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*Rural Development*

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# Rural Finance

*Issues, Design, and Best Practices*

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## PART ONE

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# An Overview of the Traditional Approach

**T**he formulation of policies for improved rural financial intermediation calls for a thorough analysis of the problems underlying rural financial markets and a clear understanding of the dynamics of financial markets in general and rural financial markets in particular. In addition, past performance should be analyzed to identify the underlying

policies and methodologies that contributed to achievements and failures.

Chapter 1 develops the problem statement, which can be used as a checklist in the design of future projects. Chapter 2 provides an overview of the policies and outcomes of the traditional approach, which largely dominated thinking on rural finance until the late 1980s.

# The Challenge of Rural Financial Intermediation

The challenges of rural financial markets are broadly related to (a) obstacles to and shortcomings of financial markets in general, (b) urban-biased policies, (c) systemic weaknesses of rural financial markets, and (d) poorly designed interventions.

### Obstacles to Financial Intermediation

Various obstacles prevent financial markets in general, and rural markets in particular, from operating efficiently.<sup>1</sup> These obstacles all have a direct impact on the effectiveness of rural financial markets. Most of the obstacles are related to the promissory feature of financial contracts. For example, a bank will lend to a client in exchange for a *promise* of repayment with interest over a given period.<sup>2</sup> Because of the promissory feature and the time dimension of financial contracts, financial intermediaries and their clients require good information to determine the riskiness of transactions, need a reasonably stable political and economic environment to extend contract maturities over time, must be free to price perceived risks appropriately, and must be able to exercise remedies when contractual terms are not honored.

These conditions are rarely met. The main problems are:

- *The macroeconomic environment.* Unsound macroeconomic policies adversely affect

the performance of financial markets, and negative external shocks could aggravate the resulting situation.

- *The sectoral policy context.* Government price controls, trade policy, and public investment priorities frequently distort the allocation of resources by financial intermediaries.
- *Financial market constraints.* Financial market rigidities, imperfect information, and in some instances social barriers to financial transactions preclude an optimal allocation of resources.
- *Legal and regulatory constraints.* Problems with enforcing claims increase uncertainty and reduce the expected returns to creditors from financial transactions, thereby increasing transaction costs and reducing the supply of credit and deposits.

These constraints are generally more binding on financial transactions in the rural sector because of the effects of widespread, distorted sectoral policies and the unique characteristics of rural markets.

### Urban-Biased Policies

Widespread urban bias exists in sectoral policies and in the orientation of the legal and regulatory framework. (This bias is outlined in chapter 4, box 4.1: "Eight Pillars of Urban-Biased Policies.") Examples of these policies

include restrictive price controls on agricultural produce; excessive agricultural export taxes; overprotection of domestic industry; low investment in rural infrastructure and human resources; and collateral laws that are better defined for urban assets, such as consumer durables, than for farm implements. In many countries with a comparative advantage in agriculture macroeconomic policies that result in overvalued exchange rates are also urban-biased because the policies encourage excessive food imports and thus depress agricultural producer prices and rural incomes.

### **Systemic Weaknesses of Rural Financial Markets**

Rural populations are generally poorer than their urban counterparts. They generally work in agriculture or agriculture-related activities, and they live in areas in which overall population density is low. These factors, combined with poor infrastructure and lack of integration with urban markets, cause rural inhabitants in many countries to live in relative isolation. These characteristics are related to the following problems in rural financial intermediation:

- Low population density, small average loans, and low household savings increase transaction costs.
- Rural clientele often lack the traditional forms of collateral required by commercial banks.
- Poor communication and lack of integration with other markets result in highly fragmented markets, which create information barriers and limit risk diversification.
- Seasonality of the rural agricultural business cycle and the high probability of covariant production price and income shocks add to the risks of rural financial intermediation.

Because of inadequate collateral (and the perception that rural financial markets have a high

risk and low profitability), commercial banks have largely avoided servicing rural areas. Often, the only financial services available are those provided by the informal sector, which offers a limited range of services along with limited availability of funds. Cases in which households have paid to have their savings placed in safe keeping are well documented.

