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Indirect Effects of Foreign Assistance On Rural Financial Markets in Less Developed Countries

By

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Indirect Effects of Foreign Assistance On Rural Financial Markets in Less Devloped Countries

By

Donald W. Larson and Robert C. Vogel*

Transferring resources from developed countries to less developed countries (LDCs) through foreign assistance programs is largely made up of commodity assistance such as food aid, or by foreign exchange assistance. Both of these forms have been used to transfer large amounts of resources to LDCs in the last 30 years, and both have had far more problems and negative side effects than had been expected. While the direct impact of this assistance on the LDCs is well known, its indirect effects, especially on the agricultural sector and on financial intermediaries that service agriculture, have not been adequately addressed. The purpose of the present paper is to examine these indirect effects of commodity and foreign exchange assistance on the performance of rural financial markets (RFMs) in LDCs. We will argue that these indirect effects may reduce in a fundamental way, the farmers' ability to borrow, save, and repay loans, and thereby substantially weaken the ability of financial institutions to mobilize and lend funds in rural areas.

Foreign assistance creates opportunities for the recipient countries to change economic policy to promote more rapid economic

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growth, but at the same time the opportunity may be wasted because the foreign assistance may also enable the recipient to delay making tough economic policy changes. The creditworthiness and savings capacity of farmers and the ability of financial institutions to mobilize resources and recover loans importantly depends on local economic policies. For example, agricultural prices, exchange rates and interest rate policies can either stimulate the economic growth and prosperity of the agricultural sector or contribute to its stagnation. Policies that depress agricultural prices and discourage production affect farm income and consequently the ability of farmers to save and borrow funds. Even the very best rural financial institution will have difficulty mobilizing and lending funds in a depressed agricultural economy. In the next section of this paper we will elaborate on these arguments and also analyze the extent to which many LDCs have followed policies of low prices for agricultural products because of the Public Law 480 Food for Peace program. The following section will analyze the extent to which over-valued exchange rates in many LDCs may have further contributed to low prices in the agricultural sector. The final section summarizes the main conclusions of the analysis for government price, exchange rate and interest rate policies.

Food Aid

Recently the number and extent of food aid programs has increased rapidly with the addition of the European Economic Community, Canada, Australia and others to the list of major food donors.

Food export subsidies and the danger of food trade wars between the EEC and the U.S. suggest that competition for more exports among donors is strong. One indication of this increased competition among food aid donors is that the U.S. share of food aid in cereals has declined from over 90 percent of the total in the mid-1960s to slightly over half of the total in the early 1980s. Since an analysis of the indirect effects of all these programs on RFMs is beyond the scope of the present paper, the U.S. Public Law 480 program is selected to illustrate these effects because it is the largest food aid program.

The U.S. Agricultural Trade Development and Assistance Act of 1954 (also known as Public Law 480 or Food For Peace) under which nearly $32 billion of food assistance has been provided to recipient countries on a concessionary basis has been a generally politically popular program in the U.S. as well as in the recipient countries. Within the U.S., food assistance has had strong support among farm groups because it represents an important outlet for farm product and among other groups because food assistance to the poor and hungry of the LDCs has appealled to humanitarian values. In addition, food aid is popular because it is thought to be additional aid that would not otherwise be available from donor countries.

There are several arguments in favor of food aid in terms of its impact on recipient countries. One of these arguments is that food aid can have a favorable impact on the poorest of the poor through distribution at concessionary prices or through food-for-work projects. Another argument is that food aid can provide financing for government development projects which promote economic growth and increased self reliance in the recipient country. It is also widely argued that food aid can assist the recipient country to accumulate inventories of basic foods that can be used to stabilize farm and consumer prices and to assure adequate food supplies.

The P.L. 480 Law as amended, states that it is U.S. policy "to expand international trade; to develop and expand export markets for U.S. agricultural commodities; to use the abundant agricultural productivity of the United States to combat hunger and malnutrition and to encourage economic development in the developing countries, with particular emphasis on assistance to those countries that are determined to improve their own agricultural production; and to promote in other ways the foreign policy of the United States."[1/] Inconsistencies in the above objectives are readily apparent since the expansion of export markets for U.S. agricultural commodities can easily conflict with efforts to increase agricultural production in developing countries.

