APPENDIX 4
RURAL FINANCIAL MARKETS IN ASIA: PARADIGMS, POLICIES, AND PERFORMANCE—SUMMARY

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Rural Asia has undergone a fundamental economic transformation during the past three decades. Economic growth rates have been particularly high in East and Southeast Asia, and even the slower-growth countries have made progress. This growth has been accompanied by rapid structural transformation of the rural economy, decline in the relative importance of agriculture, increased use of sophisticated capital inputs in agricultural production, greater specialization in production, explosive growth of rural cities and towns, and an emerging heterogeneous rural nonfarm economy. However, the development of rural financial markets has lagged. Their performance has been poor and, in most Asian countries, they are ill-prepared to serve rural areas in the 21st century.

ECONOMIC TRANSFORMATION AND RURAL FINANCIAL MARKETS IN ASIA

The Commercialization of Agriculture

The green revolution fueled the structural transformation of rural areas. The new technologies expanded agricultural production and induced demand for fertilizers, chemicals, and other purchased inputs. Commercialization of production led to the rise in marketable surpluses with increased marketing of agricultural inputs and outputs. Cash incomes rose for many farm households, market exchanges substituted for barter, and the rise in use of money as the medium of exchange helped integrate the rural with the urban economy. In addition, decisions regarding product choice and input use evolved from subsistence to a profit-maximization orientation. Integrated farming systems were often replaced with specialized crop and livestock enterprises. Highly specialized large-scale plantations are now found along with small farms that combine farm and nonfarm enterprises to increase and diversify income sources.

Markets and the Critical Role of Finance

Structural transformation requires markets to facilitate the division of labor in which one producer specializes in one activity and trades with others who have different specializations. Markets integrate specialized producers and consumers so that they can engage in transactions involving an increasingly heterogeneous set of goods and services. As structural transformation progresses, markets for land, labor, capital, and finance emerge, multiply in number, and become more complex in response to the greater variety of goods and services demanded. Markets with varying degrees of efficiency have emerged in the developing market economies of Asia. The transition economies, however, are experiencing difficulties in creating markets and supportive institutions, and this

constrains agriculture from contributing more fully to economic growth.

Financial markets contribute to economic growth. The primary function of the financial system is facilitating resource allocation across space and time in an uncertain environment. Finance is used to reduce risk, allocate resources, monitor managers and exert corporate control, mobilize savings, and exchange goods and services. When these functions are performed well, they contribute to economic growth through two channels: capital accumulation and technological innovation. Limited access to financial services can constrain economic development. For these reasons, governments and donors have devoted vast resources to developing financial systems in low-income countries during the past three decades.

Policymaker Perceptions about Rural Finance

In the 1960s and 1970s, many Asian policymakers did not believe that a farmer's ability to self-finance investments would lead to a socially optimum rate of growth. They perceived that the potential of the green revolution would not be realized unless farmers could access an elastic supply of funds at more reasonable interest rates than available from informal sources. These views provided the rationale for directed and subsidized agricultural credit programs along with strong support for input- and output-marketing projects. The BIMAS project in Indonesia and Masagana 99 in the Philippines are examples; both failed, imposing great losses on the financial institutions that participated in them.

DEVELOPING RURAL FINANCIAL MARKETS

High Costs and Risks in Rural Areas

The directed-credit approach to supplying agricultural loans did not properly recognize the especially difficult

problems of providing financial services in rural areas. Rural bank clients are more dispersed than urban clients and often demand only small loans and savings accounts, such that per-unit transaction costs are high for the financial institutions. Information costs for providers and users are higher because transportation and communication infrastructure is usually less developed. Agricultural loans are often considered inherently risky because of production and marketing risks, and the returns on farm investments are often low because of urban-oriented agricultural policies. Loan repayment by farmers may be contingent on borrower ability to meet household consumption requirements. Many potential clients have little loan collateral, and property rights to land may be hard to enforce. Although farm households engage in a variety of enterprises, the geographic concentration of crops and livestock results in high covariance of household incomes, which makes returns for local institutions vulnerable to local disasters.

