



# Technical Assistance Consultant's Report

Project Number: 35412  
November 2005

## People's Republic of China: A Report on the Demand for Credit from Microenterprises in Erdos, Inner Mongolia Autonomous Region

Prepared by He Guangwen Enjiang Cheng  
For the Asian Development Bank

This consultant's report does not necessarily reflect the views of ADB or the Government concerned, and ADB and the Government cannot be held liable for its contents.

**Asian Development Bank**

## Table of Contents

<b>ACKNOWLEDGEMENT</b> .....	3
<b>ABBREVIATIONS</b> .....	4
<b>I. Introduction</b> .....	5
<b>II. Credit Uses and Household Demand for Credit</b> .....	8
2.1. Credit Constraints for Farmers and Herders .....	8
2.2. Demand for Credit and Credit Supply in 2004 .....	9
2.3. The Future Demand for Credit by Rural Households.....	10
<b>III. Credit Uses and the Demand for Credit from Enterprises</b> .....	12
3.1. Credit Constraints .....	12
3.2. Enterprise Borrowing in Erdos .....	15
3.3. The Demand for Credit In the Future .....	17
<b>IV. The Development of Non Banking Finance in Erdos</b> .....	17
<b>V. Conclusions and Recommendations</b> .....	20

## ACKNOWLEDGEMENT

1 US\$ = ¥ 8 (RMB)

## **ABBREVIATIONS**

ABC	Agricultural Bank of China
ADBC	Agricultural Development Bank of China
BICA	Bureau of Industrial and Commercial Administration
ICH	Industrial and Commercial Households
IMAR	Inner Mongolia Autonomous Region
RCCs	Rural Credit Cooperatives
UCCs	Urban credit Cooperatives
SOCBs	State Owned Commercial Banks

## I. Introduction

This report aims to provide the potential bidders of the credit only micro-finance institutions with information about the demand for credit from rural households and micro and small enterprises in Erdos of Inner Mongolia Region (IMAR). Efforts have been made to study the supply side of the market by examining the operations of non-banking financial institutions, though the report should not be viewed as a full market study report, by which a detailed study of the suppliers of credit should be included.

With a population of 1.4 million (of which 162,000 are Mongols) and covering an area of 86,800 square kilometres, Erdos is located in the Gold Triangles of IMAR, made of Hohhot (the Capital of IMAR), Baotou (the largest city in IMAR) and Erdos.<sup>1</sup> As a prefecture level city in Inner Mongolia, Erdos is connected to Hohhot and Baotou by freeway, about two and half hours drive from Hohhot and only an hour drive from Baotou. Two national grade highways, No. 109 and No. 210, go through the city as well. An airport near Dongsheng is under early stage of construction.

Erdos has been one of the fast growing cities and prefectures in IMAR, thanks to the resource boom and a reasonably good rainfall in recent years.<sup>2</sup> The basic economic indicators of the city are shown in Table 1.1.

**Table 1.1. The Basic Economic Indicators for Erdos 2004**

	Population	Total GDP <sup>1</sup>	Fiscal Revenue <sup>1</sup>	Urban income <sup>2</sup>	Rural income <sup>3</sup>
Dongsheng District	26.53	8,000	923	9,603	3,940
Yijinhuoluo Banner	14.16	5,470	656	8,808	3,986
Wushen Banner	9.54	1,965	190		3,914
Dalate Banner	33.31	6,780	600	7,812	3,822
Zhungeer Banner	27.6				
Hangjin Banner	13.39	1,820			
Etuoqe Banner	10.3	4,102	373	8,203	3,700
Etuoqian Banner	7.33	1,320			
<b>Erdos Total</b>	142.16	34,110			

**Notes:** 1. Unit: ¥Million; 2. Refer to disposable incomes per urban capita in ¥; 3. Refer to net income per rural capita in ¥.

From the 10<sup>th</sup> to 31<sup>st</sup> of October 2005, a field investigation on the demand for credit was conducted in three counties of Erdos: Wushen Banner, Yijinhuoluo Banner (Yi Banner in abbreviation), and Dongsheng District (the seat of Erdos). Both Wushen and Yi banners are animal production counties, of which, Wushen is a state designated poor county and Dongsheng is the urban centre of Erdos. 406 farming and

<sup>1</sup> Erdos means plenty of palaces in Mongolia.

<sup>2</sup> Banners and district are county level administrative units in China and IMAR. Banners are specific to IMAR, in principle, the counties with a large share of animal incomes and output remain banners, an old administrative unit in the Mongolian inhabited region of China.

herding households and 64 micro and small enterprises in the three counties were investigated. The number of households and micro-enterprises sampled in the three counties is shown in Table 1.2.

