PN-ABM-150

AGENCY FOR INTERNATIONAL DEVELOPMENT
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1. Project/Subproject Number: 936-5450

2. Contract/Grant Number: DHR-5450-A-00-9084-00

3. Publication Date:

4. Document Title/Translated Title:

5. Author(s)
1.
2.
3.

6. Contributing Organization(s):

7. Pagination:

8. Report Number: ESO #

9. Sponsoring A.I.D. Office: R&D/EID

10. Abstract (optional - 250 word limit):

11. Subject Keywords (optional)
1.
2.
3.
4.
5.
6.

12. Supplementary Notes:

13. Submitting Official: M. Brinkerhoff, R&D/EID

14. Telephone Number: (703) 875-4491

15. Today's Date: 9/15/92

....DO NOT write below this line..

16. DOCID:

17 Document Disposition: DOCRD [ ] INV [ ] DUPLICATE [ ]

AID 590-7 (10/88)

Studies in Rural Finance

Economics & Sociology
Occasional Paper
No. 1840

Differences in Uses of Rural Financial Markets in Taiwan and the Philippines

by

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(Revised Version)
May 15, 1992

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ABSTRACT

Taiwan and the Philippines had many similarities immediately after World War II, especially in agriculture. Rural people in Taiwan, however, were much better off in the early 1990s than were their counterparts in the Philippines. Authors argue that Taiwan used its formal rural financial market (FRFM) more effectively than the Philippines and that this explains a significant part of the superior economic performance in Taiwan. The Philippines often used its FRFM to transfer subsidies and to target loans at priority activities and groups, while Taiwan generally did not. This resulted in the FRFM in the Philippines being far less effective in helping to allocate resources efficiently and being less able to fund major private investments in agriculture than was the case in Taiwan. After analyzing the performance of FRFMs in both countries the authors identify ten policies that help explain the superior performance of FRFMs in Taiwan. They go on to conclude that lessons drawn from the Taiwan and Philippines cases might be applicable in other developing countries.

DIFFERENCES IN USES OF RURAL FINANCIAL MARKETS IN TAIWAN AND THE PHILIPPINES

by

D.W Adams, H.Y. Chen, and M.B. Lamberte

1. INTRODUCTION

Taiwan and the Philippines are neighbors who shared many similarities immediately after World War II. Their natural resources were comparable, both relied primarily on agriculture, both were several times colonized, both soon emerged from colonial status, both received sizable foreign assistance for a time, both had easy access to expanding markets in Asia and the U.S., and rural people in both countries were poor by most standards. Despite these similarities there have been striking differences in the economic performance of the two countries since World War II. In the early 1990s rural Taiwan exhibited most of the features of a high income country while many rural areas in the Philippines still were poor. An explanation of these differences involves numerous factors: some known, some unknown, and some unknowable. In the following discussion we focus on only one of these factors: the way formal rural financial markets (FRFMs) were used to support development in the two countries. We argue that FRFM performance explains an important part of the difference in rural development. For the most part Taiwan used a market-based approach in its FRFM while the Philippines employed a more popular strategy that used FRFMs to allocate subsidies and to process targeted loans.

Before discussing the uses made of FRFMs in the Philippines and in Taiwan it may be appropriate to present our definition of success in FRFMs.

2. MEASURING SUCCESS

Disagreement persists over how success should be measured in FRFMs. Advocates of traditional programs that target loans at particular groups or activities usually measure success through the impact of loan use on borrowers, the number of loans granted to target groups, inputs purchased with loans, output increased through borrowing, or changes in income and employment associated with borrowing. Critics of this approach propose alternative measures that concentrate, instead, on the performance of providers of financial services and on depositors (David and Meyer). Critics further argue that traditional credit-impact studies often overestimate project benefits and underestimate costs--especially the wear-and-tear imposed on financial institutions.

This disagreement stems from conflicting views about how FRFMs should be used in fostering development. Supporters of targeting contend that loans accelerate the adoption of new technology and induce borrowers to increase output. They further argue that concessionary loans offset the effects of other adverse conditions or policies and that cheap loans are a useful way of assisting poor people.

