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Subsidized Credit Programs:

The Theory, the Record, the Alternatives

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Summary

SHOULD DEVELOPING economies rely on market forces for the allocation of credit, or should developing-country governments emphasize subsidized or (much the same) targeted credit to “deserving” borrowers?

From the 1950s until recent years, conventional wisdom favored government intervention. That approach, however, has fallen into disfavor. It has been found to contribute to resource misallocation, financially unviable lenders, weak mobilization of savings resources, stunted financial sectors, and regressive income effects. In other words, it worsened the conditions it sought to improve. A better course is to move toward financial liberalization.

Subsidized or targeted credit usually has two goals: achieving economic efficiency and distributing income more equitably throughout the population. These were supposed to be accomplished by channeling cheap credit toward sectors thought to promote development.

On issues of economic efficiency, governments justified intervention generally on grounds that existing credit institutions were inadequate for funding the modernization of agriculture and industry; that is, the private financial markets had failed. As to concerns about redistribution, the argument for intervening ran that such lending institutions as did exist favored the rich and powerful and thus put poor people at a disadvantage.

The goals of intervention were well intentioned, but the subsidies, for the most part, did not work. A chief failing was that lending institutions set up to provide capital to small farmers and small entrepreneurs could not survive without the concessional aid provided by donors. (Such institutions included government-sponsored bodies as well as nongovernmental organizations [NGOs] and private voluntary organizations [PVOs].) In part this inviability came about largely because interest subsidies for money *borrowed* pushed down the rates for money *deposited*. That discouraged potential savers, drying up the flow of funds for credit purposes. Moreover, the default numbers ran high, owing to lax screening of borrowers. But while the institutions were struggling, private moneylenders continued to charge high rates—and to thrive.

More fundamentally, though, subsidized credit often missed its target—the rural poor and small entrepreneurs. It is costly and risky to make small loans to large numbers of poor borrowers. As a result, lending institutions tended to extend credit to large and less risky borrowers. Protecting their solvency in this way caused the institutions

generally to redistribute income regressively. A Costa Rican study, for example, estimated that some 80 percent of subsidized agricultural loans in 1974 went to large farmers.

Accordingly, it turns out that what small farmers and small entrepreneurs really need is *access to financial services* rather than cheap credit. The creation of viable lending institutions thus is critical. Such institutions must be able to cover their operating and capital costs from revenues (interest spread and customer fees) without receiving outside aid.

Because of the unhappy track record of subsidized credit, many developing-country governments (supported by international donors) have been liberalizing their policies. They are moving toward (1) less targeting of loans, (2) more flexible interest rates for loans and deposits, (3) more attention to deposit mobilization, (4) fewer concessional lines of rediscounting from central banks, (5) emphasis on reducing transaction costs for borrowers rather than trying to lower interest rates on loans, and (6) contributing to the viability of financial institutions and the performance of the financial markets.

Overall, a large body of theory, combined with direct experience, points to various lessons broadly applicable to credit programs. Among them:

(1) Projects that lend funds at free-market rates and pay market rates to savers can be financially viable and successful. Lenders who provide cheap credit can be neither.

(2) Farmers can increase output profitably while paying market rates of interest. Market-rate credit has not been the major constraint to development it was often presumed to be.

(3) The best approach to correcting market failure is to address it head-on through reforming economic policy and institutions. Similarly, direct transfers are the best way to redistribute income. Government can play a strong financial role, but that role is not to provide cheap credit. Rather, it is to help develop a legal framework, enhance the availability of market information, and provide proper regulation, supervision, and enforcement of the financial markets.

(4) Small farmers and small entrepreneurs benefit from financial liberalization policies and the development of institutions able to efficiently provide financial services to them. Credit access is more important than credit price.

(5) Through their local knowledge, nongovernmental agencies and private voluntary agencies have advantages over government agencies in lending to small enterprises. To succeed, though, they must act as lending institutions rather than philanthropic

agencies. They should, moreover, aim at reaching financial sustainability within a relatively short time.

(6) Donors can complement their efforts to reform macroeconomic policies and related institutions with programs to help develop financial services that reach efficient small entrepreneurs and the poor. Priority should go to supporting development of commercially viable, nontargeted financial institutions that can meet the liquidity demands of borrowers. Here, too, the programs should become financially self-sufficient in a short period—say, 3 years.

The disappointing overall record of credit programs suggests that donors should proceed with caution in their initiatives. They should only gradually expand the scope of resources allocated to microenterprise financing as additional successes warrant. At this point donors should emphasize limited pilot programs in countries selected on the basis of adequate policy and institutional settings. In this light, international donor subsidization of institutions that provide financial services to microentrepreneurs should be of short duration and conditioned on rapid movement toward financial self-sustainability.

1

Introduction

THIS PAPER presents an overview of experience with targeted and subsidized credit and of the theoretical foundations of such programs. The paper links the conclusions of USAID analyses with other relevant work and experience to present a clearer understanding of where development economics stands relative to the use of directed credit interventions by governments and donors.

The paper first reviews how governments and donors have traditionally approached credit and the rationale involved. The next section presents an overview of how thinking about credit policy and development has evolved and what the main issues have been. Next, the paper goes over the empirical record of both targeted credit and the financial liberalization alternative as reflected in USAID or USAID-supported analyses and the professional literature. The paper concludes by identifying lessons learned of operational significance.

2

Traditional Credit Policies and Their Conceptual Foundations

FROM THE 1950S until recent years, most governments in developing countries and most official international development institutions channeled cheap credit toward sectors or activities thought to promote development.¹ Although concentrated in agricultural projects, such credit activities covered a broad range of economic sectors, including small enterprises.

Targeted activities might not involve explicit interest rate subsidization, but historically directed credit and subsidization tended to go together.² Governments and international donors justified such policies on grounds of economic efficiency or of more equitable income distribution. When economic efficiency was at issue, the arguments ran along these lines:

- There is a paucity of formal financial institutions. Moreover, the institutions that do exist often service, basically, only well-established concerns, many of which are foreign owned. Owners of small and medium-size local businesses frequently have only limited access to bank credit; local farmers have even less access.
 - Sources of equity capital and of long-term finance are scarce.
 - Although informal financial institutions (moneylenders, pawnbrokers, traders) do provide credit to local businessmen and farmers, overall volume of lending is too small and costly.³
 - Accordingly, existing financial systems are inadequate for sustaining industrialization and agricultural modernization.
-

These limitations were seen as a consequence of market failure—in this case, inability of the private financial markets to function in a socially optimal way. Specifically, they reflected a too-limited capacity to evaluate, price, and monitor risk;⁴ vague legal systems covering collateral and foreclosure; and uncertainty about economic prospects (inflation, for instance) and the stability of the economic policy regime.

The arguments concerning income distribution took these forms:

- Where banks are owned by industrial groups, the banks lend primarily to members of the groups and thus tend to reinforce the concentration of power and wealth.
- People with low incomes often do not meet collateral requirements. Moreover, they are at a disadvantage because of their poor education and lack of influence.

Concluding that direct intervention was needed, governments moved to approach financial institutions as their own tools for channeling credit to priority activities.⁵ The aim was to achieve (1) positive externalities (that is, welfare-enhancing effects on third parties) by allocating resources to projects considered to have high social (but not necessarily high private) internal rates of return and (2) income redistribution. The former objective included support for state-owned enterprises. In addition, governments used credit allocation and related financial policies as a means to offset distortions caused by such other policies as price controls, overvalued currency, and trade protection.

In this way, with the support of international donors, governments directed credit flows to (1) industry to promote rapid industrialization; (2) agriculture to raise output and speed the introduction of new technologies; (3) state-owned enterprises for reasons that included natural-monopoly arguments and achievement of externalities and income-distribution objectives;⁶ (4) small and medium-size firms to generate employment and achieve more equitable income distribution; (5) housing to benefit the poor; (6) exporters to bridge the period between production and payment, offset the effect of policies biased against exporters, and especially more recently, achieve externalities associated with exporting—as, for example, development of management

know-how and technological dissemination and modernization; and (7) underdeveloped regions to achieve externalities⁷ and income-distribution objectives.

A conceptual linchpin to the approach was the sense that planning was probably the most effective way of achieving economic development. Governments deemed control of financial resources necessary for plan implementation. Furthermore, as economic externalities were a rationale for investing in particular projects, externalities provided a justification for subsidizing the capital costs of such projects. This at times meant interest-free loans.

Finally, direct government intervention in credit markets had political advantages. The notions of providing cheap credit to “help the poor” and to “promote development” are popular and can be used for political ends—for example, by allocating credit to political supporters (Duesenberry and McPherson 1991).

Tools Used to Control the Allocation of Credit Directly⁸

A widespread tool for directing credit was the imposition of *lending requirements* on public and private banks. Such requirements obligated banks to allocate given proportions of their loan portfolios (or even absolute amounts) to specific sectors.

Another mechanism, frequently supported by international donors, was *refinance schemes*. Through these schemes banks could borrow funds, generally from the central banks, for specific uses at significantly lower rates than the banks would ordinarily charge.

Interest rate subsidies were probably the most common tool. Such subsidies meant that governments specified below-market interest rates for specific lines of credit.⁹ As a variation on the same tool, often governments would specify *interest rate ceilings* on deposits or loans (or on both). The ceilings on loans might apply across the board or vary according to type of loan by sector or term.

Two other mechanisms were often used by governments and international donors. The first was *credit guarantees*, through which at least part of the risk of a loan was absorbed by the institution providing the guarantee (the central bank under funds

provided by an international donor, for example). The second was the establishment of *development finance institutions* to provide specialized credit.

3

Theoretical Underpinnings: A Stylized Historical Perspective

LATER SECTIONS ELABORATE on the main conclusions drawn from a body of assessments done during the last 20 years on credit programs. It will be apparent that, in the main, the conclusions have been critical of the rationale for and the results of subsidized credit interventions.

While that is the majority view, opinions differ over the development effect that credit interventions have had. Moreover, strands of recent theoretical literature may be used to vindicate credit targeting and subsidization. Before we examine the empirical record in chapter 4, let us therefore review some of the theoretical aspects that (1) influenced the perception of credit programs and (2) have been affected synergistically by the empirical record of such programs.

An extended analysis of how thinking on intervention by governments (and donors) has evolved in recent years is beyond the scope of this paper. Such analysis would, however, be useful in assessing the respective weight one should attach to conflicting views on the effect of directed credit.

Nonetheless, it is reasonable to sketch some of the salient aspects of the changes in thinking on these topics. The idea is to provide basic points of reference that may shed light on the conceptual foundations of the assessments mentioned in this paper.

The common thread in the three following subsections is the issue of whether societies should essentially rely on market forces for the allocation of credit or whether, instead, the emphasis should be on discretionary allocations of credit. This paper reviews the issue through the prism of the debate surrounding financial liberalization.

The Financial Liberalization Perspective

As suggested earlier, concerns about economic efficiency involving failure, uncertainty, and limited information offered a rationale for directly intervening in credit markets through targeted and subsidized credit. The perception was that, especially in developing countries, financial markets were not mobilizing and allocating savings in a socially optimal way.

According to established theory (Fisher 1930), competitive, well-functioning financial markets would reward savers by providing a return on their savings that reflected the social cost of saving. This would be the return on savings that savers should expect. Accordingly, savers would be in a position to make optimal decisions regarding what proportions of their income would be saved and consumed (Cole and Slade–Yaser 1989).

Likewise, well-behaved financial markets would provide financing for investors consistent with the cost to savers and in a way that promoted the most socially profitable activities. *The sense that markets were not well behaved prompted governments to allocate credit directly and establish the terms for lending.*

However, while governments and donors engaged in directed and subsidized credit allocations, economic analysis was developing a framework that postulated how financial systems change as countries develop. The work of Gurley and Shaw (1960) helped clarify the different functions of the financial sector and the institutional changes that occur as the sector develops. This work led to the formalization of how financial systems can promote or impede development.

Because economic growth was seen as essentially a function of investment, it was natural for governments to approach finance as simply the means of paying for investment. However, growth in money and credit that was excessive relative to real savings (i.e., the availability of real resources) raised concerns about inflation and related balance-of-payments difficulties. Too much growth in nominal finance hindered, rather than helped, development of the financial sector and of economic growth.

Moreover, attempts to control inflation by restricting the growth of money and credit, while at the same time maintaining tight government control and direct intervention in the allocation of credit, further prevented the healthful growth or development of the financial sector (Cole and Slade–Yaser 1989). This led to influential analyses of the causes and consequences of financial “repression” and how to eliminate it (McKinnon 1973, Shaw 1973).

