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RURAL FINANCIAL MARKETS

Guidelines for AID Projects

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S U M M A R Y

Credit to help increase agricultural production in developing countries has long been a high AID priority. Recent research has shown, however, that trying to channel low-interest-rate credit directly to small farmers does not help them. Instead, it undermines rural development in general and rural financial institutions in particular.

Accordingly, while the overall goals of increased production and a more equitable distribution of rural income have not changed, AID programs in this area are being broadened to include the strengthening of rural financial institutions (RFIs), the mobilizing of private rural savings, and the extension of credit to all qualified rural borrowers, utilizing market intrest rates as the mechanism for credit allocation.

After discussing in Part I the goals and purposes of the newer programs, this report focusses on the conclusions of recent research (Part II) and how they should be applied to AID projects (Part III). Helping RFIs to become financially viable was found to be the single most important ingredient of a successful rural financial market (RFM) project. Such viability is needed to provide rural borrowers reliable sources of credit, so they can purchase the additional inputs needed to increase agricultural and other production in rural areas over the long term. To achieve this viability, RFIs must mobilize private savings in rural areas, by offering savers attractive interest rates as well as safe and convenient depositories. And they must loan funds at interest rates sufficiently high to cover all their costs.

These practices, it was found, would enable RFIs to become and remain financially viable, not only because of the higher interest received but also because lending local funds to borrowers they know as savers leads to higher loan-repayment rates. The practices also lead to a more equitable distribution of income, since rural savers are both poorer and more numerous than rural borrowers. They benefit small borrowers who have profitable uses for the funds but can not compete with the richer and politically more powerful borrowers who in the past obtained the cheap credit. Finally, using interest rates as the mechanism for allocating credit, instead of trying to target credit to small farmers by fiat, benefits the economy as a whole through a more efficient use of resources, since producers borrow only when they have profitable uses for the funds and not simply because they have access to cheap credit.

The report also discusses: the role of RFMs in the rural economy and the need for simultaneous attention to improving both the overall economic climate and rural conditions generally; appropriate measures for evaluating the effects of RFM projects; and the need for credit components of non-RFM projects to follow the guidelines set forth for RFM projects.

Illustration of the newer and more comprehensive RFM projects is focused on two countries, Bangladesh and The Dominican Republic. After describing briefly the country setting and the AID approach, the report notes the results to date and the tasks remaining.

Finally, the report touches on several additional issues which were raised at various times by AID/W officers, including intersectoral fund flows, informal financial markets, and fulfilling the Congressional Mandate. Discussions of these topics in the text are brief; they are not, therefore, summarized again here.

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RURAL FINANCIAL MARKETS

Guidelines for AID Projects

I. BACKGROUND, GOALS, PURPOSES

AID's assistance to rural financial markets (RFMs) in developing countries is evolving from its traditional agricultural credit programs . The newer and more comprehensive programs--which are still few in number--place greater stress on:

(1) strengthening rural financial institutions, by research and technical assistance as well as by making their continued existence dependent on more efficient and profitable operations,

(2) mobilizing private rural savings to supplement and gradually replace inflows of donor or LDC government funds, and

(3) utilizing market interest rates to allocate credit among all qualified rural borrowers rather than trying to channel subsidized credit directly to small farmers.

Goals

The overall goals to which both prior and current AID programs are to contribute have not changed. They are still increased production of agricultural and nonagricultural goods and services in rural areas and a more equitable distribution of rural income.

What has changed, however, is an earlier belief that pushing low-cost credit to small farmers in particular could by itself stimulate agricultural production and promote rural equity. While agricultural credit is recognizably important because it gives command over additional inputs essential to investment and production, the availability of credit cannot by itself offset the inhibiting effects of low farmgate prices, of high-cost or undependable or inadequate inputs, of low yields, of inadequate rural infrastructure, or of a scarcity of profitable investment opportunities in rural compared with urban areas. Moreover, AID has increasingly recognized that the underpricing of credit itself has many unintended inhibiting effects on agricultural production (see below).

Purposes

These and other changed beliefs, resulting in large part from AID-financed research in developing countries, are leading to a new definition of AID purposes as well as to programs which emphasize research and technical assistance more than the channeling of AID funds and which are also more comprehensive in their approach to rural financial markets.

The newer programs no longer focus mainly or entirely on credit, which in the past was expected to come largely from low-cost donor funds and rediscount facilities at the country's central bank. Instead, they have as their central and most immediate purpose the encouraging and supporting of LDC efforts to make rural financial markets (RFMs) more efficient and effective and thus financially viable in the long run. Such long-run viability can be achieved only if rural financial institutions (RFIs) are successful in both mobilizing rural savings and lending them profitably to creditworthy borrowers. In turn, the mobilizing of private savings is dependent on efficient RFMs and profitable uses of the mobilized funds, which allow RFIs to pay positive real rates of interest to depositors. And borrowing is dependent in the long run on a larger and more dependable supply of domestic savings as well as on functioning RFMs and profitable investment opportunities. Thus, the three purposes/tasks of the new programs--long run financial viability of RFMs, mobilizing private funds in rural areas, and lending to creditworthy borrowers--are interdependent.

Financial viability for rural financial institutions and organizations has evolved as a central purpose of the new programs from the recognition that neither donor nor LDC government funds can be sufficiently large to satisfy the demand for rural credit on a continuing basis particularly if the demand for credit is artificially stimulated by the allure of cheap funds and the supply of credit is held down by inadequate efforts to mobilize domestic savings. This would be true at almost any time, but it is especially the case in view of budgetary restrictions in both LDCs and donor countries. Hence, AID stresses the need for RFIs to raise interest rates to levels which cover the full costs of their funds on loans made and also attract an increasing inflow of funds from private rural savers. Moreover, paying market interest rates for funds, rather than receiving them virtually free from outside sources, will act as a powerful stimulus to RFIs to reduce their costs and become more efficient.

RFI funds will also be better protected from the costs of loan-delinquency and default, since lending institutions are better able to judge the credit-worthiness of loan applicants when their savings program acquaints them with a broader spectrum of the rural community. Moreover, the knowledge that loans are based on private savings rather than on outside funds increases peer pressure for timely repayments.

Mobilizing rural savings by providing more attractive and convenient savings opportunities in rural areas has evolved, as a second major purpose of the new programs, from the recognition that the numbers of poor savers who will thereby benefit are potentially far larger than the numbers of poor farmers who will benefit from AID-financed loans. Providing safe, convenient, adequately-compensated depositories where the rural poor can save for emergencies as well as for investment and consumption purposes will thus contribute to a more equitable distribution of income. Equally important, it adds to the pool of savings available for continued investment in rural areas.

Lending to all creditworthy rural applicants has evolved as a third major purpose from the recognition that previous donor attempts to target lending to small farmers by fiat have been largely unsuccessful and usually counter-productive. The combination of limited funds and an excess demand for credit at arbitrarily low interest rates has inevitably led to arbitrary, non-market credit rationing by lending institutions, with loans going mostly to the rich and powerful rather than to the small farmers specified by many donors. Lending to large borrowers with collateral is less risky (except for "politically-based" defaults), large loans are less costly to administer, and return favors are sometimes available.

From a national economic point of view, the resultant allocation of resources has been inefficient, since many low rate-of-return investments are undertaken that would not have been financed at market rates of interest, while potentially higher-return investments are not undertaken because credit was not available to non-favored borrowers. Moreover, allowing nonagricultural rural enterprises to compete for credit recognizes that they are often major sources of income to the rural poor. Also their more varied schedules of credit needs and repayment capabilities help to even out the income and work flows of lending institutions, and RFIs further benefit from the additional spreading of risks.

II. RESEARCH CONCLUSIONS

Several conclusions, important for AID program purposes, have emerged from the AID-financed research on RFMs conducted by the Ohio State University and other institutions. Some of these conclusions, such as the need for RFIs to charge interest which covers the full cost of money lent, are already well known to most AID officers. However, some officers may not yet be fully aware of the extent to which cheap credit undermines rural development nor of the need to charge market-rate interest for credit extended as a component of other projects.* And they may be even less aware of other conclusions, such as the importance of assistance to RFIs so they can reduce transaction costs and mobilize private funds efficiently and thus become self-sustaining in the long run without infusions of donor or LDC government funds. Accordingly, these and other conclusions of the RFM research are summarized below.

