LAC TECH

AGRICULTURE AND RURAL DEVELOPMENT TECHNICAL SERVICES PROJECT

AID/LAC/DR/RD, CHEMONICS INTERNATIONAL, U.S. DEPT. OF AGRICULTURE

RURAL FINANCE IN LATIN AMERICAN COUNTRIES

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Submitted to:

U.S. Agency for International Development
Bureau for Latin America and the Caribbean
Office of Development Resources
Rural Development Division
LAC/DR/RD

December 1993

ENTER INFORMATION ONLY IF NOT INCLUDED ON COVER OR TITLE PAGE OF DOCUMENT

1. Project/Subproject Number	2. Contract/Grant Number	3. Publication Date
	LAC 0022 C 009041 00	

4. Document Title/Translated Title

5. Author(s)

1.

2.

3.

6. Contributing Organization(s)

7. Pagination	8. Report Number	9. Sponsoring A.I.D. Office

10. Abstract (optional - 250 word limit)

11. Subject Keywords (optional)

1.	4.
2.	5.
3	6.

12. Supplementary Notes

13. Submitting Official	14. Telephone Number	15. Today's Date
Amy Buckner	202 466-0649	4/12/94

DO NOT write below this line

16. DOCID	17. Document Disposition
	DOCRD [ ] INV [ ] DUPLICATE [ ]

AID 590-7 (10/88)

ACKNOWLEDGEMENTS

Both the research and writing of this study have benefitted from expert criticisms and suggestions from several colleagues. To all, especially the most critical, we are indebted: Claudio Gonzalez-Vega and Rodrigo Chavez of Ohio State University; Alain de Janvry of the University of California at Berkeley; Nelson Aguilera-Alfred of Universidad Catolica de Chile; Luis Ruben Zavaleta and Jeffrey Poyo of the Inter-American Development Bank; Ivan Rivera and Jacob Yaron of The World Bank; Richard Nishihara and Fyrman Aji of USAID/Jakarta; Clarence Zuvekas of USAID/Washington; and Peter Bittner, Scaff Brown, and Candace Conrad of Chemonics International.

To all our colleagues at the LAC TECH project we are grateful for the consistent and kind support during the period of intense concentration necessary to complete the study. We were stimulated by the insights of Jim Riordan, Roberta van Hafften, Emilia Roberts, John Dorman, Bill Goodwin, and Wayne Nilsestuen. Our special thanks to David Elmer. The study benefitted enormously from his research and unselfish enthusiasm.

We remain thankful to all these friends. Needless to say, any errors of the study should not be attributed to them. We are solely responsible for them.

EXECUTIVE SUMMARY

The central objective of this report is to discuss the rationale of financial policy reform and its limitations when applied to the rural context in Latin American countries. It presents an overview of rural finance for field practitioners of agricultural development to enhance their understanding of this issue. It is especially addressed to agricultural development officers at AID missions so that they can offer effective and timely technical assistance in rural finance to host governments.

The development of rural financial markets is one of the important challenges facing Latin American policy makers. Several countries of the region sustained for too long the application of misguided economic policies that ultimately contributed to an exponential increase of the marginalized rural population and to the total collapse of agricultural finance. Not surprisingly, economic reforms are now being adopted throughout the region. In the context of rural finance, these reforms include the elimination of credit targeting, the termination of credit subsidies, and the expansion of local savings as the foundation for the promotion of deposit mobilization. However, while the introduction of these policies is necessary to set the stage for the sustained financing of rural activities, it does not guarantee the conditions to complete this task. Usually, financial policy reforms reach only the formal sectors of the economies. In doing so, they fail to incorporate the large masses of the marginalized clientele into the web of specialized, dynamic, cost-effective, and innovative financial services that characterize a modern economy.

Consequently, financial policy reform is a necessary but not sufficient condition for the development of rural financial markets. This is due to the presence of high generic transaction costs, which underline the poor quality of the institutional infrastructure in many Latin American countries. Information-sharing networks, enforcing mechanisms of credit contracts, and systems for close supervision of banks are crucial components of institutional infrastructures. A major problem is that these components are poorly developed in most Latin American countries. If adequate and sophisticated institutional infrastructures are not established, financial markets will fail to operate efficiently because a vital factor of finance—trust—requires contact among participants. This personalistic relationship between lenders and borrowers, in turn, stifles the growth of "at arm's-length" transactions at the core of the overall expansion of finance and economic development.

The existence of high generic transaction costs underlines the tendency within financial markets to discriminate against lending to the agricultural sector, specifically to small-and medium-sized farmers. Traditionally, obtaining the required information to assess the creditworthiness of lenders is more costly and arduous in rural areas. In addition, the low-level incomes and the unavailability of collateral in real assets that are prevalent in these areas constrain the process of financial intermediation. Consequently, financial entities end up rationing credit to rural borrowers. This discrimination is more severe when the leading lenders show a strong urban bias, a prevailing feature in many Latin American countries.

A *laissez-faire* or hands-off approach will eventually perpetuate the conditions of inequality, exclusion, and economic stagnation of vast numbers of small-and medium-sized farmers in several Latin American countries because it does not address the special problems of rural finance. The issue is not laissez-faire or government intervention, but what specific actions the public sector must undertake to foster adequate provision of financial services to the rural poor. Fortunately, the legacy of the ill-designed rural financial policies that were implemented until the 1980s illustrates what should not be done. However, there is ample room for the government to be constructively and actively engaged. Five areas are thus identified:

(1) First, governments should ensure that exchange rate policies do not penalize farm exports and that industrial protection does not turn the terms of trade against agriculture. Failure to do so usually renders rural activities unprofitable.

(2) Second, governments should be committed to improving rural infrastructures, traditionally one of the major structural constraints to efficient markets.

(3) Third, a careful implementation of the process of financial reform is imperative. This entails the adherence to an appropriate sequencing of financial policy reforms. While the order of financial reform is usually determined by how the differing interests and agendas of the most influential groups in society are ultimately played out in the economic policy making process, it should be pointed out that there are valuable lessons that can be drawn from the experiences of several countries that have undertaken financial liberalization. For example, taming inflation should be the overriding priority. Implementing financial liberalization is too risky and dangerous with high inflation. Likewise, deregulation of interest rates should also be implemented gradually, especially if macroeconomic conditions are unstable. Finally, the elimination of all controls on capital movements should not precede the enactment of a thorough trade reform.

(4) Fourth, a strict monitoring of the financial system is necessary. Governments should ensure that the expansion of rural financial services be accompanied by more effective supervisory and inspection agencies. Prudent supervision and inspection of financial entities are crucial to the ultimate success of rural financial markets.

(5) Fifth, governments must enact measures aimed at lowering generic transaction costs, such as finding ways to improve legal systems and information-sharing networks. Above all, reducing generic transaction costs can be best attained by establishing public trust. This means adopting rules and regulations aimed at safeguarding the liquidity of the entire financial system, sanctioning the sanctity of credit contracts, and protecting the safety of deposits.

It should also be stated that USAID missions can be engaged in constructive ways. missions, for example, can be instrumental in persuading host governments that it is imperative that the policy reforms relating directly and indirectly to agriculture stay in place. Without them, any program designed to strengthen financial intermediation in rural areas is doomed to failure. Missions can also provide valuable technical assistance to central banks to improve the regulatory and supervisory mechanisms of financial systems. Lastly, missions can select a specific rural financial entity with which a pilot program could be developed. The goal would be that this entity provide financial services on demand, including the mobilization of savings, while ensuring the financial viability of its operations.

1.0 INTRODUCTION

1.1 Background and Rationale

The development of rural financial markets is one of the most important challenges facing Latin American policy makers. Until the 1980s, most countries in the region traditionally relied on a government-driven approach to serve the financial needs of their agricultural sectors. Targeted credit programs and subsidized finance were the normal, prevailing practices of development banks and foreign donors. There is, however, little evidence that such practices resulted in sustained increases in output and productivity in the agricultural sector. In extreme cases, such as Peru and Nicaragua, the application of these policies led to total collapse of agricultural finance. This is hardly surprising in a political economic context whereby subsidized credit to farmers was used to compensate for industrial protection.

This government-driven approach has now been rendered obsolete as central banks, in general, are successfully resisting pressures to keep afloat the hopelessly decapitalized state-owned agricultural banks. Furthermore, the need to cope with high inflation, sluggish economic growth, and the shocks of the debt crisis has prompted many countries to adopt badly needed economic reforms. These countries, in varying degrees, have now embarked upon reform, resulting in painful shocks from stabilization and adjustment. The introduction and successful implementation of market policies is expected to spearhead the development effort. In the context of rural finance, this entails competitively determining interest rates, eliminating credit targeting, expanding local savings as the foundation for the promotion of deposit mobilization and, in general, efficiently providing public goods and implementing adequate supervision and regulation. These measures are expected to revitalize rural finance and foster the development of agricultural capital markets.

However, while the introduction of these market-oriented policies is necessary to set the stage for the sustained financing of rural activities, it does not guarantee the conditions to complete this task. This is explained by the problems inherent in the process of transition to a competitive market economy. Conventional market reforms, unfortunately, have a limited impact when applied in economies riddled by serious supply bottlenecks and other structural obstacles that prevent the rural poor from securing access to productive resources. Consequently, it is common to observe market reforms reaching only the formal sectors of the economies. In doing so, they fail to incorporate the large masses of the marginalized clientele into the web of specialized, dynamic, cost-effective, and innovative financial services that characterize a modern economy.

Therefore, the central tenet that guides this paper is: **financial policy reform is a necessary but not a sufficient condition for the development of rural financial markets.** The presence of high generic transaction costs found in segmented markets (in which competition is limited) chokes the expansion of financial services to small- and medium-sized farmers. Consequently, effective government action is needed. A commitment to improve the quality of institutional infrastructures so that generic transaction costs are minimized and careful monitoring of financial policy reform should be the main elements of a strategy whose central purpose should be the removal of all political, institutional, and economic factors that prevent rural finance markets from operating efficiently. In several Latin American countries the rural areas are now at a disadvantage because they suffered under industrial protection policies. Just the consideration of this fact may serve to justify, on economic and ethical grounds, a decision to treat rural areas that were affected the most as special cases.

Furthermore, the paper will also propose that a more direct, hands-on approach and effective government action for the development of rural financial entities should not be ruled out. As Claudio González-Vega and Rodrigo Chávez have accurately pointed out, "providing financial services to marginalized rural clients depends on the solution of the paradox resulting from the fact that those agents with inexpensive access to information and monitoring mechanisms to ensure reasonable repayment rates may not have enough resources or may be too risk averse to provide widespread financial services in their locality, while those who do have the resources and the required attitudes toward risk have no access, at reasonable cost, to the required information and contract enforcement tools." (Cháves and González-Vega 1993.) The problem is that there are no signs that point to the solution of this paradox in many Latin American countries because the ill-conceived policies of the past propelled the growth of the vast, marginalized rural sectors whose financial needs have been inadequately served by informal lenders, private commercial banks or poorly managed state agricultural banks.

1.2 Objective and Organization

The objective of this paper is to discuss the rationale of financial policy reform and its limitations when applied to the rural context. This report is an overview of rural finance for field practitioners of agricultural development. A firm grasp on these issues will enable agricultural development officers of AID missions to offer effective and timely technical assistance to host governments. This advice can be focused, at one level, on assisting central banks improve the regulatory and supervisory mechanisms of financial systems. At another level, AID missions may select a specific rural financial entity with which a pilot program could be developed. This pilot program might fund start-up costs through a soft-term loan and provide technical assistance to selected entities. It would be advisable that missions help target a specific clientele to be served, preferably private small farmers with growth potential. The goal would be to provide financial services on demand, including the mobilization of savings, while ensuring the financial viability of the entity.

This paper consists of five sections and an appendix. Section Two discusses the rationale of financial reform, including its components and the sequencing of its policy instruments. Section Three attempts to demonstrate that these reforms are of limited effectiveness in rural areas due to the presence of high generic transaction costs. Section Four provides guidance for effective government action to improve on the provision of financial services in rural areas. Section Five details the main conditions that are necessary for the successful operation of rural financial entities. An epilogue concludes the paper, and an appendix offers a more detailed analysis of the most important concepts that are discussed in these sections.

2.0 FINANCIAL REFORM: NEED AND RATIONALE

The development of rural financial markets in general, and the expansion of agricultural credit in particular, are closely related to the presence of a predictable, stable economic environment. The design and implementation of sound financial policy is a necessary condition for macroeconomic stability. For the most part, in the 1970s, Latin American countries were deprived of this condition, and featured high inflation, fluctuating interest rates, distorted relative prices, and general uncertainty. This situation led to sluggish economic growth, low levels of savings, capital flight, and overinvestment in assets with low social returns.

Not surprisingly, a consensus now emerges from Latin America on the need for financial policy reforms to lay the foundations for launching a dynamic and sustained process of economic growth. This section will analyze the basic components of financial policy reform and the optimal sequencing of the policy instruments that are necessary for its successful implementation.

