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DEPOSIT MOBILIZATION AND FINANCIAL SECTOR GROWTH

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RURAL FINANCE AND FINANCIAL
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FOR ALMOST THREE DECADES, FACULTY AND STUDENTS AT THE OHIO STATE UNIVERSITY (OSU) HAVE DEVOTED THEIR ATTENTION: (1) TO THE ANALYSIS OF RURAL FINANCIAL MARKETS IN DEVELOPING COUNTRIES AND (2) TO THE DESIGN OF POLICIES AND PROGRAMS TO IMPROVE THE PROVISION OF FINANCIAL SERVICES IN THE RURAL AREAS OF THOSE COUNTRIES.

THROUGH RESEARCH (PARTICULARLY FIELD RESEARCH), INSTITUTIONAL EXPERIMENTS, TECHNICAL ASSISTANCE, AND POLICY DIALOGUE, OSU HAS ACCUMULATED A SUBSTANTIAL BODY OF THEORETICAL AND PRACTICAL KNOWLEDGE ABOUT THESE MARKETS AS WELL AS CONSIDERABLE EXPERIENCE ABOUT THEIR PERFORMANCE IN SEVERAL DOZEN COUNTRIES.

WITH THE SUPPORT OF THE SCIENCE AND TECHNOLOGY BUREAU OF THE AGENCY FOR INTERNATIONAL DEVELOPMENT (AID), OSU HAS CHALLENGED THE ASSUMPTIONS OF TRADITIONAL PROGRAMS, HAS INFLUENCED THE POLICIES OF GOVERNMENTS AND DONORS, AND HAS DEVELOPED A NEW CONCEPTUAL FRAMEWORK FOR THE ANALYSIS OF RURAL FINANCIAL MARKETS AS WELL AS A SET OF STRATEGIES FOR THE PROMOTION OF THEIR DEVELOPMENT.

A KEY COMPONENT OF THE OSU APPROACH (ALTHOUGH NOT THE ONLY ONE) HAS BEEN ITS EMPHASIS ON THE CRUCIAL ROLE OF DEPOSIT MOBILIZATION. THIS DIMENSION OF FINANCIAL INTERMEDIATION HAS BEEN HIGHLIGHTED AND IS AT THE CORE OF THE RECENT COOPERATIVE AGREEMENT WITH AID.

ANOTHER SIGNIFICANT COMPONENT OF THE OSU APPROACH HAS BEEN ITS EMPHASIS ON THE IMPORTANCE OF TRANSACTION COSTS IN EXPLAINING MARKET AND INSTITUTIONAL PERFORMANCE. CONCERN WITH TRANSACTION COSTS HAS FOCUSED OSU'S ATTENTION TO THE NEED TO GENERATE COST-REDUCING FINANCIAL TECHNOLOGIES TO REACH MARGINAL CLIENTELES WITH FINANCIAL SERVICES.

BEST KNOWN IN THE PAST FOR ITS PERCEPTIONS ABOUT INTEREST RATES, OSU'S FIELD OBSERVATIONS CONTINUE TO CONFIRM THAT CREDIT SUBSIDIES ARE POOR AND SOMETIMES PERVERSE INSTRUMENTS TO PROMOTE INVESTMENT, TO ACCELERATE TECHNOLOGICAL CHANGE AND, PARTICULARLY, TO REDISTRIBUTE INCOME TOWARDS THE POOR.

THROUGH THESE EFFORTS, OSU HAS IDENTIFIED LESSONS THAT ARE RELEVANT, NOT ONLY FOR RURAL FINANCIAL MARKETS BUT, AS THE MOST RECENT RESEARCH SUGGESTS, ALSO FOR THE PROVISION OF FINANCIAL SERVICES TO ALL KINDS OF MARGINAL CLIENTELES (MICRO-ENTERPRISES, NEW NON-TRADITIONAL EXPORTS) AND FOR THE PROMOTION OF FINANCIAL DEVELOPMENT IN GENERAL.

THIS SHOULD NOT BE SURPRISING: ON THE ONE HAND, THE OSU APPROACH WAS DEVELOPED IN PARALLEL AND IN CLOSE CONNECTION WITH THE NEW VIEWS ON FINANCE AND DEVELOPMENT PIONEERED BY SHAW AND MCKINNON. ON THE OTHER HAND, OSU'S EFFORTS HAVE GONE BEYOND INTEREST IN THE AGGREGATE FINANCIAL REPRESSION, MACROECONOMIC STABILIZATION, AND FINANCIAL LIBERALIZATION ISSUES, BECAUSE OF OSU'S ATTEMPTS TO ADDRESS THE SPECIAL PROBLEMS OF RURAL FINANCIAL MARKETS.

IN SO DOING, OSU'S RESEARCH HAS ADDED NEW DIMENSIONS TO THE UNDERSTANDING OF THE MICROECONOMIC BEHAVIOR OF PARTICIPANTS IN FINANCIAL MARKETS, OF THE DIFFICULTIES OF INSTITUTION BUILDING IN FINANCE, AND OF THE POLITICAL ECONOMY OF THE POLICY DIALOGUE. THUS, OSU'S INSIGHTS ABOUT THE BEHAVIOR OF DEPOSITORS, BORROWERS AND INTERMEDIARIES HAVE BEEN CRITICAL TO UNDERSTAND THE CONSEQUENCES OF AGGREGATE OR PARTIAL FINANCIAL REFORMS.

