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HAS FOREIGN ASSISTANCE UNDERMINED CREDIT UNIONS IN DEVELOPING COUNTRIES?

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Like agricultural development banks and other financial institutions in developing countries, credit unions have often been the recipients of foreign assistance. A thorough survey of credit unions in Latin America, and perhaps elsewhere in the developing world, would almost certainly reveal that the vast majority of these credit unions are currently facing severe problems. In the case of Latin America, such problems are usually attributed to the severe problems that most Latin American countries themselves are facing, including rampant inflation, decreasing output and employment, and balance of payments crises aggravated by massive foreign indebtedness. The present paper attempts to examine the extent to which past foreign assistance may have contributed to the problems currently facing credit unions, as well as the extent to which future foreign assistance could help to alleviate the situation or would simply perpetuate the current problems.

One aspect of the situation needs to be mentioned initially because it is potentially a serious problem for credit unions and their federations but will receive little attention in the balance of this paper. Credit and other services that credit unions and their federations provide to members are almost exclusively in terms of domestic currencies and domestic resources. However, foreign

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assistance involves international resource transfers that are received as foreign exchange; and, if the foreign assistance involves a loan rather than a grant, this foreign exchange must be repaid. Until recently the countries of northern South America and northward to the United States had experienced only moderate inflation and had, for the most part, fairly stable exchange rates. Based on the expectation that such a situation would continue, many credit unions and their federations assumed liabilities payable in foreign currencies without considering the potential foreign exchange risks. Loans from international donor agencies that were designed to be foreign assistance may now have become quite burdensome for credit unions and their federations. It is important to consider who should assume these losses and the foreign exchange risks in similar future arrangements, particularly when the credit unions and their federations are interested only in obtaining domestic resources, while governments and their central banks may often want to promote such international resource transfers to obtain the foreign exchange involved.

The analysis in the present paper is focused almost exclusively on credit unions in Latin America. This is not to deny that the experience of credit unions in other parts of the developing world may be of at least as much importance or that it may be strikingly different. The reason for the Latin American focus is simply that empirical research must begin somewhere and that international donor agencies also appear to have focused their attention on credit unions, primarily on those in Latin America. The focus of the present paper is in fact much narrower than all of Latin America, but it is hoped that continuing analysis of credit unions in other parts of Latin America will not totally contradict the preliminary findings of these initial investigations. Findings from two countries, Peru and Honduras, are based on in-depth studies covering a period at least two years in each case. Additional short-term work which tends to confirm the findings from Peru and Honduras has been undertaken in a number of other Latin American countries: Costa Rica, Ecuador, Bolivia, Paraguay, Haiti and the Domonican Republic, in particular.

The usual brief acknowledgment at the beginning of a paper is totally inadequate to give appropriate credit to the individuals and institutions that have carried out the work on which the findings reported here are based. In addition, the nature of this work needs to be described briefly in order to appreciate the extent to which these findings are likely to be applicable to other Latin American countries where such investigations have not yet been undertaken. The first in-depth study was carried out in Peru from early 1979 through the end of 1981 under support from USAID/Peru and USAID/Washington through its cooperative agreement with Ohio State University on Rural Financial Markets and also involved Syracuse University. The main purpose of this project was to strengthen the ability of the Peruvian National Cooperative Bank (BANCOOP) to provide financial and technical assistance to rural cooperatives in two target areas, Huancayo and Tingo Maria, with particular emphasis on savings mobilization by BANCOOP itself and by the credit unions in the target areas. George Wohanka, the long-term advisor to BANCOOP under the project, was not only primarily responsible for the successful implementation that resulted in BANCOOP's surpassing the savings mobilization goals of the project, but also contributed significantly to the analysis of savings mobilization by BANCOOP and the credit unions. In addition, John Gadway and Jeffrey Poyo each spent six months in Peru carrying out field research under the project and assisting BANCOOP and the credit unions with their savings mobilization activities. This research contributed greatly to a better understanding of the behavior of credit unions and, in particular, their failure to undertake aggressive savings mobilization activities. Although Paul Burkett did not participate in the field research, the empirical part of his Ph.D. dissertation is based on data obtained under the project and his analysis provides important new insights into savings behavior in rural areas of developing countries.

