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FORMAL CREDIT FOR FARM AND NON-FARM
ENTERPRISES IN RURAL AREAS OF THAILAND

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ABSTRACT

This paper reviews recent developments in rural finance in Thailand. Formal credit supplies for farm enterprises have sharply expanded since 1975 due to government quotas for commercial bank lending. Rural nonfarm enterprises, however, have been largely ignored. Most lending to nonfarm enterprises by specialized agencies is concentrated in and around Bangkok with limited impact on agriculturally related activities. Little information is available on the nature of demand for borrowing. Systematic study of the current credit supply situation and ways to improve it are required if Thailand is to meet the stated objective of assisting the small-scale sector to play a more dynamic role in the economy.

FORMAL CREDIT FOR FARM AND NON-FARM
ENTERPRISES IN RURAL AREAS OF THAILAND

INTRODUCTION

Agricultural credit policy is emerging as a key policy instrument in Thailand to accelerate and shape the pattern of rural development. Recent policies have sharply increased formal credit supplies in rural areas and have encouraged commercial banks to expand their capabilities to service rural needs. Although the impact of these developments has yet to be carefully analyzed, it is clear that these policies have set in motion a process in which rural credit is taking on increased importance in rural development strategy.

Consistent with trends in many developing countries, Thailand's emphasis on rural credit is directed largely towards farm enterprises including the production, processing and distribution of crops (food and nonfood) and, to a lesser extent, livestock and poultry. Nonfarm enterprises in rural areas have been largely ignored with the exception of large-scale industrial firms concentrated in and around a few large cities. Yet nonfarm enterprises provide significant amounts of employment and income for rural people and increased attention is now being given to them in

Thailand. A problem is that there is relatively little information about nonfarm enterprises in Thailand, or in most countries for that matter.

This paper describes and analyzes recent developments in rural institutional credit in Thailand.^{1/} The first section reviews credit activities related largely to farm enterprises, while the second section discusses credit for nonfarm enterprises. The final section discusses some of the reasons why lending for rural nonfarm enterprises has lagged behind that of farm enterprises.

FINANCING FARM ENTERPRISES^{2/}

The principal sources of formal institutional credit for farmers, processors, and distributors of agricultural products and inputs are commercial banks, cooperatives and the Bank for Agriculture and Agricultural Cooperatives (BAAC). Other government agencies make smaller amounts of credit available for special development projects. The Bank of Thailand (BOT) has been particularly active in

^{1/} It is generally believed that both farm and nonfarm rural enterprises use large amounts of informal credit. However, little information is currently available for use in discussing this source of credit.

^{2/} This section draws heavily from the paper by Meyer, Baker and Onchan. Additional details and analysis about farm finance are found in that paper.

recent years in regulating and coordinating financial intermediaries, particularly commercial banks, and providing resources to lending institutions.

The activities of the BOT became important for farmers beginning in 1967 when it was first authorized to rediscount promissory notes arising from agricultural transactions. Rediscount arrangements were eventually developed for notes issued for agricultural production, marketing, livestock production and purchasing of agricultural inputs. By 1978, rediscount operations had grown to over $\text{฿} 2 \text{ billion}$ ^{3/} with BAAC accounting for about 90 percent of the total.

Prior to 1975, only 5 of the 29 commercial banks in Thailand did much farm lending. Since response to rediscounting had been modest, the BOT adopted a quota system. By the end of 1975, the banks were required to lend to agriculture at least 5 percent of their total 1974 lending. The quota could be met either through direct lending or through deposits with BAAC. Loans to agro-business, warehouses, and fertilizer and machinery imports were excluded. Each subsequent year, the quota was raised so that for 1979

^{3/} Twenty baht have been approximately equal to one U.S. dollar for the past several years.

it was set at 13 percent of 1978 year-end deposits.^{4/} Of that 13 percent, two percent could be allocated to agrobusiness.

A third policy regarding agricultural lending was later established by the BOT. The previous controls over opening new bank branches were relaxed, but each new branch was required to lend at least 60 percent of its deposits in the local area and at least one-third of the loans must go to farmers. Banks not able to meet this requirement must deposit the remaining amount with the Bank of Thailand. A number of banks are having difficulty meeting this condition so that as of November 30, 1978, such deposits amounted to B 68.7 million (Bank of Thailand, Annual Economic Report, p. 134). The total number of branches at the end of 1979 had grown to 1,400, but about 60% were concentrated in the wealthier central region.