BECAUSE OSU HAS BEEN CONCERNED WITH FINANCIAL PROGRESS AT THE FRINGES OF CLIENTELES THAT TEND TO BE EXCLUDED FROM ACCESS TO FINANCIAL SERVICES, A LOT HAS BEEN LEARNED ABOUT WHAT IT TAKES TO PROMOTE FINANCIAL EXPANSION IN DEVELOPING COUNTRIES.

IN THE PROCESS, OSU HAS SUBSTITUTED A NEW, SYSTEM-WIDE PERSPECTIVE FOR THE MORE LIMITED TRADITIONAL VIEW THAT HAD BEEN BEHIND THE DESIGN OF THE POLICIES AND PROGRAMS OF THE PAST. (SEE CHART ONE)

THE NEW APPROACH TAKES A GENERAL-EQUILIBRIUM VIEW OF THE PERFORMANCE OF RURAL FINANCIAL MARKETS AND MOVES AWAY FROM THE PARTIAL VIEWS AND ACTIONS OF THE PAST. IN THE ECONOMIST'S JARGON, A GENERAL EQUILIBRIUM FRAMEWORK HAS BEEN ESSENTIAL FOR POLICY EVALUATION. IN THE PRACTICIONER'S JARGON, A SYSTEMS APPROACH IS ESSENTIAL FOR THE SUCCESSFUL PROMOTION OF FINANCE.

THE SCOPE OF INTEREST HAS THUS SHIFTED: RATHER THAN BEING CONCERNED WITH THE DESIGN AND IMPLEMENTATION OF SPECIFIC CREDIT PROJECTS, THE NEW APPROACH EMPHASIZES THE EFFICIENCY AND INTEGRATION OF **MARKETS**.

CHART ONE
RURAL FINANCIAL MARKETS

<u>OLD VIEW</u>		<u>NEW VIEW</u>
	Approach:	
Partial		General
	Scope:	
Projects		Markets
	Supply:	
Loans		Financial Services (Deposits)
	Pricing:	
Interest Rates		Total Cost of Loans Net Return of Deposits Intermediation Margins (Transaction Costs)
	Organization:	
Public Development Banks		Financial Sector Formal and Informal Interlinked Markets
	Allocation:	
Target Farmers Restricted Uses		Rural Population Integral Service
	Evaluation:	
Farm-Level Impact		Market Integration Institutional Viability
	Focus:	
Market Imperfections		Incomplete Organization Technological Innovations

THE ULTIMATE GOAL OF FINANCIAL POLICY SHOULD BE: (1) TO CREATE MARKETS, WHERE THEY DO NOT EXIST OR ARE INCOMPLETE, (2) TO IMPROVE MARKET OPERATION, WHEN IT IS IMPERFECT OR DISTORTED, AND (3) TO USE MORE EFFECTIVELY THE POWER OF FINANCE TO INTEGRATE OTHER MARKETS IN THE ECONOMY.

WHILE TRADITIONALLY, THE EMPHASIS HAS BEEN ON THE SUPPLY OF LOANS (AT LOW INTEREST RATES, TO PARTICULAR GROUPS), OSU STRESSES THE IMPORTANCE OF THE WHOLE RANGE OF FINANCIAL SERVICES: THE PROVISION OF AN EFFICIENT MEANS OF PAYMENTS, THE PROVISION OF ALL THE DIMENSIONS OF FINANCIAL INTERMEDIATION, AND THE PROVISION OF SERVICES FOR RISK- AND RESERVE-MANAGEMENT.

IN PARTICULAR, OSU HAS STRESSED THAT THE FINANCIAL INTERMEDIATION FUNCTION PROVIDES VALUABLE, INCOME-AUGMENTING AND WELFARE-INCREASING SERVICES NOT ONLY TO BORROWERS BUT ALSO TO DEPOSITORS (THEREFORE, THE EMPHASIS ON DEPOSIT MOBILIZATION, WHICH HAD BEEN NEGLECTED). OSU HAS STRESSED THAT DEPOSIT MOBILIZATION, BECAUSE IT DESTROYS LOW-RETURN USES OF WEALTH, IS AS CRITICAL FOR ALLOCATIVE EFFICIENCY AS THE SUPPLY OF LOANS. OSU HAS STRESSED THAT, BECAUSE OF THE POLITICAL ECONOMY DIMENSIONS OF INSTITUTIONAL BEHAVIOR, DEPOSIT MOBILIZATION IS CRITICAL FOR THE VIABILITY OF FINANCIAL INSTITUTIONS.

TRADITIONAL CONCERNS WITH CREDIT EMPHASIZED INTEREST RATES AND REASONS TO KEEP THEM BELOW EQUILIBRIUM LEVELS. OSU HAS IDENTIFIED ALL COMPONENTS OF FINANCIAL COSTS AND PRICES AS IMPORTANT IN SHAPING BORROWER AND LENDER BEHAVIOR.