As shown in Table 1, total P.L. 480 assistance equalled nearly 32 billion U.S. dollars from July, 1954 through September 1981. Of the $32 billion, slightly over $22 billion were Title I sales, of which about $12 billion were local currency sales and $10 billion were long term dollar credit sales and convertible local

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[1/] Agricultural Trade Development and Assistance Act of 1954, as amended Public Law 480, 83rd Congress, Washington, D.C., 1979, p. 1.

Table 1: Value of U.S. Farm Products Shipped Under Public 480 Compared With Total Exports of U.S. Farm Products, July 1954 through September 30, 1981*

Year	Public Law 480: Title I: Sales for Local Currency[1/]	Public Law 480: Title I: Long-Term Dollar and Convertible Local Currency Credit Sales[2/]	Public Law 480: Title II: Government to Government Donations and World Food Programs[3/]	Public Law 480: Title II: Donation through Voluntary Relief Agency[4/]	Barter for strategic materials[5/]	Total P.L. 480	All Total Agricultural Exports	P.L. 480 Exports as a Percent of Total Agricultural Exports
	---Million dollars---							
1955	73	---	52	135	125	385	3,144	12
1956	439	---	63	184	298	984	3,496	28
1957	908	---	51	165	401	1,525	4,728	33
1958	657	---	51	173	100	981	4,003	24
1959	724	---	30	131	132	1,017	3,719	27
1960	824	---	38	105	149	1,116	4,519	24
1961	951	---	75	146	144	1,316	4,946	26
1962	1,030	19	88	160	198	1,495	5,142	29
1963	1,088	57	89	174	48	1,457	5,078	29
1964	1,056	48	81	189	43	1,418	6,068	23
1965	1,142	158	55	183	32	1,570	6,097	26
1966	866	181	87	180	32	1,346	6,747	20
1967	803	178	110	157	23	1,271	6,821	19
1968	723	300	100	150	6	1,280	6,383	20
1969	346	427	111	154	1	1,039	5,826	18
1970	309	506	11[illegible]	128	---	1,056	6,718	16
1971	204	539	138	142	---	1,023	7,753	13
1972	143	535	228	152	---	1,058	8,046	13
1973	6	661	159	128	---	954	12,902	7
1974	---	575	147	145	---	867	21,293	4
1975	---	762	148	191	---	1,101	21,578	5
1976	---	650	65	192	---	907	22,147	4
July-Sept. 1976	---	316	18	51	---	385	5,355	7
Oct.-Sept. 1976-77	---	760	92	250	---	1,102	23,974	4
Oct.-Sept. 1977-78	---	739	112	223	---	1,074	27,291	4
Oct.-Sept. 1978-79	---	793	128	265	---	1,186	31,975	4
Oct.-Sept. 1979-80	---	859	222	254	---	1,335	40,481	3
Oct.-Sept. 1980-81	---	770	234	275	---	1,279	43,788	3
Total	12,292	9,834	2,885	4,784	1,732	31,527	350,018	9

--- = Not applicable. Details may not add to totals due to rounding

* Oct.-Sept. 1976/77 is the beginning of the new fiscal year. No comparison will be made for Oct.-Sept. 1975/76 year.

1/ Authorized by Title I, P.L. 480.

2/ Shipments under agreements signed through Dec. 31, 1966, authorized by Title IV, P.L. 480. Shipments under agreements signed from Jan. 1, 1967, authorized by Title I, P.L. 480, as amended by P.L. 89-808.

3/ Authorized by Title II, P.L. 480. Includes World Food Program.

4/ Authorized by Section 416 of the Agricultural Act of 1949 and Section 302, Title III, P.L. 480 through Dec. 31, 1966. Authorized by Title II, P.L. 480, as amended by P.L. 89-808, effective Jan. 1, 1949.

5/ Authorized by Section 303, Title III, P.L. 480, and other legislation. Includes some shipments in exchange for goods and services for U.S. agencies before 1963.

Source: Food for Peace 1981 Annual Report on Public Law 480. USDA, Washington, D.C.

currency sales. Title II donations comprise most of the remaining $10 billion in total P.L. 480 assistance. P.L. 480 exports have exceeded $1 billion annually nearly every year since 1954 which demonstrates that this has been an important market for U.S. farm products, especially during the 1960s.