The second in-depth study of credit unions began in 1981 as part of an assessment of rural financial markets in Honduras carried out by Ohio State University under its cooperative agreement with USAID/Washington and is still continuing. Because of the earlier work on savings mobilization and cooperatives in Peru, USAID/Washington and USAID/Honduras were particularly supportive of focusing some attention on credit unions and savings mobilization in Honduras. Barry Lennon, the individual working with USAID/Honduras who was chiefly responsible for the cooperative sector including credit unions, saw this as an opportunity to develop an innovative savings mobilization project for the Honduran Federation of Credit Unions (FACACH) and a selected number of its affliated credit unions. This resulted in a project which involves not only continuing support under Ohio State University's cooperative agreement but also a direct relationship between FACACH and Syracuse University for technical assistance and economic analysis of savings mobilization by credit unions. Jeffrey Poyo, who had previously worked on the Peru project, carried out the initial survey of credit unions in Honduras and then spent over one year in Honduras undertaking in-depth studies of several credit unions, providing technical assistance with savings mobilization to selected credit unions, and carrying out an extensive field survey of credit union members. This field research has provided important insights into various aspects of credit union behavior, not simply savings mobilization activities, and is serving as the basis for Poyo's Ph.D. dissertation at Syracuse University. In addition, John Gadway, who had also previously worked on the Peru project, carried out a very useful analysis of FACACH's relationship with its affliated credit unions, particularly with respect to problems of loan delinquency. In-depth work on loan delinquency is also being carried out by Robert Christen who spent several months in Honduras gathering extensive financial and administrative information on thirty credit unions including a sample of more than six thousand outstanding loans. This information, together with a field survey of credit union members, has already provided significant new insights into the principal reasons for loan delinquency and will be reported more fully in Christen's masters thesis for Ohio State University.

It is not possible to give adequate credit to all the individuals and institutions that have contributed significantly to the in-depth studies of credit unions in Peru and Honduras, and in the case of the other Latin American countries included more briefly in the present paper this is even less possible. As mentioned above, short-term field research, conferences, seminars, and so forth have taken place in Costa Rica, Ecuador, Bolivia, Paraguay, Haiti and the Dominican Republic, all of which have contributed significantly to the findings reported here. In addition to the federations and the individual credit unions in these countries, two institutions representing this sector have been especially important in providing useful information and helpful collaboration: the Latin American Confederation of Credit Unions (COLAC) and the World Council of Credit Unions (WOCCU). USAID/Washington and USAID missions in these countries have provided not only financial support but also the enthusiastic participation of numerous individuals, including especially Roberto Castro who has been most important in promoting work in Bolivia, Paraguay and the Dominican Republic. Other international donor agencies such as the World Bank, the Inter-American Development Bank and the Inter-American Foundation have also shown continuing interest in the analysis of credit union behavior for the purpose of improving credit union performance. Syracuse University and Ohio State University through its cooperative agreement with USAID/Washington have provided essential support, and the collaboration of the members of the rural finance program at Ohio State University has been a crucial intellectual resource. Finally, it is important to mention again the three individuals who participated in the in-depth studies in Peru and Honduras and have also contributed significantly to the short-term activities in other countries: John Gadway, Jeffrey Poyo and George Wohanka.

