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BUILDING DURABLE RURAL FINANCIAL MARKETS

by

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October 10, 1991

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Abstract

Author evaluates two schools of thought on how success should be measured in financial markets and goes on to discuss the important but limited contributions these markets can made to development. Reasons for the poor performance of rural financial markets in many low-income countries and lessons that can be drawn from this experience are then presented. Author concludes that credit activities have been overemphasized and that more attention ought to be given to developing durable financial markets instead.

BUILDING DURABLE RURAL FINANCIAL MARKETS

by

Dale W Adams
The Ohio State University

It seemed clear and straight forward three decades ago when I, along with others, began to spread credit on problems in low income countries. Most of us felt concessionary lending was an ideal way of assisting poor people, dealing with disasters, stimulating production, speeding technological change, and prodding productive investments. The fact that credit activities could be done quickly and were able to absorb large amounts of funds made it easy to jump on the credit-led-development bandwagon. Subsequently, credit programs became the all-purpose "antibiotic" for treating development ills as governments in most low income countries--with substantial assistance from donors--committed major quantities of money for agricultural credit.[1] The initial results from many of these efforts were promising; new lending institutions were built, existing institutions were expanded, large numbers of loans were made, and many foreign technicians--me included--were employed in these efforts.[2]

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[1]For example, from the early 1970s until the late 1980s the Agency for International Development funded more than 180 rural projects with major credit components in Latin America worth nearly $2 billion (U.S.). Over a slightly longer period of time the World Bank funded 167 rural credit projects in Africa worth about $US400 million.

[2]Enthusiasm for rural credit activities was typified by a statement made in 1975 by a World Bank official in an FAO sponsored conference in Rome. He stated agricultural credit programs realized the highest rates of return of any projects funded by the Bank.

It was not until the early 1970s that sores appeared on these activities. A worldwide review of small farmer credit programs sponsored by the Agency for International Development in 1972-73 uncovered problems in loan recovery, projects that stalled after the pilot stage, and high operating costs.[3] Despite these early problems, donors and governments continued to promote rural credit, especially in Africa. It was not until the early 1980s that festering problems in many of the programs became so serious that they attracted the attention of policy makers. Nowhere have these problems been more severe than in Africa where many of the rural credit projects have been transitory and others have become bottomless pits for funds.

What many of us thought thirty years ago to be a simple way to treat poverty has turned out to be much more difficult and problematic than any of us imagined. We "finance engineers" designed and build many rural banks and credit cooperatives that failed in Africa and elsewhere. If, instead, we had been civil engineers who designed bridges and other buildings that experienced similar high rates of structural failure, I suspect we would have faced a number of malpractice lawsuits. Clearly, no one has perfected a patent on how to build efficient and durable rural financial markets.

For some time I have attempted to understand the causes of these failures, and in so doing, glean lessons that might be helpful in improving the future performance of rural finance programs. Most of the discussion that follows summarizes what I have learned about these problems and lessons. Before presenting my summary, it may be useful to

[3]A summary of this review is provided by Donald.

clarify the criteria I use to measure success and to also briefly discuss the role finance ought to play in development.

MEASURING SUCCESS

Two schools of thought exist on how success should be measured in rural finance activities: the traditional credit-project view, and the newer market-performance view.

Credit-Project View

Many designers and evaluators of rural credit projects view loans as part of a package of productive inputs. The success of these programs is usually measured by number of loans made to target group members, inputs purchased with loans, output increased through borrowing, and changes in levels of income or employment among borrowers. These measures concentrate on borrowers and evaluations often report successful results: the target number of loans were made, the expected inputs were purchased, borrowers' income and employment increased, and the internal rates of return on projects are reported to be high. While some concern is occasionally expressed over loan recovery problems, or over the high costs of carrying out the credit activities, these are often viewed as necessary project costs.

In general, the durability of the credit activity, the welfare of depositors, and the well-being of the financial system are largely ignored by individuals who hold the credit-project view. Overall these projects are dominated by concerns about borrowers or potential borrowers. Someone with deep pockets is expected to fund these efforts and in many cases credit is viewed as a universal entitlement. In extreme cases, promoters of these views act as if loans were one-time inoculations against poverty.

