Serving the low-income group with microfinance in China[i]

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Abstract: This paper demonstrates that micro-finance, initiated by government and reinforced by industrial initiatives, can contribute to serving the low-income group in China. In previous studies, micro-finance is considered an effective method to alleviate poverty, if it can be integrated with some innovative initiatives, by MNCs or by social entrepreneurs, to serve the poor. However, how micro-finance, initiated by government, can help the low-income group in the 'big government' context has not been effectively addressed in the literatures. An exploratory analysis, involving interviews with micro-finance providers and low-income population, original case studies, and archival material, indicates that the micro-finance models in previous studies, as presented by Grameen Bank, may not be suitable in the context of China where a strong government plays important roles in social life. Results suggest that the success of micro-finance initiatives targeting low-income markets is enhanced by the activities of integrating low-income group into the value chain of local economy. Building on the findings of case studies, the paper presents studies which demonstrate how the so-called "Company+Farmers+Micro-finance" mode and "Government+ Company+Farmers+Micro-finance" mode succeed in creating social and economic development in underdeveloped area in China. The findings suggest that micro-finance need to cooperate more with local firms to find some Win-Win business model in underdeveloped areas, in order to help the low-income group get out of poverty.

I Introduction

Microfinance, defined in this paper as the supply of savings, credit, insurance, and payment services to relatively poor people, is regarded as a powerful tool to fight poverty, which can help poor people raise income, build their assets, and cushion themselves against external shocks [3]. Worldwide, microfinance institutions (MFIs) expand the frontier of finance by providing loans and other financial services to underserved populations. Historically, efforts to deliver formal credit and financial services to the rural poor in developing countries have failed. Commercial banks generally do not serve the needs of the rural poor because of the perceived high risk and the high transactions costs associated with small loans and savings deposits. The recent proliferation of innovative microfinance programs, often based on group-lending methods, has been inspired largely by the belief that such programs reach the poor and have a positive impact on various measures of their welfare, including economic measures (e.g., wealth and income), social measures (e.g., educational attainment and health status), and less tangible measures such as "empowerment". The faith in microfinance is based on the highly selective anecdotal evidence of

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individuals who are reported to have pulled themselves and their families out of poverty with the benefit of microcredit.

On the other hand, most observers agree that in the right circumstances microfinance can increase household incomes, but its impact on poor clients remains controversial. Several recent impact evaluations have emphasized the nonuniform distribution of benefits. Most households are better off with microfinance, but income impacts vary in magnitude and durability, and a sizeable proportion of clients find that their post-credit incomes stagnate or fall [5][[17][18][19][20]. An influential cross-country study found that loans produce the greatest percentage increases in the incomes of ''upper-poor'' and nonpoor borrowers who are close to or above national poverty lines. The poorest 50% or thereabouts of those in poverty—were not only less likely to participate in microfinance programs; when they did participate their post-credit incomes were less likely to increase. Moreover, such increases as occurred were often too small and short-lived to enable sustainable poverty exit [11].

To explore the poverty-alleviation mechanism behind microfinance, we can find that income promotion through microenterprise lending remains the primary strategy of most microfinance institutions (MFIs), including many which serve poor clients. The poor commonly face nonprogram obstacles to microenterprise development, in the form of unfavorable market environments or inadequate physical infrastructure, over which MFIs have little influence. In such circumstances, a more socially beneficial allocation of resources may result from targeting less-poor borrowers who derive greater benefits from microenterprise loans or, for MFIs which choose to maintain a poverty focus, reorienting their activities away from income promotion in favor of protectional or nonfinancial interventions. There is considerable potential for improving impacts of microfinance on the poor by encouraging the take-up of high-earning microenterprise occupations. In arid rural areas, however, where market and infrastructure constraints virtually rule out poverty-clearing microenterprises, the utility of microenterprise development for poor clients is more problematic. Support for rural microenterprises helps to alleviate some ill effects of poverty—although it has little impact on poverty incidence—but its benefits are offset by significant risks and costs for borrowers and lenders, and the generation of negative externalities. According to them, MFIs should lend to entrepreneurs who already have the skills and the markets but lack credit [4].