McKinnon and Shaw observe that inflation, interest rate ceilings and subsidization, heavy reserve requirements on bank deposits, and compulsory credit allocations reduce the attractiveness of holding claims on the domestic banking system. Financial systems

in which those conditions exist are termed “repressed.” Repressed systems often exhibit negative real rates of interest on monetary assets (for substantial periods of time) and are difficult to predict. As a result, the demand for money falls as a proportion of gross national product (McKinnon 1973, 1988).

In developing countries, savers (especially small savers) have few financial alternatives to holding claims on the banking system (as with deposits or bills). Under financial repression, savers seek to protect their wealth and reduce the flow of savings through the banking sector. As a consequence, many potential investors have no alternative but to rely on self-finance.

However, even the process of self-finance is impaired as people invest in inflation hedges. The dispersion of interest rates on loans is large, and rate differentials are arbitrary. The development of nonbank financial institutions is hindered by illiquidity and instability.¹⁰

The remedy, according to McKinnon–Shaw, is to stabilize prices through appropriate macroeconomic policy and to allow real interest rates to be positive and more uniformly high for comparable categories of bank deposits and loans. To accomplish the latter, governments would have to do away with interest rate ceilings and mandated credit allocations. They would also have to eliminate onerous reserve requirements.

Such recommendations run counter to the practices of developing-country governments and of donor agencies. But, the rationale went, once price stability is achieved and targeted and subsidized credit ceases to be the norm, it becomes easier to see what the real price of capital is. This would reduce the arbitrary dispersion in the returns associated with investing in different sectors of the economy. People would recover their faith in monetary assets, and a basic precondition for financial sector development would come about.

In sum, financial repression may adversely affect the level of domestic savings, savers may prefer to maintain their savings in unproductive rather than in loanable assets that facilitate productive investment, and arbitrary interest rates will tend to misallocate capital (Schiantarelli and others 1992). Economic growth is likely to suffer.

By and large, these views have been supported by much of the empirical research of the last two decades (Fry 1988, Gelb 1989, King and Levine 1992). The proposition that the quality of investment is adversely affected by financial repression has received especially strong support.

It is the McKinnon–Shaw perspective that provided the theoretical underpinnings to most of the evaluations referred to in the following sections of this paper. Yet, as pointed out next, the conclusions have not gone unchallenged.

The Challenge to the Financial Liberalization Perspective

The challenge to the McKinnon–Shaw perspective has largely been developed by taking issue with the idea that financial liberalization (which, at times, is used synonymously with deregulation) will lead to a socially efficient allocation of resources.¹¹ As argued by Joseph Stiglitz, a distinguished critic of financial liberalization in developing countries, financial repression has not impeded growth.¹² Stiglitz sees the financial market as particularly affected by market failures that impair the mechanism of resource allocation and call for direct and strong government intervention. Such intervention, however, does not necessarily have to include directed credit.

Stiglitz argues that equilibrium in the credit market may exist at a point that does not equate the demand and supply of loans. Banks may not want to lend beyond a certain interest rate because borrowers willing to take loans at higher rates may be bad risks. When this happens, the demand for loans may exceed the supply, and banks will then ration credit. This means that freely determined interest rates may not lead to efficient resource allocations. In other words, the free market cannot guarantee efficiency.¹³

A basic reason why financial markets may not lead to efficient allocations is that information flows imperfectly. That is to say, information asymmetries are pervasive in financial markets. (“Information asymmetries” refers to the fact that the parties to a transaction have unequal knowledge of the relevant information. For example, as obtaining information is costly, and information gathering involves uncertain results, some banks will know more about their clients than other banks, and potential borrowers have more information about the projects they propose than the banks to which they go for loans.)

Such asymmetries and the resulting market failures result from information having many of the properties of a public good. (That is, the acquisition of information by an individual will not reduce the amount of information available to others, and it can be

costly to prevent others from benefiting from the information one has acquired.) As happens with public goods, the market will tend to supply information by an amount less than optimum.

From the perspective of the critics, a totally free process of lending and interest rate determination is too vulnerable to conditions known as moral hazard and adverse selection. (*Moral hazard* occurs when a firm or person is able to pass to a third party the cost [or part of it] of its own actions. When this occurs in the context of credit, the lender or the borrower reduces the level of effort he would otherwise apply to see that the loan is repaid. *Adverse selection* occurs in lending when the good borrowers [borrowers likely to repay] find that the interest charges are too high relative to expected returns and drop out of the market. A consequence is that borrowers entailing greater-than-average risks may prevail.) Thus, in contrast to McKinnon–Shaw, lower (rather than higher) interest rates may improve the loan portfolio because the average creditworthiness of loan applicants may increase.

In this light, if competition forces a bank to raise the interest rate it pays on deposits, the bank might be induced to finance riskier loans to preserve its profit margin. If such tendency spreads to other banks, prudent banks might be displaced by their less prudent (and less socially worthy) competitors.

Because of imperfect information, depositors might not be able to discriminate among good and bad banks. Moreover, and probably more important, if deposits are explicitly or implicitly insured, as they often are, depositors will have weaker incentives for distinguishing among banks. By contrast, as mentioned, banks cannot just rely on raising the interest rates they charge because they then run the risk of attracting only borrowers who are too risky. For example, a business owner faced with bankruptcy might decide to gamble his resources on an endeavor with an extremely low probability of success but a high payoff if it does succeed.

These arguments are central to the criticism of financial liberalization. There are, in addition, other arguments that (1) suggest that directed credit may better take into account social returns and externalities, (2) take issue with the contention that higher real interest rates are likely to raise saving in developing countries, (3) criticize the empirical basis used to support the record of financial liberalization, and (4) refer to apparent successes of specific countries with directed and subsidized credit (more on this in chapter 4 under “Two Regional Experiences . . .”).¹⁴

As advanced above, to challenge the propositions of the financial liberalization school (McKinnon–Shaw) does not necessarily lead to acceptance that subsidized or targeted credit are appropriate policy tools. For instance, in reference to rural financial markets, where market imperfections are likely to be more acute, Hoff and Stiglitz (1990) are wary of the record of cheap credit.

According to Hoff–Stiglitz, in some cases the use of cheap credit by governments was intended to break or compensate for the monopoly power rural moneylenders were perceived to have. Nonetheless, Hoff and Stiglitz acknowledge that moneylenders continued to charge high interest rates (despite the coexistence of significant credit subsidization), that target populations were not reached, and that high default rates prevented the financial institutions created to channel cheap credit from becoming self-financing.

Hoff and Stiglitz recognize that cheap credit is unlikely to work. For one thing, as in most rationing schemes, political pressures will tend to direct credit to the more influential members of society. For another, reliance on cheap credit ignores the fact that interest rates are used also as a screening device to control the risk of the lender's portfolio.

Further, public financial institutions would be under the same information constraints as private institutions. (That is because the real problems are the high cost of screening to determine default risk, the costs of ensuring that borrowers take steps to make repayment more likely, and the difficulties involved in enforcing repayment.) Consequently, publicly directed credit hardly seems an adequate answer to lack of access to credit or to the prevalence of very high interest rates. Thus for Hoff and Stiglitz, formal market intermediation is unlikely to solve those problems—at least in rural markets. One would think they would raise the same concerns in connection with microenterprises.

Having acknowledged the bad record of targeted and subsidized credit and partially rejected the interplay of market forces and the resulting interest rates, how would Hoff–Stiglitz approach policy?

A strong government role is the answer. That role is not necessarily through the provision of cheap credit, but rather through the redressing of information imperfections. Examples of how to accomplish this include improving land-titling processes and improving the infrastructure for commercializing goods. The idea is for

the government to reduce the importance of information asymmetries by diminishing farmers' risks.¹⁵

A different but related role for government may be helping to develop institutions that provide financing and are based on small-scale peer monitoring. Such institutions may be successful because they are based on the concept of a group's cosigning a loan and the fact that the cosigner has an incentive to monitor the behavior of the borrower.¹⁶ (For a related discussion, see chapter 4 under "Credit and Microenterprise.")

Finally, a separate criticism of financial liberalization is that an increase in interest rates may not necessarily translate into a rise in the level of loanable funds available to firms because of the existence of informal financial markets (Schiantarelli and others 1992). If an increase in interest rates causes a transfer of funds from the unregulated to the formal market (due to savers' shifting their deposits to the sector offering the higher risk-adjusted returns), the real supply of credit may fall. The reason given is that banks are subject to reserve requirements that limit lending capacity, whereas unregulated-market institutions are not—yet. But read on.

More Recent Contributions¹⁷

As seen above, potential difficulties of adverse selection and moral hazard in credit markets can be used to argue for direct government intervention in such markets. Adverse selection is a problem because, as explained, when banks raise their interest rates, some of the good borrowers will drop out of the credit market. In contrast, the bad borrowers will be less discouraged. To protect themselves, bankers will, after some point, ration loans rather than raise interest rates.

In this way, left to itself, the market could result in levels of credit and output that are too low. Bad borrowers (and imperfect information) have brought on a market failure, which the government may offset through credit subsidies. As discussed earlier, Stiglitz and Weiss show how this could happen.

However, the Stiglitz–Weiss results are sensitive to model specification (i.e., to the authors’ assumptions).¹⁸ First of all, the Stiglitz and Weiss construct is a one-transaction model. Indeed, in a world in which people engaged in only one transaction, the development of finance would be very difficult. But in a real-world setting, where individuals and firms engage in multiple transactions, the outcome would be different from that of Stiglitz and Weiss. Even when faced with the possibility of getting away with moral hazard in a given transaction, borrowers will not necessarily disregard the implications for their reputation and creditworthiness—our history accompanies us, as with bankruptcy. In this light, rather than providing cheap or targeted credit, the best policy course is to strengthen the legal and enforcement settings.¹⁹

Another problem with the Stiglitz–Weiss specification is that for simplicity, in their model, they assume that all projects have identical mean returns but different variance (i.e., the risk is higher with some projects than with others, although, on average, all projects have the same return).

In contrast, still accepting the existence of asymmetric information, DeMeza and Webb (1987) start from the assumption that the profitability of projects will differ (the expected return for good projects is higher). With that change in assumption, they show that some projects with negative social rates of return are going to be financed.

Accordingly, in the DeMeza–Webb scheme, market failure translates into excessive (not too little) financing of investment. The implication is that the government should curtail, not expand, the level of credit. Credit subsidies would be the opposite of what is needed.

So, although both Stiglitz–Weiss and DeMeza–Webb conclude that the market-determined level of investment will not be efficient (i.e., there can be market failure), the policy implications derived from the scheme of each are in direct conflict. As pointed out by Besley, in the end their results are based on initial assumptions such as whether the mean return of the projects should be held fixed. In practice this becomes an empirical issue difficult to settle. Accordingly, it becomes difficult to hold that credit subsidization is the right policy course.

Another complication exists with the application of the concept of moral hazard in the Stiglitz–Weiss scheme. As explained above, moral hazard would also affect adversely

the lender's profits by inducing more risk-taking behavior on the part of the borrower when interest rates are raised. As with adverse selection, lenders will react by curtailing the amount of lending.

The real problem with moral hazard occurs in instances in which a borrower borrows from different lenders, each lender relying to some extent on the monitoring of the other lenders. A result could be insufficient monitoring. However, it is not clear whether this would lead to too *much* or too *little* lending relative to the efficient level. Although the result would be inefficient, one wonders why other types of government intervention, better prudential legislation and bank supervision, and strict enforcement of contracts (for example) would not be preferable to directed or subsidized credit.

Moreover, lenders can indeed increase their information. They can analyze the projects proposed by would-be borrowers, look into their credit history, and monitor project implementation. This of course involves a cost and raises the issue of achieving the most efficient way of carrying it out. The emergence and development of risk-rating firms is a market solution to the costs of monitoring by individual lenders.

In this connection, a potential constraint is the “quasi-public good” nature of information — information developed by one lender may be used by another who did not contribute to its financing. The problem is that public goods tend to be undersupplied in the market.

Although the public-good issue of credit-related information is of theoretical interest, its practical relevance in developing-country rural markets has been called into question (Besley 1994, 38). And it is in such markets where one would presume that the problem would be more serious. Yet markets in developed countries have been effective in creating mechanisms for information about borrowers. One can venture that although there may be differences of degree, the same mechanisms may not be used in many of the developing countries.²⁰

Another aspect one has to take into account is that the high cost of processing some types of loans (say, small loans) does not necessarily reflect market failure. It may in fact reflect the high opportunity costs involved in using scarce management and technical skills, and that information may be relatively scarce. In such cases, the difficulty in obtaining credit calls for better information networks and human capital, a policy course different from that of providing targeted or subsidized credit.

