

Rural Financial Services: A Comparative Study of Mozambique and Vietnam *

Rafael Uaiene, Direcção Nacional de Estudos e Análise de Políticas (DNEAP)

Nguyen Manh Hai, Central Institute for Economic Management (CIEM)

Pham Minh Thu, Institute of Labour Science and Social Affairs (ILSSA)

Simon McCoy, University of Copenhagen

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List of Acronyms and Abbreviations

BdM	Banco de Moçambique (Central Bank of Mozambique)
FARE	Fund for Economic Rehabilitation (Mozambique)
GDP	Gross Domestic Product
GoM	Government of Mozambique
GoV	Government of Vietnam
GSO	General Statistics Office of Vietnam
HCMC	Ho Chi Minh City
INE	Instituto Nacional de Estatísticas (National Statistics Office of Mozambique)
JSCB	Joint Stock Commercial Bank
LURC	Land Use Right Certificate (Vietnam)
MPD	Ministry of Planning and Development (Mozambique)
MFI	Microfinance Institution
MT	Mozambican Metical
NGO	Non-Governmental Organisation
NPL	Non-Performing Loan
NTP	National Targeted Program
PCF	People's Credit Fund
ROSCA	Rotating Savings and Credit Association
SBV	State Bank of Vietnam (Central Bank of Vietnam)
SME	Small and Medium Sized Enterprise
SOCB	State Owned Commercial Bank
US\$	United States Dollar
VARHS	Vietnam Access to Resources Household Survey
VBARD	Vietnam Bank for Agriculture and Rural Development
VBSP	Vietnam Bank for Social Policy
VHLSS	Vietnam Household Living Standards Survey
VND	Vietnamese Dong
VPSSC	Vietnam Postal Savings and Service Company
WTO	World Trade Organisation

1. Introduction

Poverty is predominantly a rural phenomenon in both Vietnam and Mozambique, and the large majority of rural households depend on agriculture as their major source of income. Improved agricultural productivity is well established as a major force for moving people out of poverty. Comparative work between Vietnam and Mozambique is particularly interesting in this area: Vietnam has experienced considerable success in raising agricultural productivity and in establishing markets, particularly export markets, for the increased production, and there are therefore numerous potential lessons for Mozambique where efforts to improve agricultural productivity are widely viewed as having achieved considerably less success.

Among the numerous potential causes of agricultural productivity, the availability of credit, or more generally, rural financial services, is commonly found to be a key determinant. However, due to market imperfections (information asymmetries and moral hazard) most of the rural poor in many developing countries lack access to the range of financial services that they require. Rural financial services are often relatively costly and rigid, whether from formal or informal financial providers, and many of the primary products of many (micro-)financial institutions (short-term working capital loans with frequent repayments for example), are not well-suited to agricultural activities. Furthermore, financial institutions seeking to work in rural areas face numerous constraints, such as poor infrastructure, high information and transaction costs, seasonality of many agricultural activities, and a lack of human resources.

As a result, it is more often than not the case that commercial banks chose not to enter rural areas- and those that do enter do so only with incentives and often do not lend directly to agricultural producers. The rural community is thus commonly found to be underserved by the financial sector, and a role for the state and international donor community to correct such market failures is therefore potentially important. While the above is certainly true in both Vietnam and Mozambique, the approaches of the respective governments, and the resulting situation for credit in rural communities in both countries is markedly different.

With this in mind, an analysis of rural financial services in Mozambique and Vietnam is presented here, consisting of an in-depth diagnosis of the rural financial system in the two countries using descriptive statistics and qualitative assessments. In particular, an informed judgement regarding the efficiency/value-add of rural finance through the lenses of outreach, sustainability, and, to the extent possible, impact on rural livelihoods is presented. Given the markedly different institutional set-ups currently in existence in the two countries, the analysis identifies areas in which the two countries can learn from each others' experiences in the area of rural financial service provision.

2. Rural Credit: Context, Theory and Empirics

Rural credit markets in developing countries do not function perfectly. Perhaps the clearest manifestation of this is the high proportion of rural households who remain without access to the (formal) financial services that their urban neighbours enjoy. Commercial banks on the whole simply chose not to enter rural areas, and those that do enter, do so only with (government- or donor-financed) incentives, with lending largely channelled to big companies, short-term commercial loans (used for working capital) and salaried employees (consumer loans). Rural bank credit seldom directly reaches small scale agricultural producers.

If you are a profit-maximising entity, then it is not hard to see why this might be the case. Agriculture is inherently risky: Variable rainfall, pests and disease, input and output price fluctuations and small farmers' poor access to inputs, advice and markets all cause uncertainty and mean that risks are high. Moreover, in rural areas, many non- and off-farm activities are linked with farm-activities. Rural non-farm households are subject to many risks that also affect the agricultural sector. Thus, although rural households may engage in a variety of economic activities (agricultural and non-agricultural), there is a high covariance of incomes (Nagarajan and Meyer, 2005). Such systematic variability and risk often results in involuntary default on loans, and discourages commercially-orientated banks from lending outside of urban centres.

Information regarding clients is a vital tool used by financial institutions to manage and assess risk. Indeed, good information can serve as a partial substitute for a lack of real collateral- particularly important in rural settings where farmers often do not possess sufficient tangible assets to offer as collateral, and/or suffer from ill-defined property and land-use rights for the assets they do possess. In rural areas, the often weak transportation and communication infrastructure, the heterogeneity of production conditions, and a dispersed client base associated with low population densities all combine to mean that information is costly to acquire and transmit. There is thus an asymmetry of information between the lender (the principal) and the borrower (the agent), in which the former cannot easily ascertain the characteristics and likely repayment decision of the latter, or effectively monitor what the loan is actually used for. The problem of moral hazard (voluntary default) is thus not easily circumvented, and banks are further discouraged.

It is further made difficult by the fact that many rural activities, by urban standards, are characterised by low profitability, with many rural enterprises/farms not generating sufficient margin to cover the financial costs associated with a debt obligation. In this context, and given that demand is often for relatively small loans and savings accounts, per-unit transactions costs for financial services providers are often high (high fixed costs), and risk-averse commercial banks are deterred from entering rural areas. Indeed, most proven microfinance technologies are short-term in nature and more appropriate for commercial retail activities in urban areas. In contrast, due to the cultivation of perennial crops, the fact that many soil and water conservation investments have long gestation periods, and the lengthy amortisation period for machinery, medium/long-term credit is often what is most needed in rural settings. Standard microfinance practices often remain, therefore, inapplicable.

Rural communities are thus largely underserved by the formal financial sector, leading many to point toward a legitimate need for intervention (by the state and international donors) to correct this market failure.

According to modern growth theory,¹ the financial sector can affect long-run economic growth through its impact on (i) capital accumulation (human and physical), and (ii) technological progress. These effects essentially arise from the intermediation role provided by financial institutions which enable the mobilisation of savings for investment, facilitate capital inflows from abroad, and optimise the allocation of capital between competing uses, thus ensuring that capital is allocated to its most productive use.

Levine (1997) identifies five basic functions of financial intermediaries. Firstly, financial intermediaries provide a place for people to save, not only rewarding them with positive returns in the form of interest payments², but also enabling the recycling ('mobilisation') of these savings funds in the form of loans. Secondly, they enable the management of risk, offering liquid savings to creditors while being able to provide medium and long-term commitments of capital to debtors. Thirdly, a critical role of financial intermediaries lies in their ability to acquire process and compare information, and subsequently allocate capital to areas where it will generate the highest returns. Fourth is their ability to monitor the performance and use of loaned funds on behalf of many investors who would not otherwise have the resources to do so individually. Finally, the financial sector facilitates transactions in the economy, by providing the mechanisms to make and receive payments, and by reducing information costs in the ways alluded to above.³

Nowhere are these roles/functions of the financial sector more relevant, and at the same time more complex and challenging, than in the rural sector of developing countries.

The existence of a causal link from a developed and well-functioning financial sector to economic growth is more often than not taken as axiomatic in development literature and by key development stakeholders. Furthermore, it is often posited that financial development reduces inequality as it levels the playing field and enables poorer individuals and enterprises of smaller scale to participate in the formal economy and grow. As such, the underdevelopment of rural financial markets in developing countries (including Mozambique and Vietnam) is seen by many as an important drag on productivity-enhancing investment in agricultural technologies and thus rural growth.

Empirically examining these issues, and in particular the *direction of causality* from financial sector development to economic growth and poverty, or from the provision of rural credit to agricultural productivity, is however not always straightforward. As a result, the existence of such causal relationships is often not entirely clear and there is an active debate dating back to the widely-cited Joan Robinson (1980) who famously stated '*where enterprise leads, finance follows*'.

In the absence of a panel dataset and thus ability to control for any unobserved heterogeneity across individuals, the problem of selection bias is acute. In the specific case of rural credit, the possible existence of unobserved variables influencing both farm productivity and access to credit is very real. For instance, a more skilful and agriculturally-able farmer (whose farm is therefore yielding higher productivities) might also be expected to be more adept at gaining access to credit. In other words, there are strong a priori reasons for why a successful farmer, and indeed one who possesses more productive assets (land, labour, livestock) would have a higher propensity to not only demand credit, but

¹ See, for example, Levine (1997).

² There is also evidence that the poor value illiquidity and the security of savings.

³ As Honohan (2003) notes, underlying all of this need to be 'solid intertemporal contracts' that are supported by the legal and judicial structure.

also to be granted it.⁴ Without controls, such a situation would lead to an *overestimation* of the impact of rural credit on agricultural productivity.

At the same time, many rural credit schemes, including several in Mozambique and Vietnam, actively target those in most need. Program placement, and therefore access to credit, in other words, is non-random, and any analysis might therefore *underestimate* the impact should this go uncontrolled. Similarly, such issues complicate matters when analysing the effect of state-led expansion of the banking sector on welfare (Burgess & Pande, 2004). Specifically, while commercial banks favour opening branches in richer areas, state-led bank branch expansion (such as that in Vietnam) tend to target poorer clientele. As such, the programs are not random and identification of causal impact is therefore problematic.

Finally, it is important to note that financial institutions can offer a multi-dimensional range of services which are often not captured by empirical studies using rather blunt measures of financial sector development such as private banking to GDP (Honohan, 2003). Such aggregate indicators do not capture the degree to which the population in general, or the poor in particular, access financial services. Moreover, in the case of agriculture specifically, credit represents just one subcomponent of total investment in agriculture. Investment comes from a diverse basket of sources, including non-monetised inputs such as labour, saved seeds, and the use of local resources for pest control and fertilizer, and monetised inputs such as household savings and, finally, (formal and informal) borrowings. Any empirical analysis should therefore be careful to take full account of these various issues when forming a judgement of the impact of rural financial services.

Notwithstanding these methodological complexities, a large theoretical and empirical literature has emerged examining the role of the financial sector in growth, poverty and agricultural productivity. Turning firstly to growth, a paper by King and Levine (1993), in which financial development is found to be '*significantly and robustly correlated with faster current and future rates of economic growth...*' (p.717) using a multi-country dataset for the period 1960-89, is widely cited. More recently, an innovative paper by Levine, Loayza and Beck (2000) persuasively deals with the endogeneity problems mentioned above by instrumenting financial sector development with legal system origin. The authors make use of the fact that countries that have inherited variants of English common law tend to have deeper financial systems than those of Napoleonic origins, and because the legal framework has been in place for many years, it is unlikely to exert any meaningful influence on current economic performance. Controlling for this, a significant beneficial impact of financial development on economic growth is found.

Numerous other empirical studies have been conducted⁵ and while the consensus, at least in the eyes of many in the development world, is that financial sector development is a positive and important contributor to economic growth, the evidence is by no means conclusive. Barnebeck & Tarp (2003), for instance, succinctly show how a number of the better known theoretical and empirical findings ('perceived truths') relating to the causal link between financial development and economic growth are

⁴ See Barslund and Tarp (2003) where this is indeed found econometrically for farmers in Vietnam.

