

## **An Analysis of Microfinance Demand in China**

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### **Executive Summary**

The Chinese microfinance market is currently booming. But what sectors of the population are demanding microfinance services? How large is the demand for micro credit? Is there a potential market for microfinance investors? After an empirical based analysis of financial service demand and an analysis of the potential microcredit market, it was found that there are some 249 million rural households, more than 8 million registered unemployed workers and more than 42 million SMEs and microenterprises in China. These figures confirm the existence of a potentially huge microcredit market. The current low rural coverage, limited outreach and high loan/deposit ratio of formal financial service institutions also indicate a large potential microfinance market. In addition, the Chinese government's policy of opening-up the microcredit market provides an excellent opportunity for microcredit investors.

### **Keywords**

Microfinance, Microcredit demand, Potential market, SME, China

## 1 Introduction

In 2006, the World Bank published the CGAP research report “*Access for All: Building Inclusive Financial Systems*” by Brigit Helms which advocated the construction of an inclusive financial sector in order to allow the entire society, especially middle and low income earners, to enjoy access to financial services. The report emphasized the significance of building inclusive financial sectors at the micro, meso and macro levels. This approach quickly received popular acceptance. In the beginning of 2008, the World Bank issued a second report, “*Finance for All? Policies and Pitfalls in Expanding Access*” (World Bank, 2008). The report focused on the issues of financing channels, measuring indicators and the analysis of the determinant factors of access to financial services, both from the perspective of corporations and individual households. The report expounded the role that access to financial services has in economic growth, equity, and poverty alleviation. In addition the report discussed the role of government in promoting outreach of financial services and made a number of policy recommendations.

The World Bank aims to promote the construction of perfectly inclusive financial sectors. The Chinese government has been conducting continual reforms since the 1980s in order to allow all members of society, especially middle and low income earners, to enjoy equal access to financial services. Examples of these reforms include: the reform and innovation of Rural Credit Cooperatives (RCC), the development of urban credit cooperatives and urban commercial banks, and the creation of NGO microfinance institutions (MFI). On December 20th 2006, the China Banking Regulatory Commission (CBRC) published its: “*Opinion regarding easing market access for banking financial institutions in rural areas in order to better support the construction of a new socialist countryside*” (CBRC, 2006, number 90). This document described the new rural financial market access policy, and outlined a pilot program in six provinces. On October 13th 2007, upon the approval of the State Council, the CBRC decided to expand the scope of the pilot project from six to a total of thirty one provinces.

Since March 1st 2007, the number of village banks has expanded rapidly from an initial number of three which operated in Yilong County of Sichuan Province, and Dongfeng County and Panshi County of Jilin Province. In addition, the village banking model has continued to evolve. By the end of 2007, more than ten village banks had already been founded by local commercial banks, commercial banks from outside regions, county RCC unions, and foreign banks. In addition, the China Development Bank (CDB) and commercial banks, such as the Agricultural Bank of China (ABC), also created village banks.

Capitalizing on the momentum caused by the publishing of the government policy document entitled: “*Easing market access for banking financial institutions in rural*

areas”, a new round of institutional reform has been formally launched in the field of rural finance in China. The new reforms focus on the diversification, marketization and standardization of financial institutions as well as on the opening up of markets. These reforms not only represent extraordinary innovation, with regard to the creation of a comprehensive rural financial system in China, but also a significant breakthrough in market access policy in the Chinese banking industry, signifying that the Chinese banking sector, and the rural banking sector in particular, is set to enter a new phase of competition, development and growth.

However the following questions remain unanswered:

- How large is microfinance demand in China?
- How much of this demand is not currently being met?
- What sections of the population are most lacking in access to financial services?
- Have financial services actually been improved?
- What aspects have been improved?
- What obstacles are restricting the improvement of financial services?

## **2 Analysis of the Demand for Financial Services**

### ***2.1 What Sectors of the Population Demand Microfinance?***

Demand for microfinance services typically comes from: the urban unemployed, rural households, enterprises, and the government. Moreover, there are many types of financial demand, such as credit, savings, insurance, and investment. Among these types of demand, the demand for credit is the most difficult to satisfy. Furthermore, the credit capacity of individuals at each level of demand has very distinct characteristics, and their different requirements should be met through different types of financial institutions and supply models (Table 1).