2.1 Components of Financial Reform

These reforms encompass three fundamental objectives:

- Stable price level
- Stable exchange rate
- Positive real interest rates on bank deposits in an open capital market

In general terms, stabilizing the price level can be executed with a rigorous adherence to fiscal restraint. This refers to the need to bring public expenditures for consumption under tight control. The objective is to eliminate persistent budgetary deficits. These deficits, essentially financed by borrowing directly from the Central Bank, exert strong pressure on the monetary accounts and constitute one of the primary sources of inflation. Moreover, unlike the 1960s, when Keynesian expansionary fiscal policy was a popular development strategy, public deficit finance may not be advisable nowadays, since the lesser tolerance of foreign and domestic creditors will be reflected on high borrowing costs. The decision to pursue such a policy, most likely, will exacerbate the problems resulting from crowding out the private sector. This refers to a drop of private expenditures, particularly investment, that results from a public borrowing-induced rise of interest rates. Crowding out should be avoided at all costs, especially in those economies which, having been long subject to undue, massive government intervention, are now striving to let the market and the private sector play a more prominent role in resource allocation.[1]

It should be emphasized, on the other hand, that adherence to fiscal restraint is a monumental task in countries that are still burdened by hefty payments on external debt

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[1]See Appendix, item 1.0.

service. In most Latin American countries, debt is held by the public sector, which has often had to resort to domestic borrowing in order to service it. For this reason, external debt relief packages such as the Brady Plan have come to constitute a vital ingredient of a credible stabilization program. But the demand for debt relief and an adequate level of external financing is made more legitimate when countries, at the onset of a stabilization program, strive to attain a sustained increase in the primary fiscal surplus.[2] In order to achieve this, it will be necessary to implement a thorough fiscal reform. (See Selowsky 1990.) **One of the key components of this reform is to introduce measures aimed at lessening the dependence of fiscal revenues on foreign trade taxes that penalize export and import activities.** This practice has been so pervasive and so detrimental for agriculture in many Latin American countries because incomes are sucked from a sector that contributes a sizeable portion of foreign exchange earnings. Meanwhile, it depends on imported inputs. For this reason, it is more advisable to implement programs aimed at increasing collections by broadening the tax base and eliminating loopholes.

All efforts to foster the development of rural financial markets must be predicated upon the need to avoid a serious misalignment of the real exchange rate, particularly when it leads to a loss in the international competitiveness of the country. If the exchange rate is persistently overvalued, the effects on the financial markets may be pervasive.[3] Also, in general terms, profitability in the agricultural sector decreases with sustained overvaluation of the exchange rate because this leads to a process of disinvestment in the sector. Under these circumstances, it is not uncommon to find small- and medium-sized farmers either leaving the land or seeking profitable investment opportunities elsewhere. These options, in the end, result in neglect in irrigating or maintaining the land. Often the nominal exchange rate plays a key role in the process of economic stabilization (e.g., it provides a reference point for domestic prices and thus keeps inflation under control); however the danger for overvaluation remains when it is not supported by a fiscal reform aimed at curbing the rate of growth of domestic credit, or alternatively, as the Chilean experience of the late 1970s and early 1980s so dramatically illustrates, when a premature opening of the capital account leads to substantial capital inflows. In this case, foreign capital poured massively into this country, attracted by wide differentials between domestic and international interest rates. The unfortunate consequence was that the money supply expanded considerably. This extraordinary expansion served to erode the anti-inflation drive and also reinforced the overvaluation of the Chilean peso. This, in turn, provided incentives for massive speculation and for overspending in non-tradeable activities.

For these reasons, **it is imperative that governments pursue an exchange rate policy that simultaneously allows for the financing of current account deficits on one hand and, on the other, for bringing down unemployment to a minimum.** This means that the exchange rate should be set at a level that reflects both an equilibrium in the transactions with foreign countries (i.e., a balance between exports and imports) and an incentive to private producers for the maximum employment of domestic land, capital, and

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[2]This term refers to the difference between public sector revenues and non-interest expenditures.

[3]See Appendix, item 2.0.

labor. The key to achieving this goal is to align the rate of new domestic credit creation to the rate of real economic growth. And this, in turn, requires fiscal restraint.

Above all, the exchange rate should be stable. In this regard, the classical monetarist approach of targeting monetary aggregates to let the market freely determine the foreign exchange rate will not necessarily succeed. For one, the market rate may not be an accurate indicator of the international competitiveness of domestic producers. This happens, for example, under conditions of the "Dutch disease," whereby a massive influx of foreign exchange leads to a generalized increase in the price level and to a sustained overvaluation of the exchange rate. Under these circumstances, rising foreign exchange reserves will be accompanied by large trade imbalances and misallocation of resources in the economy at large. In addition, a market-determined, freely floating exchange rate is simply too risky within the context of a small economy subject to external shocks and prone to speculation. Ultimately, such a policy will lead to highly variable interest rates, a feature that stunts economic growth. For all these reasons, it is far more advisable that governments adopt either fixed or managed (also called dirty) floating exchange rate regime.

Highly variable interest rates are intimately related to macroeconomic instability. In this regard, the decision to let interest rates be freely determined by the market in the midst of economic stabilization may bring unwelcome consequences. In fact, real interest rates may rise to very high levels so that the creditworthiness of borrowers becomes suspect. In the case where inflation has yet to be vanquished, a high nominal interest rate will be needed to offset increased prices. The problem is that the real interest rate that is realized ex post is at best uncertain. This raises the risks that banks normally take, making painful financial breakdowns a real possibility.

High and unpredictable volatility of interest rates should be avoided at all costs. However, policy makers should work to ensure higher yields on deposits in real terms. This constitutes the key ingredient for fostering the rapid growth of financial assets and, at the same time facilitating the dissemination of new financial instruments. In this way, Latin American economies will be better positioned to simultaneously promote higher savings and increase the efficiency of investment since firms will be less prone to hold non-productive inflation hedges or undertake investment projects with low internal rates of return. Furthermore, maintaining positive real deposit rates will enable small- and medium-sized farmers to accumulate more wealth through higher savings, provided that there are appropriate savings facilities and that they have adequate income levels. Credit access for them may still be restricted, but they could engage in self-financed investments by drawing from their savings.

2.2 The Sequencing of Financial Reforms[4]

Policy mistakes in this area can be extremely costly. Latin America is littered with

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[4]This section has greatly benefitted from McKinnon 1991 and from Blejer and Sagari 1988. The proper sequencing of these reforms is graphically illustrated in the Exhibit 1. Also, for a more detailed discussion of the proper sequencing of financial reforms, see the Appendix, item 3.0.

the debris of failed attempts at reform from the late 1970s and early 1980s. In Chile, financial liberalization led to the total collapse of the banking system because a system of prudential supervision of financial entities was not in place. The state had to intervene to overhaul the system, but at enormous cost. More recently, similar problems have occurred in the Dominican Republic.

Fortunately, important lessons can be learned. The first is that **any attempt at reforming the financial markets must stabilize the price level. What this means is that taming inflation should be the overriding priority.** If this condition is not met, there will be high, unpredictable interest and exchange rates. Under these circumstances, it would be extremely difficult to steer the economy through a path of sustained growth. As was pointed out before, achieving price level stability requires fiscal restraint, a condition that can be best met when the government budget is balanced and when a thorough, strongly committed public sector reform, aimed at downsizing, is implemented. In addition, the enactment of a trade reform with the purpose of forcing more price-competition for domestic producers supports the anti-inflation drive (See Exhibit 1). All this is important for the financial markets, since it reduces the temptation of the government to keep financing its deficit by issuing money. By giving in to this temptation, the government, in effect, is forcing people to spend less in goods and services and more in adding to their money balances if they are to offset the effects of inflation. This is called inflation tax, which, for financial markets, is usually expressed in the form of below-market deposit rates and above-market loan rates.

Once this task is completed, it would then be possible to liberalize and reform the financial markets by relieving banks of high reserve requirements and freeing them from credit targeting and ceilings on loan and deposit rates. Both high reserve requirements and targeted and subsidized credit are distinctive features of the so-called financial repression, a term depicting a situation whereby a high degree of intervention in capital markets prevents the financial system from promoting economic development.[5] High reserve requirements are basically a device of forced borrowing that governments extract from the banking sector, whereas ceilings on loan and deposit rates are normally associated with an overall policy of "cheap" subsidized credit. Targeted and subsidized credit are policy instruments that were used extensively during the 1960s and 1970s. The underlying assumption was that the existing imperfections in capital markets prevented small- and medium-sized farmers from accessing credit. But the implementation of these policies, unfortunately, significantly worsened the condition of capital markets, especially in countries such as Nicaragua and Peru, where they were applied to the extreme. Moreover, the tight credit rationing that these policies entail triggered higher transaction costs for lenders and borrowers. Under special circumstances, however, targeted and subsidized credit may be useful policy tools, especially during the early stages of economic development.[6]

As the liberalization and reform of financial markets proceeds, authorities should

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[5]For an example of financial repression in practice, see the case of Ecuador, discussed in the Appendix, item 10.0.

[6]See Appendix, item 4.0.

contemplate measures to eliminate barriers to the entry of foreign banks. This decision, nevertheless, should be implemented gradually, to ensure that the process of internal reforms is firmly in place, and, at the same time, to enable local banks—so long accustomed to an overly regulated environment—to adjust to a more competitive environment. But the final objective has to be unmistakably clear: the development of a profitable domestic banking system is boosted when domestic banks are forced to compete with foreign banks. If this process is properly regulated, the advantages for the country are immense since, in principle, foreign banks could enter with superior technologies that ultimately would enable the entire industry to benefit from lower operation costs. Furthermore, this process could lead to the reduction of intermediation margins and even to the elimination of the conditions of natural monopoly.

Deregulating interest rates should also be implemented gradually, especially if macroeconomic conditions are unstable (characterized, for example, by the presence of large budget deficits and unsustainable foreign trade deficits), if the trend of macroeconomic policy is erratic, and if there is no system that can guarantee an adequate supervision of financial entities. By the same token, **the decision to open the capital account to allow for free, unimpeded international capital flows, which are mainly responsive to the differentials between domestic and international interest rates,** should be taken with care. Ideally, this option ought to be taken last, once the stability of the price level has been achieved, and after completing the reforms in the domestic market so as to minimize the opportunities for capital flight. If these conditions are not present, then there is a case for keeping controls on the capital movements. But one has to recognize that governments have very limited options in these times of high capital mobility and strong international linkages of financial markets. Seldom do controls work, especially in economies with woefully inefficient mechanisms to enforce public policy. The most that can be achieved is the institutionalization of regulations on foreign exchange holdings and limitations on foreign borrowing and to ensure that domestic interest rates, reflecting the expectations of a nominal depreciation of the exchange rate, are in line with international interest rates. However, going beyond these measures may imperil the flow of remittances from nationals living abroad, an important source of foreign exchange for many countries in the region.

While this discussion has sought to provide a blueprint depicting the proper sequencing of financial policy reforms, it must be recognized that some countries, in practice, opted to follow different paths. Indonesia in 1983, for example, launched financial policy reforms that included substantial reductions of targeted credit lines and the elimination of ceilings on lending and deposit rates in the presence of macroeconomic imbalance. Moreover, the decision to open the capital account was made simultaneously with the implementation of macroeconomic adjustment policies. (See Hanna 1992.) Most recently, New Zealand eliminated all controls on capital movements before attempting to bring down trade barriers. In fact, very seldom do processes of financial reform proceed according to script. The reason becomes clear once fundamental forces that are at work are recognized: in short, the order of financial reform is determined in the end by how the differing interests and agendas of the most influential groups in society are ultimately played out in the economic policy making process. In other words, the depth and sequencing of financial reform are related to country-specific features of political economy, since they greatly depend on how the political and economic power is distributed in society at large. To illustrate, the present government of Ecuador cannot marshall political support for the liberalization of interest rates. Interest rate liberalization did proceed in Guatemala in the mid-1980s, but its effects in practice were negligible because banks, which hold shares on many industrial concerns, refrained from raising loan rates to their most important customers, usually their own firms. (See Vogel et al 1990.) Another stark example is Argentina in the late 1970s, which succumbed to the pressure of local industrialists who blocked trade reform while the government proceeded with the opening of the capital account. This contributed to a process that generated a severe foreign exchange crisis, production and employment losses, and financial breakdown.[7]

Finally, it is pertinent to ponder the role that USAID can play in providing technical assistance to sustain the process of financial reform. More concretely, it could be argued that, since these reforms pertain mainly to the domain of the International Monetary Fund, The World Bank, and the Inter-American Development Bank, USAID's role, at best, should be constrained in this area. While it is certainly unwise to replicate the tasks that these entities are carrying out, it is nonetheless important that USAID remain engaged in the monitoring of financial policy reform. USAID missions may well choose to devote most resources to provide technical assistance aimed at strengthening institutional reforms in rural areas and at enhancing the organizational capabilities of rural financial entities. But these projects will not be successful if the process of financial reform does not succeed.

Nonetheless, if AID is constrained from working at the policy level in regard to macroeconomic/financial reform, the crucial relationship between macroeconomic and institutional factors cannot be overstressed. This is especially evident in the case of rural finance. To illustrate this linkage, efforts directed at expanding the number of rural financial entities should go hand in hand with the presence of an agency capable of exercising adequate financial supervision. By the same token, a sound interest rate policy makes the chances for success of these institutions more feasible. Last but not least, providing technical assistance in the field of financial policy reform is relatively inexpensive, especially if it is done by financing a high-powered team of advisors. For example, Bolivia, in the mid-1980s, launched a highly successful economic stabilization program with the assistance of foreign experts. The returns from this exercise, most analysts concur, have been extremely high.