⁵ See Honohan, 2003, for a comprehensive review)

highly sensitive to changes in assumptions, sub-samples used, and econometric methodologies, such that *'the picture that emerges from different econometric studies is blurred'* (p.204).⁶

A logical next step has been to examine whether any resulting growth is pro-poor, that is, that financial development reduces inequality. This too is a divisive area. Some maintain that because it is only the relatively well-off (urban) population who enjoy access to financial services, it is only they who truly benefit. Others (Aghion and Bolton, 1997) argue that it is only in later phases of development that the poor gain access, as financial services start to disseminate throughout the economy and become more accessible to all. In this regard, Greenwood and Jovanovic (1990) find an inverted U-shaped relationship between financial and economic development, with the poor gaining access and benefiting from financial services after some time. Others argue that benefits to the poor arise in an indirect way, such that they benefit even if they themselves do not enjoy immediate and direct access to financial services- if the loan capital is invested productively and other input and output markets are competitive.

In theory, access to financial services can allow the (rural) poor to better plan their futures and invest in productivity-enhancing assets, allowing them to smooth their income and better cope with unforeseen adverse events such as drought and death of a family member. In a rural setting, where economic activities are often spread over time, such that the adoption of a new crop or technology requires investment today for a return tomorrow, the role of credit is evident. Indeed, some (e.g. Eswaran & Kotwal, 1990) argue that just the knowledge of the availability of credit can induce a household to adopt new (more risky) technologies which might in turn lead to increased productivity. For the same reason, it is plausible that access to financial services will reduce the proportion of low-risk, low-return assets held by poor households for precautionary purposes (e.g. jewellery), and enable them to invest in (riskier) assets which will enhance income in the future. Equally, rural incomes are subject to seasonality: Households not only have to satisfy an annual income constrain, but must also balance budgets during the lean season when there are high expenditures on inputs and consumption, and low revenues.

Having a secure and liquid place for deposits also represents an important financial service to the rural poor, as aside from earning a positive interest rate, it facilitates the accumulation of savings over time.⁷ Developed and competitive financial intermediaries can also be expected to reduce inequality by facilitating new enterprise entrants' entry into the market and reducing their dependence on personal wealth and political connections (Beck, Kunt & Levine, 2004).

Again, empirical studies in this area are numerous. Li, Squire and Zou (1997), for instance, find financial development to be a strong and significant contributor to lower inequality (as measured by the Gini coefficient), finding increasing income of the lower income strata of the population. Beck et al (2005) also find that financial development has not only a positive effect on the incomes of the poorest quintile of the income distribution, but also accelerates improvements in the poverty ratio. Finally, Honohan (2003) analyses the relationship between financial sector development and poverty, and finds a robust and significant effect, even persisting when GDP per capita is taken into account- suggesting financial development works via a reduction in income inequality.

⁶ For example, following Ram (1999), Barnebeck & Tarp (2003) disaggregate the full sample used by LLB into regions, and find that while in the full sample a positive and significant relationship holds, the financial indicators become insignificant and eventually negative, in the regional sub-samples.

⁷ Indeed, there is some evidence that people value illiquidity.

The impact of rural credit on agricultural productivity has also been examined by some. Carter (1985) identifies three channels through which rural credit might positively impact on agricultural productivity: Firstly, the existence of credit might encourage an efficient allocation of resources by overcoming constraints to purchase inputs and use them optimally; secondly, credit might be used to purchase new (productivity-enhancing) technology, such as high yielding seed varieties and machinery; and thirdly, credit might be employed to increase the use intensity of fixed inputs like land and family labour (higher consumption, improved nutrition).

In this regard, Claessens and Feijen (2006) examine the impact of financial sector development on undernourishment through the channel of agricultural productivity. They find a highly significant causal effect of private credit on agricultural productivity (in particular cereal yield), a result that holds even when controlling for possible endogeneity (private credit instrumented by legal origin). The channels through which this might occur are next determined, and with varying degrees of significance and size, it is found that credit is positively associated with increased use of fertiliser and tractors per agricultural worker. Finally, the direct link from private credit to undernourishment is analysed. The authors find that a 1 percent rise in private credit to GDP reduces hunger by 0.22-2.45 percent.

With the above in mind, we now consider the specific cases of Vietnam and Mozambique.

3. Characteristics of the Rural Economy and Financial Services

3.1. Vietnam

Vietnam's rapid economic growth and development since the Doi Moi reforms of the mid-1980s are well documented. Average annual growth rates of c8% since 2000 are impressive, and the country continues to increase its international status, becoming a full member of the World Trade Organisation (WTO) in 2007, and continuing to show impressive export and import growth rates. The economic reforms and impressive development have brought with them a structural transformation of the economy: From 2001-07, Gross Domestic Product (GDP) grew by 58% (constant prices), while the agriculture, forestry and fisheries sector grew by 26%, industry by 80% and services by 55% (GSO,2008). Together, agriculture, forestry and fisheries now only account for under one fifth of GDP, although the majority of the Vietnamese population still derive their income from this sector.

State budget expenditure in 2008 increased to 474 thousand billion, an increase of 22% compared to the number in 2007. Of this, expenditure on development investment accounts for 55%; direct investment to social policies' beneficiaries accounts for 9% and 11% for other expenses. In addition to state budget spending, National Targeted Programs (NTPs) are run targeting farmers and rural communities. One such program, the Poverty Reduction Program targets the poor, of which 85% live in rural areas. 'Program 135' targets ethnic minorities in Vietnam living in extremely difficult conditions. The 'Rural Safe Water and Sanitation Program' also targets rural dwellers.

Vietnam is a developing country with significant poverty reduction achievements. The proportion of the population living under the poverty line has quickly fallen from 42% in 1993 to 14.2% in 2007. The poor household rate in 2008 is estimated to be 13.5%, equivalent to 2.5 million households.

Table 3.1: Poverty Rate (calculated using average income in the national poverty line, 2006-2010)

	2004	2006	2007	2008 Prel.
Urban	8.6	7.7	7.4	6.7
Rural	21.2	18.0	17.7	16.2
Whole country	18.1	15.5	14.8	13.5

Source: GSO, 2008

The poverty gap between rural and urban areas is thus considerable, with the rate in rural areas twice that of urban centres. While just over 70% of the *total* population of Vietnam live in rural areas, 85% of the *poor* population currently live in rural areas.

Characteristics of the Economically Active Rural Population

Vietnam processes a rather young labour force: 47.1 million in 2007, of which three quarters is in the age range of 15-44 years. Between 2003 and 2006, the labour force increased by an average of 1.2 million people per year, with an annual growth rate of 2.7%, two times higher than the population growth rate and also higher than in the past. Table 3.2 presents some of the key characteristics of the rural labour force in Vietnam.

Table 3. 2: Labour Force in Rural Areas of Vietnam in 2007

	Total	Male	Female
Total Rural Labour force ('000)	35,248	17,700	17,548
<i>By age group (%)</i>			
- 15-24	19.66	20.45	18.87
- 25-34	23.75	24.05	23.45
- 35-44	25.46	25.36	25.57
- 45-54	19.13	18.52	19.75
- 55 and older	11.99	11.62	12.37
<i>By technical skill (%)</i>			
- Unskilled labour	83.63	79.53	87.77
- Technical worker without certificate	5.56	7.75	3.36
- Vocational trained labour	3.81	5.13	2.47
- Professional high school	4.06	4.53	3.59
- College, university and higher education	2.94	3.07	2.82
<i>By employment status (%)</i>			
- Unemployment	1.4	1.6	1.3
- Employed	89.6	89.4	89.7
Agriculture	62.6	59.9	65.5
Industry	17.7	21.7	13.6
Service	19.7	18.4	20.9

Source: The author, calculated from data of Labour-Employment Survey 2007, GSO

Despite structural changes in the economy resulting from high rates of industrialisation and urbanization, three quarters of the total labour force continues to live and work in rural areas. Most rural labourers are not trained, although the unemployment rate is lower than the national rate. Employment in rural areas is concentrated primarily in agriculture, forestry, and aquaculture activities.

The Vietnam Access to Resources Household Survey (VARHS) in 2008⁸ details economic activities in twelve rural provinces of Vietnam (see Table 2.1 of the report). It is found that over 85% of active age population are engaged in some form of income earning activity, with over one third involved in wage work. Approximately 12% of individuals work in their own off-farm enterprise and 70% work on their own farm. At the household level, a considerable degree of diversification is observed, with almost 80% of surveyed households reporting that they derive their income from at least two different activities. Moreover, agricultural wage work, a dominant characteristic of many rural poor in developing countries, is relatively unimportant in Vietnam.

Furthermore, faced with limited fallow cultivable lands and an ever-growing labour force, rural non-farm activities are representing an increasingly important part of the rural economy. Such enterprises are more likely to be established by wealthier rural households, households located close to large urban hubs where market access is easier for their inputs and produce, and are generally very small in size and are not registered with the authorities.

Characteristics of Rural Finance System

Since Doi Moi, financial sector reforms have represented a core part of the Government of Vietnam's (GoV) policy. The former mono-bank system has gone through a series of progressively more far-reaching reforms to the situation today where the sector is comprised of a wide array of state-run, private domestic commercial and foreign-owned banks. The formal financial sector is supervised and regulated by the State Bank of Vietnam (SBV) which has branches in all 63 provinces. There are presently five state-owned commercial banks (SOCBs) which continue to dominate the sector, accounting for over half of assets (loans) and liabilities (deposits). In addition, there are currently 37 joint stock commercial banks (JSCBs) which have grown their balance sheets rapidly in recent years in an aggressive bid to gain market share. Operations of JSCBs are generally concentrated in urban areas, and they specialise in providing credit to smaller sized companies and retail finance. Finally there are foreign-owned banks, currently accounting for 12% of total credit, and 9% of deposits (*2008 estimates*).

From a low base, financial depth in Vietnam is increasing, with credit/GDP reaching 82% in 2007 and M2/GDP 112%. Of this, credit to the private sector rose to almost 70% in early 2007 (IMF, 2007). The Vietnamese financial sector is still less liquid than some of its regional counterparts, with nearly all deposits absorbed by loans: The loan/deposit ratio in Vietnam is now 95%. Loans have grown faster than deposits over the past several years, and more recently steady loan growth in 2007 resulted in a credit balance of 93% of GDP- much higher than the 80% average seen across Southeast Asia.⁹

Accurately assessing the demand for *commercial* financial services, and in particular, those offered in rural areas, is not straightforward. The penetration rate for the country as a whole, as measured by number of bank accounts with commercial financial institutions remains very low at around 10%. Services are heavily concentrated in the urban centres of Hanoi and Ho Chi Minh City (HCMC).

Poverty reduction represents a major part of development strategy in Vietnam, especially in rural areas. Within this, credit is seen by the GoV and other stakeholders as a core tool to promote income-generating activities, helping the poor to control resources, raising the status in economic transaction as well as in social relation to help the poor escape from poverty. This is evidenced most clearly by the fact

⁸ Characteristics of the Vietnamese Rural Economy: Evidence from a Rural Household Survey in 12 Provinces of Vietnam.

⁹ Margarete Biallas, Kien Dam, IFC (2008), Vietnam Financial Sector Diagnostic.

that policy lending is one of the key features of Vietnam's rural financial landscape, with the Vietnam Bank for Social Policy (VBSP) mandated to serve the poor and other beneficiaries with government support.

One can characterise the rural financial system in Vietnam as having three components (ILO, 2008). Firstly, the *formal state-run sector* consists of the Vietnam Bank for Social Policies (VBSP), the Vietnam Bank for Agriculture and Rural Development (VBARD), the People's Credit Funds (PCFs), and the Vietnam Postal Savings Service Company. Secondly is the *semi-formal sector* which consists of a large number of international non-governmental organisations (NGOs) and a far smaller number of GoV-recognised microfinance operators. Finally the *informal sector* consists of money lending by friends and family, informal money lenders, and the *Ho/Hui*, a Vietnamese rotating and savings association (ROSCA).