The in-depth work with BANCOOP and credit unions in Peru did not involve a substantial amount of foreign assistance, basically just a grant of $500,000 to BANCOOP for technical assistance and a credit fund, but the behavior of the target credit unions before and during the project is nonetheless quite revealing. After years of impressive growth, Peruvian credit unions began to falter in the mid-1970s, apparently due to a dramatic upsurge of inflation and the failure of credit unions to adjust their traditional low interest rate policies in the face of this inflation. From the early 1950s through 1973 the rate of inflation in Peru averaged less than 10 percent per year, but accelerated to over 30 percent per year in 1976 and 1977 and later climbed to over 50 percent per year. Until mid-1976 interest rates were rigidly controlled by the Peruvian Central Bank at 5 percent on savings deposits, 7 percent on time deposits, and 12 percent on short-term loans. These interest rate ceilings were raised initially in mid-1976 and substantially in 1978. During 1979 and 1980, the ceiling rates were 30.5 percent on savings deposits, up to 35.5 percent on time deposits, and 32.5 percent on short-term loans. Early in 1981 interest rate ceilings were again raised significantly to 50.5 percent on savings deposits, up to 54.0 percent on time deposits, and 49.5 percent on short-term loans.

When the project was initiated in 1979, none of the five major credit unions in the two target areas had taken advantage of the opportunity to raise interest rates, but rather continued the tradition of charging 1 percent per month on loans. With such low rates on loans, they were unable to pay high enough rates on time and savings deposits to compete effectively with other financial institutions, especially commercial banks, which quickly took advantage of the increase in interest rate ceilings. Consequently, the credit unions were forced to rely for their resources almost entirely on the capital contributions of their members, with dividends limited to 6 percent per year by Central Bank regulations. Such interest rate policies created perverse incentives and serious problems for the credit unions. On one hand, members have a strong incentive to borrow as much as possible because interest rates on loans far below the rate of inflation mean that borrowers have to pay back in real terms much less than the amount borrowed. On the other hand, members have little or no incentive to maintain time and savings deposits with their credit unions because the purchasing power of these deposits is rapidly eroded by inflation when adequate interest rates are not paid. Members who make capital contributions to their credit unions do so primarily to secure access to loans, and these loans can be as much as three times the amount of a member's capital contribution under the regulations of most Peruvian credit unions.

The results of these interest rate policies can readily be seen in the serious problems experienced by credit unions in the two target areas of the project (see Gadway, 1979 and 1980). There were increasing complaints of severe shortages of loanable funds, as members' demands for low interest loans far exceeded their capital contributions and meager time and savings deposits. Disgruntled members who were told that their approved loans could not be disbursed because of a lack of funds, or that there was no point in even applying for a loan, often ceased making capital contributions and became inactive. For some credit unions the loss of active members spread to serious repayment problems as members saw no point in repaying old loans when the prospects for obtaining new loans were bleak. In addition, many credit unions experienced substantial operating deficits as stagnant interest income failed to keep pace with inflating operating costs, and even those that grew in nominal terms have seen the purchasing power of their capital dramatically reduced since the mid-1970s.

As indicated by the final report for the project and by the evaluation of the project, BANCOOP was extremely successful in reaching and in fact greatly surpassing the savings mobilization goals of the project (see Wohanka, 1981, and Adams and Larson, 1981). Savings mobilization by credit unions under the project was, however, much less successful. In spite of the availability of technical assistance from BANCOOP to help credit unions in the target areas with savings mobilization, these credit unions were slow to accept the higher interest rate policies that are a prerequisite to successful savings mobilization. By the end of 1979, only two of the five major credit unions in the target areas had raised their interest rates. One of these changed its interest rate policies only after it had reached the verge of collapse and had received an inordinate proportion of the project's technical assistance in the form of detailed analysis and persistent explanation of the consequences of its low interest rate policies (see Gadway, 1979). The other, however, had quickly raised its interest rates to the maximum permitted under Central Bank regulations. These credit unions subsequently received some technical assistance with savings mobilization from BANCOOP and together mobilized approximately the amount of savings that was established as the project goal for all credit unions in the two target areas.

Each of the other three credit unions finally raised its interest rates during 1980, but in each case it was too little and too late to be effective for savings mobilization under the project. One credit union became convinced of the need to raise interest rates on loans because of operating losses, but the need to raise interest rates sufficiently to compete with other financial institutions for savings was not recognized. A second raised interest rates to the maximum permitted on time and savings deposits, but gave so little publicity to these changes that several employees of the credit union were unaware of the new interest rates. Both of these credit unions experienced considerable turmoil in early 1981 which resulted in major changes in management. The last credit union did not make any changes in interest rates until almost the end of 1980, and the increases finally made were trivial (see Gadway, 1980).