### **Poorly Designed Interventions**

Governments responded to the perceived shortage of financial services in the rural sector by creating a range of different institutions, such as specialized agricultural credit institutions, intended to channel government and donor funds to rural clients, especially farmers. Though well intended, some of these initiatives were misdirected and did not address the real problems. Indeed, some exacerbated the problems. A few examples:

- Subsidized below-market ceiling rates of interest often led to the crowding out of poor farmers because the subsidies were captured by wealthier, better-connected farmers, increasing the income disparity between rich commercial farmers and poor subsistence farmers and reducing the poor's access to credit. In many instances subsidized credit also became highly politicized, and it was consequently difficult to eliminate.<sup>3</sup>
- Inefficient business practices often resulted in substantial losses and further reduction in access to financial services by the poor. Rural financial institutions were often treated as disbursement windows rather than as financial institutions, and recipients sometimes viewed "soft" loans as grants that did not have to be repaid.
- The focus on lending exclusively for agriculture increased the risk carried by RFIs and reinforced the perception that lending to rural areas is a special activity, not to be integrated with the broader financial market.

## **Conclusion**

These problems have resulted in rural communities, particularly their poor members, being underserved by the formal financial sector. *Consequently, rural households often have less access to adequate credit, savings, and insurance services than urban ones.* The underlying causes of the problems are interrelated and call for an

integrated solution, taking into consideration macroeconomic, microeconomic, sectoral, and institutional issues.

Chapter 2 discusses in more detail the successes and shortcomings of the traditional approach to rural finance. Part 2, chapters 3 through 6, proposes a framework for developing an integrated approach to improved rural financial intermediation.

# The Traditional Approach to Rural Finance

Throughout the world, financial markets are subject to government intervention. During the 1980s government loans and guarantees accounted for about 25 percent of all lending in the United States (Schwarz 1992). The largest Indian commercial banks are government owned, and smaller private commercial banks in India have had up to 60 percent of their resources preempted by the government or locked into directed lending. Until 1988 the Soviet Union's entire banking system consisted of just two state-owned banks: a savings bank (Sberbank) and a lending monobank (Gosbank). The degree of intervention has varied by country, but in no case has any government refrained from intervening in the rural financial sector.

Governments have intervened in financial markets to protect depositors, ensure the solvency of financial intermediaries, promote competition, ensure macroeconomic stability and growth, and pursue social and political aims. To achieve these ends, governments have used various instruments to regulate, direct, increase, complement, and supplant the provision of financial services by privately owned financial intermediaries.<sup>4</sup> These interventions have sometimes been indirect, aimed at improving the policy environment (by promoting macroeconomic and financial sector stability, for example), in other cases they have been direct and have included actions such as establishing state-owned financial intermediaries and subsidizing interest rates.

Government-intervention instruments include financial accounting standards, prudential regulations, deposit insurance, loan guarantees, interest floors or ceilings on loans and deposits, interest subsidies, fiscally motivated preemption of funding (for example, through unremunerative reserve asset requirements or liquidity ratios), and supervisory mechanisms (contracted or implemented directly by governments). Governments have also intervened in financial markets by acting as lenders of last resort to maintain the liquidity of the system; prohibiting loans to particular groups (for example, shareholders or insiders); restricting entry and exit of banks from particular sectors; directing concessional loans to given sectors; directing loans to particular clients; establishing new government banks; and nationalizing, expropriating, or prohibiting privately owned banks.<sup>5</sup>

It is widely accepted that without indirect interventions there would be widespread failures in financial markets. However, the case for direct interventions is more controversial and is at the core of the difference between the traditional approach that dominated economic thought on rural finance until the 1980s and the new perspectives on rural finance that have emerged since 1980 (see chapter 3).