Critics, in contrast, contend that interest rates on loans do little to alter farmers' production incentives and that attempts to redistribute income through concessionary loans result in less equitable income distributions (Gonzales-Vega, p. 227). Additionally, they assert that futile attempts to stimulate output with loans, or to use financial markets to channel subsidies and to satisfy supposed credit needs, damage the fundamental contributions FRFMs make to development: allocating resources more efficiently by intermediating among surplus and deficit economic units. Critics also argued that these policies lessen the ability of the FRFM to expand and encompass additional clients (Von Pischke). Critics further argue that these traditional policies often lead to credit programs and financial institutions that are not durable (Yaron). Major donors such as the World Bank, the Inter-American Development Bank, and the Agency for International Development increasingly promote policies consistent with these new views.

Since we agree with these critics, we look for indications of success, not among the activities of borrowers, but rather in the ability of FRFMs to provide a sustained flow of services to an expanding number of people. We employ four measures in this regard: the number of people served by these markets, the transaction costs incurred by participants, loan recovery, and the magnitude of deposit mobilization. Applying these criteria we can identify only a small number of successful rural credit efforts in low income countries, the FRFM in Taiwan being one of them.

2. BACKGROUND ON TAIWAN

Taiwan's culture is the result of influences from various directions. It was first settled by people from the south. Next, from the west, came the Hakkas and the Fukienese. Colonization attempts by the Dutch and the Spanish during the 16th and 17th centuries were followed by several hundred years of control by the Manchu rulers. From the north Japan then took a turn at appending Taiwan as a colony only to be replaced by another wave of Chinese refugees from the west at the conclusion of China's civil war. The U.S. inserted a bit of its influence from the east for several decades after the war before Taiwan was diplomatically secluded.

Despite nearly three decades of diplomatic isolation, Taiwan has made impressive economic progress; its real gross domestic product increased at an average annual rate of nearly 9 percent from 1952 to 1990 (Council for Economic Planning and Development, p. 24). Agriculture contributed substantially to this. As Ho points out: "Rising productivity in agriculture contributed to development not only because it increased output but also because it facilitated the transfer of resources from agriculture to the nonagricultural sector" (p. 248). A significant part of this transfer occurred through financial markets that mobilized deposits in rural areas.

Agricultural production was boosted first by an extensive land reform done in three phases from the late 1940s through the early 1950s. This made new landowners out of almost half of Taiwan's 725 thousand farm households (Tang, pp. 288-293). In turn, extensive public investments in rural infrastructure, farmers' organizations, and rural education reinforced rural development efforts. This lead to rapid growth in agricultural exports and to a steady expansion in rural demand for goods produced by Taiwan's embryonic industries (Oshima, p. 160). The country gradually diversified its agriculture, moved away from traditional crops, and made farming much more capital intensive. This included impressive increases in the production of livestock, aquaculture products, specialty crops, and high quality fruits. The flexibility of Taiwan's agriculture is particularly impressive. Taiwanese farmers are able to shift resources among a relatively large number of products and enterprises, depending on economic conditions and export markets. In many cases, capitalizing on export opportunities entailed relatively large farm investments that, in turn, required access to large- and long-term loans that only an efficient formal financial system could provide.

Changes in Taiwan's agricultural sector also included a rapid expansion in non-farm employment. In 1989 the average farm household made less than one-third of its income from farming (Department of Agriculture and Forestry 1990, p. 356). Only about one-third of Taiwan's 782 thousand farmers derived a substantial portion of their income from farming activities in the early 1990s. Virtually all of these farmers, plus most of the part-time farmers in the country, have easy access to formal loan and deposit services.

(a) The rural finance system

As can be noted in Table 1, a number of organizations in Taiwan offer rural loans. The Land Bank, the Farmers' Bank, and the Cooperative Bank provide over half of the funds lent to agriculture, while the Farmers' and Fishermens' Associations supply funds for 40 percent of the loans. These associations also administer a substantial part of the loans extended by other banks and agencies and are the foundation of Taiwan's FRFM. Most associations also accept deposits.

In addition, a number of commercial banks, savings companies, a large postal savings system, and various cooperatives provided additional deposit services that are widely used by farmers. In recent years the Farmers' and Fishermens' Associations alone were

Table 1: Formal Agricultural Loans in Taiwan by Lending Agency, Outstanding Balances, December 31, 1991

Lending Agency	Outstanding Balance Million US$	Percentages
Financial Institutions		
Farmers Bank	4,448	23
Land Bank	2,250	12
Cooperative Bank	4,179	21
Farmers Associations	7,756	40
Commercial Banks and Central Bank	323	2
Government Agencies		
Council of Agriculture	413	2
Other Agencies*	15	**
Total	$19,384	100

Source: Unpublished information provided by the Council of Agriculture, Taipei, Taiwan, April 1992.

