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# Reviewing the Development of Rural Finance in Vietnam

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**Abstract**

*The objective of this article is to review the development of the rural financial system in Vietnam in recent years, especially, after Doi moi. There are two opposite schools of thought in the literature on rural credit policies in developing countries. One is the conventional supply-side (government-led) approach while the other is called "a new paradigm" that emphasizes the importance of the viability of financial providers and the well functioning of rural credit markets. Conventional theories of rural finance contend that rural finance in low-income countries is generally accompanied by many failures. Contrary to these theories, rural finance in Vietnam does not encounter the above-mentioned failures so far. Up to the present time, it is progressing well. Using a supply-side approach, methodologically, this study reviews the development of the rural financial system in Vietnam. The significance of this study is to challenge the extreme view of dichotomizing between the old and the new credit paradigms. Analysis in this study contends that a rural financial market that, (1) is initiated and spurred by government; (2) operates principally under market mechanisms; and (3) is strongly supported by rural organizations (semi-formal/informal institutions) can progress stably and well. Therefore, the extremely dichotomizing approach must be avoided.*

**Keywords:** Rural finance, Vietnam, financial market.

## 1. The setting

Does finance make a difference? Levine (1997, p. 688) documents that the preponderance of theoretical reasoning and empirical evidence suggests a positive, first-order relationship between financial development and economic growth. A growing body of work would push even most skeptics toward the belief that the development of financial markets and institutions is a critical and inextricable part of the growth process and away from the view that the financial system is an inconsequential side show, responding passively to economic growth and industrialization. There is even evidence that the level of financial development is a good predictor of future rates of economic growth, capital accumulation, and technological change. Moreover, cross country, case study, industry - and firm level analyses document extensive periods when financial development – or the lack thereof – crucially affects the speed and pattern of economic development.

Credit, in the same fashion, plays an important role in agricultural development. Agricultural household models suggest that farm credit is not only necessitated by the limitations of self-finance, but also by uncertainty pertaining to the level of output and the time lag between inputs and output. (For a comprehensive discussions of household models, see Sadoulet and de Janvry, 1995, chapter 6). The farm household is, however, typically located in an environment characterized by a number of market failures. An extreme case of market failure is simply the nonexistence of markets. It is believed that a frequent cause of market failure is limited access to working capital credit. Thus, creating and maintaining a well functioning rural credit market is a prerequisite condition, first, to correct for market failures, and then to spur rural development in terms of economic growth and consumption smoothing.

Agricultural credit access has particular salience in the context of Vietnamese rural development. Agricultural production plays a very important role in the Vietnamese economy where approximately 80% of the population lives in rural areas with the main source of income derived from agriculture. The economy, including its rural sector, has achieved remarkable successes that have stemmed from the adoption of economic reforms since 1986. Agricultural production has achieved substantial growth over the past 25 years since embarking on the renovation ("*Doi moi"*) process. The output of the primary sector is estimated to have increased by 3 to 4 percent per year for the past 25 years. This high growth enables Vietnam not only to have enough food for domestic consumption, but also to become one of the largest rice exporters in the world. Needless to say, the growth of agriculture underpins the development of the rural sector as well as the whole economy.

There have been a number of factors contributing to the remarkable agricultural development, of which one is undoubtedly the rural finance. Provision of rural credit has made a large contribution to the increase in agricultural production. The reform *Doi moi*, which is a significant institutional development, recognized the household as a basic unit of produc-

tion and relaxed many of the regulations applying to farmers to give them incentives to take part in economic activities. However, these incentives alone were not enough to make the possible production gains. Realization of potential technology requires, more than anything else, funds. In this, the role of rural finance and the policies by which it is steered has been instrumental (Izumida and Duong, 2001).

Thus, with many emerging opportunities for expanding production, farm households – being defined as autonomous economic units - repeatedly have made an extraordinary demand for funds to finance their production. At the same time, however, the economy has faced a serious shortage of funds. As is well known, Vietnam is a developing country that has suffered from wars. The country's economic starting point was quite low and the national savings have been rather small. Under such circumstances, lack of funds is a severe problem, consequently hindering the process of development.

