FINANCIAL SECTOR POLICY REFORMS: IMPLICATIONS FOR RURAL GROWTH

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SUMMARY

This essay discusses the functions of the financial sector in developing countries and the policies required to promote rural growth. The paper's premise is that rural growth has been disadvantaged, historically, by financial sector policies which favor urban over rural development. Examples from Costa Rica and Indonesia show how appropriate and inappropriate policies related to banking and financial services infrastructure, rural savings mobilization, capital formation, securities markets, and credit allocation can impact rural development. The author recommends financial sector reforms such as privatizing financial structures, legislating the prudential supervision of intermediaries, and liberalizing credit and interest rate systems in order to stimulate production and provide incentives for rural growth.

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INTRODUCTION

This essay discusses the functions of the financial sector in developing countries and the policies required to promote rural growth. The paper's premise is that rural growth in developing countries has been disadvantaged, historically, by financial sector policies which favor urban over rural development. It does not seek to explain in detail the reasons for this phenomenon--there are many and pages are limited. Rather, its objective is to outline a set of financial policies which may ameliorate the bias against rural development in striving for balance between urban and rural growth priorities.

Rural sectors in developing countries are characterized by low population densities, subsistence level agriculture, relatively low incomes, and the absence of basic services similar to those found in urban centers. Financial systems components are discussed within the context of these characteristics to distinguish those policies which can alleviate constraints to rural growth. Specifically, those components include (a) banking and financial services infrastructure, (b) rural savings mobilization (c) capital formation and securities markets, and (d) credit allocation. Although not a comprehensive list (there are other important elements to financial services such as insurance facilities, guarantee mechanisms, etc.) these components are arguably the most significant when considering the impacts of financial sector policies on rural development.

LAYING THE FOUNDATION: DEFINING THE PROBLEMS OF RURAL

FINANCIAL SYSTEMS

A financial system is essential for creating and sustaining economic growth because it serves four fundamental purposes: it furnishes a medium of exchange, provides services of intermediation between borrowers and savers, reduces risks by acting as a store of value and services the public sector through fiscal support by providing government access to capital.

Yet a functioning financial system, as an underlying prerequisite for sustainable development, is rarely featured in developing countries. Instead, financial infrastructure is skewed in favor of urban centers. Banks cater to the collateral-laden aristocracy. Inefficient and ineffective attempts to disburse credit have delayed capital formation and the development of financial markets. Scarce resources remain underpriced and misallocated. The absence of an adequate rural financial structure is a *consequence* of long-standing government policies and market failures which have (1) retarded private sector market entry, (2) promoted lending which has concentrated rather than redistributed income and (3) increased, rather than decreased, transaction costs. In essence, financial sector widening and deepening have been constrained by highly inappropriate policies.

High transaction costs are symptomatic of a dysfunctional system and are defined as those which are incurred in borrowing and lending in addition to the cost of funds. They include costs of locating and negotiating with customers, costs associated with imperfect market situations, for example, monopoly surcharges imposed by

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[1]Lenders' transaction costs are the result of activities undertaken to assure that loans are repaid. These include initial screening of borrowers, monitoring of loans, enforcing contracts and any other activity in which lenders engage to minimize the risk of a default. Also, excessive prices and interest rates due to monopoly holdings, as a component of price, are an example of market failure. Strictly speaking, the high cost of funds is not defined as a "transaction" cost although its impact on transactions is the same: costs are increased.

input suppliers, and unreliable sources of supply.[1] Per unit transaction costs of lenders increase with the large number of small-value loans and are passed on to borrowers in the form of excessive rates, fees or other charges.

The problem of high transaction costs for rural intermediaries and their clients is the result of a combination of factors. Principal among them are (1) the structure of *formal* lending processes, (2) informational barriers to market penetration by private intermediaries, and (3) a predisposition to categorize the rural borrowers as "bad credit risks". Typically, formal financial intermediaries will transplant lending practices into a rural setting. Standards and processes created for urban and relatively sophisticated clientele, however, are unsuitable for lending to the rural poor. Stringent collateral requirements designed for urban borrowers eliminate otherwise credit-worthy rural applicants: rural borrowers rely on reputation and community standing rather than tangible collateral. Loan application processing can typically mean weeks of waiting with the borrower uncertain of the outcome: rural borrowers often need funds immediately for both farm and non-farm purchases and cannot easily afford weeks of application processing. Filling out a loan application is, itself, inhibiting and intimidating. Rural borrowers frequently live far from a lending institution: they are hard-pressed to get to the lending location. Once there, illiterate rural applicants find complicated questionnaires and credit histories difficult to complete.

Likewise, formal intermediaries are disadvantaged in trying to overcome informational barriers. Efforts to assess the rural applicants' creditworthiness impose additional cost burdens on intermediaries and are compounded by negative preconceptions held by managers (usually from urban centers) regarding lending to the rural poor. Transposing traditional processes which require detailed information is inappropriate for the short-term working capital loans usually sought by rural borrowers. Attempts to overlay formal structures on rural lending practices increase transaction costs of intermediaries engaged in such lending.