**Table 1.2. The Sample of Households and Enterprises from Erdos of IMAR**

	Wushen Banner	Yi Banner	Dongsheng	Total
Farming Households	194	181	31	406
Micro-enterprises	11	11	17	39
Small Enterprises	2	3	20	25

The households in Wushen were sampled from two townships: Erlatu and Nalinhe Township, three townships before the recent merging, and the households in Yi Banner were drawn from Tai-jizhao and Xinjie Township. Within a township, households in principle were sampled randomly.<sup>3</sup>

The micro and small enterprises surveyed are sampled mainly from Dongsheng, and some from the county seats of Wushen and Dongsheng. In this report, we define industrial and commercial households (ICHs) as micro-enterprises. Industrial and commercial household (ICH) is a special category of businesses in China. ICHs, involving mainly small traders and shop owners, register with the Bureau of Industrial and Commercial Administration (BICA) and have unlimited liabilities. In principle, ICHs pay a fixed amount of taxes set by the local taxation bureau based on their sales. In addition, ICHs are required to pay a management fee to BICA. Most ICHs are self-employed small operators, and some have a number of employees, most are casual ones. Small enterprises in this study are defined as enterprises having a registered capital of two million RMB or less. A number of non-banking financial institutions, including pawnshops and credit guarantee companies in Dongsheng, were also investigated.

The formal financial institutions operating in Erdos include state owned commercial banks (Bank of Industry and Commerce, Bank of China, People's Construction Bank of China, and Agricultural Bank of China), rural credit cooperatives (RCCs) and urban credit cooperatives (UCCs). The major supply of formal credit to rural households and small-scale enterprises is RCCs. RCCs in IMAR and other parts of China have been ordered to provide loans to rural households without demanding a physical collateral.

Our study found that the demand for credit from rural households and micro and small enterprises in Erdos has been high, following the increases in incomes and investment opportunities. However, similar to the operation of commercial banks in other areas of China, the local commercial banks have generally target large and medium scale enterprises and overlooked credit demand from small and micro-enterprises. The loans provided by rural and urban credit cooperatives (UCCs and RCCs), limited by their funds available, can hardly meet the growing demand for

<sup>3</sup> It is difficult to run a strict random sampling process in an animal production county because (a). Herding households scatter in a large area; (b). The survey was conducted in the busy harvest season and some selected households were too busy to make themselves available for interviews.

credit from households and enterprises. The shortage in the supply of formal credit has given rise to an increasing number of credit constraint households and enterprises in the area and many of them could be judged as having loan repayment capacities. The shortage in the supply of formal credit has also led to higher rates of interest on the informal markets, which tend to raise the costs of borrowing for micro entrepreneurs and resulted in forgone of investment opportunities.

Section II of this report studies credit uses and the demand for credit from rural households, and the demand for credit from micro and small enterprises in the three counties of Erdos is analysed in Section III. The development of non-banking financial institutions and the informal financial market in Erdos are discussed in Section IV. Section V contains conclusions and policy recommendations.

## II. Credit Uses and Household Demand for Credit

### 2.1. Credit Constraints for Farmers and Herders

The demand for credit from rural households are analysed from the following three perspectives: credit rationing by formal financial institutions (mainly RCCs) on farmer households since 2003, the demand for credit by the sample households and the supply of credit by RCCs in 2004, and the farmers' demand for credit by uses at the time of the survey.

**Table 2.1. Formal Credit Constraint (RCCs) for the Sample Households in the Three Counties Since 2003**

	Wushen	%	Yi	%	Dongsheng	%	Total	%
No. Valid Samples	189		179		30		398	
No. Households Applied for a loan	156		96		20		272	
No. Households Obtained a loan	143		89		20		252	
Of which								
No. Loan amount applied = granted	112		74		18		204	
No. Loan amount applied > granted	31		15		2		48	
<b>1. No. Applications Rejected &amp; Application not fully satisfied</b>	44	23.3	22	12.3	2	6.7	68	17.1
No. Households Not Applied	33		83		10		126	
The Reasons for not Apply								
(1). Do not need a loan	27		55		7		89	
(2). Will be rejected if applying	3		6				9	
Do not know loan officials	1							
Regarded as too poor to Repay	1							
Non RCC members	1							
Unable to provide collateral								
(3). The interest is too high	2		7		1			
(4). Other borrowing costs too high			2					
(5). Feel cannot repay								
(6). Having other loans			2					
(7) Other <sup>1</sup>	4		11		2			
<b>2. Credit Constraint HH among those not applied <sup>2</sup></b>	7	3.3	17	9.5	2		26	5.8
<b>3. Total Credit Constraint Households (3=1+2)</b>	51	27	39	21.8	4	13.3	94	23.6

Source: Survey data.

Notes 1. Those households who did not apply because they thought they would have been rejected if applying; 2. Credit constraint households among those not applied =(2)+(7).

