Research briefing

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Government policies and microfinance growth

Institutional Influences on the Development of Microfinance in Emerging Economies: Insights from China

By Alex Newman, Daniel Borgia and Wu Wei

Efforts to alleviate poverty in rural China are being undermined by measures that are stunting the growth of the country's microfinance industry, according to new research by GEP.

Excessive government interference and the authorities' refusal to grant money-lending NGOs legal status are among the root causes of the problem.

Despite a third of all citizens in the world's most populous country still lacking access to formal financial services, regulations imposed by the government – including interest-rate caps and credit restrictions – remain more stringent than those in other emerging economies.

As a result, says the study, microcredit NGOs acting in the public interest to stimulate entrepreneurship in remote rural areas are struggling to expand.

The authors argue that regulations need to be modified to create a more robust and competitive microfinance industry to better serve China's rural poor.

Research basis

Researchers conducted 30 in-depth interviews with senior executives and loan officers at seven microfinance organisations operating in rural China between May and August this year. They also shadowed loan officers in the field and analysed company documents.

The microfinance providers studied were either village and township banks (VTBs), which can accept deposits and provide loans worth between 5,000 and 500,000 yuan ($783 to $78,340) or more traditional "public interest" microcredit companies (MCCs).

MCCs tend to be run by NGOs or local governments and have an average loan size of around 5,000 yuan. Since they are not registered as financial institutions, they are prohibited from accepting deposits.

Because of the low interest-rate cap imposed by the central government, many VTBs are reluctant to provide small and micro loans to borrowers with little or no credit record. They are permitted to charge only twice the Central Bank's interest rate, which makes it difficult to recoup the substantial transaction costs incurred through approving, monitoring and collecting loans.

Comments and implications

The absence of legal and regulatory support mechanisms for microfinance providers, coupled with significant government intervention, has cemented a reliance on borrowing from family and immediate social networks in rural China, says the study.

According to co-author Dr Alex Newman, the situation is inhibiting the development of the Chinese microfinance sector.

Key findings

- Efforts to alleviate poverty in rural China are being hampered by measures that are stunting the growth of the country's microfinance industry.
- Excessive government interference and the authorities' refusal to grant money-lending NGOs legal status are among the major causes of the situation.
- Regulations imposed by the Chinese government – including interest-rate caps, credit restrictions and rules regarding geographical areas of operation – remain more stringent than those in other emerging economies.
- Such regulations need to be modified to create a more robust and competitive microfinance industry to better serve China's rural poor.
- Government officials and policymakers can also help microfinance providers to connect to the informal social and professional networks that already exist.

He said: “The government failure to properly regulate ‘public interest’ MCCs has led to a ‘commercial logic’ dominating the Chinese microfinance industry.

“As a result the majority of microfinance providers are targeting loans to support the growth of small and medium-sized enterprises rather than microfinance initiatives aimed at alleviating poverty among the rural poor, as original microfinance practitioners envisaged.”

The research found credit-tightening policies introduced by the People’s Bank of China (PBOC) to tackle inflation are preventing some VTBs from meeting client demand.

One of the organisations that took part in the interviews revealed it planned to lend over 200 million yuan in 2011 but found itself restricted to 50 million yuan.

Another VTB told how a PBOC regulation published in May 2011 stated the credit it provided to clients should be less than double the amount of registered capital. This VTB used up its entire quota of credit by the end of March, leaving it at risk of breaking contracts with clients.

Government-imposed geographical operating restrictions also prevent VTBs and MCCs from setting up sub-branches outside the district in which they are formally registered unless they undergo the costly and time-consuming process of applying for a separate licence.

In addition, the growth of MCCs is being hampered by a law that prevents them from collecting deposits from savers, the study said.

The research also found that Chinese MCCs generally have irregular access to capital and insufficient cash flow to cover financing and operating expenses, meaning they must identify and solicit alternative sources of funding – primarily from individual and corporate donations.

Much of these donations comes from outside China, but MCCs also face difficulties in transferring funds from overseas because of regulations on foreign exchange transactions.

They are required to apply for an exchange certificate from the State Administration of Foreign Exchange (SAFE), and there are limits on the value of funds that can be transferred.

One MCC’s SAFE certificate took six months to obtain – only for the organisation to find it could exchange no more than $5,000.

The study argues that the prevalence of informal financing mechanisms – such as borrowing from family members or social networks – poses a “significant challenge” to the development of an efficient formal microfinance system in China.

Dr Newman said: “Policymakers should consider removing the interest rate imposed on VTBs, along with credit and geographical operating restrictions, while at the same time keeping the restrictions in place on urban financial institutions that the policy was arguably designed to affect.

“They should also consider providing legal status to MCCs in addition to permitting them to accept deposits, making charitable donations tax-deductible and removing foreign exchange transaction hurdles and limitations.

“Government officials and policymakers can also help microfinance providers to connect to the informal social and professional networks that already exist. This is particularly true for ‘public interest’ MCCs, which are unable to operate without the close cooperation of local government officials.”

Globalisation and Economic Policy Centre (GEP)

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