3.0 LIMITS OF FINANCIAL REFORM IN RURAL AREAS

The implementation of a sound financial reform policy is a necessary condition to foster the development of rural financial markets. Unfortunately, policy reform will not be enough to expand financial services into the rural areas. More specifically, it is very unlikely that market reforms in the financial sector will succeed in improving access to credit for small- and medium-sized farmers. Fundamentally, this is due to the presence of high generic transaction costs, which, in turn, signal the existence of market segmentation, asymmetric information, and economic dualism.

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[7]See Appendix, item 3.1

3.1 Generic Transaction Costs, Market Segmentation and Institutional Infrastructure[8]

Market reforms in the financial sector *per se* will not manage to eliminate market segmentation, a prevailing condition in many countries of Latin America that has severely penalized rural economic development. Market segmentation is a feature associated with the absence of competition, i.e., the existence of entry barriers that ultimately profit the privileged.

This proposition is grounded in the fact that agricultural financial markets are generally dominated by high generic transaction costs, i.e., costs incurred to operate a financial system, such as the costs of information, negotiation, coordination, monitoring, and enforcement. These costs are assumed away by conventional neoclassical theory. The efficiency of markets, otherwise known as "Pareto Optimality," is obtained only in the absence of generic transaction costs. When generic transaction costs are significantly high, then the quality of the institutional infrastructure or the clarity, predictability and stability of the "rules of the game" that underpin contracts between private parties within a market society, matter. (See North 1992.) **For financial markets to operate efficiently, the presence of an adequate and sophisticated institutional infrastructure is required.** Trust is the foundation of credit markets because they are grounded on transactions that embody the promise of a payment in the future. The quality of an institutional infrastructure is measured by its ability to establish trust-building mechanisms. In this regard, developed countries, in general, have managed to minimize significantly the generic transaction costs because of the high quality of their institutional infrastructures. The efficiency in their impersonal markets is a consequence of institutions capable of defining the property rights in the acts of exchange and enforcing private contracts at reasonable cost.

Not so, unfortunately, in most parts of Latin America. Credit to small- and medium-sized farmers is seriously constrained by poor institutional infrastructure.[9] Information-sharing networks, enforcing mechanisms of credit contracts, and systems for close supervision of banks are poorly developed. In this environment, that vital factor of finance—trust—normally requires the direct personal knowledge among participants to effect financial transactions. In Nicaragua, for example, loan approval will be determined not so much by how sound a particular project is or even by how financially wealthy a borrower appears to be. Rather, the perceived character of applicants will be the determinant of loan approval. This problem of credibility poses important limitations on the overall expansion of finance, and will be solved as economic development gradually "depersonalizes" the relationship between lenders and borrowers.

The existence of high generic transaction costs underlines the tendency within financial markets to discriminate against lending to the agricultural sector, specifically

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[8]A well detailed analysis of this relationship can be found in Floro and Yotopoulos 1991. This discussion has benefitted from this work.

[9]See Appendix, item 5.0.

to small- and medium-sized farmers. For example, it is common for small borrowers to have the returns on their projects positively correlated with each other because the crops are subject to the same vagaries of soil and weather conditions. If conditions are bad, the profitability of all borrowers of the same group will be affected negatively. In principle, this problem can be solved by having the borrower purchase an insurance policy that covers the bank against this risk, a practice that is common in developed countries. The problem is that the insurance market in most Latin American countries is not fully developed and insurance companies, in general, are reluctant to offer these policies at a reasonable cost. Also, past government programs have failed badly because they were poorly designed and riddled with fraud and abuse. (Aguilera-Alfred 1992.)

3.2 Generic Transaction Costs and Asymmetric Information[10]

High generic transaction costs are also intimately related to the existence of asymmetric information, which refers to the lender's difficulty in assessing the creditworthiness of potential customers. Traditionally, obtaining the required information is costly and arduous in rural areas. **Asymmetric information severely penalizes the development of rural financial markets because it breeds the moral hazard and adverse risk selection problems.** Loans may default either because of (1) credit terms that are too risky for the best customers, and are instead accepted and taken by less safe, risk-taking borrowers **(adverse risk-selection)** or (2) they are unable to deter borrowers from undertaking higher-return, yet riskier activities that the lender would not normally accept if well informed of the real intentions of the borrower **(moral hazard).**[11]

The implications that adverse risk selection and moral hazard have for financial markets are far reaching. Market efficiency is predicated upon the existence of the price mechanism to clear the market, i.e., an automatic, unimpeded process that equates supply and demand of goods and services. According to conventional neoclassical theory this is the "invisible hand" at work. However, reality is much more complex in financial markets. On paper, the interest rate, which is the price of credit, should function as the clearing mechanism that brings into equilibrium the supply and demand of credit. If, for example, there is an excess of demand for credit due to government-imposed, below-market ceilings on interest rates, an increase in the supply of credit would be brought about by allowing for a market-determined, higher interest rates. In practice, unfortunately, the results may not conform with theory. Lenders are aware that beyond certain levels of interest rates the quality of loans declines because the probability of repayment by borrowers, now facing higher financing costs, decreases. If the best-known, safest customers curtail their demand for credit, lenders will have to contend with customers for which no adequate information is available. The fact that it is costly and very difficult to sort out those customers heightens fears of lenders that the increasing revenues attributed to higher interest rates may be offset in the end by lower expected returns on a portfolio that now contains many more loans of doubtful recovery.

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[10]For a thorough discussion of this issue see Stiglitz and Weiss 1981 and also Floro and Yotopoulos 1991.

[11]See Appendix, item 6.0.

For these reasons, lenders may end up rationing credit. Some borrowers may be able to obtain loans while others with identical characteristics, but less known to the bankers, may not. In addition, there will be some customers that will be rationed out even if they are willing to pay higher interest rates. Consequently, interest rates do not clear the credit market. On the contrary, lenders, in their zeal to avoid problems of adverse risk selection and moral hazard, will attempt to keep those customers deemed "safe" and well-known by charging them below market-clearing interest rates. But, as indicated above, this serves to restrict the supply of credit to many borrowers. The discrimination is more severe when the leading lenders show a strong urban bias, a feature prevalent in many Latin American countries. Small- and medium-sized farmers, unfortunately, have been traditionally discriminated against. Consequently, they are excluded from the credit market.

3.3 Generic Transaction Costs and Economic Dualism

High generic transaction costs are also closely related to the policies of exclusion, the curse of many Latin American countries. In these countries, the development strategies applied in the past contributed to the marginalization of vast parts of the population, especially those in rural areas. This is another example of the market segmentation that has ultimately resulted in the emergence of dual economies: (1) a formal sector, which operates in the "modern" economy where impersonal exchange and infrastructural market institutions generally prevail, and (2) an informal sector, characterized by an underdeveloped institutional infrastructure where personalistic relationships are normally the rule. It is the formal sector, with substantially higher levels of productivity and incomes, that determines the overall pattern and dynamism of economic development.

The implication is that low incomes and the unavailability of collateral in real assets smother the expansion of financial services in rural areas, especially if they conform to the characteristics of the informal sector. In countries where policy distortions against agriculture prevailed to an extreme, it is very difficult for market policy reforms alone to remedy the problems associated with excessive marginalization of the rural poor, since their subsistence-level incomes and inadequate human capital prevent them from taking advantage of the opportunities that the market offers. Even Chile, a country that has been hailed as a "success story" due to the impressive market-oriented growth of agriculture the mid-1960s, has failed to incorporate into the market a substantial number of laborers. This situation is more serious in countries with widespread poverty, where the policies of exclusion have been more pervasive.

Informal lending cannot fill this gap adequately. Of late, the tendency has been to extol its virtues in many Latin American countries as proof that there is an untapped source of invaluable, growth-contributing entrepreneurship that awaits a commitment to market policy reforms and deregulation to unleash its wealth-creating potential to the fullest. This is buttressed by the fact that informal lenders provide a valuable service to small- and medium-sized farmers by taking risks that are shunned by formal creditors. Indeed, their intimate knowledge of local conditions and customers makes this possible. While few could argue with this proposition, it nonetheless will not provide a lasting solution for the problems of finance in rural areas. For one, the growth potential of informal financial intermediation is limited since it is grounded in personalistic relationships. **Also, this financial "system" (i.e., the informal sector lending) does not provide for a safe, convenient, and sustained process of savings mobilization, which is a critical component of rural financial intermediation.** Moreover, one frequently finds that informal lending operates within monopolistic market structures in rural areas. Finally, it is not at all inappropriate to think of informal lending in rural areas as the living proof of acute market segmentation, or as safety valves of economic systems that have long neglected the need to establish adequate institutional infrastructures in the countryside. The lack of this critical ingredient constitutes perhaps a decisive factor that smothers a sustained process of private investment in rural areas.

In sum, financial policy reform, under the presence of pronounced economic dualism, is not a sufficient condition for the development of rural financial markets. High generic transaction costs, which explain the presence of and even propel the segmentation of markets, choke the expansion of financial services to small- and medium-sized farmers. They do so because these costs are rooted in an economic milieu that is devoid of an adequate institutional infrastructure, one that stunts the development of impersonal relationships in the acts of exchange. Under these circumstances, market policy reforms in the financial system, i.e., the competitive determination of interest rates, the elimination of credit targeting and the elimination of high reserve requirements, will be probably effective only in the formal, modern sectors of the economy but will likely fail to reach the vast number of potential customers located in the informal sector. The reason is that these policies lack the appropriate instruments to properly account for the problems of asymmetric information, poor monitoring, and weak enforcement that render generic transaction costs prohibitively high for financial transactions.

4.0 THE NEED FOR GOVERNMENT ACTION

A *laissez-faire* or hands-off approach will eventually perpetuate the conditions of inequality, exclusion, and economic stagnation of vast numbers of small- and medium-sized farmers in Latin America because it does not address the special problems of rural finance. To neglect this sector will cause it to go into decline, which has adverse effects economically and politically. Rising incomes in agriculture generate substantial backward and forward linkages to the benefit of other sectors of the economy. It is all the more exigent not to abandon the rural sector in countries like Nicaragua, which is characterized by a strong agricultural base.

The issue is not *laissez-faire* or government intervention, but rather what specific actions the public sector must undertake to foster adequate provision of financial services to the rural poor. Fortunately, the legacy of the ill-designed rural financial policies that were implemented until the 1980s illustrates what should not be done. However, there is ample room for the government to be constructively and actively engaged. This public action should follow three guiding criteria:

- Removal of structural constraints that prevent markets from operating efficiently (e.g., improved rural infrastructure).

- Careful monitoring of the process of financial reform (e.g., improved supervision of financial entities).
- Commitment to bring generic transaction costs down (e.g., improved operational efficiency of institutions).

4.1 Removal of Structural Constraints

The limited effectiveness of rural financial reform is explained by the constraining presence of several structural factors. First, these policies act on the existing income distribution, which, in many Latin American countries is highly uneven. Unfettered financial markets cannot change this unfortunate reality, since the process of financial intermediation essentially mirrors income conditions. Second, inadequate economic infrastructure—roads, energy, and water supply—characterizes the countryside. The scarcity of these public goods negatively affects the profitability of agricultural activities, which, in turn, lessens the chances for access to formal private credit on normal terms. Third, rural financial markets cannot be developed when small- and medium-sized farmers use cost-inefficient, outdated technologies, and yields compare unfavorably with investment projects in other economic sectors and, at best, are either very low or uncertain. This problem of inadequate technologies in the countryside is indeed extremely serious, more so in countries like Ecuador, which took away the incentive to invest in agriculture through industrial protection policies that were applied until recently.

4.2 Monitoring Financial Reform

Financial markets are of little use when the rural economy is mired in deep recession. In this situation, rural investments, in general, are not competitively profitable, especially if the exchange rate is overvalued. But, financial instability may emerge when the rural economy is growing too quickly. Under these circumstances, an increase in the supply of credit may ensue as financial entities scramble for additional profitable opportunities. This phenomenon can even take the form of an increase in the number of financial entities that offer services to the rural sector. However, while these events bolster the development of rural financial markets, informational problems for lenders may become more acute as new borrowers enter into the financial markets. In addition, it is conceivable that the stability of the financial system could be imperiled, especially if financial entities incur problems of moral hazard of their own. This happened, for example with the Chilean banks in the early 1980s and more recently with savings and loan entities in the United States; the banking practices of these entities were not sound because they operated under the expectation that the government would ultimately bail them out.

Therefore, the expansion of rural financial services must be accompanied by more effective supervisory and inspection agency(ies). The purpose of such an agency is to monitor all financial systems, including those in rural areas. **Prudent supervision and inspection of financial entities are crucial to the ultimate success of rural financial markets.** Furthermore, a system for implementing these tasks—which include enforcement of rules on capital and reserves, lending restrictions to single borrowers and bank owners, and inspection of loan portfolios—should be in operation before any all-out privatization campaign of the banking system is undertaken.

Another problem relates to the liberalization of interest rates. **The presence of poor rural infrastructure, asymmetric information between lenders and borrowers, overall weaknesses in financial entities, and macroeconomic instability will require control over interest rates. This is important in the initial stages of reform programs, since these problems are not quickly resolved. Therefore, effective control by the Central Bank on interest rates is necessary to set them at a level that will cover all costs on loans, but not so high as to incur the problems of adverse risk selection and moral hazard.** In doing so, the Central Bank should take into account the inflation rate, the normal returns on investment, the rates that prevail in informal lending, and the spreads between deposit and lending rates. Japan and Taiwan, often heralded as development success stories, exercised stringent controls on interest rates to ensure that they would remain positive but not excessively high.