At least four reasons can be suggested for the reluctance of Peruvian credit unions to change their interest rate policies, even when such changes were so clearly necessary. First, credit unions may simply be confused by cooperative rhetoric, as members genuinely believe that raising interest rates on loans would be usurious and that problems can best be dealt with by appeals to altruism against the economic rationality of individual members. Second, members who are on boards of directors or key policymaking committees may have better access to credit union loans than most other members and may use the rhetoric of cooperativism to keep interest rates low on loans for their personal benefit. Third, credit union board members and management change frequently and ofter have little professional knowledge of economics or finance, so that they may view any departure from traditional policies as very risky and of little potential benefit. Fourth, credit unions continually hope for some low cost source of funds through which they can avoid the unpleasantness of raising interest rates to compete for savings, and past experience with government agencies or international donors often suggests that such funds may be forthcoming given sufficient patience.

This fourth reason for the reluctance of credit unions to raise interest rates appeared to cause some problems for BANCOOP's relationship with credit unions under the project. As indicated above, some cooperatives expected low interest rate funds from BANCOOP because it is the bank for cooperatives.

Moreover, the fact that BANCOOP had received a grant from USAID had been widely publicized throughout the Peruvian cooperative movement. Thus, when BANCOOP officials visited credit unions in the target areas, often in the company of USAID consultants to the project, the credit unions were expecting offers of low interest rate funds from BANCOOP and were keenly disappointed when all they received were offers of technical assistance with something for which they had no great enthusiasm. It is also interesting to note that Jeffrey Poyo's interviews with a sample of BANCOOP depositors and a control group of nondepositors revealed that in choosing a particular financial institution, the main difference was not between BANCOOP depositors and nondepositors, but rather between individuals who were credit union members and those who were not (see Poyo, 1981a). For credit union members, the possibility of obtaining a loan was clearly predominant, followed by confidence in the institution, with almost no weight given to any other factor. Those who were not credit union members placed as much or more weight on good service, location, hours of operation, and interest payments.

The in-depth study of credit unions in Honduras differs from the work in Peru in three important ways: (1) a large number of credit unions throughout Honduras are involved rather than just five credit unions in two target areas; (2) the work in Honduras is still in process so that more concrete findings can be expected to emerge in the near future; and (3) the Honduran economy has experienced only moderate inflation during the past decade, so that interest rate policies may not be so crucial to credit union viability as they were in Peru. An initial survey of eighteen rural credit unions located throughout Honduras nonetheless revealed major variations in financial health which appear to be significantly related to interest rate policies (see Poyo, 1981b). Those credit unions that had maintained the traditional 1 percent per month interest rate on loans tended to be experiencing more serious financial difficulties in terms of a lack of liquidity, loan repayment problems and operating deficits, as well as a stagnation or decline in the number of active members. On the other hand, those credit unions that had raised interest rates on loans even modestly and were paying competitive rates for time and savings deposits tended to have less serious liquidity and loan repayment problems and often had operating surpluses and growing numbers of active members.

An important aspect of interest rate charges on loans that emerged from the initial survey was the significant difference between stated and effective rates of interest. Many credit unions charge commissions and/or require that part of the loan be capitalized (i.e., left with the credit union as an addition to the borrower's share capital), and both these practices clearly raise the effective rate of interest over the stated rate. More important, however, is the amount that a credit union member can borrow in relation to his share capital because, in effect, one component of a member's loan is simply a return of his share capital which, for his purposes, had been frozen with interest earnings of at most 6 percent per year. Credit unions charging and paying low rates of interest and consequently finding themselves short of liquidity have often reduced the permitted ratio of a new loan to the member's share capital from 3 or 4 to 1 to as low as 2 to 1, thereby raising the effective interest rate on loans substantially without providing any higher interest rates on deposits to attract additional savings from members. Some credit unions with insufficient liquidity have delayed loan approvals and loan disbursements, thereby decreasing the quality of the credit service provided and effectively increasing in another way the cost of credit for actual and potential borrowers.

