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Rural Financial Markets and Development in Low Income Countries: Some Insights for the U.S.?

by

Dale W Adams*

During the past four decades financial markets in the U.S. have generally received high marks for the way they served farmers and rural nonfarm businesses.[1/] A large number of commercial banks, credit cooperatives, Farmers' Home Administration offices, savings and loan associations, and life insurance companies provide dependable and accessible financial services in most rural areas. The Cooperative Farm Credit System alone has become a huge borrower in the U.S., second only in size to the Federal Government. Despite this overall success, some recent criticism has been aimed at activities in U.S. rural financial markets (RFMs). A recent television program questioned the propriety of Farmers' Home Administration granting cheap loans to large landowners in Southern California, and the Government Accounting Office recently criticized where and to whom some Federal Land Banks are making sizable loans. Some observers have also questioned the role that financial markets and tax laws play in helping large farm. .s and

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* In this paper I have borrowed a number of ideas from my collegues Compton Bourne, Douglas Graham, Warren Lee and Robert Vogel.

1/ We should remember that these recent successes were preceded by a good deal of turmoil. U.S. history includes a number of attempts to improve financial services in rural areas that failed (Hammond). The two versions of the Bank of the United States, and hundreds of corporations, private banks and state banks that failed in their attempts to provide financial services in rural areas are grim reminders that a stable system does not come automatically.

corporations acquire more land on credit. The well-to-do find it easy to obtain formal loans because they have ample collateral, and tax laws allow those with high income to write off a substantial portion of their interest payment against income taxes. There has also been some recent discussion about credit quotas aimed at directing loans to high priority groups.

Despite these recent problems, many low income countries have tried to emulate, through institutional transplants, U.S. RFMs. These include formation of cooperative credit institutions similar to Production Credit Associations, supervised credit programs modeled after Farmers' Home Administration, rural private banks like those found in the Midwest, government lending agencies similar to the Small Business Administration, and credit unions along the lines of those formed in North America. Thousands of technicians and policymakers from low income countries have come to the U.S. to study our financial system. As a result of their visits, reinforced by U.S. credit technicians and foreign assistance programs, many of the policies used in RFMs around the world are close cousins to policies used in the U.S.

Despite these institutional and policy transfers, many people are very unsatisfied with the performance of RFMs in low income countries. Even with large increases in the number of institutions providing financial services in rural areas and very large increases in the funds available for rural lending, small business and the rural poor continue to have little access to formal loans in most countries. They find it even more difficult to find financial savings services, and to get loans that are medium or long term. Overall, financial markets strongly resist lending to agriculture in general and even more strongly resists lending to those who do not have ample collateral.

Some people have felt that the limited success of RFMs in LICs was largely due to the need to tailor unique financial institutions for each country to service local financial needs. As a result, a number of countries have experimented with various forms of state ownership of banks, development banks for specific commodities, credit services closely integrated with area development programs, credit programs tied to agrarian reform agencies, and lending to informal groups. While some of these institutional innovations look promising for a time, most fail to give the results desired. In the discussion that follows, I argue that two poorly understood factors are making it difficult to develop effective RFMs in LICs and that these have relatively little to do with the institutional form in which financial services are provided. I also argue that careful analysis of problems in these RFMs can provide valuable insights into difficulties that are appearing in less serious form in the U.S. (Sometimes it is easier to diagnose problems when they emerge in extreme form). While LICs may have learned a bit from us about institutional arrangements, we may be able to learn more from them about the effects of policies that adversely affect the performance of financial markets. By doing this we may be able to diagnose and treat problems that emerge in our RFMs before they become serious.

Before discussing these problems in more detail it may be useful to briefly review the contributions that finance makes to economic activities and especially to economic development.

