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A CRITIQUE OF TRADITIONAL AGRICULTURAL CREDIT PROJECTS AND POLICIES

by

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Summary

Article presents a critique of the results, assumptions, and policies commonly associated with agricultural credit projects in low income countries. An outline of new views on these projects is also presented that stresses voluntary savings mobilization and positive real rates of interest. Several explanations are given why so few of these new views have been accepted by policymakers.

The past several decades aid agencies have spent large amounts of money on rural financial market (RFM) projects. These projects have been associated with substantial increases in the number of institutions providing formal loans in low income countries (LIC), as well as increases in amounts lent. Currently the volume of new agricultural loans in low income countries is between 30 and 40 billion dollars per year. In part, interest in agricultural credit

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projects results from the ease with which these projects can be carried out, and the feeling that loans are a vital part of a package of inputs needed to stimulate change in agriculture. Some policymakers have also felt that cheap credit is an effective way of treating rural poverty. This emphasis on loans to stimulate production and to help the poor has diverted attention from the basic roles that rural financial markets ought to play in development. While some attention has been given to overall resource misallocation caused by RFM policies, little attention is paid to how RFMs intermediate between savers and borrowers. Likewise, very little attention has been given to how RFM policies affect overall income and wealth distribution and how political forces use financial systems to further their own aims. Even less attention has been given to how various policies affect the vitality of RFMs.

Traditional Agricultural Credit Projects

Many agricultural credit projects carried out in the past twenty years in LICs have been similar (Donald). Part of this is due to the replication in these countries of financial institutions that were successful in several developed countries: credit unions, credit cooperatives, private banks, and supervised credit agencies (Belshaw). Additional similarities are due to the common assumptions that underlie most of these projects (Technical Cooperation Administration). Many of these assumptions relate to loan demand. These assumptions can be grouped into those relating to saver-borrower behavior, those relating to lender behavior, and those tied to the performance of rural financial markets. Common assumptions about saver-borrower behavior are that the rural poor cannot save and therefore will not respond to incentives or opportunities to save, that most farmers need cheap loans and supervision before they will adopt new technologies or make major farm investments, and that loans in-kind are used in the form granted. Common assumptions about lender behavior are that informal lenders are evil and charge borrowers rates of interest which are excessively high, that the rural poor do not receive formal loans because formal lenders are too risk averse, that nationalized lenders can be made to ignore their own profits and losses to service riskier customers and the rural poor, and that all formal lenders can be induced to closely follow government regulations in allocating financial services. At a national level it is commonly assumed that cheap credit is an efficient way of off-setting production disincentives caused by low product prices or high input prices, that loan quotas established in the capital city are efficient ways of allocating loans elsewhere, that loans should be a part of a package of inputs, that only production loans should be made, and that RFM vitality is not related to projects and policies. Recent research is showing that practically all of these assumptions are either weak or incorrect.

Because so many institutions and assumptions are similar, it should not be surprising that RFM policies and techniques in LICs are also very similar. For example, heavy emphasis has been placed on creating new financial institutions to service particular rural needs or target groups such as the rural poor. These institutions generally do not offer financial savings facilities. Instead they depend largely on central banks, government budgets, and foreign aid to fund their loans. Low interest rates are usually assigned to formal loans and savings deposits alike, thereby penalizing savers. Governments typically try to force lenders to allocate loans to priority groups through quota systems, political persuasion, nationalization of banks, or special inducements. Lenders quickly find ways to subvert many of these regulations, however.

While some RFMs work better than others, a number of common problems stand out in many countries. These include very serious loan repayment problems in all too many countries, very little medium and long term formal credit, and high loan transaction costs for some borrowers and lenders. These transaction costs discourage some from seeking formal loans, and also discourage lenders from serving certain groups. These costs include waiting in line, transportation costs, bribes, legal and title fees, paperwork expenses, and time lost from work to deal with these demands. Even more serious, in all too many countries policies have been ineffective in allocating a larger share of formal loans to agriculture in general and to the rural poor in particular because the risks, returns and costs of doing so are unattractive to formal lenders. A less obvious problem relates to the nature of innovation taking place in RFMs. Most of this innovation is increasing rather than decreasing the total cost to society of financial intermediation. Many of these "distorted" innovations are defensive in nature; that is, they emerge in response to various regulations such as loan portfolio quotas and interest rate ceilings. Most serious of all, it appears that operations of RFMs in most countries are resulting in inefficient allocation of resources, causing income and asset ownership concentration, and also causing financial resources to flow out of low income areas and, in many cases, diverting resources out of agriculture.