Finally, in its coordinating role, the BOT works with banks to determine the amount of their quota that should be channelled to BAAC to regularize its source of funds. Several banks still do little farm lending and their entire quota is deposited with BAAC.

^{4/} The expected increase in quota to 15 percent for 1980 was postponed due to the liquidity problems of banks at the end of 1979. Some banks were not able to meet their 1979 quotas.

The impact of BOT policies on commercial bank lending is clear. The number of banks with agricultural portfolios has grown from 5 to 16. Table 1 shows the growth of bank loans and overdrafts in recent years. From 1971 through 1974, the agricultural share of total lending actually declined slightly. Beginning in 1975, however, that share began to increase until it reached almost 5.5 percent by the end of 1979.^{5/}

Another measure of commercial bank credit flows is seen in table 2 where the yearly goal is given along with actual direct lending and BAAC deposits. The goal increased from ₦ 4.3 billion in 1975 to over ₦ 20 billion by 1979. In the same period, commercial bank direct agricultural lending rose from just over ₦ 2 billion to more than ₦ 17 billion. In most years, the banks surpassed their lending quota. In 1979 they lent a large amount to agro-business but failed to meet the quota for agriculture due to liquidity problems.

In terms of volume, the largest single source of agricultural credit is BAAC. It was formed in 1966 to take over the cooperative lending activities of the former Bank

^{5/} Two reservations need to be kept in mind regarding these data. First, some double counting exists because of inter-bank transfers. Second, some redefinitions of loans probably occurred as banks attempted to meet their quotas.

Table 1. Commercial Bank Loans and Overdrafts Outstanding.^{a/}
Total and Agricultural, Thailand, 1971-1979.
(Million Baht)

Year	End of Year Balance		Percent Agricultural
	Total	Agricultural ^{b/}	
1971	31,709.8	742.7	2.34
1972	35,845.7	771.2	2.15
1973	51,291.2	990.5	1.93
1974	68,815.7	1,305.3	1.90
1975	82,898.8	2,823.7	3.41
1976	96,377.3	4,121.4	4.28
1977	122,810.0	6,340.5	5.11
1978	160,878.5	8,656.9	5.38
1979 (Sept.)	187,185.8	10,183.1	5.44

^{a/} Including inter-bank transfers.

^{b/} Including agro-industries.

Source: Bank of Thailand, Statistical Bulletin, Vol. XIX,
No. 11, November, 1979.

Table 2. Agricultural Lending by Commercial Banks,
Year-end Balances, Direct, and BAAC Deposits
Thailand, 1975-1979.

(Million Baht)

Year	Goal	Direct	Actual	
			BAAC Deposits	Total
1975	4,333.3	2,233.6	1,670.8	3,904.4
1976	6,139.0	3,810.9	3,160.6	6,971.5
1977	9,647.0	5,891.8	4,528.0	10,419.8
1978 Agriculture	11,771.0	8,099.5	5,511.4	13,610.9
Agrobusiness	2,616.0	6,382.5	-	6,382.5
Total	14,387.0	14,482.0	5,511.4	19,993.4
1979 Agriculture	17,322.4	9,970.0	6,330.1	16,300.1
Agrobusiness	3,149.6	7,755.8	-	7,755.8
Total	20,472.0	17,725.8	6,330.1	24,055.9

Source: Bank of Thailand unpublished statistics.

of Cooperatives and institute direct lending to farmers. The BAAC had 58 provincial branch offices, 409 field offices and over 780,000 farmers registered as branch clients on March 31, 1979 (BAAC).

The financial structure of the BAAC can be seen in table 3. About one-half of the liabilities are represented by commercial bank deposits. About twenty percent of the liabilities are deposits by private individuals and government agencies. Almost twenty percent represent rediscounting of notes with BOT. The BAAC has become more active recently in deposit mobilization from farmers, but previously it was heavily dependent on government support and commercial bank deposits.

