

V DEVELOPING RURAL FINANCIAL MARKETS IN ASIA: WHAT SHOULD BE DONE?

This chapter summarizes the key findings of this study and identifies priority actions to be taken to strengthen rural financial markets. The first section summarizes the major conclusions of the research. The second section discusses the problems in implementing the new paradigm in Asia. These two sections draw heavily from the previous chapter and the case studies presented in Part B. The third section outlines the key recommendations. The fourth section discusses special issues for donors, and the last section presents some final thoughts on the region's challenges in entering the twenty-first century.

MAJOR CONCLUSIONS

The Rural Economy, the Green Revolution, and Rural Financial Markets

Although it is difficult to measure impact precisely, a major conclusion of this study is that robust rural financial markets are correlated with rapid agricultural growth in Asia. The PRC is the only country in the region that has experienced rapid agricultural growth without the benefit of a strong market-oriented rural financial system. No country in the region has developed a strong rural financial system without having a progressive agricultural sector. Moreover, rural financial institutions are part of the overall financial system; it is logical

that no strong rural financial institutions exist in a country with a weak financial sector.

The financial sector can respond to opportunities created by rapid economic growth, but cannot accelerate the growth process in the face of an unfavorable economic environment. Agricultural credit, for example, can facilitate economic transactions, enable borrowers to adopt technology, make investments, smooth consumption expenditures, and ameliorate risks. However, credit cannot compensate for unprofitable production activities. It cannot compensate for missing roads, bridges, and communications. It cannot compensate for bad seed, missing input supplies, inefficient marketing systems, and poor transportation. These fundamental economic and agricultural bottlenecks must be addressed before more loans can make a significant impact. Moreover, merely granting loans to the poor is unlikely to lift them single-handedly out of poverty.

Rural financial markets consist of formal, semiformal, and informal financial arrangements. Banks, cooperatives, moneylenders, friends, and relatives, and commodity traders are all part of the financial system. Informal loans are often used for short-term emergency and consumption purposes, but they also finance production and marketing activities. Formal loans are more likely to be used for large-scale investments and major working capital expenses. Both informal and formal finance play a role in financial markets, and firms and households often use both sources because of their unique characteristics.

Experience has shown that the massive amount of directed credit channeled to agriculture to support the green revolution did not have the desired impact. First, it did not contribute significantly to the adoption of technology beyond what would have occurred without it. Farmers convinced of the merits of the new technology used self-finance and informal financial sources in the absence of formal credit supplies. The destructive effects of the directed credit strategy on formal financial institutions overshadowed any positive impact. Second, there is little evidence to demonstrate that expanded formal finance made a significant impact on the importance of informal finance or on its terms and conditions. Where informal finance has been

historically important, it continues to finance many consumption and emergency loans for rural households.

Intervention by the State in Rural Financial Markets

The governments in all Asian countries have intervened in their rural financial markets to a greater or lesser degree during the past three decades. Often that intervention has been greater for agriculture than for other sectors. Directed agricultural credit programs with heavily subsidized rates were the norm in the 1970s and 1980s and donors contributed heavily to them. The primary governmental interventions have included interest rate regulations, lending quotas, directed and subsidized credit projects, special refinance facilities for agricultural lending, and funding specialized agricultural development banks. Agricultural loan forgiveness and write-offs have been frequent, financial institutions have been created and rehabilitated with government subsidies, and guarantee funds have been designed and capitalized. Whereas 25 years ago the rationale for intervention was to stimulate the adoption of green revolution technologies, especially by small farmers, today the rationale is more frequently the social objective of making small loans to the poor to alleviate poverty.

The high costs and risks of providing financial services in rural areas explains some of the problems encountered by rural financial institutions, but poor governmental policies and investments also play a role. Many governments engaged in directed agricultural credit policies that in retrospect proved to be damaging to rural financial markets. At the same time, they often failed to do what governments should do. There were three major problems with this approach:

- First, too little attention was paid to creating a favorable policy environment in which healthy financial markets could grow and develop.
- Second, a suitable financial infrastructure was not created. Most importantly, a strong prudential regulatory and

supervisory framework was not created to protect the financial system. This became clear in the recent economic and financial crisis in Asia. Moreover, political involvement in financial markets, such as has occurred in Bangladesh, India, and Indonesia, prevented the effective enforcement of existing regulations.

