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WORK SHEET

Rural Financial Markets in Low-income Countries: Recent Controversies and Lessons*

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Summary — Recently some researchers have criticized traditional agricultural credit policies in low-income countries. This article identifies the major points of controversy between traditional views and these new views and also summarizes the primary lessons learned from these controversies. Savings mobilization, more flexible interest rate policies, less loan targeting, and greater emphasis on improving the quality of financial services in rural areas are new views that are emphasized.

1. INTRODUCTION

During the past two decades many low-income countries (LICs) have rapidly expanded the volume of agricultural loans as well as the number of rural offices of financial intermediaries. Governments have often used credit programs to promote agricultural output, and have also attempted to help the rural poor through cheap credit. As with most development efforts, these programs have included both successes and failures. Some credit efforts, for example, have encountered serious loan recovery problems, and many LICs have found it easier to expand the volume of short-term credit than to increase long-term rural loans. Loan recovery problems, combined with relatively large transaction costs, have sometimes caused lenders to collapse.

Over the past few years a large number of studies, evaluations, and publications have challenged traditional views on rural finance. Since most of these new views are summarized in Donald (1976), Von Pischke *et al.* (1983), and Adams *et al.* (1984), we cite extensively from these sources as we outline the major points of controversy between the new and traditional views. Our presentation is divided into eight parts. The next section provides a brief discussion of the contribution that rural financial markets (RFMs) make to development. Follow-

ing sections cover the main controversies, lessons, and conclusions that emerge from the recent experience with RFMs in LICs.

2. FINANCE AND RURAL DEVELOPMENT

Most financial markets conform to the contours of the societies they serve. In those societies where economic management is centralized, lending decisions tend to be rigid, concentrated, and programmed, while in societies where production decisions are dispersed, financial markets must be flexible. In most cases financial markets play a more dynamic role in market-oriented countries than in centrally-planned economies.

Typically, intermediaries in RFMs are diverse across countries¹ but there is more uniformity in agricultural credit policy objectives, rural financial policies, and in problems encountered.² It is common for RFMs to suffer more severe problems than are found in other segments of a

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country's financial system because of the difficulty of serving clients who are widely dispersed, borrowers who make large numbers of small transactions, and clients who operate in an industry that experiences unanticipated changes in prices, incomes, and yields. Also, because adversities in rural areas often affect a large number of households at the same time, it is difficult for lenders to diversify portfolios to cushion economic shocks. Government policies biased against agriculture add to RFM problems.

Evaluation of RFM projects are often weak or misleading because the fungibility of financial instruments is poorly understood. Fungibility, or interchangeability, means that one unit of money, be it owned or borrowed, is just like any other unit of money.² An example may clarify how fungibility accompanies borrowing. Assume that, without borrowing, a farm household has two units of money and plans to spend one unit on consumption and the other on agricultural production during a given time period. Further assume that, a short time later, an agricultural bank lends the household additional money which increases the household's money holdings to three units and that the lender specifies the loan be used for agricultural production.

The household can make three choices as a result of the loan. (1) It can double its expenditure on agricultural production by using all of the borrowed money to buy agricultural inputs. This would result in 100% additionality because all of the marginal liquidity provided by the loan would be spent for agricultural inputs — fulfilling the loan objectives. (2) Alternatively, the household may decide to apply the borrowed money to buying agricultural inputs, but use all of its own money, two units, to double household consumption. This choice would result in 100% financial substitution and fulfill the letter of the loan agreement, but not the spirit. The loan would cause increased consumption, not increased use of agricultural inputs, an outcome lenders find virtually impossible to control. Some financial substitution is involved in virtually every loan. (3) It is also possible that the household may decide to divert all of the borrowed funds, as well as owned-funds, to consumption, effectively tripling consumption. The additional liquidity provided by the loan may allow the household to buy some costly consumer item that it was unable to buy with just its own funds. While this diversion of funds may be illegal, it is difficult to control when large numbers of borrowers are involved and they are geographically dispersed. Low and uncertain returns to farm investments nurture loan diversion. Moreover, granting loans

in kind does not obviate fungibility because borrowers can usually sell unwanted inputs provided by the lender in secondary markets and realize cash to buy any good or service that is available in the market.

Because of fungibility and the numerous borrowers and lenders that participate in decentralized RFMs, it is virtually impossible for policymakers to allocate loans effectively in accord with a credit allocation plan.³ For example, policymakers may program cheap loans for a crop such as rice and try to force financial intermediaries to extend loans for that purpose. The intent may be to compensate rice farmers for low rice prices through cheap credit, but the low rice prices cause the expected returns from investments in rice growing also to be low. Under these circumstances borrowers will divert the additional liquidity provided by rice loans to other activities that provide higher returns.⁴ Because of fungibility and the large number of participants in RFMs, the ability of credit planners to target loans to specific activities is illusory.