BAAC basically makes two types of loans: loans to individual farmers, usually organized in informal groups, and loans to Farmers Associations and Cooperatives. Table 4 reports on the growth of loans in each category. The volume of loans made and outstanding grew slowly until 1974 when the growth rate sharply increased, in large part due to the commercial bank deposits. The total amount of BAAC credit outstanding at the end of fiscal 1978 was just over P 9 billion. However, due to the more rapid growth of commercial bank lending in recent years, the amount of agricultural credit outstanding from these two important sources was about equal.

Table 3. BAAC Liabilities and Capital, March 31, 1979
(Million Baht)

Item	Amount	Percent
Liabilities		
Deposits		
Public and gov't agencies	2,167 ^{a/}	19.8
Commercial banks	5,586	51.0
Borrowings		
Domestic sources	327	3.0
International sources	627 ^{b/}	5.7
Notes payable to BOT	1,990 ^{c/}	18.2
Other liabilities	<u>255</u>	<u>2.3</u>
Total	10,952	100.0
Capital		
Paid-up capital		
Held by Ministry of Finance	1,403	79.1
Held by cooperatives and private individuals	17	1.0
Accumulated profit	296	16.7
Reserves	<u>57</u>	<u>3.2</u>
Total	1,773	100.0

^{a/} General time and saving deposits, and unmatured balances of loan compensatory deposits.

^{b/} Loans from U.S. and Japan.

^{c/} Rediscount operations with BOT.

Source: BAAC, Annual Report, 1978.

Table 4. BAAC Loans by Type of Borrower, Thailand, 1970-1979
(Million Baht)

Year	Loans to Individuals		Loans to Farmers Associations		Loans to Agricultural Cooperatives	
	Made	Outstanding	Made	Outstanding	Made	Outstanding
1970	563.3	753.7			198.1	409.2
1971	509.4	843.3			203.5	539.5
1972	670.9	993.8			276.7	681.5
1973	773.7	1101.2	3.4	3.4	307.0	785.3
1974	1203.7	1446.1	142.7	138.6	388.7	966.6
1975	2100.9	2472.8	387.8	440.9	866.1	1642.4
1976	3200.9	3848.9	288.2	533.0	914.7	2172.9
1977	3789.2	5012.0	267.4	589.6	1005.6	2679.0
1978 ^{a/}	4014.7	4403.9	263.9	521.0	1207.4	2536.1
1979 ^{b/}	4876.3	5679.7	183.4	481.8	1641.1	3008.1

^{a/} Jan. 1977 to March 31, 1978.

^{b/} Fiscal year 1978, April 1, 1978 to March 31, 1979.

Source: BAAC Annual Reports and unpublished statistics.

One way to place agricultural credit in perspective is to compare growth of credit with growth of output. Although the data are somewhat incomplete, it appears that the ratio of formal agricultural credit to agricultural GNP was about .03 in 1973. The ratio increased to more than .13 by 1977. This increase suggests that farmers should have been able to finance a substantially larger proportion of their agricultural output with formal credit.^{6/}

Unfortunately, there have been no large-scale surveys of Thai agriculture in recent years which show how many farmers have benefitted from this credit expansion. It appears that over 700,000 farmers have been reached by BAAC credit, either through individual loans or through Associations and Cooperatives, although the number that borrow in any one year may be significantly less. It is generally believed that commercial banks serve larger farmers and make larger average size loans than BAAC. Assuming that some farmers receive more than one loan and some borrow from more than one source, it is possible that a total of 1 million Thai farmers may have received formal credit in recent years. The total number of farm households is about 5 million so perhaps 20 percent have received credit.

^{6/} The calculations and assumptions used in deriving these estimates are explained in detail in Meyer, Baker and Onchan.

A number of problems obviously exist at this stage in the development of the agricultural credit system. Significant amounts of arrears are accumulating in BAAC. The costs of making and servicing loans is high and lenders complain about the impact of costs on profits. Most credit goes for short-term purposes and, although important experiments are underway with group liability loans, most borrowing requires collateral. The Bank of Thailand has noted that the expansion of formal credit has mainly benefitted middle income farmers and relatively wealthy farmers with loan collateral (Bank of Thailand, Annual Economic Report, p. 9). Nevertheless, these recent changes have done much to increase the current and future importance of agricultural credit in shaping rural development in Thailand.