Developing country policy-makers have been slow to recognize and understand these issues and have been largely unsuccessful in adopting financial sector reforms for a variety of reasons. Chief among them is the *subtle* and *diffused* process of financial intermediation. Effective intermediation is difficult to structure and to manage given the requirements for expedited and detailed information flows and the economies of scale[2] which characterize an efficient rural system. A false sense of capacity to control resource flows to the sector also accounts for policy-makers' inability to address

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[2]In this regard, economies of scale are an important consideration for establishing rural financial intermediaries. While fixed costs of opening a rural financial unit can be reasonably ascertained, access of rural populations to the intermediary will determine the extent of the intermediary's profitability, especially if deposit and lending rates are market based. Therefore, to maximize its opportunity for financial returns, the intermediary's location and accesibility to potential clients must consider an optimum economy of scale, where the minimum amount of resources invested can return to the intermediary the maximum profit.

the underlying cause of the problems. Policy-makers' confidence in the adequacy and equity of their countries' financial structure has been reinforced by attempts to dictate the terms and conditions of financial operations. Controls, however, are largely illusory because participants often appear to be complying with the intent of the regulations while doing something quite different in practice.

Believing their understanding of financial structures to be adequate and assured that sufficient controls are in place, policy-makers concentrate on more visible and politically appeasing interventions such as credit allocation (supply-led strategies) which they claim will stimulate production, access new technology and help the poor.[3] Financial system reform in developing countries, especially in rural areas, has been a difficult process as government policies which restrain growth and efficiency are dismantled in favor of those which promote it.

BANKING AND FINANCIAL SERVICES INFRASTRUCTURE

In carrying out the functions of a financial system mentioned above (monetization, intermediation, reserve management and fiscal services) the financial sector must be organized and integrated so that markets are allowed to operate with minimum government interference. To be sure, the regulatory functions of governments should not be diluted or discounted in the process. Yet interventions should be limited to those situations in which market forces fail to provide remedies, such as is the case with monopoly control (over information or financial services, for example).[4]

In fulfilling the regulatory objectives for financial services and allocation of resources, banking laws, policies and regulations must incorporate principles that promote a fair and efficient exchange of resources among various economic sectors. The institutional capacity of intermediaries and the legal and regulatory frameworks under which financial intermediaries operate are, perhaps, the two most influential factors in determining the adequacy of intersectoral resource flows. Each impinges upon the other. For example, institutional capacities to successfully provide services to rural areas depend on the ability to generate profits and mobilize savings but are often undermined by regulatory or legal impediments imposed by governments. Ironically, laws and regulations are subsequently constructed to compensate for what governments perceive is a failure of financial intermediaries to adequately perform their function for rural inhabitants, in turn further distorting market-based incentives.

As a manager of a country's medium of exchange and regulator and administrator of interest rates, the Central Bank is a "first line" actor in determining the response of public and private intermediaries. Financial market performance can be severely limited by the effect of inflation on the economy and Central Bank action is an important determinant of inflationary trends. In particular, inflation is especially burdensome for rural producers who have fewer means to supplement meager incomes to compensate for increasing domestic

[3] See Dale W Adams, "Effects of Finance on Rural Development," in Dale W Adams et. al., eds., *Undermining Rural Development with Cheap Credit,* Boulder: Westview Press, 1984, p. 12.

[4] The role of government in prudentially regulating and supervising deposit-taking intermediaries is perhaps one of its most important functions. See Rodrigo A. Chaves and Claudio Gonzalez-Vega, "Principles of Regulation and Prudential Supervision and Their Relevance for Microenterprise Finance Organization," in Maria Otero and Elisabeth Rhyne, eds., *The New World of Microenterprise Finance: Building Healthy Financial Institutions for the Poor,* West Hartford, Connecticut: Kumarian Press, 1994.

prices. Rural areas suffer proportionally more than richer urban sites since the rural poor, usually in the bottom income quartile, can afford least to pay the "inflation tax" caused by excess domestic credit creation which erodes limited savings and diminishes purchasing power. Consequently, central banking policies which successfully control inflation by curtailing monetization in excess of money demand help rural stabilization.

Similarly, the extent to which Central Banks can allow domestic interest rates to reflect market conditions can be a significant force for rural growth. Positive and real interest rates and the policies which stabilize them reduce the risks of agricultural borrowers over time. Although the benefits of interest rate stability are economy-wide, agriculturally- dependent rural sectors benefit more than industrial centers given the long lead times involved between planting and harvesting for many crops. Interest rate stability also reduces risk caused by the relative *price inelasticities of supply* for agricultural commodities compared to the relative price *elasticities* for manufactured goods usually produced in urban areas.

These two principal Central Bank interventions are necessary but insufficient conditions to lay the foundation for market-based incentives to promote rural growth. Establishing private, rural financial intermediation requires an "enabling environment" as a prerequisite. Elements of an appropriate environment to attract private financial intermediaries to rural areas include adequate market size to generate economies of scale for operations, profit potential (high returns to compensate for transaction costs), and a satisfactory legal and operational framework to "intermediate" the public's resources. For example, private intermediaries need to have the legal capacity to accept demand deposits and place those deposits into profit-yielding investments of their own choosing. Intermediation services such as those provided by commercial banks, savings and loan institutions, and cooperative credit unions, must be available *and* accessible to the general public. Laws, government regulations and policies which undercut market mechanisms by offering below-market credit to rural areas (more on this later) prohibit demand deposits in private institutions, restrict deposit rates, impose sectoral lending requirements on intermediaries, or which otherwise distort market signals can seriously disadvantage the very sector they were designed to promote.

