A NEW LOOK AT SMALL FARMER CREDIT

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In this draft AID paper it is argued that conventional financial institutions have been ineffective in delivery of credit to small farmers; that certain systemic problems render them incapable of doing so in most LDCs, no matter how well managed.

The author, an AID Evaluation Officer, suggests that the village shopkeeper network present in most peasant societies is by far the most efficient allocator of small farmer credit. He proposes a method by which international donors might retail credit through such informal lenders, relying on the conventional institutions for credit wholesaling. He also offers a "formula" approach to interest rate determination that enables rational rate setting even in high inflation/high risk lending environments.

The basis for these views is an evaluation of 200-plus AID agricultural credit, input and marketing projects carried-out world-wide over a 25 year period. A synthesis of this evaluation series is "in publication." For a copy, contact: Richard Ray Solem, AID/PPC/CDIE, SA-14 Room 607, Agency for International Development, Washington, D.C. 20523.

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I. Traditional AID Approach To Small Farmer Credit

A recently completed PPC/CDIE impact evaluation series reviewed AID's success with agricultural credit, input and marketing projects over the past 25 years. Some 203 projects were identified overall, and evaluation abstracts read for each. Of that universe, a sample of 44 projects was randomly sampled and all materials located in AID/W files concerning them was read. Finally, field level evaluation was done for 5 of the 44.

The result of this intensive study was disconcerting. Although AID's investment in agricultural services over the years has been very substantial, its successes have been few. Institutions tailored to implement AID's programs have been established all over the world, in most cases at great cost in human and capital resources. Few have achieved economic viability, for the most part still depending upon government subsidy years after start-up, and even fewer have been effective in reaching the target small farmers with their services.

What the agricultural services evaluation series demonstrated is that AID's traditional operating mode of working through government and parastatal institutions can be effective in certain areas (eg. service packages can be developed and delivered), but it has not produced the self-sustaining small farmer impact programs envisioned by the project designers.

In the case of seed and fertilizer production and distribution projects, in many instances AID has been successful in setting up apparatus for producing a desired product, but has generally failed in distributing such product to target small farmer recipients. With regard to agricultural credit, AID has once again succeeded in establishing credit institutions that meet our compliance requirements for loan processing and monitorship, but such institutions have failed miserably in passing AID's funds on to the target small farmers. There have been similar problems with marketing programs. They have tended to look good on paper, but effectiveness has been poor among the target clientelle.

Government and parastatal institutions seem to be capable of organizing to produce products or services but incapable of delivering them to small farmers on a "cost effective" basis. On reflection, the problem is understandable. There are a great many small farmers in the developing countries, and very few government and parastatal banks, seed and fertilizer companies and marketing boards. With LDC small farmers being for the most part poor and illiterate, and transportation and communication infrastructure rudimentary, it stands to reason that such farmers are going to have a tough time reaching the government and parastatal institutions at their mostly urban locations.

The answer, it would seem, is to find a way to bring farmer oriented services to the farmers - on their turf and on their terms. If AID could find a way to help government to deliver credit, input and marketing services to the farmer's village, every day all year long, the acceptance ratio would increase. If AID could further dispense with some of its traditional procedures (with regard to credit, for example, we favor complicated application forms, mortgage collateral, farm development plans and deep subsidies on interest rates) and simply give the farmer quick service at a market interest rate, we would have more interested borrowers.

Ironically, even as AID has gone about the task of encouraging the development of government and parastatal institutions for delivery of agricultural services, meeting with little success along the way, there is, in most developing countries, an indigenous agricultural service delivery system that functions very effectively. This indigenous system is the network of village shopkeepers.

Rural villagers themselves, these shopkeepers live on the local economy like their neighbors, often farming as well, and enjoy no subsidy of any kind. They are highly diversified in their economic activity. The typical rural shopkeeper, in addition to selling products ranging from aspirin to seeds, also does hauling when he goes to town, purchases his neighbors crops, provides customer credit when it is needed (generally in-kind), and may also run a sort of social center as neighbors congregate to discuss politics or the crops over a bottle of coke.

A study done in rural India during the early 1970's (Lloyd, 1975) showed that even as AID promoted agricultural credit through several of its traditional projects, the network of village shopkeepers extended vastly more credit by itself. Some $80 million in pumpsets were sold during 1966 and 67 through village shopkeepers, the bulk of them through credit in-kind. Another extensive study of rural credit in Viet Nam (Barton, 1968) demonstrated that the bulk of rural credit in that nation came from private sources. Finally, a 1984 impact evaluation of agricultural credit in Paraguay (Solem et al, 1984) discovered that despite massive infusions of AID funds through a government lending institution, a parastatal bank and a national credit union network, some 98 percent of Paraguay's small farmers (those holding 5 hectares or less) still rely exclusively on traditional credit sources.

The bottom line, it seems, is that AID's traditional vehicles for agricultural service delivery have been poor competitors with those indigenous systems which have been in place for decades.

II. Problems With The Traditional Approach

What does the indigenous agricultural credit delivery system offer small farmers that the AID supported formal credit institutions do not? How do the indigenous shopkeepers manage to be both more popular with the small farmer borrowers and more viable economically? Perhaps through a close look at these two questions we can come up with a more successful approach to our own programs.

A. The Small Farmer Perspective

The Paraguay impact evaluation mentioned above provides some interesting insights into how small farmers view the three AID assisted credit projects there. Interviews with farmers in rural Paraguay concerning their credit preferences revealed that AID's primary concern when discussing small farmer credit, the rate of interest, is actually rather low on the small farmers list of concerns. More important to him are things such as (1) response time, (2) application costs and (3) compatability with the lender as a person and with his procedures. The cost of the money is a consideration, but cost is never viewed simply as the rate of interest. Rather, it is composed of myriad factors including cost of the product taken from the shopkeeper's inventory on credit, the price paid for the farmer's produce when he sells it to the shopkeeper to satisfy the debt obligation, and the length of time the debt is outstanding. Before dealing with the cost of money, however, let's first look more closely at the concerns that our target small farmer borrowers rank highest.

1. Response Time

Farming is a very complicated business, and to succeed at it the farmer must be highly responsive to conditions totally out of his control; weather, for instance. Although in any region there are general rules of thumb on when to plant, when to fertilize, when to cultivate and when to harvest, the precise timing varies from season to season. It varies depending upon natural phenomena such as temperature, rain, sunshine, and residual soil moisture. An experienced farmer will know within a few days when he should carry out a given farming operation, and if that operation requires capital he needs the money then, not two weeks later. A delay in planting, fertilizing, cultivating or harvesting his crop can have a devastating impact on productivity, no matter what he does with his time during the rest of the cropping season.

