

## Nurturing Microfinance in a Challenging Environment: The Ford Foundation In China

by Ann Duval, with Ruth Goodwin-Groen

*This case study describes how the Ford Foundation supported the emergence of microfinance in China by funding research, conferences, training, and an experimental Grameen project, run by an academic team, that developed into a large microfinance program.*

### Overview

The potential of microfinance to alleviate poverty is gradually being recognized in China. In the context of a tightly regulated financial industry with high barriers to entry, the Ford Foundation has supported microfinance development through a wide range of local capacity-building activities. These initiatives include research and conferences on poverty, microfinance, and rural financial reform, as well training tours and an action-research project led by Chinese scholars. Ford's support of these activities has contributed to greater experimentation with microfinance in China, where a long history of massive subsidized rural finance programs makes the environment especially challenging. Today, Chinese specialists on poverty and policy makers are expanding the policy dialogue on microfinance.

Among the local initiatives supported by Ford is an experimental microfinance project led by a group of scholars at the Rural Development Institute (RDI) of the Chinese Academy of Social Sciences. In 1994, the scholars began a modest action-research initiative based on the methodology developed by Grameen Bank (Bangladesh). Funded by the Grameen Trust (\$50,000 soft loan) and the Ford Foundation (\$50,000 grant), Funding the Poor Cooperative (FPC) has since grown into a large microfinance program. As of August 2003, it had approximately 15,300 clients. FPC continues to experiment with adapting microfinance models to the Chinese context, providing valuable lessons, and disseminating information on good microfinance practice to a growing Chinese audience of interested policy makers, researchers, and practitioners.

### Setting the stage

The People's Republic of China initiated sweeping economic reforms in 1978. These reforms led to rapid

economic development: more than 30 million private businesses were created over the next two decades, bringing unprecedented prosperity to many Chinese citizens. However, close to 100 million people in rural China still live in poverty.

As part of its liberalization effort, the government restructured existing official financial institutions, created new ones, and allowed unofficial financial institutions to operate. In repeated attempts to ensure a sound financial sector, the government alternated between relaxing and tightening financial controls throughout the 1980s and early 1990s. By 1993, however, the financial system found itself in crisis.

A number of unofficial financial institutions had failed outright, causing many people to lose their savings. Politically motivated lending by state-owned banks (which dominate the banking sector) had dire results: close to 25 percent of outstanding loans were non-performing and loan-loss reserves proved to be inadequate. The government responded by introducing new, stricter reforms to restore health and fiscal control to the financial sector. The new measures included restricting small industry financing, closing unsanctioned financial institutions, and establishing artificially low interest rate ceilings in an attempt to curb inflation.

*We must severely attack all actions in the financial arena that are illegal or in violation of regulations. We must guarantee that financial laws, regulations, and rules are implemented thoroughly. We must emphasize the prohibitions against banks using high interest rates to monopolize deposits, illegal fund-raising in society, and haphazard financial activities.*

Renmin ribao (People's Daily), February 1999, as quoted in *Back-Alley Banking* (2002) by Kellee S. Tsai

Concurrently, the government continued to subsidize loans in the effort to alleviate poverty. During the 1980s and early 1990s, the Ford Foundation in China concentrated on capacity building and poverty research. Several Ford research grants were extended to Professor Du Xiaoshan and his colleagues at RDI. In addition to studying rural poverty in China, RDI scholars studied microfinance. In particular, they followed the progress of the Grameen Bank in Bangladesh. By 1992, Professor Du and his team wanted to move beyond research and test whether the Grameen model would work as a poverty alleviation tool in China. Their idea for a test project, however, coincided with the financial crisis and subsequent tighter government controls.

### Meeting the Challenge: Funding the Poor Cooperative

**Start Up.** Rather than seek permission to create a microfinance institution, Professor Du and his colleagues sought and received informal government approval in 1994 to test the Grameen model as an action-research experiment—the Funding the Poor Cooperative.

**Learning through Trial and Error.** FPC chose to conduct its experiment in three of the country's poorest counties. (The photo shows a typical client.) Although the RDI scholars had studied the Grameen methodology, they found putting it into practice to be more difficult than theory. As the research experiment grew, like many MFIs, it experienced ups and downs, including occasional instances of corruption and financial mismanagement. Yet, the project leaders worked diligently to continuously improve FPC's financial performance and promote its institutional development.

*It was the first time we had done a real project. Practice is so much more difficult than theory. The Grameen model is very easy to understand, but very difficult to make real.*

Du Xiaoshan, Economist, Rural Development Institute, and FPC Founder

*We didn't really understand what microcredit was. We thought it was just handing out loans and getting the money back.*

Sun Ruomei, Economist, Rural Development Institute, and FPC Co-founder

Despite occasionally uneven performance, FPC's three branches continue to demonstrate that rigorously implemented microfinance works in China. In September

2003, one branch had an arrears rate<sup>1</sup> of 0.08 percent. The second branch had an arrears rate of 11.95 percent and needed to strengthen its management, while the third was struggling to survive. Although not uniformly successful, the experience of the three branches has identified valuable lessons for creating a sustainable microfinance sector in China.

The founders of FPC have recognized that stronger management is needed to ensure the program's long-term success. Accordingly, they have hired professional staff in Beijing in an effort to standardize management across the branches.



An FPC client in Hebei Province, August 2001.  
(Photo: Kellee Tsai.)