4.3 Reducing Generic Transaction Costs

Lowering generic transaction costs entails a commitment to develop infrastructural market institutions. Rural financial markets will not prosper in an institutional vacuum. One of the most pressing issues in this regard is to enforce property rights. In several Latin American countries, ongoing property disputes are cited by bankers as one of the most important obstacles to credit expansion in the agricultural sector. In Nicaragua, for example, at least 50 percent of farmers are either landless, occupy land without title, or possess nonbinding titles. Consequently, property cannot be offered as collateral. **Also, governments must find ways to improve the legal systems and information-sharing networks.** In many Latin American countries, the legal systems have favored borrowers since actions to exercise guarantees in case of loan default are often tedious and costly. As a result, financial entities tend to ration credit more strictly.

Information-sharing networks are usually poorly developed and inefficient. Lenders, consequently, cannot take advantage of credit reference checks. Not surprisingly, this penalizes small- and medium-sized farmers, who are denied credit from formal financial entities because they are unable to present commercial references. In Nicaragua, for example, small producers are not considered creditworthy on these grounds even when they are engaged in profitable activities and with properties that have been properly recognized.

Above all, however, the government must establish public trust. This means adopting and enforcing rules and regulations aimed at safeguarding the liquidity of the entire financial system, sanctioning the sanctity of credit contracts, and protecting the safety of deposits. These are necessary components to spur the integration of financial markets to eliminate acute market segmentation by facilitating a dynamic process of saving and investment within a unified, homogenous domestic market. The success of this process, ultimately, will depend on the financial viability of rural financial entities.

5.0 VIABILITY OF RURAL FINANCIAL ENTITIES

Several types of financial entities provide rural financial services: commercial banks, finance companies, state-owned agricultural banks, cooperatives, village banks, credit unions, and self-help groups. **In promoting the establishment of rural financial entities, it is not important to choose a single institutional model suitable to all countries** (Padmanabhan 1988). This is not realistic. **It is far more important, ultimately, that the entities—no matter their structure—be self sustainable and properly designed.**[12] This will be determined by their ability to adapt to the conditions of the local markets.

Adherence to this principle serves to put the issue of state versus private banking to rest. **There is nothing inherent in private banking that makes its performance superior or inferior to state banking. What truly matters is the development and protection of policies that make banking practices safe to foster an increasingly dynamic and efficient process of financial intermediation in rural areas.** In this regard, Asian countries such as Indonesia, Taiwan, and South Korea chose to rely on state-owned banking until the 1980s to finance their successful rural development. In most Latin American countries, however, state banks have generally failed because they operated within misguided economic policies. Yet, reform of these institutions is of utmost importance since, under certain circumstances, they may well be the only available alternative. Such seems to be the case in Nicaragua.[13]

This study benefitted from first-hand knowledge of some financial entities that are widely considered to be successful.[14] The numerous factors that account for the success of rural financial entities include:

- The drive to lower firm-specific transaction costs
- The commitment to savings mobilization
- The commitment to financial self sufficiency

5.1 Low Firm-specific Transaction Costs

J.D. Von Pischke defines firm-specific transaction costs as those incurred by economic agents involved in conducting financial operations. These entail the normal administrative costs of lending—loan approval procedures, information gathering, transaction processing, monitoring and collection procedures, etc.—as well as the default risk. They also include the costs borrowers and depositors must incur when accessing financial services, such as the documentation gathered to obtain a loan, resources in time and money spent in visiting banks' offices, and information on alternative sources of loans and deposits. (Von Pischke 1991)

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[12]See Appendix, item 7.0.

[13]See Appendix, item 8.0.

[14]A brief analytical description of these entities is provided in the Appendix, item 9.0.

Loans to small farmers are generally small. The costs of lending should be commensurate with the size of the loan (Rhyne and Otero 1991). **This entails very low administrative costs as well as simplified and streamlined procedures on loan application, approval, disbursement, and collection.** Various techniques that can be used to reduce the costs of lending include the computerization and mechanization of loan accounts, mobile credit/collection officers, and the establishment of branch units as profit/cost centers. The key component is to reduce the default risk. Some of the techniques that have proved to be effective include interest rate rebates, forced savings as collateral and, above all, the prospect of repeated loans.

All this suggests that it is imperative that rural financial entities adapt their lending technologies to local conditions. This disqualifies commercial banks bent on using costly lending technologies that are based on project appraisal and formal collateral. (Rhyne and Otero 1991.) On the contrary, appropriate lending technologies should rely foremost upon discretionary decisions by bank managers based upon their personal knowledge of and prior experience with customers. In settings characterized by poor institutional infrastructure and strong market segmentation, relations in the act of exchange appear in general to be extremely personalized. **The bank's *proximity* to the clientele is a key ingredient, making it possible to screen loan applicants and monitor repayment schedules.** Loan applicant screening, in particular, is one of the most difficult tasks. Financial entities in Indonesia have successfully made use of character-based lending. There, loans are disbursed only with the consent and approval of the village head, who, in effect, vouches for the integrity of the applicant. This authority also mobilizes peer pressure to dissuade potential defaulters.

The proximity of successful rural financial entities to the rural clientele, it should be emphasized, refers not just to a geographical dimension, but to a close cultural identification that enables them to embrace and reflect the ethos of the rural village. (Padmanabhan 1988.) This constitutes the key determinant of trust, and is enhanced when the financial entity manages to provide exactly the range of services demanded by the rural population. This helps to partially explain the colossal failure of state agricultural banks in Latin America, where excessive centralization, stifling bureaucratization, and dependence on government funds led to the implementation of flawed credit programs.

Two additional modalities often suggested as vehicles to lower firm-specific transaction costs are group lending and matching financial entities with agents knowledgeable of conditions in rural markets. Group lending reduces firm-specific transaction costs because it improves the process of screening applicants by lowering the costs of gathering information, while some of the costs associated with loan approval and processing can be absorbed by the groups. Most importantly, groups are instrumental in the selection of clients and can facilitate loan repayment. The problem, however, is that it is costly and difficult to set up these groups.

To link financial entities with agents, such as traders and input suppliers, one must see that they are well positioned, on paper, to undertake financial intermediation. In countries that have substantial production in high value crops, or crops used in agro-processing, traders are often the entity for providing technical assistance (especially in the form of quality control), inputs, and credit. The terms of this credit are often quite generous (in the case of some Chilean cases, non-interest bearing, although adjusted for inflation). In regions where food crops are traded domestically traders also advance funds and subsidize transportation from farm to market. The limit on this type of credit is that it is linked to market demand of a specific commodity or product. Consequently, it does not represent a "line of credit" that can be renewed by the same borrower for another crop or productive activity, nor does it establish any kind of a working relationship between a credit agency and an individual producer. In a country such as Chile, which exports high-value crops, trader-related credit and technology packages are excellent and reach farmers without access to working capital. However, a very small percentage of the country's farmers are actually involved in these programs. Moreover, these intermediaries are not suitable for savings mobilization.

5.2 Savings Mobilization

Savings mobilization lessens the dependency of financial entities on outside funds for survival. It also facilitates the process of screening loan applicants, since deposits can act as guarantees for loans. Moreover, it induces depositors to take an interest and be actively engaged in the management of the entities. This is especially true in the case of small rural communities where the villagers may develop a strong sense of identification with the entities that serve their financial needs. This sense of identification will normally be stronger if the entity is owned by the community. This is one of the key factors linked to the success of numerous village banks in Bali, Indonesia.

Proximity to customers, safety, convenience, ease of deposit and withdrawal, and positive returns are all conditions that must exist for a successful mobilization of savings. Financial entities can greatly facilitate this process by offering simple savings instruments (e.g., stipulating) and low minimum balance limits (to lure small depositors and discourage the excessive build up of cash balances). By the same token, service fees on savings accounts should be discarded. This is particularly important for Latin American countries, where past policies have both implicitly and explicitly taxed savings.

Above all, savings mobilization is intimately related to a sound economic environment. High inflation, for example, will force farmers to save in the form of physical assets, not foreign currency. The expansion of financial markets is stunted in this way. Also, savings mobilization cannot proceed without an institutional framework that allows for effective supervision and inspection of financial entities.

5.3 Financial Self-sufficiency

Rural financial entities should be able to charge loan rates that enable them to cover operating costs (including loan reserves), cost of funds, and inflation, so as to maintain the real alue of the loan portfolio and capital. Ideally, they should generate surpluses and profits, since these will enable the entities to increase capital and expand operations.

A rural financial entity, if it is to be competitive, should be able to offer loans at substantially lower rates than those charged by informal lenders. While its operating costs are usually higher than those of the informal lender, its average costs will be significantly reduced as the number of loans increases. This will be the best indicator that the entity is operating effectively and approaching the maximum number of clients at minimum cost.

EPILOGUE

In many Latin American countries, excessive industrial protection policies were applied until very recently. The legacy from these policies has been the exponential growth of marginalized rural sectors. Unfortunately, the path to economic reform is blocked by the presence of high generic transaction costs that prevent financial policy reform from reaching these sectors. This, in fact, is the situation that is observed in these countries—the failure to incorporate the marginalized clientele into the web of specialized, dynamic, cost-effective, and innovative financial services that characterize a modern economy.

At the same time, this situation also offers opportunities for USAID missions. First and foremost, USAID missions can be instrumental in persuading host governments that it is imperative that the policy reforms relating directly and indirectly to agriculture stay in place. Without them, any program designed to strengthen financial intermediation in rural areas is doomed to fail. A vibrant rural economy is the foundation of rural financial markets. A stagnant rural economy stunts this process because it limits the number of creditworthy customers, erodes the ability of borrowers to repay loans, and reduces the incomes available for deposits. To the extent that the roots of a declining rural economy are traced to the presence of economic distortions that constrain the profitability of rural activities, there is a case for the enactment of policy reform aimed at eliminating them. In this regard, governments should ensure that exchange rate policies do not penalize farm exports and that industrial protection does not turn the terms of trade against agriculture.

Second, it is essential that USAID missions continue supporting the development of private banking. In countries that were long exposed to severe financial repression (e.g., Nicaragua and Peru) it is not realistic to expect in the immediate future that private financial entities will serve the financial needs of the marginalized rural sectors. In time, however, this is bound to change as the process of financial reform takes hold and as attractive investment opportunities spring in rural areas. USAID missions can contribute to these ends by helping central banks adequately monitor the process of financial reform and by identifying constraints that prevent the integration of financial markets. It will be valuable if USAID missions explore other modalities to help rural financial intermediation, including the proposal of actions that can be taken to support and strengthen informal modalities of lending.

Finally, it is pertinent to emphasize that some Latin American countries, in spite of undertaking the measures just described, may fail to bring together those who have access to information but don't have resources to those who have resources but do not have access to information (Cháves and González-Vega 1993). Informal lenders are definitely agents with inexpensive access to information, but they usually do not have enough resources to provide widespread financial services in their localities. Private commercial banks, on the other hand, have the resources, but having abandoned the field to state banks for so long, have no access to the required information and contract enforcement tools. Thus, not surprisingly, they continue to serve a largely urban clientele. Under these circumstances, what is to be done to meet the financial needs of the marginalized clientele?

To address this problem, it may be necessary that the public sector, guided this time by the correct application of economic policy, take the initiative and expand financial services to this clientele. Although the track record of state banks has been dismal in Latin America, under certain conditions (shift of economic policies, appropriate regulatory environment, and appropriate management techniques) they may well be the only available alternative. This is especially relevant in countries such as Nicaragua, where state banks still provide 90 percent of total credit. Therefore, the fact that a state-owned financial entity can play a useful role should not be dismissed. This, in turn, offers opportunities for timely participation by AID missions in providing technical assistance.

APPENDIX

1.0 PUBLIC DEFICIT FINANCE MAY HARM PRIVATE ACTIVITY

To finance budget deficits, the government may decide to issue securities. **A market of government bills will finance the fiscal deficit in non-inflationary ways, provided that no monetary expansion is needed to finance a prohibitively high level of domestic debt service.** A reasonable, sustainable level of domestic debt and keeping interest expenditures in check can do the job. In addition, the existence of a market of government securities will make it possible for the government to engage in open market operations, which, in turn, can be used to manage monetary policy more efficiently. **Nevertheless, it is important to point out that offering government securities also has an adverse effect.** For example, for the government securities market to thrive, it is imperative that the government be willing to pay the market interest rate. The government may well decide to "sweeten" the instruments by offering generous tax benefits on their yields and on capital gains. All this has the potential effect of overinvestment in these securities on part of the financial entities. Consequently, the private sector will be crowded out.

On the other hand, it is not uncommon for governments to resort to forced borrowing from financial entities in the form of high reserve requirements to reduce the fiscal deficit. This form is clearly preferable than borrowing from the Central Bank since it is less inflationary, but also has negative effects. For one, high reserve requirements in all likelihood deeply aggravate the worst features of financial repression. **By "parking" a substantial amount of funds within the Central Bank, the private commercial banks are restricted from channeling funds into high-yield projects. In addition, the profitability of financial entities may suffer, especially if required reserves earn little or no interest.** To compensate, banks may be forced to increase effective loan rates by charging higher service fees and/or lower deposit rates, which, in turn, would have adverse effects for deposit mobilization. In the end, interest rates will be distorted, and the private sector, once again, will be crowded out.