Credit rationing in this report refers to the quantity rationing on credit supply by formal financial institutions. Credit constraint households refer to the households whose demand for credit cannot be met by the amount of credit supplied. Formal financial institutions refer to rural credit cooperatives (RCCs), the Agricultural Bank of China (ABC) and other state owned commercial banks (SOCBs); informal finance refers to the credit transactions occurred among relatives and friends with or without interest charged, and borrowing from professional moneylenders. The credit constraint households by formal financial institutions in the sample areas are shown in Table 2.1.

There are formal credit constraints for rural households in Erdos. In terms of number of households, credit constraint households in Table 2.1 include the following two parts: a). Households applied for a loan from RCC but were rejected plus the households applied for a loan from RCC but were rationed by RCC, i.e. the amount of loan approved by RCC less than the amount of loans applied; b). Households who did not apply but have a demand for credit from formal financial institutions. It is shown in Table 2.1 that about 24 per cent of the sample households is formal credit constraint, of which, over 25 per cent for Wushen Banner, 22 per cent for Yi Banner and 13 per cent for Dongsheng District. Apparently, of the three counties, credit constraint is most serious in Wushen Banner.

## 2.2. Demand for Credit and Credit Supply in 2004

The demand for credit and the gap between the demand and supply in 2004 are shown in Tables 2.2 and 2.3.

**Table 2.2. The Demand for RCC loans for the Sample Households from the Three Counties in 2004**

	Wushen	%	Yi	%	Dongsheng	%	Total	%
Valid Sample	180		182		31		393	
No. HHs Demand Loans	154	85.6	101	55.5	15	48.4	270	
Amt of Loans Demanded (10000 ¥)	275.8		268.4		121.		665.2	
Amt demanded by each HH ¥	17,909		26,574		80,667		125,150	
<b>Distribution by Amt Demanded</b>								
No. HH demand ¥ 0-1000	4	2.6	3	3.0		0.0	7	
No. HH demand ¥ 1001-2000	26	16.9	10	9.9		0.0	36	
No. HH demand ¥ 2001-3000	7	4.5	10	9.9		0.0	17	
No. HH demand ¥ 3001-4000	4	2.6	3	3.0		0.0	7	
No. HH demand ¥ 4001-5000	22	14.3	11	10.9		0.0	33	
No. HH demand ¥ 5001-10000	42	27.3	26	25.7	2	13.3	70	
No. HH demand ¥ 10001-20000	30	19.5	11	10.9	4	26.7	45	
No. HH demand ¥ >20000	19	12.3	27	26.7	9	60.0	55	
<b>Distribution by Loan Uses</b>								
1. Cropping	28	18.2	11	10.9	0	0.0	39	
2. Animal Production	62	40.3	27	26.7	0	0.0	89	
3. Small Trade and Commerce	18	11.7	22	21.8	2	13.3	42	
4. Migrant labour	0	0.0	0	0.0	0	0.0	0	
5. Other Off farm working capital	0	0.0	1	1.0	3	20.0	4	
6. Other off farm investment	3	1.9	11	10.9	7	46.7	21	
7. Education	14	9.1	10	9.9	1	6.7	25	
8. Housing	11	7.1	5	5.0	1	6.7	17	
9. Wedding	4	2.6	4	4.0	0	0.0	8	
10. Medical Expenses	5	3.2	2	2.0	1	6.7	8	
11. Grain Consumption	0	0.0	0	0.0	0	0.0	0	
12. Other Consumption	4	2.6	0	0.0	0	0.0	4	
13. Repay other loans	2	1.3	0	0.0	0	0.0	2	
14. Lending	0	0.0	1	1.0	0	0.0	1	
15. Other	0	0.0	1	1.0	0	0.0	1	

Source: Survey data.

**Table 2.3. The Satisfaction of the Demand for Loans from RCCs in 2004**

Borrowing from RCCs	Wushen	Yi	Dongsheng	Total
Valid Sample	180	182	31	393
No. HH borrowed from RCCs	119	90	14	223
Total Amt applied (¥10,000)	136	177	221	534
Average Amt applied each HH ¥	11,441	19,701	157,500	23,944
Total Amt Disbursed (¥10,000)	113	152	127	391.7
Average Amt Obtained each HH ¥	9,525	16,877	90,357	17,567
The Satisfaction for Loans Applied % <sup>1</sup>	83.25	85.66	57.37	73.37
The Satisfaction for Loans Demanded % <sup>1 2</sup>	41.10	56.59	100	58.89

