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AN EVALUATION

EXPERIMENTAL APPROACHES TO RURAL SAVINGS
(AID Project No. 936-5315)

Prepared For

U.S. AGENCY FOR INTERNATIONAL DEVELOPMENT
BUREAU OF SCIENCE AND TECHNOLOGY

Prepared Under

AID Contract No. DHR-0000-C-00-6048-00

APRIL 30, 1987

Prepared By

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BASIC PROJECT IDENTIFICATION DATA

1. Country: Worldwide
2. Project Title: Experimental Approaches to Rural Savings
3. Project Number: 936-5315 (Grant)
4. Project Dates:
   - a. First Cooperative Agreement: September 27, 1982
   - b. Final Obligation: FY -- 1988 (Planned)
   - c. Project Assistance Completion Date: December 31, 1988
5. Project Funding:

a. AID/W Core Funding (Grant):	$ 3,000,000
b. Mission Funding:	4,000,000
c. Host Country Counterpart Funds:	n.a.
Total:	$ 7,000,000

6. Mode of Implementation: Cooperative Agreement with Ohio State University.
7. Project Design: S&T/RAD designed the project based upon a successful OSU savings mobilization effort conducted under a predecessor project.
8. Responsible S&T Bureau Officials:

a. Office Directors:	1982-85	Jerome French
	1985-86	Christopher Russell
	1986-Present	Eric Chetwynd
b. Project Officers:	1982-Present	Sandra Frydman Henderson

9. Previous Evaluation: None
10. Cost of Present Evaluation: $ 45,700

	Person Days	Dollar Costs
a. Direct Hire		
(1) AID/W TDY:	20	---
(2) USAID staff:		
b. Contract:	99	$ 45,700
c. Other:		---

EVALUATION

EXPERIMENTAL APPROACHES TO RURAL SAVINGS
(AID No. 936-5315)

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SUMMARY

AID Responsibility

This report evaluates the project "Experimental Approaches to Rural Savings" (936-5315), known prior to FY 1983 as "Rural Savings for Capital Mobilization." The project is being carried out under the Bureau of Science and Technology, Office of Rural and Institutional Development, Regional and Rural Development Division. It was obligated by Cooperative Agreement No. DAN-5315-A-00-2070-00, dated September 27, 1982, as amended, between USAID and the Ohio State University Research Foundation (OSU).

Project Purpose

Experimental Approaches to Rural Savings (EARS) had a central purpose testing the ability to mobilize rural savings and thereby increasing the availability of financial capital for improving economic circumstances, particularly of small borrowers. As the project evolved, its purposes expanded to encompass a broader range of rural financial market (RFM) needs. This included technical assistance for improving efficiency of administration, credit allocation and training. An ultimate goal of the project was to assist AID missions in establishing, testing, and implementing improved approaches to mobilizing savings in rural areas.

Evaluation Purpose and Methodology

This is the final and only evaluation of the EARS project. Evaluation objectives were: (a) to examine contributions made by the project; (b) to recommend further research that may be required, and (c) to indicate priorities for continuation of S&T/RD efforts in support of rural savings mobilization and financial systems improvement. Methodology was consistent with the AID Evaluation Handbook and Chapter 12 of AID Handbook 3, and is outlined in annex B to this report. An extensive selection of project documents were studied and listed in a bibliography. Persons interviewed are listed in annex D. Field visits were made for discussions with project staff at OSU and to the Dominican Republic to observe one of the specific country projects directly.

Findings and Conclusions

The general assessment of OSU's performance was quite favorable. Their research effort was of high quality, and project staff were professional. Good field working relationships were apparent. Over the course of the project, OSU appears to have clearly emerged as a leader in research on rural financial markets.

Findings and conclusions are described throughout the report. Some of the more important ones are summarized below:

- Demonstrating the ability to capture rural savings in certain countries.
- Supporting the thesis that saver-dominated institutions show lower loan delinquency, greater efficiency, and greater viability.
- Demonstrating that loan targeting increases lender costs and contributes to poor loan recovery.

Many subsidiary findings and conclusions were observed as supportive or contributory to the more general results.

- Despite the high quality of research, only modest gains were achieved in the area of policy dialogue in Honduras, due apparently to political questions.
- In searching for a success story, it appeared that in the Dominican Republic top administrators and central bankers were not yet fully converted to the "new thinking."
- No systematic procedure exists for selecting countries to receive assistance for their rural financial institutions. This poses a risk of receiving inappropriate policy or infrastructure support.
- Rural financial markets may not be limited to farmers or even to the more general rural population but to all savers and borrowers that are considered marginal by the formal system.
- Questions of negative real interest are very difficult to deal with, even in an experimental setting, i.e., Banco Agricola in the Dominican Republic actually had a negative rate after considering the inflation factor.
- In the Dominican Republic, success of Banco Agricola in deposit mobilization may not be solely due to mobilizing rural deposits but also to attracting relatively large urban deposits.

OSU did an adequate job of disseminating research results, largely through reports, papers, seminars, and personal contacts. Some question is raised whether more dissemination to bankers would be beneficial, especially in non-project countries.

The project has unquestionably made an impact on donors and host governments, but it is difficult to describe or measure. International donors and most practitioners of development banking in LDC's are actively aware of this new thinking. To test the magnitude and rate of change would, in itself, require a significant research budget.

Recommendations

Recommendations are made throughout the report. Some of the more important recommendations are summarized below:

- AID should continue to play an active and leading role in supporting development of and research on rural financial institutions, drawing on the established strengths of OSU and incorporating contributions from other groups with complementary skills.
- AID should continue to develop both internal and external sources of individuals with capacity to undertake financial sector policy dialogue, both in relation to rural financial markets and, when needed, broader financial sector policy issues.
- AID should encourage OSU to continue to develop its policy support methodology under proper conditions.
- AID should encourage OSU to assist local financial organizations to use proven concepts and methodologies.
- AID should support additional research in new financial areas, such as: similarities and differences in RFM and urban, entreprenuerial financial needs; informal institutions and methods of integration into financial markets; role of credit unions; related managerial research and other subjects.
- AID should develop a follow-on project through a process of mission and AID/W participation and may draw upon suggestions for research, institution strengthening, and coordination project components described in the evaluation.

CHAPTER I. EVOLUTION OF PROJECT

This report is the final evaluation of the AID Project entitled Experimental Approaches to Rural Savings (No. 936-5315). The objectives of this evaluation are to:

(a) Examine project contributions;
(b) Recommend further research and field support; and
(c) Indicate priorities to continue AID efforts to support improvement of rural financial markets.

This evaluation was carried out pursuant to a contract with Social Consultants International, Inc., of Reston, Virginia. The statement of work is given in Annex A. Evaluation methodology is described in Annex B. A bibliography is included in Annex C, and key contacts are listed in Annex D.

This report is organized into five chapters and a summary. Chapter I describes project evolution including environment, history, and project description. Chapter II deals with project activities performed by Ohio State University (OSU) (field work and impact on donors and host countries) and by Dr. Maxwell Fry (major study). Chapter III provides an overall assessment of issues, such as: OSU policy dialogue methodology, informal financial markets, and operational questions. Chapter IV identifies knowledge gaps and suggests possible next steps. Chapter V is devoted to conclusions and recommendations.

A. Environment

AID has supported agricultural credit programs for a long time, during which "old style" subsidized credit projects have evolved to "new style" rural financial markets (RFM) projects. AID and some other donors have changed attitudes towards subsidized credit projects partly from disillusionment with their impact, and OSU has advanced and articulated the reasons for this evolution. Concomitantly, AID has provided leadership in trying to reorient other donors and host governments away from subsidized credit to self-sustaining financial systems.

Donors have supported agricultural (and industrial) credit projects with large amounts of funds. Exact figures are not available; however, estimates can be made. For AID, total funding approximates $1 billion for agricultural credit programs during 1950-85. The World Bank has extended $10.1 billion in 1967-86 for agricultural credit ($6.3 billion) and industrial credit ($3.8 billion). The International Fund for Agricultural Development (IFAD) financed nearly $0.4 billion of rural credit projects in 1978-85. Within the past few years, these three donors have averaged close to $900 million per year for credit projects. Thus, the policy approach to these projects has a substantial impact on donor and host country budgets.

1. <u>Policy Guidance</u>

AID's forthcoming Policy Paper on Financial and Capital Market Development will cover rural financial markets and should be completed soon. Until it is ready, policy guidance is provided in the following sources:

First, the AID Policy Paper "Pricing, Subsidies, and Related Policies in Food and Agriculture," 1982, describes key elements:

- AID will support financial institutions that mobilize and allocate private indigenous financial resouces;
- Financial institutions should be free to set interest rates high enough to clear markets between savers and borrowers;
- Financial institutions' spreads should provide self-sufficiency and eliminate subsidies; and
- Missions should seek innovative, cost-effective methods to serve previously unserved groups on a self-sustaining basis.

Additional guidance is found in "Guidelines on the Terms of Aid," dated May 16, 1985. This guidance requires AID to make private sector loans at interest rates paid on U.S. Treasury obligations of similar maturity and not less than the prevailing local interest rate approximating the opportunity cost of capital. At minimum, the interest rate must be positive in real terms. For intermediate financing institutions, adjustments may be made for extra costs of innovative activities.

Guidance is also contained in AID Cable State 252939 dated September 9, 1982, entitled "Policy Regarding Credit Programs." The cable, after the 1981 Colloquium on Rural Finance, says that Missions should support expansion of indigenous institutions that mobilize and allocate private resources; real interest rates must become positive; interest and credit controls must be eliminated; targeted credit must become self-sustaining; and financial institutions should be financially viable.

To amplify policy guidance, the Agency has developed discussion papers. None, however, has been published. They are:

- "Intermediate Financial Institutions: An Overview," dated January 1985. This discussion paper proposed an agenda to unify approaches to credit programs for intermediate financial institutions. It proposed five subjects for consideration and included nine policy recommendations. While the paper was well thought through, it may have been too ambitious an undertaking at the time.

- "Alternative Financial Instruments for Less Developed Countries," by E.F. Hutton & Company, dated November 1986. This study is competent and well grounded; however, it does not make specific recommendations. Its broad approach to financial sector issues is more suitable for relatively sophisticated financial systems, and it does not draw upon this project.

2. Related Evaluations

Evaluations also reveal the Agency's environment towards credit projects, and three recent evaluations support "new style" financial markets projects.

- "Agricultural Credit, Input, and Marketing Services," by Ray Solem, et al., August 1985. The purpose of this evaluation was to determine factors contributing to project effectiveness and to assess strengths of various institutions (i.e., public, mixed, or private). In 1958-82, 203 projects provided agricultural credit, agricultural inputs and marketing services. Of these projects, 50 percent included credit as the principal or a significant component. This evaluation concluded that AID planners are still ambivalent about agricultural credit's role: as an input or as financial intermediation. The report lists three major lessons: borrowing rates must be high enough to ensure institutional viability; loan application procedures must be prompt; and farming operations must be profitable.

- "A Synthesis of AID Experience: Small Farmer Credit, 1973-1985," by Joseph Lieberson, et al., October 1985. This evaluation assessed the economic impact of credit projects by examining conceptual approaches and institutional delivery mechanisms. The authors selected 50 out of 80 projects for review. The evaluation identified critical factors for project success, developed a "winner's profile" and provided a project checklist. Success was judged by financial viability of both credit institutions and small farmers. This evaluation is comprehensive and informative; it examined factors in a context of macroeconomic issues, financial policies, and credit delivery issues. This evaluation was also used as a key AID paper for the AID-IFAD Small Farmer Credit Meeting in June 1985.

- "Credit Programs for Small Farmers," by Siew Tuan Chew, draft dated October 1986. This report summarizes AID experience, policy, and lessons learned. It is intended for AID project managers. It describes "conventional approach" and "new emphasis" projects, synthesizes issues, and describes this project and a

Honduran equity investment project. The evaluation notes unresolved issues as: banks' needs to manage both assets and liabilities instead of only loan portfolios; and project evaluation criteria as viability of financial institutions instead of loan usage and impact (which will be discussed in Chapters III and IV).

3. Complementary Programs

AID supports a variety of projects in financial sector development which are influenced by this project's intellectual leadership. Some of these projects, which complement this project, are outlined below.

a. Financial Markets Development Program

AID's Bureau for Private Enterprise (PRE) manages the $2 million Financial Markets Project (No. 940-2005) which was authorized in September 1985 for two years. Missions can participate by "buying in" (i.e., sharing costs) to finance specific activities. The project purpose is to assist Missions to develop strategies and design projects incorporating the use of various financial markets. The project concentrates on: (1) policy dialogue to improve the climate for private enterprise and savings mobilization; (2) technical assistance to countries with a favorable financial sector climate; and (3) strategies for financial markets. Technical services are provided by a joint venture of Arthur Young & Company (accounting firm), Ferris & Company (investment banking/stock brokerage), and International Resource Group (consulting firm in financial intermediaries), complemented by the First Boston Group (investment bankers) and Curtis, Mallet-Prevost, Colt & Mosle (law firm in financial markets).

The project has financed an impressive array of activities. At the end of July 1986, it had 21 on-going activities and 14 potential or completed activities. These include short-term programs for: assessment of financial systems, analysis of financial sector policies; establishment of financial institutions; mobilization of savings; etc. PRE is considering concentrating project resources to target a limited number of countries. Criteria would be based upon: (1) a minimum level of market sophistication and (2) host government willingness to change policies. Countries being considered are: Indonesia, Ecuador, Morocco, Kenya, and the Philippines.

b. PL 480 Program for Local Currency Lending

PRE also assists missions in administering the PL 480 program for local currency lending to private enterprise. The amount of funding could reach $200 million per year, to be available to intermediary financial institutions (IFI) such as banks, non-bank financial institutions, cooperatives, and private voluntary organizations (PVO), which select borrowers and take the credit risk. Several guidelines govern this program: IFI's are to be privately owned; interest rates should be free market rates or approximate the opportunity cost of capital; and activities should be consistent with donor efforts to promote financial sector policy reform.

Overseas missions develop country programs according to local needs. Three programs are presently in formative stages. The Sri Lanka Mission is reviewing plans to create a venture capital company or to select IFIs based upon their proposals which will include: interest rate to be paid the U.S. Government; proposed types of loans and customers; and description of new activities. The Morocco Mission has an agent bank, which will help find IFI's, negotiate loan agreements, help establish lending guidelines, and monitor performance. Tunisia has a limited number of private IFI's, and plans are not yet firm.

c. Credit Union Projects

AID's Bureau for Food for Peace and Voluntary Assistance (FVA) monitors several grants to cooperatives, which may involve the financial sector. First is the $2.6 million Credit Union National Association (CUNA) Project (No. 940-0332), authorized in 1986 for three years. The project purpose is to expand and strengthen the international system of democratic, productive, and viable credit unions. This grant finances CUNA/World Council of Credit Unions (WOCCU) assistance for specialized credit programs, participant training programs, study tours, technical consultancies, and other activities for member organizations. CUNA/WOCCU currently provides technical assistance to seven projects including regional confederations in West Africa and the Caribbean and credit unions in Togo, Lesotho, and Jamaica. In addition, FVA also monitors grants to several cooperatives which often design or implement credit projects. Recipient cooperatives include: the National Cooperative Business Association (formerly CLUSA), Agricultural Cooperative Development International (ACDI), Cooperative Housing Foundation (CHF), and Volunteers in Overseas Cooperative Assistance (VOCA).

d. Small Enterprise Support Project

AID's Bureau for Science and Technology (S&T) manages the $2.9 million Small and Micro Enterprise Support Institution Development Project (ARIES) (No. 931-1090) authorized in 1985 for five years. The project purpose is to strengthen capabilities of support institutions which promote small and micro enterprise, including financial sector activities. It funds field research, technical assistance, and training under a contract with Robert R. Nathan Associates, Harvard Institute for International Development, Control Data Corporation, and Appropriate Technology International. Some activities include: a working paper entitled "Improving Rural Financial Markets: Appropriate Design of Savings Projects;" a discussion paper on informal financial markets; technical assistance in training for El Salvador's Credit Cooperative Federation; and financial experts to help design projects, establish training programs, etc.

e. Individual Financial Sector Projects

AID geographic bureaus have a large number of separate projects which support financial sector development. These projects usually provide credit facilities and technical assistance and are usually intended to benefit small farmers or entrepreneurs.

4. AID Science and Technology Series

A non-technical book on AID's accomplishments in rural finance will be added to the "AID Science and Technology in Development Series." Author Avrom Bendavid-Val plans to complete this 60-100 page book in Fall 1987. It ought to contribute to easy understanding of this subject, including developmental problems.

B. History of Agricultural Credit

"Old style" agricultural credit projects are at least as old as Spanish efforts to subsidize tobacco exports from the Philippines. Undoubtedly earlier examples could be found. Post World War II development efforts led in 1952 to an international conference on agricultural and cooperative credit at Berkley, California. This conference recommended additional agricultural credit projects, characterized by: subsidized borrowing rates; targeting of borrowers; establishment of specialized institutions; and more donor contributions. By the 1960's, donors were providing substantial funds for both industrial and agricultural credit, spurred by the Green Revolution.

OSU undertook its first contract with AID to study agricultural finance in 1964-67. These studies concentrated on costs of operations, and were a period of "stumbling around, to find out what was going on," according to Dale Adams, of OSU. In 1968-69, AID provided funding to further investigate Brazilian data. OSU continued work in Brazil in 1970-75 under the Farm Capital Formation Project. OSU conducted 3,000 farm surveys and concluded that traditional agricultural projects wer[illegible] gressive as an income transfer mechanism. In 1971-74, OSU also received AID grants to study savings in Taiwan and South Korea and concluded that large savings capacities existed. By this time, OSU had become an acknowledged critic of "old style" traditional agricultural credit projects.

The 1972-73 AID Spring Review of Small Farmer Credit undertook a major reconsideration of "old style" credit projects. This Review included individual country papers, regional conferences, and a conference in Washington, D.C. The resulting 20-volume report contained country studies and academic papers (summarized in Gordon Donald, Credit for Small Farmers in Developing Countries, Westview Press; 1976). OSU helped design the Review led by E.B. Rice, formerly with AID; wrote several country and analytic papers; and conducted 15 workshops. This Review concluded that financial systems of developing countries share common problems, policies, and assumptions.