Role of Finance

Financial intermediation is a simple process too often confused by moral judgments and political activities. It involves the passing back and forth, through some third party, of contracts among individuals who want to exchange real resources. These individuals do not want to go to the trouble of making contact with someone to effect the exchange in person. The fact that someone will do this intermediation allows an economy to realize a number of important benefits. Most importantly, financial instruments allow savers a more diversified menu of ways to hold their surpluses. In a semi-subsistence economy some households find they produce more in a given period than they prefer to consume. They may also find that the returns to alternative uses of their resources in other available production activities are unattractive. Without financial instruments these households have only two options: to consume more, or to invest their surpluses in some low return production activity. Neither of these options provide the household with incentives to substantially increase future surpluses.

In a semi-subsistence economy there may be firms or households that are producing too little to satisfy current consumption needs or to capitalize on attractive investment alternatives. These households may find it difficult to find additional real resources unless they are in close proximity to surplus households. Trading of land, labor and animal power is difficult if people are strangers and located far from each other. Financial intermediation allows surplus households to issue a claim on some of its real resources in the form of a savings deposit to someone who can more productively use these resources and is willing to buy a saver's claim on real resources by taking a loan from the intermediary. If the costs of financial intermediation are modest, society gains through real resources being transfered from producers who realize low marginal returns to producers who have higher returns at the margin. Financial markets that are working properly allow for very substantial efficiency gains.

Finance also allows households and firms to manage their risks in more acceptable ways. For the saver, liquid financial assets may be a very important way of responding to unforeseen events.

Most of us take financial intermediation for granted. We ignore how difficult it would be to carry out day-to-day economic activities without financial instruments. It would be virtually impossible to buy airplane tickets, reimburse hotel owners for their services, pay for our food, save for retirement, and make investment decisions, for example, without financial instruments. The reason Man invented and accepted financial instruments was that barter was a cumbersome, wasteful and inconvenient way to make exchanges. How many of us would save parts of our production if the only way we could do so would be to store part of our output: wheat, potatoes, or economic advice? Many of us would find that our products would not store, or that saving in these forms would be virtually impossible.

Financial instruments are a marvelous invention that allow a large variety of heterogeneous commercial transactions to be carried out with minimum transaction costs. The reason that these instruments can do this is because they are highly fungible and divisible. The increased availability of financial instruments was a major factor that allowed increasingly complex commercial transactions to emerge the past several hundred years. Capitalist as well as socialist economies owe a significant part of their growth to the inventions of money, deposits, and loans. One needs to do relatively little reading about frontier life during early U.S. History to realize how shortages of financial instruments and an unstable financial system can severely limit real economic activities.

Performance of RFMs in LICs

With few exceptions, RFMs in low income countries are plagued with serious problems, some obvious and some obscure. A number of countries have very large loan repayment problems, for example, with some government credit programs recovering less than half of the amount lent. These repayment problems blight the agencies involved, and absorb valuable management time. In most countries it is very difficult to get financial markets to service rural areas and especially the rural poor. In all too many cases the loans that do move through formal financial markets into rural areas are concentrated in the hands of the well-to-do. With rare exceptions, formal financial markets offer people in rural areas few financial savings opportunities. Those institutions that do provide deposit facilities, often require large minimum balances, pay very low rates of interest, or make it difficult for savers to withdraw deposits. In cases where some rural savings are mobilized, a significant part of these funds are moved out of rural areas and relent in the cities. It is also very difficult for most rural entrepreneurs to get formal loans that are longer in term than 6 to 12 months.

Despite very large investments in rural credit activities by foreign aid agencies, many of the financial institutions serving rural areas are in weak financial shape. Management turnover is often rapid, and political intrusions into the system are common. The onslaughts of inflation, combined with low interest rates and default often seriously erode the purchasing power of the loan portfolios of these institutions. Reporting requirements forced on these lenders by local governments and foreign aid agencies often bury the agencies in a blizzard of paperwork. I recently talked with the head of an agricultural bank in Latin America who was providing separate reports on thirty lines of credit within his agency to his government and outside aid agencies. None of these reports was useful for management decisions by the bank or the aid agencies. Lender procedures often cause borrowers to incur very large borrowing costs despite concessionary interest rate policies.