Finally, a related point goes back to the issue of whether a rise of interest rate causes a shift of funds from the unregulated to the formal market. Even if this does occur, whether the economy is better off would depend on the relative efficiency of these markets. On the one hand, the local knowledge of informal lenders does imply lower transaction costs for some loans; on the other hand, the informal market is frequently segmented, with very limited potential to achieve economies of scale, information processing, and scope. In the end, the issue of the comparative efficiency of one sector versus the other is an empirical one, and whichever sector is more efficient will dominate (Schiantarelli and others 1992).

4

The Empirical Record

ANALYSES DONE during the last 20 years of credit projects, of projects having credit components, and of government interest rate policies are numerous. This section highlights results that typify the thrust of the findings. The comments are organized around specific themes, but the interrelatedness of the issues is considerable.²¹ Although the section draws on the general literature, it highlights the results of USAID's experience as reflected in the work of the Center for Development Information and Evaluation (CDIE) and in other Agency-supported studies.

Sustainability, Economic Impact, and Effects on the Poor

This rubric covers aspects that range from the "purely" financial to those of economic efficiency and equity. The following are key questions.

Have Credit Projects Been Financially Self-Sustainable?

Two worthwhile analyses of these issues are the 1973 review by USAID of its small-farmer credit programs (U.S. Agency for International Development 1973) and a 1985 CDIE synthesis of the Agency's experience with small-farmer credit. The synthesis assessed the results of 50 projects in Africa, Asia, and Latin America (Liebersohn 1985).²²

Going by the frequency of high default rates and operational losses or defunct cooperatives, the 1973 review concluded that, on the whole, USAID small-farmer credit institutions and programs were not financially viable. The 1985 CDIE synthesis found that only about one third of the projects analyzed could be considered successful. One explanation for the high rate of failure was that nearly every project design assumed that profitable small-farmer investments existed. On that premise, the projects concentrated on agricultural extension and credit delivery.

Often, however, increases in output arising from application of new technology bought with the subsidized credit fell short of expectations. Reasons included lack of timely supporting services and inadequate fertilizer, marketing, and storage. Although credit was generally part of a project package that included new seeds, fertilizer, extension, and marketing services, credit could not overcome the lack of other inputs.

Another factor was that lending institutions were frequently doomed to losing their capital when inflation rates were high and interest terms were not allowed to adjust for inflation. Even when the institutions were being paid back, their capital base was eroded by inflation.

The CDIE study also found that, by and large, *lenders that provided cheap capital were not financially viable*. In other words, they could continue operations only so long as donors continued to provide concessional aid. Projects that supported such lenders did not contribute to the creation of the sustainable institutions needed by the farmers. By contrast, *projects that lent funds at market rates and paid market rates to rural savers were the successful ones*.

These findings were consistent with a later review of results that underlined that the list of successful and sustainable credit projects in low-income countries is very short (Adams and Von Pischke 1991). The point was that the programs were not sustainable because they were expensive, collected too little revenue, depended too heavily on outside funding, and often suffered from serious default problems.

Analogously, the impact on farmers was not encouraging. Few farmers who had benefited from concessionary finance were able to “graduate” and become clients of the formal banks. They had to continue to depend on subsidized credit or go back to self-finance. Also, most “rotating” credit funds failed because of defaults, inflation, and high administrative costs.

Although there is a different viewpoint among some World Bank staff (see below), similar points have been repeatedly made in Bank studies and reports.²³ For instance, one point made by the Bank in many of its publications is that many local banks initially attracted by favorable interest rate spreads in refinancing programs later found those programs inadequate to cover high rates of default.

Even what may be considered an exception within the Bank, a recent review by the Operations Evaluation Department (OED) of the Bank’s experience with agricultural lending for the years 1948–92 (World Bank 1993), largely confirms the bleak picture

regarding the number of sustainable credit projects in developing countries.²⁴ The review accepts that there has been a high and unsatisfactory number of projects with debtors in arrears and that many of the financial institutions that received subsidized credit were subsequently found to be in poor financial shape.

Nonetheless, the review argues that the high degree of arrears does not justify dumping agricultural credit projects. The reason is that arrears do not necessarily lead to default and that debtors may eventually pay their debts. However, as pointed out by Meyer and Larson (1993), even if a significant proportion of debtors in arrears end up paying, the collection process may entail high costs to the lender, and the proportion of arrears that do default may suddenly increase.²⁵

Were the Credit Projects Economically Justified?

As with the later 1985 CDIE Synthesis, the Spring Review found little or no economic justification for small-farmer credit programs. The Review highlighted the fundamental adverse effects of policies and other problems common to the countries analyzed. Such problems included price controls, underinvestment in marketing facilities, and inappropriate technologies. Regarding credit, the two studies support the contention that low interest rates on savings accounts discouraged potential savers and hindered mobilization of funds in rural areas.

A common assumption behind most of the projects was that farmers did not avail themselves of modern technologies because, being poor, they lacked the capital needed for investing in a new technology. Accordingly, directed, low-cost credit was seen as a critical promotional tool. Nonetheless, the 1985 CDIE study concluded that credit was often not the major constraint it had seemed to be.

From the perspective of this review, perhaps the most important conclusion of the 1985 CDIE study was that *most of the projects provided subsidized credit to borrowers and that because of misallocation and adverse impacts on lending institutions, subsidized credit did more harm than good* (see the next two sections). Thus the analysts found little justification for the credit subsidies.

Another point was that good farmers were able to increase their output profitably while paying market rates of interest. Many such farmers were already paying high market

rates to local moneylenders. The conclusion was that if financial returns to the technology could not cover the cost of capital, the investment in such technology was not justified (Liebersohn 1985, viii).

As mentioned, the 1973 Review concluded that low interest rates on savings accounts discouraged potential savers and hindered the mobilization of funds in rural areas. In light of such effects, the Review found that additional credit would not lead to increases in agricultural production and called for a new focus on mobilization of rural savings.

Such conclusion was corroborated in another empirically based USAID-sponsored study on the experience in Central America (Vogel, Auernheimer, Fernandez, Lizano, and Protasi 1993). The study found that subsidized lending by the central bank hinders the development of long-term capital markets because

- Prime borrowers tend to take advantage of the subsidies. Accordingly, the demand for long-term funds at market rates is pulled down. This discourages the development of competitive capital markets.
- Financial intermediaries with access to subsidized central bank funds will tend not to pay the market rates of interest required to attract long-term funds. This obstructs mobilization of such funds.

The adverse effects on savings mobilization observed was consistent with mainstream economic theory (Adams and Von Pischke 1991). Distortions were held to occur because (1) the lower the regulated interest rates, the less incentive lenders had for making small loans and (2) the low interest rates depressed the interest rates paid on deposits. In turn, low deposit rates weakened the incentive to deposit funds. Moreover, as pointed out by Vogel and others, concessionary discount lines from central banks reduced incentives for retail banks to mobilize deposits in rural areas.

The sense that prevails within the World Bank is analogous. For instance, as one can tell from several Bank sources:

- Directed credit programs have frequently damaged financial systems. One reason is that cheap rates often led to the financing of unviable projects and to nonperforming loans. A result has been unprofitable and even insolvent financial intermediaries.
- Extensive refinance schemes at low interest rates have reduced the need for intermediaries to mobilize resources on their own. This has often led to a lower level of financial intermediation.

- Moreover, as they have encouraged firms to borrow from banks, refinance schemes have hindered the development of capital markets (World Bank 1989a, 1989b, 1991).

Again the exception is the World Bank OED 1993 review. Although the review acknowledges that it was not able to confirm “its assessment of generally positive results of the farm investments, either in financial or economic terms,” it took a favorable view of directed agricultural and subsidized credit (World Bank 1993a, 108).

However, even the review mentions several examples in different countries in which credit subsidies were followed by resource misallocation and unintended results. In some of these instances, though, the review argues that the problem was not cheap credit but other factors. Moreover, it argues that there is no compelling evidence of abuse resulting from interest rate distortions and that the argument that credit programs have tended to discourage financial sector development is not persuasive. Further, in its defense of targeted and subsidized credit, it goes back to the argument that in developing countries banks often are too conservative and that the United States and other industrial countries avail themselves of credit—so why not developing countries?

The problem with the review’s approach, as well as with much of the impact analyses done by donor institutions, is that it did not use a methodology that enabled the analysts to separate the effects of credit from the effects of other factors. This is important because credit is fungible, and a borrower may use subsidized loans to substitute for his own savings or for loans from the informal sector.²⁶ Moreover, the review is particularly long on impressions, short on analysis. It does not make clear the conceptual or theoretical linkages on which it bases much of its conclusions.

Another point of operational interest for donor institutions is that actions at the project level (with credit, for example) might negate broad policy objectives. An instance was illustrated by a 1991 CDIE evaluation on economic policy reform in Africa (Lieberson 1991) and of USAID practices relating to them. That evaluation found that in Cameroon USAID was arguing for privatization of the market for fertilizer while still being involved with the government in managed markets, subsidization, and special access to credit. Such involvement delayed the movement to a free market.

In the same assessment, the evaluators concluded that the effects of market liberalization in one market are often negated by application of controls in other markets. This result underscores that the effect of sound changes in credit policies can be offset by bad policies in other areas and vice versa.

Also indicative of USAID experience is a project assistance completion report on the Investment Encouragement Fund in Egypt (Kirschtein 1992). Kirschtein finds that the project did not achieve its overall goal of encouraging financial institutions to make longer term investments in the private sector. He explains that the failure resulted from the restrictive regulatory practices in Egypt; from the project's use of administratively set variables such as credit allocations, interest rates, and exchange rates; and from excessive regulations covering loan approvals.

Among the lessons learned:

- Avoid directed-credit projects except in cases of serious market failure or to redress past discrimination in lending
- Analyze the policy and regulatory framework affecting the financial sector and use nonproject, policy-based assistance to encourage liberalization of the economy and the financial system

Has Targeted and Subsidized Credit Been Effective in Compensating for Policy-Related Adverse Economic Effects?

As reflected in the theoretical literature noted earlier and in discussion to come, opinions differ (see "Two Regional Experiences: The United States and East Asia," page 38). Yet the predominant sense in the empirical literature is that targeted and subsidized credit is an inefficient way of compensating for policy distortions.

For example, in a USAID-supported study of monetary management in Sub-Saharan Africa, the authors elaborated on the difficulties created by systems of direct credit control (Duesenberry and McPherson 1991). They found that Sub-Saharan Africa showed many of the problems commonly associated with controls in other regions and that such problems raised the need for reforming financial sector policies. The basic problems associated with direct control were disintermediation, excessive credit creation, expanding public sector deficits, rising inflation, de facto and de jure exchange depreciation, currency substitution and capital flight, rapid increases in external debt, and failure of key financial institutions.

Duesenberry and McPherson indicate that artificially low interest rates have reduced saving, distorted allocation of capital, increased regulation costs, stifled financial innovation, and led to credit rationing and the fostering of corruption in the administration of credit programs. In stressing the importance of generating confidence in the financial system, the authors conclude that public confidence cannot be restored

by more government interference. Lack of confidence, they note, is reflected in such things as parallel markets, financial disintermediation, persistent inflation, and lack of debtor discipline.

This conclusion is consistent with that of CDIE findings in 1985 that credit activities cannot compensate for economywide policy-related disincentives. Such disincentives in many cases relate to policies that penalize agriculture—such as controls that set prices for agricultural commodities below market clearing levels, controls on grain marketing, overvalued national currency (which hinders exports), and high taxes on export crops (which reinforces the antiexport bias) (Lieberson 1985).

CDIE's report on international donors and development finance institutions reaches a similar conclusion (McKean 1990). It finds that development finance institutions have not contributed to the strengthening of financial markets in developing countries. One factor is that the policy setting in such countries severely limits the potential of development finance institutions to become self-sustaining and innovative. The policy setting is too hampered by interest rate controls, directed allocations of credit, and other limiting regulations and practices. From such conclusions, the report recommends that international donors concentrate on promoting financial policy reform. It further recommends that donors avoid using development finance institutions and, where there is no alternative to relying on them, encouraging such institutions to charge positive real interest rates.

A different perspective is presented in the World Bank OED 1993 review. The review argues that while credit programs should have been complemented with policy changes in the financial sector, the omission was not limited to the financial sector. Other sectors were distorted as well. Although the distortions weakened the impact of the credit programs, they did not render it ineffective. This point, however, raises a purely empirical issue that has to be analyzed on a case-by-case basis. It runs counter to much of the literature discussed here.

To sum up, directed credit has by and large failed to overcome distortions in nonfinancial as well as financial markets. First, the use of targeted credit is a second-best and inefficient way of addressing policy distortions. Second, offsetting distortions in nonfinancial markets is nearly impossible because of fungibility and the costs and difficulties of detecting diversion. Third, directed credit has failed to target distortions precisely, and because it targets borrowers with subsidies, it has had costly and unintended side effects.

