

III DEVELOPMENT OF RURAL FINANCIAL MARKETS

This chapter presents a discussion of why the development of viable and efficient rural financial markets is important for rural Asia, summarizes major issues about government involvement in creating these markets, and presents an improved strategy for developing financial markets and institutions. The development of rural finance is placed in the broader perspective of financial markets. The chapter also provides a framework for analyzing the Asian approach to promoting rural finance discussed in the next chapter, for organizing the six country studies presented in Part B, and for formulating the recommendations presented in Chapter V.

The chapter consists of three main sections. The first section contains a discussion about the relationships between economic development and the financial sector. The financial system is defined and the special challenges of providing financial services in rural areas are identified. Government intervention in financial markets is discussed in the second section. Some of the key debates about the appropriate role of government are highlighted, including the paradigm shift that has occurred in the approach advocated for developing rural finance. The section also briefly describes how new thinking about knowledge and information is contributing to the debate about the appropriate role of the State and donors in the development of financial markets. A three-pronged framework for building rural financial markets is introduced in the third section; it includes creating the policy environment, building financial infrastructure, and developing institutions. The topic of developing institutions includes one subsection that

summarizes lessons learned from microfinance, and another that deals with the problematic issue of agricultural development banks. These two topics are especially relevant for several Asian countries.

THE FINANCIAL SYSTEM AND ECONOMIC DEVELOPMENT

Finance and Economic Development

The efficient functioning of markets affects the pace, speed, and pattern of economic development. Financial institutions—formal, semi-formal, and informal—represent an essential part of the institutional infrastructure required for an efficient market economy. Financial systems provide vital services in an economy as noted earlier (Levine, 1997; World Bank, 1989). They provide payment services; they mobilize savings and allocate credit; and they price, pool, and trade risks. In this way they make it cheaper and less risky to trade goods and services and to borrow and lend. Without finance, economies would be reduced to the inefficiency of barter. Investors would be limited to self-financing their investments. Households with surpluses, but without good investment alternatives, would be forced to store their savings under the mattress or hold them in less productive assets. Limited access to financial services due to inefficient financial markets constrains economic development (Fry, 1988). For these reasons, governments and donors have devoted vast resources to developing financial systems in low-income countries during the past three decades.

There has been considerable debate about the role of financial markets and economic growth, and the appropriate role of the State in regulating financial systems. Shaw (1973) and McKinnon (1973) pioneered the view that repressed financial systems constrain economic growth. Countries that have held interest rates at artificially low real rates were found to experience lower growth rates than those that have adopted

market rates (World Bank, 1989). Although competing views still exist, the preponderance of theoretical and empirical evidence today firmly suggests a positive relationship between financial development and economic growth (Levine, 1997). In recent years, the debate has increasingly focused on what the State should and should not do, and the impact of financial policies in the specific case of the "East Asian Miracle". One view argues that suspected market failures are a rationale for government intervention to improve access to credit (Stiglitz, 1992). Another view, however, is that the state of empirical evidence makes it difficult, if not impossible, to determine situations in which intervention can be unequivocally prescribed and its consequences fully anticipated (Besley, 1994).

Rural Development and the Demand for Financial Services

Financial services are important for the development of rural areas. Rural transformation provides opportunities for investments in farm enterprises. Technological changes often require complementary investments that increase demand for working and investment capital. Some of this demand is self-financed, some is serviced by informal sources, but still others require longer-term loans provided by formal institutions. Supplying reasonably priced loans, therefore, can speed the adoption of technology, expand the production of food supplies, and increase farm incomes. When a reliable supply of formal finance is established, farmers may alter their perceptions about the risks of investing. They may choose to invest more of their own funds knowing that their unused borrowing capacity will be available to meet future cash needs (Zeller et al., 1997).

A wide variety of rural nonfarm enterprises also arises in response to new opportunities and demands for new goods and services that emerge with economic transformation (Rosegrant and Hazell, 1999). In the absence of financial services, income from nonfarm enterprises may provide funds for farm investments, but they also generate a demand for

loanable funds that cannot always be met by savings or informal finance (Meyer, 1999). Taken together, farm and nonfarm enterprises with their diverse economic activities comprise a large and heterogeneous pool of potential customers for formal loans.

A safe and reliable place for savings is another important but largely overlooked financial service demanded in rural areas (Vogel, 1984). The widespread use of informal finance, self-help and village-level savings groups, and funeral funds is evidence of demand for savings services. All rural households must save; otherwise they would not survive seasons of the year when cash is in short supply or in bad years when crops fail and livestock die. They must also save for unexpected family emergencies of illnesses and death. Saving to make lumpy investments is also important. A recent study showed how access to loans and remunerative ways to save influenced the decision of poor farmers in India to undertake irreversible investments in digging wells for irrigation (Fafchamps and Pender, 1997).

Insurance markets do not exist in most developing countries so rural households employ a variety of strategies to cope with risks and smooth consumption over time (Zeller et al., 1997). Some households acquire assets that produce uncorrelated returns, and hold physical assets in the form of livestock that are easy to liquidate. But such liquidations may jeopardize the ability of households to recover after the emergency passes. Other households use risk-reducing strategies such as pesticides or engage in multiple and diverse income-earning enterprises. Those with access to financial services, however, have additional options of holding financial savings and borrowing in times of emergencies. As noted in Thailand, risk pooling occurs in villages through informal borrowing and lending (Townsend, 1995), but these traditional methods cannot easily accommodate large shocks, such as occurs with a major drought or a disease epidemic that simultaneously affects everyone in the village.

Another financial service demanded in rural areas is a safe and reliable method to transfer remittances. Transfers by

family members who have emigrated are an important source of income for many small farm households. For example, a survey in poor Pakistani villages revealed that internal and external remittances represented 9 to 18 percent of annual per capita income over a five-year period in the late 1980s. They made an important contribution to rural investments (Richard Adams, 1998). It was estimated that between 1977 and 1986, Bangladesh earned about \$3.3 billion¹ in foreign exchange through remittances, an amount equal to about 5.6 percent of GDP, 43 percent of the foreign aid received, and 74 percent of the country's export earnings. About three quarters of this total came from Middle Eastern countries where thousands of Bangladeshi workers were employed. The main informal method of sending money into the country is through the *hundi* system. The migrant overseas gives the foreign exchange to a hundi agent with an associate in Bangladesh who gives the equivalent amount in taka to the specified recipient. This informal arrangement is attractive because a higher exchange rate is obtained, and the recipient avoids the confusion and poor service of the banks and the potential fraud in banks and post offices. The most frequent uses of the remittances were reported as constructing housing and buying land (Bakht and Mahmood, 1988).

The users of financial services in rural areas are heterogeneous and include farm households, plantations, agribusinesses, rural nonfarm enterprises, and landless workers. Households and firms of all income and wealth levels demand financial services. Their demand includes short-term working capital and long-term investment loans, small quickly disbursed loans for emergencies, consumption loans, secure places to hold deposits, and efficient banking mechanisms to transfer payments and remittances.

Farm households employ a variety of methods to manage their cash inflows and outflows over time (Meyer and Alicbusan, 1984). Some have financial surpluses just at the

¹ \$ means US\$ throughout the text.

time that others face deficits. This provides opportunities for financial intermediation within rural areas in spite of apparent similarities in the seasonality of farm enterprises. The covariance of incomes earned on some farms, however, and a local financial institution's vulnerability to the systemic risks that farmers face can impede financial intermediation (Binswanger and McIntire, 1987).

The Structure of the Financial System

The financial system consists of many institutions, instruments, and markets (World Bank, 1989) including formal, semi-informal and informal financial arrangements and institutions. In rural Asia formal financial institutions include commercial banks, development banks, specialized savings banks, postal savings systems, cooperative banks, and unit and regional rural banks. Semi-formal financial systems are composed of farmers' associations, credit cooperatives, credit unions, village banks, self-help groups, integrated rural development programs, and nongovernmental organization (NGO) financial programs. Communal and savings clubs, mutual aid societies, rotating savings and credit associations (RoSCAs), input suppliers, storekeepers, trader/farmer/agent lenders, moneylenders, and friends and relatives comprise a heterogeneous category referred to as informal finance (Meyer and Nagarajan, 1992). In financial markets, specialized institutions such as savings banks that only mobilize deposits co-exist with purely credit-dispensing government and NGO programs, full service banks, member-owned cooperatives and credit unions, and informal sources.

