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## Modalities for Microfinance Delivery in Asia and Latin America: Lessons for the People's Republic of China

By Heather Montgomery, Asian Development Bank Institute  
John Weiss, Asian Development Bank Institute

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# **Modalities of Microfinance Delivery in Asia and Latin America: Lessons for the People's Republic of China**

**Heather Montgomery and John Weiss**

## **I. Introduction**

Microfinance – the provision of small size loans and other financial services to low income households – is often seen as the key innovation of the last 25 years in terms of means of reaching out to the poor and vulnerable. There is extensive experience in microfinance provision in both Asia and Latin America, but as yet relatively little use of the approach in the People's Republic of China (henceforth PRC).

This paper first assesses different approaches to microfinance delivery using a simple threefold distinction to generalize across recent Asian and Latin American experience. It then considers the merits of these alternatives in the context of a theoretical discussion of the role of microfinance in poverty reduction. Another section addresses the current relatively undeveloped microfinance sector in PRC and a final section asks what might be learnt from experiences elsewhere.

## **II. Modalities of Microfinance Delivery**

### **A) The Credit Union Approach**

One of the oldest modalities of microfinance delivery is the credit union, or financial cooperative. In the informal sector, ROSCAs (Rotating Savings and Credit Associations) have always been an important way for poor households to fill the gap left by formal financial institutions. Credit unions are probably best characterized as “semi-formal”: unlike informal ROSCAs, they are registered entities subject to commercial law, but are not usually regulated or supervised under banking law, although in some countries specific regulations for credit unions are being developed. These institutions are member owned and provide financial services - usually savings and loan services, in some cases insurance - to members. They are non-profit institutions and there are no external shareholders. Traditionally, membership in a credit union was the result of some common bond among the members: employment or membership in the same community. Closed bond credit unions are usually organized at the workplace and membership is open only to employees. Open bond credit unions operate in a given community and membership is open to any member of the community.

Where available, financial cooperatives often choose to become affiliated with a national apex institution which will provide training and technical assistance and channel resources from external donors to the national financial cooperative system. These national institutions may in turn affiliate with one of the international credit union apex agencies. The World Council of Credit Unions (WOCCU) – the largest of these international credit union apex agency – reports that there are now 40,421 credit

unions<sup>1</sup>, enabling 123 million members in 84 countries to gain access to affordable financial services.

#### B) The NGO Approach

To many outside the microfinance sector its natural delivery mechanism might be expected to be a non-profit making non-governmental organization (NGO). This modality was the basis of what has come to be called “the microcredit revolution” in both Asia and Latin America and the pioneering institutions in both regions were NGOs. For example, the Grameen Bank in Bangladesh, which founded many of the fundamental concepts we associate with microcredit such as small loans to groups of female micro-entrepreneurs and Prodem, the successful Bolivian microfinance institution that later became the first microfinance NGO to transform into a commercial bank, both started as NGOs.

The breadth of outreach of NGOs varies greatly between countries. In South Asia, NGOs have much greater outreach in Bangladesh, for example, than in India or Pakistan. In Latin America outreach is far greater in the smaller economies of Bolivia and Central America than in the larger economies of Brazil, Mexico and Argentina.

Limits on the NGO modality are mostly regulatory. NGOs cannot access domestic or international capital markets. In most countries, NGOs cannot legally offer savings services and thus cannot mobilize deposits, using client deposits as a way to finance other parts of the organizations operations such as lending. Both of these restrictions in effect limit the scale of most NGO operations. In countries where microfinance NGOs have achieved significant scale, regulators have either come up with a regulatory framework suitable for microfinance institutions separate from banks (Bolivia), or have allowed the sector to flourish unregulated (Bangladesh), what some in the industry have referred to as “benign neglect”.