The objective of this paper is to review the development of the rural financial system in Vietnam in recent years, especially, after *Doi moi*. For nearly 30 years the Vietnamese economy has been transitioning from a central planning mechanism to the current one - described as a socialist oriented market economy. The rural financial system in Vietnam has also been reformed in parallel with this process. Starting from a mono central state bank before *Doi moi*, nowadays, the rural financial system in Vietnam has been significantly developed with the existence of a number of state and private commercial banks, social banks, financial institutions, and other semi formal - and informal - financial institutions. Although the government still plays a very important role, however, basically rural finance in Vietnam is operating in line with market disciplines.

In this paper, the progress of rural finance in Vietnam is evaluated in the light of the theory of rural development finance. Conventional theories of rural finance contend that rural finance in low-income countries is generally accompanied by many failures, such as low levels of loan recovery, insufficient savings mobilization, high transaction costs, and distribution bias to relatively wealthier customers (World Bank, 1989; Adams, 1998). Contrary to the theories, rural finance in Vietnam does not encounter the above-mentioned failures so far. Rural finance in Vietnam after the reform could be regarded as a "success". Hence, in order to refer to the relevance of the theory of rural development finance, reviewing the development of the rural financial system in Vietnam is of great worth.

In pursuit of this aim, this paper is structured as follows. In the following section 2, the theoretical underpinnings of rural finance in Vietnam are discussed. This section is started with discussions concerning two opposing schools of thought on rural finance, and is then followed by arguments about market failures, the developmental state, and the economics of rural organizations, which are the key elements in the progress of rural finance in Vietnam. Section 3 highlights key features of the rural credit market in Vietnam. Finally,

concluding remarks and policy implications for rural finance in low-income countries are offered in the last chapter of the study.

It is noted that a supply-side approach is employed throughout this study. Methodologically, this is a reviewing paper. Data and information for discussing the progress of rural finance in Vietnam come from various published sources, both in and outside of Vietnam.

## 2. Theoretical underpinnings of rural finance in Vietnam

### *2.1. Two opposing schools of thought on rural finance*

Egaitsu (1988) reports that there are two opposing schools of thought on rural credit policy in developing countries. One is the conventional supply-side approach that tries to inject subsidized credit from the outside in order to get rid of moneylenders and modernize the credit market. Originally in Egaitsu (1988), it is termed “Farm Finance approach”. The nature of this approach is also similar to other approaches, such as “policy-based directed credit”- see, Tsuji (1995) for further details, and the interventionist approach (World Bank, 1989). The other is called “a new paradigm” that emphasizes the importance of savings mobilization and the viability of rural credit markets. The latter criticizes, on the basis of a resurgence in neoclassical economics, government intervention in the rural credit market. Of course, there are potentially a large number of variations in these two extremes. Basic differences in features between the old and new paradigms of rural finance are described in Table 1.

As pointed out in many studies (typically, World Bank, 1989), a so-called interventionist approach for the promotion of financial development is much less successful with several “exceptional” cases in Asia. Financial institutions try to lend loans to priority sectors at below-market interest rates. In many countries, these institutions were directed to open branches in rural areas to provide loans to priority sectors. However, interest spreads were too small and could not cover the costs. Many of the directed credits were not repaid. The poor loan recovery has proved to be a serious problem for the sustainability of the financial activity. Moreover, regulations on interest rates discouraged depositors from acquiring financial assets while, in some cases, providing funds through public borrowing from money creation brought about serious inflation. Quite often, subsidized credit failed to reach its targeted beneficiaries. For these reasons, the interventionist approach failed to serve its intended objectives. Changes in the paradigm for financial development thus have been strongly required (Izumida, 2001).