The suppliers and users of financial services come together in markets and are matched through various types of instruments, the most frequent being loans and deposits. While most formal lenders make only short-term loans for production purposes (for agricultural and nonfarm activities), a few also experiment with consumption and term loans. Most financial NGOs specialize in making short-term loans that can be used

by the borrowers for any purpose. The majority of traditional banks provide only collateral-based loans but some banks and most NGOs offer innovative noncollateral-based loans.

Markets are often segmented, with some sources specializing in offering limited instruments to specific types of clients (e.g., Yadav, Otsuka, and David, 1992; Nagarajan, Meyer, and Hushak, 1995). Users of services may be able to meet all their demands from one source, but frequently more than one source is used. Formal loans generally carry lower interest rates but impose higher transaction costs than informal sources, such that borrowers in rural Asia often seek large formal production loans and small informal loans for consumption and emergencies. The formal and informal systems are linked when a trader borrows from a bank and on-lends to producers as contract farmers, or when a self-help group or NGO collects savings in a village and deposits them in a neighboring bank.

Several countries are attempting to exploit the comparative advantage of each type of finance by strengthening the links between them. For example, the case studies presented later describe German-funded projects designed to link self-help groups and NGOs with formal financial institutions. Because of information problems and high transaction costs, the residents of specific geographic areas may have access to only a small number of suppliers of services. Remote areas with poor transportation may lack access to formal financial institutions. This is why Asian policymakers have tried to induce banks into broadening their rural outreach, and why many NGOs target households with little or no access to formal finance.

A major contentious issue has been the extent to which informal loans, especially from moneylenders, are exploitative. The term *usurious interest rates* is often used with respect to informal finance, but there is relatively little firm evidence to evaluate whether or not the observed high informal lending rates exceed the costs and risks of lending. Several studies have noted that a large number of moneylenders operate in a market and each makes a fairly small number of loans (e.g., Aleem, 1993). The evidence of many lenders has often been used to

argue that competitive conditions exist such that interest rates, although high, reflect costs. The number of lenders in itself does not conclusively demonstrate contestable markets, however, because of market segmentation. Any given borrower may be limited to only a few informal lenders who have the liquidity and the information about a client to make a loan (Esguerra, Nagarajan, and Meyer, 1991).

The Costs and Risks of Providing Financial Services

The provision of financial services consumes resources in the economy. Building an efficient financial system is expensive and supplying services imposes costs on both providers and users. The costs of developing the formal financial system involve the direct costs of building, equipping, and staffing networks of banks, cooperatives, and financial institutions. There are also important indirect costs in developing and operating courts, legal systems, and regulatory and supervisory bodies, as well as the communication, information, and transportation systems needed within banking networks, and between banks, clients, and supervisory authorities.

Transaction Costs for Providers and Users

Finance is an information-intensive industry. Providing services requires significant expense in collecting, processing, storing, and manipulating vast amounts of information on clients, loans, and savings accounts. Institutions must learn how to use this information effectively to determine what services to provide, to whom, and at what price. They must design, monitor, and enforce financial contracts, and earn enough income to cover the costs of staff, the use of capital, taxes, adhering to regulations, and the cost of loan losses (World Bank, 1989). Formal institutions must systematically collect and evaluate information needed for screening clients, making loan decisions, and monitoring borrower performance, and they must conform to rules set by owners, directors, and regulators.

Informal rural moneylenders and traders have an advantage because they can access local information about their clients efficiently through living and working in villages. They have the freedom to decide whom to serve or not serve without being held accountable to others.

The users of financial services also bear transaction costs including the value of time lost, travel costs, and other noninterest costs in getting and repaying loans and making deposits. Borrowers often have to visit distant bank offices to apply for loans, to provide documents and information demanded by the lender, and to make payments. Likewise, depositors incur travel costs and the opportunity cost of time in waiting to deposit and withdraw funds. Financial institutions have experimented with different methods to reduce costs. For example, Viet Nam uses mobile banking and several countries are experimenting with making loans through lines of credit. Many NGOs make group rather than individual loans to reduce costs.

Surveys in several developing countries reveal that rural formal loans cost borrowers 1 to 30 percent of the loan amount in transaction costs (Meyer and Cuevas, 1992). The largest percentages were found for small loans in Bangladesh. Underdeveloped support institutions, financial regulations, small institutions, small loan sizes, and lack of innovation contribute to these costs. One study found that the high reporting requirements for donor funds raised the transaction costs to lenders and borrowers (Cuevas and Graham, 1984). Due to high transaction costs, borrowers tend to use informal sources for small consumption loans even though the interest rates may be higher than for formal loans.

Risks of Providing and Using Financial Services

Providers and users of financial services face multiple risks that increase costs. Lenders face the credit risk that borrowers may default. They face price risks due to unexpected changes in interest rates and foreign exchange risks if they have liabilities in foreign currencies. There is systemic risk in which the default

of one or a few large borrowers may endanger the whole financial system (World Bank, 1989). The current financial and economic crisis in Asia illustrates the demonstration-effect risk in which investors question the risk of doing business in one country due to problems in another. Localized lenders with portfolios concentrated in small geographic rural areas are exposed to covariant income risk: that their clients will be simultaneously affected by a local drought or disease epidemic. Formal financial institutions with broader coverage have greater capacity to withstand the effects of highly localized shocks and can provide the liquidity needed by affected households and firms for recovery.

Information asymmetries create lending risks because borrowers have more information about their projects and intentions than do lenders (Stiglitz and Weiss, 1981). Lenders attempt to reduce credit risk by improving their expertise in collecting and analyzing information about borrowers and their projects. The use of loan collateral is the most common method for reducing credit risks. This does not work efficiently in countries such as Bangladesh, however, where many intended clients do not have acceptable collateral, and expensive and time-consuming legal procedures prevent effective realization of legal claims on collateral. Therefore, the well-known Grameen Bank and many NGOs in Bangladesh use a group-liability lending technology to induce borrowers to use their local information to screen persons selected into the groups and to apply peer pressure to encourage delinquent members to repay.

The legal constraints that impede financial transactions in developing and transition economies are just beginning to be understood. Laws on movable collateral, for example, impede businesses from using machinery inventories as collateral for loans. Accounts receivable are also not acceptable collateral in some countries. This constrains the ability of equipment dealers to borrow for their businesses and provide suppliers' credits to their clients (Fleisig, 1995). The indirect channel of linking financial institutions to small borrowers is broken, access to credit is restricted, and interest rates are pushed upward.

Lenders typically raise interest rates to cover risks, but there are several limitations to this approach. Some countries have usury laws that prohibit setting rates high enough to cover the costs of serving the riskiest clients. For example, India imposes a ceiling of a 4-percent nominal interest rate on loans made to the weaker segments of the population, and commercial banks are required to make one percent of their total priority sector loans to those segments. In the extreme case, raising rates can be self-defeating because of adverse selection: high rates may discourage the more creditworthy customers from borrowing, leaving the lender with the most risky clients. Furthermore, there is the risk of moral hazard: clients may take on riskier projects to cover high interest costs (World Bank, 1989). There may be social resistance to charging higher rates for poorer clients to cover the transaction costs and risks of servicing their small loans and deposit accounts. For example, NGOs in Pakistan and other countries that oppose high interest rates use hidden fees to help cover their lending costs.

Financial savings also involve risks. Financial institutions face a potential liquidity mismatch when mobilizing short-term savings to make longer-term loans. They face potential bank runs when the liquidity problems of one institution cause panic among savers who then demand withdrawals from other institutions, as occurred recently during the financial and economic crisis in Asia. Savers face the potential loss of savings in uninsured institutions. Even if deposits are insured, savers may have to wait long periods before actually receiving their funds when an institution fails. The potential risk of poor people losing savings is a major policy issue in Bangladesh and other countries where unregulated NGOs engage in aggressive savings mobilization. Small localized institutions have a disadvantage compared to larger ones with more dispersed networks because, in the event of a localized problem such as drought, savers will demand to withdraw funds just at the time that borrowers want to borrow (Binswanger and McIntire, 1987).