1. Financially Viable RFMs a Primary Goal

Rapid and sustainable rural development requires a system of financially viable RFMs to facilitate the exchange of claims on resources between rural savers and investors. This "intermediation" function of RFMs enables those with high rate-of-return investment opportunities to use resources that otherwise would be saved in such less productive forms as precious metals, stocks of farm output, small livestock, or banknotes. Resources are thus allocated and used more efficiently, so that all parties benefit: savers, from the interest plus greater liquidity for later consumption or investment; borrowers, from the opportunity to make profitable investments; the financial intermediary, from additional profits and jobs created; and the national economy, from the greater production and employment.

For long-run RFM viability, research and technical assistance to strengthen RFIs and make them more efficient and profitable are essential. Otherwise, as noted below, the funds provided from outside sources are often used for purposes and in ways other than those intended or anticipated by donors and

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*The term "market rate" is used throughout this paper, even though its common meaning--a rate that will bring supply and demand for credit into balance--is not accurate in developing countries where governments control financial and other markets to varying extents. The initial setting of nominal interest rates in those instances should try to ensure positive real rates of interest to savers while basing initial charges to borrowers on such factors as estimated total costs of money including inflation, rates of return on rural investment, urban interest rates, and costs of money in the informal credit market. With sufficient flexibility, the market can then be relied on to adjust interest rates, in time, so as to allocate resources more efficiently and equitably.

are quickly eroded. Many of the RFIs established or "strengthened" under foreign-aid programs then become virtually defunct and unable to carry out their financial functions.

The major reasons for the virtual demise of some RFIs are clear. Relying on an inflow of cheap (i.e., underpriced) funds from donors or their own central bank, many RFIs failed to act aggressively to protect and increase the real value of their capital. Most importantly, they failed to mobilize private savings in rural areas; to lend at rates which would cover the full costs of funds (including allowances for loan arrears and inflation); to reduce transaction and other costs; and to train their staff to engage in full-service operations for both borrowers and savers. As a consequence of these failures as well as the donor/LDC budget restrictions which led to a virtual drying-up of donor and LDC central bank inflows, many RFIs have found themselves with virtually no funds to lend.

Accordingly, the newer RFM programs emphasize as a central and immediate purpose the establishment/strengthening of RFIs--including the mobilization of rural savings and the profitable lending of these funds to creditworthy borrowers--and they downplay the channeling of aid funds to agriculture as an aim in itself, even though the infusion of such funds sometimes leads to short-term increases in agricultural or rural production.

Full realization of this purpose will be both difficult and time-consuming, and it will require both additional research and long-term technical assistance. RFI staff must be trained to handle new functions; ways must be found to increase the volume of funds mobilized concurrently with lowering the transaction and other costs on both savings mobilized and loans made; interest rates charged to borrowers must be raised to cover the full costs of funds including a profit margin; and some modern equipment must be introduced. The choice of RFI organizational form to establish or strengthen--for example, cooperatives, private rural banks, a government-owned agricultural bank, or a combination of them--depends largely on the economic and financial circumstances in the LDC as well as on the predilections of donors and the host country. Public institutions, for example, have often been inefficient and inflexible, while private banks often have no rural branches.

2. Mobilizing Private Savings Essential for RFMs

The mobilizing of rural savings is important for many reasons, one of which--contributing to the long-run financial viability of RFIs--has already been noted. In fact, research has shown so many advantages from mobilizing private funds in rural areas that one might wonder why so little attention has been paid to this aspect of RFMs by earlier agricultural credit projects. The main answer seems to be the still widely held but now disproved belief that poor people in rural areas do not have sufficient income to be able to save and that therefore there are no savings for RFIs to mobilize. The poor do save, of course, or they could not continue to subsist from one harvest or emergency to the next. Often the savings are in the form of low-yielding investments such as small livestock; or they are in stocks of farm output or consumer goods or banknotes or precious metals if attractive investment opportunities are not available for their (usually) limited funds.

The advantages to the economy of having safe, convenient depositories where savers can earn more from their savings than in the past and still have access to their funds when needed may be summarized as follows:

a. Additional funds are available to RFIs, which reduces their dependency on outside funds to lend for investment and other purposes and helps to even out the feast-or-famine inflows of foreign-donor or LDC-government funds.

b. Resources are used more efficiently, since savers almost by definition do not have investments available which will yield higher rates of return than the interest paid them, while some potential borrowers have investment opportunities which they feel will be profitable even at the higher interest rates they pay for the credit. This is of course true only if credit is <u>not</u> subsidized. Subsidized credit has flowed invariably, according to OSU research,* to a small proportion of the richer and more powerful farmers who do not necessarily have high-return agricultural uses for it.

c. <u>Loan defaults and arrears are lower</u>, since peer pressure to repay locally-mobilized funds is very high. In The Dominican Republic, for example, loan delinquencies in three of the four credit unions involved in the AID pilot project declined from a range of 45 to 71% of their portfolio to a range of 7 to 15%.

d. <u>Income distribution is more equitable</u>. Rural savers are many times more numerous than borrowers in poor countries. Offering them attractive interest rates in safe, convenient depositories thus increases the income of a far larger number of persons than the granting of credit. This has been particularly true with subsidized credit, as noted above, where loans have gone mainly to a few richer borrowers.

e. <u>RFI-client relationships are mutually beneficial</u>. RFIs that become better acquainted with customers through savings relationships have a better basis for establishing quickly, cheaply, and accurately the creditworthiness of borrowers (i.e., borrower integrity and debt-repayment capacity). At the same time, savers become more familiar with a formal credit institution and can

*Claudio Gonzales-Vega states (Reference No. 4, p. 13) that "only about 2% of the agricultural producers of Latin America and the Caribbean have been the beneficiaries of at least 80% of the substantial volume of credit granted and of a similar proportion of the large implied subsidy as a consequence of the underpricing of loans." Joseph Lieberson notes similarly (in Reference No. 7, p. 18) that "World Bank estimates for Pakistan, the Philippines, Thailand, Tunisia and Bolivia show that 5-10% of the farmers receive 70-80% of institutional credit."

establish a basis for future borrowing. Moreover, such relationships, with their prospect of continuing and perhaps larger loans in the future, add a significant incentive for borrowers to repay current loans.

f. Rural liquidity is enhanced. The rural poor are able to save easily and profitably, even in small amounts, and yet have ready access to their funds for emergencies and investment opportunities--a clear advantage over savings formerly held in such forms as small livestock, precious metals, or banknotes. And the greater access of rural borrowers to credit for emergencies enables them to risk investing more of their own savings as well.

3. Cheap Credit Undermines Rural Development.

Most AID officers involved with RFMs seem now to accept the conclusions of OSU and other research, that cheap credit undermines rural development.* They seem to agree that if profitable investments are available, farmers and other rural borrowers can afford to pay the market rate of interest, and if they are not available, then improved economic policies or technology or rural infrastructure are required, not cheap credit. Moreover, even where subsidies of some kind could possibly be justified, perhaps for an experimental or demonstration project, providing technical assistance and temporarily-subsidized inputs rather than subsidized credit is a better approach--until the profitability of the activity is either clear or disproved.

Despite the gradual AID acceptance of the above principles, the damaging effects of subsidized credit are so great that they are worth summarizing here:

a. Cheap credit erodes the financial viability of lending institutions, and thus both the future flow of funds to farmers and rural enterprises and the provision of adequate services to rural savers, since the rates and fees charged borrowers are substantially less than the full costs of funds to the RFIs. These costs include: (1) costs of donor or central bank or locally-

*E.g., see References Nos. 2 and 3 listed in the final section of this report.

mobilized funds, with account taken of reserve requirements, (2) administrative costs, (3) delinquency or default costs, (4) a margin to offset expected inflation, and (5) a margin for profits and/or additions to reserves. Moreover, loan delinquency and default costs are substantially higher than otherwise, since the borrower and lender both perceive the donor funds supporting cheap credit as "outside capital" rather than the savings of their friends and neighbors. And administrative costs are also higher, because RFIs feel no economic pressure to reduce transaction and other administrative costs and also because they are obliged to fulfill donor analysis, monitoring, and reporting requirements.

b. <u>Cheap credit encourages LDC governments and RFIs to rely on the continued inflow of donor funds</u> and thus defer remedial measures. For the LDC, these remedial measures are primarily improved overall economic/financial and agricultural policies. For RFIs, these measures include (1) setting interest rates sufficiently high to cover the full costs of funds, (2) mobilizing the private savings needed to ensure a stable and continuing inflow of funds, (3) reducing administrative costs and increasing operating efficiency, and (4) lending funds only to creditworthy borrowers who intend to repay.