Has Directed Subsidized Credit Helped the Poor? What Have Been Its Effects on Income Distribution?

By 1973 the USAID Spring Review had concluded that artificially low interest rates as well as administrative policies forced credit institutions to lend to large and less risky borrowers. Moreover, the Review reasoned that, because lending institutions protected their solvency by lending only to borrowers with the best credit ratings, subsidized credit tended to regressively redistribute income to larger farmers.

On this issue, the key point that one frequently sees in the empirically based literature is that a substantial portion of the subsidies passing through the credit programs were captured by people who were not poor (Adams and Von Pischke 1991). In the same vein, the CDIE evaluation of economic policy reform programs in Africa (Lieberson 1991) pointed out that special treatments create special interests that actively lobby for the preservation of a status quo that favors them.

Likewise, as pointed out by the World Bank, subsidized credit has often failed to reach intended beneficiaries. Loans have been often misclassified to comply with directives. Within priority sectors the bigger and more influential borrowers benefited the most. Moreover, nonpriority businesses have been crowded out of the formal financial markets (World Bank 1989).

Two cases that illustrate the perverse income distribution effects of subsidized credit (i.e., the rich benefit more than the poor) were documented by studies on Costa Rica (Vogel 1984) and Brazil (Araujo, Shiota, and Meyer 1990). The Costa Rican study estimated that some 80 percent of subsidized agricultural loans in 1974 went to large farmers, who thereby captured most of the subsidy. Something similar took place in Brazil. The implication is that subsidized credit increased inequality in the distribution of income (Meyer and Larson 1993).

The World Bank OED review, however, presents a differing view (World Bank 1993a). The review argues that

- Many of the findings that credit projects really benefited the big farmers resulted from a misclassification of farms. Medium-size farms were incorrectly taken as big farms. The real problem was a deficient system of classification.
- In general, the beneficiaries of agricultural subsidized credit were farmers who needed credit and who had no access to it in the formal sector. Although, by and large, such farmers were not small, neither were they big and influential.

The beneficiary farmers were private investors who, in general, seem to have used the funds well. Those farmers simply took advantage of the opportunities to reduce the interest burden on farm investment. Accordingly, it is incorrect to portray them as rent seekers just because they benefited from subsidies.

The Bank's review, however, presents no evidence regarding the actual size distribution of borrowers, and its conclusions are not anchored in theory. It does not, for example, explain why lenders would not have directed their resources to less risky nonpriority borrowers, or why nonpriority borrowers could not succeed in having access to subsidized funds. The latter seems to have happened in many other instances (Meyer and Larson 1993).

The sense that credit programs have benefited primarily the nonpoor and, accordingly, have often had regressive income distribution effects is consistent with a 1989 CDIE report on the experience of international donors with development finance institutions.²⁷ Among its conclusions: (1) Although in some countries programs of development finance institutions increased the supply of credit to the private sector, they did not benefit small and medium-size enterprises. (2) The activities of the institutions tended to concentrate resources in a few large enterprises.

Credit and Microenterprises

During the past 10 to 15 years, significant amounts of directed credit have gone to very small enterprises. Current interest in microenterprise programs, as a means of alleviating poverty and promoting growth, is considerable.

What Has Been the Experience With Microenterprise Credit? What Makes Financial Institutions Successful?

In 1989 CDIE published its analysis of microenterprise programs (Boomgard and Angell 1989).²⁸ Although such programs included much more than lending, credit was an important element in them. The evaluation concluded that USAID should give priority to supporting the development of commercially viable, nontargeted financial institutions that can meet the liquidity needs of microentrepreneurs. The analysis suggested that USAID should focus on "graduating" the microenterprise programs or

institutions rather than focusing on the enterprises themselves. The essence of graduation was to enable such programs or institutions to raise nonconcessional funds in the capital markets and then retail the funds to microenterprises. The evaluation found that, in most projects, it had not been possible to graduate the microenterprises into having access on their own to the existing formal financial sector.

For the most cost-effective approach to microenterprises,²⁹ the evaluation found that the enterprises were less concerned with interest rates than with the simplicity and timeliness of the credit process. Moreover, it was determined that microentrepreneurs were willing and able to finance their businesses (operations and expansions) at positive real interest rates. Further, the analysts concluded that interest rate subsidies were not needed. With regard to the financing institutions' ability to achieve financial sustainability, the evaluation emphasized the importance of employing efficient risk-reducing procedures, charging free competitive market interest rates, and maintaining tight controls over delinquencies and arrearages.

As to prescriptive aspects, Adams and Von Pischke (1991) offer an interesting starting point. From their review of rural finance, they infer that the following lessons are likely to apply to microenterprise lending:

(1) As with small farmers, the most serious constraints faced by small enterprises may not include lack of funds for investments or operating costs. If shortage of funds is the result of managerial or other problems, credit may not solve the more fundamental problem. In the case of small farmers, lack of funds was not the most serious problem. The main obstacles to small farmers were product prices, land tenure, modern input costs and availability, low yields, and risk. However, government and donors found it easier to fund credit activities than to help attack the underlying issues.

(2) Access to liquidity (small, short-term lending) might be more important for small enterprises than are large long-term loans.

(3) In general, technical assistance and training are ineffective against a hostile economic environment. The heterogeneity of small enterprises suggests that technical assistance and training for microentrepreneurs would be more costly and difficult than in the case of small farmers for whom such aid was largely ineffective.

(4) Loan guarantee funds are likely to fail. In the case of small farmers, they had no lasting effects, banks carried them out during short periods to meet public-relations needs, and the funds proved to be not sustainable.

(5) If credit programs for microenterprise lending are not allowed to set interest rates that cover the costs of making small, short-term loans to borrowers with weak credit ratings, the programs will be under great pressure to ration their loans.

(6) Small-farmer lending faced immense loan recovery problems owing to overly long grace periods, bureaucratic complications, political factors, indiscriminate lending, and lack of attention to deposit mobilization.

(7) Small-farmer credit programs were afflicted with bankrupt or financially weak lending institutions such as cooperatives, agricultural development banks, and supervised credit agencies. By and large, it was not possible to restore the health and credibility of these institutions. To the extent that microenterprise credit depends on small nongovernmental organizations (NGOs), credit programs for microenterprises may experience an even greater degree of fragility and institutional attrition. (However, this is not an unavoidable result, as will be shown shortly in comments on the potential of NGOs.)

(8) Often, evaluations of the impact of small-farmer credit programs were methodologically flawed and misleading. The reasons included money fungibility, costly data requirements, inadequate control groups, and inappropriate use of the before-and-after methods.

(9) Because of donor pressure, the methodological problems were disregarded or downplayed. Program benefits were frequently overestimated, and costs were underestimated by ignoring the detrimental effect on lending institutions, on incentives to save, and on contract enforcement. The same problems occur in assessments of microenterprise lending.

Although Adams and Von Pischke are skeptical about the effectiveness of credit programs in general for helping the poor, they indicate that competitive formal financial systems should expand and serve a larger number of individuals who until then had no access to credit. For such to happen, the authors say, two things are needed: (1) financial systems that deal efficiently in small transactions and (2) innovations that help poor entrepreneurs become creditworthy. The authors conclude that targeted credit will achieve neither.

However, Adams and Von Pischke acknowledge that the use of NGOs for microenterprise lending can be an advantage. The best of the NGOs, they say, can be flexible and results oriented. Nonetheless, in their opinion, the jury is still out on whether NGO credit projects can be self-sustaining.

On the conditions that influence the success of NGOs (or private voluntary organizations—PVOs) in microenterprise lending, Aguilera (1992) underlines similar points. He argues it is not clear that NGOs and PVOs will channel credit efficiently to microenterprises in developing countries. To be successful as lending institutions, Aguilera says, NGOs and PVOs will have to reduce loan default losses and high operational costs and protect their loan portfolios from inflation. If these organizations behave as lending institutions rather than as philanthropic agencies, they will have a greater chance of succeeding.

NGOs and PVOs should use risk-reducing procedures, charge interest rates that allow them to cover operational costs and losses from inflation, and be capable of mobilizing most of their own funds. The success of microenterprise credit programs will be limited by risks and problems created by institutional deficiencies, such as imperfections in land insurance, product markets, incomplete legal and informational systems, ill-defined property rights, and financial regulations.

These recommendations are consistent with CDIE's findings on the subject. In its 1985 synthesis of the experience with small farmer credit, CDIE analysts concluded that lending institutions that had local-level outreach mechanisms were the best attuned to local needs and had the lowest default rates (Liebersohn 1985). Thoroughness of the loan application form and complexity of bureaucratic review had little systematic relationship to repayment rates. The key factor was the skills of the local loan officer. Another important factor was the quality of the accounting and loan monitoring system. The type of credit institution (bank, co-op, or credit union) was not important.

Rethinking Microenterprise Financing

There is an ongoing effort to consolidate, reformulate, and empirically examine the approach to microenterprise financing. In general, the effort is based on two premises: (1) that microenterprises can and do make important contributions to their economies and their societies and (2) that assisting them is an effective means of helping the poor.

The new emphasis stresses financial services rather than merely lending. In this perspective, to be developmentally effective, intermediary institutions that provide lending services to microentrepreneurs should emphasize multiple relationships with their clients (Von Pischke 1991). For example, they might offer savings account and payment services in addition to loans. One reason is that by providing multiple services, institutions increase the probability of achieving economies of scope through services that can be produced jointly and tend to reinforce one another. An example is that the more services a client uses, the greater the information about the client

available to the intermediary institution. Such information is useful for managing risks and costs. Moreover, overhead costs are economized, and profits tend to be larger.

Although there are shades of opinion among authors, the emerging perspective stresses the importance of savings mobilization (especially voluntary savings) and flexible lending practices tailored to specific markets. The emphasis is on improving the operations of financial markets. One influential view even holds that misplaced concern about credit needs may lead to an excessive emphasis on increasing the supply of loanable funds (Von Pischke 1991). Of genuine concern is the capacity of the intermediary institution to achieve financial self-sustainability. The emerging views reflect the extension to microfinance of lessons applicable to financial intermediaries in general, the record of widespread failures of credit programs, and the analysis of a relatively small number of institutions that have been effective in delivering financial services to microenterprises and the poor.

For example, on the basis of the experience of Indonesian institutions, Robinson (1992, 1994) proposes a model of local financial intermediation. According to the model, institutions will (1) lend widely at the local level at commercial interest rates; (2) maintain low default rates through knowledge of the markets and the clients served; (3) mobilize savings locally with deposit instruments appropriate for local demand; (4) provide loans at commercial rates to low-income clients, substituting group lending and peer monitoring for collateral; and (5) establish a spread between loan and deposit interest rates that enables institutional profitability and sustainability for the long term.

Robinson's views have been influenced greatly by her work on the Bank Rakyat Indonesia (BRI), an institution that evolved from registering negative profits to being a profitable and viable enterprise. Accordingly, the BRI demonstrated that it is possible to profitably provide financial services (credit and deposit) that reach low-income households without relying on subsidization.

Robinson's analysis of the turnaround of the BRI is similar to that of Patten and Rosengard (1991). The three authors underline the importance that a favorable change in the economic policy and institutional setting, as well as in the overall country economic performance, had for the success of the BRI. Fundamental were good macroeconomic management (including low inflation), political stability, and a clear move toward reliance on market forces with the elimination of burdensome regulations and "intrusive and devastating government intervention." Other factors included good management practices, charging and payment of commercial interest rates on loans and deposits, introduction of deposit instruments with different mixes of liquidity and returns appropriate for the local markets, and rejection of traditional supply-leading theories of rural finance that stressed credit subsidization (Robinson 1992).

An important aspect is the experience of financial institutions that lend at commercial rates but receive subsidies from governments or donors.³⁰ The point is that although these institutions have shown they can reach the poor and recover loans, their capacity to lend has been constrained by their lack of attention to voluntary savings mobilization.

In this connection, Patten and Rosengard find that at least in the case of the Indonesian Badan Kredit Kecamatan (BKK), the lack of attention to mobilization of voluntary savings deposits was a consequence of the institution's having abundant outside capital from government and aid donors. Added to retained earnings, such outside (subsidized) capital encouraged a sense of institutional comfort not conducive to efforts at savings mobilization.³¹

Nonetheless, operationally the BKK was able to provide effective and profitable services by (1) charging interest rates high enough to cover operating expenses including the cost of funds; (2) relying on character references from local officials for loan eligibility, rather than on collateral and lengthy feasibility studies; (3) reducing risk by making small initial loans to new borrowers and over time raising the size of the loan as the credit history of the client warranted; (4) using repeat loans as the borrower's primary incentive for full and timely repayment; and (5) blending local autonomy with overall program quality control (Patten and Rosengard 1991).