* Includes the Provincial Food Bureau, the Taiwan Sugar Corporation, and the Provincial Tobacco and Wine Monopoly Bureau.

** Less than one percent

Note: In 1992, 25.75 NT$ were equal to one US$.

mobilizing more than three times as much money as they lent from their own funds, and they also managed deposits that exceeded the total amount of loans made to farmers and fishermen by the entire FRFM.

(b) Farmers' and fishermens' association

Farmers' Associations were initiated in Taiwan in the early 1900s when the Japanese introduced the idea of cooperatives to their colonies. The older cooperatives in Japan had grown rapidly in an environment conditioned by traditional forms of cooperation such as labor sharing and informal savings and lending groups (Izumida). The growth of cooperatives in Taiwan was reinforced by similar traditions and occurred with surprisingly little support from the Japanese (Grajdanzev, p. 172). Taiwanese cooperatives, in fact, became focal points for anti-Japanese sentiment. As a result, the Japanese attempted to monitor cooperative leadership and also impeded development of a strong central organization for cooperatives.

Because the farmers' associations were useful indigenous organizations they survived the passage from colony to independence. Over the next four decades these multipurpose organizations played a major role in most rural development efforts (Lasson). In the early 1990s there were about 280 township farmers' associations and also 39 district associations and one provincial organization servicing fishermen. Most of these associations have credit departments and they also have an average of more than two branch offices each that essentially blanket the country. The one-quarter of a million households in the country that continue to depend mainly on farming or fishing for their income are virtually all association members. Although only a small fraction of these farmers have loans from the associations, virtually all of them have deposit accounts there.

At the end of 1990 these associations had the equivalent of more than US$22 billion in deposits, and had year-end outstanding balances on loans of US$ 7.8 billion (Taiwan Provincial Cooperative Finance Institute). Association loan-recovery rates are similar to loan-recovery rates in commercial banks on non-agricultural loans. Throughout most of the past four decades the associations paid and received positive real rates of interest on their deposits and loans. In most years the credit departments of these associations realized a profit on their lending and deposit taking activities that in 1990 amounted to more than US$250 million. In large part the profits from financial services provide the sustenance that supports these farmers' and fishermens' cooperatives.

It is also worth noting that officials were judicious in the restraints they placed on rural financial markets. The government made little use of concessionary rediscount facilities to fund targeted lending programs through farmers' associations.[1] This forced cooperatives to depend mainly on deposits and share capital for loans. This, in turn, resulted in few political intrusions into association lending.

Even more importantly, the associations operated as serious financial institutions that only make loans on the basis of creditworthiness and were also dependable places to deposit savings. During the early 1950s when Taiwan had serious problems with inflation, the government was pragmatic in allowing financial institutions to adjust nominal rates of interest so that both savers and borrowers expected positive real rates of interest (Irvine and Emery).

At various times the government funded a few targeted credit programs that carried concessionary interest rates, especially during the early 1950s. The handful of special credit programs that existed in the early 1990s were largely administered by the Council of Agriculture and made up only 2 percent of agricultural credit in the country. The interest rate subsidies tied to these programs were funded by the government's budget and were paid directly to lending agencies participating in the programs, thus avoiding any adverse effect on deposit mobilization.

3. BACKGROUND ON THE PHILIPPINES

In contrast to Taiwan, the Philippine culture has been mainly shaped by migrants from the south modified slightly through colonial embraces by Spain, the United States, and Japan. Geographic dispersion along with linguistic and cultural diversity made it more difficult for the Philippines than for Taiwan to form a unified and stable society. Even with these additional handicaps the Philippines achieved overall economic growth rates from 1965 to 1980 of nearly 6 percent per year. Impressive growth rates in excess of 4 percent per year were also realized in agriculture over the same period (Bautista). A partial land reform program and expanded use of fertilizer, farm chemicals, and new cereal varieties contributed to agricultural development.

Much of the overall growth in the country, however, was concentrated near Manila, investments in rural infrastructure were modest, and rural people had much less access to off-farm employment than did their Taiwanese counterparts. Until the early 1980s the Philippines was able to expand agricultural output by increasing the productivity of labor-intensive farming in traditional crops. For a variety of reasons agricultural growth slowed in the 1980s and most Filipino farmers were unable to diversify their farming and agricultural exports as did the Taiwanese. In part, Filipino farmers were unable to shift into more capital-intensive agriculture because of weaknesses in formal financial markets.