The new financial market paradigm adopts the perspective of financial markets and limits their role to financial intermediation rather than being a tool to stimulate production, compensate for distortions in other markets, and alleviate poverty. These outcomes are expected to occur as a natural result of efficient intermediation rather than through specifically mandated programs. Innovations to reduce transaction costs and the freedom to set interest rates high enough to cover costs are of pri-

**Table 1: Primary features of the Old and New paradigms**

| Features | Directed Credit Paradigm | Financial Market Paradigm |
|---|---|---|
| *Problem of definition* | Overcome market imperfections | Lower risks and transaction costs |
| *Role of financial markets* | Promote new technology<br>Stimulate production<br>Implement State plans<br>Help the poor | Intermediate resources used more efficiently |
| *View of users* | Borrowers as beneficiaries selected by targeting | Borrowers and depositors as clients choosing products |
| *Subsidies* | Large subsidies through interest rates and loan default<br>Create subsidy dependence | Few subsidies<br>Create independent institutions |
| *Sources of funds* | Governments and donors | Mostly voluntary deposits |
| *Associated information systems* | Designed for donors | Designed for management |
| *Sustainability* | Largely ignored | A major concern |
| *Evaluations* | Credit impact on beneficiaries | Performance of financial institutions |

*Source: Adams (1998)*

mary importance. Borrowers and savers are not considered to be beneficiaries but rather valuable clients with whom relationships should be nurtured to achieve long-term growth. Institutional sustainability, breadth and depth of outreach, and quality of services provided are emphasized as key performance measures. Furthermore, the new paradigm emphasizes voluntary savings mobilization rather than funding from governments or donors. The information systems of the financial intermediaries can be designed to serve the needs of management rather than of donors. The sustainability of the institution and its ability for growth are the major criteria for evaluating the performance of a financial institution (Meyer and Nagarajan, 2000).

### *2.2. Market failures, developmental state, and the economics of rural organizations*

The description of the differences between the old and the new paradigms is expressed in an oversimplified manner. Of course, different characteristics discussed above are worth not-

ing and essential. However, a closer look at Table 1 reveals that other important features of the directed credit paradigm are not sufficiently described. These are as follows.

First, it is a problem of definition. Directed credits are defined as formal credits implemented partly or totally by the local and/or the central government. Credits from private financial institutions supported by a credit guarantee system, implemented directly or indirectly by government, are also included in this category (Izumida, 2001).

Considering this problem of definition, it is safe to say that the dichotomy of the old and the new paradigms is misleading. The classical definition of directed credit as described in the Table is an extreme case of the "directed debt paradigm". There can be other types of directed credit, and whether particular types of directed credit can work or not depends on many factors. These factors include institutional capability and social background (i.e. social and moral values and history affecting financial disciplines). Thus, discussions on the functioning of directed credit have to take into account a full consideration of surrounding social circumstances. For instance, as described in World Bank (1993), Japan and Korea have used unusual mechanisms that have helped to increase loan repayment rates and the overall success of directed credits. There, subsidies to directed credit have been small; keeping positive real interest rates; and savings mobilization has been successfully promoted. Also, one has to keep in mind that these countries have a homogeneous social structure and a favorable value system for the success of directed credits.

Second, regarding the new paradigm, it is worth noting that the market mechanism does not solve two important issues. The first is the problem of the stability of the financial market, which is serious in view of the recent financial crisis in Asian countries.

The other issue has to deal with the market imperfections, which is a problem related to the role of directed credit as expressed in the Table. A vast majority of the population in rural Asia are micro-entrepreneurs: farmers, shopkeepers, food processors, traders, and small-scale manufacturers. Like other entrepreneurs, rural Asians, including farmers, require access to dependable and well-designed financial services in order to better manage and expand their businesses. Without this access, many poor entrepreneurs are simply unable to take advantage of new market opportunities that public investments and/or market reforms provide. But conditions conducive to the rapid development of modern financial institutions are generally lacking in rural areas. Farmers are dispersed over wide areas and information on creditworthiness or project-specific risks is costly to collect, making general risk assessment expensive. Poor households lack collateral-suitable assets, transactions are small and expensive to administer, and business risks, especially in agriculture, are highly covariant. No wonder then that private sector banks have not bothered to set up shop in rural areas. Thus, the farm household is typically located in an environment characterized by a multiplicity of market failures. Recurrent problems cited as failures of

