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Formal and informal rural credit in the Mekong River Delta of Vietnam: Interaction and accessibility

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ABSTRACT

This paper examines the factors influencing rural households' access to credit in the Vietnamese market. Analysis confirms an interaction effect between informal and formal credit sectors in which informal credit positively influences accessibility to microcredit programs. Ignoring this interaction effect may lead to microcredit providers making loan decisions that are less than optimal. In the formal credit sector, the lowest income group faces more credit rationing than other groups, despite the fact that microcredit programs are designed to target households at the bottom of the income pyramid. Results demonstrate that land holding status, informal interest, and informal loan duration are important factors influencing access to informal credit. Factors influencing microcredit accessibility include local government employee status, credit group membership, a "poor" certificate, educational attainment, working skills and village road access. To reduce reliance on informal credit and improve microcredit accessibility, rural households should actively participate in a microcredit group.

1. Introduction

Microcredit is an important component of Vietnamese rural finance, providing small loans to the rural poor. Supplying microcredit to a large proportion of rural households remains a difficult task because of the nature of the rural credit market and the lending procedures that prevent rural households, particularly the poor, to access credit. In general, poor and low income households face two main problems in borrowing from commercial banks. First, most poor households have no collateral and are not able to borrow against their future income. Second, banks find it costly to deal with small credit transactions, such as individual lending and lending through microcredit programs. Without any external support the rural poor find it difficult to access formal credit and seek alternative sources of credit instead. Thus, improving formal credit access through subsidized microcredit programs can function as a strategic tool to support the rural poor. Although government intervention in rural credit markets is controversial, this external support is widely accepted because it can overcome loan failures in these markets (Armendariz de Aghion & Morduch, 2005).

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In Vietnam, formal credit is granted through both individual lending and group lending schemes. Group lending schemes notably improve repayment incentives and monitoring through peer pressure, based on the joint-liability principle[3]. Grouping and sharing information among credit group members also helps to build support networks and educate borrowers (Ghatak & Guinnane, 1999; Karlan & Goldberg, 2007). Even so, individual lending is quite a popular practice in Vietnam. Another form of lending, where microcredit is distributed to individuals, is also widely practiced in the rural credit market. This lending practice differs from the typical individual lending path since it relies on the joint-liability principle in a credit group. Specifically, the borrowers are required to form a group, including a number of certified poor members and a group leader without joint liability specification. Compared to individual lending, lending through a group helps to reduce transaction costs as it deals with asymmetric information more effectively (Quach, 2005). The condition of individual liability remains.

Microcredit programs represent the main credit channel, providing collateral-free loans, which have considerably improved credit accessibility to the low income and poor households in rural areas. However, due to asymmetric information, screening problems in formal lending practice continue to exclude a number of the poor from the pool. For example, empirical evidence shows that as much as 30% of farm households were unable to borrow from formal lenders in Vietnam (Pham & Izumida, 2002). This limited accessibility to formal credit sources leads households to rely more on informal sources that exist in many forms in rural Vietnam. Both formal and informal lenders employ various screening strategies to avoid adverse selection and moral hazard in their lending process. For example, Pham and Lensink (2007) reveal that formal credit providers tend to associate the probability of default with contract-related items such as interest rate and consistency of loan repayment as part of the client's previous credit history, while informal lenders link default risk to household-related characteristics, particularly the lender-borrower relationship.

Empirical studies on rural households' accessibility to microcredit often presumed the coexistence of the formal and informal credit sectors, but treated them separately (for example, see Gan, Nartea, & Garay, 2007; Li, Gan, & Hu, 2011; Menkhoff & Rungruxsirivorn, 2009; Mohamed, 2003; Pham & Lensink, 2007). Several studies have considered the interaction between formal and informal credit providers, but the interaction effects on credit accessibility are mixed. For example, Kochar (1997) provides empirical evidence in the Indian rural credit market, where accessibility to informal credit plays a role in determining participation in the formal credit sector. However, Diagne (1999) shows no significant relationship between the formal and informal credit sectors in the rural credit market in Malawi. Recent evidence provided by Guirkinger (2008) suggests that the formal and informal credit sectors coexist and their interaction is fundamental to the operation of rural credit markets in Peru. In Vietnam, both credit sectors exhibit their complementary and substitute sources of credit, but the coexistence of both credit sources has not been investigated extensively.

This paper examines the determinants of informal and formal credit in the Vietnamese rural credit market, where the interaction between formal and informal credit sectors possibly affects the household's access to formal microcredit programs. This study provides a different way of looking at the rural credit market and thereby advances our understanding of household's accessibility to microcredit. The remainder of the paper is organized as follows: Section 2 provides an overview of the rural credit market in Vietnam. Section 3 presents the research method, including the empirical model, data and estimation techniques. Section 4 discusses the empirical results and Section 5 concludes the paper.

2. Vietnam rural credit market

The Vietnamese rural credit market is characterized as fragmented, heavily subsidized, having a high degree of government intervention, and operating with many credit providers who coexist in order to serve clients (McCarty, 2001). The credit market is dominated by state-owned bank providers; the Vietnam Bank for Agriculture and Rural Development (VBRAD), the Vietnam Bank for the Poor (VBP) and the People's Credit Funds (PCFs). Together, these financial institutions control as much as 70% of the total credit (World Bank, 2002). VBRAD has branches at the district level and only to a limited extent at the commune level; therefore, outreach to the poorer households in remote and rural communes is limited. In addition, bias in risk assessment and complicated administrative procedures have contributed to the underdevelopment of VBRAD's operation (Putzeys, 2002). To overcome the VBRAD's operational weaknesses, the VBP and the PCFs were established to address the credit needs of the rural poor. The PCFs, whose objectives are to restore public confidence in the formal rural finance system, aim at mobilizing savings from its members. Since the PCFs' networks have been predominantly established in areas that are economically better off and have better developed infrastructure, the PCFs plays a limited role in microcredit provision.

The VBP began operation in 1996, providing credit at low interest rates through formal microcredit programs to the rural poor who did not qualify for individual loans because of limited collateral. In 2003, it was renamed the Vietnam Bank for Social Policies (VBSP). Its operations have been modified to focus on the poor and it closely cooperates with local organizations in lending procedures. For example, the Commune People's Committees help the VBSP to identify

[3] The joint-liability principle in group lending implies that all group members are classified as in default if any member of the group fails to repay his or her loans (Besley and Coate, 1995).