This period was important for other contributions to support "new style" projects in the area of rural financial reform. In 1973, the theoretical basis for financial liberalization was described in two books: E.S. Shaw's Financial Deepening in Economic Development and R.I. McKinnon's Money and Capital in Economic Development. Both of these books were an outgrowth of the AID-supported work of Professors Shaw, John Gurley, and Hugh Patrick in connection with financial sector reforms in Korea in 1965. Shaw and McKinnon advocate market determination of interest rates, integration of financial markets, and encouragement of efficient financial markets. In 1975, the World Bank published its "Agricultural Credit Sector Policy Paper," and the Food and Agriculture Organization (FAO) hosted a conference to debate agricultural credit issues.

In 1976-80, OSU participated in the predecessor Rural Financial Markets Project. This project provided applied (not state-of-the-art) research and short-term consulting services. Research activities included: savings mobilization projects in Peru and Honduras; financial market studies in Thailand; transaction cost studies in Bolivia; and studies of a development bank and small farmer credit programs in Jamaica. Research expanded upon earlier conclusions on availability of savings, importance of interest rates, and non-interest rate charges. OSU also constructed a network of experts; published 21 quarterly newsletters from 1976 to 1981; prepared three annotated bibliographies; and conducted two dozen seminars in Thailand, Jamaica, and other countries. AID funded $1.7 million in "core" financing, and Mission "buy-ins" increased the amount to $2.1 million.

This predecessor project was included in the 1983 AID S&T Bureau's evaluation of the effectiveness of AID's Cooperative Agreement as a mechanism to support research. The evaluation concluded that: (1) the project made a significant contribution by emphasizing adverse incentives of cheap credit; (2) research was incomplete as to making policy recommendations; and (3) it lacked a model of rural credit within the financial system. This evaluation was not a customary project evaluation and did not cover technical assistance and other OSU activities.

The OSU-AID-World Bank Colloquium on Rural Financial Markets at Washington, D.C., September 1981 advocated "new style" programs and disparaged "old style" credit projects. OSU feels that AID generally agreed with its principles; the World Bank and Interamerican Development Bank held mixed reactions but generally agreed; FAO provided some support; and IFAD did not agree. The nub of difference between "old style" and "new style" projects pivots on the role of finance: Is it an agricultural input as in "old style" projects or is it financial intermediation as in "new style" projects? Chief differences between old and new style projects are outlined in Annex E.

C. The Project

1. Project Description

The Experimental Approaches To Rural Savings Project (No. 936-5315) was authorized as a $1,392,000 grant in 1982. Subsequently, it was increased to a funding ceiling of $7 million, comprised of $3 million "core" funds and $4 million Mission "buy-in" funds. The project was obligated by Cooperative Agreement (DAN 5315-A-00-2070-00) with Ohio State University on September 27, 1982; it has been amended 15 times (as of April 30, 1987). The project's original four-year life has been extended by two years to December 31, 1988.

The project paper focuses on rural savings mobilization. The project goal is "to assist USAID missions in establishing, testing, and implementing improved approaches to rural savings for capital mobilization so as to aid in the development of rural areas of LDCs." The project purpose is "to mobilize private savings in rural areas, to increase the availability of financial capital in rural areas -- especially to small borrowers -- and thereby improve the economic circumstances of these borowers." The project was intended to expand financial capital in rural areas through savings mobilization by formal financial institutions. Thus, technical assistance would be available only if clearly linked to savings mobilization. If so linked, then technical assistance could be provided to improve: efficiency of financial administration; allocation of credit to small rural borrowers; and training in loan administration. As the project evolved, it expanded beyond this narrow "savings only" approach to encompass a broader range of needs required for rural financial markets projects.

Project outputs were planned in four categories:

- Savings mobilization demonstration projects;
- Technical assistance and training to support demonstration projects and;
- Applied research on impediments to savings, including economic, social, cultural, and institutional issues;
- Dissemination of results through seminars for development practitioners, scholars, etc.

Project inputs were to include:

- $1,392,000 in core funding (increased to $3 million);
- A comprehensive volume on the 1981 Colloquium on Rural Financial Markets (published as: D. W. Adams, D. H.

Graham, and J. D. Von Pischke, eds., Undermining Rural Development With Cheap Credit, 1984; Westview Press), and parallels J. D. Von Pischke, Dale W. Adams, and Gordon Donald, eds, Rural Financial Markets in Developing Countries, 1983; Johns Hopkins Press);

- AID mission and host government project contributions; and

- Advice, guidance, and decision making by the AID S&T/RD Human Resources Sector Council;

2. Project Activities

Project activities are outlined below and are described in more detail in Annex F. Activities described in this evaluation include OSU's work in five selected countries, and Dr. Maxwell Fry's report on Domestic Resource Mobilization.

a. OSU Cooperative Agreement

(1) Selected Countries

(a) **Honduras**: OSU conducted seminars to support the $1 million Agricultural Credit Project, which provided technical assistance to banks. Research was conducted on savings mobilization, lending costs, and financial market structure and competition, borrowing costs. Work was performed during 1983-85.

(b) **Dominican Republic**: OSU provided a broad range of technical assistance, field research, and dissemination for the $1 million Rural Savings Mobilization Project, a pilot project. Work started in late 1983 and was scheduled to end in 1986.

(c) **Bangladesh**: OSU provided field research and dissemination to support the $75 million Rural Finance Project. OSU performed research to determine whether the project was achieving its purpose and to document changes in the financial system resulting from the project. Work was performed in 1984-86.

(d) **Niger**: OSU, in cooperation with the Institute de Researches et Sciences Humaines, conducted a comprehensive analysis of rural financial markets, to support USAID's policy dialogue under the $32 million Agricultural Sector Development Grant Project. Work was performed in 1985-86.

(e) **Philippines**: OSU is to conduct research to support the $20 million Rural Financial Services Project, which is tied to a $100 million World Bank project. OSU research will include monitoring project performance, as in the Bangladesh project, and also independent studies, such as loan and savings costs. Work is to be performed in 1987-88.

(2) Other Activities

(a) **Guatemala:** OSU sub-contracted with Arizona State University for a comprehensive assessment of several AID rural credit programs, together with a seminar on results and recommendations. Work was completed in 1984.

(b) **Dominican Republic:** OSU studied rural financial institutions to help design a savings and loan component of an agricultural project. Work was completed in 1986.

(c) **Project Guidelines:** OSU sub-contracted for guidelines of AID rural financial markets projects. This is available in draft. It has, however, pointed out the difficulty of developing operational guidelines for field application.

(d) **OSU Book:** OSU will consolidate what it has learned under this project, which will be published as a book in 1988 or later.

b. Report on Domestic Resource Mobilization

In addition to OSU work, Dr. Maxwell Fry, of the University of California - Irvine, prepared a comprehensive review of the theoretical basis of the financial sector in economic development. He presented his draft report on Domestic Resource Mobilization in September 1986.

3. Evaluations and Audits

No evaluations have been performed previously of this project. However, evaluations have been performed of two projects in "selected" countries. The first is the evaluation of the Dominican Republic Rural Savings Mobilization Project dated February 1985. The report was highly complimentary of OSU's performance in providing research and technical assistance. The second is the evaluation of the Bangladesh Rural Finance Project dated February 1987 which commented that OSU adequately performed the assigned activities.

Audits have not been performed of the AID-OSU Cooperative Agreement nor contracts under the project.

4. Project Monitoring

The project is monitored by AID's Bureau for Science and Technology, Office of Rural and Institutional Development, Regional and Rural Development Division.

The Cooperative Agreement requires OSU to provide quarterly reports. OSU provided eight quarterly reports covering the periods April 1983 to March 1985. These reports succinctly describe progress in carrying out project activities and appear to be a good reporting system. Starting in September 1985, OSU has only submitted monthly financial reports, which do not provide much substantive information. AID and OSU should improve the project reporting system.

In addition, OSU provided annual work plans with detailed descriptions of proposed work, estimated staffing and budgets. Although the work plans are somewhat long, (1985-87's was 86 pages), they contain much helpful information.

CHAPTER II. ASSESSMENT OF ACTIVITIES

This chapter reviews major project activities which include field work performed by OSU and a monograph on domestic resource mobilization by Dr. Maxwell Fry. The main thrust of this project has been OSU's work in five selected countries (Honduras, Dominican Republic, Bangladesh, Niger, and the Philippines). This chapter will provide a qualitative assessment of OSU's outputs relating to: savings mobilization demonstration projects; applied field research on impediments to savings; technical assistance and training; and, dissemination of practical results. Following the review, the chapter will assess the impact of these activities on AID, host countries, and international donors. Finally, the chapter will provide a brief critique of Dr. Fry's monograph.

A. OSU Activities

1. Savings Mobilization Demonstration Projects

Although the project paper emphasized savings mobilization demonstration projects, this emphasis shifted early to include a broader concern with the efficient functioning of rural financial markets. It was found that one could not mobilize savings in a vacuum, but that macroeconomic policies and favorable regulations were also necessary as preconditions. As a result, of this shift, spectacular results in savings mobilization could not be expected nor were they achieved. Nevertheless, these experiments produced a number of important findings regarding savings mobilization that will continue to be cited in policy dialogue agenda for their relevance to the rural financial market.

a. Savings Mobilization -- Honduras

The Honduran savings mobilization demonstration project was completed under the present project but was begun under the earlier one. This first activity under the present agreement signaled the shift in emphasis toward concern with rural financial markets. It did not call for a demonstration project, but rather for studies to document savings performance and incentives. Although no demonstration project was called for, OSU's work with rural credit unions demonstrated the validity of its major theme -- "new view" rural financial markets. In 18 months work with five credit unions and a control group of 10* OSU demonstrated conclusively both the practicality of capturing voluntary savings from modest rural households as well as the predicted institutional strengthening resulting from offering deposit services. The five credit unions participating in the experiment not only increased savings and time deposits at a significantly faster rate than the control group, but they also became stronger financial institutions through dramatic improvements in loan collection and overall efficiency.

The central theme in this demonstration project was the issue of saver-dominance versus borrower-dominance of financial institutions. This experiment concluded that borrower-dominated institutions tend to show high rates of loan delinquency, poor rates of growth, perennial liquidity problems, and other weaknesses associated with dependence on external sources of funds, whereas saver-dominated institutions tend to show steady growth in assets and liabilities, lower loan delinquency and greater efficiency and financial viability.

Comparison In Growth Of Credit Unions' Key Liabilities

(In Honduran $)

Five Project Credit Unions

	June, 1982		December, 1983		% Change
Shares	486,370	(79.0)	629,596	(69.2)	29.4
Savings	61,856	(10.0)	141,075	(15.5)	128.1
Time Deps.	67,577	(11.0)	139,154	(15.3)	105.9
	615,804	(100.0)	909,825	(100.0)	47.7

Control Group of Ten Credit Unions

	June, 1982		December, 1983		% Change
Shares	474,147	(77.7)	478,798	(74.8)	1.0
Savings	61,555	(10.1)	71,977	(11.2)	16.9
Time Deps.	74,237	(12.2)	89,726	(14.0)	20.9
	609,940	(100.0)	640,502	(100.0)	5.0

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* The 10 credit unions do not constitute a control group in a strict methodological sense. Rather, of the 15 participating institutions, five were selected on the basis of their willingness to institute policy changes for deposit mobilization. There was, therefore, a bias and a certain amount of momentum favoring savings mobilization in these institutions. This bias does not affect the validity of the demonstration.

While these conclusions were expected, inasmuch as they had been argued in the literature for a number of years, this project's data make a strong case for the importance of savings to institutional viability.

b. Savings Mobilization -- Dominican Republic

The project's only savings mobilization demonstration activity was established in the Dominican Republic, as part of the Mission's Rural Savings Mobilization Project (No. 517-0179). This activity provided technical assistance to the Agricultural Bank and to a small number of cooperatives belonging to the National Federation of Credit Unions (FEDOCOOP) with the two purposes of improving financial viability and helping savings mobilization.

The principal OSU advisor spent three and a half years in the Dominican Republic and was the same individual involved in the earlier Honduras project. He had an office in the central bank, was supported by a project coordinator and a capable staff, and was backed up by OSU faculty, a number of short-term consultants, and, for work with the credit unions, several capable and dedicated Peace Corps volunteers. He divided his time approximately equally between the Agricultural Bank and the credit unions, when averaged over the three and a half years, but the Agricultural Bank received more attention during the first half of the project, and the credit unions more during the second half.

<u>Savings Mobilization At The Agricultural Bank</u>:

The original plan called for a pilot savings effort at just four branches, with the modest goal of mobilizing between DR$50,000 and DR$100,000 at each location within the first year. These activities were soon expanded to include all 31 of the Bank's offices, despite OSU's misgivings at the rapid pace of expansion. What began as a pilot project evolved into a bank-wide activity aimed at transforming the institution. Project activities far exceeded their modest goals, and the Bank internalized the savings mobilization effort. There are important questions, however, which have not been emphasized in OSU reports, that are significant to the design of future activities. In a trip to the Dominican Republic, Gustavo A. Vega of USAID/Bolivia, raised some of these questions in a memo:

> ... in presenting alternatives to the Mission in Bolivia, it would be worth mentioning that some of the information provided by Banco Agricola does not present a clear idea of the actual results of the savings mobilization pilot plan, e.g., how many out of the 30,911 passbook accounts opened as of October 1986 are active? Many of the savings accounts were opened in isolated regions on one and

only [one] trip; how are these deposits served? It was practically impossible for the Banco Agricola officials to [supply information] concerning how much it cost per peso attracted. Why are they changing strategy, going back to the urban areas to attract savings, and why are they interested in promoting induced savings, if the essence of the Project is to demonstrate that rural savings exist and can be successfully mobilized?

A visit to the Bank's La Vega office--the first office to participate in the project--resulted in a number of similar questions. A hasty review of individual ledger cards, for example, showed that the great majority of savings accounts--perhaps upwards of 80%--showed no movement after an initial deposit except for monthly interest calculations. It appeared in discussions that opening a "no-minimum balance" savings account was just another bit of paperwork to be completed in applying for a loan. Furthermore, a perverse, little discussed corollary of Prof. Gonzales Vega's Iron Law of Interest Rate Restrictions* seems to obtain in this case: An unanticipated result was the concentration of loans made from locally mobilized funds. At the time of the visit, funds mobilized from almost 3,000 individuals were placed in a total of eight loans to cattlemen and rice merchants.

It appears that the Bank's success in mobilizing deposits may be due to its ability to attract large urban deposits. This finding is consistent with the importance placed on the Bank's securing permission to offer certificates of deposit in minimum denominations of DR$10,000. These certificates pay 14%, as opposed to the 6% paid on pass book accounts, and the 10% paid on regular time deposits, and were considered necessary to permit the bank to compete more effectively for funds. Judged strictly from the point of view of rural savings mobilization, the findings suggest that the demonstration project may have achieved less than has been claimed for it. On the other hand, the Bank has been affected more profoundly by this project than it would have been by a small pilot effort.

Perhaps the most interesting aspect of the project was the Bank's readiness to embrace savings mobilization and to absorb technical assistance. According to Bank officers, earlier visits

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*The Iron Law of Interest Rate Restrictions says that when interest-rate ceilings become more restrictive, the size of loans granted to the nonrationed borrower classes increases, while the size of the loans granted to the rationed borrower classes diminishes, as defined in Claudio Gonzalez-Vega "Credit Rationing Behavior of Agricultural Lenders: The Iron Law of Interest Rate Restrictions" in Undermining Rural Development With Cheap Credit, ed. by Dale W. Adams, Douglas H. Graham, and J.D. Von Pischke, Westview Press, 1984; Boulder, Colorado; page 86.

by consulting teams had planted the seeds of savings mobilization to resolve the problem of dwindling funds from traditional sources. Factions within the Bank were anxious to proceed but lacked the confidence to embark on a potentially unknown area. It took the external project to push the idea through the Bank.

Given the Bank's readiness to explore alternative sources of funds, potential tension existed between their desire for savings mobilization and the project's focus on rural savings mobilization. One of the customary arguments for savings mobilization is that it imposes discipline on financial institutions to achieve greater efficiency and better resource allocation. A subtle weakness in project design is that demonstration projects, *per se*, may not be consistent with the new view of rural financial markets. In this case, the insistence on mobilizing rural savings was a close relative of loan targeting so well known from the "old style" agricultural credit projects. This perception was strengthened by the un-banklike project requirement that deposits be lent only in areas where they had been mobilized. This was an unnecessary constraint on the Bank's ability to manage its liabilities, which raised costs with no discernible benefits. It is a requirement that goes against both the new-view insistence on allowing financial markets a greater role in allocating resources and the project's own institution strengthening goals. The geographic restrictions on lending, coupled with preoccupation with the collectibility of loans made with these funds, dampened the Bank's enthusiasm for savings mobilization and undoubtedly reduced savings mobilization totals. It should be borne in mind, however, that the Bank achieved results far in excess of the project's modest goals.

While the project's goals were modest in terms of the small number of offices originally included in the experiment and first year savings targets, they were ambitious in attempting not merely to transform an inexperienced institution into an efficient mobilizer of domestic savings but into an efficient mobilizer of rural savings. The project caused the Bank to undertake savings mobilization not in the relatively easier and lower cost urban financial markets, but rather in the more difficult rural financial markets where more experienced retail commercial banks are cautious.

Future interventions with agricultural banks may want to adopt a less ambitious, two step approach that begins with an attempt to transform the one-sided credit institution into a domestic financial intermediary--accepting the fact that it may be easier for an institution with no experience in liability management to begin working with large certificates of deposit mobilized in urban areas. Once savings mobilization has been internalized, it should be possible to initiate, as a logical second step, mobilization of rural savings. Such an approach was not possible, however, given project time constraints. A second lesson learned is the inconsistency between the project's objective of mobilizing rural savings and the Bank's objective of mobilizing resources from least-cost sources. The latter objective is consistent with the project's institution building goals.