- Third, too little attention was paid to institution building. The governments and donors channeled too many resources through financial institutions into agricultural lending and not enough into financial institutions to build up capacity for efficient financial intermediation.

Significant financial liberalization was not undertaken in most Asian countries until the 1990s, even though many negative effects of financial repression and subsidized directed credit were identified well before then. Even today, many countries continue to employ the outdated directed credit paradigm for agriculture and resist the lessons of microfinance.

Major Shortcomings of Asian Rural Financial Markets

The major shortcomings of Asian rural financial markets can be briefly summarized as follows:

- Most countries have resisted adopting a market-based approach to rural finance. This is especially true for Bangladesh, the PRC, and the Kyrgyz Republic in our six-country sample. Financial policies are somewhat less repressive than in past years in most countries, but the sustainability of financial institutions is usually a secondary objective compared with the goal of increasing disbursements.
- Regulations and political pressure prevent rural financial institutions from setting loan interest rates high enough to cover the costs and risks of lending. Many MFOs have set more realistic interest rates.

- Many financial institutions, especially the State-owned commercial and agricultural development banks, are weak due to their large portfolio of nonperforming loans, and exist only because of subsidies.
- Rural savings mobilization is still neglected, and most formal institutions that serve agriculture and the MFOs that serve the poor rely on government or donor funding.
- Policymakers have been more concerned about financing agriculture than about meeting the financial demands of rural nonfarm enterprises.
- Because of their many problems, most rural financial institutions are ill-equipped to make long-term loans, and to use the explosion in new information and communication technologies. As a result, Asian agriculture will be at a disadvantage in competing in global markets in the twenty-first century compared with other countries with more modern financial institutions.

Asian Success Stories

In spite of this overall negative picture, there are a few examples of successful rural financial institutions in Asia. These flagship institutions either avoided the directed agricultural credit syndrome or recovered after it was discontinued. They have made good progress in expanding outreach to marginal clientele groups and improving financial sustainability. BAAC in Thailand is unique in its portfolio largely composed of agricultural loans with an increasing share being medium and long term. It has achieved extraordinary outreach by serving most of the country's farm households, and reaching well down in the poverty profile with its services. It could become entirely free of subsidies by raising its portfolio yield by only three to four percentage points. The BRI unit desas in Indonesia are famous for turning their loss-making agricultural lending into highly profitable operations that specialize in small loans in

rural areas for farm and nonfarm activities. They have generated large profits that subsidize other bank operations. The Grameen Bank in Bangladesh is well known for its large outreach, especially to poor women, but its chief handicap is that it is still overly dependent on subsidies.

These successful rural financial institutions and the best MFOs have several similarities. They include effective methods to reduce the information and transaction costs of lending, incentives to induce staff to engage in behavior conducive to the health of the organization, and considerable autonomy to develop programs, design products, and set policies. The best MFOs use subsidies to strengthen their institutions and expand operations rather than create dependency on them. They develop valuable long-term financial relationships with clients, who strive to protect personal reputations by fulfilling credit contracts to maintain access to future financial services. This implicit contract for future services and the technology used to make and collect loans contribute to achieving good loan recovery. Grameen and BAAC use joint liability group lending as a collateral substitute for poor households, while the BRI unit *desas* and several other Indonesian programs successfully use individual lending to reach the poor.

The successful institutions provide important lessons for rural finance. First, institutional development requires a long-term commitment: strong institutions are not created overnight. Second, good institutional design is important, but the policy environment and financial infrastructure are also important. If they are not supportive, at least they must be benign. Third, women, landless, the poor, and other marginal clientele can be effectively served if the correct products, instruments, and technologies are used. Fourth, a large outreach can complement the objective of reaching sustainability, but reaching low levels of poverty may detract from financial sustainability. Fifth, microfinance is not a panacea. It often serves women better than men, is most cost-effective in densely populated areas, and works best with small short-term loans repaid in frequent small installments. Therefore, rural financial institutions cannot easily meet their objectives by simply mimicking microfinance.

