

#201

Rural Credit Markets in Thailand

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Credit markets in rural Thailand have changed very rapidly in the last two decades. The most important change has been the expansion of the role of organized or formal lending institutions in the supply of credit to the rural population. TDRI, the Thai Khadi Research Institute, and the Faculty of Economics of Thammasat University, together undertook a study to explore the structure, conduct, and performance of the credit markets that emerged from these changes.

To minimize logistical problems, the researchers decided to concentrate on one large Province, Nakhon Ratchasima, in which, from April to June of 1985, we conducted a sample survey; 1,600 households were surveyed to obtain information about income, wealth, and borrowing behavior. Also, because credit transactions are socially delicate matters, we supplemented the survey data with information gathered "anthropology-style" by sending a group of researchers to stay in six selected villages for six to eight weeks. Thus, aside from available secondary

sources, two new sources of information were generated during the study.

Structure

The research design divides credit suppliers into two major categories--formal and informal. Formal lenders include the Bank for Agriculture and Agricultural Co-operatives (BAAC), commercial banks, credit cooperatives, and farmer groups. These formal lenders supply about 44% of all credit given to rural households. Informal credit suppliers are the remaining lenders, including farmers, merchants, salaried individuals, and rentiers, all of whom lend out money as their primary or secondary occupation. There are very few professional moneylenders who have no other occupation. Included in the 56% of credit supplied by this sector is the amount lent through "installment" purchases, which we placed in the informal category and forms 13% of all credit provided to rural households. The particular division between the formal and informal sectors

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that we chose for the study has the incidental advantage that all rural lending by the formal sector is explicitly or implicitly subsidized through government policy.

Credit transactions in rural areas are predominantly short-term, regardless of whether the source of the credit is formal or informal. Thus, among informal lenders, only 10% of all loans are for periods exceeding one year. Of the loans granted by the BAAC, only a quarter of them are for more than one year. There are both demand-side and supply-side reasons for the predominance of short-term loans. The demand for long-term credit is low because much of Thai agriculture is devoted to annual rather than perennial crops, and production loans are the major components of rural borrowing. On the supply side, there is no way to put out long-term credit without demanding collateral (even the BAAC requires it). And, because much of Thailand's agricultural land does not have a "title" to be put up as collateral, there is a limitation on the total credit that can be given.

The credit market is stratified as follows. The poorest households are generally free of debt simply because no one will lend to them. The next poorest will borrow entirely from the informal sector. Those with middling income will look to the BAAC as their primary source of credit, supplementing, as the need arises, with loans from the informal sector. The richest households obtain credit from commercial banks.

Among formal lenders, official figures indicate that commercial banks lend almost twice as much as the BAAC (35.9 billion baht in December 1984 compared to 19.6 billion baht). The 2:1 ratio also holds for the specific case of Nakhon Ratchasima. Our survey, on the other hand, indicates that the ratio in Nakhon Ratchasima is 3:4--in favor of the BAAC. The discrepancy indicates that there is considerable leakage of so-called agricultural loans by the commercial banks to other non-rural sector loans. Even our figures underemphasize the importance of the BAAC in another respect. Commercial banks lend about twice as much per credit recipient as does the BAAC, which means that the reach of the latter among rural households is considerably larger than that of the former.

There is no lack of people lending money informally in the Thai countryside. Of the 54 villages surveyed, in only one village did all households claim that there was no moneylender in it, and in only three did they identify only one moneylender. Most villages (60%) reported between three and five. These figures refer to lenders residing in the

village, but there are also lenders in other villages, not to mention the merchants in the market towns. And, there are also substitutes for credit, such as the sale, from growers to speculators, of cassava still in the ground.

Despite the existence of numerous suppliers, it would be premature to conclude that the rural credit market is competitive. Of the households that reported some borrowing from the informal sector, about 85% reported loans from only one informal source--although some may also borrow from formal sources. The capability of informal lenders to lend to rural households is predicated on detailed information about prospective borrowers' income sources and spending habits. Such information requirements preclude entry of new lenders to ensure competition. Entry is not completely impossible, but it takes time. Because of this lack of full competition, lenders may be able to make a profit from their information monopoly.

