The New View of Rural Financial Markets

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INTRODUCTION

A new view of rural financial markets and their relationship to rural development has emerged in the past few years. This view has emerged because of an analysis of the generally disappointing results obtained from the several agricultural credit policies and programs implemented in developing countries during the past couple of decades. The purpose of this paper is to present a concise outline of the key elements of the analysis that underlies the new ideas. In the short-time available for this session, only a brief outline is possible. Readers interested in pursuing the matter further can find an excellent summary of the literature in a paper by Adams and Graham.[1/] A more detailed and comprehensive treatment is found in the several papers presented in the 1981 Colloquium on Rural Finance cosponsored by the World Bank and AID.

Many of the new ideas developed regarding rural financial markets can be traced to over a dozen years of research by faculty and students at the Ohio State University working with several collaborating researchers in the U.S. and abroad. AID played an important role through the financing of some of the research, consultancies, training, conferences, and information dissemination activities.[2/]

The first section of this paper summarizes some of the common assumptions held about agricultural credit. The second section describes a number of credit policies and programs that are frequently found in

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1/ Adams, D.W. and Douglas H. Graham, "A Critique of Traditional Agricultural Credit Projects and Policies," Journal of Development Economics, Vol. 8, 1981, pp. 347-366

2/ Although AID support is gratefully acknowledged, the conclusions of this work do not necessarily reflect the views of AID.

developing countries. Thirdly, the results of these policies and programs are described. The final section summarizes some of the new views of rural financial markets which are aimed at overcoming the shortcomings of past efforts.

ASSUMPTIONS

Although the details of the objectives and operations of agricultural credit policies and programs vary from country to country, the broad outlines are fairly standard. This similarity is due to the common assumptions or "truths" held by planners and policy makers, many of which have been formulated without formal testing or empirical verification.

1. Farmer behavior. Traditional farmers are reluctant to adopt new inputs and technology so they must be bribed with cheap credit. Since they are likely to squander it, they must be given credit in kind and/or be closely supervised. Farmers face essentially the same seasonal pattern of cash flow so the timing of their household cash surpluses and deficits coincide. Furthermore, farmers in low income countries are too poor to save. For these two reasons, there is little scope for financial intermediation in rural areas. Cheap credit must be supplied from outside.

2. Lender behavior. In the absence of formal credit, farmers borrow from informal sources. These sources are dominated by rapacious moneylenders who systematically charge usurious interest rates, and use every opportunity to steal the unwitting farmers' land and possessions. Agricultural credit programs should seek to at least provide competition to the moneylenders, and better yet drive them completely out of business. Formal lenders are too risk averse to lend to agriculture, but they can be coerced by government regulations to forego their normal criteria for

resource allocation in order to service agriculture. Nationalized lenders are even more prone to forget profit and loss considerations to follow government objectives.

3. Financial markets. Credit is an essential input into the production process like seeds and fertilizer. If it is lacking, the entire package fails. It can be directed and controlled for specific purposes like other inputs. Therefore, credit planning can be an effective complement or even substitute for production planning. Opening and closing the credit spigot or redirecting the flow will cause production and income to rise and fall in response. Quotas, targets and other measures are efficient ways of allocating loans. Cheap credit can also meet other social objectives such as offsetting the disincentives of cheap food prices or improving the income distribution of the rural poor.

POLICIES AND PROGRAMS

Planners usually have two general objectives for agricultural credit: increase the total supply and reduce the cost. A further objective in many countries is to help the rural poor by reducing the cost of loans to small farmers below the rates charged other farmers. The following policies and programs characterize the efforts of many countries. It is also frequently the case that the credit system becomes increasingly complex because of "re-regulation": adding new rules and institutions over time to compensate for past failures to meet objectives.

1. Incentives and regulations. Special funds, complex rediscounting and reserve arrangements, loan guarantees and other incentives are used to encourage lenders to increase credit flows. Quotas, penalties, bank licensing rules, and political suasion are used for the same purpose.

2. Targeting. Loan targets and guidelines are developed to specify who should get credit, in what amount for which purpose.

3. Pricing. Interest rates on loans are set at low and inflexible levels. Rates paid on savings necessarily must be set even lower. With high and variable inflation rates, lending and savings rates are often negative in real terms.

4. Source of funds. Little attempt is made to encourage savings mobilization. Many agricultural lenders are even prevented from providing deposit and savings services. Most loan funds come from government, central banks or donors.

5. Institutions. New specialized institutions like agricultural banks, development banks and cooperatives are created when existing lenders fail to meet desired credit goals. Expensive supervised credit programs are introduced to monitor end use of borrowed funds.

