



BEYOND MICROFINANCE
BUILDING INCLUSIVE RURAL FINANCIAL
MARKETS IN CENTRAL ASIA

Edited by:
MARIO B. LAMBERTE
ROBERT C. VOGEL
ROGER THOMAS MOYES
NIMAL A. FERNANDO

Asian Development Bank

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Foreword

The Asian Development Bank (ADB) is proud to present this book on rural finance in Central Asian countries, the culmination of more than 2 years' research and analytical work. The book is important for a number of reasons. First, it focuses on rural finance development issues in a set of countries about which little current literature on the subject exists. Second, it represents an attempt to redress a serious imbalance in the attention paid to rural financial market development that has been created by the overwhelming interest in and emphasis on microfinance during the last 2 decades. This emphasis on microfinance seems to have generated a view that microfinance development could provide an answer to the problems of rural financial market development. While the development of microfinance is undoubtedly critical in improving access to finance for the unserved and underserved poor and low-income households and their enterprises, it is inadequate to address issues of rural financial market development. In fact, this recognition has led to the title of this book, "Beyond Microfinance." Thus the book's central message: microfinance development is necessary but not sufficient for rural financial market development; rural financial market development remains an equally important facet of overall financial sector development, in Central Asia, as well as throughout developing Asia.

Rural Asia presents a paradox: poverty in Asia retains a markedly rural dimension but, at the same time, economic opportunities abound throughout rural areas of Asia. Robust, inclusive rural financial markets can help people take advantage of economic opportunities, build assets, manage risks, and reduce their vulnerabilities to external shocks and, in so doing, help people living in rural areas improve their welfare. Rural financial markets, however, remain largely underdeveloped throughout emerging Asia. While microfinance targets very small businesses and the poor, rural finance encompasses rural microfinance and cuts across all economic strata. Building robust, inclusive rural financial markets is essential to developing healthy rural economies. ADB is committed to promoting rural financial markets that allow rural populations—including the poor—broad access to a wide array of financial products that meet their diverse demand for quality financial services at competitive prices.

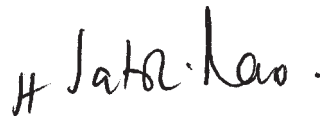
The book grew out of an ADB financed regional technical assistance project, the purpose of which was to increase knowledge of rural financial market development in

Azerbaijan, Kazakhstan, Kyrgyz Republic, Mongolia, Tajikistan, and Uzbekistan (referred to in the studies as “the Central Asian republics” or CARs). This work presents a diagnosis of the current state of rural financial systems, and examines approaches through which rural financial systems could be made more robust and inclusive. The study considered how both banks and alternative financial institutions might meet the diverse demand for financial services of people living in rural areas, including the poor, and for firms, including micro, small and medium enterprises. The field surveys, institutional analyses, and systems diagnostics were completed over the period 2003–2004. National workshops and a final regional workshop were held to discuss preliminary findings of the study. During the past year, the editors engaged in a thoroughgoing analysis of the country-level work, and undertook painstaking rounds of editing and refinement of the main chapters of the book. The result is a study that provides both closely detailed and broad perspectives, and which, along the way, highlights much of the evolution in thinking about rural and microfinance.

The book is a valuable contribution to our knowledge of the rural financial markets in Central Asia, and should be useful to microfinance practitioners, researchers, bankers, policy makers, regulators, and development partners. The book will hopefully trigger further work and fresh approaches to rural financial markets development both within Central Asia and beyond.

I would like to acknowledge the indispensable grant support provided by the Government of Denmark, without which this valuable work may not have been published. Crucial to the overall publication effort was the energy and wisdom of Betty Wilkinson (Project Specialist, Rural Development and Finance) who supervised the implementation of the technical assistance project which generated the material included in this book. She provided insightful comments on the developing drafts. Nimal A. Fernando (Lead Rural Finance Specialist) and Roger Thomas Moyes (Rural Financial Markets Specialist) also contributed significantly to the creation of this book. Noy Siakhachanh, Director of the East and Central Asia Regional Department’s Governance, Finance, and Trade Division, provided guidance and patient encouragement to the editors to bring this work to full fruition. Also providing valuable support were Edna Gonzales, Associate Project Analyst, who guided the internal processing from the inception of the TA through to publication, and Ma. Priscila Del Rosario, Senior Copy Editing Officer, who proved a thorough and responsive editor. Dr. Robert C. Vogel, Project Team Leader, and Dr. Mario Lamberte carried out much of the research under the project and contributed the lion’s share of the material for this book, for which they deserve special mention for their outstanding contributions. The services of Drs. Vogel and Lamberte and their team of local and international consultants were secured through a contract between ADB and

the firm International Management Communications Corporation (IMCC). Key IMCC team members also deserve recognition for their fine work, including Gail Buyske, Mariano Cordero, Delbert Fitchett, Richard Meyer, and Dennis Sheets. Many local consultants also contributed to the research effort in each country studied, for which they receive specific mention inside the book.

A handwritten signature in black ink that reads "H Satish Rao". The signature is written in a cursive, slightly slanted style.

H. Satish Rao
Director General
East and Central Asia Regional Department
Asian Development Bank

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Introduction

Nimal A. Fernando and Roger Thomas Moyes

Central Asia (defined as the region encompassing Azerbaijan, Kazakhstan, Kyrgyz Republic, Mongolia, Tajikistan, and Uzbekistan¹) is very different from the rest of Asia. Relatively low population density is an oft-cited characteristic that sets it apart from South, East, or Southeast Asia. The unique and largely shared recent history of the former communist republics is an equally salient feature that places Central Asia in contrast to the rest of the continent. The collapse of the Soviet Union and the creation of newly independent Central Asian republics (CARs) along the eastern and southern borders of the Russian Federation (Mongolia, of course, was already an independent state) was a

¹ The study focuses on these key ADB Developing Member Countries in transition, which are active borrowers and are grouped operationally for ADB's purposes, in the East and Central Asia Regional Department. Viet Nam, Cambodia, Lao People's Democratic Republic, and People's Republic of China are in some ways akin to the countries of Central Asia; these countries also experienced communism and central planning, and are "transitioning" toward fully market-oriented economies. But these East and Southeast Asian countries are in many significant and fundamental ways dissimilar to the Central Asian countries that are the subject of this study. A short list of differences (which applies differentially in each case) includes their continuing political orientation toward one-party rule, high population density, and significantly less historical influence from Soviet Russia. Furthermore, the authors are fully cognizant that Azerbaijan is not in Central Asia at all, nevertheless, ADB groups Azerbaijan with the other Central Asian states and with Mongolia, and thus it is included in this study. Mongolia is linked closely by language, culture, and history to the formerly Soviet Central Asian states of Kazakhstan, Kyrgyz Republic, Uzbekistan, and Tajikistan, and is—arguably—a Central Asian state. With apologies therefore for any geopolitical awkwardness, and without further qualification, reference throughout the book to "Central Asia," the "Central Asian republics", or "CARs" refers to the six countries indicated.

At the beginning of the transition process, the policy makers in these countries did not have a clear idea of how to proceed.

unique event for which there is no historical precedent in Asia—or elsewhere for that matter. At the beginning of the transition process, the policy makers in these countries did not have a clear idea of how to proceed—in terms of the kind of reforms, their sequence, the speed with which they needed to be carried out, and how best to finance the required reforms, among other things. Neither academics nor donor agencies had much meaningful experience to offer these states in dealing with the massive “development policy shock” generated by the disintegration of the Union of Soviet Socialist Republics (USSR) and the kind of thoroughgoing transformation of society and economy that the disintegration set in motion. It is in this context that the donor agencies rushed in to Central Asia with help, providing funding and experts, but no real proven approaches or models to apply.

The disintegration of the USSR generated both political and economic expectations through all strata of society in CARs. The majority of people wanted to harness emerging opportunities to improve the welfare of their families. Realization of these expectations depended on a number of factors, and among these one was especially critical: creating a healthy, competitive, and inclusive financial system. Without robust, inclusive financial systems, the majority had little hope of taking advantage of economic opportunities that the transition was expected to unleash. If most people are unable to actively participate in the development process and share benefits generated by that process, the new political system will also have no meaning for them. More broadly and fundamentally, a healthy and competitive financial sector capable of allocating resources efficiently based primarily upon risk/return criteria is a vital element in recasting CARs into market-oriented economies.

Recognizing the central role that a financial system plays in the development process and the concerns about growth, stability, and equity prompted many funding agencies to offer assistance for financial sector development in the CARs. Asian Development Bank (ADB), among others, has been deeply involved in promoting the development of the financial sector in each of these six transitional economies, all active members and borrowers of

ADB. Through technical assistance and loan projects, including policy-based loan programs, ADB has contributed significantly to financial market development in these countries.

This book organizes the findings of the Rural Finance in Central Asia Regional Technical Assistance (TA) project, approved in December of 2002² and launched in 2003. The TA sought to diagnose the current state of rural financial systems in the six CARs, by identifying constraints, key issues, and indicating useful approaches to the development of efficient rural financial systems. The goal of the TA project was to promote sound and viable rural financial systems in the CARs. This is obviously a laudable goal. It is also a formidable one, requiring continuous learning and unwavering commitment to apply the lessons of relevant experience. Approaches must be refined and development effectiveness measured critically and constantly enhanced. The better we understand how financial markets work in these countries and the wider we share our knowledge on the subject, the easier will be our task of building inclusive financial systems that enable the majority to actively participate in the development process.

This book provides a thorough analysis of findings of the individual diagnostic reports and a framework to determine what those findings mean in terms of what needs to be done to further develop rural financial markets. The book helps to answer a fundamental question that development partners committed to pro-growth, inclusive financial systems ask themselves: what can we do to develop robust rural financial systems—financial systems that not only carry out efficiently their generally expected functions, but in so doing also allow access to needed services by a majority of the rural population, including the rural poor, in Central Asia? Beyond this, the book also attempts to deal with a broader question of whether the lessons of emerging rural financial markets in CARs teach us anything about rural finance that might have relevance for building inclusive financial systems elsewhere.

The book helps to answer a fundamental question that development partners committed to pro-growth, inclusive financial systems ask themselves: What can we do to develop robust rural financial systems?

² ADB. 2002. *Technical Assistance for Rural Finance in Central Asia*. Manila.

The country studies presented in this volume amply demonstrate that rural finance is much more than microfinance.

The issue of access to finance on the part of the poor and rural dwellers has become an increasingly urgent priority in the development community, with the advent of sustainable microfinance across the developing world. The emergence and commercial expansion of successful microfinance institutions has roughly coincided with the first decade of post-Soviet transition. The relative importance of rural microfinance and its potential role in emerging rural financial systems was an important theme in the country research carried out. This book will hopefully contribute significantly to understanding, among other things, how microfinance fits within rural financial markets in CARs. Interestingly, some people still consider the terms “microfinance” and “rural finance” to be more or less synonymous. This misconception has emerged for two main reasons: first, because of the imperfect understanding of how microfinance relates to broader rural financial markets and, second, due to the gaps in understanding of rural financial markets themselves. Also, the country studies presented in this volume amply demonstrate that rural finance is much more than microfinance. While the current emphasis on microfinance contributes significantly to promoting inclusive financial systems, it is necessary to pay equal attention to the rest of rural financial markets if these countries are to harness the potential of those markets for equitable economic growth. This study can help improve knowledge of rural finance, clear up misconceptions, and put rural finance within the mainstream of finance.

Each country-focused article in the book presents the way rural financial markets are emerging in CARs. Although the developments are outlined roughly through year-end 2004, the data set is sufficient to highlight the structure and important trends in rural financial markets, and underline the pace and direction of key developments. Readers with a desire for more detailed information on rural financial market developments in any of these countries are invited to explore the companion Volume II, in which the six country studies are presented in their entirety.

Chapter 1

From Agricultural Credit to Rural Finance: In Search of a New Paradigm

Robert C. Vogel¹

INTRODUCTION

If this chapter had been written 30 or even 20 years ago, the title would likely have been “Agricultural Credit” and not “Rural Finance.” The world of rural finance has come a long way in those intervening years, not only in what the subject is called but also in how it is approached. Hopefully, these changes in understanding encompass government officials and international development agencies as well as rural financial service providers. Unfortunately, many political and bureaucratic incentives can make the old approach appear highly attractive even today. It is for this reason that this chapter begins by discussing the key lessons that should have been learned in moving from agricultural credit to rural finance, along with what has been learned from microfinance.

The year 2003 was a particularly significant year, not only for launching the Asian Development Bank (ADB)’s research effort on rural finance in Central Asia, but also in that it marked the 30th

Unfortunately, many political and bureaucratic incentives can make the old approach appear highly attractive even today.

¹ The number of individuals who should be thanked for contributing to this chapter is virtually endless, but only Dale Adams and the collaborators in this study of rural finance in Central Asia are specifically thanked. The inputs of the collaborators have been crucial throughout this activity, while Dale is thanked not just for his collaboration over the years, but especially for coming out of semi-retirement to comment on this chapter. However, neither these individuals nor anyone else besides the author is responsible for the views expressed or any errors in fact or analysis.

anniversary of three important events that have been helpful, if not crucial, in the movement from agricultural credit to rural finance:

- United States Agency for International Development's 1973 *Spring Review of Small Farmer Credit*
- Ron McKinnon's book, *Money and Capital in Economic Development*
- Ed Shaw's book, *Financial Deepening in Economic Development*.

The *Spring Review* showed clearly that the widespread failures of agricultural credit projects were not due to faulty implementation, but rather to the inappropriateness of the basic concept that subsidized and targeted credit could promote agricultural production and increase the welfare of small farmers while contravening market forces. At the same time, the books of McKinnon (1973) and Shaw (1973) gave greater theoretical importance to finance, showing its key role in resource allocation, whereas the previous focus had been almost exclusively on the relationship of money to inflation.

The purpose of this chapter is not so ambitious as to attempt to provide a comprehensive review of the development of rural finance over the last 20 or 30 years or to analyze all aspects of its current status. Rather, the purpose is more limited; that is, to extract the main lessons from the failures of the traditional agricultural credit approach and, to the extent of their applicability to rural finance, lessons from the successes of microfinance in expanding outreach to microentrepreneurs and low-income individuals in general on a sustainable basis. A second purpose is to set the stage for an in-depth analysis of rural finance in four countries of Central Asia, plus Azerbaijan and Mongolia, by introducing many of the main themes and issues to be investigated in those country studies. Because Central Asia, including Azerbaijan and Mongolia, are unlike most of Southern and Eastern Asia, especially in population density in rural areas, many of the examples referred to in this chapter are from Latin America, where the physical and human geography appear much more similar to Central Asia and, hence, more relevant.

Because this chapter is not meant to be a comprehensive survey of rural finance and is focused in particular on providing an optic that can best be used to understand rural finance in Central Asia, the reader who seeks an understanding of rural finance that is both broad and deep will need to look further. For a thorough in-depth understanding of rural finance, the most appropriate starting point is perhaps the massive amount of research that the Rural Finance Group in the Agricultural Economics Department at the Ohio State University did during the 1970s and 1980s. Its major findings were presented at a conference in Washington in the early 1980s supported by several international development agencies, with many of the papers from the conference later published in *Undermining Rural Development with Cheap Credit*.² Nonetheless, this chapter will hopefully provide not only an adequate starting point for understanding rural finance in Central Asia but also an appreciation of the most useful lessons from rural finance for government policy makers and development agency staff, as well as rural finance practitioners, from all parts of the world.

The following section of the chapter briefly reviews the traditional agricultural credit approach and its shortcomings, with particular attention to laying the groundwork for the care that needs to be taken to avoid repeating these mistakes. The next section focuses on the more recent successes of microfinance in providing a sustainable expansion of outreach in access to financial services, and especially the extent to which these successes provide lessons that are helpful in developing a new approach to rural finance. The last section covers a number of points that the author believes are crucial in shifting paradigms toward a new, more appropriate approach to rural finance including, but not limited to, the agricultural sector. This is followed by a brief summary of the main points on which there should be substantial agreement, followed by those that need further attention by government policy makers,

² For a later comprehensive summary of these findings plus further innovative extensions, see especially J.D. Von Pischke's *Finance at the Frontier*. To understand relevant regional settings, both the Asian Development Bank (ADB) and Inter-American Development Bank (IADB) have published a number of studies and books, with Richard L. Meyer and Geetha Nagarajan's, *Rural Financial Markets in Asia: Policies, Paradigms, and Performance*, Asian Development Bank, 2000, and Mark Wenner's, *Lessons Learned in Rural Finance*, Inter-American Development Bank, 2002, perhaps the most pertinent.

development agency staff, and rural finance practitioners themselves.

The Agricultural Credit Approach

Government officials supported by international development agencies relied heavily on controls over interest rates.

The traditional agricultural credit approach failed for a number of reasons, but primarily because it reacted to the symptoms, and not to the causes, of the lack of financial services in rural areas and injected solutions that were at variance with market incentives. Rather than seeking to understand the causes, perhaps because the analytical work involved would require time to carry out and produce results whose immediate usefulness could not be foretold, government officials supported by international development agencies relied heavily on controls over interest rates and filled the gap by providing the financial service for which there was greatest clamor—cheap credit for agriculture. In fact, the clamor for cheap credit remains even today (as it does understandably for subsidies for anyone who might benefit from such political interventions).

Transaction Costs. During the 1970s, theoretical arguments were refined and empirical evidence was amassed that showed the failure of the traditional agricultural credit approach to providing rural financial services. Agriculture credit subsidies in the form of below-market interest rates implied excess demand that had to be rationed, and market incentives were to ration through transaction costs rather than through seeking out the intended beneficiaries of the subsidies.³ Lenders could shift some of their transaction costs to borrowers and still find demand because of the low interest rates, while borrowers were willing to incur the higher transaction costs because the total cost of this credit was still relatively attractive. A key point, both theoretically and empirically, was that transaction costs are largely fixed without respect to loan size, while interest costs vary proportionately with loan size. Thus, borrowers of smaller amounts, receiving relatively

³ There would have been no gap in agricultural credit to fill unless these intended beneficiaries were relatively costly and risky for lenders to reach.

less of the credit subsidy but paying essentially the same transaction costs, were the first to be rationed out by rising transaction costs. Larger borrowers still benefited on balance because of their larger interest subsidies relative to their transaction costs, and hence continued demanding this credit. In short, economic incentives could explain the failure of subsidized credit to reach the intended small farmer beneficiaries, without recourse to the alternative political explanation that personal connections of larger borrowers largely determined the allocation of subsidized credit.⁴

Fungibility. Cheap agricultural credit was also supposed to promote agricultural output, but this failure can likewise be explained by economic incentives. What makes money, and hence credit in monetary terms, so attractive is that it is completely fungible and can readily be spent for whatever the holder would like to acquire.⁵ Recipients of loans could spend the fungible proceeds on whatever was most attractive to them, which was not necessarily increasing agricultural production as government officials and international development agencies had planned. Recognizing the importance of multiple (often nonagricultural) activities of a typical farm family is a key aspect of the new rural financial approach. From this perspective, it is easy to understand how loan proceeds to increase rice production could easily end up being spent on children's education or a truck or even a taxi to be employed by a family member living in the city. Moreover, the targeting of credit to agricultural production is extremely difficult to monitor and control. Suppose credit for rice production goes to rice farmers who continue to produce rice, but devote no more resources to rice production than before their loans (substitution) and instead spend the additional money on something else. This is extremely difficult to detect and control without intimately monitoring all family activities. If farmers receiving loans intended for rice

Larger borrowers still benefited on balance because of their larger interest subsidies relative to their transaction costs, and hence continued demanding this credit.

⁴ For a seminal empirical study on transactions costs in rural finance, see Carlos E. Cuevas and Douglas H. Graham, "Agricultural Lending Costs in Honduras," in *Undermining Rural Development with Cheap Credit*, 1984.

⁵ For the classic study of fungibility in rural finance, see J.D. Von Pischke and Dale Adams, "Fungibility and the Design and Evaluation of Agricultural Credit Projects," *American Journal of Agricultural Economics*, November 1980.

The targeting of credit to agricultural production is extremely difficult to monitor and control.

production do not produce any rice at all (diversion), this is obviously easier to detect but may not necessarily be easier to control because the actions of an inspector will likely be detrimental to both borrowers and lenders and thus create strong incentives for bribes and collusion.⁶

Recognition by advocates of rural finance reform of the key importance of the fungibility of money and credit led to emphasis on a number of corollaries that have been important for developing a new approach to rural finance, among them:

- While finance is more important for resource allocation than the earlier focus on money and inflation recognized, finance can only facilitate and not determine resource allocation⁷
- Farm families, primarily for reasons of diversification against risk, typically engage in a variety of nonagricultural activities and, likewise, the overall rural economy may not even be primarily agricultural⁸
- Prices for agricultural outputs and the policies that determine them (e.g., policies affecting exchange rates) are the key factors in determining what will be produced
- Rural infrastructure such as roads, availability of social services such as health and education, and, recently of increasing importance, access to telecommunications also affect the returns to agriculture, as well as to rural off-farm economic activities.

Informal Finance. In addition, recognizing the importance of transaction costs led to greater appreciation of the value of

⁶ In addition to the costs of more inspectors, often including inspectors to inspect the inspectors, governments and development agencies often instituted other mechanisms to contravene fungibility such as providing credit in the form of inputs (e.g., seeds and fertilizer). This not only tended to raise costs for lenders and especially for borrowers who might not find the seed and fertilizer package optimal for them, but also involved the dubious assumption that governments and development agencies know more about agricultural production than the farmers themselves (cf., the performance of agriculture in most centrally planned economies).

⁷ See Richard L. Meyer and Geetha Nagarajan, *Rural Financial Markets in Asia: Policies, Paradigms, and Performance*, Asian Development Bank, 2000 for an excellent concise statement that finance does not create economic opportunities but rather facilitates their exploitation.

⁸ Among the many papers by Carl Liedholm and his associates at Michigan State University showing the major role of nonfarm activities in rural areas, see Peter Kilby, Carl E. Liedholm, and Richard L. Meyer, "Working Capital and Nonfarm Rural Enterprises," in *Undermining Rural Development with Cheap Credit*, 1984.

informal unregulated finance and, in some minds, replaced the image of monopolistic moneylenders exploiting ignorant farmers with a view that borrowers choose credit sources rationally based on total cost (i.e., both interest and transaction costs) and not just on interest rates. Furthermore, informal finance was seen to include not only moneylenders but also agricultural traders and processors and rotating savings and credit associations (ROSCAs), among others. Moreover, the demand for savings services implicit in the use of ROSCAs highlighted the importance of financial services beyond just credit. This observation led to further recognition that savings (deposit services) had been forgotten in rural finance because of the incentives implicit in subsidized agricultural credit to neglect deposit mobilization to the extent that funds provided for subsidized credit were themselves subsidized.

Bankrupt Agricultural Development Banks. Another important lesson from the traditional agricultural credit approach was that the costs of administering subsidized credit programs typically proved very high, while loan repayment rates were usually very low, leading to bankruptcy and the need for recapitalization of the institutions involved, most often government-owned agricultural development banks. Given these findings, international development agencies began to withdraw their funding for traditional agricultural credit programs and, with governments unwilling or unable to provide continuing support, pressure mounted for agricultural development banks and similar institutions to be liquidated if they could not quickly be reformed. Analyzing the experiences with government-owned agricultural development banks in a number of countries has shown that, while rehabilitating such banks successfully is very difficult, liquidating them has often left a major “institutional gap” in rural areas as these banks had driven out private sector competitors.⁹

Another important lesson from the traditional agricultural credit approach was that the costs of administering subsidized credit programs typically proved very high, while loan repayment rates were usually very low.

⁹ Dale W Adams, Juan Jose Marthans, and Robert C. Vogel, “Approaches to Rehabilitating Insolvent Government-Owned Banks: Costs and Benefits of Liquidating an Agricultural Bank in Peru,” *Harvard Institute for International Development*, 1997. In Asia, the Unit Desas of Indonesia’s BRI show how infrastructure put in place for a government-owned bank to deliver subsidized credit to the agricultural sector can, after reform, be utilized to deliver highly effective and efficient microfinance services, including deposit services as well as loans. Moreover, in a subsequent chapter in this book, the even more dramatic turnaround of Mongolia’s Agricultural Bank (now known as Xaan Bank) is highlighted.

Unsubsidized private entities were typically unable to compete with subsidized interest rates. More importantly, however, subsidized credit often came to be seen as a political favor, not needing to be repaid, thereby “polluting” the market with a culture of nonrepayment that private institutions seeking sustainability found difficult to overcome.

Lessons from Microfinance: Some Learned, but Others Not

The decline in international development support for traditional agricultural credit projects was paralleled by a later shift in emphasis toward microfinance, seen as having major potential for poverty alleviation. Successful microfinance programs were first analyzed systematically in the mid-1990s in a study commissioned by the United States Agency for International Development (USAID), with a main conclusion being that microfinance could be profitable and hence viable in the long run.¹⁰ Sustainability, together with outreach to the poor, thus became a realizable goal. Findings in the USAID study emphasized how lessons from informal finance had been incorporated by successful pioneers in microfinance, especially that high interest rates were not a barrier to borrowers of small amounts for short periods so long as transaction costs were kept low.¹¹ In Asia and the Pacific, a later ADB study found a variety of approaches to microfinance, reflecting the fact that microfinance has evolved differently in different environments.¹² Moreover, these approaches are not static as new variants have emerged that incorporate features not found earlier (e.g., voluntary savings scheme, no group guarantee). Despite differences, some common elements for success emerge:

¹⁰ Robert Peck Christen, Elisabeth Rhyne and Robert C. Vogel, *Maximizing the Outreach of Microenterprise Finance: An Analysis of Successful Microfinance Programs*, USAID, August 1995.

¹¹ Robert Christen, “Lessons from the Moneylender,” in Dale W. Adams and Delbert A. Fitchett eds., *Informal Finance in Low-Income Countries*, Boulder, Colorado: Westview Press, 1992.

¹² Asian Development Bank, *The Role of Central Banks in Microfinance in Asia and the Pacific*, Manila, 2000. The study covered twelve developing member countries of ADB: Bangladesh, the People’s Republic of China, India, Indonesia, Kyrgyz Republic, Nepal, Pakistan, Papua New Guinea, Philippines, Sri Lanka, Vanuatu, and Viet Nam. For the World Bank’s view of the key elements of microfinance, see Robert Buckley and Robert C. Vogel, *The World Bank and Microenterprise Finance: From Concept to Practice*, Operations Evaluation Department, World Bank, November 1999.

- Successful microfinance institutions (MFIs) know their market
- Lending outlets are located near the client, application procedures are simple, and loans are disbursed quickly
- Interest rates are market-oriented to cover both operational and financial costs, recognizing that the poor are willing to pay for access and convenience.

Nonetheless, of the 10 countries studied, only in Bangladesh and possibly Indonesia had microfinance reached a significant proportion of poor households. In the other 10 countries, outreach and sustainability of microfinance are much lower. Although central banks in most of the countries studied have been active in support of microfinance, these activities have not been successful in the majority of cases for three reasons:

- Most of these activities have been in the form of directed credit schemes and programs channeling funds through licensed banks
- Central bankers typically have limited understanding of the microfinance sector
- Developmental activities of central banks have rarely embodied microfinance best practices.

While successes in microfinance have led international development agencies and governments to reconsider rural finance,¹³ much of microfinance has been urban-based, though with notable exceptions in the densely populated countries of South and East Asia (e.g., BRI's Unit Desas). This predominantly urban base has led some agriculturalists to argue that the relatively long gestation periods of agriculture and the often large funding requirements, in contrast to the short maturities and small amounts typical of microcredit, make successes in microfinance largely irrelevant to rural finance. However, as mentioned above, much of the economic activity in the rural areas is not agricultural production, and even farm families are typically engaged in a number

¹³ Note, for example, the June 2003 rural finance conference held in Washington, sponsored by the United States Agency for International Development (USAID) and implemented by the World Council of Credit Unions (WOCCU).

By the 1990s, most international development agencies had come to understand the highly negative effects of controls to keep interest rates below market levels and thus assisted Central Asian policy makers in largely avoiding these earlier mistakes.

of economic activities that extend well beyond the farm. Nonetheless, it is also important to recognize that simply replicating urban microfinance by dealing with market vendors in small towns is in no way an adequate approach to rural finance and will likely inspire efforts to re-institute various aspects of the traditional agriculture credit approach under new guises.

Interest Rates. As mentioned earlier in this chapter, an important characteristic of microfinance is that it evolved largely in the informal unregulated sector, in part because its clients, microentrepreneurs, were also in the informal sector.¹⁴ However, most MFIs were also informal to escape the problems of regulation, especially the controls over interest rates that were so prevalent in most developing countries before the onset of financial sector reform. By the 1990s, most international development agencies had come to understand the highly negative effects of controls to keep interest rates below market levels and thus assisted Central Asian policy makers in largely avoiding these earlier mistakes. Notwithstanding sporadic attempts to subsidize interest rates in microfinance, the avoidance of interest rate controls helps explain the relatively rapid introduction of viable microfinance into several Central Asian countries. Nonetheless, a major barrier impeding the entry of large and highly visible commercial banks into microfinance can be the threat of populist attacks on high interest rates, in spite of the acceptability of such interest rates to small-scale borrowers so long as they are coupled with low transaction costs. Furthermore, interest rate controls are not the only cost involved in becoming a formal financial institution and thus being regulated, as discussed in detail below.¹⁵

Deposit Mobilization. Microfinance has nonetheless not learned all the lessons that it might have from the shortcomings of

¹⁴ While microentrepreneurs are typically not registered or licensed in any way, microfinance institutions (MFIs) are often registered as nonprofit or commercial enterprises but not as financial institutions that would be regulated by the central bank or other supervisory agency for financial institutions.

¹⁵ It is also worth noting that most MFIs have also avoided “formality” by developing lending techniques that do not rely on the formal legal system for loan collection, but instead use effective alternative incentives to promote timely loan repayment (e.g., the promise of ready access to a new larger loan if the current loan is repaid promptly).

the agricultural credit approach. The agricultural credit approach has been harshly criticized for its neglect of deposit mobilization—and not just neglect but the major incentive against deposit mobilization stemming from the use of subsidized funding to support subsidized interest rates for beneficiaries. Indeed, banks that engaged in such agricultural lending (or nowadays in micro- or rural finance) typically depended heavily on subsidized funds from governments or development agencies and consequently neglected deposit mobilization. When subsidized funds were later withdrawn, these banks have often found it difficult to adjust quickly in seeking out other funding sources, including deposits. Because microfinance arose primarily in the informal unregulated sector, deposit mobilization was not a possibility for the typical microfinance nongovernment organization (NGO). Instead, these institutions have been primarily dependent on development funding, sometimes with funds for on-lending at subsidized rates, and often with major technical assistance programs to strengthen selected microfinance NGOs.¹⁶ Today, however, some microfinance NGOs seem to be recognizing the need to mobilize deposits in order to increase outreach and the likelihood of sustainability, not only through capturing more funds but also through providing an important additional service for microclients. The resulting need for microfinance NGOs to formalize themselves and be licensed and regulated and to engage in deposit mobilization has become part of a more extensive debate about whether even MFIs that intend to remain informal and not to take deposits should nonetheless be regulated.

Regulatory Issues. Prudential regulation for all types of MFIs has become a major controversy, with substantial pressure to regulate all such institutions regardless of whether they take deposits from

Notwithstanding sporadic attempts to subsidize interest rates in microfinance, the avoidance of interest rate controls helps explain the relatively rapid introduction of viable microfinance into several Central Asian countries.

¹⁶ There are of course major MFIs that have always been regulated, such as the BRI in Indonesia, whose Unit Desas have reached a point where they mobilize far more in deposits than they lend and serve far more depositors than borrowers. Nonetheless, many microfinance nongovernment organizations (NGOs) that have transformed to a regulated status have had major difficulties with their deposit mobilization activities, even BancoSol in Bolivia, which is seen to be one of the most successful microlenders in Latin America.

Most regulatory agencies recognize that their main responsibility is to guard the stability of the financial system, and perhaps to protect small depositors as well.

the public.¹⁷ While international best practices as followed by most regulatory agencies and enunciated by the Bank for International Settlements in Basle is that institutions that do not take deposits from the public should not be subject to prudential regulation, many development agencies and some MFIs themselves have been seeking such regulation. These development agencies would like to have some other entity responsible for the tasks of monitoring and evaluating the MFIs they are supporting, while some MFIs would like to have the added credibility that regulation can imply. Most regulatory agencies, on the other hand, recognize that their main responsibility is to guard the stability of the financial system, and perhaps to protect small depositors as well, but does not include responsibility for institutions that do not take deposits from the public. Moreover, regulatory agencies often do not have sufficient resources to deal adequately even with banks and other deposit-taking institutions, especially during times of banking crises, without having peripheral responsibilities added.

In addition to the issue of what institutions should be regulated is the major controversy over how such prudential regulation should be implemented. As just mentioned, some of the larger and more aggressive non deposit-taking MFIs have wanted to expand their services and their funding by offering deposit services, but this requires obtaining some type of banking license and being regulated. These MFIs and their supporters often complain that capital requirements are too high and that traditional regulatory agencies do not understand microfinance so that supervision tends to be too harsh as well as misguided. Some MFIs and their supporters even argue that the role of regulatory agencies should be to promote microfinance and not just to regulate it, but the inherent conflict between promotion and regulation is typically reflected in weak supervision and

¹⁷ For a detailed review of this debate, see Robert Peck Christen and Richard Rosenberg, "The Rush to Regulate: Legal Frameworks for Microfinance," CGAP Occasional Paper No. 4, 2000 (condensed version published in the *Journal of Small Enterprise Development*, December 2000), and Robert C. Vogel, "Regulatory and Supervisory Trends in Microbanking: Examining Experiences in the Philippines and in Latin America," *Asia-Pacific Economic Community*, July 2002.

subsequent crisis. Another option that is often promoted is specialized supervision, but this also often means weak supervision and can likely lead to fragmentation in both the regulatory and financial sectors. In financial markets, different types of institutions may be walled off into noncompeting segments, while regulatory agencies lose flexibility in personnel assignments, with the most capable and ambitious staff gravitating toward big banks and away from small institutions that generally deal with microclients.¹⁸

Nonetheless, there are some approaches to resolving these two controversies that could be promising. These approaches, which should be of great interest to rural finance as well as to the microfinance industry, involve two key elements:

- Requiring transparency (e.g., standardized charts of accounts and performance indicators, external audits, and availability of financial statements) for MFIs that do not take deposits rather than subjecting them to costly prudential regulation and supervision
- Moving from traditional compliance-based supervision (e.g., “do’s” and “don’t’s” that lead to risk avoidance) toward a dedicated and thoroughgoing implementation of risk-based supervision for all types of deposit-taking institutions that require regulation, thereby encouraging bankers to identify and manage risks rather than simply avoiding them.

Transparency. When required to supervise non deposit-taking MFIs, regulatory agencies typically complain about the chaotic situation of the financial accounts of these institutions, not to mention the fact that they rarely have adequate external audits. A necessary solution to this problem is to require non deposit-taking MFIs to use essentially the same chart of accounts that is required for banks and other regulated institutions, thereby providing a basis

¹⁸ Ibid.

for standardized performance indicators and external audits and even evaluations by rating agencies.¹⁹

Moreover, with these steps to transparency, there is no need for participation by the regulatory agency, as development agencies and other potential funders of MFIs would then have what they need to do evaluation and monitoring—which should be their own responsibility in the first place as knowledgeable investors (in contrast to small-scale depositors). The key element is that development agencies and other potential funders of MFIs must themselves require such transparency as a precondition for financing.

Risk-Based Supervision. According to its name, the focus of risk-based supervision is on risks, not only identifying and monitoring risks facing individual financial institutions and the overall financial system, but also analyzing the ability of regulated institutions to deal with these risks. As implemented by the Office of the Comptroller of the Currency, the leading bank regulatory agency in the United States and the originator of risk-based supervision, risk profiles are developed for each regulated institution based on nine elements of risk.²⁰ Then, the amount of regulatory resources to be devoted to each institution (e.g., off-site surveillance relative to on-site inspections) can be optimized depending on the institution's risk profile and any changes in it, especially adverse

¹⁹ For applications of this approach, see Felix Riera and Jorge Molina, "Guatemala: Reporte Sobre el Manual Contable," IMCC report for USAID under the AGIL project, August 2002; Felix Riera, "Honduras: Chart of Accounts Report (Phase I and Phase II)," IMCC report for USAID under the PEP project, June and December 2002; Lee Arbuckle, Rescina Bhagwani, Gilberto Llanto, and Maria Piedad Geron, "A Review of the Regulatory Environment for Credit and Deposit-Taking Cooperatives in the Philippines," IMCC report for USAID under the CPIP project, November 1998; and Lee Arbuckle, William Griffin, and Eduardo Jimenez, "Recommendations for the Regulation of Credit and Deposit-Taking Cooperatives in the Philippines," IMCC report for USAID under the CPIP project, February 2000.

²⁰ The six predominant risk factors that are responsible for the overwhelming majority of losses are credit risk, liquidity risk, market risk, operational risk, interest rate risk, and foreign exchange risk. The Office of the Comptroller of the Currency (OCC) also includes legal, reputational, and strategic risks in its approach (inflation risk is reflected in market risk and interest rate risk). In risk-based supervision, the OCC analyzes three dimensions of each risk (size, duration, and the probability of adverse consequences), three ways to minimize the adverse consequences of risk-taking (avoiding, mitigating, and offsetting), and four components of risk management (identifying, measuring, controlling, and monitoring), all of which are used to develop risk profiles for various products and services and for the institution as a whole.

movements relative to similar institutions. Focusing in a uniform way on risks and the ability to manage risks makes risk-based supervision highly flexible while facilitating communication among supervisory staff. In particular, such uniformity with flexibility frees risk-based supervision from the constraints of the traditional approach in which large numbers of loan files are typically reviewed for adequate documentation (e.g., full-fledged financial statements and formal collateral), which is often a highly contentious issue between regulators and MFIs. Instead, risk-based supervision can focus on the adequacy of policies and procedures, their implementation and the systems used for monitoring and control, which are at the heart of an MFI's ability to manage risk.²¹ However, because the "Basle standards" now mandate risk-based supervision, virtually every bank regulatory agency will insist that it is using a risk-based approach, so that micro- and rural financial service providers faced with regulatory controversies must themselves understand the key elements of risk-based supervision.

Focusing in a uniform way on risks and the ability to manage risks makes risk-based supervision highly flexible

Impact Studies. Getting credit to poor borrowers thought to have potentially productive activities was initially the sole purpose of the socially minded developers of microfinance. The subsequent emergence of sustainable microfinance has led to more far-reaching claims, perhaps excessive claims, as to the potential poverty alleviation benefits of microfinance, sometimes resulting in an overriding attention to targeting poor clients and often an accompanying insistence on impact studies to demonstrate that these poor clients are indeed benefiting from their microloans. While targeting poor borrowers is an important element of microfinance, if such targeting imposes substantial additional transaction costs on borrowers, and especially on lenders beyond what lenders consider necessary for client selection, this will necessarily reduce the breadth, if not the depth, of microfinance outreach.²² Even more

²¹ Tom Fitzgerald and Robert C. Vogel, "Moving Toward Risk-Based Supervision in Developing Economies," *Harvard Institute for International Development*, CAER II Discussion Paper No. 66, May 2000.

²² Breadth refers to the number of microclients reached, while depth refers to their level of poverty, generally measured by how low their income is, and with loan size often used as a proxy for depth.

problematic has been the insistence on involving MFIs in data collection for impact studies. Rather than relying on loan repayment as the primary indicator that borrowers have benefited, development agencies have often insisted on various measures of family welfare that require collecting far more information about clients than is necessary for client selection and loan recovery. When supporting particular MFIs, development agencies obviously have the right to place such requirements on these institutions, but they should also recognize that the increases in transaction costs that necessarily result from these requirements inevitably reduce outreach.²³ Given the controversies around the possibility of having meaningful estimates of impact without incurring very substantial data collection costs, development agencies wishing to expand outreach would be well advised to absorb these costs through other (external) means of collecting and analyzing data for impact studies. Rural financial service providers would likewise be well advised to resist support that involves such targeting and impact studies.

A Changing Economic Environment. Before turning to a discussion of new approaches to rural finance, it is only fair to mention that microfinance began to be implemented successfully during a period with a substantially different macrofinancial climate than in the heyday of agricultural credit. For example, in spite of occasional crises, some of which were severe and involved contagion from one country to another, a much greater degree of macrofinancial stability existed worldwide during the 1990s than during the 1970s, especially when measured by the rate of inflation and its volatility.²⁴ In addition, significant progress had been made in financial sector liberalization, especially when measured by the removal of interest rate controls as well as improvements in monetary control mechanisms and the regulatory systems needed to deal with the greater freedom given to financial institutions.

²³ For a more extensive discussion of such impact studies, see Robert C. Vogel, *Measuring the Role of Financial Institutions in Poverty Reduction*, Asian Development Bank, March 2002.

²⁴ Of course, this is not true for Central Asia during the first half of the 1990s when most Central Asian countries suffered several bouts of severe inflation during their initial attempts to move from plan to market.

Indeed, liberalization also extended to a dramatic opening up of international trade, which undoubtedly benefited the agricultural sector in particular, even if agricultural subsidies in developed countries continue to be a highly contentious issue.

New Approaches to Rural Finance: Some Key Elements

The Dimensions of Rural Finance

It is important to be clear about the dimensions of rural finance. First, rural financial services are not just agricultural credit or even credit in general. As first emphasized long ago,²⁵ access to safe and convenient deposit facilities is equally as important as access to credit. Rural finance can also include such other services as money transfers (e.g., both foreign and domestic remittances), insurance, pensions, etc., but the services to be emphasized in the present discussion are deposit facilities and credit. Collecting deposits and making loans are at the heart of financial intermediation. Nonetheless, since rural residents inevitably demand most of the financial services just mentioned, among others, one question that rural financial service providers need to consider is how far they can go in offering these other products and services. While rural credit cooperatives around the world have successfully offered death and disability insurance based on loans and deposits, can they likewise offer health insurance or casualty insurance? Moreover, even in the case of life insurance covering loans and deposits, individual rural credit cooperatives act as agents and not as insurers, as they have neither the expertise nor the capacity to manage or diversify the risks covered. In the case of pensions, these can readily be dealt with like other contractual savings products so long as they are the defined contribution type and not the defined benefit variety. International remittances using the main existing channels

Rural financial services are not just agricultural credit or even credit in general.

²⁵ Robert C. Vogel, "Savings Mobilization: The Forgotten Half of Rural Finance," in *Undermining Rural Development with Cheap Credit*, Westview Press, 1984. See also Stuart Rutherford, *The Poor and their Money*, Oxford University Press, 2000, for one of the most insightful discussions of rural savings.

involve high fees, but to compete requires transaction volumes beyond the reach of most rural financial service providers unless they develop consortia.²⁶ Such views can, of course, be debated, especially given the trend among major banks in developed countries to offer as wide a range of services as possible to earn fees and retain clients.

As already emphasized, rural finance must include financial services for agriculture but not be limited to agriculture. In-depth field studies have shown clearly that agriculture is not the only economic activity in rural areas and may often not even be the primary activity.²⁷ Moreover, data for almost every country show that the percentage of the population that is rural is much higher than agriculture as a percentage of gross domestic product (GDP), and, likewise, higher than the percentage of the labor force engaged in agriculture. While these patterns may be due in part to low productivity in agriculture, they also help to confirm the importance of nonagricultural activities in rural areas. Another major issue to be noted is how to define rural. In some countries, the capital city is the only urban area, while in others several secondary cities may also be considered urban. Furthermore, rural areas can be densely populated, as in much of South and East Asia, thereby allowing important economies of scale, or they can be sparsely populated as in most of Latin America and Central Asia, thereby presenting a greater challenge to potential rural financial service providers. While no definition of rural is universally applicable and significant differences may exist among countries in the definition of rural actually used, discussions of specific countries must be clear as to exactly what is considered rural for analysis and recommendations to be as meaningful as possible.

²⁶ Furthermore, many rural financial service providers fail to understand the potential of remittances, which are far more likely to provide fee income and information about potential new clients and their cash flow patterns than to end up as deposits in the accounts of recipients.

²⁷ Among the many papers by Carl Liedholm and his associates at Michigan State University showing the major role of nonfarm activities in rural areas, see Peter Kilby, Carl E. Liedholm, and Richard L. Meyer, "Working Capital and Nonfarm Rural Enterprises," in *Undermining Rural Development with Cheap Credit*, 1984.

Learning from Informal Finance

Informal finance has played a major role in developing microfinance, as pointed out earlier,²⁸ and informal financial arrangements have likewise played a major role in rural areas in providing the financial services that the formal financial sector does not provide. However, the importance of informal finance is often minimized, perhaps because, being informal, it is largely undocumented or because it is populated in part by unpopular moneylenders and ROSCAs that are often seen to be illegal gambling devices or Ponzi schemes.²⁹ Nonetheless, informal financial arrangements offer at least two important types of lessons:

- The existence of informal arrangements provides evidence of demand for the financial products and services provided
- The arrangements themselves may subsequently be incorporated into the formal financial system.

Some of the specific lessons that can be learned from informal finance are:

- High interest loans from moneylenders can be acceptable if transaction costs are kept low, thereby emphasizing the importance of analyzing transaction costs in the process of developing new financial products and services;
- ROSCAs confirm the demand for deposit services and indicate why such services deserve as much attention as credit access; and
- Agricultural processors, input suppliers, and marketing agents often play major roles in supplying credit to agricultural

²⁸ For one of the earliest papers emphasizing this point, see Robert Christen, "Lessons from the Moneylender," in Dale W. Adams and Delbert A. Fitchett, eds., *Informal Finance in Low-Income Countries*, Boulder, Colorado: Westview Press, 1992.

²⁹ While most central bankers deny that rotating savings and credit associations (ROSCAs), exist in their countries, ROSCAs have even been found in the International Monetary Fund (IMF) in Washington. In fact, as early as the 1970s, the importance of ROSCAs in rural finance and the essential nature of their operations were made clear in a series of path-breaking papers by F.J.A. Bouman; see especially, "Indigenous Savings and Credit Societies in the Third World: A Message," *Savings and Development*, 4, 1977, and "The ROSCA: Financial Technology of an Informal Savings and Credit Institution in Developing Countries," *Savings and Development*, 4, 1979.

Credit channels involving agricultural processors, input suppliers, and marketing agents deserve special attention.

producers and may sometimes have the potential to be linked to the formal system.³⁰

Credit channels involving agricultural processors, input suppliers, and marketing agents deserve special attention, even though they are often disparaged as “monopolistic,” because they nonetheless can be the dominant and preferred sources of financing for agricultural producers even in advanced countries like the United States.³¹ In credit relationships involving marketing channels, it is clear how transaction costs can be especially low because the parties are already in contact with each other and, more specifically, the lender in his role as purchaser from (or seller to) the agricultural producer will already have key information about the cash flows of the borrower and the borrower’s reliability. In addition, efforts to increase the access of agricultural processors, marketing agents, and input suppliers themselves to formal sources of credit can allow more competitors to enter these markets and thereby help break down whatever monopoly positions might exist that exploit small farmers.

Dealing with Remnants of the Agricultural Credit Approach

An important element in implementing the new rural finance approach is to look for any remnants of traditional directed credit programs that focus on providing subsidized credit for agriculture, especially small farmers, through agricultural development banks and other government-owned financial institutions. This is important not only because the traditional agricultural credit approach has failed to produce the desired results, but also because such programs can directly affect the quality and quantity of rural financial services by impeding the entry of sustainable private sector

³⁰ The concept of “value chains” focusing on the value-added aspects of agricultural processing has recently become a major theme in rural development, but often overlooking what is most relevant here: the key role of such relationships in financing agriculture.

³¹ Some estimates suggest that in the United States, credit of this type may account for as much as 50% of credit to agricultural producers.

entities into rural finance. In part, this is due to the difficulties that unsubsidized private sector entities can have in competing with the subsidized interest rates that these traditional programs offer, but even more detrimental in most cases is the “market pollution” that arises from poor loan recovery in traditional programs. Because of the political process that enters into allocating subsidized credit, borrowers often come to feel that they have a right not only to receive such loans but also not to repay them. In achieving and maintaining an environment favorable to sustainable rural finance, support may thus be needed to help reform advocates identify such programs and analyze their impacts, and thereby prepare the way for reforms to continue. This may also include identifying advocacy efforts that may later be required.³²

Because of the political process that enters into allocating subsidized credit, borrowers often come to feel that they have a right not only to receive such loans but also not to repay them.

Approaching Insolvent Government-owned Agricultural Banks

Eliminating government-owned agricultural development banks would appear to be an important part of the reform process, but this should not be done without first taking a close look at the existence of alternative institutions to deliver financial services in rural areas. Looking at some specific cases in Latin America where a substantial portion of government-owned agricultural development banks have been eliminated, liquidating the Peruvian Government’s agricultural bank may have been much more costly than appeared on the surface.³³ Without debating the fiscal impact, that is, whether the costs of liquidation were less than or greater than incurring ongoing losses, many rural areas in Peru were left without formal financial service providers because the Government’s bank had successfully occupied so much of the rural landscape. Moreover, the clamor for cheap agricultural credit never subsided, and the Government continued to support policies to respond to

³² Preparing for advocacy work, such as identifying groups potentially supporting reforms so that they can later be supplied with analytical materials to help overcome vested interests, can be especially important in countries where expertise in rural finance or an understanding of financial markets in general may not be widespread, such as those of Central Asia where emergence from central planning is so recent.

³³ Adams, Marthans, and Vogel, *op.cit.*

these demands (e.g., creating the *cajas rurales*) and ultimately a law was passed to create a new government-owned rural bank.³⁴ In Nicaragua, on the other hand, the Government took great care to sell the branches of its liquidated agricultural bank to private banks, even offering up-front subsidies for taking over branches in towns where no other bank offices existed. In Guatemala, the Government's agricultural development bank was privatized and has become profitable while continuing to expand its network of rural branches, which far exceeds that of any other private bank. In Honduras and Trinidad and Tobago, on the other hand, government-owned agricultural development banks have shrunk to the point that they have become marginal players in the financial sector even in rural areas, and the main question is what in the political environment prevents their liquidation.³⁵

Finding Regulatory Barriers to Rural Finance

In rural areas, travel times and travel-related expenses are potentially major components of transaction costs.

The institutional infrastructure for rural finance is particularly important because, as already emphasized at several points, transaction costs are so important. In rural areas, travel times and travel-related expenses are potentially major components of transaction costs, especially if borrowers have to travel long distances from their towns or villages to find a bank branch, often over difficult terrain. Moreover, the importance of access to deposit services suggests that unregulated lenders alone (even highly efficient and well-intentioned microfinance NGOs located in these isolated areas) cannot fill the gap because they are not permitted to take deposits from the public. In fact, a recent study of the microfinance regulatory environment in Bolivia found that in rural areas, unregulated

³⁴ As already noted, both Indonesia's BRI and Mongolia's Agricultural Bank provide Asian examples of how important the existence of rural infrastructure, albeit created for other (inappropriate) purposes, can be in supporting the rapid deployment of rural financial services, compared to the substantial developmental costs that an urban bank, even one that is highly successful, must incur in penetrating rural areas.

³⁵ Ecuador's Banco Nacional de Fomento would appear to fall in the same category, according to a study carried out in 1998 for the Inter-American Development Bank. See Dale Adams, Phil Fritz, Dennis Sheets, and German Tabares, "Banco Nacional de Fomento: Diagnostico Integral y Posibles Politicas para el Futuro," IMCC report for the Inter-American Development Bank, April 1998. See also Dale W Adams and Robert C. Vogel, "Options for the Agricultural Development Bank and Rural Finance in Trinidad and Tobago," Report for the Inter-American Development Bank, February 2000.

microfinance NGOs heavily predominate over similar but regulated financial service providers.³⁶ More generally, the failure of private banks to populate the rural landscape after a government-owned agricultural development has been liquidated suggests that regulatory barriers may be involved.³⁷ Because the potential volume of business in a small town or village may be quite limited, a bank branch there must have low operating costs to be profitable. However, many countries have created costly regulatory barriers to opening small bank branches in rural areas, albeit inadvertently, through requirements for expensive security systems, standardized hours of operations, and the provision of accounting data to the head office either online or on a daily basis. Such requirements, among others, can make the establishment of small rural bank branches prohibitively expensive. Thus, the regulatory issues already discussed above in detail with respect to microfinance may have even greater importance for rural finance. Indeed, rural financial service providers themselves can often be especially helpful in pinpointing regulatory barriers that may be inhibiting rural finance in subtle ways—regulations that may, moreover, not be the most effective and efficient ways to control the risks that financial institutions face.³⁸

Many countries have created costly regulatory barriers to opening small bank branches in rural areas, albeit inadvertently, through requirements for expensive security systems, standardized hours of operations, and the provision of accounting data to the head office either online or on a daily basis.