**Table 1: Credit Demand Levels, Main Characteristics and Methods of Supply**

Levels of Credit Demand		Main Characteristics	Ideal Methods of Meeting Credit Demand	
<b>Unemployed urban population</b>		Living expenses, initial investment credit demand	Government business start-up subsidies, informal microloans, microcredit (including commercial microcredit), policy finance, cooperative finance	
<b>Rural Households</b>	<b>Impoverished rural households</b>	Small size farming production loan demand, and living expenses	Informal microlending, microcredit (including commercial microcredit), government poverty alleviation funds, policy finance	
	<b>Normal rural households</b>	<b>Normal farming rural households</b>	Small size farming production loan demand, and living expenses	Private capital, informal microloans, microcredit from cooperative financial institutions, small size commercial loans
		<b>Merchant rural households</b>	Specialized, large scale production and industrial and commercial industry demand	Private capital, microcredit, small size commercial loans, cooperative finance
<b>Enterprises</b>	<b>Micro and small enterprises</b>		Start-up and expansion	Private capital, informal finance, venture capital investment, commercial credit (government guaranteed), policy finance, microcredit
	<b>Medium enterprises</b>		Market-oriented production credit demand	Private capital, commercial credit, policy finance, microcredit
	<b>Market leading enterprises</b>	<b>Embryo-stage market leaders</b>	Specialized technical production expansion credit demand	Commercial credit, government funds, venture capital investment, policy finance
		<b>Full-fledged market leaders</b>	Specialized technical production expansion credit demand	Commercial credit
<b>Government</b>		Infrastructure funds demand	Fiscal funds, infrastructure bonds, BOT, etc.	

Potential microcredit demand comes from unemployed urban workers, rural households, SMEs, and microenterprises.

## **2.2 How Large is the Demand for Microcredit?**

Although the potential size of the market does not necessarily correspond to the true levels of demand for microcredit, it can be used as a starting point. The size of the market can be estimated on the basis of statistics on the number of urban unemployed workers, rural households, SMEs, and microenterprises throughout the country.

### **2.2.1 Massive Microcredit Demand in Rural China**

At the end of 2006, there were a total of 37,000 townships, 624,000 villages, 4.5 million sub-villages, 740 million village dwellers, and 249 million rural households – a huge potential market.

Between 1978 and 2006, the size of the extremely poor rural population in China was reduced from 250 million to 21.48 million. As a result the percentage of the extremely poor rural population, as part of the total rural population, dropped from 30% to 2.3%. However, there is still a large population of poor people in rural China. At the end of 2007, there were 14.8 million people with a yearly net income lower than 785 ¥RMB, and 28.4 million with a yearly net income of between 786 and 1,067 ¥RMB<sup>1</sup> (Guang Ming Daily, Feb.29,2008).

### **2.2.2 Huge Urban Unemployed Population<sup>2</sup>**

During the reform of State Owned Enterprises (SOEs) and collective corporations workers were laid off. In addition, the population of unemployed college graduates is growing and the numbers become even higher when also considering disabled workers and decommissioned soldiers.

The unemployment rate increased by 1.0% between 2005 and 2006, with the total number of unemployed increasing from 8.4 million to 8.5 million. At the end of 2006, the official unemployment rate was 4.1% (State Statistics Bureau, 2006).

### **2.2.3 Large Number of SMEs and Microenterprises**

As of the end of June, 2007, more than 42 million SMEs and microenterprises were registered with the Administration of Industry and Commerce (AIC), accounting for 99.8% of the total number of enterprises in China. Of these, 4.6 million belonged to SME proprietors and almost 38 million belonged to individual proprietors (SME Department of the National Development and Reform Commission [NDRC], 2008)

The number of SMEs in China, especially small enterprises, is increasing rapidly. For example, by the end of 2006, the total number of SMEs in Shanghai had reached 363,600, accounting for 99.7% of the total number of enterprises registered in Shanghai. This number included 355,900 small enterprises, of which 26,800 were

newly registered in 2006, an increase of 8.16% upon the previous year. According to the Shanghai AIC, by the end of 2006, there were a total of 264,100 registered individual proprietors. The majority of these proprietors were in the wholesale and retail industries, had a small amount of fixed assets and encountered difficulties when attempting to access loan capital. (www.1128.org)

There are also 23.1 million township and village enterprises (TVEs) operating in China which employed 146.8 million workers at the end of 2006. Some 99% of TVEs are SMEs and microenterprises. Since the beginning of the 21st century, the number of TVEs has expanded rapidly (Table 2, Figure 1). Although the TVE category overlaps with that of private enterprises, it can be readily seen that there are an enormous number of microenterprises currently operating in China.