2.0 PROBLEMS OF EXCHANGE RATE OVERVALUATION

A persistent overvaluation of the exchange rate will have profound effects for the financial markets. One nasty side effect is capital flight. Equally important is that a speculation frenzy will be touched off. For example, under a regime of a fixed exchange rate, firms, in anticipation of devaluation, will increase their demand for credit in domestic currency to finance the build-up of imported goods. By the same token, inventory costs will also be increased as firms delay the shipment of exportables. Consequently, loan interest rates will increase. This trend is aggravated when bankers hedge against exchange rate devaluation by charging a premium on the loan rates. What usually happens is that loan rates will be pushed up further by some percentage point above the estimated overvaluation. An alternative procedure is for bankers to demand that borrowers accept loans in domestic currency but indexed to the value of the dollar. This practice was observed in the new private commercial banks in Nicaragua. Unfortunately, this option has risks, as borrowers may become insolvent with a devaluation. Last but not least, it should be noted that interest rates will also be driven up in cases of an open capital account, especially when the country is dependent on borrowing remittances from abroad, since non-residents will demand higher deposit rates in domestic currency to compensate for the risk of devaluation.

Delaying exchange rate correction, if anything, worsens the situation. The problem is more acute when speculation activities, as described above, are financed with bank credit. In this case, banks will be unable to collect interest payments. Under extreme circumstances, banks may go under, and, if they incur foreign borrowing, will default on these loans. This is what Chile experienced in the early 1980s. The government had to step in with public funds to protect depositors and assume the liabilities with foreign banks. The drain on public resources will be catastrophic when the government, in a misguided attempt to obliterate the expectations for devaluation, decides to offer exchange rate guarantees to importers in general and to private firms and banks that obtain foreign loans. In the end, the day of reckoning is inevitable. **When exchange rate correction comes, the government usually finds itself picking up the tab for the huge exchange rate losses incurred, thus fueling larger deficits and, deficit finance, probably higher inflation, and further devaluation of the exchange rate.**[1]

3.0 SEQUENCING FINANCIAL REFORMS[2]

The proper sequencing of financial policy reform is of utmost importance. Normally, reform entails market-determination of interest rates, the elimination of credit targets and ceilings, the reduction of reserve requirements, the elimination of excessive capital requirements that prevent the entry of local participants in the financial markets, and the privatization of state concerns. It also encompasses the external liberalization of financial markets, or a commitment to a more open capital account that would include the elimination of barriers to the entry of foreign banks and the removal of exchange controls and restrictions on international capital flows. **Financial policy reforms that are not sequenced properly may generate huge losses in production and employment and lead to a collapse of the financial system.**

3.1 Financial Policy Reforms Should Not Precede Trade Reform

Normally, trade reform should precede financial reform. If financial policy reform is undertaken without ensuring first that trade reform is firmly in place, investment may increase, but, since the structure of relative prices in the market of goods and services would still be distorted, the ensuing resource allocation would be inefficient. However, it is very tempting for governments to follow this path. Professor Michael Bruro cites three reasons that explain why this option is attractive for governments. (Bruno 1988.) The first

[1]For an excellent discussion of this issue see Dornbush 1988.

[2]Discussion of this section has greatly benefitted from McKinnon 1991.

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is less political opposition is usually expected from financial groups than from the powerful groups, such as local industrialists and organized labor, which thrive on trade protection. The second is that allowing for foreign capital inflows actually buttresses the process of economic stabilization by cushioning the costs of high domestic interest rates. This availability of foreign funds enables private firms to access cheaper foreign finance than what the domestic financial market offers. The third reason is that the government can finance expenditures without resorting to higher taxes or printing money.

Relying on a total or partial liberalization of financial markets in the absence of trade reform is very dangerous. In the 1970s, the real cost of credit in international markets was very cheap. Private firms in Argentina and Uruguay that resorted to heavy borrowing during that period undertook investment projects which, shielded by high tariff-protection, offered internal rates of return that were lower than the long-run cost of foreign funds. The situation was made worse by the massive influx of these funds, since this led to a substantial appreciation of the exchange rate in both countries. This exchange-rate overvaluation, in turn, greatly aggravated the distortion of relative prices and thus, the process of resource allocation. In the end, this process generated a severe foreign exchange crisis, production and employment losses, and financial breakdown.

3.2 Domestic Financial Reforms Should Precede External Liberalization

Freeing international borrowing and lending in the absence of internal financial liberalization could also bring unwelcome consequences, especially in economies whose financial market structures are highly monopolistic or oligopolistic. Under these circumstances, local banks enjoying oligopolistic advantages could borrow more cheaply from foreign banks and loan these funds domestically at higher rates to borrowers excluded from international credit because of costly and/or imperfect information. When this happens, it is very likely that domestic interest rates will remain above international rates indefinitely. (See Blejer and Sagari 1988.) In principle this problem could be solved by allowing for the free entry of foreign banks. But this decision will hardly make a dent if the market structure of the industry is unlikely to change significantly, i.e., when domestic conditions are that of a natural monopoly. Moreover, if this decision is ill-timed and inadequately enacted, it could bring far more serious consequences. A precipitous "foreign entry" may pose potential problems for those domestic banks that are saddled with a portfolio that contains numerous loans that were given out at concessionary rates on one hand, and which still have to contend with the taxes implicit on high reserve requirements on the other.

3.3 Interest Rates Should Be Liberalized Gradually[3]

Interest rate liberalization makes sense under conditions of a stable macroeconomic environment and with the presence of a system that guarantees adequate bank supervision. Macroeconomic stability is of critical importance because the cost and availability of credit is steady and predictable. When macroeconomic stability exists, the presence of volatility and excessively high rates on deposits and loans is unlikely. On the

[3]For an excellent discussion of this particular issue see Villanueva and Mirakhor 1990.

other hand, adequate bank supervision entails the enactment of several policies aimed at ensuring the soundness of the entire financial system, such as adequate reserves against losses, adequate bank capitalization, limits on bank exposure to large borrowers and shareholders, limits on foreign exchange exposure, independence of bank regulators and supervisors, and a deposit insurance scheme with appropriate costs that reflect the riskiness of the individual bank's loan portfolio.

If these conditions are not present, then the decision to allow for a totally deregulated, free market-determination of interest rates will definitely pose the most serious threat for the stability of the financial markets due to the following:

- Free-market interest rates, rather than expressing equilibrium clearing prices, may reflect serious distortions in other markets. This is precisely what happened in Argentina, Chile, and Uruguay in the early 1980s. The persistence of unusually high interest rates for several years was related to the overvaluation of the domestic currencies, including the expectations for devaluation, and to the distortions in the market of goods, whereby the prices of domestic goods stubbornly remained way above those prevailing in international markets. The inefficiencies embedded in these disequilibria were ultimately shouldered by high interest rates, since prices in the financial markets adjust more rapidly than in assets and goods markets. These circumstances, in combination with the presence of an oligopolistic domestic financial system, make it unlikely that the decision to liberalize interest rates will succeed in substantially lowering very high, above-inflation nominal interest rates.

- Interest rate liberalization in the midst of economic stabilization could bring unwelcome consequences. In fact, real interest rates may rise to very high levels so that the repayment capabilities of borrowers becomes endangered. If, for example, inflation has yet to be vanquished, a high nominal interest rate will be needed to offset the increases in the price level. The problem is that the real interest rate that is realized ex post is, at best, uncertain. This raises the risks that banks normally take and makes painful financial breakdowns a real possibility.

- High real interest rates may lead banks to incur problems of adverse risk selection. This term applies to the fact that banks may lose their best, safest customers when loan rates are pushed up because of their unwillingness to absorb higher financing costs. The problem is that risk-taking borrowers without the highest credit ratings may step in to take the loans. In order to service the debt, the borrower must undertake higher-yielding, albeit riskier, investments. If these yields do not materialize, the consequences are either default or, alternatively, the devaluation of financial claims through higher inflation.

- Finally, banks may not be immune to risky behavior of their own, especially if supervision of their loan portfolio and control of reserves against expected loan losses is lax. Such behavior, moreover, will be abetted by the expectation that if loans go sour, the public sector will end up bailing the banks out. The combination of risky behavior by both borrowers and banks sets the stage for domestic overborrowing and overlending. This does not bode well for the stability of the financial system.

What all this suggests, in sum, is that **credit markets, when left unregulated and especially in times of uncertainty and macroeconomic instability, are prone to market failure.** Hence, there is room for active public policy, especially in temporarily regulating interest rates so as to avoid unpredictable volatility and excessively high yields on deposits and loans. The decision to completely liberalize interest rates should be totally subordinate to the presence of both macroeconomic stability and adequate bank supervision.

4.0 TARGETED AND SUBSIDIZED CREDIT: PROS AND CONS

Special credit programs that are designed for priority sectors at concessionary rates are distinctive features of financial repression. This term, coined by Professor Ronald McKinnon of Stanford University, depicts a situation whereby a high degree of government intervention in capital markets prevents the financial system from promoting economic growth. (See McKinnon 1973.) The impact from this modality of government intervention on rural financial markets has been severely criticized by the pioneering work of Ohio State University (See especially Adams, González-Vega and Von Pischke 1987 and Adams, Graham and Von Pischke 1984.) This criticism is discussed below:

4.1 Targeted Credit Programs

Targeted credit programs, when applied over the greater part of the financial system, may create costly inefficiencies due to the following reasons:

- By constraining flexibility, (i.e., banks are directed toward certain types of loans), it prevents banks from expediting their loan disbursements, since credit managers are forced to spend additional time and resources in appraising projects that otherwise would not to be taken into consideration.

- It creates frictions between the banks and the institution in charge of enacting and supervising overall credit policy (in most cases the Central Bank). Usually, this institution has to contend with pressures from banks demanding changes in the target limits to obtain additional resources that will allow them to fulfill targets. In the cases in which the Central Bank has been directly involved in the provision of credit, such as Nicaragua, the pressures to modify target limits emanated directly from interest groups.

- The policy entails high administrative costs, since the Central Bank and financial entities must devote valuable resources to implement and supervise a targeted credit program. For the Central Bank in particular, this task burdens its staff and endangers the monitoring of monetary and exchange rate policies.

- Financial costs tend to increase, since banks may find themselves with idle resources and target limits that exceed the demand for credit. Usually, this situation prompts banks to disburse loans outside of the program's credit targets.

- Lastly, customers will find ways to circumvent the system. It is common to see a demand for credit for activities in which the target limits have not been reached and for activities in which the funds will not be actually spent. In fact, experience demonstrates that it is difficult, if not impossible, to trace the final destination of credit.

4.2 Interest Rate Ceilings

Private financial entities are not motivated to execute targeted credit programs carried at concessionary rates. Such programs entail lower revenues, higher risks, and increasing costs, since they usually consist of a large number of small loans that require adequate control and supervision procedures. The consequences of these programs may indeed be pervasive:

- The availability of credit decreases. Since banks are reluctant to carry these lines, many customers are forced to seek credit from informal sources, whereby loan rates are normally far more expensive.

- In view of the lower revenues and higher risks that accompany these programs, the financial entities will seek to protect themselves by demanding additional guarantees, making credit more cumbersome and unwieldy.

- Interest rate ceiling policies invariably lead to credit rationing, which, in the end, increases the microfinancial transaction costs for the lender and borrower. Credit rationing normally introduces an element of discretion in the process of loan approval that may easily degenerate into unwelcome arbitrariness on the part of the lender. The borrower may find that the high microfinancial transaction costs negate the subsidized loan rate.

- Income distribution may worsen as large farmers, perceived by bankers to be safer and creditworthy customers, generally elbow out small farmers from the programs.

- The cost of the policy is transferred to unsubsidized rates, as they would normally be higher than the ones that would prevail in the absence of concessionary rates.

- Savings are discouraged, since customers will find it profitable to take advantage of the availability of cheap credit rather than increase their own capital. In the same manner, subsidized credit is diverted away from productive uses and utilized instead to finance speculative transactions.

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4.3 Should These Programs Be Discarded?

Professor McKinnon and the advocates of financial reform strongly believe that targeted credit programs containing subsidized loan rates inevitably lead to misallocation of resources in the economy at large, because they facilitate low-return investments that otherwise would not be undertaken, and block projects outside the programs (which are penalized by the higher-than-normal rates that banks charge to compensate for the mandatory subsidies). In addition, the system carries an implicit tax in the form of below-normal deposit rates.

However, it is interesting to note that developed nations frequently implement targeted credit programs. In fact, Joseph Stiglitz has estimated that 25 percent of credit in the United States falls under this type of program. In Japan, Taiwan, and South Korea, targeted and subsidized credit has been provided to benefit exporters, electricity and industrial transport projects, large scale projects in steel and other intermediate products, high technology ventures, and large scale projects in manufacturing. The rationale was that targeted and subsidized credit could be used as a useful instrument to promote investment in these sectors, widely considered to have strong growth potential and large positive externalities, (i.e., their capacity to induce additional growth in other sectors of the economy). Additional recipients of these programs have included small farms and the so-called sunset firms, i.e., firms that lost their competitive position in world markets. The rationale for the former lies in the explicit government policy of smoothing over the costs of industrial reconversion, whereas special credit programs for small farms are justified on the grounds that private financial entities find it very costly to gather information to assess their creditworthiness and to monitor their projects.[4]

In general, the experience of those Asian countries with targeted and subsidized credit has been hailed as successful. Since the Latin American record has not been as successful, it is pertinent to point out what contributed to the success of these programs:

- Direct and subsidized credit in Asian countries was usually accompanied by regulated deposit rates and restrictions on non-industrial lending.
- Government savings played a key role. The government was able to raise substantial low-cost funds from these savings and insurance schemes, which were channeled to selected activities without relying completely on deposits made through the financial entities.
- Asian countries enacted these programs as part of an overall, coherent development strategy that greatly enhanced economic growth, while the Latin American countries used them as instruments to dispense economic rents to the benefit of special groups.