Dealing with Some Special Risks in Rural Finance

Risks are an overriding concern in rural finance, with a traditional focus on crop losses and price volatility in agriculture. To ameliorate these potential negative impacts, all-risk crop insurance has often been proposed, especially as part of the traditional agricultural credit approach. However, where such crop insurance has been implemented the costs have typically been extremely high, in part

³⁶ Arelis Gomez, German Tabares, and Robert C. Vogel, "Microfinance, Bank Regulation and Supervision: The Bolivian Case Study," IMCC report for USAID under Microfinance Best Practices project, August 2000.

³⁷ There are, of course, other barriers that appear to have been particularly important in Central Asia, such as the continuing presence in rural areas of large state-owned banks with access to subsidies and potential to pollute the market with a culture of non-repayment, or private bankers' failure to recognize the need for greater attention to cash flow and less to collateral in serving rural clients.

³⁸ The risk-based approach to supervision, emphasized earlier, would likely leave decisions about the characteristics of branches to management and focus on whether management is able to handle the risks involved.

because of the difficulties of administering large numbers of small contracts spread over wide areas, but more often because of problems of adverse selection and moral hazard. Loan guarantee programs have also been a frequent part of the traditional agricultural credit approach to risk and despite highly negative cost/benefit evaluations, many international development agencies continue to support these programs.³⁹ Traditional loan forgiveness programs, although often politically attractive to governments, have even greater negative effects as they introduce “market polluting” expectations of such future bailouts that are highly effective in keeping private financial services providers that seek sustainability out of rural finance.

On the other hand, some recent efforts to deal with risk in rural areas have attempted to avoid the administrative and moral hazard problems of traditional all-risk crop insurance for individual farmers by supporting the development of insurance based on weather conditions. However, data requirements for the actuarial estimates necessary to price such insurance appropriately can be daunting, especially where there are a variety of microclimates. Another more market-based approach has been for development agencies to work directly on risk management arrangements that involve spreading risks across processors and other market intermediaries as well as producers, as suggested by the earlier discussions of informal finance.

Identifying and Managing the Key Risk: Undiversified Local Areas

The foregoing approaches to risk management may nonetheless largely neglect what can be the most crucial risk element for rural finance—the largely undiversified nature of most rural economies. In not dealing with this key feature of most rural settings, the foregoing approaches may fail to ameliorate the main risk facing financial services providers in these areas (e.g., in an area largely devoted to cotton production, a local lender cannot avoid such

³⁹ Robert C. Vogel and Dale W. Adams, “Costs and Benefits of Loan Guarantee Programs,” and Michael Gudger, “Sustainability of Credit Guarantee Systems,” *The Financier: Analyses of Capital and Money Market Transactions*, February/May 1997.

risks by avoiding loans to cotton producers and lending to shopkeepers instead).⁴⁰ For local financial institutions to survive in rural areas in the long run, refinancing mechanisms must exist that can allow financial institutions with limited geographical coverage to manage inevitable local shocks. However, for such refinancing mechanisms to merit support, they must be market-based and demonstrate an ability to select for support only those institutions momentarily needing liquidity but having the specialized knowledge of local conditions that provides the competitive advantage necessary for long-run sustainability. Such localized financial service providers can have a permanent advantage over rural branches of large geographically diversified financial institutions if these larger institutions cannot develop adequate information systems for monitoring and control in order to delegate effective responsibility to local managers. Nonetheless, such decentralization can be possible, as BRI's Unit Desas in Indonesia and Mongolia's Agricultural Bank (now known as Xaan Bank) have demonstrated.

For local financial institutions to survive in rural areas in the long run, refinancing mechanisms must exist that can allow financial institutions with limited geographical coverage to manage inevitable local shocks.

Using Collateral to Overcome Risk

Another approach that many lenders take toward risk management is placing heavy reliance on collateral, with some traditional lenders paying overriding attention to collateral to the neglect of the cash flow and character of potential borrowers. However, using mortgages over land, even where clear titles to land make this feasible, can often involve high transaction costs for both the borrower and the lender. Furthermore, the costs of executing mortgages over land in rural areas can involve not just long delays in the legal process and uncertainty as to the outcome but, even after adjudication, the inability of lenders to take possession of farms in rural areas dominated by tradition in order to sell these farms or even manage them.⁴¹ Furthermore, even where farmland can effectively be

⁴⁰ It is ironic that low-income individuals in rural areas (e.g., small-scale farmers and microentrepreneurs), perhaps because of the essential need to diversify simply to survive, have had greater success in dealing with the lack of diversification in rural economies than have most financial institutions, as discussed in greater detail in the concluding section about the types of financial institutions involved in rural finance.

⁴¹ Even in the United States as recently as the 1980s, during difficult times for agriculture, farmers came together to prevent the effective auctioning of land taken by lenders.

possessed by lenders, there may be no functioning market for rural land due to major inefficiencies in rural land titling or registries or restrictions on land ownership or use, among other factors. It is thus understandable why lenders may insist on urban real estate as collateral, rather than a farm, even for an agricultural loan.

Attitudes toward land in many rural societies have encouraged efforts to improve the functioning of alternative types of collateral such as mortgages over movable (personal) property, including the use of warehouse receipts. However, in spite of thorough studies in a number of countries throughout the world that pinpoint the precise changes that would be required in laws and regulations, plus the improvements in infrastructure (e.g., registries), little headway has been made in implementation. What may be required is involving rural financial service providers in advocacy, as among the primary beneficiaries of such improvements, in order to overcome well-entrenched vested interests. In addition to the nontraditional forms of guarantees widely used in microfinance—and thus tend not to depend on the legal infrastructure—other improvements in the legal infrastructure that could facilitate recourse to leasing, for example, are worthy of support by rural financial service providers. Nonetheless, for large and long-term loans such as those for farm development, the traditional use of land as collateral may be the best option, so that effective reforms in this respect may also need the benefit of advocacy support by rural financial service providers.

For large and long-term loans such as those for farm development, the traditional use of land as collateral may be the best option.

Expanding the Availability of Information for Improved Risk Management

As emphasized at several points, information plays a key role in facilitating access to financial services in rural areas. Even with improvements in the legal and regulatory system to facilitate the use of collateral, circumventing the higher transaction costs that will likely be associated with the use of formal collateral will always be difficult. Moreover, microfinance has functioned well with relatively little reliance on formal collateral, relying instead primarily on information about the cash flow and character of potential

borrowers. However, acquiring information is not costless, as the microfinance loan officer must visit the microentrepreneur to develop at least rudimentary cash flow estimates and to see what the work/home environment reveals about the potential borrower's character. Then to keep these informational costs within bounds, the loan officer may recommend a small loan with a short maturity as the cheapest way to obtain more information about the borrower (i.e., if repayment is timely).

Enhancements in the availability of information can be especially important for expanding access to financial services in general and in rural areas in particular. Consumer lending has benefited greatly when credit bureaus provide information about the outstanding obligations and repayment histories of potential borrowers. This has been spreading to micro- and rural finance, but progress has been slow because of especially difficult challenges in providing adequate coverage. Because of incentives inherent in information sharing, a given lender will not participate unless most other lenders also participate, so that compulsion is usually required at least if rapid progress is desired.⁴² In many countries, regulatory agencies require lenders to provide information about individual loans for supervisory purposes but in some cases, this is limited to larger loans and in others, legal limits exist on sharing this information outside the regulatory agency. Peru provides an example of a country that has overcome these obstacles, as information is required on loans of all sizes from all lenders subject to regulation and is shared with authorized private credit bureaus. Nonetheless, compulsory coverage cannot extend to informal unregulated lenders and other types of creditors such as merchants and public utilities, so that credit bureau information can be seriously incomplete, especially in rural areas and for microlenders. The largest and most aggressive credit bureau has overcome this problem in Lima, Peru, partly through reciprocity requirements (i.e., to obtain information from the credit bureau, it is necessary to be a member and supply

Enhancements in the availability of information can be especially important for expanding access to financial services in general and in rural areas in particular.

⁴² A rural area in Guatemala near Lake Atitlan provides an exception where informal lenders collaborated successfully to form a voluntary credit bureau with broad coverage.

information to the credit bureau or else pay a much higher price for access to information).⁴³ However, this has not been as successful outside of Lima, apparently because of the lack of economies of scale and the higher proportion of informal unregulated lenders.

Expanding the Range of Loan Products for Agriculture

While the lessons from microfinance can help extend the availability of financial services to many segments of the rural sector, it is not always a matter of simple replication.

Without returning to the traditional agricultural credit approach, it is important to recognize that special efforts may be required to supply certain financial products and services that are in particular demand by agricultural producers. While the lessons from microfinance can help extend the availability of financial services to many segments of the rural sector, it is not always a matter of simple replication. As already mentioned, larger loans with longer maturities than are typical of microfinance are often important for farm development. On the other hand, some agricultural experts have insisted that loans to small farmers must conform to the concept of an agricultural cycle, with several months of grace without any repayments of principal or even interest. However, such an approach is “overly agricultural,” neglecting lessons from microfinance that small-scale entrepreneurs, even small farmers, must have effectively diversified to deal with risk to survive. Furthermore, successful microlenders have learned that maintaining continuous close contact with their small borrowers is essential to achieve good loan recovery. In fact, commercial bankers who listened to the advice of these agricultural experts to provide significant grace periods, and consequently experienced serious loan recovery problems, may be a major reason that commercial bankers often view agriculture as excessively risky and thus tend to avoid all rural lending.

⁴³ Usually there is little difficulty having lenders provide “negative lists” (information on bad borrowers), but they are often hesitant to provide information on good borrowers, fearing that such information could fall into the hands of competitors, unless the credit bureau is highly credible.

Some Lessons Learned and Remaining Challenges for Rural Finance

As indicated by the title of this chapter, it is the author's view that rural finance has not yet arrived fully at a new paradigm, although important progress has been made. The remaining challenges, most of which involve regulatory and risk management issues, are discussed after first reviewing briefly some of the main lessons that should have been learned from the failures of the traditional agricultural credit approach and the successes of microfinance in reaching a significant segment of the populations in urban areas and in more densely populated rural areas on a sustainable basis.

Rural finance has not yet arrived fully at a new paradigm, although important progress has been made.

- Deposit services have long been neglected, if not forgotten, especially in rural areas, and this gap cannot be filled unless regulated institutions are present. This implies the need for special attention to the subtle regulatory barriers that can make establishing small bank branches in rural areas prohibitively expensive. It also means that governments and development agencies need to take care not to undercut incentives for deposit mobilization by offering subsidized funds to financial intermediaries. Furthermore, given the difficulties that microfinance NGOs have often encountered in transforming into regulated financial institutions and then achieving success in deposit mobilization, it may be important not to destroy existing infrastructure (e.g., branches of government-owned agricultural banks) without first analyzing all the options.
- Developing transparent information covering rural finance institutions that do not take deposits from the public can circumvent a major controversy stemming from pressure to subject such institutions to prudential regulation and formal supervision. Implementing a standard chart of accounts and developing performance indicators should satisfy the demands of development agencies while also facilitating the access of nonregulated, non deposit-taking institutions to funding on a commercial basis from private lenders and investors. What is

required is a concerted and coordinated effort by development agencies and private funders to require such transparency, and possibly to support it as part of assistance with implementing improved management information systems, which are also crucial for effective risk management.

- Informal finance is likely to be as widespread in rural as in urban areas and may even be more important in rural areas than formal finance, especially in the number of individuals served if not in the amounts involved. Because informal financial activity is not systematically reported, its importance is likely to be significantly underestimated. Furthermore, stories about unscrupulous moneylenders are likely to predominate, rather than the attractiveness of informal finance to users because of its low transaction costs in spite of high interest rates.
- In addition to highlighting the importance of transaction costs, informal finance can provide important specific lessons. For example, ROSCAs show the demand for saving services and illustrate the potential of “bottom-up” member-driven institutions. Agricultural processors, traders, and input suppliers may already be, or can become, a major source of finance for agricultural producers because of transaction cost advantages stemming from intimate knowledge of cash flows and reliability. Rather than being castigated as monopolistic exploiters, they can more usefully be supported by assuring that no special barriers are present to their obtaining financing from banks and other formal sources.
- In lending decisions, character and especially cash flow need to take predominance over collateral. Cash flow and the borrower’s perception of the importance of maintaining a relationship with the lender are the essential ingredients of loan repayment, whereas the process of creating and utilizing collateral (asset-based) guarantees are costly for both the borrower and the lender, and often with uncertain results for the lender.⁴⁴

⁴⁴ In fact, it can be argued that the use of collateral can only be rationalized as a signaling device through which the borrower indicates that he intends to pay and the lender indicates that he intends to collect.

Recognizing the importance of cash flow and character does not, however, easily solve all the problems of rural lending even to microentrepreneurs and small farmers. In microenterprise and small farm finance, cash flow means estimating all the receipts and expenditures of the family and not just the enterprise, while measuring character almost always involves observational visits to the borrower at both the home and the workplace (which, of course, are often the same) as well as conversations with neighbors and with business contacts. While information from credit bureaus can be highly useful, if available, it is difficult to see how the complexities of such a borrower's cash flow and character can be reduced to a credit scoring model, as has been so successful in consumer lending.

- The last lesson for rural finance to be noted here is the need for continuing vigilance to avoid reinstating some of the subtle but nonetheless highly damaging elements of the traditional agricultural credit approach. It is always tempting for governments, and sometimes even for development agencies, to try to overcome the more difficult challenges of rural finance through the “quick fix” of subsidized credit. Not only does this postpone trying to solve the real problem, but it also inevitably drives out sustainable private providers of rural financial services, most obviously through the unfair competition of subsidized interest rates, but more importantly through the “pollution” of loan recovery that arises from the allocation of such subsidies on a nonmarket basis. It must also be recognized that the amounts of subsidized credit that governments and development agencies are willing and able to provide is but a very small fraction of the amount of deposits that can be mobilized for on-lending by private financial institutions seeking sustainability.

Remaining Challenges. Some of the major unmet challenges in rural finance persist because an effective approach is not yet clear, while others may be understood but nonetheless persist because effective approaches are costly and time-consuming to implement.

- Rather than microentrepreneurs or small-scale farmers, the greater challenge facing rural lenders is small- and medium-sized commercial farmers, much like the problems facing small and medium nonfarm enterprise lending in either rural or urban areas. In these cases, the enterprise looms relatively large in the cash flows of the family unit and thus requires detailed analysis (e.g., efficiency of the enterprise, its position in the market, future prospects for the product, etc.). Such analysis is costly, especially relative to the loan sizes typical for such enterprises and so far, there have not been major innovative breakthroughs comparable to those that have enabled microlending. Nonetheless, there is some promise from improved credit bureau databases and from greater attention to personal (movable) property as collateral, including the alternative of leasing where capital equipment is important.
- In promoting rural lending and deposit mobilization, it is likely to be necessary to focus on seemingly innocuous regulatory requirements that raise the costs of establishing small bank branches in isolated rural areas. Given the importance of transaction costs, especially in small-scale and rural finance, having branches near potential borrowers and depositors is clearly a crucial element for serving a rural clientele. However, traditional approaches to regulation are typically compliance-based, with checklists of requirements for opening branches rather than leaving such decisions to management in the case of banks that are clearly solvent and have adequate systems for managing risks. Requiring banks to do feasibility studies for new branches, as well as specifying various security measures such as lighting, dimensions of safes and walls, and numbers of security guards, while also insisting on weekly hours of operation attuned to urban rather than rural areas, and requiring that accounts be closed with the head office at least daily, may do little to control risks but will certainly make opening a small branch prohibitively expensive.
- Support for moving to risk-based supervision may have great potential to enhance rural finance, as well as promoting more prudent banking while also making regulation both more

effective and less costly. Traditional approaches to prudential regulation and supervision are typically compliance-oriented, with long lists of “do’s” and “don’t’s” for bankers. In effect, such an approach casts supervisors as “super bankers” who know how to manage banks better than bankers themselves, while the approach itself is inevitably oriented toward risk avoidance rather than risk management (e.g., favoring the purchase of government and central bank notes rather than lending, especially to clients who appear risky because they lack favored types of collateral). Risk-based supervision instead asks a regulator to focus on the capacity of bank management to identify and manage risks—not on what documentation is in the loan file and how “weighty” the collateral is but rather on what systems are used to identify, manage, and monitor risks, and whether they are effectively in place or just to be found in some seldom-used manuals.

- Lenders in rural areas can be categorized into two types: (1) local entities like rural banks or credit cooperatives; and (2) branches of nationwide entities, which are typically commercial banks. The advantage of a local lender is intimate knowledge of individual borrowers and the local economy but, at the same time, the challenge is diversification (recalling that the local economy is largely undiversified), which is likely to be reflected in difficulties with liquidity management. The local lender must either hold relatively large amounts of low-return liquid assets (thus reducing rural lending) or have a reliable source of liquidity for the time when some local disaster strikes (diversification through lending in other locations is not a viable option because of comparative disadvantage in trying to compete elsewhere). For external liquidity, there are normally three options: (1) the central bank as a lender of last resort, but central bankers typically see liquidity problems as a prelude to insolvency and impose draconian conditions; (2) apex institutions such as credit cooperative federations, but these are typically unable to make arms’ length assessments of the situation; and (3) development agencies, but these typically offer traditional credit lines for loan rediscounting and do not

provide liquidity management support of the type required. Governments and development agencies may thus want to consider creating or supporting institutions that appear to be taking an effective approach to helping local rural lenders with liquidity management, especially during times of local crises.

- It would thus seem that nationwide financial institutions, typically commercial banks, should have a comparative advantage in local lending, at least with respect to portfolio diversification that avoids liquidity problems in times of local crises. However, it appears that most nationwide commercial banks do not have the expertise to comprehend these local markets or to delegate effectively to their rural branch offices. While some banks may provide branch office officials with adequate lending limits, they rarely delegate effectively (e.g., they rarely offer incentive payments for good performance and may have unrealistic collateral requirements). At the same time, these banks may not have fully adequate financial control and internal audit systems to accompany the delegation of responsibility to branch offices. Many commercial banks, even large ones with nationwide coverage, could thus benefit from technical assistance programs to enhance internal audit and financial control systems and to show how successful MFIs have implemented systems for effective delegation of responsibility, both of which are key elements in sustainable rural, as well as micro, lending.

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Chapter 2

Rural Finance in Central Asia: Emergence and Challenges

Mario B. Lamberte and Robert C. Vogel

I. INTRODUCTION

A. General Background

The six countries under study vary considerably in terms of land area and population size (Table 1). The largest country in terms of land area is Kazakhstan, followed by Mongolia, while Azerbaijan has the smallest land area. In terms of population size, Uzbekistan ranks first, followed by Kazakhstan. Mongolia has the smallest population size.

Azerbaijan is the most densely populated among the six countries, with 95 persons per square kilometer (km²). The least densely populated is Mongolia with only 1.5 persons/km², followed by Kazakhstan with 5 persons/km². These countries have considerably lower population densities compared to other Asian countries.¹

The share of rural population in the six transition economies has remained large. In Azerbaijan, fewer people live in rural areas than in urban areas. However, the rural population has been growing much faster than the urban population over the last decade. As a

¹ Population densities per square kilometer for some countries in South and Southeast Asia are: Bangladesh – 916; India – 330; Indonesia – 114; Pakistan – 187; Philippines – 276; and Viet Nam – 249.

Table 1. Basic Background Information

Country	Land Area (In thousand km ²)	Population (In million persons)	Density Ratio (No. of persons per km ²)	Rural Population (%)	Per Capita Income (\$)
1. Azerbaijan	86.6	8.2 (2003)	95.0	49.0	745 (2002)
2. Kazakhstan	2,717.3	14.9 (2003)	5.0	43.4	1,992 (2003)
3. Kyrgyz Republic	198.5	5.0 (2003)	24.0	65.0	319 (2002)
4. Mongolia	1,564.0	2.5 (2003)	1.5	41.5	442 (2002)
5. Tajikistan	143.0	6.5 (2003)	45.0	73.5	184 (2002)
6. Uzbekistan	477.4	25.7 (2003)	57.0	63.0	312 (2003)

Sources: ADB Key Indicators, 2004; Various country diagnostic studies.

result, the share of the rural population rose from 46% in 1990 to 49% in 2001. Also, the rural population comprises a large majority in 10 of the 12 economic regions. In Kazakhstan, 43.4% of the population is located in rural areas. The relative proportion of rural and urban populations has not changed significantly since 1979. However, with rural areas accounting for over 95% of Kazakhstan's land mass, it is easy to understand the country's low rural population density.

In Mongolia, the rural population comprises 41.5%. People residing in *aimag* centers (provincial capitals) are counted as urban, but out of 21 *aimag* centers, 9 have populations of less than 20,000; 10 have populations from 20,000 to 40,000; and only 2, Erdenet and Darkhan, have populations of 70,600 and 69,000 persons, respectively. Thus, most of the Mongolian population is indeed rural, except for the urban population centers of Ulaanbaatar, Darkhan, and Erdenet. Some 74% of Tajikistan's population is defined as being rural, that is, living outside of cities, towns, and settlements. In the Kyrgyz Republic, 65% of the population lives in rural areas. The distribution between urban and rural population has remained fairly stable for the last 30 years. Uzbekistan's rural population has been growing more rapidly than its urban population due to higher fertility rates. As of 2003, some 63% of the population lived in rural areas, up from 60% in 1996.

Per capita income in current US dollars varies considerably among the six transition economies, with Tajikistan having the lowest at \$184 and Kazakhstan having the highest at \$1,992.

Azerbaijan, Kazakhstan, Kyrgyz Republic, Tajikistan, and Uzbekistan became part of the Soviet Union after the 1917 Revolution. Although not part of the Soviet Union, Mongolia, which became the second socialist republic in the world in 1924, was largely dominated by the Soviet Union. Central planning, state-ownership of property, and collectivization of agriculture were imposed in these countries. All six played a similar role in the centrally planned Soviet economy as suppliers of primary products—such as cotton, energy products, and minerals—to other republics in the Soviet Union. Mongolia also supplied local services to untold numbers of Russian troops stationed along its border with China. Transport, pipeline, and communications facilities supported the trade flows in the centrally planned Soviet economy.

State farms and collective farms that were larger than 1,000 hectares (ha) in size and had dozens or even hundreds of families dominated agricultural production. The government gave them annual production plans that specified the number of hectares to be planted to each crop. Besides being economic entities and providing employment, the farms were units of social organization that supplied housing and met the other needs of their populations. Each family was given a house with an adjacent plot of land for home garden use. Workers were organized into brigades to perform farm work. Salaries were paid to workers, and the farms were also responsible for health, education, and social welfare. The state provided the production inputs and marketed the major crops. In Mongolia, herding collectives adopted the Soviet system where individual households lived in permanent settlements rather than traveling with their herds as in the pastoral tradition. Herding collectives, which concentrated on livestock production, were organized into *brigad* (brigades) and then into *suuri* (bases), composed of several herder households. Each *suuri* had its own equipment and production tasks. Individual members of herding collectives were permitted to own livestock.

Under this agricultural production system, there was little scope in these economies for developing rural nonfarm firms to supply goods and services to farms and to market farm products. This system stymied development of the rural nonfarm sector that

The Soviet Union invested heavily in education in these six transition economies, so that average education levels are much higher in these six countries than in most developing countries with similar levels of per capita income.

thrives in a market economy and creates opportunities for off-farm employment.

It is noteworthy that the Soviet Union invested heavily in education in these six transition economies, so that average education levels are much higher in these six countries than in most developing countries with similar levels of per capita income. This means that strategies to develop the rural economy and rural financial services can count on a higher level of human capital than what exists in many low-income countries. Rural people with more education are likely to be more flexible and able to absorb new ideas and technologies that had never been tried during the Soviet era. With the liberalization of the economies in these countries, better educated people will be quicker to perceive new business opportunities, especially in the nonfarm sector. Given this, investment in short-term training programs can more effectively expose them to new products and technologies and equip them with new skills including simple business accounting systems that can have a large payoff.

B. Political and Economic Changes

The Russian democratic changes of the late 1980s influenced Mongolia and, in 1990, a peaceful democratic revolution changed that country's political system. In 1990, the first democratic general election took place, and Mongolia became a parliamentary republic with a president and a multiparty system. Azerbaijan, Kyrgyz Republic, Tajikistan, and Uzbekistan declared independence in 1991, while Kazakhstan was the last of the Soviet republics to declare independence. After the political reform, these countries started to change their economic system from a centrally planned to a market-based economy. However, the speed and depth of economic reforms have differed among these six countries. Mongolia and the Kyrgyz Republic appear to be the most liberal and rapidly transforming economies and, in fact, the only two among the six countries that became members of the World Trade Organization in the late 1990s. The Kyrgyz Republic was the first Central Asian country to replace the ruble with a national currency. At the other

end of the spectrum is Uzbekistan, which took a more cautious approach in reforming its economy. The Uzbekistan Government delayed large-scale privatization and maintained its marketing monopoly for key agricultural products. It liberalized its foreign exchange market and introduced current account convertibility only in 2002–2003, much later than the other five transition economies.

Like most economies starting from state ownership and central planning, the six countries' road to a private, market-based economy has not been smooth. Because their economies were heavily linked to the Soviet Union, the breakup of the Soviet Union imposed severe negative economic shocks on these countries. Budget transfers from the Central Union budget to the six countries stopped, and inter-republic trade and payments arrangements collapsed.² Some countries were subjected to additional shocks. The war with Armenia over Nagorno-Karabakh and low oil prices contributed to the fall in Azerbaijan's output in the early 1990s. Tajikistan was in a state of civil war from independence until a peace agreement was put in place in 1997. All told, the economies of these transition countries severely contracted in the first half of the 1990s (Table 2). Most severely affected were Tajikistan and Azerbaijan where per capita incomes in purchasing power parity (PPP) terms in 1995 were only 39% and 32%, respectively, of their 1990 levels. Next most severely affected were the Kyrgyz Republic and Kazakhstan where per capita income in PPP terms in 1995 were 49% and 61%, respectively of their 1990 levels. On the other hand, Mongolia and Uzbekistan suffered smaller transitional recessions than the other four countries. Their per capita incomes in PPP terms in 1995 were 79% and 72%, respectively, of their 1990 levels. Uzbekistan's success in reorienting its main exports (cotton and gold) to economies not part of the former Soviet Union and its determination to become self-sufficient in energy and food grains, which it achieved in 1995

Like most economies starting from state ownership and central planning, the six countries' road to a private, market-based economy has not been smooth.

² With its entry into the Council for Mutual Economic Assistance (CMEA) in 1962, Mongolia began to receive substantial agricultural assistance from the Soviet Union and other CMEA member countries. However, following the democratic revolution in the early 1990s, Mongolia's rural economy was hard hit by transition. Crop production, which had depended heavily on machinery and monetary assistance from CMEA, was most negatively affected. Soviet assistance, at its height one third of gross domestic product (GDP), disappeared almost overnight in 1990 and 1991 at the time of the dismantlement of the USSR.

Table 2. Per Capita GDP at PPP
(1990 International Geary-Khamis dollars)

Country	1990	1991	1992	1993	1994	1995	1996
1. Azerbaijan	4,639	4,537	3,463	2,632	2,093	1,832	1,847
2. Kazakhstan	7,319	6,457	6,066	5,503	4,817	4,429	4,468
3. Kyrgyz Republic	3,596	3,253	2,766	2,326	1,869	1,772	1,895
4. Mongolia ¹	1,333	1,182	1,049	1,002	1,010	1,058	1,066
5. Tajikistan	2,979	2,652	1,758	1,451	1,123	967	909
6. Uzbekistan	4,241	4,117	3,578	3,427	3,223	3,071	3,139

¹ The figure for 2002/1990 is based on 2001 per capita GDP at PPP.

Source: Angus Maddison, *The World Economy: Historical Statistics, 2003*.

and 1998, respectively, helped mitigate the negative shocks brought about by the collapse of the Soviet Union. On the other hand, Mongolia's economy, buoyed by the reforms that the new government initiated in the early 1990s, started to recover as early as 1994 while the economies of the other five countries were still contracting.

The economies of the six countries under study started to recover in the second half of the 1990s. In the early 2000s, gross domestic product (GDP) grew on average by 11.8% in Azerbaijan, 10.6% in Kazakhstan, 3.4% in the Kyrgyz Republic, 2.9% in Mongolia, 9.2% in Tajikistan, and 4.2% in Uzbekistan. The soaring international price of oil boosted the economies of Azerbaijan and Kazakhstan. However, despite the strong recovery of the economies of these countries beginning in the second half of the 1990s, their per capita incomes in PPP terms still have not recovered to their 1990 levels. While per capita incomes in PPP terms of Kazakhstan, Mongolia, and Uzbekistan are already close to their 1990 levels, those of Azerbaijan, Kyrgyz Republic, and Tajikistan still have a long way to go.

With the fall in real per capita incomes during the transition period, poverty has become more serious in all six transition economies. Azerbaijan's poverty incidence as of 2001 stood at 49%. Rural poverty incidence fell below the national average at 42%. In the Kyrgyz Republic, 48% of the total population in 2001 was considered poor, and rural areas' poverty incidence was estimated

1997	1998	1999	2000	2001	2002	1995/ 1990	2002/ 1990
1,947	2,136	2,290	2,538	2,758	2,965	0.39	0.64
4,532	4,458	4,586	5,041	5,707	6,159	0.61	0.84
2,076	2,105	2,162	2,250	2,336	2,404	0.49	0.67
1,093	1,115	1,100	1,085	1,070		0.79	0.80
908	938	954	1,012	1,092	1,144	0.32	0.38
3,166	3,250	3,336	3,408	3,505	3,542	0.72	0.84

at 51%. In Mongolia, the 1998 Living Standards Measurement Survey estimated that 35.6% of the population was poor, with 32.6% for the rural population. The survey also showed that poverty was particularly severe in *aimag* centers and other rural towns. According to the Tajikistan Living Standards Survey of 1999, 83% of the population lived below the poverty line, with poverty incidence in most rural areas significantly higher than the national average. In Uzbekistan, the population below the poverty line was estimated at 27.5% in 2003, with rural poverty incidence higher than the national average at 30.5%. Poverty incidence varies greatly across the 14 regions of the country, ranging from a low of 9.2% for Tashkent City to a high of 62.6% for Kashkadarya. Among the six transition economies, Kazakhstan appears to have the lowest poverty incidence, which was estimated to be 19.8% in 2003. However, poverty incidence for the rural population was considerably higher than the national average at 30.5%.

All six transition economies experienced hyperinflation in the first half of the 1990s (Table 3). Although sudden increases in prices of imported raw materials and finished products contributed to rapid increases in domestic prices, macroeconomic mismanagement contributed more. More specifically, the governments in these countries provided highly subsidized loans to favored sectors of the economy, including unprofitable state-owned enterprises (SOEs), and resorted to money creation to finance high budget deficits. There was a further aggravating factor in the case

Table 3. Inflation Rate (%)

Country	1991	1992	1993	1994	1995	1996
1. Azerbaijan						19.9
2. Kazakhstan	79.0	1381.0	1662.0	1876.6	176.2	39.3
3. Kyrgyz Republic	85.8		1081.0	181.0	43.5	32.0
4. Mongolia	40.4	153.8	268.4	87.6	56.8	49.6
5. Tajikistan	112.0	1157.0	2195.0	350.0	609.0	418.3
6. Uzbekistan	82.0	645.0	534.0	1568.0	305.0	54.0

Note: Change in Consumer Price Index.

Sources: ADB Key Indicators 2004; EBRD Transition Update, April 2001; various country diagnostic studies.

The six transition economies quickly recognized the costs of hyperinflation and addressed the problem by applying standard macroeconomic tools. More specifically, they trimmed budget deficits and tightened monetary policy.

of Kazakhstan. A critical aftereffect of the collapse of the Soviet Union was that Kazakhstan remained in the ruble zone and therefore not able to control its own currency for 23 months following independence, as the tenge was not introduced until November 1993. By that time, the highly expansionary monetary policy practiced by the Russian central bank had created hyperinflation in Kazakhstan.

The six transition economies quickly recognized the costs of hyperinflation and addressed the problem by applying standard macroeconomic tools. More specifically, they trimmed budget deficits and tightened monetary policy. However, the six countries moved at different speeds to stabilize their economies. Azerbaijan and Kazakhstan were able to quickly bring down inflation rates to single-digit levels by 1997 and 1998, respectively. Increases in government revenues from oil production supported the application of tight monetary policies in these countries. Mongolia did exceptionally well in containing inflation. Its inflation rate fell to single-digit levels since 1998, except in 2000. Nonetheless, its fiscal deficit has continued to present a significant challenge, although performance has improved greatly from a deficit of over 10% of GDP during most of the 1990s to less than 6% in the years since 2000. At the other end of the spectrum are Tajikistan and Uzbekistan, which have been very slow to stabilize their economies. Although they were able to bring down inflation rates substantially

	1997	1998	1999	2000
	3.7	(0.8)	(8.5)	1.9
	17.4	7.1	8.3	(0.6)
	23.4	10.4	35.9	18.7
	36.6	9.4	7.5	11.8
	88	43.2	27.5	32.9
	58.8	17.9	29.1	24.9

toward the second half of the 1990s, they still posted double-digit inflation rates in the early 2000s. While improvements have been made in fiscal discipline, the problem can still be attributed to poor monetary control in these countries. The Kyrgyz Republic stands in the middle. Its rate of inflation was highly erratic in the 1990s, but has not been a major problem since 2001.

The structure of the economies of the six transition countries has changed considerably during the period 1990–2003 (Table 4). The share of the economies attributed to industry has fallen during this period. The industrial sectors have not recovered from the collapse of the Soviet Union. The exceptions are Azerbaijan and Kazakhstan whose oil sectors have been growing rapidly during this period. In the industrial sectors, output from a growing number of small and medium enterprises (SMEs) has partly replaced lost output from the large SOEs that collapsed following the break-up of the Soviet Union. Meanwhile, the shares of the services sectors have increased substantially. Small, family-owned enterprises, many of which are engaged in trading and food services, have sprouted in these countries. A vibrant services sector is one of the characteristics of a market-based economy. Again with the exception of Azerbaijan and Kazakhstan, agriculture has remained important in the other four countries; in fact, its share in total output has increased in the case of the Kyrgyz Republic and Mongolia.

The structure of the economies of the six transition countries has changed considerably during the period 1990–2003 (Table 4). The share of the economies attributed to industry has fallen during this period.

Table 4 - Structure of Output (% of GDP)¹

Country	1990			2003		
	Agriculture	Industry	Services	Agriculture	Industry	Services
1. Azerbaijan	28.6	32.9	38.6	14.1	53.7	32.2
2. Kazakhstan	41.8	37.0	21.2	7.3	35.6	57.1
3. Kyrgyz Republic	33.6	35.0	31.4	38.7	22.9	38.4
4. Mongolia	15.2	40.6	44.2	20.0	21.5	58.5
5. Tajikistan	27.1	45.4	27.6	24.3	24.0	51.7
6. Uzbekistan	33.1	33.0	34.0	33.2	22.6	44.2

¹ 1992 and 2002 for Tajikistan.

C. The Changing Rural Economy: Farm and Nonfarm Activities

Agriculture remains the major sector in the rural areas of the six transition economies.

However, reforms in agricultural production systems have significantly altered the rural economies of these countries.

Agriculture remains the major sector in the rural areas of the six transition economies. However, reforms in agricultural production systems have significantly altered the rural economies of these countries. The new challenge that rural households face has been the transition to privatized production. Land privatization has been undertaken, albeit this varies in degree and pace among the six transition economies, and privately owned enterprises have been promoted.

In 1995, the Azerbaijanis adopted by referendum a new constitution that permits private land ownership. The following year, the Parliament passed the Land Reform Law, which was implemented through the free distribution of over 1.3 million ha of agricultural land among rural residents who thereby acquired the right to buy and sell their agricultural plots.³ It appears, however, that agricultural land units are small, ranging from 0.3 to 1.1 ha per person. Aside from distributing land, the government also distributed 63,000 pieces of agricultural machinery and tractors; over 4,000 livestock stalls; more than 2,000 stalls for sheep; more than 450,000 heads of cattle; and 1,900 sheep and goats to farmers, according to the labor contribution of each member within the farms. All food processing and service enterprises as well as chemical

³ This comprises 90% of the 1.46 million hectares (ha) of land under the control of about 1,800 collective and state farms.

plants have been privatized. All in all, about 800,000 persons benefited from the distribution of government properties.

With the privatization and distribution of agricultural lands, landowners are now free to choose what to do with their farms. Indeed, there has been a perceptible change in the use of land during 1991–2001, which is an apparent response to changes in the supply and demand for agricultural commodities after central planning was abandoned. More specifically, while the total number of hectares devoted to the production of cotton, tobacco, grapes, fruits and berries, and teas has declined markedly during said period, the number of hectares used to produce grains, potatoes, market garden crops and vegetables has risen significantly.

The Kazakhstan Government instituted its land reform program in 1996. Under this system, the Government granted long-term leases (49 or 99 years) to farmers. Kazakhstan's recently revised Land Code (June 2003) gives Kazakhstani legal entities and individuals the right to own agricultural land, which must be used for agricultural purposes. The Code gives priority in purchasing what is currently state-owned agricultural land to rural residents with experience and knowledge accumulated in working on a specific land plot. Land can be purchased in cash or on 10-year terms; in the latter case, the land can only be used as collateral after 50% of the purchase price has been repaid. The purchase price is set by the local branch of the Agency for Land Resources, based on a methodology that takes into account such factors as location, soil quality, access to water, and others. Buyers also have the option to purchase land at 75% of the stipulated price but are then prevented from selling the land for 10 years. Buyers who wish to rent out their land have to do so at prices established by the Government.

One important characteristic of Kazakhstan's agricultural sector is that small peasant farms and individual households now produce a large proportion of agricultural output. Indeed, data indicate that there has been significant growth of peasant farms in crop production (from 3% in 1995 to 42% in 2002) and growth of individual households in livestock production (from 66% in 1995 to 87% in 2002). It is also noteworthy that individual households

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produce a significant proportion of Kazakhstan's crop output, with the figure reaching 26% in 2002.

The Kyrgyz Republic began the process of privatizing state and collective farms in the early 1990s and completed this process in 1997. Under this program, state enterprises were transformed into stock companies with the subsequent sale of stock to their workers. A law was passed in 1998 allowing private ownership of land. However, the government imposed a 5-year moratorium on the transfer of ownership due to its weak administrative capacity to implement the policy. This moratorium was lifted on 1 September 2001 with the introduction of the Land Code.

Land ownership and land use have limitations under the Code. Foreigners are not allowed to own rural land in the Kyrgyz Republic, but foreign ownership could easily be disguised if rural land could be owned by legal entities rather than by actual persons. Thus, legal entities are not permitted to own rural land in the Kyrgyz Republic, so that rural land taken by banks and similar lenders as a result of foreclosures of mortgages must be sold quickly, under conditions that are complex and can be quite unfavorable. Moreover, the Law on Mortgages states that, in case of default, the sale of mortgaged rural land can be delayed for up to 3 years if natural calamities (e.g., floods or hail) or even a bad harvest caused the default. In addition, only individuals that have been rural residents for at least 2 years can own rural land, and this has been widely interpreted in a narrow way to mean residents of the specific village where the land is located, so that rural land markets, rural land values, and possibilities for collateralization are further limited. There are also restrictions on land use or, more precisely, changes in the use of rural land. While the Land Code states that individuals can freely transfer land and that government bodies cannot interfere with land transfer or land use, these protections do not apply if other provisions of the Land Code are violated. Specific examples include that permission be obtained from a government body to transfer land from agricultural to nonagricultural use or to different uses within agricultural, and that failure to use a plot of rural land for its designated agricultural purpose for a period of 3 years can lead to loss of ownership.

Nonetheless, progress in land reform in the Kyrgyz Republic boosted the agricultural sector's productivity and promoted steady increases in yields for all major crops. By the latter part of the 1990s, over 62,000 new individuals and families were reported to have taken over large state farms and cooperatives, accounting for about 49% of all cropped land by 2000. Yields from such farms were reportedly 20–30% higher and were more focused on producing more profitable cash crops than state and collective farms. As of January 2004, 61.9% of agricultural output was produced by private farms, 31.8% by personal households, and 5% by state and collective farms, while 1.1% was accounted for by agricultural services, and 0.2% by hunting and forestry services.

In Mongolia, where livestock production remains the mainstay of the economy, the government privatized its state and collective farms in the early 1990s and discontinued its aid to farms. Herding has experienced dramatic demographic changes since 1990, accompanying the dramatic increase in livestock production during the 1990s. In 1990, there were 74,710 herder families, with a total of about 25.8 million livestock grazing on about 80 million ha of pastureland. Ten years later, the number of herder households had more than doubled to 191,526 families. One factor that contributed to the increase in herder population and livestock production was the migration of laid-off urban workers to the countryside due to closures of state industries. Although most herders maintained only a subsistence number of livestock, the size of the livestock population nonetheless increased from 25.8 million heads in 1990 to a maximum of 33.6 million heads in 1999. This increase resulted in overgrazed pastures, especially near populated areas, and steadily decreased productivity and profitability of the livestock business, finally culminating in the years of *dzud* (severe winter storms). Consequently, the number of herder households has been decreasing since 2000 and 3 years later was reduced by 20,000, with just 172,412 herder families in 2003. Deteriorated conditions for rural inhabitants resulted in reverse migration to urban areas.

After the dissolution of state cooperatives in 1992, about 95 small companies were formed. These are vegetable companies that were privatized from state farms, each with 50–60 ha. In addition,

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the number of small-scale private farms with 1–3 ha has recently been increasing. However, during the past decade, privatized crop farms have not developed further but have remained simple “wheat-fallow-wheat-fallow farms” with low productivity and generally little profitability. Since transition to a market economy, crop production has gone down dramatically due to the shortage of good quality seed, financial weakness of crop farms, outdated techniques and technology, and lack of managerial skills, together with the impact of bad weather conditions. Compared to 1990, in 2000, total arable land had been reduced by 3.2 times, and wheat and vegetable production declined by 3.7 times and 1.6 times, respectively. With only 142.1 thousand tons of wheat harvested in 2000, production meets only one third of domestic flour demand, with the remaining balance being covered through imports.

In Tajikistan, land reform involves transforming the large state farms (*sovkhoses*) and collective farms (*kolkhozes*) into peasant or *dekhan* farms. Under the Tajikistan Constitution of 6 November 1994, the state retains ownership of the land. Lack of transferable ownership rights reduces farmer incentives to invest and constrains the development of agricultural lending institutions that take land as collateral for loans. Beginning in 1992, land not used by the *sovkhoses/kolkhozes* was set aside into a special land fund, and individuals could apply for it to start their own independent *dekhan* farm. This land remains the property of the state and cannot be bought or sold, but the recipients are granted inheritable land use rights. The local land committee determines the allocation of land, but the head of the local government unit has a strong influence over its membership and decisions. Farmers must pay the costs incurred in land assignment and registration, and these costs have been estimated to range from \$150 to \$250, nearly equal to national GNP per capita.⁴ Theoretically, *dekhan* farmers have complete freedom to manage their farms independently. The state collects taxes from them and can take back the land if it is not used

⁴ This estimate was reported in ULG Northumbrian Ltd., *Agricultural Sector Assessment Project (ASAP) Tajikistan, Draft Final Report*, prepared for ADB and the Tajikistan Ministry of Agriculture, Dushanbe, August 2000. It also contains a description of the procedures required for the application process and outlines several abuses reported in the process of allocating land.

effectively. After the civil war ended in 1997, the Government embarked on a program to speed up the creation of *dekhan* farms, but by this time many *sovkhoses* and *kolkhozes* had fallen into financial crisis. *Sovkhoses/kolkhozes* designated for seed production, livestock breeding, and research would be retained by the state, but all others were to be converted into *dekhan* farms by 2005.

Dekhan farms consist of three different types depending on the way applications for land rights are prepared. First, an individual man or woman can be granted land-use rights. Second, a family consisting of husband, wife, and other family members can be granted land rights. Third, two or more families and/or individuals can be granted land in a type of partnership that does not need to be a legal entity and can be treated as an NGO. However, this creates uncertainty about the legal status and limitations about the type of economic activities that can be legally undertaken in the name of the partnership. Moreover, *dekhan* farmers can choose to operate their farms as collectives and associations. Therefore, on the ground, land privatization and the creation of *dekhan* farms can involve the actual breakup of large farms into smaller farming units or the large farm operations can be continued mostly unchanged with the farmers thinking of themselves largely as employees.

The production of major crops has varied widely since the 1990s. The total production of cotton, potatoes, grapes, barley, and maize in 1995 amounted to only about half the level of 1990. The production of cotton, barley, maize, and grapes still has not fully recovered, while the production of wheat, potatoes, and rice now exceeds earlier levels. These production patterns suggest that some shifts in enterprises have occurred following farm privatization.

The share of livestock production originating from household plots and private farms steadily increased in 1997–2002. The number of livestock slowly increased, while poultry numbers tripled during this period. There have been some productivity increases in both livestock and poultry production. This might be associated with the shift to a greater concentration of production on individual farms where the incentives are greater for improved livestock husbandry.

In Uzbekistan, the privatization of farms has been done gradually over the years. Three major farm types have emerged.

In Uzbekistan, the privatization of farms—that is, transforming state and cooperative farms into private or farmers’ farms through the transfer of use rights—has been done gradually over the years. Three major farm types have emerged, namely *shirkat* farms or farm enterprises, private or farmers’ farms, and *dekhkan farms*. *Shirkat* farms replaced the Soviet era collective and state farms and have an average land size of 1,500 ha. To improve management and monitoring, each *shirkat* farm is organized into smaller production units. Each unit operates a farm as large as 15 ha. Private farms are those leased by the government to farmers for 10–50 years. The size of private farms averages 20 ha. *Dekhkan* farms are household plots whose land-use rights are life-long and can be inherited. The average land size of *dekhkan* farms is 0.17 ha, and no household is allowed to have a *dekhkan* farm exceeding 0.35 ha.

Aside from land size, the three farm types also differ from each other as to the extent of flexibility enjoyed by farmers. *Shirkat* farms, which mainly produce strategic crops, are the least flexible in that farmers have to follow the same centrally planned production quota system applied to collective farms during the Soviet era. Private farms are also subject to the same production quotas since farmers are also engaged in producing strategic crops. However, they have flexibility in the use of inputs including labor. *Dekhkan* farms are the most flexible in that farmers can choose their own crops and decide on the mix of inputs.

As of 2003, the number of private farms had reached 87,500, with a total land area of 2,148 thousand ha and employing 603,011 workers. It should be noted that private farms employ less labor than *shirkat* farms (0.66 workers per ha vs. 0.90 workers per ha).⁵ In terms of production, *shirkat* farms and farm enterprises are large producers of cotton, grains, cereals, and wheat—all of which require substantial land size to be profitable. On the other hand, *dekhkan* farms dominate the production of commodities such as potatoes, vegetables, and fruits, which can be grown profitably in the backyard. They also have the largest shares in the total production of cattle, poultry, milk, and eggs.

⁵ World Bank (2003a).

BOX 1. FROM FARMING TO PROCESSING

In Piskent, Uzbekistan, a farmer has a 20-ha wheat farm, a small plot beside the wheat farm planted to various types of high-value cash crops, a livestock farm behind the wheat farm, and agricultural machinery that he rents out to other farmers whenever he is not using them. He recently acquired land in his hometown and plans to construct an oil processing plant using sunflower and cotton seeds for raw materials. He has already completed the feasibility study and is securing long-term loans from a bank to import the machinery. Another farmer in the same place is into wheat farming and silk production. In addition, he recently bought a rundown livestock farm that used to be operated by a collective farm enterprise. He has a few cows now, but he plans to increase the herd after rehabilitating some of the facilities. He also recently bought an abandoned building just at the outskirts of his hometown and plans to convert it into a cheese processing plant, with milk partly coming from his own livestock farm and partly from other dairy producers in the area.

Source: ADB. 2004. Rural Finance in Uzbekistan, Country Diagnostic Study. December.

Since independence, there have been changes in the mix of agricultural crops and land utilization. Out of the 44,410.3 thousand ha of land, 22,614 thousand ha are allocated for agricultural purposes; 235.5 thousand ha for settlement purposes; 72.3 thousand ha for environment protection, enhancement and recreation purposes; 8,578.3 thousand ha for forests; 822.6 thousand ha for water facilities; and 10,201.5 thousand ha for reserved lands. Whereas during the Soviet era cotton was the single most important crop produced in Uzbekistan, today grains and various types of fruits and vegetables have increasingly become important crops produced in the country.

Although agriculture has remained the mainstay of the rural economies in the six transition economies, rural households are no longer totally dependent on agricultural activities, and even less solely on agricultural production. This fact is commonly missed in most developing economies where development and financing

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programs are biased toward agricultural activities and have long ignored the multiple sources of rural household incomes and the potential for expanding opportunities in nonfarm economic activities. The presence of a large number of rural households with multiple sources of incomes reduces risks in rural lending and makes cash flow-based lending a viable strategy for rural finance, although it does not wipe out the diversification problem facing localized rural lenders, such as credit unions and microfinance institutions (MFIs).

Unfortunately, little comprehensive information is available about the rural nonfarm economy. However, casual observations suggest that the nonagricultural sector in rural areas of the six transition economies in general comprises a *mélange* of retail stores; trade, vehicle, and home appliance repair shops; agro-processing industries; and other industries. The mixture of food processing industries now emerging in rural areas reflects the changing mix of agricultural products since the transition from a centrally planned to a market-based economy.⁶

In Azerbaijan, although 92% of the rural population is engaged in agriculture,⁷ rural households are actually engaged in a variety of economic activities other than agriculture. The phenomenon that rural households have several income providers who are engaged in multiple sources of income and activities seems to be more common in recent years than during the Soviet era. More specifically, results of a survey show that the sample of rural households has on the average 3.2 income providers and that some 79% of them have multiple sources of income. Employment is the second most important source of income for rural households, contributing 27% to total income.

In Kazakhstan, although the proportion of rural economic activity that is not related to agriculture has not been officially quantified, a reasonable working assumption is that non-agricultural rural economic activity is in the range of 10% and consists largely of small retail operations, such as local general stores. Production activity is rare, partly because the local markets are so small and because access to large markets is difficult for transportation reasons.

⁶ The rural areas are dotted with severely underutilized agro-processing plants that used to be the spark plug of the rural economy before the breakup of the USSR.

⁷ World Bank (2003b).

In the Kyrgyz Republic, the share of income from work activities (wages, salaries) in total income in rural areas ranged from 31 to 37%, where selling agricultural products accounted for about 33% of total household income. In Tajikistan, rural nonfarm enterprises are also slowly emerging to service the agricultural sector and the growing populations in towns and villages.

Nonfarm activities abound in Uzbekistan, contributing to the vibrancy of the rural economy. Most of them are carried out by small and microenterprises. Of the 229,600 SMEs operating as of 2003, 84% were located outside Tashkent City and the Tashkent Region. SMEs' shares in industrial production are quite high in Djizhak, Samarqand, Syrdarya, and the Republic of Karakalpakstan. However, it is in the service sector, such as construction work, retail trade, and paid personal services, where SMEs make much larger contributions to the rural economy.

BOX 2. NONFARM BUSINESS FINANCED BY REMITTANCES

Mrs. Huseynova's house is just a few steps away from an Albanian church in Sheki, Azerbaijan, that was built in the 1st century AD. The Norwegian Government provided a grant to rehabilitate the church, which has attracted many tourists in the last 5 years. Her eldest daughter serves as the curator of the church, which has now become one of the country's museums. Her second daughter helps her in her household chores and in the small family business. She has two sons who have been working in the Russian Federation for more than 5 years and regularly remit to her some money for her daily needs, sometimes through informal channels and at other times through Western Union, which charges a hefty fee. When tourism started to boom in Sheki, her two sons sent money to build a second house at the back of their ancestral house to accommodate tourists, especially those who want to spend more time at the Albanian church and other tourist spots around Sheki. Mrs. Huseynova's food and lodging business has been doing well since the completion of the house 2 years ago. However, she cannot accommodate tourists during winter for lack of heating facilities, and because electricity is hardly available at night.

Source: Interview with Mrs. Huseynova (Sheki, 15 November 2003).

II. OVERVIEW OF THE FINANCIAL SYSTEM

The history of modern financial systems in the six transition economies commenced after the breakup of the Soviet Union. The newly independent states including Mongolia shifted from mono banking to two-tiered banking systems by separating the commercial banking system from the supervisory and regulatory agency—the central bank. As discussed elsewhere, central banks in the six transition economies have been given the task of supervising and regulating not only banks but some nonbanking institutions as well.⁸ Subsequent reforms included the privatization of state-owned banks, allowing the entry of new domestic banks and foreign banks, and promoting nonbank financial institutions, such as credit unions, MFIs, leasing companies, finance companies, insurance companies, and pawnshops. However, the depth and speed of financial sector reform vary across the six transition economies, with Mongolia having the most liberalized financial system and Uzbekistan, the least liberalized.