Over the past few years an increasing number of observers have criticized RFM performance. They argue that too little attention has been given to the economic and policy environment that influences RFM performance. These critics have also challenged the validity of many assumptions on which RFM projects are built. They are also attacking policies commonly used to influence the behavior of lenders, borrowers, and financial markets as a whole. Ubiquitous low interest rate policies have taken the brunt of these attacks.

Out of these criticisms, a new consensus has emerged on changes needed in RFM projects so that publically-stated goals and the performance of RFMs can be more closely synchronized (Lipton). Despite this consensus, there have been very few changes in rural financial market projects to date. We speculate in the last section of this paper on why these changes are slow in coming.

New Views on Rural Financial Market Projects

A key element in the new consensus is the identification of the expected real rate of interest as a major determinant of borrower, saver and lender behavior (Gonzalez-Vega, McKinnon, Shaw). Real rates are also thought to strongly influence the overall performance of financial markets. The real rate of interest is defined as the nominal rate of interest (the contractural rate) adjusted by some overall price index for the economy. When the percentage change in the price index is greater than the nominal rate of interest, the real rate of interest is negative. Generally fixed and concessionary rates of interest combined with substantial inflation in most LICs during the 1970s have resulted in negative real rates of interest in most RFMs.

Proponents of the new view argue that low real rates of interest seriously disrupt the supply side of the financial system. Because interest rates on savings deposits are low, savers minimize the amount of financial savings they hold. This forces formal lenders to rely on external funds to finance loans. Poor people in rural areas are especially disadvantaged by these low interest rates on savings. They find it difficult to assemble enough funds to acquire many types of assets. They are thus forced to hold savings in cash, crop inventories or livestock, or to consume what might otherwise be saved. Furthermore, because the funds lent in these programs are not locally mobilized, borrowers feel less obliged to repay funds that are "owned" by national or foreign governments.

Because the risks and costs of lending to agriculture in general, and to the rural poor in particular, are often higher than for loans to other parts of the economy, formal lenders tend to shy from lending in rural areas, even with government pressure to serve agriculture. Lenders have even less incentive to lend to agriculture and the rural poor when interest rate regulations set even lower rates on agricultural loans than can be charged on other loans (Araujo and Meyer). The same economic forces cause formal lenders to shorten the loan term structure and allocate their funds into a more concentrated and less risky portfolio when expected rates of inflation increase.

Governments have used a number of techniques and policies, up to and including the nationalization of banks, to force formal lenders to ignore their own profit and loss considerations, and serve some social objective or target group not reached through market criteria. Generally, the results of these efforts have been disappointing (Kane). It is virtually impossible for a government to monitor and enforce credit rationing policies when hundreds or thousands of formal loans are made in widely disbursed areas of the country. Lenders, for example, may meet the letter of the law by simply reclassifying loans to meet quota requirements.

Negative real rates of interest also disrupt loan demand. If expected interest rates are negative, the borrower may realize an income transfer by taking a loan, investing the money in a non-productive asset that inflates in value, and later liquidating the asset to repay the loan. With negative real rates of interest some loan demand may be for acquiring this income transfer rather than for making productive use of loans (Boulding and

Wilson). The excess loan demand stemming from the negative interest rates may also cause the lender to create a number of administrative hurdles that raise the loan transaction costs for potential borrowers who are not profitable clients. In this way the lender effectively discourages loan demand from some potential borrowers without violating policy mandates. In the end, lenders squeeze out small borrowers and concentrate their loans on larger borrowers who have the best collateral.

The new consensus also includes much more positive attitudes toward informal financial markets (Barton and Bouman). Informal lenders are thought to provide valuable services, and impose lower costs on most borrowers than had been generally thought. For the rural poor, informal loans may be less costly than formal loans when total loan transaction costs for the new and small borrower are carefully calculated.