In spite of the advantages of microenterprise, [12] pointed out that microenterprise usually operated at too small a scale. With low skills, little capital, and no scale economies, these businesses operate in arenas with low entry barriers and too much competition, and the earnings cannot lift their owners out of poverty. Since most people do not have the skills, vision, creativity, and persistence to be true entrepreneurs, the poor would be much better served through their integration into the market system as producers rather than consumers. Therefore, providing microfinance to the so-called microenterprise cannot eradicate poverty. Furthermore, some researchers believe that debt is not an effective tool for helping most poor people enhance their economic condition—be they operators of small farms or micro entrepreneurs, or poor women [1]. They argue that access to credit is not a significant problem faced by small agricultural households and that factor and product prices, land tenure, technology, and risk are the factors limiting small farmer development. According to these studies, microfinance need to be combined with some economic development projects to help the poor out of poverty.

Concerning the case of China, scholars have long noted the complexity of providing effective rural credit delivery in large, agrarian countries such as China. Establishing and maintaining a network of rural financial institutions is expensive, and managing their operations is difficult in the absence of proper training, monitoring, and incentive structures. At the macrolevel, the gap between agriculture and industry redistributes savings from rural to urban areas, thereby limiting the relative supply of rural credit. At the microlevel, this means that even well-located rural households that have the option of keeping their savings in official financial institutions may lack access to formal sector. In order to solve these problems, Chinese government initiated microfinance since 2005, and several state-owned financial institutions began to provide microfinance for poor people. In the underdeveloped area of China, mostly in North-West provinces, microfinance is considered to play "a major part" in eliminating poverty.

In 2008, our research team conducted investigation of microfinance in rural area of three districts in China. The investigation's objective was to observe what impact microfinance might have on poverty. To accomplish the goal, we measured the socioeconomic and financial status of three groups: farmers, microfinance institutions and local firms. Our assumption was that if microfinance wanted to help the poor become less poor, anti-poverty projects must be complementary to the microfinance initiatives, and local firms might be helpful in this process. After deciding upon which groups to analyze, we created a mixed research design of small-N survey and case study. More about this will be discussed in the methodology section.

This paper reports on this study regarding the impacts of microfinance in reducing poverty. Does it work? How does it impact various family challenges? Does it improve people's quality of life? Does it help build greater family self-reliance? Our study attempts to shed light on such questions.

The article proceeds as follows: Section 2 explains the methodology and research strategy used in the paper. Section 3 outlines the main finding of our field research. Section 4 brings forth a framework in which MFIs and local firms collaborate to help the poor out of poverty.

2 Methodology

Given the relatively new and unexplored nature of the phenomenon, this study adopted an exploratory research strategy [7][22], complemented by small-N structured questionnaire survey. Qualitative research, rather than traditional quantitative empirical tools, is particularly useful for exploring implicit assumptions and examining new relationships, abstract concepts, and operational definitions [2][21]. The small-N questionnaire was delivered before the interview to The objective was to conduct an analysis of the existing microfinance model in these areas that would help to build theory on how microfinance can better help the poor to get out of poverty and to develop constructs that would facilitate future hypothesis testing[7].

An exploratory methodology such as this has been recognized as being particularly useful for researchers interesting in examining strategies in emerging economies [9]. In addition, qualitative research has provided critical insights into innovation [8], entrepreneurship [16], and alliances [13][14], as well as a variety of other phenomena, such as social issues [6].

