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COMPENDIUM OF EVALUATION FINDINGS

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AGRICULTURAL CREDIT VERSUS RURAL FINANCE

Few agricultural credit projects have either achieved their agricultural production and rural development goals or significantly improved rural financial markets. They generally have failed to strengthen rural savings mobilization, reduce transaction costs for borrowers and lenders, and create sustainable financial institutions. Thus, USAID should contribute to the long-term development of viable rural financial markets and provide technical assistance and training to strengthen rural financial institutions and markets rather than subsidize cheap loans to a few beneficiaries.

Background

Agricultural credit has been one of the major components of USAID's assistance to agriculture in developing countries. USAID has funded two types of credit projects: (1) "credit-component" projects, in which credit is included as an input necessary for the adoption of new technology, and (2) "credit-only" projects, from which funds are on-lent to producers to finance selected inputs and investments. Historically, the underlying rationale for these projects was that targeted cheap credit would accelerate the adoption of new technology, increase agricultural output and income, and improve rural income distribution. The implicit assumption was that farmers either had no savings or were unwilling to risk them in new technologies or investments.

Beginning in the early 1970s, various academic studies and donor evaluations revealed that many credit projects not only failed to meet their objectives, but also damaged the participating financial institutions. The Agency's experience, synthesized in CDIE evaluations and USAID-funded research at Ohio State University, is the basis for this summary. Different conclusions have emerged from recent research and evaluation studies by the World Bank and others; a further CDIE special study of all relevant reports is underway.

Findings

Subsidized agricultural credit projects have:

- **Had limited impact on agricultural production.** Formal loans have been small for most farmers relative to the large investments that remain to be financed with equity funds or informal loans. Targeted loan funds have often substituted for farmers' own funds or have been diverted to other purposes. Viable financial institutions have not been created to ensure farmers of a reliable source of future loans to finance production and investments once a credit project is completed.

- **Negatively impacted on rural income distribution.** Most targeted loans have gone to medium and large farmers rather than to small farmers and the landless. The few fortunate borrowers potentially benefit in three ways: (1) they get the loans; (2) they receive the interest subsidy provided in most credit projects; and (3) they may be able to use political clout to avoid repayment.

- **Weakened financial institutions.** The largest burden for many institutions is the poor loan recovery that occurs with targeted loans. Borrowers often perceive that loans financed by government or donor funds do not have to be repaid, and the periodic forgiveness of loans by governments reinforces this view. Credit projects also often impose large lending and reporting costs on financial institutions, but the narrow interest margins permitted for most targeted loans do not cover these costs and the loan losses. Financial institutions have failed because of these problems. Some have been recapitalized or merged with stronger institutions, while others have continued to limp along with large nonperforming portfolios. Some public institutions employ questionable accounting procedures to hide financial weaknesses, and managers may receive salary bonuses for profits based on accrued interest for nonperforming loans. Because of this negative experience, privatized institutions have withdrawn from agricultural lending when permitted to do so.

- **Discouraged creation of competitive financial markets.** Institutions that do not participate in traditional credit projects are often discouraged from offering competitive rural financial services. Also, donors for credit projects frequently overlooks the need for broader reforms.

They generally did not require changes in financial policies that controlled interest rates; limited lending and financial operations; restricted competition; constrained financial diversification; and discouraged financial innovations, competitive offerings of new financial services, savings mobilization, and institutional sustainability.

- **Conflicted with financial system reform.** Some donor projects that provide subsidized credit for targeted beneficiaries have avoided financial institutions by channeling credit through ministries, special offices, and, more recently, NGOs. Simultaneously, other donor projects have stressed market-based interest rates, self-sufficiency of financial institutions, competitive financial markets, and regulation and supervision to ensure the safety and soundness of financial institutions. The result of these competing projects has been overlapping jurisdictions among institutions, confusion among intended beneficiaries, and segmentation rather than integration of markets.

Recommendations

- **Avoid targeted, subsidized credit projects** as a means to pursue short-term agricultural production goals.

- **Encourage financial sector reforms and promote a flexible interest rate structure** as parts of a strategy to achieve broad economic objectives of growth and stability, which benefit the entire economy, rather than aid a specific sector or a small number of beneficiaries.

- **Assist governments to build institutional capacity** to conduct policy analyses for agriculture and the financial sector.

- **Collaborate with other donors** in implementing country strategies to strengthen financial institutions and markets.

In considering how to strengthen the financial system and expand financial services for farmers and other rural nonfarm enterprises, USAID should:

- **Determine whether proposed technological packages and investments are appropriate** for the intended farm and nonfarm producers.

- **Analyze how other technologies have been financed** as an indication of whether formal finance is likely to be an important constraint for future growth.

- **Analyze price and market incentives** to determine whether they are adequate for profitable technology adoption investment.

- **Explore whether crop insurance, loan guarantees, or other methods** may be cost effective in reducing some risks of agricultural lending.

- **Conduct comparative analyses of institutions** that provide inexpensive savings and loan services and aim to expand the most promising ones.

- **Emphasize savings mobilization and encourage diversified lending portfolios** and other sound financial techniques to enhance institutional viability.

- **Fund institutional start-up costs, training, and the experimentation needed** to develop appropriate financial technologies; avoid directly subsidizing interest rates for borrowers. Provide technical assistance to financial institutions in the design of innovative client-oriented financial services.

- **Establish monitoring systems** to evaluate the accessibility, efficiency, and self-sustainability of assisted financial institutions.

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