the market justifying intervention are: (1) Enforcement; (2) Imperfection: Adverse selection and Moral hazard; (3) The risk of bank runs; and (4) The need for safeguards against the monopoly power of some lenders (Besley, 1998). Directing financial services to small farmers when market failures are known to abound is not itself an intrinsically bad idea. Furthermore, it has been noted that the overemphasis on financial sustainability often results in the more severe restriction of credit for small/medium size enterprises, farmers, the poor, and other socially disadvantaged people. There is a possibility that when the financial market becomes more competitive, financial institutions try to specialize in business areas, which are highly profitable and tend to withdraw from relatively non-profitable activities/areas/sectors. If this is the case, the problem of credit restriction to socially disadvantaged people remains. It opens up room for commitments of directed credit policies to poverty alleviation and hunger eradication. Thus, the social aspect of government involvement in the development of rural finance should be taken into consideration as well.

Government under the framework of a developmental state can do such a job as supporting development, which is beyond so-called government intervention justified by market failures. Economic development can be either promoted or retarded by the political environment of the country. The state is the most important single actor in the development process - it has the capacity to bring about success or failure. But, like the economy, it does not operate in a vacuum. It becomes essential to understand the politico-economic factors that explain the success of some states in realizing development.

Developmental states are defined as "States whose politics have concentrated sufficient power, autonomy and capacity at the centre to shape, pursue and encourage the achievement of explicit developmental objectives, whether by establishing and promoting the conditions and direction of economic growth, or by organizing it directly, or a varying combination of both". Hence, a developmental state is one in which the institutional environment is such that it allows the state to pursue a state-directed economic strategy unswervingly. Such a state has the capacity to formulate and effectively execute its policy doggedly, overriding any conservative or radical interests, in favor of economic transformation (Luiz, 2000, p. 237-238).

The important role of government, *particularly* in the early stage of financial as well as economic development, is highlighted in the hypothesis of "Supply-Leading" finance developed by Patrick (1966). "Supply-Leading" is the creation of financial institutions and supply of their financial assets, liabilities, and related financial services in advance of demand for them, especially the demand of entrepreneurs in the modern, growth-inducing sectors. "Supply-leading" has two functions: to transfer resources from traditional (non-growth) sectors to modern sectors, and to promote and stimulate an entrepreneurial response in these modern sectors. The difference between traditional and modern sectors is that the former are dominated by ele-

ments (attitudes, forms of economic organization, production technology) inherited from the pre-modern sectors and dominated by internationally modern technology, rational maximization behavior and attitudes) and modern institutions and other forms of economic organization.

By its nature, a supply-leading financial system initially may not be able to operate profitably by lending to the nascent modern sectors. There are, however, several ways in which new financial institutions can be made viable. First, they may be government institutions, using government capital and perhaps receiving direct government subsidies. Second, private financial institutions may receive direct or indirect government subsidies, usually later. Indirect subsidies can be provided in numerous ways, such as issuing banknotes under favorable collateral conditions, low reserve requirements, and rediscount of commercial bank loans. Third, new, modern financial institutions may initially lend a large proportion of their funds to traditional (agriculture and commercial) sectors profitably, gradually shifting their loan portfolio to modern industries as these begin to emerge. Japan between the 1870's and the mid-1890s presents an excellent example of supply-leading finance (see Patrick, 1966). A modern banking system was created in the 1870's, subsidized by the right to issue banknotes and by government deposits. These banks, in the absence of large-scale industrial demand for funds, initially concentrated their funds on financing agriculture, domestic commerce, and the newly important foreign trade. However, they also became the locus for much of the early promotional and entrepreneurial talent, which initiated the industrial spurt beginning in the mid-1880's. The banks also became an early important source of industrial funds, albeit via an indirect route. The modern financial system thus was not only created in advance of Japan's modern industrialization, but, by providing both funds and entrepreneurial talent on a supply-leading basis, contributed significantly to the initial spurt.