### **The Traditional Perspective on Rural Finance**

The traditional perspective on rural finance envisages a government active in rural financial

markets and leans heavily toward direct interventions. It dates from the 1950s, when Keynesian economic thinking was inspiring successful interventions at the macroeconomic level. Over the next thirty years policymakers identified a host of problems in rural financial markets, which they tried to resolve by targeting, providing subsidies, and applying government controls. They hoped that these measures would stimulate growth and reduce rural poverty. The (perceived) problems included:

#### *Lack of Credit in Rural Areas*

Private banks avoided lending in rural areas because they viewed the sector as risky and unprofitable. They particularly avoided long-term loans with grace periods, which are important for certain agricultural investments (see box 2.1). As a result, governments estab-

lished RFIs, notably specialized agricultural credit institutions, to provide credit to farmers. Some countries (India in 1969 and 1980, and Mexico in 1982) nationalized commercial banks to increase lending to agriculture. Other countries (Morocco and Thailand) mandated that commercial banks allocate a specified portion of their portfolio to agriculture or to government-owned specialized agricultural credit institutions for on-lending to agriculture.

#### *Lack of Modern Technology in Agriculture*

Rapid growth in agricultural productivity was essential to keep pace with rapid population growth. Policymakers believed that the best way to increase agricultural productivity was to encourage the use of modern pesticides, fertilizers, and farm equipment.<sup>6</sup> Because farmers were viewed as risk-averse and cash-

#### **Box 2.1 Merits of long-term finance**

Does lack of long-term finance prevent firms in developing countries from investing in potentially profitable growth opportunities? The answer appears to be yes. An empirical study investigated the question of using firm-level data on thirty industrial and developing countries for the 1980–91 period. The evidence shows that use of long-term credit by firms is important in facilitating their growth. Interestingly, the study finds no evidence that government subsidies to firms are associated with the ability of firms to grow faster. To the contrary, the evidence indicates that although the ability of firms to enter into long-term debt contracts is associated with greater numbers of firms growing at higher than predicted rates, the result is reversed when governments subsidize credit.

A firm's external financing needs depend on the magnitude of its internal cash flows relative to its investment opportunities. Both the firm's cash flows and its optimal investment level are endogenous. The ratio of cash flows to optimal investment may differ systematically across countries, even for similar firms employing the same technology. Thus, for example, a firm with capital-intensive technology may need to finance large investment expenditures in order to grow. If the firm has sufficient market power or faces high demand, it may be able to generate sufficient cash flow internally to finance investment,

whereas a similar firm in a more competitive economy may require external financing to grow at the same rate.

To control for this endogeneity, the authors of the study estimated for each firm in their sample a predicted growth rate that could be attained by relying on self-financing and short-term credit only. They show that the proportion of firms that grew at rates exceeding this predicted rate is related to the development of financial markets—both long-term debt and equity—and legal institutions in the economy. Thus the underdevelopment of financial markets and institutions prevents firms in developing countries from investing in potentially profitable growth opportunities. However, government subsidies to industry do not increase the proportion of firms growing at higher than predicted rates, and the positive effect of long-term debt is reversed to the extent that the debt is subsidized. Thus, although the study found evidence to support the premise that "availability of term finance affects firm growth" (an argument used to justify many directed-credit programs), it also found that government intervention in providing such finance has generally not been successful, possibly due to weaknesses in design and underlying institutional infrastructure.

Source: Demirgüç-Kunt and Maksimovic 1996.

constrained, interest rate subsidies were used to accelerate adoption of these technologies.

### *Pursuit of Industrial Growth at the Expense of Agriculture*

Influenced by dualist theories of economic development and by the example of the wealthy industrial economies, policymakers in developing countries looked to industry rather than to agriculture as the vehicle for rapid growth.<sup>7</sup> Agriculture was often heavily taxed through price and budgetary mechanisms to subsidize industrial expansion. However, for equity reasons (and to ensure adequate food supplies for urban consumers) policymakers sought to compensate farmers for this heavy taxation by providing credit subsidies.