As a result of the critical nature of timing, it is no wonder that AID's target small farmers are reluctant to do business with our formal credit institutions. Generally located in cities a day or two away in travel time, and operated by strangers with unfamiliar policies and procedures, they are just about the last thing that the farmer thinks of when he needs seeds, fertilizer or equipment in a hurry. Required to deal with such institutions is not only time to travel, make application and, worst of all, an unpredictable amount of time for waiting in line, filling out forms, dealing with any special requirements, and then waiting for a decision. All this when the farmer has an easy and familiar alternative - either save his own seeds from last year, or lacking those, stroll over to the village shopkeeper to drink a cup of coffee, talk about the weather, and arrange for his input needs on credit. Total response time is the time it takes the shopkeeper to assess the farmer's skills, the productivity of his land, and his personal integrity. Since the shopkeeper already knows the answer to each concern from long familiarity, that translates to a response time normally equal to the time it takes to drink the coffee.

2. Application Cost

To understand the small farmer's objections to the aplication costs involved in dealing with AID's traditional government and parastatal credit institutions, one must recognize that all farmers are businessmen. Though they may be illiterate, they can always count and calculate; perhaps not in the same way as AID officers are trained to do it, but they can do it in a way that enables them to survive in their own business. They understand "shadow pricing," for instance, and they also know enough probability theory to know that a "bird in the hand is worth two in the bush." How does this translate to the farmer's decision as to source of credit?

Unrecognized by AID's project designers for more than two decades is that the true cost to target small farmers of doing business with AID's government and parastatal lenders is very high, and that most of that cost is incurred by the farmer "up-front," before he knows whether or not he will be given a loan. By "shadow pricing" his time spent in traveling to the city, waiting in line at the credit institution, moving about the city, back to the village, and returning again to the city in search of documentation for the loan application and finally, if he is lucky, to collect his loan, the farmer sees a high price being incurred. When he adds to that the "hard cost" of purchasing a notary seal, hiring an attorney to search his land title, possibly even employing a facilitator to help him deal with an application form he can't read, he is even more concerned.

Several years ago Dr. Jerry Ladman of the University of Arizona did a study of "up-front" costs to small farmer borrowers in an AID agricultural credit project in Bolivia. He developed an economic model to translate the farmer's time and "hard cost" to dollars, then converted that dollar amount to a percentage of the average small farmer's loan amount, and the result was stunning. What looked to AID and Government of Bolivia officials as cheap credit at 12 percent, actually cost the small farmers around 48 percent.

The irony is that the small farmers knew that long before the Ladman study, which is why they did not line-up at the credit window in the expected numbers. Instead, they stayed with their village lenders, paying for their credit in-kind in the traditional way, thus avoiding the high up-front cost associated with so-called modern credit systems.

What are the application costs of dealing with the village shopkeeper? In terms of paper, none. The shopkeeper does not require a mortgage for security. He knows who owns the land in his village and, unlike the formal credit institution, he doesn't delude himself about the probability of taking away a deliquent farmer's land to satisfy a debt. Neither does he require his borrower to fill out a long application form he can't read, or develop a farm plan that merely documents what he is going to do anyway. The shopkeeper doesn't need the application form because he already knows enough about the borrower to fill it out for him, and he doesn't need a farm plan because he knows who the good farmers are and how they operate. The sole documentation for the average village shopkeeper loan is a note in a cigar box kept under the counter, sometimes signed by the borrower, sometimes not.

3. Compatability With Lender's Procedures

Something that is often lost sight of in development of procedures for implementation of AID small farmer credit projects is that there are major social, educational, cultural, sometimes even linguistic differences between the target small farmer borrowers and the employees of the formal credit institutions which we have favored as implementing agents. These differences never really existed in our American experience, and have proved to be a significant consideration in determining the viability of AID's formal approach to small farmer credit.

Let's look at it from the perspective of the target borrower. He needs a small amount of credit for purchase of, say, fifty pounds of seeds, a calf, a new motor for his water pump, and a new hoe. A month later, he knows that he will need five bags of fertilizer. At the same time, he is worrying about school books for the kids, a pair of shoes for his youngest child, and a tooth extraction for his wife. Adding it all up, including an amount for unforseen contingencies, he figures that he's going to require credit of around $200 before the next harvest enables him to raise some cash.

One approach to dealing with his needs is to journey to the city and get in line at the government or parastatal agricultural credit institution where it is rumored one can borrow money at very low interest rates. Closer analysis gives him pause, however. To begin with, his neighbor who took such a loan last year had a bad experience. Aside from the cost of dealing with all of the application procedures ("up-front" expense), he found himself in a totally alien environment at the bank. The loan officer wore a suit and seemed not to know much about farming and village life. When his neighbor explained the importance of the school books, shoes and tooth extraction, he learned that somehow those priorities didn't qualify for credit - only the seeds, fertilizer, hoe and pump motor. Worse, the loan officer required him to discuss his farm operation with another "city fellow," an extensionist, and that person was promoting a different supplier for his seeds and fertilizer, clearly an offense to his neighbor and traditional supplier, the village shopkeeper.

The alternative, dealing on familiar ground with familiar faces, is generally less frightening and thus more appealing. The shopkeeper knows that it is the farm inputs that will generate income to pay back the loan, but he also knows that school books, shoes and the tooth extraction are important to the farmer's overall priorities. As a fellow villager, he will accomodate these legitimate needs to the best of the farmer's ability to pay for them.

B. The Formal Lender's Perspective

The formal credit institutions with which AID has worked on its small farmer credit programs have also been critical of the traditional approach they have found themselves cooperating in. Principal concerns, from their perspective, are (1) difficulties of targeting on very small borrowers who generally lack credit experience and collateral, (2) fixing of interest rates below the cost of money and/or the cost of administering the loans being promoted, and (3) inability to provide sufficient loan servicing given the economies of reaching the target clientelle.

1. Targeting

The natural clientelle of the formal lending institutions are the consumers and business people in their communities. Traditional procedures are geared to a certain average loan size, and a literate, sophisticated borrower. Small farmers do not fit the profile, and the result is that formal lenders are often inefficient in making the necessary procedural adjustments.

2. Fixing Of Interest Rates

Under the traditional small farmer credit project interest rates on AID loans to the cooperating lender are generally set at very low rates, and rates to target small farmer borrowers are also set low. Spreads of 5 to 15 percent are common, the dollar/local currency inflation risk being put on the cooperating lender.

Experience with this "serindipitous" approach to rate setting has been unhappy. First, cooperating lenders have been insidiously undermined in their long-term savings mobilization efforts as a result of the seemingly "cheap money" from donor institutions. They have fallen-down in marketing domestic savings accounts, with the result being a growing dependency on international donor loans for growth.

Equally devastating has been the long-term effect of dollar/local currency inflation. To illustrate, in several Latin American countries today the small farmer credit programs dictate 12 to 24 percent loans even as inflation runs 100 percent. Decapitalization occurs over a very short period of time under such circumstances. This, in addition to the high administrative costs associated with making very small loans to marginal (at best) borrowers, make the formal lender's frustration with arbitrary rate fixing understandable.