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[4]For a more thorough discussion of the characteristics of targeted credit programs in Asian countries see World Bank 1992.

- Strict limits have always been placed on these programs so as not to disrupt the financial markets. In Taiwan, for example, the programs have never constituted more than 10 percent of the total credit portfolio of the country. (Adams, Chen and Lamberte 1991.) In Latin America, the extensive application of these policies led to widespread abuse, inefficiency, and fraud. Furthermore, the programs were not properly managed and monitored.

What are the lessons that can be drawn from this discussion? In order to answer this, it is appropriate to consider credit targeting and credit subsidies separately. In principle, targeted credit programs, if designed and executed with care, may be useful instruments of economic development. **What is of critical importance is the selection of the targeted recipients and the mechanisms to carry out the programs.** The selection of the groups should be based on a careful analysis of their growth potential and the willingness of formal financial entities to consider them as creditworthy economic agents. With respect to the mechanisms, it is far more efficient to implement these programs through the rediscounting windows of the Central Bank and not by forcing on banks quantitative allocations of their portfolios. Central Bank rediscounts offer commercial banks special lines of credit that are relent by the latter to selected sectors. To prevent large borrowers from usurping these lines, a ceiling on the loan size can be set. This ceiling should be low, so as to reflect the usual credit working capital needs of small farmers and microentrepreneurs.

Lessons learned in regard to subsidized credit are less clear. The unrelenting pursuit of import substitution industrialization policies led Latin American countries to underwrite huge, unwarranted subsidies on loan rates. This policy was flawed. Credit expansion is not normally facilitated by providing subsidies via interest rates. This is not to deny that, as illustrated by the experiences of Asian countries, credit programs containing subsidies on interest rates could be usefully applied when they are properly managed and carefully monitored. If so, it is recommended that the interest rate subsidy be reflected in the government budget, to be paid directly to the lending entities willing to participate in the programs out of fiscal accounts and not from Central Bank "credit." In general, however, it is more convenient that subsidies be provided through technical assistance to small borrowers. If necessary, it would be interesting to contemplate providing subsidies to financial entities engaged in offering loans to the targeted recipients. This subsidy could take the form of reimbursing financial entities the administrative costs incurred in lending to small borrowers.

The Inter-American Development Bank's current loan programs for microenterprise development provides a good illustration of well-designed targeted credit programs. These loans are normally disbursed through the Central Bank to financial entities willing to participate in the program. The rediscount rate applied to the participating institution normally would match the prevailing deposit rates in the beneficiary country. The financial institution, in turn, can charge loan rates that reflect the cost of funds plus an intermediation margin freely determined by the institution.

To conclude, targeted and subsidized credit programs are not a panacea to eradicate the problems that beset rural areas. Governments, through other policy tools, must eliminate imperfections in the financial markets, reduce the degree of market segmentation, improve the internal terms of trade to the benefit of the countryside, and attack the extreme inequality in income distribution. Unfortunately, when these programs are extensive, the consequences are pervasive, as the implicit costs detailed above far outweigh the alleged improvements in income distribution that these programs entail. For this reason, it is imperative that they be limited to a specific, small number of priority sectors. If so, the sound administration of the programs becomes an issue of crucial importance and carried out through the presence of a single, technically competent entity in charge of rediscounting earmarked funds for small farmers from the treasury and, when applicable, from foreign donors.

5.0 POOR INSTITUTIONAL INFRASTRUCTURE[5]

Many Latin American countries have failed to develop adequate institutional infrastructure. This term refers not to the strength of social organizations, but to the so-called "rules of the game" necessary to secure contracts between private parties within a market society. In this regard, the state plays the most critical role, since it establishes rules and enforces them in a predictable way.

An investor must normally contend with the economic risk of future prices, costs, technologies, and demand. In addition, he may well face institutional uncertainty if, for example, a change in government rules results in an economic environment permeated by constrained property rights, expropriation of assets, unnecessary regulation, unpredictable legal system, weak system of judicial enforcement, and undue interference in the economic arena (such as an unpredictable exchange rate policy, interest rate manipulations, and price controls). All these features, in general, reveal an inconsistent enforcement of private contracts.

Under this situation, the process of economic development suffers. This happens because the rules of the game are not credible in the eyes of economic agents who, in their zeal to reduce institutional uncertainty, end up establishing their own norms to guide and validate their economic transactions and devise their own forms of enforcement. However, this can be made possible only with the existence of exchange relations characterized by intense personal contact. At the same time, unfortunately, this poses limits to the number of transaction partners because there is only a limited number of exchange transactions that can be effected on the basis of personal knowledge, unlike the numerous, unlimited transactions that can be carried out within a large, anonymous market. As a result, the obvious advantages that are normally derived from a high degree of specialization and division of labor are lost.

The presence of this institutional uncertainty serves to explain the weaknesses of credit markets in Latin American countries. Formal financial intermediaries are reluctant to offer loans to borrowers whose collateral cannot be foreclosed rapidly and at reasonable cost. This uncertainty, in combination with the poor and unreliable information that is available, explains why small farmers are excluded as potential borrowers. For these

[5]This section has benefitted from Borner, Brunetti, and Weder 1992.

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customers, other mechanisms must be devised to enforce loan collection. One of these is the character reputation of the borrower. Its effectiveness, ultimately, will depend on the close personal knowledge of the individual. But this means high transaction costs, which make it prohibitively expensive for commercial banks to lend to small farmers. The high transaction costs, in turn, doom small farmers to be served only by those financial entities that are willing to adapt their financial technologies to the characteristics of the clientele.

Institutional uncertainty begets, therefore, high transaction costs. The consequences for economic growth are detrimental because high transaction costs underline the segmentation of markets. Latin America is dotted by many different networks with intensive economic transactions that hardly generate exchanges among themselves because each network is based on personal relations. As long as economic transactions remain "personalized," it will be very difficult to increase the size of the market. This situation will endure so long as the rules of the game are not credible for the vast majority of the population, and when the population perceives that rules are manipulated at will and inconsistently enforced either by the discretionary power of an entrenched bureaucracy or by the vested interests of ruling economic elites that benefit from a socially unacceptable income distribution.

6.0 ADVERSE RISK SELECTION AND MORAL HAZARD

The problem of asymmetric information breeds two major problems that lending entities must contend with because they act to increase the risk on loan-default. The first is adverse risk selection, which occurs before the loan is approved, and refers to the fact that lending entities, facing imperfect information, cannot offer lending terms for each borrower that accurately reflect their particular risks on loan-default. Instead, these lending terms reflect the average risk on loan-default of all credit applicants. Adverse risk selection occurs when lending entities offer stiffer lending terms. Under these circumstances, the safest, risk-averse borrowers withdraw from the credit market while borrowers with higher risks on loan-default step in. The second problem is moral hazard. This refers to the incentives that borrowers have to channel loans into riskier activities, presumably with the potential to generate higher returns, but which the lender would not normally accept if well informed of the real intentions of the borrower. Moral hazard occurs because it is normally difficult for the lender to control the actions that the customer will undertake with the borrowed funds.

Financial entities can resort to specific procedures to counter the problems of adverse risk selection and moral hazard. One is the use of improved techniques for screening customers and evaluating the feasibility of projects. Another is the demand of guarantees from the borrower which, when exercised, may reduce lenders' losses in case of loan default by borrowers. Finally, the lending entities could make use of effective monitoring techniques to preclude borrowers from engaging in moral hazard behavior. But the use of these techniques is not devoid of prohibitively expensive additional costs that financial entities must incur when lending to small farmers, because the size of the loan that small farmers normally demand is very small. The operation costs per loan, which include the costs associated with screening the applicant and approving, processing, monitoring, and collecting the loan, would therefore be very high. To make this profitable, lending entities would need to charge higher lending rates. (Aguilera-Alfred 1992.)

However, higher lending rates might increase the probability of adverse risk selection and moral hazard. In the case of adverse risk selection, the risk-averse customers will most likely bow out from credit offers since higher finance costs can be covered only with the undertaking of projects with higher returns and risks. At the same time, the incentive for incurring moral hazard increases, since riskier projects bring higher yields.

7.0 PROPER DESIGN OF RURAL FINANCIAL ENTITIES

To ensure viability, the proper design of rural financial intermediaries is of utmost importance. A successful approach to this task requires the following:

- The entity must be conveniently located, as close as possible to its clients. Proximity plays a crucial role in lowering firm-specific transaction costs. These costs should be kept low, correspond to the average loan size, and be properly reflected in the loan rates as part of borrower's expenses.

- The fixed cost structure of the entity should also be compatible with the size of the market that it will serve. Loans to small farmers are usually small. These loans cannot be profitably offered by rural branches of commercial banks with high fixed costs. There are several methods to minimize fixed costs. One is to take advantage of low-rent costs of vacant offices that may exist in public buildings. Another entails avoiding the payment of high fixed salaries to employees, relying instead on a system that makes wages earned proportional to loan recovery. Lastly, fixed costs can be lowered by using mobile banking services, which enable the entity to service several villages with a small number of employees.

- The entity should be backed by a sound, well established bank. This is very important because it enhances the credibility of the entity in the eyes of the rural clientele. Furthermore, support from a bank facilitates the supervision of the entity and the dissemination of technical assistance to the benefit of the employees assigned to the rural financial entity. Nevertheless, basic decisions must be decentralized. In other words, managers should have total responsibility in the screening of loan applicants and in deciding whether to grant the loans and for what amounts. To this end, it is imperative that managers who know the clients be recruited.

- The entity should function as a profit center. Goals such as agricultural growth, regional development, the support of agricultural reform, the adoption of new technologies, etc., should be subordinate to the financial viability of the entity. Lending policies, consequently, should be guided by this principle. In this regard, loans should be granted to any creditworthy borrower, priced to cover operation costs, and earn a profit. Success, among other factors, depends on keeping administrative costs low and on adopting efficient and flexible credit delivery mechanisms. Most critically, the entities should work to ensure a high rate of loan collection. This can be achieved by introducing incentive schemes for the benefit of the staff, such as profit sharing.

- The absence of formal collateral should not be an impediment for granting loans to small farmers. Managers' acquaintance with local conditions should allow for the proper investigation of each loan with the use of simplified techniques of credit analysis. To minimize the risk of default, the entities should offer interest rate rebates for prompt and timely repayment or penalties for delayed repayments. Mostly though, it is value that borrowers place on their good standing with financial entities, as well as the prospect of receiving additional loans, that will reduce delinquency.

- Finally, the priority of the entity should be the mobilization of savings.

8.0 STATE BANKING IN NICARAGUA: THE NEED FOR REFORM

Remarkably, agriculture remains the backbone of the Nicaraguan economy, despite the civil war that ravaged parts of the countryside and the mismanagement of the economy in the 1980s. A salient feature of that decade was an unrelenting pursuit of financial repression, which ultimately led to runaway inflation, misallocated resources, and the decapitalization of financial entities. Not surprisingly, the 1980s engendered a financial culture devoid of any appreciation for the vital role that a well managed, highly efficient, profit-seeking banking sector can play in fostering economic growth and development by offering innovative financial services. In essence, credit policy was guided and determined by political imperatives that ignored the most basic principles of economic efficiency. In this environment, the Nicaraguan government considered credit as an-all-powerful instrument capable of solving the ills of development, while the recipients began to view it as an entitlement.

The existing options that are available to improve small farmer access to credit in Nicaragua include private banks, marketing agents, and state banks. These are briefly explored below:

8.1 On the Role of Private Banks

Private commercial banks now play a very limited role in agriculture. Furthermore, it is highly unlikely that they will play a significant role in providing credit to small or even medium-sized farmers in the immediate future. Three factors account for this:

First, according to information elicited from interviews with private bankers, one of the greatest obstacles to expanding credit in rural areas is the **lack of branches in the countryside**, which prevents the banks' staff from analyzing in detail the creditworthiness of loan applicants. To alleviate this problem, some have suggested that the government provide incentives (e.g., tax breaks) to private banks to open branches in the countryside. This is not recommended, as private banks do not need to be prodded nor do they need to be given special incentives to move operations to rural areas. If anything, such measures will lead to the introduction of market distortions that in the end may spur the wrong type of investments and end up erecting barriers to entry and smothering the process of financial innovation. On the contrary, private banks will go to the countryside on their own, attracted by expected profitable opportunities. These banks that took the unprecedented decision of investing in the highly uncertain and volatile Nicaraguan scene hardly need special incentives to compensate for the alleged riskier ventures that characterize agricultural loans.