Data collection involved several overlapping steps. Three district were selected as the research sites. These districts were not selected randomly, rather they were chosen because they offered a variety of different approaches to exploring the effect of microfinance in Chinese BoP market, the

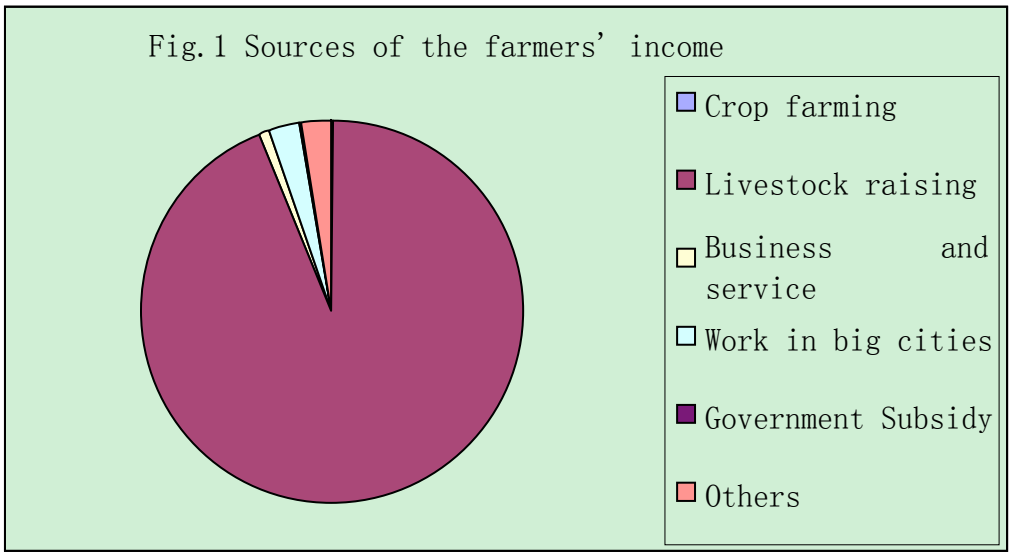
rural area [7]. The preliminary research instrument was a questionnaire administered to 150 farmers of each of three selected districts, to get some general information of the farmers' income structure, loan usage etc. And after the survey, in-depth interview were followed. In each of the three districts, the research group interviewed farmers, MFIs and local firms that had business with farmers, as these firms played an important role in facilitating income-generating initiatives in areas where there had been limited economic development, which maximized the utility of the microfinance.

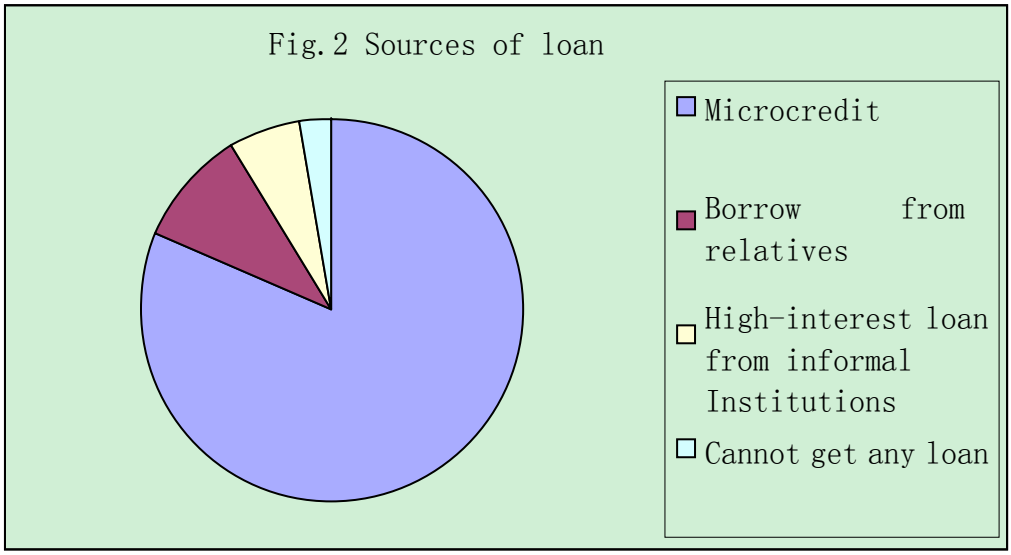
To encourage greater disclosure of information, we assured the respondents that confidential information would not be attributed to specific low-income market ventures. Where possible, material on district was collected and reviewed in advance. These interviews, together with the case studies and other archival material, were compared and contrasted in an exploratory manner, based on John Stuart Mill's inductivist methods of agreement and difference [15]. As we iterated back and forth between existing theory and our findings, the displays and our conclusions were updated and refined [10]. The results of this analysis are discussed below.