Governments can adopt measures to reduce information costs and lending risks. For example, strengthening the accounting and auditing requirements improves the quality of

information about large firms. Creating credit bureaus facilitates the exchange of information about borrowers. Investments in transportation and communication infrastructure reduce the costs of acquiring and sharing information. Forecasting information about commodity prices and market opportunities is especially helpful to agricultural lenders who have to project debt repayment capacity of farm borrowers. Improved prudential regulation and supervision of financial institutions reduces risks to depositors and systemic risks for the entire financial system. Loan guarantee schemes are frequently created to reduce lending risks but, as seen in India and the Philippines, they often have not worked well in reducing risks and have been sustained only through massive subsidies (Meyer and Nagarajan, 1996). Only in specific circumstances can guarantee schemes be expected to be effective in expanding rural lending (Gudger, 1998).

High Costs and Risks in Rural Areas

Rural areas present especially difficult and costly problems for the provision of financial services (FAO/GTZ, 1998). Rural bank clients are more dispersed than urban clients and often demand relatively small loans and savings accounts, so per unit transaction costs are high for financial institutions. Information costs for providers and users are higher because transportation and communication infrastructure is usually less well developed. Agricultural loans are often considered inherently risky because of production and marketing risks. Moreover, the returns on farm investments are often low because of urban-oriented agricultural policies. Loan repayment by farmers may be contingent on the borrowers' first meeting household consumption requirements. Many potential clients have little acceptable loan collateral, and property rights to mortgaged land may be uncertain and hard to enforce. Although farm households engage in a variety of enterprises, the concentration of crops and livestock in specific geographic locations results in high covariance of household incomes that makes localized institutions vulnerable to local disasters.

Recognition of these costs and risks provides a rationale for governments and donors to intervene in rural financial markets. This intervention, however, has often focused on the symptoms of the problems rather than the underlying causes. Most governments have underestimated the difficulties, costs, and risks of supplying rural financial services. Moreover, as noted in the case studies, politicians have used policy interventions as a way to appeal to voters. This situation is most obvious in the Bangladesh and India case studies.

EVOLUTION IN POLICIES AND APPROACHES TO RURAL FINANCE: MOVING FROM MANDATES TO MARKETS

Government Intervention in Financial Markets

Governments intervene several ways in financial markets. Historically, they have controlled the means of payment to guarantee soundness and collect seigniorage² (World Bank, 1989). More recently, they have attempted to influence credit allocation, the subject of the next section. Their primary concern has often been to ensure prudent behavior by banks. The impact of bank failure is especially important in developing countries because there are few alternative sources of finance for firms and households. Financial crises can occur when regulation fails, such as happened in the recent financial and economic crisis in Asia. Depositors lose confidence in the banking system in such circumstances so governments introduce deposit insurance and lender-of-last-resort facilities, and bail out failed institutions to prevent bank runs, reduce depositor losses, and restore confidence in the banking system. For example, due to a lack of confidence in banks during the crisis that began in 1997, Indonesians shifted deposits to State and foreign banks

² This refers to the profits earned by issuing currency.

that were perceived to be stronger (McLeod, 1998). The government eventually agreed to protect all depositors to calm the market.

Governments influence the growth in money supply and interest rates as part of overall macroeconomic management. Prudential regulation and supervision procedures are implemented to prevent fraud and excessive risk taking by financial institutions. These include minimum capital requirements, auditing and reporting requirements, and portfolio restrictions. The difficult task of regulation is one of balancing efficiency and innovation, which require freedom to act, and stability, which requires some regulation. A recent concern is the moral hazard problem that can occur when banks are not allowed to fail. If bank owners and managers are not required to pay for their mistakes, they may be induced to undertake risky investments in the future knowing that the government or an international agency will cover their losses.

Directed Credit

Most Asian countries have viewed control of finance as an important means to speed industrial development, expand exports, promote small business, fight poverty and assure cheap food supplies to urban areas. Rather than rely on financial institutions to use market mechanisms to mobilize savings and allocate resources, they have intervened in markets to direct credit for specific purposes. Five main types of interventions have been used: lending requirements and quotas imposed on banks, refinance schemes, loans at preferential interest rates, credit guarantees, and lending by development finance institutions. These actions are intended to increase lending by reducing the costs and risks to lenders of making loans to preferred clients and sectors. Loan waivers and forgiveness programs are also used to reduce the debt burden of priority borrowers.

The donor agencies have made substantial investments in directed credit projects and in agricultural development

projects with credit components. The ADB approved 72 projects between 1970 and August 1991 for a total of almost \$1.4 billion. Just over \$1.0 billion went to 36 projects providing credit to crop farmers and cooperatives for the acquisition of equipment. Over 60 percent of the credit projects went to 13 market economy countries in the region (ADB, 1993).

Much has been written about the impact of directed credit but it is impossible to be precise about the impact in any given situation. While targeted firms and industries may receive more credit than they would without the directed credit, it is hard to determine if aggregate growth is affected. The problem is that credit subsidies are not free; someone must pay them. If regulations lead to cross-subsidization within banks, nonpriority borrowers pay some of the costs through higher interest rates. Bank owners may also experience lower returns on their capital. Moreover, the credit allocation may worsen income distribution if the credit is explicitly or inadvertently skewed in favor of larger firms. The clearest impact has been observed in the damage that directed credit inflicted on financial systems (World Bank, 1989). Many directed credits became nonperforming loans because cheap interest rates encouraged unprofitable investments. In some cases borrowers intentionally defaulted because they believed that governments would waive or forgive their loans or not take action against defaulters in priority sectors. Financial discipline was damaged and intermediaries weakened. The problem was particularly serious for Asian development finance institutions and many became insolvent and were closed or had to be recapitalized, in some cases, many times. Refinance schemes discouraged savings mobilization, leading to lower financial intermediation. Therefore, whatever economic benefits that countries realized due to directed credit imposed a high cost on the financial system.³

³ In the late 1980s, Egaitso (1988) concluded that directed agricultural credit had made a positive impact in expanding outreach but recognized that viability was a problem.

Doubts About the Directed Agricultural Credit Paradigm

Policymakers in the 1950s and 1960s assumed that farmers lacked access to formal credit, that informal lenders charged usurious interest rates, and that short-term high-cost informal loans were unsuitable for financing the productive investments considered essential for rapid technological change and sustainable rural development. Therefore, supply-leading directed agricultural credit policies were implemented to overcome perceived financial market imperfections. A major role was assigned to financial institutions to address numerous economic and social issues. The paradigm was based on the false idea that rural poverty could be addressed through credit alone (Adams, 1998). Donors helped formulate these ideas and funded many projects to expand financial and marketing services in rural areas (Meyer and Larson, 1997).

USAID Spring Review and FAO Conference

Two major events were instrumental in raising concerns about the directed credit paradigm used to rationalize agricultural credit projects in developing countries: the 1972/73 Spring Review of Small Farmer Credit by the United States Agency for International Development (USAID); and the 1975 World Conference on Credit for Farmers in Developing Countries held at the Food and Agriculture Organization of the United Nations (FAO) headquarters in Rome.

The Spring Review was a massive exercise. About 60 reports were prepared on specific farm credit programs in developing countries and 20 analytical papers were written. In total, it generated some 6,000 pages of reports. The Review involved considerable interaction among authors, academics, USAID personnel, and policymakers in workshops held in developing countries and a major final conference held in Washington DC. Finally, a book was published summarizing the results of the analysis and discussions (Donald, 1976). The FAO conference was preceded by a study conducted by a joint

working group composed of staff from FAO and the Cassa di Risparmio delle Provincie Lombarde (CARIPLO) (FAO/CARIPLO, 1975). The content of the group's report was tested in regional agricultural credit seminars, and it became the basic working document for the Conference.