**Source:** Survey data.

**Notes:** 1. Total Amt Disbursed / Total Amt applied; 2. Total Amt Disbursed / Amt of Loans Demanded in Table 1.2.

The proportion of the households that have a demand for credit and the amount of credit required are related to the income levels and investment opportunities in a county. Of the entire sample households, about 70 per cent had a demand for credit from formal financial institutions, mainly from RCCs in 2004. The highest proportion is found for the households in Wushen, followed by those in Yi Banner and Dongsheng. However, in terms of the average amount of loans required, the lowest is from the households in Wushen, followed by those in Yi Banner and Dongsheng. Over 60 per cent of the households demanded a loan of less than ¥10,000 in 2004. A high proportion of credit demand falls between ¥4000 and ¥10,000. The priority uses of farm credit are animal production and cropping, and off farm production, followed by investment in children's education, non-farm investment and housing. Over 70 per cent of the credit demanded is for the productive uses. Apparently, following the increases in farm incomes, households demand more credit for farm and off farm production and investment, as their subsistent needs on basic food and clothing have been met. A higher proportion of demand for loans for productive uses signals a higher loan repayment rates.

Compare to a total demand of ¥6.65 million from the sample households, RCCs provided an amount of ¥3.91 million, about 60 per cent of the loans requested. In terms of the extent of demand satisfaction, the lowest is Wushen, followed by Yi Banner and Dongsheng.

### 2.3. The Future Demand for Credit by Rural Households

The demand for credit from both formal and informal sources by the sample households in the three counties at the time of survey (October 2005) is shown in Table 2.4. The total demand for credit from the 393 valid sample households reached ¥35.5 million. In terms of the amount of credit required, a high proportion of credit demand is for small trading activities (32.7 per cent), next is animal production (24.8 per cent), and then followed by investment in manufacturing and processing plants and housing, whereas the demand for credit for cropping is a mere 7 per cent of the total demand.

**Table 2.4. The Demand for Loans at the Time of the Survey, October 2005**

	Wushen	%	Yi	%	Dongsheng	%	Total	%
Valid Sample	180		182		31		393	
<b>Cropping</b>								
No. HH Demand Loans <sup>1</sup>	118	65.0	42	23.1	1	3.2	161	41.0
Amt Demanded ¥10,000 <sup>2</sup>	134.7	11.4	117	5.7	0	0.0	251.7	7.1
Amt Per Household ¥ <sup>3</sup>	11,415		27,857		0		15,634	
<b>Animal Production</b>								
No. HH Demand Loans	138	76.7	131	72.0	2	6.5	271	69.0
Amt Demanded ¥10,000	307.6	26.1	494.6	24.3	80	23.8	882.2	24.8
Amt Per Household ¥	22,286		37,756		400,000		32,552	
<b>Small Trading</b>								
No. HH Demand Loans	50	27.8	82	45.1	13	41.9	145	36.9
Amt Demanded ¥10,000	282.4	23.9	689.6	33.8	191	56.8	1163	32.7
Amt Per Household ¥	56,480		84,098		146,923		80,207	
<b>Start up a factory</b>								
No. HH Demand Loans	16	8.9	29	15.9	1	3.2	46	11.7
Amt Demanded ¥10,000	302.6	25.6	434.3	21.3	20	6.0	756.9	21.3
Amt Per Household ¥	189,125		149,759		200,000		164,543	
<b>Migrant labour</b>								
No. HH Demand Loans	0	0.0	0	0.0	0	0.0	0	0.0
Amt Demanded ¥10,000	0	0.0	0	0.0	0	0.0	0	0.0
Amt Per Household ¥	0		0		0			
<b>Housing</b>								
No. HH Demand Loans	40	22.2	31	17.0	8	25.8	79	20.1
Amt Demanded ¥10,000	98.5	8.3	240.3	11.8	30	8.9	368.8	10.4
Amt Per Household ¥	24,625		77,516		37,500		46,684	
<b>Wedding</b>								
No. HH Demand Loans	9	5.0	11	6.0	1	3.2	21	5.3
Amt Demanded ¥10,000	12	1.0	35.5	1.7	3	0.9	50.5	1.4
Amt Per Household ¥	13,333		32,273		30,000		24,048	
<b>Children's Education</b>								
No. HH Demand Loans	31	17.2	19	10.4	4	12.9	54	13.7
Amt Demanded ¥10,000	40	3.4	25.7	1.3	12	3.6	77.7	2.2
Amt Per Household ¥	12,903		13,526		30,000		14,389	
<b>Medical Expenses</b>								
No. HH Demand Loans	4	2.2	1	0.5	0	0.0	5	1.3
Amt Demanded ¥10,000	2.6	0.2	2	0.1	0	0.0	4.6	0.1
Amt Per Household ¥					0		9200	
<b>Total</b>								
Amt Demanded ¥10,000	1180.4		2039		336		3555.4	
Amt Per Household ¥	65,575		112,033		108,387		90,467	

Source: Survey data.

Note: 1. Number of households from the sample demands credit from both formal and informal sources. 2. Total amount of credit demanded by the households who have a demand for credit. 3. Amount of credit demanded by an average household in the sample.