Second, the lack of private banking facilities in Nicaragua's rural areas relates directly to another serious, genuine obstacle: **the presence of high transaction costs.** Currently, private bankers believe that agricultural credit is extremely expensive because it requires careful supervision and follow up, including the hiring of agrarian experts capable of assessing the technical aspects of planting and harvesting.

Finally, **ongoing property disputes** are cited by private bankers as one of the most important obstacles to credit expansion in the agricultural sector. At least 50 percent of Nicaragua's farmers either are landless, occupy land without title, or possess nonbinding titles. Consequently, property cannot be offered as collateral. In those cases in which the property of new owners has been properly recognized, the problem persists for those producers who, even though engaged in profitable activities, are not creditworthy, since they cannot present commercial references.

To conclude, **it is not realistic to expect that private banks will be involved directly in lending to small and medium-sized farmers in the immediate future.** At present, they are constrained by a small capital base. Their limited resources are now going primarily to industry and commerce, where they can earn higher returns, and not to small and medium-sized farmers, who are generally perceived as being presently decapitalized and using outdated, economically inefficient technologies. However, as economic conditions improve in the countryside, and as the process of financial reform proceeds, it is expected that private banks will gradually expand operations to meet rural financial needs. This process took place to some degree in Chile in the mid- to late-1980s, as financial entities looked for niche markets.

8.2 On the Role of Marketing Agents

Theoretically, marketing agents and traders are well positioned to undertake financial intermediation. Preliminary observation suggests, however, that the impact of these agents is still small in Nicaragua. This is evidenced by the fact that the well established commercial enterprises—engaged in the importation of agro-chemical inputs for large, medium and small producers—are generally reluctant to take an active role in credit provision to their customers on the grounds that they would have to screen borrowers carefully and monitor the utilization of credit (tasks that are deemed as costly and complex).

On the other hand, evidence suggests that informal modalities of financial intermediation in the rural sector are gradually emerging. Spearheaded by small traders, this financial intermediation is probably monopolistic, therefore denying benefits of competitive market structures. In fact, small producers often complain that traders and other middlemen do not pay fair prices for their products. The result is that producers are squeezed by the combination of low prices and very high credit terms. Under these circumstances, it is impossible for small producers to introduce more updated and cost efficient techniques that would allow them to raise incomes because there is no price incentive to do so.

In order to remedy this situation, small producers could develop their own entities to bridge formal credit to their membership. This offers the opportunity to the USAID Mission to contribute by strengthening farmers associations as creditworthy entities. This, in fact, is precisely what the Mission is currently doing with UPANIC. But this task, it should be stated, is not devoid of difficulties and risks. For one, such an undertaking needs to respond to genuine initiatives that emanate from farmers and not as a venture that is designed and imposed by outside parties. Moreover, it is an organizational building task and, as such, its results and impact can only be assessed in the longer run.

In sum, it is not realistic to expect that formal marketing agents and informal lenders will provide a significant expansion of financial services in Nicaragua.

8.3 On the Role of State Banks: The 1980s Redux?

The situation is indeed critical. As much as 80 percent of the agricultural population of Nicaragua may be negatively affected in the short run if the transition to a market economy stumbles or fails to correct the structural problems that plague the rural sector. Producers of basic grains seem to be the most adversely affected. Farmers' associations complain bitterly because this sector has been virtually eliminated from all sources of formal credit.

What is to be done? Given the fact that private banks are not likely to play a predominant role in the immediate future, and informal credit mechanisms are still too incipient to serve unmet credit demand, then a final, but perhaps inevitable option is the revitalization of state banks which, at present, account for most of the total bank portfolio in the country.[6] This alternative, it should be emphasized, is not devoid of risks because past administrations destroyed the capabilities and credibility of the BND. But the option of revitalizing this entity should be examined very carefully. This can be justified as follows:

(1) Nicaragua, at present, typically presents a case of "market failure" in the provision of financial services to the rural sector. Nicaragua is far from offering the basic pre-conditions for a successful functioning of a competitive market economy. In the last decade, poor rural infrastructure, undeveloped information networks, and institutional weaknesses were factors that prevented the smooth functioning of the market. These factors explain why private banks and well established marketing enterprises are either unwilling or unable to step in at the moment with sources of credit. Furthermore, the existing income distribution will definitely preclude private banks from lending to small

[6] It has been estimated that as much as 90 percent of total lending is provided by state-owned financial entities, of which the BND is clearly the most important.

farmers, even if they are creditworthy, since larger returns are expected from loans to larger producers or to other sectors of the economy.

(2) The BND, for all practical purposes, still dominates the financial system. This state-owned entity controls sizeable financial resources because of its access to rediscount lines from the Central Bank (albeit at competitive market rates.) Moreover, unlike the small private banks, the BND has a strong presence in the countryside, with well established agencies that can serve the financial needs of medium-sized and even small producers. If this entity is liquidated—as has been suggested—painful production losses may occur as a result of an unwarranted retrenchment of formal credit.

(3) Privatization of the BND is not a feasible option at the moment since it is not realistic to assume that the small private banks will be interested in acquiring assets that are located in remote, difficult-to-service regions. At best, only part of its operations can be transferred in this way.

If the BND is to play a useful role, the challenge is to convert it into an economically efficient unit serving the public. The Inter-American Development Bank is presently pursuing this goal through technical cooperation; this is a viable action that the Mission should explore with the bank. A reformed BND may well be modelled under the successful BRI in Indonesia (see below), and strive to mobilize savings and attain financial viability. This would require a thorough institutional reform that should include, at a minimum: (1) elimination of moral hazard from the bank's operations; (2) the ability to charge interest rates high enough to cover costs and risks on loans to unproven clientele; and (3) the decentralization of bank operations, since it would allow branch managers, usually knowledgeable of local conditions, to assume responsibility for loan approval and rejections.

9.0 SUCCESSFUL FINANCIAL ENTITIES

The use of specialized, mostly state-owned financial entities as conduits for the delivery of targeted, subsidized credit was a common feature of financial policies in Latin America. The rationale behind this decision was to relieve the central government from the administrative burden of implementing these programs. Within the Latin American context, these institutions seldom performed well. In the end, they merely acted as vehicles for handing out credit from the Central Bank, and became hopelessly decapitalized, as the inflationary process that normally accompanies the unlimited use of rediscount privileges from the Central Bank eroded the real value of their loan portfolios. This fact has been dramatically illustrated with the current situation of the BND of Nicaragua and with Ecuador's Banco Nacional de Fomento.

Notwithstanding these problems, it is not appropriate to conclude that all state-owned specialized agencies are failures. There are also examples of impressive successes. One of them is the experience of Banco del Estado in Chile. Although this institution has privileged access to rediscount facilities from the Central Bank, it has nevertheless performed admirably well throughout the years, serving a clientele with no access to the financial services offered by private commercial banks. Banco del Estado is financially viable and does not resort to government support to cover operating costs. Furthermore, unlike private commercial banks, it was the only financial institution that survived the banking collapse of 1982 without government help. In Asia, a success story is the BRI's Kupedes program, which has been designed to finance small credit projects. By the end of 1992, this program had total outstanding loans of $1.7 million, for a total portfolio of $800 million. Total deposits for the same period were $1.6 billion. The program is profitable with a default rate of just 2 percent. These examples are analyzed in greater detail below.

9.1 Banco del Estado

The Banco del Estado de Chile has existed for 142 years, and has functioned as a consolidated state bank since 1953. It is currently the largest bank in the country (there are more than 25 commercial banks in Chile) with a very solid and conservative portfolio. This financial entity has deep roots in servicing the private sector but it has been used, since its inception, as a developmental tool of the Chilean government.

As a development entity, the Bank has the following objectives: (1) to provide financial services to small- and medium-sized enterprises; (2) to raise the nation's savings rate; and (3) to increase mortgages to small- and medium-income families. The success that this state bank has had with savings mobilization is particularly impressive. In fact, Banco del Estado has managed to capture 73 percent of Chile's savings, or 7,000 out of 13,000 total savings accounts in the country. The bank targeted savers not considered profitable by other commercial financial entities.

Banco del Estado also works closely with INDAP, a government agency in charge of providing technology transfer and credit to small farmers with 12 hectares or less of non-irrigated land. These farmers are considered to be marginalized and outside of available commercial credit. Normally, INDAP offers credit at subsidized rates, while its by-laws prohibits it from raising savings. Banco del Estado's program consists of providing credit to INDAP's clientele at market rates but with minimal guarantees, usually against savings accounts. The goal is to educate low income farmers on the advantages of savings. INDAP's role is to organize and select the rural low income families willing to participate in the program. The maximum loan size is three times the value of the savings account. The risk of default is absorbed by Banco del Estado.

An important source of income for the bank is the management of the accounts of the Chilean government. This is cited as proof that this institution enjoys financial advantages over other private intermediaries. Yet, Banco del Estado pays 40 percent tax on interest earned as (compared to the 15 percent rate paid by Chilean businesses). During the Pinochet Administration, the bank was a candidate for privatization. Allegedly, during the period of impending, anticipated privatization, the bank went into a state of limbo and implemented no new programs or mechanical modernizations. Since 1991, it has returned to its role as the financial development tool for the Chilean government. With this renewed emphasis, the bank is cautiously entering into programs to lend to smaller-scale farmers and more marginalized clients. It recently modernized and implemented automated systems for managing savings and credit, and has the potential for reaching a vast clientele due to its network of branches throughout the country, especially in extremely remote areas.

9.2 The Bank Rakyat Indonesia (BRI)[7]

BRI is the oldest and largest bank operating in Indonesia. Until the early 1980s, this institution operated mainly as a "faucet" and not as a bank. In other words, it was a vehicle to deliver credit from the central government to target groups. Therefore, it acted the same as the failed state credit agencies of Latin American countries. But goals and operational procedures and principles radically changed in 1984, when the bank commenced small-scale banking activities through the so-called Unit Desa network, consisting of over 4,000 branches scattered all over the country.

Simple organizational principles guide the activities of the Unit Desas. Each is a separate, identifiable profit center, with a staff of just four people: a manager, a field person, a teller, and a deskperson/bookkeeper. Each unit is supervised by a BRI branch. In these branches, there is one full-time supervisor for each Unit Desa. Appropriate in-house supervision is exercised to stop collusion and corruption between supervisors of branches and the managers of the unit desas. In addition, there is a strong emphasis on training; 6,000 employees are trained annually by 80 full-time instructors in five regional training centers.

Each Unit Desa, while being an independent profit center, is closely linked with the BRI. Excess funds are placed in the supervising branches at market rates. The Unit Desas can also borrow from these branches, normally at unsubsidized rates. Unit Desa managers have strong incentives to do well because they are paid bonuses based on financial performance and participate in profit sharing plans. While they normally charge loan rates (high enough to cover costs and return a profit) that are set by the supervising branches, the managers have total freedom and responsibility for the selection of the customers. This is of important, since the success of this vital task depends on knowledge of local conditions.

Loans have grown exponentially. As of late 1992, there were 1.7 million loans with an outstanding balance of $800 million. The average loan size was $375, mainly to small traders. The loans are not targeted, nor are they collateralized in practice. Most impressive has been the success of BRI in mobilizing savings. A total of 9.7 million accounts with balances of $1.6 billion were reported in December 1992. Savings have played a key role in the sustainability of the institution.

9.3 Some Common Elements of Success

Chile and Indonesia offer interesting examples of how state banks can play a positive role in economic development. Both countries underwent profound financial market deregulation in the early 1980s. But, defying conventional wisdom, it was

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[7]For a more complete discussion of BRI see Hook 1992, González-Vega and Chaves 1992, Patten and Rosengard 1991, and Yaron 1991. This discussion has benefitted from these studies.

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implemented before the enactment of adequate, prudential bank supervision. As indicated before, the private banking system collapsed in Chile, whereas in Indonesia the financial system survived because it was largely dominated by state banks. It has been argued that Chile's Banco del Estado and the Indonesian state banks survived because, being smothered by stifling bureaucratic inertia, they were very slow to respond to the opportunities that were opened up by deregulation. But this view ignores the high quality management of these institutions, which, in general, profess a sound, conservative approach to banking. Furthermore, the populations in both countries possess great confidence in the stability and safety that state banks offer.

Another key element is that both institutions invest heavily in programs for savings mobilization. These programs offer safety, easy withdrawal, and convenient locations. In addition, they have largely succeeded in finding their market niches. The clientele that they serve, while normally neglected by private commercial banks, generate enough income so that lending at commercial terms is profitable. Small farmers with very low incomes, however, are not served by these banks.

Two additional elements are worth mentioning. The first is that both countries, steered by sound macroeconomic policies, have enjoyed high economic growth and low inflation. The second is that both have been able to operate largely without political interference. Thus, management has not had to contend with governments pressing for debt forgiveness to special clients or intruding in lending decisions.

9.4 Specialized Banks Can Also Be Privately Owned

Privately owned banks can also succeed in providing specialized financial services to small lenders. The examples of Banco de Desarrollo in Chile and Finagro in Ecuador illustrate this.

Banco de Desarrollo provides financial services to small-scale, marginalized producers not targeted by other commercial banks. The bank, which was started in 1983, is funded by the Catholic Church as a development finance company. The original orientation was always towards servicing marginalized clientele. Managers were hired and the Church itself did not participate in managing the funds. Rather than operate as development project, the bank evolved to function, almost from inception, as a for-profit business.