Vietnam has just newly embarked on a market-oriented economy. The majority of economic entities – rural households – are still very ill-prepared for operating under the new playing environment. By and large, they are very small, too weak in technical outfitting, and also much too vulnerable to vagaries of the markets. Small farmers are placed in the environment that is characterized by a number of market failures. Earlier studies in the literature report that there are also many potential types of government failures including that of establishing efficient institutions. Moreover, in many situations, even if governments could establish formal institutions, the costs of doing so, relative to the benefits, may be high. Theories on the economics of rural organizations, at the same time, contend that local communities can and do play a role in rectifying these failures (Hoff Braverman & Stiglitz, 1993 and Hayami, 1997). Thus, rural organizations are expected to play an extremely important role in rural development. Those informal institutions used by societal groups can influence transactions in the market, i.e., market activities are supported by a complex blend of

informal and formal institutions. Informal institutions can be superior to formal alternatives, either because they are more efficient at achieving the objective or because they embody features that formal institutions are unable to provide (World Bank, 2002). Rural financial programs should be designed to harness a community's particular strengths – its local resources, agro-ecological characteristics, historical and cultural experiences, and occupational patterns in order to reduce the costs of screening participants, monitoring financial activity, and enforcing contractual obligations.

## 3. Highlights of rural finance in Vietnam

### *3.1. Overview of rural finance providers in Vietnam*

The rural credit market in Vietnam has a dual structure in which formal and informal finance exist side by side. The formal sector, led by the Vietnam Bank for Agriculture and Rural Development (VBARD), has been evolving to cover an increasing share in the market. The given VBARD's interest rates are determined within the interest rate framework specified by the State Bank of Vietnam (SBV). In essence, lending interest rates of the VBARD loans at a given period of time in rural areas were the same in 1996. This exogenously predetermined interest rate policy significantly affects the business of the Bank. As Hoff and Stiglitz, (1993) pointed out, interest rates can function as an indirect screening mechanism for lenders to select good risk borrowers. Therefore, as will be mentioned later, the Bank would overcome this situation by employing other devices to screen applicants.

To spur rural development, the SBV allowed rural households to borrow up to 50 million Vietnamese Dong (VND) without collateral from the VBARD. When collateral was required, a household could offer their Land Use Certificate (LUC) with the value specified by the government as collateral. Officially, land use prices determined by the government are generally lower than those in market transactions. The question that arises here is that given the uncertain existence of the land market whether using LUCs as collateral is really meaningful. There are a few cases where land has been liquidated in the event of a farmer's collapse. It may serve only as a kind of threat for rural borrowers to comply with credit contracts.

Facing such a situation, the Bank has employed various devices to secure their loans. First, the VBARD has a nationwide network down to the village level. Secondly, the VBARD's loans enjoy the full support of rural organizations including political and administrative organizations as well as the indigenous village groups (see details below).

The separation of policy and commercial lending was a desirable development in Vietnam's banking sector and deserves detailed investigation. Against this background, on October 4, 2002 the Vietnam Bank for Social Policies (VBSP) was established by a decision of the Prime Minister (131/2002/QD-TTg). It commenced operations in January 2003.

The VBSP is a non-profit organization

charged with programmed lending. The VBSP's services have been diversified and are being extended via new mechanisms. As the bank's name suggests, its primary objective is to contribute to specific policies (predominantly social policies) through the provision of credit.

The basic mission of the VBSP is to provide low interest and accessible financial services to the residents and rural communities that have been left behind during the steady growth of the Vietnamese economy in recent years, in an attempt to narrow the gap that has emerged and to alleviate poverty. Whilst these objectives are essentially appropriate, the financial services provided by the bank all represent so-called "subsidized credit", which inevitably gives rise to doubts concerning the sustainability of its system. Inevitably, the characteristics of financial services provided by the VBSP are complex by nature (Izumida, 2004).

Other than the VBARD and VBSP, there are some institutional lenders such as the Vietnam Bank for Social Policies (VBSP), People's Credit Funds (PCFs), and some other private and commercial banks involved in rural lending, such as Rural Shareholding Banks. They do not appear however, to have a great influence on rural financing or else their lending policies differ from commercial lending principles.