The major findings of these two events implicitly challenged the directed credit approach. They offered a different vision captured in these ten points:

- Small farmer credit projects are part of a larger rural capital market.⁴ Small farmers tend to have greater access to informal sources, and the major increases that occurred in formal finance have mainly gone to larger farmers.
- The introduction of special, subsidized agricultural credit programs inhibits commercial lenders from expanding into rural areas. This helps perpetuate the dualism observed in rural financial markets.
- Low interest rates (in both nominal and real terms) are the most contentious issue. Many analysts argue that low interest rate policies are a major factor determining the observed distorted patterns of credit allocation.
- Preferential interest rates for small farmers are especially detrimental to improving access to formal loans, and are not an effective way to transfer income to small farmers.
- Low interest rates are more important in determining the ability of institutions to cover costs and risks than they are in influencing farmer demand for loans. The profitability of new technology, the supply of related farm inputs, and the prices received by producers are more important in determining farmer adoption than access to low interest loans.

⁴ The concept of a capital market was used for the first time in the discussion of agricultural credit. Later, the term financial market became more widely used.

- When interest and other subsidies are provided, they should be utilized to build up institutions rather than passed on to farmers in low interest loans. Savings mobilization should be given more emphasis in financial policies. The low interest rates paid on savings are detrimental to rural savings mobilization.
- Loan default rates are high and demand more attention, but crop and credit insurance and loan guarantees are not likely to be good solutions to the problem.
- The administrative costs of lending are high and require cost-reducing innovations such as partial service bank branches, mobile banks, village bank agents, and the creation of rural banks. Group lending contributes potentially more to cost reduction than to improving debt recovery.
- There is no single best type of institution to provide rural financial services. Commercial banks, agricultural development banks, and farm cooperatives have all experienced successes and failures in serving agriculture.
- The benefits of small farmer credit projects may not cover costs. When the conditions for successful credit projects are not met, other programs may be capable of raising small farmer welfare at lower costs.

In the ensuing years, much additional research was conducted on rural financial markets. Generally the results tended to support the critical observations made in the Spring Review and FAO conference. The Asian and Pacific Regional Agricultural Credit Association (APRACA) was established in October 1977. Through its auspices, studies were also prepared in the region and training was conducted on agricultural credit policies and programs. Many important studies were abstracted and published for use in training courses of the Economic Development Institute of the World Bank (Von Pischke, Adams, and Donald, 1983). All these efforts contributed to raising concerns about the wisdom of the old paradigm.

Colloquium on Rural Finance

The next major event in which agricultural credit policies and programs were debated by academics and policymakers was the Colloquium on Rural Finance in Low-Income Countries sponsored by USAID and the World Bank in Washington DC in 1981. A publication summarizing the research findings presented at the Colloquium became a focal point for discussions and debates around the world (Adams, Graham, and Von Pischke, 1984). The findings confirmed many of the arguments of the previous decade and provided several new insights. The central theme stated that “traditional thinking often leads to costly and sometimes counterproductive policies and that financial markets would make a much more positive contribution to rural development if appropriate policy changes were adopted” (p. 6). The specific key points included (p. 1-7):

- Agricultural credit is not a direct input in agricultural production, but is provided as the result of a process of financial intermediation. Financial services are as important to rural nonfarm enterprises as they are to farming.
- Credit is fungible and it is costly and difficult to effectively target end use.
- Maintaining positive real interest rates is the most important element in improving rural financial market performance.
- Financing loans out of savings will diminish or erase patronal relations that currently exist between borrowers, intermediaries, and financial authorities.
- Reducing dependency on external funds will reduce the politicization of rural financial markets.
- Broadening financial intermediation will increase competition among formal and informal lenders and reduce any monopoly profits that may exist.
- Analysis should build a better understanding of the factors affecting the performance of financial institutions

rather than attempt to measure credit needs or impact at the farm level.

- Reforms in financial market policies are more often blocked by political obstacles than by economic forces.

Many of the conclusions of this meeting were strikingly similar to the AID and FAO meetings held 10 years earlier. However, there were two new major contributions of the research reported in this volume. They concerned costs and politics. Papers were presented that measured the transaction costs incurred by lenders and borrowers, and the authors explained how these costs influence the behavior of both. Other papers reported how subsidized credit programs are part of a system of political patronage, and how subsidized interest rates for farmers fail to compensate for other policies that discriminate against agriculture. Unfortunately, the insights presented in these research results and disseminated in these meetings did not make a major impact on Asian policymakers, so credit projects in the region often continued to be designed and implemented under the directed credit paradigm.

The Microfinance Revolution: Fad and Fundamentals

Beginning in the 1970s, a new financial development began to emerge in developing countries that also contributed to changing views about the appropriate strategy for developing rural financial markets. This was the emergence of microfinance, mostly the granting of small loans, which began as a series of small experiments and mushroomed into a development fad. Many institutions, especially NGOs, make small loans as part of their programs to create employment, raise the income of the poor, provide emergency relief following natural disasters and conflicts, and improve rural health, education, and nutrition. Microfinance experiences in Bangladesh and Indonesia have made important contributions to the emergence of microfinance. In this section the highlights of this new approach to expanding the

financial frontier are summarized and the lessons for rural financial markets identified.

The Origins of Microfinance

Agricultural credit policies had their origin in a desire to improve agricultural technology and speed agricultural growth. The rationale for making small loans or microloans sprang from three different development initiatives (Churchill, 1998). First, several countries promoted the establishment of small and medium enterprises (SMEs) and many donor projects contributed to this objective. Many of these projects enjoyed only modest success and the sustainability of the services provided to entrepreneurs was a chronic problem. Over time, the approach evolved into supporting microenterprise development through small loans, with or without training, because it was one way to provide sustainable support to micro and small enterprises.

Second, microlending or microcredit originated in projects to alleviate poverty. The objective of these projects is often income generation rather than enterprise development. Means tests or other criteria are used to identify the poorest of the poor who are the primary target groups. Once again, microloans to the poor offer some promise of sustainability in the face of declining subsidies. The Grameen Bank and the Bangladesh Rural Advancement Committee (BRAC) are recognized pioneer organizations in Asia with this orientation. Some of these organizations strive to self-finance the costs of their credit services while seeking subsidies for education, training, and technical assistance activities.

Third, many microfinance organizations (MFOs) emerged to provide financial services for firms and households not served by the conventional financial sector. ASA in Bangladesh and the unit desa system of Bank Rakyat Indonesia (BRI) fall into this category. They specialize in microloans and other financial services, but do not particularly target the poorest of the poor who may need more than credit to start and successfully manage a microenterprise (ADB, 1997f).

The early microlenders emerged in the late 1970s, and their efforts gained momentum during the 1980s. By the mid-1980s, researchers began to evaluate these experiences systematically and, by the early 1990s, suggestions for best practices emerged. Many of the pioneer microlenders had a far superior performance than the earlier agricultural credit projects in terms of outreach and loan recovery even in countries, such as Bangladesh, where the conditions were very unfavorable.

The Fundamentals of Microfinance: Lessons for Rural Finance

The microfinance experience is important to analyze because of the potential lessons for developing sustainable rural finance. The fact that the microfinance approach produced results superior to many of the old paradigm agricultural credit projects contributed to the development of a new paradigm. The MFOs managed to develop important innovations that enabled them to expand the financial frontier in developing countries. For the first time, large numbers of poor borrowers have access to formal financial services due to these innovations, which reduced lending costs and risks, and permitted MFOs to serve poor clients successfully without the collateral normally required by banks. The techniques that contributed to their success include:⁵

- Loan sizes - loans are small in size, and are made for only a few weeks or months to be used mostly for working capital purposes.
- Repeat loans - incentives are given to clients to maintain good repayment records by rewarding them with (almost automatic) repeat loans. For some lenders, the

⁵ No single list of lessons or best practices exists. Many of the points listed here were discussed in Chaves and Gonzalez-Vega (1996), Christen et al. (1995), Churchill (1999), Donors Working Group (1995), Otero and Rhyne (1994), Rhyne and Rotblatt (1994), and Yaron et al. (1997).

size of the first and repeat loans is set according to a predetermined formula.