#### C) The Banking Approach

The most recent entrants to the microfinance industry are commercial banks. This modality includes many variants: transformed microfinance NGOs, government owned development banks, reformed state banks and diversification into microfinance by existing commercial banks. The Khushhali Bank in Pakistan is an unusual example of a newly-established retail commercial bank specialized in microfinance

The transformation of NGOs into commercial banks is still a relatively new phenomenon, but so far they seem to be performing well in terms of profits and have been able to expand the scale of their operations significantly (Fernando (2004)). In comparison, state banks have generally underperformed. In the heyday of directed credit in the 1970s, subsidized loans often went to politically-favored wealthy-landowners rather than poor farmers. Despite this repayment rates were low and many programs operated at a loss. However, many state owned banks have extensive branch networks, enabling them to achieve significant outreach. There are an increasing number of examples of commercial banks diversifying into microfinance, either directly or through partnerships with financial NGOs. Even big multinational banks such as ABN Amro, Citibank and Deutsche Bank are now involved in microfinance.

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<sup>1</sup> As of 2002, WOCCU reports 2287 credit unions operating in Latin America and the Caribbean and 16, 586 in Asia.

The examples above of incorporation of microfinance into the formal financial system is paradoxical given that the initial motive of microfinance was to serve poor borrowers who could not have access to formal finance. In some cases, such as in Nepal or India, sector lending requirements may be the impetus behind diversification of large commercial banks into microfinance. But ICICI Bank in India, for example, has expanded its involvement in microfinance beyond the minimum requirement and very little of their involvement in the microfinance sector now counts toward meeting the regulatory requirements. In these cases or others where such requirements do not exist, the motive seems to be profits and diversification of business lines. In Latin America in particular there is a growing market for relatively small loans and in a number of countries the larger MFIs have been generating considerably higher returns than have commercial banks. In contrast, smaller MFIs (principally NGOs) in the region show negative returns (Ramirez (2004)).

#### D) Comparison of the Three Approaches

The distinction between three approaches - NGO, credit union and commercial banking - is becoming blurred as credit unions and NGOs themselves take a more commercial approach to microfinance (see Charitonenko, Campion and Fernando 2004 and Drake and Rhyne 2002). For example, in the late 1980s, WOCCU embarked on a new strategy to renovate and strengthen credit unions using a commercially oriented approach, that has been particularly well-received in Latin America (Lennon and Richardson (2002) and Westley and Branch 2000). The more commercial approach among NGOs is exemplified by the small number of NGOs that have transformed into microfinance banks or regulated non-bank financial institutions. Transformation is still far from a dominant trend in the sector, but many microfinance NGOs borrow funds from APEX institutions at market rates, requiring a more commercial approach to their overall operations. It should be noted that from an early stage in the evolution of the sector MFIs in Latin America have had a greater focus on commercial returns and financial sustainability than have their counterparts in Asia. This can be seen in the emphasis placed on loans to microenterprises rather than to individual households. However in the aggregate microfinance NGOs and credit unions do not cover costs.<sup>2</sup>

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<sup>2</sup> This can be seen in the fact that the average return on assets for MFIs and credit unions in the late 1990's was negative (at -4.5%); more recent figures suggest a close to breakeven position; see Ramirez (2004).

Table 1: Modalities of Microfinance

	<b>NGO</b>	<b>Credit Union</b>	<b>Commercial bank</b>
<b>Target Clients</b>	The poor, especially disadvantaged groups	Members	All small clients, particularly microenterprises and traders
<b>Primary Source of Funds</b>	Donors	Members	Depositors, Investors
<b>Strengths</b>	Deep outreach (strong poverty focus), Credit combined with training and support	Participatory, Access to remote rural areas	Savings mobilization, Access to commercial funds, Regulation to ensure prudential operations
<b>Weaknesses</b>	Limited sources of funds for expansion, Governance issues, Management standards	Governance issues, Managements standards, Outreach limited to members	Mission drift and exclusion of poor, Constraint on expansion due to prudential requirements.

Despite this apparent convergence to a commercial approach to the provision of micro-financial services, one can still draw broad distinctions between these three approaches as summarized in Table 1.