In addition, there are also informal sources of funds such as moneylenders, distributors, Rotating Savings and Credit Associations (*hui/ho*), relatives and friends. This informal finance used to play a large role in rural Vietnam. In general, distinct features of the informal financial operations are: (1) supplying short or even very short-term credit for urgent and indispensable demands of rural households that are usually not met by the formal sector; (2) interest rates charged by the informal financial entities are generally higher than the formal sectors and there are wide disparities in interest rates in the informal credit market.

### 3.2. Rural financial progress

Accompanied by the growth of the national economy, there appears to be significant progress in finance. First, the legal framework for the development of rural finance was actively strengthened. On November 9, 1995, the National Assembly approved the Civil Code, which covers most civil relationships including those of a private financial nature. Concerning civil borrowing contracts, there are nine articles regulating relationships between lenders and borrowers in terms of lending, repayment, interest rate, and dispute settlement. Particularly, the Code confirms that (1) private lending and private credit markets are recognized by administration agencies. Disputes relating to private loan contracts can be heard in court and (2) the interests of lenders are protected. As a result, borrowers have an obligation to repay loans lent to them by lenders, which encourages private lenders to expand their credit services.

Following this, the Law on Credit Institutions was passed in December 1997 governing the operations of the central bank and commercial banks. The law officially

states that the State Bank of Vietnam (SBV) shall be in charge of establishing policy banks that operate on a non-profit basis for the purpose of serving the poor and implementing socio-economic policies. The State shall issue preferential credit policies on financing, interest rates, lending conditions and duration applicable to the poor to facilitate the development of their business and production. The law also confirms that banking activities of non-bank organizations shall be subjected to relevant provisions regarding permitted banking activities.

Under the two laws, the government and its line ministries have issued many ordinances and resolutions regarding rural finance that detail implementing measures of the two laws. Also, many other rural related laws have been enacted and revised to be more suitable to practical situation at different periods of time such as the Law on Cooperatives, The Land Law (amended), and so on. All of these pieces of legislation aim at completing a legal environment capable of spurring economic development of the rural sector.

Second, in order to overcome the nation's economic hardships, the government has implemented several stimulus measures, including increasing fiscal expenditure for investment, improving the investment and trade environment, reducing interest rates, and increasing money supply. Rural credit and rural investment have been promoted under economic reforms implemented in Vietnam since 1990. There exist very strong commitments to the agricultural and rural sectors.

Third, currently as a leading lender to rural areas, the VBARD has been striving to develop innovative lending devices suitable for rural borrowers. Notably, the bank signed agreements on cooperation to disburse loans with the Vietnamese Farmer Union (FU) and the influential Vietnamese Women Union (WU) in 1999. The VBARD's and the VBP's loans enjoy the full support of rural organizations including political and administrative organizations as well as indigenous village groups. This is embodied in the group lending technique. Group lending can take two forms: through Joint Liability Groups (JLGs), in which all members undertake an obligation to repay each other's debts, and through Joint Borrowing Groups (JBGs) in which there is direct lending to groups such as women's unions and farmers' unions. Note that in the latter case, group members are not liable for the debts of other members. As an example of the latter, a farmers' association might organize a group of about twenty people, and with the agreement of all members, the group leader will submit a loan application and serve as the bank agent collecting interest and the like. While this does not involve joint liability, it does provide for joint monitoring functions.

Women's unions, farmers' associations, and other mass organizations already in place within villages, are generally involved in organizing these groups. Also, when these rural mass organizations formulate groups, they commonly require the approval of People's Committees. This is the equivalent of the group being acknowledged as credible within the village by political and administrative

organizations. This procedure relieves the lender from having to investigate the credit-worthiness of individual borrowers. It also helps reduce transaction costs, since there are great reductions in the amount of work involved in paperwork and collecting repayment.

This lending technique appears to be particularly suited to the mutual aid traditions and behavior patterns of rural Vietnamese villages especially in the North. The information asymmetry problem facing most development financial institutions in low-income countries (Hoff & Stiglitz, 1993) has been eased somehow in Vietnam by utilizing this unique factor.