3. INSTITUTIONAL FORM

During the past 30 years many institutions have been formed to provide rural financial services in LICs.⁵ The organizational form has depended on the dominant economic philosophy of the country, the nature of the formal financial system, and the interests of international donors at the time. As a result, a large variety of rural financial intermediaries is found across LICs, and these can be grouped into four categories: co-operatives, various types of government-owned agricultural banks, rural private banks, and credit activities included in multipurpose development agencies. Most countries have experimented with more than one institutional form and often sustain several types of rural lending agencies.

Initially, many newly created credit agencies were modeled after those in high income countries. Examples of this are the farmers' associations in Taiwan and in South Korea that were patterned after farmers' associations in Japan; rural private banks in Vietnam and the Philippines based on similar banks in the United States; and credit unions in Africa and Latin America similar to credit unions in North America.⁶ A number of countries, especially in Latin America, have also formed supervised credit programs for small farmers, similar to the Farmers Home Administration's activities in the United States.⁷ Relatively few of these programs,

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however, persisted for long. In some cases the technical assistance provided was of little use to the borrower, and in most cases the costs of providing supervision was prohibitively expensive for the intermediary (e.g., Colombia, Jamaica, Dominican Republic, El Salvador). Even in the best-run programs, administrative costs are a quarter or more of the value of the loans made, well in excess of the intermediary's interest income. In some cases loan supervision turned out to be an expensive form of loan collection.

Recently, there has been greater emphasis on developing financial intermediaries unique to LICs or on strengthening existing intermediaries. Also, there is now less emphasis on substituting formal for informal credit. Recent research from various countries has shown that monopoly profits in informal lending are less than had been widely assumed and that informal lenders provide some financial services more efficiently than formal credit programs.¹⁰ Several countries, including Malaysia, have even experimented with marketing intermediaries as retail outlets for loans from government credit agencies.¹¹ An expansion of the formal credit system often causes growth in informal finance, results in more competition and reduces any monopoly profits found in informal lending.

Lessons learned

Most institutional forms for providing financial services in rural areas have had serious shortcomings or have failed in some LICs, while in other countries virtually every institutional form has been at least moderately successful.¹² While certain institutions, such as cooperatives, work better in some societies than in others, it appears that any financial intermediary will flounder if the sector it serves is heavily taxed or if financial intermediaries themselves are taxed through interest rate ceilings or targeted credit programs. Institutions that mobilize savings as well as lend are more likely to be viable than intermediaries that only lend. Policies, not organizational form, appear to be the main determinant of institutional success or failure.

4. ECONOMIC RETURNS IN AGRICULTURE

The well-being of financial markets partly depends on the economic vitality of the clients they serve.¹³ If farmers receive low prices for their products because of distorted exchange

rates, food price controls, imports of cheap food, or inefficient markets, their ability to use financial markets will be diminished; they will be less willing to borrow, less able to repay loans, and will have less capacity to save. Low and unstable yields and lack of public investment in agriculture reinforce adverse effects of low farm prices. It is much easier to develop RFMs that are self-sustaining when returns to agricultural investments are high and relatively stable, and rural incomes are increasing.

It is common for governments to attempt to compensate farmers for adverse effects of other economic policies by providing loans at low interest rates. The government may realize that farmers are "taxed" through low product prices resulting from food price controls and that this tax decreases farm production. The government may also believe that it is impossible to remove this tax and, as a result, decide to use a second-best policy of giving farmers an offsetting "subsidy" through cheap credit.¹⁴ Policymakers hope that the cheap credit will encourage borrowers to increase production and that the low-interest-rate subsidy will make up for farmers' income losses.

The second-best argument has serious shortcomings when used to justify cheap credit as an equitable and efficient way to compensate farmers for the adverse effects of other policies. When it is in their interest to do so, lenders — like borrowers — exercise fungibility and substitute targeted funds for owned funds in their loan portfolios, thus defeating the plans of policymakers who program loans. Low interest rates induce both borrower and lender to concentrate loans in the hands of the well-to-do.¹⁵ Lenders have powerful incentives to minimize their cost of lending by concentrating cheap credit in loans to a select few: e.g., those who have borrowed previously, those with excellent loan collateral, and those who take large loans. At the same time, borrowers with clout have strong incentives to capture as much of the cheap credit as possible. These reinforcing incentives result in a small number of farmers getting most of the inexpensive credit.