A major conclusion is that savings mobilization should proceed on a step-by-step basis. First, institutions should begin mobilizing the lowest cost and most economic deposits. Then, they should expand their marketing base to include additional, higher cost funds to finance expansion of their loan portfolios. The danger of using agricultural development banks to demonstrate in a one-step process the viability of mobilizing rural savings is that the unavoidably wobbly initial steps of learning resource mobilization may be cited as evidence against the process. There is a danger that the data generated by this experiment could be used to support such an erroneous conclusion.

Savings Mobilization With Credit Unions

Savings mobilization through credit unions is hampered by a weak national federation, FEDECOOP. Despite the country's relatively weak credit union movement, however, substantial success was achieved in demonstrating rural savings mobilization. Credit unions showed strong deposit growth as well as improvement in key indicators of financial viability, such as sharply declining rates of loan delinquency. As in the Honduran case the importance of share capital on the liability side of the balance sheet declined, while savings and time deposits increased.

The growth in time deposits outpaced the growth of savings deposits in three of the four institutions, but the percentage figures for time deposits are relatively meaningless due to the extremely small base number. Of greater interest is the strong growth in savings deposits in all four institutions, particularly the largest, which infers that this instrument is preferred by small depositors. The largest cooperative increased time deposits by 55 per cent (from DR$670,722 to DR$1,037,206), passbook savings by 78 per cent (from DR$497,556 to DR$884,926), and share capital by 34 per cent, (from DR$1,013,461 to DR$1,361,428).

OSU pointed out an interesting aspect of cooperatives' savings mobilization: They appear to compete with the informal sector for funds. If this is so, the credit union savings mobilization experiment is immune from one of the oft-repeated criticisms of formal sector savings mobilization projects, namely that they merely transfer deposits from one intermediary to another, with no increase in financial intermediation. If, however, credit unions compete with the informal sector for funds -- and evidence from other countries indicates that they do -- then savings promotion by credit unions will tend to cause the formal sector to grow at the expense of the informal sector. Whether such a development is beneficial to long-run economic growth is a subject that cannot be exhausted here, other than to remark that there seems to be a prima facie case for such a contention.

Despite the predominance of credit unions in savings mobilization demonstration projects, they appear to be under-discussed in OSU's rural financial markets literature. A cursory review of OSU's 112 titles in the Dominican Republic Project Papers and documents, for example, revealed only four on credit unions. This reticence may reflect an understanding of the difficulties facing these institutions. It is equally likely, however, that this reticence reflects a lack of appreciation for their long-run potential.

OSU has pointed out that a missing element is a strong second level financial institution, which has led to the poor performance and the low opinion held by many development practitioners. Future financial sector projects involving credit unions might include the creation or strengthening of second level institutions. A project financed by USAID/Cameroon and implemented by the World Council of Credit Unions (WOCCU) suggests that a national federation of credit unions should operate a central liquidity facility, provide technical assistance and audit assistance. The experience gained in Cameroon w. be brought to bear on the rural savings pilot project to be initiated in Niger.

c. Savings Mobilization -- Niger

The OSU research report on "Rural Finance in Niger," conducted as part of the Mission's Agricultural Sector Development Grant (No. 683-0246) recommended establishment of a rural savings mobilization project involving credit unions. The report states that "village level savings and credit cooperatives...are the only formal vehicle of financial intermediation that can...emulate the strength of informal finance at the village level," and that "... an emerging network of these village and town level cooperatives offers the potential for financial intermediation between surplus and deficit units across village cooperatives, once they have become established." The report states that "this intermediation across villages is precisely what informal tontine and money-keeper activities cannot carry out." We question whether the research provides clear evidence on this matter and would like to see it explored further. In other countries such intermediation has taken place. In December 1986, Nigerien Government officials decided to promote village level local credit unions and took steps to obtain technical assistance from WOCCU.

Perhaps the most important cause of credit union failure is the absence of a strong second level financial institution clearly tied to its affiliates. The OSU report could be faulted, for failing to alert AID and Nigerien officials to the importance of setting up a strong, second level organization even in the beginning stages and for failing to include such an institution in their three year plan of action. The plan of action provides for a study tour for promotion agents to Cameroon, where a strong, second level institution exists.

2. Applied Field Research:

Applied field research was initially subordinate to demonstrating rural savings mobilization. As the project emphasis shifted, however, beyond the narrow focus on savings demonstration projects, to a broader concern with rural financial markets, field research became the principal activity. With this shift in emphasis, there was also a subtle shift of emphasis away from applied research toward research *per se*. As a result, it is probably fair to conclude that while we learned considerably more about the structure and functioning of RFM than we might have without the shift, we probably learned less about financial technologies to improve deposit services. Given the rudimentary state of understanding of RFM at the start of this project, the trade-off was beneficial from the long-run point of view.

The following sections review major field research activities. The amount of project-sponsored research was enormous, and only the major themes and findings will be discussed. It is useful to bear in mind a few principles and constraints of this research. First, the Evaluation Team did not have access to the field research itself, but to the reports of this work: the papers, memos, articles in scholarly journals, etc. Secondly, there were at least three distinct rationales for conducting research. First was the long-run rationale of extending the knowledge of rural financial markets in a variety of settings. This is the academic ideal culminating in presentations in the austere style of refereed journals. Although possibly remote from the nuts and bolts approach of practitioners who make decisions on limited information, this is nevertheless the most valuable kind of research. It has the disadvantage of being costly; but it is the kind of research at which OSU excels. At the other extreme is the research rationale that is provided from without, say, at the request of someone in the central bank, ministry of finance, or AID, who has an interest in a certain topic. Such research might be undertaken simply as a means of gaining access to such a person for the long-run policy dialogue process. Finally, there is the rationale of developing indigenous research capability in rural financial markets.

It is important to recall that each rationale imposes its own criteria for assessment. For example, it would be misleading to judge local output by the same standards set for OSU academic research, just as it would be misleading to judge academic production by the bottom-line criteria of businessmen. Field research under this project was carried out on a wide front embracing all these rationales. The emphasis here will be research undertaken under the first rationale, with the assessment criteria applied for academic work.

a. Field Research -- Honduras

In Honduras OSU first tested its model of policy dialogue based on country-specific research. OSU performed path-breaking research on transaction costs facing both individuals and institutions as well as on the economies of scale and scope. Based on household surveys and on econometric analysis of institutional data, OSU demonstrated conclusively that: (1) loan targeting increases costs substantially; (2) transaction costs ration credit in the absence of price rationing; and, (3) borrowing costs are regressive (i.e., implicit borrowing costs, being relatively fixed, fall more heavily on small borrowers than large borrowers).

Using institutional data, OSU also demonstrated that loan targeting not only increases lender costs substantially but contributes to dismal loan recovery performance. The development bank data showed that a large share of bank resources were devoted to loan disbursement and monitoring activities with few resources left over for crucial approval and recovery activities. Data supplied by a large commercial bank, with good loan recovery, showed the opposite pattern of resource allocation with most resources allocated to loan approval and recovery but little to monitoring.

An OSU Master's thesis approached the delinquency problem from a different angle. Based on an analysis of 6,000 loans made at 30 credit unions, it demonstrated that loan repayment is closely linked to the likelihood of obtaining new loans. According to this study, small farmers routinely discriminate between providers of financial services and want to maintain creditworthiness only at institutions that provide good service. Institutional variables appeared to be of great statistical significance as predictors of loan delinquency, this with borrower profile being of secondary importance. Both approaches suggest that loan delinquency is an institutional management problem and that the traditional reasons cited for poor collection of loans to small farmers (too poor, uneducated, involved in risky business, etc.) are fallacious.

OSU also looked at macro issues, such as the fiscal regulatory frameworks, to examine other applications of the Iron Law of Interest Rate Restrictions. OSU found two corollaries: concentration of financial services in the largest banks and geographical concentration in the largest urban areas. Investigation centered on discovering whether the regulatory framework stimulated competition or encouraged oligopoly and on deposit flows under price distortions. To approach this question, OSU studied the flow of funds within the banking system. This study revealed not only the anticipated flow of funds from rural to urban areas, but also an overall movement from south to north towards the more industrialized cities. Given this tendency to reallocate resources from rural areas, OSU formulated the main policy dilemma facing the project: Should rural deposit mobilization be promoted in this kind of environment? A case for the contrary could be made on at least two points. First, the flow of resources out of rural areas seems to defeat the argument for deposit mobilization to provide rural capital formation. How is rural capital to be formed if it is transfered out of rural areas? Second, what if these flows of funds reflect distorted market signals? What if the financial market is directing resources into activities with low marginal social product due, for instance, to poorly conceived import-substitution policies? Wouldn't it be better to leave rural resources unmobilized under these circumstances? To this question OSU responded with a clear "No," citing the argument that the alternative is subsidized credit which introduces additional distortions and prolongs the life of uneconomic activities. OSU also points out that the demand for deposit facilities presumes a welfare gain to savers. Also, building the financial system is a long term activity, even if the present environment is characterized by price distortions.*

Empirical findings indicated that the degree of market concentration had been decreasing for 10 years and that with savings rate ceilings the banks had engaged in non-price competition, largely through the opening of additional limited service deposit windows ("agencias"), thus lowering depositor transaction costs. While the Iron Law of Interest Rate Restrictions appears to hold for individuals (i.e., loans are concentrated among the largest borrowers in low interest rate environments) the converse appears to hold for institutions: savings rate ceilings lead to non-price competition among banks, resulting in proliferation of deposit facilities with the smaller banks expanding their market share at the expense of larger ones.

The research conducted by OSU in Honduras appearr to have been excellent. Despite the academic slant to the research, it was considered valuable by bank officials who were anxious to learn more about their cost structures. Participation appears to have been minimal, however, due to a reported lack of sophistication among local researchers.

b. Field Research -- Dominican Republic

Field research concerned chiefly the two savings mobilization demonstration activities. Approximately half of the 112 titles of papers and reports relate to the demonstration projects, and the bulk of the titles are either progress reports, memos, internal documents, or theoretical treatises. A considerable number are of Dominican origin. One does not have the sense

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* A fourth argument in favor of continued savings mobilization is the informal market's sensitivity to price. For instance, rural money lenders tended to place resources in higher return, urban, unregulated financial institutions.

that major research activities lie behind these reports, as in Honduras.

Given the importance and time required for the demonstration projects, this relative deemphasizing of research may be considered a healthy development. It affirms that the major effort did not go into research, but rather into other project activities namely demonstration projects, technical assistance, and dissemination. Much of the research output reflects technical assistance to counterpart institutions, such as the economic studies department of the Central Bank and the Catholic University.

OSU did, however, undertake a major new research investigation of the non-regulated, non-bank financial sector. Although this market is principally an urban phenomenon, there are strong arguments for including it under the rural financial markets umbrella. Indeed, one of the lessons learned is the need to recognize the interconnections of financial markets, whether rural or urban, formal or informal. Financial markets in developing countries tend to be fragmented but connected. Funds move from the formal market to the informal, and from rural areas to urban areas. The implications of broadening the view of rural financial markets is a healthy development and compares to OSU's earlier efforts at broadening the conceptual horizon by insistence on rural credit as opposed to merely agricultural credit and the concern with providing both savings facilities as well as credit instead of just credit.

The emerging view of rural financial markets suggests that the line should be drawn not so much along geographic as along socio-economic lines, and that the target group for improved financial services should not be merely farmers or rural households but all savers and borrowers that are marginalized by the formal financial system. Furthermore, this emerging new view recognizes that one cannot use the financial system to target restricted populations for benefit. One can only attempt to bring more actors into the market.

c. Field Research -- Niger

Field research was the principal activity in Niger and supported the Mission's Agricultural Sector Development Grant (No. 683-0246). The OSU terms of reference required a comprehensive study of the rural finance system. This was OSU's first work in Africa, and it collaborated with an expert in Niger. Initial activities appear to have been a mutual learning process with OSU helping the Mission to understand the new approach to rural financial markets and the Mission helping OSU to understand local working conditions. Once underway, work proceeded at a good pace, and OSU researchers were obviously enthusiastic about what they accomplished in Niger. The Mission appears quite satisfied with OSU's effort and professionalism. The OSU report recommendation for establishment of a savings mobilization project was discussed above.

d. Field Research -- Bangladesh and the Philippines

The OSU involvement in Bangladesh and the Philippines was more limited than in the other countries. In Bangladesh, OSU performed a monitoring and advisory role for the Mission separately from work performed by the prime contractor Robert R. Nathan Associates. OSU carried out, nevertheless, important research based upon unique data generated by the prime contractor which served as the basis for studies of transaction costs, deposit mobilization and loan recovery. An unanticipated result of the analysis of transaction cost analysis was that some institutional loan costs were found to be too <u>low</u> -- an indication of inadequate loan screening.

The working relationship between OSU and the prime contractor appears to have been quite good, and OSU also appears to have had excellent rapport with the Mission. Yet one is left questioning the lasting impact of these accomplishments. The principal lesson learned concerns the difficulty of conducting a meaningful policy dialogue in a setting such as Bangladesh. There was an excellent AID mission; there appears to have been close coordination among key donors; OSU fielded a good team and did solid work; individual institutions seem to have benefited from research results; and the 1986 seminar program got off to a good start with plenty of discussion of the major issues and a lot of play in the press. Yet the Mission may be at a crossroads concerning its support for the project because of the difficulty of working with RFM where political patronage seems to be the principal means of allocating funds. The prime contractor supports the OSU model of policy dialogue based on in-country research, but insists that the model is relevant only over the long haul. It suggested that the model be refined to emphasize the establishment of local data collection and research together with the cultivation of working relationships with key officials.

A major challenge facing AID is how to work with a model that is relevant only over the long-term, when institutional memory is little longer than the average tour of staff duty. One partial solution is to maintain a long-term working relationship from Washington with an outside institution which provides consistency of individual contacts. One of the surprising things about this project was its apparent independence from the predecessor Rural Finance Experimental Project (RFEP). For example, an OSU Master's thesis contains the following statement: "This study could not include interest rate as a variable in the model because of uniform interest rates across districts." Yet the RFEP, completed just a few years earlier, was designed partially around varying interest rates. In the Rural Finance Project, one yearns to hear about the rural bank branches involved in the RFEP. Are they continuing to mobilize deposits at the earlier rates? Has their loan recovery continued to be better than average? And so forth. At the level of field research, there seems to be almost no connection between the RFEP and present Rural Finance Projects. This is an unfortunate development that might have been avoided if one research institution had been involved in both projects, in some capacity.

The Philippine project calls for OSU to perform specific studies and applied research to provide the Mission with independent analyses of the impact of policy changes with emphasis on savings mobilization. OSU's involvement is being negotiated and will apparently parallel its monitoring role in Bangladesh, once the prime contractor is in the field. OSU has recently started work.

3. Technical Assistance

Technical assistance consisted principally in the work of long term advisors in the Dominican Republic, Bangladesh, and Niger. They were supported by outside consultants and staff of local institutions. AID Missions virtually unanimously praised the high quality of these professionals and the importance of their contributions. In most cases, technical assistance involved local staff in all project activities, that is, in demonstration projects, field research and dissemination activities. Also, technical assistance was occasionally carried out at the highest levels by OSU, such as the economic studies department of the Dominican Republic Central Bank.

4. Dissemination

Dissemination activities consisted of seminars and workshops to discuss research, distribution of reports to key individuals, extensive personal contacts, and an impressive list of publications in academic journals. Some concern has been expressed that OSU may not have reached all of the people it needs to reach, such as commercial bankers and union leaders. These people might be more effectively reached though articles in professional or trade journals or other means. On balance, however, OSU has done a successful job of dissemination. For instance, commercial bankers do not need to be told many of the things that make up the OSU message, such as the importance of savings mobilization, controlling costs, loan recovery, and so forth, and are not interested in hearing many of the others, such as potential for savings mobilization in rural areas. The seminar-workshop approach seems well suited to policy dialogue objectives. One informant commented that his particular Mission would have been happier simply with <u>more of the same</u> in the area of dissemination, even at the expense of research.

Well-done seminars and workshops appear to be an excellent means of dissemination with considerable potential for impacting policy dialogue. The seminar organized in Bangladesh is a case in point: It received good press coverage, which brought the discussion of the research agenda to millions of people. One suggestion concerning seminars is to slow the pace of presentation and to give local policy makers more time to discuss issues. A seminar which appears to be a forum draws more policy makers. By and large, policy makers welcome the opportunity to discuss difficult issues with colleagues and informed experts, but they are not used to the passive lecture format.

5. Project Impact

This project has had an impact on policy makers in the donor community, host countries, and local financial institutions. Exact measurement of the impact, however. is not possible. Many factors besides OSU's policy oriented research affect decision makers, and some of these factors -- perhaps the majority -- may be a varying mix of political, social, etc., factors. Also, the problem of separating the impact of this project from earlier OSU efforts is unsolvable.

OSU appears to have had considerable impact on donors because policies and projects seem generally but not always consistent with the "new style" rural financial markets orientation. There is a high degree of cooperation at most project sites among the various donors, particularly the World Bank and the Asian Development Bank, with the Inter-American Development Bank agreeing in most instances.

In the next section we consider some specific examples that describe project impact at the close-in range of individual Missions and countries.

In Honduras, the project had a negligible impact on the host country because of political considerations. Such considerations, however, do not explain the private sector's lack of support for the major policy objective of freeing interest rates by, for example, the largest private commercial banks. In any country, government policy is influenced by factions that support or oppose certain policies. It was a great disadvantage to OSU that it was not supported by a major group which would have benefited. OSU's impact on the Mission, however, was considerable. Although it is difficult to separate the impact of the predecessor project from this project, it is clear that by the beginning of the present project, OSU could count on a number of staunch Mission supporters for its new view policies. During this period, the Mission adopted a strong stance on conditionality issues in negotiations for a larger financial sector project.

This position was unacceptable to the Honduran Government, and the large project was not funded.

In the Dominican Republic, OSU had a significant impact on the Agricultural Bank and credit unions, although not all of the Central Bank and national leaders support these policies, as described above.