Like most developing economies elsewhere, the financial systems of the six transition economies are heavily bank-based. Capital markets hardly exist at all.

Like most developing economies elsewhere, the financial systems of the six transition economies are heavily bank-based. Capital markets hardly exist at all. However, as discussed below, nonbank financial institutions, such as credit unions and MFIs, have started to play a significant role in rural finance in these six countries.

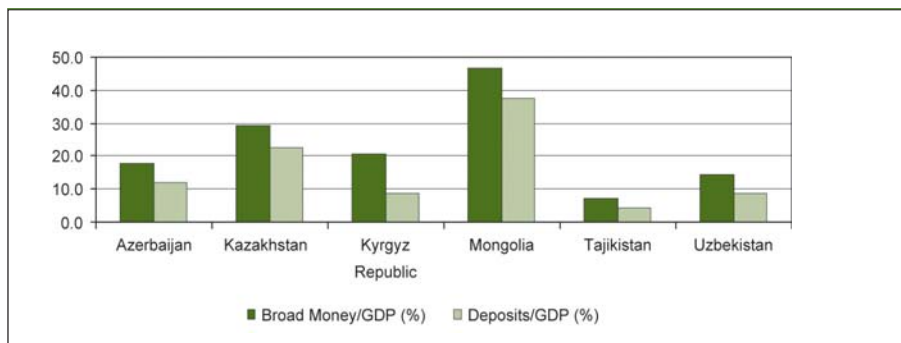
Financial deepening is an important ingredient for a country's sustainable growth. Rough indicators of financial deepening that will be used here are: (1) the ratio of broad money to GDP, which measures the degree of monetization of the economy; and (2) the ratio of deposits to GDP, which measures the extent of deposit

⁸ Kazakhstan has moved a step further, which is in line with recent trends elsewhere, by separating the supervisory and monetary functions of the central bank effective 1 January 2004. The newly created Supervisory Agency for Financial Institutions and Markets (Financial Supervisory Agency or FSA) is responsible for supervising and licensing all deposit-taking organizations, including banks, microfinance institutions (MFIs), credit unions, and Kazakhstanskaya Pochta (the postal service); for licensing and supervising pawnshops; for licensing and supervising insurance companies and for developing and supervising the insurance industry as a whole; for licensing and supervising securities companies and for developing and supervising the securities market as a whole; and for licensing and supervising pension fund managers and for developing and supervising the pension fund industry as a whole.

mobilization carried out by the banking system.⁹ The discussion that follows will first compare the extent of financial deepening among the transition economies as of 2004 and then look at the performance of each country in financial deepening over the last 10 years.

The financial systems of the five transition economies, except that of Mongolia, as of 2004, are still very shallow (Figure 1).¹⁰ Tajikistan lags even behind the rest of the transition economies considered in this study. Its degree of monetization as of 2004 was only 7.1% of GDP, and deposits mobilized by banks comprised only 4.3% of GDP. Uzbekistan's financial system appears to be the second most shallow. The ratio of broad money to GDP was only 14.2%, while the ratio of deposits to GDP was 8.6%. Azerbaijan and the Kyrgyz Republic have similar degrees of monetization at 18% and 21% of GDP, respectively. However, the latter has a much lower degree of deposit mobilization (9% of GDP) than the former (12.2% of GDP). Kazakhstan, which has the highest per capita income among the transition economies, has relatively high degrees of monetization at 29.5% of GDP and deposit mobilization at 22.6%. Mongolia seems to be an outlier among the six transition economies. Although its per capita income in US dollar terms is equivalent to only one fifth of that of Kazakhstan and three fifths of that of

Figure 1. Comparative Performance of Countries in Financial Deepening, 2004



⁹ Deposits of credit unions and MFIs are excluded from this measure.

¹⁰ The statistics here were obtained from the ADB Key Indicators 2004.

The shallowness of Azerbaijan's financial system can be partly attributed to the public's low confidence in the banking system. And there are good reasons for this.

Azerbaijan, the ratio of broad money to GDP appears very high at 46.8%, which is comparable to the countries of Southeast Asia whose modern financial systems have much longer histories than Mongolia.¹¹ The degree of deposit mobilization in Mongolia is also significantly higher at 37.5% of GDP.

The performance of the individual countries in financial deepening over the last 10 years (1995–2004) is shown in Figures 2a to 2f.

Azerbaijan's performance in financial deepening appears to be erratic, albeit some signs of sustained improvement can be observed in the last 2 years (Figure 2a). The shallowness of Azerbaijan's financial system can be partly attributed to the public's low confidence in the banking system. And there are good reasons for this. Still fresh in the minds of Azerbaijanis is the sudden demonetization of Soviet ruble banknotes announced by the Soviet authorities in January 1991.¹² The time given to people to exchange their old notes for new notes at government banks was so short that many people ended up holding worthless notes. During the first few years of Azerbaijan independence, charity funds undertook banking functions, such as deposit taking, offering returns as high as 20% per month. These turned out to be "pyramid schemes," similar to the "pyramid schemes" created in the Russian Federation at about the same time. An estimated 10–20% of the population, mostly coming from the middle class such as workers, doctors, teachers, farmers, etc., participated in these schemes using their life-long savings. In the mid-1990s, the government cracked down on these schemes and jailed their managers. However, most of the money invested in these schemes was never returned to investors. Then, the first independent bank was closed in the mid-1990s and its managers and owners prosecuted. Deposits of foreign and local companies in this bank were frozen and eventually transferred to the International Bank of Azerbaijan. This was followed by the closure of more than a hundred small local banks in 1996–1999.

¹¹ In the Philippines, the ratio of broad money (M4) to GDP is around 50%. It is to be noted, however, that the Philippines has other investment instruments, such as trust accounts in banks, government securities, commercial papers, and listed shares.

¹² This admittedly also affected other Central Asian countries that were in the ruble zone.

One important development in Azerbaijan, particularly since 1995, is the rapidly increasing dollarization of the economy against the background of a stable macroeconomic environment. More specifically, the ratio of foreign currency deposits (FCD) to total deposits rose sharply from 49% in 1995 to 82% in 2003. Likewise, the FCD/M3 ratio increased from 26% to 49% during the same period.

Dollarization could be an ingenious way of diversifying portfolios and reducing risks in an economy where few attractive assets are denominated in local currency.¹³ In this case, dollarization represents a symptom of existing system-wide risks that arise not only from macroeconomic instability but also from institutional factors, such as the poor quality of the contractual environment (i.e., absence of an appropriate legal framework for financial contracts, weak enforcement of contracts including weak judiciary), weak capacity of financial supervisory agencies and lack of competition, and noninstitutional factors such as heavy dependence on one or two commodity exports. In short, dollarization can occur in Azerbaijan even if the economy is relatively stable so long as other factors that affect system-wide risks are not being adequately addressed.

Kazakhstan's financial deepening indicators were low in the second half of the 1990s. Starting in 1999, however, they have risen consistently (Figure 2b). Economic growth and the following three policy initiatives have had important impacts on financial deepening:

- (i) The capital amnesty program of 2001 resulted in the repatriation of \$480 million, which is equivalent to about 13% of year-end 2000 banking sector assets.
- (ii) The three-pillar pension reform program, which established a pay-as-you-go system for those entering the work force after January 1998, brought an estimated initial \$1.2 billion of pension fund assets into the banking sector, including long-term funding that has enabled banks to successfully issue 7–9 year subordinated bonds (total pension fund assets as of year-end 2003 were \$2.6 billion, or about 22.5% of GDP).

Kazakhstan's financial deepening indicators were low in the second half of the 1990s. Starting in 1999, however, they have risen consistently.

¹³ This is the coping mechanism hypothesis (De la Torre and Schmukler 2003).

- (iii) The introduction of deposit insurance in February 2000. As of May 2004, 23 of Kazakhstan's 34 banks were participating in the deposit insurance program and accounted for 98.4% of total retail savings in Kazakhstan. The program covers principal (not interest) losses of about \$2,900 per individual for each failed bank that participates in the program.

In addition to financial deepening, a further indication of increased confidence in the economy is the decrease in dollarization. Kazakhstan has had a highly dollarized economy since the early 1990s, driven by lack of confidence, first in the ruble and then in the tenge. In the early 1990s, foreign currencies (mostly US dollars) were held mainly in the form of cash. Some of these holdings were shifted to deposits later in the 1990s. Indeed, the share of FCDs in total deposits peaked at 64% in 2001, before declining to 45.8% as of February 2004. Exchange rate stability, continuing reforms aimed at modernizing the financial system, prudent macroeconomic management, as well as uncertainty over the future of the dollar, have all contributed to this recent reversal of dollarization.

In the Kyrgyz Republic, the ratio of broad money to GDP had been declining in the second half of the 1990s, but it recovered rapidly in the 2000s, mainly due to a significant rise in currency in circulation (Figure 2c). Despite these recent developments, the Kyrgyz Republic's financial system is still small. The smallness of the system stems largely from low deposit mobilization. The main reason for this does not appear to be lack of confidence in banks (although some banks may, on the other hand, have only limited confidence in depositors, fearing runs), but rather fees and other charges, especially for withdrawing cash, and, in particular, the cost and difficulties of moving funds around, even among branches of the same bank.¹⁴

Mongolia's financial deepening indicators were already relatively high in the mid-1990s compared to those of the other five transition companies (Figure 2d). The ratios of broad money

¹⁴ There are charges of up to 1% for withdrawals, even from sight deposits, especially if the withdrawal is in cash and the deposit was not in cash. Moreover, to move money even from one branch to another of the same bank requires opening an entirely new account at the other branch and then waiting another day or two for the actual transfer.

to GDP and of deposits to GDP rose geometrically in the 2000s, reaching peaks of 48.1% and 37.7% in 2003, although both ratios declined slightly in 2004. During the past 10 years, substantial reforms have been undertaken in the financial sector, including especially major changes in the legal and regulatory framework. The main purpose of these reforms has been to improve public confidence in financial intermediaries, strengthen financial institutions, diversify financial products, lower interest rate spreads, expand the outreach of financial services, enhance transparency, and strengthen enforcement mechanisms aimed at enhancing repayment of loans.

The monetization of the economy and deposit mobilization not only lag in Tajikistan compared to the other five transition economies, but they also appear to have deteriorated since 1995, with no signs of sustained improvement in recent years (Figure 2e). There is a well-grounded fear among the populace about keeping funds in local currency. Since independence, the savings of the public were twice virtually wiped out by surprise devaluations, once when the Russian ruble was converted into the Tajikistan ruble and later when the Tajikistan ruble was converted into the somoni. The ratio of currency outside banks relative to deposits rose from 2.7 to 6.8 between 1996 and 1999. Also, the composition of deposits moved in favor of foreign currency. Whereas in 1996 foreign deposits were only 70% of the amount of domestic deposits, they were 260% by 1999. In addition to foreign currency deposits in banks, massive amounts of foreign currency are thought to circulate outside banks.

Like Tajikistan's, Uzbekistan's monetization of the economy and deposit mobilization also lag behind the other five transition economies. In fact, they deteriorated from 1996 until 2004 when a mild recovery occurred (Figure 2f). The inability of the financial system to perform its intermediation function can be attributed to several factors. First, hyperinflation in the early 1990s eroded the value of the newly created soum, making it one of the weaker currencies among the transition economies in Central Asia.¹⁵

The monetization of the economy and deposit mobilization not only lag in Tajikistan compared to the other five transition economies, but they also appear to have deteriorated since 1995.

¹⁵ After being expelled from the ruble zone in late 1993, Uzbekistan issued an interim soum coupon in November 1993. The permanent currency unit, the soum, was issued in the third quarter of 1994.

The Central Bank of Uzbekistan (CBU) lent cheap funds to banks. With these cheap funds, banks were not motivated to offer attractive deposit rates to depositors.

Second, the gradualist reform strategy, which worked well in the early 1990s in minimizing the transition cost to the economy, became a stumbling block to more rapid growth of the economy by the mid-1990s. This strategy, which included postponing macroeconomic and structural reforms, has created more distortions in the economy. Exchange rate misalignment was allowed for a long time, thereby encouraging capital flight, discouraging foreign investment and weakening export competitiveness. Moreover, the Central Bank of Uzbekistan (CBU) lent cheap funds to banks. With these cheap funds, banks were not motivated to offer attractive deposit rates to depositors. Thus, deposit rates were well below inflation rates, implying negative real rates. Aside from the negative real deposit rate, there were other factors that discouraged individuals and legal entities from depositing funds with banks. One is that banks are given a significant role in tax collection. Individuals who try to avoid encountering problems with the tax authorities prefer not to deposit their money in banks.¹⁶ This partly explains why many income earners like salaried employees, who are supposed to be important sources of deposits, do not keep deposit accounts with banks. By law, legal entities are required to have a bank account. However, until recently, legal entities were allowed to have only one settlement account to simplify the task of banks in collecting taxes from enterprises that kept accounts with them.¹⁷

The “cash plan” that the CBU used to directly manage liquidity in the system also adversely affected the operations of enterprises and the intermediation function of banks.¹⁸ Legal entities, especially those with high sales turnover and seasonal operations, could not perfectly predict their cash requirements for the following month. Once they deposited their excess funds with their banks, they could be put in a situation where they could not withdraw the amount of funds that they needed for their operations during the month. They could also not respond quickly to emerging

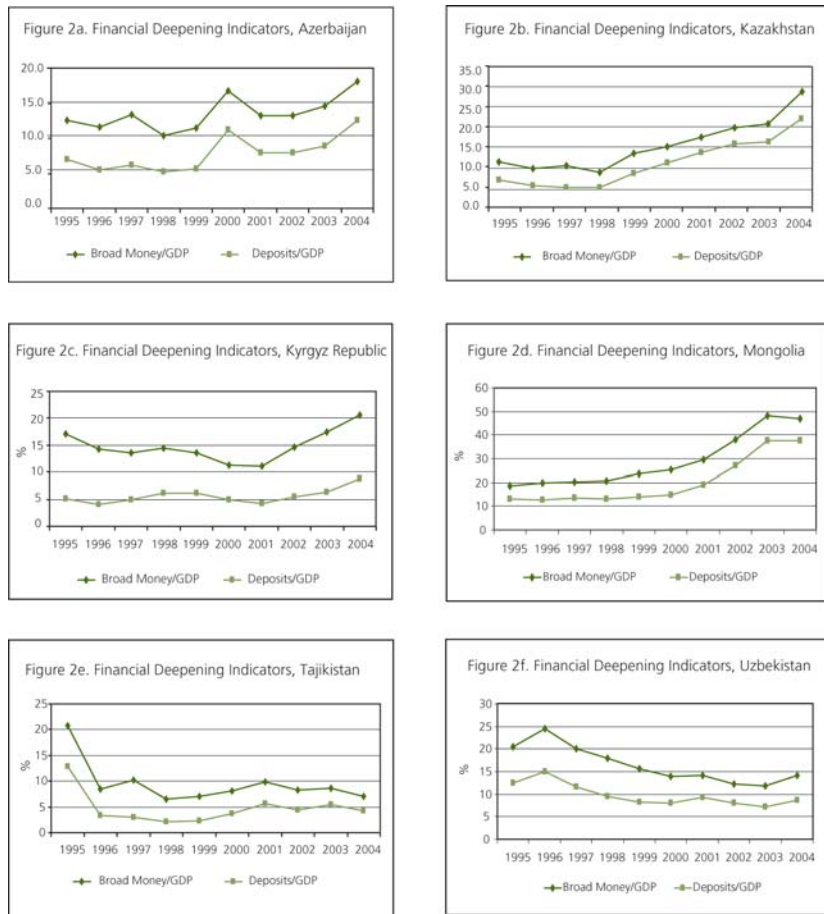
¹⁶ They can, for example, be suspected of conducting unlicensed business.

¹⁷ This had denied legal entities the ability to seek the best services they could obtain from banks.

¹⁸ Under the “cash plan” system, banks were required to develop and submit to the Central Bank of Uzbekistan regular cash flow projections for client accounts. This was replaced by the “cash forecasting” system, which many observers believe is essentially the same as the “cash plan.”

profit opportunities. Indeed, results of a survey of SMEs done by the International Finance Corporation showed that regulatory restrictions on cash withdrawals were one of the most pressing problems that a large proportion of SMEs encountered. Some SMEs tried to circumvent this regulation in various ways, but in the process they incurred unnecessary costs aside from putting themselves at risk of being caught by the authorities. Another means of paying enterprises' obligations was using their suppliers for noncash payments, specifically through bank-to-bank wire transfers, which should not be difficult since all legal entities are required to have

Figure 2. Performance in Financial Deepening by Country, 1995–2004



an account with a bank. However, this limits the ability of enterprises, especially SMEs, to exploit opportunities for minimizing costs by combining cash and noncash payments.

III. INSTITUTIONS INVOLVED IN RURAL FINANCE IN CENTRAL ASIA

A. The Banking Systems in the Six Transition Economies

This section is divided into two subsections. The first subsection discusses the emergence of modern banking systems in the six transition economies after the collapse of the Soviet Union, the problems that banks have encountered during the initial years of transition, and efforts exerted by the governments of the six transition economies to strengthen their banking systems.¹⁹ The second subsection deals with the extent of participation of the banking systems in the rural financial markets of the six transition economies and major issues that have limited their penetration into rural areas.

1. Emergence of the Modern Banking Systems

The banking system has been the dominant subsystem in the financial systems of the six transition economies. Under the existing regulatory frameworks, banks in the six transition economies can offer a full range of banking services.²⁰ In fact, some of them are engaged not only in traditional banking activities but also in nonbanking activities, such as leasing, insurance, etc., either directly or through subsidiaries, depending on the individual country's regulatory framework.²¹ However, the demand is primarily for

¹⁹ A more extensive discussion of financial sector policy and regulatory environments in the six transition economies is presented in a separate section below.

²⁰ A few banks were not authorized to offer some banking services, notably lending, for specified periods. Examples are BUSBank in Azerbaijan and the Settlement and Savings Company in the Kyrgyz Republic, which is technically not a bank.

²¹ Some countries, such as Azerbaijan, Tajikistan, and Uzbekistan, allow universal banking.

traditional banking services: loans (mostly short-term loans), traditional deposit instruments (demand, savings, and time deposits), and payments including foreign and domestic remittances and foreign exchange transactions.

Immediately after independence,²² the six transition economies paid much attention to developing their banking systems. However, such development has not been smooth, as bank failures have punctuated the short history of the modern banking systems of the six transition economies. While external shocks—such as the collapse of the countries' external markets immediately after the breakup of the Soviet Union—have contributed to the failures of several banks in these countries, policy, regulatory, and supervisory weaknesses have contributed even more.

During the initial years of the formation of the two-tiered banking systems in the six transition economies, there was a clear mismatch between the policy makers' efforts to develop modern banking systems and their attitudes toward banks—that is, they continued to regard the newly created state-owned banks as instruments for delivering subsidized loans to favored sectors of the economy. Thus, these banks lent not on the basis of criteria normally used by banks for lending but on the instructions they received from the government. Many of these loans became nonperforming, but the banks continued to carry them on their books for quite some time until the government decided to close some of these banks and to rehabilitate others by absorbing nonperforming loans. In Mongolia, for instance, until 1995 the government continued to direct banks to make new loans to favored enterprises, thwarting efforts to introduce prudent bank lending. A second banking crisis came in 1996, and four more banks were closed. By this time, the public had lost confidence in Mongolian banks, and withdrawals of deposits were widespread. Two government-owned banks were shut down, and more than 50% of total banking system loans were nonperforming at the end of 1996. Various state-owned banks in Azerbaijan, Kazakhstan, Kyrgyz Republic, and Tajikistan encountered similar experiences.

While external shock have contributed to the failures of several banks in these countries, policy, regulatory, and supervisory weaknesses have contributed even more.

²² Relief from Soviet dominance in the case of Mongolia.

Bank entry was liberalized well before regulatory frameworks, including accounting standards, had been put in place and before capacities of supervisory agencies in these countries had been strengthened to deal with new institutions.

Inappropriate sequencing of financial sector liberalization also contributed to the weaknesses of the banking systems in the transition economies. More specifically, bank entry was liberalized well before regulatory frameworks, including accounting standards, had been put in place and before capacities of supervisory agencies in these countries had been strengthened to deal with new institutions. This led to a proliferation of small, poorly managed, and weakly supervised banks. In Azerbaijan, for instance, the number of newly registered and operating banks reached 233 in 1993–1994. Most of these banks had no more than short-term objectives and were engaged in purely speculative operations. The absence of proper prudential regulation and supervision led to chaos in the market. Moreover, banks had an average capital of only \$13,000 and were often being created to finance single companies or projects. In Kazakhstan, the number of banks peaked at 203 in 1993 and, as in the other former Soviet Republics, the National Bank of Kazakhstan found it impossible to assert effective control over institutions created in the chaotic periods both before and after the Soviet Union's collapse.

Recognizing these problems, the six transition economies introduced reforms to improve governance and strengthen the regulatory and supervisory framework for banks. Minimum capital requirements for existing banks were raised over a specified period, and higher minimum capital requirements were imposed on newly registered banks. In Azerbaijan, the National Bank of Azerbaijan (NBA) raised the minimum capital requirement for existing banks from \$50,000 to \$3.5 million over a 5-year period starting in the late 1990s, and for newly opened banks from \$500,000 to \$5 million over a 3-year period. In Kazakhstan, the National Bank of Kazakhstan (NBK) introduced phased-in minimum capital requirements as early as 1993. Presently, the minimum capital requirement for banks is KZT1 billion (about \$7.25 million). The National Bank of Kyrgyz Republic introduced new minimum capital requirements for banks in 2002. In Tajikistan, the minimum capital requirement for existing banks, effective since 1 January 2002, is the equivalent of \$1.5 million, an amount to be gradually increased until it reaches \$3 million in 2006. The minimum requirement for

newly established banks is already the equivalent of \$3 million. The Bank of Mongolia (BoM) gradually raised the minimum capital requirement for banks, which is currently MNT3 billion (about \$2.7 million). In Uzbekistan, the current minimum capital requirements for newly opened banks are as follows: commercial banks established in Tashkent City—equivalent to \$2.5 million; commercial banks established in other regions—equivalent to \$1.25 million; and commercial banks established with foreign capital—equivalent to \$5 million. In addition to the minimum capital requirements, the central banks of the six transition economies introduced financial ratio requirements following Bank for International Settlement (BIS) standards and issued guidelines for banks to follow international accounting standards.

The changes in minimum capital requirements have either drastically reduced the number of banks in the system, as in the case of Azerbaijan and Kazakhstan, or slowed down the proliferation of banks, as in the case of the other transition economies.²³ Presently, the number of banks ranges from 15 to 44, with branches numbering between 152 and 803 (Table 5). The present number of banks in both Azerbaijan and Kazakhstan clearly indicates that there has been a drastic drop since the peak years.

Another important measure that the governments of the six transition economies introduced to strengthen their banking systems was the privatization of state-owned banks. Some of the state-owned banks traced their origins back to the Soviet era, but their functions had been broadened so that they could function as full service banks. Others were created directly after independence by the governments of the six transition economies as specialized banks to provide banking services to certain sectors of the economy. Many of these banks collapsed and were either liquidated, merged with other state-owned banks, or rehabilitated. A few of these banks have been retained by the governments of the six transition economies while the rest have been privatized. As the discussions below will show,

The changes in minimum capital requirements have either drastically reduced the number of banks in the system, as in the case of Azerbaijan and Kazakhstan, or slowed down the proliferation of banks, as in the case of the other transition economies.

²³ Despite this, regulatory forbearance is not uncommon in these countries. In Tajikistan and Azerbaijan, for instance, some banks have not yet met the minimum capital requirements. Kazakhstan and Mongolia appear to be exceptions in that their central banks more effectively enforce banking regulations.

most of these remaining state-owned banks are savings banks that have large branch networks but with limited banking functions.

In terms of privatization of state-owned banks, Uzbekistan appears to lag behind other transition economies (Table 5). The government still has substantial control over five banks, including the largest bank, out of 33. There are plans to privatize them, but the government appears to be slow in implementing the plans. Azerbaijan still retains two banks with privatization of such banks delayed. The other four countries each has at most one remaining state-owned bank.

To strengthen their banking systems, the governments of the six transition economies have also been easing regulations on foreign equity participation in the domestic banking system. However, some have limited foreign equity participation in their domestic banking systems not by percentage of foreign equity participation in any one bank but rather by foreign equity participation in the banking system as a whole.²⁴ In Tajikistan, for instance, the limit put in place has been 35% of consolidated banking system capital. In other countries, the limits on foreign capital participation in the domestic banking system were initially very restrictive, but later on were relaxed. In Azerbaijan, the NBA limited to 30% the aggregate ceiling on foreign capital participation in the banking sector. This ceiling was raised to 50% in 2001 and was finally lifted in 2003. In Kazakhstan, the NBK raised the limit on foreign bank capital in 1998 from 25% of total banking system capital to 50%. Uzbekistan is an exception in that the government allows foreign banks to operate in the country, but only in the form of joint ventures with local investors, with no ceiling on foreign equity participation in a joint venture bank.

As Table 5 shows, foreign banks are present in the domestic banking systems of all these transition economies, with Kazakhstan standing out as having the largest number of wholly owned foreign banks.

²⁴ This effectively limits entry of more foreign banks in the country because the aggregate ceiling can easily be reached by one or two foreign banks, especially since domestic banks have low capitalization.

Table 5. Structure of the Banking Systems of the Six Transition Economies

Country	Total Number of Banks	State-owned	With Foreign Equity	Wholly Foreign Owned	Number of Branches
1. Azerbaijan (2004)	44	2	9	5	350
2. Kazakhstan (2004)	36	1	4	10	354
3. Kyrgyz Republic (2003)	20	1		2	152
4. Mongolia (2003)	17	1	3		635
5. Tajikistan (2003)	15	1	4	1	209
6. Uzbekistan (2004)	33	5	5		803

Notes: (1) Tajikistan - includes 92 banking agencies. These are small offices, often with minimal staffing (just one credit officer and one accountant/auditor) and can carry out all types of operations delegated by the branch to which they report.

(2) Uzbekistan - state-owned banks include two wholly owned banks and three joint stock banks with the Government having controlling interest. The number of branches indicated excludes about 700 mini banks. These are small banking offices with two to three staff who provide banking services to clients but are required to close all accounts at the nearest regular branch at the end of the day. Loans are processed and approved at the regular branch, but are disbursed and collected at mini banks.

(3) Mongolia - includes bank branches and units.

One notable characteristic of the banking systems in the six transition economies is the high degree of banking concentration. In Azerbaijan, despite the presence of 42 privately owned banks, two state-owned banks still dominate the banking system. Together, as of October 2003, they accounted for 58% of total banking assets, 51% of total loans, and 69% of total deposits. However, these shares are lower than 1995 when the state-owned banks controlled 80% of total loans and 77% of total deposits. Furthermore, the number of branches of these two banks constitutes 44% of the total number of bank branches in the country.

In Kazakhstan, three privately owned banks—known collectively as the “Big Three”—accounted for 65.6% of banking sector assets, 67.2% of retail deposits and 71.7% of lending as of year-end 2003. The Big Three also own over 50% of the sector’s 354 branches. It is also noteworthy that concentration in the sector has been on an upward trend.

In Tajikistan, three private banks plus the state savings bank dominate the banking system. Together, they account for about 70% of total deposits and 75% of total loans. In Uzbekistan, a single state-owned bank accounts for 62% of the banking system total

Despite the large numbers of banks currently operating in the six transition economies, only a few have significant involvement in rural finance.

assets, 70% of total loans, and 53% of total deposits. The banking system in the Kyrgyz Republic appears to be the least concentrated among the six transition economies. As of end 2002, the three largest banks jointly held 47.7% of total sector assets, 48.1% of total deposits, 54.5% of total loans, and 38.5% of total equity.

Banking density, which is computed as the number of people per bank branch, can be used as a rough measure of the population's access to banking services. The lower the ratio, the greater is the population's access to banking services. In terms of this measure, Mongolia has bested the other five transition economies with a banking density ratio of 3,937 persons per bank branch,²⁵ which compares favorably with the countries of Southeast Asia²⁶ (Figure 3). Interestingly, as discussed above, Mongolia also ranks first among the six transition economies in deposit mobilization. A distant second to Mongolia is Uzbekistan, with a banking density ratio of 17,299.²⁷ However, its banks appear to be weak in deposit mobilization, as it ranks only fourth among the transition economies in deposit mobilization. Kazakhstan lags behind the rest of the six transition economies in terms of its banking density ratio. However, it ranks second in deposit mobilization as its banks have recently intensified deposit mobilization efforts, especially for retail deposits, to increase their funding base.

2. The Banking Systems and Rural Finance

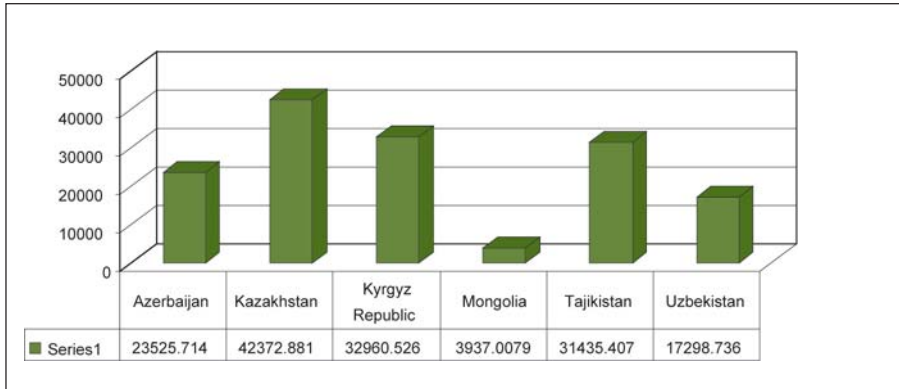
Despite the large numbers of banks currently operating in the six transition economies, only a few have significant involvement in rural finance. While an institutional legacy largely explains the present involvement of some banks in rural finance, for others, commercial interests have involved them in rural finance.

Since almost all bank headquarters in the six transition economies are located in capital cities, branching is an essential

²⁵ This includes bank branches and units.

²⁶ For example, the Philippines' present banking density ratio is 10,892.

²⁷ This measure includes mini banks. Mini banks are small banking offices with two or three staff that provide banking services to clients but are required to close all accounts at the nearest regular branch at the end of the day. Loans are processed and approved at the regular branch, but are disbursed and collected at mini banks. Excluding the mini banks, the banking density ratio is 32,379.

Figure 3. Banking Density: No. of Persons per Bank Branch

strategy for banks to involve themselves in rural finance. The distances involved in rural areas and the barriers to transportation mean that a large portion of the rural population will not have access to bank savings and credit services unless there is ample branching. In the Kyrgyz Republic, only 3 of the 20 banks have large networks of branches, including many in rural areas, accounting for about 70% of total bank branches, with between 75% and 100% of bank branches in five of the seven regions outside of the capital, Bishkek, and about 65% in the other two regions (Issyk-Kul and Osh). Two of the three banks with large branch networks are in private hands but are “descendants” of state-owned banks of the Soviet era, while the third, the Settlement and Savings Company, which was established in 1996 out of the liquidation of two banks with large networks of branch offices, remains in government hands and, strictly speaking under Kyrgyz law, is not a bank as it deals only with deposits and payments and does not in general make loans but rather holds government securities.

In Mongolia, fewer than half of the 17 banks have any significant direct link to the rural/agricultural sector of the economy. Both Xaan Bank and Mongol Post Bank, which are now privately owned banks, inherited branch networks from state-owned predecessors and have built up their branch networks further since privatization. By several orders of magnitude, Xaan Bank has the widest outreach of any financial institution in Mongolia. It has 31

One notable characteristic of the banking systems in the six transition economies is the high degree of banking concentration.

branches in Ulaanbaatar, and a total of 343 banking outlets outside the capital city. It is in every sizeable town and most villages (*soums*). Xaan Bank claims that more than one half of Mongolian households bank with it. Just as impressive is XAC Bank, which started out essentially in 1998 as a merger of NGO microcredit programs, and has set out purposely to devote itself to rural finance. By the end of 2002, XAC Bank was already operating branches in all 21 *aimags*. The only state-owned bank in Mongolia is the Savings Bank, which is governed by the same corporate law and banking laws as the private commercial banks. It was created in 1996 when the People's Bank was broken up. At that time, it was not meant to be a lending bank but rather to offer a safe haven for nervous depositors after the raft of bank failures in the 1990s. Aside from its 32 convenient branches or settlement centers in Ulaanbaatar, the largest network of branches in the capital city, it has seven branches in western *aimags*. Currently, it is no longer restricted to investing in low-risk Government of Mongolia and BoM securities and has now gone into lending to the private sector, starting in December 2002 through the Asian Development Bank (ADB)'s Agricultural Sector Development Program and since then gradually building up a rural loan portfolio.²⁸

Of the 15 banks in Tajikistan, 2 banks appear to have significant involvement in rural finance. Amonatbank, which is a savings bank, is the only remaining wholly government-owned bank, with origins in the Soviet era when it was the fiscal agent of the state. It has an unparalleled outreach into the countryside, with a total of 75 branches and agencies distributed among the five regions of the country. Agroinvestbank also traces its origins back to the Soviet era, and much of its widespread branch network dates to that era. It has 60 branches distributed among five regions of the country and has remained an exclusively rural bank. In Uzbekistan, seven out of 33 banks have significant linkages with the rural/agricultural sector. Two of the largest banks in number of bank branches and mini banks are Pakhta Bank and Khalq Bank. Pakhta

²⁸ At the end of 2002, its loan portfolio was still only about 11% of its total assets, compared to 66% assets in securities.

Bank, a joint stock bank, specializes in cotton financing.²⁹ It has 181 branches and 229 mini banks spread across the 14 regions, and accounts for roughly 70% of the banking system's loans to the agricultural sector. However, its funds for agricultural lending come mainly from the government's centralized advanced payment system for strategic crops, such as cotton. Khalq Bank, which has remained a wholly state-owned savings bank, has 203 branches and 62 mini banks spread across the 14 regions of the country.

Azerbaijan and Kazakhstan differ somewhat from the four transition economies discussed above in their banking systems' outreach into rural areas. In Azerbaijan, the banking system had 350 branches as of 2004, but only 121, or a little over one third, are located in rural areas. Of those branches located in rural areas, 87 belong to two state-owned banks, one of which, the International Bank of Azerbaijan (IBA), does very little agricultural lending while the other, the United Universal Bank (BUSBank), has a limited banking license and has been prohibited from lending for 2 years.³⁰ The 42 privately owned banks have hardly any presence in rural areas. In Kazakhstan, currently no banks specifically serve the rural market in the sense of having branches in rural areas that actively seek to develop business with rural clients, whether businesses or individuals. The absence of such banking activity appears to be driven by commercial considerations because of the relatively low level of economic activity in the rural areas. In fact, the branch network of Nauruz Bank, which is the former state-owned agricultural bank, has shrunk from 202 branches in 1997 to 27 branches as of January 2004. Although Halyk Bank, a state-owned savings bank that was fully privatized in 2001, currently has 112 of its 149 branches located in rural areas, these serve mainly as payment centers³¹ and have only limited lending operations.

Existing branching policies in the six transition economies generally favor the expansion of bank branches into rural areas.

²⁹ A joint stock bank is owned by private and state-owned enterprises with the former as controlling shareholders.

³⁰ The performing assets of the three failed banks, including a savings bank, were transferred to the newly created BUSBank.

³¹ Halyk makes about half of Kazakhstan's pension payments.

Most banks see branching into rural areas as less lucrative than branching into urban areas due to lower population densities, lower per capita incomes, less diverse economic activities, and inadequate physical infrastructure.

However, banks face certain constraints in expanding their branch network into rural areas. First, disincentives to branching, such as tax and capital requirements for branches (discussed in detail below), still remain in at least some countries. Setting up bank branches in rural areas is not simply a brick and mortar issue but, more than anything else, requires a cadre of qualified bank managers who have local knowledge of specific rural areas. A number of bank officers had been laid off due to closures of banks and branches in the six transition economies over the last 5 years. But their skills and experience do not match the requirements of banks operating in market-based economies, where innovations are key to survival. While training can partly address such problems, much of these banking skills need to be acquired through actual practice, an opportunity that most of these countries can hardly offer at this time due to the brief history of their modern banking systems.

In a market-based economy, profitability of branch operations takes precedence over political considerations and the need for a network of funds-dispensing locations, which were the basis for setting up extensive branch network in the six transition economies during the Soviet era. Most banks in the six transition economies now see branching into rural areas as less lucrative than branching into urban areas due to lower population densities, lower per capita incomes, less diverse economic activities and inadequate physical infrastructure. Indeed, many banks that had wide branch networks during the Soviet era have considerably scaled them back,³² while newly organized private banks have tended to confine their operations to capital cities and large urban centers, leaving rural areas with greatly diminished banking services. However, making or maintaining profitable bank branches in rural areas appears to be not an insurmountable constraint, as the Xaan Bank of Mongolia has demonstrated (see Box 3). Indeed, its experience offers important lessons to other banks in transition economies that want to retain or expand their involvement in rural finance.

³² This is true for both state-owned banks that have been privatized and those that have remained in government's hands.

BOX 3. OVERCOMING IMPEDIMENTS TO RURAL FINANCE

Xaan Bank inherited 337 branches from the pre-1991 “mono-bank” system and was heavily loaded with nonperforming state-directed credit. It was a bankrupt bank in the late 1990s, rehabilitated, and eventually privatized in 2003. Instead of closing rural-based branches, bank management opted to retain them and successfully turned them into profit centers by designing simple and attractive loan products that carried such low administrative costs that the smallest branches could be profitable with only a few loan transactions. Substantial autonomy was also delegated to branch staff, with salaries based largely on performance to keep costs low and incentives high. This local autonomy was complemented by a tough internal audit and financial controls team that was equipped with the latest in management information systems and information technology. Xaan Bank has achieved this feat despite the fact that in Mongolia, rural population density is extremely low and rural infrastructure is no better than the rest of the transition economies.

Although agriculture is still the major activity in the rural areas of the six transition economies, available data suggest that lending to agriculture through the banking systems of the six transition economies is very low, ranging from 3 to 12% of total loans (Figure 4). Tajikistan is an exception because a single bank, the Agroinvestbank, has been specializing in cotton production financing. Excluding loans to the cotton sector, the share of agriculture in total lending in Tajikistan is only 11.2%. Lending to the agriculture sector in the six transition economies is considered highly risky due to uncertain weather conditions, highly volatile prices for agricultural commodities, land that has little or no collateral value, and legal impediments associated with the collateralization of moveable assets in rural areas, among other factors.

Focusing on bank loans to the agricultural sector alone may grossly underestimate the involvement of banks in rural finance. First, banks vary in whether they classify lending to the food processing industry as agricultural lending, so that the figures are not strictly comparable from bank to bank and from country to

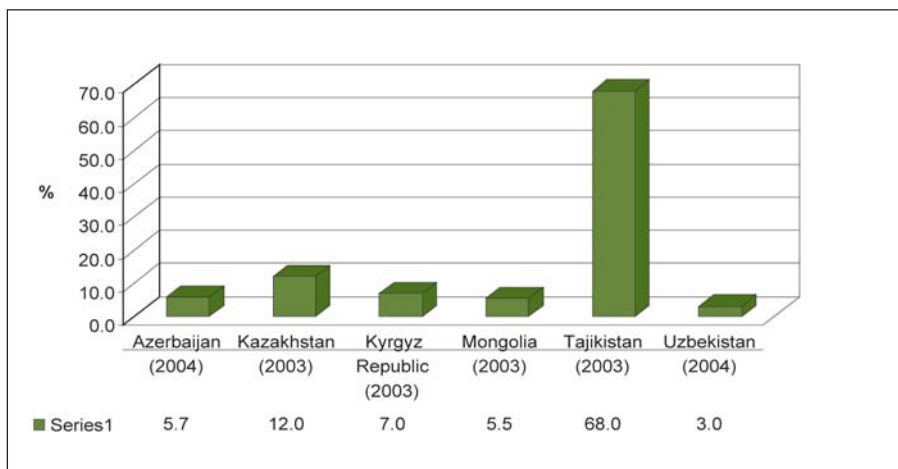
Although agriculture is still the major activity in the rural areas of the six transition economies, lending to agriculture through the banking systems is very low, ranging from 3 to 12% of total loans

Food processors play a significant role in informal rural credit markets, lending to agricultural producers in particular.

country. It is also important to note that food processors play a significant role in informal rural credit markets, lending to agricultural producers in particular.³³ Second, the share of wholesale and retail trade in total bank lending is quite significant. A sizeable proportion of these loans may have gone to rural wholesalers and retailers or to urban-based wholesalers and retailers with linkages to rural households through informal credit markets. As will be discussed below, informal credit markets are quite significant in the six transition economies. Third, some loans are separately classified as loans to households or individuals, and some of these may be based in rural areas.

Deposit mobilization can be key to expanding rural lending by banks. According to findings elsewhere, there are typically at least six depositors for every borrower. Thus, the more rural depositors a bank can serve, the more rural borrowers it can accommodate. Although the absence of interest rate ceilings in the six transition economies should favor deposit mobilization, the amount of deposits mobilized by banks, including those that have large branch networks, is nonetheless typically very low as shown earlier.

Figure 4. Bank Loans to Agriculture (%)



³³ See below for the discussion on informal rural finance.

The restoration of economic stability, acceleration of economic growth in recent years, and the transformation of rural economies brought about by the privatization of agricultural lands and emergence of nonfarm activities suggest increasing potential for banks to expand their involvement in rural finance. To realize this, however, the governments in these transition economies must remove the remaining regulatory impediments to bank branching and deposit mobilization, as discussed elsewhere, while banks need to be more innovative.

B. Nonbank Financial Institutions

1. NGO-MFIs

In most countries there is a wide variety of nonbank financial institutions (NBFIs). But in Central Asia, the main types are finance companies and MFIs, the latter typically supported by international development agencies and usually implemented by nonprofit, nongovernment organizations (NGOs). While Mongolia has a large number of NBFIs, most of them (90) are for-profit finance companies with headquarters in the capital, Ulaanbaatar, and only a few small ones (15) are located elsewhere, although at least six with headquarters in Ulaanbaatar have branches elsewhere. One of these, Credit Mongol, was founded by four local NGOs and has received significant funding from various international development agencies and is devoted exclusively to rural lending (more than 60% of its borrowers are herders). Although the interest rates it charges, ranging from 1.5 to 3.8% per month, should be adequate for sustainability, its costs are quite high due to the extensive training it provides to borrowers. The main constraint facing other Mongolian NBFIs is that they are not permitted to take deposits even though they are supervised by the Central Bank, but some reportedly capture deposits through “captive” credit unions.

In Tajikistan, a significant number of NBFIs of the NGO-MFI variety are said to be operating in rural areas, but little is known in any detail about the operations of most of them because a law governing their operations was passed only in 2003. Nonetheless,

one founded by the National Association of Business Women of Tajikistan has more than 5,000 clients and \$1.4 million in loans outstanding. Moreover, although norms and regulations still need to be developed and implemented, the MFI law recently put in place has the important feature of flexibility, allowing two types of MFIs—those that can take deposits and those that cannot, with both types allowed to carry out a range of financial activities including leasing.

Despite the number of NGOs operating in Uzbekistan, over 60, only a few are involved in microfinance, and these are dominated by international NGOs, with just three NGO-MFIs accounting for more than 90% of the 9,000 active clients and more than 80% of the \$1.2 million in loans outstanding. This limited development can be attributed to the lack of any kind of microfinance law, with only a rather restrictive Cabinet resolution in place that does not clearly define the types of operations or institutions that are permitted. While the apparent focus is on the lending programs of international NGOs, only a limited list of potential participants has been set up, thereby apparently restricting the entry of others.

In Kazakhstan, some 30 private NGO-MFIs have an aggregate loan portfolio of about \$6 million. While many of these follow international best practices, most are still too small to assure viability, and their entrance into rural areas is relatively recent so that their total rural loan portfolio is only around \$2 million. Moreover, while Kazakhstan has an adequate law specifying the regulatory framework for microfinance, the announced intention is not to allow expansion beyond the five MFIs already licensed, with unlicensed MFIs facing various limitations (e.g., limits in loan size and limits in provisioning against problem loans). Furthermore, the government itself is the main provider of microfinance, with one of its agencies, NGO Microcredit, an example of what can happen when international best practices are not followed (e.g., subsidized interest rates and loans based on political connections have led to a collection rate of only 81%). Moreover, just this one government agency, with a loan portfolio of about \$9 million, exceeds that of the entire private MFI sector. Even more problematic is the Government's draft microfinance program that plans a rapid rollout of some \$35 million

for rural microfinance in its first year, without any assurance that adequate lending infrastructure will be in place and with subsidized interest rates on loans that can easily drive out potentially viable private MFIs and promote a culture of nonrepayment.

In both Azerbaijan and the Kyrgyz Republic, NBFIs, largely in the form of NGO-MFIs, play significant roles in rural finance. In the mid-1990s international NGOs began to establish MFIs in Azerbaijan, forming an umbrella entity in 2001, and by the end of 2003 having in total a loan portfolio of more than \$18 million, with more than 30,000 active clients, many in rural areas where these NGO/MFIs have greater penetration than commercial banks. About three quarters of their loans are to solidarity groups of 10–15 members, and the remainder to individuals, with the latter required to provide guarantees in the form of reputable co-signers or physical collateral, but not crops. There is no special legal framework for NGO-MFIs, so they must register as limited liability commercial entities and are thus liable for the normal taxes levied on profit-oriented enterprises. They must also secure a license from the National Bank of Azerbaijan to operate as nonbank credit entities and, as such, they are prohibited from mobilizing deposits even in the form of compensating balances against loans.

The Kyrgyz Republic has a large number of NBFIs, including pawnshops and exchange houses as well as some 70 NGO-MFIs. Of these, however, only three have reached significant size, but these three do operate primarily in rural areas. By far the largest is FINCA, part of a worldwide NGO-MFI network, with its Kyrgyz operations beginning in the mid-1990s and by late 2002 having 21,000 active clients and a loan portfolio of \$6 million. Although FINCA has an extensive network of rural branches and does significant rural lending, little of it is directly for agricultural purposes. To retain successful clients, FINCA recently added larger individual loans to its solidarity group lending, using best practice techniques for both. BaiTushum, the next largest NGO-MFI, is much smaller than FINCA, but it makes substantially larger loans and its main focus is agricultural lending. The oldest NGO-MFI in the Kyrgyz Republic, predating FINCA, is Mercy Corps, which operates as a wholesaler to a network of affiliates, mainly located in

rural areas. However, by far the largest NBFI, and almost certainly the largest lender in rural areas and for agricultural purposes, is the government-owned Kyrgyz Agricultural Finance Company (KAFC). It has been supported by a number of international development agencies, has rural branches throughout the Kyrgyz Republic, and makes loans with up to 4 years maturity and in amounts up to \$10,000 for farms and \$250,000 for processing and trading firms. Although KAFC cannot capture deposits, it is nonetheless regulated by the National Bank of the Kyrgyz Republic, perhaps because the Kyrgyz Government would need to cover losses that it might incur. Currently, one of its development agency supporters is providing technical assistance to help KAFC sort out its major problem—whether it should simply seek a license to capture deposits, become a bank, and/or be privatized.

An array of NBFIs, including NGO-MFIs, can clearly be useful in Central Asian countries to supplement the financial services being offered in rural areas by banks and credit unions, among others. Nonetheless, two important issues should be sorted out in many of these countries: (1) to be clear as to which NBFIs can capture deposits and which cannot, subjecting only those that can take deposits to prudential regulation, but promoting transparency for the others (e.g., by requiring a standard chart of accounts and performance indicators, as well as external audits with the results to be made public); and (2) to be sure that the government is focused on providing the type of infrastructure described above and not on creating its own NBFIs that can drive out private sector competitors with loans at subsidized interest rates and by promoting a culture of nonrepayment.

2. Credit Unions

Although credit unions in many countries have made significant contributions to providing financial services to individuals of modest means, including those in rural areas, the experience thus far in Central Asia has not been particularly positive. Nonetheless, the variety of experiences in the different Central Asian countries, including some recent improvements in performance, can provide several important lessons.

The countries with by far the largest numbers of credit unions, Mongolia and the Kyrgyz Republic, have by no means had the best experiences. In the Kyrgyz Republic, international development agencies supported the creation of an apex institution with oversight responsibilities for the credit union system, together with more than \$6 million for on-lending to credit unions. An explosion in the number of credit unions was the main result, with little evidence of sustainability, especially given their highly leveraged positions. At the same time, the apex institution became bloated with staff and paid little attention to its oversight responsibilities. Nonetheless, there have recently been some positive developments as the National Bank of the Kyrgyz Republic has agreed to take over credit union supervision, one of the international development agencies is providing support for a monitoring system and for deposit mobilization in 10 pilot credit unions, and the apex institution has initiated internal reforms under a new management team.

In some ways, the situation in Mongolia has been even more dramatic. Immediately after the announcement that an international development agency would provide major funding for credit unions, the number of registered credit unions soared to almost 600. The development agency quickly responded by investigating the regulatory situation for credit unions and discovered that, while the credit union law was largely adequate, there was no supervisory agency for credit unions as they were simply required to register with the tax office. To have basic information to develop an effective and efficient regulatory system, a survey of registered credit unions was carried out, but fewer than half of those registered could be even found—in either urban or rural areas. Although the supervisory agency for credit unions has not yet been chosen, the Bank of Mongolia became sufficiently concerned (many of the credit unions surveyed were found to be breaking the credit union law) that it is taking an active role in creating a regulatory framework and in promoting credit union transparency. At the same time, the development agency has changed the focus of its project from providing funds for on-lending to technical assistance for credit unions, including the implementation of a standard chart of accounts and a monitoring system for performance indicators, as well as supporting further development of the regulatory framework.

Both Azerbaijan and Tajikistan have also encountered serious problems in attempting to develop their credit union systems. Efforts of international development agencies in the early 1990s to promote credit unions in Azerbaijan were based on access to cheap credit. Although the number of credit unions organized reached 128, loan defaults were high, so that only 29 of these credit unions with 760 members were able to qualify under the Credit Union Law of 2000 (some had even become pyramid schemes). In spite of this experience, another development agency is currently working to develop 80 credit unions to channel subsidized loans to farmers. While the National Bank of Azerbaijan may be the most appropriate regulatory agency for credit unions, it has taken a highly conservative approach and does not even allow deposits from members, thereby making credit unions permanently dependent on external funds and depriving rural residents of potential deposit services.

In Tajikistan, the situation is even more problematic, as credit unions need only register with the Ministry of Justice, with no regulatory framework, no data required, and no role for the National Bank of Tajikistan. In fact, two of the four credit unions said to exist are banks that were downgraded to credit union status because they could not meet bank capital requirements, but nonetheless retain bank-style ownership and governance. In addition, an international development agency that recently attempted to organize credit unions on farms undergoing privatization failed, in part because credit unions are required to have at least 50 members and cannot take deposits even from members.

Kazakhstan is another country that does not allow credit unions to take deposits, but is even more unusual in that all its credit unions are government-owned (although private ones are permitted, none exist). The Agricultural Credit Corporation of the Ministry of Agriculture has created some 80 credit unions and plans 40 more by 2006. This is clearly inconsistent with the long-standing credit union tradition of self-help through member ownership and governance. Moreover, these credit union members would appear to be relatively well off given loan size and membership requirements, in addition to being attracted by access to low-interest loans.

Uzbekistan's credit unions provide an interesting example of a different approach, where credit unions have originated from member initiative, often from informal rotating savings and credit associations (ROSCAs), such as the highly successful one that the Business Women's Association created. Moreover, they have received support from international development agencies primarily in the form of technical assistance rather than money, a financial performance monitoring system for example. In addition, assistance has been provided to the government in developing the 2002 Credit Union Law and its regulations, which provide a solid basis for credit union development (although there is no appropriate distinction between institutional capital and member shares). In a perverse way, credit union development may also have been facilitated by severe restrictions on banking activity that has left more potential clients and services for credit unions.

Various lessons emerge from these attempts during the post-Soviet period to promote the development of credit unions in Central Asian countries. Perhaps the most important lessons pertain to the appropriate roles for international development agencies and governments. Efforts to build credit unions through external funding or to use them to channel funds to targeted groups or activities will mainly attract rent seekers and are doomed to failure, as should already be clear from earlier experiences around the world in the 1970s and 1980s with the agricultural credit approach to rural financial markets. Rather, governments and development agencies need to face the greater challenge of providing an appropriate regulatory framework, together with technical assistance to help credit unions enhance their capabilities and ultimately reach sustainability within this regulatory framework and within the credit union traditions of self-help. Which agency should best supervise credit unions is a question that can only be answered after knowing the profile of the credit unions within a particular country, but in no case should it be an entity that has promotional objectives or a broad range of responsibilities for all types of cooperatives. Moreover, efforts to build sustainable credit unions must begin with a focus on transparency, initially a standard chart of accounts and performance

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indicators, so that members, regulators, and potential supporters can understand their actual situation.