TRANSACTION COSTS ARE CRITICAL IN UNDERSTANDING FINANCIAL MARKETS. WHAT MATTERS TO BORROWING INVESTORS AND PRODUCERS IS THE TOTAL COST OF THE FUNDS, INCLUDING EXPLICIT INTEREST RATES, IMPLICIT RATES, NON-INTEREST COSTS OF BORROWING AND THE ASSOCIATED RISKS. FIELD RESEARCH HAS SHOWN THAT FOR MARGINAL CLIENTS, THESE NON-INTEREST COMPONENTS OF THE COSTS OF FUNDS ARE MORE IMPORTANT THAN INTEREST RATES. THUS, THE EMPHASIS ON LOW INTEREST RATES HAS BEEN MISPLACED.

WHAT MATTERS TO DEPOSITORS IS THE NET RETURN ON THEIR SAVINGS. THUS, DEPOSIT MOBILIZATION EXPERIMENTS SHOW THAT, WHILE INTEREST RATES CERTAINLY MATTER, TRANSACTION COSTS FOR DEPOSITORS AND THE QUALITY AND PERMANENCY OF THE SERVICE ARE ALSO CRITICAL.

WHAT MATTERS FOR INTERMEDIARIES ARE THEIR PROFITS, THE DIFFERENCE BETWEEN INTEREST-RATE MARGINS AND THE TRANSACTION COSTS AND RISKS OF MOBILIZING FUNDS AND MAKING LOANS. POTENTIAL CLIENTS ARE EXCLUDED FROM ACCESS TO FINANCIAL SERVICES WHEN INTERMEDIATION MARGINS DO NOT COVER THE COSTS OF SERVICING THEM.

MOREOVER, OSU FOR A LONG TIME HAS RECOGNIZED THAT, PARTICULARLY IF THERE ARE INTEREST-RATE RESTRICTIONS, NON-PRICE RATIONING AND QUANTITY-DRIVEN ADJUSTMENTS TAKE PLACE IN FINANCIAL MARKETS. MY OWN WORK ON THE IRON LAWS OF INTEREST-RATE RESTRICTIONS HAS ATTEMPTED TO IDENTIFY THE CONSEQUENCES OF PRICE AND NON-PRICE RATIONING AND MARKET CLEARING ON INCOME DISTRIBUTION. GIVEN EXCESS DEMANDS FOR LOANS, RATIONING USUALLY DISCRIMINATES AGAINST THE SMALLER AND RISKIER BORROWERS.

THE TRADITIONAL APPROACH EMPHASIZED THE SEARCH FOR AN IDEAL INSTITUTIONAL TYPE AND THE CREATION BY DECREE OF SPECIALIZED INSTITUTIONS. MOST PROMINENT AMONG THEM HAVE BEEN THE PUBLIC, AGRICULTURAL DEVELOPMENT BANKS.

OSU RECOGNIZES THAT FINANCIAL SERVICES ARE NOT HOMOGENEOUS AND THAT DIFFERENT INSTITUTIONAL FORMS POSSESS COMPARATIVE ADVANTAGES FOR THE PROVISION OF SOME AND NOT OTHERS AMONG THESE HETEROGENEOUS SERVICES. WHAT MATTERS IS THE PERFORMANCE OF THE WHOLE FINANCIAL SYSTEM. NUMEROUS AND DIVERSE MARKET PARTICIPANTS ARE CLOSELY LINKED THROUGH FLOWS OF FUNDS AND OF INFORMATION. BORROWERS IN ONE MARKET SEGMENT BECOME LENDERS IN OTHER MARKET SEGMENTS. THE SAME BORROWER SATISFIES HIS INVESTMENT-CREDIT DEMAND FROM ONE INTERMEDIARY AND HIS EMERGENCY-CREDIT DEMAND FROM ANOTHER, IN ORDER TO REDUCE HIS TOTAL COSTS OF FUNDS. INTERLINKED MARKET TRANSACTIONS GENERATE ECONOMIES OF SCOPE AND REDUCE TRANSACTION COSTS FOR ALL PARTICIPANTS.

WHAT MATTERS IS THE PRESERVATION OF A HOSPITABLE ENVIRONMENT IN WHICH SEVERAL KINDS OF EFFICIENT FORMAL AND INFORMAL FINANCIAL AGENTS CAN COMPETITIVELY DEVELOP A DIVISION OF LABOR AND A NETWORK OF INTERCONNECTIONS THAT IS OPTIMUM.

WHILE TRADITIONAL CREDIT PROGRAMS TARGETED LOANS TO PARTICULAR GROUPS AND FOR SPECIFIC USES, OSU HAS RECOGNIZED THAT VIABLE FINANCIAL INSTITUTIONS NEED TO DIVERSIFY THEIR PORTFOLIO, IN ORDER TO MANAGE LIQUIDITY THROUGH TIME, REDUCE RISKS AND MINIMIZE POLITICAL INTRUSIONS.

