerging Microfinance International. 18-20 June 2002.

Bai Chengyu, Program Director, CICETE. 10 June 2002

Bai Zheng, Microfinance Program Director, China Foundation for Poverty Alleviation. 27 June 2002

Dipal Chandra Barua, General Manager, Grameen Bank. 27 June – 2 July 2002.

Chen Taiyong, Program Director, Heifer Project International China Office. 17 July 2002.

Di Xiaoyin, Assistant Branch Manager, Yixian Branch, FPC. 20 May 2002.

Winona Dorschel, Country Representative, PACT China. 3 June 2002.

Du Xiaoshan, Executive Director, Funding the Poor Cooperative. Various Dates, Summer 2002.

Feng Mingling, Programme Officer, Oxfam Hong Kong. 4 July 2002; 7-8 July 2002.

Gou Changyuan, Branch Manager, Nanzhao, FPC. 4-6 June 2002; 29 June-1 July 2002.

Han Xiaoqiang, Langzhong City Branch Manager, CFPA/ARDPAS. 16 July 2002.

Huang Chaode, Program Officer, Malipo Rural Economic Development Association. 9-11 July 2002.

Huo ?, Manager, Chifeng Women's Sustainable Development Association. 18-20 June 2002.

Brent Johnson, President, China Little Flower. 2 August 2002.

Li Yiqing, Managing Director, Funding the Poor Cooperative. Various Dates, Summer 2002.

Lin Fei, National Programme Officer, UNICEF Office for China. 2 July 2002.

Liu Dongwen, Senior Programme Coordinator, China Foundation for Poverty Alleviation. 27 June 2002.

Liu Sheng'an, Deputy Division Director, Foreign Capital Project Management Center, State Council Leading Group Office of Poverty Alleviation and Development. 27 June 2002.

Liu Wenpu, Professor, CASS-RDI/SMAP Project Director, CICETE. 10 June 2002; 18-20 June 2002.

Valerie Mamara, China Country Representative, Habitat for Humanity International. 3-6 July 2002; 13 July 2002.

Jeff Nankivell, Canadian International Development Agency, 1 June 2002.

Pan Zhufeng, Program Officer, ARDPAS.
16 July 2002.

Pu Jiabu, China Director, Heifer Project
International. 17 July 2002.

Ren Changqing, Director, Microfinance
Training Center. 6 August 2002.

Junko Sasaki, Deputy Resident
Representative, UNFPA China. 24 July
2002.

Shen Chengfu, Secretary General, Malipo
Rural Economic Development Association.
9-11 July 2002.

SMAP Consultative Committee. 17 June
2002.

Jonathan Su, Program Officer, World Vision,
China. 5 July 2002.

Sun Ruomei, Associate Professor, Rural
Development Institute Chinese Academy of
Social Sciences. Various Dates, Summer
2002.

Tian Xuemei, Women's Federation, Chifeng,
Inner Mongolia. 18 June 2002.

Daniel Wang Dexiang, Programme
Specialist, UNDP China. 6 June 2002.

Yu Yu, Programme Officer, UNFPA China.
29 July 2002.

Wang Zhengming, Oxfam Luquan County
Project Officer manager. 7-8 July 2002.

Wang Zhuo, Research Fellow, Sichuan
Poverty Alleviation Office. 17 July 2002.

Andrew Watson, Country Representative,
Ford Foundation Beijing. 12 June 2002.

Yang Shuncheng, Director, ARDPAS. 15
July 2002; 17 July 2002.

Yunnan NGO Forum, Kunming. 5 July
2002.

Zhou Xueren, Branch Manager, Yixian
Branch, FPC. 21 May 2002; 28 June 2002.

Annex 2: Focus Group Discussions

The following is a chronological list of all focus group discussions and interviews held with clients during the course of this research.

20-21 May 2002. Individual interviews with six FPC clients. Yixian County, Hebei Province.

21 May 2002. Focus group discussion with five staff of Yixian County branch of FPC.

5 June 2002. Focus group discussion with five FPC clients. Nanzhao County, Henan Province.

5 June 2002. Focus group discussion with seven FPC staff in Nanzhao County, Henan Province.

6 June 2002. Focus group discussion with twelve FPC clients. Nanzhao County, Henan Province.

19-20 June 2002. Focus group discussion with six UNDP/CICETE staff in Sanliba Township, Chifeng City, Inner Mongolia.

19 June 2002. Focus group discussion with six UNDP/CICETE clients. Sanliba Township, Chifeng City, Inner Mongolia.

20 June 2002. Focus group discussion with five UNDP/CICETE clients. Sanliba Township, Chifeng City, Inner Mongolia.

10 July 2002. Individual interview with one Malipo REDA client. Yangwan Township, Malipo County, Yunnan Province.

16 July 2002. Focus group discussion with five CFPA/ARDPAS clients. Langzhong City, Sichuan Province.

16 July 2002. Focus group discussion with four CFPA/ARDPAS staff. Langzhong City, Sichuan Province.

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