### *Prevalence of Usurious Moneylenders*

Interest rates in the informal sector were considered to be unconscionably high (often more than 100 percent a year). It was argued that poor agricultural borrowers could not afford these rates of interest and should not have to pay them. Subsidized, government-directed lines of credit were introduced to drive usurious moneylenders out of business and reach farmers with loans at "reasonable" rates of interest.

### *Low Savings Capacity in Rural Areas*

Rural communities were traditionally viewed as too poor and subject to too many shocks of nature to be able to save. Policymakers relied on budgetary funds and on external donors to provide loanable funds for government rural credit programs.

### *Political Pressure*

Although immediate political pressure on governments tended to come primarily from urban populations, governments had to do something, or at least be seen to attempt to do something, to address the concerns of rural

populations. Interest subsidies and debt forgiveness offered visible means of meeting this objective and placating rural voters. The benefits of the subsidies and loan write offs accrued primarily to wealthy and influential rural borrowers, but this was an acceptable outcome to many governments (Ladman and Tinnermeier 1984).

### **Assessing the Traditional Approach**

Experience has varied across countries, but the results of the traditional approach have generally been poor or modest at best. This conclusion is based on an assessment of the traditional approach against three criteria: (a) the success of traditional strategies, such as targeting and subsidization, in addressing the perceived problems; (b) the cost-efficiency of traditional methodologies; and (c) the success of the traditional strategies and objectives in achieving the broader goals of income expansion and poverty reduction.

### *Success of Traditional Strategies in Addressing the Perceived Problems*

It is difficult to assess the effects of targeted credit because of several methodological problems (see box 2.2). First, it is not clear how much liquidity a borrower might have had in the absence of a particular "directed" loan. That is, in the absence of the loan the borrower might have obtained the funds from other sources. This lack of clarity is a problem in assessing "additionality." Other methodological problems are examined in chapter 7.

*Impact on access to credit.* The additionality of directed credit programs for agriculture cannot be quantified, but in the short run the programs often result in increased investment and seasonal credit that benefit agriculture. However, the subsidies are often captured by the rich (see box 2.3). In addition, because of government budget constraints the potential number of borrowers decreases as the subsidy per borrower increases, limiting the potential impact on access to credit.

**Box 2.2 Assessing the performance of agricultural credit projects**

States, donors, and managers of rural financial institutions have used different methods to assess the performance of agricultural credit projects. The World Bank's Operations Evaluation Department (OED) provided several guidelines on such matters:

When there are strong and well-substantiated doubts about the commitments or capability of the financial intermediary or government to implement a project, the World Bank should defer lending until doubts are dispelled. Going ahead with a project prematurely can lead to far greater problems than those caused by delaying it. (World Bank/OED 1989)

The OED has highlighted the need for a thorough assessment of institutional strengthening at the completion of projects, particularly of the financial impact of Bank operations on intermediary institutions and on farming. In a 1990 report the OED asserted that "as a working proposition, the OED approach is to require favorable outcomes on both of these counts in order for a credit project to be evaluated as satisfactory" (World Bank/OED 1990).

Attributing "production gains" to access to formal credit might be misleading unless inherent measurement difficulties are overcome. Frequently, production gains are attributed to formal credit in an exaggerated and unjustifiable manner. The financial performance of the participating intermediaries, however, has often been unambiguous:

Traditional credit projects sought to provide credit to farmers in need of support. Criticisms that these projects failed to address systemic problems are substantiated, as are assertions about the poor performance and lack of financial viability of many credit institutions represented in the portfolio. Failure to raise collection rates was nearly universal. Some institutions, dependent on portfolio and government transfers that are no longer reliable, are at risk. Criticism of the banking side of traditional agricultural credit operations is mostly valid. (World Bank/OED 1996)

Source: Authors' findings.