The Changing Paradigm for Developing Rural Financial Markets

The failure of many credit projects led to a paradigm shift in some developing countries. The paradigm of directed and subsidized lending has been gradually replaced by a new one oriented towards financial-market efficiency. The main features of the old and new paradigms are summarized in Box 1. Some Asian countries are using ideas from the new market-oriented paradigm, while others cling to the old directed-credit approach. Evidence of the new thinking is found more often in microfinance than in rural finance policies.

The perspective offered by the changing paradigm is useful for identifying weaknesses in policies and programs in many developing countries. However, it has shortcomings as an analytical tool for determining the nature of specific problems that individual countries face in resolving bottlenecks in their rural financial markets. For example, the issue of an appropriate regulatory and supervisory framework for rural

Box 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	Small 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
Evaluation	Credict impact on beneficiaries	Performance of financial institutions

finance and microfinance is not addressed, nor are legal issues nor the appropriate method for subsidizing institutional development without creating subsidy dependence.

Creating Financial Markets in Transition Economies

Creating sustainable finance in transition economies 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. The Asian transition countries are heterogeneous. On the one hand, the People's Republic of China (PRC) and Viet Nam embarked on a gradual transition in the 1980s with microeconomic reforms preceding macroeconomic reforms. The banking sector in the PRC captures rural surpluses for use in financing projects including rural industrialization. On the other hand, the Central Asian republics became independent countries only in the 1990s, and macroeconomic reforms dominated the first phase of transition, which was limited to liberalization of the economy and redistribution of the State-owned assets. The second phase of transition involves creating financial institutions, developing skills, and accumulating knowledge. The situation in the Kyrgyz Republic described in this volume shows how rapid changes in property rights and liberalization of prices and foreign exchange are being implemented. The banking sector is expected to play a role in the privatization strategy.

The transition countries need financial reforms in two major areas. First, they need to improve the efficiency of their banking sectors by reducing bureaucratic interference and overdue loans, unclogging payment systems, strengthening regulatory and supervisory systems, developing legal systems that can enforce contracts and inculcate financial responsibility, reducing corruption, and improving the skill level of the staff to assess and manage risks. Second, they need to reduce systemic problems in their financial markets to increase competition, by reducing insider control of financial institutions, developing capital markets, reducing the political hold on institutions, reducing barter transactions, and reducing barriers to entry for private banks and nonbank financial institutions.

Building Rural Financial Markets

In recent years, financial institutions have been evaluated on the dual objectives of outreach and sustainability. Generally speaking, a financial system meets more of society's objectives and merits the allocation of scarce resources if it

- serves many clients;
- serves many poor clients;
- provides a large range of services;
- costs the users as little as possible;
- provides services over a long period of time; and
- can be sustained with only a minimum of support from nonusers or taxpayers.

These should be the objectives of the policies and programs for rural financial markets. The priorities for developing rural financial markets form a three-pronged framework: creating the policy environment; building financial infrastructure; and institutional development.

Creating the Policy Environment. Many directed-credit programs were introduced in environments hostile to creating healthy financial markets: macroeconomic instability produced highly variable inflation rates; repressed interest rates prevented charging cost-recovery rates on loans; and high reserve requirements discouraged deposit 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 negative environment. Policy reforms are necessary to create an environment conducive for financial markets. Some countries may greatly improve their financial systems through systemwide reforms, but in other cases, more direct proactive measures will be required to build the financial infrastructure.

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 communication systems, particularly in rural areas, indirectly affect the costs and risk of finance.

Institutional Development. Institutions may not develop automatically because of improvements in the environment and financial infrastructure. Institution building may be required in order to take advantage of the newly emerging opportunities and markets. 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. Providing support to institutions that target these groups, particularly in their initial start-up phase, may yield high social returns, provided that the subsidies received are for specific institution-building purposes and are transparent, time-bound, and linked to performance. Ultimately, individual institutions need to experiment with alternatives to find methods of operation that fit their objectives and capabilities.

WHAT HAS BEEN LEARNED ABOUT DEVELOPING RURAL FINANCIAL MARKETS IN ASIA?