PROBLEMS IN IMPLEMENTING THE NEW PARADIGM

The Asian region faces several problems in adopting the new financial market paradigm, as do many developing countries elsewhere. These problems include some special regional issues and uncertainties resulting from the financial and economic crisis.

Special Asian Problems

Although Asia has a few flagship financial institutions, it also has many poor ones. For example, in Asia there are more MFOs serving large numbers of clients than in other regions, but Asia lags behind Latin America in the commercialization of microfinance. Except for Indonesia, few Asian MFOs are evolving into some type of regulated institution, and there is little evidence of commercial banks entering rural finance or microfinance with a commercial orientation.

The slow spread of commercial rural financial activities can be attributed to three sets of problems. First, government and institutional policies inhibit market-oriented operations to a greater degree than in many developing countries elsewhere. For example, interest rate regulations prevent charging the rates needed to cover the high transaction costs and risks of serving poor clients and rural areas with small loan and deposit services. Rigid personnel policies discourage the use of bonuses and other incentives to spur high levels of efficiency from the management and staff of financial institutions. Second, some influential Asian leaders resist adopting the new paradigm and advocating a clear institutional mission to develop strong market-driven financial services. Instead, their mission is to channel loans to the poor and their views, such as the poor having a right to credit, mix social objectives with good banking policies. Their underestimation of the importance of deposit mobilization and other financial services, coupled with a view that the poor cannot

pay high interest rates, discourages the emergence of true market-oriented financial intermediaries. Therefore, many Asian MFOs do not have a clear mission of achieving high levels of efficiency and becoming subsidy free within a short period of time. Ready access to subsidized government and donor funds without clear performance expectations contributes to this problem.

Third, there are six sets of circumstances within Asia that pose special challenges for providing financial services in rural areas, especially for the poor. Financial organizations successful elsewhere under quite different circumstances offer only limited guidance on ways to tackle these difficult challenges:

- First, many transition economies in the region have nascent financial systems that are weak and underdeveloped. The uneven pace of economic reform suggests that the old State-planning mentality is still alive and well in some countries.
- Second, there are several conflict-affected countries. The temptation for policymakers in these countries is to distort the financial system by attempting to meet emergency needs and create employment for uprooted people through the rapid disbursement of loans. This weakens the financial institutions and prevents them from appropriately screening clients and establishing long-term banking relationships based on good performance.
- Third, the region has several disaster-prone areas, such as the lowlands of Bangladesh, subject to regular flooding, drought, and other natural disasters. These regions are difficult to serve at best and, unfortunately, most financial institutions including the MFOs are not well designed to cope with large systemic risks.
- Fourth, there are remote areas with especially poor transportation and communication, such as in Nepal and parts of the PRC, which will always be expensive to serve by even the most efficient institutions.
- Fifth, the region includes countries with influential religious communities that regard high interest rates

as immoral; therefore, interest rates and fees must be disguised so the true cost of borrowing is not transparent.

- Finally, the very large countries, India and the PRC, have unique problems. They face enormous difficulties in developing an efficient rural financial system involving multiple institutional forms with thousands of banking outlets to serve millions of clients with differing languages and cultures spread over an enormous landscape.

The Financial Crisis and Beyond

The financial and economic crisis in Asia has introduced tremendous uncertainty into the world economy. Its spread to Russia and Brazil is a cause of concern for investors, and the desirability of liberalized international capital markets is being seriously questioned. Investors suffer from a herd mentality: investment funds are being withdrawn from developing countries not exposed to the same problems as were Indonesia, Republic of Korea, Malaysia, and Thailand. Leaders in the region question the wisdom of free capital flows and Malaysia recently introduced new restrictions. Some of the questions being asked about the world economy include: Will the \$500 billion that Japan pledged to bail out its ailing banks be sufficient to restore the country to its role as economic locomotive for the region? Will the financial support given to Russia by the international community stem the contagion effect in Central Asia? Will greater social and political unrest break out in Indonesia? Will the PRC devalue its currency and, if so, what will be the impact on other Asian countries? Will other countries in the region reverse their economic and financial reforms and re-impose greater regulations on capital and financial markets? Will the US and Europe maintain economic growth and a strong demand for imports from developing Asian countries?