The lag gap between the demand for credit in 2004 (Table 2.2) and their demand at the time of the survey can be attributed to a number of factors. First, an increase in credit demand is expected for 2005 following the increases in incomes and investment opportunities in the area. Next, the demand presented in Table 2.4 represents the demand from both formal and informal sources, compared with the demand for formal finance in 2004 shown in Table 2.2. Last but not least, some farmers may have overstated their demand for credit at the time of the survey, with the expectation to borrow from the microfinance institutions to be created.

### **III. Credit Uses and the Demand for Credit from Enterprises**

An important aspect of the economic growth in Erdos is the growth of its privately owned small-scale enterprises. According to the information from the City's Economic and Trade Commission, by February 2005, the registered private enterprises and micro-enterprises (ICHS) in the city reached 6,234 and 22,049 respectively.

The demand for credit from small and micro-enterprises in this report may not be accurate and complete based on the following reasons: (i). a relatively small sample size due to the time limit and difficulties in interviewing enterprises;<sup>4</sup> (ii). tendency of some enterprise owners to understate their incomes and profits (for tax reasons mainly) and to hide or understate their borrowing from informal sources, especially from those institutions that are not allowed to provide loans, and/or the institutions that had provided loans at a high lending rate (e.g. over 25 per cent, over 4 times of the base lending rate set by the PBC); (iii). small mine operators, as well as small traders and transporters of coals and other resources, were not interviewed. In general, the owners and traders of coals and cashmere are more willing to pay a higher rate of interest for short-term loans. Because of (ii) and (iii) above, it can be reasonably assumed that the actual demand for credit from enterprises in Erdos and the rates of interest they are willing to pay would be higher than what we obtained from our interview.

Of all the 64 sample enterprises (Table 1.2), 20 were created by laid off state workers.

#### **3.1. Credit Constraints**

The definitions for credit rationing by financial institutions and credit constraint enterprises in this section are the same as those in Section II. The credit constraint enterprises are defined as those enterprises whose demand for credit cannot be fully met by financial institutions. The credit constraint enterprises in Erdos are shown Table 3.1

---

<sup>4</sup> Some small and micro enterprises refused to be interviewed, because they were too busy to make themselves available, or they do not want to reveal their business operations, including their incomes, profits and loans.

**Table 3.1. Formal Credit Constraint (RCCs) for the Sample Enterprises in the Three Counties Since 2003**

	Small Enterprises	%	Micro-enterprises	%
<b>Valid Samples</b>	24	100	35	100
No Enterprises Applied for a Loan	13	54.2	18	51.4
No Enterprises Obtained a Loan	12	50	14	40
Of Which,				
No. Loan amount applied = granted	10		11	
No. Loan amount applied > granted	1		3	
<b>1. No. Applications Rejected &amp; Application not fully satisfied</b>	2	12.5	7	20
No. Firms Not Applied	11	45.8	17	48.6
The Reasons for not Apply		100		100
(1). Do not need a loan	7	63.6	4	23.5
(2). Will be rejected if applying	4	36.4	7	41.2
Do not know loan officials			2	
Regarded as too poor to Repay	4		5	
Non RCC members		0.0	1	5.9
Unable to provide collateral		0.0	4	23.5
(3). The interest is too high				
(4). Other borrowing costs too high	1			
(5). Feel cannot repay		0.0	1	5.9
(6). Having other loans			1	
(7). No local Residence Right				
<b>2. Credit Constraint Firms among those not applied</b>	4	16.7	13	37.1
<b>3. Total Credit Constraint Firms (3=1+2)</b>	6	25.0	20	57.1

Source: Survey data.

In terms of number of enterprises, credit constraint households in Table 3.1 include the followings: (i). those enterprises that applied for a loan from financial institutions but were rejected, plus those enterprises that applied for a loan from formal financial institutions, but were rationed by RCC, i.e. the amount of loan approved was less than the amount applied; (ii). those enterprises that did not apply but had a demand for a loan from formal financial institutions. From Table 3.1, we can draw the following preliminary conclusions:

- The credit constraint on small and micro enterprises is serious in Erdos, with about half of the sample enterprises are credit constraint, which is more serious than constraint on rural households.
- There is more credit constraint on micro enterprises than that on small-size enterprises, with credit constraint micro-enterprises reached 57 per cent of the sample, compared with a mere 29 per cent for small scale enterprises. The indication is that the smaller the scale of an enterprise, the more likely it will face formal credit constraint.

- Of those enterprises that did not apply for a formal loan, half of them could not meet the conditions for collateral by formal financial institutions. They would not be granted a loan even they had applied.
- The secondary reason for not applying is the complicated procedures for loan application and approval, and high non-interest borrowing costs.