The distribution of P.L. 480 assistance by major recipients demonstrates that the countries have been mostly Asian, some Latin American and even a few European (Table 2). Seven countries (India, South Korea, Pakistan, Egypt, Indonesia, South Vietnam and Yugoslavia) have each received over $1 billion of P.L. 480 assistance since 1954. In recent years, Egypt has been the largest recipient of P.L. 480 assistance while other major recipients have been India, Indonesia and Bangladesh. Significant reductions in food aid to South Korea, Pakistan, South Vietnam, Brazil, Israel, Turkey, Morocco, Taiwan, Tunisia, Sri Lanka, Cambodia and Colombia have occurred since 1975. The distribution of food assistance by major recipients suggests that a mixture of economic and national security interests have been important selection criteria.

The Public Law 480 Food for Peace program was approved to provide food commodities to LDCs and to reduce the large food stocks in the U.S.; however, the program did not take into account the long run impact of cheap food (food prices below market equilibrium clearing levels) on incentives for agricultural production in LDCs. The provision of cheap food imports may not only reduce farm prices and hence the incentive to produce food but may

Table 2: Major Recipients of Public Law 480 Aid, By Selected Periods
Fiscal Years July 1, 1954 through September 30, 1981[a/]

Country	1954-64	1965-74	1975-81	Total
		-- Million Dollars --		
India	2,084	2,933	1,023	6,040
South Korea	493	1,034	445	1,972
Pakistan	736	906	493	2,135
Egypt	690	222	1,543	2,455
Indonesia	212	757	738	1,707
South Vietnam	130	1,307	27	1,464
Yugoslavia	783	238	--	1,021
Brazil	501	385	11	897
Israel	289	375	52	716
Bangladesh	--	66	775	841
Turkey	452	218	4	674
Spain	604	18	--	622
Poland	535	33	--	568
Morocco	97	264	166	527
Italy	403	3	--	406
Taiwan	237	158	--	395
Chile	128	112	199	439
The Phillippines	89	167	165	421
Japan	367	--	--	367
Tunisia	96	200	93	389
United Kingdom	342	11	--	353
Sri Lanka	56	101	139	396
Cambodia	--	207	145	352
Colombia	118	131	31	280
Portugal	59	48	90	297
Greece	202	43	--	245
West Germany	212	3	--	215
World Total	11,692	11,463	8,372	31,527

a/ Includes all countries which directly received over $200 million under all titles of P.L. 480 -- sales, grants, and barter -- during fiscal years July 1954 through September 30, 1981.

Source: Annual Reports on Public Law 480 for 1955, 1964, 1974 and 1981, and U.S. Agricultural Exports under Public Law 480, ERS Foreign Report No. 395, U.S. Department of Agriculture, 1974.

also depress incomes in the agricultural sector where the majority of the poor in LDCs is located. The food imports may be cheap because of low prices or the soft loan terms on which the food is sold. In addition, food imports under P.L. 480 may reinforce the cheap food policies that are already popular in many LDCs. This type of aid indirectly affects the performance of RFMs through its impact on food prices, farm production and food policy in recipient countries. These indirect effects can greatly reduce the performance of RFMs in LDCs.

At first glance, food assistance would appear to be a boon to financially hard-pressed LDCs that import substantial amounts of food. Over the past decade they have increasingly relied on food imports to meet the demand from rapidly growing populations and some increases in income. Egypt, Sudan, Ghana, Jamaica, The Dominican Republic, Bangladesh and others now depend on sizable food imports, even in normal agricultural years. In Bangladesh, for example, cereal food aid imports have averaged over 90 percent of total cereal imports in the latter half of the 1970s. Cereal food aid was 38 percent of total cereal imports in Sudan in this same period [Clay and Singer, 1982]. In The Dominican Republic and Jamaica concessionary cereal imports reached 25 percent of total cereal imports in 1980. Many of these countries have become dependent on food aid to the extent that termination of food aid imports would cause severe food shortages in the recipient country. In most cases, the recipient country would not have sufficient foreign exchange to import an equal amount of food through normal commercial channels without sharply curtailing imports of other essential goods. A major danger of this massive food aid effort is that the recipient countries may become virtually permanently dependent on food aid in the long run rather than graduating from food aid to a combination of increased domestic production and commercial imports [Adams and Larson, 1982].