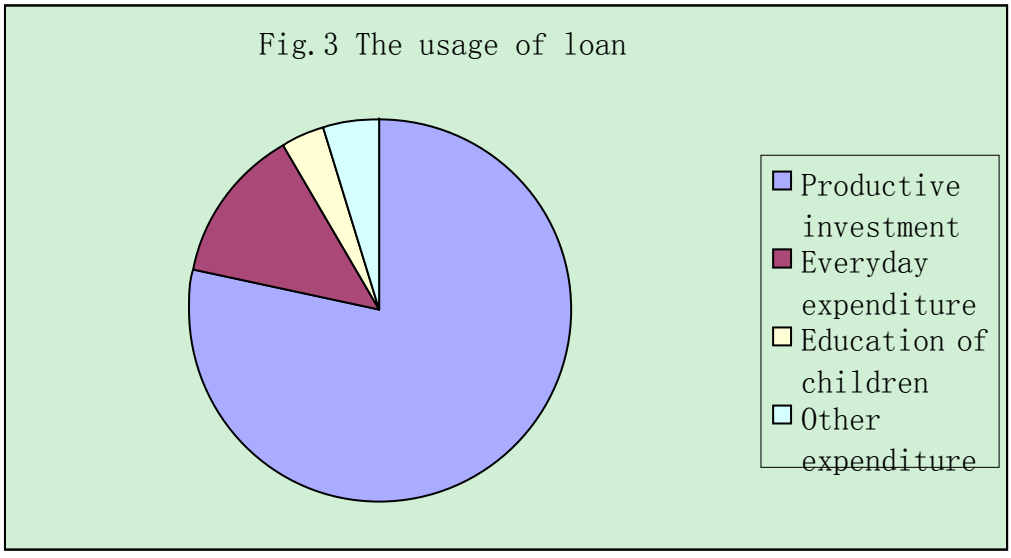
3 Results

3.1 Learnings from the survey

The analysis of the survey can show us the income and expenditure structure of the farmers, as well as where the farmers could get the loan and how they used the money. Fig.1, Fig.2 and Fig.3 show the results of the survey.







As indicated in Fig.1, the main source of the farmers' income was from livestock raising. In a certain period of a year, the farmers would need money to buy young stocks, and microcredit played an important role in this period. As indicated in Fig.2, of all the farmers who needed money, 81.4% of the farmers got their loan from MFIs, 10.03% borrowed their money from relatives, 5.71% got the money with high interest from informal institutions, and the rest 2.86% could get no money at all. When the farmer got the money, 78.4% of the money was used for productive investment, 13.3% was used as everyday expenditure, 3.7% was used for the education of their children, and 4.6% was used as medical and other expenditure, as indicated in Fig.3.

Due to the characteristic of livestock raising, the farmers' demand for finance were periodic. The two cliffs of the demand were winter time and the period of stock-breeding. In winter, there were not enough grass for the livestock, and farmers need money to buy forage to feed them. And during the period of stock-breeding, farmers need money to buy young stocks. In other times, the demand for finance was very low. Microfinance was very important for the farmers to get the needed money.

With the data, we can see microcredit was very important in the farmers' production cycle, thus

had a positive impact in stimulating local economy. But the over-dependence on livestock raising as source of income also led to the overburden of the grassland and the high risk of the farmers, which caused some serious problem for the MFIs. The local government had initiated some policies to improve the productivity of the farmers and diversify their income structure. The next part of the paper will go to details of these.