3. Loan Servicing

A key element in minimizing loan defaults is close loan supervision. Lender and borrower should be in regular contact so that problems can be anticipated and dealt with before they get out of control. This has proved impossible for most formal lenders when dealing with AID's target small farmer clientelle. They aren't set-up for it, and given the difficulties of transportation and comminication in most LDCs it isn't economic.

III A New Look At Small Farmer Credit

Needed is an approach to delivery of agricultural credit that (1) meets AID's needs for a legally organized counterpart institution with operating procedures that meet its minimal requirements for management controls and (2) meets the target small farmer's demand for a lender who will deal with him on his own turf, on terms he can understand. In the following section of this paper the critical elements of such an approach are examined.

A. The Proposed Approach

Donor funds are channeled to the traditional government and parastatal credit institutions, but these institutions are charged with wholesaling, rather than retailing, the credit. Bank borrowers, in this mode, are the indigenous village shopkeeper lenders (credit retailers), not the small farmers themselves.

Shopkeeper loans would be in the form of revolving credit lines. Use of the funds might be tied to purchase of agricultural inventory (e.g. seeds, fertilizer, equipment), or it might not be tied at all. Enforcement of any loan ties would be "post-effective," ergo. there would be no complicated application or verification procedures. The borrower would be instructed as to the rules, and upon returning to the lender for a second credit draw he would have to demonstrate compliance on the first to qualify.

Targeting on desired small farmer groups would be accomplished by dealing only with shopkeepers from the target areas, and restricting their activity to such market areas - e.g. a shopkeeper could not change his business operation and use the credit to engage in commodity arbitrage across regions or nations. Here again, enforcement would be "post-effective."

It would be left to the shopkeeper to discriminate among borrowers within his normal market area, recognizing that all risk of default is his.

Rates charged the wholesale lender by donor institutions would be set high enough so as not to discourage savings mobilization within the local economy (higher than a reasonable depositor savings rate), but low enough to allow a profit from the on-lending to shopkeepers.

Rates charged for shopkeeper credits would be adjusted periodically by the lender according to the following formula:

+ Cost Of Donor Money
+ Anticipated Rate Of Inflation
+ Anticipated Administrative Cost
+ Contingency For Bad Debt
+ Return (Real Rate) On Capital
= Rate Of Interest Charged

Rates charged by shopkeepers to their small farmer borrowers would be left entirely to the marketplace. The general assumption is that the effect of the program would be to drive down rates of interest in the informal market somewhat (by increasing the supply side of the lender/borrower equasion) as well as to increase the number of borrowers reached. If it turns out that the traditional lender's "cost of money" is perceived as being lower than that offered by the program then (1) the shopkeepers will be reluctant to participate in the program and (2) if they do they will actually charge more for the new credits than for loans made from their own capital.

B. Critical Elements

1. Interest Rates

Many years of poor planning must be corrected in this area. Traditionally AID and its fellow donors have erred in rate setting both at the level of the intermediary lending institution and at the level of the small farmer borrower. In both cases, the tendency has been to set rates at fixed amounts lasting the life of the program, often chosen without regard to the financial markets in the cooperating LDC.

a. At The Lending Institution Level

Out of concern for the economic viability of cooperating lending institutions, AID and other donors have tended to charge low as possible rates for their money. Given the donor's romance with targeting hard-to-reach borrowers, and with setting-up complicated loan application and servicing procedures, this has probably been necessary to accomplish lender cooperation.

Unfortunately, this reliance upon cheap donor funds has had a devastating side-effect: it has severely discouraged savings mobilization. Why would any rationally managed institution compete in the marketplace for depositor funds paying, say, predicted inflation plus three percent, when they can mobilize donor money at far lower rates? It makes no sense to do so, so they don't. The long-term result is a continuing dependency upon donor assistance for capital mobilization.

AID and other donors must be sensitive to the importance of domestic savings mobilization and set their rates to cooperating lenders accordingly. An immediate effect of such a change in policy will be to make the cooperating lenders far more critical in their decision to participate in AID programs. They will look carefully at the traditional high-cost lending procedures, and at the target borrowers as well. The result should be some long needed refinements in such procedures, and eventually a "weaning away" from dependence upon donors for institutional growth.

b. At The Shopkeeper Level

Rates charged to program borrowers (in this instance, village shopkeepers) have traditionally been set arbitrarily, also without regard to circumstances in the cooperating LDC's financial markets. At this level, too, they have normally been fixed for the life of the program. Given little, if any, regard have been critical factors such as (1) the rate of inflation, (2) the true cost to the lender of complex donor policies and procedures and (3) reasonable predictions as to borrower default rates under the overall circumstances.

In the proposed program new approach, arbitrary, life-of-program rate determination is no longer attempted. Rather, a simple formula which represents the methodology for rate-setting in free capital markets is established. Taking into account cost of money, inflation, administrative cost, bad debt contingency and an acceptable yield factor, the formula passes rate-setting responsibility to the people closest to the "line of fire." If these people are conscientious and competent the program should work fine under most circumstances. If they are not, the money could be priced too high to attract borrowers, or too low to allow a yield, or even break-even. Needed is for donors to demonstrate faith in free-market systems for rate-setting and faith in thier LDC counterparts.

2. Marketing

Another badly managed element of the traditional AID approach to small farmer credit is the way that credit has been marketed to farmers. The traditional approach to-date has been composed of (1) establishment of very low nominal rates combined with (2) advertising of such loans through government channels. Although this approach looks good "on paper," it has rarely been effective.

The earlier referenced Ladman study in Bolivia said it best when it showed, through economic modeling, that the true cost of such credits, when taken in the small amounts appropriate to small farmers, is very high. A subsequent study carried out by an AID Impact Evaluation Team in Paraguay (Paraguay - Agricultural Credit, 1984) shows that when small farmers were asked to prioritize their preferences concerning various aspects of agricultural credit programs nominal interest rates ranked well below such factors as ease of access, response time, familiarity with procedures, and perceptions of reliability. Based on this evidence, it seems that AID has a double failure on its hands: its money has not been low-cost in real terms; and farmers haven't been rate-sensitive anyway.

a. Access

LDC small farmers rarely own automobiles, and as a rule they do not live in areas where public transportation is cheap and convenient. Given these circumstances, it is no wonder that they hesitate to travel to the primary and secondary cities which house the government and parastatal lending institutions. Such travel is both expensive and intimidating. The typical LDC small farmer has a limited range of mobility, and in many cases may never travel outside that range.

In many of the traditional AID and other donor credit programs the farmer's lack of mobility has been recognized and efforts made to overcome the problem by sending lender or Ministry of Agriculture employees into the countryside to market the credit from the back of vehicles, much like the mythic traveling snake-oil salesmen. This approach, though well intentioned, has not worked very well. The problem is that borrowing is serious business, requiring lots of thought and intra- as well as inter-family discussion. It is also a transaction that one would not normally choose to do with strangers. To expect a high "closing ratio" from these traveling road shows is unrealistic, as the results have demonstrated.