Outreach to rural clients is high by any standards, primarily due to borrowers being served by the state-managed VBSP and VBARD. Microfinance operators in the semi-formal sector are also significant, operating in over half of Vietnam's 63 provinces and reaching more than 350,000 clients. Even accounting for possible double-counting, rural financial service providers, as a whole, might be reaching over 6 million borrowers, implying more than one borrower per low income household.¹⁰

Table 3. 3: Structure of rural credit by loans and amount borrowed (%)

	Source	By Number of Loans	By Value of Loan
1	Vietnam Social Policies Bank (VBSP)	17.18	9.52
2	Agriculture and rural development Bank (VBARD)	35.92	54.30
3	Other banks	2.21	4.52
4	Employment assistance fund	0.97	0.38
5	Credit organizations	3.47	3.72
6	Socio-politic organization	6.47	2.86
7	Money lender	7.88	4.55
8	Friends/relatives	23.35	19.00
9	Other	2.55	1.14

Source: The author, calculation from VHLSS 2006, GSO

Besides the vast network of VBSP and VBARD, the majority of *commercial* banks in Vietnam remain reluctant to invest in rural areas given the low hanging fruit (easy wins) on offer in the urban centres and the presence of the heavily subsidised credit from VBSP and the branch network of VBARD already in existence in the countryside. According to the SBV, commercial credit for agriculture remains limited and cannot meet the requirements for agriculture restructuring. The general perception from the commercial private sector seems to be that people in rural areas (particularly in remote areas) still apply backward traditional production methods without any connection to processing industries and/or the consumption market for agriculture produce, resulting in a low effect of credit. Furthermore, it is posited that loan values are too small to have any meaningful impact.

Rural borrowers are thus in large part served by the state supported banks, and as will become clear below, this is an area that is taken very seriously by the GoV. In recent years, a number of policies on preferential credit for farmers have been issued, with the aim of simplifying credit procedures, prolonging loan periods, and increasing loan amounts for credit from the commercial sector. But despite

¹⁰ Banking for the Poor Network (2008).

this, farmers, not only the poor but also farms, co-operatives, or small enterprises in rural areas do still encounter difficulties in accessing credit due to complicated procedures and conditions. One primary reason is that banks in Vietnam tend to reserve their capital, focusing on safety rather than profit or service scale, leading to a clear preference to serve big customers in urban areas.

Finally, it is important to note that the wide network of *mass organizations* play an key role in rural credit provision. Indeed, they represent a key defining feature of the rural finance landscape in Vietnam, helping lenders overcome many of the problems associated with information asymmetries and high transactions costs. These organizations help the government to provide credit according to programs such as National Program on Poverty Reduction, Reforestation Program, Employment Program, etc. In short, mass organizations act as the middleman between, for example, the VBSP and the borrower, helping local People's Committees to establish groups to guarantee loans at the commune level and receiving commission from the Bank. In short, they often act as the client screen. Active organizations are the Vietnam Women's Union, Farmer Union, Youth Union, Veteran Union and Gardener Union.

3.2. Mozambique

Around 70% of Mozambicans live in rural areas, where the majority ekes a living from subsistence farming. Recurrent drought in the country's interior, however, has led people to migrate to urban and coastal areas with adverse environmental consequences, such as desertification and pollution of surface water. While Mozambique's income per capita is US\$ 340, well below the sub-Saharan average of US\$ 754, the country has emerged as one of Africa's most successful examples of post conflict reconstruction and economic recovery. By 2003 the number of Mozambicans living in absolute poverty had been reduced to 54% from 69% in 1997. Yet the vast majority of the rural population still lives on less than US\$1 a day, and lacks basic services such as clean water supplies, and access to health facilities and schools. Poverty remains predominantly a rural phenomenon. More than 80% of poor households live in rural areas. Farming is their main source of food and income, but agricultural productivity is very low. Farmers and fishermen generally make enough to meet their households' basic food requirements, with perhaps a little surplus for sale. Incomes from both farming and fishing are meager and most of the rural population survives at subsistence level. Rural communities are extremely vulnerable to natural disasters, which recur particularly in the southern and central areas of the country.

The central and northern provinces have higher agricultural potential than other parts of the country, more fertile soils and more abundant rainfall, and generally produce agricultural surpluses. Moving into the southern parts of the country the climate is drier, the soils are poor and natural disasters such as flooding and drought are periodic occurrences. These, together with the coastal communities which suffer extreme isolation, are the poorest areas in the country.

Poverty is caused by isolation, inadequate infrastructure and the consequent lack of access to goods and services, including financial services¹¹. In rural Mozambique the road network is in very poor condition and basic services are inadequate. Two-thirds of rural people have to walk more than an hour to reach the closest health unit. Only 60% of them have access to safe water. Poverty in rural areas is also closely related to lack of access to education. While 82% of urban dwellers have access to primary school

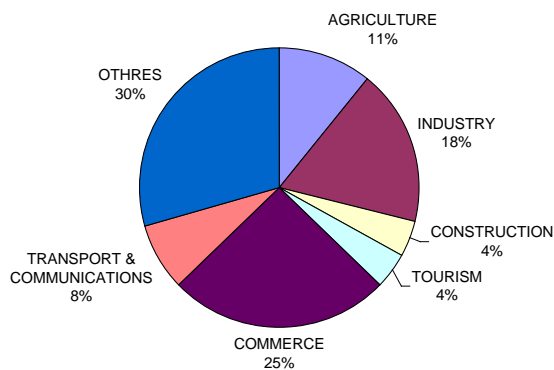
¹¹ The term rural financial services refers to financial transactions related to both agriculture and non-agricultural activities that take place among households and institutions in rural areas

education, the figure drops to 57% for the rural population. More than two-thirds of rural Mozambicans are illiterate.

Low agricultural productivity is the result of a lack of appropriate technologies and support services (research, extension, rural or agricultural credit, input providers, etc). It can also be attributed to the fact that produce markets are distant, unreliable and uncompetitive. Smallholders depend on traditional farming methods, low-yield seed varieties and manual cultivation techniques. Alternative sources of income outside agriculture are very few, and this increases the vulnerability of rural poor people to natural disasters. In times of scarcity they have little to buffer them from food insecurity.

In 2008, agriculture contributed with 26% of total GDP (INE) but received only 11% of the total credit (BdM) as indicated in Figure 3.1.

Figure 3.1: Credit to Agriculture relative to other sectors of the Economy



Small Scale Agricultural Producers and Nonfarm Enterprises

The rural economy is dominated by smallholder agriculture and small-scale fisheries, characterised by low yields and returns that see most families operating close to subsistence level. Many rural areas are strikingly poor and still not fully part of the monetized economy. The country is vast with difficult communications and a poor road network. Rural input and output markets are poorly developed and most rural communities have only limited knowledge of marketing or how markets operate. Similarly, many rural traders have little understanding of how to operate effectively in a free-market environment.

While the above is the dominant picture of the situation in rural communities in Mozambique today, the opportunities for major improvements in the quality of rural life are equally obvious. The country has one of the best natural agricultural production capabilities in Africa and good potential to increase agricultural production both quantitatively and qualitatively. Significant untapped agricultural production potential exists in most rural areas. Less than one fifth of the farmable land is currently being productively used. Of the utilized land, the yield could be significantly increased by improved techniques and utilization of improved inputs. There is also much room for adding value to commodities produced in Mozambique for local consumption as well as exports. Besides the cotton ginneries, tea and cashew factories, and sugar and maize mills, there are a few agro-processing plants in the country.

Accelerated smallholder development can be observed particularly along the three main transport corridors: the Maputo corridor with South Africa, the Beira corridor with Zimbabwe and the Nacala corridor with Malawi. At the same time, the operations of large commercial outgrower/agroprocessing companies, particularly cotton and tobacco concessions, have grown in scale. These are run by local enterprises often affiliated with international companies. Today, some 400,000 families work on these schemes, representing about 12% of the rural population. In recent years it has become apparent that as smallholders, livestock herders and fishermen in Mozambique move from subsistence to higher levels of production and as the rural economy generally develops, there is an increasing demand for a broad range of financial services. To respond to these growing demands for services by the rural population and enterprises, the financial sector is as yet poorly equipped.

Most of the rural population in Mozambique operates totally outside the reach of any financial sector operator. Nearly all of the rural districts have no formal banking facilities at all, and the lack of rural finance in Mozambique is thus pervasive, even by African standards. This is can be attributed to several factors, including a predominance of low-input, low-output subsistence farming, high poverty levels and low population densities, a high frequency of droughts and floods, and high and volatile interest rates. As a result, there is low demand and low supply of rural financial services, and the little supply that does exist is channelled to large scale farmers/traders.

The problem of poorly functioning credit markets is particularly acute because many enterprises are new entrants, and therefore do not have established or long track records. Moreover, the sorts of institutions that are designed to reduce information costs and opportunistic behaviour are not well-developed in Mozambique. Contract enforcement, accounting standards are also weak, and state ownership and uncertain titles to land use reduce the assets that farmers can use as collateral.

Table 3.4 indicates the distribution of financial service providers which include commercial and development banks, non-bank financial institutions, cooperatives, microfinance institutions (MFIs) and semi-formal or non-formal organizations- such as savings and credit cooperatives, self-help groups, rotating savings and credit associations (ROSCAS) and accumulating savings and credit associations (ASCAS).

Table 3.4: Geographical Distribution of financial service providers in Mozambique, 2008

Province	Commercial Branches	Cooperatives	Microfinance
Maputo City	103	6	35
Maputo Province	18	3	10
Gaza	14	1	1
Inhambane	13	0	0
Sofala	22	0	0
Manica	12	0	1
Tete	8	1	0
Zambezia	10	0	0
Nampula	17	0	1
Cabo Delgado	7	0	10
Niassa	4	0	0
Total	228	11	58

Source: Bank of Mozambique/DEP (2008)

The microfinance sector is thus small and has an urban orientation, while both the community-based financial arrangements and development credit institutions have a very limited outreach in rural areas. This institutional situation makes it very difficult for the financial sector to respond to the increasing demands for rural financial services in the country and today. Practically all seasonal agricultural credit to smallholders is provided by marketing and processing companies under interlocking arrangements. Credit under contract farming arrangements is one of the major (indeed, often, the only) forms of access to production finance among smallholders in Mozambique.

In Mozambique, access to production finance among smallholders is very limited and the pace of formal rural finance system development will continue to be slow in the short term, particularly with regard to agriculture production finance. A lack of means of delivering effective and efficient credit to smallholders is also a severe constraint. While recognizing that rural households require a wide range of rural financial services including savings, credit, remittances and insurance, it is necessary to ensure that supporting policies are in place, markets are functioning and support for business development are available so that rural finance can have a powerful impact on poverty reduction and rural development.

As a result of the lack of formal credit provision, informal sources of finance such as ROSCAs (known as Xitique in Mozambique) is often used. Traders, processors, input suppliers and exporters also represent a major source of financial services to rural agriculture dependent households in Mozambique. These buyers and suppliers provide credit to farmers as part of input supply and product purchase transactions

4. Role of the State

4.1. Vietnam

Government Policies and Strategies on Rural Financial Services

Although the agricultural share in the economy is declining, the sector's growth has been stable. In addition, as shown above, employment demand is large in rural areas. Capital demand for production expansion has also been growing. Given the fact that most of Vietnam's poor reside in rural areas, the shortage of rural capital is clear. Microfinance¹² has therefore become increasingly important in Vietnam, contributing to successes in poverty reduction objectives of the country's Comprehensive Poverty Reduction and Growth Strategy (CPRGS).

The GoV has been aware of capital shortages and the potential beneficial role of financial services in the rural economy for a number of years, and has accordingly issued a number of policies to boost microfinance services especially in rural areas. According to the SBV, credit outstanding for agriculture and rural lending grew by more than seven times from VND 34,000 billion (US\$ 1.9bn) in 1998 to VND 250,000 billion (US\$ 14.0bn) in 2008 (Ham Yen, 2009).