Continued reliance on cheap donor funds is of course unrealistic, since at best such aid is unstable and is characterized by alternate surges and scarcities of funds, which leads to RFM inefficiencies and RFI staffing problems. The reliance is even more unrealistic in view of the changing attitudes of donors toward cheap credit and the historical downtrends in the availability of such financing. Dependency relationships, however, are often difficult to break.

c. Cheap credit results in excess demand for credit and a consequent need for credit rationing.* Such non-price rationing by RFIs has a number of unfortunate results: (1) Loans go mainly to richer borrowers, who have collateral and political influence, since large loans are less costly to administer, are less risky (except for "politically-based" defaults), and often result in return favors to RFI officers; (2) the corruption of RFI and other LDC officials as well as of borrowers is thereby facilitated if not encouraged; and (3) the allocation of resources in the LDC is less efficient, since many low-return investments are undertaken that would not have been financed at market rates of interest, while potentially higher-return investments are not undertaken because credit was not available.

d. Finally, cheap credit usually involves an income transfer from savers, who are poor, to borrowers, who are less poor. Rural savers in LDCs are far more numerous than borrowers; and they are usually among the poorer elements in society. They are penalized by the absence of financial institutions in which to save or the low, usually even negative real rates of interest paid on their savings. Borrowers of cheap credit, as already noted, are far less numerous than savers, and they are usually better off financially.

4. Targeted Credit Does Not Work

AID-financed agricultural credit programs in the past attempted to target their loans at selected groups (small farmers in particular) or for selected purposes (e.g. to purchase irrigation pumps or other agricultural inputs), in order to increase agricultural output particularly by small farmers and thus improve income distribution in rural areas.

*The demand for credit also depends on non-interest costs (e.g., the time and money spent to obtain loans) as well as on borrower expectations regarding both inflation and their need to repay loans. The availability and profitability of investments is the other major determinant of credit demand.

Such targeting could not be carried out successfully, even where loan supervision was practiced. The reasons are simple: Credit, as is true for any funds, is fungible and can be used for any purpose--indirectly, if need be, since the availability of credit frees the borrower's own funds for other uses including consumption or investment in urban areas. And especially since rural clients are so widely dispersed, any attempts to channel the credit to particular groups could be circumvented easily (though at some cost) by extending multiple small loans, for example, or by fudging the books. As already noted, OSU research indicates that small farmers, a primary target group of past AID-financed loans, received a very small share of the low-interest-rate loans extended.

Equally important, the costs of these targeting attempts were high for virtually all groups involved, so that the efforts were in fact counterproductive:

a. Costs to RFIs. The costs to RFIs of administering targeted loans, for those programs analyzed by OSU staff, have been about double the administrative costs usually allowed by donors in setting up the credit programs, and many times larger than the estimated private-lender costs for the simpler task of establishing creditworthiness of borrowers. In addition, the limited RFI staff is forced to use their time in unproductive tasks such as loan-use monitoring and record keeping/reporting for donor purposes; and they are also more exposed to bribery by ineligible larger borrowers. Moreover, the RFI's ability to pay rural depositors a positive rate of interest is further eroded; and their staff time and energy for mounting a savings-mobilization drive is further limited.

b. Costs to borrowers. The costs even to successful applicants is often higher than otherwise. For those circumventing the restrictions (usually larger borrowers), bribery or juggling of books is often involved. For small farmers who legitimately receive some credit, the non-interest costs are often excessive: for example, forms which are difficult to fill out or understand, travel/lodging/meals costs re trips to distant RFIs, time away from productive work, long waiting periods to obtain the loan, loan deliveries which are not timely,and inflexible repayment schedules not suited to borrower needs. In addition, borrowers may be required to pay "non-interest" fees or keep some of the money on deposit at the RFI without interest. More important, the receipt of an occasional loan (even if the total costs of that loan were in fact low) does not fulfill the small farmer's need for reliable financial services over a long period. Moreover, the uncertain process may well reduce his readiness to seek formal loans.

c. <u>Costs to the rural economy.</u> Small rural enterprises are a major source of nonfarm jobs, particularly during off-peak seasons for farming. Inhibiting their profitability or their expansion potential by denying them credit (or adding the costs of subterfuge) thus inhibits job creation opportunities, reduces rural income, and denies RFIs the opportunity to diversify their loan portfolios by lending to nonfarm enterprises and thus spread the risks and even out their work and money flows.

5. <u>RFMs Necessary But Not Sufficient for Rapid Rural Development</u>

Financial markets are needed for two principal purposes in rural areas: (1) to provide safe, convenient, and profitable opportunities for small savers to accumulate funds which will be readily available to them for emergencies, major consumption or investment opportunities, and (2) to make these rural savings (and other funds) available especially to smaller rural borrowers who have investment uses for the funds which promise rates of return higher than those available to savers (the function of "intermediation" between savers and investors).

Larger borrowers and savers can often use urban financial facilities, but smaller savers must otherwise rely on banknotes or precious metals or such low-return investments as small livestock, while small borrowers must otherwise rely on informal money markets when investment opportunities arise.

Functioning RFMs, while necessary for rapid and sustained rural development, are not of course sufficient to insure development. Rural savers may use convenient, secure depositories which pay a positive real rate of interest. But if, for example, farmgate prices do not adequately cover input costs, or if farm inputs are not available in adequate quantities and quality at the right time, or if an appropriate yield-increasing technology and supporting services are not available, farmers will simply not borrow investible funds. In short, while credit can finance the purchase of inputs essential to increased farm production, farmers must also be convinced that they will be adequately rewarded for their extra work and risk before they will borrow funds for the investment--unless of course the credit involved is from outside sources and is considered more a gift than a loan.

Nonfarm rural borrowers must, similarly, have profitable investment opportunities--most often the providing of goods and services to agriculture or the processing/distributing of farm output. Their need for investment funds is thus indirectly dependent largely on a healthy agriculture, although it may also be influenced directly by national economic policies.

6. A New Basis Needed For Evaluating RFM Programs

Increased agricultural and rural production is and has been an overall goal of both the earlier agricultural-credit and more recent RFM projects. It is not surprising, therefore, that such projects were sometimes judged successful or unsuccessful on the bases of their estimated impact on agricultural output. The two major problems with this approach are those of attribution and fungibility: How much of the success/failure could be attributed to the agricultural credit or RFM projects, given the importance of such factors as price incentives, technology, and weather? And what proportion of the funds made available represented in fact additional funds for agricultural investment and production?

These questions are in practice virtually unanswerable. Moreover, even if the output increases could be attributed to credit infusions, the project could not be considered successful if it undermined the long-term viability of RFMs and/or the output increases could not be sustained. Accordingly, while taking account of production and other changes, the OSU research suggests the advisability of evaluating RFM projects on the basis of changes in, for example, (a) transaction costs, (b) loan-recovery rates, (c) savings mobilized, (d) the numbers of persons served, and (e) RFI assets and profits--which indicate changes in RFI viability and efficiency as well as in LDC economic and RFM policies.

7. Credit Components of Non-RFM Projects

Conclusions about agricultural (or nonagricultural) credit extended as a component of non-RFM projects are extrapolations of OSU and other research on major credit projects rather than the results of specific analyses. Although they might therefore be characterized as more theoretical than empirical, the conclusions nonetheless seem valid--that credit should be extended at market rates and that the viability of RFMs should be protected to the fullest extent possible.

If the credit component is at market rates and in moderate volume, it may well produce the desired benefits without significant harm to the viability of the RFI or savings mobilization efforts. If it is extended in large volume, however, it could serously undermine the RFI's resolve to mobilize private rural savings and also depress rates paid to savers. And if the credit is underpriced (i.e., extended at below-market rates), it will carry with it all the disadvantages associated with cheap credit which were enumerated earlier--the larger the volume of credit the more serious the disadvantages.