Current thinking and the success stories mentioned in works such as the ones by Robinson and Patten–Rosengard have inspired broader empirically based attempts to analyze the operations of institutions perceived as successful. Are there common practices that explain the successes? Although these analytic attempts have had to struggle with a generally weak data base, they have provided a clearer sense of how such institutions have done.

A recent article by Yaron (1994) is a good example. Yaron reviews the practices and experiences of four rural finance institutions often considered successful: the Bank for Agriculture and Agricultural Cooperatives (BAAC) in Thailand, the Badan Kredit Kecamatan and the Bank Rakyat Indonesia Unit Desa in Indonesia, and the Grameen Bank (GB) in Bangladesh.

Except for the BRI, established in 1983, the institutional operations analyzed by Yaron had been active for at least 13 years. Nonetheless, one striking aspect is that there are

significant differences in volume of operations and outreach objectives among the institutions. For example, toward the end of the 1980s, the number of clients (borrowers) ranged from 500,000 for the BKK to 2.6 million for the BAAC. And whereas the BKK and the GB had the objective of lending to the very poor, the BAAC and the BRI focused their operations on low- to middle-income groups. Moreover, while the BAAC lent exclusively to agricultural producers, the other three institutions financed any rural income-generating activity.

Also of interest is the fact that, among the four institutions, only the GB provided nonfinancial services—in health, education, and nutrition. As one would expect from institutions that concentrate on reaching the very poor, the BKK's and the GB's average size of outstanding loans was small—less than \$100. However, average size of loan was much smaller for the BKK (\$26) than for the GB (\$80). Analogously, while both the BRI and the BAAC, on average, made significantly bigger loans, the BAAC's loans were about twice the size of the BRI's (\$560 versus \$290).

Although the four institutions lent at positive real rates of interest, two of them, the BAAC and the GB, were subject to legal ceilings on interest rates charged on their loans. As a result, these banks charged annual real rates of less than 6 percent (yet still positive), whereas the BKK and the BRI charged real rates of more than 15 percent (Yaron 1994).

Another similarity among the institutions, that they all provide savings services, has to be contrasted with the fact that two of them, the BKK and the GB had a policy of obligatory savings, whereas the BAAC and the BRI did not. Not surprisingly, the BAAC and the BRI paid high positive real interest rates on savings deposits, while the BKK and the GB did not. Likewise, although the relative average size of deposit for the BAAC and the BRI was high, it was small for the BKK and the GB.

All institutions were judged to be relatively efficient in loan processing. That is to say they were able to process loans quickly, they provided mobile bank components, and they provided some type of incentive to their staff to promote efficiency. With the exception of BAAC lending to cooperatives, Yaron reports high collection rates for the four institutions.³²

A key aspect relates to the extent to which the institutions have become financially self-sufficient. To measure self-sufficiency Yaron developed a “subsidy dependence

index.” It indicates the percentage increase in the average on-lending interest rate required to compensate for eliminating subsidies.³³

It is noteworthy that three of the four institutions are subsidy dependent and that those three (BAAC, BKK, and GB) are the oldest institutions. As Yaron points out, although the GB experienced a fall in its subsidy dependence index from 180 to 130, the bank was, in 1989, still highly subsidy dependent. The other two subsidy-dependent institutions, the BAAC and the BKK, would have had to raise their on-lending rates by 26 and 20 percent, respectively, to offset the loss of subsidies.

Of the factors that might shed light on the differences in self-sustainability among the institutions, it is worth pointing out that the less subsidy-dependent institutions charge the highest on-lending real interest rates. These are the BRI, which is not subsidy dependent, and the BKK, which is next closest to being subsidy independent. This is consistent with the notion that, at least within a certain range, being able to price lending services so as to take costs into account is important for financial sustainability. It is relevant information for the type of settings donors should encourage or require when considering support for a financial institution. In this connection, Yaron emphasizes that what is important for the clientele served by this type of financial institution is *access* to credit rather than *price* of credit.

Another outstanding factor is that the BRI, the non-subsidy-dependent institution, has been by far the most effective in mobilizing voluntary savings deposits.³⁴ By contrast, the most subsidy-dependent institution, the GB, was the weakest in savings mobilization. It appears to be relevant also that whereas the BRI paid the highest annual real deposit rates, the GB paid the lowest (and negative) rates. These facts support the proposition that attention to savings mobilization is a key factor.

Success of several institutions in achieving full or substantial financial self-sustainability has led to the formulation of a scheme that portrays a time-phased path toward financial independence (Otero and Rhyne 1994). The central concept is that if the right conditions are met (see previous paragraphs), an institution can evolve from being very subsidy dependent (level 1), to being able to cover operational costs (level 2), to being fully self-sufficient (level 3). Such an analytical construct has the potential of providing a useful gauge against which the performance of an institution over time can be assessed. From a donor’s perspective, a key issue in this connection is the

determination of what is the reasonable time for vaulting the hurdles between one level and the next.³⁵

Summing Up

Recent thinking and empirical studies corroborate the conclusions of the 1989 CDIE report and other works discussed at the beginning of this chapter. The conclusions are that microentrepreneurs are able to finance their businesses at positive real interest rates, the policy and institutional setting is fundamental, and management skills and program strategies to mobilize voluntary resources are important.

So, should governments and donors limit themselves to (1) promoting stable macroeconomic contexts, (2) eliminating direct controls on credit and interest rates, and (3) improving the legal and regulatory environments? Or does it also make sense to attempt to reinforce the beneficial effects from an improved macroinstitutional environment by engaging in microinstitutional strengthening?

This review suggests that attention by donors to the economic and regulatory environment is essential but that donors can indeed usefully complement actions at the macroinstitutional level with financial services programs geared to the small entrepreneur. Some financial institutions have found innovative ways of reaching low-income population groups through secure deposits and efficient lending on a self-sustaining basis, and that is grounds for hope.

Yet a word of caution is in order. One has to bear in mind that the number of such successful institutions is small and that still there is much to learn about new lending techniques for the poor, especially in rural areas. This suggests that the wise course for international donors is to limit support for institutions that engage in microenterprise lending to no more than, say, 3 years. Moreover, donors' assistance should be in covering start-up costs, including management assistance and training. Further, it must be made clear that the institutions are expected to achieve self-sufficiency relatively quickly.

At this point a cautious and limited approach to resource allocation to microfinance is warranted. Pilot programs that help institutions develop adequate financial services and efficient techniques would seem the way to go. Broader programs should be launched only after the number of institutions that reach microentrepreneurs and achieve full financial self-sufficiency expands considerably and there is a clearer sense of how to

implement the necessary techniques. Such expansion would signal that the development community has learned how to turn around the predominantly failed record of well-intentioned credit programs.

How Has Financial Liberalization Done as an Alternative?

Clearly, the predominant record of targeted or subsidized credit programs has not been exemplary. Driven by experience and by the financial liberalization thrust that built on the McKinnon–Shaw insights, many developing-country governments and their international donors have been shifting their credit policies toward (1) less targeting of loans, (2) more flexible interest rates for loans and deposits, (3) more attention to deposit mobilization, (4) fewer concessionary lines of rediscounting from central banks, (5) emphasis on reducing transaction costs for borrowers rather than trying to lower interest rates on loans, and (6) contributing to the viability of financial institutions and the performance of the financial markets.³⁶

These and other related financial policies have, in many countries, been part of a broader effort at economic liberalization and macroeconomic stabilization.³⁷ To ascertain the relative merits of financial liberalization versus direct government intervention in financial markets through interest rate and direct credit controls, it is thus not enough to review the record with targeted and subsidized credit. It is necessary also to examine whether the relationships postulated by McKinnon and Shaw between financial liberalization and economic growth have been corroborated by empirical research.

In case of unambiguous and strong support for the McKinnon and Shaw thesis, it is clear that credit and related interest rate policies by governments and international donors that tend to perpetuate financial repression would be antagonistic to growth. Conversely, if the empirical evidence clearly contradicts such a thesis, then one could not dismiss the validity of targeted and subsidized credit projects.

As often happens in applied economics, though, the results of empirical research are not conclusive. The majority of analysts probably would argue that the empirical evidence supports the McKinnon–Shaw contention that, within some range, as real deposit interest rates are allowed to become increasingly positive, financial savings and

investment will rise, capital allocation will become more efficient, and higher growth will take place. But the available empirical evidence is not definitive.

The inconclusiveness of the results reflects methodological difficulties and data constraints. One obstacle is that the direction of causality between growth, on the one hand, and interest rates, savings, and investment, on the other, can be two-way. Accordingly, correlations among these variables do not clarify the issue of causality.

One argument used against attempts at financial liberalization relates to the experience of countries that have attempted it with unhappy results. The case of the Latin American Southern Cone countries—Argentina, Chile, and Uruguay—in the mid-1970s is often mentioned. These countries, especially Chile, carried out broad programs of financial reforms, including the lifting of controls on interest rates and capital movements, the elimination of directed-credit programs, privatization of nationalized banks, and relaxing of barriers to entry and competition by domestic and foreign banks in the domestic market. These measures were accompanied by significant reforms in other areas such as trade and fiscal policies.

Although there were similarities in the three countries, there were also significant differences in the emphases and sequencing of policies. Chile, for example, achieved substantial reform in its trade policy before liberalizing the capital accounts in its balance of payments. By contrast, Argentina and Uruguay liberalized their capital accounts earlier and did not do away with trade barriers so fast. Moreover, whereas Chile was able to reduce inflation significantly, Argentina and Uruguay were not able to do so until more recently.

The point raised by critics of financial liberalization is that although the immediate postreform paths of these economies differed, by the early 1980s all three countries had had to reverse their liberalization efforts. The same critics point out that the results were not as expected.³⁸

To these critical arguments, however, one could respond by admitting, as McKinnon (1991) does, that the sequencing of policy reforms was not the right one, and that preconditions for successful reform were not present. For instance, the importance of bringing inflation under control before deregulating the banking system and of establishing appropriate supervisory and prudential controls were not adequately taken into account. In any case, after the policy reversal in the early 1980s, Chile was later able to resume a successful liberalization course. Argentina has followed suit in more recent years.

Among critics of financial liberalization efforts, Khatkhate (1988), for example, uses cross-country macroeconomic data for 1971–80 and nonparametric tests to analyze the impact of interest rates on developing countries. He finds no statistically significant relationship between the interest rate and macroeconomic variables. Khatkhate concludes that exploring such relationships is a matter of great difficulty and that interest rate policy cannot in itself lead to substantial development impact.

Likewise, González Arrieta (1988) reviews the empirical literature on the relationship between interest rates, savings, and growth. He finds fault with much of such literature. His main conclusion is that the issues are empirically unsettled.

Among the studies supporting financial liberalization, an interesting one is Gelb (1989). It analyzes the links between real interest rates (3- to 6-month deposit rates) and growth in gross domestic product (GDP).³⁹ Gelb used data for 34 developing countries for the period 1965–85. He classified countries as having had positive, moderately negative, or strongly negative real interest rates during two subperiods. He then carried out a comparison among the three sets of countries with respect to real GDP growth and other indicators of financial performance.

For an earlier subperiod (1965–73) Gelb finds that countries in the group with positive real interest rates (3.7 percent) grew at an average rate of 7.3 percent, whereas countries with real rates of –1.7 and –13.7 percent grew at 5.5 and 4.6 percent, respectively. For the second subperiod (1974–85) the results were analogous. Countries in the positive real interest rates group (3.0 percent), grew at an average rate of 5.6 percent, whereas the groups of countries with interest rates of –2.4 and –13.0 percent grew at only 3.8 and 1.9 percent. Using regression analysis, Gelb confirms the strong positive association between real interest rates and economic growth. His results comport with earlier findings by Fry (1988) and the International Monetary Fund (1983).

Gelb also explored the links between real interest rates, investment, efficiency of capital, and economic growth. He measured capital efficiency in terms of the incremental output–capital ratios. He sought to discover whether changes in real interest rates affect economic growth mainly by inducing changes in the *amount* of investment or through changes in the *efficiency* of investment. He finds that the efficiency effect was much greater than the effect associated with amount.

In summary, Gelb’s findings are strongly consistent with the McKinnon–Shaw perspective. His study can be challenged, though, on the grounds that his results are

consistent with reverse causation—that is, high growth leading to high efficiency and interest rates, rather than the other way around (Summers and Caprio Jr. 1992). Reverse causation, however, would not be an issue if interest rates were independently set by policy.