The initial survey of credit unions raised some concerns about repayment problems, and these concerns were heightened by indications that the federation, FACACH, also had significant loan delinquency problems. An interim evaluation of the FACACH project, other than its savings mobilization component, suggested that loan delinquency was in fact one of the most serious issues facing FACACH (see Gadway, 1982). In assessing the extent of delinquent loans owed to FACACH by its affliated credit unions, it became apparent that FACACH had followed a rather generous policy of refinancing overdue loans and that such refinancing had to be considered in obtaining a realistic picture of the delinquency situation. Some interesting patterns emerged with respect to the sources of funds and the types of programs financed, on one hand, and the extent of loan delinquency, on the other. In particular, funds that FACACH had obtained from external sources and that were used to finance agricultural production programs tended to be associated with much higher rates of loan delinquency. The reason usually stated for this pattern is that agricultural activities are risky to finance and that credit unions cannot repay FACACH when members do not repay the credit union. However, subsequent investigation suggests that other reasons may be more important in explaining this pattern of loan delinquency. It is also interesting to note the extent to which FACACH has focused its lending on weaker credit unions, or it may be that reliance on external resources from FACACH has made certain credit unions more dependent and hence weaker. In either case, stronger credit unions with substantial capital contributions to FACACH are often heard to complain that they receive relatively few benefits from FACACH in comparison to the benefits received by the weaker credit unions that often have much less capital in FACACH.

The concern with loan delinquency led to the initiation in 1983 of a research effort focused exclusively on this problem. This work is still continuing, but some preliminary findings are already available (see Christen, 1983). The widely-held view that agricultural lending in general leads to higher delinquency rates does not appear to be confirmed, as loans to farmers and loans for agricultural purposes tend to be repaid as promptly as other loans. Instead, the main differences appear to be between those credit unions that effectively mobilize their own resources and consequently have adequate liquidity and those that depend heavily on external funds and consequently often lack liquidity, as the former group tends to have much lower delinquency rates than the latter. This suggests that an important factor in prompt repayment is whether the borrower sees the lender as potentially a good source of credit in the future so that it is worthwhile to repay promptly in order to maintain a good credit rating. It also appears that some credit unions are more rigorous in evaluating loan applications and more persistant in efforts to collect overdue loans, and these credit unions tend to have lower delinquency rates.

The continuing work with savings mobilization by credit unions in Honduras also reveals some significant relationships among loan delinquency, dependence on external funds and successful savings mobilization (see Poyo, 1983). Of the fifteen rural credit unions included in the savings mobilization project, five have participated actively by raising interest rates and promoting time and savings deposits. Not only have these five credit unions been the most successful in capturing additional deposits, but they have also tended to have the lowest delinquency rates and the lowest dependence on external funds. On the other hand, those credit unions that depend heavily on external funds have tended to be uninterested in aggressive mobilization of deposits and to experience relatively high rates of loan delinquency.

As mentioned above, FACACH and its affliated credit unions appear to have experienced the most severe problems of loan delinquency on externally funded agricultural production programs. It is important to analyze this case in somewhat more detail because similar programs have been undertaken in several other Latin American countries, and an evaluation of these programs has recently been carried out in six Latin American countries including Honduras. From the perspective of credit unions and their financial viability these programs may have been unfortunate, but this is not too surprising when it is recognized that credit union viability was not a major concern of these programs. The major objectives were to increase agricultural output and to improve the incomes of small farmers, and the evaluations of these programs were likewise focused primarily on the impact on agricultural output and incomes of small farmers. Judging from the foregoing analysis of Honduras and a reading of the preliminary versions of the reports on Honduras and some of the other countries, many of the credit unions that participated were initially selected because of their strength and became much weaker during the course of the program. This apparent negative impact of programs that use credit unions as instruments for purposes basically unrelated to their essential role as financial intermediaries has also been reported elsewhere (see Youngjohns, 1980).