Because only those who receive cheap loans are subsidized by low interest rates, while all who produce the low-priced product are taxed, there is an inefficient match between the incidence of the tax and subsidy. Those with no loans, or those receiving only small amounts, get little or no compensation.¹⁶ Those who do not receive loans cannot be expected to increase the output of products with depressed prices resulting from government policy. Even those producers who receive cheap loans are not induced to make

investments that are privately unprofitable. In most cases, changes in the interest rate on a loan do not alter the relative profitability of an investment alternative whose returns may be depressed because of government action or inaction. When expected economic returns are low, producers as well as lenders exercise fungibility and divert additional liquidity to uses that provide higher private returns.

Also, because cheap loans tend to be concentrated in relatively few hands, second-best policies result in less equitable income distribution. Since the size of the interest rate subsidy is proportional to the amount of the loan, large borrowers receive large subsidies while borrowers of small amounts receive small subsidies.¹⁷ Since the majority of farmers do not get any cheap loans, they realize no subsidy. Because credit access and loan size are highly correlated with income levels and assets, the well-to-do benefit most from cheap credit. As a result, the second-best argument comes up short on both equity and efficiency grounds.

Lessons learned

It is unrealistic to expect RFMs to work well if the sector they serve is not economically healthy. Moreover, cheap credit, even if abundant, cannot compensate for low incomes or low returns to investment agriculture. Cheap credit does not make an unprofitable investment profitable and is largely captured by the well-to-do, thereby worsening income distribution.

5. POLICIES AND REGULATIONS

It has been common for governments to attempt to influence lender behavior through regulations. Many such regulations are aimed at tilting the behavior or performance of the financial system toward a preferred group or activity: e.g., small farmers, medium- and long-term loans, or land reform participants.¹⁸ Techniques used to target loans can be grouped into five categories: loan portfolio requirements, rediscount facilities, crop or loan insurance, regulations on bank branching, and nationalization of banks.

(a) Loan portfolio requirements

Governments commonly try to influence lenders through loan portfolio requirements. This may include setting floors or ceilings on

certain types of lending and placing limitations on loan size. For example, in the Philippines, Thailand, India, and Colombia banks have been required to make at least a certain percentage of their total loans for agricultural purposes. In the Dominican Republic the government has set maximum sizes on loans that can be made by the government-owned agricultural bank. The main problem with a portfolio restriction is that it is relatively easy for the lender to conform to the restriction, yet evade its intent. For example, a lender may make multiple medium-sized loans to one individual to evade a loan-size ceiling, or a lender can redefine the purpose of a loan — from that of purchasing a truck to that of an agricultural transportation loan.

(b) Rediscount facilities

Another popular policy tool has been rediscount facilities. These are windows at the central bank allowing final lenders to discount targeted loans with the central bank and receive funds at concessionary interest rates. Most of the LICs that have large and relatively well-developed financial markets make extensive use of these rediscount facilities. Governments and donor agencies have been particularly aggressive in promoting these facilities as ways of moving their funds into RFMs.¹⁹ Typically, final lenders are allowed an attractive spread between the concessionary rate paid to the central bank and the rate charged final borrowers. Wide spreads are thought to be an effective way of inducing the lender to stress targeted loans.

There are two weaknesses in rediscount facilities. First, the concessionary interest rates on rediscount lines are usually lower than the rates that intermediaries would otherwise pay to mobilize voluntary private savings. This provides powerful incentives for intermediaries to ignore private deposits which, in the long run, may result in fewer funds for agricultural lending. Second, concessionary discount facilities have a weak effect on lenders' loan decisions. As mentioned earlier, intermediaries, as well as final borrowers, exercise fungibility when it is in their interest to do so. If governments, for example, impose a low ceiling on the price that farmers receive for their crop, final lenders may be very hesitant to expand lending for the crop in question because expected farm returns for that activity are low. Lenders typically react to this by transferring their regular clients who satisfy the target criteria to the rediscount line, thereby expanding the volume of funds available for non-target lending.

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(c) *Loan and crop guarantees*

Several LICs (e.g., Mexico and Costa Rica) have made extensive use of guarantees or insurance to lessen lenders' risks from loan default. Loan guarantees from a government agency may insure that the bank will be reimbursed for a certain percentage of loan defaults,²⁰ or the guarantee may be crop insurance that is payable to the intermediary (e.g., Philippines, Sri Lanka, and India), as the insurer agrees to pay the lender a certain percentage of the loan after crop damages have been verified. The main objective of these guarantees is to induce lenders to extend more loans to a target group by transferring part of the loan recovery risk to other agencies.

There are several problems with loan and crop guarantee programs. First, they are often expensive, as governments may be forced to provide large subsidies to pay for costs of insured defaults not covered by premium payments (Sri Lanka and Costa Rica). Second, the government is also often required to subsidize administrative costs, particularly in crop insurance programs in the tropics. Third, because crop damage in these areas often affects numerous producers at the same time, a large staff is required to make timely assessments of crop damage. Finally, insurance may weaken the resolve of lenders to collect overdue loans.