The new consensus goes on to suggest that the rural poor may have much larger savings capacities than heretofore thought when they are given adequate opportunities and incentives to save (Adams). It also holds that borrowers of agricultural credit are more likely to repay their loans if a substantial part of the money lent is mobilized via savings deposits in the local area. The new consensus also holds that borrowers' loan transaction costs are more important in determining loan demand among small and new borrowers than are interest rates. In contrast, large and experienced borrowers may be very sensitive to changes in interest rates because interest payments make up a large part of their total borrowing costs and hidden loan transaction costs are negligible. The new views also posit that overall savings behavior in rural areas is quite sensitive to changes in real rates of interest paid on deposits, but that interest rates and loan supervision have a weak effect on decisions to adopt new technology or make on-farm investments. In this case, product prices are much stronger incentives. Interest rates do, however, have a very strong influence on lenders' behavior (formal lenders as well as formal savers). The interest rates also have a very powerful affect on the overall vitality of RFMs and their ability and willingness to perform vital developmental roles. With long periods of negative real rates of interest, lenders are forced to rely on permanent subsidies to cover their operating expenses, to cut back on their scale of operations or go out of business altogether.

Critics have also questioned attempts to include loans as part of a package of inputs. They argue that packaging loans and use of other similar non-market rationing devices diminishes the most attractive and useful property of finance, fungibility. It is the fungibility of money that allows it to be converted into any good or service available in the market (Von Pischke and Adams).

Some observers are also questioning the way traditional credit projects are evaluated. They argue that too much emphasis and time has been spent on trying to measure the impact of loans at the farm level. Because loans and money in general are fungible, and readily mix with other liquid assets, it is very difficult and costly to accurately measure the impact of the additional liquidity provided by a loan to farm-households (Barry Hopkin and Baker). They go on to point out that even when loans are given in-kind, it is relatively easy for the borrower to convert the goods lent into cash and use this to purchase any good or service available to the borrower (David and Meyer). Even when loans are closely supervised, it may be possible for borrowers to substitute purchases made with loan monies for purchases that might otherwise have been made with other owned liquid assets. It is very difficult to sort out the changes in household expenditures that are due to a loan, and isolate how many of these activities would have occurred without a loan. Because the farm-household impacts of loans are so difficult to measure, the new consensus holds that the performance and vitality of the lender and of overall RFMs may be more useful measures of the success or failure of a credit project. They also argue that rural financial markets ought to be encouraged to better service the financial needs of nonfarm rural enterprises. Employment by these enterprises may have a more significant impact on rural poverty than small farmer loan programs.

Key Elements in a New RFM Strategy

The new consensus on RFM projects challenges many of the assumptions and policies that have been vital parts of LIC agricultural credit projects in the past. It also argues that the results from these projects are not consistent with efficiency or equity goals. While the specific suggestions for improving the results of RFM projects must be time and place specific, a few general suggestions do emerge out of these new views.

One of the most prominent suggestions is that more flexible interest rates should be a key factor in improving the results from most RFM projects. Nominal rates of interest must be flexible so that they go up and down with inflation. Interest rate policies on both credit and deposits should be aimed at maintaining relatively stable and positive real rates of interest. Lenders (banks and savers) must expect to receive positive real returns from their financial transactions if RFMs are to function equitably and efficiently.

With more attractive incentives for savers, RFMs could be encouraged to mount major saving mobilization schemes in rural areas. Changing the image of who owns the money lent will improve loan repayment. If formal lenders were able to depend less on central banks, foreign aid and government budgets for funds, they would experience less political interference. If lenders like cooperatives were able to provide attractive savings deposit facilities to their members, it would give more cooperative members strong reasons for being active members. In early stages of development, savings mobilization should receive top priority in RFM activities, and loans should receive secondary attention.

In most cases it also appears that the building of new specialized credit institutions to service fragmented needs in rural areas should receive less attention. Rather, attention should be directed to understanding why existing financial institutions are not providing the types and amount of services desired. Policy changes should be aimed at providing more incentives to existing lenders to expand their services in the desired directions.

Governments and aid agencies must also be careful when they introduce additional loanable funds into RFMs via special rediscount facilities in central banks. If these facilities provide funds to RFMs at lower rates than rural lenders are required to pay on savings deposits, lenders are discouraged from aggresively mobilizing voluntary savings deposits. Loan guarantees or adjustments in reserve requirements may be better ways to encourage lenders to service particular target groups.