To be really effective a lender must be on the farmer's turf all of the time, ideally as a member of the community. He must be a familiar and trusted figure to whom one can comfortably turn in time of need. Limiting a lender's operations to just one dimension of the small farmer's credit needs (economic verses personal) makes the lender's job hard enough. To also take the lender out of the community makes his job impossible.

b. Response Time

Farming is a very complex business in which timing is everything. To plant or harvest a few days early or late can take a heavy toll on yield. This sensitivity translates to everything that the farmer does. He constantly evaluates his environment, taking note of soil moisture, temperature, insects, labor availabilities, price flictuations and myriad other factors and, after processing all this information, makes his decision about the next stage in his farming process. He may not know when or what he is going to plant until a few days before doing so. Weather, the condition of roads, or the presence of insects on Wednesday can influence whether he will harvest alone, at his leisure, over a week's time or employ help to do it in a hurry on Thursday.

In this environment, quick lender response time can spell the difference between success and failure. A lender who is nearby, who understands the vicissitudes of farming operations, and can respond to the farmer's needs on short notice is critical to successful marketing of small farmer credit.

c. Procedures

Successful marketing of any product depends upon knowing the target consumer and making it as easy as possible for him to purchase the product. If you want to sell beer in a society where there are restrictions with regard to the drinker's age and level of intoxication, you could require that would-be customers bring with them proof of age and fill out forms verifying same prior to the initial sale, and you could require sobriety tests before each resale. That might screen a few ineligible drinkers, but it would also encourage many eligible customers to go down the street to a competitor; particularly if he used the traditional "eyeball" method of assessing qualificatioins.

AID's traditional procedures with regard to small farmer credit could not be more inappropriate to the task had designers deliberately set-out to drive the target clients away. If the target borrower is illiterate, or semi-literate, then paper should be de-emphasized, and where it is necessary it should be designed for non-readers. Social marketing literature developed for AID's population control and oral rehydration programs offer good examples of this. If the target borrower does not have a written title to his land, none should be required. If he plans to plant the same fields and crops that he has planted for years, a "farm plan" is not appropriate.

Ironically, the so-called experts on economic development and dealing across cultures have proved thoroughly insensitive to the realities in both areas. By-and-large the target small farmer knows a great deal about the particular parcel that he farms and can make his crop selections intelligently; often even where a new technology is involved. Under normal circumstances he does not see much benefit from drawing a farm plan. By-and-large the small farmer is comfortable with purchasing his inputs from the village shopkeeper, often taking them on credit. He is reluctant in any event to change sources, particularly when the new source is a stranger and all sorts of unfamiliar procedures are required.

d. Reliability

People who live and work in classic LDC peasant farming communities do not experience change at as fast a rate as their urban counterparts. They are accustomed to dealing in familiar surroundings with familiar people. From such familiarity comes the ability to determine with a large degree of certainty what one can be relied upon to do.

AID's traditional government or parastatal operated small farmer credit program is a new player in this environment. Flooded with credit money at the outset, it is faced with prospecting for borrowers and "pushing the product" by whatever means permitted under the program. Typically, this early rush to lend, combined with unwise policies with regard to rate-setting and loan administration, result in rapid decapitalization and thus program set-back. Farmers who take a loan in one year find the "window" closed the next. In short, history has shown that farmers cannot count on these programs over time.

Alternatively, the village shopkeeper has been selling inventory on credit as long as anyone can remember. He is always there, with the only variations in his business being extent of inventory and depth of ability to extend credit. Usually, the causes of these variations are related to what is going on in the local economy (e.g. farm prices, weather) and thus understood by all.

The general perception of the village shopkeeper as a credit supplier is that (1) he will qualify his borrowers carefully, starting with very small loans and graduating them, over time, to large loans and (2) once qualified, the borrower will find the credit window closed only if he fails to repay an obligation, or the shopkeeper simply doesn't have the wherewithall to lend. This reliability over time makes him a tough competitor in the smalll farmer credit marketplace.

3. Administrative Costs

A third critical element in development of successful small farmer credit programs is cost of operation. Because of the smallness of their operations, small farmers typically are looking for very small loans - a range of $200 to $500 is not uncommon. Dollar for dollar, these are very expensive credits to administer.

AID's traditional cooperating lenders (government and parastatal banks) have had a difficult time dealing with these loans because they have failed to adapt their lending procedures accordingly. Indeed, in most cases AID has made a requirement of its program that the lender make very high overhead investments in each loan. From the salaries of the loan making and loan supervision staff to the cost of the buildings in which they operate, it has proved impossible to make small farmer credit programs "pay their way" in most cases.

The village shopkeeper lender, on the other hand, is a "master" of low overhead operations. His survival over the generations, in good and bad economic times, attests to this. Because he operates in the free market, without subsidy of any kind, he has been forced to develop an economically viable approach to small farmer credit. What are the critical elements to his aproach to administrative costs?

a. Policies And Procedures

With the village shopkeeper there are no cumbersome policies and procedures. His policies are to lend to whomever can be relied upon to repay, for whatever purpose such borrower desires. His procedures are to know everything he can about his borrower's personal and economic circumstances, receive the request verbally, make a note of it on a slip of paper which is placed in a cigar box under the counter, sometimes signed by the borrower, sometimes not, and to supervise the loan by keeping apprised of the borrower's activities day-to-day in the community. Except for the note in the cigar box, there are no written records kept. There are no forms to fill out, no lawyers consulted, no mortgages pledged. The whole system operates on familiarity, good faith and community influence.

b. Diversification

Unlike the formal lender, which engages only in the lending business, the village shopkeeper is a vertically integrated conglomerate. Like most of his clients, he engages in farming. This gives him an understanding of their problems on this front, and makes him a wise judge of relative abilities. As a relatively affluent member of the community, the shopkeeper may also own an animal drawn vehicle. This puts him in a position to help with hauling within the community, or to markets elsewhere. Related to his shopkeeping enterprise, he may also engage in crop storage or drying. In short, he is often engaged in production, storage, processing and marketing simultaneously.

This diversification enables the shopkeeper to operate very efficiently overall because there is little "down time" for him. When one activity slows down, he turns to another. He works long days, all year long, and in this way is able to earn a little better living than his neighbors while remaining competitive in each individual enterprise. Competitiveness is critical because entry into each of these enterprises at the level on which he operates is easy. Were hauling, lending, storing or marketing to become highly profitable, the shopkeeper would soon have competition.