Learning from Failure

The directed-credit paradigm employed by most Asian countries in the 1960s and 1970s had the following characteristics:

- Interest rates for farm loans were subsidized and loans for small farmers were set at especially low rates.
- The source of funds for most programs was the government and donors. Local savings mobilization was largely ignored.
- The objective of government policy was to increase the supply of loans made to farmers with little attention given to institutional sustainability.
- Production packages, in which credit was treated as an input like seeds and fertilizer, were created for farmers.
- Credit was targeted for "productive purposes." Loans for consumption and rural nonfarm enterprises were ignored and, in some cases, prohibited.
- Credit programs were often aimed at small farmers and employed supervised credit through cooperatives as a means to ensure that it was used properly.
- Cooperatives were the primary credit channels in many countries, while commercial banks and agricultural development banks were more important in other cases.
- Transaction costs for lenders and borrowers were largely ignored.
- Some programs eventually broadened their target groups from small farmers to the rural poor.

The Emergence of New Views

Research conducted on many failed directed-credit projects provided the following conclusions:

- 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; it is costly and difficult to target end-use effectively.

- A policy of maintaining positive real interest rates is the most important element in improving rural financial market performance.
- Use of savings to finance loans will diminish or erase patronal relations that currently exist between borrowers, intermediaries, and financial authorities.
- A reduction in dependence on external funds will decrease 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. Informal finance plays an important role in providing savings services and small loans for consumption and emergency purposes.
- The aim of analysis should be to provide a better understanding of the factors affecting the performance of financial institutions, rather than an 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.

Lessons from Microfinance for the Poor

Microfinance emerged in the late 1970s and several projects for lending to the poor produced results superior to many of the old-paradigm agricultural credit projects. Microfinance organizations (MFOs) designed important innovations that enabled them to expand the frontier of financial markets in developing countries. These innovations reduced lending costs and risks and permitted MFOs to serve poor clients successfully without the collateral normally required by banks. This experience contributed to the emerging new paradigm. The techniques used by successful MFOs include the following:

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- Repeat loans—incentives are given to clients to maintain good repayment records by rewarding them with (almost automatic) repeat loans. For some lenders, the 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 process 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 household goods and other assets with high-use value to their clients as collateral.
- 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—MFOs 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 MFOs offer interest rebates for on-time or early repayments, and others charge penalty interest for late payments.

Present Status of Rural Financial Markets in Asia

A surprisingly large number of Asian countries have made relatively little progress in adopting the new paradigm. There are important exceptions, but the primary problems today are similar to those two decades ago:

- Interest rates on rural loans are often too low to cover the costs and risks of lending. Some MFOs charge rates high enough to cover most costs, but regulations and political pressure have kept rates low for many agricultural lenders.
- Many countries have resisted adopting a market approach to rural finance. Targeted programs, subsidized refinance funds, and restrictions on clientele served still exist. The sustainability of financial institutions continues to be a secondary objective.
- Many rural financial institutions are weak and exist only because of subsidies. Nonperforming loans are a serious problem and sap their vitality.
- Savings mobilization is still relatively neglected.
- Policymakers continue to be largely preoccupied with the problems of agriculture and overlook the broader demand for financial services by the rural nonfarm economy.
- Most rural financial institutions are ill-equipped to make long-term loans and to use new information and communications technologies characteristic of modern banking.

Three Successful Rural Financial Institutions in Asia

Three Asian institutions have been extensively studied because their performance has been far superior to most rural financial institutions in the developing world. They are the Bank for Agriculture and Agricultural Cooperatives (BAAC) in Thailand, the unit desa system of Bank Rakyat Indonesia (BRI-UD), and the Grameen Bank (GB) in Bangladesh. The

three have achieved good outreach and sustainability. Outreach refers to the increased degree of market coverage of low-income groups that were previously without access to formal financial services. It includes both a horizontal dimension (breadth of outreach or number of clients served) and vertical dimension (depth or level of poverty of clients). Sustainability refers to the ability of a financial institution to supply financial services on a continuous cost-covering basis without external subsidies. A sustainable institution covers its costs, including operating expenses, loan and inflationary losses, and the cost of funds, without external subsidies. It makes a profit to compensate owners, to accumulate reserves against future losses, and to fund new investments. Subsidy dependence is the inverse of sustainability, and the calculation of a subsidy dependence index (SDI) has been used effectively to evaluate the degree of subsidization received by financial organizations.