Finally, RFM projects would be improved if designers and policymakers stopped viewing loans as inputs similar to fertilizer, labor, seeds, or breeding stock. Rather, loans must be viewed for what they are, pieces of paper that allow the borrower command over additional goods and services that may or may not be used for the purposes stated in the loan application. Instead of trying to ration this command over resources in predetermined lumps to thousands of borrowers, policymakers should provide proper incentives for lenders-mobilizers to perform in more socially desirable ways. The focus should be on inducing RFMs as a whole to service better the credit and deposit needs of a much broader clientele in rural areas. Along with this, RFMs should also be given strong inducements to adopt innovations that reduce the total social costs of financial intermediation. RFMs cannot be used to transfer cheap credit to thousands or millions of small, previously unserviced farmers. If governments attempt to push this strategy, the cheap credit will mostly end up in the hands of the wealthy. Other methods must be used to help the rural poor.

Why So Little Change in RFM Projects and Policies?

There are at least four major explanations for why there has been so little change in agricultural credit projects the past several decades, even though a number of people are heavily criticizing the results of traditional projects. The first reason might be that the new views are incorrect or that they are based on faulty research or on research done on cases or areas that make generalization inappropriate. It seems to us that, while additional research would be useful, enough information is at hand and enough knowledgeable people agree on the results of this research so that the generalizations along the lines presented above are warranted.

A second reason for so little change might be that it takes a good deal of time for policymakers to understand, accept, and adopt the ideas included in the new consensus. Many of the views in this new consensus challenge dogma about RFMs that have deep historical roots whose "truth" has been reinforced in the minds of policymakers by endless repetition, numerous horror stories, and even religious teachings. Old ideas die very hard!

A third explanation might be that policymakers understand that RFM projects are not working well and that elimination of some RFM distortions might improve resource allocation and help meet equity goals. The reasons these policy changes are not made are that distortions in RFMs are often justified as off-sets to other distortions in the economic system that penalize agriculture (Vogel). These other distortions may be overvalued exchange rates, price controls on food, import regulations, taxing policies, or sectoral investment strategies favoring industry. The distortions in RFMs are second best measures to partially off-set these other distortions. To the extent that circumstances continually force the adoption of broader macroeconomic policies that penalize agriculture policymakers may feel compelled to resort permanently to concessionary priced credit programs to help the sector adopt satisfactorily to these other penalizing measures. Some argue that it would be impossible to institute appropriate policy adjustment to make RFMs perform more satisfactorily unless these other distortions are also removed. Thus, the prospects for effective reform of RFM policies becomes inextricably tied up in the difficult tasks of reforming the entire structure of the economy.

A final reason for the lack of change in RFM policies may be due to the fact that the political system finds that the current performance of RFMs <u>is satisfory</u> (Ladman and Tinnermeier). That is, political forces in the country may be more than satisfied with the results of distortions introduced by negative real rates of interest in RFMs because they result in the allocation of political patronage in the form of applied income transfers to those influential people in the economy who end up receiving most of the cheap credit. Distortions in interest rates as well as other price distortions, caused by fixed exchange rates, import and export regulations and licenses allow the political system to allocate "administrative profits." If interest rates were raised to equilibrium levels, the political system would have no cheap credit to hand out to those favored patrons and strong supporters of the political system.

One might ask why individuals in society who are disadvantaged by low interest rate policies do not organize to press for more appropriate policies. An explanation for this is that large numbers of widely disbursed individuals (i.e. small to medium-sized farmers) are disadvantaged by current interest rate policies. They are excluded from access to formal credit because of the credit rationing process. Others are paid low returns on their small savings or decide not to save at all in financial form because of the low returns, which with inflation erode the purchasing power of their savings deposits. When a large number of people are only hurt a small amount by a policy, it is difficult to mobilize these individuals into political action for reform. The opposite is true for those who benefit from low interest rate policies. Since the size of the benefit is proportional to the size of the loan, large borrowers receive very large benefits from concessionary interest rates. Many who receive these benefits are powerful individuals in the political-economic system. Any policy changes that might reduce the amount of benefits they receive through cheap credit draws immediate and strong reactions. This may be one of the reasons why a number of powerful economic interests are so tolerant of inflation. Inflation along with low and inflexible interest rate policies allow those with access to concessionary priced loans to receive large income transfers because of the negative real rates of interest. Inflation also allows the political system to mask the magnitudes and directions of the political patronage transferred through the financial system. In most cases it is not a conspiracy among a few individuals that results in fixed nominal interest rates, inflation pressures, and negative real rates of interest rates. Rather, it is a convergence of interests that result in the popularity of negative real rates of interest once they have become established through rising rates of inflation.