Reasons for Poor Performance

Many people are confused over the reasons for the poor performance of financial markets. The reasons are often expressed in terms of institutional failures or individual shortcomings. It is easy to assign a credit cooperative failure by pointing a finger at management or members who are unwilling to cooperate, for example. The quest for the unique institution manned by well intentioned managers to service the financial needs of rural people is seemingly endless in most countries.

My feeling is that these problems are not due to the lack of appropriate institutions or lack of capable and honest management, or to the lack of people who will cooperate. The problems in RFMs around the world are too similar to be explained by institutions and personalities. Rather, these problems are due to rural development policies and to the way financial markets have been used and abused by policymakers.

RFM problems are closely associated with ubiquitous low interest rate policies. These low and inflexible interest rates, when combined with inflation, result in negative real rates of interest being in force in most of the low income countries. These negative real rates of interest are a tax on all holders of financial assets, cause the purchasing power of loan portfolios to erode, and <u>force</u> lenders to ration their services through non-market means. Lenders use non-market rationing because there is excess demand for loans at negative real interest rates. Those who have stood in line recently to get student loans in the U.S., which carry concessionary interest rates, understand how banks work this non-market rationing system. With excess demand, the lender is very choosy about the people and firms that receive loans. Borrowers typically must have excellent collateral, provide a cosigner, and have an excellent loan repayment track record. People who have done business with the lender previously receive more favorable considerations than new borrowers because it costs the bank less to gather information about repayment capacity for old borrowers. Those who find it increasingly difficult to obtain loans when the real rates of interest are low or negative include all of the rural poor, small and new businesses, those without secure and clear collateral, and those who have never borrowed from the lender before.

In addition to selecting borrowers more carefully, the lender exercises rationing power by increasing the borrower's loan transaction costs. The lender can make the borrower stand in long lines, treat the borrower with less dignity, and on occasion ask for an under-the-table-payment in order to recieve the loan. The lender may also increase the borrower's loan transaction costs by shifting some of the lender's normal costs to the borrower. The lender can charge the borrower for loan application forms, add closing costs, and service fees, and require the borrower to pay fcr a technician to survey and approve the collateral offered for the loan. All of these techniques are used by lenders to increase the effective borrowing costs of those customers who are least profitable for the lender, without forcing the lender to refuse, outright, the loan application.

When negative real rates of interest are in force and financial markets are generally repressed, the financial system becomes much more vulnerable to political intrusions. Since it becomes much more difficult for the financial syst to mobilize voluntary financial savings, RFMs become more dependent on the central bank or the government for funds to maintain the purchasing power of loan portfolios. The political system can then force the financial system to march to political music by extending or withholding funds needed to keep the lender afloat. Because the financial system is handing out loans that include implied income transfers, those who are politically powerful press in to get a piece of the action. The political system, in turn, quickly recognizes that it can gain support by allocating these goodies to those favored few as political patronage.

Policies that repress activities in financial markets are a major explanation for the poor performance of RFMs (Shaw). The economic abuse that is heaped upon the heads of rural entrepreneurs in many countries also helps to explain some of the unsatisfactory performance. In too many countries the net results of various policies are low returns to private investments in rural areas. Overvalued exchange rates often tax agricultural exports and provide unfair competition to local producers from cheap imports. Price ceilings and subsidies to large industries further weaken rural production incentives and reduce rural purchasing power. Disincentive prices may be reinforced by the lack of public investment in rural education, transportation, marketing facilities, and technologies. This creates an unfavorable investment climate in rural areas, reduces the voluntary savings capacity of rural residents, weakens their repayment capacities and limits the opportunities for business ventures that normally emerge when vigorous economic growth is taking place. Added to this, erratic policies may present the rural producer with so much uncertainty that private investments are retarded.

