

# I INTRODUCTION

## BACKGROUND

Rural financial markets in Asia are ill-prepared for the twenty-first century. That is the undeniable conclusion of this study.

Asian rural financial markets have been buffeted by several major forces during the past three decades. Policymakers have tried to direct them to meet economic and social objectives, first to support the green revolution and, more recently, to aid in poverty alleviation. Massive amounts of subsidized funds have been supplied for these purposes. New specialized development finance institutions have been created to deliver credit to targeted clients when commercial lenders failed to serve the intended clients adequately. The transition economies have been forced to dismantle their planned allocation of resources and now struggle to create market-oriented financial institutions. The market economies have removed some of the most repressive features of their urban-biased policies, but both entrepreneurs and financial institutions have much to learn about how to succeed in the new environment.

The result of these many changes and government interventions is a fragile financial system with limited outreach. Many institutions have failed, many have been recapitalized, and many are weak with large nonperforming portfolios. Few countries have strong, self-sustaining institutions with the capacity to serve large numbers of rural farm and nonfarm clients, including the poorest members of the rural economy.

A positive feature is the large amount of experimentation that has occurred in many countries, especially by nongovernmental organizations (NGOs), to break the barriers faced by the poor in accessing formal finance. These innovations appear to be more promising than previous attempts to induce lenders to serve this clientele group.

While Asian financial markets have been struggling, the rural areas in much of the region have undergone a major transformation. This transformation was caused by an unprecedented technological and economic revolution that raised agricultural productivity and helped the region escape the worst cycles of hunger and despair faced by previous generations. The scientific breakthroughs of the green revolution induced major changes in farm and nonfarm production systems, resulting in new sources of employment in rural areas.

Public institutions created the technology, adapted it to local environments, and disseminated it to farmers. Complementary investments were made in irrigation, roads, and distribution systems such that farmers could access the water, seed, fertilizer, and chemicals needed for production. Markets emerged to handle the inputs and expanded production in many countries. Private traders and cooperatives performed the marketing functions in several countries, while governments and parastatal agencies were dominant in others. Policymakers created major subsidized credit programs as part of the technological package extended to farmers to encourage the rapid adoption of the new technology.

In the 1970s, many studies were undertaken of rural financial systems, often with the objective of determining whether farmers were receiving the funds targeted for them and whether the funding affected the adoption of technology and improved rural income. There has been no comprehensive survey of rural finance in the region, however, to analyze the role of the financial system in the transformation process and to assess the status of the system today. This study fills that void and furnishes important lessons about the appropriate role of finance in rural development. It analyses how rural financial markets in Asia evolved during this period of rapid

rural transformation. It is one of five studies for a major research project commissioned by the Asian Development Bank (ADB) in 1998 entitled *A Study of Rural Asia*. The objective of the project was to identify, for the Bank's developing member countries, policy and investment priorities that will promote sustainable development and improve economic and social conditions in the rural sector. It represented a follow-up study to two earlier regional studies of rural Asia that the ADB undertook in the 1960s and 1970s, respectively.

The five studies review developments in the Asian rural economy to gain an understanding of the causes and consequences of economic performance during the last two decades, and to identify possibilities and constraints to furthering the transformation into the next century. The five studies identify strategies and priorities for Asian developing countries and for the international donor community. Within the ADB, they provide background information and material for the formulation of its rural development strategy and the basis for its future operations in agriculture and rural development. The intended audience for the published reports of these studies is professionals and policymakers involved in efforts to improve conditions in rural Asia.

## METHODOLOGY

The primary objective of this study was to examine the provision and use of financial services in Asia's rural economy since the last survey by ADB, published in 1978, and to identify the relationship between the transformation of the rural economy and the rural financial system. Asia is a vast region composed of many heterogeneous countries that have employed a variety of policies and programs since the 1970s to improve rural finance. To narrow the task to manageable proportions, six countries were selected for detailed study—Bangladesh, People's Republic of China (PRC), India, Indonesia, the Kyrgyz Republic, and Thailand. Bangladesh was

chosen because of the key role that microfinance organizations have come to play in the country. India and the PRC were selected because they represent huge countries with a long history of heavy governmental intervention in their financial markets. The Kyrgyz Republic is one of the transition economies and has rapidly implemented major economic reforms. Indonesia and Thailand represent countries in which market forces have been allowed to play a larger role in shaping the financial system.