FINANCING RURAL NONFARM ENTERPRISES

The previous section briefly summarized recent developments concerning credit for farm enterprises. This section covers nonfarm enterprises. Two types of enterprises are of interest. One type is enterprises found in farm households not directly associated with the production of food and fiber. This category covers such diverse enterprises as pottery making; mat making, baskets and other bamboo products; brick making; tailoring, dress making, silk and cotton weaving; etc. The second type refers to enterprises

found in nonfarm firms in rural towns and villages. These include processing enterprises for rice, cassava, kenaf, fruits and vegetables; repair shops; silk and cotton textiles; wood, leather and metal products; pottery and ceramics; etc. Many of these enterprises are closely tied to farming because they use farm produced raw materials or labor or are highly dependent on farm demand.

Rural nonfarm enterprises are increasingly recognized for their important role in rural development.^{7/} First, employment in these enterprises represents a significant share of total employment and income for many rural people. Second, the production of these enterprises, many of which are small-scale, represents a significant amount of total output for some industries. Third, compared to large-scale firms, rural small-scale enterprises frequently are less capital-intensive, are more geographically dispersed, offer more opportunities for unskilled and family labor, have greater linkages with the agricultural sector, and have greater export potential than frequently assumed.

Thailand is beginning to recognize the importance of these enterprises and the Fourth Five-Year Plan places increased emphasis on them (Government of Thailand).

^{7/} See Anderson and Leiserson, Chuta and Liedholm, and Meyer et.al. for a more detailed discussion of economic development issues associated with these enterprises.

Unfortunately, there is little information on the nature, extent and composition of these enterprises or their problems. The results of one of the few studies conducted on small-scale industries were recently discussed by Tambunlertchai. This study was based on a nationwide sample of more than 1,000 small-scale manufacturing firms employing from 10 to 200 workers. The results showed the expected pattern of a large number of labor-intensive small firms with fewer more capital-intensive large ones. Like similar studies in other countries, the study concluded that small firms faced financial problems, were mostly self-financed and depend much more on informal credit in both the initial and operating stages of production. They have poor accounting and lack collateral so they frequently turn to informal credit sources with higher interest rates.

Although the argument is appealing, in reality it is very difficult to determine the extent to which inadequate formal credit is a real constraint for small-scale firms.^{8/} However, considering the present situation in Thailand, the credit constraint argument is plausible.

^{8/} See Meyer for a more detailed discussion of the problem of clearly establishing the existence of external credit constraints.

Only fragmentary information is available on formal credit for nonfarm enterprises. Commercial banks, BAAC, the Industrial Finance Corporation of Thailand and the Small Industries Finance Corporation are the most important potential sources of formal credit. Commercial banks and BAAC logically should be the most important sources since they have the most available resources and only they have a widespread network of branches throughout the country to serve local customers. Unfortunately, it is impossible to analyze the distribution of credit by banks to nonfarm enterprises because most of it is provided through and reported as overdrafts. Apparently much of the credit used by processors of rice and cassava for purchasing supplies is obtained by overdrafts. It is unlikely that many small nonfarm firms receive much credit in this way, however, since overdraft provisions require a deposit account and normally are fully collateralized. Furthermore, it appears that only one bank, the Siam Commercial Bank, is beginning to experiment with a special loan program for nonfarm firms. Likewise, with the exception of a few small special projects, BAAC has put little emphasis on nonfarm enterprises. However, since many farm households have both farm and nonfarm enterprises, it is likely that some funds borrowed from banks and BAAC, supposedly for farm enterprises, have been used for nonfarm enterprises, with or without

the knowledge and consent of the lender.

The privately owned Industrial Finance Corporation of Thailand (IFCT) is another potential credit source. It was incorporated in 1959 as a development bank to "offer financing facilities which are more attractive in terms and conditions than those which are generally available from other financial institutions within the country, so as to encourage increasing industrial activities in Thailand's private sector" (IFCT, p. 2). The government has assisted IFCT with low interest loans, guaranteed loans obtained elsewhere, and exemptions for taxes on income and profits. IFCT makes direct medium and long-term loans, both in local and foreign currencies, to establish, expand and modernize industry and participates with commercial banks in large-scale projects. Beginning in 1978, IFCT began to make working capital loans to its clients. It also makes equity investments in certain projects.