Market-Performance View

Recently, a growing number of individuals who are uneasy with the results of rural credit projects have argued that new criteria should be used to evaluate these efforts.[4] Supporters of these views contend that more attention should be given to the supply-side of financial intermediation, to long-run issues, to deposit mobilization, to intermediary behavior, to lowering transaction costs, to cost-reducing financial innovations, to building sustainable financial services, and to how policies affect the performance of rural financial markets. Criteria suggested for measuring overall performance include loan recovery, transaction costs of lending and deposit mobilization, number of people with sustained access to formal financial services, and the proportion of lending that comes from deposits. These measures stress the vitality and durability of the financial system and the efficiency of intermediaries therein. Advocates of this view argue loans are a privilege that should be earned through borrowers establishing their creditworthiness and should not be used as a demi-grant or a form of patronage.

Proponents of these views argue that too little attention has been give to the benefits depositors realize from access to efficient financial markets. They go on to suggest that strategies to development rural financial markets and associated evaluations ought to be

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[4]This view was strongly expressed in the World Bank's World Development Report 1989.

depositor dominated, instead of borrower focused, as is the case in traditional credit-projects.

ROLE OF FINANCE

Differences in opinion over the proper measures of success, in large part, stem from disagreements over the appropriate role of financial markets in development. Individuals with the project-view of credit often think of loans as an effective vehicle for transferring subsidies to selected target groups or as an effective tool for promoting targeted activities. Individuals holding the market-performance view, in contrast, stress the role finance plays in resource allocation and the importance of deposit mobilization.

Subsidies

Financial markets may transfer subsidies in two fundamental ways: through loan default, and through concessionary interest rates. In both cases the size of the subsidy is proportional to the size of the loan; defaulters on large loans receive a large subsidy, those who default on small loans receive small subsidies, and non-borrowers realize no subsidy. Since loan size is everywhere highly correlated with assets and income of borrowers, subsidies tied to loans turn out to be a highly regressive technique of helping poor people. Policies that tolerate higher rates of default on small loans than on large loans, or that impose higher interest rates on large loans than on small ones, provide powerful incentives for lenders to avoid making small loans. There is no practical way to overcome these fundamental characteristics of financial transactions and tilt credit operations in the favor of poor people. Most attempts to help poor people differentially through credit programs end up either destroying the financial institution that is involved, and/or largely benefiting individuals who are not poor. Typically, these programs last only as long as some outside organization or the government is willing to provide substantial subsidies.

Promoting Activities

Large numbers of credit programs have been used to promote activities such as fertilizer application, use of new technology, publicly desired investments, and enrollment in groups. Low interest rates have been used to induce intermediaries to lend for targeted purposes and to coax borrowers to undertake targeted activities. Credit components in some rural development projects are there mainly to facilitate other project efforts. Research in a number of countries, however, is showing that financial substitution, and fungibility in general, enable borrowers of targeted loans to do what is largely in their own self interest, regardless of the policy maker's objectives. Neither the access to a loan nor the interest rate charged on a loan alter the relative returns expected from various investment options faced by borrowers--unprofitable investments remain unprofitable. Product and input prices, yield increasing technology, and dependable markets are far more important than are targeted loans in influencing borrower behavior.

Finance and Resource Allocation

If financial instruments were abolished, the search costs of surplus and deficit units making contact and exchanging goods and services through barter would be prohibitive for most individuals. In addition to reducing the transaction costs of exchange, an integrated financial system also facilitates movement of goods and services among parties who are far distant from each other. It does this by mobilizing claims on resources (deposits) from units that are surplus, and allocating these claims (loans) to units that are able to productively use more resources. When these claims are spent in product and factor markets a reallocation of resources occurs from surplus to deficit units.

What does an economy lose if its formal financial market is repressed, fragmented, or poorly developed? These costs are substantial when numerous heterogeneous units are not connected by integrated, durable, and efficient markets. If financial markets are repressed, or are shallow, and connect only a few firms or households in a society, the resulting losses in aggregate output can be substantial when millions of units are involved. Assisting in this reallocation of resources is the most important contribution that financial markets make to development. No other institution in society can perform this function.