Physical collateral, consisting of commercial houses and land mainly, is crucial for loan access. According to the enterprises interviewed, banks and RCCs in the area usually accept commercial land and buildings, and a second residential house only as collateral for a loan. An applicant's residence and the farmland that had been allotted to the family do not count as collateral since evictions of families in China are next to impossible. Moreover, neither the banks accept other immobile assets as collateral for loan, nor they use cash flows as a base for lending. Seldom a financial institution in the area disburses loans to a small or micro enterprise on credit. On some occasions, banks and financial institutions prefer to take private assets of enterprise owners as collateral, of particularly for newly established small enterprises. Consequently, many small and micro-enterprises without physical collateral have been denied of credit access, though they have good investment opportunities.

It was also found in the interviewed that the real monetary costs paid by enterprise borrowers are usually higher than the nominal rates of interest charged by financial institutions.<sup>5</sup> One estimate is that the real monetary costs could be as high as 15-18 per cent per annum for a loan from a formal financial institution. In general the costs tend to be lower for a well-established enterprises and for the enterprises that have sufficient collateral. Some enterprises simply switch to informal lenders, confronting with a high real monetary cost and complicated procedures for loan application and approval.

---

<sup>5</sup> The real monetary costs here do not include the transaction costs of complicated procedures for loan application and approval.

### 3.2. Enterprise Borrowing in Erdos

Under credit constraint, borrowings by the sample enterprises from formal financial institutions in Erdos are shown in Table 3.2.

**Table 3.2. Borrowing from Formal Financial Institutions for the Sample Enterprises in Erdos**

	Small Firms	%	Micro-firm	%
<b>Valid Enterprises</b>	24	100	35	100
<b>No Firms Obtained a Loan</b>	12	50.0	14	40
Of Which				
ABC	1	8.3	1	7.1
ADBC	1	8.3		
Other Commercial Banks	2	16.7		
RCCs	8	66.7	13	92.9
<b>Of all the Borrowings</b>			14	
Loans on Credit	1	8.3		0.0
Loans on Firm Collateral <sup>1</sup>	5	41.7	3	21.4
Loans on Private Collateral <sup>2</sup>	4	33.3	9	64.3
Loans on collateral provided by a third party	1	8.3	2	14.3
Loans on the conditions that the borrower	1	8.3	0	0.0
<b>Loan Terms</b>				
No. Loans within 3 months	0	0.0	3	21.4
No. Loans within 6 months	4	33.3	4	28.6
No. Loans within 12 months	8	66.7	6	42.9
No. Loans over 12 months	0	0.0	1	7.1

**Source:** Survey data.

**Notes:** 1. Real estates, mainly land and buildings; 2. Collateral owned not by the firm, but belonging to the owners or managers of an enterprise, usually family houses.

Table 3.2 indicates that the main source of formal loans for small and micro-enterprises in Erdos is RCCs. Over 90 per cent of the enterprise borrowers had their loans from RCCs. According to some entrepreneurs interviewed, it is almost impossible for a small operator to borrow from a commercial bank unless he has a very special relationship with the bank manager. Commercial banks target large and medium enterprises and are reluctant to provide small size of loans to small scale and micro-enterprises. Borrowing from commercial banks usually involves complex procedures, which also frightened off small operators.

Enterprises have more access to RCC loans, though RCCs impose certain conditions on their loans. Membership of a RCC, which means to buy a given amount of shares from RCCs, is often a necessary condition for RCC loan access. Moreover, the terms for RCC loans are usually short, and many borrowers are asked to repay the loans before the end of a calendar year, and then borrow the amount from a RCC again (RCCs are subject to control over their total lending at the end of year).

According to the entrepreneurs interviewed, to borrow ¥300,000 from an urban credit cooperative (UCC), an enterprise will be required to organize 600,000 of deposits for the cooperative, the cost for doing so is equivalent to paying an over 15 per cent of lending rate of interest, plus a great deal of time.

A loan from either a commercial bank or RCC would require physical collateral. It was found from the survey that the amount of loans provide is between 20 to 100 per cent of the value of collateral, mostly between 50 and 70 per cent.

Constraint by formal financial institutions, many small and micro-enterprises seek finance from informal sources of finance. The borrowing by sample enterprises from informal sources is shown in Table 3.3.

**Table 3.3. Borrowing from Informal Sources by the Enterprises in Erdos**

	Small Enterprises	%	Micro Enterprises	%
No. Valid Sample	24	100	35	100
No. Enterprises Having a Informal Loan	9	37.5	17	48.6
Of Which, those also have a formal loan	7		5	
According to Loan Sources				
1. Relatives and Friends	3	33.3	15	88.2
2. Private Moneylenders	1	11.1		
3. Other Firms	2	22.2		
4. Employees	1	11.1		0.0
5. Other	3	33.3	2	11.8
Loan			17	
1. Working Capital;	6	66.7	14	82.4
2. Capital Investment;	2	22.2	3	17.6
3. Other [explain]	1	11.1		0.0

Source: Survey data.

