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POLITICAL ECONOMY AND RURAL LOAN RECOVERY: AN EXAMPLE FROM BANGLADESH

by

M.A. Baqui Khalily

and

Richard L. Meyer

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Agricultural Finance Program
Department of Agricultural Economics
and
Rural Sociology
The Ohio State University
2120 Fyffe Road
Columbus, Ohio 43210-1099

Abstract

The rural loan recovery problem in developing countries is frequently analyzed from borrowers and institutional perspectives. But a frequently overlooked problem is that borrowers often are discouraged to repay or institutions are not aggressive enough to recover loans because of political interventions of the government into rural financial markets to derive the benefits of getting re-elected. Failure to address this dimension in recovery analysis may lead to an incorrect prescription of policies. This paper provides an empirical analysis of how political interventions affect rural loan recovery in Bangladesh. The government in Bangladesh intervenes into rural loan allocation and recovery indirectly through financial policies - interest exemption, loan targeting, interest rates - and directly through local political leaders and government officials. The intensity of direct intervention is expected to increase during an election period. Four variables - inflation rate, election years, interest exemption years, and bank type - were included in the model. The empirical results showed that election, inflation rate, and bank type affect the loan recovery negatively, and interest exemption positively.

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Introduction

The recovery of rural loans is necessary to maintain lender viability and to provide funds for new loans. In many developing countries, e.g., Bangladesh, Pakistan, Nepal, the supply-leading finance strategy has contributed to the expansion of the banking network and to the disbursement of large amounts of rural loans, but frequently recovery rates have been low. Often times the low rural loan recovery rate in specialized programs has been attributed to the idea that (a) rural loans are risky and (b) rural borrowers are too poor to repay (Donald). Some analysts have argued that the low recovery rate is due to lending policies, loan targeting, lender unwillingness to recover loans, and the management ability of bank employees (Braverman and Guash; Gregory et. al., Maharajan, et. al., Von-Pishcke et. al.). But a frequently overlooked problem is that borrowers are discouraged to repay and/or lenders can not recover loans because of political interventions into rural financial markets (Blair; Kane). This paper presents an empirical analysis of how political intervention affects rural loan recovery in Bangladesh.

Three basic conjectures provide the framework used in this paper for evaluating the loan recovery problem. First, honest borrowers may not be able to repay loans on time because of fluctuations in production and/or unforseen contingencies. However, a shortfall in income in one period may be offset by an increase in another period so eventually honest

borrowers repay their loans. Second, delinquent borrowers under the political protection of their sponsors can avoid repaying loans. Three, government intervention in rural loan allocation and recovery indirectly through financial policies and directly through local government officials and political leaders negatively affects loan recovery.

The Rural Banking System and Loan Recovery:

The rural banking system in Bangladesh essentially consists of four nationalized commercial bank (NCB) and two government owned agricultural development bank (BKB and RAKUB) branches. The rural banking system has undergone significant changes since 1977 because of the government's supply-leading strategy and the introduction of the "two-for-one" branching policy by the Bangladesh Bank (Central Bank). This branching policy required banks to open two rural branches for every new urban branch so rural loans could be disbursed effectively. During the 1977-81 period, the rural banking network expanded from 1,094 in 1977 to 2,851 in 1981. This slowed, however, following suspension of the policy in 1981. During the period 1976-87, the amount of total rural loans made increased by about 82 times (Khalily, Meyer, and Hushak).

Rural bank managers make two types of loans - target and non-target loans. Target loans are government sponsored rediscounted loans made under the terms and conditions set by the Bangladesh Bank, while non-target loans are made by banks using their own deposits. This paper analyzes the problem of recovering target loans. The loan recovery rate is defined as the percentage of target loans recovered to the total recoverable target loans (principal plus interest). Table 1 shows target loan recovery rate by bank. Three major

findings emerge from the table. First, the loan recovery rate shows a declining trend. Second, the recovery rate is relatively better for development banks than for NCBs. Third, the recovery rate improved marginally in 1983-84 and substantially in 1986-87 when the government granted interest exemptions to borrowers in the flood/cyclone affected area in 1984, and to all borrowers in 1987. Interest exemptions are expected to stimulate recovery in the short run but the effect of interest exemptions on the long term recovery rate is negative.