In Niger, OSU's impact was felt after its research report was completed. The Government of Niger showed considerable interest in the findings, if not universal agreement. After the final report became available, government officials and donor representatives held a roundtable discussion. The government liked the recommendation to establish a pilot credit union project, on the model of those in neighboring Cameroon and Togo but was understandably more reluctant to act on the recommendation to close the Caisse National de Credit Agricole.

In Bangladesh, OSU had considerable impact on the Mission. OSU was characterized as being particularly effective in keeping the Mission on track, reminding them at crucial times that the project was not an ordinary one, and that it was doing unusual and good things. OSU was also credited with encouraging development of savings mobilization and transaction costs studies. The impact on the host country was more problematic. Many individuals within the Bangladesh Bank were positively affected by involvement with the project, as were a number of key commercial bankers. At the policy making level, however, clear impact was not discernible because of a tendency to view the financial system as a means of distributing patronage.

B. Report on Domestic Resource Mobilization

Two years into the project, the S&T/Bureau recognized that it was increasingly being asked to deal with a broad range of financial system and policy issues. At the time, the PRE Bureau's Financial Market Project did not exist, and AID did not have a policy paper on financial and capital markets. Moreover, more and more missions recognized that financial factors were affecting their projects and they were promoting market oriented interest rates as part of their policy dialogue.

For many missions which did not have financial economists, and for some that did, this project was perceived as having the technical capability of analyzing financial sector issues. At the time, S&T was debating the impact of the financial sector on economic development and the role that AID could take. To provide a research basis for these concerns, S&T contracted with Dr. Maxwell Fry, Chairman of the Department of Economics of the University of California, Irvine, who has both practical and research experience in financial sector growth and liberalization. The work was to be organized in two stages:

Stage I consisted of a comprehensive review of research findings on financial sector performance in LDCs. The primary objectives were:

(a) To provide a basic reference source with comprehensive documentation of empirical evidence relevant to AID policies involved directly or indirectly with the financial sectors of LDCs;

(b) To identify the effects of different financial conditions on domestic resource mobilization and allocation, specific economic sectors (in particular, agriculture), income distribution, and employment;

(c) To devise a typology of LDC financial sectors that identifies normal, exceptionally effective, and pathological stages of financial development with respect to financial institutions;

(d) To devise a typology of financial instruments and markets that includes an analysis of both the effectiveness and ineffectiveness of various types of instruments and markets existing currently in LDCs or adaptable from industrial countries.

Stage II analyzed the effects of alternative monetary and financial policies (in particular, interest-rate and selective credit policies) on the efficiency of domestic resource mobilization and allocation through the financial sector.

The work resulted in a three part encyclopedic draft report entitled "Domestic Resource Mobilization and Allocation Through the Financial Sector." Fry will revise the report, add a regulation and supervision section, and include a list of policy conclusions. It is expected that the report will be published as a book in 1988. The first part reviews theoretical models of financial development. Part Two presents empirical tests of the financial development models presented in Part One. Part Three presents a discussion of the institutional aspects of financial development.

Part Three is the most relevant to AID and examines institutional aspects of financial development. It reviews the financial structures and experiences of a number of countries, mostly in Asia, and gives helpful generalizations about sources of difficulty and corrective actions. This kind of information could be useful to AID missions and policy-makers concerned with institutional reform and the probable effectiveness of different regulatory policies. It also relates closely to this project which is mainly concerned with micro approaches to institutional reform.

The report's Chapter Nine is a useful review of literature on indigenous financial instituions which describes how important they are and that they appear, at least in some cases, to be more efficient, effective and equitable than is commonly assumed. At no point is any consideration given to how policy-makers might devise a positive approach to these institutions. Questions regarding methods of encouragement and integration into the national financial system are simply not asked. Given the common tendency either to ignore, to try to substitute for, or to try to destroy the indigenous financial institutions, it would seem worthwhile, in a study that notes positive contributions of such institutions, to give some attention to whether and how they might be strengthened.

Parts One and Two are of greater interest to the academic community. Part One is an extended analysis of alternative theoretical models of financial development and empirical tests of their relative merits. It may have some interest as an academic exercise, but it has minimal relevance for policy makers, or for policy advocacy by organizations such as AID. Part of the reason for this is that the differences in the models is more esoteric than basic, often reflecting differences in assumptions about the real world rather than how it actually works. The empirical tests are not convincing because the data are not good and critical pieces are missing, such as the activities of the informal, unrecorded financial markets.

The Shaw-McKinnon family of neo-classical financial development models essentially ignores informal markets, whereas the neo-structuralist models include them in their theoretical framework, but lack data to include them in their empirical formulations. The two schools do not disagree about fundamental directions of financial policy. Where they do differ is, first, in their expectations about how the rest of the economy will respond to financial policy changes, and, secondly, in whether financial policy makers should, or could, make further policy adjustments to cope effectively with changing conditions after an initial "financial reform" or "shock." This is a basic dilemma for "pure" models. There is no good way to build in the learning and adaptation which happens in the real world.

McKinnon, who used to be a staunch advocate of financial liberalization and letting free markets take care of the adjustment process, has come around to the view that markets do not always function perfectly, and that some continuing policy adjustments may be desirable. This is quite close to the neo-structuralist critique.

On the other hand, Lance Taylor, the leader of the neo-structuralist camp, has recently suggested that in some settings, where inflation is basically demand-driven and basic prices (wage, interest and exchange rates) are reasonably flexible, then neo-classical Shaw-McKinnon-Fry-type stabilization programs and financial reforms can probably be successful. But where these conditions do not exist, that is where cost-push and ratchet effects of basic prices are the common pattern, then generalized monetary-policy measures are not likely to be successful. Thus leading exponents of the two schools seem to recognize that their models may be more culture specific than they originally thought. Neoclassical models work better in Asia where flexible prices and informal markets prevail, while structural models are better for Latin America, where unions are more powerful and inflation adjustments are part of economic structure.

The author is clearly in the McKinnon-Shaw camp, and he seems to be more concerned in Parts One and Two with defending his case and refuting the neo-structuralists than with establishing the agreed general principles and the remaining areas of dispute.

AID played a crucial role in initiating the interest in financial sector policies by bringing three academics (Shaw, Gurley and Patrick) to Korea in 1965 to study that country's financial system and recommend reforms. From that involvement came many of the strands of subsequent writing on financial policy and one of the test cases of financial liberalization that has been studied and cited by practically all students of financial policy. The attempt to build the experience of Korea and a few other countries into a generally applicable model of financial reform is probably not a very worthwhile undertaking, but it seems to be the intent of Parts One and Two of this report.

CHAPTER III. CROSS-CUTTING ISSUES

This chapter presents a broad and more general discussion of steps taken by AID, OSU, and others with respect to the development of Rural Financial Institutions (RFI) under this project. The chapter is set up as a series of questions.

1. Should AID concentrate on RFM or national finance?

At present, the World Bank and the IMF have both the personnel for and the task of assisting with macroeconomic policy and, to a lesser extent, on national financial development. There is no other donor agency which focuses on assisting rural financial development, although some Canadian and Scandinavian groups are active in credit union assistance. Nor is there any institutional parallel to OSU where research and training in rural financial markets is undertaken to the extent and degree that it now is. Meanwhile, many LDC's would clearly benefit from developing viable RFI's. Therefore, there is both a need and capacity for AID to continue its assistance to the development of RFM, even though certain additional resources are needed to make its involvement more effective.

The question of broad, macroeconomic policy dialogue involvement is more complicated. To the extent it requires participation in a macroeconomic policy dialogue (as it often must since interest rates and exchange rates are often key in a financial reform, even just for RFM development), it takes AID somewhat beyond its normal capacity, although there may be cases where it is needed. To the extent that it requires more narrowly focused assistance in improving national bank or financial market regulation, mechanisms such as check clearing, or banker training it is desirable for AID to become involved. However, the Team felt that AID has and ought to continue to have a special role as a lead agency in promoting RFM. This is an area where it has no peers, where development is clearly consistent with AID priorities, and where needs are urgent.

2. Should AID undertake RFM and macroeconomic policy dialogue?

Changes in policies to support RFM development often involve broad financial and macroeconomic reform. It is natural that AID should consider what role it should play in this dialogue. AID is often interested in influencing policy for rural financial market development. This is best done by communicating not just occasionally with top level people (as might a Mission Director), but more frequently with others at a working level as well. By explaining, helping craft alternatives, and answering new questions the policy perspective (if it is cogent and applicable) becomes much more embedded in the thinking of people than through external pressure or "leverage."

Under this project, OSU developed a policy dialogue model which has three basic elements. First, it is "extended," that is, it is expected to go on for relatively long periods of time. For instance, in Honduras OSU has been working for about five years and in the Dominican Republic, some four years. Financial sector policy changes are not made quickly and, once made, some time lapses before impacts are measurable. Second, OSU conducts policy dialogue at three levels: (1) with international donors; (2) with officials and professionals of central banks and related institutions; and (3) with financial institutions themselves. With regard to other donors, AID and OSU recognize the importance of coordinating financial market reform proposals; otherwise, one agency may work at cross purposes with another agency. This is particulary important when financial market reforms modify interest rate structures, reserve requirements, etc., since changes may be sabotaged by the inflow of other donor funds under subsidized conditions. Under this project, OSU consulted with the World Bank on Bangladesh and Niger, the Asian Development Bank on Bangladesh, and the Inter-American Development Bank on the Dominican Republic, to urge consistent policies towards RFM.

Third, with regard to local institutions and officials, OSU has developed a mode of interaction to influence local policymakers on controversial issues in rural finance. This two-stage process is summarized as follows:

(a) **Research.** Research is undertaken within the country itself. Citing relevant studies in nearby or comparable countries is helpful but often insufficient to convince doubtful officials of the wisdom of financial reforms. This research must be carried out from a secure and influential institutional base, such as the economic research division of the central bank, and local staff should be drawn in as collaborators. This allows a good opportunity for professional interaction and builds valuable domestic support for financial reforms suggested by the studies. This model has been followed with positive results in Honduras (30 studies), the Dominican Republic (112 papers and reports), Bangladesh, and Niger.

(b) **Workshops and Seminars.** Research is disseminated in workshops where OSU, local researchers, professionals, and officials from the central bank, relevant ministries, and financial institutions participate. An important element of these workshops is the open and professional debate on RFM issues that destroys many conventional myths about financial policy, causes of distortions in financial markets, and social costs and equity consequences of overregulation of financial institutions. The active participation of local staffs from financial institutions ensures a professional understanding of the value of operations innovations, promotes effective contact with the central bank, and instills confidence for future work. The combination of locally produced research and workshop activity seems to be most promising as a useful tool when oriented to policy dialogue issues.

In the Dominican Republic, for instance, OSU provided a highly skilled and personally sympatico professor who visited frequently and worked on a broad range of issues including macroeconomics. There is no doubt that this person was useful to the Mission Director and to parts of the government. This model provides one set of circumstances under which a policy dialogue can be conducted with some success. On the other hand, it is not likely that this specific set of conditions will be frequently replicable. It requires broad skills, good personal chemistry, institutional independence from AID, and nearly constant availability. Even with all these positive attributes, however, it did not produce clear cut success within the narrow range of macroeconomic reforms needed to support RFM.

Generally, if AID can provide an independent contractor who can replicate such functions, there is no doubt that this can be very useful. (An independent contractor is more likely to command confidence than an internal AID professional, who will usually be closely identified with AID's own agenda.) Experience from other countries suggests that at least one person should serve as a primary liaison and be able to call upon others who can work on different problems, but be able to receive help from the primary person in defining problems and selling solutions. Finding appropriate people for these slots can be difficult. There is no clear career path for such people, and they need to be highly skilled and, often, to have a fairly long acquaintance with the country concerned. Universities are a possible but limited source for these people, and most consulting firms have a much shorter time horizon than is needed. About all that can be said is that if it is possible to create conditions under which such people become available, there is a higher probability of successful policy dialogue.

In summary, the OSU "model" is one of a more general set of conditions in which trusted and skilled people carry on long term, broad ranging consulting and advisory service to a government. To the extent that the AID agenda is consonant with the government's objectives, that agenda can be promoted by someone who can explain, interpret, and discuss policy options with working levels as well as top levels of a government.

Policy dialogue concerning RFM may involve a set of issues ranging from procedural changes in financial institutions, to central bank regulations, to interest rate and other reforms which may impact macroeconomic policies. In dealing with the last group of broader macroeconomic and overall financial sector policy reforms, AID should continue to involve itself only occasionally and carefully and to coordinate with the World Bank, IMF, and other donors.

Macroeconomic reform is politically sensitive and requires a set of skills not now typically available internally with AID, nor easily mobilized externally. Other institutions, such as the World Bank and International Monetary Fund, are more oriented towards these issues and will typically play a leading role. However, there may be cases where AID finds itself as a major player, especially if reforms associated with RFM development lead to broader discussions. Having some internal capacity and a greater ability to call upon external experts will be helpful in such cases. It is especially important to realize that LDC's may wish to hire their own experts in such cases to insure neutrality, at least at an analytical or working level, although in some cases third party experts hired by AID can play an important role if they are perceived as being independent. These warnings are less applicable if the issues are narrower: e.g., providing assistance to specific financial training institutes. Many U.S. organizations are available to advise on technical issues such as check clearing, setting up securities markets, bank regulation and insurance, and banker training. AID has and should continue to provide funds so that such organizations can provide technical assistance to interested governments.

3. <u>How should countries be selected for RFM development?</u>

There is really no systematic procedure to assess a host country's ability to undertake necessary steps for RFM development. Missions tend to take the initiative in inviting OSU to become involved in a particular country, and OSU responds to the extent that its limited resources will allow. To be sure, there may be various levels of AID investment in a country. A low level of AID support for local research, transactions cost and case studies, training, and policy dialogue via seminars or local Mission interaction with government officials can be undertaken cheaply and with little risk. This activity may change perceptions of financial sector issues and strengthen the hand of pro-reform groups within a government. On the other hand, powerful groups often benefit from subsidized credit and will often block attempts to reduce subsidies.

For a larger amount of AID investment, an assessment should be made as to whether a government is likely to undertake certain macroeconomic, regulatory, and management reforms. At a macroeconomic level, the government should be willing to control inflation so that it is low to moderate, have savings rates be equal to or above the inflation rates, and have an exchange rate that is reasonable. (This last point reduces the likelihood of speculative runs on the local currency and insures that interest rates on savings will not have to exceed inflation by a very large amount.) Realistic pricing for rural outputs is not necessary to set up RFM, but is needed to insure that RFI savings will not be siphoned off to urban or even international borrowers. Without a favorable macroeconomic climate, it is difficult even for well run RFI's to function, and nearly impossible to establish or transform RFI's that will be viable.

The assessment should also explore whether certain regulatory changes are needed. Regulations are typically set by the Central Bank or Ministry of Finance. Regulations which mandate quantitative lending by sector or product, decree savings and lending rates, impose high reserve requirements and control the number and distribution of branches, all impede the successful development of RFI's. A more liberalized approach is needed, in which banks are not forced to lend to particular categories of borrowers, interest rates are set by market forces, and decisions about the location of branches and the services offered are determined by the RFI's. Management reforms may also be necessary to make financial institutions viable, and owners must be willing to undertake needed changes.

Because the amount of talent available to assist RFI development is limited, situations should be chosen carefully before committing significant human resources. Indeed, it is the ability to assess promising situations and respond quickly, patiently, and effectively that constitutes the greatest potential leverage that AID has. While donor funds may help strengthen the hand of pro-reform elements in a government, there must already be a significant group supporting RFM development. Otherwise, attempts to use donor funds to promote policy actions are apt to become bogged down, and scarce human resources will have low productivity.

A longer run approach would be to develop talent that could be helpful in assisting RFM development. A major limitation is probably the high cost of consultants that provide services for accounting, management, and banking firms at a multinational level. Their salaries are well beyond the levels agricultural banks are willing to pay. They also have not had relevant experience with some of the unique problems that small scale lenders encounter -- high transactions costs, highly decentralized activity, poor documentation, etc. People that can work in these difficult environments, over long periods of time, and at a variety of levels are hard to find or even develop. Outside of AID or the World Bank, there is no logical career path for them and few highly qualified young people are drawn to such a difficult and uncertain activity.

4. <u>Once a nation is chosen, how should AID become involved?</u>

This depends on the capacity and institutions in any particular nation, but some general guidelines are evident. First, as OSU has shown, local researchers should become involved in local studies of borrowers, lenders, and credit and savings. Initial work should focus on the state of existing RFI's, both formal and informal; their penetration among the rural population, and the types of products they offer. Cost studies will show levels of loan losses, costs of branches, etc. This research will provide essential information about the nature, extent, and limitations of existing financial intermediation.

Often a particular institution emerges as a major player in rural lending. This institution may be functioning poorly due to "old style" policies and poor training of staff. At this point, there has to be a three pronged effort. First, macroeconomic reforms should be addressed so that the environment supports financial intermediaries. Second, regulatory reform should allow institutions, including the target institution, to make their own decisions concerning interest rates, loan allocation targets, borrowers, and branches. Finally, there should be a program of management assistance and training. For instance, new accounting and reporting systems, more effective supervision, new product design, better review of personnel, and other issues typically must be addressed. (Even if there is not one target institution, support for this type of activity in a national bank training school can often assist interested RFI's generally, especially if they are competing private banks.)

5. <u>How can these reforms realistically be implemented?</u>

Getting governments to change policies is difficult. First, choosing situations where fiscal stringency or other pressures have created a favorable climate for reform is helpful. Coordinating RFM reforms with broader reforms supported by the World Bank and or IMF is one way to increase the likelihood that the overall environment will be supportive. Second, the process of policy dialogue is important, although at least some major players should be perceived as neutral -- i.e., not simply representing AID interests. Third, it is helpful if the process of training, persuasion, and discussion goes on over an extended period. Many of these reforms take time or must wait for favorable circumstances. In any case, governments are likely to listen to people they know, trust, and believe to be disinterested.