OSU HAS EMPHASIZED THE FUNGIBILITY OF LOANS IN ORDER TO EXPLAIN THE LIMITED SUCCESS OF TARGETING. OSU HAS EMPHASIZED TRANSACTION COSTS IN ORDER TO IDENTIFY THE MAIN NEGATIVE CONSEQUENCES OF TARGETING. THUS, WHILE LOANS DISBURSED HAVE NOT ENTIRELY REACHED TARGET GROUPS AND ADDITIONALITY IN FUNDS USE HAS BEEN MUCH LESS THAN 100 PERCENT, THE INTERMEDIARIES HAVE BEEN CRIPPLED BY SUPERVISION, REPORTING, AND OTHER BUREAUCRATIC REQUIREMENTS OF TARGETING.

IN SUM, SOCIAL WELFARE AND FINANCIAL VIABILITY WILL INCREASE WITH THE PROVISION OF A WIDE RANGE OF FINANCIAL SERVICES TO A NUMEROUS AND DIVERSE RURAL POPULATION, IRRESPECTIVE OF OCCUPATION OR FUNDS USE. WHAT MATTERS IS THE COST, QUALITY, AND RELIABILITY OF THE FINANCIAL SERVICES PROVIDED. WHAT IS NEEDED IS THE CREATION OF COMPLETE, PERMANENT, AND VIABLE FINANCIAL INSTITUTIONS. TARGETING JOEPARDIZES THE ACHIEVEMENT OF THESE GOALS.

THUS, RATHER THAN IN EVALUATIONS OF THE FARM-LEVEL IMPACT OF LOANS, OSU CONCENTRATES ITS EFFORTS IN THE ASSESSMENT OF THE PERFORMANCE OF FINANCIAL MARKETS.

BEHIND THE NEW PERSPECTIVE, THERE IS A DIFFERENT PERCEPTION AND APPROACH TO THE PROBLEM OF ECONOMIC DEVELOPMENT. MANY DEVELOPING-COUNTRY POLICIES WERE DESIGNED ON THE ASSUMPTION THAT MARKETS ARE GROSSLY IMPERFECT AND THAT ALL KINDS OF GOVERNMENT INTERVENTIONS ARE NEEDED TO CORRECT FOR THESE DISTORTIONS. THUS, FORMAL CREDIT POLICIES WERE DESIGNED TO CORRECT FOR THE MONOPOLY POWER PRESSUMABLY EXERCISED IN INFORMAL MARKETS.

SUBSIDIZED INTEREST RATES WERE JUSTIFIED IN TERMS OF SEVERAL OTHER MARKET IMPERFECTIONS. OSU BELIEVES THAT, WHILE IMPERFECTIONS MAY BE IMPORTANT IN SOME CASES, WHAT IS NEEDED IN THE DEVELOPING COUNTRIES IS THE ESTABLISHMENT OF A MORE COMPLETE ORGANIZATIONAL FRAMEWORK THAT WOULD FACILITATE THE OPERATION OF THE MARKET FORCES. IN PARTICULAR, WHAT ARE NEEDED ARE INSTITUTIONS THAT GENERATE KNOWLEDGE AND FACILITATE THE MANAGEMENT OF RISK, A BETTER DEFINITION OF PROPERTY RIGHTS AND A BETTER DESIGN AND ENFORCEMENT OF CONTRACTS, AND AN INFRASTRUCTURE (ROADS, COMMUNICATIONS, BANK BRANCHES) THAT REDUCE TRANSACTION COSTS AND THUS HELP TO INTEGRATE MARKETS. REPRESSION AND SUBSIDIES ARE NOT A SUBSTITUTE FOR GOOD POLICIES AND THE DEVELOPMENT OF MARKETS.

THE MAIN OBJECTIVE OF OSU'S WORK ON RURAL FINANCIAL MARKETS HAS BEEN: (1) TO CREATE CONDITIONS WHICH INCREASE THE ACCESS TO FINANCIAL SERVICES BY POPULATIONS AT PRESENT WITHOUT THIS ACCESS, PARTICULARLY IN THE RURAL AREAS OF THE DEVELOPING COUNTRIES, AND (2) TO IMPROVE THE QUALITY OF THE FINANCIAL SERVICES PROVIDED.

THE PROVISION OF FINANCIAL SERVICES IS A DIFFICULT AND EXPENSIVE TASK. SUCCESS DEPENDS ON MANY CIRCUMSTANCES. THESE INCLUDE FEATURES OF THE ENVIRONMENT, THE DEGREE OF ORGANIZATION IN SOCIETY, THE IMPACT OF NON-FINANCIAL AND OF FINANCIAL POLICIES, THE DESIGN OF INSTITUTIONS AND OF INSTRUMENTS, AND THE CHOICE OF THE APPROPRIATE TECHNOLOGIES TO PRODUCE FINANCIAL SERVICES. (SEE CHART TWO)

CHART TWO
SUPPLY OF FINANCIAL SERVICES

ENVIRONMENT	Nature of the Rural Economy Transaction Costs Risks
ORGANIZATION	Contracts and Property Rights Enforcement Infrastructure Information Supervision
NON-FINANCIAL POLICIES	Farm Profits Creditworthiness Deposit Potential
FINANCIAL POLICIES	Macroeconomic: Inflation Devaluation Crowding out Microeconomic: Interest Rates Rationing Market Regulation
INSTITUTIONAL DESIGN	Objectives Political Economy Authority Economies of Scope Moral Hazard Accountability
TECHNOLOGY	Delivery Systems Innovations