All three institutions have millions of clients with loans; BAAC has been the most successful, as it reaches more than 80 percent of the country's farm families. It has a larger portfolio than the other two because of its larger average loan size. It also performs well in reaching the poor as seen in the relationship between average loan size and the country's GDP per capita. BAAC and BRI-UD have about the same amount of savings mobilized, but the number of savers is much larger in BRI-UD. Moreover, the total amount of BRI-UD savings far exceeds its loan balance, while BAAC and GB rely on other sources for a significant share of their total lending. Unlike the other two, Grameen does not actively promote voluntary savings, but it is particularly successful in reaching poor women clients with loans. BRI-UD is by far the most profitable institution. In 1995, it could have reduced the yield on its loan portfolio from 31.6 to 16.3 percent and still have remained free of subsidy. BAAC would have had to raise its average yield on loans from 11 to almost 15 percent, and GB would have had to raise its rates from 20 to 33 percent to be free of subsidy.

These institutions show, first, that institutional development requires a long-term commitment because strong

institutions are not created overnight. Second, good institutional design is important, but the policy environment and financial infrastructure are also important. Third, marginal clientele can be reached if the correct approach is used. Fourth, extensive outreach can complement the objective of financial sustainability. Fifth, microfinance is not a panacea; it often serves women better than men, is most cost effective where there is a dense population, and works best with small short-term loans repaid in frequent small installments. Therefore, rural financial institutions cannot meet their objectives by simply mimicking microfinance.

Problems in Implementing the New Paradigm

The Asian region faces two sets of problems that must be overcome before it adopts the new financial markets paradigm. First, it is making slower progress in commercializing rural finance and microfinance than Latin America. The causes of this problem include controlled interest rates, influential leaders who do not have a clear vision of developing market-driven financial services, and particular situations, e.g., several countries are in transition; some have frequent natural disasters; some are conflict-affected; some have poor transportation and communication; some have religions opposed to high interest rates; and finally some have huge areas and heterogeneous populations.

The second problem is that several countries were particularly hard-hit by the economic and financial crisis in Asia that began in 1997 and that has set back economic progress, raised questions about the policy of economic liberalization, and created uncertainty about how the financial system, including rural financial institutions, will be regulated in the future.

RECOMMENDATIONS

The experiences of the three institutions mentioned above, along with analyses of other financial institutions, reveal crucial factors that enable them to achieve outreach and sustainability. These factors are presented in terms of the three-pronged framework mentioned above—policy environment, financial infrastructure, and institutional development—and two special challenges for institutional development and donor issues are added.

Creating an Appropriate Policy Environment

Although the urban bias of economic policies in Asian countries has been reduced, several policies influence the prospects for developing sound rural financial markets.

- *Interest Rates*. Interest rates are controlled in some countries while in others financial institutions are reluctant to raise rates even when they are deregulated. BRI-UD determines its own rates and follows a policy of covering costs. The low-interest-rate policies of BAAC and GB are well intentioned, but the cost of this policy for the institutions is that they cannot become self-sufficient. When some institutions are subsidized, market-oriented institutions cannot compete. This problem is worsening in Indonesia because of special subsidized projects created in the wake of the financial crisis. The freedom to set interest rates is often linked to the freedom to select clients. Subsidized-credit projects usually carry restrictions about the target groups to be served, which implies that the lender ends up with a risky, undiversified portfolio. Financial institutions need the flexibility to set interest rates consistent with costs, risks, and competition.