Fortunately, since the late 1930's, U.S. agriculture has been vigorous and generally profitable. Lenders in the U.S. have not had to worry about lending to a weak agricultural sector. The recent slow down in agricultural productivity growth, and the increasing use of grain embargos as a part of our foreign policy may, however, result in more disruption of RFMs in the U.S.

It is clear to me that the main threat to the continued satisfactory performance of rural financial markets in the U.S. is inflation combined with regulation of some interest rates. If rates of inflation exceed the rates of interest charged or paid in financial markets for very long, predictable things begin to happen. The performance of our RFMs will appear more and more similar to the sad story being played out in low income countries.

Conclusions

Long ago Moses divided the Red Sea and allowed the children of Israel to leave Egypt. Too many policymakers and credit specialists have visions of duplicating Moses's miracle in their own financial markets. They try to command through fiats the liquidity represented by loans to divide and go in desired directions: to agriculture, small farmers, into long term loans, and to purchase productive inputs instead of consumption goods. In country after country these desires have been frustrated. Those "managing" financial markets, especially in rural areas, ought to learn from the lesson taught by wise King Cnute, an 11th Century Danish ruler of England (Holinshed, p. 731). To demonstrate that even a King who controlled most of 5 countries had limited powers, Cnute commanded the tide not to continue in on the piece of beach where he was sitting. Despite his command the tide moved in and soaked the King. While retreating from the tide, Cnute pointed out to his nobles that, although the tides worked on part of his sovereign domain, they were beyond his control. He had the good sense to retreat before the tide and publically acknowledged that, while he could causes taxes and duties to rise and fall, he had no influence on tides. The laws of gravity had more command over water molecules than did the King.

Those interested in rural financial markets ought to emulate the wisdom of Cnute and resist trying to duplicate the miracles of Moses. Financial instruments are almost as liquid as water. The irresistable pull of profits in a market economy will cause those financial instruments to flow to activities that give the user the most satisfaction. Because these instruments are as divisible as water they are virtually impossible to control by fiats from the capital city; too many actors are involved in financial intermediation to be able to override the economic forces that propel the movement of this liquidity to its highest and best use. As argued earlier, the redeeming characteristic of finance is its fungibility. Its divisibility, its liquidity, its substitutability for other activities, and the ability to divert this liquidity into a wide range of uses are the main reasons that Man invented these instruments. As Cnute found out, water is wet, and to eliminate this desirable property of water would destroy water's usefulness. Most economies are fortunate that policymakers can not destroy the fungibility of financial instruments through various credit controls. The main impact of these controls is to increase the costs of maintaining fungibility; e.g. the farmer who is forced to take a loan in-kind, in the form of bags of fertilizer, resells that fertilizer and buys those things that he really needs or wants.

Financial intermediation should play an important role in rural development in any country. Policymakers ought to focus on improving and strengthening the <u>process</u> of financial intermediation rather than trying to finesse the fungibility of finance. Interest rate restrictions and credit controls are part of the problem not part of the solution. Recent events in low income countries ought to give the U.S. clear insights into how financial markets react in rural areas under the onslaughts of inflation.

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Despite the good record of rural financial markets (RFM's) in the United States during the last four decades, some recent criticism has been aimed at similar institutions patterned on U.S. models and operating in low-income countries. This paper is concerned with objections to perceived financial intermediation practices in rural financial market administration. Even with large increases in the number of institutions providing financial services in rural areas and very large increases in the funds available, small businesses and the rural poor have little access to formal loans in most countries. With few exceptions, RFM's are plagued with serious problems, some obvious and some obscure. With rare exceptions, formal financial markets offer people in rural areas few financial savings opportunities. Many of the financial institutions serving rural areas are in weak financial shape. Political intrusions into the system are common. Lender procedures often cause borrowers to incur very large borrowing costs despite concessionary interest rate policies. These problems are due to rural development policies and the abuse of financial markets by policymakers. Interest rate controls are part of the problem, not part of the solution. ~~A bibliography citing three references is included.~~