THE SPECIAL NATURE OF THE RURAL ECONOMY EXPLAINS SOME OF THE DIFFICULTIES. POTENTIAL DEPOSITORS AND BORROWERS ARE VERY HETEROGENEOUS, THEY ARE GEOGRAPHICALLY DISPERSED AND LESS ACCESSIBLE, THEIR TRANSACTIONS ARE VERY SMALL AND THEY FACE HIGH RISKS. IT IS VERY DIFFICULT FOR INTERMEDIARIES FROM OUTSIDE THEIR COMMUNITIES TO ACQUIRE AND INTERPRET INFORMATION ABOUT THEIR CREDITWORTHINESS.

THE CONSEQUENCE ARE VERY HIGH TRANSACTION COSTS, WHICH INCREASE THE TOTAL COST OF THE FUNDS FOR THE BORROWERS, REDUCE THE NET RETURN TO DEPOSITS FOR SAVERS, AND DIMINISH THE PROFITABILITY OF POTENTIAL INTERMEDIARIES. AS A RESULT, FEW TRANSACTIONS TAKE PLACE AND FINANCIAL MARKETS ARE SHALLOW.

INSUFFICIENT ORGANIZATION INCREASES THE COSTS AND RISKS OF FINANCIAL TRANSACTIONS. IF PROPERTY RIGHTS ARE NOT ADEQUATELY DEFINED OR EFFICIENTLY ALLOCATED, COLLATERAL CANNOT BE GENERATED. IF CONTRACTS CANNOT BE SPECIFIED AND SUCCESSFULLY ENFORCED, ONLY THE LEAST RISKY OF THE FINANCIAL TRANSACTIONS WILL TAKE PLACE.

IF INFORMATION IS EXPENSIVE, UNRELIABLE, NOT ACCESSIBLE, THE MOST IMPORTANT INPUT IN FINANCIAL PRODUCTION FUNCTIONS WILL BE MISSING. IF THERE ARE NO ROADS, PEOPLE CANNOT VISIT BANK BRANCHES. IF POTENTIAL CUSTOMERS CANNOT READ OR WRITE, COMMUNICATIONS ARE MORE COSTLY. IF THERE IS NO ADEQUATE SUPERVISION OF THE FINANCIAL SYSTEM, DEPOSITORS WILL NOT BE SUFFICIENTLY PROTECTED.

ALL OF THESE ORGANIZATIONAL DEFICIENCIES INCREASE THE COSTS AND THE RISKS FOR ALL PARTICIPANTS IN FINANCIAL MARKETS AND REDUCE MARKET SIZE.

ECONOMIC POLICIES WHICH REPRESS RURAL INCOMES AND INCREASE THEIR VARIABILITY REDUCE THE DEMAND FOR DEPOSIT AND LOAN SERVICES AND CONSTRAIN THE GENERATION OF CREDITWORTHINESS. THE STRENGTH OF FINANCIAL INSTITUTIONS DEPENDS ON THE SOLVENCY AND DYNAMISM OF THEIR CLIENTELE. FARMERS WHO RECEIVE LOW PRICES FOR THEIR OUTPUT, PAY HIGH PRICES FOR THEIR INPUTS, OBTAIN POOR YIELDS AND DO NOT HAVE ACCESS TO MARKETS AND PUBLIC SERVICES ARE NOT GOOD BANK CLIENTS.

RIGID FINANCIAL POLICIES ALSO CONSTRAIN THE GROWTH OF FINANCIAL MARKETS. FIRST, INFLATION AND DEVALUATION EXPECTATIONS, COMBINED WITH INTEREST-RATE CEILINGS, REDUCE THE NET REAL RETURNS ON DOMESTIC FINANCIAL ASSETS AND LEAD TO CURRENCY SUBSTITUTION, THE ACCUMULATION OF INFLATION HEDGES, AND THE CONTRACTION OF THE DOMESTIC FINANCIAL SYSTEM.

SECOND, THE FINANCING OF FISCAL DEFICITS WITH BANK CREDIT LEADS TO THE CROWDING OUT OF THE PRIVATE SECTOR IN LOAN PORTFOLIOS. THE FINANCIAL SYSTEM CEASES TO BE AN INTERMEDIARY BETWEEN PRIVATE SAVERS AND INVESTORS AND BECOMES A FISCAL TOOL TO TAX FUNDS AWAY FROM DEPOSITORS TO FINANCE GOVERNMENT EXPENDITURES OR GRANT SPECIFIC SUBSIDIES.

THIRD, RESERVE REQUIREMENTS SIMILARLY TAX FINANCIAL INTERMEDIATION.

FOURTH, INTEREST-RATE CEILINGS FORCE INTERMEDIARIES TO ADOPT NON-INTEREST AND NON-PRICE FORMS OF RATIONING THAT DISCRIMINATE AGAINST COSTLY AND RISKY BORROWERS.