Further support of the financial liberalization perspective was obtained by King and Levine (1992a, 1992b). These authors used cross-sectional data for more than 80 countries for different periods ranging from the 1960s to the late 1980s. Once again, they explored the relationships between financial development, efficiency, investment, and growth.

King and Levine find that higher levels of financial development are positively associated with economic growth, physical capital accumulation, and economic efficiency before controlling for numerous country and policy characteristics. They also looked at the relationship between financial development and *future* rates of long-run growth capital accumulation, and improvements in economic efficiency.

The authors find financial development to be a good predictor of growth over the next 10 to 30 years and of future capital accumulation and improvements in capital efficiency. Linking growth indicators with lagged values of financial development indicators, they find that financial development does not simply follow economic growth. Moreover, the rate of economic growth does not simply reflect a positive association between contemporaneous shocks to both financial and economic development. The authors also find that economies grow faster in countries where commercial banks intermediate most of the credit than in countries with large, directed credit programs intermediated by the central bank. Similarly, countries in which the private sector receives a higher proportion of credit grow faster than those in which most credit goes to the public sector.

The King–Levine analysis goes beyond finding relative simple correlations and supports the view that financial innovation or development is important for economic development. However, some observers have interpreted the authors’ results as consistent with the view that, although severe interest rate repression must be avoided, some mild repression might be acceptable (Summers and Caprio Jr. 1992).⁴⁰

Another example of an attempt to analyze relationships within the constraint of scarce data is a study by Seck and El Nil (1993) on financial liberalization in Africa. The authors explored (also through regression methods) the sensitivities of some variables relative to others to see whether the results are consistent with the McKinnon–Shaw

hypotheses. Because data constraints forced them to pool cross-country and time-series data (as done also by other authors), they point out that they were unable to use what they consider more appropriate vector autoregression techniques. Consequently (as they themselves observe), their results should be seen as illustrative rather than as unqualified evidence.

Seck and El Nil find that, consistent with financial liberalization hypotheses, real deposit rates do have a positive effect on financial savings, investment, and growth. However, their results lead them to argue that African countries' "limited success" with financial liberalization can be explained by high and unstable inflation; by continued direct government interventions in credit markets, which force banks to maintain low deposit interest rates; and by the high cost of financial intermediation. Essentially, Seck and El Nil's contribution is to show that financial repression was still a serious problem in Africa during the 1980s.

Most of the empirical analyses done on the effects of financial liberalization have been based on macroeconomic data, but some have not. An interesting analysis by Harris, Schiantarelli, and Siregar (1994) relies on panel data for individual manufacturing establishments in Indonesia. The data allow the analysts to explore the effect of financial liberalization on such variables as productivity, access to credit, and profitability of firms grouped according to size (small, medium, or large), market orientation (exporter or not), and organizational form (belongs to conglomerate or not).

Given that key financial liberalization measures took place in 1983, and the influence of measures in 1983 would not be measurable until approximately 1 year after, the authors took the years 1981–84 as indicative of prereform conditions, and 1985–88 as the postreform period. Before 1983 the financial sector in Indonesia was significantly repressed. In part, the 1983 reforms deregulated the banking system by allowing banks to set interest rates. The reforms also abolished administratively determined credit ceilings and substantially reduced central bank liquidity credits. The reforms had two immediate effects: (1) interest rates paid on deposits and charged for loans rose and (2) the share of financial resources (as a proportion of GDP) channeled through the formal financial system increased substantially.

Harris and others examined whether the reforms that resulted in interest rate increases helped or hindered smaller and nonconglomerate firms that traditionally had only limited access to "cheaper" credit. The analysis was based on cross-tabulations by firms' characteristics complemented by econometric estimation of an investment equation.

The authors acknowledge the difficulty in isolating the effects of financial reforms from other factors, but the pattern of change after the reforms was consistent with deductive

theoretical expectations. Overall, cost of borrowing rose by 22 percent, value added per unit of capital rose by more than 40 percent, and the investment rate rose by more than 25 percent. Profitability of investment and return on equity increased substantially. Despite the rise in interest rates, the degree of financial leverage in the manufacturing sector also rose.

Aside from the reinforcing effect of other liberalization measures (e.g., exchange rate changes), the authors explain the impact of financial liberalization this way: The higher interest rates led to more intensive uses of labor (with higher returns to capital) and to a higher intermediation of savings. Firms that before the reforms had access to cheap credit despite their relatively low productivity had to drop out of the credit market. By contrast, competitive firms eager to expand production even at higher credit costs were able to increase their access to credit.

Although smaller firms experienced the largest increases in the interest rates they faced, they also experienced the highest relative increases in their investment rates, their leverage ratio, and the productivity of their capital. Large firms also experienced significant gains in productivity and profitability. There was a convergence across establishment sizes of leverage ratios and profitability. The positive effects on small firms still held after controlling for organizational form.

Summing up, Harris, Shiantarelli, and Siregar conclude that although the change from an administrative to a market-based allocation of credit increased borrowing costs for small firms, the increases were more than offset by widened access to finance and decreased market segmentation. The net effect on small firms was positive. In investment and net profits, the small firms subsector benefited.

What, then, can one infer regarding credit and interest rate policies from the empirical analyses of financial liberalization? Although there is still room for debate, by and large the analyses have supported, rather than undermined, the case for liberalization and against government use of directed and subsidized credit. A complication, however, is that there is no clear consensus on how to carry out the transition from a repressed to a liberalized setting. Perhaps a fair way to put it is that the issue is not so much whether financial liberalization is good or bad or whether targeted and subsidized credit is warranted. Rather, the most interesting issue is how to get away from the latter to achieve the former without exacerbating financial instability and giving way to uncertainty (Sundararajan and Balino 1991, McKinnon 1991, Caprio, Atiyas, and Hanson 1993).

Two Regional Experiences: the United States and East Asia

What about the contention that targeted and subsidized credit has been used elsewhere to good avail?

The U.S. Experience With Targeted and Subsidized Credit

One of the arguments used in defense of targeted and subsidized credit in developing countries is that most if not all developed countries use it (or have used it at one time or another). One implication is that developed countries use such tools because they have found them economically effective. Doing an in-depth review of the experience with targeted and subsidized credit in developed countries is beyond the scope of this paper, but it is of interest to see what recent studies have to say about the U.S. experience.

Perhaps the most comprehensive study on the subject done in recent years is the one by Bosworth, Carron, and Rhyne (1987). In the study the authors evaluate the economic justifications for government credit programs, clarify methodological issues, and explore the impact of government lending on economic activity. By and large, their study sheds doubt on the worthiness of many of the government credit programs. They are especially critical of the subsidized interventions.

Because of the political or humanitarian goals of such programs, the authors point to the difficulty in using economic criteria to assess programs that seek income redistribution. What the economist should do, nonetheless, is to assess their costs and determine whether credit is the most appropriate form of intervention.

The authors find, however, that income redistribution programs are often disguised as market perfecting—that is, as programs designed to offset market failures. Such practice creates an additional difficulty for the analyst.

Programs that direct credit toward activities judged to carry public benefits that exceed private benefits are generally subsidized by loan guarantees or by below-market interest rates. Although, in principle, as with income redistribution programs, subsidization might be an appropriate tool, the authors find that credit programs justified on the basis of public benefits are often ineffective in achieving their goals. Among the reasons:

- (1) The programs frequently provide loans to borrowers who would have been able to get loans in the market anyway.
- (2) Given that money is fungible, the loans often finance activities other than the ones intended.

(3) Because a loan subsidy does not increase the total supply of funds to the capital market, interest rate subsidies to a group of borrowers often result in higher interest rates for other borrowers. This means that the costs of these programs might exceed by a substantial margin the obvious or direct costs to the taxpayers of financing the subsidy. Accordingly, unless the social benefits surpass the direct costs to the taxpayers by a significant amount, the programs reduce the efficiency of resource use.

Bosworth, Carron, and Rhyne conclude that, in general, loan subsidies are an inefficient means to allocate resources or to redistribute income. They find that it is hard to show that the subsidized programs achieve their aims and generate benefits sufficient to justify the costs. They also establish that subsidized credit programs have often resulted in transfers to politically powerful groups and that they have lost their original aim of correcting for market failure.

For example, using estimates from the U.S. Department of Agriculture, the authors point out that loan subsidies are a fairly inefficient means of promoting capital investment in agriculture. That is because reductions in interest rates seem to increase the demand for land by twice the increase in the demand for equipment and structures. This means that, as the supply of agricultural land is relatively fixed, the subsidies will benefit largely the landowners rather than the borrowers.⁴¹

Another example of an effort justified by its great public value and for reasons of market failure is the credit programs of the Small Business Administration (SBA).⁴² Bosworth, Carron, and Rhyne point out, however, that the rate of loan default of the SBA has been high. Because the SBA did not charge a fee to cover those losses, the government subsidized the SBA programs, and the programs involved an income transfer for small businesses.

In their study the authors conclude that the most effective programs have been those that have focused on improving the efficiency of capital markets and have avoided large subsidies. Rather than subsidies, the authors favor the use of direct transfer payments to achieve redistribution objectives. They also support measures to address the cause of market failure, and using unsubsidized loans when such failure does occur.

A narrower yet methodologically more ambitious attempt to measure the economic effects of federal credit programs in the United States is found in Gale (1991). Gale developed a model anchored on the concepts developed in Stiglitz and Weiss (1981),

mentioned in chapter 3, “Theoretical Underpinnings.” Through the model Gale simulates the impact of federal lending.

One of the conclusions is that the estimated efficiency costs of actual credit policy are high—between \$10 billion and \$15 billion in 1987. Gale points out that his estimates are relatively insensitive to assumptions relating to the supply elasticity of funds (i.e., to the strength with which the supply of funds reacts to changes in interest rates). Accordingly, he finds that even if crowding-out effects are small, the welfare loss is still sizable.

Gale estimates that, because both new and inframarginal borrowers (borrowers who would have received credit even without the credit programs) receive funds, credit subsidies cost the government more than 50 cents per dollar of incremental target-group investment. Moreover, he points out that most direct welfare gains seem to accrue to inframarginal borrowers; therefore, the subsidies represent windfall gains to the recipients and have no obvious societal benefits. (A windfall gain is an increase in the value of an asset when such increase is due to forces external to the owner of the asset—government credit policy, for example.)

Gale emphasizes that all current programs require large external benefits (i.e., positive externalities) to be welfare improving. Given the high cost of the subsidies and the high default rates, such requirement holds even in the case of groups that would not have had access to private credit in the absence of government assistance.

Gale also finds that often interactions among programs eliminate much or all of the original gain. That is because a subsidy to one target group often crowds out other target groups as well as nontargeted groups. Gale concludes that although there is a role for government in the more marginal sectors of the credit market, the role is more limited and of a different nature from what current policies suggest.

A still more recent study is a literature survey on the effectiveness of directed credit policies in the United States (Schwarz 1992). After explaining that there are relatively few in-depth empirical analyses (not just description or theory) of the effectiveness of U.S. Government interventions in credit markets, Schwarz discusses the methodological problems involved. She then reviews available literature by economic sector.

Schwarz’s basic conclusion is that existing evidence sheds doubt on the effectiveness of U.S. credit programs to generate growth by increasing investment in targeted industries. (The force of this conclusion may be somewhat softened, however, by her acknowledgment that growth has not been an explicit objective of U.S. credit policies.) She arrives at this conclusion by identifying the mechanisms through which directed credit would affect growth and analyzing whether the programs in the different sectors

meet such conditions.⁴³ Nonetheless, she points out that directed credit programs may have been effective in achieving the objectives of removing market imperfections and achieving income distribution objectives.

In summary, although there is plenty of theoretical and descriptive material, the empirical basis for firm conclusions regarding the effectiveness of credit programs in the United States is quite limited. Such evidence as does exist regarding the U.S. experience does not support a case for credit programs in developing countries, where many such programs have economic growth as a key objective. Even in the case of programs designed to offset market failure, which (as pointed out by Bosworth and others) do not require a subsidy in most instances, or of those aimed at income redistribution, there are serious doubts about whether the net effect has been to enhance welfare.

The Record of the East Asian Countries

The economic success of a set of countries in East Asia during 1965–90 has encouraged considerable research on the determinants of the countries' performance. Moreover, the experience of these countries has been used to support arguments in favor of strong and direct state intervention in the economy—as well as in support of arguments *against* such intervention.

To shed light on the different factors that contributed to the performance of these countries, and the weight attached to each factor, the World Bank recently completed a study on eight high-performance Asian economies. The countries are Japan, Hong Kong, Republic of Korea, Singapore, Taiwan, Indonesia, Malaysia, and Thailand (World Bank 1993b). This section examines the implications of the World Bank study for the issue of financial liberalization versus the use of controls to allocate credit.