In short, facing the adverse effects of financial crisis and a slowdown in economic growth, the government has introduced many stimulus measures to reactivate the economy, especially the rural sector. Rural finance is a key component of this stimulus package. The legal environment has been constructed and rural lending has been strongly encouraged.

It is clear that there has been significant progress in rural finance in Vietnam in particular. The system was transformed from a "mono-bank" type that is peculiar to command economies into the currently market-based. *Doi moi* and thereafter post *Doi moi,* policies have constructively built a number of institutions conducive to the development of the rural financial market. The government itself, with a certain capacity on one hand, has been strongly involved in constructing market-based rural finance. At the same time, on the other hand, the government has also been more and more serious in harnessing a community's particular strengths to improve the rural financial system. As a result, a significant development of rural finance in Vietnam has been observed (see Izumida and Duong, 2001; Senanayake and Ho, 2001).

Key factors for the progress of Vietnamese rural finance are determined as follows: Institutional capability, restoration of public confidence in the financial system through successful macroeconomic policies, financial reform towards liberalization, profitable investment opportunities, and support from rural organizations. It is also econometrically confirmed that credit significantly contributes to rural development (see, Senanayake and Ho, 2001; Izumida and Duong, 2001).

However, rural finance in Vietnam still has many issues to be solved. First, it is quite an urgent task to create a more competitive rural financial market. The Vietnamese rural finance market consists of several players in which the VBARD has a monopolistic position. The VBSP is a nonprofit bank, having sister relationship with the VBARD, providing funds to the poor at preferential interest rates. Although the PCFs and other private financial institutions have been established, so far they have not achieved significant importance in Vietnamese rural finance. Obviously, it is not recommended that the system should be under the influence of only one leading institution. Competition among players is necessary. At present, the PCFs may be a candidate. The government should have policies encouraging the development of cooperative finance in rural areas, including the PCFs. In that case,

the relationship of the PCFs with existing agricultural cooperatives has to be examined carefully.

Second, there is also a need for the creation of a more active land market. As mentioned above, some *de facto* transactions of land have been occurring in rural areas. The question that arises here is, with the ambiguous existence of the land market, whether LUCs as collaterals are really meaningful.

At a grassroots level, there are also several important problems (see, Duong, 2003). First, regional diversity in rural finance can be singled out. A basic factor for the regional diversity in rural finance is the difference in the levels of agricultural activities. In addition, it is worth noting that there has been a regional diversity in financial infrastructure that is caused by the difference in the degree of issuance of LUCs. The second is that the rural credit market in Vietnam is quite segmented. By the nature of the dual structure, formal and informal finance exist side by side. The formal sector specializes in lending for production purposes whereas the informal sector's lending is quite diverse. The formal sector has been evolving to gradually replace the informal sources of financing; however, it is still not sufficient, consequently, some rural households that are mostly marginal have to seek recourse in the informal sources. Another problem is that in response to the strong demand for funds and due to information asymmetry, the formal sector rations the size of loans granted to borrowers. And the last is that due to credit rationing as well as other features of the nascent rural finance in Vietnam, many households are severely liquidity-constrained. This is clear evidence of market failures in rural financial markets. This causes a significant problem in that credit-constrained households cannot make optimum and separable production and consumption decisions compared with those of the unconstrained counterparts (see Duong and Izumida, 2002).

## 4. Concluding remarks and implications

Rural financial reform in Vietnam was initiated in line with the financial sector as well as the overall reform known as *Doi moi*. In the financial sector, it was started from a legal aspect, with the passages of the law on banks, the law on SBV, and recently, the law on credit institutions, which are accompanied by numerous decrees and guidelines of the government and ministries concerned. As a result, four state commercial banks were established. With respect to rural finance, the picture has been diversified significantly with the establishment of the VBARD, the VBSP, the PCFs, and others. So far Vietnamese rural finance is progressing well (see Izumida and Duong, 2001; Senanayake and Ho, 2001).