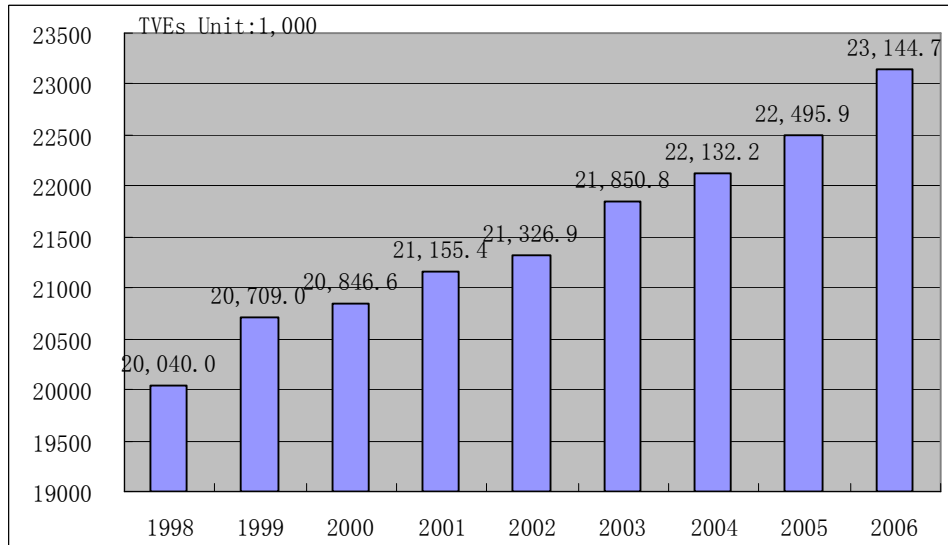
**Table 2:** Number of TVEs in China between 1998 and 2006

(National Statistics Bureau, 2006)

Unit: 1,000

Year	TVEs	Farming, Forestry, Animal Husbandry & Fishery	Industry	Construction	Transportation and Storage	Wholesale & Retail Trade	Hotels & Catering Services	Social Services	Other
1998	20,040.0	189.0	6,620.0	821.0	4,148.0	5,455.0	2,211.0	Na.	595.0
1999	20,709.0	165.0	6,735.0	825.0	4,127.0	5,831.0	2,414.0	Na.	611.0
2000	20,846.6	151.2	6,740.1	795.2	4,125.2	5,913.0	2,491.9	Na.	630.1
2001	21,155.4	127.4	6,721.7	762.6	4,128.6	6,141.7	2,627.0	Na.	646.4
2002	21,326.9	321.7	6,276.8	697.5	3,801.3	6,271.2	2,110.2	1,062.9	785.3
2003	21,850.8	414.3	6,431.3	680.6	3,834.5	6,478.5	2,132.0	1,242.2	637.4
2004	22,132.2	414.4	6,402.8	654.1	3,775.0	6,773.5	2,085.8	1,366.1	660.5
2005	22,495.9	411.8	6,329.9	642.9	3,798.6	6,909.4	2,150.9	1,529.8	722.7
2006	23,144.7	410.8	6,565.7	654.3	3,812.3	7,125.6	2,187.0	1,580.5	808.4

**Figure 1:** Trend in the Number of TVEs in China between 1998 and 2006



### 3 Analysis of the Potential Microcredit Market

It is difficult to directly measure the potential size of the microcredit market. However, a number of case studies have helped to clarify the situation regarding financial access to rural households and SMEs and from these results the potential size of the market can be indirectly derived.