All the relevant literature that could be identified for these six countries was assembled, and a limited amount of primary data was obtained with the help of nationals in the countries. The key literature on rural financial markets in other developing countries was also consulted.

Since the study was based largely on existing literature, key details were often not available on specific topics such as total rural loans made or outstanding; the characteristics of the participants in formal and informal rural financial markets; the terms and conditions of financial transactions; financial policies and supporting financial infrastructure; the details of the design and operations of formal financial institutions and informal financial arrangements; and the perceptions of policymakers, bank employees, farmers, and nonfarm entrepreneurs. This limitation meant that the current status of rural finance and its evolution since the 1970s were constructed from fragmentary and incomplete information. Fortunately, several commentators on various drafts helped clarify specific points and correct possible misinterpretations.

## ORGANIZATION

This volume is divided into two main parts. The first part consists of five chapters that present the study's objectives, the conceptual framework, and the principal findings. The second part presents a short overview of the six countries followed by the detailed case study of each.

Chapter II summarizes the nature of the economic transformation that has occurred in Asia since the 1970s, explains the structural changes that occurred in the rural economy, and identifies the opportunities and challenges that these changes present for rural financial markets. It draws heavily on a companion volume by Rosegrant and Hazell (1999).

Chapter III provides the conceptual framework used to analyze financial markets. It presents a lengthy review of the evolution in views that has occurred about the role of financial markets in economic development, and the costs and risks of providing rural financial services. It describes the approach governments took to rural finance in the 1970s and 1980s, the problems identified with this approach, and the resulting shift from the old directed credit approach to the new market-oriented paradigm for developing financial markets. The emergence of microfinance and its contribution to the new paradigm are explored. The problems of creating financial markets in transition economies are discussed as well as the new understanding of the role of information in finance. The chapter concludes with a three-pronged strategy for building rural financial markets based on the new paradigm: creating the policy environment, building financial infrastructure, and institutional development.

The first section of Chapter IV traces the history of rural finance in Asia since the 1970s and summarizes the current status. It begins with a description of the perspective of rural finance held at the time of the previous rural Asia studies conducted by ADB in the 1960s and 1970s. It discusses why directed credit may have made a more positive contribution in some Asian countries than elsewhere, but also describes how financial problems contributed to the financial and economic crisis in Asia that began in 1997. The section ends with the status of rural finance in the region today. Three financial institutions in the region have been identified as flagship institutions because of their relatively good performance compared to most rural financial institutions in developing countries. The second section summarizes the experience of these flagship institutions: the Bank for Agriculture and Agricultural Cooperatives in

Thailand, the unit desa system of Bank Rakyat Indonesia, and the Grameen Bank in Bangladesh. The key factors that determined their relative success are identified.

Chapter V summarizes the key findings of the study and identifies priority actions to be taken to strengthen rural financial markets in Asia. It describes some of the special problems that complicate the task and discusses how the financial crisis may influence the process. It identifies the key policy areas that demand attention, the financial infrastructure that is weak or missing, and the need for institutional development, especially regarding failing institutions and microfinance organizations. Major issues for donors are identified. The chapter ends with a statement of the financial market challenges the region faces as it enters the twenty-first century.

The detailed case studies follow a similar outline, but the details presented vary because of differences in the available information. The studies explain the general strategy that each country has followed in its financial sector and how the rural sector has been treated in term of policies and institutions. To the extent possible, information is presented on the nature of formal and informal rural financial transactions. The evolution of microfinance is discussed, describing its expanding role in making small loans to farm and nonfarm enterprises. The outreach and sustainability of financial institutions are emphasized because of the poor performance of many countries in these key performance measures. Recommendations for improvements in rural financial markets are presented at the end of each country study.