(a) Rural financial markets in the Philippines

Rural lending programs have a long and checkered history in the Philippines.[2] Early in the first Colonial Period, for example, the Spanish Government provided concessionary loans to farmers as an incentive to produce tobacco. Later, in 1907, the U.S.-founded Philippines Commission attempted to induce the formation of new banks in rural areas. Still another private sector initiative emerged in the Rural Credit Law of 1915 that authorized a system of agricultural credit cooperative associations similar to credit unions. These cooperatives provided relatively few loans to farmers because they mobilized few deposits. Still another attempt to supply more formal rural loans was made in 1916 with the chartering of the Philippine National Bank.

Since World War II the Philippines is unique among the low income countries in the number of studies that have been done on its rural financial markets.[3] These studies chronicle the frustrations associated with many rural credit programs. The first major post-war step in building a rural financial system was the formation of the Rehabilitation Finance Corporation (later renamed the Development Bank of the Philippines) in 1946, in part, to finance agriculture. Virtually all of the funds lent by the Corporation were provided by government and donor agencies, but few of its loans went to operators of small farms.[4]

(b) Rural private banks

Two major initiative were undertaken in 1952 to expand lending in rural areas. The first was an Act in June authorizing the formation of private rural banks with half of their equity coming from government funds managed by the Central Bank. The Central Bank was also given the responsibility of promoting and supervising these small units. By 1956 nearly two-thirds of the loans made by these banks was for agricultural purposes. Understandably, many of the loans were made to farmers who were relatively well-to-do. Unlike most of the earlier efforts to promote agricultural credit, the new rural banks were authorized to accept deposits.

An important feature of the early development of these banks was the patient and steady efforts that went into their formation. Eventually these efforts paid off in the formation of more than a thousand rural banks. They provided financial services to a gradually expanding number of clients until the early 1970s when their lending mushroomed under a targeted and subsidized credit program aimed at boosting rice production (Masagana 99). Many of these banks later became insolvent as an increasing portion of the government-financed loans were not repaid. In the early 1990s only about 400 rural banks were still providing financial services, 400 were being restructured; the rest were closed, merged, or moribund.

(c) Cooperatives

Another step in building rural financial infrastructure also occurred in 1952 with the formation of an Agricultural Credit and Cooperative Financing Administration (ACCFA).[5] It was a funding and promoting agency for local Farmers' Cooperative Marketing Associations (FaCoMas) that were later formed throughout the country. ACCFA lent low-cost money to FaCoMas for on-lending at concessionary rates to members. The FaCoMas were responsible for both making and recovering farm loans.

A significant number of operators of small farms received formal loans under ACCFA-FaCoMas, partly as counterinsurgency measures. Just six years later in 1958, a total of 484 FaCoMas with nearly 300 thousand members had been organized, certainly a rapid rate of growth--perhaps too rapid.

While the ACCFA lending program expanded apace with the expansion in the FaCoMas, loan recovery problems dogged these efforts. Typically, new FaCoMas reported high loan recovery rates for several years and then defaults increased rapidly, finally rising to such a high level that the system collapsed. Even at its zenith the ACCFA-FaCoMa system only reached about 10 percent of the farmers.

Several lessons can be drawn from the ACCFA experience. In retrospect, many of the seeds of its failure were sown at its conception. Most importantly, it depended too heavily on government funds that borrowers felt little obligation to repay. In addition, the lending program expanded too rapidly and too little emphasis was given to making loans on the basis of creditworthiness. Further, no attempt was made to mobilize voluntary deposits and the procedures used imposed substantial transaction costs on borrowers. Because many of the loans arrived long after they were requested, borrowers viewed ACCFA and the FaCoMas as undependable sources of funds. In addition, subsidized credit policies made it impossible for cooperatives to cover their real costs of lending.

(d) Masagana 99

The Philippines next mounted a major agricultural credit effort in the form of the Masagana 99 rice promotion program in 1973. Although this program included improved rice varieties, fertilizer subsidies, technical assistance, and some attention to rice prices, a major part of the effort involved large increases in subsidized loans. Since the agricultural cooperative system had atrophied as a result of the ACCFA-FaCoMa debacle, the Government turned to the fledgling rural banking system as its credit outlet. Most of the loan funds were supplied by the Central Bank through concessionary rediscount lines combined with partial loan guarantees. The program reached its apex in 1974-75 when about one-third of all rice farmers in the country received Masagana loans, 530 thousand individuals in total.