From the point of view of borrowing households, there is a further limitation on their access to credit, particularly the poorer households. As much as 43% of all households reported no credit activity of any kind during the survey period. Those who reported that they wished to borrow but could not, have a mean annual income of only 25,000 baht, compared to 35,000 baht for all households. Those who did not wish to borrow, on the other hand, have a mean income of 32,000 baht. This compares with the figure of 31,000 baht for those who borrow only from the informal sector. It is possible that those who did not wish to borrow include those who would like to have borrowed but were discouraged by the high interest rates of the informal sector, but were not wealthy enough to borrow from the formal sector.

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Conduct

In a credit transaction, the terms under which a bargain is struck between the two parties include not only the rate of interest, but other conditions as well. There is an element of trade-off between interest rate and other conditions. By and large, the lower the interest charged, the stricter the conditions of the loan. A high interest rate generally implies easier conditions in other respects, but these easier conditions generally imply a greater effort on the part of the lender to follow up on the borrower. There is, therefore, a three-way trade-off involving interest rate, loan conditions, and lender effort.

All interest rates charged by the formal sector are set by government policy, although the rates differ slightly according to who the lenders are. The consequence, particularly for commercial banks, is that lenders impose strict

loan conditions. Thus, over 90% of the loans granted by commercial banks require land as collateral. The BAAC, on the other hand, has somewhat less strict loan conditions, as its mutual guarantee system stands in place of loan collateral. Without any collateral from borrowers, the BAAC has to supervise its loans more closely. The result is that the administration cost for a BAAC loan is about 5% of its loan portfolio. Despite this high administrative cost, the BAAC is able to lend at a low interest rate (about 14% in 1985, and now 12%). It can do so because it is able to obtain subsidized credit, not only from the Bank of Thailand but also from foreign sources. The pricing rule used by the BAAC is based on "average pricing" rather than on "marginal cost pricing," which would have been, theoretically, the more appropriate rule in the long run.

The interest rate in the informal sector is quite high in Nakhon Ratchasima, running at 5-7% per month for loans of about 5,000-10,000 baht. By and large, the smaller the loan size or the loan duration, the higher the rate. Risk factors specific to each transaction, tend to cause rates to differ. For example, borrowing to finance a trip to the Middle East for employment can be quite expensive because of the very high risk that would-be workers will be cheated by the middlemen organizing the export of labor.

The source of the loan makes no difference to the interest rate charged, except when there is a clear non-economic motive involved--for example, when the source is a relative of the lender or the source is the temple fund. We made a particularly intensive check on loans from middlemen. While their rates are no better than those of other informal sources, they do not appear to be any worse. Middlemen generally demand that borrowers dispose of their crop with them and with no one else. Conventional wisdom, to which we subscribed at the beginning of the study, was that middlemen will use their monopsony power so acquired to depress the crop price relative to what it would be in the free market. This contention turned out to be false, however. Both the middlemen and farmers we interviewed insisted that the price received by debtor farmers was lower than that for those who are not indebted. It appears that the middlemen/lenders' primary concern at harvest time is to get their debts repaid. Giving their debtors a lower price than that given to the rest of the market would induce them to renege on their debts. To the extent that these middlemen have monopsony power in the output market and monopoly power in the credit market, it is apparently wiser for them to use their latter power to charge a higher interest rate, than to use the former to press down product prices.

We also inquired as to how much arbitrage took place between the formal-sector finance, with its low interest rate, and the informal sector's, with its very high rate. It appears that some such activity does take place, but the relative size appears to be small. Most informal lenders appear to have considerable liquid assets, which they can quickly, as demanded, divert to their very profitable moneylending activities. If they run out of such resources, they can sup-

plement them by overdrawing on the commercial banks. We asked also whether the rapid increase in formal-sector lending activities from 1975 onward has had any impact on informal interest rates. Borrowers and lenders were unanimous in responding that there has been none. The question as to whether the expansion of formal-sector lending has had any impact on the size of informal-sector activity, elicited a mixed response, ranging from "none" to "a perceptible decline."

Performance

The central motivation that drives the government to intervene in rural credit markets is the extremely high interest rates that prevail there. To evaluate the necessity for this intervention, as well as its success and failure, it is incumbent on us to understand the reason why such high rates prevail in the first place. Three reasons are usually given for this phenomenon in rural areas:

1. Relative to need, funds are scarce
2. Lenders have monopoly power in the credit markets; and
3. Risks and transaction costs in lending to rural borrowers are high.