While private financial institutions operate frequently in developing countries, *access* to their services by rural inhabitants is limited by the physical location of the institution. Policies which either directly or indirectly encourage the placement of financial institutions in rural areas by compensating for market deficiencies would help to address the negative bias against the rural areas (i.e., road infrastructure would help take advantage of economies of scale for a private intermediary by facilitating depositors' access to institutions). At the very least, policies should not *discourage* private financial infrastructure in rural areas by implicit or explicit tax differentials such as mandatory, below-market interest ceilings for rural lending, restricting fees or directed credit to the agricultural sector. Conversion of existing government-owned buildings in rural areas, for example, into private lending facilities can also be a useful state contribution and would reduce some of the barriers to establishing private intermediation.

Policies which encourage private *instead* of public financial intermediation in rural areas also promote more efficient growth . Nationalized banking systems and the government agrarian credit programs they administer are highly inefficient and unsustainable. Loan rates do not cover the cost of lending and result in an underpricing of capital resources and substantial losses for the institutions. As an underpriced resource, loans are rationed by the lender based on *nonmarket* factors. Nonmarket rationing processes result in loans that are usually given to a few of the most influential borrowers instead of those with the best projects.[5] Private intermediation, however, operating on market-based principles avoids these pitfalls and limits the rent-seeking behavior found in nationalized banking structures. Policies aimed at privatizing financial services in rural areas can promote efficient rural growth.

Privately-formed and managed cooperatives can also efficiently allocate resources in rural areas. Governments can encourage the development of rural cooperative credit unions as an alternative to nationalized financial intermediaries. Laws and regulations allowing cooperative behavior can be effective for rural capital formation.

Another effective alternative to government-owned financial intermediation is to *encourage* informal sector lending in rural areas. The services provided by informal markets where deposits, small-value loans and short-term loans to poor people are featured are not easily accommodated by formal public or private institutions. Informal lenders and borrowers alike learn discipline in the process of lending and borrowing. It takes disciplined behavior to save money to lend and to collect information about your borrower. Borrowers also learn discipline as they establish creditworthiness with their lender and "earn" the privilege of borrowing. Deposits potential which could be generated by informal financial markets is substantial and shows the failure of the formal financial systems to meet the savings needs of the rural sector. The structure of government-owned rural banks and cooperatives which do not accept deposits or which pay negative rates of interest on deposits have resulted in few formal deposits being mobilized. Transaction costs also are typically lower for informal sector borrowers and loans are usually flexible to allow adjustments to changing conditions of inflation, economic booms or downturns.[6]

Policy-makers should observe the lessons from the informal sectors to help clarify the type of financial services that rural credit markets are demanding and that informal lenders are providing. Policies aimed at encouraging banks and cooperatives to adopt features of *flexibility* and *access* found within the informal system may help to make the formal system more responsive to rural populations as Adams has indicated.

RURAL SAVINGS MOBILIZATION

Growth and equity are important objectives for promoting rural development. Policies that improve savings opportunities can do much to redistribute income toward the rural poor instead of typical government-sponsored, interest-subsidized schemes. Capital accumulation provides productive sectors with the investment necessary to grow. Rural capital is a significant untapped resource for economic growth. The dynamics of rural financial markets are such that more savers are served than borrowers because institutions collect *many* individual deposits that are smaller, on average, then the *few* larger loans they provide. Without the distorting effects of low deposit rates, rural financial intermediaries can bring together relatively small deposit amounts from many savers so that relatively large projects involving economies of scale can be undertaken. The important implications of savings mobilization for reducing transaction costs should not be underestimated. The larger the savings volume, the greater the economies of scale and of scope for all

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[5]Claudio Gonzalez-Vega, "Cheap Agricultural Credit: Redistribution in Reverse," in Adams, *Undermining Rural Development,* pp. 78-96.

[6]F.J.A. Bouman, "Informal Savings and Credit Arrangements in Developing Countries: Observations from Sri Lanka," in Adams, *Undermining Rural Development*, pp. 232-235.

transactions, including borrowing. As Larson and Vogel have pointed out, policies which focus on improving services for *rural savers*, not for borrowers, are thus important for rural promotion.

Savings mobilization is also a method for efficiently allocating resources. Effective savings mobilization can redeploy the stock of assets of the rural population in more productive ways as savers shift their deposits to institutions that provide higher interest returns. Savers benefit from increased returns. The effect of savings on depository intermediaries is also positive since those institutions that neglect the savings function fail to provide adequate services to their rural clients and make themselves less viable institutions. When institutions deal with clients only as borrowers, they forgo useful information about their clients' savings behavior which could refine estimations of creditworthiness and reduce the costs of collecting loans. Institutions that mobilize savings also are likely to maintain a continual flow of new resources for additional lending. Without those flows, an "all-or-nothing" environment persists, usually depending upon the cycle of government injections of capital, increasing costs and the uncertainty of loanable funds in the process.