Essentially one must trade-off the advantages of expansion through commercial banks - principally access to finance and prudential regulation- against the poverty focus that can be obtained through NGOs and credit unions operating in poor areas. These need not of course be wholly mutually exclusive. One modality sees microfinance as part of the formal financial sector, with the key difference from other financial activities only being the size of transactions. The other two see microfinance as part of the aid delivery and poverty targeting system, which need not be financially self-sustainable. To clarify the options for PRC it may be useful to explore further how microfinance fits into theorizing on poverty.

### III. Microfinance and Poverty

In terms of understanding poverty a simple distinction can be drawn within the group 'the poor' between the long-term or 'chronic poor' and those who temporarily fall into poverty as a result of adverse shocks, the 'transitory poor'. Within the chronic poor one can further distinguish between those who are either so physically or socially disadvantaged that without welfare support they will always remain in poverty (the 'destitute') and the larger group who are poor because of their lack of assets and opportunities. Furthermore within the non-destitute category one may distinguish by the depth of poverty (that is how far households are below the poverty line) with those significantly below it representing the 'core poor', sometimes categorized by the irregularity of their income. In some Latin American cases for example the core poor or destitute are taken to be those below 50% of the poverty line (although Latin American poverty lines are generally higher than in Asia)

In principle, microfinance can relate to the chronic (non-destitute) poor and to the transitory poor in different ways. The condition of poverty has been interpreted conventionally as one of lack of access by poor households to the assets necessary for a higher standard of income or welfare, whether assets are thought of as human (access to education), natural (access to land), physical (access to infrastructure), social (access to networks of obligations) or financial (access to credit) (World Bank 2000:34). Lack of access to credit is readily understandable in terms of the absence of collateral that the poor can offer conventional financial institutions, in addition to the various complexities and high costs involved in dealing with large numbers of small, often illiterate, borrowers. The poor have thus to rely on loans from either moneylenders at high interest rates or friends and family, whose supply of funds will be limited. NGO MFIs initially attempted to overcome these barriers through innovative measures such as group lending and regular savings schemes, as well as the establishment of close links between poor clients and staff of the institutions concerned. As we have seen in more recent years a more strictly commercial approach has been applied in some MFIs and countries.

The case for microfinance as a mechanism for poverty reduction is simple. If access to credit can be improved, it is argued, the poor can finance productive activities that will allow income growth, provided there are no other binding constraints. This is a route out of poverty for the non-destitute chronic poor. For the transitory poor, who are vulnerable to fluctuations in income that bring them close to or below the poverty line, microfinance provides the possibility of credit at times of need and in some schemes the opportunity of regular savings by a household itself that can be drawn on. The avoidance of sharp declines in family expenditures by drawing on such credit or savings allows 'consumption smoothing.'

It is one of the most interesting generalizations to emerge from the micro finance and poverty literature that the poorest of the chronic poor (the core poor) will borrow essentially for protectional purposes given both the low and irregular nature of their income. This group, it is suggested, will be too risk averse to borrow for promotional measures (that is for investment in the future) and will therefore be only a very limited beneficiary of microfinance schemes (Hulme and Mosley 1996: 132).<sup>3</sup> The view that it is

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<sup>3</sup> The sector has responded in a number of cases by establishing special programs for the core or 'ultra poor'. The best known of these are in Bangladesh and involve the well-established institutions of BRAC and ASA. The programs essentially aim to provide a range of services, covering training, health provision and

the less badly-off poor who benefit principally from microfinance has become highly influential and, for example, was repeated in the World Development Report on poverty (World Bank 2000:75).

The poorest of the poor may be missed by microfinance for many of the reasons that the poor as a whole are excluded from the formal financial sector: higher transaction costs and default rates usually result in higher interest rates than the formal financial sector, and in the absence of collateral lenders may ration credit even at these higher rates. If the investment projects undertaken by the poorest of the poor have lower marginal returns, perhaps because this group suffers from a lack of other capital inputs, they will not be able to bear these higher rates of interest anyway. And even if relatively high return projects are available to them, the poorest of the poor may not be willing to undertake such projects if they incur greater risks.