3.2 Learnings from interviews

In all of the three districts, the Prairie grassland was greatly destroyed because the farmers overused it as pasture to raise livestock. The government made various policies to protect grasslands, such as forbidding raising livestock in some area or forbidding raising livestock in some time of the year, and so on. These policies influenced the income of the farmers, because the major income of most farmers was from livestock-raising. The government provided subsidy for those who lost their income in livestock-raising. The grassland grew better because of the protection policies, but the government would not provide subsidy forever, and without the subsidy, farmers will be dissatisfied for not being able to raise livestock. Therefore, this kind of development pattern is not sustainable, and these districts need to find some new development model.

In our interview, we found it necessary for these districts to change the development style of livestock raising. To improve the productivity was a practical way to overcome the dilemma between grassland protection and income improvement of farmers. The local government hoped the initiatives of microfinance and the development of local firms can solve these problems. But the existing business model still met with great challenges. In particular, the interviews with farmers and MFIs shed substantial light on the impacts and the limitation of the existing microfinance business model. And the interviews with local companies revealed the importance of local firms in addressing to the existing challenges. Put them altogether, this paper suggests local firms and MFIs integrating their business, to better empower the poor to get out of poverty in a environmental friendly way. The results of the interviews are summarized in table 1.

Table.1 The main findings of the interviews

		Farmers and MFIs	Local firms
General Pattern	Existing model	Credit Joint guarantee	Involve farmers into the firms' value chain. Create incentive for self-governance of farmers. Provide work opportunity for farmers.
	Challenges	Cannot create incentive for farmers Relatively high risk of lending money to farmers. Not easy to find enough members for joint guarantee.	Many firms were not scale economical. Difficult for small sized firms to get financial support. Not enough collaboration between firms and MFIs.
District X		The major model was credit, complemented by the model of	Firms+Farmers+Microfinance

	Three-Family Joint Guarantee.	
District B	The major model is Five-Family Joint Guarantee, supplemented by credit.	Government +Firms+Farmers+Microfinance
District E	Similar to District B.	Government +Firms+Farmers+Microfinance

3.2.1 Learnings from interviews with farmers and MFIs

The interviews with farmers and MFIs were especially important when it came to critically evaluating the role of microfinance in improving farmers' livelihoods. According to our survey, 78.4% of the loan was used for productive investment, and microfinance was very important for the farmers to get the needed money. In all of the three districts, the microfinance was mainly provided by the Credit Cooperatives, initiated by government. The general business models of microfinance were credit or joint guarantee.

For example, in Xi Lin Hao Te District (District X), the major model was credit, complemented by the model of Three-Family Joint Guarantee. In the credit model, the farmers were ranked as three levels: Not Good, Good and Superior, and farmers with different rank could get different amount of credit, with different interest. In the Three-Family Joint Guarantee model, two families would jointly guarantee for another family who wanted to get the loan. In Blue Flag District (District B) and East Black Flag District (District E), the major model is Five-Family Joint Guarantee, supplemented by Credit. In the model of Five-Family Joint Guarantee, a family needed to find five other families to be guarantees to get the loan. No Mortgage is needed in both of the models. A family just needed the rank certification by Credit Cooperatives or two other families' guarantee to get the loan, thus made it easier for farmers to get the needed money.

Yet, the existing models faced with some problems. The farmers of these districts were highly distributed, and it needed lots of time and money to evaluate the rank of the farmers. What's more, the farmers' assets were difficult to evaluate, because in China the farmers only have the operational right of the pasture, but no property right. In District D, for example, an employee of the Credit Cooperatives could only evaluate 2 to 3 families within one day. The same problem also existed in other districts. In the Joint Guarantee model, especially the Five-Family Joint Guarantee, it was always not easy for a family to find five eligible families to guarantee for him. The reality was, the rich farmers only guaranteed for rich families, and the poor ones could only find the poor families to guarantee for them. As a result, the rich farmers could get more money more easily, but the poor ones who needed more money couldn't get enough loan.