(d) *Rural bank branches*

A few LICs have been very aggressive in promoting new rural banks or rural branches of existing banks. In India and Bangladesh commercial banks are forced to open a certain number of rural branches before they can receive permission to open additional, more profitable urban branches. In Vietnam, the Philippines, and Ghana donor or government funds have been used to induce the formation of private rural banks, with the funds given or lent to the new bank on concessionary terms. In some cases these funds provide part of the equity needed by the new owners.

Banks may respond to government pressure by building token branch offices in rural areas that are open only a few hours a week or that offer only a limited range of services.²¹ In extreme cases, new rural branches may simply mobilize rural savings for use in urban areas because banks may not have incentives to offer a broader range of services (India and Bangladesh).

(e) *Bank nationalization*

A number of LICs have nationalized some or all of their commercial banks. This may occur as a colony becomes an independent nation, or as part of an attempt to give governments greater control over financial intermediaries. Costa Rica, for example, nationalized most of its banks over 40 years ago, while Mexico has done so within the past several years. India, Pakistan, Sudan, and Bangladesh (also) have banking systems that are largely nationalized.

Nationalized banks in the subcontinent have been particularly effective in increasing the number of bank branches. It is less clear, however, if nationalized banks are more effective than other financial intermediaries in increasing the financial services available to the rural poor, in increasing the amounts of medium- and long-term loans for farmers, in providing attractive deposit services, in lowering transaction costs associated with financial intermediation, and in creating rural financial institutions that are innovative and self-sustaining.²² Recent research in Costa Rica, for example, has shown that the government-owned financial system is having difficulty extending loans to a larger number of the rural poor. Costa Rica's performance appears no better than that of other LICs that do not have nationalized banks.

Lessons learned

The results of various policy measures aimed at altering lender behavior in favor of a target group or commodity have been mixed. In a few cases the results have been quite different from those intended, and in other cases they have been accompanied by undesirable side effects. In many cases the net result of these policies has been to orient the financial intermediaries away from mobilizing private savings in rural areas and toward obtaining loanable funds from governments and donors.²³

6. TRANSACTION COSTS

The resources used for transactions by RFM participants are important measures of performance. Like well-oiled and efficient machines, financial markets that perform with little friction create few transaction costs for participants. Transaction costs for the lender include the expenses of mobilizing funds for on-lending, costs of collecting information about potential borrowers, and costs of extending,

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maintaining and collecting loans.²⁴ A significant portion of these costs may result from loan targeting requirements placed on the lender by policymakers.²⁵ It is often overlooked that borrowers and savers also incur transaction costs. For small and new borrowers and savers, these costs can be large relative to the size of their transactions. Loan transaction costs, including the time taken to negotiate loans, can be several times the interest paid on loans.

Recent research has shown that the costs of financial intermediation are not shared by borrowers and lenders in fixed proportions.²⁶ Under some circumstances lenders may find it in their interest to absorb, for preferred clients, some of the loan transaction costs normally incurred by borrowers. At the same time, a lender may force non-preferred clients to incur transaction costs normally absorbed by the intermediary as a way of discouraging them from asking for a loan. An analogous situation can occur for depositors.

Interest rate ceilings limit the ability of intermediaries to ration borrowers, so that increased collateral requirements and reallocation of transaction costs to borrowers are often used as substitute rationing mechanisms. When intermediaries are eager to obtain borrower or saver business, they may reduce transaction costs for preferred clients by sending mobile banks to villages (e.g., Philippines, Sri Lanka, and Pakistan). They may also allow preferred borrowers to negotiate new loans by phone or by visiting a bank's office only once. Meanwhile, non-preferred clients may be forced to visit the intermediary numerous times to negotiate, obtain, and repay the loan (e.g., Sudan, Belize, Brazil), to wait in long lines during each visit, to fill out numerous forms to obtain the loan (e.g., Haiti, Tunisia, Portugal), and also to give gifts to the loan officer for rapid and favorable attention.

Formal lenders in many LICs have experimented with loans to small informal groups of borrowers as a way of reducing loan transaction costs and also increasing loan recovery rates.²⁷ Typically, one loan is made to a group of five to 20 farmers, and the loan is negotiated and repaid by a representative of the group (e.g., Ghana, Philippines, Dominican Republic, Ivory Coast, Thailand, and Turkey). Ideally, this procedure should reduce the intermediary's lending costs and reduce the overall costs of obtaining formal loans.

Recent research on group lending shows results that are less positive than originally hoped. While group lending generally reduces loan transaction costs for borrowers, it has had a less positive impact on lenders' transaction costs and

on loan recovery. Group loans appear to work best where groups have non-credit reasons for collective actions.