The countries shared certain traits. Each had (1) high levels of domestic savings, which sustained high investment rates, and (2) sound development policies. Such policies included

- Good macroeconomic management, which provided an adequate environment for economic initiatives and growth
 - Attention to the integrity and accessibility of the banking system, which led to increased levels of financial savings
-

- An emphasis on primary and secondary education, which translated into higher labor-force skills

Agricultural policies that did not tax the rural economy excessively and that encouraged productivity increases

- Limited price distortions

By controlling inflation the eight countries avoided high real interest rate volatility on deposits and ensured that such rates were largely positive. A result was higher real interest rates than in other developing regions. For the most part, these countries also paid strong attention to prudential regulation and supervision of the financial system.

Although the above points are consistent with the financial liberalization perspective, there was also substantial direct government intervention. Governments made frequent use, for example, of targeted and subsidized credit to selected industries. They also used interest rate controls that kept rates on deposits low and placed ceilings on borrowing rates.

In short, these countries relied on a mix of market and state-determined allocations of resources. The mix, however, was not uniform across the countries. For instance, Singapore and Taiwan achieved high savings rates thanks, in part, to high public sector savings. Japan, Korea, and Taiwan imposed stringent controls and high interest rates on consumption loans. Malaysia and Singapore guaranteed high minimum private savings rates through mandatory provident fund contributions.

Japan, Korea, Malaysia, Taiwan, and Thailand had extended periods during which the interest rates for loans were kept somewhat below market clearing levels. Thus there was mild financial repression.⁴⁴ But even while the eight high-performance economies experienced some degree of financial repression, it is important to note that they managed to maintain real interest rates at zero or mildly positive. They also avoided significant fluctuations in those rates (by stabilizing inflation).

Except for Hong Kong and Singapore, the high-performance countries have at times simultaneously regulated deposit and lending rates and, consequently, the spreads of the financial institutions. By controlling the spreads while protecting the banks from competition (see below), the governments have limited the rents that banks could have enjoyed from such protection.

What effect did mild financial repression have on savings and investment? A suggested answer is that, on the one hand, the positive (or at least nonnegative) real interest rates encouraged financial savings. On the other, once real rates were positive, the interest elasticity of household savings may have been low. If firms (the corporate sector) had a higher propensity to invest than did households, mild financial repression may have translated into higher investment and growth rates.

In light of the above, it is possible that periods of mild financial repression allowed the financial system to retain, and transfer to investors, a relatively high level of funds. From this perspective, mild financial repression may have made a net transfer from savers to investors possible.

Moreover, although the study acknowledges that even mild financial repression generates excess demand for credit, the potentially negative impact on growth resulting from additional credit rationing may be weak. The rationale is that even in the free market there will already be rationing as banks will not necessarily allocate loans to the higher bidders (see chapter 3). Accordingly, the effects of some additional rationing associated with mild financial repression may be weak.

Although the authors seem inclined to think that, especially in Japan, Korea, and Taiwan, mild financial repression at positive real rates of interest may have had a positive effect on growth, they acknowledge that the analysis cannot establish that conclusively. What the authors state is that it apparently did not inhibit growth. Moreover, the reasoning that some repression might have contributed to the transfer from savers to investors runs counter to the evidence that establishes a negative association between financial repression and intermediation.

In general, most of the eight countries influenced credit allocation in three ways. They (1) enforced regulations to improve private banks' capacity to select worthy projects, (2) created financial institutions—especially long-term-credit (development) banks, and (3) directed credit to specific sectors and firms through public and private banks.

Emphasis on these tools varied across the countries. In Hong Kong, for example, banks are private and are regulated primarily to ensure their solvency. In Indonesia, Malaysia, Singapore, and Thailand, although governments have provided broad guidelines to credit allocation through regulations and moral suasion, banks are privately owned and exercise independent authority over lending. In these four countries (and in Hong Kong), project selection is generally left to bankers.

By contrast, in Japan, Korea, and Taiwan, banks have been subject to direct state control or stringent credit allocation guidelines. The public banks, in particular, had their allocation of credit tightly controlled.

There have also been similarities and contrasts in targeting. All the studied economies except Hong Kong give automatic access to credit to exporters. Housing was a priority in Singapore and in Hong Kong. Agriculture and small and medium enterprises were targeted in Indonesia, Malaysia, and Thailand. Taiwan targeted technological development. Japan and Korea have used credit to promote the shipbuilding, chemical, and automobile industries. In contrast, neither Thailand nor Hong Kong has actively relied on credit instruments to protect selected industries.

In Korea during the 1970s the subsidy from preferential credit was large, but in general throughout the high-performance countries the implicit subsidy of directed-credit programs was small. Moreover, in recent years even Korea has moved away from heavy credit subsidies to selected sectors.

Stressed in the study is the point that the continued allocation of credit was subject to performance criteria. In some cases, some major enterprises were allowed to go bankrupt when they failed to meet the performance criteria.

In explaining the countries' high savings rates, the report underscores the importance of promoting confidence in the health of the financial institutions. To such end, the eight governments worked on the prudential regulation of savings institutions and on protecting depositors from bank defaults.⁴⁵

What, then, is one to make of all this regarding the appropriateness of targeted and subsidized credit for other developing areas? The report provides relevant guidance. First, one should note the following differences between the experience in the high-performance countries and that of other countries:

- Financial repression in the high-performance economies was relatively small and, in general, did not entail persistently negative real interest rates.
- Financial repression was undertaken in an environment of macroeconomic stability. It was not the unintended consequence of rapid inflation.
- Bank regulators squeezed the interest rate spread, ensuring that low rates paid to depositors were passed on to borrowers.

Although directed-credit programs have failed catastrophically elsewhere, in some high-performance East Asian economies, particularly in Japan, Korea, and Taiwan, the programs have caused relatively little damage to capital allocation. Where

directed-credit programs were most successful, they took place in a context of sound monitoring of performance, small interest rate subsidies, good loan repayment, and application of strict performance criteria for allocating funds. “These preconditions for effective directed credit were present in only a few of the [high-performance economies],” according to the World Bank report. “Where they were absent, directed credit programs largely failed” (World Bank 1993b, 256).

Moreover, regarding the use of targeted interventions for capital accumulation,

More selective interventions—forced savings, tax policies to promote (sometimes very specific) investments, efforts to repress interest rates, and sharing of risks—also appear to have succeeded in some [high-performance countries], especially in Japan, Korea, Singapore, and Taiwan. But the potential costs of these more selective interventions if misapplied can be very high in terms of consumer welfare, and strong institutional capability is necessary. They would not have succeeded without the important monitoring and disciplinary roles performed by the banks and public sector institutions of these economies. Where other East Asian economies have lacked this capability—in Indonesia, Malaysia, and Thailand—efforts at selective interventions to promote rapid accumulation have been generally unsuccessful [World Bank 1993b, 224].

So, does the experience of the eight countries suggest that interest rate controls, credit subsidization, or targeted credit should be used in other developing areas to achieve developmental goals? The study’s answer is that such would not be a wise course. The record of these interventions in the high-performance economies has been mixed, and directed-credit programs have had a poor record in Indonesia, Malaysia, and Thailand. Even in Korea, where along with Japan and Taiwan, directed credit seems to have been successful, the cost of extensive and highly subsidized credit was high as regards banks burdened with nonperforming loans.

What has been common among the high-performance economies, and much less frequently found in other developing areas, is attention to the fundamentals of macroeconomic stability, openness to foreign influence, and attention to the promotion of human capital and to maintaining a competitive economy.⁴⁶

5

Conclusions and Operational Implications

THIS PAPER HAS REVIEWED three types of empirically based analyses of directed credit: (1) USAID evaluations and USAID-supported studies, (2) other institutional and academic work, and (3) assessments of the experience of selected regions. The paper has also discussed the theoretical literature that underpins much of the empirical work. Conclusions and implications follow.

Conclusions

The main conclusions summarize the experience with targeted and subsidized credit in light of the justification for such credit. Related items address such questions as the financial viability of lenders, the effects on poverty, the importance of credit as a development constraint, and the relevance for small firms and nongovernmental organizations.

Targeted and Subsidized Credit: Rationale Versus Impact

Historically, targeted credit has meant subsidized credit. Credit subsidization was deemed necessary to achieve income distribution and efficiency objectives. The latter included offsetting economic distortions caused by policy.

However, reliance on directed credit and on interest rate controls hindered development of the financial sector because of illiquidity and instability. One consequence was that creation and growth of financial institutions able to efficiently serve small entrepreneurs was hampered. Overall, the experience with targeted and subsidized credit has not been happy.

In most cases, directed or subsidized credit practices have done more harm than good—for example, they have led to misallocation of capital resources. Likewise, although theory can be used to show that market forces may not lead to efficient situations, government-determined outcomes may be worse.

The thrust of economic development theory would suggest addressing the cause of market failure rather than relying on directed credit, and using direct transfer mechanisms to achieve redistribution objectives. In sum, there seems to be little justification for subsidized credit to final borrowers, or for long-term donor intervention through directed credit.

Financial Viability

In general, lenders that provide cheap capital are not financially viable. They can continue operations only as long as donors continue to provide concessional aid. The projects that support such lenders have little development impact because they do not contribute to the creation of sustainable institutions needed by farmers, microentrepreneurs, and the poor. In contrast, projects that lend funds at free market rates and pay market rates to savers can be viable and successful.

Directed Credit and the Poor

The effect of credit projects on poor farmers has not been encouraging. Few farmers who benefited from concessionary finance were later able to become clients of commercial banks.

By and large, the nonpoor have benefited the most from credit projects. One reason is that, when providing credit at artificially low interest rates, lending institutions have sought to protect their solvency by lending only to borrowers with the best credit ratings. Moreover, nonpriority influential groups have lobbied to take advantage of cheap credit. As a result, targeted credit often has not reached its intended beneficiaries and has tended to redistribute income regressively.

Credit as a Development Constraint

Credit has not been the major constraint to agricultural development it was often presumed to be. Farmers have been able to increase their output profitably while paying market rates of interest. In reality, there is little justification for credit subsidies.

Directed Credit and the Mobilization of Savings

Low interest rates on savings have discouraged potential savers and hindered the mobilization of funds in rural areas. Subsidized interest rates on loans depress interest

rates paid on savings. Accordingly, interest rate subsidization hinders the mobilization of savings.

Directed Credit as an Offset to Policy-Caused Distortions

In general, directed credit has failed to compensate for distortions in nonfinancial as well as in financial markets. One reason is that targeted credit is a second-best and inefficient way of addressing policy distortions. Moreover, fungibility and the costs and difficulties of detecting diversion make offsetting distortions in nonfinancial markets nearly impossible. Finally, directed credit has failed to target distortions precisely and, because it targets borrowers with subsidies, for the most part it has had costly and unintended side-effects.

Directed Credit in the United States and East Asian High-Growth Economies

On grounds of either redistribution or growth and efficiency, it is hard to justify credit subsidization on the basis of the experience of such practices in the United States. The prevailing view is that the costs of such subsidization in the United States have been too high and that the effects have probably been regressive. The existence of subsidized credit in the United States is more a reflection of political than of economic or equity considerations.

Even with respect to the East Asian “miracle” economies, the record of direct intervention, including directed and subsidized credit, is mixed. The success of such economies probably owes more to the fundamentals of ensuring economic competition, macroeconomic stability, and the accumulation of human capital.

In fact, recent research stresses that it was attention to the integrity and accessibility of the banking system in these countries that led to increased levels of financial savings. This is consistent with the importance the economic literature places on creating the conditions that encourage development of a sound financial sector.

Financial Liberalization and Small Firms

Empirical research has not been conclusive, but the prevailing opinion is that, within some range, as real deposit interest rates are allowed to become increasingly positive, financial savings and investment will rise, capital allocation will become more efficient, and higher growth will come about. More important, recent empirical microeconomic analysis indicates that financial liberalization has a positive effect on the investment

rates and capital productivity of small firms. It also helps such firms increase their leverage ratios.

Relative to conditions prevailing under an administrative allocation of credit, the small-firm subsector benefits through widened access to finance and decreased market segmentation. This conclusion is consistent with the interest in creating conditions so that formal sector transactions can expand and effectively service small enterprises—what is sometimes referred to as an expansion of the formal finance frontier. This indicates that financial liberalization and the objective of reaching the poor through financial services programs supported by international donors are complementary. It further suggests that for financial services programs aimed at microentrepreneurs to be effective, a clear move toward financial liberalization is an important prerequisite.