According to the regulation of government, the Credit Cooperatives were only allowed to be involved in lending and recovering money, but not the productive process. Although the Credit Cooperatives could bind the farmers' activities with loan contract, they could not create incentives that encouraged self-governance of farmers to maximize the utility of the money. And the lack of penalty mechanism for not returning money in time made things worse. For the loan designed for productive investment, some farmers would use it for consumption, because they thought money borrowed from the government need not to be returned.

What's more, a serious challenge before the farmers was the overload of the grassland. For the farmers, the main source of income was from livestock raising. If farmers wanted to improve income, the most practical way was to raise more livestock. But the grassland was already overloaded, restricting the increase of livestock. According to the requirement of sustainable development, one sheep needs 40~50 Mu (a Chinese unit of land) of grassland, but in Land B, for example, the average grassland for one sheep was 10～20 Mu. In the other two districts, the average grassland was also much smaller than required. As mentioned above, the government had brought forth several policies to protect the grassland, and finally reduced the income of those farmers. In respond to this, farmers need to improve their productivity to improve income. New species of livestock with higher productivity and scale economy were considered good method to achieve this objective. But in these cases, if Credit Cooperative and local government only provided microcredit without get involved in real business of farmers, such initiatives might fail, because farmers lacked not only the loan, but the knowledge and technology for the new species and new style of livestock raising. In District E, for example, local government tried to help the farmers introduce New Zealand Cow to improve productivity. Part of the money was provided by government subsidy, the rest was solved with microcredit from the Credit Cooperatives. After the introduction, the government didn't pay much attention to such activities as training and technical service, and the farmers lacked the needed knowledge to raise the New Zealand Cow, and most farmers lost money in this business. Since all the initiatives were organized by government, the farmers thought all the money needn't to be returned. As a result, all the losses were burdened by the Credit Cooperatives. Neither the Credit Cooperatives nor the farmers benefited from this business.

Another risk met by the farmers was the over-dependence on livestock raising to get income. External factors such as weathers and macroeconomic environment can greatly influence the income of the farmers. For example, in 2007 and 2008, drought attacked northern part of China, and most of the farmers in these three districts saw the shrink of their income, which brought negative influence to their livelihoods. Insurance was considered one way to solve this problem, but no successful insurance business model had been built in these districts. Another solution is to diversify the farmers' income structure. Since most of the farmers acted as producers rather than entrepreneurs in local economy [12], they lacked not only money but also new capabilities to diversify their income. Microcredit itself was not enough, especially when new technology and new production style needed to be introduced in the existing business model. The MFIs needed to ally with other institutions to provide solutions to empower the farmers with both the money and the capabilities to earn more money. Our interview found the cooperation between MFIs and local firms could be a good solution to this.

3.2.2 Learnings from interviews with local firms

While the Credit Cooperatives couldn't create incentive that encouraged the farmers to maximize the utility of the loan, firms bridged the gap. The interviews showed that local firms were usually part of the value chain of local economy, either providing input necessary for the farmers, or purchasing products of farmers to make some high value-added products. In the former pattern the firms provided not only hard inputs but also such soft inputs as training, technical support etc., by which the firms could empower the farmers with necessary capability to create more value with more productive inputs. In the latter pattern, some firms not only bought crude

products from farmers, but also fine processed the crude products into high value added products, thus extended the whole value chain, and created more value. The general development model was "Firms+Farmers", in which firms and farmers formed alliance to create value added altogether. Both the firms and the farmers can benefit in this model

As mentioned before, the farmers usually needed money to initial their business and maintain the operation. In this model, the firms could sign business contract with the farmers and guaranteed for them to get microcredit. The guarantee of the company lowered the risk of the farmers, and the Credit Cooperative could provide microcredit to the farmers with low risk, thus make it easier for the poorest ones to get loan. The firms could provide new technology and technical support for the farmers, and stimulated the farmers to improve productivity with incentive system, thus speed the regulation of the loan and improve the farmers' income. The microcredit within this model can catalyze significant improvement in the livelihoods of the farmers, and create a virtuous cycle of growing incomes and purchasing power within their communities, as indicated in fig.4.