3. Informal Finance

Worldwide, the perception of informal finance is highly negative—the realm of pawnshops and moneylenders, operating on the edge of the law, charging high interest rates to poor clients and sometimes with the primary objective of seizing whatever few assets these poor people have. However, research in country after country has shown this view to be essentially wrong. While moneylenders like those just mentioned do exist almost everywhere, informal finance is almost always dominated by very different types of financial service providers such as friends and relatives, ROSCAs, and, especially in rural areas and serving agricultural producers are input suppliers selling on credit, and agricultural processors and marketing agents providing advances against crops to be delivered in the future. The traditional negative perception of informal finance was encountered throughout Central Asia, but even the brief surveys carried out under ADB's rural finance project revealed clearly the predominance of the other types of financial service providers in virtually every country. Only in Tajikistan where market systems are just beginning to develop was informal finance not found to be pervasive.

In rural Azerbaijan, informal finance is commonplace, as rural households and enterprises borrow mainly from friends and relatives but also from moneylenders for a variety of purposes, such as to meet emergencies, purchase home appliances, start a business or raise working capital. In fact, moneylenders even advertise in local newspapers. There was also evidence of credit relationships for agricultural inputs, with wholesalers selling on credit to retailers who in turn sold on credit to farmers. Because of a lack of formal financial institutions in rural areas, MFIs have been forced to rely on informal financial arrangements, promoting the formation of ROSCAs that allow participants options for saving in financial form as well as borrowing.

In rural Kazakhstan, there is also moneylending, but the most significant type of informal finance involves credit operations in which agricultural processors not only sell inputs to the farmers with repayment in produce at harvesttime but also provide cash advances. Such arrangements not only provide farmers with access to good quality inputs and a known selling price, in addition to financing, but also help assure processors of adequate supplies of the appropriate quality produce that they need.

More in-depth studies of such informal financial arrangements involving agricultural producers, processors, and input suppliers were carried out in the Kyrgyz Republic, Mongolia, and Uzbekistan. In the Kyrgyz Republic, financing for cotton was found to be especially important in Osh and Jalal-Abad, for sugar beets around Bishkek, and, to a lesser extent throughout the country, for fruits and vegetables to be processed. Processors mainly provide inputs rather than cash, with security typically just a promise to deliver the crop at harvesttime (and with rural land never used as collateral). While implicit interest rates may be high, ongoing relationships keep transaction costs very low and help assure reliability. Processors reported that the main constraint to expanding these relationships was their own limited access to credit. Credit arrangements involving wholesalers, retailers, and producers are so common that there is a specific area in the market in Osh for such transactions, while newspaper advertisements touting credit can be found in Bishkek.

In rural Mongolia, the main products subject to credit relationships are meat and cashmere. Processors (and exporters in the case of cashmere) sometimes make arrangements directly with herders, but dealing through traders is at least as common, especially in more remote areas. Advances to herders may be either in cash or in kind (e.g., flour and rice) for periods as long as 3 or even 6 months. In cases of long-term relationships, which are typical, no collateral is required and often not even a written contract. Parties to contracts, either written or unwritten, also typically agree to adjust prices at the time of delivery if market prices then differ substantially from the prices agreed to earlier. Processors and traders also report obtaining their own financing from banks, although smaller traders

Credit relationships among agricultural producers, processors, and input suppliers may provide a much more efficient way to finance producers than direct lending to producers by formal financial institutions.

may often borrow from processors/exporters or even from larger traders. Meat wholesalers in town markets often have agents who make advances to herders to obtain supplies later, and these wholesalers sometimes provide meat to retailers with payment delayed, typically financing these advances with bank credit. Implicit interest rates in the foregoing credit transactions are difficult to calculate, but with moneylenders interest rates typically range between 4 and 9% per month, while pawnshops are much more expensive at 8 to 15% per month. In addition, rural Mongolians commonly borrow from friends and relatives for consumption or educational expenses, but not often for business purposes.

Informal finance appears to be particularly widespread in Uzbekistan where bank finance has been significantly repressed. ROSCAs are particularly common among lower- and middle-income groups throughout the country, including associations of farmers, artisans, and even salaried employees, among others. In fact, a ROSCA that the Uzbek Business Women's Association formed was the basis for creating Uzbekistan's most successful credit union, which has subsequently been replicated in several similar transformations. Rural Uzbekistan is also rife with the types of arrangements among agricultural producers, processors, and wholesalers described above, some of which have been evolving into contract-growing relationships. Arrangements most often involve vegetables, fruits, and dairy products and credit can flow in either direction and be in cash or in kind. In addition to this variety and flexibility, arrangements are typically totally informal, without collateral or even a registered contract, and with amounts financed sometimes reaching almost 100% of the value of produce involved where long-term relationships exist. Also pervasive are credit sales to farmers by input suppliers.

Perhaps the most important lessons that these studies provide are about the nature and pervasiveness of informal finance in rural areas, especially compared to the huge gaps in financing that governments and international development agencies typically imagine and try to fill. Not only is the gap far smaller than is usually imagined, but the credit relationships among agricultural producers, processors, and input suppliers may provide a much more efficient

way to finance producers than direct lending to producers by banks and other formal financial institutions. These informal but typically ongoing relationships provide crucial information that keeps transaction costs very low and loan recovery rates very high—keys to sustainable finance—as well as providing valuable services to farmers such as good quality inputs, assured markets, and guaranteed attractive prices. The primary role of governments and development agencies could well be to study these relationships in greater depth and assure that no needless barriers exist, for example, to bank financing of input suppliers, processors, traders, and wholesalers for their on-lending to farmers.

IV. OTHER FINANCIAL PRODUCTS AND SERVICES

Aside from loans and deposit services, other financial products and services are available in the six transition economies but at varying degrees of importance to rural finance. These are discussed below.

1. Payment and Remittance Services

As the economies of the six transition economies become increasingly monetized, payment and remittance services are becoming more important services demanded by the general population. The rural populations in these economies have a higher demand for payment services than might be expected, caused by requirements of the government (e.g., pension and salary schemes) and the largely check-free nature of these countries' economies. As a result, all exchanges of money have to take place either in cash or through a bank or the postal service. Regularly scheduled payments for such services as gas, electricity, water, and telephone are made by bringing cash directly to the service provider or instructing the bank or post office to pay either with cash provided by the payer or, in the case of a bank payment, by debiting the payer's account. While banks in urban areas in the six transition economies are beginning to provide automated payment services for clients,

individuals in rural areas typically make these payments in person. Similarly, small borrowers often make their loan payments by taking cash to the bank designated by the nonbank lender.

In terms of receiving payments, the most commonly received payments in rural areas are pensions, which are remitted either through selected banks or postal offices. Because of the typically acute need for this money, pensioners usually visit banks on the payment date and take the entire payment in cash. Ongoing distrust of banks, state-owned or private, in many transition economies provides a further incentive to take any cash that is available.

The growing demand for remittance services is also due to the increase in cross-regional and cross-border remittances. In the past, pensioners were often the sole users of the banking system's remittance services, and the remittance flow was one way; that is, from the central government to the accounts of pensioners in rural areas. Presently, remittances come from various sources, such as relatives working in the six transition economies' urban centers and in other countries, such as the Russian Federation and Germany.³⁴ Some families in rural areas regularly send money to their children who are studying in colleges or universities located in urban areas. Statistics on remittances are not available but the ubiquity of remittance facilities, such as Western Union, in the premises of bank branches suggests that the volume of remittances going to rural areas is quite significant.³⁵ Cross-border remittances are important almost everywhere, both as a service for clients and as a source of fee income for banks. For instance, a bank branch in a rural area of the Kyrgyz Republic earns significant fee income from remittances, which amount to about \$1,000 daily from foreign countries and Som10,000 daily from within the country. Thus, banks with extensive rural branch networks can exploit profit opportunities arising from growing regional and cross-border remittances.

Cross-border remittances are important almost everywhere, both as a service for clients and as a source of fee income for banks.

³⁴ The importance of diversification for families in rural areas, especially those with low incomes, due to the typically undiversified nature of rural areas even where towns or larger villages are present has undoubtedly contributed significantly to the growing importance of remittances.

³⁵ There are indications though that a sizable portion of remittances has been used for business purposes.

One major impediment to offering dependable remittance services is the unreliability of rural electric service in many of the six transition economies, which affects rural bank branches' ability to pay remittances to beneficiaries upon demand. Also, some rural roads are in such bad condition throughout much of the year that it is hard to keep branches that are net users of cash supplied with cash. This means that at times a beneficiary of a transfer cannot simply walk out with cash, even though the transfer has been confirmed. This same problem can affect the regular withdrawal of deposits.

2. Leasing

All Central Asian countries except Mongolia, with significant support from international development agencies, have recently put in place modernized laws covering financial leasing; even in Mongolia financial leasing is clearly permitted. Nonetheless, several countries need to speed the process of repossessing leased assets when lease payments are not made, especially since the major advantage of leasing in most countries is to circumvent the slowness and inefficiencies in dealing with movable property as collateral for loans.

In Azerbaijan, financial leasing is quite active but mainly in urban rather than rural areas. In Tajikistan, there is reported to be a shortage of longer-term funding to support leasing. In Uzbekistan, leasing, especially of agricultural equipment, appears to be widespread. In 2002, nonbank leasing companies accounted for over 2,000 new lease transactions for over \$60 million, mostly for agricultural machinery. In addition, the majority of bank leasing is carried out by banks with offices in rural areas. In Kazakhstan and the Kyrgyz Republic, no information was readily available about financial leasing activity, only that appropriate legal infrastructure is in place.

3. Pawning

Unlike elsewhere in Asia where pawning of immovable and movable properties is widespread even in rural areas,³⁶ pawning is just emerging in some of the six transition economies of Central Asia. In Azerbaijan, for instance, pawnshops (lombards) operate as subsidiaries of banks. However, they operate mostly in urban areas and accept only a few items for pawning, such as gold, for lack of a cadre of appraisers who can make reliable appraisals of the value of pawned goods.

4. Equity

Equity markets in the six transition economies of Central Asia hardly exist at all. Stock exchanges exist in some countries, but listed stocks are few and mostly illiquid. There are foreign equity investments, but most of these foreign investments have little direct linkage with the development of rural finance, except those investments in a few banks that have branches in rural areas and large corporations that are engaged in contract farming.

V. FINANCIAL SECTOR POLICY AND REGULATORY ENVIRONMENT

Worldwide experience, not only in Central Asia or developing economies or others in transition from plan to market, shows clearly the crucial importance of the policy and regulatory framework for financial sector development. Before the financial reforms of the 1990s, many countries imposed controls over interest rates that severely impeded the expansion of financial services, especially to potential clients who were more costly and risky to serve, often those in rural areas. While Central Asian countries have largely

³⁶ This includes informal pawning of land as in the case of the Philippines. In the six transition economies, private ownership of land has just been newly introduced.

avoided such constraints, several have programs that involve subsidized interest rates, sometimes supported by international development agencies, which impede the entry of private sector financial institutions seeking sustainability that cannot compete with these subsidies. Even the richest countries (e.g., Kazakhstan) cannot afford the broadly based subsidies that would be necessary to reach all potentially worthwhile clients. Everywhere, moreover, subsidized interest rates have promoted a culture of rent seeking and ultimately of nonrepayment of loans that further discourages the sustained participation of viable private sector financial institutions.³⁷

Many aspects of best-practice financial regulation are in place in Central Asian countries, especially for the banking sector, but significant gaps nonetheless remain. Undoubtedly the most important is the untested ability of most regulatory agencies to enforce rules in a timely and transparent way. Earlier lessons of the problematic results of “regulatory forbearance” may not have been fully learned (a problem that extends even to fully developed countries such as Japan). But the greater problem facing most regulatory agencies in Central Asia is the option of recourse to the judicial system where banks being disciplined can sometimes overturn judgments against them because judges do not yet have full capacity to understand commercial cases or where problem banks can continue to operate because of long delays in settling cases.³⁸ Unfortunately, solving this problem runs far beyond bank regulation and, within finance itself, involves an array of crucial issues such as contract enforcement and the use of collateral to secure loans. A second shortcoming in most Central Asian countries is the lack of thoroughgoing implementation of risk-based supervision, something that can adversely affect small borrowers in

Everywhere, subsidized interest rates have promoted a culture of rent seeking and ultimately of nonrepayment of loans that further discourages the sustained participation of viable private sector financial institutions.

³⁷ Virtually all Central Asian countries have recognized the problematic aspects of government-owned financial institutions and, with some faltering in the earlier years, most have largely privatized the state-owned banks that they inherited from the prior era of central planning.

³⁸ Deposit insurance, which may not greatly promote deposit mobilization if the problem lies elsewhere (e.g., in poor service to depositors), will nonetheless reduce depositor incentives to monitor bank soundness and thereby increase the exposure of the entity providing the insurance (typically the government) to greater losses to the extent that supervision and enforcement are less than fully adequate.

rural areas in particular (e.g., a traditional compliance-based insistence on physical collateral and financial documentation for even small loans, together with arbitrary rules that raise the costs of establishing small branches in rural areas). Even the Basle guidelines mandating risk-based supervision, with support from the International Monetary Fund (IMF) in its country reviews, have not yet been fully effective, as most Central Asian regulatory agencies are still in the process of complying with the Basle guidelines by issuing a few regulations even if they claim to be moving to risk-based supervision.

For nonbank financial institutions, the situation is far more complex, and the results for rural finance can be especially adverse. For example, non deposit-taking MFIs in some Central Asian countries (e.g., Azerbaijan and Mongolia) are subjected to basically the same prudential regulation applied to banks, thereby incurring most of the costs and limitations faced by banks without the advantage of being able to offer deposit services to their clients or to fund their loans with deposits. In some Central Asian countries there is no legal framework at all for MFIs, while in others the number of such institutions that can be established is arbitrarily limited. Although some regulatory aspects remain in dispute for MFIs, the emerging consensus for all types of financial institutions that primarily lend and do not take deposits from the general public is transparency rather than formal prudential regulation, since there are no unsophisticated depositors to protect and little likelihood of spread effects that could provoke a general financial crisis. Moreover, transparency allows potential funding agencies to make informed decisions while avoiding unnecessary burdens on bank regulatory agencies or costs that can limit the outreach of lenders to small-scale borrowers in rural areas.

Even more contentious is the issue of prudential regulation of credit unions (i.e., cooperatives providing financial services to their members), extending even to which entity, if any, should be responsible for their supervision. Worldwide, the norm is that credit unions can take deposits from members and only members. But in some Central Asian countries, credit unions are not allowed to take deposits at all, while in others they can take deposits from (and

lend to) anyone.³⁹ Beyond the realm of small credit unions with few members and no branches—which can be considered clubs wherein members can know each other well enough to effectively monitor behavior and for which the costs of regulation would be very high relative to the small amounts involved—the necessity of prudential regulation has become increasingly recognized. However, the question of which should be the regulatory agency appears to have no universally agreed upon answer. Bank regulatory agencies in most countries including Central Asia resist taking on this responsibility given the costs of dealing with potentially large numbers of small entities, as well as the distraction from their main task of overseeing banks. While some international development agencies favor giving this responsibility to credit union federations, this neglects their weakness in most Central Asian countries and, more importantly, the inherent conflict of regulation with a federation's primary function of promoting credit unions and their interests.

Although each Central Asian country may need to resolve this regulatory issue individually, certain improvements in credit union laws and norms should nonetheless be given high priority in virtually every Central Asian country. For example, as the basis for credit union solvency, institutional capital (e.g., accumulated surpluses and reserves) needs to be differentiated from member share capital that belongs to individual members and is thus subject to withdrawal so that it does not effectively protect institutional solvency. Furthermore, combining financial intermediation with other economic activities in multipurpose cooperatives has proven disastrous almost everywhere, as member shares and deposits are easily drawn off to finance these other ventures without proper diligence, much like lending to related parties in banking.⁴⁰ Beyond the obvious need for careful rules for classifying loans and imposing

³⁹ Limits on deposit taking by credit unions overlook the fact that these can readily be circumvented if member share capital is made liquid (e.g., by providing for partial withdrawal of shares or automatic loans against shares) and/or if nonmembers can readily become members (e.g., with minimal payments and without any training in cooperative principles).

⁴⁰ While a few international development agencies have policies of promoting multipurpose cooperatives as a way to achieve economies of scale and scope, especially in rural areas, the evidence so far in Central Asia is negative, as it has been in most countries around the world.

requirements for loan-loss provisions, among other technical issues, respect must be shown for the crucial credit union tradition of mutual self-help. Where this has been neglected by overly generous offers of external funding, typically by well-intentioned international development agencies in the Central Asian case, aggressive rent seeking has become the norm in the worst cases or, at best, careless management of other people's money.

In Mongolia and Kazakhstan, bank supervision has been given quite high marks, although neither country has recently had to confront a major crisis, and judicial interference is seen to be a potential weakness. Nonetheless, significant deficiencies exist in both countries with respect to regulating both NBFIs and credit unions. In Mongolia, the bank regulatory agency (the central bank) has been required to oversee NBFIs, potentially a waste of regulatory resources since NBFIs cannot legally take deposits. Although the central bank has so far handled this by focusing primarily on low-cost off-site supervision, this is not assured for the future, especially with recognition that regulatory responsibility can imply a *de facto* guarantee. Furthermore, NBFIs can be licensed to undertake certain activities that could easily be used to disguise deposit taking, and the chart of accounts currently required for NBFIs reporting to the central bank is not well designed to detect illegal deposits. Mandating greater NBFIs transparency while moving away from direct central bank responsibility for NBFIs supervision could provide a multidimensional improvement. In fact, Mongolia appears to be assigning the regulation of NBFIs to a new agency that would also be responsible for regulating pensions, insurance, and the securities markets.

Mongolia also presents a case where the overeagerness of international development agencies to promote credit unions has resulted in such proliferation that many could later not even be found. Although the central bank has become highly concerned about the nonprudential behavior of many credit unions, it nonetheless wants to avoid taking primary regulatory responsibility given the large numbers that have come into existence. At least one international development agency has been promoting supervision by a credit union federation. But a law under consideration would place credit unions under a commission to be

created to regulate securities, pensions, insurance, etc. However, this option ignores the key deposit-taking feature that makes credit unions more like banks than like the institutions to be under the commission.⁴¹ At the same time, the focus of international development agency support for credit unions in Mongolia has fortunately changed from funding to technical assistance and especially to drafting a law, a set of regulations, and recommended bylaws for credit unions. While certain elements of the proposals could be improved (e.g., differentiating between member shares and institutional capital, and banning credit unions from nonfinancial, multipurpose activities), this shift in focus marks a key improvement in approach.

Like Mongolia, Kazakhstan has made major headway in bank regulation and in banking itself. In fact, the IMF recently stated that “the key issues facing regulators are to generalize the significant progress made in banking supervision to the rest of the financial sector and to ensure that adequate risk management techniques are implemented....” While the legal, regulatory, and supervisory framework for NBFIs in Kazakhstan is relatively extensive, it involves certain anomalies such as provisions for regulating pawnshops even though these cannot take deposits. More importantly for rural finance, while Kazakhstan’s new law on MFIs is generally helpful, the regulatory agency has stated its intention not to issue more than the five existing MFI licenses.⁴² Although Kazakhstan’s new credit union law is not too problematic in itself, a key aspect of the government’s approach to rural finance is to increase further the major role of state-owned credit unions, with the result, among others, that no private credit unions exist even though they are permitted under the law.

In the Kyrgyz Republic, like Kazakhstan and Mongolia, bank regulation is seen to be adequate, although enforcement has not been tested recently and may be even more problematic than in those

⁴¹ The commission can better supervise non deposit-taking NBFIs. In addition, a thoroughgoing approach to risk-based supervision could allow the central bank to focus on larger and/or riskier credit unions and to avoid the costs of applying traditional regulatory practices to large numbers of very small credit unions.

⁴² Having such a license provides two operational advantages: lenders can make loans exceeding \$6,000 and can reserve against problem loans, but cannot take deposits in any case.

other two countries given experiences with the Kyrgyz judiciary. However, the most immediate issue seems to be a move to implement deposit insurance, supported by international agencies without any clear assurance that supervision and regulatory enforcement are adequate to handle the moral hazard incentives that come with deposit insurance. Moreover, poor deposit mobilization in the Kyrgyz Republic, even relative to currency holdings, is unlikely to be overcome by deposit insurance given the evidence that the main problem is poor service for bank depositors (e.g., even transfers of funds from one branch to another of the same bank are costly and time-consuming). In fact, a few strong Kazakh banks with retail banking expertise have recently begun operating in the Kyrgyz Republic and have been enjoying notable success in attracting depositors, underscoring the poor performance of indigenous institutions in deposit services. Furthermore, questions about regulatory enforcement with their roots in the judicial system suggest challenges that range far beyond the financial sector but nonetheless create specific problems for enforcing loan contracts and using collateral.⁴³

The regulatory framework for NBFIs and credit unions in the Kyrgyz Republic is among the best in Central Asia.

The regulatory framework for NBFIs and credit unions in the Kyrgyz Republic is among the best in Central Asia. For NBFIs that do not take deposits, the main requirement is for reporting, which requires a standard chart of accounts and external auditing. Furthermore, there are useful distinctions among the types of NBFIs: microcredit companies (for profit) cannot take deposits, nor can microcredit agencies (nonprofit), but these can convert into microfinance companies that can take deposits, and then regulation and supervision become more strict like those for banks. However, the law restricts even microfinance companies to time deposits only, while their target clientele is likely to need more liquid savings deposits. The law dealing with credit unions is also generally appropriate, notwithstanding a provision that allows partial withdrawals of member shares, thereby implying that the stricter requirements for credit unions wanting to take deposits can easily be circumvented by giving greater liquidity to member shares. As elsewhere, however, the main issue has been

⁴³ Such weaknesses make it difficult to understand the heavy reliance of lenders on collateral and their superficial understanding of cash flow lending (e.g., the widespread failure to distinguish between profits and cash flow).

which institution would regulate and supervise credit unions. Both the government agency charged with promoting and funding credit unions and the credit union federations have serious conflicts of interest with respect to simultaneously promoting and regulating. Recognizing this, the central bank has finally stepped forward to accept regulatory responsibility for credit unions.

Although Azerbaijan passed two laws in 1991 moving to a standard two-tier system with commercial banks and a central bank, progress in bank modernization has been slow with only partial privatization of commercial banks, as discussed elsewhere. Moreover, substantial work still remains to be done for the new chart of accounts for banks that conforms to international accounting standards to be effectively implemented so that the transparency of the banking system can be improved. Perhaps in recognition of these weaknesses, in 2003 the minimum capital requirement for banks already in operation was raised to \$2 million and for newly opened banks, to \$5 million. Moreover, a newly licensed bank is not allowed to mobilize deposits until 2 years after commencing operations, although banks may conduct insurance and pawnshop operations and open branches in any part of the country.

When these laws were amended in 1996, the new law made a distinction between banks and nonbanking credit organizations. Accordingly, a bank is a credit organization licensed to carry out a full range of banking operations including deposits, loan services, and foreign exchange operations, while a nonbank is licensed to carry out only certain types of banking operations. Nonbanks fall into three categories: (1) those created in Azerbaijan and sponsored by international NGOs to finance small and medium businesses; (2) those created in Azerbaijan by international development agencies; and (3) state-owned nonbanking credit institutions. Although subject to banking laws, they are not subject to the capitalization requirements applicable to banks or credit unions. However, no specific legal framework for MFIs exists. Although all of those operating in Azerbaijan are basically nonprofit organizations, under existing laws, MFIs have to register as limited liability companies like purely commercial entities without developmental or social functions and are thus subject to all the

taxes applicable to profit-oriented commercial enterprises. MFIs also have to secure a license to operate as nonbank credit organizations, which are prohibited from mobilizing deposits, including even compulsory savings from their borrowers or liability groups.

The law adopted in Azerbaijan in 2000 places credit unions under the central bank and subjects them to many of the same statutory requirements and prudential rules as banks. Although the law requires only 11 members to establish a credit union and the prudential rules issued in 2001 require a minimum capital of less than \$5,000, the central bank has not permitted credit unions to accept deposits even from members. The current legal framework for credit unions is thus structured so that credit unions will be largely dependent on external funds from either the government or development agencies.

In Tajikistan, the central bank, as financial regulatory authority, has adopted standard international procedures, has the legal power to enforce sound practices for the banking system, and has staff trained in procedures for bank regulation and supervision. Nonetheless, whether political interference can be resisted—especially given the wide discretion provided in granting temporary waivers to banks that are not in full compliance with all requirements—remains to be seen. For example, minimum paid-in capital for new banks is \$3 million, while existing banks are to increase their capital to \$1.5 million, but not all had done so by 2004.⁴⁴ Greater transparency in supervision methodology without violating the precepts of bank confidentiality could help avoid such interference, specifically with financial statements to be published annually, based on audited financial statements, and quarterly, based on interim data and treated as nonconfidential so that they can be made widely available. In Tajikistan there are also major impediments to bank branching as tax law requires treating each branch as a separate legal entity whose start-up expenses cannot be offset against the profit of the head office. In addition, a bank must have 125% of the minimum capital requirement before it can apply to open a new branch and then

⁴⁴ Another peculiar rule is that any specific bank may be 100% foreign-owned but in the aggregate, foreign ownership of private banks is limited to 35%.

must allocate capital for the proposed new branch and pay a fee of 0.5% of that allocated capital. These requirements, of course, substantially reduce the attractiveness of opening new branches in rural areas, as is crucial for providing affordable financial services to rural residents.

For microfinance in Tajikistan, legislation has been enacted that will permit the licensing of micro credit-deposit companies that can take deposits from individuals and legal entities, as well as carry out other banking operations (e.g., extend microcredits, provide cash and transfer services, engage in leasing, issue debt securities, etc.), including in foreign currencies after a year of operations and by obtaining an additional license. The law also permits creating micro-lending organizations that cannot collect deposits but can make microloans and engage in leasing. Norms and regulations being developed to implement the new law need to differentiate appropriately according to deposit-taking powers; for those MFIs that do not take deposits, requiring transparency should be adequate without formal external regulation. For credit unions and other types of cooperatives, there is no appropriate legal and regulatory framework. Current civil law on cooperatives permits credit unions to have only 50 shareholders when they are started and authorizes them only to make loans, thereby undermining the spirit of self-help and promotion of savings that are at the heart of credit union philosophy. In addition, member-owned institutions are only required to register with the Ministry of Justice, with the result that there is no data regarding even the number of existing credit unions.

In Uzbekistan, two major laws passed in late 1995 and early 1996 set the legal framework for regulating and supervising banks, with the central bank as the sole regulatory and supervisory institution. Existing regulations on bank entry and branching seem to favor the development of rural financial markets as the minimum capital required for newly opened banks in Tashkent is \$2.5 million, but only \$1.5 million for banks in other regions (and \$5 million for banks established with foreign capital).⁴⁵ Banks are encouraged to

⁴⁵ Foreign banks are allowed, but only as joint ventures with local investors, with no ceiling on foreign equity participation in the joint venture so long as it is less than 100%.

open branches in rural areas subject to certain requirements such as qualified staff and a business plan to show the financial viability of the proposed branch (which may, in fact, be relatively costly for a very small branch in a rural area). Aside from branches, banks are also allowed to operate mini banks with fewer requirements, mainly a computer link to the main branch in the area for cash payments. However, the size of the banking system remains very small for reasons discussed earlier. These are negative real interest rates on deposits, banks' significant role in tax collection, and CBUs' use of the "cash plan" to directly manage liquidity in the system.

Cabinet of Ministers' Resolution 309 is currently the only instrument that lays down the government's policies and intentions for the microfinance subsector. The resolution recognizes the need to develop microfinance to support vulnerable groups and promote private entrepreneurship. It also allows implementers of microfinance projects to have independence in matters of lending and repayment within the framework that donor agencies established. However, the Resolution contains drawbacks that undermine the development of the microfinance market in Uzbekistan as it appears to have a very narrow and dated view of microfinance, equating it largely to micro lending. The Resolution also has not clearly defined the types of institutions that can engage in microfinance, including the other financial operations they can engage in and the qualifications to perform such functions (e.g., prudential requirements for deposit taking). Most importantly, however, it appears to focus mainly on donor organizations and nonprofit organizations, as it sets up a restrictive list of (international) NGOs and donors that may bar the entry of additional players into microfinance.

The 2002 Law on Credit Unions provides a good foundation for the creation and functioning of credit unions in Uzbekistan, generally conforming to universally accepted best practices for credit unions and prescribing that the central bank register, license, and supervise credit unions, although the law does not distinguish between members' share capital and institutional capital. However, certain limitations might be addressed given their potential impact on the expansion of credit unions, especially in rural areas. Although

risk-based supervision should be applied to credit unions, just as to banks, once the number of credit unions reaches a certain level, the central bank may find it difficult and costly to supervise all of them, including the smallest ones. Regulation 1151 sets the minimum statutory cash fund for credit unions established in Tashkent at the equivalent of \$20,000, and at the equivalent of \$10,000 for those in other localities, which could be a barrier for low-income groups and rural residents wanting to set up a credit union since it normally takes some time for a credit union to build up a membership base. In most countries, credit union laws only prescribe the minimum membership, without the statutory fund, to ensure a critical mass of members for a viable start-up operation. Some credit union laws that require minimum capitalization do so only as a provision for those wanting to offer financial services beyond the usual savings and credit services, such as foreign exchange transactions, remittances, or payment services. Finally, unlike new banks, credit unions will no longer be given tax holidays after January 2006.⁴⁶ This does not provide a level playing field for credit unions in the financial market.

⁴⁶ Setting a cutoff date will mean that not all credit unions will be able to enjoy the tax holidays over the same number of years, as credit unions formed later will have increasingly shorter periods to enjoy their tax holidays. In contrast, new banks are provided tax holidays lasting 3 years after they are set up, no matter what the date.

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Chapter 3

Rural Finance in Azerbaijan

Executive Summary

Mario B. Lamberte and Delbert Fitchett¹

A. Background

Azerbaijan has one of the oldest civilizations in the world. Tribes were formed in the 3rd millennium BC, and the first political structures appeared in the 1st millennium BC. Its capital, Baku, was founded 1,500 years ago. Presently, the country is divided into 12 economic regions including the exclave of Nakhchivan.

Azerbaijan covers an area of 86,600 square kilometers (km²), which is less than one fifth the size of France. It is rich in oil and gas deposits, with crude oil being its main export and a key driver of its economy. It also has abundant mineral resources that include iron ore, aluminum, copper, lead, zinc, limestone, and salt. Its diverse climate allows the cultivation of a wide variety of crops—from peaches to almonds and from rice to cotton.

As of 2002, Azerbaijan's population was estimated at 8.2 million, of which 49% lived in rural areas. The country's population density stood at 95/km², with the most densely populated area being the Absheron Peninsula where major cities are located. Baku alone had 2 million residents. As a result of a violent conflict between Armenia and Azerbaijan in 1988, some 1 million Azeris became refugees or internally displaced persons (IDPs) temporarily settled in

¹ Support for the preparation of the country study, from which this summary is taken, was provided by Aguil Kouilzadeh and Nargiz Umayeva.

Overall poverty incidence is estimated at 49.6%, and rural areas have lower poverty incidence (42%) than urban areas (52%).

As of 2002, agriculture's share in GDP was only 15.2%, although it accounted for 40.2% of total employment.

1,600 shelters in 62 cities and regions of the country.² Fourteen years after the Armenia-Azerbaijan conflict, many IDPs still live in temporary and unsatisfactory living quarters.

Overall poverty incidence is estimated at 49.6%, and rural areas have lower poverty incidence (42%) than urban areas (52%).

The sudden separation from Soviet markets in 1991—attenuated by the severing of transport links to Azerbaijan's traditional markets as a result of fighting in Chechnya, the war with Armenia over Nagorno-Karabakh, and low oil prices—caused a severe contraction in the economy lasting 4 years beginning in 1992. Between 1991 and 1995, gross domestic product (GDP) fell by 55%. In the mid-1990s, the Azerbaijan government, with assistance from multilateral agencies, introduced measures to stabilize and restructure its economy to cope with the demands of a private, market-based system. Indeed, its economy had grown fast in the last 7 years. As of 2002, however, total output had not yet recovered to its 1991 level. The agriculture sector had the worst performance in that its output in 2002 was still 59% lower than the 1991 level. On the other hand, industrial output in 2002 exceeded the 1991 level by 27%, which can be attributed mainly to the oil boom of recent years.

As of 2002, agriculture's share in GDP was only 15.2%, although it accounted for 40.2% of total employment. On the other hand, the shares of industrial and services sectors in GDP were 49.5% and 35.3%, respectively, while they accounted for 11.5% and 48.3%, respectively, of total employment. Although crude oil and natural gas extraction (a subsector of the industrial sector) contributed 27.4% to GDP, it absorbed only 1.1% of total employment.

Azerbaijan's financial system is still very shallow. As of December 2002, the M3/GDP ratio reached only 13.3%. The shallowness of Azerbaijan's financial system can be partly attributed to the general public's lack of confidence in the banking system. The large devaluation of the Soviet ruble announced by Soviet

² Refugees are Azeris who were forced out of Armenia, while internally displaced persons are Azeris who lost their permanent residences in occupied territories or who lived along the borders with Armenia.

authorities in January 1991, “pyramid schemes” that failed in the mid-1990s, and the closure of more than a hundred small local banks in 1996–1999 have made the general public wary of depositing their money in banks. Consequently, disintermediation took place, as can be seen from the fall in the ratio of deposits to GDP from 6.2% in 1995 to 4.5% in 1999, accompanied by an increase in the ratio of cash to GDP from 5.6% to 6.0% over the same period. In recent years, the ratio of deposits to GDP has risen, reaching 7.6% in 2002, boosted mainly by deposits in foreign currency.

In Azerbaijan, financial intermediation in dollars is allowed. Thus, residents can switch to dollar deposits without leaving the country. One important development in Azerbaijan, particularly since 1995, is the rapidly increasing dollarization of the economy against a background of a stable macroeconomic environment. More specifically, the ratio of foreign currency deposits (FCD) to total deposits rose sharply from 49% in 1995 to 82% in 2003. Likewise, the FCD/M3 ratio increased from 26% to 49% during the same period.

Dollarization could be an indicator of increasing confidence in the banking system in that residents are simply converting their dollar holdings into dollar deposits, thereby causing the FCD/M3 ratio to rise.³ Alternatively, and more likely the case in Azerbaijan, dollarization could be an ingenious way of diversifying portfolios and reducing risks in an economy where few attractive assets are denominated in local currency.⁴ In this case, dollarization represents a symptom of the existence of system-wide risks that arise not only from macroeconomic instability but also from institutional factors, such as a poor quality contractual environment (i.e., absence of an appropriate legal framework for financial contract and weak enforcement of contracts including a weak judiciary), weak capacity of financial supervisory agencies, lack of competition, among others, and noninstitutional factors, such as heavy dependence on one or two commodity exports. In short, dollarization can occur in Azerbaijan even if the economy is relatively stable so long as other factors that affect system-wide risks are not being adequately addressed.

One important development in Azerbaijan, particularly since 1995, is the rapidly increasing dollarization of the economy against a background of a stable macroeconomic environment.

³ This is the asset substitution hypothesis (International Monetary Fund 2003b).

⁴ This is the coping mechanism hypothesis (De la Torre and Schmukler 2003).

The boom in the oil and gas sector has a significant influence on the rural economy. This sector has received huge foreign investment inflows in recent years and increasing foreign exchange receipts from the sale of oil. These flows have already caused real exchange rate appreciation, which consequently weakened the competitiveness of rural activities. In fact, foreign food imports have already become more competitive with domestic production and are available even in rural areas, while the country's agricultural products are encountering difficulties in competing in export markets. As the World Bank's (WB) model shows, both poor and nonpoor rural households would be severely adversely affected by a 10% real appreciation in the exchange rate.

B. Status of Rural Finance

1. Demand for Rural Financial Services

Under Azerbaijan's centrally planned economy, state-owned banks existed mainly to provide cashing services to the general public and to finance investments of collective farms and state-owned enterprises. This changed since Azerbaijan shifted to a market-based economic system and privatized enterprises and land. Privately owned enterprises have flourished, and many rural households have become entrepreneurial since the implementation of the land reform and privatization programs. This has given rise to demand for diverse types of financial services. No rigorous market studies for the demand for credit in Azerbaijan were conducted. However, a study using a small sample showed that 84% of rural households would be willing to borrow for agricultural activities.⁵ If only half of rural households borrowed \$2,000 each for a term of 1 year, total demand for rural credit would be about \$740 million annually. Obviously, the banking system, which has total assets of only \$1 billion, would not be able to meet such demand unless it ceased providing credit to urban-based enterprises and households.

⁵ Kudat and Ozbilgin (2000).

Many Azeris currently live and work in the Russian Federation or other former member countries of the Union of Soviet Socialist Republics (USSR), and most of them send part of their income to relatives in Azerbaijan. There is, therefore, significant demand for remittance or money transfer services. However, such demand is not limited only to cross-border remittances; Azeris also demand money transfer services in order to transfer funds from one town or city to another.

2. Supply of Rural Financial Services

a. Banks

The banking system largely dominates the domestic financial system, both in assets and branches. As of January 2005, there were 43 banks (2 state-owned banks and 41 private banks), of which 41 were authorized to accept savings from the public. This represents a substantial decrease from more than 200 banks in the early 1990s. The National Bank of Azerbaijan (NBA) also reports that, in January 2005, 70 nonbank credit organizations existed, increasing from 61 a year earlier. This group includes credit unions and microfinance institutions, which are discussed below.

Total assets of the banking system as of September 2003 stood at AZM4.8 trillion (around \$1 billion), which is equivalent to about 16% of GDP. This is very low compared to international standards and emerging Southeast Asian countries. Despite the presence of 44 privately owned banks, the two state-owned banks, International Bank of Azerbaijan (IBA) and BUS Bank, still dominate the banking system. Together they account for 58% of total assets, 51% of total loans, and 69% of total deposits.⁶ However, these shares are lower than in 1995 when state-owned banks controlled 80% of total loans and 77% of total deposits.

As of January 2005, there were 43 banks (2 state-owned banks and 41 private banks), of which 41 were authorized to accept savings from the public.

⁶ BUS Bank's license allows it only to collect deposits, perform limited foreign exchange activities, invest in government securities, and perform cash payment services for the Social Protection and Pension Funds and other budgetary entities. The terms of its license further prohibit BUS Bank from engaging in lending activities for 2 years, so that it operates as a narrow bank.

That banks have few branches in rural areas is an important reason for rural households' lack of access to bank loans. However, there are other equally important reasons.

As of November 2003, the banking system had 348 branches, of which 121 were located in rural areas. The two state-owned banks had about 39% of bank branches. Unlike the 44 privately owned banks whose branches are mostly situated in urban areas, the two state-owned banks have significant penetration in rural areas, as 64% of their branches are located there.

Bank loans to the agriculture sector were minimal, comprising less than 10% of total loan portfolios. On the other hand, loans to the trade and services sector and to natural persons or individuals accounted for almost 50% of the total bank loans. Some of the loans classified under these two categories might be to rural households and enterprises, but available statistics do not indicate the relative amounts of loans that went to rural households and enterprises.

That banks have few branches in rural areas is an important reason for rural households' lack of access to bank loans. However, there are other equally important reasons. Banks usually require 125–200% collateral (mortgage) as guarantees for loans and accept only real estate properties located in Baku City as collateral. Complex loan application procedures discourage rural enterprises from borrowing from banks. Moreover, because credit is tight, corruption in the banking sector has been observed to be significant. Bankers charge fees as a bribe that can sometimes account for 20–30% of the loan.⁷

One recent development in the banking sector is the establishment of the Microfinance Bank of Azerbaijan (MFBA), owned by a consortium of foreign entities and is the only bank in the country whose corporate mission is to provide financial services to micro- and small enterprises using microfinance technology. However, like other banks, MFBA is taking a cautious stance as far as expanding its operations to rural areas is concerned.

b. Microfinance Institutions

Microfinance institutions (MFIs) are key players in rural financial markets of Azerbaijan. In the second half of the 1990s,

⁷ See Grace and Sadykhov (1997) and Kudat and Ozbilgin (2000).

several international NGOs with successful microfinance programs in other countries came to Azerbaijan and established MFIs. In 2001, the MFIs organized an umbrella organization, the Azerbaijan Microfinance Association (AMFA), aimed at strengthening the capacity of MFIs and promoting effective collective action in advancing the interests of the microfinance community.

As of December 2003, international nongovernment organizations (NGOs) own and manage 11 major MFIs. Although most MFIs have headquarters in Baku City, they have branches spread out to about 40 of the 70 regions in the country, giving them more penetration in the rural economy than commercial banks.

MFIs offer various types of loan products suited to the needs of agricultural and nonagricultural enterprises. The maturity period of these loans varies from 1 month to 24 months. The size of their loans ranges from a low of \$50 to a high of \$30,000. Solidarity group lending accounts for 76% of loans granted, with most groups having 10–15 members. As of December 2003, MFIs' active clients already reached 31,187 while their combined loan portfolio stood at \$18.4 million. Together, they had already disbursed loans amounting to \$67.2 million. MFIs in Azerbaijan demand collateral for the loans they grant to individuals, with acceptable collateral including real estate, motor vehicles, home appliances, livestock, gold, and guarantees from reputable individuals. Standing crops are not acceptable as collateral.

If MFIs were to be relied upon solely to meet the demand for rural credit, they still have a long way to go. Presently, their total loan disbursements comprise less than 10% of the estimated demand for rural credit mentioned earlier. Their active clients are also less than 10% of the total number of poor households in rural areas. Moreover, MFIs do not provide savings services to their clients.

c. Credit unions

Credit unions were introduced in Azerbaijan in the early 1990s. However, they departed from the usual self-help model that can be found in most other countries that the European Union's Technical Assistance for the Commonwealth of Independent States

If MFIs were to be relied upon solely to meet the demand for rural credit, they still have a long way to go. Presently, their total loan disbursements comprise less than 10% of the estimated demand for rural credit.

(TACIS) program heavily supported. Interest in joining credit unions was high among rural households because of the opportunity to access cheap credit through the TACIS program. At one time, the number of credit unions that the TACIS program formally organized and financially supported reached 128. Many of them experienced high default rates and, in turn, could not repay the subsidized loans provided to them under the TACIS program. In fact, only 29 credit unions with a total membership of 760 were able to register under the new Law on Credit Unions.

In Azerbaijan, credit unions may grant unsecured and secured loans. The types of collateral accepted are the same as by MFIs. As of 1 July 2003, the total assets of registered credit unions stood at \$1,638,798, while the total loan portfolio was \$1,498,409, equivalent to only 15% of the total loan portfolio of MFIs.

The Agricultural Development and Credit Project of the WB, which was launched in January 2000, plans to establish 30 credit unions with about 100 to 200 members each to serve as channels of credit to farmers who would use loan proceeds only for farming activities. This project provides sub-loans of up to \$1,500 per member for a term of 2 years. Credit unions pay 10% for their loans from the project. The project was able to organize 26 credit unions in 2002–2004 with a capitalization of about AZM20 million each. Four more credit unions are expected to be organized by June 2005.

No matter how well a credit union is managed, its sustainability remains uncertain if it continues to rely heavily on borrowed funds, such as the interest-free Social Fund for the Development of IDPs (SFDI) loans to credit unions. Once these loans are not renewed, credit unions with limited capital will not be able to provide the same amounts to their clients. Credit unions are aware of this problem. The credit union in Sheki, for instance, believes that it can mobilize deposits from members and will be able to pay competitive rates, such as 1% per month. Moreover, their members have expressed willingness to deposit their funds with their credit union because they trust it more than banks. However, existing regulations do not allow credit unions to mobilize deposits, even from members.

d. State-Owned Agricultural Finance Institutions

AgrarCredit, a state-owned nonbank credit organization, has two functions: (a) collecting the bad loans of the former Azerbaijan Agroindustrial Bank, Prominvest, and Savings Bank (all state-owned); and (b) carrying out the agency function for specific agricultural lending projects of international donor agencies. Until the recently announced merger with the Rural Investment Fund (described below), AgrarCredit consisted of a headquarters and 12 branches located in all the territories of the country. It operates as an agent for the credit component (\$6.5 million) of the WB Farm Privatization Project, which started in 1998 in six rayons in Azerbaijan, and acts as agent for leasing and collection of leasing fees for agricultural equipment, amounting to \$16.3 million, financed by a grant from the Government of Japan. A follow-on grant from the Japanese Government has recently been approved.

The Rural Investment Fund (RIF), which started its operations in March 2001, is a limited liability nonbank credit organization licensed by the National Bank of Azerbaijan (NBA), the country's central bank. Its capital is derived from the monetization of food aid from the European Union (EU) to the Government of Azerbaijan. The RIF lends to farmers and rural entrepreneurs, both directly and indirectly, through existing formal credit organizations. It may fund up to 80% of a selected project's cost, and the borrower should provide the remainder. RIF has been lending in 23 districts out of the 65 districts in rural Azerbaijan. From March 2001 to September 2003, RIF granted 769 loans with a total value of \$4 million for an average loan size of \$5,000. Most of the 769 loans were granted to individual rural borrowers representing a family. About 65% of total loan volume was granted to livestock farmers (including dairy production), 23.6% to crop farmers, 4.5% to traders, and 6.2% to agro-processors. The repayment rate had been relatively high at about 95%. It is to be noted that RIF has been underutilizing its resources for on-lending due to limited number of branches and staff, and especially to the strong preference of management to invest the funds in safe

RIF has been underutilizing its resources for on-lending due to limited number of branches and staff, and especially to the strong preference of management to invest the funds in safe government securities.

government securities. Out of its total assets of about \$10 million, 80% are invested in government securities that generated most of its profits.

In the fall of 2003, the authorities announced their decision to merge the AgrarCredit and RIF into a single state-owned agricultural lending institution. The AgrarCredit nonbanking joint stock organization was registered with the Ministry of Justice on 24 November 2003. It has an authorized charter capital of AZM56,970,200,000 (\$11.6 million) primarily derived from the RIF. AgrarCredit also announced that it may access funds from the National Fund for Entrepreneurship Support (NFES), a state-owned fund. This new institution is permitted to carry out nonbanking functions in national and foreign currencies, such as lending to natural persons and legal entities, including credit unions, working in agricultural sector and rural areas, among others. Thus, AgrarCredit could play a major role in rural financial markets in the near term.

Other financial institutions, such as insurance and leasing companies, that have emerged in the 1990s do not yet play a key role in Azerbaijan's rural financial markets.

e. Other Government Interventions

Aside from directly participating in rural financial markets through its state-owned banks and nonbank financial institutions, the government also indirectly participates through its two programs that make funds available to micro- enterprises and IDPs through conduit banks and nonbank financial institutions. One is the NFES, which was established in 1992 by presidential decree. It currently provides subsidized loans for a variety of business activities through 14 participating banks, some of which have branches in rural areas. The allocation from the state budget for this lending was AZM57 billion for 2003 and AZM100 billion for 2004. In 2002 and 2003, 36.1% of the volume of lending occurred in Baku and 21.2% in the Nakhchivan Autonomous Region. The remainder of the lending was spread across a variety of rayons. The government plans to

include nonbanking credit organizations as credit conduits in the near future.

The other program is the SFDI, the government agency responsible for channeling donor funds to IDPs through a number of microcredit programs. It was established on 6 December 1999 by presidential decree. The program targets two types of clients—legal entities (with no less than 80% ownership by IDPs) and natural persons who are IDPs. The actual distribution of loans is done through implementing agencies, chosen by means of tenders held by SFDI. These agencies are chosen because of their capacity to distribute credit, experience in implementing similar programs, and managerial competence. Seven credit unions have been chosen to distribute credit to legal entities, while five NGOs have been chosen to distribute credit to natural persons. The implementing agencies are licensed by the NBA as nonbank credit organizations and subject to its prudential norms, regulations, and reporting requirements as appropriate for nonbank credit organizations.

f. Donors/Interventions

Multilateral and bilateral donor agencies have played a key role in reforming the Azerbaijan financial system. They have provided technical assistance to the government in crafting various laws, such as the two basic banking laws, credit union law, leasing law, and others in strengthening the capacity of the NBA to carry out its responsibilities and in restructuring and privatizing state-owned banks. For instance, under the auspices of the WB's Financial Sector Technical Assistance Loan approved in 2002, the Government and the NBA set out a comprehensive strategy for systemic banking sector reform aimed at three broad areas: (i) a more effective approach to restructuring and divesting state-owned banks; (ii) a more systematic focus on problems in the private banking sector; and actions to identify more clearly and address weaknesses in infrastructure supporting banking activity. For its part, the US Agency for International Development (USAID) has provided support to the NBA in implementing reforms to increase

Multilateral and bilateral donor agencies have played a key role in reforming the Azerbaijan financial system.

consolidation and capitalization of the banking sector. Emphasis on banking supervision and the regulatory framework governing commercial banks will continue under the same assistance to NBA.

A second type of assistance that multilateral and bilateral donor agencies provide to Azerbaijan is designed to support establishing rural financial institutions. For instance, European Union's TACIS program, along with WB's and IFAD's agricultural development and credit projects, aimed at encouraging the formation of credit unions in rural areas. USAID's credit projects have encouraged the entry into Azerbaijan of NGOs, such as ACDI/VOCA, FINCA, Oxfam, and World Vision, which have long experience in managing microfinance projects elsewhere.

A third type of assistance that multilateral and bilateral donor agencies provide is various credit lines to rural financial institutions. Funds generated through EU food aid (Partnership Fund), together with technical assistance, initially supported rural lending through a number of local banks, including Agroprombank, Azadbank, M-bank, Azerdemiryolbank, Ajemibank, Imperbank, United Credit Bank, and Arcobank under the Regional Agricultural Reform Program (RARP). Under the Agricultural Development and Credit Project, a line of credit has been made available for on-lending to credit unions and groups of borrowers. The European Bank for Reconstruction and Development (EBRD) provides an SME credit line through a number of local banks, such as the International Bank of Azerbaijan (IBA), Azerdemiryolbank, and Unibank. Aside from credit lines, EBRD also invested \$1.3 million along with International Finance Corporation (IFC), KfW Bankengruppe, Black Sea Trade and Development Bank, and LFS Financial Systems in the newly created MFBA, which started to operate in October 2002. EBRD also has equity investments in another commercial bank, Unibank, which has future plans for opening branches in regions outside Baku City.

Despite uniformly good intentions, the results of donors' interventions in developing rural financial markets are mixed.

Despite uniformly good intentions, the results of donors' interventions in developing rural financial markets are mixed. In particular, assistance that has supported subsidized credit programs has failed miserably. For example, EU-TACIS' highly subsidized credit program for promoting credit unions succeeded in creating many

nonviable credit unions, while its subsidized rural lending program through a number of local banks (e.g., Agroprombank, Azadbank, M-bank, Azerdemiryolbank, Ajemibank, Imperbank, United Credit Bank, and Arcobank) under the RARP has experienced high loan default rates. The WB-supported credit program that grants loans to credit unions and liability groups at below market rates of interest promotes unfair competition that can constrain the growth of market-oriented MFIs.

g. Informal Financial System

As in many developing economies, informal financial markets in Azerbaijan appear to be vibrant and meet a significant part of the demand for financial services in rural areas. Rural households and enterprises tap informal financial markets for various purposes, such as to meet emergency needs, purchase home appliances, start a business, or raise working capital. There are various types of lenders and lending arrangements in rural Azerbaijan. While relatives and friends appear to be a major source of loans, money lenders seem to be ubiquitous in Azerbaijan. They may grant loans with or without collateral. Acceptable collateral includes jewelry, gold, real estate, and motor vehicles. Some moneylenders who are targeting large borrowers are more aggressive and advertise their business in newspapers. Although not widespread, a chain of trade credit arrangements exists from wholesaler to retailer and finally to farmers, providing a crucial link between rural and urban financial markets. For instance, a businessman in Zagatala started his fertilizer and veterinary supplies store partly with his own money and partly by obtaining a 30-day trade credit from wholesalers in Baku City. He later expanded his business by borrowing \$2,500 twice from CredAgro. One of the largest wholesalers of veterinary medicines in Azerbaijan also sells his veterinary medicines to both veterinary drug stores and veterinarians either in cash or on credit for a term up to 45 days.