Saving mobilization also requires intermediaries to be disciplined. Funds received on deposit must receive a market-based return if capital is to be mobilized. Government subsidized loans deprive financial institutions of incentives for competitiveness and for loan recuperation. Soon, both borrower and lender view loans as "giveaways". The irony is that the value of resources that could be mobilized potentially through savings mobilization and loan recovery is far greater than the most optimistic estimates of the amounts of subsidized loans and grants available from governments in many developing countries.[7]

> *Emphasis on savings mobilization is also incompatible with programs of low interest rate lending because financial institutions cannot be expected to mobilize savings and on-lend them at interest rates that cover neither interest payments to depositors nor administrative costs. It has sometimes been alleged that government officials use subsidized lending as a means to distribute patronage.*[8]

Policies which allow the rural institutions to receive deposits, pay market interest rates and charge appropriate market-based fees would begin to address the constraints to the formal mobilization of savings in rural areas for the benefit of rural depositors and the institutions alike.

SAVINGS AND THE INFORMAL SECTOR

The formal sector has been ineffective at meeting the financing needs for rural development for a variety of reasons, but largely because of the disincentives structured into government policies which discourage deposit mobilization and rural lending and cap interest rates charged to borrowers. Yet the level of financial activities observed in rural areas is significant and depends upon *informal* savings networks. The propensity of the rural poor to

[7]See Dale W Adams, "Mobilizing Household Savings Through Rural Financial Markets," *Economic Development and Cultural Change*, 26 (1978), pp. 547-560.

[8]Jerry R. Ladman and Ronald L. Tinnermeier, " The Political Economy of Agricultural Credit: The Case of Bolivia," *American Journal of Agricultural Economics*, 63, (1981), pp. 66-72.

save is great in a larger number of developing countries and under a wide range of circumstances. The amounts, in the aggregate, are significant. Savers who want to shelter funds need to find a safe depository and they do this in the informal sector through either group or individual arrangements. Savers place a premium on the quick access, flexible terms and multiple services provided by informal mechanisms. [9]

People save for a variety of reasons. Because agriculture is a seasonal and risky business and constitutes the majority of productive rural activity, rural households generally have irregular income flows. A main concern of households is balancing the flows of receipts and expenditures. Savings and borrowing are tools in this balancing process. The majority of this saving is done informally; that is, without the benefits of formal institutions. For example, in the Philippines and Sri Lanka, nearly 80 per cent of the consumer finance is estimated to have been through informal sector mechanisms. The chief mechanisms have been group savings (saving with others for a mutually beneficial goal, i.e., group discount on purchases), debt claims (deferring income until some future date), investments in tangible assets (gold and silver are popular in many regions) and cash.

Informal financial networks function effectively. They are, however, limited in scope and economies of scale which reduces their efficiency. Their ability to intermediate between the *demand* for resources and the *supply* of capital to achieve economies of scale is constrained by the very informality which makes the system effective at small levels. Consequently, returns to savers are small or negative in real terms. To inject appropriate economies of scale and broaden the provision of financial services, policy-makers need to remove the obstacles to capital accumulation which include fixed deposit rate ceilings and restrictions on authorities in private institutions to mobilize deposits. By so doing, the incentives of private financial intermediaries to access undermobilized and underutilized rural savings would be strengthened, political patronage for loan disbursements would be reduced, rent-seeking behavior would recede, higher returns for savers would be realized and more efficient rural capital transactions would ensue.

SECURITIES MARKETS

As a natural counterpart to deposit mobilization, securities and commodities exchange markets can also efficiently transfer resources among sectors. Securities markets, however, have been largely absent in developing countries because of the small market size and the lack of transparency in financial transactions as a result of inadequate information flows. Regulatory frameworks have also been insufficient or nonexistent in limiting moral hazard and conflicts of interest which can easily arise in securities markets intermediation. Nonetheless, securities markets are a natural corollary to increasing savings and can thus play an important role in asset reallocation between rural and urban areas. For example, futures and options markets are useful for ameliorating some of the risks involved in the agricultural production cycle, by setting future prices and selling commodities in advance of production.

Securities markets also provide access to broader capital markets by rural savings institutions and usually result in higher returns to rural savers than time deposits placed in savings and loans institutions. Borrowers too, can benefit as transfers from urban to rural areas

[9] F.J.A. Bouman, "Informal Savings and Credit Arrangements in Developing Countries: Observations from Sri Lanka," in Adams, *Undermining Rural Development*, pp. 232-247.

become more efficient, and as capital markets raise large sums of financing for large rural infrastructure projects which exceed the capacity of local rural intermediaries. Securities markets also play an important role in distributing equity opportunities to wider groups of individuals, thereby broadening economic participation to share in the benefits of growth.

Policy-makers should support the development of securities and commodities markets as a means of deepening and widening financial services. As mobilization of deposit resources increases, creating mechanisms for channeling those assets to projects with high real returns is the next step to efficient allocation between the rural and urban sectors. Government policies should encourage market development by establishing or reinforcing the legal and regulatory environment which increases the level and type of information available to investors, by raising the degree of transparency for transactions, and by appointing supervisory agencies with appropriate punitive authority.