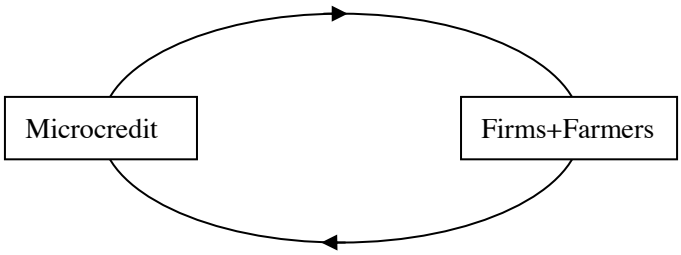


Fig.4 Business Model of Microcredit with "Firms+Farmers"

In different districts, this model had different forms. For example, in District X, Inner-Mongolia Mutton Limited Corporation (MC) and United Gut Film Limited Corporation of Inner-Mongolia (UGF) were two major local firms that had business with farmers. The former one, MC, bought Mutton from farmers who raised sheep. In order to lower the risk of the farmers, MC sighed contracts with the farmers, committing a lowest "protective price" of buying Mutton. If the market price was higher than the protective price, the farmers could get the market price; otherwise the farmers got the protective price. Thus, the interests of the farmers were protected. In order to stimulate farmers to improve productivity, MC initiated Points Prize System and Encouragement Prize System. In Points Prize System, Farmers who sold Mutton of good quality to MC could get some points according to the weight of the Mutton, and when the points accumulated to a certain level, the farmers could get some prize from MC. In Encouragement Prize System, farmers could get some prize if they supplied mutton sooner than MC required. With the commitment of MC the farmers borrowed money from the Credit Cooperatives in spring and bought lambs with the money. After that, the farmers were willing to improve the productivity to get the Encouragement prize. As a result, almost every farmer improved their income by at least 5000 Yuan (about 720 Dollars) compared to past, and MC could get steady supply of good-quality mutton, and made them into good-quality food for hot pot (a very famous Chinese dish), and got good profit because of the reputation of the food. The microcredit within this business model circulated faster than in other business, and the Credit Cooperatives also benefited from it. This was a win-win business model for all that involved.

In the case of UGF, the company provided plants for farmers to make gut film, a kind of

material for Chinese sausage, from the gut of animals, and then purchased the semi-manufactured products from the farmers. Before 2004, gut films were made mainly in little scaled workshops of families. The terrible smell and the waste were hard to manage because the workshops were highly distributed in this district. And the productivity was low because the little workshops couldn't meet the requirement of scale economy. In 2004, UGF was founded, and the company provided plants and equipment for farmers with a little fee. 300 farmers could work in one plant, thus scale economy achieved. The semi-manufactured gut films were purchased with market price. For the farmers, the fee was compensated by the improvement of productivity. For UGF, the company could get stable supply of semi-manufactured gut films to make them into the final product. Because the guarantee of the company lowered the risk of the farmers, the Credit Cooperative could provide microcredit to the farmers with low risk. By 2008, there were 63 plants in UGF, and the company achieved great social impact, because it provided job opportunities for thousands of farmers, and the waste from the production was able to be processed by the company.

In District B and District E, similar patterns existed. But the firms were smaller, and the local governments played more important role. Firms that had business with farmers were developed from farmers' cooperatives, with the business of special local products. They purchased raw material or semi-manufactured products from farmers and made them into special Inner-Mongolian products, such as dried meat, Inner-Mongolian tent houses and so on. And the government helped the farmers to introduce higher productive livestock raising style and new species of livestock which high productivity with microfinance from Credit Cooperatives. In order to avoid the failures discussed in Section 3.2.1, farmers' cooperatives were set up to provide training and technical support for the farmers. The involvement of government enabled the farmers to improve their productivity and income. But the scale of the firms restricted the capability of their effect in stimulating the economic development of the farmers. And due to the scale of the firms, it was often difficult for them to get financial support.