This risk-return tradeoff is illustrated diagrammatically in figure 1.<sup>4</sup> Line M represents the minimum position of borrowers, in that for a given level of risk they will not choose to use MFIs if returns are below those shown in line M. This assumption of a minimum position for borrowers implicitly assumes there is either some sanction for default (loss of collateral or the opportunity to avail themselves of microfinance services in the future) or loss of the borrowers own income as a result of investment failure. Line E is a hypothesized maximum position for investment projects. Assuming that very high returns can only be achieved with very large loans, this line sets the limit on available returns to borrowers for a given level of risk. Lines M and E set the boundaries for MFI activity from the point of view of borrowers. Line X gives the minimum position of MFIs; that is it gives the minimum interest rate the MFI will charge for a given level of risk. Rate  $r$  therefore represents a risk-free charge that covers operational costs, whilst rates above  $r$  add a rising risk premium. The riskier the project, the higher the MFI's rate of interest will be above this risk-free rate.

Poor borrowers are shown as clustered in three different zones (A, B and C), with different preferences for combinations of risk and return. The very poor are clustered in zone A. Because of their vulnerability, they will be willing to borrow only small amounts, engaging in relatively low-risk projects yielding relatively low returns. Thus much of their borrowing will be for 'protective' purposes'. The 'better-off poor' who are willing to take on a higher level of risk and for example borrow for working capital purposes, will be clustered in zone B we have. Finally, in zone C there are those micro-entrepreneurs who can look for higher yield, higher risk activities and borrow for simple asset accumulation in the form of equipment or premises. Such 'near poor' households with relatively high return projects requiring larger loans may graduate out of microfinance and turn to the formal financial sector for credit if they have built up a reputation for being credit-worthy. Or, if their high return investments fail, they may move back to zone B.

Line X, the minimum position for the MFIs, adds a screening device, since only borrowers with expected returns above the market interest rate charged by the MFI will take out loans at that rate of interest. In figure 1, only borrowers in the shaded parts of

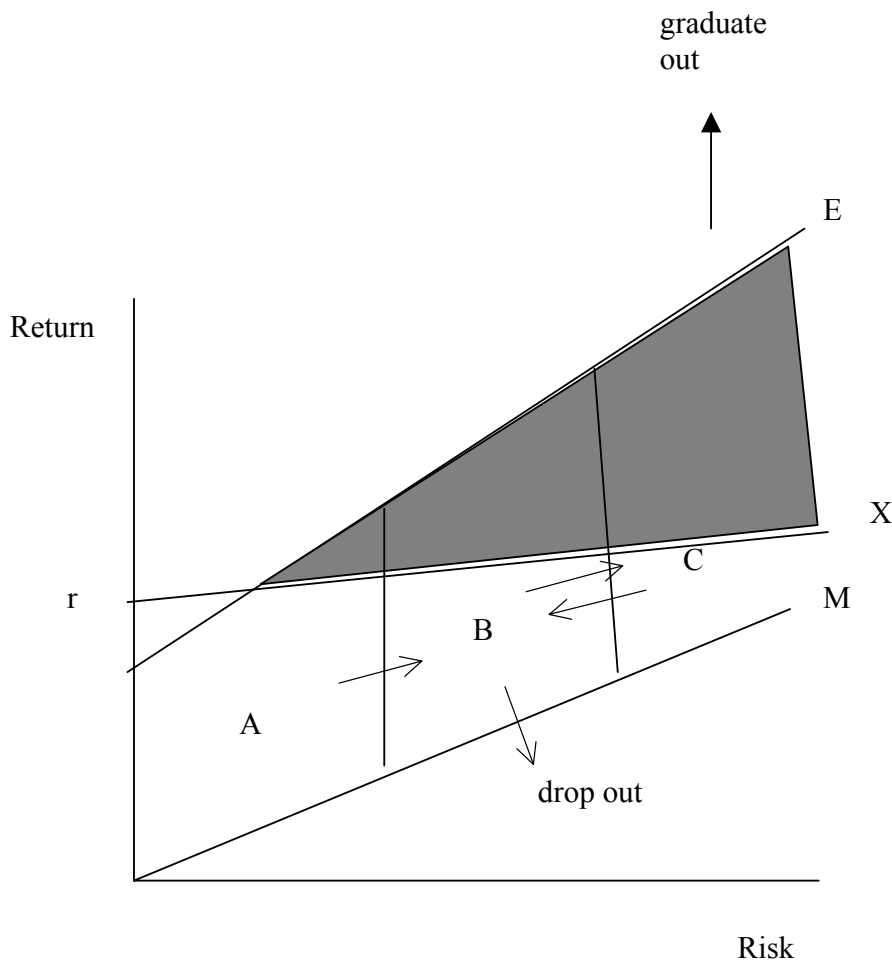
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more general social development for the disadvantaged, as well as grants of assets or credits. The ultra poor are encouraged to build up a savings fund and to graduate to conventional microfinance programs. Other variants of this approach involve greater flexibility in repayment terms for the poorest (Fernando 2003).