- Loan repayment schedules - frequent payments are required, often weekly or monthly, to enable close monitoring of borrower performance.
- Interest rates - interest rates and fees are high, usually much higher than those charged by conventional lenders, and are usually positive in real terms.
- Loan officer efficiency - loan officers frequently handle 75 to 100 borrower groups or 200 to 500 individual borrowers. Financial incentive schemes for employees stimulate high levels of efficiency.
- Loan collateral - many MFOs use a lending technology involving peer group formation and peer monitoring as a substitute for conventional loan collateral to reduce transaction costs and risks. MFOs that use the more conventional individual lending technology accept as collateral household goods and other assets with high use value to their clients.
- Decentralized lending procedures - the procedures for screening applicants and processing loans are simple, with considerable autonomy given to loan officers, who are required to maintain close contact with their clients.
- Loan delinquencies and losses - lenders frequently report loan recoveries of 95 percent or more. Computerized systems are often used to produce daily repayment reports so loan officers can take corrective action at the first hint of unexplained delay in their clients' payments. Some organizations offer interest rebates for on-time or early repayments, and others charge penalty interest for late payments.

These techniques are in sharp contrast with the old paradigm agricultural credit projects, and contribute to the success of microfinance. There are limitations, however, in the applicability of microlending technologies for rural finance. First, they appear to be best suited to urban enterprises or rural nonfarm households and firms with regular and frequent cash

incomes. They have yet to be rigorously tested with specialized farmers who have highly seasonal cash flows or for medium- and long-term lending. Second, transaction costs for the financial institutions and their clients are likely to be higher in rural than in urban areas. The clients are more dispersed so travel costs are higher for loan officers and it is difficult for them to serve a large client load. Some MFOs reduce their transaction costs through group lending, but this raises borrower transaction costs. Moreover, peer pressure may not be as effective in sparsely populated areas where group members have less information about each other and peer monitoring is more costly.

The third limitation in microlending is that, except for some urban locations, financial markets for the poor are highly segmented with each microlender usually serving only a small market niche. Small MFOs have limitations similar to most informal lenders in serving only a local clientele because high information and transaction costs discourage competition and constrain them from rapidly expanding to serve new clients and regions. Being limited to local markets, they have concentrated portfolios with a large covariant risk. Fourth, most MFOs have paid little attention to providing savings services, but a safe and secure place to deposit savings may be more important than credit for farm households that need to smooth consumption in the absence of insurance markets. Many MFOs obtain their resources from subsidized sources, have little experience in mobilizing savings, and conclude that the cost of mobilizing resources from clients is high by comparison.

Since the microfinance field is fairly new with the oldest organizations having only 10 to 20 years of experience, many design questions still have to be resolved. For example, rural finance must deal with clients subject to the systematic risks of floods, drought, and disease, but relatively little is known about the capacity of MFOs to cope with such adversities. The 1998 floods in Bangladesh created liquidity problems for MFOs. Most have little capital and are dependent on donor or government sources that need to provide new funds to cover losses and supply liquidity. Emergency procedures to deal with this problem must be worked out in advance to enable MFOs

operating in high risk areas to plan prudent levels of reserves. Nonfinancial services also present a challenge. Financial services alone are not sufficient to lift the poor out of poverty but cost recovery for these services presents a serious problem. Some poor people are not prepared to participate in group-based financial activities and a process of social intermediation may be required in order for them to be linked to financial markets (Bennett, Goldberg, and Von Pischke, 1998).

The Changing Paradigm for Developing Rural Financial Markets

Many developing countries continue to use the traditional directed credit approach toward agriculture, but a significant shift in views is occurring in some developing countries. The old paradigm of subsidized and targeted lending has been gradually replaced by the new paradigm oriented more towards financial market efficiency (Robinson, 1997; Vogel and Adams, 1997; Adams, 1998). The failure of most countries to develop a sustainable rural financial system using the old agricultural credit paradigm, coupled with the successes of a few MFOs, contributed to the emergence of a new paradigm. In Asia, the experiences of the unit desa system of BRI in Indonesia, of the Bank for Agriculture and Agricultural Cooperatives in Thailand, and of the Grameen Bank in Bangladesh, made important contributions to the new views. The main features of the old and new paradigms are summarized in Box III.1. The policies implemented in many developing countries today reflect the shift from a traditional supply-leading directed credit approach to more market-oriented, demand-leading financial services.

New Paradigm: Financial Market Approach

The shortcomings of targeted agricultural credit programs are well documented (e. g. Adams, Graham, and Von Pischke, 1984; Meyer and Larson, 1997; FAO/GTZ, 1998) and have been

Box III.1 Primary Features of the Old and New Paradigms

Features	Directed Credit Paradigm	Financial Market Paradigm
Problem definition	Overcome market imperfections	Lower risks and transaction costs
Role of financial markets	Promote new technology Stimulate production Implement State plans Help the poor	Intermediate resources more efficiently
View of users	Borrowers as beneficiaries selected by targeting	Borrowers and depositors as clients choosing products
Subsidies	Large subsidies through interest rates and loan default Create subsidy dependence	Few subsidies Create independent institutions
Sources of funds	Governments and donors	Mostly voluntary deposits
Associated information systems	Designed for donors	Designed for management
Sustainability	Largely ignored	A major concern
Evaluations	Credit impact on beneficiaries	Performance of financial institutions

Source: Adapted from Adams (1998).

summarized above. The results of negative evaluations coupled with the financial drain that subsidized programs imposed on government resources led to a gradual shift in financial policies in many countries beginning in the early 1980s. The early success of some microfinance projects, which operated on different assumptions and with different procedures, contributed to the change in paradigm (Otero and Rhyne, 1994).

The new financial market paradigm adopts the perspective of financial markets and limits their role to financial intermediation rather than being a tool to stimulate production, compensate for distortions in other markets, and alleviate poverty. These outcomes are expected to occur as a natural result of efficient intermediation rather than through specific mandated programs. Innovations to reduce transaction costs and the freedom to set interest rates high enough to cover costs are of primary importance. Borrowers and savers are not considered to be beneficiaries but rather valuable clients with whom relationships should be nurtured to help achieve long-term growth. Institutional sustainability, breadth and depth of outreach, and quality of services provided are emphasized as key performance measures (Adams, 1998).

The new paradigm is reflected in commitments by some governments to financial market liberalization, reduced targeting of loans, and better pricing of financial products. The financial frontier is being pushed outward to include several innovative financial institutions, programs, and products designed to service those previously excluded from formal finance (Von Pischke, 1991). The new paradigm emphasizes voluntary savings mobilization rather than funding from governments or donors, which is consistent with the objective of creating independent institutions. The information systems of the financial intermediaries can then be designed to serve the needs of management rather than of donors. The sustainability of the institution and its ability to grow are the major criteria for evaluating the performance of a financial institution. The recent emergence of a few sustainable MFOs offering financial services to clients outside the formal financial frontier is evidence that the new paradigm offers insights into a better way to expand finance into rural areas on a more sustainable basis. These issues are discussed in more detail in the next chapter as they relate to rural Asia. Evidence of the new thinking is found more frequently in microfinance than in rural finance policies, and this represents the serious policy challenge for decision makers in Asia today.

Expanding the Paradigm

This perspective of a changing paradigm for rural financial markets is useful in identifying key weaknesses in the policies and programs employed by many developing countries. It is also useful in comparing the policies commonly used in the past with more modern approaches employed in several countries today. However, it has some shortcomings as an analytical tool for determining the nature of problems that countries face in identifying and resolving constraints and bottlenecks in their rural financial markets. For example, the important issue of an appropriate regulatory and supervisory framework for rural finance and microfinance is not addressed. This issue is important because savings and deposits are increasingly substituting for government and donor funding. Deposit insurance may be the answer in some countries, but moral hazard problems must be resolved. Legal issues represent a second set of issues not addressed in the new paradigm. Microfinance can skirt some problems related to collateral and contract enforcement, but they are more serious in rural finance that involves land and other physical collateral. A third area of concern is institution building, and the appropriate method to subsidize institutional development without creating subsidy dependence. These issues are addressed in the framework presented at the end of this chapter, but first it is important to understand the special problems of transition economies and our new understanding of the key role of information in affecting financial market performance.