Subsidies on food exports from developed countries, whether provided directly through product prices or through concessionary interest rates on loans extended for the borrower to pay for imported food, may reduce the amount of foreign exchange the recipient countries are forced to use on food imports. The extent to which foreign exchange is saved depends upon whether or not food aid substitutes for commercial sales. In some cases such as Egypt, concessionary sales, combined with low consumer prices, create additional demand for wheat and commercial sales were not reduced. However, the concessionary sales may have substituted for what might have been additional commercial imports [Blue et al., 1983]. In the case of Brazil, food aid combined with low consumer prices substituted for commercial sales and saved foreign exchange [Hall, 1980]. The foreign exchange saving possible through food aid may resolve a short term balance of payments problem that enables the recipient country to import other critical non-food items. It may, however, reinforce an over-valued exchange rate policy, a problem to be discussed in the next section of this paper.

The balance of payments support from Public Law 480 Title I credit sales are subject to a number of conditions which may make such a resource transfer an inferior form of developmental assistance compared with a foreign exchange transfer. The transaction is a tied commodity transfer limited to the commodities currently available under the program and this varies from year to year. Wheat and wheat flour with nearly 60 percent of the value of all P.L. 480 exports have been the principal products available through the program. Rice, corn, sorghum, vegetable oil and dairy products have also been available in more limited amounts. Since the availability of the commodities varies from year to year, the balance of payments support and value of the resource transfer to the recipient country may also be reduced. The fact that Title I sales are made on a freight on board (FOB) basis and the requirement that at least 50 percent of the commodities should be shipped on U.S. flag carriers which are higher cost than other international carriers also erode the real value of the resource transfer. In addition, the recipient country must continue its usual commercial imports from the U.S. and "friendly" exporters and must ensure a positive developmental impact of the assistance. While these conditions may be desirable for a variety of reasons, they increase the transaction costs of food assistance because of the added time and adminstrative costs needed to fulfill these conditions. Furthermore, Title I programs are only on an annual basis.

Although few research studies have systematically analyzed the relationship between food aid and food prices in the recipient countries, several studies have analyzed farm prices in LDCs. One reason for the lack of studies is that it is hard to establish a cause and effect relationship between P.L. 480 and cheap food policies in LDCs. The LDCs appear guilty by association because it is too commonly observed to be ignored. Peterson [1979] estimated the prices received by farmers for output relative to the price of a major input for 53 countries in 1968-70. The results point out that real farm prices are more favorable to farmers in developed countries than to farmers in the LDCs with a few exceptions such as South Korea and Pakistan, and that farm prices in the top ten countries averaged 3.7 times more than farm prices in the lowest ten. Food price policies of the LDCs tend to result in low farm and consumer prices in contrast to the high farm and consumer prices of the developed countries. Consumer welfare seems to be a more important policy objective than producer welfare in LDCs.

Lutz and Scandizzo [1980] in a study of price distortions in seven developing countries (Argentina, Egypt, Kenya, Pakistan, Portugal, Thailand, and Yugoslavia) found substantial disincentive effects on food production because of heavy implicit and explicit taxation of the agricultural sector. Agriculture was penalized in 21 out of the 24 cases studied in these seven countries. As a consequence, agricultural production is discouraged, while consumption is subsidized, and the opportunity for more foreign exchange earnings from agricultural exports is lost.[2/]

[2/] Larson and Vogel [1980] in a study of price and price policy in Costa Rican agriculture found that government policy toward the agricultural sector resulted in declining real farm prices and the stagnation of farm output in the 1970s.

Three countries (Egypt, Pakistan and Yugoslavia) of the seven in the Lutz and Scandizzo study have each received over $1 billion of P.L. 480 assistance. A recent study of P.L. 480 Title I wheat imports in Egypt concluded that an association has existed between wheat imports and declining or stagnant domestic production of wheat. The Egyptian government's policy of keeping bread cheap and plentiful, and maintaining artificially low producer prices has reduced the economic incentive for farmers to produce wheat [Blue et al, 1983]. Thus, it is quite evident that various major recipients of P.L. 480 assistance have followed agricultural policies that depress farm prices and discourage farm output. Clearly these low food price policies would have been much more difficult to sustain without P.L. 480.