- *Loan Targeting and Institutional Support*. Financial institutions need the flexibility to select their own clients; if institutions participate in targeted and subsidized projects, the subsidy should be used to strengthen the institution, rather than be passed to borrowers as lower interest rates.
- *Emergency Loans*. Financial institutions are a poor channel through which to allocate subsidized emergency loans to alleviate social and economic crises, because such funds are usually intended to be quickly disbursed without careful attention to client selection, creditworthiness, or recovery enforcement procedures.
- *Institutional Independence and Political Interference*. Countries that desire strong rural financial markets must find ways to shield rural financial institutions from well-intended but detrimental political interference.

Building Financial Infrastructure

Projects to build public institutions that reduce the cost of financial intermediation may generate high returns because they benefit the entire financial system. Experience has shown that governmental support is vital for two sets of supporting infrastructure:

- *Legal and Regulatory Systems*. Prudential regulatory and supervisory systems need to be strengthened in most countries and the inefficiencies of legal and judicial systems reduced so that contract enforcement is less costly and less time-consuming.
- *Information Systems*. All countries need to review the information systems that support finance, because reducing information costs will lower costs for all financial institutions and drive down interest rates. Some information systems need to be supported by governments because they are public goods. Universal

identification systems are important so that clients of an institution can carry their credit history from one location to another.

Institutional Development

Institutional development requires a commitment by owners and managers to establish good quality and efficient client-oriented services:

- *Client Preference*. Institutions must determine what products and services are demanded. Greater appreciation for client preferences will encourage loan repayment.
- *Autonomy*. Financial institutions require autonomy to adopt the new market-oriented paradigm and to hire well-trained staff, pay high salaries, use incentive systems to motivate efficiency, and decentralize decision making to reduce transaction costs for clients.
- *Efficiency and Costs*. Competition is increasing in some markets, so financial institutions must strive to improve efficiency and reduce the costs of their services. Improved efficiency will also permit charging the lowest possible interest rates and fees consistent with financial sustainability.

Two Special Challenges for Institutional Development

There are two special challenges that need to be dealt with as part of institutional development in several countries:

- *Rehabilitation*. There exist failing or poorly performing agricultural development banks, cooperatives, and credit unions that consume resources and may cause negative spillovers that damage other institutions. They represent a potential resource in the form of installations and staff that could be salvaged. However,

the conditions required for successful rehabilitation are frequently not met. Decisions are required to either close them if that is the best alternative, or rehabilitate them so that they can perform better.

- *MFOs*. Existing MFOs may have the potential to be upgraded to serve the rural market, but this requires institutional strengthening and an appropriate regulatory framework so that they can legally mobilize savings. A decision is needed in countries where they are important to determine which ones have the capacity to expand in rural areas, and to provide support for them to do so.

Major Issues for Donors

Donor organizations are in a strategic position to disseminate best practices, encourage the exchange of information, and build a consensus for reforms. They must judiciously determine which situations are conducive to institution building for rural financial institutions, and which are better suited for structural adjustment projects to support policy changes.

FINANCIAL MARKETS FOR THE TWENTY-FIRST CENTURY

The rural financial markets in Asia are generally not in a strong position to support modernization of rural economies. Financial dualism appears to be increasing in many countries. Urban financial markets are modernizing at a faster rate than their rural counterparts. Larger farms and agribusinesses obtain financial services from these modern urban financial institutions, while most small farmers and rural nonfarm enterprises must rely largely on savings and informal finance. A digital divide is emerging that separates those using modern computers and communication technologies from those who do not.

Many rural financial institutions are weak and depend on subsidies. They lack professional competence to evaluate credit risks and they operate in environments that are not supportive. Asian agriculture will be at a disadvantage relative to that in other regions and countries with more advanced financial systems. Fortunately, the Asian region has a few good financial institutions that are well advanced and can serve as models for others. Successful microfinance experiences offer insights into how finance can be successfully extended into rural areas. Moreover, several countries have highly trained personnel who could create new technologies and manage institutions if they were given the opportunity, flexibility, and financial support. It is up to the governments in the region to support them. Asian policymakers must do a far better job in the future than they have done in the past three decades in order to create appropriate environments, build financial infrastructure, and develop institutions necessary for strong market-based financial systems to serve rural farm and nonfarm enterprises and households.