The OSU model to support policy dialogue is useful in this context. It suggests a continuing effort to bring around key players amidst ongoing efforts to improve RFM. That process requires a fairly broad gauge, senior person either in country or close-by over an extended period assisting the AID Mission. This set of conditions is seldom available, especially since the continuity in AID Missions (e.g., Mission Directors and staff) is usually limited to 3-4 years. This suggests a dilemma. Finding the appropriate personnel and keeping policy focused over an extended period may be quite difficult for AID. There may be only a limited number of situations in which substantial progress can be made within the job cycle of a typical Mission director.

6. Why aren't there more success stories of profitable RFI's?

There are several reasons for this, some of which have already been suggested. First, the countries chosen for major investment may not have been especially promising in terms of their willingness to undertake the necessary macroeconomic and regulatory reforms. (Most AID-assisted countries lack sophisticated financial systems, and donors are becoming increasingly aware of the need for such reforms.) This appears to be the case in the Dominican Republic (see Annex H case study) where after several years of energetic and well directed effort aimed at changing policy, there are still negative real interest rates for savers and 100% reserve requirements on deposits -- i.e., essentially complete sectoral targeting of loans. While a number of important decision makers have been persuaded of the validity of the new view, these apparently do not yet include the President of the nation or the Governor of the Central Bank. While progress has been made on the exchange rate and some interest rates, it is evident that considerable effort is still required to create the conditions under which new style institutions could emerge.

A second problem is that, especially where pro-reform forces are weak, the changes needed require a period of several years of sustained effort. The process works best when a skilled person is involved over a long period. Getting such people is not easy. Changing priorities may make success difficult.

A third problem involves the lack of management or of an overall strategy. So long as RFM development is thought of as a technical problem, the OSU-AID arrangement is reasonable. Transferring technical skills may take some time but can be compartmentalized and handled as it has been. Missions contact AID Washington (S&T), which contacts OSU, which provides research or training. OSU has stated that it did not feel responsible for overall management of RFM reform -- that was far beyond its terms of reference. It responded to requests for assistance with very limited core resources. Yet there has been a gap. No one person has had a sense of the overall picture, of how OSU's contributions would fit into a total program of action. Given the nature of the problems -- that they range from macroeconomic and regulatory to managerial, serious efforts must be made to identify the overall goal and then tailor efforts to that goal. Various groups need to be identified and coordinated. The need for a coherent vision and effective management of different resources to bring it about is perhaps the single largest factor that has limited success. To some extent, it underlies the other problems. It explains some of the surprising findings in the Dominican Republic -- the lack of branch level profit and loss statements, for example, or the lack of an interbranch funds transfer mechanism. In a program where basic institutional issues were in the forefront, many of these issues would have been addressed initially, rather than at a later stage.

While an organizational solution to this problem must rest with AID, a few observations may be helpful. First, the degree of management needed cannot come from Washington. More focus and contact is needed than can be managed from a central point. Second, the skills needed for this type of management will be scarce, but need not be resident within the LDC being coordinated or even within AID. The notion of a "circuit rider" was discussed -- someone who spends a good part of his or her time visiting RFI projects and helping keep the parts of the overall effort coordinated. This person would also be a good surveyor of possible new projects and disseminator of lessons and literature. Third, to the extent that many problems reappear in regional contexts, the circuit riders might be based in an LDC and cover a region or part of a region in order to maximize the value of shared experiences.

7. <u>How well have the research findings been disseminated?</u>

OSU has been extremely active and successful in reaching an academic and educated donor audience through its books and journal publications. It had been distributing a newsletter which was discontinued due to lack of support from AID which was certainly reaching a wider audience. In the Dominican Republic, they were extremely active in setting up seminars and meetings where the results of local research were reported, and the "new style" of RFM pushed.

There are, however, other groups which have probably not been reached and have certainly not been persuaded by the work to date. Few bankers in non-project countries appear to have been reached, and even policy makers have only occasionally (sometimes by M.A. level training and subsequent promotion) been involved. Systematic consideration needs to be given to the types of publications; seminars, national training institutes or courses, technical assistance, or visits which would reach a broader and less academic or donor oriented group. In this context, OSU's M.A. training is a valuable activity that deserves continuing and increased support. However, there are a variety of other activities which AID may wish to undertake independently or in consultation with OSU. More policy makers and bankers need to be persuaded than have been thus far.

Another dimension of dissemination is that as operational results and experiences are accumulated, these too should be spread among interested groups. Seminars which are more participatory, newsletters, and contributions to local or regional banking journals might be an appropriate way to communicate this type of finding, and also to reach groups not now interested or involved in present patterns of dissemination.

Finally, much of this information is not so much presented as sold. Therefore, a circuit rider for a region could play a valuable role in not only disseminating but marketing the findings and experiences being generated. He or she would be a useful conduit for disseminating information, synthesizing experiences, and overseeing periodic seminars or discussions.

8. Can informal institutions help RFM development?

The team took special note of the importance of studying informal financial institutions and considering their role in the overall development of RFM. OSU did an apparently good job of surveying the informal sector institutions in Niger, although a number of details about survey techniques and likely sources of bias were not covered. A further question is how well they applied these findings to their ultimate recommendations. It appeared that there were not strong or even evident links between the findings about vigorous informal institutions and the conclusion that local moneyholders would be a good basis for new formal institutions. The Fry monograph similarly acknowledges the importance of informal institutions in the theoretical section, but then goes on to summarize and interpret the empirical findings without the caveat that they ignore the informal sector. Since the informal sector is typically larger, and sometimes much larger, than the formal financial sector in rural areas and sometimes even nationally, these omissions are serious. On the other hand, Part Three and Chapter Nine of Fry look at selected countries and their financial structures and experiences, and review the literature on indigenous financial institutions. This is a useful examination which provides a link to micro approaches to institutional reform, and which opens the question (without really posing it) of how informal institutions should be treated in RFM development. The team feels that at both micro and macro levels there is a need for a wide range of additional research. Right now there is only a scant basis for saying if informal RFI's should be discouraged, ignored, or built up and ultimately integrated into national credit markets. As they seem to be more pervasive, and sometimes more equitable and efficient than formal sector institutions, a clearer sense of how to proceed is needed.

Increasingly the research and project work on rural financial markets is coming to acknowledge not only the existence but also the potential contribution to rural welfare of the many types of informal financial institutions. Despite this recognition, there remains an almost total lack of consensus as to what to do about it.

One approach has been to try to replace the informal institutions with formal ones that are at least registered with and often promoted by government. The process of replacement can be facilitated by attempting to suppress the informal institutions, or by replicating them as closely as possible with formal institutions, or by encouraging existing or new formal institutions to at least provide some similar services and thereby compete the informal institutions out of existence.

A second approach has been simply to ignore the informal institutions, to let them continue to play their role, but not take them into account, and to expect that eventually, as rural development proceeds, they will wither away.

A third approach, which has not received much attention, is to explore ways in which the existing informal financial activities in rural areas can be made more effective and beneficial to rural inhabitants with the possibility that eventually these informal institutions may grow up into, and want to become, more complex institutions that would benefit from registration and recognition as formal regulated entities.

It may be, as some of the OSU reports suggest, that the localized informal financial institutions are not well integrated into the broader national financial markets. It would first of all be useful to try to find out whether this is in fact the case. If it is, then some consideration should be given to whether the formal institutions are themselves linked into nationally integrated markets, or whether government policies discourage effective financial integration. If that is not the case then it may be worth exploring whether the formal institutions might provide financial services to the organizers or managers of informal institutions that would help to tie them more closely to the formal markets. This might be as simple as holding deposits of, or making short term loans to, the informal institutions. Or it might include introducing accounts receivable financing for small rural shops that extend credit to their customers.

AID could encourage and support further studies of informal rural financial markets in developing countries not only to understand better their present role in the societies where they are found, but also to explore ways of integrating them better into the financial fabric so that they can make a most constructive contribution to rural development and equity. Whether this would simply perpetuate the informal institutions, transform them into registered and regulated institutions, or replace them with new or existing regulated institutions would need to be worked out in each setting.

Whoever is chosen to undertake such work should be capable of approaching it with an open mind and not committed in advance to any particular outcome.

CHAPTER IV. ACCOMPLISHMENTS, KNOWLEDGE GAPS AND NEXT STEPS

This chapter gives a brief overview of the state of knowledge about rural financial markets. It describes some accomplishments and principles which are now generally accepted intellectually (although sometimes not in practice); it identifies and prioritizes some knowledge gaps for future investigation; and suggests some possible follow-on activities as next steps. The chapter is organized around these three concepts and draws upon material covered in earlier chapters. Consequently, some discussions here may be relatively brief.

A. Accomplishments

1. New View Rural Financial Markets

First, OSU has helped pioneer "new style" rural financial markets concepts and has clearly emerged as a leader in research. It has contributed several books and a large number of papers that have documented, supported, and elaborated the basic insights of the 1973 Spring Review. They have clearly persuaded academics and many in the policy community of the logic of the new view. They deserve to be congratulated for this work.

AID and OSU have played a key role in redefining the thinking about the role and structure of RFM's, and in linking their development with the broader developments in financial theory and practice. Briefly put, the 1950's and 1960's view was that subsidized credit was one way to support a particular sector, usually agriculture or industry. Credit was an input for a given output, its quantity needed being related to some predetermined input package. Institutions providing credit existed to help the chosen sector or product, and were most helpful when the credit was subsidized. The full implications of this view gradually became apparent. RFI's failed to develop a loan appraisal capacity since most credit was dictated by program requirements or sectoral allocations. And in very few cases was the availability of this type of credit shown to be of positive value to agricultural output.

The new view, which is now widely accepted among academics and many donor practitioners, is very different. It holds that rural people need functioning financial institutions for a continuing flow of financial services for a wide variety of economic activities. These services include providing a reliable source of quickly available credit for any remunerative activity; collecting savings at a positive real rate of interest; and providing for safety, liquidity, and cash transfers. The only way to provide these services in a convenient and reliable manner is to develop profitable and self-supporting RFI. Savings must be generated to reduce dependence on fluctuating budgetary support, and this implies paying a positive real interest rate to savers. An adequate spread that covers cost of funds, loan losses, administrative costs of making loans, and profit is needed to insure an adequate branch network and continued operation. Loans should not (indeed cannot effectively in any case) be targeted by sector or specific output, but made for any profitable purpose. Interest rates rather than directives and red tape should ration the credit available. The result will be more equal access to loans across income classes, less land concentration and uneconomic mechanization, and viable RFI's that promote economic efficiency and distribution.

This view is still controversial among some LDC policy makers and donor officials. Some argue that cheap government credit compensates borrowers for low, government controlled pricing or exchange rate distortions. The evidence does not support this view. Others believe that the new approach makes meeting sectoral or output targets more uncertain, although there is little evidence to support that belief either. It also makes it harder to reward favored political groups through cheap credit, often a major consideration.

2. Savings Mobilization

Second, OSU has demonstrated the importance of savings mobilization. Even if RFI's are a small part of the total financial picture -- and whether this is actually so depends on estimates of the size of the informal sector -- it is clear that they can be a significant element in mobilizing savings and contributing to rural development. Unless there are severe distortions in other markets, it seems likely that the benefits of liberalization in rural markets will out-weigh the costs, although this conclusion depends on the impact of liberalization on informal markets and the extent of the distortions in product markets. Certainly most nations today would benefit if more domestic savings could be mobilized, and if more were available in financial form. This would allow lower levels of foreign borrowing and/or higher levels of investment.

3. Transactions Costs Studies

Thirdly, OSU's recent work on transactions costs also holds promise as an effective tool for describing elements of RFI's and diagnosing preliminary problems in a particular institution. It seems likely to be especially useful in an initial assessment of the RFI situation, to be supplemented later with more functional and managerially oriented studies. There are probably only a limited number of nations in which lengthy transactions cost studies are needed at the standard of academic publishing. More nations would benefit from shorter policy oriented research. This latter type of research lays less stress on novel or advanced methodology, and more on finding and demonstrating expected results. OSU has developed a questionnaire for transactions cost analysis with a high degree of transferability across countries. This is one example of the direction that policy oriented research might take. Other possible areas are discussed in the next section.

B. Knowledge Gaps

This project is facing a juncture -- some of OSU's key theses now seem adequately verified, but new questions have arisen which need resolution. This appears an appropriate time to examine opportunities in relatively unexplored areas of research. Also, it may be desirable to broaden somewhat the scope of the program for research and institution strengthening beyond that of the existing project. Research must be directed to a greater extent to describing the conditions under which successful RFI can be successfully implemented.

First, the very notion of what kind of credit is being studied has changed and is continuing to change. The initial notion was that credit was for smallholder agriculture, often in specific crops. This was later broadened to general smallholder credit, and later to general rural credit for groups that did not have access to "normal" large scale commercial lending. There is now a growing realization that many urban groups (e.g., small scale enterprise and the informal sectors) have difficulties getting small to moderate sized loans, and that they share similar problems with those in rural areas. As the focus has shifted from programs to help crops to institutional development that will result in better financial services to the poor and small scale producers, the exclusively rural emphasis of RFI development has begun to be diluted. Given the interrelated nature of financial, product, and labor markets this is an expected and welcome development. Research needs to be conducted to make sure that accepted principles apply also to this market and to investigate any unique characteristics. In addition, a new acronym is needed.

Secondly, more emphasis needs to be given to assessing the likely commitment of a government to undertaking reforms. As previously suggested, this assessment will help AID determine how much support should be provided for RFI reform. This type of assessment is not the classic academic research, but more the informed judgement of a highly experienced person. It consists of a short visit and many questions, preferably with people that know the country, not just the government, being visited. A good circuit rider might be a good assessor but so may others.

While the assessment itself is not basically an academic exercise, there is a need for academic research that could aid the assessors. Studying what macroeconomic and regulatory conditions are favorable to RFM development is an area in which more needs to be known, based on empirical studies. How important, for example, is inflation control compared to positive interest rates, or flexibility in setting rates and selecting lenders even if funds do not come from savings? Research in this area includes analyzing the impact of financial sector liberalization combined with continuing distortions in the real sector.

Thirdly, one type of academic research which is needed is how to describe and assess a set of financial institutions in a relatively brief period, say of no more than a few months or so. Before any policies are prescribed or proscribed, a basic study of what the major sources of credit are, their interest rates and terms, type of customers, sources and costs of funds, etc. needs to be undertaken. The output needed is something like an abbreviated World Bank Financial Sector Study, but with more emphasis on informal and small scale credit. Both the informal sector studies and the transactions costs studies should fit in here, though additional work may be needed in some cases beyond the initial period. This suggestion bears some resemblance to the "Rapid Appraisal of Marketing Systems" (RAMS) approach that AID has promoted, but its purpose is fairly broad gauge, while RAMS is supposed to be focused on a well defined part of the agricultural system.

This sort of rapid depiction of a financial system would be easier if certain basic prototypes of country institutional situations could be drawn. We note below the need to study particular subtypes of situations, such as rice economies with strong minority businesses, or settled African smallholders. Better understanding of the patterns or prototypes will allow more confident analysis of nations resembling the prototype.

Fourth, there is a need to study not only the types of informal institutions, but also to study and experiment with the ways that they can be used to promote RFM development. As these institutions often form a predominant part of rural financial services, and often are better able to serve their clients than formal institutions, a more coherent strategy is needed to incorporate them. This research might require a multidisciplinary approach including RFM experts plus anthropologists, sociologists, bankers, lawyers, etc. Some suggestions are made as to how this can be done in the previous chapter.

Fifth, there is a vast range of management related research which needs to be undertaken and disseminated. The best way to judge market potential, types of services needed, siting of offices, accounting, etc., are all areas needing much more attention. This research covers a wide spectrum of subjects which may require contractors with management experience, academic researchers, or combinations of both. Included in this spectrum are "second generation" problems of financial intermediaries which recently started savings mobilization programs and must find ways to reduce transactions costs. Some research subjects could include:

- Management activities such as rapid methodologies for market studies of financial services needed; siting of branch offices; the best forms of performance incentives, supervision, accounting, etc.;

- Development of financial technologies to reduce transactions costs, such as improved infrastructure (branches, mobile units, and microcomputers), new deposit instruments, and new institutional designs and organizations;

- Assessment of credit unions as financial intermediaries: their role, structure, development, and operation. Studies should include comparisons across and within countries. Recommendations should address factors for success and institutional viability, including role of parent holding companies.

- Research procedures may have to be developed for several prototype situations of financial markets rather than for a single general case. Some countries have fledgling financial markets while others have well-developed institutional structures, and policy prescriptions may vary widely. This could be true even within a continental area. Islamic banking presents different problems in the Middle East than dc systems organized around standard western concepts. Survey techniques to determine the role of the informal sector might differ markedly in going from the Caribbean to the altiplano or from the Sahel to settled African agricultural areas, or from Asian settings without economically important ethnic minorities to those that have this characteristic.

- Methods to estimate costs of subsidized credit should be developed. Illumination of these costs, including drains on national budgets, might be useful in policy dialogue agenda to help convince host governments and donors of the need for changes. Methods need to be developed to estimate both measurable costs and also opportunity costs.

- Bad and delinquent loan causes should be investigated including recommendations for strategies to achieve reductions. Costs of bad loans can exceed all other costs of subsidized credit. Problems stem from a complex of political, social, legal, economic and institutional issues. Comparative studies among countries might be useful in articulating reasons and discovering solutions.

There are other research topics which we note here. One question which came up, but on which little work has been done, is whether it is better to reform an existing RFI or start up a new one. The Lieberson evaluation, A Synthesis of AID Experience: Small-Farmer Credit, 1973-85 noted that it was difficult to start new institutions and the success rate in Africa was lower due to the need for creating many new institutions. Until there are more success stories to study, the Team endorses this view, although the alternative of supporting a number of private or informal RFI's as well should not be ruled out. The types of assistance appropriate to a quasi-governmental Agricultural or Rural Bank may have to be very different than that extended to private or informal institutions.

Special emphasis might be placed on the best techniques to use in small countries or projects of limited size in a large nation, especially when the existing pool of local research talent is limited. The cost/benefit ratio of using expensive foreign technical assistance to do a lengthy study of informal markets when the savings or lending potential of the institutions may be less than the cost of the consultant stands as a reminder that judgement is needed in forming a research and assistance agenda.