**CREATING FINANCIAL MARKETS IN
TRANSITION ECONOMIES**

Creating sustainable finance in transition economies is an especially challenging problem. Transition involves a complex process of rapid transformation from a State-planned to a market-based economy; it means creating new institutions,

adapting existing institutions, and dismantling inefficient institutions and overbuilt capacities (World Bank, 1996b). The Asian transition countries are heterogeneous. Some countries such as the PRC and Viet Nam have a long history, old institutions, and fairly well developed infrastructure. They embarked on a gradual transition in the 1980s with microeconomic reforms preceding macroeconomic reforms. The PRC, for instance, gives priority to agriculture and rural industries. Inflation is under control and the Government can concentrate on price reforms. The banking sector is used to capture rural surpluses for use in financing projects including rural industrialization.

The picture in the Central Asian republics is different. They became independent countries only in the 1990s and undertook several reforms simultaneously to ensure sovereignty and economic growth. Many adopted a 'big bang' approach similar to that in Eastern Europe where macroeconomic reforms dominated the early phase of transition (Rana, 1993). The first phase of transition was limited to liberalization of the economy and redistribution of the State-owned assets to the public. The second phase began in 1993 and involves creating financial institutions, developing skills and accumulating knowledge. The Kyrgyz Republic case study describes how rapid changes in property rights and liberalization of prices and foreign exchange are being implemented under the watchful eyes of donors. The creation of private enterprises and farms was secondary to the privatization of State-owned enterprises, and the banking sector is expected to play a role in the privatization strategy.

The rural sector is significantly affected because transition affects property rights and the allocation of resources through decollectivization and the changing patterns of land ownership rights. The choice of the transition path—gradual or big bang approach—is determined by initial conditions such as existing property rights, importance of agriculture and rural industries, inflation, and the philosophies of donors. Understanding the differences in transition paths and in initial conditions is important since it helps to anticipate the effects of the transition and the reform outcomes in rural areas.

The transition countries are grappling with several challenges in developing a market-based financial sector (Box III.2). Five interrelated problems pose major challenges in the transition countries. First, a part of the resource reallocation process can be effectively handled by the banking sector, but transition countries are characterized by weak and passive banking sectors with little capacity to assess credit risks and allocate resources. Therefore, there is a need to change attitudes towards the financial sector and learn about its role in market economies. The skill levels of the bankers need to be rapidly improved to function within a market environment.

Box III.2 Challenges in Developing the Financial Sector in Transition Countries

1. Strengthening the banking sector to improve efficiency
 - Reducing bureaucratic interference and overdues
 - Unclogging payment systems
 - Strengthening regulatory and supervisory systems
 - Developing legal systems that can enforce contracts and inculcate financial responsibility
 - Reducing corruption
 - Improving the skill level of staff to assess and manage risks

2. Reducing systemic problems in financial markets to increase competition
 - Reducing insider control of financial institutions
 - Developing capital markets
 - Reducing the political hold on institutions
 - Reducing barter transactions
 - Reducing barriers to entry for private banks and nonbanks

Source: Adapted from EBRD (1998).

Second, the financial infrastructure, such as regulatory and supervisory capacity, is very weak. Financial crises tend to occur when the financial sector expands rapidly into new activities, and the regulatory system cannot ensure transparency in operations, standardize auditing and accounting practices, and protect the rights of minority share holders and depositors. Banking crises have already occurred in countries, such as Russia, that liberalized their economies without developing their regulatory framework. Government intervention is needed to create a stronger regulatory structure.

The third problem for transition economies is that although they collected a vast amount of information on several aspects of their societies, much is now obsolete and not suited to market-based transactions. Little information is available to assess loan applications because it was not required for State-mandated credit allocations, and market and technical information to help make production and marketing decisions is limited. A major challenge is to develop public institutions, such as credit bureaus, that can facilitate the creation and dissemination of information that was not necessary prior to the 1990s.

Fourth, contract enforcement is difficult because the use of sanctions, such as loss of future benefits, is undermined during the transition process. The economy is so volatile that repeat transactions cannot be anticipated. Sanctions can work only when exchange relations are clearly defined, the level of uncertainty is low, and enforcement is easy. It has been challenging to develop institutions to enforce laws, to generate information for enforcement, and to encourage individuals and enterprises to demand the implementation of laws. In the absence of sanctions, trust can be used to consummate transactions but this requires building up of social systems that can facilitate the development of trust (Humphrey and Schmitz, 1998).

Finally, corruption, fraud, political interference, and implicit subsidies and guarantees in the transition economies are widespread and impede the development of an efficient banking sector.

Building strong financial institutions in transition economies is now seen as a much longer-term effort than first

envisioned in the initial days following the collapse of State planning. The first phase of policy reform may turn out to be relatively easy compared to the second phase of institution building. The case study of the Kyrgyz Republic illustrates some of the problems. Financial institutions have portfolios dominated by nonperforming loans that need to be cleaned up and the institutions must be recapitalized. Managers and staff must develop new skills required for operating market-based financial intermediaries. Incentive systems must be designed to stimulate efficiency, and information systems must be created to give managers and loan officers timely information needed about institutional and clientele performance. The new and rehabilitated institutions need to be supported by a financial infrastructure that financial markets require to perform efficiently. New laws have been passed to support business transactions. In the area of finance, the new legislation expands the scope of types of property that can be subject to a security interest.

However, many legislative uncertainties remain that undermine lending against collateral. A detailed study of Romania, another transition economy, revealed a fragmented system of civil and commercial codes coupled with a large variety of ordinances and special laws on creating security interests that cause gaps in the types of loans that can be secured by movable property (Fleisig and Peña, 1998).

THE NEW EMPHASIS ON INFORMATION IN FINANCE

It is becoming clearer that poor nations differ from rich ones not just because of differences in capital, but because they also have less knowledge. Developing countries suffer from a knowledge gap in several areas, especially technology, and have incomplete knowledge about attributes, such as the creditworthiness of potential borrowers, referred to as information problems (World Bank, 1998b). Rural areas suffer from information disadvantages relative to urban areas, and the poor

have more difficult access to information than the rich. Therefore, improving access to good information contributes to reducing income inequalities. Institutions are critically important in facilitating the flow of information essential for efficient markets; this view is well established in the public support for creating and disseminating new agricultural technologies. It is equally important in banking because of its public goods features. Improved processing of the economy's financial information is an appropriate government intervention in financial markets, and this is implicit in many recommendations proposed in the wake of the financial and economic crisis in Asia. Investing in improved information is a more promising way to encourage sustainable rural finance than the old paradigm policies to induce more lending in rural areas.

All financial transactions involve giving up funds now in return for a promise to be repaid in the future. Financial markets perform their economic function when they allocate scarce capital to the best projects, then monitor them to ensure that the funds are used appropriately (See Chapter II). Lenders need to evaluate the probability of getting repaid, which requires verifying information supplied by borrowers who have an incentive to exaggerate their ability and willingness to pay. Offering large amounts of collateral is one means that borrowers have to signal their intention to repay. Moreover, loan collateral helps resolve the contract enforcement problem in the event of default if the costs of realizing the collateral are reasonable.

Informal lenders often know and live in close proximity to their clients so they can more easily evaluate creditworthiness and monitor their performance. But formal institutions incur costs in collecting and analyzing data for loan appraisals, monitoring the use of funds, and enforcing contracts. Some financial institutions attempt to reduce transaction costs by using local sources of information to screen clients and by designing contracts that induce borrowers to respect them. For example, several Indonesian lenders use information obtained from third parties such as village headmen to screen borrowers. Joint liability groups require that members use their information about potential members in the process of group formation.

Information that is widely available about delinquent loans can lead to peer pressure for repayment.

The effective supervision and governance of financial institutions require many types of information. For example, bank supervisors require information to determine whether intermediaries are following established norms and are engaging in prudent behavior. Bank owners need information about the institution's performance and prospects, and bank managers must monitor the performance of loan officers. Loan officers, in turn, need information about prospective clients and timely reports on the repayment status of their borrowers. Members of joint liability group loans need to know the repayment status of other group members. Improved information often leads to better performance because incentives change. Better information helps regulators more readily identify problems, and helps managers to design and implement staff incentives for banks and cooperatives.