At least two MFIs promote savings through the formation of savings groups whose members also belong to the same credit groups. Since MFIs are prohibited from accepting deposits, the savings

There are various types of lenders and lending arrangements in rural Azerbaijan. While relatives and friends appear to be a major source of loans, money lenders seem to be ubiquitous in Azerbaijan.

groups manage their savings in the same way that rotating savings and credit associations do. Under the WB's Agricultural Development and Credit Project, 200 joint liability groups, each consisting of 15–20 members, are to be formed to serve as channels for credit. These are unregistered or informal groups and may disband after everyone repays the loan to the project. However, the joint liability group may evolve into a credit union registered with the Ministry of Justice and with a nonbank license from the NBA. As of November 2003, 233 joint liability groups with 4,400 borrowing members were already organized. The average loan size was \$300 and will be increased to \$500 and then to \$900 in succeeding loan cycles. Loans can be used only for farming and for working capital purposes.

C. The Policy, Legal, and Regulatory Environment

The history of the modern financial system of Azerbaijan commenced in 1991 with the passage of two laws: Law of Azerbaijan Republic on the National Bank and Law on Banks and Banking Activities. These laws created the country's two-tier banking system, consisting of the NBA and the commercial banking system. The NBA is responsible for supervising and regulating banks. These laws were amended in 1996, and the new Law on Banks and Banking Activities makes a distinction between banks and nonbanking credit organizations. A bank is a credit organization licensed by the NBA to carry out full banking operations including deposits, accounts maintenance, bill payments, foreign currency exchange, and loan services. A nonbank credit organization is a legal entity with a license from the NBA to carry out certain types of banking operations. The NBA licenses both state-owned and privately owned credit organizations. As of 2003, the minimum capital requirement for banks already in operation was set at \$2 million, while for newly opened banks it was \$5 million. A newly licensed bank is not allowed to mobilize deposits until 2 years after commencing operations. Banks may conduct insurance and pawnshop operations and may open branches in any part of the country. The NBA initially limited

the aggregate amount of foreign capital participation in the entire banking system, but lifted this limit in the latter part of 2003.

The Law on Credit Unions, adopted in 2000, defines a credit union as a nonbank credit organization established on the basis of common interest of voluntarily associated individuals and/or legal entities that pool funds for the purpose of lending to each other. Credit unions are subject to statutory requirements and prudential rules of the NBA. According to the law, a credit union must be established by at least 11 natural and/or juridical persons. Under the NBA's Prudential Rules for Credit Unions issued in 2001, a credit union must have a minimum capitalization of AZM20 million (\$4,072). The law is silent on the issue of deposit taking, and the NBA has not permitted credit unions to accept deposits from members.

Other types of nonbanking credit organizations are authorized to conduct limited banking activities. These may be categorized into three: (1) nonbanking credit organizations created in Azerbaijan by international credit institutions and sponsored by international NGOs to finance small and medium businesses; (2) nonbanking credit organizations created in Azerbaijan by international financial institutions such as the IFC and EBRD; and (3) state-owned nonbanking credit institutions. Nonbanking credit organizations are subject to the general banking law requirements. However, they are not subject to any of the capitalization requirements applicable to banks and credit unions and to the limit on foreign participation applicable to the country's banking industry.

Interest rate ceilings do not exist in Azerbaijan. The government allows the market to determine both end user borrowing rates and deposit rates, although in some cases it dictates lending rates for its own credit programs that are usually below market rates. For instance, under the NFES, participating banks pay only 5% per annum for the funds they borrow from the program, and they are allowed to charge only 7% for loans to end borrowers. This is considerably lower than the normal short-term lending rates in local and foreign currency of close to 20% per annum.

The government allows the market to determine both end user borrowing rates and deposit rates, although in some cases it dictates lending rates for its own credit programs that are usually below market rates.

D. Major Remaining Issues

The rural economy in Azerbaijan is undergoing stress due to the weakening of the price competitiveness of agricultural products. This damaging process should be addressed at both the macro- and microlevels. At the macrolevel, the authorities must continue to institute monetary and credit policies that can support monetary and financial stability. Considering the expected windfall from the oil boom, exchange rate policy must be set such that it is conducive to producing tradable goods, like agricultural commodities, thereby avoiding the “Dutch Disease.” In this regard, the International Monetary Fund’s recommendation to strike the right balance between current expenditures and conserving assets for future generation must be taken seriously.

At the microlevel, the government must address major factors that tend to raise the costs of doing business in rural areas. The poor state of the physical infrastructure, especially in rural areas, not only increases the costs of doing business but also discourages rural entrepreneurs from undertaking what might otherwise be worthwhile business ventures. The existing road network needs to be rehabilitated, while farm-to-market roads either have to be constructed or improved. The deterioration of electricity generation and distribution networks needs to be reversed. Rampant roadside bribery that raises the costs of transporting goods from rural to urban areas must also be stopped.

Private land ownership is allowed in Azerbaijan since the passage of the Land Reform Law in 1996. The government distributed about 1.3 million ha of land to rural residents. However, banks still do not accept real estate properties located outside Baku City as loan collateral. The government must therefore address some issues so that banks can accept rural property as collateral for loans. These include establishing an efficient collateral registry system, promoting land valuation systems so that banks and landowners have an objective way of valuing land, and improving the efficiency in settling foreclosure cases.

Banks still do not accept real estate properties located outside Baku City as loan collateral.

E. Further Priorities for Government and Donor Interventions

1. Government

The introduction of several reform measures in the mid-1990s substantially improved the legal, supervisory, and regulatory framework for the financial sector. However, more reforms need to be undertaken to accelerate the development of the financial sector in general and rural financial markets in particular.

The current legal framework for credit unions is structured in such a way that credit unions will be largely dependent on external funds either from the Azeri government or donor agencies. Savings mobilization has not been given due attention in the present policy framework and, given the present attitude of banks toward opening branches in rural areas, the credit union system appears to be the most viable alternative for mobilizing deposits in rural areas. The concern raised in some quarters regarding the pitfalls of allowing such institutions to mobilize deposits can be addressed by having an appropriate legal framework for credit unions and a strong supervisory institution, as well as instituting a uniform chart of accounts to make credit unions more transparent to members. In addition, some prudential norms applied to credit unions appear to be unnecessary or excessively restrictive, thereby constraining the growth of credit unions, so these need to be revised.

There is no specific legal framework for MFIs. All operating MFIs in Azerbaijan are basically nonprofit organizations. However, under the existing Law on Banks and Banking Activities and the Civil Code, MFIs have to register as local limited liability companies just like purely commercial entities that have no developmental or social functions. As such, they are subject to all the taxes applicable to profit-oriented commercial enterprises. MFIs also have to secure a license from the NBA to operate as nonbank credit organizations, which are prohibited from mobilizing deposits, including even compulsory savings from their borrowers or liability groups. There is a consensus among MFIs and other stakeholders that a separate

Existing government-funded subsidized credit programs that have undermined the development of rural financial markets must be phased out or their interest rates aligned with market rates of interest.

legal and regulatory framework be put in place to recognize the difference between MFIs and profit-oriented commercial entities.

A strong financial infrastructure is needed to improve the efficiency of the financial system and reduce risk. In this regard, substantial work still needs to be done so that the NBA's new chart of accounts for banks that conforms to International Accounting Standards can be effectively implemented and the transparency of the banking system thereby improved. Such efforts should also be extended to other financial institutions such as credit unions and MFIs. Moreover, a uniform set of performance standards that cuts across all types of financial institutions could be developed and applied.

Another element of financial infrastructure that needs to be put in place is a collateral registry system that can help improve the effectiveness and cost efficiency in delivering secured lending services to the private sector. Still another part of financial infrastructure is a credit bureau that will accommodate all loan sizes and include both positive and negative lists of borrowers.

While resources are pushed to the rural areas to support rural economic activities, it must be done in a market-oriented manner. In this regard, existing government-funded subsidized credit programs that have undermined the development of rural financial markets must be phased out or their interest rates aligned with market rates of interest. The planned privatization of state-owned banks, the IBA and BUSBank, should proceed. However, it should be done in a way that fosters competition, not merely transfers the monopoly power of these banks from government hands to private hands. One option is to sell some of the two banks' branches in rural areas to existing private banks that want to expand their banking operations to rural areas prior to their privatization.

Unless the commercial banks decide to enter rural financial markets in a major way, rural dwellers will continue to be underserved. The government may wish to focus more on measures and policies that remove barriers to entry by commercial banks into the rural economy, while not actually mandating specific actions or activities. In this regard, the recent creation of a new state-owned agricultural credit institution is very worrisome and threatens to

produce a corollary of Gresham's Law, i.e., bad rural financial institutions will discourage the entry of and/or drive out good rural financial institutions.

The reforms proposed above would clearly require enhancing the capacity of the NBA to carry out its tasks of regulating and supervising financial institutions.

2. Multilateral and Bilateral Donor Agencies

International donor agencies are expected to play an important role in developing Azerbaijan's financial system, and there are at least two areas of intervention where donors are badly needed. First, donor agencies should continue providing support to the government's efforts to reform and strengthen the financial system. Such efforts could focus on enhancing the legal and regulatory framework for various types of financial institutions, strengthening the capacity for regulating and supervising financial institutions, and building financial infrastructure, such as internationally accepted accounting and auditing standards, a collateral registry system, and a payments system, all of which are necessary to support a sound and efficient banking system. Second, given the considerable excess demand for credit in rural areas, donor agencies may continue providing funds to rural financial institutions. However, such interventions should aim primarily at developing viable rural financial institutions that pay attention to savings mobilization and are subjected to market discipline. Thus, any subsidized credit programs that donor agencies currently support must be reformed, with the pricing of funds in line with prevailing market rates of interest. Donor agencies should also urge the government to do the same with its own credit programs. Second, donor agencies could provide training and technical assistance to financial institutions that have definite plans to build their capacity to provide financial services to farms and nonfarm rural enterprises. Existing private banks are primarily servicing the financial needs of Baku-based enterprises, and many of them still do not have the capacity to provide financial services in rural areas that are perceived to be more costly and risky.

Interventions should aim primarily at developing viable rural financial institutions that pay attention to savings mobilization and are subjected to market discipline.

Chapter 4

Rural Finance in Kazakhstan

Executive Summary

Gail Buyske and Mario B. Lamberte¹

A. Introduction

Rural finance is an important issue for Kazakhstan, a country where 31% of the rural population lives on less than the minimum subsistence income² and about 43.4% of the population (total 14.9 million) lives in rural areas. However, the relative scarcity of rural finance, particularly borrowing opportunities, is only part of a complex of issues that contribute to rural underdevelopment. These include weak infrastructure (for example, an estimated 50% of national roads and 80% of rural roads require significant repairs); low average population density of six individuals per square kilometer;³ and suboptimal farm size.⁴ Furthermore, Kazakhstan is already largely self-sufficient in agricultural production. Therefore, a significant expansion in agricultural output resulting from improved rural conditions would require increased access to international markets to have a positive impact on economic growth. Finally, with 42% of Kazakhstan's crop output produced

¹ Support for the preparation of the country report, from which this summary is taken, was provided by Nurlan Almangabetov and Sabit Khakimzhanov.

² About \$35 per month.

³ With a total landmass of 272.5 million hectares, Kazakhstan is about the same size as western Europe.

⁴ An estimated 83% of Kazakhstan's farms are of suboptimal size. Scanagri, *Participatory Rural Sector Planning and Development, Final Report* (Manila: Asian Development Bank), February 2003.

While countries with abundant natural resources sometimes pay insufficient attention to other sectors of the economy, the Government of Kazakhstan has initiated several extensive programs addressed at developing rural areas and agriculture.

by peasant farms and 87% of its livestock produced by households, many required improvements, such as infrastructure, can only be implemented on a painstaking microlevel—from one rural settlement to the next.

Kazakhstan has the advantage of having the financial resources to address its rural development challenges, with oil production accounting for about 25% of gross domestic product (GDP) and proven and probable crude oil reserves that could eventually make Kazakhstan one of the world's top 10 crude oil exporters. While countries with abundant natural resources sometimes pay insufficient attention to other sectors of the economy, the Government of Kazakhstan has initiated several extensive programs addressed at developing rural areas and agriculture, which account for an estimated 90% of rural economic activity.

Kazakhstan also benefits from the internationally recognized professionalism of its Financial Supervisory Agency (FSA)⁵ and a correspondingly strong banking sector. These elements help ensure the competitiveness of Kazakhstan's banking sector and therefore its potential interest in rural finance as a new market, provided that it is commercially feasible. The FSA also takes a strong interest in the appropriate regulation of other rural finance lenders, although in some cases its cautious approach may be counterproductive, as this summary discusses.

While the Government of Kazakhstan has several programs that have been thoughtfully developed and address perceived development needs, two serious shortcomings underlie some programs, particularly those with a rural finance component. One shortcoming is the widespread use of subsidized interest rates, without any apparent evaluation of the relative costs and benefits. The other shortcoming is a sometimes nontransparent process for allocating funding. These shortcomings could also characterize the Government's proposed new microfinance program, planned for implementation in 2005. They also threaten to undermine commercial initiatives to provide rural finance, by creating conditions under which commercial providers may not be able to compete.

⁵ The FSA is a recently created supervisory agency spun off from the National Bank of Kazakhstan (NBK).

B. Status of Rural Finance

This study evaluates the demand for the three basic types of rural finance products and services: payment services, savings products, and loan products. Because the major gap between demand and supply is in lending, this topic is discussed in detail below, following a brief description of payment services and savings options.

The demand for payment services in Kazakhstan is relatively high because it is largely a check-free economy. The primary payment services that rural citizens need are for paying utility bills and receiving pensions. The two major providers of these services are the Halyk Bank, the formerly state-owned savings bank, which has 112 of its 149 branches in rural areas and provides about 50% of pension payments nationwide; and the Kazakhstanskaya Pochta (Kazpochta), the mail service, which has offices in 3,401 of Kazakhstan's 7,660 rural locations and provides about the other 50% of nationwide pension payments.

Rural payment services were not a major focus of this study for two reasons. First, the Government instructed Kazpochta to continue to improve its outreach into the rural areas. Second, the existing inconveniences seem surmountable; for example, rural areas without permanent Kazpochta offices are visited on a regular schedule by a Kazpochta delivery service.

Turning to savings, Kazpochta and Halyk provide most formal savings services in rural areas. These services appear to be underutilized; Kazpochta's entire rural deposit base was about \$500,000 as of January 2002,⁶ while Halyk's average rural area deposit is about \$60, compared to \$343 in urban areas. In Halyk's case, while better-off urban residents could be expected to have higher average deposit levels than rural residents, a more telling perspective on these deposit figures is provided by the fact that being able to pay for one's own funeral is an extremely important cultural norm for both Russians and Kazakhs. Therefore, adult rural residents can reasonably be assumed to be hoarding several hundred

The demand for payment services in Kazakhstan is relatively high because it is largely a check-free economy.

⁶ Kazpochta's recently expanded authority to invest its own financial resources more extensively may help it expand its deposit base in the future; by earning a higher return itself, Kazpochta can pass on a higher return to its clients.

While commercial bank lending to the agricultural sector accounts for 10–12% of total bank lending, the majority of this lending is to large agricultural producers and processors.

dollars apiece for this purpose. That this money is not being held in a formal deposit-taking institution reflects a lack of confidence in these institutions that has been endemic since the demise of the Soviet Union, when essentially all private savings were lost with the collapse of the ruble. As a result, it is not clear that providing more formal savings opportunities would raise the level of formal savings. On the other hand, a lingering reputation for poor service on the part of Halyk and Kazpochta may also play a role, in which case improving their services might increase deposit levels.

In terms of the third major category of rural finance products and services—loan products—demand by creditworthy rural borrowers appears to far outstrip supply. While commercial bank lending to the agricultural sector accounts for 10–12% of total bank lending, the majority of this lending is to large agricultural producers and processors. Banks generally consider lending to small rural households and peasant farms as having an unacceptably low level of return, taking into account the level of risk, small loan size, and degree of effort required to make each loan.

One reflection of these challenges is the relatively small rural loan portfolios of the two primary private sector rural lenders: Halyk Bank and Tsesna Bank.⁷ Halyk's portfolio of loans to peasant farms totaled \$4.9 million as of July 2004, while Tsesna Bank's was about \$58 million (April 2004). A third bank that lends to the rural sector was Nauruz Bank, a formerly state-owned agricultural bank, which had an estimated total loan portfolio of \$80.5 million in April 2004. Due to its financial difficulties, Nauruz Bank was put into liquidation in June 2005.

Despite the challenges of lending in rural areas, phase one of the World Bank's Agricultural Post-Privatization Assistance Project (APPAP) was notably successful in lowering the average loan size made to family farms by the seven participating banks to about \$37,000, while achieving excellent loan portfolio quality as well.⁸

⁷ Tsesna Bank is part of the Tsesna Group, a conglomerate that includes agricultural interests.

⁸ Of the seven participating banks, five did not have nonperforming loans, while one had a nonperforming loan portfolio representing 0.6% of its total APPAP loan portfolio and another accounted for 3.7% of its APPAP portfolio. World Bank, *Implementation Completion Report on a Loan in the Amount of \$15 Million to the Republic of Kazakhstan for an Agricultural Post-Privatization Assistance Project*, 2003.

While there is clearly a lower limit to the size of loans to rural borrowers that commercial banks will find profitable, the second phase of the APPAP project will continue to explore what that lower limit is. For context, using the microfinance definition of the Consultative Group to Assist the Poor (CGAP), a microfinance loan in Kazakhstan would be a maximum of \$3,000. It is relevant to note that some banks that participated in phase one of the APPAP loan may not participate in the second phase, at least in part, because extending smaller loans to the agricultural and rural sector does not correspond to their strategy.

Turning to Government efforts to close the rural finance lending gap, there are four worth mentioning: an initiative to develop rural credit unions; the joint Government-EBRD (European Bank for Reconstruction and Development Kazakhstan Small Business Program (discussed under donor activity); three key entities⁹ that provide microfinance loans in rural areas (Fund in Support of Agriculture, Kazakhstan Agricultural Fund, and NGO Microcredit); and the proposed microfinance program.

The Agricultural Credit Corporation (ACC) of the Ministry of Agriculture has created 79 credit unions through debt and equity participation, and it intends to create a total of 120 credit unions by 2006. ACC will eventually exit from the ownership of the credit unions, although there is no stipulated time frame or defined exit strategy for doing so. The total loan portfolio of the credit unions is about \$24 million, of which \$10 million is allocated to the agricultural sector. Although exact data are not available, it is reasonable to estimate that over 50% of this lending is funded by ACC contributions, since ACC makes an investment of 39–59% in each credit union and lends up to four to six times a credit union's capital.

While a potentially positive outcome of the Government's credit union program is the demonstration effect and actual experience that it provides in the functioning of credit unions, the general perception is that only well-connected rural inhabitants are able to participate in these organizations. As an example, the

⁹ These are the three largest Government-initiated programs; other smaller programs, such as at the regional level, also exist.

The credit union law does allow the creation of fully private credit unions, but few have been created to date.

ACC approves the membership of each credit union. Furthermore, not only is the minimum capital contribution (about \$700 compared to gross national product (GNP) per capita of \$1,992) a constraint for many potential members, but the subsidized financing terms inevitably create rent-seeking incentives.¹⁰ Also, international experience in government-initiated credit unions has been uniformly negative, precisely because credit unions by their nature are grassroots, self-help organizations. The credit union law does allow the creation of fully private credit unions, but few have been created to date. The further growth of both state-initiated and private credit unions is in question because neither is allowed to take member deposits, although proposed changes to the legislation would lift this restriction.

The three primary Government-initiated direct lending programs—Fund in Support of Agriculture, Kazakhstan Agricultural Fund, and NGO Microcredit—have total loans outstanding of about \$27 million. NGO Microcredit, which was created after the 1998 visit to Kazakhstan of the founder of Grameen Bank, should be highlighted in particular as a cautionary lesson because of its lack of compliance with international best practices in microfinance. NGO Microcredit's loans are disbursed on the recommendation of the local *akim* (essentially the state-appointed local leader) and elders, thus putting a premium on connections rather than business acumen; interest rates are a highly subsidized 2–5% per annum; and the repayment rate of about 81% on a loan portfolio of roughly \$9 million compares poorly with that of the best performing microfinance institutions (MFIs) in Kazakhstan. All Government-initiated microfinance programs notably feature subsidized interest rates.

The final Government initiative to be noted is the draft microfinance program, scheduled for implementation beginning in 2005. Acknowledging that the program is still in its draft phase and that this study's research team only received informal information about the program, several potential design elements are cause for concern. First, the rapid rollout of the rural finance element of the program (as much as \$35 million in its first year, or the equivalent

¹⁰ Funds can be borrowed from the ACC at 5% and on-lent to members at 10%.

of almost 15% of official finance-related expenditures on agriculture in 2003) appears to indicate a serious underestimate of the necessary infrastructure and training required to implement such a large microfinance program. Second, the objectives of the proposed program are not clear, particularly the degree to which the potential borrowers are essentially grantees rather than viable borrowers who simply have not had access to finance. Third, and related to the second point, there is apparently a preference to cap the rate at which the loans will be made, without differentiating between those borrowers who can afford to pay a market rate of interest, and grantees.¹¹ The program's large-scale and subsidized interest rates also create the risk that the program will contribute to the failure of other seasoned microfinance programs because they will not be able to compete with the nonmarket conditions offered.

Donor activity in rural finance in Kazakhstan consists largely of the creation and support of microfinance organizations and microfinance on-lending by commercial banks. While most microfinance lending in the past has focused on urban areas (except the Kazakhstan Fund for Assistance to Entrepreneurs, a successor to a TACIS-funded initiative of the mid-1990s), a number of donors are now exploring expansion into rural areas. Kazakhstan is estimated to have 34 MFIs with a total loan portfolio of approximately \$67 million. Some of the largest MFIs have recently created a microfinance association. Based on information provided by 7 of their 11 members, their total rural finance portfolio is about \$1.66 million. It is important to stress that several MFIs interviewed for this study observe international best practice standards in their lending practices and have consequently created loan portfolios of high quality. Most of the programs are still too new, however, to have achieved the productivity levels characteristic of the microfinance industry's most efficient MFIs and are therefore not yet financially sustainable.

Also relevant to note is the joint Government-EBRD Kazakhstan Small Business Program, which as of February 2004 had provided a total of \$470 million in micro- and small loans

¹¹ The urban component of the program will charge market interest rates.

Informal finance provided by larger processing companies appears to be widespread, reflecting the difficulties of smaller producers in obtaining working capital as well as good quality fertilizer, seeds, etc.

(\$100,000–\$200,000 each) through seven participating banks in 38 cities. A program underway to extend this program to agricultural lending will have important implications for the further development of rural finance.

Informal finance also plays a role in the financial sector, both in the form of straightforward moneylending and in the form of larger producers and processors providing cash and in-kind financing to smaller producers who are part of their supply chain. Interviewees contacted for this study stated consistently that moneylending is a common practice though terms vary considerably. Informal finance provided by larger processing companies appears to be widespread, reflecting the difficulties of smaller producers in obtaining working capital as well as good quality fertilizer, seeds, etc.¹² This financing is typically provided under an enforceable contract. The producers who were interviewed noted the general success of this type of arrangement, characterized by closely aligned interests of both parties. The system is attractive to processors because it ensures them the necessary supply, grown with their specified inputs and often under their close supervision. The borrowers are able to obtain high quality seeds, fertilizer, and other inputs that are often not accessible in the open market, in addition to a confirmed sale at a known price.

In summary, efforts are being made to address the lending gap in rural financial services, both in terms of ensuring that the gap is addressed by commercial banks to the extent commercially feasible, and closing the rest of the gap through credit unions and MFIs. Nevertheless, Government-initiated programs raise the following serious concerns: the prevalence of interest rate subsidies in Government-sponsored initiatives; the likelihood that some Government programs, such as credit unions, favor the well-connected; and possible design shortcomings in the upcoming Government microfinance program. There is a significant risk that these shortcomings could prevent rural finance from developing on a commercially sustainable basis, by rendering it impossible for commercial providers to compete.

¹² This is also a common practice in developed markets because of the efficiencies created by the shared objectives of the two parties.

C. Policy, Legal, and Regulatory Environment

The Government of Kazakhstan's overall track record in supporting economic development is impressive. Kazakhstan has implemented the most successful banking sector reform of the non-Baltic former Soviet republics; reduced inflation to under 10% per annum by 1998, following the hyperinflation of the early 1990s; created a national oil fund to guard against the Dutch disease and to conserve some oil earnings for future generations; and implemented a three-pillar, fully funded pension program.

On the negative side, however, Kazakhstan typically receives poor ratings on international corruption indices, with the Government frequently being accused of having opaque interests in the private sector.¹³ The opacity is increased by the executive branch's appointing judges and regional and local governors who therefore have minimum accountability to the general public.

Kazakhstan's legal framework and judicial system are sufficient to create an environment that is at least moderately favorable for rural finance. Most important, Kazakhstan has a well-developed collateral registration system, in which all applications for registration must be processed within 5 days for a fee of about \$35. While some interviewees (all of whom were microlenders) expressed frustration that the mandated time frame is not always observed, the key point is that a collateral interest in immovable and movable property (including livestock) can be registered.

While shortcomings in the transparency of the judicial process and the enforcement of decisions are commonly noted, these tend not to be relevant for rural finance borrowers because they are typically prepared to settle any differences with lenders out of court. Furthermore, regulations for collateralized lending do not require that a lender go to court to seize and liquidate collateral.

Kazakhstan's Land Code of 2003 is potentially a positive development because it allows for permanent land ownership,

Kazakhstan's legal framework and judicial system are sufficient to create an environment that is at least moderately favorable for rural finance.

¹³ Transparency International's 2004 Corruption Perception Index rates Kazakhstan 2.2 on a scale of 1–10, in which a rating of zero is defined as "highly corrupt." By comparison, Russia's rating was 2.8.

While Kazakhstan's banking sector is clearly concentrated, with the top three banks accounting for over 60% of banking sector assets, the sector defies the standard assumption that concentration implies lack of competitiveness.

although it is too early to judge the outcome at present. On the positive side, the Code will put land into private hands and give owners the incentive to develop the land for its best use. On the negative side, despite efforts to create price formulas to protect small buyers, particularly farmers, it seems inevitable that insiders will devise ways to sidestep these regulations. While such sidestepping could lead to property speculation, a more positive outcome could be more optimal farm sizes.

Another important characteristic of Kazakhstan's political, legal, and regulatory framework is the successful development of its banking sector and, to a certain degree, its financial sector overall. The International Monetary Fund provides a representative assessment, which states that, "The key issues facing regulators are to generalize the significant progress made in banking supervision to the rest of the financial sector and to ensure that adequate risk management techniques are implemented..."¹⁴

While Kazakhstan's banking sector is clearly concentrated, with the top three banks accounting for over 60% of banking sector assets, the sector defies the standard assumption that concentration implies lack of competitiveness. Signs of competitiveness include a rapidly expanding retail banking activity, declining interest rate margins, and expanding Kazakhstan's largest banks to the Russian Federation and Kyrgyz banking markets in search of new business. The facts that (1) all of Kazakhstan's large state-owned banks have been privatized and (2) foreign bank ownership is allowed to reach 50% of banking sector capital also contribute to a competitive environment.¹⁵

The degree of competitiveness in Kazakhstan's banking sector is particularly relevant for rural finance because a more competitive environment will push banks more quickly toward relatively untapped markets such as rural finance. The willingness of Kazakhstan's banks, including the three largest banks, to participate in the World Bank's and the EBRD's agricultural finance programs

¹⁴ International Monetary Fund (IMF), *Republic of Kazakhstan: Selected Issues and Statistical Appendix*, 2003, 56.

¹⁵ One caveat could concern bank ownership. If critics are correct that there is opaque Government-related ownership in the banking sector as well, this could create an uneven playing field that would not necessarily be apparent to an outside observer.

indicates their interest in further exploring at least the agricultural aspect of rural finance.¹⁶ However, the fact that only Halyk Bank has an extensive branch network (as was noted, 112 of its 149 branches are in rural areas) means that other banks would face significant infrastructure and personnel hurdles as part of the challenge of expanding significantly into rural finance.

The legal, regulatory, and supervisory framework for nonbank financial institutions in Kazakhstan is relatively extensive for the region. Kazakhstan has a revised leasing law that the International Finance Corporation praised; a law on microfinance institutions; the credit union law (whose shortcomings were noted above); a plan for further development of Kazpochta's rural financial services; and provisions for regulating pawnshops¹⁷ by the Financial Supervisory Agency (FSA). Also useful for banks and nonbanks will be the creation of a credit bureau as the result of legislation passed in June 2004.

One possible shortcoming in this framework that does merit attention is the FSA's stated intention not to issue any more than the five existing MFI licenses. Having such a license provides two operational advantages: lenders can make loans exceeding \$6,000, and loan loss reserves are considered a pre-tax expense.¹⁸ The FSA's apparent unwillingness to contemplate the creation of additional licensed MFIs would seem to dampen competitiveness among the smaller MFIs and reduce growth in the industry.¹⁹

Finally, in terms of the nonfinancial aspects of developing agriculture and the rural sector, the Government of Kazakhstan deserves positive notice for a range of programs that fit in the overall context of the Government's strategy for 2030, which includes

The FSA's apparent unwillingness to contemplate the creation of additional licensed MFIs would seem to dampen competitiveness among the smaller MFIs and reduce growth in the industry.

¹⁶ Support for this argument is provided by the IMF's observation that "the banks appear to be fairly competitive within their own group, but not necessarily between groups. For instance, the three largest banks compete with each other, but view some of the medium-sized and smaller banks as competitors. In addition, banks are competitive in and around the big cities, but only a few banks cater to the smaller towns. Recent economic growth has enabled large Kazakhstani business groups to access international markets with lower borrowing rates. This has led some of the larger banks to change their strategy to focus more on SMEs, and diversify into retail business." IMF, *Republic of Kazakhstan: Financial Sector Assessment, Program Update: Technical Note on Bank Profitability and Competition*, 2004, 16.

¹⁷ Note that pawnshops do not take deposits, despite being regulated by the FSA.

¹⁸ Neither licensed nor unlicensed MFIs can take any type of deposits.

¹⁹ The law on MFIs is currently being reviewed to consider possible changes in the maximum size of loans that can be issued by nonlicensed MFIs.

narrowing the gap between urban and rural standards of living. The Government's medium-term national strategy, which extends to 2010, specifies the aim of doubling Kazakhstan's GDP, including increasing the competitiveness of the agricultural sector. Regarding rural areas specifically, 2003–2005 have been designated as Kazakhstan's "Years of Rural Revival" within the longer-term context of the "National Rural Development Program in the Republic of Kazakhstan for 2004–2010."

The rural development program is particularly relevant because it identifies overpopulation relative to livelihood possibilities as the key reason for low living standards in rural areas and categorizes rural areas into four groups based on their economic potential.²⁰ Those with the highest economic potential will receive the most resources under the plan. Of Kazakhstan's 7,660 rural settlements, 1,062 received high economic potential scores, while 5,664 received medium scores. These scores were based on a detailed methodology that international consultants, using ADB funds, developed.²¹

The State Agrofood Program of the Republic of Kazakhstan for 2003–2005 covers further development of the agricultural sector. This program has three objectives: ensuring food security, establishing an efficient agribusiness system, and increasing the sale of raw and processed agricultural products domestically and internationally.

Finally, it is useful to note that state support for agriculture in 2002 accounted for about 0.7% of GDP, compared to 1% in the Russian Federation and considerably more in European Union countries.²² The State Agrofood Program forecasts that budgetary expenditures on agriculture will reach at least 1.8% of GDP starting in 2005 and that agricultural production will slightly exceed 10% of GDP by year-end 2006, compared to 7.9% in 2002.

²⁰ Although this report emphasizes the low population density of Kazakhstan's rural areas, a number of them are nevertheless overpopulated in terms of the available resources. Scanagri, *op. cit.*

²² Direct state support for agriculture in 2002 was about \$164 million, while direct subsidies (tax preferences, debt deferrals, loan guarantees, etc.) brought the total to about \$605 million.

D. Major Issues/Problems Underlying Rural Finance

Three key characteristics of Kazakhstan's rural sector pose particular challenges for providers of rural finance. One characteristic is the low population density that makes it difficult for financial institutions to create economies of scale. As one example, one microfinance provider in Almaty agreed to provide finance to a potential borrower, about a 2-hour drive from the city, if that borrower could identify three other borrowers. Ultimately two other borrowers from that settlement successfully received microloans, creating a situation that is marginally manageable for a microfinance organization with a social objective, but perhaps not feasible for a commercial bank.

A third challenge is caused by suboptimal farm size; as already noted, one recent study estimates that 83% of Kazakhstan's farms are smaller than optimal. The resulting inefficiencies inevitably create inefficiencies for lenders as well—less efficient farms create smaller margins for error, therefore requiring lenders to spend more time analyzing the creditworthiness of potential borrowers.

There are also two specific finance-related constraints to the further development of rural finance. One is the relatively small loan sizes required. Creditworthy rural borrowers with financing needs of \$35,000 and above could arguably be served by the banking sector, based on benchmarks created by the World Bank's APPAP program. Options for smaller borrowers are credit unions and MFIs. As noted, however, credit unions presumably favor better-connected members, while only five MFIs have a license entitling them to make loans over \$6,000. Therefore, at least until the Government-EBRD Program for Small Business expands substantially into rural areas with its new agricultural lending program, smaller borrowers are still at risk of being underserved.

The second finance-related constraint—which is in the process of being addressed by the APPAP program, the joint Government-EBRD Program for Small Business, and those MFIs focusing on rural areas—concerns the methodology for lending effectively to rural borrowers. Two primary methodological issues are evident: (i) to ensure that the analytical emphasis is shifted

One recent study estimates that 83% of Kazakhstan's farms are smaller than optimal.

from relying on collateral to lending on a cash flow basis; (ii) rural finance lenders must learn to maximize their productivity levels, given the low population density challenges that have been discussed.

E. Conclusions

Some of the key elements supporting further development of rural finance in Kazakhstan are in place. The banking sector is competitive, and the World Bank's ongoing APPAP program, which targets smaller agricultural borrowers, and the joint Government-EBRD Program for Small Business, which is now expanding into agricultural finance, are taking the lead in helping banks determine the degree to which at least the agricultural component of rural finance is a good commercial fit with their overall strategies.

To the degree that commercial banks cannot address rural finance needs, a network of complementary institutions is being developed and expanded, including state-initiated credit unions, microfinance institutions, and Kazpochta. Furthermore, this network is being developed within the larger context of national programs for the support of agriculture and rural areas.

It must be stressed, however, that two potentially fatal shortcomings undermine a number of these Government programs. One is the subsidized interest rates that characterize many of the programs from microfinance institutions, to Kazagofinance, the state-owned leasing company, to programs encouraging banks to lend to large agricultural processors. There is no indication that the actual need or effectiveness of these subsidies has been evaluated. As one example, Kazakhstan's commercial banks appear quite eager to lend to large agricultural processing companies, so that it is not clear what role is played by subsidizing interest rates. Regarding interest rate subsidies to microborrowers, international experience has consistently shown that subsidies reduce the repayment incentives of creditworthy borrowers. They also render MFIs nonsustainable unless they have their own permanent source of subsidized funding.

Kazakhstan's commercial banks appear quite eager to lend to large agricultural processing companies, so that it is not clear what role is played by subsidizing interest rates.

A second shortcoming in at least some programs is a nontransparent process for allocating financing, such as through the NGO Microcredit program in which loans are made based on recommendations from the local *akim* and elders. A second example is provided by the credit unions.

As noted, these and other shortcomings lead to concern about the Government's draft microfinance program, scheduled for implementation in 2005. They also threaten to render the encouraging commercial efforts to expand into rural areas nonviable, by creating an environment in which commercial providers cannot compete.

In conclusion, recommendations for further steps by the Government and the donor community are:

- (i) reevaluate the design of the Government's draft microfinance program to ensure that it complies with international best practice and will not threaten the further development of existing microfinance lenders;
- (ii) analyze the degree to which interest rate subsidies in existing rural and agricultural finance programs achieve an appropriate cost-benefit result, given the fact that lenders appear ready to provide financing without this subsidy;
- (iii) encourage the development of privately owned credit unions and develop a practical time frame and procedures to privatize government-sponsored credit unions;
- (iv) evaluate the impact of the FSA's stated intention of not issuing more MFI licenses on the development of the MFI industry, particularly in rural areas, in light of the positive role that licensed MFI providers have played in other countries; and
- (v) continue work underway to apply best practice methodology to rural finance lending, including effective borrower analysis (with an emphasis on cash flow lending) and maximum lender productivity.

Chapter 5

Rural Finance in the Kyrgyz Republic

Executive Summary

Mariano Cordero and Robert C. Vogel¹

A. Introduction

The area that is now the Kyrgyz Republic was populated for centuries by nomadic tribes and came under Russian control only in the 1860s, becoming a full-fledged Soviet Socialist republic in 1936. But the forcible settlement of nomads in the 1930s greatly reduced the influence of tribal and nomadic traditions. Along with much of the former Soviet Union, the Kyrgyz Republic became independent in 1991 and since then has been a leader among Central Asian countries in liberalization and transformation from central planning to a primarily private and market-based economy.

The Kyrgyz Republic is also distinguished from other parts of Central Asia by its extremely mountainous topography that provides impressive scenery—and hence tourist potential—but at the same time makes road transport very difficult in many areas. This topography also creates highly varied climatic conditions, with many areas unfavorable for agriculture but at the same time creates abundant water for both hydropower and irrigation. Specifically, 45% of the Kyrgyz Republic is pastureland with less than 10% dedicated to crops, but mostly irrigated, while the rest is not suitable for agriculture. Among crops, wheat is the most important in the

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¹ Support for the preparation of the country report, from which this summary is taken, was provided by Askar Khadjimouratov and Dinara Masydykova.

The incidence of poverty is especially high in rural areas, with over half of the population considered poor and almost 25% extremely poor.

north while the south, especially the Ferghana Valley, has more variety (cotton, fruits, and vegetables), although the amount of land per capita is much less. In any case, because of topography and tradition, meat and wool are overall the most important agricultural products. The rugged terrain hints at gold and other mineral resources; in fact, gold is the country's most important export.

The population of the Kyrgyz Republic is currently almost 5 million, and the distribution between rural and urban has been largely unchanged for at least 30 years, with about two thirds being rural and one third urban. Typical of most countries of the former Soviet Union (FSU), the level of education in the Kyrgyz Republic is quite high, although it has fallen in the years since independence. In any case, the Kyrgyz Republic is among the poorer countries in the region with gross domestic product (GDP) per capita of only slightly over \$300 using an exchange rate conversion (of course, this is higher using purchasing power parity). The incidence of poverty is especially high in rural areas, with over half of the population considered poor and almost 25% extremely poor.

However, although overall income inequality has increased greatly in the years since independence, the rural areas have improved relatively in terms of poverty indicators.

Relative to other Central Asian countries, the overall economic performance of the Kyrgyz Republic has been quite reasonable with a growth rate in real GDP as high as almost 10% in one year. However, growth was low or even negative in the initial years after independence and highly erratic overall, mainly because of external shocks—such as the Russian crises and variations in export markets and prices—and a major fall in domestic gold production in 2002. The rate of inflation was highly erratic in the 1990s, but has been low since 2000, with interest rates falling in response. Due to variations in inflation and the nominal exchange rate, the real exchange rate has also been quite variable and thus problematic for developing stable exports markets. However, the main macroeconomic problem has been the growing external public debt although the fiscal deficit has been better controlled recently.

Agriculture is still the main sector of the Kyrgyz economy, accounting for more than one third of GDP (down from almost

half in some earlier years) and employing about half of the labor force. However, it accounts only for about 10% of exports, partly due to the predominance of gold. Manufacturing accounts for less than one fourth of GDP and has tended to be unstable, due to erratic gold production in some years. In rural areas, only about one third of income is generated by selling agricultural output, suggesting substantial auto-consumption on the one hand, but possibly also significant diversification on the other.

Economic liberalization has also largely transformed the agricultural sector, with reforms including the government getting out of agricultural pricing and marketing and allowing free entry into agricultural pursuits. The basics of land reform were mainly completed by 1996, with state and collective farms now producing less than 10% of agricultural output and with significantly higher yields on private farms. With the fragmentation accompanying privatization, there have been complaints about small farm size but the main problems seem to be inadequate infrastructure, especially roads, and imperfections in land ownership and land markets, as discussed in more detail below, although land can freely be rented.

B. The Status of Rural Finance

1. Banks

In most countries, the banking system is the main provider of financial services in rural areas. This is also true in the Kyrgyz Republic, except for two or three donor-created lenders that are also quite important. Overall, the formal financial sector is very small in the Kyrgyz Republic, including in rural areas. Total bank assets comprise only 10% of GDP, with the assets of nonbank financial institutions (NBFIs) another 2.5%. Moreover, the money supply is composed primarily of currency, with deposits considerably smaller, and a substantial share of deposits in foreign currency.² This poor performance in deposit mobilization is usually attributed to

Total bank assets comprise only 10% of GDP, with the assets of nonbank financial institutions (NBFIs) another 2.5%.

² Whereas total deposits relative to GDP have risen significantly from less than 5% in 2002 to more than 10% in 2004, the share of these deposits in foreign currency has also risen and is now close to 90%.

lack of confidence in the banking system stemming from various banking crises since independence. But research for this paper indicates that poor service, including difficulties with intra-bank money transfers that can be especially problematic for rural residents, may be as important. This has two major policy implications, which are discussed later in more detail: (1) benefits from deposit insurance would be few, especially compared to the risks; and (2) more in-depth analysis is needed to understand the reasons for poor service, possibly followed by appropriate donor technical assistance.

The Kyrgyz Central Bank (NBKR) was established in 1991, followed by two-tier banking in 1993, with four traditional banks (all state-owned) initially dominating the system. As of late 2003, there were 17 private banks, two branches of foreign banks, and the Savings and Settlements Company (SSC), which is still government-owned. The three largest banks account for half of banking system assets, and two of these have large rural branch networks. Together with the SSC, they account for two thirds of all bank branches, with most of these branches outside of Bishkek. A major focus of this study has thus been on these three banks, including visits to many of their rural branches in various parts of the country, in addition to examining government statistics. For banks in general, and especially the three with major rural branch networks, the main source of funds is deposits, accounting in most banks for over 60% of liabilities. Assets are predominantly liquid assets and loans, each ranging from 25 to 50% for almost all banks in the system including those with the large branch networks—clearly very conservative positions, possibly a lingering effect of the earlier banking crises.

Visits to rural branches largely confirmed the information obtained in Bishkek from bank head offices and from government statistics. Interest rates and spreads, though declining since 1999, were still seen to be high, especially by international standards. Almost everyone agreed that collateral requirements were a major barrier to increased bank lending for agriculture, while excessive requirements for documentation and procedural delays were also often cited as problems for rural bank lending in general. Nonetheless, bank lending for agriculture was substantial and even

more for commercial purposes in rural areas, with most loans ranging in value from a few hundred to a few thousand dollars. Moreover, loan approval powers were typically delegated to branches, with approval limits tending to be more than adequate for most loans being made. The main factor limiting rural bank lending, especially for agriculture, was insistence on physical collateral, together with the inability to use rural land effectively for collateral, as discussed in greater detail below. Cash flow-based lending was rarely encountered in banks, whether due to excessive risk aversion among bank staff or to a lack of understanding of cash flow lending—issues that require further investigation and possible donor interventions to ameliorate.³

Bank staff at rural branches also consider deposits, remittances, and payment services in general as important. Remittances, especially from the Russian Federation, were important almost everywhere, both as a service for clients and as a source of fee income for banks. The view in rural bank branches that deposits are important is not, however, consistent with the evidence discussed above that deposit mobilization is generally quite poor, so that this issue had to be studied in greater depth. One bank (the SSC) provided detailed information on its deposit patterns showing that, overall, deposits were primarily demand deposits from firms but outside of Bishkek, time deposits of individuals were relatively more important. Nonetheless, the SSC performs no better in deposit mobilization than private banks, suggesting that lack of confidence is unlikely to be the main cause. So, the quality of bank deposit services needed to be investigated in depth.⁴

This investigation involved a Kyrgyz member of the study team actually opening deposit accounts and carrying out related transactions at the three banks under study. Requirements to open an account were found not to be onerous or time consuming, with low minimum balance requirements and small fees only for legal

The main factor limiting rural bank lending, especially for agriculture, was insistence on physical collateral, together with the inability to use rural land effectively for collateral.

³ In the workshop held at the end of the study, many leading bankers and other major lenders often failed to understand the crucial difference between cash flow and profitability.

⁴ The relatively high demand for currency suggests that government macro-financial policies are credible, while government ownership would make the SSC a relatively safe haven for deposits compared to private banks if the fear of further bank failures was the main factor limiting deposit mobilization.

The major advantage in the Kyrgyz Republic of numerous and widespread (and presumably competing) bank branches appears to be largely offset by inadequacies in bank deposit services.

Entities. Banks also offered reasonable interest rates, 3% annual for 3-month time deposits, up to 8% for those of a year or longer, with a more aggressive bank paying one or two percentage points more.⁵ Surprisingly, however, there are charges of up to 1% for withdrawals, even from sight deposits, especially if the withdrawal is in cash and the deposit was not in cash. Moreover, to move money even from one branch to another of the same bank requires opening an entirely new account at the other branch and then waiting another day or two for the actual transfer. Bank staff said that this is done for security reasons. Thus, for deposit mobilization, the major advantage in the Kyrgyz Republic of numerous and widespread (and presumably competing) bank branches appears to be largely offset by inadequacies in bank deposit services. This, however, may now be changing with, as noted above, the overall ratio of deposits to GDP rising substantially since 2002. Moreover, this increase has been primarily in foreign currency deposits, which coincides with the growing importance of more sophisticated and service oriented Kazakh-owned retail banks in the Kyrgyz economy. Furthermore, while donor technical assistance might be helpful in increasing rural deposit mobilization in particular, the deposit insurance schemes currently under consideration would not be—and might instead add moral hazard risks to bank behavior.

2. Nonbank Financial Institutions (NBFIs)

The Kyrgyz Republic also has large numbers of nonbank financial institutions (NBFIs), mainly exchange houses, pawnshops, and credit unions. Most are very small. Only the Finance Company for the Support and Development of Credit Unions (FCCU), Kyrgyz Agricultural Finance Company (KAFC), both state-owned, and some three private microfinance institutions (MFIs) are really important in rural areas. The amount of rural credit supplied by NBFIs is significant, mainly because of KAFC, but no NBFI is yet permitted to take deposits (*see policy and regulatory discussion below*). KAFC, which is government-owned, started operations at the end

⁵ In comparison, the rate of inflation has recently ranged around 2 to 3%, except in 2003 when it was slightly higher but still under 6%.

of 1996 with external funding from various donor agencies, especially the World Bank. KAFC has over 200 professionals and a widespread network of branches with ample delegation of lending powers and thus potentially good response to clients. It lends up to \$10,000 for farms and up to \$250,000 for trade and processing firms, with loan maturities up to 4 years. Although most loans require physical collateral, interest rates are low compared to other lenders, 18% for initial loans and going as low as 15% for repeat borrowers.⁶ Recently KAFC has been spreading out from purely agricultural lending to include other rural activities and to use solidarity groups with support from donors (the United Nations Development Programme [UNDP] and the Swiss), thereby implying a further subsidy element as well as some loss of control over the lending and loan recovery process. KAFC claims over 95% repayment, but this may be overstated due to rapid growth, long maturities, and subsidy elements. Although KAFC is not allowed to take deposits, NBKR carefully regulates it perhaps because government would ultimately need to cover any losses it might incur. With support from the European Union (EU), KAFC is studying various options for its future, including obtaining a license to take deposits or becoming a bank and/or being privatized, but some major reservations have been expressed, as discussed below.

Overall, there are some 72 MFIs but only three of these have attained enough size to play a significant role in rural finance, and none is in the deposit-taking category. Most MFIs lend predominately to women, for a wide variety of uses, and in amounts of a few hundred dollars with less than a one-year maturity. But with trade clearly the dominant activity financed, MFIs typically focus on cash flow and character, often using a solidarity group approach rather than requiring physical collateral. These MFI-pioneered approaches could provide some interesting lessons for collateral-oriented banks.

FINCA, which began operations in 1995 with support from the United States Agency for International Development (USAID), is by far the largest MFI, with a loan portfolio of \$6 million and

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⁶ Many competitors complain that KAFC can subsidize its lending rates because of subsidized funding from donors.

21,000 active clients as of October 2003. Beginning with only women's solidarity groups, FINCA extended its operations to individual loans in 1998 to retain its larger and better clients. Individual loans now account for 20% of its loan portfolio and 10% of its clients. FINCA is already self-sustaining, with its operations considered "best practice," and it would like to become a microfinance company to capture deposits and offer other services. Although it has an extensive network of rural branches with adequate powers delegated to them and does substantial rural lending, little of it is for agricultural purposes.

BaiTushum, created and supported by the US nonprofit ACDI/VOCA with funding primarily from USAID, is much smaller than FINCA with fewer branches and much larger sized loans. Its traditional focus has been on lending for agricultural purposes, and now it wants to expand to reach smaller clients using solidarity groups with the assistance of outside donor agencies (e.g., UNDP), much like what KAFC is doing. Mercy Corps is the oldest MFI in the Kyrgyz Republic, beginning operations in 1994. Mercy Corps' approach is different from the other two large MFIs as it functions primarily as a wholesaler providing funds to affiliated MFIs for on-lending. Most of these affiliates primarily make small solidarity group loans, but in Bishkek larger individual loans up to \$25,000 are made. Recently, however, Mercy Corps has made some major adjustments, selling to KAFC its programs of agricultural production loans that finance agricultural machinery purchases up to \$15,000, with financing for processing and storage firms for up to \$50,000, among others.

3. Informal Finance

Visits to rural areas suggested that informal finance might play an important role in rural finance in the Kyrgyz Republic, as it does in so many other countries.⁷ A special study was thus carried out that focused on the financing of producers by agricultural processors in

⁷ Even in the United States with its highly developed financial and agricultural sectors, as much as half of finance for agricultural producers appears to come from informal sources, especially providers of inputs, marketing agents, and processors, due to informational economies.

Osh, Jalal-Abad, and Chui oblasts. Such financing was found to be especially important for cotton in Osh and Jalal-Abad and for sugar beets in Bishkek and, to a lesser degree, for processed fruits and vegetables. These arrangements typically provide in-kind inputs with payment delayed to the harvest to provide a secure source of supply for the processor. All producer costs other than labor may be financed, maturity is usually planting to harvest, and security is a claim upon the harvest, never rural land as collateral. While implicit interest rates may be relatively high, ongoing relationships of this type keep reliability high and transaction costs very low, with the main constraint being processor access to funding. Credit transactions involving marketing agents and traders are also common, but credit may run in either direction— from agent to producer or vice versa. Particularly common are consignments from wholesalers to retailers in city markets (e.g., in Bishkek). In fact, informal credit is even advertised in newspapers in Bishkek, and in Osh there is a particular area in the market where credit information can be obtained and arrangements made.

Credit transactions involving marketing agents and traders are also common, but credit may run in either direction— from agent to producer or vice versa.

4. Credit Unions

With the objective of providing greater access throughout the country to small loans, the Asian Development Bank (ADB) helped set up and promote the FCCU and provided it with \$11 million for on-lending to credit unions. Notwithstanding the good intentions, this effort has proved problematic at the level of both the FCCU and the credit unions themselves. In response to the offer of a loan matching the amount of credit union members' equity, the number of credit unions increased from 83 at the end of 1998 to 349 by the end of 2002, but decreased to 306 by the end of 2003. The most recent figures show that credit unions have relatively highly leveraged positions, with 164 million in member equity compared to 121 million in loans (both measured in local currency), much higher than recommended by international standards that emphasize internal funding through member shares and deposits rather than external loans. Visits to several rural credit unions confirmed that their main focus was on obtaining ADB money through loans from the FCCU.

In response to its poor financial performance, due most clearly to excessive overhead resulting from too many highly paid staff (potential losses from bad loans could not be ascertained), FCCU management had been planning various new profit-making activities. These included major increases in its lending to credit unions, allowing a loan to equity ratio of 4:1. Not only would this compound the current incentive for “rent seeking” by credit unions but would also violate the existing credit union law. Other proposed FCCU profit-making activities also contradict international credit union standards, including dealing directly with credit union members in some lending and leasing activities. However, a newly arrived head for the FCCU appears to be taking it in new directions with greater attention to reducing costs and improving performance in essential ways. Furthermore, as discussed in greater detail below, the movement (with some donor support) to give the FCCU a major role in regulating and supervising credit unions—in spite of the potentially serious conflict of interest in having the FCCU both regulate and promote—appeared to have been thwarted by NBKR’s decision to take on the function of regulating credit unions.

5. Donor Agencies

Many donor agencies are active in providing technical assistance and funding for lending in the financial and rural/agricultural sectors.