The question has been raised as to the merit of extending only market-rate credit under circumstances where all prices, including other credit, are distorted. While each situation deserves separate analysis, in general it can be said that, in addition to better serving of savers and avoiding the other disadvantages of cheap credit, market-rate credit is more likely to reach some of its intended beneficiaries than underpriced credit. Because low-cost credit generates excess demand for the funds, the credit is usually concentrated on larger borrowers who find it too good a bargain to pass up even when they have only low-return uses for it.

The difficulty of persuading LDCs of the benefits of market-rate credit is another argument raised, particularly when the volume of credit is small. Some effort should be made, however, perhaps by helping them with aid in related areas, since every concession to cheap, targeted credit may make it more difficult later to persuade LDC officials of the long-range economic and financial benefits of market pricing. If the persuasion is not successful, then some consideration should be given to eliminating the credit component. How much persuasion and how much consideration to dropping the credit component depends on factors outside the scope of this report.

III. GUIDELINES: POLICY AND PRACTICES

For well over ten years, since it issued "Guidelines on Project and Program Planning for Small Farmer Credit" in June 1974, AID policy has pointed out that credit is useful to small farmers only when profitable investment opportunities exist, opportunities that are often related to a new technology. Noting that the distribution of loans is often highly skewed against the small farmer and the landless poor, even when they are specifically targeted as beneficiaries, the Guidelines stated that charging higher interest rates would give small farmers with profitable investment opportunities greater access to loans. The possible need to link rural savings to credit programs was also noted, though not emphasized.*

In late 1982, an AID Policy Paper on "Pricing, Subsidies, and Related Policies in Food and Agriculture" stated that "the basic role of financial institutions is to lower the transaction costs of matching savings with investments ... [which] induces an increased flow of funds from savers to borrowers." And it followed this by stating that "AID's primary purpose in the area of credit and finance should be to create and to support a system of financial institutions that effectively mobilizes and allocates private indigenous financial resources."

In short, AID policy, at least at a macro level, is now in tune with the research conclusions enumerated above. What is less clear is that these broad policies have made their way into more specific AID directives and (a fortiori) that the policies have become internalized at Mission levels, so that they can be expressed in AID programs.

In particular, do Missions view RFM projects as an opportunity to strengthen a system whose financial viability, if it could be established and sustained, would contribute much more to increasing agricultural production in any given LDC in the long run than even several large infusions of credit? And are Missions willing to forego this opportunity to disburse, either for LDC balance-of-payments purposes or for internal AID reasons, a large volume of funds quickly? Also, are Missions aware of the time and effort required for research and technical assistance, the research to determine how best to help strengthen RFMs in LDCs with widely differing problems, the technical assistance to help

*The above discussion is based on a summary of the Guidelines, taken from Reference No. 7.

carry out the programs? And are those involved with providing credit as one aspect of a larger agricultural or nonagricultural project aware of the disadvantages of subsidizing credit? Moreover, even if Missions are aware of all the above points, are LDC governments and RFIs themselves fully aware of and in agreement with the newer thinking?

Trying to pin down answers to the above questions would probably be unrewarding if not futile. However, consideration of the questions suggests the advisability of (1) updating central AID/W guidance on RFM projects, so that it takes fuller account of recent research and also includes discussion of the problems inherent in extending particularly low-cost credit, whether rural or urban, as a component of other (i.e., non-RFM) projects, (2) elaborating the central guidance in AID Bureau guidance, making it more specific and taking fuller account of regional and country differences, (3) providing more training, particularly to Mission officers involved in designing and carrying out RFM projects but also to Mission leadership and interested AID/W officials, and (4) using RFM project discussions as a basis for initiating policy dialogues between LDCs and USAID Missions on both RFMs and the larger question of improving LDC policies generally so as to support more rapid economic development in both rural and urban areas.

The remainder of this report deals mainly with central policy guidelines (point 1 above), although it pays some attention to training (point 3), and it touches on regional and country differences (point 2) in the process of discussing the applications of policy in specific AID projects. Regarding the potential contribution of RFM discussions to both the initiation and substance of a more general policy dialogue (point 4 above), it should be noted that recent OSU research may help to clarify and make more specific the linkages between LDC overall economic policies, rural production, and the efficient functioning of RFMs. Given the current focus of many LDCs on making their agriculture more productive, the specific research on RFMs could strengthen the case for changes not only in RFM policies but also in overall LDC economic policies. RFM projects, however, are worthwhile even if they make only a minimum contribution to the policy dialogue, because of the long-term benefits viable RFMs bring to rural savers, rural borrowers, and the rural economy--provided that the projects are wisely designed and carried out.

The policy guidelines set forth below are intended to help AID fulfill that proviso. They say in essence that AID should design RFM projects in accordance with the lessons learned from OSU research and continue to support RFM projects only when they fulfill the conditions noted below.

1. <u>Long-term Financial Viability of RFMs</u>

The long-term financial viability of RFMs must be the immediate primary goal of an RFM project. This is true regardless of the organizational form of the RFM--whether it is a private or a cooperative or a government entity, whether it is newly established or new branches of an urban institution or an existing rural institution, whether it is a separate financial organization or a component of a multi-purpose organization, or whether it is some combination of the above. Without such viability, RFIs cannot fulfill on a sustained basis their major purpose of mobilizing and allocating private indigenous financial resources in rural areas efficiently and effectively.

To reach and sustain financial viability, the first requirement is that interest rates charged to borrowers cover the full cost of funds, including (1) the costs of funds borrowed or mobilized, (2) administrative costs, (3) default or delinquency costs, (4) a margin to offset expected inflation, and (5) a margin for profits and additions to reserves. Charging market rates of interest is important for several reasons: A lower rate and the consequent losses will undermine the financial viability of the lending organization, thus insuring that it can continue to function only if donor or LDC government funds are available. Also, a below-market rate increases the demand for credit and discourages private saving, setting up a need for non-price rationing of credit by the lending institution. Inevitably, as both field research and logic have demonstrated, the credit goes predominantly to the rich and politically powerful, especially since large-volume loans are less costly to administer, usually less risky (except for "politically-based" defaults), and may result in return favors to the lending official.

Second, interest paid to savers must be generally positive in real terms, and RFM polices and practices must be attractive to savers so that the lending institution is assured of a continuing and more stable inflow of private resources and is also better acquainted with potential borrowers through their role as savers.

Third, it is imperative that the transaction costs involved in both savings mobilization and lending be reduced, so as (in time) to reduce borrower costs and increase saver returns. Combining savings and lending activities of RFIs will by itself reduce some costs, including that of establishing creditworthiness, since RFIs will be better acquainted with borrowers through their role as savers and since both functions can be handled in the same branch, with some savings in office space and personnel. Lending to all creditworthy borrowers, in lieu of targeting loans at selected groups for selective purposes, will also reduce costs very substantially, both because of the portfolio diversification and consequent reduction of risk and because establishing creditworthiness is much less costly than administering detailed loan forms, employing specialists to evaluate borrower plans and help supervise the transfer of technology, and monitoring and reporting to donors on borrower performance.

Missions can help RFIs go beyond these sources of cost reductions, by financing research and technical assistance. The research might focus on the practical physical and financial packages needed to reduce costs and improve the quality of RFI services. Some package ingredients are almost always required, such as equipment and training to improve information processing on savers, borrowers, and loan applications/monitoring, so that (e.g.) creditworthiness and loan status can be determined quickly, accurately, and cheaply. And the training of RFI staff in banking and accounting techniques generally is also a standard requirement.

Some technical assistance could therefore be started concurrently with the research, so as to help RFIs speed up the process of cost reductions as well as managerial, organizational, and staff improvements. Assisting RFIs in a savings mobilization program could also start quickly, although some research on locating branches or acquiring mobile units as well as on saver attitudes and the incentives needed might well come first. Similarly, assistance on measures to provide incentives to both borrowers and RFI employees to reduce loan delinquencies (including heavier penalties on overdue loans) should not be delayed too long, since loan arrears and defaults are often a major part of RFI costs. Other technical assistance needs, however, might not become clear until after the first research results are in.