FIFTH, OTHER FORMS OF MARKET REGULATION FREQUENTLY UNDULY RESTRICT ENTRY, REDUCE COMPETITION AND CONSOLIDATE OLIGOPSONIES, INCREASE TRANSACTION COSTS AND CONSTRAIN OPPORTUNITIES FOR THE GENERATION OF ECONOMIES OF SCALE AND ECONOMIES OF SCOPE.

FOR ALL OF THESE REASONS, OSU HAS INSISTED ON THE NEED TO SURVEY AGGREGATE FINANCIAL AND NON-FINANCIAL POLICIES AS PART OF THE ASSESSMENT OF RURAL FINANCIAL MARKETS AS WELL AS ON THE IMPORTANCE OF FINANCIAL REFORMS, WHEN NEEDED.

DESIGN CONTRIBUTES TO THE SUCCESS OR FAILURE OF FINANCIAL INSTITUTIONS. MULTIPLE AND INCONSISTENT OBJECTIVES REDUCE THEIR VIABILITY. CREDIT IS NOT A TOOL CAPABLE OF SOLVING EVERY CONCEIVABLE PROBLEM IN OTHER MARKETS. UNDUE SPECIALIZATION INCREASES RISKS AND THE POTENTIAL FOR MORAL HAZARD. IN PARTICULAR, THE ABSENCE OF DEPOSIT MOBILIZATION SERIOUSLY WEAKENS FINANCIAL INSTITUTIONS. SPECIALIZED RETAILERS OF EXOGENOUS FUNDS HAVE BEEN PARTICULARLY UNSUCCESSFUL.

SINCE INSTITUTIONAL PERFORMANCE IS DETERMINED BY THE BEHAVIOR OF MANAGERS, EMPLOYEES, AND CUSTOMERS AND SINCE DIFFERENT OBJECTIVES GUIDE THEIR ACTIONS, IF THE SET OF INCENTIVES IS NOT CORRECT, THEIR BEHAVIOR WILL ENDANGER THE INSTITUTION OR WILL LEAD TO UNEXPECTED, UNDESIRED RESULTS FROM REGULATION.

UNLESS AUTHORITY FOR EVALUATING CREDITWORTHINES AND FOR COLLECTION OF LOANS IS GRANTED, THE INTERMEDIARY WILL BE CRIPPLED. UNLESS ACCOUNTABILITY IS SPECIFIED, AGENTS WILL NOT PERFORM IN SOCIETY'S BEST INTERESTS.

FINALLY, COST-REDUCING INNOVATIONS ARE NEEDED TO INCREASE ACCESS TO AND IMPROVE THE QUALITY OF FINANCIAL SERVICES. ONCE MARKET SIGNALS ARE APPROPRIATE AND PRICES ARE RIGHT, CONCERN FOCUSES ON THE MAGNITUDE OF THE SUPPLY RESPONSE: HOW SOON, WITH WHAT INTENSITY, AND IN WHAT AREAS WILL FINANCIAL SERVICES EXPAND AS A RESPONSE TO THE NEW SET OF INCENTIVES. FINANCIAL TECHNOLOGIES ARE A MAJOR CONSTRAINT HERE.

INCORRECT INCENTIVES HAVE STUNTED FINANCIAL INNOVATION IN THE PAST. WRONG ASSUMPTIONS HAVE CHANNELLED INSTITUTIONAL INNOVATION IN THE WRONG DIRECTIONS. ABSENCE OF PROFITABILITY OF FINANCIAL INTERMEDIARIES HAS DISCOURAGED EXPERIMENTATION AND PRODUCT DEVELOPMENT. IF ONE WANTS TO REACH MARGINAL CLIENTELES, TECHNOLOGICAL CHANGE IN FINANCIAL PRODUCTION FUNCTIONS WILL BE ESSENCIAL.

THE MOST RECENT COOPERATIVE AGREEMENT WITH AID WAS BASED UPON THE PERCEPTION THAT DEPOSIT MOBILIZATION PRESENTED A CONSIDERABLE SCOPE FOR INNOVATION IN RURAL FINANCIAL MARKETS.

SPECIALLY AMONG THOSE WITH LOWER INCOMES AND STATIONARY PRODUCTIVE OPPORTUNITIES, THE DEMAND FOR FINANCIAL SERVICES IS ESSENTIALLY A DEMAND FOR DEPOSIT FACILITIES, THAT IS, A DEMAND FOR A SAFE AND CONVENIENT MEANS OF MANAGING LIQUID ASSETS. FREQUENTLY, THERE ARE MORE DEPOSITORS WITH ACCESS TO FINANCIAL INSTITUTIONS THAN THERE ARE BORROWERS. DEPOSITS PROVIDE AN ENTRY POINT INTO FORMAL FINANCE UNDER THE CONTROL OF THE SAVER AND THE DEPOSIT CONNECTION EVENTUALLY FACILITATES ACCESS TO LOANS.

FROM THE PERSPECTIVE OF POTENTIAL BORROWERS, THEREFORE, DEPOSIT ACTIVITIES CONTRIBUTE TO THE GENERATION OF CREDITWORTHINESS. FROM THE PERSPECTIVE OF THE INTERMEDIARY, DEPOSIT MOBILIZATION INCREASES VIABILITY AND INDEPENDENCE.