Generally most target loan borrowers repay loans. Honest borrowers may not be able to repay loans when due because of production problems or unforseen contingencies, but they eventually repay. Meyer and Srinivasan, using short term borrower data for the period 1979-84 for 89 rural bank branches, showed that about 70 percent of the principal amount of recoverable loans is recovered within five years after the due date. Borrowers under the political protection of their sponsors, however, do not repay loans (Khaled). In a recent case study, Khaled showed that elected chairmen and members of rural local governments who are most powerful in terms of rural power structure and influence did not repay any loans and no legal actions were taken against them. Not only did they not repay their own loans, they were instrumental in supporting their clients to not repay loans. Consequently, loan recovery rate is affected by political intervention.

The Nature of Political Interventions in Rural Loans:

Political intervention in rural loan allocation is frequently found in developing countries. The nature and extent of intervention depends on the rural social structure,

particularly the type of relationship that exists between patrons and clients and the sources of rural political power. In a faction based rural society as exists in Bangladesh, the traditional power structure is dominated by big farmers (Bertocci; Wood).

The government uses rural financial markets to contribute to its political objective of getting re-elected (Blair; Kane). One of the crucial components in getting re-elected is voters' perception. There are at least two ways for a regime to influence voter perceptions: (a) through achieving economic growth with low inflation and unemployment (Frey and Schneider), and (b) through distributing economic and financial benefits directly among voters. In a developing country like Bangladesh where democratic institutions are weak and the government is not stable, it is difficult for the government to influence voters through the first approach so the latter approach is more frequently used.

In Bangladesh, the government intervenes in rural financial markets to distribute financial benefits among rural borrower-voters. This has been done by creating massive target loan programs, by granting interest exemptions, and by permitting local and national political leaders to intervene in rural loan allocation and recovery in favor of their agents. The government, on the other hand, will not introduce general Central Bank or specific bank policies affecting borrower selection and loan recovery during an election period that may make it unpopular and cost it votes.

The relationship between the government's political objective and intervention in rural financial markets is schemetically represented in figure 1. As shown, the government's basic objective is to influence voter perceptions through macro-economic variables, rural financial markets, local political leaders and other socio-cultural factors. Because of

government instability and weak democratic institutions, influencing voter perceptions through macro-economic variables is difficult. Intervention in the rural financial market is a more feasible way for the government to reach a large number of rural borrower-voters. Loan recovery rates are affected by such interventions.

A Loan Recovery Model:

A model was developed to evaluate the impact of political interventions on the rural target loan recovery. Following Frey and Schneider, the general framework of the model was specified as -

$$\text{MAX } U(.)$$

$$\text{S.T. } V(t) > V(t)^{*} \qquad (1)$$

$$V(t) = f(\text{ POLIT, ECOPOL, RFMPOL, SOCIO}) \qquad (2)$$

The basic objective of government is to maximize its utility function of getting re-elected, subject to the constraints (1) and (2). Constraint (1) specifies that the government must get a minimum number of votes, $V(t)^{*}$, to be re-elected. The second constraint indicates that voting decisions are a function of political intervention (POLIT), macro-economic developments (ECOPOL), rural financial policies of the government (RFMPOL) and other socio-culturai factors (SOCIO). Since only aggregate data are available to test this model, information about individual borrowers can not be included.

Three political economy variables - interest rates, interest exemptions, and direct intervention in loan allocation and recovery - likely to influence voter's decisions and loan

recovery rate are included in the model. Interest exemption programs are expected to have two major effects: (a) they generate political support for the government in the election since they provide direct financial benefits to borrowers; (b) they contribute to a higher recovery of loan principal in the short run, but in the long run they negatively affect the recovery rate since borrowers may form expectations about future exemptions. The inflation rate is included in the model to capture the effect of real interest rates. It is argued in the rural finance literature that inflation through reducing the real interest rate may negatively affect recovery if borrowers have expectations about future higher inflation (Von Pischke et. al.).

Local government officials and political leaders also intervene in rural target loan allocation and recovery in favor of their clients. Since the degree of intervention can not be measured directly, it is assumed that the general political environment determines the degree of direct intervention. A government is less likely to support a loan recovery drive and strict borrower selection procedures during an election period because of the negative impact on borrowers. In contrast, during an election period, local government officials and elected representatives are expected to intervene in target loan allocation and/or in loan recovery efforts so that potential voters can get loans and avoid the pressure of bank officials for repayment of loans. That is, the intensity of direct intervention by local political leaders and local government officials increases in election years. Therefore, election (ELEC) is treated as a proxy for degree of direct intervention in loan allocation and recovery.