¹² Defined as small lending with or without collateral to low-income individuals and households using for income-creation activities and improvement of their living standards. The lending amount is called "microfinance" to a customer if total lending to that customer does not exceed VND 30 millions (Circular 02/2008/TT-NHNN dated April 2, 2008 of the SBV)

As mentioned, a key defining feature of the Vietnamese rural lending landscape is structured policy lending. Over the past couple of decades, as Vietnam has shifted toward a market economy, policy lending has been explicitly separated from commercial lending, and specialised institutions have been given responsibility for managing such operations. The VBSP which provides targeted lending to the poor and other disadvantaged groups primarily located in rural areas and who may otherwise not have access to credit, is the key institution in this regard. VBSP, and to a lesser extent VBARD, require only land use right certificates as collateral. This is a critical characteristic that is simply not present in Mozambique.

Importantly, there is a long held perception in Vietnam that microfinance is a humanitarian tool for poverty reduction, rather than an economic tool for expanding access of sustainable financial services to the poor. Indeed, the GoV has set a target to provide 90% of poor households with credit, regardless of whether there is demand for it. This is not necessarily in-line with international thinking (see Consultative Group for the Poor, CGAP) that the role of the government should be that of an enabler and facilitator of financial services, rather than a direct provider. Early theoretical literature on rural credit markets in developing countries is based on the assumption that all households have a positive demand for credit (Eswaran and Kotwal, 1989). That is, all households who do not have credit are considered credit rationed. In-line with this, credit in Vietnam is often offered on a supply-driven basis with only superficial analysis of actual demand.

The GoV promulgated Decree No. 78/2002/ND-CP dated October 4th 2002 on credit for the poor and other policy clients to identify the beneficiaries of preferential credit policies and set the framework for establishing the VBSP. The VBSP itself was established by Decision No. 131/2002/QD-TTg on the same day. The bank is tasked with implementing credit policy for the poor and other policy clients broadly following the structure of the Bank for the Poor which was established in 1995. The GoV view, reflected in the above decree, is that it will use state-mobilised financial sources to provide loans for the poor and other policy beneficiaries to support production, business, job creation and welfare and by doing so contributing to the proper implementation of the national targeted program on hunger elimination and poverty reduction, and social stability. The VBSP is entitled to act as a non-profit bank which does not have to participate in deposit insurance and is exempted from taxes as well as other state budget duties.

The GoV also promoted the operation of VBSP by enacting Decision No. 180/2002/QD-TTg and Directive No. 09/2004/CT-TTg on promulgating the regulation on financial management applicable to the VBSP as well as raising the operational capability and efficiency. Decision 69/2005/QD-TTg dated April 4th 2005 on the debt risk treatment mechanism of the VBSP allows two main treatment measures for risked debts, namely exempting or reducing lending interest and writing-off debts. These three policy documents reflect government concerns about the improvement of VBSP performance to meet the designed objectives of the bank.

The operations of VBSP raise many pertinent issues about rural finance to poor households. As with many microfinance institutions around the world, lending largely relies on Savings and Credit Groups whose members are jointly accountable for loan repayment. But unlike the standard microfinance model, VBSP works closely with mass organisations and local authorities to screen aspiring borrowers. This close working relationship between the three partners represents an essential element in the successful operations of VBSP. Important questions surrounding the solvency and thus sustainability, replicability in other contexts, and efficiency of targeting and hence impact on welfare will be examined in more depth below.

In order to create a more complete legal framework for rural credit activities, the GoV enacted Resolution 28/2005/ND-CP ('Resolution 28' as it is known) dated March 9th 2005 on the organisation and operation of microfinance institutions. The Resolution has promoted the formalisation and development of microfinance service providers which meet the increasing financial services needs of the rural population in general and the poor in particular. This framework is widely considered as a good policy strategy in forming a level playing field in microfinance service provision in Vietnam- for instance, the resolution recognises microfinance as a 'business with a social mission' that has to be run in a financially sustainable way.

However, there also valid criticisms. Although the resolution stipulates strict requirements on the establishment and operation of microfinance institutions (MFIs), it does not provide measures that might correct for the distortionary effects of subsidised lending by VBSP. Due to these distortions, it is possible that the commercial-based activities of VBARD and other commercial banks could be somehow affected. Furthermore, the implementation of Resolution 28 presents many challenges for provincial authorities, such as the responsibility to approve applications for the license of MFIs.

During the implementation of Resolution 28, a number of issues appeared that were subsequently adjusted. Resolution 165/2007/ND-CP dated November 15th 2007 of the government on the amendment, supplementation and abolishment of selected articles of Resolution 28 was promulgated to meet this demand. Therefore, the current legal framework for the operation of MFIs is characterised by these two policy documents. To guide implementation of Resolution 165, the SBV issued Circular 02/2008/TT-NHNN dated April 2nd 2008 for the implementation of Resolution 28 and 165.

The legal structure of microfinance institutions which are licensed under Resolutions 28, 165 and related Circulars is summarised in Table 4.1:

Table 4. 1: Legal Structure of MFIs licensed under Resolutions 28, 165 and their related Circulars.

<i>One-Owner Company</i>	<i>Multiple-Owner Limited Company</i>
MFIs must be wholly owned by a Vietnamese socio-political organisation	<ul style="list-style-type: none"> • Between two and five owners (except if authorized by the Governor of the SBV). • Eligible owners: (i) socio-political organizations, (ii) social organizations, (iii) charities & Social Funds, (iv) vocational organizations (v) Vietnamese NGOs (Decree 88, 30/7/2003), local individuals, foreign individuals & organizations . • Owners (i)-(v) must own at least 25%, and must be the largest owners. • Foreign owners can have a maximum 50% share

Source: Adapted from Banking with the poor Network & SEEP Network (2008).

The GoV pays special attention to help ethnic minorities in disadvantaged regions in the country. The majority of ethnic minority households are poor and they demand just small loans for expanding their production. Being aware of this need, the government issued Decision 32/2007/QD-TTg dated March 5th 2007 on providing highly concessional loans to develop production for especially disadvantaged ethnic minority households. The target clients are ethnic minority households (i) Living in communes belonging to the disadvantaged regions, (ii) Having income per capita of lower than VND 60,000 per month, (iii) Having total asset value of VND 3 million or lower, and (iv) Having productive plan but lacking of or no capital for production. The lending interest rate is 0%, and households are not obliged to repay loans in

case of natural calamity, fire, epidemics or other unavoidable difficulties. The VBSP is in charge of implementing the credit operations of this policy.

Apart from credit activities, VBSP also provides services to meet the demand of savings from rural inhabitants. The bank issued Guidance 244/NHCS-KH dated February 18th 2009 on savings mobilisation from members of credit and savings groups. The main purpose of savings mobilisation is to set a system of savings mobilisation from the poor to help them gradually become aware of savings practices. In this way, it is hoped the poor can be helped to create their own capital source and be familiarised with credit and financial activities. On the other hand, the policy can help the bank to absorb more capital for expanding its lending activities. Most recently, the Prime Minister promulgated Decision 579/QD-TTg dated May 6th 2009 and Decision 622/QD-TTg dated May 17th 2009 on the interest subsidies for lending at the VBSP. According to these Decisions, the interest subsidies are applied for all lending amounts at VBSP with maximum subsidised maturity period of 24 months and for lending amounts disbursed from May 1st to December 31st 2009. The financial source for implementing this policy is extracted from “stimulus package” of VND 17,000 billion of the government.

The GoV is thus clearly a highly proactive advocate and supporter of rural financial services in Vietnam. Despite limited resources, these efforts have contributed significantly to meeting an increasing credit demand, though to what extent demand outstrips supply, or vice versa, is less clear.

Formal State-Supported Credit Institutions providing Rural Financial Services in Vietnam

As outlined in Section 3.1, the rural financial system in Vietnam can be classified into the three sectors of formal, semi-formal, and informal. Here we will focus on the mandate and operation of the formal credit institutions which provide rural financial services in Vietnam with varying degrees of state involvement and support.

There is a consensus among industry analysts and microfinance practitioners that the market for microfinance services in Vietnam amounts to approximately 24 million poor and low income individuals, or 5.4 million households (Banking with the Poor Network, 2008). The outreach of formal financial service providers to rural clients is extremely high by any standards, primarily due to borrowers being served by the two giants VBSP and VBARD (Table 3.1), who are estimated to have in excess of 5 million and 6 million borrowers respectively. Three main financial institutions in Vietnam receive some form of government support and financial backing: VBARD, VBSP, and the People’s Credit Funds (PCFs). The following will examine each institution in-depth.

VBARD

VBARD is the largest of the five state-owned commercial banks in Vietnam, and was officially licensed by Decision 280/QD-NH5 dated October 15th 1996 with a large legal capital of VND 10,400 billion. It was formed out of the Vietnam Bank for Agriculture which was established in 1988. The presence of VBARD is extremely important outside of the cities, as it meets the commercial financial demand of all types of businesses, as well as households, in rural areas. At present, the bank has 115 branches over the country and in value terms is the largest supplier of credit to rural areas, accounting for 54.3% of total loan value (Table 3.1).

Following the establishment of VBSP, VBARD transferred its poverty and targeted policy lending operations to the VBSP. However, the bank has remained the largest partner of international donors in implementing credit lines for development projects. Although there is no longer formal support from the state to VBARD, the bank still enjoys advantages of managing and implementing the entrusted

service programs of the government, financial and credit institutions and socio-economic organizations. Significant recent projects in this regard implemented by the bank include Rural Finance Projects I and II financed by the World Bank, In addition, the Agricultural Development Project financed by ADB and a loan project from European Investment Bank.¹³

Freed from political lending, VBARD now concentrates solely on commercial lending. Perhaps as a result of its now more commercial orientation, VBARD has been gradually expanding its activities to supplying credit to small and medium enterprises (SMEs) in urban areas, in addition to providing credits to rural farmers and entrepreneurs. It now provides rural (and increasingly urban) financial services to a broad range of debtors and creditors, though its roots remain outside of the city, and lending is conducted at rates slightly lower than those of commercial banks. At present, about 45% of total deposits of the bank are mobilized in urban areas while around 55% of the total credit portfolio is disbursed in rural areas. According to the Bank, its customer base consists of 10 million farmers of which 47%, or 4.7 million, are poor (Banking with the poor Network & SEEP Network, 2008).

VBARD employs three ways of delivering credit services for three different groups of clients.

1. Firstly, it provides loans for individual farmers and entrepreneurs conditional to required collateral which is usually in the form of Land Use Right Certificates (LURCs, also known as 'Red Books'). With such commercial loans, the bank in principle can manage the risk, however the risks of agricultural production could be transferred to the bank: it is not always easy to liquidate the collateral by selling the LURCs.
2. Secondly, the Bank lends to individuals through group loans, where the group is jointly responsible for all obligations associated with the loan. In doing so, VBARD circumvents the problems of information asymmetry (group screening), high transactions costs (clusters of client located in the same area) and also manages to increase its client base.
3. Finally, through framework agreements, VBARD provides loans via mass organisations such as the Vietnam Women's Union and Farmer's Unions. More specifically, the bank grants loans through 'guarantee groups' which consist of the mass member organisations. Under such arrangements, collateral is not required and the group members are jointly liable for repayments. This method is particularly applicable for farmers lacking collateral.

VBSP

The VBSP was officially established in 2002 out of the structure of the former Bank for the Poor. Its primary mandate is to provide credit at concessional terms to the poor and other policy clients. Therefore, the bank does not work under a profit-maximising principle. Indeed, as it currently stands, the bank cannot be considered solvent as interest rates are well below cost-covering levels. As of 2008, outstanding loans from VBSP totalled approximately 30 trillion VND (US\$ 1.7bn). One third of this was funded by public deposits, one quarter from (mandatory) deposits from the SOCBs, one fifth from state budget grants, and the remainder from borrowings from the SBV and State Treasury.