#### 3.1 The Great Potential of the Rural Microcredit Market

##### 3.1.1 Significant Rural Household Demand

According to a 2003 survey conducted by a research team at the China Agricultural University, via interviews with 291 rural households in Zhejiang and Ningxia provinces, the credit demand of rural households was substantial with some 64% of surveyed households expressing interest in obtaining credit and 63% of households showing interest in obtaining credit over the next two years. This figure rose to 78% of households when appropriate technical training was also included in the credit package. (He Guangwen, Li Lili, 2005a).

A 2005 survey of 502 rural households in four counties/cities in Guizhou Province, Tongren, Jiangkou, Shiqian, and Yuping, indicated that 89% of rural households expressed interest in obtaining credit. (He Guangwen, Li Lili, 2005b). Research also showed that 84% of 720 surveyed households, located in 6 counties in Tongren Prefecture (including Wanshan and Songtao), expressed interest in bank and RCC loans (He Guangwen, Li Lili, 2005c).

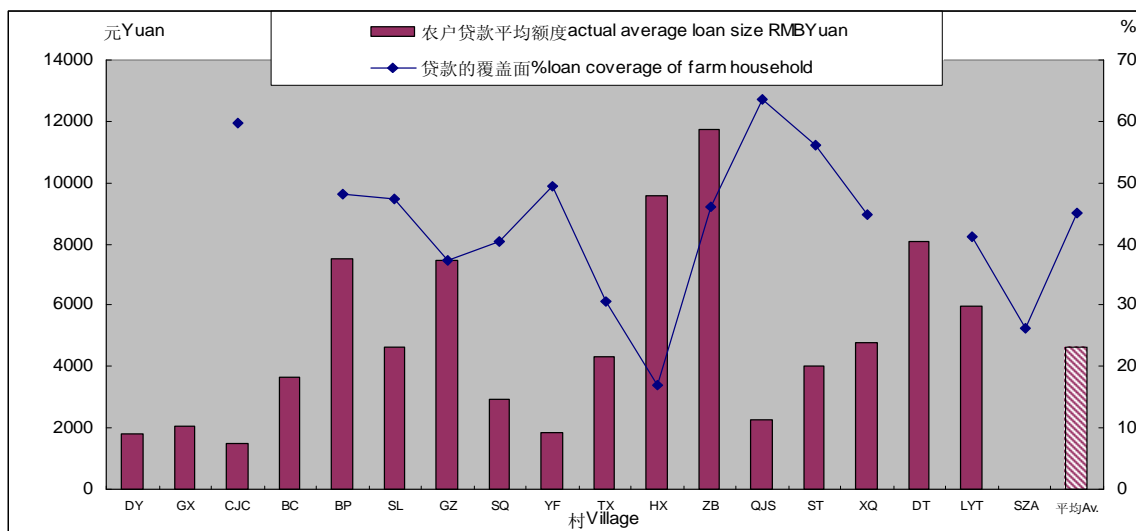
The survey also revealed that farm household loan demand did not rely on interest rates and that such households would be prepared to pay high interest rates in order to receive loans.

### 3.1.2 Large Under-served Market.

The market share of Rural Credit Cooperatives (RCCs) is still relatively small and the remaining potential market is massive. Since early 2002, RCCs have promoted rural household microlending operations throughout the country. Based on the statistics of the People’s Bank of China (PBOC), in September 2007, the number of loan clients exceeded 77 million, representing 33% of the country’s 230 million rural households (PBOC, 2007). These numbers serve to illustrate that there is a large potential microfinance market and show the significance of formal financial institutions and state banks in providing microcredit.

In 2005 a survey was undertaken by a research team from the China Agricultural University in order to calculate the total number of loans disbursed by 11 township RCCs to rural households in 20 villages in Guizhou’s Tongren, Jiangkou, Shiqian, and Yuping. The statistics from the survey show that, as of June 30th 2005, the average loan size for rural households was only 4,612 Yuan, approximately 80% of China’s per capita GDP, and that only a small portion of total demand was being met. The figures also show that RCC loan supply remains limited in rural areas, with a lowest coverage rate of 17% in HX village (Figure 2), and confirm that there is still significant unmet demand. (He Guangwen, Li Lili, 2005b)

**Figure 2: RCC Coverage and average loan size in selected villages**



### **3.1.3 Informal Lending Market**

Some well-executed case studies have shown that informal lending in rural areas is extremely common, indirectly illustrating the potential size of the rural microcredit market.