During the 1970's, IFCT made 40 to 50 loans per year. In 1978 it approved 45 loans for just over ฿ 1 billion, and at the end of 1978 it had about ฿ 2 billion in loans outstanding. The principle industry to benefit in 1978 was cement manufacturing. Eight agriculturally related enterprises received about ฿ 60 million (Bank of Thailand, Annual Economic Report).

The nature and composition of IFCT lending was analyzed by the Asian Development Bank for 188 loans approved in the 4 years of 1974 to 1977 (Asian Development Bank, p. 54). About 80 percent of the loans went to manufacturing enterprises with food products and tobacco representing close to 20 percent. Most of the rest of the loans went to enterprises that appeared to have little relation with agriculture. Thirty six loans were for more than $\text{B} 20$ million each and together they represented 60 percent of the total volume of loans. About half the loans went to the Greater Bangkok area. Thus it appears that most IFCT lending has not had much impact on rural nonfarm enterprises. Most of its lending has been concentrated in large loans. Recently, however, the IFCT has shown more interest in small and medium industries. It financed the study by Tambunlertchai mentioned above with the objective of obtaining information from it of use in future lending programs.

Another potentially important credit institution for rural nonfarm enterprise is the government's Small Industries Finance Office (SIFO) created originally in 1964 and subsequently reorganized. It was created to provide financial and management services to small industries and power generating facilities. Its financial structure permits it to make only about $\text{B} 200$ million in total loans. Loans

can be made for a maximum of 10 years for purchasing machinery and equipment, acquiring land for plant sites, erecting buildings, and for working capital. The maximum size loan is ₦ 1 million per client.

Currently SIFO has less than 1,000 loans outstanding with a total value of ₦ 130 million. Table 5 gives detailed information on the evolution of SIFO lending. By 1978 after 15 years of operation, only 1,109 loans had been made for just over ₦ 352 million. Recall that IFCT made over ₦ 1 billion in loans in 1978 alone! The most loans made by SIFO in any one year, 119, were made in 1969 when ₦ 32 million were lent. The largest amount of money lent in any year was in 1977 when ₦ 46 million were lent. Almost 95 percent of the total loans were for 6 years or less. Furthermore, not all loans are completely disbursed in the year made. Thus the maximum amount of loans outstanding never reached more than ₦ 75 million between 1964 and 1974.

The most recent detailed breakdown of industries receiving SIFO loans covers loan commitments through 1975 (Table 6). Metal working industries represent the largest single beneficiary, closely followed by construction materials. The distribution of loans gives the impression that a surprisingly large number of firms benefitted are urban oriented. This impression is strengthened by analyzing data on geographic distribution of loans made. Table 7 reports

Table 5. Loans Made and Outstanding by SIFO, Thailand,
1964-1968

(Thousand Baht)

Year	No. of Loans	Amount of Loans	Loans Outstanding
1964	12	2,439.0	1,289.0
1965	49	11,049.0	10,746.8
1966	70	15,667.0	19,410.6
1967	86	22,022.5	33,399.9
1968	112	26,226.5	51,922.4
1969	119	31,656.0	66,951.1
1970	114	26,358.0	72,567.6
1971	67	18,554.0	75,333.5
1972	79	21,678.0	75,504.2
1973	58	16,229.0	67,548.0
1974	43	14,917.0	58,170.3
1975	72	28,675.0	N.A.
1976	60	26,290.0	N.A.
1977	83	46,195.0	N.A.
1978	85	44,880.0	N.A.
Total	1,109	352,836.0	

Source: 1964-1975, Small Industry Finance Office (SIFO), Annual Report, 1975. 1976-1978, SIFO, mimeographed statistical summaries.

Table 6. SIFO Loan Commitments by Industry, Thailand

1964-1975

(Thousand Baht)

Industry	No. of Loans	Amount of Loans
I. Metal working		
a. Metal products	61	22,041
b. Machinery	28	9,281
c. Servicing	95	23,403
d. Handicraft	17	2,637
II. Construction materials	164	42,770
III. Textile	95	31,111
IV. Leather industry	14	3,944
V. Ceramic	20	6,140
VI. Food	86	26,425
VII. Animal feed	72	21,608
VIII. Chemical	11	2,162
IX. Handicraft	47	9,060
X. Rubber products	23	9,372
XI. Wood products	13	3,035
XII. Plastic products	15	4,490
XIII. Boat and bus body building	18	7,019
XIV. Miscellaneous	38	11,492
Total	818	235,990

Source: Small Industries Finance Office (SIFO),

Annual Report, 1975.