**Creative Solutions to Contextual Challenges.** FPC overcame two major stumbling blocks—institutional and financial—to initiate microlending operations. Unable to register as a financial institution, the experiment developed an unusual structure. FPC “headquarters” is a research center within a research institute (RDI), comprised of the scholars who founded and continue to guide FPC. Each of its three “branches,” however, is registered as a separate association with the Bureau of Civil Affairs at the county level. Although the branches are legally independent of headquarters—the project is essentially four organizations, not one—they are operationally and financially dependent on the central office.

The interest rate ceiling was another hurdle FPC had to overcome. FPC sought and received permission to charge higher interest rates on the basis that all its loan capital comes from foreign sources. While these creative solutions to institutional and financial obstacles allowed

<sup>1</sup> FPC's arrears rate: total portfolio in arrears plus loans rescheduled, divided by total loans outstanding. FPC does not calculate portfolio at risk.

FPC to proceed and gain practical experience as a microlender, they also constrain its long-term sustainability.

### Raising Awareness of Microfinance in China

As FPC evolved, other donors and international organizations (including the United Nations Development Programme, the United Nations Children's Education Fund, Oxfam, and Save the Children) initiated their own microfinance projects across China. UNDP alone sponsored microfinance demonstration projects in 48 counties. By the end of the 1990s, however, many of these experiments had failed.

As microfinance projects sprang up around the country, FPC realized that it had a role to play in disseminating information about microfinance to a larger audience. With support from the Ford Foundation, FPC organized several national conferences on microfinance in China, raising the visibility of the sector. At the same time, Ford sponsored a number of seminars that focused on defining microfinance standards in China. Stephen McGurk, Director of the International Development Research Center (Singapore) and former Ford Foundation Program Officer for Economic and Social Policy in China, remarked, "FPC grew in its ability to influence people, and this became an important role over time. In a way, their work was less about microfinance and more about policy reform."

FPC conferences brought many actors to the policy table and were instrumental in attracting the attention of the Chinese government to microfinance. As a result, several high-ranking officials looked at what FPC was doing and publicly voiced their favorable impressions. In 1999, FPC received official approval of its "experiment" from both the People's Bank of China and the State Council. The losses of other experimental programs (often run by the government) served to highlight the positive experiences of FPC.

At the same time, the many failed experiments raised questions about the viability of microfinance in China. National policy makers increasingly recognized that microfinance could be a key poverty alleviation tool, but the model for building microfinance in the China was still being developed. Although interested in microfinance, the government continued to use highly subsidized rural credit programs as a means of poverty alleviation in the late 1990s.

### Encouraging Microfinance in China: Good Donor Practice

Ford's success in encouraging microfinance in China can be attributed to several factors.

**Ability to Experiment.** Ford was able to support the FPC project largely due to its willingness to take risks and experiment. Ford did not know if microfinance would work in China; in fact, microfinance was not even part of its program when the scholars of the Rural Development Institute approached the Foundation. The Ford team in China was, however, able to back the project due to an established policy of setting aside about a fourth to a third of the country portfolio to finance potential opportunities not included in the defined program. Having decided to fund FPC, Ford had the flexibility to go on to sponsor conferences and training on microfinance and rural finance reform.

*"We thought microfinance was not a possibility [in the mid-1990s]. It seemed crazy in some ways, and was very removed from what we were doing. . . [yet] it also seemed like a good idea."*

Stephen McGurk, former Ford Foundation Program Officer in China

**Banking on Local People.** Ford has consistently supported local people and initiatives in China. It has funded study tours, training sessions, translation of technical materials, research grants, and conferences. These actions allowed Chinese experts on poverty to become conversant in microfinance good practice, gain first-hand experience, and articulate the problems and possible solutions needed for microfinance to succeed in the country. The China Microfinance Training Center has been an important part of these initiatives.

**Fostering Policy Dialogue through Research.** Ford recognized that credible local research was needed for Chinese practitioners and policy makers to elaborate an enabling policy environment for microfinance. In the late 1990s, it began to support research on key policy issues such as rural financial reform. Andrew Watson, Resident Representative of the Ford Foundation in China, points out that "the rural financial reform work [seeks] to help people think about creating a more flexible rural financial environment within which microfinance could play a role."

A Vice President of the People's Bank of China attended the most recent Ford conference on rural financial reform

in August 2003, as did officials from the Rural Credit Cooperative and staff from the Agricultural Bank of China. The conference took place at the same time a new experimental policy for Rural Credit Cooperative reform was being launched in the country.

*An understanding of the overall Chinese rural financial sector, its problems and reform prospects, is crucial for the continued, sustainable operations of microfinance in China and its wider adoption.*

Minquan Liu, Professor of Economics, Nanjing-Hopkins Center, Nanjing University

## Conclusion

Ford's support of research and capacity building in China has promoted greater professional and practical knowledge of microfinance. Scholars, practitioners, and government officials are now engaged in policy discussions about the sector. As a local project initiated by a prestigious Chinese research institution, FPC has given microfinance credibility and visibility in the country, while illuminating some of the concrete legal and financial constraints to sustainable microlending in China.

What does the future hold? The Chinese environment continues to be extremely fluid, making it difficult to predict. More fundamental financial system reform is needed before microfinance can find its true place in China. Sarah Tsien of PlaNet Finance China, says that in addition to FPC, two other strong programs show promise of becoming sustainable institutions: the China Foundation for Poverty Alleviation (CFPA, which is closely linked to the State Council's Poverty Alleviation Office), and the Sustainable Microfinance to Alleviate Poverty project (SMAP, which was spun off from the UNDP initiatives). Tsien contends, "Together, if FPC, CFPA, and the SMAP project can make the next step to officially institutionalize, the bar for the formalization of microfinance in China will be both set and met."

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