The VBSP has a large network of branches and outlets, close to 10,000 in all. The number of active borrowers increased fast going from 3.7 million at the end of 2004 to 4.7 million at the end of 2006, and as of September 2008, 6.3 million. In terms of gross loans outstanding, the bank reached US\$ 1.2 billion at the same time implying an average loan value of US\$ 245. Despite such healthy growth, both the return on assets (ROA) and return on equity (ROE) were significantly negative with -4.0% and -13.7% at the end of 2006. It can be said that the bank cannot be financially sustainable without the continuing

¹³ Information from VBARD Website: www.vbard.com

subsidies from the government. Most recently, the government decided to use part of stimulus package of VND 17,000 billion relating to the so-called international financial crisis for subsidising preferential interests for all clients at VBSP (Decision 622/QD-TTg dated May 17th 2009).

The target clientele of VBSP is quite broad as can be seen in Table 4.2:

Table 4.2: VBSP Credit Portfolio Breakdown

Program	Outstanding Loans (VND bn)	Number of Beneficiaries	Average Loan Size (VND '000)
Poor Households	26,776	3,917,793	6,834
Safe Water Supply and Rural Sanitation	3,181	757,698	4,198
Disadvantaged Students	6,061	731,224	8,289
Especially Disadvantaged Communities	5,839	353,572	16,514
Job Creation	3,278	305,422	10,733
Housing	541	65,642	8,242
Temporary Migrants Abroad	730	44,846	16,278
Ethnic Minority Households	162	34,095	4,751
Forestry Development by Households	108	6,646	16,250
SMEs	134	440	304,545
Other	245	53,250	4,601
TOTAL	47,055	6,270,628	7,504

Source: VBSP, data as of September 2008

The portfolio therefore includes households that are classified as poor and/or disadvantaged in other ways and a long tail of other target groups. Poor or disadvantaged households can borrow for productive investment purposes or housing and schooling. In addition, financial services are provided through National Targeted Programs (NTPs) which aim to serve the development goals of the government. One notable example of this is the National Employment Fund whose purpose is to grant preferential credit to small projects in order to create more employment in the country. Based on a proposal of MOLISA, Decision 71/2005/QD-TTg dated April 5th 2005 was promulgated regarding the mechanism for managing and regulating lending capital for the Fund. Two groups of borrowers are eligible to borrow from the Fund: (a) household businesses, cooperatives, small and medium enterprises (SMEs), farming business owners and labour- social education centres; and (b) households.

The services of VBSP have been expanded to reach ethnic minorities in remote areas such as the Central Highlands, since 2006. However, the share of loans explicitly targeting minorities remains small, accounting for under 2% of total loans outstanding of VBSP as of mid-2006. This policy was boosted by Decision 32/2007/QD-TTg dated March 5th 2007 providing loans to develop production for especially disadvantaged ethnic minority households. To provide loans to clients in such disadvantaged regions always results in higher transaction costs, and in this Decision, the GoV encourages the bank itself to serve in these regions through an incentive in the form of a management cost subsidy equal to 0.3% of its annual average outstanding loans. Time will tell regarding the efficiency of this policy.

The current conditions for borrowing are simple: Eligible borrowers need to be (i) households with a permanent residence in localities where they borrow capital, (ii) households classified as poor in their commune/ward/town and (iii) members of and proposed by credit and savings groups. Lending technologies used can be split into two. For business households and production units, disbursement is made directly to the borrower with VBSP controlling all lending procedures, as well as supervising the

borrower and collecting the repayment. For poor households and other disadvantaged groups, Savings and Credit Groups and mass organisations play a key role.

For this latter group, importantly, there are no collateral requirements in transactions with VBSP, and borrowers are exempted from administration fees. The lack of collateral requirements is clearly a significant benefit to those seeking credit, and something that is certainly responsible in large part for the high outreach of this bank. In addition, heads of households are representatives for the families and take all responsibility in all transactions with the bank. The borrowing procedure at the VBSP for poor households can be seen as follows¹⁴:

- i) Aspiring borrowing household must voluntarily join a Savings and Credit Group;
- ii) Submit a request for borrowing to the leader of the Savings and Credit Group;
- iii) The Savings and Credit Group hold group meetings to select the poor households eligible for borrowing, and prepare a list of selected borrowers to submit to the Poverty Reduction Board and Commune People's Committee for verification. The Board and the Committee then pass the list of poor borrowers to VBSP for consideration;
- iv) The Commune People's Committee announces the bank's results to mass organisations.
- v) The mass organisations announce the approved results to the Savings and Credit Group. Subsequently, the Groups announce to the households about whether they are approved to borrow or not, the schedule and location of disbursement.

PCFs

The People Credit Funds (PCFs) are the third type of financial institution with state involvement providing financial services primarily in rural areas. The collapse of rural credit cooperatives in 1990s gave rise to the demand for a reorganisation of the system. Demand in rural areas of financial services is highly diversified. For those who are not eligible for receiving credit from VBSP and do not possess sufficient collateral to meet the requirements of VBARD or other commercial banks (if any), PCFs are often the answer. The peri-poor for example, could be potential clients of the PCFs as they may face difficulties in accessing credit from both VBSP and VBARD (if they do not have sufficient collateral). The relationship between PCFs and their clients is not the same as a bank and its customers. This is because the clients are also members of the Fund and the main purpose of the PCFs is to make mutual supports among members. Of course, these credit institutions are also self-financing and self responsible for their operation results.

The PCF system was established in 1993 to meet this demand, and this is the main reason why the system of PCFs has been in existence until now. Although having operated mainly in rural areas, the system of PCFs seems to have been established in regions that are economically better off and that have better infrastructure (Putzeys R, 2002). The contribution to poverty reduction is therefore questioned by many. As of December 2007, there were 982 PCFs operating in 56 provinces and cities in Vietnam at central, regional and commune levels.

The GoV has enacted Resolution 48/2001/ND-CP dated August 13th 2001 on the organisation and activities of PCFs, and the Resolution 69/2005/ND-CP dated May 26th 2005 on amendment of the above Resolution. The organisational and operational principles of PCFs was adjusted and supplemented in the new Resolution to include four main principles namely, (i) voluntariness, (ii) democracy, equality and

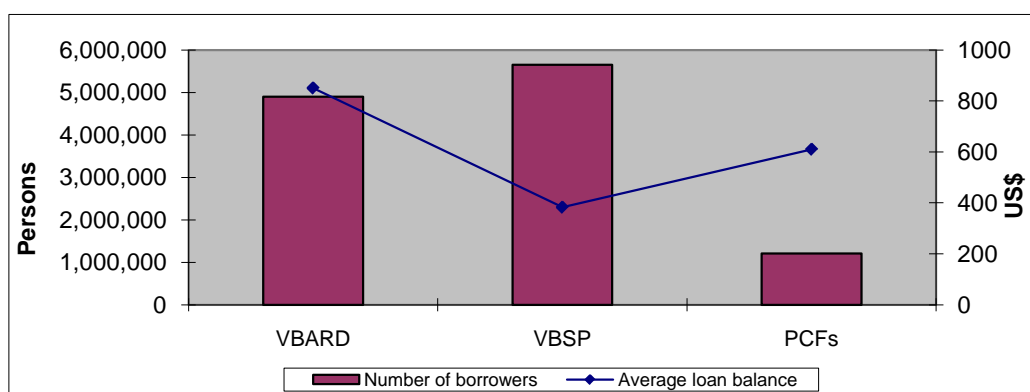
¹⁴ Information from the Website of VBSP: <http://www.vbsp.vn/en/>

transparency, (iii) self-management, self-accountability and joint-beneficiaries, and (iv) Cooperation and community development. Rights and responsibilities of PCFs are stipulated in the Resolution.

PCFs are eligible to mobilise deposits from individuals, organisations and other credit institutions. The lower-layer PCFs can borrow capital from its central fund as well. The PCF network often approaches close clients, and has a relatively fast approval processes. However, its market share on both sides of the balance sheet is relatively small, accounting for only about 1-2% of total market (Dufhues, 2007).

The following figure shows the current situation and market share split between the three institutions discussed above:

Figure 4.1: Formal Rural Credit Institutions 2006-07



Source: Depicted from data from Banking with the poor Network & SEEP Network (2008).

VPSSC

Another formal non-bank institution providing financial services to rural areas is the Vietnam Postal Savings Service Company (VPSSC). The company was founded in 1999 and operates under the administration of Vietnam Post and Telecommunication Corporation (VNPT). The company, however, does not have the function of proving credit to clients. The main focus is to provide a savings product for the underserved segments of the population (rural, women, and poor). In addition, the VPSSC works to mobilise savings for government development investments (Le Lan & Nhu An Tran, 2005). The major rationale for establishing the company is that it can take the advantage of post office network to mobilise savings- an idea known often as piggybacking. The company has its head office in Hanoi and a branch office in HCMC providing different types of post savings services. The company's clients are located all around the country including both urban and rural areas.

In addition to the savings product, the company also supplies the service of money transfer between accounts within the VPSSC. Therefore, it is certain that the services of the company are helpful for rural residents.

A comparison of three main formal rural credit institutions in Vietnam is presented in the table below:

Table 4.3: Comparison of Three Main Formal Rural Credit Institutions in Vietnam

	VBARD	VBSP	PCFs
Target Clientele	Rural farmers and entrepreneurs, liability groups, “guarantee groups”.	Poor households and other “policy” beneficiaries.	Farmers and small entrepreneurial households. Deposits from both members and non-members, but loans provided only to members.
Goals	Commercial-based (commercial bank). Focus on rural areas and agricultural activities.	Non-profit seeking. Subsidised by the State.	Commercial-based (shareholding bank).
Collateral requirement (CR)	For farmers and rural entrepreneurs: Land Use Right Certificates are commonly used. No CR for liability and guarantee groups.	Not required.	Not required for small loans, but is required for large loans.
Outreach	Large rural portfolio, though lending to urban areas also; not directly to the poor.	Rural and disadvantaged regions; directly to the poor.	Economically well-developed areas; not directly to the poor.
Lending Interest rate	In between VBSP and PCFs.	Lowest- virtually zero.	Highest of the three.

Source: Author’s summary.

Summary

In many ways, the formal rural credit institutions in Vietnam complement each other in providing financial services to the rural population in general and the rural poor in particular. This is because their targeted clients are, in general, quite distinct.

The commitment of GoV to credit as means to alleviate rural poverty is clear. This in itself is certainly laudable; however, the means of achieving this, through the heavy subsidisation of interest rates is not obviously the best solution. Questions such as can a heavily subsidised rural bank really be considered financially viable, and is it a sustainable option in Vietnam in the longer term, and in other countries, such as Mozambique, are important.

Accurately assessing the impact of VBSP’s operations is not straightforward- for many of the reasons outlined in Section 2. A quick glance at Table 4.1 shows that in terms of outreach, VBSP appears to have been highly successful. Its 6.3 million active loans are equivalent to more than one quarter of the total number of households in Vietnam. The average loan size is modest and interest rates charged on these loans are very low. The efficiency of its targeting (of the most needy) also appears to be reasonable. The highest participation rates with VBSP are found among the poorest segments of society, and borrowing amounts relative to household expenditures show a clear progressivity. A typical loan of a household

living below the food poverty line accounts for 58% of its annual expenditures. For non poor households, this number is 23% (Cuong Viet Nguyen, 2008).

However, one can look at this a different way. Most obviously, one can point to the fact that almost half of all borrowers from the VBSP are non-poor and they account for almost half of the total credit portfolio. Given that VBSP is heavily subsidised by public funds, there is thus considerable leakage, and this would certainly imply the need to strengthen the targeting procedures. Another implication of this is that the VBSP now competes, to some extent, with other money lenders- formal and informal. The most obvious competitor in this regard is VBARD. Household survey data show that among the poor VBSP does directly compete with other credit providers, and this is criticised by many who point to the government subsidies allowing VBSP to undercut their competitors. Indeed, given that VBSP will become, if it is not already, the dominant rural credit provider and is able to offer such attractive borrowing terms, there is a disincentive to commercial banks and microfinance operators to move into rural areas. This will potentially reduce the overall efficiency of the rural financial service sector, and the crowding out such alternative credit sources will have also implications for sustainability.