It is shown in Table 2.3, of 17 micro-enterprises who borrowed from informal sources of finance, only five of them borrowed from formal financial institutions at the same time. This tends to suggest that micro-enterprises turn to informal finance for support when they have difficulties in accessing formal loans. Micro-enterprises borrow mainly from their relatives and friends. In contrast, many small enterprises borrowed from both formal and informal sources, and their loan sources are more diversified. The informal lending rates for the sample small enterprises range between 12 to 24 per cent per annum, with the highest 48 per cent per annum. According to enterprises interviewed, the well established small and micro-enterprises can access loans at a rate of between 15 to 24 per cent per annum, whereas newly established enterprises have to pay a rate above 30 per cent per annum. The main use of enterprise credit is working capital.

### 2.3. The Demand for Credit In the Future

The survey also found that since the beginning of 2005, many enterprises have experienced a shortage of funds, mainly shortage of working capital (Table 3.4). At least two thirds of enterprises interviewed require a loan in 2005 and 2006 (Table 3.5). In terms of loan amount, most enterprises demanded a loan of within ¥500,000, and about half demand a loan within ¥100,000.

**Table 3.4. The Number of Enterprises Experienced Shortage of Funds in 2005**

	Small Enterprises	Micro-enterprises
Number of Sample	25	39
No. Enterprises Had Fund Shortage	12	22
% the Sample	48.0	56.4
The Reasons		
Shortage of working capital	5	12
Problem with Marketing	3	6
Delay in customer payments		4
A decline in product prices	2	
A rise in prices of input	2	
Other		
Total	12	22

Source: Survey data.

**Table 3.5. The Demand of the Sample Enterprises for Loans in 2005 and 2006**

	Unit	Small Enterprises	Micro-enterprises	Total
No. Valid Sample		24	35	59
No. Enterprises demand a loan		16	25	41
Of Which, demand				
¥ 20,000-60,000		1	8	9
¥ 60,001 – 100,000		0	4	4
¥ 100,001-500,000		2	5	7
¥ 500,000 - 1,000,000		4	5	9
> ¥ 1,000,000		9	3	12
Total Amount of Loans Demanded	¥ Million	35	6.5	41.5
Average Amount by an enterprise	¥	2,187,500	260,000	1,012,195

Source: Survey data.

## IV. The Development of Non Banking Finance in Erdos

The development of semi and informal financial institutions often reflects the distortions on the formal financial markets. Four pawnshops, two credit guarantee companies and the relevant government departments in Dongsheng of Erdos were interviewed to further assess the extent of demand for credit from enterprises and households in the region.

The government regulations on pawnshops stipulate that pawnshops in China are permitted to engage in lending against physical collateral only, no lending on credit are allowed. Neither is pawnshop allowed to engage in other financial transactions, such as deposit taking and remittances. Moreover, the only source of the loan funds for pawnshops is the funds from investors. Every pawnshop must have three legal person owners, plus a number of natural person investors. The investment from legal persons shall account for not less than 50 per cent of all the shares capital.

There are eight officially sanctioned pawnshops in Erdos, out of 39 registered pawnshops in IMAR.<sup>6</sup> All the four pawnshops interviewed are created in 2002 and 2003. It was found in the survey that the clientele of pawnshops has changed from the poor to the rich, including private enterprise owners, property developers, mine owners, traders of mineral resources, wool and cashmere. This change was caused partly by the rapid economic growth, and partly by the serious credit constraint imposed by the formal financial institutions. Accordingly, collateral for pawnshops has also changed from consumption items to real estate and mineral resources and mines in the area.

**Table 3.6. The Operation of Registered Pawnshops in Erdos**

Items	Unit	Shop 1	Shop 2	Shop 3	Shop 4
Loan Portfolio	¥ 10000	2000	4000	600	800
Annual Disbursement 2004	¥ 10000	3000-4000	17500	2400	2000
<b>Loan Terms</b>					
Maximum	Day	180	6	6	6
Average	Day	30		90	60
Minimum	Day	8	5		3
<b>Interest Rate</b>					
Maximum	% p.a.	60	60	60	60
Average	% p.a.	45.6	36	36-48	36-42
<b>Loan Size</b>					
Maximum	¥ 10000			>100	200
Average	¥ 10000	15			20
Minimum	¥ 10000			5	1
<b>Loan Uses</b>					
Property Development				60	
Mining & animal product trade				30	
Other				10	
<b>Auction of Collateral</b>	Times	1	1	2	1

Source: Survey data.