Another question arose regarding the relation of RFM work to overall progress in financial development. Fry focuses on overall domestic resource mobilization and allocation. Arguing in the tradition of Gurley-Shaw-McKinnon, he clearly takes the view that financial reform is an essential part of economic development. Against this view is the neo-structuralist position (e.g., Lance Taylor) that partial liberalization in the financial sector can lead to negative outcomes on output and equity. The initial positions of the two camps have converged somewhat over time. It appears as though the two sides are moving towards a common framework in which the methods of liberalization can be evaluated and ameliorative policies, if needed, can be implemented. The Team felt that macroeconomic research under this program should be confined to studying the macroeconomic conditions under which RFM development is hampered or enhanced. AID may also wish to undertake separate initiatives relating macroeconomic stabilization and overall national resource mobilization and financial development. Such research would be valuable, but is beyond the scope of that necessary for RFM development.

Another facet of macroeconomic research concerns the <u>impact</u> of financial liberalization given particular sets of distortions often found in exchange rates, tariffs, or product pricing. It is at least possible that decontrol of the financial sector with continued distortions in the real sector would result in a worsening of economic conditions. There is also a need for examining the impact of such policy experiments in countries where they have occurred.

C. Next Steps

In looking at next steps, the Team felt that follow-on activities should reflect several important principles. They should:

- Build upon existing, demonstrated institutional strengths;
- Draw upon institutions' comparative advantages in different fields of expertise;
- Be flexible, to respond to new needs defined by new research and by host country requirements; and
- Develop a means to pull together AID's different interests in the financial sector.

Based upon these principles and conclusions of the evaluation, follow-on activities should concentrate in three chief areas: research, institution strengthening, and coordination.

1. Research

A large amount of effective research has already been accomplished under this project. Because of these successes, new subjects have now emerged as important. These tasks may be suitable for AID/W core funding.

a. Academic Institution(s) Role

An academic institution(s) with a capability to work on financial market issues could perform applied research and related tasks under a Cooperative Agreement or other arrangements. Sample tasks are outlined below:

- Applied research described in the "knowledge gaps" section;
- Technical assistance to stimulate local research in subjects oriented to policy dialogue;
- Dissemination of research results to academics, bankers, development practitioners, and others;
- Academic training of graduate students;
- Support for AID Mission policy dialogue efforts; and
- Advisory services to AID/W and Missions on financial markets including: short and long-term technical support, input to scopes of work, project monitoring systems, etc.

b. Individual Roles

Individuals or possibly academic institutions could perform research on macro-finance issues to complement applied research. This work might be performed under individual contracts. It could include such topics as:

- Macroeconomic and regulatory conditions which favor RFM development;
- Relationships between real and financial sector policies;
- Relationships of fiscal and monetary policies to rural and urban financial markets;
- Optimal sequencing of financial sector reforms to minimize adjustment problems; and
- Impacts, costs, and benefits/constraints of comparative regulatory practices with recommendations for optimal systems.

2. Institution Strengthening

It is obvious from OSU's work on savings demonstration projects that many financial intermediaries need technical assistance. OSU has identified "second generation" problems which arise as financial markets develop and has emphasized the importance of finding innovations in financial technology, such as mobile branches, new deposit instruments, and new forms of organization. In addition, bankers in financial regimes which are liberalizing can speed efficiency by drawing upon expertise of more sophisticated practitioners. Effective management and operations of financial intermediaries is key to improving institutional viability.

This work could be carried out by a group of organizations offering a broad range of expertise. Such a group might be formed by a management consulting firm, an accounting firm, a bank, and others. Connections with local firms are important for access to local law, practices, and language. This group might be complemented by developing lists of individual experts. In addition, central bank technical assistance could be obtained under a PASA with the Federal Reserve System, say, for bank examination, etc. Retired experts in all fields might be obtained from the International Executive Service Corps.

Activities might include:

- Technical advisory services;
- Development of on-the-job and classroom training pro-

grams;

- Dissemination of research and management information on a broader basis, perhaps with assistance of a public relations firm;
- Diagnostic studies of markets and institutions;
- Project feasibility and design studies;
- Policy dialogue support for Missions; and
- Development of training modules for host country and AID personnel.

Contracting could follow patterns established by other S&T Bureau projects, such as ARIES, which permit Mission buy-ins. After competitive bidding and contract, a work order mechanism could provide services tailored to specific needs. Alternatively, it may be possible to draw upon PRE's contract under the Financial Markets Project, which provides a broad range of technical services. It would be critically important to assure that work was consistent with research findings.

3. Coordination

AID is undertaking a large variety of financial sector activities in several bureaus, all of which draw, to some extent, upon this research project for intellectual stimulus. The degree of coordination among bureaus is not clear; it appears to be ad hoc without formal institutional requirements. Some might consider this coordination question establishment of overly rigid inter-bureau clearance procedures. This area is close in concept to Chapter III's discussion of the need for management or an overall strategy in financial sector projects.

The Team does not see an easy and practical resolution to the need for coordinating a range of capabilities -- strategic and sectoral policy guidance, operational research, applied short-term technical assistance -- in addressing financial sector problems. Several plans have been discussed, but each has drawbacks. One plan might be to ask OSU to undertake this role; however, OSU is not sufficiently staffed nor is the task suitable for a research-oriented university faculty. A second alternative might be to divide this role between management-oriented consultants and research-oriented academics, perhaps with a prime contractor who draws upon a variety of subcontractors' expertise for specific tasks, somewhat like PRE's Financial Markets Project. Here, the problem is the question of suitably qualified entities: Which firm? Which individuals? Which persons for which tasks? Can they do the job required? A third alternative might be to undertake the role within AID where the basic notion might be a new "center" unit supported by regional financial sector officers (somewhat akin to "circuit riders"). Such a structure might require AID to hire a staff of, say, five highly qualified individuals who have both theoretical knowledge of financial economics and practical knowledge of banking. Perhaps, this plan could be tried on a less ambitious, experimental basis with substantially more modest staffing by drawing upon some existing AID staff to cover mini-regions with a narrower substantive focus. If successful, it could be expanded.

There are, however, some steps which AID might take at little or no cost: first, establishment of a Financial Sector Working Group and, second, establishment of a Central Coordination Unit, outlined below.

a. Financial Working Group

It might be useful to form an AID Financial Sector Working Group with representatives from bureaus interested in financial market development. This Working Group might be patterned after AID's Sector Councils, but with a considerably narrower focus and reduced role. It could include representatives of S&T, PRE, FVA, PPC, and geographic bureaus and could be expanded or contracted. It could start on an experimental and informal basis, perhaps of the brown bag lunch variety. Activities could include:

- Assuring the flow of information and exchange of ideas among bureaus on financial market development;
- Coordinating AID programs and projects in research and institution strengthening;
- Disseminating information on research results and project activities within AID; and
- Maintaining liaison with other donors.

b. Central Coordination Unit

A central unit might coordinate the effective delivery of follow-on project services at the right time and place. This task must continuously balance demands between research and institution building, between academic and consultant objectives, between Mission ambitions and host government desires. This unit needs to have a broad perspective of financial sector activities so that it can match Mission and bureau needs with academic and consultant capabilities. AID/W might prefer to maintain control of this function with staff assistance from preferably, a consulting firm, or possibly, a university. This unit might have several tasks:

- Assisting Missions to develop projects by providing experts to participate in policy dialogue agenda; by helping conceptualize and guide design of technical assistance, research activities, and training; and by reviewing completed studies in cooperation with others;

- Guiding the design of academic and individual research on macroeconomic and cross-cutting issues of the financial sector;

- Brokering among AID offices, academics, and consultants for performance of services; developing key contacts in various fields of expertise;

- Monitoring work of "circuit riders" (even on an experimental basis) and serving as their chief AID/W contact point;

- Developing a program to disseminate information to AID, donors, and others regarding AID activities in financial market development;

- Maintaining liaison with other donors to encourage compatibility and non-duplication of activities.

CHAPTER V. CONCLUSIONS AND RECOMMENDATIONS

This chapter addresses some of the more important conclusions and recommendations. It does not attempt to include all of the many recommendations described in previous chapters, nor is it intended to be a comprehensive list of recommendations. Consequently, this chapter's recommendations refer to previous chapters which provide amplification of subjects covered.

1. AID Role in RFM Development

The general assessment of this project is favorable. OSU's research effort was of high quality, and project staff were professional. Good field working relations were apparent. Over the course of the project, OSU has clearly emerged as a leader in research on rural financial markets.

While AID has apparently acquired an institutional conviction about the deficiencies of subsidized credit projects, and a commitment to promote viable rural financial markets, these views are not necessarily fully shared by, or at least, have not become the operational guidelines of, other development assistance agencies. Thus there remains a role for AID to play not only in acquiring a greater understanding of how rural financial markets work, but also of giving appropriate support to institutions that are attempting to fill this important function.

The rationale for this is clear. Developing RFM remains a priority need for many LDC's. Knowledge about RFM development is not widely spread, nor are other donor agencies positioned to play a major role. By virtue of its experience, ability to provide assistance in-country over a number of years, and its own priorities, AID is able to and should choose to support RFM development.

<u>Recommendation</u>: AID should continue to play an active and leading role in supporting development of and research on rural financial markets, drawing on the established strengths of OSU and incorporating contributions from other groups with complementary skills, as amplified in Chapter III.

2. Policy Dialogue

AID should involve itself in broader macroeconomic and overall financial reform only occasionally and carefully, and coordinate with the World Bank and IMF when this is possible.

Macroeconomic reform is politically sensitive and requires a set of skills not now typically available internally within AID, nor easily mobilized externally. Other institutions are more oriented towards these issues and will typically play a leading role. However, there may be cases where AID finds itself as a major player, especially if reforms associated with RFM development lead to broader discussions. Having some internal capacity and a greater ability to call upon external experts will be helpful in such cases. It is especially important to realize that LDC's may wish to hire their own experts in such cases to insure neutrality although in some cases third party experts hired by AID can play an important role if they are perceived as being independent. These warnings are less applicable if the issue is a narrower one, i.e., providing assistance to national financial institutions. Many U.S. organizations are available to advise on technical issues such as check clearing, setting up securities markets, bank regulation and insurance, and banker training. AID has and should continue to provide funds so that these organizations can provide technical assistance to interested governments.

Recommendation: AID should continue to develop both internal and external sources of individuals with capacity to undertake in financial sector policy dialogue, both in relation to rural financial markets and, when needed, broader financial sector policy issues, as described in Chapter III.

The OSU methodology to support policy dialogue appears to be suitable for illuminating financial sector issues when the correct mix of local research, workshops, individuals, and incentives are present. However, it also requires appropriate real sector policies and national commitment to support financial sector reforms.

Recommendation: AID should encourage OSU to continue to develop its policy support methodology under proper conditions, as described in Chapter III.

3. Dissemination:

Existing dissemination has worked well transmitting the results of research to academic and many donor institutions. Training at OSU has also functioned well and should be expanded. Seminars in project countries have had a positive impact, although they have not been as comprehensively successful as hoped for.

The existing system is probably weakest in reaching bankers and policy makers (and some donor agencies) that are not in a project country. Publications in non-academic journals read by bankers, local or regional newsletters; and participatory seminars are all possible techniques for reaching these groups.

Recommendation: Dissemination efforts need to be broadened to include bankers and policy makers not in project countries and to cover operational experience as well as research, as noted in Chapter III.

4. Research Needs

OSU has successfully pioneered "new style" rural financial markets concepts and has clearly emerged as a leader in research. It has successfully demonstrated desirability of savings mobilization, developed transactions costs methodology, and shown the need for improved managerial techniques.

Recommendation: AID should encourage OSU to assist local financial organizations to use proven concepts and methodologies, as described in Chapter IV.

Success in the originally defined area of savings mobilization has revealed that more and different types of research need to be undertaken.

Recommendation: AID should support additional research in new financial areas, such as: similarities and differences between RFM and urban, entrepreneurial financial needs; informal financial practices and methods of integration into financial markets; role of credit unions; related managerial research; and other subjects described in Chapter IV.

5. Follow-On Activities

AID is examining the desirability of financing follow-on activities in financial markets. It plans to examine various components which might be suitable for inclusion in a project and to invite AID/W and mission participation in this process through a conference.

Recommendation: AID supports S&T Bureau's plan to continue efforts in this area through a process of AID/W and mission participation and it may want to draw upon suggestions for research, institution strengthening, and coordination project components described in Chapter IV.

ANNEXES

STATEMENT OF WORK

I. Objective:

The objectives of this final evaluation are to:

(a) examine the contributions of the Experimental Approaches to Rural Savings project (#936-5315), carried out for AID under a cooperative agreement with Ohio State University (OSU);

(b) recommend what further research and field support activities are required, based on knowledge gaps and field support coverage gaps uncovered by the evaluation; and

(c) indicate priorities for continuation of S&T/RD's efforts in support of rural savings mobilization and financial systems improvement.

II. Scope of Work:

A. To carry out this evaluation, the contractor will:

1. Work with the AID project officer to identify and review key project documents including the original PP, the Cooperative Agreement, Mission add-on agreements, working papers and research documents, work plans and progress reports, studies, conference papers, consulting reports, and other research outputs produced by the contactors with emphasis on the work conducted in the primary countries (Honduras, Dominican Republic, Bangladesh and Niger);

2. Interview members of the OSU project team both on an individual and group basis at OSU;

3. Interview key AID, World Bank, and other contacts with knowledge of the project.

4. Examine the OSU contributions to the pilot savings mobilization projects being undertaken in Honduras, Niger, Bangladesh, Philippines, and Dominican Republic (the so called, primary countries). Representatives of the team should plan a one week visit to the project in Dominican Republic, to be coordinated by the AID project officer. The AID technical advisor to the project will accompany the team to the Dominican Republic.

5. Examine and assess the technical assistance undertaken in both the primary countries and in other countries, basing this assessment on key documents provided by S&T/RD/RRD and OSU plus direct field observation in Dominican Republic.

6. Assess the policy impact of OSU's research and technical assistance activities in primary and other countries;

7. Assess the adequacy of OSU's dissemination process for distributing the knowledge generated in the primary countries, other geographical regions, within AID, to development practitioners and learning centers (US and overseas), at conferences and professional meetings, and in books, journals and other professional outlets;

8. Assess the interaction of the Ohio State University (OSU) and other consultants and researchers around the world interested in rural finance and identify areas where improvements can be made, such as greater use of other than OSU consultants in technical assistance and field research.

9. Assess the training component of the project in terms of relevance, adequacy, and role in future or follow-on activities.

10. On the basis of the above, and incorporated into a final report, identify:

    (a) Specific major contributions the project has made in the rural savings mobilization field; emphasizing knowledge breakthroughs and their policy relevancy; contributions to policy dialogue strategies and approaches; methodological contributions; and insights into and approaches tested for institutional reform and development;

    (b) Gaps remaining in the general knowledge base important for continued work and progress in this field, with particular attention to priorities that should be addressed by AID in its future role in the savings and finance area;

    (c) AID field support needs based on perceptions of current and projected needs and the degree to which AID is presently equipped to meet those needs; and

    (d) Basic directions and priorities AID should pursue in the savings mobilization and finance field.

B. In all of the above, and especially in considering AID's future endeavors in this field of research and technical assistance, the contractor is asked to bear in mind the following questions:

- Are there savings to be mobilized and what is the structure of their source?

- What factors affect or induce savings rate increases (political stability, inflation rates, economic confidence, exchange rates, etc.)?

- How much savings can be expected from different income levels with what kind of interest rates for depositors?

- How do transactions costs affect savings rates?

- Are policy reforms (interest rates, reserve rates, tax structures) sufficient to attain institutional viability for savings mobilization? If not, what is important?

- Can reform of financial institutions be effective in the midst of other price distortions?

- Should we reform or rehabilitate existing institutions or create new ones? What are the priorities for institutional reform and development? How should AID address them?

- Are the contractors and AID paying sufficient attention to the existence of informal capital formation and credit offerings and the interrelationship between informal and formal financial markets? What are the team's recommendations for future AID work in this area?

- What research or knowledge generation remains to be done? What are the priorities as perceived through this evaluation?

C. 1. The contractor will assemble a team to carry out this work with the following make-up:

2 economists, 22 and 25 days each

1 administrator, 19 days

2 finance advisors, 18 and 15 days each

1 A.I.D. representative from the ANE Bureau

The schedule for the evaluation will require one to two days preparatory work, one day of design work for the study in AID/Washington, two days of AID/Washington interviews, three days at Ohio State, and one week in the Dominican Republic. A return trip to Washington for final coordination and presentation will also be included. The Administrator will not be required to make all the field visits. The two finance advisors will participate in the design workshop in Washington, assist in reviewing the field team's observations, and contribute to the final evaluation report. The Administrator will coordinate the contracting services and reproduce the final report, and the ANE representative will supervise the substantive developments of the team and guide the overall evaluation process. The contractor will follow the proposed time schedule shown below:

Document Review	January 1987
Evaluation Team Design and AID/W Interviews	Week of January 19, 1987
Visit OSU Campus	Week of January 26, 1987
Visit Dominican Republic	Week of February 2 or 9, 1987 (or as soon thereafter as possible)
Draft Report Presentation	March 18, 1987
Draft Report Due	NLT March 18, 1987
Final Report Due	NLT April 30, 1987

2. The evaluation will be carried out prior to March 31, 1987 and the final report will be due at the S&T/RD office NLT April 30, 1987.

3. The evaluation team will incorporate the AID project officers (POs) into AID/Washington discussions during the design phase, brief the PO's after the AID/Washington interviews, discuss all pertinent findings with the PO's after each field trip, and hold a final report seminar with the PO's, S&T/RD staff and interested AID/Washington personnel, based on the draft report.

4. The evaluation report will include a section on recommendation for design and selection of the most appropriate contractual mechanism for any follow-up activities in the area of finance research and technical assistance. This part of the evaluation will be led by the PO's, and involve the AID team members and the AID contract office. The evaluation administrator will assist with this investigation and assure its inclusion in the final report.

5. Field language interpretation will be provided to the evaluation team by the project (OSU field representatives) during the Dominican Republic (DR) field trip. The project will also cover local transportation costs in the DR and arrange for site visits and interviews.