Farmers' cooperatives were found very important also in organizing the farmers and protect the farmers' interests. For instance, in District X, an agriculture base was built up by the local farmers' cooperative. In the base, farmers could plant corn or potatoes, the base provided technical support and public infrastructure for the farmers. There were 86 large agriculture equipments and 17 large irrigating systems, which were public tools for all the farmers of the base, and greatly improved the productivity of the farmers. At the same time, the base signed contract with McDonald to be long-term potato suppliers of McDonald, and signed contract with Cow Associate to supply a certain kind of corn to feed cows. The alliance between the base and the Cow Associate benefited both the agriculture and the dairy industry. In District B, the Cow Associate provided milk collecting equipment for public use, and negotiated with firms representing the interests of the farmers.

4 Discussions and Conclusions

According to the study, the firms could complement the MFIs in creating opportunities and incentives for the farmers to maximize the utility of the microcredit. Since the success of Grameen Bank, microcredit was considered to be a powerful tool to empower the poor. But in case of North-West China, microcredit itself was not enough when the farmers were met with the challenge of the overload of the grassland. The farmers could not simply improve their income by

improving the scale of their livestock. Productivity improvement and income sources diversification were required. Since the Credit Cooperatives were not allowed by the government to get involved in the productive activities of the farmers, the collaboration with local firms was the best solution for the Credit Cooperatives to full exploit the potential of the microcredit. At one side, the firms could provide business opportunities and technical support for the farmers, thus provided opportunities for the microcredit to get the value added; at the other side, the involvement of firms into the microcredit process could lower the business risk of the farmers, thus lower the risk of the loan. What's more, the involvement of firms into the microcredit process could also make it easier for farmers to get loan. In North-West China, the farmers lived highly scattered, and it was a little difficult for them to find five families for joint guarantee to get money, especially for the extreme poor farmers who needed money very much. The guarantee of firms could lower the barriers to get loan.

With the discussions above, this paper presented a framework for MFIs and firms to collaborate with each other to empower the farmers to get out of poverty and get profit at the same time (Fig.5).

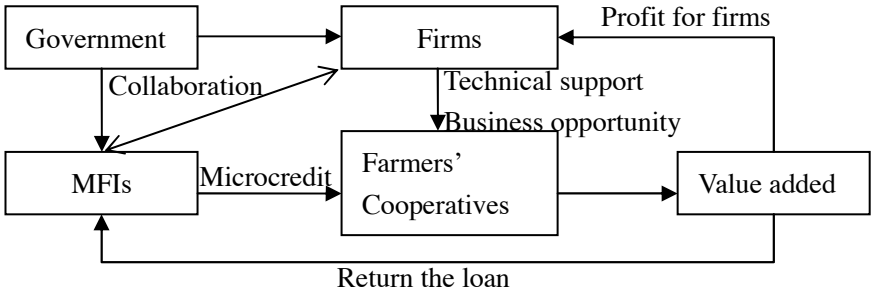


Fig.5 the framework of "Firms+MFIs+Farmers"

As indicated in Figure 5, the joint effort of MFIs and firms could empower the farmers with money, business opportunity and knowledge to improve their income, and meanwhile, both the MFIs and the firms could benefit when the farmers could create more value. The farmers' cooperative is a useful way to organize the farmers and protect the farmers' interest. And the government should regulate the two sides in this process with policies. This is the so-called "Firms+MFIs+Farmers" or "Government+Firms+MFIs+Farmers" business model in the rural area of China.

The development of rural area is an important aspect in the sustainable development of China. Our extended tracking, through interviews and archival material, of three rural areas of China highlighted potential of the collaboration of MFIs and firms. Our in-depth analysis explores the advantages and limitations of the existing business model, and tries to provide hint both for academic study but also for the future development of these rural districts. As our results suggest, MFIs will need to be more involved to collaboration with firms, which allows them to understand and leverage the strengths of the farmers. These findings from our qualitative empirical study have important implications for both theory and practice.

As this was an exploratory study, there are limitations to the conclusions that can be drawn. In the future, additional case studies and broader empirical analysis would be valuable in extending

the results of this research effort.

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