4. Loan Default

A forth critical error in AID's traditional approach to small farmer lending is in the area of loan default. The formal lending institution model which has been favored by AID relies on several loan protection methods that may have worked well in the U.S., but have not "traveled well" to most LDC environments. The shopkeeper lender, on the other hand, relies on unwritten conventions and overall community support. These contrasting approaches are analyzed below.

a. Formal Lender's Approach To Minimizing Default

(1) Farm Plans

Farm plans are great in theory, but when introduced into an environment where farmers are largely semi-literate, where qualified extensionists to assist with these are far removed from the target borrowers both in distance and social class, and where farm plots are so small that the drawing and reviewing of a supervised plan becomes a high-cost (per unit of production) operation, they don't make much sense. The farmers weigh the costs of complying with such a requirement (which is fairly well known to them) against the benefits (access to a new source of credit) and often prefer to stay with their traditional lender.

(2) Mortgage Collateral

The taking of mortgage collateral for small farmer loans is perhaps the single best example of misguided transfer of lending practices from one society to another. In most LDC peasant environments population mobility is limited. Land tends to stay in families generation after generation, and ownership is a matter of common community knowledge. In such situations, surveys may not have been undertaken at all, and even if they have farmers may not have bothered to seek a written record of title. Furthermore, land ownership is often a highly political issue. Farmers may not have a strong voice in government when it comes to competing for physical and social infrastructure, but when their basis for economic survival (land ownership) is threatened, they tend to react with fervor, generally enjoying community support in the process.

To go into such an environment and require mortgage collateral for production credit loans is naive. It doesn't work (1) because many of the potential borrowers cannot produce a mortgageable title, and (2) even where such title is mortgaged, the lender rarely has the political "clout" to deprive a borrower of his land. The whole process of taking mortgages as security for small farmer credit is a sham, and it has gone a long way toward limiting the success for formal agricultural credit institutions.

b. Shopkeeper Lender's Approach To Minimizing Default

By way of contrast, the shopkeeper lender has disregarded both the farm plan and mortgage collateral as devices for securing his small farmer loans. His security comes from (1) pre-qualification of the borrower's sense of responsibility for debt, (2) keen insight into his overall character, (3) intimate knowledge of his abilities to provide for himself and his family, (4) a close sense of identity with the client, (5) long standing presence in the community, and (6) community presure on both sides to deal fairly. Forms are not needed in such an environment. The shopkeepers know who the worthy borrowers are and how much they are "good for." Because he and his borrowers attend the same church, and send children to the same schools, they are disinclined to take advantage of one another. Were one to do so, their shared friends and neighbors would exert subtle pressures to conform to acceptable behavior.

Data indicate that shopkeeper loan defaults are uncommon. The price for default, loss of future credit privileges, is very high. Because of the high level of communication within rural villages, loss of credit with one merchant is likely to cause similar reactions among the others. Loan default from formal government and parastatal lenders, however, is common in AID projects. The threat of forclosure is rarely exercised (too political, and there is often no commercial market for a one or two hectare parcel, and the idea of defaulting on a loan from a large, unfamiliar institution located in a distant city is not regarded as seriously as cheating one's own neighbor.

5. Targeting

Targeting of small farmer credit is taken very seriously in traditional AID programs. The methods normally used, however, have added to the already excessive administrative burdens on cooperating lenders, and contributed to their dismal record for institutional viability.

a. Targeting Through Formal Lenders

The traditional method for targeting AID's credit to small farmers is to establish definitions of the targeted clientelle, generally in terms of land farmed and loan size, and hold loan officers to such criteria. The theory is good, and where criteria are enforced, loans outside the prescribed client range can be effectively limited. The problem is that without more effective marketing than is generally present in traditional programs, and lessening of the loan application cost, most of the farmers who fit the lender's definition are either never reached or, if reached, decline to participate in the program.

b. Targeting Though Shopkeeper Lenders

How can one ensure that loans reach the target small farmers in the proposed system of relying on village shopkeepers to retail the credit? Should such shopkeepers be "saddled" with definitions of qualified borrowers and required to document each credit transaction? Probably not. The various means by which credit is extended in the course of a normal day are too complicated to justify documentation. Most shopkeepers would refuse to cooperate.

What can be very easily done, however, is to instruct the credit wholesaler (the formal lender) on target regions and villages where the preponderance of farmers are small-holders, and restrict lending activities to shopkeepers which serve them. Granted, if left to his own devices, the shopkeeper will give top priority to the most qualified (often synonymous with most wealthy) borrowers. With all risk of default on his shoulders, that is simply rational behavior. By introducing additional credit into the village, however, it is anticipated that the shopkeeper will deal with successively lower income clients, always taking the best of the remaining pool. By qualifying only those regions and villages that comprise the poorest populations, targeting can be effectively achieved without burdensome qualification on an individual borrower basis.

6. Extension

The last of the critical elements viewed as having been improperly treated in most LDC small farmer credit programs is the approach taken to extension of technical advice. Here again, the problem is seen as one of proposing "cadillac" solutions in a "cheverolett" environment.

a. Traditional Approache To Extension

In most of its small farmer credit projects undertaken through government and parastatal banks, AID has encouraged linkages between the formal lender and the Ministry of Agriculture extension service. Such government extensionists have often been responsible for assisting with development of farm plans, and to the extent that follow-up advice and assistance is given, for providing such advice.

Results have been mixed. Though generally well qualified for the task from a technical perspective, government extensionists have often been too few in numbers, inadequately supplied with transportation to reach into the countryside effectively, and often so removed from the target farmer client socially and culturally that he is unpersuasive.

b. Extension Through Shopkeepers

An alternative approach to small farmer technical assistance might be to learn from the lessons of recent year social marketing programs in the population and oral rehydration areas. In these programs emphasis was on reaching target clients on their own turf (at the village level) with information adapted to their educational and social situation. The products themselves were distributed through indigenous distribution systems (village shopkeepers) rather than government nurses, doctors, social workers and the like.

These techniques could be adapted to small farmer inputs simply by investing in instructional materials oriented to semi-literate farmers, and placing such materials in urban supply stores for distribution to shopkeepers when they come in to purchase inventory. Village stores tend to be places where people gather anyway, and if the instructional materials were on the counter and free, they would be looked at and discussed. Even in the U.S., with its extensive system of federal, state and county extensionists, there is more agricultural extension carried out at the local feed and seed store than anywhere else. Farmers and their suppliers like to compare notes, and a small investment in information that they can read would reap large dividends.

IV Conclusions

In summary, AID's efforts over the past twenty-five years to transplant the agricultural lending system that proved so successful in the U.S. - a marriage of formal lending institutions with government programs for extension - has not been effective in most developing countries. Even after decades of investment, the indigenous rural credit system built around village shopkeepers continues to dominate the market. It is time for AID to rethink its traditional approach, to learn from its more successful competitor (the shopkeeper), and to work with him rather than against him.

The critical elements in a small farmer credit program include (1) a rational approach to interest rate setting, (2) agressive marketing techniques, (3) attention to limiting administrative costs, (4) cautious borrower qualification, (5) targeting by region and village, and (6) agricultural extension through natural commercial channels. In each of these areas AID's traditional approach has been lacking. In each of these areas, the village shopkeeper credit system has either performed well or offers an opportunity to accomplish good performance.