Finally, donors and LDC governments must reach an understanding that RFIs must become profitable and self-sustaining, perhaps after a relatively short transition period. This means (inter alia): no political forgiving of loan defaults; a restriction of central bank rediscount windows so that they serve as a back-up source of market-rate funds rather than a source of underpriced funds for routine lending; and the removal or amelioration of inappropriate regulations that restrict RFM competition or that raise RFI costs through the imposition of high reserve requirements or restrictions on RFI operations. Knowing that they must depend on their own resources and freeing them to do so will then serve as a powerful stimulus to cost-cutting innovations by the RFIs themselves.

2. Mobilizing Private Savings

Mobilizing private savings in rural areas is essential if RFMs are to become financially viable, since the mobilization effort provides an additional and more stable source of resources for RFIs to lend, lowers loan transaction costs because of the additional information on borrowers and the combining of functions in the same branch, and leads to lower loan delinquencies and defaults. From a national economic point of view, savings mobilization also makes income distribution more equitable, enhances rural liquidity, and leads to a more productive allocation of resources.

For a savings mobilization effort to be successful, interest rates paid to savers must be positive in real terms. Savings depositories must be safe, easy to reach, and convenient/attractive to do business with. In particular, services must be friendly and efficient, hours convenient, and paperwork and other requirements such as minimum balances and penalties for early withdrawal must not be onerous. Savers must also see the prospect of enhanced access to future loans. Finally, savings mobilization campaigns must be well publicized and include prizes or other incentives for savers as well as incentive payments for RFI employees. That such measures can attract a substantial volume of savings is clear from research by Gonzales in The Dominican Republic, Meyer in Bangladesh, and Vogel in Peru (see References Nos. 8 and 2 as well as Part IV of this report).

As noted in the preceding section on RFM viability, costs must also be reduced by a combination of training, incentives, and modern equipment. In addition, use of the central bank rediscount window must be restricted, so as to send an unambiguous message to RFIs that mobilizing private rural savings is essential to their survival as an institution.

3. Interest Rates at Market Levels

Interest rates charged to borrowers must cover the full costs of funds, as already noted, and depositors must be adequately compensated for their savings. Otherwise, the excess demand generated for credit leads to arbitrary credit rationing and a less efficient allocation of resources; the underpricing of credit depresses interest rates paid to savers as well as the volume of savings; income is transferred from savers (who are generally poor) to borrowers (who are generally richer), thus making income distribution less equitable; RFI operating costs are increased, and pressure is reduced for RFIs to institute cost-cutting efficiencies; and, finally, RFI funds for lending are eroded, thus further strengthening the dependency relationship between RFIs and foreign donors/LDC governments and further delaying the policy reforms needed.

These difficulties notwithstanding, the allure of underpriced credit is still strong among those who have not been fully exposed to the problems and/or continue to look upon donor funds as a virtually inexhaustible gift to be used. Thus, even where AID officers are convinced of the need for interest rates that are high enough to clear the market, so that small farmers and rural entrepreneurs with profitable investment opportunities will in fact have access to credit, USAID missions sometimes have difficulty in persuading LDC officials of the benefits of charging market interest rates on loans and paying positive real rates of interest on savings.

This report, backed up by the reference material and by LDC participants trained in this area, may help to convince LDC officials. But it may not be sufficient, especially if other donors offer cheap credit for agriculture and if foreign financing for the economy as a whole is readily available. In those instances, Missions may want to consider compromising--not the principle but only its timing. While gradual (but substantial) movement toward market interest rates, with full realization only during (say) the final year of the project would not be as beneficial to rural development as a speedier interest-rate reform, gradual progress might be politically easier and represent substantial improvement over no reform.

4. Targeted Lending

The notion of extending credit to selected groups or for selected purposes may seem attractive at first, especially where donors are concerned with improving equity or stimulating the use of new technology and inputs. Unfortunately, the disadvantages of such targeting attempts in practice, as already noted, have far outweighed the advantages (if any), even for the targeted groups. Accordingly, in its full-scale RFM projects, AID has already moved away from the targeting principle toward a policy of making loans available to all creditworthy rural borrowers. It is only in instances where credit is a component of more comprehensive agricultural projects that the transition is not yet complete.

Targeting, it should be noted, carries with it fewer disadvantages if the credit is offered at market rates of interest. Where interest rates are also subsidized, Missions should be aware of the penalties normally exacted from small farmers, whether or not they receive some of the funds (see Part II above). Subsidizing the costs of inputs is almost always a better alternative than underpricing the credit, although even that subsidy should be offered only in rare instances if at all.

5. RFMs Necessary But Not Sufficient

Rural financial markets may fulfill their primary function of making an increased flow of private rural savings available to rural borrowers. But if the overall economic climate and rural conditions are not reasonably favorable, then profitable investment opportunities may be lacking. In that event, the funds may remain largely unused or be diverted outside the area, rural development will not be stimulated, and the RFM project itself will flounder. In this sense, appropriate RFM policies are a necessary but not sufficient condition for promoting long-run rural development.

Fortunately, the process of designing and carrying out an RFM project will almost invariably involve opportunities for Missions to engage in dialogues with host governments on the linkages between rural (particularly agricultural) production and rural conditions and national economic policies. And since both donors and LDCs are currently focusing on the need for increased agricultural production and improved economic policies nationally, Missions may well find LDC policy makers more receptive to dialogue on the policy changes needed--even though agreeing on the specific changes and then carrying them out may be as difficult as ever.

Under the circumstances, Missions may find it worthwhile to explore the potential for a successful RFM project, keeping in mind both the opportunities for strengthening RFMs and the possibility that in the process they can help bring about improvements in other rural conditions, particularly in those aspects related to economic policy improvements. However, Missions should proceed cautiously with RFM projects, delaying large-scale infusions of funds until improvements in the national economic climate and rural conditions are underway or in sight.

<u>Overall economic climate</u>. Unfavorable national economic policies affect rural areas most directly through prices which are too low relative to production costs to compensate farmers/rural business for the added work and risk of investing. Often, for example, farmgate prices have been depressed by LDC overvaluation of the national currency, which penalizes food exports vis a vis food imports, or by government marketing policies including retail price controls on food, or by subsidies on competing food imports in order to avoid urban unrest.

An overvalued national currency (i.e., an inappropriate foreign-exchange rate) may also contribute to foreign-exchange shortages and consequently to curtailed or delayed importation of essential inputs for farm production. Or nationally-set minimum wages may be so high as to discourage farmers/rural business from expanding their production. Or fiscal/financial policies may contribute to an inflation which is so rapid that it discourages savings and erodes the financial viability of lending institutions.

Rural conditons. Among the conditions deserving attention from USAID Missions before they undertake RFM projects are, first, the presence of profitable investment opportunities, most often in the form of a new low-risk, appropriate technology for agriculture which shows promise of dramatic yield increases. The expected returns from using this technology (or other uses of credit) must be sufficiently high to justify any additional costs or risks, particularly in view of the risk-aversion attitudes of many farmers. Other, more individual opportunities include the availability of additional land or a recognized demand for agricultural inputs which can be manufactured locally.

The presence of profitable investment opportunities suggests that other rural conditions are favorable, but these other conditions--all of which are influenced one way or another by national economic policies--bear summarizing here:

Supplies of supporting inputs must be dependable, with timely deliveries and prices which justify their use. These inputs include seeds, fertilizer, pesticides, fuel, and sometimes irrigation water and agricultural equipment.

Rural infrastructure must also be reasonably adequate, including farm-to-market roads, vehicles, storage and marketing facilities generally, and timely market information for both agricultural and locally-manufactured products.

Technical assistance and supporting agricultural services must also be adequate. These include agricultural extension and research focused on local physical and economic factors.

6. Evaluating RFM Projects

How successful any project is judged to be depends of course on the purposes and goals set forth for it. When earlier AID agricultural credit projects were viewed mainly as channels for infusing low-cost credit quickly and in large volume into an LDC's agricultural sector, a project might be judged successful if it disbursed all allotted funds in the given time period. If judged by the larger goal of increasing agricultural output, the evaluation would have to consider (inter alia) whether the results were attributable to factors other than credit (e.g., weather), whether the credit was additional to or simply replaced other sources, and whether the production results could be maintained in the long run--all of which are generally unanswerable questions for an evaluation team.