Many donor agencies are active in providing technical assistance and funding for lending in the financial and rural/agricultural sectors. As discussed, ADB has a major project with the FCCU for on-lending to credit unions. Deutsche Gesellschaft für Technische Zusammenarbeit (GTZ) complements ADB’s efforts with technical assistance that focuses on introducing a simplified version of PEARLS⁸ for credit union monitoring, along with MicroBanker computer software. In addition, GTZ is providing more intensive technical support to 10 pilot credit unions to prepare them for effective deposit mobilization.⁹ GTZ also has a number of other rural support projects, mostly related to cooperatives, while ADB’s

⁸ PEARLS or Protection, Effective Financial Structure, Asset Quality, Rates of Return, Liquidity, and Signs of Growth.

⁹ GTZ was also planning to develop FCCU’s regulatory and supervisory capabilities, but as mentioned above, a decision by NBKR to take on this responsibility appears to have made this part of GTZ’s program redundant.

Area Development Project provides funds to KAFC for on-lending. Among its many other activities, ADB also has a wide-ranging project for legal and regulatory infrastructure and improved governance in financial institutions.

While the World Bank has a number of important projects related to the rural/agricultural sector, including land registration and irrigation, the activity most relevant to rural finance has been its support of KAFC, already discussed in detail. EU/TACIS has a number of small projects, including trying to develop a credit bureau, and is also providing the technical support for KAFC's analysis of its alternative for further development, including privatization and/or conversion to a bank. Among its various activities, UNDP also assists KAFC as well as some MFIs in developing solidarity group lending. World Bank's companion, the International Finance Corporation (IFC), has made investments in several banks and in FINCA, and has also taken the lead in developing leasing throughout Central Asia, including the Kyrgyz Republic. The European Bank for Reconstruction and Development (EBRD) is providing four banks with funds for micro- and small enterprise finance, along with various other donors, and has equity investments in three banks, and a trade finance arrangement with four banks, but nothing specifically targeted to the rural/agricultural sector although it supports agricultural input supply firms and agro-processing firms.

USAID has a number of projects supporting the rural and agricultural sectors and for developing the financial sector. In particular, it has been the main supporter of the three MFIs noted above, while also strongly supporting improvements in land holding and the legal system and helping NBKR improve its regulation and supervision capabilities. The International Monetary Fund (IMF) is also providing specific support to NBKR for bank regulation and supervision and for the development of deposit insurance, as well as carrying on its usual functions. Among the other donors, the Department for International Development (DfID) has a variety of small rural projects— some in support of agriculture but mostly in handicrafts. The International Fund for Agricultural Development (IFAD) is providing advisory services for farmers,

while the Food and Agriculture Organization (FAO) has a number of projects in Central Asia, and some specifically in the Kyrgyz Republic, in a variety of technical areas related to agriculture. The Swiss have worked significantly in agriculture and related areas, including one project that includes subsidized credit for poor farmers in isolated areas.

C. The Policy, Legal, and Regulatory Environment

In general, prudential regulation and supervision for banks are reasonably good.

For the most part, the policy, legal, and regulatory environment in the Kyrgyz Republic is favorable for rural finance. Specifically, there are no controls over interest rates although a few subsidized and targeted credit programs run by government nonfinancial institutions could crowd out sustainable private finance. Fortunately, the funding for such programs is very limited due to budgetary considerations.¹⁰ In general, prudential regulation and supervision for banks are reasonably good, with staff having adequate skills but with some shortcomings on the effectiveness of enforcement due especially to court interference. On the other hand, government policies have not strongly supported rural or agricultural infrastructure.

The regulatory framework is also good for nonbank financial institutions that do not take deposits, as the main requirement is for reporting, which in turn requires a standard chart of accounts and external auditing. However, this appropriate treatment could readily be changed, as it is given in NBKR regulations and not in the relevant law. Microcredit companies (either profit or nonprofit) cannot take deposits but they can convert into microfinance companies that can take deposits, after which regulation and supervision become more strict and similar to that for banks. However, the law restricts them to time deposits only, while their normal clientele will likely need more liquid savings deposits. In

¹⁰ The Ministry of Agriculture and Water Resources currently has no funded programs, but the Ministry of Labor and Social Protection has a small one for the poor and unemployed, as does the State Committee for the Development of Entrepreneurship for small and medium enterprises.

addition, conversion into a deposit-taking microfinance company requires a feasibility study, and branching privileges can be limited.

The law dealing with credit unions is generally appropriate, notwithstanding the provision allowing a partial withdrawal of member shares and some ambiguity about the requirement for a common bond. Furthermore, the stricter requirements for credit unions wanting to take deposits can easily be circumvented by giving greater liquidity to member shares. The main issue had, however, been whether NBKR or the FCCU (or possibly even some federation, although these are currently very weak) would regulate and supervise credit unions. While only NBKR does not have a serious conflict of interest with respect to simultaneously promoting and regulating, it preferred not to assume this responsibility given the large number of small entities that would need to be dealt with. Nevertheless, as mentioned above, NBKR has recently decided to assume regulatory responsibility for credit unions. However, as emphasized elsewhere, more transparent information needs to be obtained to adequately understand the characteristics of credit unions to design an efficient and effective system for their regulation and supervision.

The main impediment to expanding the outreach of lending in rural areas is the poor framework for secured transactions, especially given bankers' preferences for collateral relative to cash flow-based lending, together with the many impediments to using rural land as collateral.¹¹ Moreover, these same impediments limit the possibility of developing rural land markets that are also essential for rural land to be effective as collateral since bankers would want to sell such land, not keep it to use. In fact, banks can only own land very temporarily, as the law prevents legal entities from owning rural land to prevent foreigners from owning rural land indirectly. Moreover, only an individual who has been a rural resident for at least 2 years can own rural land, and the interpretation in some court cases has been that residence must be in the same area where

The main impediment to expanding the outreach of lending in rural areas is the poor framework for secured transactions.

¹¹ In addition, character-based lending has been inhibited by the lack of an effective credit bureau, which is said to be opposed by most banks (as they have few clients, many of whom are related parties), nor is the EU credit bureau project likely to advance quickly, especially as it is based on voluntary participation when only a mandatory start-up can deal effectively with the externalities involved in information sharing.

the land is located. Other impediments include that, in the rural land privatization process, land was distributed to individuals in single shares that were often noncontiguous parcels and, for individual sale, would need to be re-registered, a costly process even when land use right is well recognized. In addition, rural land use cannot be changed without permission, and rural land can also be confiscated if it is not farmed for 3 years. Furthermore, foreclosure can be delayed if lack of payment can be attributed to some natural calamity. Finally, as is widely recognized, the Kyrgyz judicial process can often be slow and nontransparent, including cases involving contracts and collateral. On the positive side, bankruptcy law gives even unsecured creditors relatively high priority, and new laws also make leasing an effective alternative for circumventing some of these problems.

D. Major Remaining Issues

Given the overall smallness of the Kyrgyz financial sector, the formal, rural financial sector has some way to go to fulfill the demand for rural financial services. Nonetheless, there appear to be enough participants, including banks, government nonbank financial institutions, NGOs, and credit unions, with substantial rural networks and a variety of financial services (e.g., loans, deposit, payments, and remittance services) that, with growing experience and expertise, are well positioned to expand and deepen rural financial markets in the Kyrgyz Republic. There is also clear evidence that informal providers of rural financial services (e.g., agricultural processors, input suppliers, moneylenders, and wholesalers) are currently filling much of the existing gap. However, most formal lenders show an obsession with physical collateral and little knowledge of, or interest in, lending based on cash flow and character. Moreover, the banking system suffers from serious problems in deposit mobilization, as the ratio of deposits to GDP in the Kyrgyz Republic has been among the lowest in the world, while the ratio of currency holdings to GDP is relatively high.

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1. Improving Infrastructure for Rural Enterprises

A viable and sustainable expansion of rural financial services in the Kyrgyz Republic will depend greatly on the competitiveness and profitability of rural enterprises. In general, the government will need to maintain its resolve in continuing macrolevel reforms, but with more specific attention to the agricultural and rural sector and especially the adequacy of rural infrastructure. A major challenge for the Kyrgyz Republic is the isolation of many of its rural areas due to rugged terrain and poor infrastructure that raise the costs of operating rural enterprises. Rehabilitation of roads and improvements in communications and power distribution (given substantial generating capacity) can greatly enhance the competitiveness of rural enterprises. At the same time, other types of infrastructure such as agricultural extension services need to be improved, along with social services—education in particular—given the falling level of educational attainment in rural areas. Diversification is also especially important in rural areas for household risk management, and foreign tourism may hold particular promise because the Kyrgyz terrain is so problematic in other respects. Moreover, as discussed, a number of issues involving land ownership need to be resolved to increase further the productivity of private farming and the incomes of rural families. Finally, considerable special attention to rural areas would be consistent with poverty objectives given the low income levels in rural areas.

E. Other Priorities for Government and Donor Interventions

With respect to the policy, legal, and regulatory environment, legal aspects present the greatest challenge, with obstacles that range far beyond financial sector issues to be overcome. While the laws affecting rural finance are not particularly problematic, with only a few exceptions, enforcement can be another matter. Lack of transparency may adversely impact regulatory enforcement and compromise loan contracts and the use of collateral. In fact,

A major challenge for the Kyrgyz Republic is the isolation of many of its rural areas due to rugged terrain and poor infrastructure that raise the costs of operating rural enterprises.

understanding the heavy reliance of lenders on collateral given such enforcement problems is difficult to understand. Furthermore, to the extent that shortcomings in the legal system may compromise NBKR's ability to deal with problem banks, implementing deposit insurance will likely not only increase risks in the banking system but also fail to promote increased deposit mobilization, given the likelihood that poor service is the main obstacle, as already indicated. Nonetheless, as discussed above, there are some recent signs of improving deposit mobilization, which may be due largely to the entry of Kazakh banks into Kyrgyz financial markets with their greater understanding of customer service and its importance, but to what extent this is true in rural areas or is mainly an urban phenomenon is still unclear.

As also indicated above, which entity should regulate credit unions may recently have been resolved. Recognizing that neither the FCCU nor a credit union federation could be given primary regulatory responsibility because of the conflict of interest between regulating and promoting, NBKR has apparently stepped forward to accept this responsibility. Moreover, whether the FCCU can be successfully rehabilitated, given its history of inefficiency and apparent contribution to rent seeking by credit unions, remains to be seen. In the case of microfinance NGOs, some reluctance to reveal financial statements suggests the need to set up a standard chart of accounts and uniform performance standards for these entities, along with required reporting at least to interested parties. This can provide the government, especially NBKR, donors, and potential commercial sources of funding the information they need to make informed judgments, while also moving microfinance entities that show strong signs of sustainability along the road to deposit mobilization.

KAFC, being government-owned and heavily donor-supported, can operate inefficiently and/or subsidize its lending operations; in fact, it is widely reported to be taking clients away from private lenders with its low interest rates. Tentative plans to convert KAFC into a private full service bank with a continuing micro and rural focus could address this issue while also enhancing its role in expanding rural financial services in the Kyrgyz Republic,

especially with the entry of private external stakeholders who might have better expertise to deal with rural financial markets. However, the government and some donor agencies in particular remain cautious that government involvement could continue, with possible political influence in lending decisions and government responsibility for losses that depositors in a full service KAFC might incur.

With respect to policy, there are no controls over interest rates and few of the subsidized credit programs that in many countries negatively affect participation in rural lending by private financial institutions seeking sustainability. Nonetheless, the insignificance of such programs may not be due to a lack of desire but to the government's severe fiscal constraints, as suggested by existing lending programs that government nonfinancial agencies operate and the remnants of government-subsidized agricultural input and equipment distribution schemes. Possible over-eagerness by donor agencies to support poverty alleviation could lead to funding for such programs, thereby adding a major impediment to the development of sustainable rural finance. Government should give strong signals by curtailing lending by nonfinancial agencies and its direct involvement in distribution schemes that can be more efficiently handled by the private sector. More generally, the wide-ranging efforts of donor agencies to assist the Kyrgyz Republic—while well intentioned and important for poverty alleviation—and continued development of a market economy may have strained the capacity of the government's human resource base to coordinate and prioritize donor interventions and to develop a more strategic and coherent approach to the economy's transformation.

Donor assistance might also be more effective in furthering sustainable rural finance if focused more on the systemic issues cited above and less on providing funds for on-lending, despite the obvious gaps in rural lending. For example, donor support for training and technical assistance to establish cash flow lending could be coupled with more aggressive efforts to establish a comprehensive credit bureau that is essential for evaluating a borrower's "character" more efficiently. The importance of informal providers of rural financial services was largely unrecognized and could benefit from more

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in-depth government- and donor-supported studies to understand the process more thoroughly, to remove significant barriers to greater competition in these informal relationships, and to lessen impediments that informal lenders may face in securing financing from the formal financial sector. Poor performance in deposit mobilization also requires more in-depth analysis, not only because deposits should be the major source of funds for rural lending but also because high-quality deposit services are crucially important for rural residents. The necessity of ongoing efforts to make the foregoing suggestions effective also implies the need for permanent centers for applied research, certainly within NBKR for at least its own internal use, and also warranting government and especially donor support for “think tanks” in the private sector.

Chapter 6

Rural Finance in Mongolia

Executive Summary

Robert C. Vogel and Dennis Sheets¹

A. Introduction

The early history of what is now Mongolia consisted of the rise and fall of a series of nomadic empires (Hun, Simbe, Nirun, and Kidan) dating back more than 2,000 years and culminating with Chinggis Khan, who unified Mongolia early in the 13th century AD and extended control over a vast area, rivaling the achievements of Alexander the Great. However, this empire dissolved by the mid-14th century. From the late 17th century until the early 20th century, the Manchus controlled Mongolia. Independence was achieved in 1921. Though never officially part of the Soviet Union, Mongolia was closely linked to that country until 1990. The first democratic elections took place in 1990 under a parliamentary system that has since proved, that it is truly multiparty, but always maintaining a course away from state ownership and central planning toward a private, market-based economy, even though private property had not been a traditional feature of the Mongolian economy.

Geography is clearly Mongolia's dominant characteristic with a vast territory (almost three times the size of France) and a population of only 2.5 million, making it one of the least densely

¹ Support for the preparation of the country report, from which this summary is taken, was provided by Altangerel Anudari, Batkhuyag Jamiyandorjiin, and Batjargal Dorligjav.

Providing rural infrastructure services such as transportation and education may be an even greater challenge than rural financial services—and thus possibly an even higher priority.

populated countries in the world (as few as 0.3 persons per square kilometer in South Gobi Province). Most of Mongolia is undulating semiarid steppe lands, but its mountains reach over 4,000 meters, and it also contains the famous Gobi Desert. It has a classic “continental” climate, with generally low rainfall and extreme seasonal variations in temperature between winter and summer. These characteristics severely limit Mongolia’s potential for crop production, but clearly not for herding and, together with the extremely low population density, provide a potential paradise for ecotourism. Mongolia is also rich in a variety of mineral resources, including copper (its leading export) and gold, and has some potential in petroleum, which might become substantial with further exploration. Nonetheless, in addition to restricted crop production, Mongolia’s geography presents a major challenge for providing adequate infrastructure, especially given a widely disbursed rural population. As will be stressed later, providing rural infrastructure services such as transportation and education may be an even greater challenge than rural financial services—and thus possibly an even higher priority.²

The period of Russian domination brought major changes to the Mongolian economy, including the imposition of central planning and the collectivization of agriculture, most notably the livestock sector. In addition, industrial production came to surpass agriculture as a proportion of gross domestic product (GDP), rising to more than 35% by 1990 but falling sharply and only recovering recently to exceed 15% of GDP, much of it in the mining sector. Furthermore, what is rarely mentioned nowadays is Mongolia’s former strategic importance for the Russian Federation given its long border with the People’s Republic of China, resulting in untold numbers of Soviet troops stationed in critical parts of Mongolia and the need to supply local services to support them. From 100% state-owned property in 1990 under Soviet-style central planning, the share of

² In total, Mongolia has fewer than 50,000 km of roads, of which only slightly more than 10% are improved at all, the rest being simply trails across the steppes, often impassable and ecologically damaging. Overall educational attainment remains reasonably high with a literacy rate of 87% but women account, astoundingly, for over 60% of students enrolled in higher education and over 70% of doctors, lawyers, and teachers—suggesting bleak circumstances for rural herder boys.

the private sector in GDP has risen rapidly to 57% in 1996 and to 75% by 2001, with most economic sectors now more than 90% privatized.

Like most economies starting from state ownership and central planning, Mongolia's road to a private, market-based economy has not been smooth and has been further complicated by heavy dependence on a few primary exports, mineral (copper, gold), and agricultural (cashmere) in particular. Mongolia's real GDP per capita fell sharply until 1994, especially measured in constant US dollar terms, and only largely recovered to before-1990 levels by 2002 (although the record is much less grim in purchasing power parity terms). Since 2001, however, the growth rate of real GDP has increased each year, reaching 10% in 2004. Inflation was likewise a major problem until the mid-1990s, but since 1997 has been less than 12% annually as measured by the consumer price index, and less than 5% for the most recent years. Nonetheless, Mongolia's fiscal deficit has continued to present a significant challenge, although performance has improved greatly from a deficit of over 10% of GDP during most of the 1990s to less than 6% in the years since 2000. Despite reduced inflation and the stabilization of the exchange rate since the late 1990s, Mongolia's current account trade deficit has continued at well over 10% of GDP, complicated in certain years by poor performance of merchandise exports, such that external debt has been greater than 80% of GDP since the late 1990s.

B. A Changing Rural Economy

Although Mongolian herders in the early 1930s strongly resisted central planning, and especially agricultural collectivization, the nomadic pastoral traditions of herding families were eventually restricted, with their movements limited to a single local area. By 1960, herding collectives owned almost 75% of livestock, with less than 25% owned by individual members of these collectives. At the same time, reflecting apparent efforts to make Mongolia self-sufficient in crops considered strategic such as wheat, state farms were allocated relatively more capital (e.g., for mechanization) as

well as better locations, not only more productive lands but also nearer to population centers. With the arrival of private property and market incentives, the production of grains, mainly wheat, has fallen to less than one third of its 1990 level. Potato production has also fallen, though much less sharply, while vegetables have risen. Although the collapse of wheat production has been attributed to a variety of shortcomings, mainly on the input side and mostly related to the fragmentation of state farms accompanying privatization, Mongolia may simply not be competitive in producing wheat.³

The other major change in rural production patterns was the dramatic increase in livestock numbers and herder families, along with a return to nomadic pastoral traditions. Due to a dramatic shrinkage in the urban industrial sector, among other causes, the number of herder households increased from fewer than 75,000 in 1990 to more than 190,000 in 2000, before a steady decline set in to just over 170,000 by 2003. At the same time, overall livestock numbers increased almost as dramatically, from just over 25.8 million heads in 1990 to over 33.5 million in 1999, but then fell even more precipitously back to 25.4 million in 2003. This collapse is usually attributed to a series of “dzuds” (excessive winter cold and snow, combined with summer droughts) beginning in 1999, but is no doubt also due to exceeding the long-run carrying capacities of pasturelands, especially near population centers where many of the new herder families have located. In addition, new (and old) herder families may have lost some of their cutting-edge herder skills during collectivization by being drawn into the then growing Mongolian industrial sector and the service sector supporting the Russian military.⁴ It is also interesting to note that Mongolia’s goat population scarcely declined at all between 1999 and 2003, due perhaps to relative profitability and not only to the resilience of goats, while sheep numbers declined by a third and cattle, by over half.

³ The precipitous decline reported in fodder production is more difficult to explain, given the surge in herding activity described below. But certainly it was a major factor in the sudden decline in herd size.

⁴ Frequent claims by so-called technical experts that agricultural producers lack competence can usually be discounted. But Mongolian herders may indeed have lost some expertise in more technical aspects (e.g., in cashmere combing and selective goat breeding) and thus require technical assistance along with increased access to crucial inputs such as veterinary services and fodder.

Poverty has often been an unfortunate by-product of the move from state ownership and central planning to a private, market-based economy, including in Mongolia. Even with the recent recovery in GDP per capita, poverty remains high due to increasing inequality in income distribution, leaving as yet unanswered the key question as to when (or if) growth will be enough to reduce poverty. It is important, moreover, to understand as much as possible what aspects differentiate rural from urban poverty to have a better understanding of the relevance of access to financial services for rural residents. First, Mongolia is not 58.5% urban as reported in official population figures— while all 21 provincial capitals (*aimag* centers) are counted as urban, 9 have populations under 20,000; another 10 have populations between 20,000 and 40,000; and only 2 have populations of some 70,000. Given this, Mongolia, by most standards, is more than half rural. Moreover, the worst poverty is reported to be in *aimag* centers so that the incidence of poverty might not be higher in urban areas (39.4%) than in rural areas (32.6%) if the definition of urban were to be adjusted.⁵

Figures are also available for Mongolia, comparing urban and rural poverty levels with whether individuals are employed, unemployed, or “other” (i.e., not registered as either employed or unemployed). Individuals of all income categories in rural areas are more likely to be unemployed or “other” than their urban counterparts, but unemployment is significantly higher among the rural poor and very poor. In addition, while the income sources of the rural poor are similar to higher income categories, those of the rural very poor are markedly different: much higher in cash wages, benefits, and remittances but much lower in auto consumption and income from animal husbandry. Furthermore, the estimate that herding families need at least 200 heads to be above the poverty level implies that nearly 90% of herder families were in poverty as of the end of 1991, ameliorated only slightly by the fact that some 28% of herder families are not totally dependent on income from livestock. From these patterns, the importance of diversifying income sources of rural residents goes without saying.

Poverty has often been an unfortunate by-product of the move from state ownership and central planning to a private, market-based economy, including in Mongolia.

⁵ The worst poverty can be seen in the so-called *ger* (traditional herder dwellings) communities, which can be found around Ulaanbaatar and the two larger cities, as well as in the smaller *aimag* centers.

Mongolia's commercial banks initially remained largely under effective government control, if not ownership, and continued to direct loans according to government priorities.

C. The Status of Rural Finance

Banks. As in most countries, banks are the largest component of the overall Mongolian financial sector and of rural financial markets in particular. In efforts to create a sustainable banking system, Mongolia followed a path similar to most other countries of the former Soviet bloc by moving quickly from a mono-banking system to establish a “Western-style” system in structure but not in substance. Mongolia's commercial banks initially remained largely under effective government control, if not ownership, and continued to direct loans according to government priorities, often to failing formerly state-owned enterprises, leaving the central bank with neither effective monetary nor regulatory powers. In addition, these commercial banks were hampered by a lack of understanding of risk and risk management skills, combined with the absence of a culture of loan repayment. The result was a series of banking crises during the 1990s, the first two (1994 and 1996) largely internally generated, while the third (1998–1999) was more related to the Asian and Russian financial crises. Notwithstanding efforts at rehabilitation, liquidations were frequent, including several large state-owned banks, with public confidence in the banking system falling as reflected in a dramatic decline in the system's deposit base relative to GDP.

After the 1999 crisis, Mongolia's macroeconomic situation began to improve markedly, as detailed initially, with inflation falling to manageable levels, a reduction in the fiscal deficit and relative stability in the exchange rate. In addition, between 2000 and 2003, all but one of Mongolia's remaining state-owned banks were privatized, including two of the largest, while continuing donor technical assistance to the central bank ultimately became effective in creating a working monetary and regulatory authority.

Mongolia currently has some 16 private commercial banks, plus the state-owned Savings Bank, of which 8 have been examined in some detail as to their actual or potential role in rural financial markets. Anod Bank and Golomt Bank are among the larger and more successful private banks but, with few branches outside Ulaanbaatar (three and two, respectively), they have relatively few

rural clients. Nonetheless, both are involved in World Bank (WB) and Asian Development Bank (ADB) urban finance projects, and Anod Bank has both micro- and rural borrowers, so may play some future role in rural finance.

The Savings Bank and the recently privatized Trade and Development Bank (TDB) each have 10 branches outside Ulaanbaatar, but neither is significantly involved in rural lending, although the Savings Bank does have numerous rural depositors and has recently begun using funding from ADB's Agricultural Sector Development Program for rural loans. On the other hand, TDB is clearly focused on a role far from rural finance as a corporate bank with specialization in trade finance, e.g., TDB finances meat exports to the Russian Federation. Involving donor agencies in planned additions to its capitalization may push it into new roles, leasing in particular.⁶

Two other private banks are already expanding rapidly into rural finance. While Zoos Bank now has only seven branches outside Ulaanbaatar, it sees the Ulaanbaatar market as overcrowded and is thus focusing its plans on expanding into all *aimag* centers. It already has micro- and rural borrowers and is involved in micro- and rural finance projects of ADB, WB, and United States Agency for International Development (USAID). Although separated from the Post Office in 1998 and the state shares were sold in 2002, Mongol Post Bank has branches in all *aimag* centers and the second largest network overall (62 branches) because of its postal origins. Moreover, it is substantially involved in micro- and rural finance, participating in ADB, WB, and Kreditanstalt für Wiederaufbau (KfW) programs and facilitating its broad outreach with relatively sophisticated risk management techniques.

Mongolia also has two banks equal to any in Central Asia in rural finance. The smaller of the two, Xac Bank, was created at the end of 2001 by the merger of two NBFIs that were heavily involved in micro- and rural finance, one founded by Mercy Corps with funding from USAID and the other by a group of six nongovernment organizations (NGOs) working under the aegis of the UNDP's Microstart Program. Mercy Corps has the largest ownership share in the Xac Bank holding company (47%), with the other owners being four nonfinancial NGOs. With its 20

⁶ ADB and International Finance Corporation (IFC) have each purchased a 5% shareholding stake in Trade and Development Bank (TDB).

Mongolia's Agricultural Bank (now known as Xaan Bank) presents a truly remarkable story—the turnaround and subsequent privatization of a bankrupt state-owned agriculture lender.

branches, Xac Bank has a presence in virtually every *aimag* and, not surprisingly given its parentage, uses international best practice lending techniques focused on cash flow and character, with a flexible approach to collateral including solidarity groups. In fact, it only lends to herders using solidarity groups under the USAID's Gobi Regional Economic Growth Initiative. While over half of its loan portfolio is rural and over half its clients are either micro or small, they are primarily traders rather than farmers or herders. At the end of 2003, Xac Bank was serving 18,610 borrowers (average loan, \$640) and 25,666 depositors (average deposit, \$333), had a yield on portfolio averaging over 43% and a portfolio at risk (value of loans with any payment more than 30 days overdue) of less than 2%, yielding a before-tax profit of MNT507 million—thereby promising future sustainability in both funding and profitability.

Mongolia's Agricultural Bank (now known as Xaan Bank) presents a truly remarkable story—the turnaround and subsequent privatization of a bankrupt state-owned agriculture lender. Like many such banks, it was plagued by unrecoverable loans promoted by government officials, many said to involve bribery, becoming insolvent in 1995, and illiquid as well in 1999. With primary support from USAID and involving various other donor agencies including Deutsche Gesellschaft für Technische Zusammenarbeit (GTZ), KfW, WB, and ADB, the new management team that was put in place to rehabilitate Xaan Bank was given total control, certainly not a standard approach to bank corporate governance, but nonetheless required to totally sideline its government owners. Moreover, instead of following the standard recipe of closing small unprofitable branches, which would have undermined the Xaan Bank's only comparative advantage, management instead designed simple and attractive loan products that carried such low administrative costs that the smallest branches could be profitable with only a few loan transactions. This was coupled with locally recruited branch staff who knew the area and its residents intimately and who were given substantial autonomy, with salaries based largely on performance to keep costs low and incentives high. This local autonomy was complemented by a tough internal audit and financial controls team that was equipped with the latest in management information

systems (MIS) and information technology (IT). Initially, the primary loan products were salary and especially pension loans—simultaneously cash-flow based and effectively guaranteed, for which Xaan Bank management was heavily criticized by some as deserting its mandate of supporting agricultural and rural development. Nonetheless, by the end of 2003, Xaan Bank had some 130,000 loans outstanding, with an average size of \$350, of which 30,000 were to small and microbusinesses and 10,000 were to herders—and with fewer than 2% of loans past due. Moreover, it had 370,000 deposit accounts, serving half of Mongolian households according to Xaan Bank management and, rather than decreasing, the number of branches had actually been increased from 337 to 379. Early in 2003, privatization was achieved with a selling price of \$6.85 million (twice the book value) and commitments from private investors and donors to supply substantial additional equity.

Nonbank Financial Institutions (NBFIs). NBFIs, while numerous, are relatively unimportant in the Mongolian financial sector and especially in rural finance.⁷ Although the minimum capital requirement is only MNT1 million for NBFIs with head offices outside Ulaanbaatar, compared to MNT100 million for NBFIs with head offices in Ulaanbaatar, presumably to promote rural NBFIs, there are only 15 of them, compared to more than 90 in Ulaanbaatar.⁸ Nonetheless, at least six NBFIs with head offices in Ulaanbaatar have rural branches—one of particular importance for micro- and rural finance in Mongolia. Credit Mongol was founded by four local NGOs, three of which are nonfinancial, but has received most of its capital, which amounts to more than \$500,000, from donor agencies, especially the European Union. It has also received various types of support from several other donor agencies (e.g., UNDP, EBRD, KfW, ADB, United Kingdom's Department for International Development, and World Vision) under a wide variety of projects (most of which have a micro- or

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⁷ This leaves aside the large (and nontransparent) NBFi Chinggis Khaan, which recently became a bank.

⁸ The regulatory framework for NBFIs is discussed below, but it is worth noting here that MNT1 million in equity could scarcely support any type of financial institution.

small business or rural orientation) so that, unlike most other NBFIs, its funding is not greatly constrained by the rule that NBFIs cannot take deposits. Credit Mongol's microloans are made only in rural areas, almost exclusively to individuals rather than groups, and range from \$20 to \$10,000 with maturities up to 24 months and interest rates between 1.5 and 3.8% per month, with 66% of borrowers being herders and 53% being women. Although Credit Mongol's version of rural micro-lending is relatively high cost, including initial training for applicants (e.g., cash flow projections and business planning) and at least monthly contact with borrowers to collect interest payments, management insists that this is the key to maintaining its perfect repayment record (and can be afforded because subsidized donor funding pays administrative overhead, effectively boosting profitability).

Savings and Credit Cooperatives (SCCs). Although slightly more than twice the size of NBFIs in total assets, SCCs are also a minor part of the Mongolian financial sector compared to banks. Like NBFIs, SCCs have expanded rapidly in number but, in contrast to NBFIs, have more relevance for rural finance and more potential to grow since they can take deposits. Nonetheless, SCCs face some major problems as the central bank clearly revealed in recent statements. To develop an appropriate regulatory framework for SCCs, as discussed in more detail below, the central bank, together with the Tax Administration Office (TAO) (the only government entity to have ongoing contact with SCCs), organized initial inspections of the 570 SCCs registered with the TAO, but could find only 282, fewer than half of them.⁹ Moreover, these inspections uncovered a variety of abuses, including taking deposits from nonmembers, not treating members properly, and failing to comply with various existing prudential norms, among others. Based on these findings, the central bank has proposed a major tightening of norms governing SCCs (*see below*), but on behalf of SCCs. Tax

⁹ Since SCCs are taxed, their major requirement is to register with the Tax Office, and this registry provides the basis for searching out SCCs. The SCCs that could not be found—the majority of them—may either have failed or never really existed, having been organized to try to capture some benefits of the project announced by ADB to support SCCs (unless these SCCs were simply hiding from the tax inspectors).

Office inspectors were said to have taken an adversarial tax collector position during the inspections and that SCCs were given inadequate warning about the new norms that had just been issued.

The majority of and largest SCCs are located in Ulaanbaatar, but 242 SCCs are nonetheless registered and 116 are actually found outside Ulaanbaatar. These 116 rural SCCs had a total of 6,800 members and, on average for each SCC, almost 60 members and almost MNT22 million in total assets, making SCCs in rural areas far more important than NBFIs, especially if Credit Mongol is set apart. Furthermore, ADB's Rural Finance Project, whose announcement may have promoted the establishment of many new SCCs, has now reached the implementation stage and is taking a technically supportive, yet demanding, approach to developing rural SCCs. Specifically, high priority is being given to implementing a standard SCC chart of accounts and World Council of Credit Unions, Inc.'s (WOCCU)'s PEARLS system as the basis for performance indicators, while providing support for enhanced management information systems. The ADB project also assists in creating an appropriate regulatory framework for SCCs, as discussed in more detail below.

Informal Finance. In Mongolia, as in other countries, informal financial arrangements are widespread (e.g., moneylenders, pawnshops, friends, relatives, etc.), perhaps far more widespread than generally recognized. Of particular importance for rural finance are those involving relationships of producers with agricultural processors and traders, mainly for meat and cashmere in the case of Mongolia.

Meat processors usually make contracts with herders and traders in the spring. These contracts cover the types and quantities of meat and the prices to be paid at delivery in the fall, with 3 months advanced financing from the processor to the supplier. Collateral items can vary, but the main issues are verifying ownership and if the item has been pledged elsewhere (if the parties have long-term working relationships, no collateral may be required). Cashmere processors usually contract with traders who are then responsible for dealing with herders, usually providing monetary or in-kind advances such as flour, rice, or other merchandise. Most

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As everywhere in the world, rural Mongolians borrow from friends and relatives to cover consumption expenses, children's education, and, more rarely, for business purposes.

cashmere contracts are verbal, with no collateral required. For both meat and cashmere, if market prices differ greatly from those specified in the contract, adjustments toward current market prices are usually made. Processors of both types typically finance their advances with credits from banks or other financial institutions.

Individual traders usually procure raw materials from herders and then resell to wholesale exporters directly or to their supplier companies, with cash advances very common. With an advance, 40% of traders require a contract, while 60% see no need for one since they are usually dealing with long-time partners. Even with a contract, 70% of traders do not require collateral. Larger traders usually borrow from banks (or partners from the PRC), while smaller traders receive loans from banks and/or larger purchasers.

Another set of informal finance players are the meat and vegetable wholesalers and retailers. Meat wholesalers often have their own agents whom they finance to travel in rural areas and purchase meat from herders, giving credit to these agents for 1–3 months under formal written contract but without collateral and relying on bank credit to finance these agents. Meat and vegetable retailers usually do not provide advances to suppliers, but instead often borrow meat and vegetables from them.

As everywhere in the world, rural Mongolians borrow from friends and relatives to cover consumption expenses, children's education, and, more rarely, for business purposes. Mongolian moneylenders usually have similar occupations as their borrowers (e.g., herders, government workers, and drivers) and they themselves do not borrow since they want to increase own capital by lending their own surpluses. Interest rates vary from 4 to 9% per month. Among other common informal finance providers are pawnshops (that like SCCs are required to report to the TAO but are not otherwise regulated), but these are mainly concentrated in urban areas. Items to be collateralized usually receive low valuations, about 50% of market price, and average interest rates are between 8 and 15% per month, much higher than moneylenders.

Donor Agencies. A variety of donor agencies have supported Mongolia's finance and rural/agriculture sectors with a

wide range of programs. For example, ADB, IMF, WB, IFC, and USAID have all been heavily involved in Mongolia's financial sector, while ADB, WB, and USAID, plus International Fund for Agricultural Development (IFAD) and UNDP, have all had a number of projects supporting the rural/agricultural sector. More specifically, some UNDP, IFAD, USAID, ADB, and WB projects have contained credit lines for agricultural and rural activities, but funding has generally been accompanied by technical assistance (TA) and has followed the accepted guidelines of using only qualified financial institutions and avoiding subsidies to final borrowers (and minimizing subsidies to financial intermediaries that might disrupt deposit mobilization activities). One earlier WB project that used local government units to allocate credit was highly instructive in that loan recovery rates were very low, so that in a follow-on project, the Bank is now using qualified regulated financial institutions (banks and NBFIs) to handle lending. Likewise, in initiating implementation of its project in support of SCCs, ADB now strongly emphasizes building an appropriate regulatory environment and strong SCCs before any loan funds are disbursed.¹⁰ While GTZ also supports SCCs and other types of cooperatives, it has strongly endorsed rural multipurpose cooperatives, especially for herders, despite the poor performance almost everywhere of cooperatives that attempt to mix financial with nonfinancial activities. GTZ also supports the use of federations to regulate SCCs despite the conflict of interest thereby implied between regulating and promoting and the consequent opposition of other donor agencies.

D. The Policy, Legal, and Regulatory Environment

There is little to criticize in Mongolian government policies toward rural finance as, for example, no serious policy impediments to bank entry or branching or to foreign ownership exist. Most importantly, there are no controls over interest rates and no tightly targeted

¹⁰ In fact, given ADB's stance, which is informed by negative experiences in the Kyrgyz Republic with lending to SCCs, the Mongolian Government is reconsidering if any real advantages exist in a credit line for rural SCCs.

credit programs offering subsidized interest rates through government nonfinancial institutions—any of which would discourage the participation in rural finance of private financial institutions seeking sustainability. However, funding for such programs could emerge if the government’s budget constraints were not so restrictive or if donor agencies turned to programs of cheap credit as an effective tool for poverty alleviation—and both of these should be guarded against.

While the effectiveness of the central bank’s regulatory and supervisory powers has yet to be tested by another major banking crisis, adequate technical skills appear to be in place. Notably, the central bank has made significant efforts toward building a genuine risk-based supervision system.¹¹ Nonetheless, caution is still required because pressures against effective enforcement can be seen to abound in so many other countries, ranging from an ill-advised attitude of wait and hope that problematic banks will improve rather than fail, subtle yet powerful political intrusions, and court tests of supervisory powers overseen by judges untrained in financial matters. Also worth noting is that the central bank is required to oversee NBFIs, which is potentially a waste of scarce regulatory resources since NBFIs cannot legally take deposits. Although the central bank has handled this well so far by focusing primarily on low-cost off-site supervision, there is nothing to assure that this policy might not change, especially with recognition that central bank regulatory responsibility can imply a *de facto* government guarantee. Furthermore, NBFIs can be licensed to undertake certain activities that could easily be used to disguise deposit taking, and the chart of accounts currently used for NBF reporting to the central bank would not readily detect illegal deposits. Strengthening NBF reporting transparency while moving away from direct central bank responsibility could provide a multidimensional improvement.

As indicated above, the central bank has become highly concerned about the nonprudent behavior of SCCs but, at the same

The central bank is required to oversee NBFIs, which is potentially a waste of scarce regulatory resources since NBFIs cannot legally take deposits.

¹¹ The necessary infrastructure also appears to be in place, including international accounting standards with a uniform chart of accounts for reporting to the central bank, annual external audits by approved auditing firms that can be either local or international, risk-based capital requirements conforming to the Basle I Accord, and minimum capital of \$4 million for a banking license along with other standard requirements.

time, wants to avoid taking primary regulatory responsibility, thereby leaving SCC regulation and supervision an unresolved issue with major relevance for rural finance. Under the TA component of ADB's Rural Finance Project, an SCC law has been drafted as well as a set of regulations and recommended SCC bylaws. While certain aspects could be improved (e.g., failure to differentiate adequately between member shares and institutional capital, not insisting precisely on transparent reporting, and not clearly banning SCCs from nonfinancial, multipurpose activities), the overriding issue is which should be the regulatory agency. Whereas the central bank is reluctant, reliance on an SCC federation involves a crucial conflict of interest, GTZ's views notwithstanding. One option already being considered in the Parliament is placing SCCs under a commission to be created to handle securities, pensions, insurance, etc. While better than SCC supervision by a federation, it ignores the key deposit-taking feature that makes SCCs more like banks than NBFIs are (implying that NBFIs instead might better be supervised by the commission to be created). Moreover, implementing risk-based supervision could allow the central bank to focus on larger and/or riskier SCCs and to avoid the costs of applying traditional regulatory practices to a large number of very small SCCs.

In most countries in transition from state ownership and central planning to a market-based private economy, issues of contract enforcement and collateral have risen in importance and Mongolia is no exception, although it has made more progress than most toward cash flow-based lending in place of excessive reliance on physical collateral.¹² Because of Mongolia's return to traditional nomadic herding, most rural land remains under state ownership (similar to the "open range" concept in the United States) and thus is not available as collateral. For herders, animals and other moveable property can provide alternative collateral and likewise for traders' inventories, while claims over the ensuing harvest are common for producers of certain crops. This implies a need to assure that registries for moveable property (and for land) are adequate and

¹² Mongolia is also unusual in having developed a comprehensive credit bureau database in its central bank, to add the "character" element to lending decisions, although there are differing views as to the extent of resort to credit bureau information and its effectiveness.

that drawn out and nontransparent court proceedings are not barriers to enforcement (note that banks can seize collateral of defaulting borrowers without going through the court system, but SCCs cannot). In addition, Mongolia could follow the path of major Central Asian countries with improvement in its legal infrastructure for leasing and thus offer another alternative for moveable collateral.

E. Possible Government and Donor Interventions to Overcome Problems

With Xaan Bank and Xac Bank leading the way, especially in showing the potential for profitability, other banks are beginning to move into rural areas.

Most major problems confronting rural areas are not specifically related to rural finance, given the growing competition among banks as well as the alternative sources of financial services outside Ulaanbaatar. With Xaan Bank and Xac Bank leading the way, especially in showing the potential for profitability, other banks are beginning to move into rural areas, often to escape the growing competition and narrowing spreads in Ulaanbaatar. Informal finance is clearly very important in rural areas, but the full extent of its importance and the possible lessons it could provide to formal financial institutions have not yet been adequately explored. Informal finance is thus a promising area in which donor- and government-supported studies could have a high return—much more promising than providing more credit lines to fill gaps that may not exist in reality (being filled already by informal finance) and that may carry the danger of crowding out private sector finance. At the same time, to enhance the role of other financial institutions in rural areas, support for SCCs needs to be refocused in the direction of training and TA, including improved transparency. Implementing an appropriate regulatory framework for SCCs and improving the one for NBFIs could also help expand financial services in rural areas.

Far greater challenges than rural finance are related to improving rural infrastructure (e.g., roads and social services such as education). Moreover, improving rural roads requires more than funding for building and upgrading roads; specifically, incentives to enhance the involvement of local governments or other local groups in road maintenance has proven to be critical virtually everywhere

for lasting improvements in rural roads. Likewise, rural education is not only a matter of providing teachers and classrooms but also requires proper incentives, especially for herder boys whose present and future earning potential must be taken carefully into account.

Diversification in rural areas—or the lack thereof—also needs special consideration. First, it must be recognized that local areas are always likely to be relatively undiversified, so that lending to shopkeepers in an area dominated by herding cannot avoid impacts from failures in the herding economy. As a consequence, to manage risks effectively, a local financial institution such as an SCC will need to diversify into other region(s) where it is likely to face impossible challenges, or maintain substantial amounts of low-return liquid assets—unless appropriate links to external funding that is focused on supporting liquidity management are available. However, the types of credit lines traditionally supported by donors and governments fail to take these liquidity management requirements into account. In considering the potential for diversification in Mongolia's rural areas, tourism inevitably comes to mind. However, while tourism, and especially ecotourism, may be ideal for Mongolia given its geography and traditions of herder hospitality, barriers must be overcome—not only the lack of appropriate transportation in rural areas but also a lack of understanding of what potentially free-spending foreign tourists demand. For example, ADB's *Private Sector Assessment for Mongolia* notes (Box 7: *Tourists' Perceptions of Mongolia*, page 46) that the most pleasant tourist memories relate to nature, landscape, people, and hospitality, while the least pleasant relate to infrastructure, sanitary facilities, and service standards. Perhaps donor and government involvement might more effectively consider partially supporting (e.g., with TA) a small number of privately run tourist pilot projects for demonstration purposes, rather than supporting government tourist bodies or master plans that languish without implementation.¹³

¹³ See ADB's *Private Sector Assessment for Mongolia*, 72, for a brief discussion of donor efforts to improve tourism in Mongolia.

Chapter 7

Rural Finance in Tajikistan

Executive Summary

Richard L. Meyer and Dennis Sheets¹

A. Introduction

Tajikistan is the poorest of the Central Asian countries. It is a landlocked area of 143,000 square kilometers with mostly mountainous terrain and only 7% available for lowland agriculture. The 2002 population was estimated at 6.7 million, of which nearly 72% live in rural areas and 68% below the poverty line. The rural population is highly dependent on agriculture for cash income and subsistence, but rural nonfarm enterprises are slowly emerging. During the Soviet era, the country became dependent on the monoculture of irrigated cotton, as its principal export and source of farm employment, although many other crops can be grown in the country's wide range of climatic zones. The largest ethnic group has become increasingly Tajik, as many Russians, Germans, and others fled the country following the breakup of the Soviet Union and the 6 years of civil war between 1991 and 1997. Cotton and aluminum are the dominant exports. The economy features a high degree of informal activity.

The Tajikistan economy was heavily linked to the Soviet Union, but these economic relations deteriorated rapidly following independence. The country lost budget transfers from the Soviet Union (estimated at 50% of the total annual budget), and inter-

During the Soviet era, the country became dependent on the monoculture of irrigated cotton as its principal export and source of farm employment.

¹ Support for the preparation of the country report, from which this summary is taken, was provided by Bakhtier Abduvohidov and Rasuljon Khodoidodov.

The country lags behind others in the region in developing key institutions, laws, and rules and regulations necessary for a market economy.

republic trade and payment arrangements collapsed. The civil war and political uncertainty slowed economic activities significantly and held back the implementation of reforms required to transform from a planned to a market economy. Moreover, the economic damage caused by the war was estimated at \$12 billion, and as many as 100,000 people were killed, with some 700,000 persons internally displaced. In addition, severe drought and low prices seriously affected agricultural incomes in 2000–2001.

Due to this combination of problems, the economy contracted by almost 70% between 1992 and 1997. The trade deficit rose sharply and hard currency reserves were exhausted. By 1994, the country was insolvent and its external debt exceeded \$635 million. Economic reforms beginning in 1995, plus the peace accords, began to produce favorable economic results by 1997, the year that arguably marks the date of the country's effective conversion into a market economy. Economic growth turned positive, and the annual growth rate has ranged from 1.7 to 10.2% since then. Growth was 10.6% in 2004 and projected at 8% for 2005. GNP per capita reached a low of \$155 in 1999 but recovered to \$309 by 2004. However, this level is still only a fraction of gross national product (GNP) per capita at the end of the Soviet period. The Human Development Report of the UNDP estimated the 2002 GNP per capita—measured in purchasing power parity terms—at \$980, which ranked Tajikistan 161 out of 177 countries. The country lags behind others in the region in developing key institutions, laws, and rules and regulations necessary for a market economy.

B. Status of Rural Finance

The country's financial system is underdeveloped and unstable. The public holds a great deal of domestic and foreign currency in cash, outside the banks, and the total could exceed deposits in all the banks. At year-end 2004, bank deposits represented a mere 5.5% of 2004 GDP. The supply of formal rural financial services is particularly limited, although a large share of the loan portfolio of the banking industry is devoted to agriculture, especially cotton. The historic dominance of large state and collective farms and the

overwhelming role of cotton in the rural economy have shaped the evolution of rural financial institutions, the type of products and services supplied, and the number and type of clientele served. Opportunities for competing institutions to emerge have been few, and the important informal financial services normally provided in market economies by rural nonfarm input supply and marketing firms are largely missing.

Rural sector demand for financial services. The primary focus of rural finance has been on lending, in large part due to a concern for the over-indebted cotton sector. There is clear evidence of demand for rural savings and remittance services, but demand for loans from creditworthy borrowers is more uncertain. Several studies have identified the huge “need” for rural finance, especially loans, for financing inputs used in cotton and other enterprises, for rehabilitating the country’s irrigation system, and for renovating the dilapidated farm machinery stock, but no thorough study of the potential demand for rural financial services has been conducted. Some indicative estimates of funding requirements have been made. In 2005, almost 270,000 hectares were planted to cotton, and an estimated 230,000 irrigated hectares were planted to other crops. The total outstanding bank debt to agriculture in January 2005 was reported at roughly \$239 million, and seasonal lending for cotton and non-cotton cropping was estimated at around \$85 million. Longer term total investment requirements for agriculture over the next 10 years may top \$450 million. These total financing requirements are significant considering that the total banking system reported about \$367 million in outstanding loans at the end of 2004. Attempting to fund these future requirements may crowd out other economic sectors that also have large financial requirements.

In addition to the large farm market segment expected to be served by banks, it was estimated that, if there was effective demand, microlenders in the future might finance some 8,000 small *dekhan* (peasant) farms, with an average size of about 3.5 hectares, at the rate of about \$300–500 per irrigated hectare. This would represent \$8.6 million–\$14.3 million in new disbursements, another huge

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amount since the NGO microlenders already report financial constraints and turn away new clients and grant smaller than requested loans to repeat clients.

The lack of good employment opportunities has sparked a large out-migration of people in search of work, as well as an increase in people engaging in cross-border trading. Traders and overseas workers have prompted a huge demand for safe and secure ways to transfer remittances. According to the National Bank of Tajikistan (NBT), incoming foreign transfers flowing through the banking sector amounted to \$260 million in 2004, more than \$42 per capita and equivalent to about 90% of the national budget and about a quarter of total GNP. The bulk of these originate in the Russian Federation. Large amounts of remittances are also believed to enter the country outside the banking system.

Suppliers of financial services. As of April 2005, financial institutions under NBT supervision included 11 commercial banks, 1 branch of a foreign bank, 5 credit unions, and 7 nonbank financial institutions. Only one bank is still fully owned by the Government of Tajikistan. Commercial banks have provided most loans supplied to agriculture. Historically, the banking sector has been dominated by the state bank, AgroinvestBank, which established a widespread branch network during the Soviet period. Agroinvest became overburdened by its nonperforming cotton loan portfolio in recent years. In 2004 it was restructured, and a new nonbank financial institution, Creditinvest, was created in 2003 to take over its entire cotton portfolio of almost \$150 million. Agroinvest remains an exclusively rural-based bank focused on agriculture with a credit portfolio only 15% of what it was in the past. Although Agroinvest has the largest branch network among the banks, its future role in serving agriculture and rural areas is unclear.

The large branch network of the state savings bank, Amonatbank, also created during the Soviet era, means that it is more feasible for rural people in Tajikistan to have savings accounts in banks than in many other low-income countries. However, it has only scratched the surface in serving the total potential market since it reported a mere 116,000 accounts in local currency and 80

accounts in foreign currency. Its total deposits were only about \$2.2 million from individuals and \$14 million from companies. In fact, the entire banking system only reported about \$92 million in deposits at the end of 2004. The loan portfolio of the Amonatbank is also modest. It reported only 650 borrowers with a total portfolio of \$7.5 million. It has, however, provided important cross-border remittance transfer service. In 2003, it reportedly handled about 110,000 incoming remittances amounting to \$90 million.

Tojiksodirotkon is an example of a private bank that has successfully developed a small portfolio of agricultural loans, and its experience may point the way forward in agriculture. It is the second largest private bank but has only six branches. Its cotton portfolio in 2003 was \$6.5 million in loans to 20 individuals and 12 farmer associations with zero arrears. The remaining three quarters of its agricultural portfolio was devoted to fruit and vegetable crops, cotton ginning, and edible oil processing. It does not suffer from the burden of the older cotton loans that went bad. Loan recovery has been good, not only for cotton but also for the rest of the agricultural portfolio.

There are seven registered nonbank financial institutions in Tajikistan, and they play an insignificant role in rural finance. Two so-called credit unions are banks that were downgraded to credit union status when they failed to meet minimum capital requirements established for banks. They are owned by a few investors rather than by the many persons who use their services. One plans to create an “agro-service company” that will lend to farmers for purchases of agricultural inputs. The intent is to furnish high quality inputs of seeds and fertilizers to farmers at fair prices.

The World Bank’s Farm Privatization Support Project failed to organize credit unions on each of the 10 farms where it supported land privatization. Two major problems developed. First, there is no appropriate legal and regulatory framework for cooperatives and credit unions. The current civil law on cooperatives would permit the credit unions to have only 50 shareholders when they are first started. In addition, they would be authorized only to make loans, thereby undermining the spirit of self-help and promotion of savings that are at the heart of credit union philosophy. Second, the project

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could not agree with the Ministry of Finance about the interest rates that the credit unions should be charged for World Bank funds to be lent to them.

The governance problems of member-owned institutions need to be anticipated, and a problem is that they are not under the mandate of the NBT and are only supposed to be registered with the Ministry of Justice. Data are not available regarding the number of credit cooperatives that exist. One of the largest nongovernment organizations (NGOs), ACTED, is creating two types of self-managed farmer groups that are a type of pre-cooperative. CARE is also forming small groups that intermediate their own savings and serve as agents for loans that CARE makes to members.

The lack of an appropriate legal and regulatory framework for cooperatives and other member-owned financial institutions is not a serious problem for ACTED, CARE, and other NGOs because the size of groups and the amount of money involved is still small. However, member-owned institutions have well-known governance problems that need to be anticipated to avoid problems that have emerged in other countries when such institutions have grown larger and more money is at risk. Moreover, a framework is needed now to support the nonbank urban financial institutions that already exist and new urban cooperatives that can emerge quickly. There are reports that NGO employees have formed ROSCAs for their financial services and are waiting for regulations so they can be formalized into credit unions. A formal framework and more transparent accounting systems are crucial to help assure prudent operations of member-owned financial institutions and to assist members, officers, and staff to perform their respective governance roles.