6. The contract administrator will arrange all travel and other logistics for the evaluation, except for those set out in C.5. above.

III. Required Reports

A. The final report will be not less than forty pages nor more than sixty pages in length.

B. An oral presentation of the draft report is due March 18, 1987. The draft of the written report will be due NLT March 18, 1987. The draft report will be submitted in 10 copies plus one unbound copy. A.I.D. will provide comments to the contractor by April 13, 1987.

C. Ten (10) copies an one photo ready copy of the final report shall be submitted to S&T/RD/RRD NLT April 30, 1987.

D. The final report will incorporate the findings of the evaluation team and address the following items:

   1. A review of the historical evolution of the project with AID.

   2. An analysis of substantive contributions made by the project to AID operations, policy and institutional reforms in pilot countries, and influences on other donors' operations. (See sections II.A.4 to II.A.9 and II.A.10 (a).

   3. A critical review of research findings as stated in II.B.

   4. Identification of knowledge gaps as indicated in II.A.10(b).

   5. Recommendations with regard to II.A.10c, and II.A.10.d, and II.C.4.

Evaluation Team

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EVALUATION SCHEDULE

Dates	Place/Event	People
Jan. 13	Project organization, AID/W	Barnes, Hoover, Frydman, Tifft, Anderson
Jan. 20-22	Project briefing AID/W	All
Feb. 5 & 6	OSU, Columbus	Dappice, Hook, Gadway, Hoover, Frydman, Tifft, Anderson
Feb. 9 - 11	Dominican Republic	Gadway, Hook, Frydman, Tifft, Anderson
Mar. 5 & 6	Boston: To prepare first draft report	Gadway, Tifft, Frydman
Mar. 13	Deliver first draft report to AID	
Mar. 17	Oral presentation at AID	All
Apr. 30	Submit final report to AID	

Annex B

METHODOLOGY

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METHODOLOGY

Background

AID entered into Cooperative Agreement with Ohio State University (OSU) to develop, test, and implement techniques for mobilization of private savings in rural areas of developing countries. An overall objective of this applied research in deposit mobilization was to assess potential for developing financially viable rural financial institutions without need for public sector subsidies. This program inferred relending of mobilized funds at a margin sufficient to cover institutional operating costs, but the emphasis was clearly on savings mobilization.

The program, as it evolved, became concerned with rural financial markets in a broader sense than savings mobilization alone. It extended to matters of linkages between savings and lending, exploration of both financial and agricultural sector policies, training, technical assistance, dissemination of research results and other related issues. The agreement between AID and OSU evolved in scope and size through a series of modifications.

Specific activities took place in five primary countries, namely Dominican Republic, Honduras, Niger, Bangladesh, and the Philippines.

Provision for a project evaluation was included in the project paper, consistent with AID requirements in the AID Evaluation Handbook and in Chapter 12 of the AID Handbook 3. The evaluation was "to determine the effectiveness and technical feasibility of mobilizing private savings in adequate amounts to meet the financial capital needs of rural borrowers through mechanisms like those initiated under the savings mobilization demonstration projects."

Objectives were to:

- Examine contributions of the experimental approaches to savings mobilization.
- Recommend further research and field support activities required.
- Suggest priorities for continuation of support of rural savings and financial systems improvement.

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Sequence of Activities

The evaluation contract was designated as a minority set-aside and awarded to Social Consultants International (SCI), an "8A Firm." A contract was signed September 15, 1986. Substantial slippage occurred and revised schedule for completion was prepared. On January 13, 1987, the contractor met with the Project Officer for initial planning and orientation.

On January 20, 21, and 22 the entire mission and AID representatives met in AID facilities at Rosslyn for detailed planning of the program of work and assignment of responsibilities.

The Team except for one finance advisor, proceeded to Columbus, Ohio, on February 5 and 6 for briefings by OSU staff involved in the project. The Project Officer and a Program Office Representative accompanied the Team.

On February 9, 10, and 11 three team members were in the Dominican Republic for first-hand observations. This is one of five countries selected for the experimental project. They were accompanied by the Project Officer and Program Office Representative.

A first draft of the mission report was submitted AID on March 13 and, an oral presentation was made on March 17. Comments were received from AID, and a final report was presented on April 30.

Staff Selection

Titles for required specialists were included in the statement of work. It called for two economists, two finance advisors, an administrator and an AID representative. Terms of reference were not included for individual specialists.

Part of the team was developed directly by SCI; others strongly reflected S & T suggestion. All except the AID representative (team leader) were under the SCI umbrella. The team contained a mix of both academic research-oriented specialists who focused on the future and other more practical field implementer types who were concerned primarily with processes and comparing performances with plans. The AID representative, reflecting a broad gauge of experience and capability, served as the team leader. A continuing process of interaction took place among the team members.

Design and Orientation

Evaluation start up began with a half-day design and orientation meeting between the contractor and AID. It was attended by two representatives of the contractor, the AID Project Officer, a Division Chief, and the AID team leader.

Among the significant outputs and plans pertaining to methodology were:

- A revised time schedule was developed.
- Background documents were identified.
- A rough outline of the report was prepared.
- Strategy was firmed for planning of work and assignment of responsibilities to be taken up with a full Team meeting.

The Project Officer subsequently mailed key documents and requested OSU to send background materials, which permitted Team members to review them before the first meeting.

Work Planning and Assignment of Responsibility

The work plan was firmed at a three-day meeting in Rosslyn. This followed the design and orientation session by one week. Four major areas were covered:

- Senior officials in the Bureau of Science and Technology briefed the Mission regarding their expectations.
- The previous report outline was modified and refined.
- Work responsibility was assigned for specific sections of the report.
- Some interviews were completed with AID/W staff and, via telephone, with Mission staff.

Additional background documentation was distributed over these three days.

Certain emphases in the statement of work were introduced, including the importance of addressing follow-on needs. Numbers of person days were now also proposed to be increased by 10 percent. Time devoted to the traditional comparisons of performance with plans remained essentially unchanged, and one person was given responsibility for this area.

Field Visit to Ohio State University

About two weeks after the work planning and assignment session, five of the six-person team traveled to OSU for briefing and to question key project staff. The team was accompanied by the USAID Project Officer and a Representative of the Program Office.

For two days, five key OSU project staff gave presentations on the areas of:

- Objectives of the Cooperative Agreement.
- Background and evolution of the project.
- Highlights of country projects.
  - Honduras
  - Dominican Republic
  - Niger
  - Bangladesh
  - Philippines
- Priorities perceived for future work.

Among the many specific areas of discussion were matters relating to:

- Special challenges in carrying out the research.
- Methods of becoming involved in country projects.
- Some conclusions reached.
- Dissemination of research findings.
- Development of policy dialogue.
- Transaction costs.
- Adoption of experimental findings by other agencies.

OSU described related activities, including a brief history on major research projects, workshops and symposia, noteworthy accomplishments, publications, roster of visiting professors, and foreign graduate student involvement. A substantial library of collected documents and reports was also observed.

Questions were fielded throughout the presentations and many still remained as the session drew to a close. The Team prepared a substantial list of specific questions on the eve of the final day to assure that they would be covered by project staff. These ended up being addressed in "machine gun" fashion in the final hours of the meeting in an attempt to answer them all. The fine foundation laid out over the two days could have been profitably followed by another full day on specific questions.

Field Trip to Dominican Republic

Two days after the OSU visit, three of the six-person team traveled to the Dominican Republic to observe one of the field projects directly. They remained in the country three days, and were accompanied by the USAID Project Officer and Program Office Representative.

The OSU on-site long-term adviser returned from a new assignment in another country to assist the Team. Interviews were conducted with representatives from USAID/Santo Domingo, the Central Bank and the Agricultural Bank. Contact was also made with credit unions. Credit union and agricultural bank branches were visited.

Areas of inquiry covered such matters as:

- Perceptions and accomplishments of the project.
- Evidence of changes in mentality at the participating institutions.
- Changes in attitudes regarding subsidized loans.
- Impact regarding policy dialogue and reform.
- Philosophy surrounding savings mobilization.
- Future uses of project results.

A limited amount of data was obtained to quantify the general areas of inquiry. Additional time would have permitted closer scrutiny and confirmation of progress and results both in the participating institutions and in the field.

Report Preparation

Report preparation required innovative logistics because of the widespread locations of participating specialists. This was made possible largely because of the rather detailed outline prepared in advance and the assignment of specific sections to each individual. Draft work was also done on compatible word processor equipment which permitted merging and editing the various work contributions through a central processing point.

Initial drafting was done at home stations of the specialists, and most Team members then assembled at a common point to work on the first draft. The preliminary draft was submitted to AID for comments. Following this feedback, the team leader edited a draft final report and circulated it for comments. Comments were added and the final report was reproduced for submission on April 30, the revised due date. It complied with requirements of the terms of reference including size (40-60 pages) and numbers (10 drafts and one photo copy).

Critique of Methodology

The Team completed its assignment and achieved objectives set out for it within the prescribed time limits. This "bottom line" indication of success is perhaps the most important test of methodology.

Strengths

There were some specific arrangements that contributed to success.

- A good, experienced team leader was selected with knowledge of field conditions, project activities, and AID policies and procedures.
- A team was selected that was knowledgeable in their specialities, experienced in the field, and compatible as a working team.
- Work planning that took place after the team was organized made relatively clear what needed to be done and by whom.
- There was relative flexibility to organize and carry out the work. It was not over controlled by rigidly defined procedures.

Contract Delay

Perhaps the biggest problems preceded mobilization and were outside the area of technical performance. The time schedule was set back by delays in awarding of the contract. For instance the original due date for the first draft report was rapidly approaching before the contract was signed.

Budgeting Problems

An air of uncertainty over funding prevailed until well into the evaluation process. The contract was initially underbudgeted and was inadequate to cover prescribed staff. The contractor proceeded well into the evaluation in good faith with verbal assurances that funding would be made available to complete the evaluation and cover costs.

Planning Needs

The start-up process might have been made smoother by more intense advance planning. A more thorough listing of needs, of individual terms of reference to match these needs, and naming of staff well in advance would have greatly simplified work. Including expected person days of effort along with individual terms of reference might have reduced the budgeting problems.

Duration

Some questions may exist about the long duration of the evaluation process extending from the January 13 initial planning and orientation meeting through the April 30 final report date. Particularly in point are the series of intervals between action points, e.g., between work planning and successive field visits.

Quantification of Achievements

Methods to quantify research effort and product might be questioned. The project is applied research, not a "production-type" project. It seems, however, that a void exists in developing quantifiable indicators to test ability to mobilize savings, for example, without comparative statistics to give some quantitative measure of success.

Limits of Field Study

A final question concerns cost effectiveness and the Team's having visited only one field site. In terms of the cost of total numbers of travelers it could have been possible to send at least one person to other experimental locations. An evaluation team should be concerned about the risk of being told only what others want them to know. More intensive on-site inquiry and investigation is essential to this process.

Additional Methodology Criteria

Procedural Documentation.

Substantial amounts have been prepared by AID covering policies and procedures on project evaluation, including virtually all pertinent components, e.g.:

- When to evaluate and when not to.
- Types and forms of evaluation.
- Methods and procedures to follow.
- Why evaluations should be conducted.
- What components should be evaluated.
- How it should be scheduled.
- What are the basic concerns.
- How should it be planned.
- Make-up of evaluation team.
- How reports should be prepared and formatted.
- Evaluation follow-up.

Several suggestions can be offered. First, a comprehensive document might be helpful. The various sources could be condensed into a single document which could then be simplified by reorganization and reduction in size. Secondly, an outline would be effective as a guideline for reference. Advantage is seen in keeping instructions and procedures brief, clear, and to the point.

Research vs. Non-Research/Production Projects.

Concern exists about how the evaluation of research projects should differ from operational type projects. It is suggested here that, in principle, they can be basically the same. Inputs and outputs are obviously quite different, but they do exist in both instances. Differences in type and quality of inputs exist whether it be in the form of research techniques and visiting professors or fertilizer and seed and long-term technical assistance specialists. Output of a research project does not have a precisely planned expectation in response to some input or an easy mathematical computation of internal rates of return. In contrast, a research project starts with a thesis and does not know what the result will be. But, in both cases, monitoring and evaluation are identify results and whether corrections are needed, or, if complete abandonment of the project is indicated. With regard to evaluation methodology, it seems that similarities are greater than differences between research and non-research projects. Differences in methodology would perhaps be primarily in "fine tuning" rather than broad outline.

Quantification.

Differing positions exist regarding the need for quantification of results from research projects. It is suggested here that general "arithmetic" indications of research results should be reported and then confirmed during project evaluation. This does not necessarily suggest the use of complex and sophisticated analytical and statistical techniques. Anticipated results cannot be established in advance, in quantity, or even in type. However, numerical changes occur which are significant to assessing research results. A result need not be a precise rate of return, as might be expected from a large corporate research and development expenditure. However, to the extent possible, data should be collected to indicate potential socio-economic benefits in relation to costs because these figures may affect implementation and replicability.

Advance Planning.

Efficiency and cost effectiveness can be greatly enhanced by thorough preparation and planning. This can be accomplished through early appointment and use of the team leader if time pressures preclude this effort from regular staff. Pertinent elements include:

- Time Frames. Evaluation dates are presumably known in advance, according to existing project paper requirements, and thus permit advance planning.

- Terms of Reference. It would be helpful if the statement of work contained terms of reference for each specialty and the number of person days estimated.

- Specialists. Types of specialists should be identified corresponding to individual terms of reference.

- Consultants. If a consulting firm is used, the contract should be awarded at least six weeks before start-up to allow for organization.

- Schedules. Specific travel schedules should be firm at least a month before start-up.

- Reporting. A good technique (used in this evaluation) is to prepare a fairly specific table of contents at the beginning and assign responsibility to individual team members for drafting pertinent sections.

- Continuity. Travel can be minimized, continuity of action enhanced, and utilization of experts made more efficient if the team proceeds directly from one location to another without interruption.

Flexibility

Evaluation requires an orderly framework, but the system can be stifled by overly rigid proscription. There is risk of becoming "procedure bound" and not using common sense. Flexibility is needed to pursue the unexpected or unplanned and to avoid merely "check-off" a list of evaluation items. Too detailed procedures may require laborious reporting to address each point, even if of borderline relevance.

Impact

Development projects have a "people impact" that might be addressed in evaluations. It is perhaps even more significant when such assistance takes the intangible form of research or training. Do the people, official or otherwise, understand the purpose, objective, and intended impact of such projects? Do they know where the assistance is coming from? Do they feel better toward America because of the expenditure?

Broad Areas of Evaluation

For simplicity, evaluation methodology can be considered under four areas:

1. Processes. This measures, describes, and states the mechanical items (like cost estimates, timeliness), possibly some indication of cultural or political dimensions, etc.

2. Performance vs. Expectations. The PP normally de-

scribes specific accomplishments (End of Project Status) that a project would seek to accomplish. This area of evaluation would identify them and compare performance with expectations.

3. Unexpected Results. In research projects especially, significant results may be unexpected, incidental, or unpredictable "ripple effects." Risks posed by rigid evaluation procedures are especially great in this area. Important developments would probably not be on a predetermined list of things to evaluate. Methodology should be flexible to encourage inquiry into the unexpected.

4. Implications. Conclusions reached in a research project may suggest a follow-on activity. This, then, becomes a relevant area for inclusion.

Organizing evaluation methodology around these broad areas offers a clearly focused and uncomplicated approach.

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COMPARISON OF OLD AND NEW STYLE PROJECTS

"Old Style"		"New Style"
Agricultural (or industrial) credit at specific institution(s)	Focus	Financial markets
Farmers only	Beneficiaries	Rural or national population, regardless of occupation
Subsidized borrowing rates, to elicit investment and compensate for other price distortions.	Interest Rates	Postitive, real rates for savers. Borrowing rates provide a spread for intermediaries.
Loans only	Services Provided	Savings, loans, and other customer services
Limits customer class, e.g., small farmers	Targeting	None because of demand, fungibility, etc.
Required to ensure farmers use inputs properly	Supervision	Not required because of fungibility
Agricultural (or industrial) development banks, coops, etc.	Institutions	Multiple institutions; division of labor
Farm level impact (i.e., increases in farmer income)	Impact	Institutional viability with reduction in monoposonic profits
Impact not important if farmer income is positive in financial terms	Real Sector Policies	Market oriented policies are required

DESCRIPTION OF OSU ACTIVITIES

A. OSU Cooperative Agreement

1. Selected Countries

a. Honduras

OSU was to provide research and seminars to support the $1 million Honduras Agricultural Credit Project (No. 522-0178) which was obligated in 1982. This project purpose was to increase receptivity to policy changes and improve managerial capability to adapt to a more competitive environment. The project provided long-term advisors to the National Agricultural Development Bank and cooperatives to improve their ability to understand and analyze monetary and fiscal policies related to savings mobilization and credit allocation.

OSU's scope of work called for periodic workshops and seminars to be undertaken with Hounduran Government officials and private sector bankers to discuss policy change leading towards financial liberalization. To make the seminars more meaningful, OSU was to conduct field research at the institutional and farm levels; and research results would form the basis of seminar discussions. Three areas were selected for investigation:

- Savings mobilization studies, to include: savings performance and incentives, elasticity estimates of savings with respect to interest rate changes, non-interest rate incentives, costs of mobilizing savings, quality of service, etc;

- Lending cost studies, to include: identification of rural lending costs, measures to reduce costs, cost reductions from decentralization, and economies of scale; and

- Borrowing cost studies, to include: farm level survey, loan size impacts, implicit costs, and explicit cost trade-offs.

As a by-product of these three major areas, three minor areas were also to be investigated: credit rationing, decentralization of credit administration, and the central bank rediscount facility for basic grains. Investigations would focus on three sets of institutions: the Central Bank, National Agricultural Development Bank, and private banks.