The challenge, now, is to admit past failures and face the challenge to innovate.

V Issues

The following section provides for discussion of issues that are viewed as either (1) critical to project success or (2) likely to rise during project review.

1. Exploitation Of Farmers By Village Shopkeepers

It is frequently pointed out that village shopkeepers are guilty of charging small farmers usurious rates of interest for money loaned, overcharging for products sold and underpaying for crops purchased. Often ethnic minorities, the shopkeepers are depicted as part of an overpaid, non-productive elite that must somehow be overcome if equitable rural development is ever to occur.

In most cases this view is unrealistic. By and large the village shopkeeper lives a life not far removed from his small farmer neighbors. His home is much the same, his children attend the same schools, his work-day is long, and vacations are few if ever. The composit village shopkeeper is engaged in a multitude of activities including farming, livestock raising, hauling, lending and crop buying in addition to keeping a shop. Because of his broad range of activities, he employs his wife and children in the enterprise and probably enjoys less leisure than others in the village.

As a result of this high level of effort he tends to enjoy a better income than his small farmer neighbors. He is by no means on a par with the large farmers, however, either economically or socially.

In many parts of the world the village shopkeepers are ethnic minorities, and this fact is used as an argument to develop agricultural delivery systems that circumvent their participation (eg. government and parastatal institutions for credit and input delivery and for crop purchasing). This is an unfortunate reaction to a phenomenon that may actually be very positive. As was pointed out in studies of ethnic minority shopkeepers in Viet Nam and India, the fact that shopkeepers in such societies are minorities means that they enjoy virtually no political protection. Always issolated and on the defensive, they survive by being scrupulously careful in their dealings. In many societies landowners can accomplish special political favors (eg. price supports) through their political clout. Urban political leaders have been known to exercise such powers to help their constituencies. Not so the village shopkeepers, especially where they are ethnic minorities. Far from being the exploiters, in many societies they are continually on the defensive.

As to the claim that village shopkeepers earn obscene profits, given the ease of entry into the profession that claim is also improbable. Were keeping a shop highly profitable there would soon be more shopkeepers. Such growth might develop from within the village or from urban distribution points. The reality, however, is that the keys to survival over time in the village shopkeeper business are (1) long hours, (2) great diversity of activities and (3) frugal living. Like farming, shopkeeping is more a way of life than a job one chooses for its income potential.

2. High Cost Of Money

A major concern if AID is to try to develop agricultural credit programs that are sustainable is that the credit be priced at its true cost. In none of the credit projects reviewed by a recent Impact Evaluation series was realistic credit pricing provided for. If AID elects to come to terms with this issue it may expect interest rates well in excess of those customarily charged. Indeed, the rates charged will probably be close to the "informal market" rates AID officers so frequently decry.

To arrive at an interest rate, one must look at the various components that make-up the cost of money in any economy; inflation, administrative cost of extending the loan, allowance for predicted defaults and a real rate of interest sufficient to satisfy suppliers of capital. Putting these components into a rate determination formula, the rate necessary to long term sustainability is determined through simple addition. Looking at such a formula employed respectively in low and high infaltionary countries is revealing:

	1984 Interest Rates	
	U.S.A	Brazil
Inflation	005%	204%
Administrative Cost	004%	004%
Allowance For Bad Debt	001%	002%
Real Rate Of Interest	006%	300%
TOTAL	016%	509%

Clear from the illustration is that determination of interest rates is heavily dominated by the rate of inflation. Although real rates tend to be high in high inflation economies, that is primarily a function of fear about inflation. When guessing, it is always safer to guess high. With 200 percent inflation in Brazil it is understandable that lenders want to build-in lots of cushion on fixed-rate credits.

Though Brazil's inflation is higher than in most of AID's LDC client countries, we must expect severe inflation in many. The implications of it are that (1) rates cannot be set in advance, to last long periods of time (our conventional practice), (2) realistic formulas for rate setting need to be established and used, and (3) AID must be prepared to compete for borrowers in the marketplace through ease of application, rapid response time and convenient loan servicing if it is to be successful in a non-subsidized environment. The only part of the interest rate equasion in which AID can realistically expect to be arbitrary is determination of the allowable real rate. A policy of limiting this number to, say, 5 percent would contribute to AID's equity objectives without jeopardizing the lender's viability.

3. Shopkeepers' Administrative Systems

Another difficult adjustment for AID, should it elect to work through the indigenous small farmer credit distribution system, will be acceptance of the credit policies and procedures commonly practiced therein. Following is a rough description of the process.

As a rule, shopkeepers view themselves as shopkeepers first and lenders second. They have a keen awareness of their trade area as well as their customers' business and personal lives. Lending activity typically occurs in the context of a customer wanting to take something home from the shop but not having funds on his person to pay for it. Application for such credit is made verbally, the shopkeeper makes the credit decision on-the-spot based upon very complete information he has about the customer's credit-worthiness and the value of that customer's business to him, and documentation is generally no more than a handshake, or perhaps a scribbled note placed in a cigar box under the counter. Sometimes the borrower will be asked to sign the note, sometimes not.

Typically a customer's "credit line" is built very gradually, over many years. If he makes good on a bottle of ketchum purchased on credit, he may next be allowed to buy a hoe, and so on. Lending terms are also gradually extended. If a borrower finds it impossible to meet some agreed upon deadline for payment the subject is discussed and either the loan is rescheduled or some penalty is levied. The most common penalty is loss of credit privileges at the lender's place of business, and in cases where the loan is larger it may extend to confiscation of some borrower assets. This latter recourse is only done with reluctance and difficulty, however, as carrying out such an action requires involvement and approval of the community at large. Rarely are the courts used in such cases. Rather, enforcement is by general understanding and agreement as to what is fair.

Although this indigenous system for credit delivery and collection is rustic as compared to systems developed for the formal credit market, it is generally very effective. Detailed studies of such systems in Viet Nam and India indicate that in fact default rates are very low in normal times, although large scale economic disruption, such as general crop failure, can cause short-term business failure even among shopkeeper lenders.

Why does this seemingly imprecise, sloppily documented credit system work so well when its formal market competitor suffers high default rates? The keys seem to be in two general areas:

* Lenders know their borrowers very well and rarely misjudge their character.

* Borrowers are aware that failure to repay will cost dearly in terms of (1) loss of future credit privileges at the community store and (2) loss of face among friends and neighbors.

The bottom line, it seems, is that even with all its forms and legal documents, formal market credit systems are not taken as seriously as those developed over the years through the indigenous system. AID should accept this reality and adjust its policies accordingly, allowing the indigenous systems to function normally. Only by so doing can AID successfully work through village shopkeepers.