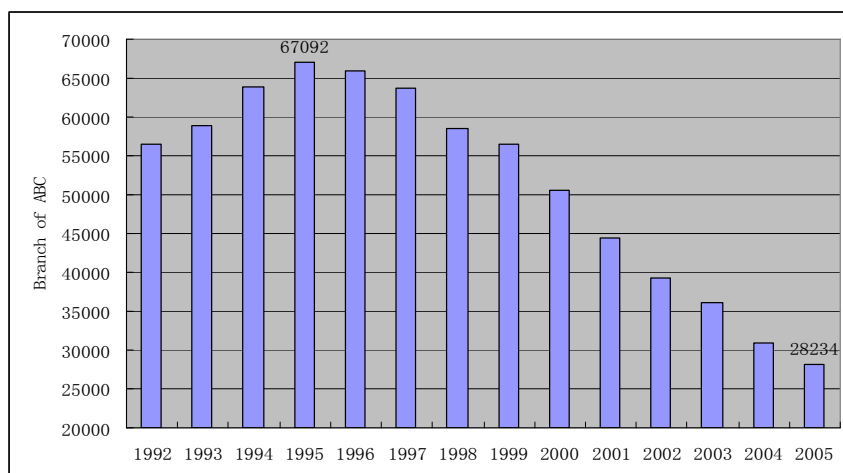
A 1998 study, performed by a team from the China Agricultural University, of 365 rural households in 21 counties in Zhejiang, Jiangsu, Hebei, Henan, and Shaanxi provinces, discovered that 38.4% of all loans accessed by rural households were from formal lending channels (RCC, ABC, other banks, and non-banking financial institutions) whilst 61.6% were from informal channels (cooperative funds – 0.6%, informal lenders – 60.96%) (He Guangwen, 1999).

According to recent research, rural household and SME financing still faces major problems. Analysis of a 2003 survey, performed by the Ministry of Agriculture's 'Agricultural Economic Research Center', of 217 rural households in 18 villages of 6 counties in Anhui Province (Zhu Shouyin, 2003) revealed that, not one loan, from a total of 524, was from a commercial bank. Some 84 loans (16%) were from RCCs, whilst informal loans accounted for 79% of all loans. Informal lending accounted for 80% of the total value of loans made, while RCCs only accounted for 15%. Guo Xiaoming's 2005 survey of 243 rural households in 17 villages of 4 counties in Sichuan Province found that the proportion of loans provided by RCCs and informal lenders was 33.5% and 66.5% respectively, highlighting that the informal sector was still the main source of loan funding for rural households.

### **3.1.3 Withdrawal of State-Owned Banks**

The fact that state-owned commercial banks have gradually withdrawn from rural areas has further magnified the unfulfilled demand for rural microcredit services. Since the mid-late 20th century, Chinese state-owned commercial banks have gradually closed their county and lower-level branches. Between 1995 and 2004, the number of branches of the four largest state owned commercial banks decreased by 77,000 (49.8%). ABC, which is regarded as the traditional credit bank in rural areas, has been declining in size since 1995. By the end of 2005, ABC's branch network had shrunk by some 58% from 67,092 to 28,234 (Figure 3).

**Figure 3: Trend in the number of ABC branches**



According to a survey performed in two underdeveloped regions, the total number of banking financial institution branches, at the end of 2005, amounted to 1,161, 317 less than in 2000. Indeed, during this time, the largest state owned banks closed a total of 222 branches and reduced staff-levels by a total of 2,234 employees (Wang Jin, Zhang Mingliang, 2006).