In one way or another, the crisis in all four of the most seriously affected Asian countries involves financial sector

problems: reforms without adequate regulation to protect financial institutions, short-term over-borrowing in foreign currencies, speculative investments fueled by low interest rates, and implicit entitlements to a government bail out for banks if priority loans fail. These problems occurred because of liberalization combined with political changes that increased the power of special private interest groups relative to macroeconomic technocrats. These cases point to liberalization gone awry, and the countries are now implementing reforms to prevent a repeat of the crisis.

The implications for future financial policies in Asia are unclear. The current problems could trigger a political backlash and increase pressures for returning to more restrictive economic and financial regimes. The economic impact so far appears to be less serious for rural Asia, but a fundamental change in financial policies could spill over into rural financial systems. If the leaders in the region reverse their financial reforms, opportunities for governments and donors to implement financial reform projects may be prejudiced. A serious immediate problem is that the subsidized credit programs being implemented in the wake of the crisis threaten to undermine the viability of financial institutions trying to adopt market-based principles. The concern of donors to respond quickly to the social problems created by the crisis may distract them from the longer-term problems of creating strong rural financial markets.

RECOMMENDATIONS

The wide range of circumstances found in Asia today and the different problems found in rural financial markets mean that no single set of recommendations can be made that will be universally applicable. The following recommendations must be evaluated with respect to each particular situation. Some are immediately applicable while others may have to be delayed until conditions are more favorable.

Creating an Appropriate Policy Environment

Interest Rate Reforms

Most Asian countries need to relax interest rate controls to allow rural financial institutions to set rates consistent with costs and risks. Interest rate liberalization should be undertaken as quickly as macroeconomic, exchange rate, and other considerations permit. Where interest rates have been liberalized, financial institutions need to respond by adjusting their rates to more realistic levels. Governments and donors should charge market interest rates for funds provided to MFOs that do not yet mobilize voluntary deposits so that these MFOs have incentives to seek greater efficiency and self-sufficiency.

Loan Targeting and Institutional Support

Funds provided to rural financial institutions and MFOs should be in the form of general liquidity support rather than targeted for specific clientele. If these funds are subsidized, the subsidies should be used for institutional development rather than passed on to borrowers as interest subsidies. Specific performance-based criteria should be established for receiving such financial support.

Emergency Loans

Financial institutions are poor channels through which to allocate subsidized emergency loans designed to alleviate social and economic crises following natural disasters, conflict situations, and financial and economic crises. These funds are usually intended for rapid disbursement without careful attention to client selection, credit worthiness, and recovery enforcement procedures. Emergency assistance should be channeled through institutions other than banks and MFOs. Financial institutions that participate in such programs risk contaminating their regular portfolios with borrowers who do

not understand the difference between the obligation to repay regular loans and the greater forbearance implicit in emergency loans.

Institutional Autonomy and Political Interference

Financial institutions must be given the autonomy to pursue sound banking practices. Loan melas, loan forgiveness programs, and other types of political interference damage financial institutions and create unhealthy expectations by clientele. Countries that desire strong financial systems must find ways to shield rural financial institutions from well-intended but detrimental political interference.

Building Financial Infrastructure

In countries where the policy environment for rural financial markets is improving, projects to build public institutions that reduce the cost of financial intermediation will generate high returns because they benefit all financial agents.

Legal and Regulatory Systems

Prudential regulations and supervisory systems need to be strengthened in most countries. Supervision of rural financial institutions must shift from verifying whether disbursement targets and specified loan terms and conditions are met, to ensuring the use of practices that lead to institutional safety and soundness. Emergency procedures must be developed to support rural financial institutions in times of massive systemic shocks such as drought and floods. The gaps in and inefficiencies of legal and judicial systems must be reduced such that contract enforcement is less costly and time consuming, and moveable property can be more easily used as collateral for loans.

Information Systems

All countries need to review the information systems that support their financial systems. Institutional changes and innovations that reduce the costs of acquiring and using information lower lending costs for all financial institutions and help drive down interest rates. Land titling, credit reporting systems, and collateral registries contribute to the stock of public information used by financial institutions. Some information systems have public goods attributes; therefore, they are an appropriate government investment. Special attention is needed for personal identification systems. A good credit record is an asset, but it needs to be portable to have maximum value. Computerized identification cards may eventually become inexpensive enough for the credit histories of borrowers to be stored on them. This would enable individuals to carry their credit histories to new locations and more rapidly gain access to financial services from new institutions.