Table 7. Geographic Distribution of Loans made by SIFO, Thailand, 1964-1978
(Thousand Baht)

Region	1964-1977				1978			
	No. of Loans	Percent	Amount of Loans	Percent ^{a/}	No. of Loans	Percent	Amount of Loans	Percent
North	125	13	30,102	10	9	11	4,030	9
Central (except Bangkok)	161	16	59,911	20	26	31	17,350	39
Greater Bangkok	280	28	99,533	32	27	32	13,630	30
East	82	8	24,563	8	2	2	1,400	3
Northeast	177	18	44,917	15	6	7	1,380	3
West	103	10	29,952	10	8	9	4,950	11
South	69	7	17,823	6	7	8	2,140	5
Total	997	100	306,801	101	85	100	44,880	100

^{a/} Total not equal to 100 due to rounding.

Source: SIFO, Annual Report, 1975 and mimeographed statistical summaries.

on 997 loans made from 1964 to 1977 and 85 loans made in 1978. About 28 percent of the loans with 32 percent of the volume went to Greater Bangkok from 1964 to 1977. An additional 16 percent of the loans with almost 20 percent of the volume went to the other provinces of the Central region. Thus, over half of the loans went to the richest region of the country, while the poorest Northeast region with the most serious employment problems received only 15 percent of the loan volume. The situation was even worse in 1978 when the Central region received almost 70 percent of the loan volume compared to only 3 percent for the Northeast. This regional shift seems to have become more accentuated in recent years. For example, an analysis of the loans made in 1975 showed that about 40 percent of the volume went to Greater Bangkok.

These performance measures analyzed for SIFO suggest that it has been an insignificant institution in terms of loan volume, although it may have made an important and necessary contribution to its customers. Furthermore, it has not significantly assisted agriculturally related enterprises, nor has it materially contributed to reducing industrial concentration in Greater Bangkok.

INCENTIVES AND DISINCENTIVES FOR FINANCING
RURAL NONFARM ENTERPRISES

Admittedly, the data reported above are somewhat sketchy but the impression emerges that Thailand has been successful in introducing a new dynamism in formal credit for farm enterprises but credit for rural nonfarm enterprises has been largely ignored. What explains this apparent lack of consistency in policies? Why has BAAC, a government agency, been given massive support, while SIFO has languished? This contradiction is discussed in this section.

When analyzing formal credit policies, it is always useful to review the origins of and justifications given for policies by policy makers. Many countries have used a so-called "supply-led" approach to financial markets. That is, they believe that increased credit supplies will stimulate output and increase income. By encouraging financial intermediaries to expand farm lending and by setting up specialized agricultural credit institutions, these countries hope to achieve macroeconomic goals of agricultural production. Until recently, however, Thailand's agricultural credit policy has been heavily influenced by a belief that Thai farmers are victims of moneylenders (Onchan). It is believed that capitalists and middlemen exploit farmers by charging exorbitant interest rates and confiscate their land when they fail to repay. Thus, formal

credit is seen as a means to provide alternatives to middlemen and protect the farmers. Cooperatives were introduced in 1916 mainly to free farmers from heavy debts and high interest rates.

Thailand's aggregate agricultural performance has been quite satisfactory. Historically, it has been a food surplus country and has enjoyed that position in spite of growing population because it could expand its agricultural frontier. In recent years, horizontal expansion has become more difficult and expensive so ways have been sought to improve productivity. Credit constraints are seen as an impediment to productivity growth so an expansion of formal credit is identified as a necessity for technological change rather than simply as an alternative to moneylenders. Thus the recent emphasis on agricultural credit can be viewed as part of the Thai decisionmakers response to perceived resource constraints.

But what explains the relatively little support given to rural nonfarm enterprises? Obviously political issues may provide a partial explanation. The farm population is large and visible, the rural nonfarm population is diverse and dispersed, and the political threat from low income urban consumers if agricultural production lags is obvious. But also, like many developing countries, the capital city of Bangkok far outstrips other urban centers in size, economic

importance, growth, preferred place to live and educate children, etc. Thus industrial activities and locational incentives historically have favored Bangkok.