4. Risk Of Default

The conventional approach to default minimization in AID's formal credit institution counterparts is to insist upon (1) well conceived investment plans to ensure wise use of credit funds and (2) mortgage collateral to make sure the borrower knows the lender is serious. Unfortunately, evaluation of AID's past efforts in this arena indicate that we are typically successful at neither.

a. Investment Plans

Investment plans, sometimes called farm development plans, are typically drawings of the small farmer borrower's fields with an indication of what areas will be planted with which crop, where fertilizer will be applied, etc. A government extension agent may be employed to assist the farmer to develop this, or it might be done with the assistance of an employee of the lender. The germane point is that the farmer already knows what he will do with the credit financed inputs, but if the lender needs something written down he will comply.

To the extent that the farm development plan is appropriate to the farmer's needs there is no harm done to the farmer and it helps the lender to know how its funds are being invested. Often, however, AID agricultural credits are tied in some way to a given technology package - usually something relatively new to the area and thus perceived as being higher risk than the normal production program. This often has the effect of discouraging credit use altogether or, alternatively, increasing the element of risk and, by extension, default. A farmer who has been encouraged by a government extensionist, or a lender's representative, to credit finance a technology that takes a season of his time and land and proves unproductive is not in a very good frame of mind at repayment time. He may feel used, and it is hard to feel sympathy for a large, impersonal credit institution.

b. Mortgage Collateral

In many cases AID's counterpart lending institutions seek to minimize risk of default by taking a mortgage on the borrower's farm as collateral for the loan. The theory, it seems, is that if a farmer is faced with loss of his means of livelihood he will be sure to repay and obligation to the mortgage holder. The reality, however, is quite different.

Forclosure on a farmer's land is difficult in any environment. It is both an expensive and political process. To initiate forclosure proceedings for a classic small farmer credit of $500 is not economic. That is only the beginning, however. Once the farmer's land is taken, what will the lender do with it? A one to five hectare parcel is not easy to covert back to cash. Renters can be found, but that leaves the lender in the undesirable position of being a landlord.

In the final analysis, lenders generally opt to avoid forclosure at any cost, including taking a loss on the loan itself. The taking of a mortgage, in effect, is little more than a bluff. It serves to keep away farmers who genuinely fear loss of their land and are unwilling to risk it for a loan sufficient to plant one crop, and it does not deter farmers who are wise to the lender's true intentions.

As is indicated in item 3 above, the only real protection against borrower default is careful screening for character and willingness to "ride out" hard times in case of a bad crop year.

5. Shopkeepers As Extensionists

AID's conventional approach to communicating agricultural technologies to small farmers is to develop technical capacity in an appropriate govermental agency - normally an agricultural ministry. Ministry employees are trained in techniques of agricultural extension, generally those developed over the past half-century in the U.S., and in many cases they are encouraged to work closely with agricultural universities for research support. The extensionists themselves are typically high school or agricultural college graduates, and as such they tend to be products of the secondary cities of their respective countries.

This approach, although a worthwhile one, has not been sufficient by itself to meet the needs of small farmers in developing countries. Because the extensionists are few, they tend to reach only a portion of the farmers and even those only occasionally. There is a tendency to concentrate on the more approachable, especially those living nearest automotive transportation and those who are most open to such visits. Often this translates to larger, better educated farmers. It is difficult for the city born, relatively well educated extensionist who occasionally appears via jeep or motorcycle, to develop close rapport with the semi-literate, rural born, tradition bound small farmers, no matter how well intentioned he may be.

Overlooked in AID's traditional approach to agricultural extension, it seems, is that there is a party with an easy entre to the small farmer who might well support the government extensionist - the village shopkeeper. He is in the village all day every day. He has known his farmer clients all of their lives. He goes to church with them, attends their baptisms and weddings, sells them medicine, school books and farm inputs, and often buys their crops. He tends to be somewhat better educated than his fellow villagers, is a farmer as well, may own a vehicle, and visits the nearby city more often than anyone else in the village because he needs to replenish his shop inventory.

In the U.S. the village shopkeeper equivalent, the feed and seed dealer, grain elevator operator or general storekeeper, has long played an important role in agricultural extension. In most cases he, rather than the county agent, is the principal contact the farmer has with new farm technologies. This natural affinity between community based farm supplier and small farmer is strongest in the smaller, poorer communities. In developing countries it tends to be very strong.

Proposed, therefore, is to look upon the village shopkeepers as an agricultural extension resource and support him accordingly. Just as he is asked to serve AID's small farmer credit activities by acting as supplier and banker, so too should he be asked to assist with extension of technical advice. Since he is probably doing this anyway, the only change in his modus operandi would be availability to him of more and better materials explaining his products and techniques for using them. This translates to carefully designed literature accompanying seeds, fertilizer, equipment, etc. oriented to semi-literates. It might also translate to certain visual materials such as callendars or comic books dedicated to increasing the small farmer's knowledge of farming techniques and technology packages.

It is important to understand that small farmers tend to be very reluctant to accept change. Because they live close to poverty, they do not enjoy the luxury of a "safety net" in case of a bad year. They are careful because they have to be. To expect them to try out a new idea promoted from the back of a jeep by an unknown extensionist who is only seen once or twice a year is naive. They want to "ponder" new ideas, making up their minds after time to reflect and discuss - not days but months. In the environment of the village shop such a decision-making process is possible.

6. Pipeline

AID will have to accept long disbursement pipelines with agricultural credit projects designed to wholesale credit through village shopkeepers. Rapid disbursal of loan funds, difficult even in retailing directly to small farmers, may be even more difficult with village shopkeeper borrowers. Such difficulty is anticipated because the shopkeepers are both conservative and sophisticated. They will not want to borrow more than they can easily "place" in the form of goods and services sold on credit, and they will not expect to be forgiven in case things don't go well for them. They understand that credit is a high stakes game, and they will only play if the odds favor them.

The likely draw-down scenario, therefore, is expected to be a slow starting program, as shopkeepers come in for a tentative first loan, and a gradual build-up as they experiment with deepening their credit clientelle on a case by case basis. Critical to successful evolution of the process is that (1) no shopkeeper be pushed to borrow beyond what he feels comfortable with (he knows his marketplace better than anyone) and (2) once he is in the program he must never be turned-down for renewal of his loans so long as he is in good standing from a credit perspective. It is an unwritten law in the informal credit market that good borrowers can always come back. As the village shopkeeper builds his own client base for credit, he will require constant support from his own backer. Priority for new credits, therefore, must always go to those already in the program.

To avoid pipeline delays, AID might consider funding agriclultural credit programs on an installment basis, frequency of installments depending upon demand.

7. Targeting AID Assistance

To the extent possible AID likes to target its economic assistance to specific economic and social groups. In the agricultural sector, our prefered target is often the small farmer. In conventional agricultural credit projects the technique employed to ensure that credit assistance is channeled to small farmers is to make it a requirement of the loan officers. This is enforced by providing a definition of small farmer and insisting that the loan officers gather sufficient information in interviewing the borrower to ensure that he fits the profile.