Institutional Development

The best rural financial institutions have spent great effort in building their institutional capacity. Some, such as the Grameen Bank, have successfully tapped donors to help finance these investments. More importantly, institutional development represents a commitment by owners and managers to establish high-quality, efficient, and sustainable services in which farm and nonfarm entrepreneurs are treated as valuable clients. This philosophy is absent in many rural Asian financial institutions, however, and requires a fundamental change in attitudes, beginning with the managers and carried down to the lowest-level loan officer and teller.

Financial institutions interested in serving clients know their products and services must be designed to meet demands. Too frequently, Asian institutions fail to consider client preferences; market research and test marketing must become an integral part of an institution's operations. Greater attention

to client preferences and more flexible financial products will be reflected in better loan recovery because clients will want to preserve their reputations and maintain access to services in future.

Many Asian financial institutions need greater autonomy to adapt to the new market-oriented paradigm and to develop staff incentives with sufficient flexibility to reward outstanding performance and productivity. Simultaneously, the skill levels of staff in most institutions must be greatly improved to decentralize decision-making processes. Greater decentralization will speed operations and reduce transaction costs for clients. The standardized financial products currently offered by MFOs will need to be more flexible when offered by rural financial institutions and their use will require greater staff skills.

Two Special Challenges for Institutional Development

Building a strong rural financial system in any country requires assessing the status of existing institutions. Existing poorly performing institutions need to be dealt with in some countries; in some, MFOs might be upgraded to serve a wider rural clientele.

Rehabilitating Failing Institutions

Several Asian countries have failing agricultural development banks, cooperatives, and credit unions with an infrastructure of offices and personnel. Closing them will be the most rational solution in many cases, as discussed in Chapter III. However, the BRI experience following the termination of Bimas and several recent credit union rehabilitation projects in Latin America suggest that under certain circumstances these resources, which represent a sunk cost to society, may be salvaged and transformed into viable institutions. The minimum necessary conditions for rehabilitation include a political consensus for fundamental reforms, a firm commitment to recruit independent directors and hire professional bankers as

managers, the flexibility to replace staff whose views are inconsistent with the new mission, and the freedom to develop and price new products and services. These conditions are often not met because of vested interests in the existing institutions. But when they are met, technical assistance may be useful for disposing of nonperforming assets, developing new products, creating management information and staff incentive systems, and training staff in modern banking practices. Grants and loans may complement local resources to upgrade facilities and equipment, and augment loan capital.

Upgrading MFOs and Supporting Apex Institutions

Assisting governments to upgrade existing MFOs may be an effective way to expand the financial frontier and serve a broader rural clientele even though there are major challenges in this strategy. First, there are important regulatory and supervisory problems to resolve, especially when MFOs begin large-scale savings mobilization. Second, some MFOs may effectively use small amounts of financial assistance without becoming subsidy dependent and swamping their limited capacity. The problem is that the amount of such funding will usually be relatively small and small-scale efforts may be too costly for most donors to manage. Providing appropriate supervision of these projects is expensive. For example, CGAP decided to make only five grants to organizations in 1998 so that it could monitor the recipients properly.

Third, channeling funds through apex institutions is sometimes viewed as an attractive method to transfer larger amounts of money and the responsibility of screening and monitoring individual MFOs to another intermediary. Apex institutions are discussed in the Bangladesh and India case studies. The positive perceptions about the operations of the Palli Karma-Sahayak Foundation (PKSF) in Bangladesh provide encouragement for this approach. The relatively poor performance of apex organizations in India, however, provides evidence that they are not automatically successful. Several conditions are necessary for success: the rationale to justify an

apex requires that several candidate MFOs already exist to be screened and monitored; the country must have skilled personnel to carefully evaluate MFOs, determine those to be funded, and develop appropriate performance expectations for receiving funds; the apex must have sufficiently strong leadership to withstand pressures to disburse to MFOs that do not meet minimum standards; and the environment for financial institutions must be conducive for MFOs to transform successfully into self-sufficient financial institutions in a relatively short time horizon by receiving limited amounts of resources. Relatively few countries in the world meet these conditions as Bangladesh did when PKSf was created. Even so, PKSf has received donor support for strengthening its operations.