CREDIT ALLOCATION

The failure of financial activities to evolve *sufficiently* and *efficiently* in rural areas relates directly to misguided allocative credit policies. As discussed above, rural financial markets in developing countries have two main features. The first is the limited *access* to institutional credit because of the nature (usually borrower-, not saver-, oriented) and structure (usually government-owned) of the institutions. The second is the high credit *portfolio concentration* among a few borrowers. Government credit subsidies through low-interest loans seriously distort market demand and supply signals, retarding rural growth instead of increasing it. The impact is often the opposite of governments' *stated* intent. Gonzalez-Vega calls it "redistribution in reverse".

The low average returns usually associated with agricultural activities and the high risks incorporated in them naturally restrict the credit supply to rural areas. Loan access for potential rural borrowers is further reduced by the high transaction costs for both borrowers and lenders.

> *The most crucial aspect of financial markets...is their degree of access to credit. Ironically, the policies that have attempted to keep the price of credit artificially low have, at the same time, modified access in unwanted ways: The access of large and influential producers to the loan portfolios of FFIs [formal financial institutions] has been improved, while at the same time the access of the small producers has been limited or even eliminated.*[10] [Gonzalez-Vega, 1984, p. 131]

The high degree of portfolio concentration is a result of the restricted access to resources and is explained by underlying wealth and political power of the small number of loan recipients. The producers who own the largest amounts of wealth also enjoy the greatest number of subsidized loans. This differential in accessing credit is not only a consequence but also a *cause* of differences in wealth. Government policies which impose interest-rate ceilings on loans only aggravate the problems of access to credit and the consequences of unequal wealth distribution. Preferential interest rates favoring agriculture have contributed to the distortions causing negative and unpredictable real interest rates. As Gonzalez-Vega, Vogel, Adams and others have established empirically for some

[10]Claudio Gonzalez-Vega, "Cheap Agricultural Credit," p. 131.

areas, policies which eliminate credit subsidies, reduce allocative mandates and allow market signals to function are the cornerstone of remedial efforts to promote rural financial systems and economic growth.

A BRIEF LOOK AT THE CASES OF COSTA RICA AND INDONESIA

As demonstrated in the first part of this paper, financial sector reforms influence significantly the balance between urban and rural development and can be a positive force for promoting rural growth. Proposed reforms have included a set of market-oriented policies which lay the foundation for change, encourage rural intermediation by the private sector and focus on savings as well as lending services. Policies which encourage the adoption of the lessons learned from informal intermediation are also an important tactical element for changing formal approaches to rural intermediation. Pricing credit at its market value and maintaining positive real interest rates are further prerequisites for transforming patterns of financial transactions. Policies which encourage the privatization of government-owned financial intermediaries such as banks, cooperatives and credit unions also create an enabling environment for fostering more efficient rural transactions. Finally, constructing a market-oriented framework which promotes rural growth requires policies, laws and regulations which (1) encourage private participation in financial intermediation, (2) safeguard depositors' resources, (3) provide real and positive returns to depositors, (4) mobilize rural savings, and (5) decrease transaction costs by adopting non-formal lending methods and by reducing expenses associated with acquiring information about borrowers.

The value of market-based financial sector policies for promoting rural growth can be assessed best by examining the experiences of countries undertaking financial reforms. Selected experiences in two countries can help to demonstrate the impacts of adopting market-oriented financial sector policies and the implication for redefining the balance between rural and urban development.

The experience of Costa Rica from 1981 to 1991 offers some revealing insights into financial sector reform and constitutes a significant portion of the experiences reviewed. Indonesia, too, has experienced important effects from its financial sector reforms during the same period. While the countries are distinctly different when compared by regional location, land mass, social and cultural behaviors such as religion, population size and densities, and real per capita incomes, they shared the common problem of economically distorted financial systems which hindered efficient rural development. Likewise, both countries have undertaken various market-based financial reforms ranging from new banking laws to the removal of credit restrictions which reduce or eliminate the negative economic impacts of the previous policies.

THE ROLE OF CENTRAL BANKING: MONETARY POLICY, REGULATION AND IMPLEMENTATION

As discussed earlier, market-oriented financial reforms for adjusting rural and urban balances begin with the laws, policies and regulations governing the Central Bank and the instruments at its disposal in managing monetary policy. As the country's principal financial institution, The Central Bank of Costa Rica (BCCR) is charged with the responsibility for implementing macroeconomic policies by exercising monetary instruments to temper inflation and maintain a favorable balance of payments position. Its actions also influence significantly the level and direction of interest rates which, in turn, impact the availability and accessibility to resources. For more than thirty years, the BCCR fixed the interest rates on both deposits and loans in accordance with the provisions and powers contained in several articles of its basic law.

These interest rates were applied to all financial intermediaries, government and private, and to quasi-formal finance companies or *financieras.* Intermediaries in Costa Rica's financial structure were simply obligated to accept the interest price without any opportunity for creating competition for deposit or loan resources. The competition that existed was confined to differences in services for clients rather than in market prices for deposits or loans.