REASONS FOR POOR PERFORMANCE

Reasons for problems in rural financial markets can be grouped into two categories. The first might be termed macroeconomic conditions and policies and the second is related to attempts by policy makers to use these markets to accelerate development.

Macroeconomic policies

In a number of cases a rural financial market limps because the agricultural sector it services is stagnant or declining. This limits the number of people who are creditworthy, erodes the ability of borrowers to repay loans, and also reduces income available for deposits; a financial system cannot be financially healthy unless most of its clients are prosperous. Exchange rates that penalize farm exports, food price controls, and lack of public investment in rural areas are examples of policies that have adverse secondary effects on rural financial markets. In addition, misfortunes such as droughts, wars, typhoons, and volcanic eruptions further stress financial markets.

A healthy rural economy makes it much easier to develop an efficient and growing financial system to support it. Unfortunately, few of the rural economies in Africa are thriving and this handicaps efforts to carry out successful rural finance projects. The fact that informal financial systems appear to be flourishing in many of the rural areas in Africa where formal financial systems are distressed, however, strongly suggests that misfortune and macroeconomic policies are not a comprehensive explanation for the poor performance of financial markets.[5] Improper use of rural financial markets by governments and donors, in my opinion, have added substantially to the severity and persistence of the problems found in these markets.[6]

Improper Use of Financial Markets

When I was quite young my parents gave me a small red wagon in which, for a few months, I hauled my toys and several of my small friends. It was a dandy wagon and I

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[5]Results from some of the new research on informal finance can be found in Adams and Fitchett.

[6]See Graham and others for an example of this point.

enjoyed it a lot until my older brother wrecked it by trying to transport a large rock that weighed hundreds of pounds. The wagon simply wasn't designed to carry heavy objects.

I have often thought that numerous well-meaning policy makers inadvertently do to rural financial markets what my brother did to my red wagon--wreck it--by imposing tasks on these markets that are not suited to their inherent capabilities. Attempts to use financial markets to transfer subsidies and to target loans are not benign when it come to the well being and behavior of these markets. Targeting affects lenders in unanticipated ways; it forces them to allocate loan subsidies regressively, forces them to incur additional transaction costs in making loans, and distorts their financial innovations. Even worse, targeting fragments financial systems and causes them to be less effective in carrying out their normal function of reallocating resources among surplus and deficit units.[7]

Providing rural financial services is expensive, as evidenced by the unwillingness of many commercial banks in Africa to do it without being forced. Small transactions, transportation and information-gathering expenses, insecure collateral, and uncertainties in farming increase these costs. Loan targeting further raises these costs through multiplying lines of credit and increasing reporting requirements, as well as distorting the information flows through financial systems. This happens at the expense of monitoring loan recovery, controlling costs, and discovering cost-reducing financial technologies. Often, for example, the intermediary has up-to-date information on the amount of fertilizer supposedly pur-

[7]Failure in credit activities also undermines other development efforts to which the credit program is attached. A recent example of this is the collapse of the Global 2000 maize/fertilizer/credit program in Ghana.

chased with a line of credit, but is uncertain about the recovery status of these loans or the cost of making loans.

The extensive use of banks and cooperatives as transfer agents and as retail outlets for central banks also undermines professionalism and warps the orientation of intermediaries. Loan officers who mainly handle formula, targeted, and politically flavored loans do not develop skills necessary to lend on the basis of creditworthiness. The extensive use of rediscount lines, moreover, forms a patronal financial system that sustains itself by transferring favors granted by government to borrowers. Political intrusions into intermediation, plus feasts-and-famines in flows of funds through the system, result in over staffing, serious loan recovery problems, and low quality financial services. As Von Pischke has pointed out, these uses of financial markets repress the overall functions of these systems and often cause the formal financial frontier to contract rather than expand, especially when it comes to providing deposit services to savers.

LESSONS

A review of rural finance programs that either were successful, or were flops, suggests the following lessons for possible application in Africa:[8]

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[8]For an excellent summary of the major features of a rural finance program that is working efficiently and on a sustained basis see Patten and Rosengard.

Avoid Loan Subsidies and Targeting

Rural financial markets will always flounder as long as they are asked to do tasks beyond their inherent capabilities. Countries that run few subsidies through their financial markets and who impose few credit targeting requirements generally have more efficient and equitable rural financial systems than do countries that cannot avoid these temptations.