<sup>4</sup> This is adapted from Mosley (2001).

zones A, B and C will be willing to participate in the lending program. Most of the poorest group in zone A will be excluded: at their preferred level of risk, they do not have investment opportunities available to them giving high enough returns to cover the cost of borrowing from the MFI. Should interest rates for MFIs be subsidized so the new line X start below  $r$  on the vertical axis, less of each group of borrowers will be excluded, although there will be concerns about long-run funding prospects for the MFIs concerned and about how efficiently poor borrowers will use the funds. For poor borrowers in the shaded areas a commercial approach to microfinance will work, whilst for the majority of those in zone A it will not. For this group, if credit is to be provided it should be as part of a targeted poverty reduction program, not part of the formal financial sector. The empirical issue is the slope of these lines and the size of the different groups included and excluded by a market-driven system. Stylized facts on the impact of microfinance in Latin America suggest a majority of most beneficiaries have been in zone C, whilst in Asia relatively more have been in zone B. Those in zone A are by far the most difficult to reach in both regions (Weiss and Montgomery 2004).

Figure 1. Returns and Risk with Microfinance



#### **IV. Microfinance in the People's Republic of China (PRC)**

Rural households in PRC must rely on the informal sector - loans from family, friends and various curb market institutions<sup>5</sup> – for roughly two-thirds of their financing needs (Cui Xin 2004). Such sources are of course limited and problems with informal sector financing in PRC have been publicized in the international press (The Economist 2004), although Tsai (2004) argues that such abuses are the exception. Formal financing for rural PRC is available principally through the Agricultural Bank of China (ABC), the Agricultural Development Bank of China (ADBC), and the Rural Credit Co-operatives (RCCs).

The ABC used to be the biggest source of rural finance in PRC, but its involvement in rural areas is diminishing. The ABC was originally a state-owned bank, its role being to disburse poverty reduction funds in poor counties. In 1994 the ADBC was established and took over the role of the ABC in funneling policy loans aimed at promoting agricultural development and poverty alleviation. The main role of the ADBC is now to provide financing to state-owned food enterprises operating in PRC and the ABC has been transformed into a commercial bank, focusing on state-owned and private enterprises and large township-level agricultural enterprises (World Bank 1999, Zhu, Jiang and Von Bruan 2002). Despite its name, privatization prompted the ABC to significantly shift its focus, and now agricultural loans comprise only about 10% of its total loan portfolio (Han 2003).

These changes have left the Rural Credit Co-operatives (RCCs) as the most important source of formal credit in PRC. Despite their name with its reference to credit co-operatives, in the past these functioned as part of the state-banking sector and were run by the ABC. Since 1996 they operate directly under the central bank. Currently there are over 40,000 rural credit cooperatives operating throughout the PRC. Although outstanding loans of the RCCs account for only 11% of the total financial system, they provide more than 80% of all rural finance (Han 2003).