*Impact on agricultural production.* The effect of traditional strategies on agricultural production has been hotly debated. The "Ohio School" (Adams, Graham, and Von Pischke 1984) believes that the methodological problems of evaluating the impact of credit render such an assessment futile because of the fungibility of money (see chapter 7). However, the World Bank's Operations Evaluation Department (OED) argues in a study on rural finance that the fungibility of farm

finance does not invalidate attempts to relate credit to incremental physical output and that difficulties in measuring the impact of credit do not mean that credit has no impact (World Bank/OED 1993). The study notes that directed credit programs were associated with the adoption of modern technologies, such as greenhouses in Morocco and tube wells in northwest Bangladesh, and that these innovations were associated with production gains.

**Box 2.3 Credit and income redistribution in Costa Rica**

Subsidized agricultural credit has been extended in Costa Rica by four commercial banks, all government owned and all well positioned to reach the small farmer. By the mid-1970s the three smaller banks had more than 30 regional offices, and the largest bank (Banco Nacional) had more than 100. Two-thirds of these branches were rural offices that specialized in credit for small farmers.

Data for Banco Nacional, which accounted for 60 percent of agricultural credit disbursed in Costa Rica in 1974, showed that only 10 percent of the bank's agricultural loans that year accounted for 80 percent of the total agricultural credit extended by the bank.

The distribution of the agricultural credit (and hence subsidies) disbursed by Banco Nacional was actually more skewed than the distribution of income and land. Low-interest rates on the loans implied subsidies equivalent to 4 percent of gross domestic product and almost 20 percent of value added in agriculture. This suggests an average credit subsidy of \$10,000 on each of the big loans that accounted for 80 percent of Banco Nacional's credit. In 1974 a family with an income of \$10,500 was in the top 10 percent of income distribution.

Source: Adapted from World Bank 1989.

In India state-owned RFIs were associated with significantly deeper rural financial markets and with measurable production gains. These gains were, however, achieved at tremendous cost in efficiency (see box 2.4). The cost of forgone intermediation by private rural financial intermediaries that result from distortions in the state-owned rural finance system cannot readily be estimated, even in the most solid empirical work.

*Impact of misdirected credit.* There is evidence that governments have often directed credit to the wrong products. In some formerly planned economies credit was distributed as a matter of policy to the weakest performers to sustain their operations. In other cases distorted policy environments made some crops profitable for farmers, even when countries lacked a comparative advantage in those products. Under these circumstances increasing the supply of credit is harmful to the economy, and production gains may be a misleading measure of de-

velopment impact. Box 2.5 presents an extreme example of how production gain could result in net economic loss.

*Impact on production technologies.* Traditional credit was often provided as part of a package of services, including agricultural extension, inputs (fertilizers, pesticides, and high-yielding plant varieties), and farm equipment (irrigation pumps, tractors, and combines). Formal credit often accelerated the adoption of modern technologies when large investments were involved. However, adopting modern technologies, such as improved seeds, fertilizers, and pesticides, requires capital in amounts that are often available and affordable to farmers even without access to concessional, directed credit schemes.

These interventions might have achieved considerably more had attention been paid to designing mechanisms to encourage sound investments. The below-market interest rates and leniency on loan collections that still char-

#### Box 2.4 Impact of formal finance on the rural economy of India

A recent study of rural finance in India analyzes data for the agricultural years 1972-73 to 1980-81 for eighty-five rural districts (Binswanger and Khandker 1995). The study found that the Indian government pursued a policy of rapid, forced expansion of commercial banks into rural areas. This expansion resulted in a rapid increase of nonagricultural rural employment and a modest increase in the rural wage rate. By inference the study concludes that the policy must have significantly increased the growth of the nonagricultural rural sector. These findings suggest that the expansion of commercial banks into rural areas eliminated severe constraints in rural financial markets and led to significant rural financial deepening.

The Indian government also pursued a policy of directing commercial banks and the cooperative credit institutions to lend specifically for agriculture. The study found that the expansion of rural and agricultural credit volumes had a small positive impact on aggregate crop output. This small increase is accounted for by a large increase in fertilizer use and by increased investments in animals and irrigation pumpsets. At the same time agricultural employment

declined. This implies that the policy of forced lending to agriculture had more impact on the substitution of capital for labor than on agricultural output, a clearly counterproductive outcome when the abundance of labor in India is considered.