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The IFC helped create a rural technical service company in 2002, the SugdAgroServ (SAS) Joint Stock Company, that operates under the Civil Code with 365 farmer shareholders on 14 *dekhans* farms that together have received land use certificates for about 1,200 ha of land. A total of 70 loans were made for the 2002 and 2003 crop seasons to more than 1,000 farmers in an amount totaling \$550,000, with a further 140 loans valued at \$1.1 million extended to more than 1,000 farmers during 2004. As of 31 July 2005, 210

loans were outstanding in an amount just under \$1,020,000. This total number of borrowers is estimated to equal roughly 2.5% of the total cotton farmers in the Khujand region. This project is the most ambitious nongovernmental attempt to deliver a wide range of input supply, production, processing, financing, and marketing services to farmers primarily engaged in producing cotton. It is important because it provides an indication of the magnitude of support required so that cotton farmers become productive and good credit risks for lenders. However, it is questionable whether anything of this scale, complexity, and cost will become available to modernize the entire cotton subsector in the near future. Nonetheless, the project provides a good example of a proper approach to agricultural lending as its cotton loans, as well as those granted by the Tojiksodirotbank, represent what might be called “the new generation” of cotton credits, technically structured and free from the stigma of government-directed credit.

The total number of clients of NGO microfinance institutions (MFIs) is 56,500 as of June 2005, with 54% of clients reportedly women. MFIs report loans of \$149, while small loans in banks were reported to be just over \$1,418 on average. By mid-2005, 29 NGOs were carrying out lending activities either as their only product or in conjunction with other services to improve rural areas and aid the poor. The newly formed microfinance coalition, Association of Microfinance Organizations in Tajikistan or AMFOT, has 17 members, but several are donor organizations rather than retailers of microfinance services. The three largest NGO MFIs are reported to be at or near to self-sufficiency. The National Association of Business Women of Tajikistan (NABWT) which is affiliated with Mercy Corps, is recognized as the market leader. In June 2005, it had over 7,800 clients and \$2.1 million in loans outstanding. Microloans have been used largely to finance trading activities, some basic agricultural processing, as well as the production of a few head of livestock or poultry.

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C. Policy, Legal, and Regulatory Environment

Government policies. Changes made in government policies since the Soviet era have improved the environment within which market-oriented financial services can emerge. Directed credit for agriculture has been discontinued, and there are no interest rate ceilings. Many of the production and pricing controls on agricultural commodities have been removed. Private traders are emerging to supply farm inputs and to market agricultural products. Reforms are being made on state and collective farms to improve access to and control over farmland and irrigation water, even though the state retains ownership of land. Serious problems remain, however, in developing the legal and judicial system so that private contracts can be efficiently enforced. Land use certificates have been distributed for significant amounts of state and collective land, but there are no provisions for facilitating the use of these certificates as loan collateral. Farmers who receive land certificates cannot transfer them except through inheritance. Moreover, the recipients of these certificates face uncertainty in their future access to land because the state has the authority to revoke them if the farmers are judged to not be using the land productively. Research, extension, information, and business development services to support the farming sector are almost nonexistent, and NGOs are trying to fill the gap for small groups of the especially vulnerable small farmers.

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Regulation and supervision of the banking system. The NBT has adopted a full set of international operational procedures and has the legal power to enforce sound financial practices for the banking system. NBT staff has been trained in procedures for bank regulation and supervision, and courses on good banking practices have been given to staff in commercial banks. But whether the regulatory authorities can be shielded from political interference in the discharge of their duties remains to be seen. The NBT has wide discretion in granting temporary waivers to banks that are not in full compliance with all standard requirements. Greater

transparency is needed in the use of the NBT's discretionary powers, however, to eliminate concerns over possible favoritism in enforcing regulations. There is no legal framework for regulating and supervising cooperatives and other forms of member-owned financial institutions. This situation poses an obstacle to the future growth and formalization of small groups that NGOs are organizing to mobilize and intermediate local savings. It also makes these groups vulnerable to mismanagement and corruption, especially if the government and donors use them to channel loans to the rural sector. The minimum paid-in capital requirement for a new bank is \$5 million. Existing banks are supposed to increase their capital to \$1.5 million, although only four had done so as of year-end 2004. Any specific bank may be 100% foreign-owned but the aggregate limit of foreign ownership of private banks as a whole is 35%. There are various impediments to additional bank branching. For instance, the tax law requires the treatment of each branch as a separate legal entity whose start-up expenses cannot be offset against the profit of the head office. Moreover, a bank must have 125% of the minimum capital requirement before it can apply to open a new branch, and then must allocate capital for the proposed new branch and pay a fee of 0.5% of that allocated capital.

New legislation was recently introduced covering microfinance. It will permit the licensing of microcredit-deposit companies (MDCs) by the NBT as one way for NGO MFIs to break their current resource constraints. This law will permit MDCs to take deposits from individuals and legal entities, extend microcredits, carry out cash and transfer operations, issue payment cards, engage in leasing, borrow money, issue debt securities, and sell property acquired as a pledge. After a year of operations and by obtaining an additional license, they can engage in these activities in a foreign currency. The MDCs will be subject to the Law on Guarantee of Deposits of Physical Persons, thereby requiring them to contribute to a guarantee fund within the NBT, and they will have a minimum capital requirement of \$300,000. The law also permits the creation of micro lending organizations that cannot collect deposits but can make micro loans, engage in financial leasing, and provide business development services to clients. The norms and

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regulations for these microfinance institutions have been issued in 2005, and NBT is soliciting comment on the norms and regulations from the microfinance industry.

D. Major Issues and Underlying Problems in the Agricultural and Rural Economy

The cotton subsector. The cotton subsector represents the biggest single challenge to economic development in the countryside. Cotton occupies large amounts of land, is a key source of cash income, provides much employment, and is the only commodity with reasonable access to an international market. However, the integrated cotton production, marketing, and financing system developed in the Soviet period collapsed after independence. The funds previously available to the subsector disappeared, so that the maintenance of farm and off-farm infrastructure was suspended and no new investments have been made. As a result, cotton yields are low, the quality of the machinery stock has deteriorated, the supply of irrigation water and other inputs is irregular, and the marketing of harvests through private investors is reportedly filled with abuse.

Huge debts have accumulated and hang over the sector.

Huge debts have accumulated and hang over the sector. Some of this debt is owed by farmers, and some of it is owed by private investors who borrowed and lent funds to finance farmers. There are allegations that both farmers and investors failed to fulfill their loan contracts. Solution of the debt problem is complicated by land reform. No clear procedure has been employed for allocating the existing debt on farms when new recipients are granted land use certificates. Nor is there any system of payment by the new owners who receive assets of value; that is, they receive the asset but not the debt associated with it. Creditinvest is in effect a mechanism for transferring the bulk of the old unpaid cotton debt of about \$150 million into a new entity, thereby freeing up the existing private banking system from an unbearable burden. This is a variation on the “good bank-bad bank” concept. While Creditinvest is expected to collect some of this bad debt, projecting anywhere near 100% recovery seems unreasonable. The government will ultimately have to write off the unrecoverable balance. Farmers are supposedly free

to decide what and how to produce, but they are actually given little choice. They cannot freely choose what to produce, where to acquire inputs, and how to market their harvests while they are indebted to their current suppliers and financiers. Major on- and off-farm investments are needed to rehabilitate the stock of agricultural machinery, the irrigation system, and the cotton gins. Although Tajikistan may not have a comparative advantage in cotton production compared to other countries, cotton is the most attractive large-scale crop available that has a market and can absorb labor while other crop and livestock activities are developed. The road and transportation systems are also much in need of repair. Although the needs are great and obvious, the financial system will find it difficult to serve this subsector until the debt problem is resolved, and productivity and profitability are improved.

Other subsectors. Farmers are attempting to diversify into other crops and to recover traditional markets for fruits and vegetables in the Soviet Union. As with cotton, serious production and marketing challenges must be addressed for other crops. In addition, the local market for most products is so thin that small increases or decreases in production produce wide price swings. Exporters face large costs and delays in having to cross what are now international borders to reach their traditional customers. Borrowers from MFIs have been guided into and have achieved some success in investing in small livestock and poultry operations to supply local niche markets, especially for religious holidays. Farmers in distant mountainous regions are especially disadvantaged in locations where they are completely isolated during the winter months.

Problems of the rural financial system. The financial system is not well equipped to serve the agricultural sector and the rural economy. On one hand, AgroinvestBank and Amonatbank have extensive networks of bank branches because they were developed in the Soviet era. Based upon fee and interest income derived from existing bank services, it is possible that some of the outlying branches of these two banks are at best marginally profitable.

However, they have the advantage that physical infrastructure and personnel are already in place and these outlying bank branches have accumulated client bases. Nonetheless, these banks are presented with the challenge of going beyond the limited savings and transfer services offered to the rural poor and to experiment with ways that can profitably expand credit services to rural people. In addition, there may be new approaches to generating fee income that these banks have not considered. At present, these banks hardly feature a customer-friendly approach, which is directly related to a lack of experience managing a retail service business under market conditions. Barriers to bank profitability may therefore be more related to internal factors. While the relative poverty of rural Tajikistan represents a substantial challenge, it is not likely to be an insurmountable barrier to creating a viable banking business model. The other banks have limited branch networks, so they are unable to offer strong competition to these two large banks. On the other hand, all the banks have to adapt to the concept of attracting clients by offering desirable products and high quality service. They need to learn the specific financial demands of agricultural clients and design products that fit this demand, but they are just beginning to develop loan products to compete with NGOs for microfinance clients. Transaction costs are reported to be low for clients who open deposit and savings accounts, but they are discouraged from holding funds in such accounts because they are often unable to withdraw funds when desired because branches simply run out of funds. The transfer of remittances is one area in which bank services are relatively good and costs for clients are minimal.

Due to the lack of interest and capacity of the banks to serve low-income clients, NGOs are actively attempting to serve this clientele group by offering credit alone or in addition to nonfinancial assistance and services. They lack the resources, however, to serve a broader segment of this market, and only one NGO is recognized as having reached financial self-sufficiency. To further penetrate the agricultural market, the NGOs need to adapt their loan products to fit the seasonal nature of rural cash flows. Moreover, none of them have much experience with attracting savings or with the difficult task of managing liquidity that will be required if they begin to fund

their loan portfolio out of savings rather than government and donor lines of credit.

The development of member-owned and -managed financial institutions is in its infancy. Donors have formed small groups to begin to mobilize and allocate savings in loans to members. In addition, some earn fee income by managing loans that NGOs make to their members. They will have to go through many growing pains if they are to develop the capacity to successfully govern themselves and create products and services desired by members.

E. Government and Donor Interventions to Strengthen the Rural Financial System

Improving profitability of farm and nonfarm investments. The financial sector follows economic activity; it does not lead it. Access to finance cannot make economic activities profitable that are otherwise unprofitable. Today, farm and nonfarm entrepreneurs in Tajikistan face major impediments that reduce enterprise returns and increase risks, so financial institutions logically shy away from them, ration the loans made, charge high interest rates, and demand large amounts of collateral. For these reasons, the first priority for strengthening and expanding agricultural and rural finance is to improve agricultural profitability so potential borrowers are more creditworthy and more rural surpluses are available to be converted into financial assets.

Since the country is pursuing an open foreign trade policy, it must become competitive in international markets. Agriculture faces many problems as it modernizes, and it must find its comparative advantage in the face of serious natural resource constraints. Donors can help the government at both the macro- and sectoral levels to improve agriculture's performance. At the macrolevel, the government needs to pursue prudent and stable monetary and fiscal policies; simplify taxation and streamline revenue collection; negotiate better trade relationships with neighboring countries; modernize the physical infrastructure including roads, railroads, and electrical and communications systems; improve the efficiency,

The financial sector follows economic activity; it does not lead it. Access to finance cannot make economic activities profitable that are otherwise unprofitable.

transparency, and predictability of public institutions that license, tax, and regulate business; and strengthen institutions that provide agricultural research, extension, and business development services.

At the sectoral level, the technology of agricultural production, processing, and marketing must be upgraded, and information about this technology needs to be widely disseminated; market information systems must be created; access to land and water must be improved, and these resources must be used more efficiently; input markets must be developed to ensure the supply of good quality seeds, fertilizers, and chemicals; the stock of farm equipment and vehicles must be overhauled and renewed; and superior livestock breeds are needed along with access to fodder, feeds, and veterinary services.

There are several reasons to diversify cropping and reduce dependence on cotton. First, the SAS project expects to show that diversification, crop rotations, and improved tillage practices will improve soil structure and fertility, and water absorption and retention. Second, diversification is expected to reduce production and price risks for farmers, and improve the efficiency and conservation of resource use. Third, enterprise diversification should also make farmers less risky as clients for lenders. However, diversification requires that farmers identify new products and markets and learn new production and marketing techniques. This involves trial and error by entrepreneurs, but publicly supported interventions have accelerated the process in developing countries. Some interventions in support of agriculture should be broad-based, such as research and extension services that serve the entire sector. Others can be targeted toward specific products and groups of farmers as a way to selectively test new techniques and products. Targeting is difficult, however, because identifying potential winners is not easy, and it can lead to abuses wherein the powerful and well connected seize the majority of the benefits.

The banking industry in Tajikistan is still in relative adolescence, if not infancy.

Commercial banking in rural areas. The banking industry in Tajikistan is still in relative adolescence, if not infancy. Steps are being taken to correct technical deficiencies among bankers. For instance, a select number of the stronger banks, chosen by the

European Bank for Reconstruction and Development (EBRD) to be those banks upon which the growth of banking services in rural areas is likely to depend, are presently the subjects of extensive EBRD assistance geared to perfecting their procedures for lending to microenterprises and to small and medium enterprises. The government-owned AmonatBank is one of the banks chosen for the EBRD program that furnishes training and, in some cases, subordinated loans.

Problems constrain the expansion of banks into rural areas: most of the rural population is poor, scattered across the countryside, and is heavily dependent on earnings from agriculture. Therefore, although banks can be expected to offer deposit and remittance services to customers in all income groups, a shift in the commercial lending paradigm is needed before banks can get involved in a significant way in lending to the segment of the rural population that is well below the poverty line. As banks develop more technical capacity, they can be expected to seek profitable lending and deposit-gathering opportunities among the economically active poor, higher income individuals, and ongoing enterprises in rural areas. Providing financial services to such persons may require the use of member-owned financial institutions and NGO MFIs that transfer a large part of the transaction costs on to the clients. In cases of the extremely poor and destitute, humanitarian grants may be required as a first step in developing creditworthy clients.

Two priority actions will encourage banks to more fully reach their rural potential. First, the cotton debt problem needs to be resolved through a selective process so those who have punctually met their credit obligations should not be prejudged because of the poor repayment of others. Those who have engaged in malfeasance should be held accountable, those with capacity to repay should do so or lose their collateral, those without capacity to pay should have their loan collateral seized and their remaining debt rescheduled or written off, and those who can repay in the future should have their loans rescheduled and new funds lent for the next cropping season. This process will require a careful evaluation of farmers and cotton investors to determine which ones actually provided collateral and guarantees of value that can be liquidated, and which

As banks develop more technical capacity, they can be expected to seek profitable lending and deposit-gathering opportunities among the economically active poor, higher income individuals, and ongoing enterprises in rural areas.

ones did not. Second, institution building is needed for financial institutions. Banks need to learn modern improved credit technologies required for evaluating and managing the risks of serving agriculture and understanding the debt repayment capacity of potential rural borrowers. Credit officers need training in cash flow analysis and projection to help reduce lender reliance on collateral-based lending and provide greater opportunities for lending to borrowers with limited assets.

Some banks may find it less risky and more profitable to offer financial leases rather than loans now that there is a new law on leasing. For both term loans and leases, however, a stable access to long-term funds must be assured, particularly as the present low volume and questionable stability of sight deposits, the result of lack of risk management and overall banking expertise, and the concomitant low public confidence do not allow for the kind of “term transformation” intermediation based upon stable core deposits that commercial banks in many developed markets practice. Donors may contribute to resolving this problem through designing reforms in pension and insurance schemes and testing long-term savings instruments and incentives for savers. The IFC financing facility for leasing being planned for Central Asia should also increase the availability of long-term financing.

Improving regulation and supervision of financial institutions. Several actions should be taken to complement the improvements already made in regulating and supervising financial institutions. For example, there is unconfirmed evidence of lax enforcement by the NBT of banking regulations and weak control over the transparency of annual audits performed by international auditing firms. Moreover, there is little transparency regarding the conditions under which banks are granted waivers for noncompliance with regulations, and this can give rise to claims of favoritism and suspicion of political interference. The NBT should improve its public image by adopting greater transparency in its bank supervision methodology without violating the precepts of bank confidentiality.

Greater transparency is also required in preparing consolidated financial statements of banks. First, to provide a clearer picture of the banking system, the NBT should segregate the financial statements of Creditinvest and other nonbank financial institutions. Second, the NBT should publish these statements annually, based on the audited financial statements of the banks and quarterly, based on interim data furnished by the banks. Third, these statements should be treated as nonconfidential and, unlike the current situation, should be widely available outside the NBT.

Three specific banking regulations should be reviewed to evaluate if they are too restrictive and have a negative impact on rural finance. First, the current regulation specifying that the ratio of liquid assets to current liabilities must be a minimum of 75% seems to be a serious constraint on ability to lend. Second, existing regulations concerning new branch openings may be unduly restrictive when applied to new branches in rural areas and may discriminate in favor of banks with existing large rural branch systems. Third, the 35% rule regarding foreign ownership of the banking system may need to be relaxed to encourage the entrance of top quality foreign banks and improve the low overall capitalization of the banking system.

A separate legal, regulatory, and supervisory framework is needed for member-owned financial institutions, and this is an area where donor experience and assistance may be especially useful. Without this framework, the development of this important segment of the financial system may lag, with negative implications for rural areas where such institutions may be the best alternative because of the normally higher bank operating costs. An important distinction needs to be made between organizations that take deposits only from members versus those that take deposits from the general public. A critical decision will need to be made about which institution should regulate and supervise these institutions. Other issues concern sustainable methods to train members, officers, employees, and boards of directors of member-owned financial institutions about the need for and practice of good governance. A system of standardized accounts also needs to be established to

Three specific banking regulations should be reviewed to evaluate if they are too restrictive and have a negative impact on rural finance.

ensure adequate transparency, along with a system of on-site and off-site inspection and auditing, so that members of these financial institutions will have faith in the integrity of their organizations.

The NBT is developing norms and regulations to operationalize the new microfinance law. Two issues are particularly important to the microfinance industry. First, the norms and regulations must recognize the unique characteristics of MFIs compared to other types of regulated financial institutions. Flexibility is needed so that the fledgling industry can continue to experiment and develop. Second, a system for on-site and off-site inspection must be implemented, once again recognizing the differences between MFIs and other profit-oriented financial institutions. As with member-owned financial institutions, the main difference is determined by whether or not they take deposits. If they do not, there is less need for external regulation so self-regulation by the industry may be adequate. If they do take deposits, risk-based supervision may be adequate.

It is urgent that the entire framework of land use certificates and their security and transfer be improved.

Strengthening financial infrastructure. Government ownership of land in Tajikistan may damage incentives for farm investments and undermine the development of rural financial institutions because land is widely used as collateral for agricultural loans everywhere in the world. Therefore, it is urgent that the entire framework of land use certificates and their security and transfer be improved. An efficient system is needed that permits farmers to pledge their land use certificates for loans and that permits the transfer of certificates in cases of loan default. Lenders must know that their creditor rights are protected when loans are secured with land use certificates. In addition, a market for land must be developed so that land can be valued for guarantee purposes and sold by lenders in cases of default. The system for registering all types of property must also be streamlined and the cost of using the system reduced. The donor projects that aim to strengthen commercial law and to support contract enforcement, and property rights need to be extended so appropriate laws are passed and support institutions are created. When the volume of loans and number of competing institutions increase, financial institutions

should quickly and cheaply access information about a prospective client's current financial situation and history of repayments on previous debts. All financial institutions will thus benefit if a public or private credit bureau is created. Credit bureaus should also help prevent overlending and overindebtedness.

Institution building. The experience of other countries reveals that institution building is an essential investment and often the first step in the process of creating competitive financial systems. In Tajikistan, the objective should be to develop institutions so they can efficiently respond to the demand for rural savings and remittance transfer services that already exists, and to the demand for rural loans that will emerge as new products and technologies emerge and as the huge structural problems of agriculture are reduced through reforms and structural changes. Historically, government and donor programs placed too much emphasis on disbursing funds and meeting loan targets and too little emphasis on designing lending procedures and ensuring the long-term sustainability of institutions. The proposed institution building elements of the ADBs Microfinance Sector Development Program should be replicated more broadly for rural finance. Special attention is needed for institutions that aim to reach the most difficult and vulnerable segments of the market: women, the poorest, and the most geographically isolated. Subsidies may be warranted for public goods investments, such as experimenting with different products and delivery systems, supporting training and information systems, cost-sharing the expense of opening rural branches, and creating a support system essential for successful member-owned financial institutions. Since there is no evidence of clear institutional comparative advantage, assistance should be provided to several institutional forms (banks, MFIs, member-owned cooperatives) so that each can find its appropriate market niche through experimentation and competition. The selection criteria for such assistance must be carefully developed to discourage rent seeking. Subsidies should also be transparent so that their cost is clearly understood and the recipients are aware of the quantitative implications when they will be withdrawn.

The experience of other countries reveals that institution building is an essential investment and often the first step in the process of creating competitive financial systems.

A global strategy for developing the rural financial system is needed so that individual projects and activities contribute to a coherent approach rather than simply fitting the current fads and fashions of individual donor agencies.

More effective donor coordination. Good examples of coordination exist in donor support for microfinance, but coordination is likely to be severely tested over the issue of when and how to resolve the cotton debt. Some mechanism is needed, perhaps in the form of a working group, so that domestic and international stakeholders interested in rural finance can come together to develop a unified long-term strategy. A global strategy for developing the rural financial system is needed so that individual projects and activities contribute to a coherent approach rather than simply fitting the current fads and fashions of individual donor agencies.

Developing capacity to analyze and monitor rural financial markets. Most of the analysis of the potential and problems of rural finance is currently being conducted and/or financed by donors and concerns their particular projects or problems. The situation is similar for other agricultural problems. No long-term national capacity is being developed in or out of the government to undertake field studies of the agricultural sector, measure the penetration of financial services, assess the potential demand for products and services, and identify the costs and risks of attempting to meet this demand. Institution building in a government agency, university, or research institute is needed in this crucial area to develop the information base for the future design of prudent policies and projects. The government and donors need to address this long-term issue in addition to their concern for short-term interventions designed for quick results.

Chapter 8

Rural Finance in Uzbekistan

Executive Summary

Mario B. Lamberte and Mariano Cordero¹

A. Background

The region where modern Uzbekistan is located has been one of the cradles of world civilization. The cities of Khiva and Bukhara celebrated their 2500th anniversary in 1997. Samarqand is as old as these two cities. Tashkent, the country's present capital, celebrated its 2000th anniversary in 1983. Presently, the country is divided into 14 administrative divisions: 12 *oblasts* (regions), 1 autonomous republic, and 1 city with special status (Tashkent City).

Uzbekistan's total land area is 477,400 square kilometers, which is about the size of France or slightly larger than California. It is rich in natural resources. Before 1992, it accounted for one third of Soviet gold production. Other mineral resources being mined are fluorspar, copper, zinc, lead, tungsten, molybdenum, and uranium. It is also rich in energy resources. Its gas reserves are estimated at 937.3 billion cubic meters. Some 3,785 thousand ha of land are devoted to crop production. The government has allocated land primarily for the production of its two strategic crops, namely, cotton and wheat.

¹ Support for the preparation of this country study, from which this summary is taken, was provided by Otabek Sh. Rakhimov and Bahram S. Yuldashev.

The population living below the poverty line is estimated at 27.5%, but about 70% of the poor live in rural areas.

As of 31 December 2003, Uzbekistan had a population of 25.6 million and a per capita income of \$312. The country has a relatively young population, the median age being 22.1 years. The population density ratio varies across the 14 regions of the country from 7.2 to 541.3 people per square kilometer. Population is highly concentrated in the south and east of the country where available natural resources can support agricultural activities. As of 2003, some 63% of the population lived in rural areas, up from 60% in 1996. The population living below the poverty line is estimated at 27.5%, but about 70% of the poor live in rural areas. Thus, poverty in Uzbekistan is largely a rural phenomenon.

With the restructuring of the agricultural sector after independence, three major farm types have emerged, namely: *shirkat* farms or farm enterprises, private or farmers' farms, and *dekhkan* farms. *Shirkat* farms replaced the Soviet era's collective and state farms and have an average land size of 1,500 ha. Farmers' or private farms are those farms leased by the government to farmers for 10–50 years. The size of private farms averages 20 ha. *Dekhkan* farms are household plots whose land use rights are life-long and can be inherited. Their average land size is 0.17 ha; and no household is allowed to have a *dekhkan* farm exceeding 0.35 ha.

In 2003, the shares of agriculture, industry, and services in gross domestic product (GDP) were 28.8%, 19.5%, and 38.3%, respectively.² In terms of employment, their respective shares were 31.6%, 21.5%, and 46.9%.

Uzbekistan can be distinguished from other transition economies in Central Asia in two respects. First, the economic contraction it experienced in the first few years after independence was the mildest among Central Asian economies undergoing the same transition phase. This was because it succeeded in reorienting its main exports (cotton and gold) to economies that are not part of the former Soviet Union, and acted swiftly to become self-sufficient in energy and food grains. Second, it took a gradualist approach in reforming its economy. In fact, it introduced current account convertibility only in 2003.

² The remainder was net taxes.

Despite Uzbekistan's success in minimizing the contraction of its economy in the first half of the 1990s, its GDP growth rate averaged only 4% during the period 1996–2003, far below the economy's potential. Disintermediation has taken place in the financial system, as the M2/GDP ratio fell sharply from a high of 53.5% in 1993 to 17.7% in 1995, and further to 13.6% in 1999. Although both cash and deposits contributed to the fall in the M2/GDP ratio, deposits contributed more, especially in recent years. Published data after 1999 are unfortunately not available, but data culled from individual reports of banks suggest that total deposits of the banking system as of the first quarter of 2004 comprised only 11.4% of 2003 GDP.

The inability of the financial system to perform its intermediation function can be attributed to several factors. First, hyperinflation in the early 1990s eroded the value of the newly created sum, making it one of the weaker currencies among transition economies in Central Asia.³ Second, the gradualist reform strategy, which worked well in the early 1990s in minimizing the transition cost to the economy, became a stumbling block to rapid growth of the economy by the mid-1990s. Cheap capital and funds from centralized loans that went to the interbank market from the Central Bank of Uzbekistan (CBU) through weekly auctions were a disincentive for banks to mobilize deposits. Indeed, deposit rates that banks offered depositors were also below inflation rates.

Aside from negative real deposit rates, other factors discouraged individuals and legal entities from depositing funds with banks. One is that banks are given a significant role in tax collection. Individuals who try to avoid encountering problems with the tax authorities prefer not to deposit their money in banks.⁴ This partly explains why many income earners such as salaried employees, who might be important sources of deposits, do not keep deposit accounts with banks. By law, legal entities are required to have a bank account. However, until recently, legal entities were allowed to have only

The gradualist reform strategy, which worked well in the early 1990s in minimizing the transition cost to the economy, became a stumbling block to rapid growth of the economy by the mid-1990s.

³ After being expelled from the ruble zone in late 1993, Uzbekistan issued an interim sum coupon in November 1993. The permanent currency unit, the sum, was issued in the third quarter of 1994.

⁴ They can be suspected of conducting unlicensed business.

one settlement account to simplify the task of banks in collecting taxes from enterprises that kept accounts with them. This regulation was lifted in December 1999; now legal entities are no longer limited in the number of accounts they can have with different banks.

The “cash plan” that the CBU used to directly manage liquidity in the system adversely affected the operations of enterprises and the intermediation function of banks.⁵ Legal entities, especially those with high sales turnover and seasonal operations, could not perfectly predict their cash requirements for the following month. Once they deposited their excess funds with their banks, they could be put in a situation where they could not withdraw the amount of funds that they needed for their operations during the month. They could also not respond quickly to emerging profit opportunities. Indeed, results of a survey of small- and medium-sized enterprises (SMEs) done by the International Finance Corporation (IFC) showed that regulatory restrictions on cash withdrawals were one of the most pressing problems that a large proportion of SMEs encountered. Some SMEs tried to circumvent this regulation in various ways but, in the process, incurred unnecessary costs aside from putting themselves at risk of being caught by the authorities. Another means of paying enterprises’ obligations using their suppliers was through noncash payments, specifically through bank-to-bank wire transfers, which should not be difficult since all legal entities are required to have an account with a bank. However, this limits the ability of enterprises, especially SMEs, to exploit opportunities for minimizing costs by combining cash and noncash payments.

While Uzbekistan’s gradualist approach lessened economic dislocation during the initial phase of the transition, it now poses a major constraint toward the rapid development that other Central Asian economies are currently enjoying after undertaking broader and deeper economic reforms. Recently, however, the government initiated major reforms to accelerate transition to a market economy. The rapid development of the rural sector is a key objective of the reform process to accelerate growth and lower poverty incidence.

⁵ Under the “cash plan” system, banks were required to develop and submit to the CBU regular cash flow projections for client accounts. This was replaced by the “cash forecasting” system, which many observers believe is essentially the same as the “cash plan.”

A rural financial market that provides diversified financial services is needed to support a more rapid, rural development process.

B. The Status of Rural Finance

1. Demand for Financial Services

Liberalizing the economy—which includes gradual privatization of state-owned farm and nonfarm enterprises, granting licenses to new enterprises, deregulation of the banking sector, and lifting of wage controls in 2003—has spawned demand for various types of financial services. With the privatization of many state-owned enterprises (SOEs), an entrepreneurial class has started to emerge in rural areas, some with diversified business interests.

Results of a survey of SMEs conducted in 2002 show that, of the 2,000 sample microenterprises and SMEs, 33% wanted external financing. However, only 25% had actually applied for bank loans. Of this, 54% wanted to borrow to purchase fixed assets, 34% to finance working capital, and 17% to finance trading operations. The growing demand for external financing can also be observed from the newly established credit unions. For instance, despite the rapid growth in the deposits of the Credit Union of Syrdarya brought about by increases in both membership and deposit per member, it still could not immediately accommodate many loan applications of their members due to lack of funds.

In 2003, over 190 SMEs were surveyed to study the potential market for leasing in the country. The results showed that the unfilled demand for financial leasing among the SMEs studied was at least \$15 million for the period, of which 31% was for agricultural equipment, 18% for light industry, and 16% for food processing equipment. Demand for retail trade equipment was also significant.

In summary, results of existing studies and in-depth interviews conducted by the team for this study suggest a growing and diversified demand for financial services in rural areas, a large proportion of which has not yet been met by existing financial institutions. Responding to this huge demand gap is a major challenge for rural financial institutions.

The government is deeply involved in the banking system as well as being the major supplier of funds to the agricultural and industrial sectors, using banks as conduits for its directed credit programs.

2. Supply of Rural Financial Services

Banks overwhelmingly dominate Uzbekistan's financial system, and the government is deeply involved in the banking system as well as being the major supplier of funds to the agricultural and industrial sectors, using banks as conduits for its directed credit programs. Although there are private banks whose assets have been rapidly growing in the last few years, their total resources are still small and they have not yet penetrated rural areas. There are rapidly growing nonbank financial institutions, such as credit unions and microfinance institutions, which are providing financial services in rural areas, but their resources still cannot match the growing demand for financial services in rural areas. Though beneficial to farmers and SMEs, leasing is still in its infancy.

a. Government Interventions

The government provides funds to the agricultural sector to support its directed credit programs at rates substantially lower than market rates. The government considers cotton and wheat as strategic crops and ensures that cotton and wheat production is in accordance with certain specified targets and will not be hampered by lack of farmers' access to credit. To attain the targets, the government requires *shirkats* and private farms to meet certain quotas each production cycle. This is supported by a government-funded centralized advanced payment system, in which farmers obtain advanced payment from agro processors and purchasing enterprises up to 90% of the contract amount to pay input suppliers.

To finance such operations, the government lends funds to the banks through the Ministry of Finance special fund at 2.5% per annum. Banks, in turn, lend the same funds to agro processors and purchasing enterprises at 5% per annum for a spread of 2.5%, of which 1.25% is paid as an insurance premium to Uzagrosugurta, a state-owned insurance company, to insure banks against the risk of nonpayment of loans. Thus, loans for the two strategic crops largely come from the government at highly subsidized rates; the government also bears the risk.

The government also has preferential financing schemes for SMEs through the banking system. Banks may obtain funds for on-lending to SMEs from various funds, such as the Employment Fund, Business Development Fund,⁶ and the Fund for Support to Dekhkan Farms and Farmers. Interest rates on these loans are pegged at a fraction of CBU refinancing rate, which currently ranges from 3% to 9%. These interest rates are well below the prevailing market rates. In addition, banks are required to set aside 25% of their profits for on-lending to SMEs at preferential rates equal to 50% of CBU refinancing rate. However, how banks allocate this fund to SMEs across the country is not transparent, and it may well be used for lending to related parties. SME loans of banks funded by the above sources can be insured with a state insurance company.

The insurance market is dominated by four state enterprises, which together account for nearly 90% of the total premiums collected in Uzbekistan. Two state-owned insurance companies—Uzagrosugurta and Madad—play a significant role in rural financial markets. Uzagrosugurta plays a key role in the advanced payment system for the strategic crops. Fifty percent of bank loans to farmers are covered by insurance and the other 50% by collateral, such as farm machinery, livestock, etc. However, the company pays only up to 80% of the 50% risk it insures. Madad, on the other hand, specializes in insurance coverage for SMEs. Presently, it works closely with almost all banks. As of end-2003, it insured 3,120 loan contracts, of which 65% were SMEs situated in rural areas. Whereas before it insured up to 85% of the value of the loan contract, today it insures only up to 50%. Also, it has increased its insurance premium to 5% of the amount insured.

b. Banks

Presently, banks can be classified into five groups: state banks, 100% owned by the state with an original charter in place before the passage of the CBU Law; state joint stock banks, where the

⁶ This was liquidated according to the Cabinet of Ministers of the Republic of Uzbekistan Resolution No. 563, dated 24 December 2003, and all outstanding loans were transferred to the balance sheet of Tadbirkor Bank as of 1 January 2004.

state has controlling shares; joint stock banks, owned by private and SOEs with the former as controlling shareholders; private banks, 100% owned by the private sector; and joint venture banks, jointly owned by foreign banks and local partners. As of March 2004, there were 33 banks in the country, consisting of 2 state banks, 3 state joint stock banks, 11 joint stock banks, 12 private banks, and 4 joint venture banks. Together they had 806 branches. The national banking density ratio is 31,900 people per branch, but the regional banking density ratio varies across the 14 administrative regions of the country from 19,000 to 38,400 people per branch. The bank branches are concentrated in four banks—Khalq Bank and National Bank of Uzbekistan for Foreign Economic Activity (NBU), which are state banks; and Pakhta Bank and Tadbirkor Bank, which are joint stock banks. Aside from regular branches there are more than 700 mini banks, most of which are located in regions outside the Tashkent Region.⁷ The presence of mini banks effectively improves the banking density ratio by half.

About 86% of total deposits and more than 90% of total loans and leases belong to the four largest banks—NBU (state bank), Asaka Bank (state joint stock bank), Pakhta Bank, and PSB (joint stock banks). The government and state enterprises together account for a sizeable share of deposits—35.2%. On the other hand, individuals, private partnerships, and corporations and joint ventures account for 21.7%, 10.1%, and 6.1%, respectively, of total deposits. The remaining 25% is classified as other deposits, which may include interbank deposits.

The industrial sector accounts for about 60% of total loans and leases. Of this, more than half went to SOEs. On the other hand, the agricultural sector's share in total loans and leases amounts to less than 5%.

Some reforms were initiated recently to make the banking system more attuned to the growing and highly diversified requirements of the rural sector, particularly the private sector. Specifically, banks have been transformed from specialized banks

⁷ Mini banks are small banking offices with two to three staff that provide banking services to clients but are required to close all accounts at the nearby regular branch at the end of the day. Loans are processed and approved in the regular branch, but are disbursed and collected at mini banks.

to banks with diversified financial services and customer bases. The recent restructuring of banking operations has some implications for the development of rural financial markets. Some cases are cited below.

Pakhta (Cotton) Bank, formerly a state-owned joint stock bank, has been a significant player in rural financial markets because it was created to specialize in financing the growing of cotton. It has 181 branches and 229 mini banks with approximately 70,000 deposit accounts and 40,000 active borrowers (both individuals and legal entities), and accounts for roughly 70% of the banking system's loans to the agricultural sector. Its funds for agricultural lending come mainly from the government's centralized advanced payment system for strategic crops. With the assistance of international donors, the bank has extended loans to microfirms and SMEs, and more than two thirds of its SME loans went to regions outside the Tashkent Region and Tashkent City.

After changing its charter in 2001, Khalq Bank, a wholly state-owned savings bank, now provides banking services to individuals as well as to legal entities, whereas before it catered only to individuals. It has 203 branches and 62 mini banks spread across the 14 regions of the country. As of 2003, loans to farmers consisted of about 30% of its total loan portfolio. Its current customer deposit base of 8 million includes about 50,000 legal entities and roughly 14,000 farmers.

Tadbirkor (Entrepreneurs) Bank, formerly a state-owned joint stock bank, did not have significant lending activities in rural areas until 2000 when many *shirkats* were already privatized. It claims that 16% of cotton producers and 16% of wheat farmers, which used to be exclusive clients of Pakhta Bank and Galla Bank, respectively, are now clients of the bank. Loans to these farmers come mainly from the bank's own resources. It has about 50,000 clients, of whom 19,000 are farmers and the rest are entrepreneurs, traders, handicraftsmen, etc.

Turon Bank, formerly a state-owned joint stock bank, was created to specialize in rural infrastructure financing for irrigation and drainage systems. It has 15 branches and 32 mini banks, majority of which are located in rural areas. As of March 2004, 80% of its

Pakhta (Cotton) Bank, formerly a state-owned joint stock bank, has been a significant player in rural financial markets because it was created to specialize in financing the growing of cotton.

deposits came from regions other than Tashkent Region and Tashkent City, while 30% of its total loan portfolio went to activities other than rural infrastructure financing for irrigation and drainage systems.

Another bank that started as a specialized bank but later became a diversified bank is Galla (Wheat) Bank. Established in 1994 as a joint stock bank,⁸ Galla Bank has been providing banking services to grain (mainly wheat) producers. Currently, it provides several kinds of banking services to its more than 4,000 clients that include about 3,000 small and medium enterprises and operators of *dekhan* farms. It has 31 branches, of which 27 are located outside the Tashkent Region and Tashkent City, and 46 mini banks, which are mostly located outside the Tashkent Region and Tashkent City. As of 2003, its total assets stood at SUM76.6 billion (\$78.8 million), of which SUM62.5 billion (\$64.3 million) were loans and advances to customers. Its total liabilities excluding interbank deposits were SUM36.2 billion (\$37.3 million).

Also established in the mid-1990s is the Savdogar Bank, a joint stock bank. It has 50 branches, of which 41 are located outside the Tashkent Region and Tashkent City. It specializes in promoting trade, and its loan portfolio mainly consists of loans to traders of agricultural and nonagricultural commodities. While its loan portfolio is still concentrated in trade financing, its deposit base has become more diversified in recent years.

c. Credit Unions

The Business Women Association (BWA) of Uzbekistan can be considered the “mother” of credit unions (CUs) in the country. Initiatives for creating CUs in Uzbekistan started as early as 1995 when BWA officers were sent to the United States for a study tour that included visits to CU operations. It was a timely exposure for BWA because it had been advocating for women to have better access to financial services given local banks’ perceived bias against them despite the growing number of entrepreneurial women ably

⁸ It has 1,191 shareholders divided as follows: 309 juridical entities and 882 natural persons.

coping with the transition from a centrally planned to a market economy. Likewise, rural women and poor households are widely known to engage in the local version of the rotating savings and credit associations (ROSCAs), from which CUs elsewhere have often evolved, making the CU an attractive and natural option for financial intermediation among low-income households in rural Uzbekistan.

As of July 2004, 17 CUs were established under the new credit union law, with total assets of SUM2.2 billion (\$2.2 million). The CUs have been growing quite rapidly in terms of both membership and internally generated resources, i.e., capital and deposits.

The CU movement in Uzbekistan is fortunate to be supported by continuous TA from the Asian Development Bank (ADB) and United States Agency for International Development (USAID). These projects have allowed the World Council for Credit Unions (WOCCU) to nurture most of the CUs from the start, helping them adopt proven best practices in CU operations, with a focus on members' self-reliance and mutual assistance rather than dependence on external assistance for their development and growth. The current USAID-WOCCU Technical Assistance has supported 10 partner CUs in various regions of Uzbekistan and has identified 5 additional partner CUs. Based on the April 2004 indicators, the partner CUs appear to be on track to meet the projected target of increasing membership by at least 50% and doubling most financial indicators by the end of 2004.

WOCCU also introduced the widely accepted PEARLS (Protection, Effective Financial Structure, Asset Quality, Rates of Return, Liquidity, and Signs of Growth) performance standards for CUs. Unlike credit unions established in other Central Asian countries, almost all CUs that have been formed are operating entirely on internally generated funds (except for the TA inputs, which are noncash). This has been universally proven to inculcate the desired cooperative values, a vital factor for the proper functioning and sustainability of CUs.

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d. Microfinance Institutions

Only six international and local NGOs are known to be implementing microfinance projects.

Despite the reportedly large number of nongovernment organizations (NGOs) formed in the country (about 64), only six international and local NGOs are known to be implementing microfinance projects. Moreover, only three of these NGOs accounted for 91% of nearly 9,000 active clients and 83% of outstanding loans of about \$1.2 million as of end-January 2004. The major microfinance NGOs (MFI-NGOs) in the country focus mostly on women and have adopted a group solidarity lending methodology, where 3 to 10 persons are jointly liable for each other's loans and with short lending cycles, usually from 3 months to 1 year.

Two of the largest microfinance operations are being implemented in Ferghana Valley by two of the major international NGOs operating in the country, namely: (i) the "Barakot" Microfinance Project implemented by Mercy Corps; and (ii) FV-MARD implemented by ACDI/VOCA. The "Barakot" project alone accounted for 59% of total active clients and 53% of total microloans outstanding as of the end of January 2004. The combined microfinance operations of Mercy Corps and ACDI/VOCA in the Ferghana Valley account for 74% of total clients and 72% of total microloans of all MFI-NGOs.

e. Leasing

Leasing is a budding industry in Uzbekistan, with both banks and nonbank financial institutions involved in the leasing business. As of 2002, total leasing operations of the 11 banks engaged in the leasing business amounted to \$385.5 million. However, only four banks (i.e., Pakhta Bank, Sadgovar Bank, Tadbirkor Bank, and Galla Bank) are engaged in financial leasing of agricultural machinery. Their combined leasing operations amounted to only \$3.8 million or 10% of the total value of the leasing business of banks.

There are six nonbank leasing companies, of which five are owned by a consortium of local banks and one is a wholly owned foreign subsidiary. As of 2002, their total leasing operations amounted to \$197.2 million. However, only two nonbank leasing

companies (i.e., UzCaseAgro Leasing, which is owned by Case Holdings and the Association of Uzbekistan Banks, and Uzelhoz mash Leasing, which is partly owned by Pakhta Bank) are engaged in the leasing of agricultural machinery. Their combined leasing business amounted to \$160.1 million or 81% of the total value of the leasing business of nonbank leasing companies.

f. Donors' Intervention

There have been two types of donor interventions in the financial sector of Uzbekistan. One is TA to the government to support its reform program for the financial system. In 1995, the IMF granted a loan amounting to \$260 million to support the government's package of stabilization measures and structural reforms, including accelerating banking sector reform. In 2002, the IMF provided further support to the government and the CBU as they embarked on a major economic reform program aimed at accelerating the transition to a market economy and establishing macroeconomic stability. This program included: (i) liberalization of the cash market for foreign exchange; (ii) reduction of government interference in bank operations; (iii) abolition of the quarterly limit on cash withdrawals from bank accounts by individual entrepreneurs; (iv) CBU reviews of the SME loan portfolios of all commercial banks active in lending to SMEs as regards loan recovery performance; and (v) allowing 50% of the volume of cotton production to be freely disposed of by farmers at their discretion.

ADB, EBRD, and WB have maintained continuous dialogue with the government and have also encouraged market reforms and development of SMEs. The \$25-million WB financial sector loan signed in 1999 included TA to Uzbek banks for training in strategic planning, risk management and accounting, introduction of appropriate management information systems, and modernization of the payments system. It also included a program for privatizing Asaka Bank, NBU, and Pakhta Bank, but so far only the Pakhta Bank has been privatized.

USAID and WB have also been working with the CBU to modernize the legal framework for the financial sector and

strengthen the supervisory capacity of the CBU. The Government of Switzerland (SECO), in cooperation with the IFC, has funded the Partnership's Central Asia Leasing Project (PCALP) that has worked closely with the government and the banking sector to develop amendments to the legislative framework for leasing. The passage of 38 amendments to various laws that affect leasing is a direct result of cooperation between PCALP, the government, and the private sector. An ADB-funded TA program that started in January 2001 facilitated the drafting of the CU Law. Among the major donors supporting microfinance in Uzbekistan are USAID, US Department of Agriculture, United Nations Development Programme (UNDP), and the British Government through the Department for International Development. These donors have provided a range of support to MFI-NGOs, including TA for institutional strengthening, information technology enhancement, and legal and policy framework advocacy.

The other type of assistance is credit lines that often include a TA component provided by donor agencies to domestic banks to accelerate the development of SMEs. In 1993, EBRD opened a \$60-million credit line to support SMEs, signing an agreement with Asaka Bank in 1996 to provide the latter with about \$30 million for developing SMEs. EBRD opened a second credit line for SME development amounting to \$120 million, of which \$60 million has been allocated to NBU. In 1997, ADB approved a credit line to NBU amounting to \$50 million for SME development. This was followed by another credit line to Asaka Bank amounting to \$15 million for the same purpose. In 2003, Asaka Bank signed a \$7.5-million loan agreement with ADB for a microfinancing project. In 1999, the IFC provided credit lines for SME development to NBU and Asaka Bank, amounting to \$15 million and \$10 million, respectively. In the same year, Kreditanstalt für Wiederaufbau (KfW) provided a Euro15 million credit line to NBU for financing SME investment projects.

Most of these foreign loans are, of course, state guaranteed. WB has noted that since borrowers do not sell their products at market prices and were hit by large currency depreciations in 2002 and 2003, many of them may already have encountered difficulties

in repaying their loans.⁹ However, banks continue to book these loans as performing since they are state guaranteed, which could imply a huge fiscal cost for the government. Thus, a CBU review of SME loan portfolios of banks is badly needed to determine the extent of SME nonperforming loans so that appropriate measures can immediately be put in place to address the problem.

g. Informal Finance

There is substantial evidence of a vibrant informal subsector in the rural financial markets of Uzbekistan. Of course, ubiquitous moneylenders, despite their reported effective lending rates of up to 120% per annum, may be more accessible than banks, although they are also reported to require collateral for large loans.

Local forms of ROSCAs are widely practiced among low-income households across the country. Such schemes are common among members of farmers' associations, handicrafts and artisans' associations, salaried employees, and members of the BWA. It was the BWA that eventually helped transform some of the ROSCAs into credit unions.

A significant development in rural Uzbekistan is the emerging financial arrangements between and among agro processors, wholesalers, and primary producers. These arrangements come in various forms, with interchanging roles among the market players as debtors or creditors, and transactions carried out either in cash, money transfers, or "in kind," depending on the agreement. One arrangement is that of processors providing financing to primary producers or raw materials suppliers. Contract-growing arrangements are now increasing between farmers and agro-processors/wholesalers. Vegetable growers, dairy farmers, and family-operated orchards are now benefiting from these arrangements because they can avail of partial financing from contractors for their production needs and, at the same time, have a guaranteed market for their products at predictable prices. The most common contract-growing arrangement is where a processor or wholesaler provides a

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A significant development in rural Uzbekistan is the emerging financial arrangements between and among agro processors, wholesalers, and primary producers.

⁹ WB (2003).

partial cash advance to primary producers, ranging from a minimum of 15% to as high as 50% of the estimated cash value of the crops or livestock under contract. Full cost financing is even reported in a few cases where the contracting parties have long and good relationships. Contracts are not registered and are usually effective for 1–6 months, depending on the product. No collateral is required from the producer other than pledging the sale of crops financed exclusively to the processor/wholesaler. There are hardly any documentation costs because of the non-registry of contracts.

A reversal of roles from the above is also found in rural Uzbekistan, with processors buying on credit from wholesalers and producers. Based on the survey, about 20% of respondent processors are able to avail of credit sales from suppliers. Such arrangements are largely unregistered, requiring no collateral and based mostly on mutual trust from long-term personal relationships.

More common financing availed of by farmers are sales on credit from input suppliers. As many as 75% of input suppliers interviewed reported to sell commodities on credit to their customers, with 6–8 months repayment terms. As described earlier, these transactions are either verbal or in the form of unregistered written contracts or promissory notes. Payments in cash are preferred, although payments in kind were reported in a few cases. In addition, about 30% of the input suppliers have availed themselves of credit from major fertilizer wholesalers or manufacturers.

C. The Policy, Legal, and Regulatory Environment

Since 1991, the government has passed several laws to reform the financial sector. However, the financial system in Uzbekistan still remains closely controlled by the state through a complex set of regulatory actions, decrees, proclamations, and practices.

Two major laws—“On the Central Bank of the Republic of Uzbekistan” (21 December 1995)¹⁰ and “On Banks and Banking

¹⁰ Some provisions of this law were amended in 1998 and 1999.

Activity” (25 April 1996)—set the legal framework for regulating and supervising banks in the country, with the CBU as the sole regulatory and supervisory institution. Existing regulations on bank entry and branching seem to favor the development of rural financial markets. Presently, the minimum capital requirements for newly opened banks are as follows: commercial banks established in Tashkent City, equivalent to \$2.5 million; commercial banks established in other regions, equivalent to \$1.25 million; and commercial banks established with foreign capital, equivalent to \$5 million. Banks are encouraged to open branches in rural areas subject to certain requirements, such as the financial viability of the branch as shown in the proposed business plan and qualified staff. Aside from branches, banks are also allowed to operate mini banks with fewer requirements, such as a computer link to the main branch in the area for cash payments. Foreign banks are allowed but only in the form of joint ventures with local investors. There is no ceiling on foreign equity participation in a joint venture bank.

One major drawback in the law covering the banking system is that banks, upon the request of tax authorities, are to present information about their clients for control and correctness of tax payments. Most loans are noncash, with payments to be made by borrowers to their suppliers through wire transfers from the borrowers’ banks to the suppliers’ banks. Under a tight monetary policy, this system has resulted in placing a large premium on cash over noncash loans.

The Law on Credit Unions, enacted by Parliament on 4 April 2002, provides a good foundation for the creation and functioning of credit unions in the country. It conforms to universally accepted best practices for credit unions. The law prescribes that the CBU shall register, license, and supervise CUs. However, at least three issues need to be reviewed given their impact on the expansion of CUs, especially in rural areas. These are supervision of CUs, tax exemption, and minimum capital requirements. The CBU must apply risk-based supervision to CUs as it does to banks. However, once the number of CUs reaches a certain level that would be difficult and costly for the CBU to supervise them, the option of having a separate supervisory agency for CUs must be considered.

One major drawback in the law covering the banking system is that banks, upon the request of tax authorities, are to present information about their clients for control and correctness of tax payments.

CUs will no longer be given tax holidays after January 2006. Setting a cutoff date will mean that not all CUs will be able to enjoy the tax holidays over the same number of years. CUs formed later will have increasingly shorter periods for their tax holidays as their formation dates go nearer January 2006. In contrast, new banks are provided tax holidays lasting 3 years after they are set up, so that banks set up in the future will enjoy the same tax holidays. This does not provide a level playing field for CUs in the financial market and partially defeats the purpose of promoting their creation through tax incentives. This incentive structure therefore needs to be reviewed.

Regulation No. 1151 sets the minimum (cash) statutory fund for CUs established in Tashkent at \$20,000 equivalent and at \$10,000 equivalent for CUs set up in other localities. This could be a barrier to entry for low-income groups and rural residents wanting to set up a credit union, which is often the only option for them to access responsive and sustainable financial services. Poor rural households may not be able to set up a credit union because they cannot afford the required minimum capital since a credit union normally takes some time to build up a membership base. In most countries, credit union laws only prescribe the minimum membership, without the statutory fund, to ensure a critical mass of members for a viable start-up of operations. Other CU laws require minimum capitalization but only as a provision for the CU to offer certain financial services beyond the usual savings and credit services, such as to engage in foreign exchange transactions, remittances, or payment services. It is to be noted that the law does not distinguish between members' share capital and institutional capital. This is a significant shortcoming that should be rectified.