RESULT

Some analysts argue that most agricultural credit programs are a failure. Others who are more hopeful admit major shortcomings. The following observations about key performance measures summarize the situation in many countries.

1. Supply of formal credit. The nominal value of agricultural credit frequently rises for a time following the introduction of a new policy or program. But the real value of credit has shown only modest increase and has declined in many cases during periods of high inflation. Some redefinition of loans occurs so the apparent increase in credit is

partly illusionary. Donor funds simply substitute for own funds in many countries. The ratio of agricultural credit to agricultural production and the ratio of agricultural to non-agricultural credit often do not substantially change.

2. Credit distribution. Most loans lend to be short-term and collateral continues to be a major loan requirement. The share of credit to small farmers rises very slowly, if at all. Small farmer credit targets are met by making multiple small loans to large farmers.

3. Informal credit. Informal credit continues to be important. Many farmers borrow both formal and informal credit, but repay the informal source first because that credit is more valuable. A borrower cannot afford to jeopardize the source of credit that is most reliable, lends quickly with low borrowing costs, and provides credit when urgently needed for consumption, weddings and emergencies.

4. Cost of credit. Low interest rates result in excess demand for credit. Since rates are controlled, other methods must be used by lenders to ration supplies. These methods raise total borrowing costs much higher than the nominal interest rates. There are few incentives for lenders to be innovative, to reduce costs and to improve service. Many innovations in fact are designed to evade rules and result in increased costs. Excess demand also breeds corruption as it provides great opportunities for low paid bank officials to "sell" loans.

5. Loan repayment. Repayment performance is poor in most programs. It is not uncommon for overdues to exceed 50 percent of loans outstanding. Since the emphasis is on "pushing out the money" (often as part of a political promise) and funds become quickly labelled as government money, it is

difficult to introduce effective sanctions for non-repayment. A borrower who "bought" his loan is less likely to feel compelled to repay it.

6. Additionality. It is difficult to clearly assess the real impact of loans made. The additionality expected in, say, use of new inputs or expanded production is frequently diluted because of fungibility. Loan funds may simply substitute for own funds or may be diverted to other uses. Resources are wasted by both lenders and borrowers as one tries to supervise loan use and the other works to cover up the true use.

7. Institutional viability. Most agricultural credit institutions are not financially viable. Margins do not cover high operating costs and low repayment means that fresh injections of funds from governments or donors are required. When priorities shift elsewhere and these funds dry up, the real value of new loans made spirals downward. When the institution is financially ruined, a new institution is frequently created to absorb and/or replace it, and the cycle starts over again with fresh funds. Savings mobilization is not an objective, so the institutions continue to be dependent on the government and subject to its whims and fads for its funds.

8. Rural financial markets. The growth of integrated and efficient rural financial markets is retarded. Safe and reliable deposit and savings services are not provided in many areas. Special programs and institutions, each with their own objectives, fragment rather than integrate the market. The precedent established by permitting non-repayment of loans sets back the development of self-sustaining institutions for years. The merry-go-round of funds continues: private institutions channel a river of funds from rural to urban areas while governments try to push a trickle back.

KEY ELEMENTS OF A NEW STRATEGY

The new views about rural financial markets challenge a number of the assumptions and policies that are part of past agricultural credit projects in developing countries. Experience gained from past projects suggest a number of key elements of a new general strategy for rural financial markets. The specific strategy for any particular country or project must, of course, be adjusted to the specifics of the local situation.

1. Interest rates. The foundation of any general strategy is flexible interest rates. Just as product prices must adjust to changing conditions of the market, so must the cost and return for money. An important factor affecting the adjustment of interest rates is inflation. Year-to-year variability in inflation rates requires that the nominal rates on loans and deposits be adjusted in a compensating fashion so that positive real interest rates are achieved. Savers cannot be expected to save over a long period of time if real savings rates are negative. Likewise, interest rates cannot effectively allocate loans if they are negative in real terms.

2. Savings mobilization. Flexible interest rates provide the basic condition for savings mobilization. More efforts should be placed on savings mobilization activities because all rural people need to save in some form but not everyone demands loans. The benefits of the many having a safe and convenient way to save may outweigh the benefits of a few getting subsidized loans. Few countries have aggressively engaged in innovative rural savings mobilization activities. Yet countries as diverse as Taiwan, Korea, Kenya, Mexico, Malaysia, Sudan, the Punjab of India, and Zambia have reported substantial voluntary savings capacity. Recent AID funded projects in Peru and Bangladesh reported positive results from aggressive savings mobilization

campaigns. Additional benefits from savings mobilization include the independence that institutions obtain by not having to continually rely on government or donor funds. If cooperatives were able to provide attractive savings facilities, it would give their members stronger reasons to be more active.