Credit, NGOs, and Microenterprises

NGOs (or PVOs) can have advantages in lending to small enterprises. But to succeed in such endeavors, they will have to use risk-reducing technologies, charge cost-covering interest rates on loans, keep loan arrears and defaults low, and be able to mobilize voluntary savings for the funds they need. They should aim at financial self-sustainability within a relatively short period of time.

Some institutions have demonstrated that given the conditions just mentioned, together with the existence of an adequate institutional and economic-policy setting, it is possible to successfully reach low-income households through financial services without reliance on ongoing subsidies. For viable microenterprises, access to credit is a more important issue than price of credit. Microentrepreneurs in such firms are willing and able to finance their businesses at positive real rates. Interest rate subsidies are not needed; financial services are.

Operational Implications

The two main operational dimensions relate to how donors can help governments fulfill an appropriate role and how donors can provide microenterprise support.

Donors' Interactions With Governments

To strengthen the synergistic links between economic development and the financial sector, governments and donors should first concentrate on establishing an institutional and economic-policy setting that encourages entrepreneurship and financial initiatives. It is through a well-developed financial system that societies are likely to have greater success in addressing financial services needs.

Accordingly, donors should concentrate their efforts on improving the performance of financial (and capital) markets and helping the government address the cause of market failure when such failure occurs. A strong government role in financial markets is appropriate, but that role should not be through the provision of cheap or directed credit. Rather, the government's role is to help redress information imperfections, develop an adequate legal framework, and provide proper regulation, supervision, and enforcement. This offers a broad area for donor action.

Donors and Microenterprises

Although the impact of the policy and institutional environment is fundamental, international donors can complement their actions at the macroinstitutional level with programs to help develop financial services that reach efficient small entrepreneurs and the poor. Such programs should become financially self-sustainable in a relatively short period. They should also offer financial services that eventually include both credit and deposit services on a commercial basis.

Priority should go to supporting the development of commercially viable, nontargeted financial institutions that can meet the liquidity needs of microentrepreneurs. Conceptual advances during the past 10 years in ways to provide financial services to low-income groups and microentrepreneurs are encouraging. Encouraging too is the performance of some institutions that are in fact successfully providing just such services. These steps forward provide reference points for future activity by international donors.

Nonetheless, the overall disappointing record of credit programs suggests that donors' initiatives should proceed with caution. They should gradually expand the scope of resources allocated to microenterprise financing only as additional successes warrant it. At this point the emphasis should be on limited pilot programs in countries selected on the basis of progress toward development of adequate policy and institutional settings.

In light of the above, international donor subsidization of institutions that provide financial services to microentrepreneurs should be of short duration and conditioned on a fast movement toward financial self-sustainability. At some stage before terminating

assistance, donors might want to consider shifting their support from grant or subsidized assistance to unsubsidized loans. The process should, however, move fast—say, an initial grant for seed capital to help with start-up fixed costs, then loan subsidies during a second year, and, for a third and last year, loans at the commercial free-market rates prevailing in the host country for activities judged of commensurate risk.

As highlighted in this review, to achieve self-sustainability, donor-supported institutions will have to pay attention to voluntary savings mobilization. But before offering deposit services, an intermediary institution will have to meet the requirements of a serious and effective system of prudential regulation and control.

Notes

¹ This chapter relies heavily on World Bank (1989a, chapter 4). It also uses material from Adams and Von Pischke (1991).

² The term “interest rate subsidization” is used in this paper to refer to interest rates lower than the rate that would equate demand and supply of credit in a competitive market. Also, it is important to note that lending to disadvantaged sectors at prime commercial interest rates involves subsidization. The reason is that, in the free market, credit would not otherwise be offered to such sectors at the prime rate.

³ This perception proved to be inconsistent with later analyses. See Adams and Fitchett (1992).

⁴ Poor accounting, auditing, and disclosure standards influenced the limited capacity to access risk.

⁵ Also for financing government expenditures.

⁶ For example, under these rationales governments created parastatal enterprises to promote industrialization or exports and to force farmers to sell certain crops to sole buyers at fixed prices.

⁷ Among them, achieving production potential and exploiting linkages.

⁸ Forms of indirect government interventions in credit markets are discussed later. See, for example, chapter 3 under “The Challenge to the Financial Liberalization Perspective” and “More Recent Contributions.”

⁹ Low relative to the loans that would prevail in the free market or even to loans prevailing in regulated markets.

¹⁰ For a consistent but different interpretation, see Vogel and Burkett (1992).

¹¹ However, as may be inferred from the previous discussion, this is not exactly what McKinnon–Shaw argued.

¹² Unless otherwise indicated, the comments in the main text are based on Stiglitz and Weiss (1981) and Stiglitz (1993). The latter reference presents a good overview of the

arguments. It contains abundant references to material that elaborates on the specific points.

¹³ More precisely, the point is that the market mechanism will not lead to Pareto efficiency. A Pareto-optimal allocation of resources exists when a change in allocation to benefit one person will hurt another. If such a change in the allocation of resources were possible, not being in a Pareto situation would mean that an economy's welfare level was not being maximized. It would mean that at least one person in a society could increase his well-being without a loss to anybody else.

¹⁴ Analysis of some of these aspects is contained in Dornbusch and Reynoso (1989).

¹⁵ These ideas are based on Greenwald and Stiglitz (1986).

¹⁶ For a theoretical defense of small-scale peer monitoring institutions see Stiglitz (1990). However, it is not clear why market forces could not lead to the same development and why the government would have an advantage over the market in doing this.

¹⁷ In part, this section builds on Besley (1993, 1994).

¹⁸ It is important to determine how sensitive analytical results, and their policy implications, are to assumptions. If slight or moderate changes in assumptions do not lead to substantially different conclusions and policy implications, one feels that such conclusions and implications are robust. However, if they indeed prove to be sensitive, one has to be wary about advocating the implied policy course.

¹⁹ On these points Hoff and Stiglitz (1990) seem to acknowledge that as countries develop they will create institutions that lead to lower costs of screening, monitoring borrower activities, setting right incentives for repayment, and enforcing loans. Their point, however, is that, in the short to medium term, market imperfections may increase rather than decrease because the new institutions need time to take hold and traditional ties may break relatively fast as technological change takes place. This argument, however, seems conjectural (it is not clear why the existence of strong imperfections would not speed the pace of institutional change) and has to be weighed against the probability of something going wrong with direct government intervention in the provision of credit.

²⁰ In fact, risk-rating firms are common in many Latin American countries.

²¹ As most credit projects (or projects with credit components) have been for agricultural development, much of the discussion in the text relates to such projects.

²² A summary of the earlier review can be found in Agency for International Development (1991). The study, known as the “1973 USAID Spring Review of Small Farmer Credit,” built on 42 country studies.

²³ Among them, World Bank (1989), *World Bank Report of the Task Force on Financial Sector Operations* (1989), “World Bank Policies Guiding Financial Sector Operations” (1991).

²⁴ Mostly on the basis of performance and project completion reports of the preceding 5 years, the OED review is critical of the Bank’s emphasis on financial liberalization (see theoretical section above) and of the Bank’s criticism of targeted and subsidized credit. It is noteworthy that the review indicates that what it views as an incorrect approach to and interpretation of targeted credit started with USAID’s work done in collaboration with Ohio State University researchers. The report notes that the approach was picked up by the World Bank.

²⁵ An instance of deterioration in the default–arrears ratio took place in Bangladesh in the 1980s. Lending expanded on the belief that eventual payment would occur. However, when overdues reached high levels, the farmers clamored for relief, and the government found it politically expedient to launch interest-exemption and loan-forgiveness programs. A complete breakdown in repayment discipline followed (Meyer and Larson 1993, 21).

²⁶ For a discussion of these issues see Meyer and Larson (1993) and the references discussed therein.

²⁷ The report was presented to the Development Assistance Committee Expert Group on Evaluation (McKean 1990). It covered projects from the mid-1970s to the late 1980s and was based on reports from nine international and bilateral donor institutions.

²⁸ The CDIE microenterprise evaluation carried out fieldwork in 10 countries and reviewed 32 microenterprise development projects. The evaluation sought to take stock of the existing USAID programs, examine the different approaches taken, and determine what works under what conditions.

²⁹ The evaluation identified three approaches to microenterprises. The approaches differed according to the type of enterprise targeted, size and type of loan, and credit conditions.

³⁰ For example, the Grameen Bank in Bangladesh, the Badan Kredit Kecamatan in Indonesia, and the Fundación para la Promoción y Desarrollo de la Microempresa in Bolivia.

³¹ To quote Patten and Rosengard (1991, 2), “this appears to be a case of ready availability of capital from government and donors stunting an institution’s development into a full financial intermediary.” Nonetheless, recently the BKK has been experimenting with pilot projects that seek to mobilize voluntary savings, although, as reported by Patten and Rosengard, such projects seemed to have little practical impact.

³² This finding has to be tempered, however, by this reviewer’s sense that the definition of “arrears” does vary significantly across institutions and, therefore, the comparability of collection performance is subject to significant error. Nonetheless, even allowing for such limitation, the point holds that these institutions have been able, to varying degrees, to limit default losses.

³³ Such subsidies include the subsidies an institution receives when it pays below the market interest rates on its borrowed funds.

³⁴ See previous discussion on Patten and Rosengard’s observations on the BRI and the BKK.

³⁵ A recent CDIE study is using this construct to classify 11 programs that lend to the poor or to small businesses and that are considered successful or of great potential. The study, *Maximizing the Outreach of Microenterprise Finance: An Analysis of Successful Microfinance Programs*, seeks to explore the factors that may distinguish the performance of the 11 successful or promising programs from the bulk of programs with similar objectives. The study has determined that one of the programs is still in level 1 and five are in level 2, with the remaining five having achieved self-sufficiency in level 3.

³⁶ As pointed out by Meyer and Larson (1933), this was accompanied by a decreased concern in trying to measure the final impact on borrowers. The main reason for such decreased concern was that disentangling the effect of financial policies from other factors is difficult and costly.

³⁷ There is a voluminous literature on recent economic policy changes aimed at structural and stabilization reforms. For a good summary of what has been (tongue-in-cheek?) termed the “Washington consensus” regarding such measures, see Williamson (1990).

³⁸ González Arrieta (1988), for example, mentions that Chilean gross national savings fell from an average of 16.3 percent of gross national product during the 1960s to 12.4 percent during 1975–81. There have been numerous analyses of reform processes in

these countries. World Bank (1987, 1989) contain summary reviews of such experiences.

³⁹ Some of the results of the study were also published as part of World Bank (1989); the study is commented on in McKinnon (1991, 17–19).

⁴⁰ A basis for mild repression of interest rates is found in arguments attributed to Stiglitz. The point is that banks in bad financial condition can tend to raise their deposit rates to attract deposits and be able to engage in high-risk loans to improve their net worth. Such competition would be seen as wasteful. It is not clear, however, why a sound system of bank regulation, monitoring, and supervision would not prevent banks with negative net worth from engaging in this type of practice.

⁴¹ Bosworth and others (1987, 120–21). In part, they rely on quantitative estimates by LeBlanc and Hrubovcak (1986). One should note, however, that Calomiris, Hubbard, and Stock (1986) found that lower collateral and higher debt service relative to income are associated with lower farm output. Such results might provide a basis for arguing that, even if credit subsidies benefit landowners by raising the value of their land, such rise in value will be translated into increases in output. Nonetheless, Calomiris and others favor a concentration by governments on improving financial markets rather than relying heavily on direct government-administered programs.

⁴² In the case of small enterprises, private lenders are thought to overestimate the risk of default.

⁴³ The conditions are as follows: (1) directed credit would lead to increased borrowing in the targeted sector, (2) the increased borrowing must be translated into increased investment in the targeted sector, (3) the increased investment has to be productive so as to increase output in the targeted sector, and (4) growth in the targeted sector must lead to growth in the overall economy.

⁴⁴ As pointed out in the study (page 217), this definition of “financial repression” differs from the one that considers financial repression as a situation of negative real interest rates.

⁴⁵ Deposit insurance explicitly exists only in Taiwan and Korea, but de facto the other six countries have it. Although the report acknowledges that there was a cost in terms of efficiency, sometimes the governments protected banks from competition to increase the financial strength of the financial institutions. Moreover, when necessary, all eight governments have bailed out troubled financial institutions through financial management assistance or mergers with stronger banks (World Bank 1993b, 198–201).

⁴⁶ These main points in the report have not gone unchallenged. For instance, Robert Wade from the Institute of Development Studies chides the World Bank for using a method that fails to detect some of the links between policy and growth. He also argues that governments should be advised to develop the factors that made for the success of some of the interventions in East Asia—a competent bureaucracy not susceptible to interest group pressures, for example. See “Letters,” *The Economist*, October 23–29, 1993, page 8.

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