Mobilize Deposits

Most of the strong and durable rural financial systems emphasize deposit mobilization: the Dominican Republic, Indonesia, Taiwan, and South Korea. Deposits offer potential borrowers a systematic way of establishing their creditworthiness, provide lenders inexpensive information that is useful in screening potential borrowers, reduce the need of lenders for funds from donors and governments, and also impose more discipline on lending. Deposit mobilization also changes the image of whose money is being lent and thereby reduces loan recovery problems. Even more importantly, any efficient financial system will always provide deposit services to a much large number of depositors than borrowers, and the depositors, on average, will be poorer people than are the borrowers. Offering rewarding and dependable deposit services may be the only significant service that financial markets can provide to large numbers of poor people. Historically, almost all people around the world who have clawed their way out of poverty did so through their own savings. Relatively few people have done so through assuming more debt.

Sustain Positive Real Rates of Interest

Next to the foreign exchange rate, interest rates are the next most important set of prices. Policy makers who insist on sustaining low and, especially, negative real rates of interest on formal financial transactions condemn a formal financial system to perform poorly. Low interest rates discourage savers from making deposits, make it more difficult for lenders to carefully screen borrowers, encourage rent-seeking behavior in financial markets, undermine the sustainability of financial institutions, and create a system that must continually seek handouts. If financial markets are to be efficient, perform equitably, continue to expand, and provide sustained services, positive real rates of interest on loans and deposits are critical. In countries experiencing inflation, this means nominal interest rates must be flexible and rise and fall with inflation to maintain positive real rates most of the time.

Avoid Concessionary Discount Lines

The interest rates charged on funds available from central banks to ultimate lenders are particularly critical. If the central bank offers large amounts of rediscount funds for agricultural lending at a rate of say 4 percent per annum, for example, it is illogical to expect lenders with access to these concessionary funds to show any interest in mobilizing deposits from individuals at higher rates. Concessionary discount lines and other cheap funds from governments and donors are primary reasons for rural financial markets largely ignoring the well being of depositors.

Reduce Transaction Costs

Transaction costs are friction in financial markets and often cause the demise of rural credit programs. They play a particularly important role in limiting the services that financial institutions are willing to provide in rural areas, to poor people, and to new clients. Excessive transaction costs encountered by clients of financial institutions also discourage them from seeking loans and making deposits. Sustaining and expanding financial services importantly depend on decreasing these costs, both for the institutions and their clients. This involves using cost reducing technology, realizing economies of scale and scope, and also avoiding policies that impose transaction costs on financial markets. For example, asking rural lenders to manage numerous targeted lines of credit, each with separate reporting and evaluation requirements, substantially increases these costs. Policy makers must avoid actions that cause financial markets to incur more of these costs and also facilitate changes that reduce same.

Emulate Informal Finance

Those of us who have promoted formal credit programs can learn much from the many people who successfully provide informal financial services in low income countries. They regularly provide small and short-term loans to people with little or no normal collateral. Several important forms of informal finance also provide high quality and dependable deposit services. Some of the techniques employed in informal finance might be utilized in formal finance. Also, informal financial transactions provide excellent insights into the types of financial services that are useful to large numbers of people. It may be more appropriate to emulate rather than to try to eliminate informal finance.

CONCLUSIONS

I wish credit had been the answer to poverty and production problems in the low income countries, in part, because donors and politicians are eager to support credit efforts. I have reluctantly come to the conclusion, however, that loans most often treat symptoms rather than causes of problems. Imposing more debt on individuals does not overcome their lack of discipline, their lack of managerial skills, their lack of high return investment opportunities, or the multitude of other factors that impeded economic development. Shakespeare's admonition: "Neither a borrower nor a lender be; for loan oft loses both itself and friend" (Hamlet I, iii 65), still conveys a good deal of wisdom. The sooner we learn that individuals, firms, and countries cannot overcome poverty with debt, the sooner we will identifying more appropriate treatments for development problems. It is time to jump off the credit-led-development wagon and begin the important task of building durable rural financial markets that provide more equitable opportunities for savers first and borrowers later.

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