3. Innovations. Current policies try to force lenders to provide subsidized credit to farmers. Some of the subsidy can be better spent on financing the learning costs of lenders so they can experiment and more quickly find an appropriate method for use in lending to farmers on a sound commercial basis. The difficulty of lending to farmers in a risky developing country economic environment should not be under-estimated. Widespread experimentation is required to identify the method and system appropriate to each situation.

4. Non-farm Enterprises. Recent studies by the World Bank document the great importance of small-scale industries in rural areas. AID funded studies by Carl Liedholm and colleagues at Michigan State University in Bangladesh, Jamaica, Honduras, Egypt and Thailand reveal that these firms are seriously under-reported in government statistics. Studies have also shown the great importance of non-farm enterprises and off-farm work for rural households. Results of a recent AID project with Kasetsart University, Michigan State, and Ohio State in Thailand show that these two sources provide more than half the total household income for a large proportion of Thai rural households. Surprisingly, small-scale rural enterprises and non-farm enterprises of rural households are largely over looked in rural credit programs. The Rural Finance Experimental Project in Bangladesh revealed a heavy demand for credit for non-farm activities at nominal interest rates of 30 and 36 percent. Efforts are needed to

demonstrate the importance of these activities in rural areas and encourage lenders to try to serve the deposit and lending needs of these types of enterprises. In some countries, specialized agricultural lenders are prohibited from lending to them.

5. Institutions. The emphasis should be directed away from developing specialized institutions and directed toward assisting existing institutions to offer a wider range of financial services. Institutions need to be opened up to a wider range of credit - short-term, long-term, farm enterprise, non-farm enterprise, etc. This permits them to spread their risks, and also provide a broader range of integrated services to customers. Incentives need to be provided to encourage rural institutions to offer deposit and savings services in addition to making loans. Nationalizing banks does not seem to have been a very successful way to get them to adopt a more socially productive role than private banks, at least with respect to agricultural lending.

6. Credit as liquidity. Policy makers should stop viewing credit as an input like seed and fertilizer. Rather it needs to be viewed as it is - claim over resources that can be acquired with the liquidity provided by a loan. The great value of money is its fungibility. Restrictions on credit reduce its fungibility and therefore, reduce its value. Instead of trying to direct and control the use of funds for specific purposes incentives should be provided so borrowers use it in socially desirable ways. If farmers hesitate to buy fertilizer with credit, the underlying reason should be studied rather than try to force them to use credit for that purpose.

THE ROLE OF DONOR AGENCIES

Donors can play an important role in developing and refining these new views, and adapting them to local circumstances. Donors first must recognize their role in contributing to market fragmentation by financing projects with the objective of channeling subsidized credit to specific target groups for specific purposes. They must move away from narrow projects to a broader systems approach to financial markets. The leverage obtained through loans and grants must be directed toward systemwide reforms rather than providing maximum impact for a select few. The financial system needs to be opened up to provide a broader range of services, and in many cases this requires adjustment of basic policies and procedures. Special attention should be directed towards the needs of rural non-farm enterprises, difficult as this will be, and the efforts of the AID Missions in Indonesia, Thailand, the Philippines, and Bangladesh in this area are to be applauded. These efforts are important for two reasons. First, non-farm enterprises will likely be relatively more important for the rural landless, and for rainfed farmers who have less opportunity to intensify farming. Secondly, these experiments will help clarify how the needs of this difficult sector can be met.

Donors can also help develop more reasonable expectations about rural finance. They can help develop clearer understanding of the great difficulty in providing self-sustaining deposit and lending services to poor people in uncertain environments; in the limitations of providing subsidized credit to the few while discriminating against the many through price, foreign exchange, trade and other controls; and by recognizing the impossibility of improving rural income distributions through cheap credit.

A couple of decades ago, financial markets were given increased emphasis because of the new idea then of supply-led development. This idea was strengthened by agricultural planners who simplistically linked credit with production. Our views are now maturing as we increasingly recognize the complexity of developing financial markets. Credit to agriculture does not provide a shortcut to avoid the difficult, fundamental problems faced by the sector. Agricultural input supplies, research to develop new technology, reforms and improvements in product markets, improved infrastructure - these remain as the top priority issues. In many cases, it will be necessary to remove the obstacles that rural financial markets present in making greater progress on these issues.