Another concern relates to the use of Savings and Credit Groups as the managers of the client screening process. It is reported that the groups are at times reluctant to include the poorest households into borrowing lists, due to concerns regarding their repayment capacity. A classic case of selection bias is thus present. And even beyond this, it is possible, as outlined in section 2, that the poorest farmers' propensity to seek credit and ability to identify investment opportunities is far lower.

The key question therefore becomes whether the government subsidies are justified. It is important to realise here though that the GoV mentality is to use VBSP as a poverty alleviation tool, rather than a *sustainable* means to help poor farmers. If subsidies are to continue, then the GoV and VBSP management would do well to try to improve targeting. Alternatively, subsidies could go to other institutions as well to incentivise their entry into rural areas by offsetting some of the high transactions costs they face. Learning from the Mozambican experience could help in this endeavour (Section 4.2).

4.2. Mozambique

On paper, there is little doubt of the importance that the Government of Mozambique (GoM) attaches to the role of financial services in rural areas. The paucity of financial services and capital and their potential role in stimulating the rural economy in Mozambique represent a key theme of the National Rural Development Strategy.¹⁵ The National Poverty Reduction Strategy Paper¹⁶ also emphasises the value of rural finance and microfinance in rural economic development.

Furthermore, the Central Bank of Mozambique (BdM¹⁷) published in 2007 a special study to be presented to the National Assembly specifically addressing the issue of rural banking and the extension of financial services to underserved rural areas, and including certain concrete proposals that are now in place. In addition, starting toward the end of 2006, the central bank began the process of opening regional offices, located on the whole in the provincial capitals around Mozambique. Their role is to

¹⁵ *Estratégia de Desenvolvimento Rural (EDR), DNPDR, approved 11th September 2007.*

¹⁶ Known as PARPA II.

¹⁷ Banco de Moçambique

supervise the functioning of the banking system, facilitate microfinance and rural banking registration, and provide services to financial institutions such as receiving deposits from them.

Behind the words, however, the picture becomes significantly more opaque such that the commitment of the GoM to rural finance is questioned by many independent commentators. At the heart of this critique is the simple fact that Mozambique does not have a state (agricultural/rural) development bank. Instead, there are a number of often uncoordinated initiatives and schemes, with different government line-ministry hosts, and most with varying degrees of involvement and financial backing from international donors. The rural finance environment in Mozambique is thus characterised as highly donor motivated and inspired, highly fragmented, and lacking a coherent overall coordinating body. It is unclear how interested GoM really is, and how much it is simply passively accepting donor initiatives.

While highly fragmented and uncoordinated, implicit in all of the initiatives with GoM involvement is the objective of encouraging (incentivising) incumbent financial institutions (including commercial banks and microfinance operators), as well as new entrants, to expand their outreach and enter into rural areas- this movement has become known as the '*bancalização rural*'. The Rural Development Strategy paper (EDR), for instance, identifies the weak incentive of the private banking sector to invest into rural areas in Mozambique as a critical constraint to development.

Central among the initiatives is a package of economic and fiscal measures designed and controlled by the BdM to incentivise/encourage investment in rural areas.¹⁸ Specifically, a 'special regime' is in place for financial institutions who wish to invest in areas in which there is no bank presence within a 30km radius. They include, (i) allowing the cash balance in bank branches located in underserved rural areas to count toward reserve requirements, (ii) a relaxed depreciation schedule for investments of tangible assets in rural branches, (iii) an accelerated amortisation schedule, (iv) an exemption from payment of import duties on goods to be used in rural bank branches, such as ATMs and computers, and (v) minimum capital requirements can be reduced by up to 70 percent if the bank headquarters are located in underserved areas.

Recently, the commercial banking sector has seen some movement, with three of the large players, BIM, Standard Bank, and BCI-Fomento all making some plans to expand their rural network. Attributing this to the above five incentives is, however, not obvious. It is highly questionable the BdM measures are sufficient, such that a bank previously not intending to open a branch in an underserved rural area might be compelled to change its mind. To put it another way, it seems unlikely that the BdM measures are enough to offset the (perceived) high transactions costs associated with doing business in rural areas (see Chapter 2). In the absence of comprehensive data one cannot accurately assess the effectiveness of these measures, but given the very low rural outreach by commercial banks in Mozambique, one is tempted to conclude that more radical measures are required.

It should also be noted that even if an increasing number of bank branches are being located outside of the traditional urban hubs, rural bank lending, for the moment at least, continues to be dominated by loans to salaried workers who demand consumer loans. Loans to agricultural smallholders represent a tiny fraction of the total rural credit portfolio.

¹⁸ See Aviso No 10/GBM/2007- Measures valid for five years from 27/05/09.

Apex Institutions

In addition to the above measures, incentivising banks into rural areas is being conducted through the mechanism of various apex institutions. Apexes are organisations that channel funds, sometimes with technical assistance, to retail financial institutions for on-lending often to a target (in this case rural) clientele. There is some debate in the international literature about the efficacy of such institutions, with many apexes in other African countries failing to build bridges to financial markets and failing to coordinate the efforts of donors in support of microfinance.¹⁹ The problem in many cases stems from the fact that apexes are often seen with a dual role of providing finance and building capacity in the rural financial sector. It is rarely the case that such objectives have been met.

The largest of these schemes in Mozambique is the Fund for Economic Rehabilitation (FARE), in the Ministry of Planning and Development (MPD). Initially established as a government fund to finance guarantees for banks located in rural areas, the scheme for various reasons did not succeed, and subsequently metamorphosed into what is now essentially an apex institution. As such, FARE is currently managing a scheme with the explicit objective of encouraging and supporting bank outreach to rural areas. It is co-financed by two international donors, IFAD and AfDB, under the Rural Finance Support Programme (RFSP), and it is envisaged that it will shift from a program to a government institution (within MPD) in 2012, thus ensuring some sustainability and continuation of activities.

In short, FARE gives support to commercial financial institutions who wish to locate in rural areas. Institutions have a twice yearly opportunity to apply for FARE support, and their eligibility for receiving such support is assessed by an independent credit committee team who judge whether their proposed geographical area and financial products are in-line with need (as defined by the District Development Strategy and other government planning documents). Once accepted, the applicant bank is offered three supporting tools: (i) technical assistance support in the elaboration of viability studies for rural branch opening, (ii) a matching grant which can be used to cover some of the initial operational costs associated with opening a rural bank branch, and (iii) a credit line to the financial institution to strengthen their rural portfolio.

Currently, there are 24 banks, microfinance organisations and credit institutions receiving some form of support from FARE. However, while there is certainly potential for the scheme to have a large impact on the rural finance situation in Mozambique, one hears of a number of complaints regarding onerous bureaucracy and slow procedures for approval and disbursement. Moreover, while many applicant financial institutions aim to disburse agricultural credit, or at least say that they aim to, the reality is somewhat different with in excess of three quarters of rural loan portfolios going to consumer and commercial customers. Finally, it is important to reiterate that the scheme relies completely on the initiative of the banks to wish to pursue a rural strategy. Like the BdM measures, therefore, one can question the extent to which the scheme is likely to have a big impact.

Two other apex schemes, with GoM involvement, deserve a mention. Firstly, is the Fundo Fomento de Pesca (FFP), which operates under the Ministry of Fisheries and makes available concessional loan capital to financial institutions who invest into areas servicing fishermen. Again, however, a very small proportion of the loan portfolio of such institutions is in reality actually allocated to fishermen, raising concerns from the sponsors. Finally, is the Centre for the Promotion of Rural Financial Services (CPRFS) which until recently operated under the Ministry of Industry and Commerce (MIC). The program provided concessional wholesale loans to financial institutions operating in rural areas. One notable

¹⁹ See, for example, Nagarajan & Meyer (2005).

success involved the guarantee of loans from BCI-Fomento, a large commercial urban-focused bank, to cashew nut processors. This success aside, the scheme again comes in for heavy criticism from critics who point to the very loose application of the term 'rural', the high interest rates, and questionable sustainability.

In addition to these 'incentive schemes', a couple of other government initiatives are important to mention to complete the picture.

(i) *Fundo de Desenvolvimento Agrícola (FDA)*

The FDA was created out of two separately operating funds in 2006 and is charged with supporting rural development initiatives, specifically in the agricultural sector. It receives the majority of its funding from the state budget, but also generates its own revenues from forestry license payments over which it has operational and financial control. It has a wide ranging remit, though basically it provides financial support (sometimes in the form of credit) to initiatives aimed at supporting the agricultural sector.

At the time of writing, the FDA is drafting a new strategic plan and is undergoing some notable changes such as new management being put in place in certain areas. As such, it is anticipated that the organisation will emerge in a somewhat different form to that of the past. Nevertheless, support is currently given to agricultural non-farm enterprises and agricultural producers (in the form of inputs such as seeds, new technology, agricultural equipment for harvesting or storage, and pesticides/insecticides). There is also talk of expanding access to financial services in rural areas by, for example, establishing relations between banks and agricultural companies, and encouraging the establishment of rural finance providers. Tangible steps to attain these laudable objectives are less clear at this stage. Substantial operational problems and costs, such as low disbursement and recovery are commonly heard, although the FdA maintains that they are planning to turn into a more serious and credible credit provider.

(ii) *Banco Terra*

A potentially important recent development, is the establishment of Banco Terra.²⁰ The bank describes itself as a commercial bank with a rural focus. The primary focus is on agri-finance (60% of loan portfolio is the unofficial objective), but not only are farmers supported, but also input suppliers, millers, processors, traders and exporters. The bank is recently formed, commencing banking operations in April 2008, and was formally inaugurated in September 2008. It has four shareholders, namely Rabobank (Netherlands, 31%), KfW (Germany, 20%), Norfund (Norway, 20%), and GAPI (Mozambique, 29%). Its strategy is to open at least twenty branches, primarily located in rural areas in three years' time. Explicit in its strategy is the acknowledgement that commercial banks, where they are in rural areas, are only financing the very large agricultural projects, the top of the pyramid. Banco Terra targets what would be best described as the middle of this pyramid, those one step up from subsistence farmers.²¹

One interesting aspect of the loan technology used by Banco Terra is the treatment of collateral, which was identified very early on as the principal constraint facing prospective clients and risk facing the bank. Specifically, donor (in this case, Danida) support has been actively sought, such that a guarantee fund has been set-up. As a result, collateral requirements, and thus Banco Terra's risk

²⁰ www.bancoterra.co.mz/eng

²¹ 20ha average farm size is talked about.

exposure, have been reduced to 25 percent of the loan value. In this way, the potential client base has been expanded, though even now, anecdotal evidence points to difficulties faced by clients to meet this demand.

The establishment of this bank, with its rural agricultural focus and commercial principles, undoubtedly represents an exciting prospect for the future, though at this stage it is of course too early to judge its success.

OIL

In addition to the usual allocation of state budgetary resources to the district level, 2006 saw the launch of the controversial OIL²² or Budget for Investment in Local Initiatives. Known colloquially as the '7 milhões',²³ the funds are transferred annually to district government offices who, in conjunction with representatives from the communities, have the responsibility to allocate the resources to projects that will generate employment and increase the production of foodstuffs in the district. Beyond this rather general description, guidance for the allocation of the funds has been scarce, with a lot of resulting confusion.

Indeed, such is the lack of guidance that, although not formally stated anywhere, the funds are apparently supposed to be disbursed as *credits*. The capacity of district authorities to loan and recover the funds is of course low, and as such, a negligible proportion has actually been paid back. Simple guidance on interest rates, repayment periods, and collateral have not been provided. And as is often the case, when the creditor is the government, debtors are less inclined to worry about repayment. In fact, anecdotally one hears that some people have taken out loans to pay off loans from the FDA for instance. In short, the scheme is clearly politically motivated, and the dedication to ensuring that the funds are used in a sustainable manner (loaned with repayment) is not there.