The loan recovery rate may be influenced by the organizational characteristics of the banks. NCBs are expected to behave differently from development banks since they are more oriented towards making commercially viable loans. A BANK variable is included to capture the effects of organizational, managerial and environmental characteristics of the banks.

The empirical model is specified as -

$$\text{Recovery Rate} = \alpha_0 + \alpha_1\text{ELEC} + \alpha_2\text{INFL} + \alpha_3\text{INTEXM} + \alpha_4\text{BANK}$$

where, INTEXM (interest exemption) is a policy variable. The inflation rate (INFL), defined as the annual inflation rate, is a macro-economic variable.

The variables representing ELEC, INTEXM and BANK are dummy variables in which election years, interest exemption years and NCBs are given the value of 1 and 0 otherwise. The government exempted interest due on target loans if loans were repaid within a specified time after the announcement in 1984, 1986 and 1987. On the other hand, two presidential and parliamentary elections were held in 1986 and 1988. The coefficients are expected to be negative for the BANK, ELEC, and INFL variables, and expected to be positive for INTEXM.

Parameter Estimates and Analysis of Results:

The model parameters were estimated using an ordinary least squares regression model for pooled data for five banks for the 1981-89 period. The data were corrected for heteroskedasticity and auto-correlation. The parameters of restricted and unrestricted

models were estimated to test the validity and significance of the dummy variables, that is, to test the null hypothesis that the coefficients for BANK, ELEC and INTEXM are equal to zero. The Chow-test comparing the models rejected the null hypothesis. The parameter estimates, reported in table 2, have the expected signs and are significant. The model explains 91 percent of the variance in loan recovery rate.

The INTEXM coefficient is significant and positive implying that the interest exemption policy contributed positively to the recovery rate. However, the marginal recovery rate with respect to interest exemption is only 5.58 suggesting that the three interest exemption programs had limited impact. The negative and significant ELEC coefficient supports the hypothesis that elections negatively affect loan recovery. The ELEC parameter estimate implies that the recovery rate declines by about 22 percent points during an election year. The INFL coefficient is negative and significant implying that a reduction in real interest rates decreases loan recovery rate because of the future expectation of high inflation which reduces the time value of money. The finding is consistent with the argument that low real interest rates discourage borrowers from repaying loans. The parameter estimate for BANK is negative and significant. Since a value of one was assigned to the

Summary and Conclusions

The empirical results of the model are consistent with our expectation of how political intervention affects the target loan recovery rate in Bangladesh. Three important findings emerged from the analysis of the regression results. First, interest exemption programs influence the recovery rate positively at least in the short run, while direct intervention in target loan allocation and recovery as proxied by elections negatively affects the recovery rate. Second, the inflation rate by reducing the real interest rate discourages borrowers from repaying loans because of the future expectation of higher inflation. Third, commercial banks have lower loan recovery rates. This may be attributed to different loan portfolios, management ability, and size of the banks.

Low loan recovery can be explained from different perspectives - economic, institutional and political economy. There is no denying that poor recovery rates in some cases are due to financial problems faced by borrowers. But, in addition, borrowers often do not repay loans and lenders can not energetically recover loans because of government interventions in rural financial markets to derive the benefits of getting re-elected. Failure to address this dimension in loan recovery analysis may lead to an incorrect prescription of policies. There is a growing evidence that for a given bank the recovery rate for government sponsored loans is lower than for loans made out of the bank's own resources (Aguilera). Improving the viability of rural banks in a developing country like Bangladesh requires the reduction or elimination of government intervention in loan allocation and recovery so that banks are free to make good loans and recover them.

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Table 1
Rural Target Loan Recovery Rate of Rural Banks, 1980-89
Year Ending June 30

Year	Nationalized Commercial Banks	Agricultural Development Banks	All Banks
		(Percent)	
1980-81	36.3	67.8	51.6
1981-82	31.3	67.9	50.6
1982-83	30.0	49.6	42.1
1983-84	32.4	49.9	42.8
1984-85	30.0	44.2	38.7
1985-86	20.7	30.6	26.5
1986-87	42.0	41.4	42.3
1987-88	17.3	27.2	24.3
1988-89	13.7	21.8	18.8

Source: Unpublished Data, Agricultural Credit Department, Bangladesh Bank.