MAJOR ISSUES FOR DONORS

Donors can observe and learn from the various country experiences they support. These experiences need to be shared and evaluated internally, then communicated to field personnel and local institutions. Dissemination of information to local policymakers will contribute to better policymaking, and dissemination to local practitioners will speed adoption. USAID and CGAP are becoming important sources of best-practice information, and ADB could assume a more ambitious role in Asia. Systematic linkages and exchanges between the ADB and, for example, the Philippines Coalition for Microfinance Standards and Cashpor Inc., could stimulate discussions about the new paradigm and build a regional consensus for better financial policies. Likewise, familiarity tours for policymakers and practitioners to study flagship institutions would provide opportunities to view how organizations in the region successfully improve outreach and sustainability.

In the design of projects, donors must select situations favorable to success and avoid those that are not. For example, the PRC is firmly committed to a heavy governmental role in

controlling its rural financial system. Attempts to develop a market-oriented financial institution today would be doomed to failure under these conditions. Moreover, there are impoverished and conflict-affected countries where poor households would benefit from emergency financial assistance, but not in the form of so-called loans through financial institutions that are not allowed to choose clients and enforce financial contracts. There are also countries in which rigid financial regulations, especially interest rate controls, make it impossible to offer financial products at prices that cover costs and risks of serving rural clients.

When conditions are unfavorable, donor assistance should have two objectives. First, use structural-adjustment projects to support policy changes needed to create better conditions for market-based financial markets. Second, seek other opportunities for project assistance to benefit the intended recipients, but in ways that will not damage whatever credible financial institutions may exist. Compensating for the reported decline in public sector investments in rural infrastructure in several countries may offer one such opportunity. Projects to improve and disseminate technology and to assist with business development may be another. Improvements in infrastructure and the profitability of farm and nonfarm rural enterprises indirectly create the conditions required for financial markets to emerge at a later date.

FINANCIAL MARKETS FOR THE TWENTY-FIRST CENTURY: IS ASIA READY?

The financial dualism that exists in financial markets appears to be increasing in many Asian countries. First, urban financial markets are modernizing faster than are their rural counterparts. Second, large farmers, plantations, agribusinesses, and rural industries obtain financial services from modern urban financial institutions, while most small farmers, landless workers, and small rural nonfarm enterprises must rely on their

savings and informal finance. In countries where microfinance is expanding, some micro firms and poor rural households can access NGO loans. This segmentation creates a “missing middle” in which small and medium farmers and nonfarm firms fall between the two sources of supply: they are not well served by either larger financial institutions or microfinance.

The rural financial markets in most of Asia are poorly prepared to enter the next century. Many institutions are weak and are dependent on government and donor funding. They lack technical competence to evaluate credit risks, the financial infrastructure is not supportive, and governmental policies are often more destructive than supportive. New information and communication technologies are revolutionizing financial instruments and financial management strategies, but most Asian rural financial institutions are worlds away from these innovations. Therefore, a second dimension of financial dualism is arising, which might be called a “digital divide” because it separates those using modern computers and communication technologies from those that do not. It is possible to leap-frog over old technologies as is occurring with the Grameen Bank cellular phone franchise in Bangladesh. This requires supportive policies by governments that are often poorly equipped to deal with these challenges.

Asian countries with weak financial markets will suffer in the worldwide competition for markets compared with other developing countries with better rural financial systems. The opportunities for rapid improvement, however, exist in Asia. The region’s advanced flagship financial institutions can serve as models for other institutions. Moreover, several countries have highly trained personnel who could create new financial technologies and manage institutions if they were given the opportunity, flexibility, and financial support by governments in the region. The roles of government are to create a favorable environment, invest in supportive infrastructure, and build institutions; recognize the role that the private sector can play in financial markets; and avoid negative policies that undermine institutional viability, such as trying to solve social problems by channeling subsidized loans through financial institutions.

Asia has the potential to build strong market-oriented rural financial systems. However, so far most countries have lacked the vision and will to make the necessary changes. The status quo benefits the rural elite but is prejudiced against the poor.