The new consensus attacks traditional RFM projects, and suggests ways these projects can be reformulated so that efficiency, equity and capital formation goals can be realized. These views call for a major overhual in how RFMs are used in development. Despite these strong criticisms, advocates of the new views have said very little about the nuts and bolts of translating this consensus into new policies and projects. The substantial number of articles, papers, books, conferences and workshops that have pushed these new views have not been sufficient to convince policymakers to abandon traditional RFM projects. A very small amount of experimentation along the lines of the new consensus is taking place in pilot projects in Peru and in Bangladesh, but it is surprising that more experimentation is not carried out since some of the new views can be tested in small pilot projects that have very small start-up and close-down costs. Do external aid agencies fail to push these types of experiments because they lead to self-help activities rather than large loans or grants typically involved in traditional credit projects?

We do not have a crystal ball that allows us to forecast the things that must be done to get policy changes made that are necessary to improve the performance of RFMs in LICs. Some further testing of the views presented in the new consensus is probably needed to further verify the policy changes suggested. It is also likely that more communication between researchers who are arguing for the new views and policymakers is needed to clarify the complicated and confusing issues involved. Researchers also need to do a more careful job of documenting the results of current projects and RFM policies, and clarifying the extent to which RFM distortions are or are not efficient, second-best adjustments to off-set other economic distortions. Researchers may also be able to help identify changes in policies outside RFMs that may compensate groups who lose benefits because of financial market reforms. However, this approach will only be possible in those cases where the implied subsidies flowing through financial markets are relatively small, real rates of interest are not highly concessionary or the total amount of formal agricultural credit is not large.

In those cases where real rates of interest are highly negative, large amounts of money are lent through RFMs and/or loan repayment performance is very poor, it will be very difficult to devise ways to "buy-off" through compensating policies those groups that are currently receiving major income transfers through RFMs. If a group has the power to maintain interest rate policies that result in large income transfers to them or repel repayment pressures, they likely already have the political clout to manipulate other policies such as product prices, public investments, and new technology development to their advantage.

In light of these new views, what can bilateral and multilateral agencies do to assist low income countries with RFM projects? Clearly, some support for further research and communication of the new views on RFMs is one way these agencies can contribute. Even more importantly, however, these agencies should form a united front toward individual LICs on the types of policy changes that are necessary to make RFMs perform in a more satisfactory way. It does little good for the World Bank, for example, to take a strong stand on the need for positive real rates of interest in RFMs in a given country if another aid agency is willing to lend money for agricultural credit projects in that same country with no interest rate strings attached (i.e. at negative real rates of interest).

It will be much easier for aid agencies to induce flexibility in interest rate policies in those countries where real rates of interest are already generally positive. Aid agencies, in these countries, might make maintainance of positive real rates of interest a requirement of any new project in these cases. In those countries where real rates of interest are already highly negative it will be much more difficult to encourage governments to adopt flexible interest rate policies that result in positive real rates of interest for the reasons suggested above. In these cases it may be more appropriate for the aid agencies to avoid making commitments to RFM projects until rates of inflation decline enough to result in positive real rates. When this occurs the agency might push adoption of flexible interest rate policies as part of any new loans or grants aimed at RFMs.

Twenty years ago development experts began to realize that rural people in low income countries were able to count, even though many were not able to read. Schultz, Hopper and others provided a valuable service by selling the profession on the rationality of farmers in LICs. Currently, almost all knowledgeable persons working in development respect the ability of farmers in LICs to efficiently allocate their resources and respond to product prices, input prices, and the new technology in rational ways. It is past time that the development profession recognized that these same individuals will and do make similar rational decisions when they participate in financial markets. Current low interest rate policies are making it virtually impossible to induce formal lenders to provide needed loan and deposit services to the rural poor. Financial systems will not produce the types of products needed to satisfy generally accepted development goals unless more enlightened interest rate policies are adopted.

Finally, there is a high social opportunity cost associated with the use of budgetary resources in LICs for programs that result in credit subsidies to a limited number of farmers. These resources could go to such things as crop insurance or minimum price programs that reduce the risks and costs of marketing for a much broader population of farmers. This policy shift would guarantee a far more efficient and equitable use of scarce resources than the current myopia associated with the large scale and inequitable diversion of scarce resources into short term credit programs that do little or nothing to improve the long run rate of return of agricultural investment for the majority of farmers.

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