Piggybacking

Piggybacking involves providing financial services at points where prospective clients from rural and remote areas regularly travel to obtain non-financial services. Offering financial services at a place and time where clients are already transacting other business can considerably reduce their transactions costs and can also make it more affordable for the rural bank. In this respect, the BdM has proposed and hosted a series of meetings between institutions such as the national postal service, fuel companies and financial service providers to investigate possibilities. The services offered by the VPSSC in Vietnam could provide some interesting lessons in this regard.

Concluding thoughts

There is certainly an acknowledgement by the GoM of the potential use and benefit that financial services can bring to rural economic development. Furthermore, the method used, of incentivising existing resources to relocate is extremely sensible from a sustainability viewpoint. But a tangible commitment to this tool is less clear. Certain measures are in place, though it is doubtful that they go far enough to redress the unbalanced distribution of banks currently seen in Mozambique. Given the not insubstantial risks associated with rural lending in Mozambique, and the low hanging fruit that remains on offer in the urban centres, it is highly questionable that the incentives outlined above are sufficient to encourage any significant shift in lending patterns.

²² Orçamento de Investimento de Iniciativa Local

²³ 7 million MT were initially allocated to each district, regardless of its size or need.

The establishment of Banco Terra does represent a potentially significant step forward. The specific agricultural focus is encouraging, but it is early days and the initiative, it must be said, was not really driven by GoM. Moreover, it is a commercial bank at the end of the day, therefore interest rates will be high and the temptation to lend to easier and more profitable urban clients will always be lurking in the background.

An important additional point relates to collateral. As noted above in Section 2, poor rural households often lack the collateral necessary to secure a loan from the formal sector. In Vietnam, while the situation is the same, credit outreach is so much higher as the state-supported institutions require either no collateral or simply the land use right certificates of the would-be borrower. This latter innovation, used by VBARD in Vietnam, is an initiative that should possibly be investigated by the GoM.

As it currently stands, therefore, it is certain members of the international donor community who are leading investment in the sector. There is also a lack of coordination and overall strategy, meaning that certain target groups and clusters of households are benefiting, while others are not. Finally, one should not ignore the more general role that the GoM can and must ultimately play by building and fostering an environment conducive to the expansion of rural financial service provision. Road and telecommunication infrastructure, material costs, and well-qualified personnel are all often cited as important obstacles to rural banking.²⁴

5. Non-State Actors

5.1. Vietnam

Besides the state-owned service suppliers, the private commercial sector consisting of joint-stock commercial banks (JSCBs), foreign invested banks and insurance companies play increasingly prominent roles in Vietnam. Most foreign invested banks focus on serving foreign invested enterprises, big corporations and foreigners. Some of these banks provide services for rich Vietnamese people. JSCBs have grown substantially over the past decade. In 2007, the market share of state owned commercial banks (SOCBs) fell from 70% to 58%, while that of JSCBs increased from 22% to 29%. The latter have thus pursued an aggressive strategy, and now account for 18% of market share in Hanoi and 38% in HCMC in 2007 (IFC, 2008). Such names as ACB, Sacombank or Techcombank are becoming more and more popular often thanks to strong support of foreign partners as Standard Chartered Bank, ANZ, and HSBC.

Interestingly, some of the smaller JSCBs such as Lien Viet Bank and Western Bank have shown the tendency to move *from rural to urban areas* via extending their transaction networks or even moving the transaction offices to big cities. Prior to 2006, there were a number of commercial banks operating in rural areas.²⁵ Some of these banks developed out of the People's Credit Funds (PCFs) or Credit Cooperatives after the crisis which hit many credit funds in the period 1988-1989.

²⁴ See for instance survey conducted by BdM to all commercial banks operating in Mozambique in 2007.

²⁵ Notable examples are Rach Kien bank in Long An province, Ninh Binh bank in Ninh Binh province, Nhan Ai Bank and Red flag bank in Can Tho Province, Dai A bank, My Xuyen bank in An Giang Province, and Hai Hung bank in Hai Duong Province.

In recent years, a number of these banks have been bought by State Corporations seeking expansion opportunities. The result is then for the banks to metamorphosize into a more urban-centric operation to the detriment of its rural clientele (Tran Thanh Tam, 2008).

In recent years, JSCBs have applied a diversified credit policy. Types of credit may be short-, medium- or long-term. The interest rate depends on loans' period and form, but SBV regulations prevent it from exceeding 150% of the basic interest rate in the economy at the time.

Table 5.1: Basic Interest rate of VND

	7/2008	10/2008	11/2008	12/2008	12/2008	2/2009
Interest rate (%/year)	14	13	11	10	8.5	7

Source: SBV

Loans can be divided into loans for business and production, and loans for consumption. Of the former, 20% of loans are currently used for trading on the stock exchange, a popular business in Vietnam today. Loans for consumption are extended for hire-purchase house, vehicle, and house construction. Depending on amount of money borrowed, loans may be mortgaged. Guarantee assets (collateral) can be land, housing, saving books or value vouchers (bonds, stocks, etc.). Trust loans for consumption are getting more and more popular, mostly applied for waged employees with a stable income. Another form of such loans is domestic debit card which user can draw a certain amount of money from his debt account.

In general, there is no discrimination between urban and rural customers. However, the shortcoming is that banks' transaction offices are often based in cities, resulting in difficulties of rural enterprises as well as individuals in accessing the services. Moreover, the credit procedure represents somewhat of a barrier to farmers, who cannot access trust loans because they are not paid employees. In such cases, mortgaged assets are required with cumbersome procedures. One also hears of rural assets being poorly (under?) valued by the urban-centric JSCBs in their loan appraisal process.

By the end of 2007, Vietnam housed 41 insurance companies, including 23 non-life, 9 life, one reinsurance and eight insurance brokerage firms. Generally speaking, Vietnam has made great efforts to develop an insurance industry. According to a number of microfinance practitioners, micro-insurance in rural areas represents a real opportunity, however, due to a number of shortcomings such as insufficient product diversification, urban-oriented services, and limited awareness of people on the products (particularly non-life insurance), this remains very much in its early stages.

The semi-formal sector plays an important role in the rural finance system. The sector includes domestic and international NGOs providing credit services through development programs. By the end of 2006 there were 57 organizations serving 164,000 customers in 547 communes, making up 7% of microfinance market (IFC, 2008).

Since the beginning of 1990s, *non-governmental organizations* (NGO) have provided technical assistance for credit programs targeting the poor. Examples of such organisations are Groupe de Recherche et d'Echanges Technologiques (GRET), ActionAid, Développement International Des Jardins (CARE), Save The Children Fund (Anh), and OXFAM. These organizations actively involve in mobilizing savings as well as capacity building for credit groups and mass organizations. Some NGOs use savings and credit programs as a way into villages to conduct their activities such as health care or family planning.

Customers of NGOs are poor women, ethnic minority communities and the poor in distanced areas. Groups, in other words, that formal sector does not reach. In some cases, NGOs have performed well, with high rates of loan settlement and rises in savings rates.

NGOs generally charge slightly higher rates than the state financial institutions- positive for sustainability of their operations. However, the coverage of NGOs remains limited. According to one survey some time ago (McCarty, 2001), by 2000, the loan balance of NGO credit programs was equivalent to 7.6% the one of government's official programs, and 4% of the total credit for rural area (including informal sector).²⁶

Micro credit organizations provide a number of credit products, the most common of which is short-term credit for production for the period of 6-12 months with the amount from 200,000 to 5 million VND. The interest rate is weekly or monthly based, ranging from 0.9 to 2% per month (ILO, 2005).

Common policies of such organizations are:

- Group guarantee instead of mortgaged assets to minimize credit risk;
- Strict monitoring system to control capital use and ensure sufficient and timely payment;
- Increasing amount of credit in the following periods;
- Requirement of savings as a condition for loaning;
- Periodically payment of certain amount including principal and interest;
- Reasonable interest rate affording operation cost;
- Regular participation in group meetings.

Target groups of such types of microcredit are poor households, minority groups, households living in remote and under-developed areas and particularly women. Moreover, NGOs often target areas receiving little support from government programs, thus filling the gap where state targeted programs through VBSP are not yet fully effective. One of shortcomings of the organizations is the dependent on limited fund supported by international donors, resulting in small operation scale. This is something that is seen more widely in Mozambique.

Finally, there is the informal sector including money lenders, and relatives and friends. In rural areas of Vietnam, the informal sector plays an important role in meeting specific and practical demands for credit of all types and profile of customer. It is estimated to provide more than 20% of the credit amount for rural households (Table 3). Indeed, in some areas, it is the only credit source for the poor. Compared to the formal sector, the informal sector is often seen as more convenient for rural poor people, with commonly cited advantages such as being close to peasant households, in the same village, flexibility, provisions meeting specific demands and capacity of each customers, simple transaction procedures, easy-to-understand and performance regulation²⁷; money quickly transferred to the borrower; activities mostly based on trust or individual relation between lenders and borrowers. However, there are still a number of shortcomings such as high interest rates, requirement attached such as purchasing material, consumption goods or selling of products or labour, causing drawback to borrowers; loans are often small and in short time, which do not improve medium-term and long term investment of peasant households.

²⁶ Pham Vu Lua Ha (2003), Developing credit system in Vietnam rural area.

²⁷ This feature is of great importance in rural areas, with low levels of education and literacy.

Often rural households obtain credit through a combination of both formal and informal lenders. Formal loans are almost entirely for production and asset accumulation, while informal loans are used for consumption smoothening.²⁸

Loans from relatives or friends are often flexible and non-interest bearing, depending on the private relationship between lender and borrower. There are three types of money lender: individual money lender with interest, spout²⁹ and small businessmen or local material suppliers. Individual lenders provide loans basing on mutual trust and the procedure is simple, while spout providing loans in terms of mortgage of land or assets. Small businessmen or material supplier provide loans in kinds or by goods, showing in allowing debit entry when purchasing goods. Loans in informal sector are small, short-term loans with flexible periods and with interest rate of several times higher than the one in formal sector.

Savings

Many types of saving are utilised in rural Vietnam. Keeping jewellery or valued assets at home is one type of in-kind saving, which is unsecured and affected by market price. Deposit savings is low-profit but a secured investment. Savings services in Vietnam are developed in certain areas, mainly in the more economic developed and urban areas. As a result, rural people find hard to get access to a formal saving service.

Some other savings products applied by banks to attract customers are 'Phat Loc' ³⁰ saving or 'Lottery saving' for certain deposit amounts. The procedure for money deposit and withdraw is quite simple, customers are allowed to withdraw cash at any transaction office or branch of the bank. For most banks, there is requirement for a minimum cash deposit in order to open the saving account. The minimum deposit level for non- state bank is often higher than the state bank. For example, the minimum deposit for save is 50,000 VND for VBARD, but 1 million VND for ACB.

Beside the mobilization of compulsory saving (precondition to get eligibility for credit), micro credit organizations also mobilize savings: scheduled and non-scheduled saving, saving by instalments. In general, interest paid by microcredit organizations in the quasi-formal sector is often higher than that of the formal sector. Microcredit organizations do not apply a minimum saving deposit level, though some organizations do have a rule stipulating a ceiling to discourage wealthy savers. The objective of these organizations is encourage the poor to save, so these organizations target low income people, especially the poor. For example, the Bamboo saving scheme of SC-US has a strict ceiling for each saving deposit of 200,000 VND. The TYM fund has the limit of 100,000 dong as a deposit.

Microcredit organizations have no insurance for saving deposit. In order to reduce the risks, these funds often work closely with mass organizations essentially to promote effective usage of the loan. Savings can be highly illiquid which might provide a big disincentive for home-savers to shift savings into formal

²⁸ Barnslund & Tarp, 2003

²⁹ A spout is a shop that loans funds (with interest) on the provision of valuable tangible assets (collateral). Common examples of assets used are motorbikes, cars, land, and mobile phones.