The modest increase in agricultural output is compared in the study with the costs to the government of the directed and modestly subsidized credit to agriculture. The government costs include rough estimates of the transaction costs, interest subsidy, and loan losses in the system. Assuming a default rate of 10 percent, the findings suggest that the value of the extra agricultural output triggered by the targeted credit almost covered the government's cost of providing it. Of course, farmers have additional costs in making their investments that are not included in the government's costs.

These findings indicate that deepening the system of rural financial intermediation in India had high payoffs in rural growth, employment, and welfare, but that specifically targeting credit to agriculture was of doubtful benefit.

Source: Binswanger and Khandker 1995.

**Box 2.5 Impact of wheat subsidies in Saudi Arabia**

Until the early 1980s Saudi Arabia imported most of the wheat that it consumed. In 1981 it produced 187,000 tons. The Saudi government then began to encourage wheat production by guaranteeing farmers artificially high prices, free land, and low-interest loans for machinery, fertilizer, and seed. Less than a decade later, production had increased fifteen fold to 3 million metric tons per year, two-thirds of which was exported. Domestically produced wheat cost about US\$1,000 per ton when wheat could be imported for about US\$80 per ton. Agriculture consumed more than 80 percent of the kingdom's water, mostly from aquifers that are not naturally replenished and may soon be exhausted (in twenty years or sooner, according to some experts).

Source: Excerpted from Yarbrough and Yarbrough 1991.

acterize most traditional credit programs increase incentives for substitution of formal loans for other resources, or even outright diversion of credit to nontargeted, nonproductive uses. Some critics of the traditional approach note that subsidized agricultural credit has often resulted in the adoption of excessively capital-intensive technologies. The classic example is concessional lending for farm mechanization in Pakistan, where tractors displaced agricultural laborers and deepened poverty in rural areas (Khan 1977). It is now widely accepted that if the goal is to reduce poverty, and the principal asset of the poor is labor, then a subsidy on capital through below-market interest rates is counterproductive.

*Impact of urban-biased industrial growth practices.* Credit subsidies clearly provided some compensation to rural producers who were powerful or lucky enough to gain access to them. However, total compensation from input subsidies amounted to only a fraction of the value of losses in agriculture that occurred because of policy distortions (Schiff and Valdés 1992). Compensation in the form of subsidies through the credit system reached only a small proportion (usually much less than 30 percent)

of all the rural producers affected by discriminatory urban-biased policies. In Mexico, notwithstanding a network of more than 500 agricultural bank branches and billions of U.S. dollars in directed credit programs through both a state agricultural development bank and nationalized commercial banks, a recent Bank study found that formal credit reached only 8 percent of rural enterprises, and direct government loans reached less than 1 percent of rural enterprises (Chaves and Sanchez 1995).

*Impact on activities of usurious moneylenders.* In many countries directed credit programs have largely failed to displace moneylenders. The share of informal finance remains large or even dominant, and interest rates remain high despite below-market rates on formal loans (Ramola and Majahan 1996).<sup>8</sup> In India, however, evidence from credit surveys suggests that the share of formal finance grew from about 33 percent in the 1950s to 55 percent in the 1980s as a result of state efforts to curtail the operation of moneylenders. Nonetheless, despite the decline in the share of informal rural lending, the absolute volume of such lending rose over the same period. The prevailing high interest rates charged by moneylenders, despite the expansion of formal (often concessional) credit, can be explained at least partly by the adverse selection of clients: the more creditworthy clients opted to borrow from the formal sector.

*Impact of political objectives.* Stiff political resistance in many countries (Bangladesh, Tunisia, the United States) to the removal of agricultural credit subsidies suggests that credit subsidies have achieved their explicit and implicit political objectives. However, the subsidies are part of an overall urban-biased strategy that has, even if unintentionally, depressed rural incomes and accelerated rural-urban migration.