OSU HAS CONDUCTED SEVERAL EXPERIMENTS IN RURAL DEPOSIT MOBILIZATION IN RECENT YEARS. SEVERAL LESSONS HAVE BEEN LEARNED. (SEE CHART THREE) FIRST, THE AMPLE AVAILABILITY OF FINANCIAL SAVINGS IN THE RURAL AREAS OF DEVELOPING COUNTRIES HAS BEEN CONFIRMED.

SECOND, DEPOSITS HAVE RESULTED FROM REDUCED PRESENT CONSUMPTION AS WELL AS FROM PORTFOLIO REVISIONS AND ASSET TRANSFORMATIONS. THUS, MORE SAVINGS HAVE BEEN GENERATED AND BETTER WEALTH USES HAVE BEEN PROMOTED.

CHART THREE
DEPOSIT MOBILIZATION

Availability of Rural Financial Services:

Savings
Non-Financial Assets
Financial Assets

Demand for Deposit Services:

Net Return to Depositors
Interest Rates
Transaction Costs
Risk
Asset Characteristics

Supply of Deposit Services:

Institutional Scope
Branch Network
Customer Relationship
Staff Incentives

Political Economy:

Borrower Domination
Patronage
Donors

Second-Generation Problems:

Liquidity Management
Portfolio Management
Loan Collection
Information Management
Competitiveness
Pricing and Costs

Procedure:

Technical Assistance
Local Research
Policy Dialogue
Experimentation
Dissemination

SUBSTITUTIONS AMONG FINANCIAL ASSETS HAVE BEEN MINOR IN RURAL DEPOSIT MOBILIZATION PROGRAMS, GIVEN THE LIMITED ACCESS TO SUCH ASSETS PREVIOUSLY ENJOYED BY THIS POPULATION.

THIRD, A STRONG DEMAND FOR DEPOSIT SERVICES HAS BEEN DETECTED. ALTHOUGH POSITIVE INTEREST RATES IN REAL TERMS HAVE BEEN AN IMPORTANT DETERMINANT OF THE MAGNITUDE OF THIS DEMAND, OTHER FACTORS HAVE BEEN SIMILARLY CRUCIAL. THE MOST PROMINENT HAS BEEN THE ROLE OF TRANSACTION COSTS FOR DEPOSITORS.

GIVEN THE SMALL SIZE OF DEPOSITS AND WITHDRAWALS, TRANSACTION COSTS HAVE A MAJOR IMPACT ON THE NET RETURN ON DEPOSITS FOR SAVERS. SIMILARLY, HIGH TRANSACTION COSTS AND RISKS HAVE BEEN ASSOCIATED WITH THE HOLDING OF OTHER ASSETS IN THE RURAL AREAS OF DEVELOPING COUNTRIES. THUS, A REDUCTION IN THE RISKS AND TRANSACTION COSTS OF HOLDING WEALTH AND IN MANAGING LIQUIDITY HAS BEEN A POTENT INCENTIVE IN DEPOSIT MOBILIZATION EFFORTS. SMALL MINIMUM SIZE, DIVISIBILITY, AND GOOD SERVICE HAVE BEEN IMPORTANT INCENTIVES, TOO.

FOURTH, DEPOSIT MOBILIZATION HAS STRENGTHENED FINANCIAL INSTITUTIONS WHERE THE NEW SERVICE HAS BEEN INTRODUCED. THIS HAS BEEN THE CASE WITH BOTH BANCO AGRICOLA AND SEVERAL CREDIT UNIONS IN THE DOMINICAN REPUBLIC. LOAN COLLECTION PERFORMANCE, IN PARTICULAR, SUBSTANTIALLY IMPROVES. EXPERIMENTS IN OTHER COUNTRIES CONFIRM THESE FINDINGS.

FIFTH, DEPOSIT MOBILIZATION HAS BEEN COMPARATIVELY EASY FOR FINANCIAL INSTITUTIONS WHICH ALREADY POSSESSED A NETWORK OF BRANCHES AND OF LINKS TO AN EXISTING CLIENTELE IN THE RURAL AREAS. THIS WAS THE CASE OF BANCO AGRICOLA IN THE DOMINICAN REPUBLIC.

AFTER LESS THAN THREE YEARS, THIS INSTITUTION MANAGED TO ATTRACT OVER 60,000 SAVINGS DEPOSITS, VALUED AT OVER 15 MILLION U.S. DOLLARS, AT ALMOST NO MARGINAL COST TO THE BANK. THAT IS, ADDITION OF THE NEW FUNCTION REQUIRED THE HIRING OF ONLY THREE NEW EMPLOYEES IN THE WHOLE NETWORK. THIS WAS POSSIBLE BECAUSE OF UNUTILIZED CAPACITY AT EXISTING BRANCHES.

DEPOSIT MOBILIZATION HAS ALSO BEEN COMPARATIVELY EASY FOR FINANCIAL INSTITUTIONS WITH A LOCAL ROOT. THIS HAS BEEN THE CASE OF CREDIT UNIONS THAT HAVE CHOSEN TO MOBILIZE VOLUNTARY DEPOSITS IN THE LOCAL COMMUNITIES RATHER THAN LIVE OFF EXOGENOUS FUNDING. AGAIN, IN THE DOMINICAN REPUBLIC, OVER TWO YEARS, FOUR CREDIT UNIONS HAVE MOBILIZED 5 MILLION DOLLARS FROM 6,000 MEMBERS, IN SAVINGS, NOT SHARE ACCOUNTS.