Cabinet of Ministers' Resolution No. 309 is currently the only instrument that lays down the government's policy and intentions for the microfinance subsector. The resolution recognizes the need to develop microfinance to support vulnerable groups and promote private entrepreneurship. It also allows implementers of microfinance projects to have independence in lending and repayment within the framework established by donor agencies. However, the resolution contains drawbacks that undermine the

development of the microfinance market in the country. First, the resolution appears to have a very narrow and dated view of microfinance, equating it largely to microlending. Second, the resolution has not clearly defined the type of institutions that can engage in microfinance, including the other financial operations they can engage in and the qualifications to perform such functions (e.g., prudential requirements for deposit taking). It has focused mainly on donor organizations and nonprofit organizations. Third, the resolution has set up a list of (international) NGOs and donors that restricts the entry of additional players into microfinance.

The Law on Leasing enacted in 1991 and subsequent amendments have made the country's legal framework for leasing one of the most progressive in Central Asia. However, still lacking are practical, efficient, and simplified repossession procedures for leased assets. The use of the accelerated depreciation method for leased assets (and other capital investments) also helps promote leasing as well as investments in the productive sectors in other countries. The method allows for substantial reductions in the taxable income of companies and is seen to be a faster and more efficient means for recouping investments, which in turn stimulates further capital infusions in the productive sector. Such a method has yet to be adopted in Uzbekistan.

The registry system for collateral in Uzbekistan seems to be operating effectively. Movable and immovable properties can be used as collateral. Other acceptable collateral include guarantees provided by either individuals or legal persons, and deposits. Land cannot be used as collateral because, under the Land Code, land is state property and therefore cannot be bought, sold, exchanged, donated, or mortgaged. Although land-use rights can be transferred to other individuals or legal entities, these are not yet widely accepted as collateral.

Existing laws provide for an orderly transfer of movable properties or land-use rights from the debtor to the creditor, and the latter can bring the case to the court for resolution. However, it usually takes a long time and significant amount of financial resources from litigants before the court settles a case.

Movable and immovable properties can be used as collateral. Other acceptable collateral include guarantees provided by either individuals or legal persons, and deposits. Land cannot be used as collateral

Because of the marketing monopoly of the state, farmers are paying implicit taxes arising from the differentials in farm-gate prices and export prices and overvaluation of the domestic currency.

D. Major Remaining Issues

Farmers that produce strategic crops, which happen to be the major export crops of the country, have less flexibility in production decisions. Moreover, because of the marketing monopoly of the state, farmers are paying implicit taxes arising from the differentials in farm-gate prices and export prices and overvaluation of the domestic currency. Recently, the government introduced some reforms to raise incentives to farmers. These are unifying the exchange rate, allowing wheat farmers to sell 50% of their harvest in the open market, and aligning the government's procurement prices to world market prices in the case of cotton and to domestic market prices in the case of wheat. The government could deepen the reforms by allowing farmers complete authority to decide what crops to plant on their farms and doing away with the government's marketing monopoly of cotton and wheat.

Farmers face other constraints as well. One is irrigation. Although almost all farms are irrigated, access to sufficient amounts of water is fairly rare. This is because many of the existing irrigation systems are badly in need of repair or rehabilitation. Still another problem is the small size of farms allocated to farmers to produce strategic crops. Officers of the Farmers Association have indicated that the optimal farm size for these crops is between 50 and 60 ha. In fact, the Association has been deluged with applications for farm consolidations or acquisitions in the last few months. However, the process is very slow because it involves several approval processes, including that of local government officials, before contracts can be registered at the regional land registration commission. Streamlining the bureaucratic red tape and making the process of farm consolidation or acquisition transparent are important administrative reforms the government could make.

The very high CBU refinancing rate in real terms indicates a very tight monetary policy that, if allowed to continue for long, could adversely affect the profitability of existing enterprises and discourage newly established private enterprises from accessing credit from the financial market. This could eventually affect the quality of banks' loan portfolios. In addition, the liquidity squeeze unnecessarily

increases the premium of cash transactions over noncash transactions. Thus, the CBU should review its current monetary stance.

E. Further Priorities for Government and Donor Interventions

The greatest challenge facing the government is how to enhance the people's trust in the banking system. The two most significant barriers to deposit mobilization are lack of liquidity of deposits and the role of banks in tax collection. If a depositor has no assurance that he can withdraw at the desired time an amount of money from his deposit account, then he will not do any banking transactions at all even in a financially strong bank. The CBU and the banking system must squarely address this problem by guaranteeing that depositors can withdraw money in the form of cash from their bank accounts whenever they want.

Article 8 of the Banking Law guarantees secrecy of operations, accounts, and deposits of clients, except under certain circumstances, such as when clients are being investigated for criminal offenses. However, this same article provides that banks, upon request of the tax authorities, must present the required information on the operations of their clients for control and correctness of tax payments. Banks' role in tax collection should be abolished, with Article 8 of the Banking Law replaced by a deposit secrecy provision that is in conformity with international standards.

Competition still remains weak, especially in rural financial markets. State-owned and -controlled banks, with all their advantages as state banks, still overwhelmingly dominate the banking system. Other banks, especially newly established private banks, would find it extremely difficult to penetrate rural areas where the incumbent also has often a special relationship with the government that regulates and provides funds to banks. Thus, the remaining state-owned and -controlled banks need to be privatized so that they can benefit from the innovation of the private sector, particularly strategic foreign investors. To attract private investors into these banks, two things must be done. First, the private sector must be allowed to own up to 100% of these banks. In this regard,

The two most significant barriers to deposit mobilization are lack of liquidity of deposits and the role of banks in tax collection.

Highly subsidized directed credit programs of the government have distorted financial markets and have weakened capacities of financial institutions to do financial intermediation, appropriately price financial instruments, and manage risks.

foreign banks must be encouraged to become strategic partners of private banks to raise their capital so that they can expand their operations to areas outside Tashkent City. Second, the portfolios of state-guaranteed loans of these banks must be decisively resolved prior to privatization in order for those banks to successfully attract private investors.

Highly subsidized directed credit programs of the government have distorted financial markets and have weakened capacities of financial institutions to do financial intermediation, appropriately price financial instruments, and manage risks. These programs should be phased out as soon as possible.

The assistance of the donor community has facilitated the acceleration of reforms in many areas of the economy. International donor agencies are thus expected to continue their policy dialogue with the government. In addition, they could provide technical assistance to financial institutions that are going or planning to go into rural areas in a significant way. Such technical assistance should aim at building capacities of rural financial institutions to mobilize deposits, structure various types of lending instruments suited to the needs of rural enterprises, and manage risks using practices proven to be effective elsewhere. However, such assistance should be limited only to banks that are not participating in subsidized lending programs, and who have met stringent transparency, governance, and performance criteria.

The substantial gap between supply and demand for credit in rural areas will not likely be filled in the near term, especially if privatization of farms and enterprises is going to be accelerated. Banks are expected to play a significant part in bridging such gap by intensifying deposit mobilization. However, bank deposits will not likely rise significantly in the near term as it will take time to overcome people's traditional distrust of banks. Donor financial assistance may therefore be needed to narrow the supply gap in the near term. Such assistance should be carefully structured so that the quality of the loan portfolio of rural financial institutions will not deteriorate and their capacity to mobilize local resources will not be weakened. In this regard, CBU's review of SME loan portfolio

of banks that have been supported by credit lines of multilateral agencies needs to be completed soon to ensure that future credit lines of multilateral agencies can truly support the development of rural financial markets without imposing a heavy fiscal cost on the government.

Chapter 9

Moving Toward Inclusive Rural Financial Markets in Central Asia

Nimal A. Fernando and Roger Thomas Moyes

INTRODUCTION

In an economic sense, Central Asia is now post-transition: there is little likelihood of policy makers in these economies attempting to put the Humpty Dumpty of central planning back together again. Commercially oriented—if not always profitable—financial institutions, mainly banks, dominate the emerging financial sectors in all six countries, though the degree of privatization varies considerably, with the spectrum running from predominately privately owned (Mongolia, Kazakhstan, and Kyrgyz Republic) to still mainly government-controlled (Uzbekistan, Azerbaijan, and Tajikistan). Central banks have largely retired from direct intervention in the day-to-day business of running financial institutions and providing financial services directly to people and are now focused on controlling the money supply and sectoral policy making, along with regulating and supervising financial institutions.¹ The region's central banks have also achieved a degree of independence in relative terms and have been able to bring down inflation thus encouraging more people (though the number remains limited) to hold financial assets within the domestic financial system.

¹ Kazakhstan recently created a unitary financial supervisory agency separate from the central bank. Mongolia has signaled its intention to adopt a similar model.

Rural financial market development in the Central Asian republics, in the context of the evolution of the broader financial system, provides some interesting lessons.

Rural financial market development in the Central Asian republics (CARs), in the context of the evolution of the broader financial system, provides some interesting lessons. These lessons can be used to refine and strengthen approaches to rural financial market development in CARs themselves, and may be useful in broadening knowledge of rural financial markets in general. Without simply repeating what the study authors have highlighted in preceding chapters, a number of issues of special importance deserve further exploration.

Role of Government

CARs' experience confirms that a major contribution that governments can make to rural financial development is to maintain macroeconomic stability. While this is necessary, it is not sufficient.

Undoubtedly many development problems in CARs have their roots in excessive and inappropriate government interventions, as well as improper sequencing of reforms. This is true for the rural financial sector as well as for other sectors. This should not lead us to the sweeping generalization, however, that government interventions must be eliminated to put rural financial system development on the right track. The experience in most developing countries shows that governments have a significant role to play in rural financial system development. CARs' experience confirms that a major contribution that governments can make to rural financial development is to maintain macroeconomic stability. While this is necessary, it is not sufficient. Perhaps an equally important though often underappreciated contribution to the effort that governments can make is building institutional infrastructure to support financial market development. This is particularly true because institutional infrastructural requirements of financial sectors in market-oriented economies are so different from those of a centrally planned, communist system—CARs are building this infrastructure from scratch. These infrastructure requirements include establishing independent central banks, creating credit bureaus, strengthening creditor rights, increasing the capacity of courts to fairly adjudicate commercial disputes, promoting the accountancy and auditing professions—the list goes on. Many countries in the region have a

long way to go in these efforts, and those countries that choose to pay more attention to these requirements will likely enjoy faster growth. What is good, then, for financial system development is certainly to the benefit of rural financial markets.

Population Density

Population density is widely believed to be a crucial factor in rural financial market development. The conventional wisdom—or perhaps to be more accurate, the general assumption—in rural finance has been that low rural population density makes provision of financial services by formal sector institutions on a profitable basis almost impossible. This has certainly been the assumption of many experts involved in micro- and rural financial market development in Latin America. While on the surface this may seem a reasonable generalization, the experience of Mongolia does not support this view. Despite a population density of 1.5 persons per km² (versus 114 to 1 for Indonesia), Mongolia's formal financial institutions have achieved remarkable success both in terms of outreach and viability. Both Xaan Bank and Xac Bank have contributed to a considerable expansion of financial services in rural areas in recent years, greatly enhancing financial inclusion. Moreover, both banks are making profits. This does not necessarily mean that low population density has no influence on rural financial sector development. At a minimum, however, it encourages us to question whether low population density could be considered a binding constraint on rural financial market development and building a more inclusive financial system. In fact, the more sensible conclusion is that low population density is simply one key challenge—among many—that must be considered in developing workable business models for rural financial institutions. Practically speaking, populations do not get much less dense than in rural Mongolia, and the Mongolian experience shows that creative businesses can develop strategies to overcome possible disadvantages of low population density.

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Land Distribution Patterns

In light of the history of CARs, both Soviet and pre-Soviet, the introduction of the individual right to own land is a dramatic development. Land distribution patterns influence rural financial markets in many different ways. As Vogel and Lamberte show, these rights do not yet extend to the actual holding of registered title to land in most CARs. In any event, there are indications that in the transition economies, family ownership, even if restricted to use rights for extended periods, unleashes considerable demand for a variety of financial services including credit, deposit, and payment services. It is interesting to consider if a more egalitarian pattern of ownership might reduce the possibilities for emergence of a landowner class that would attempt to redirect financial market development to serve its own needs at the expense of the needs of the broader market. The question then becomes: Might not fair and equitable land distribution indirectly support the emergence of a more inclusive financial system?

Land is a large source of potential wealth for rural households. There is little evidence that land is used as collateral for loans, which in itself indicates that land rights are less than fully secure. Evidence from studies of land ownership in Thailand demonstrates that with secure ownership comes greater capital investment in farms, as well as easier access to credit at lower rates of interest.² CAR governments should be encouraged to follow up on early land distribution efforts to promote secure titling and efficient registration of land, which is an important, and probably necessary, condition for the emergence of functioning land markets.³ In turn, secure

² Gershon Feder. 1993. The Economics of Land Titling in Thailand, *The Economics of Rural Organization: Theory, Practice, and Policy*. Karla Hoff, Avishay Braverman, Joseph Stiglitz editors. World Bank, Oxford Press. April. New York. At least in theory, financial system risk should be less where creditors lend on a secured basis with land as collateral than where collateral such as land cannot be fully secured, assuming creditor rights are adequately protected by the legal system. In most of the countries studied, this caveat represents a rather heroic assumption.

³ Vogel and Lamberte point out the dramatic change in the composition of agricultural production in CARs, from formerly subsidized crops to various kinds of vegetable farming and livestock raising. These production shifts are the initial response to emerging market signals. To the extent land markets are not efficiently functioning, real markets in rural areas may be developing suboptimally. More liquid, transparent land markets will likely smoothen the process through which farm households accumulate (or divest) land to arrive at plot sizes optimal for the new agricultural production mix, and promote the "highest best use" of rural land. Farms that are more economically viable should—again in theory—be more "bankable."

titling should promote more widespread use of land as collateral for loans, giving a boost to lending in rural areas that would deepen rural financial markets.

The country studies were not designed to undertake a full analysis of land distribution, but land issues appear in retrospect to be of direct relevance to other rural markets, with important implications for rural finance, in particular. Land distribution patterns, the development of private land markets, and their linkage to financial market development are therefore subjects worthy of significant additional attention.

Role of Government-owned Banks in Rural Finance

An oft-asked question in transition economies is whether state-owned banks can be successfully privatized to provide rural financial services or whether they can be reformed and continue to provide these services on a profitable basis. The experience of CARs sheds some light on this issue. In general, the country experiences highlight that what is crucial is the degree to which managers of state-owned banks are given sufficient autonomy and incentives to operate on a commercial basis. The most widely held assumption relating to state-owned banks in rural finance has been that their privatization will lead to a certain contraction of rural financial services. Again, the experience of the privatization of Mongolia's Agricultural Bank (now known as Xaan Bank) casts serious doubts on the general applicability of this assumption. As noted in Chapter 6, privatization of this bank led not to a contraction of financial services to the rural population but to an impressive expansion. Together with this expansion, the numbers of staff and service outlets have also grown. One might argue that this experience is an exception—certainly a unique set of circumstances contributed to the success of the turnaround at Xaan Bank. One must be thoughtful, therefore, in promoting this as a readily replicable model. Nevertheless, Xaan Bank, along with the well-documented example of the BRI Unit Desa system, is a case that encourages policy makers to question the conventional, stereotypical assumptions that focus on the

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negative effects of privatization of government-owned banks providing rural financial services, and provide guidance as to how to deal with those who might oppose reform of such banks.

The essential point about Xaan Bank is that the issue of the nature of ownership and that of franchise value were, to a degree, separable. There was an institution with functioning systems, a strong client base, and competent staff spread across vast rural areas without much competition. Put in new managers with much broader experience and vision; add the right set of managerial incentives; strengthen internal controls; develop some new, attractively priced products; and you can make a moribund banking franchise successful. If government policy makers can be prevented from interfering in the design and execution of a sensible business strategy, a bank with franchise value can be made profitable, and a failed policy lender can convert its extensive branch network into a profitable retail banking business. State ownership, therefore, may not necessarily be a hindrance to building sustainable and inclusive financial systems. The lesson for the rest of CARs, then, is the need to examine critically the business prospects of state-owned banks for potential franchise value that new owners—or properly incentivized new managers—can exploit. In the early years of transition in CARs, there was a general lack of appreciation for inherent franchise value, on the one hand, reinforced by an unofficial, though still prevalent bias on the part of development agencies and their advisors against state-owned banks.⁴ There may be relevant cases, particularly in Tajikistan, and possibly also in Azerbaijan and the Kyrgyz Republic,⁵ where salvageable franchise

⁴ This was the result of the negative experience with state-owned banks in other parts of the world, notably in Latin America. Vogel points to the example in Peru where development agencies recommended to the government the shutdown of a state-owned agricultural bank with a network of branches throughout rural areas. Attempts were later made to rebuild this infrastructure at great expense by creating greenfield *Cajas Rurales*. In retrospect, that franchise may have been salvageable. Of course, there are many cases in which state-owned banks engaged in policy (i.e., subsidized) lending to agriculture and failed, without creating any discernable franchise value.

⁵ The irony of the situation in the Kyrgyz Republic is notable: two government-owned rural financial institutions—Kyrgyz Agricultural Finance Corporation (KAFC) and Financial Company for the Support and Development of Credit Unions (FCCU)—were created under, respectively, World Bank and Asian Development Bank loan projects. Each institution presents its own set of unique challenges as it moves toward privatization, though KAFC certainly enjoys more obvious prospects for commercial viability. FCCU is still developing a commercial business model that might make it attractive to potential private buyers, including, most particularly, individual savings and credit unions.

value exists in otherwise troubled government-owned banks with branch networks extending into rural areas—franchise value that can be unlocked by new owners or new managers.

The recent experience in CARs might invite the conclusion that policy makers in those countries will never again use state-owned banks for policy purposes, or skew the playing field in favor of state-owned institutions such that private banks are placed at a competitive disadvantage. Does that mean that credit subsidies (with resulting market pollution) or the crowding out of potential private entrants into rural financial markets are things of the past? Many valuable lessons about the futility of direct interventions in rural financial markets seem to have been taken to heart by policy makers throughout CARs, who bear the scars of painful trial and error.⁶ Still, in both Azerbaijan and Kazakhstan—two countries that enjoy significant income from oil revenues, on the one hand, and have very poorly developed rural financial markets, on the other—are signs that temptation to intervene directly in rural financial markets remains. In Azerbaijan, credit subsidies for agricultural and other enterprises still enjoy a powerful official constituency, while in Kazakhstan efforts are under way to create a new category of community-based rural finance institutions capable of receiving government funding for agricultural finance. These efforts are unlikely to deliver positive results. Fortunately, both countries can boast of market-based financial successes in urban areas that should provide sufficient encouragement that rural financial markets can be developed without sustained government subsidization.

Role of Nonbank Financial Institutions

If there is one lesson about rural finance that could be considered central, based on the experience of CARs and elsewhere, it is the need for institutional diversity. In virtually all CARs, commercial banks have a major role to play in providing and facilitating rural financial services. Banks are essential even for the functioning of

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⁶ Mongolian policy makers suffered significant bruises from their experiences with the Agricultural Bank, which became insolvent on two occasions prior to the “last ditch,” ultimately successful, effort to salvage the franchise.

nonbank financial institutions (NBFIs) because banks provide core deposit, payment, and money transfer services. That a robust, inclusive rural financial system can be comprised solely of commercial banks, however, is a highly doubtful proposition. Given the diversity of demand and the widely different characteristics of the various client segments in rural areas, different types of institutions are likely needed to create an inclusive financial system. The studies presented in this book show that a great deal of potential exists for NBFIs to play a dynamic role in financial markets in rural areas. Many regional examples of partnerships are being forged between NBFIs and banks, such as in Azerbaijan, where microfinance institutions (MFIs) use rural banks' branches for loan disbursements. Money transfers and bill payments are also areas of significant potential cooperation between banks and NBFIs. Leasing in particular is an important financial service attractive to rural households and farm enterprises in CARs that require machinery to improve and expand production, but lack capital to purchase or collateral to secure a loan for equipment. Though leasing is essentially a financial product, the requirements for operating an equipment-leasing firm are sufficiently different from retail lending that such a product might be delivered via a special purpose financial vehicle, i.e., an NBFI.

Role of Savings and Credit Unions

The dismal experience of financial cooperatives during the post-transition period should not lead to the erroneous conclusion that cooperatives do not have a role to play in rural financial markets. The difficulties encountered by savings and credit cooperatives (or credit unions) in CARs underscore the importance of proper sequencing of reforms and phasing of interventions, and highlight the need for substantial, sustained investment in building capacity. In both the Kyrgyz Republic and Azerbaijan, cooperatives were promoted enthusiastically before policy makers had formed a proper understanding of regulatory and supervisory requirements. Furthermore, inadequate resources were provided for up-front education about cooperative enterprise management and the

importance of transparency (i.e., accounting, control, and audit). The essential self-help nature of cooperatives was not sufficiently emphasized. Nevertheless, despite the massive frauds that wiped nearly all credit unions in Azerbaijan, and the fact that about a tenth of Kyrgyz Republic's credit cooperatives experienced fraud, there is substantial upside potential for cooperatives throughout most of CARs. In Uzbekistan, the World Council of Credit Unions has successfully promoted a small number of credit unions via the "model credit union" approach emphasizing larger initial membership and professional management, which better leverages scarce, mainly donor-sourced technical assistance (TA) grant resources. A dynamic credit union movement has sprung up in Mongolia without much official support from development agencies. In the Kyrgyz Republic, despite a series of contratemps, a small subset of the more than 300 mainly rural credit cooperatives are functioning properly and growing.

There are three essential lessons from CARs about promoting viable savings and credit cooperatives systems. First, the temptation to create or promote cooperatives and then lend them money needs to be resisted because external credit vitiates the principle of self-help that is the cooperative enterprise's core value. Second, apex institutions, or industry associations providing services to individual financial cooperative members, need to develop organically, based upon real demand for services. Attempts to design and implement a "system" all at once, as in the Kyrgyz Republic, cannot properly anticipate the nature of demand for services nor the variable individual needs and capacities of financial cooperatives. Still, apexes are useful, particularly in assisting individual cooperatives to manage liquidity and to facilitate diversification of risk assets by individual cooperatives. Access to liquidity and asset risk diversification are key weaknesses that individual financial cooperatives have difficulty dealing with alone. Finally, it is devilishly difficult to design efficient risk-based regulatory and supervisory regimes for financial cooperatives that allow for prudent growth of cooperatives while ensuring that any problems that do arise do not have a significantly negative impact on the overall financial system. Credit unions tend to be either insufficiently or overly regulated;

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finding the middle ground is hard. A simple lesson learned in CARs during the past decade echoes the lesson learned in Latin America in the 1970s and 1980s: self-regulation of credit unions does not work. Realistically, in each CAR, as in each country of Latin America, a different path will be taken in attempting to achieve the goal of effective regulation and supervision of credit unions, depending on the particular characteristics of the credit unions.

An additional lesson from financial cooperative development in CARs is that credit unions are not necessarily MFIs and are a unique kind of financial institution—one that continually defies donor efforts to neatly categorize. Credit unions appear to have been oversold as rural MFIs despite the fact that they serve, as they should, a broad range of clients from various economic strata. Credit unions are community-based, member-owned, and feature an inclusive client approach. These factors differentiate credit unions from MFIs, which are usually more poverty-oriented, as well as from commercial banks, which demonstrate a bias toward bigger business clients, and are also mainly centered in CARs' capital cities. Credit unions that seriously adopt an open door policy—while still retaining necessary group cohesion—can make an important contribution toward building inclusive financial systems.

Deposit Mobilization and Deposit Insurance

Deposit mobilization is a key activity in building sound financial systems in CARs. First, as the country studies show, there is a great deal of demand for reliable and safe deposit services. Second, if the financial system is to carry out its major functions effectively and efficiently, deposit mobilization is essential. The evidence from CARs suggests that low financial savings rates have two notable underlying causes, namely, inappropriate savings products and poor service by depositary institutions, and a lack of confidence in the safety or liquidity of financial institutions by rural people.

The usual policy prescription to address the issue of lack of confidence is to establish some sort of deposit insurance scheme that aims at protecting depositors' money—or at least a part of it. Another objective of deposit protection is to reduce the chance

that a run on one bank would become contagious. While deposit protection schemes may bring some benefits, the relatively weak institutional structure, moral hazard problems, and potential adverse consequences may outweigh possible benefits. Hence, a cautious approach on deposit protection is advisable. Focusing on strengthening deposit-taking institutions, improving disclosure standards and transparency, and building effective regulatory and supervisory regimes to oversee depository institutions appear to be a more sensible approach. Also, ensuring that deposit-taking institutions will have adequate capital may provide better protection for depositors than introducing a deposit protection scheme that cannot be implemented effectively.

The experiences of Kazakhstan and Mongolia illuminate the key issues related to deposit taking, in both rural and urban areas. Kazakhstan adopted a deposit insurance scheme in 2002, but only after the central bank had essentially cleaned up the banking system by shutting down undercapitalized and poorly performing banks. The substantial influx of deposits into Kazakhstan banks in the period immediately following the introduction of deposit insurance has not resulted in any apparent increase in risk on the part of commercial banks. Timing the introduction of deposit insurance is therefore key, as is the fortitude and consistency of bank supervisors. The establishment of a functioning banking market in Kazakhstan comprised of well-regulated, sound banks created the opportunity to introduce a scheme while avoiding excessive moral hazards. In Mongolia, the central bank also conducted a thoroughgoing clean-up of problem banks in the late 1990s. Though no deposit insurance scheme has yet been introduced in that country, the activities of new market entrants and the market's consolidation into a few large, well-run banks helped spur competition for deposits. The sale of two of the country's largest banks to foreign financial corporations recently infused a significant amount of public confidence into the system. Foreign ownership has helped usher in a greater degree of professionalism in the banking industry, along with a more customer-friendly approach to deposit taking, factors which help explain the dramatic increase in deposits.

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Appropriate savings products and good service count far more than deposit insurance. Rural populations across CARs will save if they have access to good deposit services provided by well-run retail banking operations.

The experience of the Kyrgyz Republic with regard to deposit taking stands in counterpoint. Kyrgyz banks, despite maintaining a fairly extensive network of banking offices extending into many rural areas, have a dismal record of attracting deposits. The country study of the Kyrgyz Republic revealed that the quality of service provided to small retail depositors in rural areas was particularly poor. Small retail customers were treated generally as a nuisance: banks preferred having a few, large depositors (despite the greater concentration risk inherent in such a strategy) to many bothersome small depositors. In fact, transferring money between different offices of the same bank was practically impossible; so, in addition to discouraging small depositors, payments and money transfer services are simply not available. Interestingly, Kazakh-owned banks that have entered the Kyrgyz market, deploying a customer-friendly retail banking model honed in a more competitive banking market, are enjoying a considerable degree of success attracting deposits. Kyrgyz bank regulators are now challenging two key assumptions they held in relation to deposit taking, namely, that most people (particularly rural people) are poor and do not have any money to place with banks, and that for those that have demand for financial savings, deposit insurance is necessary to overcome their lack of confidence.

Appropriate savings products and good service count far more than deposit insurance. Rural populations across CARs will save if they have access to good deposit services provided by well-run retail banking operations. The implication for policy makers and development agencies alike is that it is vital to fix the banking system first. Public confidence—the foundation for deposit mobilization—is built upon the good performance of well-run banks that are effectively regulated and supervised.

Informal Finance and Rural Financial Markets

Discussions of rural financial markets in general focus most attention on formal finance as if informal finance does not play an important role in these markets. We do not wish to leave the readers of this book with that notion because we share the general view of the authors of the country studies that the reality is much different

from that. In CARs, despite many years of tight state control of the financial system prior to the transition, an expansion of informal financial markets has been witnessed post-1991. The fact that they are not as visible as they are in other Asian countries, or in Africa or Latin America for that matter, should not lead to misleading conclusions about their role. The most important message about informal markets is that they should not be considered as an anti-development component in the broader rural financial system. Informal finance needs to be viewed in a more positive light. The temptation that usually appeals to policy makers is to impose administrative controls on informal market operations with a view to eliminating them from the rural financial landscape. This temptation arises from immediate political considerations—like the popularity to be gained from denouncing high interest rates—and a lack of adequate understanding of the useful role that informal financial service providers can play in developing financial markets. While recognizing the role of informal finance in a still emerging inclusive, rural financial system, it is also important to recognize the fact that informal finance is not a substitute for an efficient and inclusive formal financial system, especially because informal service providers cannot legitimately offer deposit services. Thus, policy attention must still be focused on developing an inclusive system of formal rural finance providers. As the outreach and efficiency of formal providers of rural financial services increase, informal providers will face more competition, with the rural population emerging as the beneficiaries.

A closer examination of informal rural financial markets can provide insights useful to policy makers in CARs on how semi-formal and formal markets can be developed to provide more demand-driven services. In practically every one of the six countries studied, significant evidence of supplier financing, as well as other forms of informal debt and equity financing, was discovered in rural areas. The financing of agricultural inputs, as well as purchasing arrangements involving some form of financing for agricultural producers by suppliers, wholesalers, and agricultural processors, appears to be growing and already important phenomenon of informal rural financial markets across the region. There is some

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evidence that producers even provide credit to wholesalers. The country studies, then, offer many tantalizing glimpses of businesses emerging in rural areas that can blend financial services into their operations. Suppliers, given their knowledge of local markets and of individual producers, may be better placed to evaluate the risk of extending loans to agricultural producers than banks or similar formal lenders. This presumption leads to some key issues worthy of additional exploration, including how do suppliers/wholesalers finance themselves? And to what degree do these businesses have ready access to formal sources of finance? The Asian Development Bank (ADB) could be of assistance to policy makers in CARs by expanding research into informal finance that could seek answers to these questions.

These emerging informal financial relationships do not support the stereotype of the rapacious village moneylender or loan shark, phantom figures that the term “informal finance” often conjures. Rather than consider ways to regulate or otherwise control these businesses, policy makers and development agencies are advised to try to understand better how informal finance operates, with a view to identifying potential lessons that can be used to develop formal financial providers’ products and services.⁷

The Importance of Business Culture

The transition in CARs changed the rules for everybody, policy makers and businesses alike, and challenged these societies to come up with new economic as well as political rules and to develop simultaneously a culture for the conduct of legitimate and licit private business.⁸ Of critical importance in these societies was the lack of indigenous experience in running competitive, profitable private enterprises, financial institutions being not the least important among them. Unlike the case of Central Europe or the

⁷ In fact, informal financial arrangements can evolve into formal financial operations, as in Uzbekistan, where ROSCAs organized by women’s groups transformed themselves into credit unions.

⁸ Even in a totalitarian society like the Soviet Union, a lot of illicit but profitable private business was going on. It is useful to recall that most private business was by definition a criminal activity. Many of these habits of business acquired during the era of communist rule, e.g., the preference for paying for privileged access to markets or goods and a disdain for legalities, have proven fairly durable.

Baltic countries, no (or at least very, very few) Kazakh or Mongolian investment bankers were working in London, no overseas Tajik or Azeri families who had transplanted themselves a generation or two ago to New York or Los Angeles were ready to return to the motherland to build the new economy. The countries we have reviewed still suffer from a dearth of business leaders and entrepreneurs who have established, built up, and managed medium- to large-scale enterprises in a competitive market setting. This factor still impacts the development of the economies of these countries, including the rural economies and financial sectors, with their rural and microfinance components. Policy makers must be mindful of the need to promote a healthy business culture, which celebrates and rewards competency and professionalism. Strong official support for the accountancy and auditing professions is fundamental to the cause of building a healthy business culture. These professions create the essential yardsticks for measuring business performance and help elevate accuracy and transparency into civic virtues.

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Role of Foreign Investment

Foreign investors, financial institutions, and NGOs, bringing with them banking skills and proven technology, have all played a vital role in the development of emerging financial markets in CARs. The development of financial markets, including rural financial markets, across the region has been an exercise in selecting, adapting, and applying foreign skills and techniques to the failed Soviet-style mono-banking system. New ideas from outside the region have been applied to building new financial institutions capable of serving the new rural economy. In this process, development agencies have also played a crucial role in most CARs, particularly in the support provided to central bankers.

Evidence from the individual country studies indicates that two common factors correlate with relatively rapid financial system development in CARs: the independence of the central bank and openness to foreign investment and technology. Independence of the central bank is in this case measured by the willingness and capacity to act forcefully in shutting down poorly performing banks.

Evidence from the individual country studies indicates that two common factors correlate with relatively rapid financial system development in CARs: the independence of the central bank and openness to foreign investment and technology.

Both Mongolia and Kazakhstan have clearly been the regional standouts in terms of closing bad banks, though it took some time for their zeal to develop and to become effective watchdogs. Openness to foreign investment and technology is measured by the extent or willingness to allow foreign investment in financial institutions, and to adopt international best practices in marketing and product development, accounting and financial management, and corporate governance. Interestingly, Mongolia is far ahead of Kazakhstan in terms of the depth and breadth of outreach of rural financial markets, despite the rapid development of retail banking in Kazakhstan. One key reason is that the one Mongolian bank with offices in every rural community was simply turned over to a team of foreign bank managers to run. Later 100% of the shares of the Agricultural Bank of Mongolia (later renamed Xaan Bank) were sold to a Japanese securities firm, which has kept the same team of American managers in place.⁹

International NGOs have played an important role in introducing foreign technology into financial markets in CARs, mainly in the form of microlending methodologies. In Mongolia, Xac Bank and its precursor set of NGO-MFIs developed a significant rural presence prior to transforming into a commercial bank, their operations carried out with substantial support from foreign advisors funded by development agencies. Other countries, notably the Kyrgyz Republic and to a lesser degree Azerbaijan and Tajikistan, have seen more outreach by financial providers into rural areas than has Kazakhstan, with the difference mainly due to the activity of NGO-MFIs, practically all of which have an international NGO sponsor. Though primarily operating in urban areas, NGO-MFIs have built significant rural footprint in four of the six CARs. Activity by NGO-supported MFIs in Kazakhstan has lagged similar activity in other CARs. In Uzbekistan, political barriers have deterred expansion of NGO-MFI operations. Ironically, Kazakhstan's relative affluence

⁹ The largest commercial bank in Mongolia, Trade and Development Bank (TDB), was privatized in 2002, with the government's stake sold to a US-Swiss investor consortium. The new owners hired a team of advisors from ING Barings to manage the bank. ADB and IFC both recently purchased small ownership stakes in TDB. Foreign investors now control a majority of Mongolian banking assets.

has led many international NGOs and their development agency sponsors to choose to put their limited resources to work in the poorer countries of the region. In any event, there is significant evidence from every country in the region of the important role played by foreign investment, technology, and expertise, which strengthened considerably a great number of financial institutions across CARs. To accelerate the process of building inclusive rural financial markets, it will be important to maintain a liberal environment for foreign investment and to continue to promote the adoption of international best practices.

The Limits of Microfinance

Microfinance providers have shown that poor people, even the rural poor, can repay loans provided on commercial terms, and that they have savings. MFIs in CARs are focused on providing microloans; microlending across the region is mostly short term in nature and mainly used for working capital by small-scale service firms. Contrary to the traditional urban-biased approach to microcredit, a significant portion of MFI lending in rural areas of CARs supports livestock raising and small-scale vegetable production.¹⁰ As Vogel and Lamberte point out, rural nonfarm economic activities were not promoted during the Soviet period, and attractive new business opportunities in CAR rural areas have been slow to appear. With agriculture still the main source of income and employment in the rural areas of CARs, much of the demand for microcredit in rural areas naturally supports crop and livestock production.

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¹⁰ Early theoreticians of microfinance focused on the “lumpy” cash-flow characteristics of agricultural activity, i.e., money is invested in a crop or an animal that is raised over a protracted period of time before the final product can be marketed. Therefore, the conclusion followed, the frequent periodic payments of interest and principal that were a central feature of successful micro-credit programs could not be supported by agricultural activity. This approach, however, ignored two central factors: (i) poorer households have diversified sources of income and (ii) money is fungible.

The need for financial services by individuals, households, and firms in rural areas that are not poor are also important. The requirements of inclusive rural financial market development are greater and more multifaceted than microfinance can address.

Few NGO-MFIs¹¹ have developed into commercial banks, or begun deposit-taking activities, in spite of efforts in Kazakhstan, Kyrgyz Republic, Tajikistan, and Uzbekistan to design special laws that define a simple legal path to commercial transformation for MFIs. Total NGO-MFI lending in the region is still only a small fraction of commercial bank lending, which itself is quite limited in outreach. In CARs save Mongolia, the present rural outreach figures of all NGO-MFI operations combined would need to be expanded by a large factor to meet a reasonable projection of demand for microfinance services in rural areas.

The need for financial services by individuals, households, and firms in rural areas that are not poor are also important. Microfinance is only one piece of the larger mosaic that is rural finance. The requirements of inclusive rural financial market development are greater and more multifaceted than microfinance can address, though microfinance can provide important benefits to an important segment of the rural population. Now may be the appropriate time to pay more attention to the demand-supply gap for financial services that most people and firms living in rural areas encounter. By definition, MFIs do not seek to address the gap in rural financial services. Development agencies and policy makers must look beyond microfinance, therefore, for ways to develop robust and inclusive rural financial markets.

The successful rural finance experience of Mongolia offers some important lessons. Mongolia did not build relatively robust, fairly inclusive, rural financial markets by following any pre-agreed government blueprint or carefully wrought plan concocted by donors. Interventions have not been choreographed and have not focused on microfinance or rural finance per se. Rather serendipitously, two banking institutions took different paths to

¹¹ Herein we attempt to make a distinction between microfinance institutions (MFIs), including some credit unions, and banks that are primarily microfinance service providers. Xac Bank, Micro Finance Bank of Azerbaijan, and Aga Khan Bank in Tajikistan are three licensed commercial banks providing a broad range of services though still retaining microenterprises as their main target segment. The term "NGO-MFI" refers to those institutions or programs that international nongovernment organizations (NGOs) primarily sponsor, often with funding provided by bilateral development agencies or foreign charitable sources. Examples of these include MFI operations managed by FINCA, ACDI-Voca, Oxfam, World Vision, etc.

arrive at a fairly similar business model that works in rural areas—a model greatly conditioned by Mongolia’s low rural population density. Both Xaan Bank and Xac Bank have discovered that offering an array of products and services to everyone in sparsely populated rural areas who has a reasonable need for a financial product or service is very cost effective. In other words, they do not target mainly poor people as clients though a substantial number of their clients are, indeed, poor because rural Mongolia is far from affluent. In addition, they do not simply offer credit. Xaan Bank has been discussed already at some length. Xac Bank, for its part, was once an agglomeration of NGO microcredit programs. These programs were later merged with a large, donor-spawned small and medium enterprise (SME) finance company. The result was a commercial bank with a broad rural footprint open to serve practically all customer segments with loans, deposits, and payment services. Significantly, both of these banks have mastered microcredit lending techniques, and then modified and applied these techniques successfully to serve SME clients—and even larger herder households.

If we were to apply the lessons from Mongolia, encouraging capable NGO-MFIs throughout CARs to adopt a more inclusive client approach is highly advisable. From the rural finance perspective, this would likely allow these operations to do more business in rural areas and reach more rural customers. Second, development agencies and policy makers should actively encourage smaller NGO-MFIs to merge or otherwise combine forces to realize operating economies of scale that could support more rapid expansion—into rural as well as urban areas. MFIs can be very relevant in building rural financial markets in CARs, but right now they are not as relevant as they could be to that cause. Both Xaan Bank and Xac Bank show that a financial institution can be a competent rural microfinance practitioner without strictly qualifying for the “MFI” label.¹² Wearing the MFI label and doing microfinance well on a small scale is not as important as doing microfinance well

NGO-MFIs moving into the mainstream can become much more important participants in rural financial markets, providing more products and services to more rural people, as well as competition to other financial institutions in rural areas.

¹² This also applies to BRI in Indonesia, and to ACLEDA in Cambodia, an NGO-MFI that has transformed itself into a bank and is now a major deposit taker and provider of payment and money transfer services in rural areas.

on a large scale while also serving other segments of the market. In effect, that is what “mainstreaming” of microfinance means. NGO-MFIs moving into the mainstream can become much more important participants in rural financial markets, providing more products and services to more rural people, as well as competition to other financial institutions in rural areas.

Addressing the Needs of Rural SMEs

SMEs comprise the “missing middle” customer segment that banks serve poorly, and which are considered too “upmarket” to demand the attention of poverty-focused NGO-MFIs.

The country studies highlight the difficulty that growing small- and medium-sized firms encounter in accessing commercial credit. As has been observed in a broad spectrum of developing countries, microenterprises often enjoy increasing access to MFIs that are mastering microfinance techniques, while larger companies with established operations still find favor with traditional asset-based lenders like commercial banks. SMEs comprise the “missing middle” customer segment that banks serve poorly, and which are considered too “upmarket” to demand the attention of poverty-focused NGO-MFIs. As noted above, few off-farm economic activities were allowed in rural areas during the Soviet period. Agriculture will likely remain an important source of employment and income for rural dwellers for some time to come. Evidence in the country studies shows a lack of access to larger, longer-term loans (or equity capital) by more successful household farms, which makes financing of additional land acquisitions difficult, in many cases impossible. This means that the necessary process of farm consolidation (or reconsolidation in some cases) needed to achieve an optimal size for efficient crop production is constrained by poorly developed rural financial systems, with clearly negative implications for the rural economy. There is a critical need to expand the capacity of rural financial institutions to meet the need for short-, medium-, and longer-term loans by nonpoor households and SMEs in rural areas.

Secured transaction frameworks are poorly developed across all of CARs, a constraint which impedes most particularly lending

to medium and large businesses¹³, be they urban or rural. Though some banks and MFIs have successfully applied unsecured lending techniques used in micro credit to small business lending, this does not obviate the basic need to improve the secured transaction framework in all countries of the region. Secured lending—which also encompasses personal or corporate guarantees—is important for depository institutions extending larger-sized loans to firms that do not enjoy broad revenue diversification. Strengthening secured transaction frameworks in CARs is clearly an area requiring significant, sustained attention by policy makers and development agencies.

What About Equity Capital?

Missing from the discussion of CAR rural financial markets is any reference to equity or risk capital. The study uncovered no significant venture capital operations in any of the CARs, nor any formal institutional providers of risk capital to firms or households, rural or urban. There is, in fact, a significant “risk capital gap” in CARs, one that may exist equally in many other developing countries. This is a gap that is particularly difficult to fill. Given the present state of financial market development in CARs and the fact that only recently have a few indigenous medium- to large-scale private enterprises emerged in most of these countries, it is perhaps too early to expect formal investment banking operations to appear. In addition, contract enforcement is uneven, commercial courts are unreliable, accountancy is in a rudimentary stage, and auditing and control as practiced in more developed countries are largely unknown. Commercial banks that dominate CAR financial sectors are struggling with the basic challenges of taking deposits and making short-term (or perhaps, in some isolated cases, medium-term) loans; their lack of the kind of financial expertise required to evaluate equity risk means that these emerging depository institutions would be unwise to consider moving into venture capital as a line of business any time soon.

¹³ This phenomenon helps to explain why some larger businesses in CARs, as well as in other developing countries, also want to hold ownership stakes in a bank: it helps them secure access to loans.

The risk capital gap cannot be defined and dismissed simply as a challenge with no ready solution because the implications of this equity gap are too negative to ignore.

The risk capital gap cannot be defined and dismissed simply as a challenge with no ready solution because the implications of this equity gap are too negative to ignore. In CARs, there are generally only a few large firms, often surviving or privatized state-owned enterprises, a few medium-sized firms, and many new firms, most of them micro- or small enterprises.¹⁴ The fact that the formal financial system cannot provide equity means that these firms are likely to be relying largely on debt, mainly short term, provided either by formal or informal sources, or internally generated funds. For microenterprises with small fixed asset and thus fixed investment requirements, access to microcredit may be sufficient to allow for their limited capital formation needs. But for larger or fast-growing small firms—more dynamic firms capable of potentially taking advantage of market opportunities—the lack of risk capital represents a substantial constraint to growth.

Development agencies spent a significant amount of resources assisting CARs' governments to draft laws, rules, and regulations to promote the establishment and growth of stock exchanges, with the overall goal of facilitating equity investment. Evidence of the success of these efforts, measured in terms of actual investment, is scant.¹⁵ The ongoing policy, legal, and regulatory work designed to promote more equity investment needs to be combined with more practical—and perhaps more improvisational—efforts to address the risk capital gap. The private sector operations of development partners, including ADB's, can play a catalytic role in this regard. Equity investors or equity fund managers operating in CARs need to have a healthy appetite for

¹⁴ The data related to firm size in these emerging economies reveal another dimension to the concept of the "missing middle." Simply put, the middle segment in terms of business size is missing. The process of transition has resulted in the disintegration of many large- and medium-scale state-owned enterprises, or severe downsizing post-privatization. Data from nearly all the CARs show that many new small firms have been created since 1991. Medium-sized firms were few under the old system, and some still remain. A small number of medium-sized firms are now appearing as successful smaller firms have found the wherewithal to expand.

¹⁵ This is not to mention, of course, the significant investments in extractive industries across CARs, driven largely by the run-up in commodity prices worldwide, but also facilitated by successful investment and tax-related legal reforms. The emphasis here, however, is on national firms operating in the national economy.

risk, a tolerance for small deal sizes,¹⁶ and patience and creativity in crafting exit strategies. Support from TA grant funding will likely be required initially in developing individual deals and defraying the expense of due diligence; development partners are uniquely capable of mobilizing technical expertise and grant resources that could support initially costly investment operations. Ideally, investments made by development partners are designed to generate financial rewards while also catalyzing additional investment into promising subsectors, thereby promoting economic growth. A greatly improved understanding of the circumstances that individual firms encounter—economic, legal, and cultural—is likely to be a significant additional benefit gained through such investment operations. While helping fill the institutional investment vacuum in CARs, development agencies can also contribute positively to the emerging business culture by insisting upon financial discipline, transparency, and proper corporate governance.

Many attractive rural-based firms could benefit from an equity investment to solidify their financial structure and support further expansion. Right now rural financial markets in CARs do not feature equity products and cannot meet the long-term capital needs of predominantly smaller firms. A few dynamic larger firms operating in CARs are capable of linking with or providing investment to a small number of profitable, growing smaller firms. On the whole, however, neither indigenous financial institutions nor local firms will likely be able to fill the risk capital gap any time soon. This situation points to an opportunity, and perhaps underscores a compelling rationale at the same time, for external interventions to promote the deepening of CARs' extremely shallow equity markets.

Equity investors or equity fund managers operating in CARs need to have a healthy appetite for risk, a tolerance for small deal sizes, and patience and creativity in crafting exit strategies.

¹⁶ The issue of big vs. small deal size is important. Generally speaking, larger investment deals take place in larger countries. The People's Republic of China (PRC) and India are two places where large equity investment opportunities often appear. An institution like ADB is frequently invited to participate in, but not necessarily structure or lead manage, deals in these countries. In contrast, an investor such as ADB might have relatively more leverage to structure equity deals to its liking in CARs. Because firms in CARs are relatively small, however, deal sizes will probably not reach the minimum threshold levels that would make them interesting or attractive to a large financial institution like ADB. The irony, then, is that investment operations for a development partner might hold greater prospect for catalyzing additional investment and positively impacting the investment climate in a Central Asian country than in a larger country. A participation in an investment alongside many other investors in a deal in the PRC or India holds out significantly less opportunity for leveraging improvements in the investment climate. The upside in these markets is mainly financial return.

The challenge in developing inclusive rural financial markets in CARs goes well beyond simply providing microfinance services in rural areas.

The Central Asian countries need strong rural retail banking institutions capable of serving microenterprises and everyone else besides.

In Summary

The challenge in developing inclusive rural financial markets in CARs goes well beyond simply providing microfinance services in rural areas. MFIs are certainly needed to provide access to financial services by poor households and microenterprises in rural areas throughout the region. But because rural people, including poor people, need deposit and payment services as much as—if not more than—access to credit, commercial banking institutions will inevitably remain the predominant players in rural financial markets across CARs for the foreseeable future. Incidentally, strong rural financial institutions that serve diversified market segments, from microenterprises to SMEs, through individual households and consumers, will be in a much better position to provide credit to purely agricultural enterprises. Over time, an improved legal environment, functioning collateral registries, and efficient land markets can also make it easier for rural financial providers to serve growing farming enterprises with credit for large-scale agricultural activities.

The Central Asian countries need strong rural retail banking institutions capable of serving microenterprises and everyone else besides. Given the low population densities in the region, providing a broader array of products to many customer segments makes strong economic sense for banks. There is an important role for other financial institutions to play in rural financial markets as well, leasing companies, NGO-MFIs, investment funds, not the least among them. In localized markets, credit unions can provide strong competition on the basis of price and quality of service to commercial banks. Institutional diversity in rural financial markets, therefore, is a goal worth striving for across the region. In addition, informal financial providers will continue to play a major role in developing rural financial markets. But in strengthening the banking sector, which means improving the skills and capacity of commercial banks to innovate, and improving their balance sheets, transparency and governance are of primary importance. Foreign investment and technology are likely to be key drivers in this process of institutional development. NGO-MFIs can contribute by transforming

themselves into commercial banks dedicated to serving more of the underserved than just microenterprises and the poor. For their part, policy makers in CARs should maintain and nurture a free flow of ideas about how to develop inclusive rural financial systems in their countries, without being dogmatic, to benefit from the growing knowledge and experience related to rural financial market development in CARs and elsewhere.

About the Contributors

Gail Buyske is a former senior lending officer for The Chase Manhattan Bank and has served as a staff member of the European Bank for Reconstruction and Development, based in the Russian Federation. Dr. Buyske is a member of the board of directors of Kazkommertsbank of Kazakhstan and KMB Bank of Russia.

Mariano Cordero is a rural and microfinance expert who began his career in the Land Bank of the Philippines. For the Asian Development Bank (ADB), Mr. Cordero has been Team Leader on a variety of micro- and rural finance projects, including in post-tsunami Aceh, post-conflict East Timor, Pakistan, Philippines, and Indonesia. He has also provided his expertise to various donors related to rural and microfinance in 15 Asian countries.

Nimal A. Fernando is ADB's Principal Microfinance Specialist and Focal Point for Microfinance. Mr. Fernando is also the editor of ADB's microfinance newsletter, *Finance for the Poor*. From 2001 through 2005, Mr. Fernando served on the Executive Committee of the Consultative Group to Assist the Poor (CGAP). He has written and published extensively on rural finance and microfinance issues, and designed and managed rural and microfinance projects in many developing member countries of ADB. Prior to joining ADB, he served the Central Bank of Sri Lanka for over 15 years.

Delbert Fitchett is a retired senior economist from the World Bank now working as a consultant. During his tenure at the World Bank, Dr. Fitchett covered Latin American, Africa, and Central Asia with a primary focus on agriculture development and finance. Dr. Fitchett carried out a microfinance market study for CGAP in Tajikistan in 2001.

Mario B. Lamberte is the former president of the Philippine Institute for Development Studies. He is an economist who has analyzed a variety of forms of rural and informal finance in the Philippines, as well as in other countries in developing Asia. Dr. Lamberte has assisted the Philippine Government institute key reforms in the financial sector and draft the New Central Bank Act, General Banking Act, and Securities Regulation Code.

Richard L. Meyer is professor of agriculture economics (emeritus) at The Ohio State University. His voluminous published research focuses on informal, rural, and microfinance, and he has carried out field research throughout Asia and Latin America. Prof. Meyer, with Geetha Nagarajan, is the author of the ADB's seminal *Rural Financial Markets in Asia: Policies, Paradigms, and Performance*, published in 2000.

Roger Thomas Moyes is a Rural Financial Market Specialist at ADB. Prior to joining ADB, Mr. Moyes worked as a banking and finance consultant for Development Alternatives, Inc. and for Swiss Bank Corporation as a lending officer. For ADB, Mr. Moyes has designed and/or managed rural, microfinance, and SME projects in Azerbaijan, Kyrgyz Republic, Mongolia, Tajikistan, Indonesia, and Philippines, in addition to the regional technical assistance project that produced this book.

Robert C. Vogel is Executive Director of IMCC, a consulting firm specializing in financial sector analysis in low-income countries. Dr. Vogel has undertaken major work relating to rural, micro, and informal finance in Asia, Eastern Europe, and Latin America, including seminal publications on rural savings mobilization among the poor, the potential sustainability of microfinance and regulatory issues facing microfinance.

Dennis Sheets was a senior lending officer of Citibank, and has held high-level positions with banks in Ecuador and the United States. He has also worked for the Overseas Private Investment Corporation (OPIC). Since leaving OPIC, he has worked as a banking consultant in Africa, Asia, and Latin America, specializing in rural and small business finance.