By lowering agricultural prices, food aid reduces incomes in the agricultural sector where a vast majority of the poor in less developed countries is located. Although food aid increases the incomes of persons receiving the food, this gain may be offset by the absolute fall in farm income in rural areas caused by the decrease in farm prices due to the food assistance. The food aid not only lowers the price to domestic producers of the imported good but also the prices to domestic producers of close substitutes. Furthermore, as farmers shift resources from production of the imported good to production of other goods the prices of the other goods will decline. A study by Dudley and Sandilands [1975] found that both production and income of Colombian farmers declined because of declining wheat prices caused by P.L. 480

wheat shipments and that Colombia imported 1,400,000 tons of wheat which could have been produced domestically at a lower opportunity cost. Lipton [1977] analyzed the impact of food aid on farm income in India and quotes an unidentified report from the U.N. Office in Bangkok that the immediate loss to Indian farmers in the year of release, before they had time to compensate by switching to other crops, was equivalent to 1.9 percent of farm income between 1957-63, 7.7 percent in 1964-67 and 1.2 percent in 1968-69.

In addition to the adverse impact cheap food imports have on the incomes of farmers in LDCs, these imports reinforce the cheap food policies that are already popular in many LDCs. The possibility of cheap food from P.L. 480 may contribute to food and agricultural policies that result in less government investment in and attention to the problem of food production in the recipient country [Hayami and Ruttan, 1971]. These policies include price ceilings, forced sales of products to government agencies at low prices, agricultural export restrictions, "taxes" levied on farmers by commodity marketing boards and distorted exchange rates that tax agricultural exports and subsidize food imports. These cheap food policies are a major reason for the grinding poverty that gnaws at rural families in many LDCs. Such poverty adversely affects the ability of farmers to borrow, save and repay loans and consequently the performance of RFMs in LDCs.

Policies that depress farm prices and discourage farm output destroy the roots of agricultural development in LDCs. Since the price of the product and the amount produced strongly influence farm income, the farmer suffers a substantial loss of income when both the output price and amount produced are lower. The decline in income may lead to stagnation of the agricultural sector with reduced savings and loan demand. In a prosperous growing agriculture, the financial institutions will likely have a strong loan demand, and a strong record of mobilizing resources and recovering loans. It is not surprising that the RFM's of some countries such as Taiwan have performed so well while the RFM's of other countries such as Ghana have performed so poorly.

While agriculture may be penalized as a result of food aid, recipient governments may prefer the food aid because of the benefits to other interest groups, primarily urban based, of the country. The lower food prices possible from cheap food imports will benefit the industrial user of raw materials, the military, government employees, the consumer, and the dominant political party in the country [Lipton, 1977]. The cheap food imports may also enable the government to postpone making some difficult economic policy changes such as the appropriate exchange rate, interest rate and price level to stimulate agricultural production and growth.

Foreign Exchange Assistance

Given the shift in U.S. policy toward encouraging agricultural output in developing countries, it is useful to evaluate the effects of large amounts of foreign exchange assistance on achieving this objective. Commodity aid, such as P.L. 480, has been criticized because it is tied aid; that is, specific commodities are provided that are almost certain to be less valuable to an LDC than an equal amount of purchasing power that could be spent on whatever imports the LDC might prefer. The transfer of foreign exchange from the U.S. which allows LDCs to expand credit for agriculture while importing whatever commodities happen to coincide with the credit expansion thus appears to be an ideal way to promote agricultural output in LDCs at minimum cost. This approach is reinforced by the view that developed countries, especially the U.S., have abundant capital potentially available for transfer abroad.

The increased foreign exchange made available through either food or funds assistance may resolve short term problems of foreign exchange scarcity for the recipient country; however, this may also contribute to a far more serious long term economic problem of an over-valued exchange rate. LDCs typically fix the value of their currency in relation to that of a major trading partner such as the U.S. dollar and the exchange rate can be pegged at a value above what would be determined in a free market, when large amounts of foreign exchange grants or loans are available. If the official exchange rate is over-valued, then revenues received in domestic currency for export sales are accordingly reduced, so that the incentives for producers to export, or even to produce those products which might be exported, are reduced.[3/] In a similar way the domestic currency costs of imported

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[3/] See Schuh [1974] for an analysis of exchange rate policy and U.S. agriculture.

goods are also reduced so that the incentives to import are increased. The net effect of the over-valued exchange rate is to tax exports and subsidize imports both of which will cause an even greater problem of foreign exchange scarcity in the future. Such a policy impacts agriculture in a substantial way in most LDCs because the agricultural sector is a large segment of the economy and because agricultural exports typically represent a major source of foreign exchange earnings.