It was found in the survey that the annual loan disbursement by a pawnshop is much greater than its registered capital and also greater than its loan portfolio. The registered capital of a pawnshop company is between ¥ 5-10 million, though the actual funds in use are often greater than the registered capital by two to four times. Moreover, annual loan disbursement is much greater than the loan portfolio as shown

<sup>6</sup> There are 9 pawnshops in Hohhot and 8 in Baotou City of IMAR.

in Table 3.6 as a pawnshop on average revolves its funds six to 10 times each year (on average 2.5 times for a formal financial institution in the local area). So with a registered capital of ¥10 million, annual loan disbursement of a pawnshop can easily reach as high as over ¥100 million. A number of pawnshops have applied to increase their registered capital so as to increase their loan portfolio in a transparent manner.

Compared with banks and RCCs, pawnshops in Erdos have charged a much higher nominal rate of interest, but the loans from pawnshops are much quicker, and the application processes are simpler, so long as you have sufficient collateral. The regulation set 60 per cent per annum as the maximum rate of interest to be charged by a pawnshop. As shown in Table 3.6, the average rate of interest charged by pawnshops in Erdos has been over 35 per cent. Higher lending rates of interest and few cases of auction of collateral indicate a strong demand for credit, a good repayment capacity of local borrowers, and subsequently a high profit rates for pawnshop operators and owners. The average loan size is between ¥150,000 to 200,000, the lowest is ¥10,000 or below. These loans can be regarded as micro-loans, or small size loans. The major uses of loans are for property development, trading of mineral resources and animal products, rather than consumption. This indicates that the inflexibility of operation of formal financial institutions, cannot set their price, or differentiate clients by prices, cannot meet the demand for credit from those with sufficient collateral, and complicated procedures for loan application and approval. According to some pawnshops, they can finish all the paper work for a loan applicant within 30 minutes (does not include the time for inspecting the collateral. However, if you want to borrow from a bank, you need two months to develop the relationship with the loan official. The most important advantage of borrowing from a pawnshop is that for those with sufficient collateral, you can borrow quickly, without much paper work, convenient, so for urgent needs, not lose the market opportunities.

According to some pawnshop managers interviewed, in addition to the eight officially registered pawnshops, there are around over 200 underground ones in Erdos. In addition, there are many credit guarantee companies and others engaging in illegal lending operation in Erdos. These institutions are competitors for the officially registered pawnshops. Some credit guarantee companies lend at around 35 per cent per annum while organize funds at a cost of around 15-18 per cent per annum. This also indicates a strong demand for credit in the local area.

Nearly all the non-banking institutions engaging in lending, official or non-official, do not have detailed report on their lending activities, no report on loan quality and sources of funds. There are risks involved in such operations.

## V. Conclusions and Recommendations

Following the rapid income growth, rural households and small and micro enterprises in Erdos have a high demand for credit for productive uses, including animal production, cropping and off farm production, and for their children's education and for housing and family consumption. Formal lenders in Erdos, mainly commercial banks and RCCs have rationed the supply of credit mainly by physical collateral owned by households and enterprises. There are serious credit constraints for households and enterprises. About half of the small and micro enterprises and about 25 per cent of rural households are credit constrained by formal lenders. The lower proportion of the number of the credit constrained households is mainly due to the RCC policy of lending to rural households on credit. Credit constraint is most serious for urban-based micro-enterprises that have no collateral. Credit constraint imposed by formal financial institution has increased the costs of borrowing for rural households and small and micro enterprises and resulted in the forgone of profitable investment opportunities in Erdos.

The strong demand for credit in Erdos is confirmed by the high rate of interest charged by pawnshops and other semi formal and informal lenders. The strong demand for loans from pawnshops and other semi formal and informal lenders also indicates the high costs of borrowing and inefficiency of the operation of formal financial institution.

There is a market for a lending only microcredit institution in Erdos. The establishment of a new micro-credit institution is able to

- Openly attract investment funds from within and outside the region, to be used for local economic development and meet the demand for loans from rural households, micro and small-scale enterprises, hence contributing to local economic growth.
- Target specifically those rural households, the poor people and micro and small enterprises which have no access to credit because of the lack of collateral or other reasons, and help them to increase their incomes, employment, and contributing to social and political stability.
- Mitigate the potential financial risks, the risks generated by those institutions and lenders who take on de facto deposits and lend at a high rate of interest, beyond government regulation and supervision.
- Lower the rates of interest in local areas, hence to reduce the costs of borrowing for rural households and micro enterprises.
- Try on new lending methodologies and institutional forms for serving rural households and micro enterprises in China, replicated to other regions of China.

If a MFI is set up, it is suggested that the institution shall target

- Targeting population: Micro-enterprises, farmers and herders, some small-scale enterprises, and laid-off state workers.
- Loan products: Loans on credit, and against cash flows, newly developed loans on guarantee, and loans on collateral, with lower rates of interest than pawnshops and fast processes.
- Loan Size: mainly micro loans, with a ceiling.
- Sources of Funds: Investment, no deposits, explicit or implicit deposits.