Some of the problems that arose for the credit unions participating in agricultural production programs seem fairly obvious in retrospect. Inadequate margins were provided for the expensive process of providing technical assistance to farmers, and credit unions sometimes had their attention diverted to activities such as selling inputs and marketing agricultural outputs in which, as financial intermediaries, they had no particular comparative advantage. In addition, there was often a rush to disburse funds quickly to meet the international donor's performance criteria, and this created particular problems for credit unions that did not already have a large number of experienced farmer borrowers. Also, loan applications were often reviewed by the credit union and then by the federation leaving it unclear as to who was primarily responsible and thereby introducing a greater possibility of nonrepayment. The main reason for poor repayment performance, however, seems to have been the view by many borrowers that such production credit programs were nonrecurring, so that there was no point in repaying to establish a good credit rating because additional credit would not be forthcoming in the future in any event. The fact that agricultural activities tend to be risky may not have been an important reason for delinquency but only a convenient excuse for those concerned.

A main issue is whether problems of loan delinquency and inadequate savings mobilization are likely to be inherent in any substantial program of foreign assistance to credit unions or are they primarily the result of problems in program design and implementations that can be remedied. The reluctance of credit unions in the target areas of Peru to raise interest rates may have been due in large part to the hope that funds would be available from some international donor. To the extent that credit unions attempt to depend on foreign assistance to avoid the adjustments in interest rates that are necessary for successful savings mobilization, foreign assistance is likely to undermine credit union viability in the long run. Unfortunately, the research in Peru was not focused sufficiently on credit union behavior to give any definitive answer. In the case of Honduras, there is a definite association between dependence on external funds, on one hand, and loan delinquency and the failure to mobilize savings, or the other. At this point it is not possible to say if this relationship is due to particular problems with externally financed agricultural production programs in Honduras or to a more basic relationship between dependence on foreign assistance and the failure to mobilize savings and collect overdue loans. The research in progress on credit unions in Honduras may provide some answers to this question, but research on credit union behavior in other Latin American countries and elsewhere in the developing world will probably also be necessary.

One issue that cannot be neglected is the possible future role for the credit union federations in various countries and the confederations such as COLAC and WOCCU. Under most traditional foreign assistance programs, international donors have provided resources to the federations and confederations that have then been passed on to the credit unions and ultimately to their members. If this top-down approach is replaced by an approach that emphasizes savings mobilization by individual credit unions, it is not immediately clear what role the federations and confederations should play. Increased importance for technical assistance from federations and confederations to affliated credit unions is one possibility, but the experience with agricultural technical assistance agencies in developing countries does not provide great hope that this could be the basis for long-term viability. Another approach that has been suggested is the conversion of federations into central banks for credit unions, and this might be viable as long as the federations focus their attention primarily on providing good liquidity management services for affliated credit unions. However, it is frequently suggested that federations should impose reserve requirements on their affliates and should also secure rediscounting privileges for the federation from the real central bank. The former is basically a tax on credit unions and their depositors for the benefit of the federation, unless market rates of interest are paid on reserves, and will certainly be opposed as such by credit unions, while the latter would tend to perpetuate the old system of top-down dependency.

In spite of the problems facing credit unions in Latin American and elsewhere in the developing world, they nonetheless potentially have an important role to play, particularly in working in rural areas and with the socioeconomic groups that are not reached by commercial banks and other highly formal financial institutions. The importance of informal financial markets in developing countries has received much greater attention in recent years and, in particular, the positive role played by rotating savings and credit societies in providing financial services to individuals who are not being adequately served by formal financial institutions (see Bouman, 1977). Better understanding of the behavior of credit unions can show how they can take better advantage of their position between highly formal financial institutions, such as commercial banks, and informal financial arrangements, such as rotating savings and credit associations, in bringing improved financial services to their members at low cost. In addition, better understanding of credit union behavior can lead to policy changes by international donor agencies and developing country governments to provide an environment with more appropriate incentives to improve credit union viability and performance.

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