Work was performed over a two year period starting April 1983 and ending March 1985. Studies were to be conducted with participation of Honduran professionals from the Economic Studies Division of the Central Bank, National Agricultural Development Bank, and private banks. Costs were estimated at $365,000 funded by the Mission.

b. Dominican Republic

OSU provided technical assistance to carry out the Dominican Republic Rural Savings Mobilization Project (No. 517-0179). The purpose of this pilot project was "to demonstrate the feasibility of mobilizing voluntary savings in rural areas." The project was "to suggest the desirability of major changes both in the internal financial management of participating institutions and in the set of aggregate financial policies, including interest rate policies." This project started in late 1983 and was scheduled to end in 1986. AID financing is comprised of: Mission project funds - $950,000; this project's "core" contribution of $21,000; and PL 480 funds. The project was authorized at $500,000 in August 1983 and was increased to $950,000 in August 1985.

The project had four closely linked components:

- Improvement of institutional financial viability from more efficient management of funds, reserves, loan portfolio, and loan collection;

- Establishment of savings mobilization activities at the Banco Agricola and four credit unions;

- Establishment of research capability on rural financial markets in key Dominican institutions, including the Central Bank, Banco Agricola, Catholic University, and others; and

- Dissemination of research results, particularly financial market studies, policy analyses, and accomplishments through publications, seminars, workshops, consultations with key policy makers, and training.

OSU's cost was estimated at $772,000 of which the Mission funded $751,000 and the core grant funded $21,000. Work was performed under Cooperative Agreement Amendments No. 3, 6, and 10.

This project was evaluated by Charles Blankenstein and Jerry Ladman in a report submitted in February 1985. The evaluation is highly complimentary of OSU performance and rated it "excellent overall." USAID endorsed most recommendations with the exception of comprehensive financial and fiscal reforms which were outside the scope of this pilot project. The evaluation recommended follow-on activities; making available additional funds for completing and disseminating research studies; encouraging Banco Agricola to institutionalize some savings mobilization procedure; and identifying an institutional base for credit union consultants.

c. Bangladesh

In Bangladesh, OSU undertook to perform research work to support the $75 million Rural Finance Project (No. 388-0037), first obligated in 1983. The purpose of this project was to create an economically viable rural financial system which mobilizes savings and provides credit facilities to private farmers and entrepreneurs. Project components supported Bangladesh Government policy and procedural changes in the financial system. Policy changes included interest rate increases, savings mobilization efforts, and steps to improve loan recovery. Procedural changes aimed at increasing efficiency of rural bank branches and the central bank. The $75 million included $71.7 million to support Bangladesh Government policy reforms, and disbursements made in 1983, 1984, and 1985, were attributed to the central bank discount facility. The remaining $3.3 million financed costs of advisory services, training, and a small amount of commodities. Technical services were provided in three areas: training in interest rate review methods (Dr. Maxwell Fry); central bank operations (Federal Reserve Bank of New York); and prime contractor (Robert R. Nathan/S.F. Ahmed). The interest rate advisor and the prime contractor have completed work. This five year project is scheduled to end in 1988.

OSU was to undertake two sets of activities to support this project. First, it was to perform an independent project review to assess whether the project was achieving its purpose. OSU was to monitor three types of indicators: (1) system-wide indicators reflecting system trends (e.g., agricultural credit/agricultural GDP ratio); (2) institution-specific indicators (e.g., savings mobilization); and (3) specific indicators describing development impacts of policy changes in the rural financial system (e.g., transactions costs). These indicators were to be continually reviewed to determine positive or negative trends in the rural financial system resulting from changes introduced under the project. This review supplements work performed by project consultants.

The second task required research to document changes in the rural finance system. OSU was to undertake studies in the following areas: (1) deposit savings mobilization, covering interest and non-interest savings incentives, forced vs. voluntary savings programs, cost effectiveness of innovative savings programs; (2) client transaction costs of savers' deposits and borrowers' loans; and (3) effectiveness of loan recovery measures, particularly in relation to influential borrowers. The latter two studies were to recommend methods to improve financial efficiency.

OSU's work was to be performed over the three-year period 1984-87. Original estimated costs were $562,000, comprised of $185,000 in core funding and $377,000 in Mission funding. Work is provided by Cooperative Agreement Amendment No. 7.

This project was evaluated by Haris Jafri and Richard Patten in December 1986. The report stated that OSU adequately performed its assigned activities of implementing pilot savings mobilization projects and monitoring project progress. The report did not provide detailed comments on performance by any of the consultants but addressed substantive project issues.

d. Niger

In Niger, OSU performed a comprehensive study of rural financial markets to support USAID's policy dialogue with the government. This requirement arose from the $32 million Agriculture Sector Development Grant Project (No. 683-0246), obligated in 1984. One of the two major objectives of this project was to "promote agricultural production by diminishing policy constraints to development in the agricultural sector." Five areas of policy reform were specified as essential for better resource allocation, and specific policy reforms were agreed upon except in one area. In that area, the government and USAID agreed to undertake a study of agricultural credit, particularly the informal market, to formulate appropriate policies to promote development of rural financial markets. A study of the formal market, completed earlier in the year, revealed its disarray.

OSU was to analyze the role of savings and credit in rural Niger and recommend appropriate policies to stimulate financial markets. This study was to be broad scoped. It would describe the main features of the Nigerian financial system, including policy, regulatory, and institutional environment. It would review experience of past and existing credit programs, including causes of poor repayment rates and measures for improvement; costs of targeted, supervised credit; and feasibility of a pilot savings mobilization program. It would investigate the "lender-borrower relationship" including transaction costs. It would try to assess implicit demand for credit from farm budget studies. It would conduct a field survey of formal and informal borrowers and savers.

The study was estimated to require 18 months beginning in early 1985 and was to be carried out in cooperation with a local institution, such as Institut de Reschecheс et Sciences Humaines. Cost was estimated at $777,000 of which the Mission would provide $654,000 and the core grant would provide $123,000. Work is governed by Cooperative Agreement Amendment No. 8.

e. Philippines

OSU is to perform a number of research studies in support of the $20 million Philippine Rural Financial Services Project (No. 492-0394). This project is a parallel co-financing with the $100 million World Bank Agricultural Credit Project. The project purpose is to strengthen the policy and institutional framework necessary to develop a self-sustaining rural financial system. The AID project has two components: a $17.4 million loan, which will provide resources to the Central Bank for rediscounting specified loans, and a $2.6 million grant, which will finance technical assistance, studies, and training for institutional development. The financial system had displayed familiar characteristics of repression: subsidized rediscount window, high levels of overdue loans, government subsidized agricultural credit, weak deposit mobilization, cumbersome lending procedures, proliferation of special financing programs, and regulatory restrictions on capitalization and branching. After extensive review, the Philippine Government decided to undertake comprehensive policy and institutional reforms, and both AID and the World Bank have pooled efforts to assist.

OSU is to conduct a general project review, similar to its work on the Bangladesh project, and also specific studies and applied research. The project review includes on-going monitoring and evaluation of project components, particularly research and training. This review requires: identification of key factors for monitoring; review of study terms of reference, methodologies, and results; establishment of collaborative relations with local researchers and institutions; suggestions for additional studies; suggestions for policy and program changes emerging from research findings; and organization of seminars, workshops, and training programs to facilitate policy dialogue. In addition to project review activities, OSU is to conduct studies of:

- Deposit mobilization including interest and non-interest incentives and factors associated with institutional services;
- Viability of institutions and markets including recommendations for efficiency, such as costs and returns, demand for loans and deposits, impact of policy changes, etc.; and
- Linkages between formal and informal markets, including relative importance, methods of operations, costs, ways to improve access, etc.

OSU is to collaborate with the Philippine Institute of Development Studies, a non-profit research institution, under sub-contract. Total cost of work is estimated at $539,000 over two years 1986-88. Work is provided under Cooperative Agreement Amendment No. 13, which funds $300,000 of estimated costs.

2. Other Activities

a. Guatemala

USAID/Guatemala needed a comprehensive assessment of several rural credit programs, which were part of the $ 8.1 million Small Farmer Diversification Systems project (No. 520-0255) and the $ 3.4 million Small Farmers Marketing Systems project (No. 520-0238). The Mission needed an analysis of interest rate structure, lending policies, and savings mobilization of the National Agricultural Development Bank (BANDESA), an "old style" development bank and also four cooperative lending institutions. The report was to recommend specific policies and procedures to improve efficiency of these rural savings and lending programs. After preparing the report, findings would be presented in a three-day workshop.

Under a sub-contract between OSU and Arizona State University, Dr. Jerry Ladman and Jose Issac Torrico prepared a 200-page report on BANDESA dated August 31, 1984. Costs estimated at $53,000 were financed by $33,000 of core funds and $20,000 of Mission funds. This work is provided by Cooperative Agreement Amendment No. 4.

b. Dominican Republic

OSU was to provide information on base-level rural financial institutions to help USAID design a savings and lending component in its proposed $1.5--2.0 million Commercial Farming Systems Project (No. 517-0214). OSU was to provide a report on base-level rural financial institutions (credit unions and small private banks); their status and organization; demand for credit and savings services; customer characteristics; technical assistance needs; and bank policy and regulatory modifications. OSU was to complete the work in two months starting 1986. Cost estimate was $61,000, all provided by the Mission. Work is governed by Cooperative Agreement Amendment No. 12.

c. Project Guidelines

A report entitled "Rural Financial Markets - Guidelines for AID Projects" was prepared under a letter contract to OSU by A. David Redding in 1986. This report summarized a large number of the principal conclusions of OSU research as they apply to project design. However, it was somewhat premature to develop comprehensive guidelines for AID projects because of the need for flexibility and lack of specificity to design financial sector projects. Consequently, these Guidelines have not been released for general distribution. Two of the report's implicit recommendations, however, may be useful:

- To update AID guidance on rural financial markets projects, including regional or country specifics; and
- To provide specific training to project officers and others.

d. OSU Book

OSU plans to synthesize and consolidate what has been learned under this Cooperative Agreement. Hopefully, this work can be published as a book, and the first draft is planned for the end of 1987. An outline is not available.

B. Report on Domestic Resource Mobilization

AID contracted with Dr. Maxwell J. Fry, Chairman of the Economics Department, University of California - Irvine, to prepare a comprehensive review and updating of the theoretical basis of the financial sector in economic development. This 480-page report is entitled "Domestic Resource Mobilization and Allocation Through the Financial Sector." Work started in October 1984 and was completed in September 1986. Dr. Fry conducted a seminar on financial sector development at AID in October 1986, based upon the final report.

The final report is divided into three major parts. Part 1 on theoretical models of financial development consists of five chapters that survey and criticize the existing theories of the role of the financial sector in the process of economic development. The three chapters of Part 2 on empirical testing of financial development models survey existing empirical tests and present new tests of the financial development models covered in Part 1. The test results clearly refute the predictions of some of the financial development models surveyed in Part 1. Indeed the data simply reject many of the propositions of the neo-structuralist models, but support the neo-classical or McKinnon-Shaw school models. Part 3 consisting of five chapters examines some critical institutional aspects of financial development.

FACTS IN THE LIFE OF A CREDIT UNION

When a credit union is first formed it typically operates entirely on share capital contributed by members, who usually pledge to pay in a certain amount at more or less regular intervals over time. This capital is used to make loans to members up to some maximum multiple of the value of their shares, with each loan being guaranteed by other credit union members who pledge their shares as collateral. This model is the financial invention of the last century which allows tiny financial institutions staffed by volunteers to safely make and collect loans. The credit union built and strictly operated on this model will not experience liquidity problems,* because properly executed loans can never exceed share capital, all loans are collectible, and shares, unlike savings, cannot be withdrawn without considerable advance notice.

The weakness of the model--particularly in evidence from the point of view of the savings mobilization demonstration project--is that it has an inherent bias towards borrowers. Since shares are low yielding financial assets of low liquidity, they are relatively unattractive savings instruments, of value chiefly as a means of access to credit. A person who intends, barring unforeseen events, to remain a net saver--precisely the person targeted by savings mobilization demonstration projects--will be relatively unimpressed by the services offered by a young credit union, and hence will tend to stay away, thereby creating the bias towards people desiring to be net debtors among the membership.

The typical young credit union thus tends to be borrower dominated. If some outside agency offers such an institution access to cheap credit, the tendency toward borrower dominance will become overwhelming. If, on the other hand, no outside funds are available, the unsatisfied demand for credit among the membership will cause the institution to begin seeking more loanable funds by experimenting with more attractive savings instruments, such as time deposits offering a better yield, or savings deposits offering greater liquidity. The natural course of healthy credit union development is thus in the direction of increasing borrower dominance.

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*Which is not at all the same thing as saying there is no unsatisfied demand for credit among credit union members.

The danger to which many credit unions in the third world succumb is that by abandoning the safeguards built into the original, share-based model they are, in effect, becoming bank-like intermediaries without the usual banking safeguards, notably a strong central institution that acts as a fiscalizing agent and as a lender of last resort

Any future effort to exploit the potential credit unions hold for mobilizing rural savings must begin with the establishment or strengthening of such an institution.

OBSERVATIONS ON THE DOMINICAN REPUBLIC PILOT PROJECT

The Evaluation Team met in Santo Domingo with officials of the Central Bank and Banco Agricola, in addition to USAID Director and staff. A brief field trip was made to Vega, to meet with representatives of the Banco Agricola. branch and the Vega Credit Union. These meetings give rise to a number of questions that bear on the expansion of the Dominican Republic project and more broadly on the institution of savings mobilization programs elsewhere.

To put the Banco Agricola project into perspective, it together with the four credit unions involved, comes closest to an institution-wide program of savings mobilization undertaken within the OSU Cooperative Agreement. The first branch program started on July 13, 1983. By April 1985, the savings program was in effect at all but one of the Bank's 31 branches and at 12 satellite offices. Starting in 1984 pilot savings mobilization work has been carried out with four credit unions, representing about 20% of the viable unions operating in the country. From its inception in 1983 to the end of 1986, a total of SDR 10,873,653 was mobilized at Banco Agricola. While this is a commendable beginning, starting almost from a zero base, the totals remain very small within the Bank in relation to total assets and deposits, as shown below.

Figures Given in SDR

Year	Deposits	Loans	Total Assets	Deposits/ Assets-%	Deposits/ Loans-%
1983	472,250	238,050,786	323,290,185	0.1%	0.2%
1984	2,974,418	219,951,714	348,072,333	0.9%	1.3%
1985	6,873,653	267,616,353	415,749,222	1.6%	2.6%
1986	10,873,653	254,649,597	628,016,446	1.7%	4.3%

Source: Annual Reports, Banco Agricola

The first two questions relate to the macro environment, financially and in terms of official attitudes, within which the pilot project exists. The balance of the points are management and operations oriented, and raises questions as to the technical and banking arrangements that are necessary to move ahead with an institution-wide, let alone a national program of savings mobilization.

1. Positive Real Rates: A basic tenet of the OSU message is the importance of positive real interest rates on the savings as well as the lending side. In Banco Agricola, spreads appeared adequate, with a rate structure of 6% on savings, 10% on time deposits and 14% on the new certificates (low volume as yet), vs. lending rates of 16-18%. However, with domestic inflation rates averaging 12-14% over recent years, most of the savings mobilized are earning negative real returns. It is difficult to visualize a large volume of savings forthcoming at rates of 6% and 10%. The impression at the Vega Cooperative was of a much more dynamic though smaller program. Rates on deposits are 10% for current accounts and 16% for time deposits, with lending rates up to 30% annually.

2. Range of Attitudes Within the Central Bank: It was clear that there remains a wide spread of opinion on some of the basic messages conveyed by the OSU project, including the importance of real positive rates on savings, market rates on loans to agriculture, and the reduction of targeted lending. Early in 1987, the Central Bank instituted 100% marginal reserve requirements on deposits, which are relaxed if the banking institutions follow Central Bank guidelines on loan portfolio proportions and desired sectoral lending. There is still a group within the bank which is receptive to donor supplied, targeted, low rate lending to the rural sector. Much has been done by the OSU project to convince officials within Banco Agricola, the Ministry of Agriculture and the Central Bank of the fundamental requirements for a workable rural financial system. The "policy massage" process is clearly incomplete within the Central Bank, suggesting the desirability of setting up the framework for a continuing policy dialogue where an important savings mobilization or rural financial systems project is undertaken.

3. Accounting and Information Systems: Banco Agricola does not have the accounting ability to produce branch profit and loss statements. Without such capability, it is very difficult to reward good performance or to evaluate branches against each other. Rather than treating this as a "second generation" problem, it seems appropriate to design into the early stages of an important new intermediation project, the capacity for decentralized evaluation of performance.

4. Personal Incentive: There does not appear to be a system in place in Banco Agricola to reward branch personnel for outstanding performance in developing deposit business. Again, this appears to be a basic consideration that should be incorporated from the beginning in order to enhance the chances of successful promotion.

5. Liquidity Management/Cash Flow/Loan Marketing: Several informants commented that Banco Agricola has been extremely cautious in lending out the savings mobilized for fear that large

losses or delinquency rates would endanger the program. While reasonable caution is part of the banker's trade, we learned to our surprise that at the Vega branch, only one half of the mobilized funds have been lent. There is clearly a need for training in liquidity management, asset/liability coordination and loan appraisal and marketing. One or possibly two seminars have been held on these subjects. This is a useful beginning, but what is needed is more operational and detailed training of branch and headquarters staff in appropriate techniques. Again, information systems will have to be designed to provide the required data.

6. Transfer Pricing: After three years of pilot and now institution-wide savings mobilization, the team was surprised to learn that there is no transfer price mechanism in place to charge and credit branches for absorbing and supplying excess deposits. Without this fundamental system in place, branch profit appraisal becomes impossible.

7. Loss Reserves and Debt Write-Off Policies: We learned that at the Vega credit union, there is no program for establishing loss reserves and no clear policies for debt charge offs. It was not clear whether such policies were in effect at Banco Agricola.

These are basic operating questions that should be answered early on, in order to have an established system to support branch profitability analysis and to determine costs and pricing.

Overall, the OSU project in Banco Agricola has indeed shown that it is possible to mobilize savings in both rural and urban areas. While the absolute amounts mobilized are modest, one could argue that they are surprisingly high given the fact of negative real rates of interest, and a lack of basic incentive structure within the bank. As outlined above, a surprising number of basic ingredients of normal banking practice are missing in the Banco Agricola Program.