Exchange rates can become over-valued because of differential rates of inflation among countries and the structure of protection of a country.[4/] Since all countries have experienced some inflation during the 1970s, the exchange rate will become over-valued whenever the rate of inflation of an LDC is greater than that of the rate of inflation of its major trading partners. Domestic costs and prices will increase faster than the costs and prices of the foreign imported goods making the latter relatively less expensive. Protective trade policies such as import tariffs and quotas and export taxes and quotas also lead to an over-valued exchange rate by raising the domestic price of the protected good or lowering the price of the export good.

The over-valued exchange rates act as an implicit tax on the agricultural sector for countries that export agricultural goods while consumers of food are subsidized indirectly because of the

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[4/] See Officer [1976] for a discussion of these arguments and Balassa and Associates [1971] for a full discussion of effective protection and for estimates of effective proteccion for several developing countries including Brazil and Chile. Bale and Lutz [1981] estimate price distortions in agriculture for nine countries: France, Germany, F.F., United Kingdom, Japan, Yugoslavia, Argentina, Egypt, Pakistan and Thailand.

low prices for these items. The depressed prices for food eliminate incentives for domestic food production and cause stagnation of the agricultural sector [Pollard and Graham, 1983]. At the same time, the imports of food may increase because the over-valued exchange rate makes food as well as other items relatively cheap to import. The over-valued exchange rate benefits urban consumers while penalizing rural producers and widens the urban-rural income gap in LDCs.

In an economy with an over-valued exchange rate, the government frequently possesses a system of exchange rate controls and other restrictions to allocate access to foreign exchange among importers. In this allocation process an "urban bias" may also emerge because the urban importers are more likely to be in frequent contact with the key decisionmakers than the importer of some goods for the agricultural sector. Thus, agriculture may also lose in the foreign exchange allocation process. Agricultural producers can be heavily taxed in an economy where the commodity exported only earns the official exchange rate while some imported commodities needed in the production process must be purchased at a parallel market rate because of an insufficient allocation of foreign exchange at the official rate.

In an attempt to compensate agriculture for these depressed prices, governments frequently adopt a low interest rate policy on agricultural credit or a subsidy on selected farm inputs. However, such a policy fails to compensate agriculture adequately because the interest costs represent a relatively small percentage (about 5 percent) of the total cost of production of most farm products. A 25 percent decrease in interest rates will do very little to improve profitability in agriculture compared to a 25 percent increase in the product price. Thus, appropriate exchange rates and higher output prices will do far more to improve profitability and stimulate agricultural production than low interest rates. New technology to improve yields can also greatly enhance profitability; however, such technology is not likely to be developed for and used in an agricultural economy with such price and exchange rate policies.

In a depressed agriculture, RFMs will also fail to perform adequately for a variety of reasons. Delinquency rates may be high because farmers are less able to repay loans to the financial institutions. The financial institutions will have difficulty mobilizing resources because the low interest rates offer no incentive to save and producers have lower incomes. The availability of cheap credit will result in an excess demand for credit and lead to a rationing of credit among borrowers. [Vogel and Larson, 1980]. Financial institutions will have no incentive to attract new borrowers and/or savers because all the available funds can readily be lent to the current clientel [Vogel, 1981]. The financial institutions will be unable to grow in size to achieve the economies of scale that would lower the costs of financial intermediation.

Conclusions

Foreign assistance to transfer resources from developed countries to LDCs in the form of food aid or foreign exchange assistance to promote agricultural production and growth has very harmful, indirect effects on rural financial markets in recipient countries. These indirect effects reduce in a substantial way the creditworthiness and savings capacity of farmers and the ability of rural financial institutions to mobilize resources and recover loans. Transaction costs will be high because lending is risky and the size of deposits and loans is small.

While P.L. 480 provides additional food for the LDCs in the short run, the long run impact of cheap food consists not only in lower farm prices and reduced incentives to produce food in LDCs but also in government policies that further depress farm prices in LDCs. The easy availability of foreign exchange assistance makes it possible for the recipient countries to persistently maintain an over-valued exchange rate that further depresses farm prices, discourages farm output and lowers farm income. The over-valued exchange rate acts as an implicit tax on exports and subsidy on imports that benefits urban consumers through cheaper food and penalizes rural producers.

Such economic policies lead to a depressed agricultural economy. These conditions contribute in a significant way to the poor performance of rural financial markets in LDCs. In the past, a lot of time has been devoted to the analysis of financial policies and their impact on RFMs while ignoring the indirect effect of price and exchange rate policy on RFMs. These other policies are also important. The RFMs cannot succeed in LDCs with an agriculture subjected to these inappropriate economic policies.

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