Several years into the program, however, the old specter of loan defaults began to reappeared in Masagana 99. By 1982-83 the number of borrowers participating in the program declined to less than 70 thousand, only one-ninth of the number reached in 1974-75 (Esguerra). Most of the borrowers who exited the program were forced to do so because they failed to repay loans.

Studies of Masagana 99 show that rice output increased along with expanded lending (Sacay and others). These studies generally concluded, nevertheless, that the large increases in formal credit associated with the program had relatively little to do with the additional rice production. Instead, it was the availability of fertilizer and its price, along with increased use of improved rice varieties and technologies that explained most of the increase in rice output. The sharp declines in the real value of formal agricultural credit in the country after 1982 was accompanied by increases in agricultural output, further suggesting an ambiguous relationship between formal loans and output.

As was the case with ACCFA-FaCoMA, Masagana 99 diminished the capacity of FRFMs. The damage done far exceeded the several hundred million US$ worth of funds that were lent but not repaid. More than half of the rural banks became insolvent because of their participation in the program, and all rural banks were induced to ignore deposit mobilization because of the availability of large amounts of cheap funds from the Central Bank (Blanco and Meyer). In addition, three to four hundred thousand Filipino farmers had their formal creditworthiness destroyed by the program. Although there were still about 2,500 commercial banking offices in rural areas in 1986, as Blanco and Meyer note, 40 percent of the rural municipalities in the Philippines still did not have a single banking office in the mid-1980's.

(e) Recent Conditions

The Philippines started the 1980s with its economy and its financial markets in tatters; many of its rural banks were insolvent.[6] The general decline of the Filipino economy and additional inflation during the mid-1980s exacerbated these problems and caused a sharp contraction in the real as well as in the relative amounts of funds available for formal agricultural loans. Economic stress, burdensome foreign debts and rising inflation forced the Philippine government to reevaluate its rural credit policies. This was accompanied by a loosening of interest rate restrictions, consolidation of many of the lines of agricultural credit, moving the promotion of agricultural credit programs out of the Central Bank, and less support in general for agricultural loans from the central government.

As can be noted in Table 2, in 1990 private banks provided nearly 95 percent of the formal loans made to agriculture. It can be also noted that the total value of the outstanding balance on agricultural production loans was less than a billion US$ at the end of 1990. This was less than 7 percent of the total value of loans made by the institutions covered in Table 2 and amounted to less than 14 percent of the total value of agricultural production in the country during the year. The latter percentage was down substantially from similar credit-to-output figures in the 1960s that ranged between 20 and 25 percent.

Even though reliable estimates are not available on the number of rural people who had sustained access to FRFMs in the Philippines in the early 1990s, it likely did not amount to over 10 to 15 percent of the rural households. In large measure the decline in availability of formal financial services in rural areas has been only partially made up by an expansion in volume of informal finance. Recent studies suggest that the relative

Table 2. Agricultural Production Loans Outstanding in the Philippines, by Institution, December 31, 1990

Institution	Amount US$ (million)	Percent Share
Government Banks		
Land Bank of Phil.	49	5
Private Banks		
Pvt. Commercial Banks	534	58
Sav. and Mortgage Banks	27	3
Pvt. Development Banks	65	7
Rural Banks	230	25
Sav. and Loan Assoc.	13	2
Total	918	100

Source: Agricultural Credit Policy Council, "Final Report on 1990 Year End Agricultural Production Credit." Unpublished report prepared by the Council in Manila, 1991.

Note: Peso values converted to US$ using exchange rate of 28 pesos = one US$.

importance of informal finance increased substantially during the 1980s (Agabin and others, and Bautista and Magno).

In a majority of cases market rates of interests were applied in the early 1990s to both loans and deposits handled by formal lenders, banks again had incentive to mobilize deposits in rural areas, and the rural banking system began to revive. Although concessionary credit programs for agriculture had shrunk, targeted credit activities in the non-agricultural sector were still politically popular.

