

Development of Rural Financial Services: Asian Experience on Government Interventions

Presentation by

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Asia-Pacific Finance and Development Center, Shanghai, PRC
19 – 23 November 2007

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Outline

- Rural Poverty in Asia
- Definition of Rural Finance
- Rural Finance-Rural Development Nexus
- Government Interventions: Why?
- Government Interventions: How?
- Government Interventions: What outcomes?
- What Constructive Measures Can Governments Take
- Concluding Remarks

Rural Poverty in Asia

- Rural poverty declined, but still many poor people
- Absolute number of poor in rural areas: increased
- Most of the poor are in rural areas
- Most of the poor are in agriculture
- Unemployment and underemployment high
- Rural-urban socio-economic disparities are large

Definition

- “Provision of financial services for rural farm and non-farm population at all income levels”
- Rural Finance is not just finance for the poor
- Rural Finance is not just finance for agriculture or small farmers
- It is financial services for all in rural areas
- Rural Finance is not just credit

Rural Finance-Rural Development Nexus

- Finance-Development nexus is strong
- Credit is just one part of financial services
- Access to finance
 - Increases choices
 - Reduces vulnerabilities to shocks
 - Enables to take advantage of economic opportunities
 - Facilitates social development
- Reduces inequalities
- Improves resource allocation and contributes to growth

Rural Financial Markets: Demand Side

- Diversity in demand
- Large demand for reliable deposit services
 - [Cash under mattress]
- Large and diverse demand for credit
- Demand for insurance, payment and money transfer services
- Potential demand for financial services is huge
- Part of the demand is directed to informal services

Rural Financial Markets: Supply Side

- Formal: Agriculture Banks; Savings Banks; Commercial Banks, etc.
- Semi-formal: Co-operatives; NGOs, etc.
- Informal: Village money lenders, store-owners, friends and relatives
- This basic structure is common to all countries
- But relative importance of each differs
- Informal sources are predominant in most countries

Government Interventions: Why?

- Highly controversial issue

“The role of government in financial market development is one of the long-standing, and unresolved debates that has engaged economists around the world”

Joseph Stiglitz (1993)

Government Interventions: Why (cont'd...)

- Market failure: under-supply of rural financial services
- Perceived shortage of affordable credit (for agriculture, etc.)
- Shortcomings of informal credit: price; quality, quantity, etc.
- Under-supply of deposit and other services
- Lop-sided supply: exclusion of low-income households
- Private sector on its own will not provide the required services

Government Interventions: How?

We will first look at conventional measures

- Asian governments have intervened in many different ways
- Established state-owned financial institutions (Ag banks, etc)
 - Insurance companies; savings banks, postal banks too
- Directed credit programs through state institutions
 - Credit supply by Agriculture/rural Industries Departments
- Supply concessional funds to finance credit operations
- Administered interest rates on rural credit and deposits
- Ceilings on rural credit

Government Interventions: How (cont'd...)

- Other Measures.....
 - Mandatory requirements on opening of rural branches
 - Debt forgiveness or loan write-offs

Government Interventions: How? (cont'd...)

- Paradigm shift in rural finance: from state-driven to market-based rural finance
- The shift was part of the broader transformation in economic development policy thinking away from central planning

**With the paradigm shift in rural finance,
some governments took more
constructive measures**

Constructive Measures

- Reformed state-owned rural finance institutions
 - Indonesia (BRI-Unit Desa reform)
 - Reforming Agricultural Bank of Mongolia
- Remove or relaxed interest rate ceilings
- Allowed NGOs to provide rural credit
- Allowed foreign investments in rural finance

Government Interventions: Outcomes of Conventional Measures

- Many disagreements exist about outcomes
- Some argue: some measures produced positive outcomes
- Many argue that state-driven credit played an important role in adoption of green revolution technology
- State-owned institutions: major supplier of rural deposit services

Government Interventions: Outcomes of Conventional (cont'd...)

- But many negative consequences
- Failure to build financially sustainable institutions
- Credit supplied at tremendous cost to society
- High default rates and loan write-offs
- Damages to conducive culture of financial services
- Regressive distribution of benefits of loans
- “RMFs in Asia are ill-prepared for the 21st century”
 - ADB Study [2000]

Government Interventions: Outcomes of Non-Conventional Measures

- These outcomes are lot different and clearly positive
- The reformed financial institutions in Indonesia and Mongolia are sustainable and most dynamic
- They continue to expand outreach
- They have added value to RFMs and rural households
- Microfinance institutions: also making an important contribution to rural development

What Constructive Measures Can Governments Take?

- Fundamental: supply expansion through market-mechanisms (How?)
- Create an enabling environment for private sector investors
- Support competitive RFMs and development of financial infrastructure
- Take measures to reduce sector-wide risks and transaction cost barriers **“Transaction costs are admission tickets to financial markets”**
- Provide incentives to private investors (Tax concessions?)
- Legal framework: legal rights [borrowers/lenders/depositors]
- Eliminate political interventions in RFMs
- Promote institutional diversity and partnerships on the supply-side

Other Important Measures

- Support training of staff and innovations
 - Innovations and training requires investments
 - They are risky, costly and require long gestation periods to get returns
 - Involve significant externalities (hence insufficient incentives)
- Smart use of subsidies for some fixed cost of institutions
- **Warning: Flood of funds generally destroys incentives for performance**

Other Important Measures (cont'd...)

- Promote financial literacy
 - Value of this is not fully recognized by most policy makers
- Financial illiteracy is an acute problem in most rural areas
 - Poor cash management; over-indebtedness
 - Low usage level of available services
- More productive economic opportunities for rural people
- Opportunity-ability focused measures are critical on demand side

Concluding Remarks

- Efficient and effective RFMs: critical for inclusive development
- No magic bullet to address challenges in building such RFMs
- Many negative lessons from conventional approaches
- But there are constructive ways to promote sustainable RFMs
- Objectives must be: efficiency, outreach and effectiveness
- Particular measures and sequence of support: Context specific
- And sensitive to initial conditions

Thank you for listening

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and Microfinance, please visit ADB
Microfinance Website:

www.adb.org/microfinance