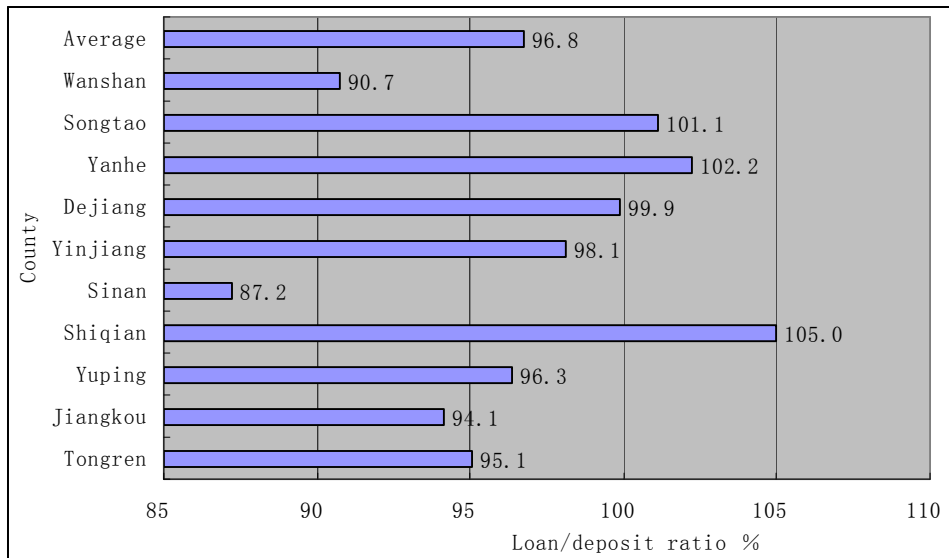
The branches which were closed by the 'Big Four' state owned commercial banks previously provided direct services to rural households and SMEs, and, geographically, were often the only viable banking provider option for their clients.

At the same time as the number of branches was being reduced, state owned banks were also restricting the ability of rural branches to disburse loans. Indeed, since 2000, branches in traditional and developed regions have only been able to collect savings. According to estimates by the author, the yearly amount of outflow of savings funds from rural areas has reached approximately 400 billion Yuan.

### 3.1.4 High Loan/ Deposit Ratio

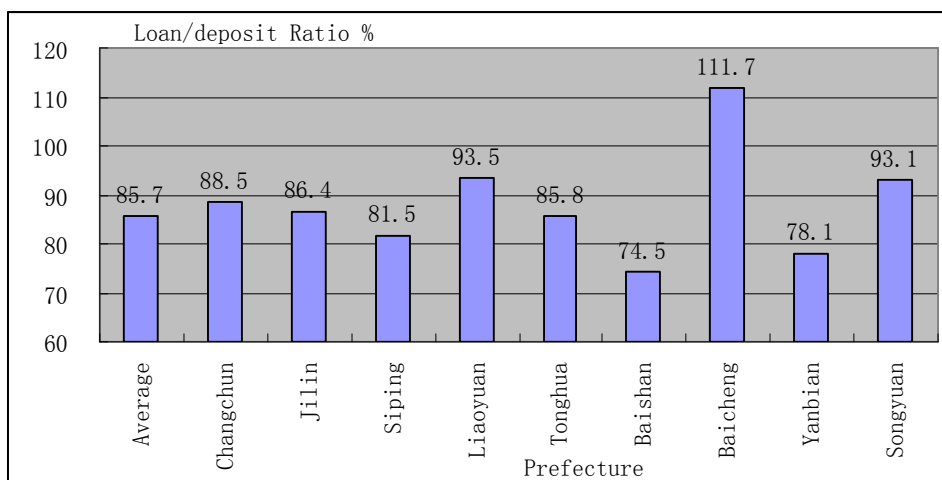
The loan/deposit ratio of RCCs in traditional rural areas is very high, illustrating the huge demand for capital from rural households and the large size of the potential market. Many RCCs, especially those in underdeveloped regions have a very high proportion of loans to deposits, demonstrating the serious shortage of funds and the over-use of capital. Figure 4 presents the findings from a 2005 China Agricultural University study of RCCs in 10 counties of the Tongren region in Guizhou Province. The average loan/deposit ratio was 95.1% and even exceeded 100% in Shi Qian County, Yan He County, and Song Tao County.

**Figure 4:** Loan/ Deposit ratio in 10 counties of Guizhou province in May 2005



At the beginning of June 2007, another study (He Guangwen, 2007) came to the same conclusion with regard to their research in Jilin Province. In May 2007, the loan/deposit ratio of RCCs in Jilin Province stood at 85.7%. This number greatly exceeds the required liability/asset ratio, indicating serious operating problems. RCCs in Bai City had loan/deposit ratios of 111.7% (Figure 5).