*Cost-Efficiency of Traditional Methodologies*

The financial performance of virtually all government-owned RFIs has usually been ex-

tremely poor. Most RFIs have remained highly subsidy-dependent. In India arrears as a proportion of amounts due and overdue hover at around 50 percent in most states. The recovery rate of Mexico's BANRURAL was around 25 percent in the late 1980s (ignoring recoveries from the loss-making national agricultural insurance company). Recoveries for the Smallholder Agricultural Credit Agency in Malawi plummeted from almost 90 percent to less than 20 percent during the most recent elections; the agency was subsequently declared insolvent. Inflation eroded the real value of the equity of government-owned RFIs throughout Latin America during the 1980s because of poor loan collection and agricultural on-lending rates that failed to keep pace with inflation.

The economic cost of this dismal performance has been enormous and has often put macroeconomic stability at risk. For example, agricultural credit subsidies totaled 2.2 percent of Brazil's GDP in 1980, and 1.7 percent of Mexico's GDP in 1986 (see box 2.6). In several cases, the subsidies could not even be measured because of poor accounting practices. Many governments do not know the full fiscal and quasi-fiscal cost of maintaining directed, cheap rural credit programs, let alone the associated opportunity costs.<sup>9</sup>

The reason for the poor performance is evident: the interventions invariably have been, and generally still are, characterized by a lack of managerial autonomy for the RFIs and by poor operating procedures.

*Lack of managerial autonomy.* Lack of managerial autonomy enables politicians to respond to populist political objectives rather than sound management principles. For example, favored clients obtain special treatment, and promises of debt forgiveness are made during elections. Such practices have led to the collapse of RFIs during election years in Jamaica (1980), Malawi (1994), and elsewhere.

*Poor operating procedures.* The consequences of poor operating procedures, such as lack of incentives for the clients and staff of RFIs, below-market interest rates, and poor information systems, include:

- Insufficient interest rate spreads to cover RFIs' overall costs, including provisions for doubtful loans.
- Negative real on-lending rates (or below-market rates) that oblige RFIs to pay below-market returns on savings, resulting in the decapitalization of RFIs. Subsidies inherent in below-market rates encourage rent seeking by borrowers and RFI staff.
- Obligatory lower on-lending rates for poorer clients—who actually demand access to credit, not subsidized loans—that have reduced lending to the poor and made it less rewarding for lenders.
- Support for state-owned cooperatives with compulsory membership, that ignores the merits of voluntary association based on self-selection principles and discourages financial discipline.

#### Box 2.6 Fiscal burden of rural finance in Mexico

The Mexican government transferred almost US\$23 billion (measured in constant 1992 U.S. dollars) to its agricultural finance institutions over the period 1983–92 (World Bank 1994c). Most of these transfers consisted of budgetary support from the Ministry of Finance and below-market rate rediscounts from the Central Bank to the government's two agricultural development banks (FIRA and BANRURAL). About US\$3.8 billion (17 percent) went to the loss-making agricultural insurance companies owned by the government (ANAGSA and AGROASEMEX).

During the late 1980s the transfers became unsustainable. Macroeconomic stabilization and adjust-

ment policies led to an almost 30 percent real decline in the federal budget between 1986 and 1992. In the process federal funds were reallocated away from RFIs, causing fiscal and quasi-fiscal transfers for rural finance to fall from the equivalent of 4 percent of the budget to less than 1 percent. Relative to agricultural and total GDP, these transfers declined from a peak of 18 percent of agricultural GDP (1.7 percent of total GDP) in 1986 to 2.7 percent of agricultural GDP (0.2 percent of total GDP) by 1992.

Source: World Bank 1994c.

- Tolerance for financial indiscipline in managing RFIs and for high loan losses over many years.

To sum up, the poor design of traditional interventions has seriously compromised the efficiency of the interventions themselves and hindered the promotion of rural financial markets.