Lessons learned

The amount of transaction costs and the way in which they are shared tell a great deal about how RFMs perform. These costs also reveal how intermediaries react to regulations. If financial markets are improving, the total costs of financial intermediation per unit of money handled should decline over time for intermediaries, borrowers, and savers. In most countries, those who work in financial markets are creative, but when markets are heavily regulated, a large part of this creativity is directed to innovations that dilute the effect of regulations on the financial intermediary. Such innovations often increase, rather than decrease, the total cost of financial intermediation.

When loans are targeted, the government or donor agency usually requires intermediaries to adopt new procedures to reach those targeted and also to provide periodic reports on the extent to which program objectives are met. Often, the effect of this targeting is to increase sharply the lender's cost.²⁸ Extensive loan targeting increases the amount of friction in financial markets and also reduces their operating efficiency.

7. LOAN REPAYMENT PERFORMANCE

Loan delinquency and default have plagued agricultural credit programs in LICs, especially agricultural development banks.²⁹ It is not uncommon to find a quarter or more of loans outstanding with payments overdue, and this is often a substantial underestimation of the problem because of loan refinancing. Accounting practices used in many LICs also disguise the extent of loan recovery problems.

The traditional view of loan delinquency is that borrowers become delinquent for one of two basic reasons: they are unable to repay, or they are unwilling to repay.³⁰ The inability to repay may result from inadequate incomes which, in turn, are explained by unexpected events such as bad weather, pests, sudden price declines, or by structural deficiencies such as inadequate markets, weak infrastructure or poor technology. The main reasons given for the unwillingness to repay are that loans are viewed as grants or political patronage or simply that borrowers plan from the beginning not to repay.

Most empirical research on loan delinquency in LICs usually involves asking delinquent borrowers why they have failed to repay loans. Not surprisingly, most delinquent borrowers report they were unable to repay, and not that they were unwilling to repay. This often leads to the conclusion that little can be done about loan delinquency, short of basic structural reforms in agriculture. Agricultural development banks, especially those that lend to small farmers, are thereby given an excuse for tolerating high rates of loan delinquency.

In recent work on loan delinquency in LICs, it has been shown that delinquency rates are not always high on agricultural loans, even when the lenders are state-owned banks with development objectives.³¹ In fact, in Costa Rica, delinquency rates were found to be lower on agricultural than on nonagricultural loans and lowest on loans to small farmers. This performance is explained, in part, by the efficient techniques that banks have developed to gather information about potential rural borrowers and also by incentives for bank employees to achieve low delinquency rates and for borrowers to repay promptly in order to maintain access to cheap credit. Other authors have pointed out that patronage and politics are often paramount in the operation of state-owned development banks, so that bank employees may have few incentives to reduce loan delinquency.³²

Increasing awareness of the importance of incentives for both lenders and borrowers in determining loan delinquency can be termed the new view of delinquency, in contrast to the traditional view, in which borrowers are seen as either unable or unwilling to repay. The point of departure for the new view is the costs and benefits to a borrower of repaying or not repaying a loan. A model along such lines has been developed recently in which a utility maximizing borrower is seen as choosing to play either of two lotteries — to repay or to become delinquent.³³ The main advantage to the borrower of playing the repayment lottery is the probability of receiving a larger loan in the future on which a positive rate of return can be expected. Against this must be weighed the explicit financial charges on the possible new loan, the transactions costs involved in repaying and then negotiating and receiving a new loan, and the timeliness of the new loan. When a borrower chooses to play the delinquency lottery, two main outcomes are possible. The lender may do nothing, in which case the borrower keeps the current loan but is denied future loans from that lender. Or the lender may take strong action so that borrowers lose collateral pledged for loans, in addition to which they may be

denied future loans from other lenders. The possible loss from failing to receive new loans may be larger than any other sanction that a lender imposes on a delinquent borrower.

This model has been applied to a sample of some 6,000 loans made by 30 credit unions in Honduras. Results of the sample support the usefulness of this new approach in explaining loan delinquency.³⁴ The most important factors in determining whether a loan was likely to be delinquent were those related to the borrower's assessment of the probability of obtaining a new larger loan in the future on a timely basis. In contrast, variables traditionally associated with the willingness or ability to repay, such as the stated use of the loan, were not helpful in explaining delinquency.

Lessons learned

Some borrowers may fail to repay because they are unable to do so, and other defaulters may never intend to repay under any circumstances. However, the new view of loan delinquency suggests that it is more fruitful to analyze the incentives that borrowers have to repay on time or to become delinquent. Borrowers will find it attractive to repay on time and maintain a good credit rating if they view the lender as able to provide new larger loans in the future on a timely basis with modest borrower transactions costs. The new view is clearly skeptical about the extent to which loan delinquency is beyond the control of the lender and is, hence, skeptical about recommendations to generously refinance overdue loans.