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We are firmly of the opinion that the first line of reasoning can be rejected. The answer to the puzzle of high rural interest rates lies in the second and third reasons. Because of certain lending practice peculiarities in rural areas, those who are already in the business can make high profits, but would-be entrants have to incur a high cost to succeed. If one were to consider moneylending as requiring basically two inputs, namely money and lender effort, then our point is that it is the latter that is scarce and expensive, not the former.

If this conclusion is accepted, then the success of government policy since 1975 has not lain so much in the flooding of rural areas with funds pressed from commercial banks, as in the creation of the BAAC--which actually predated the 1975 policy by six years--and in the BAAC's innovative group-lending method of providing the loans. Without these institutional innovations, the compulsory lending requirement introduced by the Bank of Thailand would not have succeeded. It is significant that once the BAAC has succeeded in replacing the informal sector as the provider of production loans for rich and middle income farmers, informal lending institutions have been floundering around trying to find new work to do. Indeed, at present, the lack of absorptive capacity in the rural sector is more of a problem than the simple lack of funds.

Thailand: National Issues and Goals to the Year 2000

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Over the past quarter-of-a-century, Thailand has succeeded in maintaining an average annual growth rate of around 7% with substantial developments on a broad front. If this trend continues, Thailand would have joined the ranks of the upper-middle income countries by the beginning of the next century, and would be well on the way to becoming another newly industrialized country (NIC). More importantly, it should have laid a firm basis for self-sustained growth so that, in the early decades of the new century, Thailand will have succeeded in lifting itself from the present state of underdevelopment and poverty. Future prospects thus appear to be bright, but in reality, there remains a number of serious problems and obstacles to overcome if the country is to realize its potential to the full.

The most fundamental issue facing the country is the question of sustainability. Will Thailand be able to maintain its historical growth rates and continue to build a sound economic base leading to self-sustained growth by the year 2000 and beyond? The problem has two dimensions, external and internal, which interact extensively, leading to a number of complex problems and issues. We shall try to summarize the more basic and important of these in the rest of the presentation.

Problems and Issues

The External Environment

As a small open economy Thailand is greatly affected by developments in the world economy. As we see it, the prospects do not appear to be very reassuring. A central issue is the adjustment of the U.S. economy which will have a critical impact on world trade, and may indeed, in conjunction with other developments, result in a new "world economic order." At issue is the nature and timing of the adjustment which, sooner or later, will inevitably have to take place. If the adjustment comes early, and is made voluntarily and in close coordination with other major economic powers such as Japan and West Germany, the impact on the world economy would probably be manageable. If, on the other hand, it comes later -- say it is delayed until the late 1990's -- the likelihood is that adjustment will be imposed by creditor nations and the international money market. In that case it will probably be much more confrontational, uncoordinated and retaliatory in nature with dire

consequences for the world economy. The smaller and weaker countries will probably be among those most adversely affected by such a development.

However the adjustment is achieved, the probability is high that, in the short- and medium-term, protectionism in the world market will increase significantly. This increase is expected to become a serious obstacle to Thailand in its on-going drive for export expansion and diversification as a major source of growth.

Protectionism is thus high on our agenda of issues to be tackled in both the short- and the longer-run. Other major problems of the world economy include the intractable debt problem, volatility of exchange rates, fragility of the capital market and energy prices, and availability. Potential developments in market integration and regional cooperation, such as Europe 1992 and various prospective FTA's (Free Trade Agreements) may also complicate the matter further. The combination of these various factors is likely to lead to an even greater degree of uncertainty in the world economy and concomitant risks, especially for the smaller and weaker economies.

Domestic Issues

Although Thailand has been reasonably successful in terms of overall development, the problem of distribution of the gains from growth remains unresolved. Over the past decade, income distribution has, in fact, worsened over time and there are currently no fewer than 16.5 million of our people (30% of the population) who are still living below the poverty line. This is a long-term structural problem which will need to be addressed by Thai society as a top-priority issue. Critical to the long-term solution is the maintenance of high growth and sectoral balance. A high growth-path will lead to a higher level of income when market forces will begin to operate to raise real-wage levels rapidly, and the problem of distribution will be much more amenable to solution. Sectoral balance is needed to ensure that agricultural productivity will rise sufficiently not to retard the improvement in real wages and the growth of the economy as a whole.