### *Success of the Traditional Approach in Expanding Income and Reducing Poverty*

Critics of the traditional approach have often suggested that policymakers focused on production objectives rather than on financial sector objectives and that this imbalance should be redressed (Adams, Graham, and Von Pischke 1984; González-Vega 1984; World Bank 1993). This dichotomy between financial and real sector objectives is more apparent than actual since improving the financial sector ensures that resources are allocated optimally to achieve the greatest possible gains in real income and poverty reduction.

The true dichotomy is between a narrower, short-term approach that focuses on immediate *agricultural production* gains and a broader, long-term approach that focuses on large and sustained expansion in *rural incomes*.<sup>10</sup> Directed credit may achieve the former, but efficient rural financial markets are essential for the latter. A key criticism of the traditional approach is that by neglecting financial sector imperatives, it placed insufficient emphasis on longer-term rural development objectives.

Traditional focus on *disbursing agricultural credit* had three misplaced emphases:

1. *Disbursement*. In focusing on disbursement, the traditional approach has emphasized quantity of lending over quality. However, treating banking institutions more as disbursement windows rather than demand-driven, full-service institutions has resulted in loan portfolios plagued by defaults and high arrears. This approach has reduced financial deepening and constrained long-term economic growth (Levine 1994).<sup>11</sup> Only by emphasizing the quality of lending can

#### **Box 2.7 Focus of the intervention: rural versus agricultural development**

Best practice in rural financial markets indicates that efforts should be aimed at increasing access to financial services in rural areas at large. This objective diverges from widely observed policies directed at providing credit to agriculture itself. These policies may have promoted an unbalanced overall development. The idea behind rural—as opposed to agricultural—development is that development should occur on a regional or location basis and not on a sector or activity basis. There is nothing magical about agriculture itself. The assumption seems to have been that the majority of people who live in rural areas work in agriculture and that this activity thus generates most of rural income. Even if these assumptions were true, the implied strategies may be counterproductive because they could cause an unbalanced development of the rural sector while promoting underdiversification of rural households' sources of income.

In any event, because of recent interest in understanding the entire rural economy, evidence has been found that agriculture may not be as important in rural areas as traditionally thought. For example, a

recent World Bank study in Mexico showed that in the rural area surveyed only 37 percent of self-employed people were devoted exclusively to agriculture and directly related activities (Chaves and Sanchez 1995). The majority of rural entrepreneurs (55.6 percent) were dedicated to other nonagricultural activities, and the remaining 7.5 percent of the self-employed combined agriculture activities with other nonagricultural businesses. The survey also found that agriculture was not the main source of rural cash income, generating only 32 percent of the aggregate nonwage income of rural entrepreneurs.

Targeting credit to agriculture may not even be possible because of the fungibility of credit. Attempts to prevent borrowers from diverting credit resources to other activities will most likely be futile and will impose unnecessary costs on borrowers (avoidance costs, for example) and to lenders (supervision costs). In brief, the policy is unsound and may not be implemented at a reasonable cost.

Source: Chaves and Sanchez 1995.

the quantity of lending be expanded in a rapid, efficient, and sustainable manner.

2. *Agriculture*. In focusing on agriculture, the traditional approach has neglected significant opportunities for growth and risk diversification (both for RFIs and for rural clients) in *nonfarm rural enterprises* (see box 2.7 and chapter 4).
3. *Credit*. In focusing on credit, the traditional approach has ignored *savings mobilization*, the "forgotten half of rural finance" (Vogel 1984). All three successful RFIs analyzed in chapter 9 mobilized large amounts of savings, and there is little doubt now that the rural poor can save. RFIs that have a high share of savings relative to government borrowings in their total liabilities are likely to be more careful and efficient in their

allocation of loans (Cuevas and Graham 1984).

### Conclusion

Even though the traditional approach was not entirely without benefits, particularly at the farm level, it had serious shortcomings. Essentially, the goals of rural income expansion and poverty reduction were not met, and in some cases interventions may have exacerbated the problems of rural areas and worsened the plight of rural communities.

New perspectives on rural finance have emerged from recent developments in economic theory and from the analysis of current best practices in rural financial intermediation. These new perspectives are examined in part two.