As noted in Part II, AID's more comprehensive approach to the credit issue suggests a more feasible basis for evaluating RFM projects, namely how well RFIs are carrying out their financial functions and whether the changes during the period indicate a strengthening or weakening of their future capabilities. Account should of course be taken of changes in both rural production and the other factors contributing to it, but the success or failure of the project would be judged on the basis of changes in, for example, (a) transaction costs, (b) loan-recovery rates, (c) savings mobilized, (d) the numbers of persons served, and (e) RFI assets and profits. These indicate changes not only in RFI efficiency and viability but also in LDC economic and RFM policies.

7. Credit Components of Non-RFM Projects

Extrapolation of current AID policy suggests that credit components of non-RFM projects should provide loans to rural borrowers only at rates which cover the full cost of the funds. Moreover, the funds should be channeled through an RFI in such a way as to strengthen that institution. In particular, especially if the credit is substantial, donor funds should not be offered to the RFI at rates below the cost of mobilizing private rural funds.

AID policy, however, has not specifically encompassed rural credit as a part of a more comprehensive rural project, so that other policy interpretations are possible. And in fact such rural credit components, offering cheap targeted credit, seem often to slip by without serious consideration.

A priori, it seems clear that RFIs and the entire rural economy would invariably benefit from following at all times the policy of charging market-rate interest on rural loans and also receiving donor funds at rates that would not discourage the mobilizing of private rural savings. However, in view of the possible political if not financial complications in LDCs where most prices, including that of other credit, are controlled and distorted, further consultation with AID's geographic bureaus should probably precede the setting forth of guidelines here that are more specific than those in the introductory paragraph of this section.

IV. IMPLEMENTING THE NEW APPROACH

AID-financed RFM projects applying some or many of the research conclusions discussed in Chapter II are found in The Dominican Republic, Bangladesh, Honduras, and Niger.

That these newer projects are still so few in number will be no surprise to those familiar with the process of going from theory/research to research applications--especially when developing countries as well as donor countries and institutions are involved. First, donor officials must become acquainted with the research conclusions and also become convinced that the conclusions are correct and relevant, then they must learn how to apply the new knowledge in practice, and finally they must consider the new approach important enough not only to justify the large expenditure of time and effort required to design and implement appropriate projects but also to similarly convince developing countries and other donors.

Developing country officials are often reluctant to change specific policies affecting RFMs as well as overall economic policies, even after they have become convinced that promoting healthy and self-sustaining RFMs depending largely on locally-mobilized resources will contribute more to rural development than a large infusion of donor funds. Change is frequently risky, for reasons that cannot always be foreseen, and it almost invariably antagonizes those within the country who have profited from former practices--in this case mainly the few larger borrowers receiving cheap credit and those government and bank officials who receive special favors in return. Moreover, if other donors cling to out-dated conclusions or practices and continue to offer cheap credit, developing countries feel less urgency to make any change.

The slow pace of change in this area is apparent from Lieberson's detailed review (see Reference No. 7, App. I) of 50 AID projects devoted wholly or in part to agricultural credit (selected after an initial review of 150 evaluations covering some 80 projects). Many of these 50 projects were started after the issuance of AID's mid-1974 agricultural credit guidelines which disapproved of, even if they did not explicitly forbid, subsidized interest rates. Nonetheless, only 30 of the 50 projects selected by Lieberson provided information on the key area of interest rates; and of these 30, only 5 had provided unsubsidized credit.* It is interesting to note--though one should be wary of drawing conclusions without full knowledge of the basis for and relia-

*On the related topic of financial viability for RFIs, Lieberson noted (<u>op. cit.</u>, p. 40) that only 18% of the AID projects included financial viability as a goal.

bility of the evaluations--that all 5 of the projects using market interest rates were judged successful by the AID evaluations, whereas only 9 of the 25 using subsidized interest rates were so judged.

Brief discussions of the newer approach in two specific country settings may prove useful to Missions involved in or contemplating assisting RFMs. The discussions indicate the country setting, donor and LDC attitudes, and the AID approach taken to ease the problems, including the applied research and technical assistance given to help RFIs improve their lending practices, savings mobilization, and cost-cutting efforts. While the results are only just beginning to emerge, these will be noted together with the tasks remaining to be done.

1. Bangladesh

Country setting. Bangladesh, a densely-populated country with few resources and many problems, has made more economic progress in the past decade than many once thought possible. Improved national economic policies, including measures to raise farmgate prices to more attractive levels, have been one positive factor. Another was a fairly well developed network of rural bank branches actively mobilizing deposits. However, as is still true in many developing countries, interest rates on rural loans were lower than in urban areas, so rural deposits were being channeled largely into urban loans. Moreover, low rural interest rates and low rates of rural loan recovery were destroying incentives to lend and institutional viability, while relatively low central bank rediscount rates further reduced RFI incentives to mobilize private financial assets for rural lending.

Fortunately, the World Bank completed an assessment of agricultural credit at about the time the USAID Mission was considering rural financial aid to Bangladesh. The Government of Bangladesh (GOB) was favorably disposed to make rural policy changes and had a good record of abiding by agreements with donors. Moreover, some GOB officials, who were concerned about the flow of funds from rural to urban areas and the needs of small farmers and others for reliable credit, recognized the influence of interest rates on the supply and demand for loans. Thus, the GOB was predisposed to agree with donors that it was essential to raise interest rates on rural loans, on central bank rediscounting, and on overdue rural loans, and also to undertake a program of research that would enable the GOB to improve further its financial policies.

It should be noted that because Bangladesh was not a country of high strategic priority to the U.S., as is the case with some countries in the Middle East and Central America, both the policy dialogue and internal U.S. discussions took place on the basis of economic and financial considerations, without political pressures to allocate and disburse aid funds quickly.

The AID approach. Building on an earlier experimental project, the USAID Mission in Bangladesh designed in 1983 a five-year Rural Finance Project (No. 388-0037), which provided a total of $75 million in grant assistance to RFMs in Bangladesh. About $3 million of this amount is being used for technical assistance, including practical banking research. The remaining $72 million has already been disbursed to the Central Bank for on-lending through participating banks; it was disbursed in three tranches during 1984-1985, based on Bangladesh fulfillment of an informal oral understanding with the USAID Mission. Specific actions by the GOB accompanied each tranche.

Rationalization of interest rates on loans, savings, and rediscounting is a primary reform covered by the understanding. Rural loan rates were targeted to increase to 24% by the end of the project, a rate which may still be lower than optimum, given urban lending rates of about 16 to 18%, the smaller size and greater risk of rural compared with urban loans, and the estimated 10 to

12% total cost of funds to RFIs. But that rate represents a substantial improvement over the rural loan rate of 12% at the start of the project. Savings rates for long-term deposits were targeted to increase to 14-15%.

Improvements in savings mobilization, lending policies and practices, and institutional performance are the other major reforms covered by the project. They are to be achieved through the technical assistance provided under the project and the adoption of improved RFI policies and practices. The technical assistance includes analysis and recommendations for improvements in such key areas as accounting procedures and standards for deposits and loans, loan-recovery procedures, deposit-mobilization programs, bank training programs, and laws pertaining to rural lending. The technical assistance also includes staff training and advisory services.

These reforms are expected to lead to a self-sustaining rural financial system providing timely and efficient savings and loan services in rural areas, so as to support the higher levels of rural production and employment-generating activities required for economic development.

Results to date. The first major achievement was the increase in service charges on rural loans, so that the effective rate of interest rose from 12% in 1982 to 16% beginning in October 1983. Central Bank rediscounting rates for agricultural loans were raised from a flat 6% to a variable 6 to 10.5%. And during the same period penalties on overdue loans were increased, from 1% to 6% per annum. These increases improved the incentives for lenders to make rural loans and to look less to Central Bank rediscounting and more to private rural financial assets as a source of funds. And the increased penalties provided an incentive for borrowers to repay loans on time.

Subsequent innovations included the creation of an Interest Rate Advisory Committee and a Technical Unit in the Central Bank. The Committee (composed of representatives from the Central Bank, the Ministry of Finance, and other agencies) will periodically review all interest rates and recommend changes based on current conditions. The Technical Unit will serve as Committee staff and will provide recommendations based on studies carried out by them. The Project is providing the Unit with technical assistance in the form of training, a foreign advisor, and microcomputers.