Administratively determined interest rates also led to inflexibility in adjusting rates according to inflation and often resulted in negative real interest rates. The effect of negative, real rates caused undervalued resources which (1) increased consumption, (2) discouraged savings, (3) intensified capital flight (as a result of exchange rate instability), (4) promoted inappropriate capital-intensive instead of labor-intensive production, and (5) fostered income redistribution in reverse as predominantly rural, small-scale savers and borrowers suffered disproportionally from a reduction in financial intermediation services.

The importance of maintaining real interest rates was a key factor in the Government of Costa Rica's (GOCR's) attempts to reform the system in 1978. Yet the external shock of the early 1980s and the ensuing financial sector crisis curtailed reform attempts and led instead to policies which increased distorting behaviors. By 1984, however, the BCCR began to rely on the more traditional methods of influencing interest rates by concentrating on debt instruments to manage monetary flows rather than administrative edicts. The first important interest rate reform measure of 1984 allowed commercial banks to vary both deposit and lending interest rates within a range of 3 percentage points in either direction, thereby allowing a competitive range of 6 percent. By 1986, complete liberalization of deposit rates was adopted and created a broader range for the lending rate (pegged to the six-month Certificate of Deposit rate with the ability to charge loan rates up to 10 percentage points higher). In October 1989, the BCCR approved a complete interest rate liberalization so that rates were competitively set by the country's financial intermediaries without direct BCCR intervention.

Notwithstanding the changes made during the last decade, the BCCR still retains considerable authority to administratively control interest rates.[11] The temptation to fall back on old and distorting policies may prove unavoidable during times of political pressure despite the negative long term economic consequences of acquiescence. As in other country cases, Costa Rica's maintenance of market-based policies for setting interest rates and credit allocation may be difficult when faced with severe economic disruptions. These policy reforms were, perhaps, the most significant influence in transferring an import substitution industrialization economy to one led by export growth. In large measure, the opportunity to expand export growth can be attributed with promoting Costa Rica's structural transformation and spurring its rural development in the 1980s and into the 1990s.

THE PRIVATE BANKS

Between 1984 and 1992, as liberalized policy reforms forced market-based resource pricing, competition among banks for resources and clients led to an increase of services offered in the country. In attempting to increase market share, previously limited services were expanded and extended to previously unserved rural areas. In 1992, a ruling by the *Sala*

[11]In February, 1994, legislation was proposed by Costa Rica's Special Congressional Committee on Banking Reforms to eliminate the Central Bank's authority to set interest rates.

Cuarta, Costa Rica's Constitutional Court, opened the way for the country's private financial intermediaries to accept demand (overnight) deposits, placing them in full competition with Costa Rica's four state-owned banks. The efficiency of the private sector institutions can be easily shown by their rapid and profitable expansion between 1982 and 1991.[12] In 1982, there were ten private banks with assets of 1,651 million colones, or US $36.7 million. By 1992, the number of private bank intermediaries (as opposed to *financieras*) had grown to eighteen with assets in excess of 43,175 million colones, or US $ 314.4 million. More revealing to assessing efficient behavior, perhaps, was the share of total loans extended by the private banks compared to the state-owned banks. In 1982, private banks provided 2.3 percent of all the country's loans and held 2.8 percent of the country's total banking assets. By 1991, private banks were providing *24.6 percent of all loans with only 10 percent of the total banking assets*.

The efficiency of the private banking structure has had a significant impact on Costa Rica's economic growth in general and on rural development in particular. As the country struggled with economic stabilization and recovery from the external shocks of the early 1980s, it began to diversify its agricultural base to reduce dependency on coffee and banana exports in an effort to compete in world markets. The share of loans from private banks to agriculture increased significantly between 1986 and 1992. In 1986, private bank loans to agriculture were 1.09 percent of the *total loans* outstanding in Costa Rica. By 1992, private banks' share reached 3.76 percent of an asset base that had grown 17.9 percent. In other words, the private banks were fueling agricultural growth at *nearly four times the percentage rate of six years earlier* on an increasing asset base.

Another indicator of efficient behavior suggests that the private banks were replacing government agricultural credit. Of the *total amount of agricultural loans* in Costa Rica (government and private), private banks' lending share went from 5.9 percent of agricultural loans in 1986 to 20.89 percent in 1992. Conversely, the state-owned bank's share decreased from 90.99 percent to 76.33 percent during the same period. Nonetheless, preferential interest rates for very small farmers remained as part of the BCCR's traditional program of assistance to the agricultural sector. Since 1985, however, these subsidized credit programs have been substantially reduced in their proportion of total banking system credit.]

Concentration of credit among groups is a problem cited frequently by opponents of financial sector privatization. Linkages among lenders and borrowers do represent potential hazards and have been a source of inefficient allocation in many cases. Recognizing this dilemma, the GOCR adopted the 1988 Banking Reform Act (Number 7170) which included a provision to allow the Central Bank to regulate credit concentration and lending to related groups. (The regulations provide authority to the BCCR to define the relationships that can be considered for credit concentration, such as common shareholders with not less than 25 percent of the capital for two or more companies or the same connection between a company and a bank. Borrowing limits in such cases apply as

[12]The relative efficiency of the private and state-owned banks has been measured by Edna Camacho, "Relative Efficiency in Banking: State-Owned and Private Banks in Costa Rica, 1987-1991." Several studies on this topic appear in Claudio-Gonzalez Vega and Edna Camacho-Mejia, eds., *Regulacion, Competencia y Eficiencia en la Banca Costarricense,* San Jose: The Ohio State University and Academia de Centroamerica, 1994.

if both groups were a single borrower.)