Some locational advantages of locating nonfarm enterprises in Bangkok are associated with closeness to port, and natural economies of doing business close to government offices, and financial and marketing centers. Some advantages however, may be policy induced. One theme which has dominated development planning for many countries is the supposed existence of unlimited supplies of rural labor which can be easily and with little social cost attracted into industrial employment.^{9/} Thus the policy objective becomes one of accelerating the intersectoral flow of labor by speeding industrialization in urban areas. This line of reasoning has prompted countries to largely overlook the employment and growth potential of the small-scale sector and concentrate resources instead on large-scale firms. Thus, industrial parks have been developed, tax incentives and other preferences given for new industries, and credit programs established, such as IFCT, to reduce costs of financing new or expanded firms. The current emphasis on the small-scale sector is recent in most countries, including Thailand, so it is not surprising that institutions and favorable policies are lagging for this sector compared to the farm sector.

^{9/} This issue is discussed in more detail in an article by Meyer and Larson.

The creation of SIFO several years ago seems a bit inconsistent considering the argument given above, but its poor performance is not. What explains its performance? Why has it not lent to the maximum of its authorized limit? Lack of insufficient demand for loans may be a partial explanation and only a detailed analysis of small-scale firms will determine the nature of potential demand. However the operation of SIFO itself provides part of the explanation and is an existing example of institutional disincentives worthy of analysis.

SIFO was actually set up as a type of joint venture with the partially government owned commercial Krung Thai Bank.^{10/} The Bank appraises the security offered as collateral for a loan, while SIFO conducts the technical and economic assessment of the application. A Loan Board composed of the General Manager of the Krung Thai Bank, the Managing Director of SIFO, and representatives of several government offices makes the final decision on the application.

A special joint loan fund was developed on a 1 to 3 formula, that is the government provided about B 50 million for SIFO's contribution, while the Bank provided a little over B 150 million for a total fund of just over B 200 million.

^{10/} The operation and structure of SIFO is described in the Annual Report, 1975.

SIFO earns 3 percent interest on its funds deposited with the Bank and the Bank earns 9 percent interest on the total amount lent to borrowers.

This arrangement has created an unusual set of disincentives for both SIFO and the Bank. First, SIFO earns a fixed income of 3 percent of approximately $\text{฿} 50$ million, or $\text{฿} 1,500,000$. With this amount it must meet the rising costs of appraising loans in an inflating economy. It is forced, therefore, to reduce expenses by curtailing travel out of the Bangkok area and by increasing the average size of loans made. Thus it is logical to find SIFO's portfolio becoming increasingly concentrated in loans made in or near Bangkok, and it cannot be aggressive in seeking new customers elsewhere.

On the other hand, as a commercial bank, the Krung Thai Bank has alternative uses for its funds. Before a recent change in Thailand's usury law, it could charge a maximum rate of 15 percent interest. The Bank is evaluated with several standard banking performance measures even though it is government owned so the officers are logically concerned about costs and income. The Bank has three options when faced with a loan recommended by SIFO: make the loan using the special SIFO/Bank fund, make the loan directly with its own funds or refuse to make the loan.

Consider a loan of ₱ 1 million, the maximum currently allowed under the program. Under the first alternative, ₱ 250,000 would be drawn from SIFO funds and the balance from the Bank. The Bank would earn 9 percent interest or ₱ 90,000 per year. Assume further the average cost of the Bank's resources is 6 percent.^{11/} Thus apart from the costs of appraising the collateral, the Bank's costs are ₱ 45,000 ($₱ 750,000 \times 0.06$) so the annual net return is ₱ 45,000. Suppose, however, the application is sound enough so the Bank makes the loan directly at the maximum rate of 15 percent. Then its income is ₱ 150,000 and costs are ₱ 60,000 for a net income of ₱ 90,000. In the first case, the rate of return on ₱ 750,000 invested is 6 percent, while in the second case the return is 9 percent on ₱ 1 million. Of course, in the second case the Bank must conduct its' own analysis of the application and suffers the entire loss if there is one. But the example shows why, as it is alleged, the Bank would choose to make some loans directly to applicants after SIFO has done the analysis. It also suggests why the Bank would be reluctant to lend all funds committed to this program when it has alternative uses earning a higher rate of return.