For efficient processing of information and design of contracts, financial institutions need supportive public policies to develop accounting and disclosure systems and to improve legal infrastructure. Empirical evidence shows that countries with legal systems that give high priority to secured creditors, rigorously enforce contracts, and set accounting standards that produce comprehensive financial statements, have better-developed financial intermediaries and enjoy faster growth (Caprio, 1998; World Bank, 1998b). Governments contribute to the performance of financial institutions by creating institutions that, because they are public goods, will not normally emerge spontaneously in the private sector. They include registries for recording asset transfers and financial transactions and credit reporting agencies (Fleisig, 1995). In addition, in rural areas they include land-titling projects to improve security of tenure and transferability of land, and land reform to give the poor greater access to land, which can be used as collateral for loans. Land reform can also destroy collateral, however, as occurred in the Philippines when uncertainties about the details of implementation in the 1980s prompted lenders for a time to accept only urban land as collateral.

Creating public institutions to support financial markets is especially urgent in transition economies because such institutions did not exist in centrally planned regimes in which the State allocated credit. On the one hand, the government must directly create, maintain, and support some public entities, such as a regulatory and supervisory system for bank and nonbank institutions. On the other hand, governments should support private sector entities to perform tasks for which they are more efficient, such as to accumulate credit histories, and maintain records on credit transactions and assets pledged as collateral.

The new information and communication technologies being created and adopted in developing countries present new opportunities and challenges. New technologies are making it easier and cheaper to acquire, manage, analyze, and transmit large volumes of data. Credit scoring models, for example, are being developed based on data for thousands of loans in order to predict poor credit risks. Smart cards are being designed so that a single card will carry a borrower's entire loan history. These cards can be used to withdraw funds against previously approved credit lines and to make loan payments. The financial institutions that are most successful in designing and adopting these techniques will be the most competitive. However, these new technologies are expensive, require large capital investments, and demand highly skilled personnel. State-owned financial institutions will likely have problems in justifying these expenditures. Likewise, small rural institutions will lag in being able to use them, and will have to find their market niche by specializing in technologies that utilize their superior knowledge of local environments and their personal relations with clients.

A STRATEGY TO BUILD RURAL FINANCIAL MARKETS

The previous sections summarized key concepts underlying the development of financial markets. This section presents a three-pronged framework for building rural financial

markets in terms of 1) creating the policy environment, 2) building financial infrastructure, and 3) institutional development. Governments and donors need to evaluate these three areas as they set priorities for interventions and investments.

The key objective of the financial system was once narrowly defined as providing financial services at prices that reflect their cost (World Bank, 1989). In recent years, the emphasis has broadened, especially for microfinance, to consider the dual objectives of outreach and sustainability (Yaron, 1992). Outreach involves more than just number of clients served when the scarce use of public resources is considered. Generally speaking, a financial system meets more of society's objectives and merits the allocation of more scarce resources if it a) serves many clients, b) serves many poor clients, c) provides a large scope of services, d) costs the users as little as possible, e) provides services over a long period of time, and f) can be sustained with only a minimum of support from nonusers or taxpayers.⁶ These should be the objectives of the policies and programs for rural financial markets.

Creating the Policy Environment

The urban bias of many economic and agricultural policies in developing countries contributed to the failure of old-paradigm agricultural credit projects and development banks. Many of these programs were introduced in environments that were hostile to creating healthy financial markets. Macroeconomic instability produced highly variable inflation rates. Repressed financial sector policies with interest rate ceilings prevented lenders from charging cost-recovery rates on loans. High reserve requirements discouraged deposit

⁶ These criteria are a modification of those formulated in Navajas et al. (1998). Schreiner (1999) has proposed a broader framework for outreach in terms of six aspects: worth to users, cost to users, depth, breadth, length, and scope.

mobilization. Limits on bank branching and on creating new banks restrained competition among rural financial institutions. Cheap food policies, subsidized food imports, farm price controls, unfavorable agricultural terms of trade, and distorted foreign exchange rates contributed to this poor environment (FAO/GTZ, 1998; World Bank, 1998b).

Considerable progress has been made in many countries to improve macroeconomic policy, reduce uncertainty, correct the worst policy distortions, and improve farm profitability (See Chapter IV; further information is available in Rosegrant and Hazell, 1999). The process is far from finished, however, and many policies still discourage rural finance. As noted in the case studies, Thailand still imposes subsidized interest rates on Bank for Agriculture and Agricultural Cooperatives farm lending and restricts its ability to serve nonfarm clients in rural areas. India has a huge Integrated Rural Development Program that consumes vast public funds and discourages the emergence of unsubsidized institutions to serve poor clients. Low interest rates discourage innovation and competition. Thus, liberalization is a necessary first step if countries want to create a favorable environment in which financial markets can flourish. Portfolio restrictions must be carefully examined because they limit the lenders' ability to reduce risks through portfolio diversification.

Donors can specify general policy reforms as conditionalities for sector loans based on experiences of other countries; however, technical assistance is needed in many countries to diagnose specific local problems carefully and develop solutions. Moreover, policy changes involve stakeholders who need to participate in policy reforms (FAO/GTZ, 1998). Carefully crafted policies to attract stakeholder support may be as crucial to successful policy reform as are correct technical recommendations. The long and largely unsuccessful history of donor-sponsored agricultural credit and financial reform projects described in the Bangladesh case study, for example, provides ample evidence of how powerful groups can undermine the best technical solutions. Political economy issues may determine the appropriate sequencing of financial reforms but in ways that may be difficult to anticipate (Stiglitz, 1997).

Policy reforms are necessary to provide an environment conducive for creating financial markets in many countries. Some countries will be able to improve their financial systems greatly through system-wide reforms. In other cases, more direct proactive measures will be required to accelerate the process of building the financial infrastructure, as discussed in the next section.

Building Financial Infrastructure

Building financial infrastructure was largely overlooked in the old agricultural credit paradigm, but it has now emerged as one of the top priorities for improving rural finance. Frequently, it is more important than supporting a specific financial institution because improved infrastructure contributes to the entire financial sector, not just to institutions targeted for direct assistance. Information, legal, and regulatory systems represent parts of the infrastructure that directly affect financial transactions, while transportation and communications systems, particularly in rural areas, indirectly affect the costs and risk of finance.

Several problems have been identified in financial infrastructure. For example, many shortcomings in existing laws and regulations impede rural lending. It was discovered that titles registered by the land reform agencies in Bolivia and Peru were not registered in regular real estate registries; consequently, farm lenders could not accept them as loan collateral. Insecticide and fertilizer dealers in Bangladesh could not use inventories and accounts receivable as collateral for loans to extend more credit to their clients (Yaron, Benjamin, and Piprek, 1997).

Improving loan recovery is especially challenging. Bangladesh created special courts to handle rural loan defaults. Although political intervention undermines their effectiveness, they represent an institutional approach to a serious problem. Identifying specific reforms must be done on a country-by-country basis. Examples of potential importance are listed in Box III.3. The World Bank and the European Bank for

Box III.3 Changes in Infrastructure to Improve Finance

The following list gives examples of changes to improve finance:

- Title land and register it in a registry; lower the costs of registration and foreclosure.
- Reform legal registries and expand the scope for private operation.
- Reform the law of secured transactions; permit repossession and sale without extensive judicial intervention.
- Remove barriers to the operation of credit bureaus and use the ratings of credit bureaus in bank supervision and regulation.
- Permit witnesses to give legal standing to contracts signed by illiterates.
- Develop appropriate regulations for non-deposit-taking institutions.

Source: Adapted from Yaron, Benjamin, and Piprek (1997).

Reconstruction and Development are financing projects to implement such reforms, and the potential benefits through lower interest charges and increased supplies of funds are estimated to be huge (World Bank, 1998b).