REACHING INFORMAL RURAL MARKETS

While financial liberalization has had a dramatic and positive impact on rural growth, Costa Rica's experiences in adapting informal market strategies for promoting rural development have been less successful than in other countries (such as Indonesia). The reasons for failure in this area can be attributed to mismanagement of the organizations established to serve the informal sector, especially in rural areas. A natural presumption is that the small size of the country and the relatively easy access between urban and rural areas would facilitate and simplify the task of providing services to rural informal sector borrowers. This was not the case in Costa Rica where the relatively close proximity of rural and urban populations centers discouraged financial intermediaries from establishing local branches. Experience with organizations in Costa Rica, however, differ sharply from Indonesia where the *Bandan Kredit Desa* of East Java (BKD) and the *Badan Kredit Kecamatan* (BKK) of Central Java successfully provided lending services to the poorest rural inhabitants in remote areas of the country.

COSTA RICA'S FINCA

La Fundacion Integral Campesina (FINCA-Costa Rica), was established in February 1984 with the purpose of providing financial services to poor rural communities through groups called *bancomunales*. By September 1991, FINCA had established 153 *bancomunales* serving 2,900 members in Costa Rica's rural communities. Between 1985 and 1991, FINCA's assets grew in real terms over ten-fold, from 3.6 million colones to 36.1 million colones. Its capital grew from 3.6 million colones to 18.2 million colones. The principal reason for its rapid asset growth was donations or soft loans from international agencies (A.I.D., I.D.B., etc.) and the government. Its sustainability, however, became questionable as its losses from operations grew from -1.3 million colones in 1985 to over -7.5 million colones (real terms) in 1990. One of the most important reasons for this shortfall was FINCA's interest rate subsidy to *bancomunales*, restricting its earnings to below the transaction costs of providing intermediation services. FINCA had experienced rapid growth in the volume of its lending at the same time it was coping with operational losses. In effect, FINCA was decapitalizing itself.

The biggest threat to FINCA's survival was the lack of an effective organizational strategy and philosophy to meet the expectations of the *bancomunales*. The psychology of the relationship between the lender, FINCA, and its *bancomunales* borrowers was based on the latter group's expectation of future funding from FINCA. As funds grew scarce because of FINCA's lack of solvency caused by its interest rate subsidization policies, *bancomunales* felt less obligated to make repayments, thus aggravating FINCA's financial problems and increasing loan defaults. FINCA's failure to be self-sustaining resulted from lack of understanding of its clients, a "social" rather than financial philosophy, and a policy which encouraged subsidization and loan default. [13]

INDONESIA'S BKK AND BKD

The Indonesian experience is nearly the

[13] Recent policy and institutional changes at FINCA are leading to improved performance. See Claudio Gonzalez-Vega, et. al., "Financiamiento de la Microempresa Rural: FINCA-Costa Rica," San Jose: Ohio State University and Academia de Centroamerica, 1993.

opposite of Costa Rica's FINCA. Rural financial intermediaries in Indonesia represent viable competition for the moneylender but maintain rates which provide adequate income sufficient to cover intermediation costs and losses from bad debts. Despite the high rates of interest charged, loans from BKK and BKD are typically cheaper than the informal moneylender source. At the same time, those two organizations offer more viable competition to the formal and less flexible *Unit Desa* system of the *Bank Rakyat Indonesia*. The BKK and BKD have comparative advantages in reducing transaction costs that arose from the possession of inside information about the creditworthiness of potential borrowers at the *desa* level and their use of traditional mechanisms to induce loan payments. Their main institutional constraint is a legal prohibition on mobilizing local deposits which causes undercapitalization in some branches. [14]

Unlike FINCA, borrowers from the BKK and BKD systems kept on good terms with the institutions since there was an excess demand for credit and market-based rationing was signaling allocation decisions. Many borrowers would pay the last two installments at once to be eligible immediately for a new loan. Unlike FINCA, which received mostly grants or highly subsidized loans, the BKK was capitalized with a market-rate loan for one million rupiah from the provincial government to be repaid over three years. An interest rate of one percent per month was applied and no grace period on the amortization of principal. The stringent terms under which they received capital required equally demanding loans terms to their clients to allow for loan recovery. Loan collections from the BKK to repay its loan to the provincial government were given to a formal bank which maintained stringent collection terms and conditions to assure recuperation from the BKK.

The BKK and BKD's success resided in their willingness to set interest rates high enough to cover administrative costs and bad debts. Another important factor was the system's ability to reduce high transaction costs for borrowers and lenders that resulted from simple loan procedures which did not emulate expensive formal banking structures. When rural credit programs became contaminated by a welfare orientation to subsidize interest rates, as with FINCA, little interest in loan repayment was exhibited and the ability to collect loans was diminished. Charging sufficiently high interest rates prevented Indonesia's rural intermediaries from experiencing FINCA's fate of operational shortfalls and high delinquency rates. It also conveyed an image of permanency to customers which promoted loan repayments. Competition among Indonesia's rural lenders also helped to reduce transaction costs and increased the value of the client relationship by further discouraging loan defaults.