By the early 1990s the Government has adopted most of the policy recommendations that might allow FRFMs to grow again. This includes more reliance on market rates of interest, eliminating the concessionary lines of credit for agriculture in the Central Bank, and placing more emphasis on making loans on the basis of creditworthiness.[7] In the early 1990s the country was in a much better position to stimulate the growth of a FRFM that is more durable. It had some of the financial infrastructure in place in rural areas and had most of the proper policy environment necessary for renewed growth of formal financial markets.

4. DIFFERENCES IN PERFORMANCE

It is humbling to see the time, patience, and restraint it takes to build efficient financial institutions in rural areas, such as was done in Taiwan. It is discouraging to see how quickly a financial intermediary can be enfeebled by events that reduce its clients' incomes, or by policies that distort or repress its operations, as has been done repeatedly in the Philippines. Policy makers in Taiwan had ample opportunities and numerous precedents in other countries that could have led them to make choices that would have seriously damaged their FRFM.

In part, the formal rural financial system in Taiwan was successful because it consorted with economically healthy hosts--Taiwan's policy makers did not heavily "tax" farming and placed priority on developing agriculture. This included investments in infrastructure that reduced transaction costs in rural areas, including the costs of doing financial activities, something that was generally ignored in the Philippines. First, and foremost, financial markets succeeded in Taiwan because many of their clients prospered. At the same time, farm prosperity had less effect on the well being of FRFMs in the Philippines where many farmers, especially during the period 1960s through the late 1970s, also realized significant increases in income. Thousands of Filipino farmers who received cheap loans adopted modern rice cultivation practices, substantially increased their incomes, but failed to repay loans and also failed to deposit part of their additional income in banks. Flaws in the financial system at least partially explain this behavior.

In addition to the well being of their clients, the performance of financial markets is also strongly influenced by policies and practices imposed on them. We feel the sharp contrast in these policies between Taiwan and the Philippines explains a major part of the difference in performance of their respective FRFMs and is also the most interesting feature of our case studies. The following comparisons of the policies used in the two countries may provide insights on the ingredients needed for success in other countries.

- First, deposit mobilization was stressed in Taiwan while it was ignored in the Philippines.

- Second, incentives for depositors were also featured in Taiwan; real rates of interest on deposits were almost always positive, while depositor incentives were generally ignored in the Philippines, until recently.

- Third, rural deposits allowed Taiwan to decrease reliance on government and donor funds for agricultural credit and, thus, to experience less political intrusions in lending than occurred in the Philippines. This, in turn, heightened intermediaries' incentives to cultivate clients, rather than funding sources, and allowed Taiwan to avoid the default disease that plagued agricultural credit programs in the Philippines.

- Fourth, Taiwan granted loans on the basis of creditworthiness, recovered loans, and kept loan transaction costs low. This resulted in clients viewing the lenders as serious and durable businesses. Under these conditions clients had strong incentives to repay loans and to make deposits in order to sustain and to expand their working relationship with lenders. In contrast, many of the agricultural credit efforts in the Philippines were correctly viewed by borrowers and depositors as being transitory.

- Fifth, Taiwan avoided using loans as income redistributing mechanisms. Most borrowers in Taiwan only achieved a gain through the profits realized on enterprises funded with borrowed resources. In contrast, the Philippines effected major income transfers to borrowers--too often to borrowers of large amounts--through concessionary interest rates and loan defaults. This led to extensive rent-seeking behavior by individuals who were not creditworthy.

- Sixth, only a small and declining portion of the loans in Taiwan were targeted or based on a formula crafted in the capital city. This allowed lenders to maintain low transaction costs because they had to do little reporting to higher authorities on the purposes for loans. Extensive loan targeting in the Philippines by enterprise, by type of input, and by income class imposed substantial transaction costs in the form of paperwork and reports on both borrowers and lenders and thereby diminished the value of loan services to borrowers.

- Seventh, and closely related to the previous two points, policy makers in Taiwan were concerned with building durable and efficient financial intermediaries. Policy makers in the Philippines--strongly supported by various donor agencies--in contrast, paid little attention, until recently, to the long-run viability of organizations that lent in rural areas.

- Eighth, the Philippines has gone on various quests for ideal rural financial institutions while Taiwan patiently strengthened and tailored the system it inherited from China and Japan.

- Ninth, the Philippines made extensive use of concessionary rediscount lines in the Central Bank to fund numerous targeted credit programs in rural areas, while Taiwan did not. These cheap rediscount facilities vitiated the incentives for rural deposit mobilization in the Philippines.