Weak financial regulation and supervision were dramatically exposed in the financial and economic crisis in Asia, and have been identified as priority reforms in most developing countries for all segments of the financial system. Regulation is an increasingly important issue for NGOs engaged in microfinance (MFOs) (McGuire, Conroy, and Thapa, 1998). Deposit-taking institutions must be licensed in most countries, but the banking authorities have often chosen to ignore the small MFOs that take deposits from their own members. The potential problems have become more serious now that NGOs are mobilizing larger amounts of money and some, such as

ASA in Bangladesh, accept deposits from nonmembers. Many unanswered regulatory questions must be dealt with if rural finance is to evolve in a sustainable way. Crises can never be eliminated, but they can be mitigated through prudential regulations.

Some initial steps have been taken to conceptualize the types of regulatory approach that would be appropriate for MFOs (van Greuning, Gallardo, and Randhawa, 1999). Most Asian developing countries have not yet resolved important general regulatory policy issues, such as should credit cooperatives and MFOs be regulated and supervised by the same authorities that regulate commercial banks? What level of regulation is needed to assure safety but not stifle the creativity essential for expanding the financial frontier? What is the appropriate role for special apex organizations in supporting rural financial institutions? Then there are many technical issues to be resolved. What levels of reserves are prudent for agricultural lenders with portfolios concentrated in small geographic areas that specialize in financing activities subject to covariant income risk? What lender-of-last-resort arrangements are needed to protect rural financial intermediaries in the event of bank runs or temporary liquidity problems in times of drought and floods? What are the appropriate policies on reserves and capital and provisioning requirements for institutions that make largely uncollateralized loans?

Institutional Development

The third component of the three-pronged framework for developing rural financial markets is institutional development. The requirements for rural financial institutions (RFIs) to achieve high levels of outreach and sustainability have been identified as follows:

“RFIs require appropriate governance, which entails clearly defined and limited roles and powers for government, donors, the central bank, and other agencies. Capable management with a high degree

of autonomy is also required, as are innovative and efficient operating procedures guided by a well-developed management information system” (Yaron, Benjamin, and Piprek, 1997, p. 99).

Institutions may not develop automatically just because the environment and financial infrastructure have improved. Institution building may be required to take advantage of the new emerging opportunities and markets (Krahnert and Schmidt, 1994). If financial services are to be broadly based, some groups, such as women, small farmers, and microentrepreneurs, may find that they are disadvantaged in responding to market opportunities (Fernando, 1994). Providing support to institutions that target these groups, particularly in their initial start-up phase, may yield high social returns provided that the subsidies are provided for specific institution-building purposes, and are transparent, time bound, and linked to performance. Ultimately, individual institutions need to experiment with alternatives in order to find the methods of operation that fit their objectives and capabilities.

Learning from Microfinance

Fortunately, much has been learned about institutional development in the last few years because of innovations that have been tested, especially by MFOs; thus some general principles and best practices are available for adaptation to local needs. These are discussed in detail in Chapter IV. Most of the strong MFOs have a strong mission and business plan explicitly oriented towards achieving high levels of efficiency by offering clients market-driven products. They have a clear goal of achieving institutional viability and self-sufficiency in a short period of time. Through experimentation, they have developed financial technologies and procedures that have resolved some of the high costs and risks associated with making small, short-term, uncollateralized loans to poor people. Many are new institutions that have had freedom to innovate and enjoyed

strong donor support. Their successes provide lessons for rural finance. However, since many specialize in lending in urban or densely populated rural areas, there are limitations in the transferability of their experiences to rural environments.

Weak Financial Institutions: Close or Rehabilitate?

The process of building rural financial systems in Asia does not begin with a blank slate. Many countries created specialized agricultural development banks (SADB) in the 1960s and 1970s with donor support. The SADB share several characteristics (Pomareda, 1984; Gonzalez-Vega and Graham, 1995). They are largely State owned, serve only agricultural clients, specialize in lending with little attention to savings mobilization, and charge subsidized interest rates. SADB are licensed and regulated with more attention often given to assuring compliance with lending targets than to safety and soundness. They are often subject to political intervention, so have limited ability to enforce loan contracts and seize collateral for nonpayment of loans. Many have been closed, some have been rehabilitated, and several exist with limited outreach and poorly performing portfolios.

Is it more cost effective to rehabilitate the SADB or is it better to simply close them and start new institutions? Experience to date with rehabilitation has been checkered. Perhaps the most successful case in Asia is described in the Indonesia case study. The failing Bank Rakyat Indonesia was restructured into the highly profitable unit desa system. Other successful cases include Bank Pertanian Malaysia and the BAGRICOLA in the Dominican Republic (Adams, 1995). There have also been many failures, especially in Latin America where several SADB were closed after repeated rescue attempts. The Agroprombank in the Kyrgyz Republic was closed because it was considered too costly to rehabilitate relative to the expected benefits. The agricultural development banks in Bangladesh, Nepal, and Pakistan continue to be among the region's poorest performing rural lenders in spite of repeated donor-funded rehabilitation projects.

The decision to close versus rehabilitate depends on the estimated benefits and cost of each alternative. Closing an institution could mean destroying assets that represent a sunk cost to society. It could also mean creating a new institution over a period of years if other institutions do not enter the market to fill the vacuum caused by the closure. Some SADB's may possess valuable information capital, human capital, and infrastructure. Information capital may exist in the form of knowledge about clients (credit histories and repayment records) and about the local environment that may be useful for a rehabilitated institution. Much of this information capital may also be embodied in human capital. The bank staff may have learned how to evaluate credit worthiness, but were not given the opportunity to use their skills, as occurred in the Dominican Republic (Gonzalez-Vega and Graham, 1995). Infrastructure in the form of a banking network and equipment may be salvageable, and there may be valuable goodwill among clients that would be lost with closing. Not all clients failed to repay their loans, and savers grew accustomed to using deposit services of SADB's located in areas unserved by other financial institutions.

The mere existence of these assets, however, does not automatically imply that rehabilitation is the preferred alternative. Several preconditions must be met before rehabilitation can have a reasonable chance of success (Adams, 1995; Gonzalez-Vega and Graham, 1995). These preconditions can be summarized as follows:

- Reasonably good environment in terms of macroeconomic stability, a minimum of financial repression, and a legal system that facilitates contract enforcement and swift conflict resolution.
- Dynamic agricultural sector with reasonably stable policies, remunerative farm policies, and well-developed rural support services.
- Past default problems due largely to government interference rather than staff incompetence or corruption.

- Broader mission for the institution to enable it to develop a diversified portfolio and include lending to nonfarm enterprises, deposit mobilization, transfer of remittances, and other services demanded by a rural clientele.
- Governmental commitment to a hands-off policy in the process of making and collecting loans.
- Creation of a board of directors chaired by a banking professional (frequently the Minister of Finance), with the majority of members representing the private banking sector, and authority granted to the board to set policies conducive to the institution's sustainability, safety, and soundness.
- Hiring a dynamic chief executive with banking experience, and giving that person the freedom to hire top management and dismiss existing bank staff not suited for a market-oriented banking mission.
- Compensation policies that will attract high-quality staff, and incentive packages designed to stimulate top performance of employees at all levels.
- Sufficient financial support to create a modern management information system and the adoption of a transparent accounting system designed to meet international standards.

Perhaps the most contentious and critical issues involved in rehabilitation are governance, recapitalization, and future sources of funds. To minimize the potential for political interference and strengthen the potential for effective governance, the government needs to transfer governance and control effectively to persons with strong banking experience and a private-sector orientation. At the same time, enough public resources have to be provided to clean up the existing nonperforming loan portfolio. The use of public resources and subsidies needs to be tied to explicit performance-based criteria to avoid subsidy dependence. If donor funding is to be used, it should be channeled into improving institutional capacity rather than for on-lending to targeted clients. The bulk of the future

funds should come from savers. The behavior of the institution will change if its funds are mobilized from savers rather than donors or the government, and the savers will exercise some monitoring of the performance of the institution. To attract deposits, the institution will have to convince the public that it is a prudent lender, and this requires transparent operations, the use of international accounting standards, and audited financial statements. It will have to design savings instruments that are attractive to clients, and this process will contribute to making it more of a market-driven institution (Adams, 1995). Passing this market test is the first step on the road to sustainability.