CONCLUSIONS

Financial services, especially the opportunity to save in financial instruments, invest and access credit are the cornerstone to rural growth. Agriculture and non-farm activity alike benefit from the services offered by rural financial intermediaries, but government policies have long been ineffective in providing an enabling environment in which market signals determine the price for scarce financial resources. Policies which focus exclusively on borrowers instead of savers tend to undercut market prices and obligate funds to be lent to inefficient projects. Such policies also increase transaction costs and drive out formal private intermediaries.

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[14]For further discussion of the Indonesian example, see Rodrigo A. Chaves and Claudio Gonzalez-Vega, "The Design of Successful Rural Financial Intermediaries: Evidence from Indonesia," forthcoming in *World Development*.

Institutional "ignorance" has also slowed rural growth as formal financial intermediaries are slow to grasp the lessons learned from effective, although limited, informal markets. Changes to operational procedures are required to account for distinctly different rural clients and their savings and borrowing needs. The motivation of the private sector to incur substantial costs in changing patterns of lending is discouraged by government policies which, largely for political patronage, create further distortions to efficient intermediation and discourage, in turn, greater private intermediation. Negative preconceptions about rural borrowers, difficult access to information and rigid concepts of creditworthiness also limit changes to lending patterns.

Rural growth promotion must first begin by dismantling existing systems and policies which inhibit formal financial intermediation, discourage new entrants and distort market signals. Governments should begin by striving for sound monetary and fiscal policies which limit inflation, stabilize interest rates and inject some predictability into the financial system. Positive and real interest rates should be maintained and government agricultural credit subsidies should be reduced. Directed credit and portfolio floors should be eliminated. The Central Bank has a powerful role to play as a stabilizer of interest rates and inflation which can severely harm rural development and serve as a disincentive to the expansion of private intermediaries.

Policies should also promote liberalization of domestic financial systems, encourage privatization and reduce market barriers to entrance such as information and infrastructure. Learning from the effectiveness of informal markets should be incorporated into the policy process. Eliminating laws and regulations which impede the private formation of cooperatives and private savings and loans institutions can help to meet financial services demand.

Incentives to increase rural depositors' access to services should be developed. Savings deposited in institutions must be safe, liquid and have the opportunity to provide positive and real returns. Creating commodities exchange markets help rural producers mitigate risks by "locking-in" commodity prices in advance of production and provide high return investment opportunities for deposits. Finally, governments should adopt appropriate systems of prudential supervision, regulation and levels of capitalization for financial organizations which carefully address the differences between public and private intermediation, cooperatives and quasi-formal intermediaries (such as *financieras* in Latin America).

The cases discussed above are limited but relevant snapshots of financial system reforms that have overcome some of the more difficult constraints to rural promotion. The contextual environments in which the reforms were undertaken are distinct, yet generalizations are likely to be of some use to other countries undergoing shifts to export-oriented, market-driven economies. The lessons learned from Costa Rica's structural adjustment are significant and useful. The Costa Rican experience shows that macroeconomic reforms (i.e., devaluation, fiscal restraints and exchange liberalization etc.) can set the basis for economic reform which affects rural productivity at least to the same degree, and perhaps more than, urban production. A slow but deliberate move to financial sector reform by privatizing financial structures, legislating the prudential supervision of intermediaries, and liberalizing credit and interest rate systems can stimulate production and provide appropriate incentives for rural growth. In Costa Rica, for example, nontraditional agricultural exports grew from US $443 million in 1987 to over US $906 million by September 1992, an increase of over 51 percent. Interest rate liberalization, privatization of the banking system and rural financial mobilization were clearly underlying factors in the ability of Costa Rica's rural communities to diversify their agricultural base and to respond to opportunities offered in world markets. The financial "oil" to lubricate rural growth had been put into place by market-based incentives which efficiently rewarded productive endeavors and penalized less productive ones.

Informal credit markets also played an important role in facilitating growth as both the Costa Rican and Indonesian cases shows. The difference between Costa Rica's failures and Indonesia's successes lay not in the relative economic significance or need for rural credit systems. Both countries needed financial sector widening and deepening. Rather, the differences were found in the approach to adopting policies to reduce transaction costs, provide broad services and promote self-sufficiency. While Costa Rica's FINCA succeeded in "moving the money" into rural sectors, the structure of institutional incentives was unsustainable and, in the end, created an organization of questionable self-sufficiency. Conversely, Indonesia's BDK and BKK structured their systems to accommodate rural credit needs efficiently while providing for sufficient returns to assure continued operations. They have successfully and sustainably provided intermediation services to rural borrowers.

Rural promotion requires proactive participation of governments dedicated to balancing their countries' growth. The laws, regulations and policies they adopt to impact that balance should be dynamic, meaning they must be subjected to changes as circumstance warrant. They must also be sequenced appropriately to avoid unnecessary economic hardships. Finally, successful policy adoption is contextual and requires an understanding and an accommodation of the unique political, social and economic circumstance faced by each country.

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