8. APPROPRIATE INTEREST RATE POLICIES

The traditional view of appropriate interest rates for agricultural loans is that they should be kept low to promote agricultural development and to assist the rural poor. However, it became clear by the early 1970s that agricultural credit projects based on low interest rates were encountering serious difficulties in most LICs.³⁵ Some observers began to argue that these widespread difficulties were not due to problems that were unique in each country, but rather to the low interest rate policies themselves.³⁶ Cheap loans did not appear to increase agricultural output or encourage the adoption of new technologies and often failed to reach the rural poor. Moreover, low interest rates frequently under-

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mined the financial viability of lenders and discouraged the mobilization of voluntary savings by financial institutions.

To analyze low interest rate policies, it is essential to define what is meant by low and to distinguish among different measures of interest rates. With the prevalence of inflation in LICs over the past decade, it has become necessary to distinguish between nominal and real rates of interest, real rates being those adjusted for the rate of inflation.³⁷ This adjustment is required because most formal loans are made and repaid in nominal terms (i.e., in money), so that when inflation is significant the nominal rate of interest may seem high while the real rate is actually low or even negative. When the real rates are negative (i.e., when the rate of inflation exceeds the nominal rate of interest), borrowers repay lenders less in terms of goods and services than what they initially borrowed.

It is also useful to distinguish between the stated rate of interest on a loan and the effective rate: the effective rate takes into account all charges on a loan, including not only fees and commissions, but also whether interest is collected in advance and whether compensating balances are required. When governments attempt to set interest rates on loans significantly below equilibrium, lenders often respond by imposing additional charges and conditions that raise effective rates above stated rates. Borrowers will largely be willing to accept these additional charges and conditions as long as effective interest rates remain below what would be paid in competitive markets. Moreover, government regulators will find it difficult to keep up with lenders' innovations that raise effective interest rates above stated rates. These innovations might also be associated with the transfer of loan transaction costs to borrowers.³⁸

There are three policies that governments can use to influence interest rates on deposits and formal loans in rural areas: (1) provide concessionary rediscount facilities that effectively cap the rate that intermediaries will pay on rural deposits; (2) directly set ceilings on rates intermediaries may pay on deposits; and (3) establish ceilings on rates that intermediaries may charge on formal loans. As mentioned earlier, concessionary rediscount facilities alone dampen the interest of intermediaries to mobilize voluntary savings in rural areas, and may also stimulate intermediaries to increase the transactions costs of individuals who have savings accounts. Without other restrictions, ceilings on rates paid on savings accounts also limit the ability of intermediaries to attract savings deposits through interest incentives and may induce them to offer

non-interest rewards for savings as a way of avoiding the effects of the interest rate ceiling on deposits. Ceilings on the interest rates that intermediaries may charge on their loans are the most damaging of the three policies. As mentioned earlier, interest rate ceilings on agricultural loans force lenders to ration rural loans more severely, encourage the lender to transfer funds to loans that have less restrictive interest rate ceilings, stimulate lenders to transfer part of their normal loan transaction costs to non-preferred borrowers, and also force lenders to set even lower rates on deposits. Thus, these loan rate ceilings distort both the lending and mobilizing efforts of the intermediary and can result in significant net outflows of funds from rural areas.

Lessons learned

The new view of interest rate policies rejects the traditional approach of low-interest loans. These traditional policies have generally failed to achieve their primary objectives of promoting agricultural production and assisting the rural poor and have, instead, often undermined the financial viability of the lenders involved. The traditional approach has usually overlooked the distinction between real and nominal interest rates and has generally failed to recognize the importance of effective, as opposed to stated, interest rates, in addition to the relationship between interest rates and transaction costs. The main recommendation of the new view is that interest rates must be high enough so that depositors can be adequately compensated and so that lenders can cover their costs.

9. SAVINGS MOBILIZATION BY AGRICULTURAL LENDERS

Savings mobilization is the forgotten half of rural finance.³⁹ The role of financial intermediaries is not only to lend but also to provide deposit facilities for savers. Nevertheless, almost all rural finance projects in LICs have stressed low interest loans for agriculture and have neglected savings mobilization. The bias toward lending is also reflected in the literature on rural finance.⁴⁰ The studies that do deal with savings generally ignore savings mobilization by financial intermediaries and focus instead on the determinants of the portion of income that is saved rather than consumed.

The neglect of savings mobilization can perhaps be explained by the often-heard argu-

ments that savings cannot or should not be mobilized in rural areas. It is said that most of the rural population has no margin for saving and does not respond to higher interest rates. It is also argued that if financial institutions were encouraged to mobilize savings aggressively, savings would simply be diverted from one institution to another or from rural to urban areas, as higher interest payments to depositors drive institutions toward bankruptcy or force them to lend outside of rural areas where higher returns are available. A more basic explanation for the neglect of savings mobilization may be that it is inconsistent with low-interest-rate lending.