³⁰ Phat Loc saving is a special type of saving offering higher interest compared with normal savings accounts. They also offer a higher minimum deposit, but importantly with no withdrawing allowed before the deposit term ends. Principal plus interest are be paid once the expiry date; if the depositor does not appear on this date, funds are transferred to a normal savings account for the proceeding period.

accounts. Clients often must inform the organization a number of days in advance before they can withdraw their funds. This problem remarkably reduces the flexibility of product.

Spring saving

Spring saving is a program of saving by daily instalment implemented by Women's union of Ward 5, district 11, in HCMC. This is a one year saving with 360 days of deposit of 1,000 dong per day (a person can have many accounts). The mobilized funds are used for loans, and the fund is balanced every year. No commission or management fee is charged by the Union. At the end of year, the saver receives both the principal and interest in accordance with following formula:

Interest of saver = (total interest from the loans/ total saving fund)* saver's principal

Source: ILSSA (2004), Financial Products for Risk Management in Vietnam.

"Ho / Hui / Phuong", meaning "group" of revolving credit fund is quite popular and has existed for a long time in Vietnam. "Ho / Hui / Phuong" is a saving group (or credit group) that is established on the basis of voluntary participation. The group mobilizes savings from members of this group, and the mobilized funds are used as loans for other members of the group. Members of the group can make contributions in cash or in kind (for example, rice, iron). While originally popular between families and close friends, this mechanism has now expanded to people with medium income and even the relatively well off.

"Ho" can be divided into 2 types as "credit ho" and "supporting ho". For the former, the member who receives the loan must pay interest to other members. In case of a credit default, the latter 'ho' is activated, and members of the group agree to support each other. All members must discuss and agree on matters such as the number of members, contribution levels, length of contribution, due time for contribution, interest, patterns of withdraw, responsibility and benefit of the leader of "ho". Due to the absence of a legal framework to regulate this activity, the operation of "ho" is risky. The higher deposit / or interest is, the bigger risk, especially for a large group where members may not know each other. So far, there are no statistics on the number of groups or total capital of current groups.

5.2. Mozambique

The financial sector in Mozambique is comprised of regulated and non-regulated institutions. Regulated institutions include commercial banks and non-bank financial institutions such as insurance companies, leasing companies, and finance companies. Unregulated institutions include a range of microfinance institutions including self help groups, village banks, and credit unions.

The Banking Sector

The financial sector is highly concentrated, with the four largest banks accounting for 96% of total banking deposits, compared to 83% in sub-Saharan Africa and 71% in other low-income countries (IMF 2004). The financial sector is concentrated around the capital Maputo (with secondary centres in Nampula and Beira). Bank savings total approximately US\$ 1 billion shared between four institutions: Barclays Bank, Standard Bank, *Banco Internacional de Moçambique* (BIM) Group, and BCI Group.

Most Mozambican commercial banks continue to carry high levels of non-performing assets on their books. According to a Financial System Stability Assessment conducted in 2003, the ratio of

nonperforming loans (NPLs) to total loans was 21% at the end of 2002. Writing off these assets to reflect more accurate capitalization is essential, although in the short term it creates a risk that commercial banks may not be adequately capitalized. There is considerable evidence to suggest that most NPLs result from poor lending decisions rather than from factors external to the lending institutions. The level of NPLs is often used to justify the high interest rates charged by the commercial bank sector. However, other reasons include high overhead costs (due to the relatively small size of the country's financial system), wide profit margins (thanks to a lack of competition in the sector), the lack of credit-worthy projects, and weak repayment culture resulting from a series of NPLs to the politically well-connected.

One of the greatest challenges to expanding commercial bank lending to the agribusiness sector is that banks do not have the in-house expertise to assess agricultural risk and develop products whose repayment cycles match borrower cash flow. Although three of the banks interviewed³¹ communicated a willingness to lend to agribusiness clients, only one (Group BIM) has loan products to accommodate agriculture cash flows, and another (Standard Bank) has plans to hire an agribusiness expert. In direct contrast to Vietnam, there is no agricultural bank. BIM out-sources specialists for agricultural loan risk evaluation, although these specialists do not have to be agronomists.

The Banco de Oportunidade de Moçambique, which recently announced a scheme to lend small amounts (up to US\$200) to small scale farmers for the purchase of seeds and fertiliser in the province of Manica³² is an interesting and potentially important player for the future. The lending is in partnership with various international donors and advisors who will provide a complementary technical advisory role. If the scheme is successful, the project anticipates increasing lending amounts by a factor of ten to finance purchase of capital equipment.

Commercial bank interest rates range between 29% and 31% in MT. Foreign currency loans are LIBOR-based (usual minimum LIBOR+5%). Local currency loans are MIBOR-based (usual minimum MIBOR+5%).

Non-Bank Financial Institutions

Non-bank financial institutions include pension funds, insurance companies, leasing companies, venture capital funds and finance companies. Credit unions also fall within the rubric of nonbank financial institutions, but there are none operating in rural Mozambique. Pension funds do not conduct lending activities and were not included in this assessment.

There are currently four insurance companies operating in Mozambique. Insurance companies are an important player in agriculture finance, as insurance is critical to reducing lender risk where physical capital is used as collateral. There are at least two leasing companies: BIM Leasing (which offers two kinds of leasing services) and BCI Leasing. Through its *Centre for the Promotion of Rural Financial Services* project, USAID worked with BIM Leasing to offer leasing services for the financing of agricultural equipment. To date (and after over three years of project activity), one lease has been signed. Leasing offers tremendous potential to increase capital flows to the agribusiness sector, particularly given the lack of commercial bank incentives to expand in this area. One of the challenges facing these leasing companies is capitalization. Leasing is unlikely to provide its commercial bank owners the returns they will earn from T-bill purchases. Today FDI remains an important source of leasing company capital.

³¹ BdM, 2007

³² (<http://www.oibm.org/financial-performance/rural-development/>).

GAPI is the only finance company operating throughout Mozambique that is committed to expanding its agribusiness lending. The institution's activities include the provision of financing to rural dwellers. GAPI recognizes the challenges smallholders face in accessing commercial credit, and has begun to provide marketing loans directly to associations. The advantage of lending to associations is that all members share risk in self-regulating mechanisms. Despite its willingness, GAPI faces challenges as a viable agricultural lender. The institution's interest rates remain high and its excessive operating costs prevent it from offering small loans. Indeed GAPI's smallest loan size is 100 thousand MT (US\$ 4,000), which precludes many farmer associations from obtaining credit. GAPI's role is that of a 'wholesaler' of borrowed funds to MFIs and not that of a provider of micro financial services directly to farmers and micro enterprises.

In Mozambique, a strategy to cope with limited access to financial services some families involve themselves in *Xitique*. The *xitique* system (similar to what are commonly referred to as rotating savings and credit associations (ROSCAS)) involves members regularly depositing a fixed amount into a common pool which is collected in turn by each member. *Xitique* is practiced, to varying degrees, throughout the country. It is more common in urban areas, particularly among wage workers. *Xitique* is also practiced by market vendors but more commonly in the south than in the central or northern provinces. *Xitique* facilitates the accumulation of funds to purchase a specific consumer item such as a refrigerator, television, bicycle, furniture etc. It is also practiced for income generation, for instance, as start-up capital or for the purchase of merchandise. In the markets, the rotation can be on a daily, weekly or monthly basis.

Accumulating Savings and Credit Associations (ASCAs):

ASCAs are essentially a form of ROSCA that is becoming increasingly popular in Mozambique. They have been set-up, promoted and supported by various international donors, perhaps most notably Danida. There is now an ASCA in all 11 provinces of Mozambique, and in 78 districts (63% of the total). Such is the success, that there are moves underway to formalize such schemes. They are widely acknowledged to represent a viable source of rural credit, given the implicit sustainability of the mechanisms by which they function.

Their distribution within the country is, however, heavily skewed. Two provinces in particular are huge beneficiaries: Nampula, which has 64% of ASCA clients, and Manica which has over 50% of the portfolio value. This unequal distribution is a clear result of a lack of overall coordination or central control, such that these schemes have basically sprung up based on individual donor criteria which may not necessarily reflect the distribution of the population in most need.

Traders, processors, input suppliers and exporters are a major source of financial services to rural agriculture dependent households in Mozambique. These buyers and suppliers provide credit to farmers as part of input supply and product purchase transactions. This inter-linking of credit with other services helps to reduce the risk associated with agricultural lending, particularly when the credit is tied to subsequent sale of produce. The type of financial products provided by buyers and suppliers is usually limited to seasonal credit and short term advances but, nevertheless, it has been found to be at least as important to farmers as loans from specialist financial intermediaries.

6. Concluding Remarks

Both Vietnamese and Mozambican commercial banks prefer the city, where clients abound, risk is relatively low, and transactions costs are easily kept to a minimum. At the same time, both the Vietnamese and Mozambican governments see the extension of financial services to the countryside as an important tool to spur rural development. The commitment and approach adopted by the respective countries' to address this market failure is however quite different. Accordingly the results on the ground have also been quite different.

The clearest manifestation of this is in the area of outreach of rural financial services. While in Vietnam, almost all of rural households enjoy some form of access to financial services, an extremely low proportion of rural households in Mozambique have this possibility.

Vietnam's unambiguous preference for a subsidised policy lending institution is something that Mozambique, until now, has not favoured. And while on the surface, the VBSP would seem to win every battle in terms of rural credit outreach, sustainability and impact, digging a little deeper muddies the picture somewhat. This is particularly the case vis-à-vis sustainability. The VBSP receives significant amounts of funding from the state budget and SOCBs, allowing it to significantly undercut commercial interest rates. Without such subsidisation, the bank would inevitably become financially unviable very quickly. In this sense, the 'Mozambican way' of incentivising incumbent commercial financial service providers to enter into rural areas would seem highly sensible. However, it is early days and results so far have not been encouraging.

The provision of subsidized (artificially low) interest rates has for a long time been the subject of some debate between the international donor community and the GoV. Donors point to international experiences of high levels of NPLs, low savings mobilisation, and ultimately bank failures. And concerns that VBSP could become a non substantial drain on public resources are often heard. While targeting does seem on the whole to be efficient, given that loans are subsidised by public money, households who do not need the help should not be beneficiaries of VBSP. Commercial banks can and should fill that role. In Mozambique, similar concerns about donor-financed credit projects are equally relevant. The vast majority of such operations are reliant on external funding from international donors. Yet, in numerous cost effectiveness studies such financing is not taken into account when assessments are made as to the viability and sustainability. A classic example is a car bought by donor funds and that is essential for a microfinance institution to meet with clients in remote areas. This is an essential part of the operation, yet often not included in sustainability calculations.

A primary benefit of giving loans that must be paid back with interest, as opposed to grants, to poor populations, is the sustainability of the former. In theory, microfinance allows the recycling of the same financial resources to many borrowers allowing many people to benefit with a lower cost.³³ In Vietnam, however, a dominant perception has emerged over the years of policy lending that subsidised loans are more of a right rather than contractual agreement. Indeed, there is anecdotal evidence that loans made at market (commercially viable) rates are seen as exploitative by some rural populations (Duffhues, 2007).

³³ This is in addition, of course, to the other benefits of engendering an entrepreneurial mentality etc.

Being able to replicate such an institution as VBSP in another context is of course far from straightforward. Apart from the enormous logistical and financial resource needs that this would entail, the efficient and successful operation of the VBSP relies on certain unique characteristics of the Vietnamese political and societal system. In particular, the role of mass organisations and savings and credit groups is critical in overcoming information asymmetries and high transactions costs.

Outside of the formal state-run sector, the rural credit environment in Vietnam and Mozambique share a number of characteristics. But the analysis also points to some key areas, in which one of the countries is achieving some success. One area in particular is the operation of ASCAs in Mozambique which are proving, albeit slowly, to be a sustainable and efficient means of disbursing credit in rural areas.

Finally, it is critical to note the role of savings mobilisation. In both Vietnam and Mozambique, 'home saving' (i.e. cash, gold, jewellery) accounts for the majority of all savings- in the former's case, 83% (VARHS 08). Making available some of these dormant resources, such that they can be recycled in the form of credit, is critical to ensure the sustainability and thus success of the operation.

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