Microfinance, however, remains relatively undeveloped in PRC. There are some specialized microfinance programs operating in PRC. The government finances programs in at least 9 provinces (Park and Ren 2000). There are also several non-governmental organizations (NGOs) or collaborative programs between the government and NGOs that provide microfinance. Cui Xin (2004) estimates that around 300 such programs are operating. Most of these programs follow the original Grameen Bank lending methodology: many of the clients are women, and although loans are given to individuals, if any clients from a given group default, all group members are barred from future borrowing (Armendariz de Aghion and Morduch 2000). These NGO programs, at least, report good results: repayment rates of most programs are reported to be over 90% (Chinabrief 1999), they are successfully reaching the poor and there is evidence that these programs are having an impact where they operate (Park and Ren 2001). Park and Ren (2001) also report that some of the most supported NGOs are achieving impressive operational self-sufficiency ratios.

At present, the PRCs extensive network of Rural Credit Co-operatives provide the main window for central bank microcredits which are channeled through RCCs to farm households. As commercial banks began withdrawing from rural areas in the late

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<sup>5</sup> Tsai (2004) discuss informal channels of financing in the PRC such as moneylenders and pawnshops.

1990s, policy makers in the PRC began to think about ways to use the existing infrastructure of the RCCs to provide microfinance to the rural poor. 11 counties in Jiangsu Province were chosen to participate in an experiment using reformed RCCs as apex institutions to channel funds for microfinance. In 2001, the People's Bank initiated the project, converting 3 RCCs in the province into rural commercial banks and 82 into microfinance apex institutions.

Under the reforms, RCCs in the Jiangsu province were merged at the township level into one county-level profit center and a province-wide RCC federation was established. In selected counties with high levels of rural and urban integration, the merged county-level credit unions were converted into rural commercial banks. In other counties the newly merged county centers operate as apex institutions, and the State Bank plans to provide funds for on-lending for 5 years. In the second half of 2003 the program expanded to 7 other areas: the Zhejiang<sup>6</sup>, Shandong, Jiangxi, Guizhou, Jilin, Shanxi provinces and Chongqing Municipality, and the majority of PRCs RCCs now offer microfinance services (32,000, or more than 80% of the total number of RCCs operating in the country). The objectives of the reforms were to improve corporate governance and management of the RCCs and make them financially viable. With this goal in mind the state bank aims to relinquish management of the merged county rural credit unions, focusing on its role as supervisor. As part of the reform process, over 10,000 RCC have been closed or merged and the number of permanent staff has been reduced by 10,000<sup>7</sup>.

The microfinance program operated by the RCCs is the largest in the PRC and the only nationwide program. However, coverage remains well below potential demand and in some parts of the country only a small proportion of households are reached.

## **V. Challenges for PRC in Developing a Microfinance Sector**

Building on current institutions, there seem to be three possible paths for the development of a formal microfinance sector in PRC with significant breadth of outreach: (i) the establishment of a special microfinance unit within the ABC or ADBC (ii) a significant expansion in the outreach of NGO microfinance programs (iii) further deregulation of the RCC system.

The establishment of a special microfinance unit within the ABC or ADBC, or "downscaling" of commercial banking as we have seen in other countries, seems an unlikely path for the PRC. The mandate of the ABC and ADBC has never been to provide microcredit, nor to particularly target poor households, so neither bank has a developed expertise in microfinance. Both banks are withdrawing from rural areas, focusing on enterprises in towns and cities. The ABC also suffers from a high rate of non-performing loans – the highest of any of the four major state-owned commercial banks (Han 2003). Recent estimates put the ratio of non-performing loans at 60% of the overall loan portfolio in 2003 (Cui Xin 2004). Poor management and services supplied by the ABC in rural areas, plus a view amongst borrowers that government funds should be

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<sup>6</sup> In March 2003, Ningpo Jinshou Rural Cooperative Bank, the first share-holding cooperative bank of its kind in PRC, was established in Shejiang Province.

<sup>7</sup> 30,000 temporary staff have also left.

treated as grants are said to have created this problem. Neither bank seems a good candidate for establishing a special microfinance unit.