^{11/} Based on the structure of deposits at the time, it was estimated that the weighted average cost of commercial bank deposits in 1978 was 5.5 percent (Meyer, Baker and Onchan, p. 37).

It would appear that a borrower would be disadvantaged by a 15 percent Bank rate compared to the 9 percent rate of the SIFO program. Of course, the borrower might be able to negotiate a lower Bank rate. If not, the difference in cost borne by the borrower may be less than it appears. SIFO has developed a complicated set of procedures which require time-consuming and expensive trips by the applicant to Bangkok where SIFO's only office is located. Then he must also work with the local Bank branch that will appraise the collateral and process the loan. If the lost time and related expenses were evaluated, the total cost to the borrower of the so-called "cheap" loan could be substantially higher than 9 percent, especially if the loan is small.^{12/} If the local Krung Thai branch would expedite a commercial loan, a 15 percent rate could be more attractive.

This program also represents another example of the fallacy of subsidized interest rates so popular in many credit programs. The objective of a subsidized interest rate (i.e. a rate lower than prevailing for other loans) is to help a sector considered worthy of such assistance. Yet the peculiar SIFO-Krung Thai Bank arrangement, with the disincentives inherent in the low interest rate, restricts

^{12/} Adams and Nehman have documented several similar cases of high borrower costs for small farm loans.

the expansion of loans to a broader clientele. Few loans are made and borrower costs are substantially higher than the subsidized interest rate. Clearly the intended beneficiaries are not well served by this arrangement. Fortunately, the Thais have been aware of these problems for some time and a proposal is being developed to restructure SIFO, perhaps along the lines of IFCT. But if it follows the pattern of lending of IFCT, as noted above, the prospects are not bright for major improvements in credit availability for rural nonfarm enterprises through SIFO.

CONCLUSIONS AND IMPLICATIONS

This paper summarizes the great progress Thailand has made in recent years in making farm credit policy an important component of rural development strategy. Little attention has been given, however, to increasing the supply of credit for rural nonfarm enterprises. The question of demand for credit by nonfarm enterprises has yet to be analyzed and some research is underway that will shed some light on the issue.^{13/} Even without such research, we could more confidently argue that demand is a constraint if we had an effective credit supply system which had difficulty in finding potential borrowers. However, with the limited

^{13/} See Onchan et.al.

information available it is impossible to deduce the nature of demand.

Clearly if the small-scale sector is to play the role in the economy envisioned in the current Five-Year Plan, Thailand must systematically analyze the current status of supply conditions of formal credit and alternative methods of improvement. Three lines of inquiry are urgent. First, the analysis of an improved structure for SIFO must be intensified and accelerated. A restructured SIFO is not going to resolve the entire supply issue but, if it is going to exist, it is uneconomic for it to operate with its current small portfolio and resources. Furthermore, if it had a more aggressive innovative program, it could provide useful support to other financial intermediaries and the government by more clearly identifying a) the nature of demand for credit and b) enterprises with the best potential for expansion.

Second, analysis is required concerning problems of lending to the small-scale sector. There is little information available in Thailand on important issues such as the returns, costs and risks of lending to small nonfarm firms compared to large firms or compared to farm lending.^{14/}

^{14/} A study by Saito and Villanueva of the Philippines experience is an interesting example of the type of analysis that could be useful.

Information on these issues would be helpful in quantifying the level of interest rate that would provide lenders with incentives to expand their portfolio in this area. If this rate was discovered to be high given the profitability of these firms, it would then be possible to more systematically analyze if a subsidy is required, if so, how much, and what is the most cost effective way of providing it.

Third, there are a number of interesting programs in other Asian countries providing support for the small-scale sector. Japan, the Philippines, India and, more recently, Korea have all been active in this area. Some programs focus on infrastructure, others trading services, others technical assistance, others vocational training, and others industrial estates. Some programs provide only credit, while others include credit as one component in a package of services. These experiences should be analyzed to learn what has worked and what has failed. They could provide useful insights as Thailand considers how to meet the stated objective of assisting the small-scale sector to play a more dynamic role in the economy.

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