On the surface this conventional targeting technique is valid. Looking a bit more deeply, however, its falacy becomes apparent. The problem is that the policies and procedures tied to AID's small farmer loans discourage small farmers from "coming to the window" so it doesn't matter that they are ostensibly the prefered customer.

Targeting toward small farmers is a relatively simple matter when one is dealing through village shopkeepers. Because of the nature of the shopkeeper's operations, his clients are already the small farmers. Large farmers, with larger volume consumption and farm input needs and better transportation, are likely to be doing volume shopping in a nearby city at a lower price. To the extent that they utilize supplier credits they are getting them in the city. Village shopkeeper credits thus will flow naturally to their regular client base, the small farmers. Encroachment by the larger farmers will only happen if the village shopkeeper credits become cheaper than those of the urban supplier. Given the shopkeeper's high cost of operating (because of additional transportation, storage and spoilage costs) this is unlikely.

Regulations to ensure targeting can thus be very limited; perhaps falling in two areas:

(1) Shopkeeper borrowers should be required to limit their use of the program's credit to agricultural purposes. This can be enforced through post effective monitorship by asking for receipts on his expenditures when he comes back for loan rollover.

(2) Shopkeeper borrowers should be required to limit their credit activities to their normal village clientelle. This can be enforced through post effective monitorship by requiring a list of all credit customers when he returns for loan rollover.

8. Short-term Verses Long-term Credits

It is sometimes argued that short term agricultural credit is not as critical to development as is long-term credit, and thus AID should be focussing its efforts in the latter area. Farmers are seen as able to survive from year to year based upon existing credit sources, but unable to improve their economic base without longer term capital. This is an appealing argument until one begins to probe.

The first easily discovered weakness in this case is that it is based on little or no data about the availability/adequacy of short-term credit. It is theoretically possible, of course, that there is more than enough credit to go around, and more is to no avail, but experience seems to suggest otherwise. To abandon short-term credit inteventions in favor of immensely more complicated interventions in long-term credit without strong evidence that the switch is warrented is imprudent.

A second weakness in the case is that it suggests AID intervention in a very difficult area of long-term credit when we have failed to master the relatively simple field of short-term credit. The problems of inflation risk and loan administration/default management are far greater when one deals with long-term lending.

a. Inflation Risk

The only feasible way to set long-term interest rates in highly inflationary economies is to let them "float" on the rate of inflation. For a fixed rate policy to even have a chance to succeed one would have to set rates so high as to discourage borrowers. Floating rates, on the other hand, are hard to "sell" for a variety of reasons. Most important, perhaps, is that inflation is seldom evenly distributed among the various outputs of an economy, and the slowest outputs to inflate are those produced by farmers. Translated, that means that the "float" is likely to work against the farmer, making such money very high cost for him.

With short-term rates the gamble of setting a fixed-rate is less because one need only predict inflation for a year or less. Where the prudent banker's contingency factor for a five year fixed rate loan, in an economy where inflation has ranged between 25 and 100 percent, might be the greater of the two rates, say 100 percent, for a short-term loan he would only charge that higher rate were the loan placed in a year when inflation is 100 percent. In other words, short-term rates are going to more closely reflect the fair rate of interest.

b. Loan Administration/Default Management

Loan administration/default management is an important aspect of banking that is generally given "short-shrift" by AID project designers and implementers. Yet, the manner in which it is carried out often makes the difference between high and low delinquency rates. In the case of short-term credits this is a relatively simple task. The key is to establish frequent contact with the borrower so that (1) he remembers that you expect to be repaid and (2) you know when he has the ability to repay. Short-term credits are generally tied to a particular business cycle (say, harvest) and the lender endeavors to insert himself in the process.

With long-term credits this is a much more difficult task. Periodic payments on monthly or quarterly intervals are a common technique in many societies. High frequency of payments puts the credit institution in a position of control because they can oblige frequent contacts and they will know quickly when a borrower is in trouble. Such a strategy doesn't work with farmers, however, because their paydays are few and "lumpy" - essentially only at harvest time. Once a payment on a long-term credit is missed, and this is likely to happen at least once in a five year period because profitable farm operations depend very much on factors external to the farmer's control, it is very difficult to get it back on-track. Short-term credits are more easily collected after a financial disaster because the farmer typically is obliged to renew his pledge in order to get inputs for the next crop cycle. Long-term lenders, unless they happen to also be providing production credit, do not have this hold on the farmer.

9. Applications In Tribal Societies

One of the problems with general solutions to problems is that there is often enough difference in a given situation to require some tailoring, even of the so-called "generic" solution. The proposed approach to agricultural credit is no exception.

In most of the developing world (Latin America, Asia and the Near East) the low income societies are peasant cultures with a strong farming base. Typically landholding patterns are stable, villages are well established, and a well developed system of commerce is entrenched with substantial specialization. There are players who specialize in shopkeeping, hauling, lending and the like, and they deal with a broad client base that is defined primarily in geographical and economic terms. In such a commercial environment, the specific approach to agricultural credit discussed herein is applicable.

In other parts of the world, however, the most notable examples being in Africa, there are societies dominated by tribal cultures with very different commercial systems. In tribal societies specialization is more along political and social grounds than economic, and the commercial unit is likely to be expanded beyond the single-family farm to include the extended family, clan, even tribe. The concept of private property is far less developed as well.

Translating that to terms that are relevant to this agricultural credit proposal, it is important to note the following:

-- In many tribal villages there are no resident, full-time shopkeepers. Rather, the trading function is fulfilled via weekly markets in which there are many players from the local community (also the case in peasant societies) and the shopkeeper specialists are outsiders who visit only on market days.

-- To the extent that lending occurs, it is typically done within the extended family, and obligations are treated in a less commercial sense than in more commercialized societies; eg. rather than linking debt repayment to an economic event such as harvest it may simply be a claim on "goodwill" that can be made "on demand" at any time in the future. Where an outside lending institution deals with such societies it is accepted (and advisable) to deal with the broader economic unit, such as the clan or tribe, rather than with an individual family.

The generic aspect of this proposal relating to credit delivery is not the shopkeeper network, therefore, but rather the concept of building on indigenous systems, whatever they are. Just as AID's penchant for establishing large, formal credit institutions proved inapplicable in most peasant and tribal societies, so too would a proposal building on a locally based shopkeeper network prove inapplicable where there is no such network. Where such a project implementation process is outlined in this PID, therefore, it is merely illustrative. In much of the world it comes close to describing reality, but where the indigenous system for credit delivery is different, then AID's approach must reflect that difference.

The generic aspect of this proposal relating to credit policy is the formula for determination of interest rates. Such rates must be a function of local economic circumstances (inflation, administrative cost, bad debt allowance and acceptable real rate of interest) if credit institutions are to achieve long-term viability. Beyond those two general rules the specific solutions applicable to tribal societies must be developed on a case-by-case basis.