Another basic issue lies in the area of human resource development. In the long run, this is probably the most important single factor which will determine the fate of a poor

country in its drive for higher levels of development. In Thailand where primary education is now universal, the secondary-level enrollment ratio has stagnated at around 30% in spite of major efforts on the part of the government. If this problem is not solved, and solved quickly, we shall be ensuring the perpetuation of another generation of poorly-educated farmers and urban poor who will effectively be left out of the development process. They will constitute a large pool of unemployables who will, inevitably, become a serious obstacle to further economic, social and political development. A closely related problem is the larger issue of the content and quality of education. Are we adequately preparing our children for the twenty-first century? And if not, what are we doing about it?

The question of technological development is, of course, closely tied to that of education, but it also involves other complex matters. Chief among these are the questions of organization and management and the mobilization of resources. If Thailand is going to be able to perform adequately in the world market, it will have to develop a sound technological base of its own. As a late comer, it has both advantages and disadvantages. The critical issue is to develop the capacity to make use of the advantages and reduce the disadvantages so that it can keep up with the rest of the world.

Next is the problem of natural resources and the environment. Until very recently, Thailand has always enjoyed an abundance of natural resources which, given its small population, were never a serious constraint on production. The situation has now been entirely reversed; the "resource frontiers" are all gone, and the Thai people, as a society, will have to learn to use the limited natural resources in a more responsible manner. In the short period of the past twenty-five years the country has lost almost a half of its entire forest cover. Other resource bases are also deteriorating rapidly. Clearly this process cannot be allowed to continue unchecked, as otherwise sustainable development will become impossible. In the same way as other countries, we are now awakening to the fact that development and the environment are but flip sides of the same coin.

And last but certainly not least is the whole question of political development. How does one build up an increasingly open political system and strengthen the process of popular participation while, at the same time, enhance the capacity to react quickly and appropriately to rapid changes in both the internal and external environment? The ability to act in a timely manner is a critical issue of management which will determine the success and failure of the country in meeting future challenges which will, in turn, determine its success in national development.

The Role of Japan

Because of its preeminent economic position and power, Japan will, inevitably, have to assume an increasing leadership role in the region as well as in the rest of the world. From the point of view of Thailand, there are at least

three areas where Japanese leadership and cooperation would appear to be of particular importance. Firstly, we look to Japan to provide effective and decisive leadership in defending the legitimate interests of the region. Such issues as protectionism, discriminatory treatment and unfair trade and other practices severely affect the ability of smaller countries to compete. And yet, because of their relative weaknesses, they are not in a position to defend themselves against the policies and practices of larger and stronger countries. Only a large and powerful economic power such as Japan can assume the role of championing the causes of the smaller and weaker countries in the region. This is not a selfish request. The end result will be beneficial, not only to the region, but also to the global economy as a whole.

Secondly, Thailand looks to Japan for cooperation and assistance in the development of its own technological base. The importance of this issue has been touched upon earlier. More assistance should be channelled into the "soft" sectors of development, especially in the area of R & D (research and development). In the long run, true cooperation and partnership must be solidly grounded in mutual interest which would allow all countries in the region to progress and prosper together. Japan should not hold back simply for fear of competition or merely from short-sighted and parochial interest. Thailand never expects, for instance, to be at the cutting edge of hi-tech, a situation which may pose a small threat to Japan's own position.

There is an enormous range of production and appropriate technology which can be developed and deployed for the benefit of all parties concerned.

The third area of cooperation is the opening up of the Japanese market for goods and services from other countries in the region. If these countries are to be able to buy more Japanese goods, they must be allowed to earn the necessary income to buy those goods. As Japan moves more and more into hi-tech and the production of ever more sophisticated products, there should be plenty of room for the production and exchange of less sophisticated goods by other countries. In the end, specialization and exchange will not only help the developing countries in their development, but will also enhance the economic welfare of all countries including Japan.

Conclusion

Given the dynamism of the region, the next century may indeed turn out to be the long-awaited Asian Century. But for this to happen, all countries in the region, big and small, powerful and weak, must all pull together. The prospects are bright and the potential is almost limitless. In the last analysis, however, the question whether this potential will be realized will depend basically on whether we in the region will have the wisdom to manage our affairs, separately and collectively, in a wise and constructive manner. We are all looking to Japan for the wise leadership necessary for the fulfillment of these aspirations, and I hope we shall not be disappointed.