Other innovations include a loan passbook system, introduced to improve loan processing and recovery, and a new accounting system for use by bank branches to report loans, deposits, and recoveries to the Central Bank. These changes were made in consultation with USAID and with the technical assistance provided by the project.

The Project is also helping to strengthen the Agricultural Credit Department (ACD) of the Central Bank through training and advisory services. The ACD and a U.S. technical assistance team are conducting a major study to collect detailed data on deposits, loans, loan recovery, income, and expenses from a sample of 100 deposit and 100 loan accounts in each of 100 rural bank branches.

Finally, the discussions preceding and during the process of financial reforms have facilitated the policy dialogue generally and are thus contributing to the larger process of removing policy constraints to sustained rural and national development in Bangladesh. Moreover, the ACD will use the results of the above reasearch to make a major review of financial policies and problems in September 1986.

Tasks remaining. The progress to date shows the value of using the tools of applied research, training, and technical assistance to bring about systematic improvements in an existing financial system. However, achievement of the project's purposes--a self-sustaining rural financial system which provides timely and efficient savings and loan services--will require substantial additional efforts over a period of years.

For example, once the research documenting the status of overdue loans and identifying the factors associated with repayment is completed, the loan recovery program now being initiated will need to be strengthened. Given the fact that Bangladesh has a large network of bank branches in place, careful consideration of additional actions to mobilize more rural deposits is needed.

Implementing the recommendations to be made on management information and accounting systems, so that operating costs can be reduced and bank managers provided information needed for decision-making, is a third important task. Additional training of bank managers is also needed, so they can begin to design their own loan programs rather than rely on Central Bank instructions.

Finally, it is important to continue effective coordination among donors. Just as USAID effectively used the joint World Bank-GOB agricultural credit review in the design of this RFM project, the World Bank recently decided to slow down the design process for its next agricultural loan to Bangladesh, so as to be able to review first the results of the USAID-financed research and analysis now expected to be available in September 1986.

2. The Dominican Republic*

Country setting. Rapid economic growth together with relative exhange-rate stability and low inflation--resulting from the openness of the economy and cautious fiscal, credit, and monetary policies--enabled The Dominican Republic to make significant financial progress during the 1960's and most of the 1970's. Numerous and diverse financial institutions were established, financial services were expanded, and the real volume of deposits and loans made increased rapidly.

*This section is based almost entirely on Reference No. 8, a very recent paper which summarizes the challenges, accomplishments, and lessons learned from the AID project in The Dominican Republic.

On the negative side, however, the need for and willingness of domestic intermediaries to mobilize voluntary deposits from the public was weakened by access to abundant foreign financial assistance and Central Bank rediscounting on concessionary terms. And the concentration of both regulated and non-regulated financial institutions in the two major cities (Santo Domingo and Santiago) severely restricted the access of farmers to financial institutions. Consequently, less than 20 per cent of the country's agricultural producers have received institutional loans, and fewer still have had access to a permanent and reliable credit source or to deposit and other financial services. Moreover, high operating costs, high default rates resulting in part from political intrusions, interest-rate restrictions, and the recent drying up of external funds undermined the financial viability of Banco Agricola, the principal source of formal agricultural loans.

Inadequate financial services were, moreover, only part of the rural problem. The low profitability of crucial agricultural commodities, mostly as a result of price distortions, depressed agricultural output and led to the importing of many staple commodities, so that agricultural incomes were relatively low. Fundamental policy and financial-market reforms were clearly needed, but seemed at least temporarily out of reach.

The AID approach. Given the need for fundamental policy reforms and the political constraints on less comprehensive interest-rate and other financial reforms, AID decided not to undertake the RFM reform project originally envisaged. Instead, it decided to sponsor a pilot rural-savings-mobilization project, based on the premise that the rural population could generate funds to meet at least some agricultural and other rural credit needs if convenient and attractive deposit facilities were offered.

Improving the supply of deposit and loan services in rural areas, by strengthening institutions and promoting changes in financial policies and procedures, has been the main objective of the project. Accordingly, the project includes four types of closely linked activities: (1) pilot savings-mobilization campaigns by Banco Agricola and selected credit unions, designed not only to mobilize savings and discover which techniques were most effective but also to provide empirical evidence to encourage policy reforms; (2) management improvements at these institutions, to enhance their efficiency in mobilizing savings, lending, recovering loans, and managing liquidity and portfolios generally; (3) establishment of a Dominican research capability on financial market issues, in part to facilitate policy dialogue and policy/procedural reforms through establishing their need based on locally-conducted research; and (4) dissemination of the results in order to generate polictical support for the project's activities and methods.

OSU is providing the AID-financed technical assistance, including the services of a project leader, a long-term advisor on savings mobilization, and short-term research and consulting services, working with a Project Coordination Office established in the Financial Department at the Central Bank.

Banco Agricola, which has 31 branches throughout the country and which had served primarily as a lending window for concessionary foreign and Central Bank funds, was chosen as one of two institutions at which to establish deposit facilities. The establishment of these facilities involved complex preparations, including generating support from the bank's management and staff; designing procedures, policies, and manuals; obtaining authorizations from the monetary authorities regarding interest rates and reserve requirements; training bank employees; and designing and carrying out a publicity campaign to attract deposits.

Starting with passbook savings accounts and time deposits at a first branch in July 1983, these services were to be offered at four additional branches during the next few years. Instead, the Government decided to expand the system to all 31 branches, thus creating additional problems, including excess liquidity and accounting/management problems. Fortunately, the bank's management was ready to support the changes required, including a new management-information system based on microcomputers, new borrower-eligibility and portfolio-management criteria, strengthened collection efforts, and greatly increased staff training.

Preparation efforts at the four credit unions selected as the other instituion to be assisted were even more arduous, given their weak institutional base. They included convincing the membership of the need for change and then modifying interest rates and collection procedures, improving the accounting systems, designing a new portfolio-management system, and training both credit union leaders and staff with the help of Dominican technicians.

Results to date. Achievements at Banco Agricola include the offering of deposit services at 29 of the bank's 31 branches by October 1985 and the mobilizing of nearly U.S. $2.5 million in deposits in nearly 21,000 accounts. Nearly 99% (20,539) of these were passbook accounts, comprising 57% of total deposits. The average of U.S.$67 per passbook account suggests that the savings of small savers were mobilized. The average of U.S.$3,700 per time-deposit account, comprising only 1.3% of the total number of accounts but 43% of savings mobilized, indicates an attractiveness to large savers as well.

Other achievements include the raising of interest rates charged on loans up to the maximum allowed so as to improve profitability, higher loan-recovery rates, and the introduction of a new data-processing system using microcomputers. As a result of these and numerous organizational changes, Banco Agricola was able to establish a Savings Mobilization Department with the net addition of only three employees to its total staff.

Deposit mobili ation among the four credit unions has also been very successful. In little more than a year, savings deposits increased tenfold in two of them and increased substantially in the other two. Borrower delinquency, which in three of the credit unions had ranged between 45 to 71% of their portfolio, declined to a range of 7 to 15%. The initial build-up of excess liquidity was rapidly resolved, as managers became more adept in credit analysis. Now, even at the higher interest rates charged, the credit unions are facing a substantial unsatisfied demand for credit.

Research results, embodied in about 120 reports and publications, are another accomplishment of the project. They have led not only to operational innovations but also to public discussion; and they have thus contributed significantly to policy dialogue as well as to problem solving.

Tasks remaining. That rural savings can be mobilized by financial institutions, if rural deposit facilities are attractive, and that this can be done at a relatively low marginal cost if an existing financial institution has an established network of branches, are two of the lessons learned or confirmed by this project. The task, however, is not easy. Complex preparation efforts and the mobilization of political support were required, and continued such efforts are still needed. The continued efforts include additional research on second-generation problems such as reducing costs, improving loan-recovery rates, and training of RFIs in liquidity and asset management so as to reduce or avoid the excess liquidity problems which have acted as a brake on deposit mobilization at Banco Agricola. Continued technical assistance is needed in all these areas, to increase the likelihood that progress made will be self-sustaining.