A venture capital with a foreign bank allowed expansion from eight to 34 branches. Programs include the promotion of microenterprise development in agriculture. Loan rates are higher than commercial banks and Banco del Estado, reflecting in-built transaction costs and spreads. The only competitor is Banco del Estado, but managers of Banco de Desarrollo consider their institution to be far more adaptable and less rigid in requirements. In addition, loan processing and disbursement is faster than Banco del Estado. Finally, Banco de Desarrollo provides savings services and technical assistance to its customers. In each branch there is an agricultural technician who is in charge of supervising credit uses.

Finagro is a private entity founded by 33 investors from Ecuador. In late 1992, the Inter-American Investment Corporation of the Inter-American Development Bank provided additional equity. Finagro serves traders and small farmers in the area of Babahoyo, a rich agricultural region in Southern Ecuador. The company also provides technical assistance to small farmers. It does not mobilize savings, because Ecuadorean law prohibits it.

Both Banco de Desarrollo and Finagro have established their market niches. In the case of the former, it has targeted clients that are not served adequately by INDAP. Finagro, on the other hand, draws its strength from outcompeting the Banco Nacional de Fomento. This state bank offers loan rates that are substantially lower, but its loan procedures are plagued by vast inefficiencies that result in prohibitively high transaction costs. The other competitors of Finagro are informal lenders who operate in the area. Finagro outcompetes them by charging lower loan rates and by offering technical assistance to small farmers.

10.0 AN EXAMPLE OF FINANCIAL REPRESSION: THE CASE OF ECUADOR IN THE 1980S[8]

10.1 Background

Ecuador muddled through the 1980s with unsustainable economic policies which, by the end of the decade, were ineffective in promoting growth and contributed to deepening economic imbalances. Economic growth fell sharply, and averaged only 2-3 percent between 1982-1988. During the 1990s Ecuador suffered El Niño rains and floods, damage to the trans-Andean oil pipeline as a result of the 1987 earthquake, falling oil prices, and a deepening recession due to a saturated domestic market and non-competitive industrial sector. Setting aside the pervasive effects of natural disasters, the poor economic performance of recent years points to a mixture of undue state intervention and erratic attempts at economic liberalization.

Economic imbalances were reflected in the presence of a pernicious, persistently high rate of inflation, which by mid-1992 was around 60 percent a year. Ecuador's inflation has been rooted in misguided monetary policies and in the fiscal deficit. The Central Bank did not act as an effective guardian of monetary stability, concentrating its functions more on credit. Not surprisingly, the expansion of the nominal money base was linked to Central Bank direct lending and the rediscounting of loans to the benefit of public and private financial institutions. In addition, it frequently made use of a multiplicity of instruments to emit money. For example, development bonds issued by the Banco Ecuatoriano de Desarrollo (BEDE), were purchased by the Central Bank at face value and not resold in the capital market (Youngblood et al 1991). Finally, the Central Bank's assumption of exchange rate losses from international credit to the private and public sectors contributed to inflation. This can be illustrated with the practices followed by the Banco Nacional de Fomento (BNF). This state-owned financial entity used to convert the foreign exchange it received from its international creditors at the prevailing exchange rate when the loan was disbursed. At the

[8]This discussion has greatly benefitted from Ramos and Robinson 1990 and from Youngblood 1991.

time of repayment, the exchange rate had already depreciated. Obviously, more sucres were required to repay the original dollar-denominated loan. In practice, however, no provisions were made to cover the exchange rate depreciation; therefore, the BNF incurred foreign exchange losses on foreign loans. But these losses, ultimately, were absorbed by the Central Bank.[9]

10.2 Financial Sector: Policies

A closer look to this context suggests that the main features of financial repression prevailed in Ecuador. The Central Bank used reserve requirements ineffectively and erratically in its attempt to control liquidity. No interest was paid on these reserves so that the profitability of private banks was greatly constrained. Reserve requirements were also used to discriminate among lenders, as different levels were required. A rate of 10 percent was set for the BNF in the early 1970s, whereas during the same period different reserve requirements were imposed on private banks. Furthermore, the private banks were also penalized by mandatory purchases of securities at face value. For example, banks forced to purchase securities that were issued by one parastatal financial entity earned less than 10 percent a year (negative in real terms) since the inflation rate was on average 50 percent.

In Ecuador, Central Bank policies are determined by the Monetary Board. During the 1980s these policies included subsidized and explicitly discriminatory lending. According to Ramosa and Robison (1990):

> in 1984 the BCE [Central Bank] advance and rediscount rates were set at 11 percent for the Fund for Marginal Rural Development (FODERUMA), 13 percent for the BNF and 18 percent for private banks. [In addition] the Monetary Board also sets the margin between what it charges participating financial institutions and what they can charge their borrowers. By the middle of 1989, BNF could charge a margin of five points, placing an upper limit of 32 percent on the loan rate for borrowers. The margin for private banks, however, was seven points, allowing them to set a maximum rate of 39 percent.

This system, which essentially guaranteed margins, was usually applied for target lending. This was inefficient, since it discouraged banks from seeking the highest return they could get for the loanable funds, and encouraged private banks to provide loans to the target groups so as to capture the guarantees.

Finally, the Central Bank chose not to exploit fully the use of open market operations (e.g., purchase and sale of stabilization bonds) to control the supply of money. The common praxis was for the Central Bank to purchase development bonds from BNF, private banks, and financial companies as a means to funnel relatively cheap credit to these institutions (since they are bought at face value with no discount to reflect market discount rates). The

[9]For a more thorough discussion of this practice, see Youngblood, *et al.* 1991.

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Central Bank is authorized to sell these bonds in the nascent capital market, but it has usually refrained from doing so largely because it is unwilling to price them at a discount.

10.3 Financial Sector Policies in Practice: The Operations of the BNF

This high degree of financial repression led to the displacement of private banking. Financial intermediation was mainly concentrated in state-owned entities. The most important of these has been the Banco Nacional de Fomento (BNF).

According to both Ramos and Robison (1990) and Youngblood et al (1991) the BNF is the principal source of funds for the agricultural sector, and is cited by Ramos and Robison as having provided over 36 percent of agricultural sector credit in the 1980s. Loans have been available from the BNF to borrowers who meet the following requirements: (1) belong to producer organizations; (2) have an investment plan or a feasibility study (depending on the size of the loan); (3) have an account at the BNF; (4) own land with the ability to show title; and (5) carry a card issued by the Agricultural Center certifying that the borrower is a farmer. This set of requirements is costly and cumbersome for small-scale borrowers and is an impediment to disbursing loans to small-scale farmers (Ramos and Robison 1990). Long-term agricultural loans have required clear legal title to land, problematic for Ecuador.

The BNF has offered loans at below-market rates which are, in essence, subsidized—thereby creating an excess demand for credit. Furthermore, the available supply is allocated by administrative, rather than market means, and evidence suggests that these loans have gone largely to privileged borrowers.

BNF's true financial picture is unclear. Seemingly acceptable figures on default levels are reportedly not reliable given the Ecuadorean banks' reluctance to write off bad loans. Most likely, if stricter financial soundness standards were applied, the loan portfolio of the BNF would probably be portrayed as weaker. Loan recoveries fell dramatically as an important source of funds for lending to such degree that foreign loans increased from 2 percent to over 20 percent of total source of funds between 1981-1988. This led to an additional drain on resources as recent foreign exchange losses increased substantially.

The BNF has been unsuccessful in attracting deposits, as the interest rates paid on their savings instruments was at least two points below those offered by commercial banks and savings and loans associations, and at least 25 percent below the rates offered on certificates of deposit. Consequently, as suggested above, the bank has been forced to rely on external sources of funds, mainly: (1) foreign loans, primarily from the Inter-American Development Bank and The World Bank and (2) the Central Bank. Not unlike other development banks in Latin America, foreign liabilities have risen in recent years, especially when these financial entities acted as a conduit for the disbursement of the substantial foreign debt incurred in the 1970s. The Central Bank, definitely the most important source of funds, continues to increase funds. Credit from the Central Bank has consisted of rediscounts through the financial funds mechanism and through development bonds. Like commercial banks, the BNF could issue development bonds as a source of loan funds for certain types of loans that were ultimately sold to the Central Bank at face value. While, as noted before, the Central Bank is the only entity that could turn around and sell these bonds in the capital market, in practice they were seldom sold (as the Central Bank was not willing to offer them at attractive prices to investors). Thus, these bonds were not used to mobilize private domestic savings; they were merely the vehicle for channeling credit from the Central Bank to selected borrowers.

In discussing whether or not the BNF has served the credit needs of small farmers in Ecuador, it is important to highlight two contending findings. According to the Youngblood et al. (1991), the BNF has granted credit mainly to small farmers with 10 hectares or less (based on data for 1980-1988). These farmers have received 25 to 40 percent of total lending over this period, with larger farmers (farms over 50 hectares) accounting for 2 percent of the actual borrowers, but 20 percent of the total amount loaned out. Youngblood explains that larger farms require larger amounts of credit, and that in general, lending has gone to the targeted beneficiaries. His final analysis is that the BNF has accomplished its purpose.

Ramos and Robison (1990) contend that, to the contrary, the BNF has not accomplished its purpose. Their argument is based on the size of the loans, and they argue that the percentage of smaller loans has fallen as the percentage of larger loans has risen between 1980-1988. One explanation is that smaller scale borrowers pay a higher non-interest cost per sucre for a loan than do borrowers of larger amounts, resulting in reduced demand by smaller borrowers. Further, experience has proved that loan-servicing costs are related to the number of loans granted rather than the size of each loan; therefore the BNF may have been encouraged to reduce the number of loans by lending to fewer, larger agriculturalists to maintain their own financial viability.

10.4 Financial Policies in Practice: Constraints for Private Banks

Clearly, private banks in Ecuador were crowded out of intermediation activities by public sector lending. Their profit margins were constrained by various factors, including high reserve requirements (32 percent as of June 1990) and requirements to target loans to certain groups regardless of profitability.

Furthermore, the private banks' "market" determined loan rates were actually set by the Monetary Board because they were pegged to a "reference deposit rate" derived by Central Bank calculations. In mid-1989 the average deposit rate was about 36 percent, setting the private bank loan rates at about 53 percent because of inflation. In practice, these loan rates have been very low in real terms. If risks and transaction costs are taken into account, these loan rates may have well been negative in real terms.

Since private banks could not compete with the subsidized interest rates offered by the BNF, nor were they willing to make long-term loans due to rising inflation, they often turned to the rediscount mechanism for profit-making. Yet, private bankers often complained that the Central Bank lines were too expensive, asserting that the margin between the loan rate they were allowed to charge and the rediscount rate paid to the BCE was too low preventing an adequate coverage of their transaction costs. The fact that banks in Ecuador often maintained reserve requirements higher than what was required, despite no interest earned on these funds, could be an indication that these lines of credit were judged prohibitively expensive by private bankers.

10.5 The Challenge Ahead

Not surprisingly, many private borrowers were ultimately unable to obtain subsidized credit through a public institution such as the BNF, or through the rediscount lines offered by the Central Bank. Interestingly, although interest rates charged by private banks were higher than BNF, anecdotal evidence indicates that agricultural producers preferred to borrow from a private bank because: (1) actual transaction cost are lower; (2) the loans are obtainable in a timely manner; (3) the loans are in the amount requested and qualified for; and (4) qualifying is less cumbersome.

Consequently, it should be the government's overriding priority to reverse financial repression policies and crowding out private banks. It should be noted that the current government has already launched important reforms; however, the efforts aimed at economic reform that were recently launched failed. This can be illustrated with the stabilization program that was begun under the administration of León Febres Cordero to eliminate the reliance of private banks on the Central Bank. Unfortunately, it was abandoned in the last few months of that administration, which doomed the Central Bank to keep functioning as the lender of <u>first</u> resort, both to public and private sector institutions. This lack of a sustained commitment to economic reform was also displayed during the waning months of the Borja Administration. After an impressive start, whereby the fiscal deficit as a percentage of GDP decreased from 9.6 percent of GDP in 1987 to 5.1 percent in 1988 and to 2.2 percent in 1989, it rose to 7 percent by mid-1992, reflecting the fact that the political will to undertake structural reforms had already ebbed. One can only hope that the present government will muster the political will to sustain the process of economic reform initiated in September 1992.

THE PROPER SEQUENCING OF FINANCIAL POLICY REFORM

1. Is inflation high? If yes, **balance the government's finances.**

    1. Bring public expenditures under control
    2. Increase tax revenues
    3. Fold subsidies into the balanced budget

    The stabilization of the **price level** should proceed simultaneously with the enactment of **trade reform.**

    1. Unify exchange rate; avoid overvaluation of domestic currency
    2. Eliminate quantitative restrictions on imports
    3. Lower tariffs on imported goods

2. Deregulate **domestic financial markets.**

    1. Lower excessively high reserve requirements
    2. Eliminate or reduce to the minimum government-imposed restrictions on targeted credit
    3. Bring down entry barriers to spur domestic competition
    4. Ensure that interest rates on loans and deposits are positive in real terms

    Are domestic banks financially sound?

    If yes, eliminate barriers to **entry of foreign banks.** If no, this measure should be implemented gradually.

3. Has inflation been brought firmly under control? Is there a system that guarantees adequate bank supervision?

    If yes, liberalize interest rates. If no, **the central bank should control interest rates.**

4. Once 1, 2, and 3 have been obtained—**liberalize capital account.**

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