Table 2
Estimated Parameters of the Target Loan Recovery Function

Variable	Unrestricted Model			Restricted Model		
	Coefficient	t-Ratio	Elasticity at Mean	Coefficient	t-ratio	Elasticity at Mean
Constant	55.30	10.14*	1.68	19.36	3.38*	0.59
Inflation (INFL)	-0.45	-1.48**	-0.15	-1.33	-2.63*	-0.43
Interest Exemption (INTEXM)	5.58	2.63*	0.07			
Election (ELEC)	-21.78	-7.69*	-0.19			
Bank	-17.35	-3.42*				
R-Square	0.91			0.22		

* Significant at 5 percent level.
** Significant at 10 percent level.

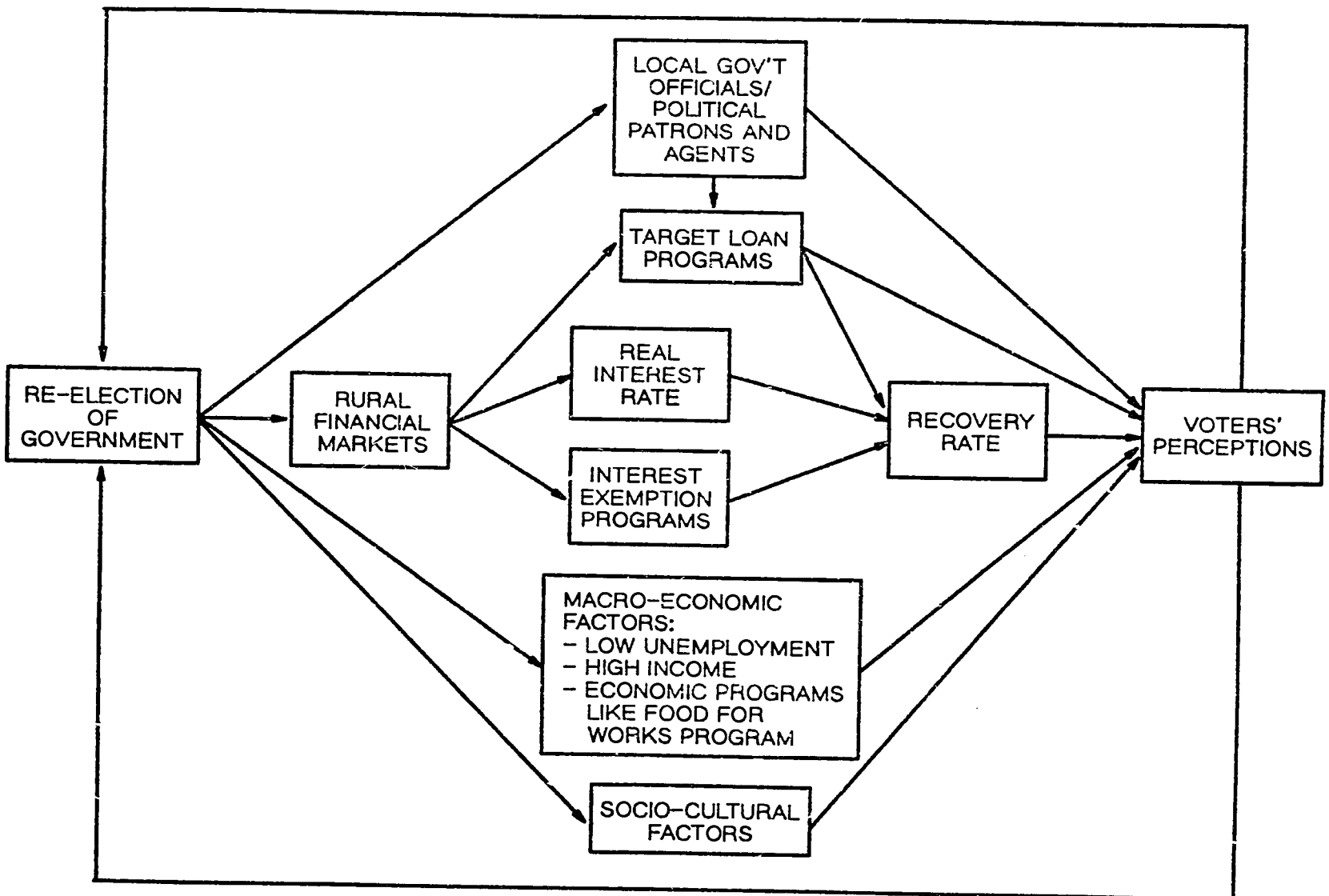

Figure 1: Relationship between Government political objective of re-election and intervention in rural financial markets