Although established microfinance programs run by NGOs in PRC are performing well by various indicators, currently, these programs reach only a small share of the rural poor in PRC<sup>8</sup>. Most NGOs operating in PRC were formed as part of donor-supported projects and despite the non-governmental label, many have an ambiguous ownership status with close involvement of local government units. As a result, their activities are limited. As officially un-regulated organization, they cannot accept deposits and so are limited in the type of financial services they can offer clients and in their sources of funds. Officially, many of these programs are able to set their own terms on loans, but in fact interest rates rarely rise above 20% per annum (Du Xiaoshan 2003), which may make significant expansion or even operational or financial self-sufficiency at the current scale impractical for most programs. Currently, there is not special regulatory status in PRC for microfinance institutions, and the requirements for NGOs to transform into rural banks are a long way off.

In our view, recent developments in reforming the Rural Credit Cooperatives hold the most promise for developing a significant formal microfinance sector in the PRC. The RCC network already has an impressive infrastructure in place in rural areas throughout the country, and these rural branches provide an effective way for poor rural households to save. The current system has its limitations. Most microfinance programs only offer traditional Grameen style group lending. At present the maximum size is RMB 5000 (approximately \$600) and loans are offered for a 1 year term. Expansion under this style of lending methodology is usually slow, and the inflexible loan products may not match well with demand. However, the most serious limitation on expansion is the interest rate ceilings in force. RCCs cannot set rates at more than double the base lending rate and for direct loans to households rates can be no more than 20% above the base rate. These restrictions prevent most of the programs for covering operating costs, even at the subsidized rate at which funds are on-lent from the peoples bank. Another discouraging statistic is that although the non-performing loans of RCCs have been reduced under the reform program, they remain a problem at around 35% of loans outstanding.

Despite the challenges, further reform of the RCCs, building upon their existing infrastructure in rural areas and experience in rural financing, seems the most realistic path for significant breadth of outreach in PRC.

## **VI. Conclusions**

Any suggested path for the development of the microfinance industry in PRC must recognize that the PRC is a highly regulated, state-dominated environment and that any microfinance initiatives will likely be subject to heavy government intervention.

With this in mind, although existing microfinance NGOs have performed well by a variety of standards, we feel this modality unlikely to flourish under “benign neglect” in the PRC as it has in Bangladesh. Unless a special regulatory framework for MFIs is established,

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<sup>8</sup> Park and Ren (2000) point out that some of the programs are large in absolute terms in comparison to programs in other countries. The largest program in southern Shaanxi Province, reached over 50,000 households in its first year.

most microfinance NGOs are still a long way from meeting the requirements to become a rural bank and thus will be handicapped in efforts to achieve significant numbers of clients and provide a range of financial services.

Development of the credit union approach faces similar constraints. In some areas rotating savings and credit associations (ROSCAs, or *hui*) have been banned. Although they remain unregulated and quite active in most areas, this modality of microfinance delivery also seems unlikely to achieve significant outreach unless officially sanctioned by the government.

Continued reform of the PRCs rural credit cooperatives (RCCs) seems the most promising modality for achieving significant breadth of outreach in PRC. The RCCs are not credit unions or true cooperatives and offer many of the advantages of the banking approach. The RCCs are already under prudential regulation which has been tightened in recent years. The RCCs already have an extensive network of rural branches and have already achieved significant success in mobilizing savings in rural areas. The RCCs ability to offer savings along with credit and other financial services and their location in areas convenient to where the PRCs rural poor live and work, provide the potential for significant outreach.

Policy makers in the PRC might look to the impressive performance of the Bank Rakyat Indonesia's (BRI's) *Unit Desa*, which, taking advantage of strengths similar to that of the RCCs, were successfully reformed from a loss-making conduit for subsidized credit into one of the largest and most efficient MFIs in the world. However, in recommending that approach, we caution that this policy prescription may still miss the poorest of the poor. NGOs in PRC, although lacking impressive breadth of outreach, are reported to perform better in depth of outreach, that is they reach a poorer segment of the population than the RCCs (Jackelen and Xianfeng 1997). Part of BRI's success may rest on the fact that it does not target this group of the poorest of the poor. This group may be better served by the NGO modality or government supported poverty targeting programs.

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