Three main arguments support a policy emphasizing rural savings mobilization. The first notes that more equitable income distribution is an important objective of rural finance projects, and traditional projects based on low-interest-rate lending have tended to bias the distribution of income away from the rural poor for reasons discussed earlier. Policies to improve savings opportunities can, however, efficiently help the rural poor. An essential function of financial intermediaries is the pooling of funds, that is, bringing together small amounts from many savers so that loans for relatively large projects involving economies of scale can be made. Hence, by their nature, formal financial intermediaries should serve many more savers than borrowers. On the average, depositors will have lower incomes than borrowers. Policies that focus on improving services for savers are therefore a better way to help the rural poor than is cheap credit.

If most of the rural population had no savings, the rural poor would have become extinct long ago with the onset of the first emergency.⁴¹ The rural poor, more than any others, must have a liquid reserve to meet emergencies. Even the moneylender will not lend to someone with no accumulated or potential surplus, and friends and relatives, as well as rotating savings and credit associations, usually require the ability to reciprocate.⁴² Bouman has emphasized the widespread importance of savings in informal financial arrangements in LICs, and other authors have reported numerous instances of significant savings capacity among the rural poor.⁴³

The most important service that financial institutions can provide for rural savers is the opportunity to hold liquid deposits which pay interest rates that are at least positive in real terms. Without this, the rural poor are forced to hold a variety of inflation hedges, many of which earn low or negative rates of return, and to pay an inflation tax on cash that is held to meet

current obligations. The non-poor, by contrast, can often avoid these unfortunate alternatives because they have access to a wider range of investment possibilities.

The myth that most of the rural population does not respond to interest rate incentives is often based on tepid responses to pseudo interest rate reforms in which rates are raised somewhat, but continue to be negative in real terms. In other cases, interest rates on deposits are raised significantly, but financial institutions are expected to continue to lend at low rates of interest or to meet very high reserve requirements on deposits. These institutions respond quite logically by discouraging deposits through the imposition of high transaction costs on depositors in the form of inconvenient locations and hours, slow service, excessive paperwork, and high minimum balance requirements. Recent research has shown substantial responsiveness by savers to appropriate policies such as higher real rates of interest.⁴⁴

Improved resource allocation is the second major argument for increased emphasis on savings mobilization. Deposit mobilization by financial intermediaries draws resources away from low return investments, especially inflation hedges, as the opportunity is provided to make deposits that earn positive real rates of interest. Funds mobilized can be on-lent by financial intermediaries for those activities that promise the highest rates of return. Some arguments frequently heard against savings mobilization can actually help to clarify the ways in which savings mobilization can improve resources allocation. It is often said, for example, that aggressive savings mobilization by one institution will only divert deposits from other institutions with no gain to society. However, this neglects the gain to savers, who would not have moved their deposits without being better off, and the fact that financial institutions earning the highest risk-adjusted returns on the funds entrusted to them will be able to compete most effectively for savings.

Critics of the new views also argue that no additional savings will be generated because the rural population will not save more because of higher interest rates. Such arguments confuse the flow of savings from income with the allocation of a stock of savings among competing assets, while also raising the question of whether savings allocated to inflation hedges, such as inventories of commodities, should be counted as saving or consumption. Regardless of whether more is saved out of income, which is an open question both theoretically and empirically, effective savings mobilization can help deploy the stock of

assets of the rural population in more productive ways.

The beneficial effect of savings mobilization on the viability of financial institutions is the third major argument for greater emphasis on savings mobilization. Financial institutions that neglect savings mobilization are incomplete institutions.⁴⁵ They not only fail to provide adequate services for rural savers, but they also make themselves less viable, as can be seen most clearly from high rates of loan delinquency. When financial institutions deal with clients only as borrowers they forego useful information about the savings behavior of these clients that could allow them to improve estimates of creditworthiness. Furthermore, borrowers are more likely to repay promptly and lenders to take greater responsibility for loan recovery when they know that funds come from neighbors, rather than from government or donors.