The introduction of deposit mobilization, as with any major new activity, has created imbalances and brought to light deficiencies that need correcting and may even require a major restructuring of the financial intermediary. In any event planned or unforseen future developments can be expected to create new dilemmas about strategy and organization that have to be faced.

V. ADDITIONAL ISSUES: A POSTSCRIPT

Five questions related to rural financial markets have arisen in the course of this work. They warrant a brief discussion, despite the absence of research conclusions.

1. Intersectoral Flow of Funds

"How can AID increase the flow of funds to agriculture?" or "How can AID help stop the flow of funds from rural to urban areas?" are two forms of this question on intersectoral flows. The sections dealing with targeted credit (II.4) and the role of rural financial markets (II.5) provided an indirect answer. The direct answer is that, in view of the fungibility of funds, AID can do little or nothing to change intersectoral flows. External as well as domestic funds can and usually do flow out of rural and into urban areas in response to the greater urban profits usually available.

Working with other donors and LDC governments particularly in three areas, however, AID can influence the flows: (1) AID can help LDCs improve national economic and financial policies, so that they do not penalize agriculture and rural industry but instead make borrowing and lending in rural areas more attractive to both investors and RFIs; (2) AID can help LDCs improve rural infrastructure (e.g., feeder roads and crop storage facilities) and other services and support for agriculture including research and extension focused on local needs; and finally, (3) AID can encourage LDCs to charge market rates of interest on rural loans (which rates may even be somewhat higher than on urban loans, in view of the greater costs and risks), so that there is less profit incentive to divert rural deposits to urban loans. With such improvements, both external and domestic funds are more likely to remain in rural areas.

2. Fulfilling the Congressional Mandate

"How can AID assure Congress that the rural poor are getting their fair share of aid funds?" is a second question often posed. In view of the earlier discussions of cheap credit targeted at small farmers, it is probably not necessary to reiterate that AID can never be sure that any group within a developing country is getting a particular package of aid. AID can, however, design the aid package and help to create conditions within a country which will maximize the chances of RFM projects fulfilling their purposes. In this instance, the package of aid should help establish or strengthen safe, convenient, high-interest depositories for the rural poor, which will do much more for the poor than the occasional low-interest (but often high total-cost) loans which have reached them in the past. Further, AID can stipulate that its funds should be loaned at market rates of interest, so as to increse their availability to small farmers and small-scale rural enterprise. Finally, AID can help the country improve those policies which have in the past penalized agriculture.

3. Informal Financial Markets

"Should AID support, discourage, or ignore informal financial markets in developing countries?" is a third question increasingly posed.

The issue seemed simpler in earlier years, when the mention of informal lending evoked an image of persons, ethnically or religiously distinct from the community, who charged excessive interest rates and kept small farmers in a constant state of debt.

The informal financial market in fact, however, includes not only traditional money lenders (some of whom may fit the above picture) but also loans provided by relatives and friends, by local merchants, by landlords and larger farmers, and by traders/processors/exporters of major crops. Their rates, while often very high by Western standards, may be reasonably competitive with the total costs of funds in the formal financial market, especially if account is taken of the non-interest transaction costs for small borrowers (see Part II above). Moreover, because they know the borrowers as well as the economic-social conditions in the community, they usually act quickly, with few if any formalities, delays, and inconveniences or indignities to the small borrower. Finally, in many developing countries, the informal financial market may be the largest source of funds for small farmers.

On the negative side, however, the informal financial market rarely if ever serves as a financial intermediary. Relying almost exclusively on its own funds, it does not mobilize savings and channel them into the most productive uses, and it is basically uninterested or unable to funnel large sums into new technology or provide other banking or technical services to speed up rural development.

Informal lending may not be the unmitigated evil of folk lore, which AID should help stamp out, and it does seem to be making a significant contribution to rural development, but its contribution and potential are too limited to substitute for formal financial markets. To ascertain more fully not only its current role but also whether and how that role should be broadened to include closer connections between informal and formal financial markets would require more country-by-country research. Such research could lead to more interactions between the two markets, with (e.g.) the informal market carrying out some functions which would be too costly for the formal market. A greater integration of functions could be expected to increase the access of small borrowers to financial services, to lower transaction costs, to enhance the financial health and viability of both markets, and to lead to increased competition, with lower interest rates to borrowers and increased rates to depositors.

At this time, therefore, AID should neither support, discourage, or ignore informal financial markets. Rather, it seems advisable to finance research on the two markets and to promote LDC recognition of the need for closer relationships between them and their eventual integration into a single financial market embracing both more competition and specialization of functions. More detailed guidelines are best deferred until after the research results are in.

4. Dissemination of Information and Training

"How can the OSU research conclusions on rural financial markets be more effectively disseminated both within AID and among host-country officials, at both policy and implementing levels?" is another important question, which was in fact a decisive factor in the decision to prepare and issue these guidelines.

The guidelines, complemented by policy guidance, are considered a primary vehicle for acquainting top AID/W and USAID officials (including agricultural development officers) with the basic nature of the research conclusions and the new approach to RFM projects. They could also perform a similar function for host-country officials, perhaps with some tailoring for a specific country audience.

The guidelines are not considered a primary training vehicle, nor a blueprint for designing either a complete project on RFMs or a credit component of a larger project, nor (obviously) a vehicle for periodic transmission of new or reinforcing information. Discussion of the merits of a bulletin or other means for such periodic transmission is beyond the scope of this report, although some OSU and other publications are listed in the following section. Note also that technical assistance for designing RFM projects is readily available to Missions through normal channels. The issue of training, however, warrants some further discussion here.

Short-term training by the OSU Group under AID contracts has consisted, most importantly, of workshops and seminars held in Washington or at regional USAID meetings or sometimes at individual Missions in connection with ongoing or prospective RFM projects. Agricultural development officers and other AID personnel as well as some LDC officials have attended; and the latter often disseminate the information further within their countries. Expansion of these activities, which have been relatively limited to date, seems both feasible and advisable. OSU professors also disseminate research results through academic meetings or informally through contacts with key officials of the World Bank and other multilateral or bilateral donors.

Long-term training efforts have consisted primarily of programs at OSU's Department of Agricultural Economics and several other universities. Over half the students in the OSU program are foreign; a small proportion of them are sponsored by AID. This training could be much more effective if the programs were expanded to include both more AID-sponsored foreign students and more current or prospective AID agricultural development officers.

5. Additional Reading on RFMs

"What reference materials could be disseminated most effectively to interested AID/W and USAID officers?" is the final question to be discussed here.

Publications dealing with agricultural credit and rural financial markets during the past 25 years number many hundreds, so that any selection must be both subjective and incomplete. Nonetheless, the following list of three books and five papers, drawn up with the help of OSU professors, seems adequate as a starter:

1. "Undermining Rural Development with Cheap Credit," edited by Dale W. Adams, Douglas H. Graham, and J.D.Von Pischke, Westview Press, Boulder, 1984.

2. "Rural Financial Markets in Developing Countries: Their Use and Abuse," edited by J.D.Von Pischke, Dale W. Adams, and Gordon Donald, The Johns Hopkins University Press (for the Economic Development Institute of the World Bank), Baltimore, 1983.

3 "Credit for Small Farmers in Developing Countries," edited by Gordon Donald, Westview Press, Boulder, 1976. (This book, though older than other references, is included because it summarizes AID's Spring 1973 Review of Agricultural Credit, a turning point in AID's approach to work in this area.)

4. "Strengthening Agricultural Banking and Credit Systems in Latin America and the Caribbean," by Claudio Gonzales-Vega, OSU, 1985, 42 pp.

5. "Rural Deposit Mobiliztion: An Alternative Approach for Developing Rural Financial Markets," by Richard L. Meyer, OSU, 1985, 31 pp.

6. "Rural Financial Markets in Low Income Countries: Recent Controversies and Lessons," by Dale W. Adams and Robert C. Vogel, OSU, 1984, 38 pp.

7. "A Synthesis of AID Experience: Small Farmer Credit, 1973-1985," by Joseph M. Lieberson, Katherine A. Kotellos, and George C. Miller, AID, 1985, 52 pp. plus Appendixes A through I.

8. "Rural Savings Mobilization in The Dominican Republic: Challenges, Accomplishments, and Lessons," by Claudio Gonzales-Vega and Jeffrey Poyo, OSU, December 1985, 27 pp.