From the development experiences of rural finance in Vietnam, what are the implications for other low-income countries? This question is related to the subject of how to understand the characteristics of the development of rural finance in Vietnam in the 1990s. Here, I would like to emphasize the government initiative to create the system. The historical development of the VBARD, as a typical example of the rural finance reform, shows that at the beginning, the VBARD had been strongly supported

by the government in giving statutory capital and operating facilities. Moreover, the Bank's borrowings from the SBV did account for a quite big proportion in the initial period. Throughout this period the Bank has evolved with a steadily decreasing reliance on borrowings from the SBV. The development of rural finance in Vietnam can be regarded as a so-called supply-led case. Vietnam currently is still in an early stage of the economic development process. Concomitant with the economic development since *Doi moi*, rural finance has been created in advance of the rural industrial demand for its loans and other financial services, and also in advance of the demand of individual rural savers for monetary and time deposits. Indeed, it would not be mischaracterizing the development of the Vietnamese rural finance to say that it has been "supply led" or has been "policy-oriented". The government subsidies made up a significant part of the VBARD's initial capital, borrowings from the SBV accounted for a fairly large proportion of its funds for several years after the establishment. The government's involvement in the development of rural finance is also to correct for market failures that encompass the full array of constraints that combine to make a market work imperfectly. In that sense, the role of government for addressing market failures is surely not trivial.

From the viewpoint of stressing the market forces in the rural financial market, it may be crucial that the VBARD did not provide subsidized loans to farmers. Emphasizing the relevance of supply-leading finance in the early stages of development, Patrick advocated realistic interest rate policies and promotion of the efficiency of financial intermediation through market mechanisms in developing countries. Interest rates were basically on par with other commercial banks, and it did not assign favorable rates to specific clienteles. But from our own viewpoint, it is not so much crucial that the VBARD did not supply the cheap loans. Of more importance is the existence of institutional capability and the restoration of public confidence in the financial system through the control and stabilization of the macroeconomic environment. Also, to utilize the social capital rooted in the Vietnamese village is essential for the success of rural finance. Anyway the Vietnamese case shows that supply-led strategy of rural financial development is possible under some conditions.

As rural financial institutions, there is a similarity between the VBARD and the BAAC in Thailand. Like the BAAC, the VBARD is a government financial institution for the agricultural and rural sectors, using the nationwide network intensively. Both institutions stress the importance of staff training, and of new financial technologies. In order to cope with the difficulty in risky lending and small-size loans to farmers, both institutions use group-lending methods. But of course as pointed out in the previous section, the VBARD's activities are supported entirely by rural organizations. This may be a point of difference between the two.

Hence, the most important implication for the development of rural financial systems in developing countries is: If conditions permit, certain kinds of government initiatives in rural

finance are possible and necessary. But as the new market paradigm of rural finance advocates, we must pay special attention to the point of sustainability of rural financial institutions and the well-functioning of the rural financial market. It is essential to introduce country specific devices into rural finance to reduce the transaction costs and risks. Therefore, it would be better if there existed some form of appropriate combination of market force and government policies. Of course, market function should be respected. At the same time, Government policies on credit supply usually fail and work only under special conditions. Checking conditions carefully, we have to explore the appropriate combinations (country specific measures) of market functions and government roles.

Here it is worth stressing that it is not easy for other low-income countries to replicate directly the Vietnamese strategy for the development of rural finance. Repeatedly, supply-led development of rural finance needs many conditions, such as institutional capability, a certain level of human capital, and potential of agricultural growth. Needless to say, these conditions are not easily fulfilled in low-income countries in general, and hence a supply-led strategy is applicable to only a few countries.

Thus, the significance of this study is to challenge the extreme view of dichotomizing between the old and the new credit paradigms. My standing point is that some forms of directed credit can work under appropriate circumstances as illustrated vividly by the case of Vietnam. Analysis in this study contends that a rural financial market that (1) is initiated and spurred by government; (2) operates principally under market mechanisms; and (3) is strongly supported by rural organizations (semi-formal/informal institutions), can progress stably well. Therefore, the extremely dichotomizing approach must be avoided.

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