SIXTH, CONDITIONS FOR SUCCESS OF THE DEPOSIT MOBILIZATION EFFORTS INCLUDE THE CORRECT SET OF INCENTIVES BOTH FOR POTENTIAL DEPOSITORS (TO GENERATE A DEMAND FOR THE SERVICES) AND FOR BANK MANAGEMENT AND STAFF (TO MAKE THE SUPPLY OF THESE SERVICES POSSIBLE).

SEVENTH, THE INTRODUCTION OF DEPOSIT MOBILIZATION ACTIVITIES IS PARTICULARLY DIFFICULT IN INSTITUTIONS WHERE THE POLITICAL ECONOMY ARRANGEMENTS ARE BORROWER DOMINATED. THIS WILL BE THE CASE IN DEVELOPMENT BANKS WHICH ARE RETAILERS OF GOVERNMENT AND DONOR FUNDS TARGETED FOR PARTICULARLY BORROWER GROUPS AND IN CREDIT UNIONS THAT HAVE ACCESS TO SUBSIDIZED FUNDS FROM OUTSIDE.

IN THESE BORROWER-DOMINATED AGENCIES, THE PRICING STRUCTURE WILL NOT INCENTIVATE THE ATTRACTION OF VOLUNTARY FINANCIAL SAVINGS, WHILE THE INSTITUTIONAL ORGANIZATION WILL NOT PROMOTE LOAN COLLECTION.

EIGHTH, DEPOSIT MOBILIZATION IS NOT EASY. A LONG GESTATION PERIOD AND COMPLEX PREPARATION MAY BE NECESSARY TO MAKE IT POSSIBLE. THE INTRODUCTION OF DEPOSIT MOBILIZATION IN INSTITUTIONS THAT DID NOT PROVIDE THIS SERVICE CREATES NEW DILEMMAS ABOUT STRATEGY, ORGANIZATION, AND POLICIES. IT BECOMES NECESSARY TO FACE A HOST OF SECOND-GENERATION PROBLEMS.

LIQUIDITY MANAGEMENT BECOMES CRITICAL, IF THE INSTITUTION IS TO FACE SEASONAL OR UNEXPECTED FLUCTUATIONS IN DEPOSIT LEVELS. PORTFOLIO MANAGEMENT IS CRUCIAL, TO INCREASE THE PROFITABILITY OF THE MOBILIZED FUNDS AND GUARANTEE THE RETURN OF DEPOSITS TO SAVERS. LOAN COLLECTION IS CRITICAL, IF THE INSTITUTION'S IMAGE IS TO BE SAFEGUARDED. INFORMATION MANAGEMENT REQUIREMENTS BECOME MUCH MORE DEMANDING AND USUALLY REQUIRE A COMPLETE REVISION OF DATA GENERATION AND MANAGEMENT SYSTEMS.

PRICING BECOMES A MORE DIFFICULT PROBLEM, AS THE NUMBER OF INTERRELATED FINANCIAL OUTPUTS INCREASES. ATTRACTIVE INTEREST RATES ON DEPOSITS NOW IMPLY HIGHER LOAN RATES. THE INSTITUTION HAS TO BECOME MORE FLEXIBLE, MORE EFFICIENT, MORE RESPONSIVE TO CLIENT NEEDS, IF IT IS GOING TO COMPETE SUCCESSFULLY FOR DEPOSITS.

THE CONTRIBUTIONS OF THE OSU EXPERIMENTS IN RURAL DEPOSIT MOBILIZATION HAVE BEEN THE RESULT OF SEVERAL STRATEGIC EFFORTS. IF AN APPROPRIATE POLICY AND REGULATORY ENVIRONMENT HAS TO BE CREATED, THE PROGRAM REQUIRES POLICY DIALOGUE. SUCCESSFUL POLICY DIALOGUE, HOWEVER, CANNOT BE ACCOMPLISHED IN THE ABSENCE OF LOCAL INVOLVEMENT. RESEARCH BY LOCAL INVESTIGATORS AND PARTICIPATION OF LOCAL AUTHORITIES AND PRESSURE GROUPS IN OBJECTIVE AND NEUTRAL DISCUSSIONS ARE CRITICAL.

EXPERIMENTATION IS NEEDED, NOT ONLY TO ADAPT RECOMMENDATIONS TO LOCAL CIRCUMSTANCES, BUT AS ANOTHER KEY INPUT IN THE POLICY DIALOGUE PROCESS. DISSEMINATION OF THE RESULTS FROM EXPERIMENTS AND RESEARCH EFFORTS INCREASE THE POLITICAL BASE OF SUPPORT FOR THE REQUIRED REFORMS.

IN ALL OF THIS, TECHNICAL ASSISTANCE PROVIDED WITH DONOR FUNDS PLAYS A CRUCIAL CATALYTIC ROLE.