**Figure 5:** Loan/deposit ratio of RCCs in Jilin province in May 2007



## **3.2 The Enormous SME Finance Market**

### **3.2.1 Limited Business Start-up Funds**

Based on a 2005 survey undertaken by Zhejiang Province's SME Bureau (Wu Jiayi, 2006), only 28.7% of 592 small enterprises (at the business start-up phase and with annual sales volumes of 5 million Yuan or below) had taken loans from banks. Some 14.7% of enterprises obtained a portion of their start-up funds from informal lenders whilst 29.4% of them received funds from friends/relatives. The survey also revealed that 65.2% of the enterprises invested their own funds in their businesses.

### **3.2.2 Shortage of Funding Sources to Fuel Business Growth**

Due to the shortage of start-up capital and limited assets, enterprises also have difficulties in financing business growth.

### **3.2.3 Limited SME Transformation Opportunities**

In June 2004, the Shenzhen Stock Exchange launched an SME module in order to enable SMEs (with total share value below 50 million Yuan and total trading shares below 30 million) to become listed. At the end of 2007, the number of listed SMEs reached 138 with a total IPO value of 40.4 billion Yuan and average financing funds of 293 million Yuan per enterprise (SME Department of NDRC, 2008). However it should be noted that the number of listed SMEs is limited and that the SMEs that are listed tend to become large-scale enterprises. As a result, the majority of small enterprises are unlikely to access funds through this channel.

## **3.3 Huge Financing Gap for the Unemployed**

Unemployed people have no stable income source and it is difficult for them to offer loan guarantees. As a result, it is extremely difficult for them to start a business or to gain reemployment. Urban commercial banks in many cities, such as the Bank of Beijing and Tianjin Commercial Bank, have initiated micro guarantee loans for unemployed workers. Local government financial departments have also set up microcredit guarantee funds through which microcredit guarantees can be provided to unemployed workers. In August 2003, the financial department and labor and social security departments of Anhui Province published its: "*Management methods of microcredit guarantee funds for provincial laid-off and unemployed workers*" (Caijin[2003]606).

However, during the implementation of the project, some financing difficulties were experienced. Firstly, when commercial banks offer loans, guarantee fund companies require that borrowers provide guarantees and provide 50% of the working capital

themselves. Secondly, the maximum loan limit is very small. Normally, an individual loan, secured by the guarantee fund, should not exceed 20,000 Yuan. Thirdly, competition in the start-up business market is fierce whilst providing finance to the unemployed can be a very risky undertaking.

## **4 Conclusion**

### ***4.1 Differing Requirements of the Population***

Unemployed urban workers require financial resources in order to help meet living expenses and initial investment credit requirements. The ideal methods for meeting such demands are: informal microlending, microcredit (including commercial microcredit), government finance and cooperative finance.

Impoverished rural households need credit in order to finance small scale farming production and living expenses. The ideal methods for meeting such demand are: informal microlending, microcredit (including commercial microcredit), government poverty alleviation funds, and government finance.

Regular farming rural households need credit in order to finance small scale farming production and living expenses. The ideal methods for meeting such demand are: private capital, informal microlending, microcredit from cooperative financial institutions, and small commercial loans.

Merchant rural households need credit in order to finance specialized large scale production and industrial and commercial industry. The ideal methods for meeting such demand are: private capital, microcredit, small size commercial loans and cooperative finance.

Micro and small enterprises need credit in order to finance start-up and expansion capital. The ideal methods for meeting such demand are: private capital, informal finance, venture capital investment, commercial credit (government guaranteed), government finance and microcredit.

### ***4.2 Huge Microfinance Demand***

Some 249 million rural households, more than 8 million registered unemployed workers and more than 42 million SMEs and microenterprises form the base of a potentially huge Chinese microfinance market.

### ***4.3 Unsatisfied Demand Indicating Large Potential Market***

Reduced coverage of formal financial services, limited outreach of formal financial institutions and higher loan/deposit ratios also indicate the existence of a large potential microcredit market in China.

### ***4.4 Government's Opening-up of Microfinance Market***

China's opening-up policy in the microcredit market provides an excellent opportunity for microcredit investors.

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