- Tenth, the Philippines used the Central Bank both to promote and to regulate its rural banks, while the Taiwanese did promotion largely outside the Central Bank. Mixing promotion and regulation in the same agency is a recipe for conflict of interest and weakened regulation.

5. Concluding Comments

Success in rural financial markets can be transitory if policy makers use rural financial markets improperly. A substantial increase in the rate of inflation, combined with sticky interest rate policies, for example, can quickly weaken a successful rural financial system by discouraging deposits, eroding the purchasing power of the loan portfolio, and encouraging loan defaults. Also, a misguided policy maker or donor who opens concessionary rediscount lines for agricultural lenders can quickly destroy the incentives intermediaries have to seek deposits. It is far easier to weaken a strong financial system than it is to build one. The various enfeebled rural banks and cooperatives in the Philippines and in other low income countries that used FRFMs similarly are disturbing reminders of this.

Taiwan built a durable FRFM that reaches virtually all of the people living in rural areas, mobilizes impressive amounts of deposits, provides services at low transaction costs, and maintains high rates of loan recovery. In contrasts, the Philippines suffered through a number of transitory rural credit efforts that left behind a debilitated FRFM. Legacies of these efforts are chronic loan recovery problems, few deposits mobilized, high transaction costs, and relatively few people in rural areas having access to FRFMs. The Philippine economy endured two severe penalties from this: resources have been inefficiently allocated and the FRFM is too small and debilitated to allow it to fund the large farm investments needed for farmers to compete in export markets.

With regard to resource allocation, both Taiwan and the Philippines experienced above average rates of growth in their agricultural sectors during the 1960s and 1970s. In Taiwan the FRFM harnessed and then redeployed a substantial part of the surpluses generated by this growth to more productive uses throughout the economy, further enhancing overall economic growth. At the same time, a repressed and faltering FRFM in the Philippines was much less able to mobilize and redeploy efficiently rural surpluses that might have helped the country to sustain overall development. Instead of helping to harness and redirect potential surpluses, the FRFM in the Philippines was largely used to allocated subsidies and to administer targeted loans. This had ambiguous effects on income distribution and production at the expense of resource allocation efficiencies.

Likewise, the atrophied FRFM in the Philippines has been unable to provide the volume of loans needed to restructure its agriculture as the Taiwanese have done. Since World War II the Philippines has spent a large amount of money on its FRFM and ended up with a system that is, in loan-value terms, only 1/20th the size of the system in Taiwan. The FRFM in the Philippines provides formal loans that would average about US$230 for each of the four million farm households if they each received equal-sized loans. In contrast, the FRFM in Taiwan lends an average of more than US$50 thousand for each of the quarter-million Taiwanese households that largely depend on farming for their livelihood. Is it any wonder that Taiwanese farmers can marshall the resources to make capital-intensive investments in activities such as aquaculture, mushroom operations, and intensive swine production, while the Filipinos largely continue with traditional crops that are much less capital demanding? Clearly, farmers in the Philippines and in other low income countries will find it impossible to make the major investments necessary over the next several decades to compete with capital-intensive farmers in countries such as Taiwan unless they have access to strong and dependable FRFMs. The way FRFMs are used to support the development process will largely determine success or failure in building such systems.

END NOTES

1. Initially, the government, mainly through the Joint Commission on Rural Reconstruction (JCRR)--later called the Council of Agriculture--provided a large share of the money used to fund FRFMs. Unpublished reports show that in 1953 JCRR supplied almost 70 percent of the total formal agricultural loans in the country. This percentage rapidly declined as deposits were mobilized and as other financial institutions grew.

2. We draw on Sacay's dissertation for this historical background.

3. Most of these studies have been done by the Technical Board on Agricultural Credit and its successor agency the Agricultural Credit Policy Council (Agabin and others, Lamberte and Lim, and Sacay and others).

4.The World Bank has been a major supporter of FRFMs in the Philippines through 14 projects with major agricultural credit components.

5. Again, we draw heavily on Sacay's dissertation for information in this section.

6. Although the formal financial system in the Philippines was severely stressed during the 1980s, a large number of studies showed that informal finance flourished during this period (Agabin, Lamberte and Mahgahas).

7.The locus of the subsidized credit programs was shifted to the Land Bank of the Philippines. In part, remaining subsidized credit programs were justified as a way of helping land reform participants.

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