Financial institutions that mobilize savings effectively are likely to have a continual flow of funds available for lending, while those that neglect savings mobilization are inevitably subject to the feast-or-famine cycle of government and donor funding. Financial institutions are likely to have little interest in savings mobilization or loan recovery when cheap funds are available through government loans, central bank rediscounts or loans from international donors. It is generally overlooked that the volume of funds that can be obtained through effective programs of savings mobilization and loan recovery is potentially far greater than the most optimistic estimates of the amount of subsidized loans and grants available from governments and donors. There is mounting evidence that substantial amounts of savings can be mobilized in the rural areas of LICs, and that certain techniques, such as positive real rates of interest for depositors are particularly effective in mobilizing these savings.⁴⁶

Lessons learned

Research on rural areas of LICs indicates that savers place considerable importance on access to future loans when selecting a financial institution and that innovative institutions can be quite successful in mobilizing savings.⁴⁷ However,

financial intermediaries have often been used by governments or donors for purposes such as low interest lending that are inconsistent with aggressive savings mobilization, and in these cases savings mobilization has been neglected and the institutions have often performed poorly.⁴⁸ Savings mobilization that can assist the rural poor, improve resource allocation, and make financial institutions more viable, has been forgotten because of powerful incentives against savings mobilization. When savings mobilization is discouraged the total amount of funds available for lending in rural areas will generally be lessened.

10. LOOKING AHEAD

Continued population growth, shortfalls in agricultural production, and widespread rural poverty will force policymakers to continue to promote agricultural development in LICs. If the past is any guide to the future, agricultural credit will continue to be a major part of these efforts. Moreover, the problems and controversies that exist in RFMs in LICs are likely to persist. The tendencies of governments to use policies that turn the terms-of-trade against agriculture while repressing RFMs through low interest rate policies will not provide healthy environments for the growth of RFMs in the future. The subtle and complex nature of RFMs makes it possible for hard-pressed policymakers to assume success in agricultural credit projects though careful analysis shows substantial shortcomings. Few policymakers in LICs take the time and effort to undertake careful diagnoses of the performance of their RFMs. This lack of analysis allows policymakers to sustain wishful thinking rather than to face reality.

The main lesson to be learned from this review of recent research and evaluation is that RFMs could play a more efficient and equitable role in development if appropriate policies were adopted. These policies include much more emphasis on mobilization of voluntary private savings in rural areas, interest rate policies that sustain positive real rates of interest most of the time, and more stress on improving the overall quality of financial services provided by these markets.

NOTES

1. Donald (1976), pp. 77-96.
2. Adams *et al.* (1984), pp. 36-58.

3. *Ibid.*, pp. 210-225.

4. Von Pischke *et al.* (1983), pp. 74-83.

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5. Adams *et al.* (1984), pp. 49-58.
6. *Ibid.*, pp. 73-76.
7. Von Pischke *et al.* (1983), pp. 151-307.
8. *Ibid.*, pp. 155-206.
9. *Ibid.*, pp. 200-211.
10. *Ibid.*, pp. 233-275.
11. *Ibid.*, pp. 218-224.
12. Schaefer-Kehnert and Von Pischke (1984).
13. Adams *et al.* (1984), pp. 194-225.
14. *Ibid.*, pp. 73-75.
15. *Ibid.*, pp. 78-95.
16. Von Pischke *et al.* (1983), pp. 365-372.
17. Adams *et al.* (1984), pp. 120-132.
18. Von Pischke *et al.* (1983), pp. 323-329.
19. *Ibid.*, pp. 330-335.
20. *Ibid.*, pp. 162-173.
21. Von Pischke *et al.* (1983).
22. *Ibid.*, pp. 43-49.
23. Adams *et al.* (1984), pp. 298-307.
24. *Ibid.*, pp. 104-119.
25. *Ibid.*, pp. 96-103.
26. *Ibid.*, pp. 104-119.
27. *Ibid.*, p. 113; Von Pischke *et al.* (1983), pp. 278-288.
28. Adams *et al.* (1984), pp. 96-103.
29. Donald (1976), pp. 137-151.
30. Von Pischke *et al.* (1983), pp. 183-189.
31. Vogel (1981).
32. Von Pischke *et al.* (1983), pp. 175-182 and 337-345; Adams *et al.* (1984), pp. 36-48 and 183-193.
33. Christen and Vogel (1984)
34. *Ibid.*
35. Donald (1976), pp. 97-117
36. Von Pischke *et al.* (1983), pp. 365-372; Adams *et al.* (1984), pp. 66-77.
37. Adams *et al.* (1984), pp. 65-77 and 120-132.
38. *Ibid.*, pp. 166-182.
39. *Ibid.*, pp. 248-265.
40. Donald (1976), pp. 159-177.
41. Von Pischke *et al.* (1983), pp. 414-420.
42. Adams *et al.* (1984), pp. 232-247; Von Pischke *et al.* (1983), pp. 262-268.
43. Von Pischke *et al.* (1983), pp. 134-147.
44. *Ibid.*, pp. 399-407.
45. Adams *et al.* (1984), pp. 36-48.
46. Von Pischke *et al.* (1983), pp. 393-420.
47. *Ibid.*, pp. 289-307.
48. *Ibid.*, pp. 346-362.

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